Strategy for Executives

2019 Edition

Sun Wu

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Introduction

How to get the CEO job

Towards the end of 1980, William P. Stiritz, then Vice President of grocery products and restaurant operations at Ralston Purina, the global conglomerate leader in a number of consumer product categories (including dog food and dry cell batteries), sent an unsolicited memo to the company's board pitching himself for the CEO job.

In the memo, Bill, who had been with the company since 1964 when he joined as a product manager in the grocery products division, outlined in clear detail his strategy for the company, should he become the next CEO.

Stiritz's letter raised some eyebrows at the board. The company had been interviewing candidates both internal and external for months after Hal Dean, its longtime CEO, announced his retirement a few months earlier.

The board had already short-listed a number of solid candidates for the job including notorious names like Thomas Wyman, then president of CBS, who had previously held top positions at Nestlé, Polaroid and Green Giant. Bill's name, however, was not on that shortlist.

Like many other internal executives, Bill had been interviewed for the job but was disregarded by the board as they didn't believe he had the background or the necessary experience they were looking for. But with this memo Bill cut through and put his name at the very top of the list.

As an insider, Bill combined his knowledge of the company with his insights about the industry to propose a series of changes and strategic moves. He proposed to reorganize the company around its portfolio of consumer brands, which he believed offered an attractive combination of high margins and returns and were less asset intensive.

Under Dean, the company had embarked on an ambitious diversification rally that resulted in a large portfolio of unrelated businesses including a ski resort, a number of mushroom farms, a company that raised rats for laboratory experiments and the St. Louis Blues National Hockey League franchise along with its arena.

Bill saw Dean's departure as an opportunity to bring order to the company, and in his memo he clearly made his case: his focus would be on profitability and returns, and to do that, the company would need focus, which meant it had to get rid of poorly performing businesses, many of which were unrelated to the company's core strengths.

The memo worked and Bill got the CEO job just a few weeks later, becoming Dean's successor and one of the most successful CEOs of all time.

In the memo, Bill combined good articulation of strategy concepts with his knowledge of the company and came up with a winning plan for Ralston.

This is, in my opinion, what you need to succeed in your career as a business executive: a clear understanding of the basic strategy principles, which you combine with your insights about the industry to produce winning formulas.

At every meeting you participate in, every presentation you give and each work discussion you engage in, you are given an opportunity to think strategically and propose viable alternatives to achieve your organization's goals.

And in some cases, like Bill Stiritz, you may be pitching yourself for the top job.

That all sounds great and inspiring in theory, but in real life luck only favors the prepared.

Imagine that tomorrow morning your board asked you to propose ideas to improve your company's bottom line. What would you do? What would you answer?

Let's say they are not happy with recent performance or the direction the company is taking.

To kick it up a notch: what if you were given an opportunity to propose a comprehensive strategy for your company and position yourself as a viable candidate for the CEO job?

What would your *strategy* look like?

Before you think too hard, let me give you a few ideas.

To start, if we agree that the goal of strategy is to maximize value for shareholders, then your job as a CEO can be broken down into two basic things you must do to be successful: protect operating businesses and maximize earnings over the foreseeable future.

If a CEO does nothing else but protect a company's earnings from erosion and grow those earnings at the same level or even higher than other high-performing companies (not only industry competitors), most people (especially shareholders) would agree that the CEO has done a great job.

It is for that reason that before thinking about new products, growth, innovation or the latest management trend, the first order of business for any CEO is a plan to protect the cash generated by the company's operating businesses, and to do that, they must ensure that each occupies a market position that is both profitable *AND* defendable.

A profitable market position will not be sustainable unless it is to some extent difficult to imitate or "defendable", while a defendable position that is not profitable is just a distraction.

As we will see later in the book, the only way a business can find such a market position is by doing things differently from its competitors. In plain English, that means that your company's products and services must either serve different needs than competing alternatives or serve the same needs in different ways.

When well executed, this *positioning* strategy is manifested through differentiated products and services, lower prices than competing alternatives, or a combination of both.

Unless you offer products that are both unique *AND* valuable to target customers, or that are to some extent difficult to copy, your profitability will be vulnerable to the attack of companies with similar capabilities and well-funded copycats.

That also implies that if at any given time you find yourself with businesses that are not profitable, or that are easy to copy, they are good candidates to be sold or closed, like Bill Stiritz did with all the unrelated businesses at Ralston Purina once he took over.

With your core businesses under control, the next step is exploring ways to maximize *growth*, and to do that, I have identified seven different ways that work in any business:

1. **Market Penetration:** Selling more of your existing products to your existing consumers or targeting new consumer "segments" within the same markets.

2. **Market Development:** Selling your existing products to new markets, or to new markets internationally.

3. **Product Improvement:** Improving your products and services that serve existing customers (to reduce your churn rate, more on that later).

4. **Product Development:** Creating new products and services to target existing customers or to enter new markets (which would qualify as some type of *diversification* move).

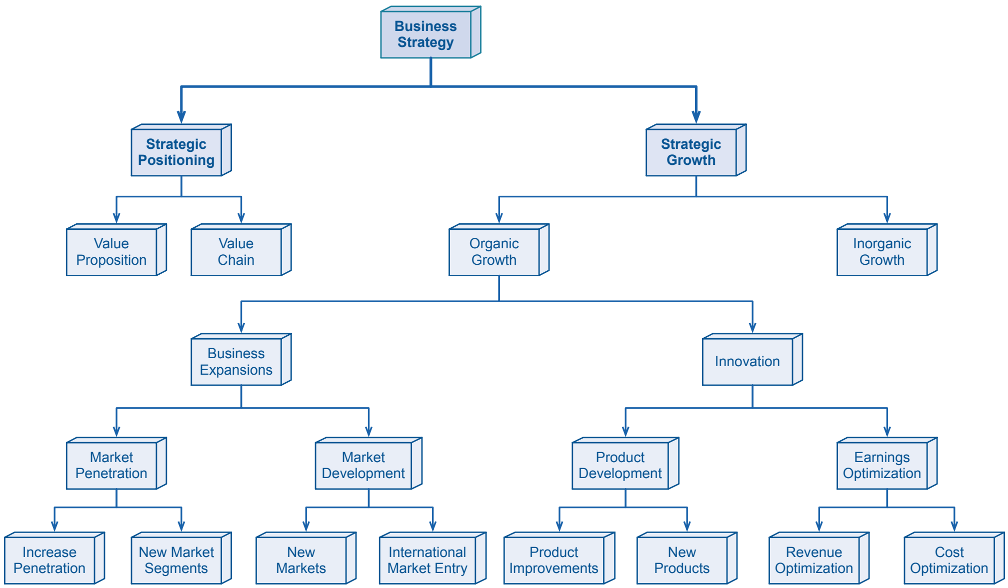
5. **Revenue Optimization:** Increasing revenues through the implementation of alternative pricing options or new business models for your existing products.

6. **Cost Optimization:** Reducing costs through the optimization of the business's cost centers, by streamlining operations or eliminating inefficient uses of cash.

7. **Inorganic Growth:** Leveraging other companies' assets through synergistic mergers, acquisitions or strategic alliances.

Your job as a company executive is to explore how this list relates to your organization and make educated decisions about which paths you believe would deliver the most impact to your bottom line.

I have put all these options together into a single mindmap to help simplify the decision-making process. The instructions to download the most recent version are included in the Downloads section at the end of this introduction.



A concise map to strategic choices. Download a complementary mindmap at: strategyforexecs.com/mindmap

You can now look at this template and see a visual representation of the strategic choices you have to make when developing a new strategy.

Now, if you've been around long enough in the business arena, you know one thing about strategy: getting it *right* is one thing, but getting it *done* quite another.

My research suggests that to "systematically" get strategy implementation right, executives must master two core disciplines: *Capital Allocation* and *Execution*.

Without those two disciplines being well rooted in its DNA, your organization is at risk of not hitting its strategic goals or derailing from the desired target even without realizing it.

Both disciplines, as well as each of the seven paths to growth and the protection of core businesses, are the subjects that we cover throughout this book.

What you will find in this book

My goal with this book is fairly simple: to provide you with a fundamental, but practical, framework to understand and create a winning strategy under the dynamic conditions we face in pretty much every market today.

It is based on more than 15 years of my own experience as an executive of two Fortune 500 companies, where I've had the opportunity to start and lead multiple business units around the world, complemented by thorough multi-year research that has taken me through more than 300 books and research papers and over 500 hours of videos and formal training.[1]

As an executive in a highly competitive market, I needed a unified framework to use as a common language to plan and communicate strategy with my teams and throughout my organization.

The final result is a concise guide that will help you understand and build a business strategy from the ground up, supported by numerous examples of modern organizations including General Electric, Amazon, Netflix, HBO, NextEra Energy, Kodak, Google, GoPro, McKinsey & Co., Rolls-Royce, Walmart, Uber, Align Technology, United Parcel Service (UPS), FedEx, Sony, IBM, Dr Pepper Snapple, Square and Procter & Gamble.

Every concept in the book is explained from scratch so that, plain and simple, this is the only strategy book you and your teams will need.

It all starts in **Chapter 1: The Building Blocks of Strategy**, where we begin our journey at the very beginning with a contemporary definition of what strategy means nowadays, explaining with real-life examples the clear distinctions that exist between the strategy at the business level, and in a company that owns multiple business units.

In this chapter, we also introduce ten fundamental rules that must support the strategy of any business, and describe the three plans that you need to implement these rules. Finally, we take you for a quick ride through the stages of the evolution of an industry and end the chapter with a few reflections about the implications that faster-paced business environments are having in the way executives design and implement strategy.

This chapter lays the groundwork for a solid understanding of the more advanced concepts in the following chapters.

In **Chapter 2: Understanding Profits** we explain the underlying mechanics of profit creation, establishing important clarifications about value, profits, profitability and how they relate to your strategy, introducing fundamental concepts that are critical such as *Value Propositions*, the *Value Chain* and *Business Models*. This chapter also provides you with a fresh take on classic concepts like *Economies of Scale* and *Learning Curves*, introducing new concepts along the way that tie into other lessons such as *Value Networks*.

This chapter also provides a modern take on Michael Porter's widely popular Five Forces framework, and introduces other types of analysis and tools to extend your understanding of the profitability of the markets where you operate. We close the chapter with a review of Michael Porter's five tests to help you craft a great competitive strategy.

This chapter covers the fundamental building blocks of strategy. Get these concepts wrong and you will get your strategy wrong. I have gone to great lengths to ensure that these concepts are introduced in the way that makes the most sense for modern strategy makers. If you are new to strategy, this will be the right way to learn these concepts from ground zero, and if you are a seasoned executive you will appreciate how these concepts have evolved over the last 40 years.

Chapter 3: Protecting Profits opens the second part of the book, introducing *Strategic Positioning* as the only path to "defendable profitability" and explaining how companies can only achieve this by offering differentiated products or lower relative prices than competing alternatives. We also introduce the use of *Perception Maps* to track the results of your market efforts and adjust your strategy accordingly.

We cover how sales and distribution channels become an extension of the product that if managed properly can help increase demand and sales, and close the chapter by introducing a number of ways to mitigate specific market forces that might be threatening your profitability.

In **Chapter 4: Protecting Profitability** we explore strategy in a dynamic context and start by understanding the underlying drivers that lead to the "commoditization" of your products and services. We also explain in detail the process to find and protect a defendable market position and provide some insights to explain the loss of relevance of some of your brands.

In this chapter we also explore how companies like IBM, Walmart, Netflix and UPS are using data analytics to create superior profitability, and towards the end of the chapter we make our case about why executives should transition towards a "multi-core" business model, where most of the profits produced by the company come from more than one core business.

Chapter 5: From Market to Operations explores the operational side of your strategy and explains how your business's value chain can become an effective barrier against commoditization, and at the same time introduces some ideas to help you keep alignment between marketing and operations.

We also discuss the decisions that you need to make with respect to which activities should remain part of your company's operations and which others should be outsourced, introducing a framework that you can use to test the defensibility of your market strategy from an *operational* standpoint.

Finally, we close the chapter and part two of the book by revisiting Michael Porter's five tests of a good strategy, but this time adding some updates so that you can apply them to faster-changing markets and to the development of multi-core business models.

In **Chapter 6: Growing the Core**, we start the third part of the book with a brief discussion about the need for growth in publicly traded companies, before moving on to a deeper exploration of the specific ways in which you can grow your core businesses. This is followed by the introduction of a few less conventional paths to growth that some companies have been able to implement successfully, including the creation of complementary products and the "productization" of the value chain to offer the things that we excel at as services to other companies.

Chapter 6 also provides a description of the multiple ways in which you can enter international markets, covering the pros and cons of each, and exploring a number of alternatives for creating growth inorganically such as mergers and acquisitions.

Next, we dive into the optimization of earnings, exploring innovative ways to increase your revenues through the implementation of non-conventional pricing and business models, and the continual optimization of your business operations.

Finally, we close the chapter by walking you through the creation of a plan for strategic growth which takes into account the different growth alternatives that we have discussed, and make specific recommendations to help you manage and track growth efforts effectively.

Chapter 7: Creating New Products and Services takes your growth efforts into a whole new dimension with the introduction of a number of frameworks to help you improve your existing products, develop new ones and even create entirely new markets. This is a meaty chapter that starts with a condensed description of Clayton Christensen's "disruption" model, which sets the stage to explore innovative ways that you can start using today to create customer value around existing and non-existing markets.

After explaining five ways to improve existing products, five ways to create disruptive products and five ways to create new markets, we introduce the idea of a customer *Value System* as a concept that ties together many of the ideas that we have explained in the previous chapters.

Next, we explore alternative ways to create new products and services, leveraging innovation from *outside* the organization, recommending ways in which you can work with startups to bring those innovations in.

In this chapter, we also explore a few technologies that promise to change the way your products and services create value, including multisided platforms and more that promise to change business as we know it.

We close the chapter with a few ideas on how to help keep your company's innovation engines always running.

Part four of the book begins with **Chapter 8: Capital Allocation**, and a clarification of common misconceptions about profits, cash and assets. We discuss the cash management disciplines that help great CEOs deliver superior performance for their shareholders, and the metrics that you should use to track the financial success of YOUR strategy.

We also introduce a capital allocator toolkit with the ten financial levers that you can use to create shareholder value, and provide you with a framework to evaluate your capital allocation decisions. Finally, we close the chapter with a discussion about *Corporate Venture Capital* as an emerging internal effort that's delivering strong results for companies that look to leverage the power of startups and external innovation.

Chapter 9: Execution: Where the Rubber Meets the Road introduces the building blocks of a solid execution system and provides you with specific guidelines for the design of your organization to improve your ability to implement the strategy and track its performance.

We cover this system step by step, and towards the end of the chapter we explore the management of key stakeholders in some detail, as well as the creation of powerful coalitions where you work with other companies, including competitors, to get things done in your industry.

Finally, as we head to the end of the book, **Chapter 10: The Human Factor** explores the people side of your company, discussing the role of A-players and providing a few recommendations to help you create a high-performing organization.

Through a series of short lessons, this chapter discusses a number of areas critical for strategy such as corporate culture and governance, and explores activities that can help you achieve your strategic goals more effectively such as the internalization of consulting services and the in-house training of your staff.

Finally, we have included a crash class on selected financial topics for those who need a quick refresh on financial statements, valuation metrics and other finance-related subjects.

This book has been written so that you don't need any previous knowledge of strategy or business experience, but it will gradually take you from the basics to a level of depth that even experienced executives will find powerful and useful.

I have included a detailed bibliography towards the end of the book with all the sources and references that I have used in writing this book. It has been broken down by chapter, and sources are listed in the order of contribution within each chapter, so take a look if you need to expand on particular topics or find the source of many of the ideas and facts included in the book.

Without the hard work and dedication of those other authors this work wouldn't have been possible, so in that section they are given the proper citation.

How to use this book

I know what you are thinking. Why another book on strategy? Don't we have enough already? Hasn't everything that's to be said about strategy already been covered by other authors?

Well, no. You *do* need a new book on strategy. At a minimum, you need *this* book.

Not because the concepts that have been taught over the last 40 years don't work, but because they have grown outdated and can't explain the success of a new breed of companies like Amazon, Netflix and Google, organizations that seem to have no boundaries or firm structure.

These companies exhibit fluid behavior that seems to break the fundamental laws of classic strategic thinking, where you could clearly identify your competitors, their strengths and weaknesses, and then go plan your strategy accordingly.

If you don't believe me, ask yourself – who are Amazon's or Google's top competitors?

Depending on your previous knowledge of strategy, your answer might be along the lines of "*It depends on which of their businesses we are talking about, because they are all over the place*".

Okay, fair enough.

If you know anything about those companies, you will have seen how they have dozens, if not hundreds, of businesses across a diverse number of markets, with mixed success across their portfolios. In some markets they are undisputed leaders while in others they are insignificant players or even flops.

Google, for example, has been very successful with products like AdWords, Translate, Docs, Chrome, YouTube, Android, Maps, Gmail and Search, but has had big failures as well with Glasses (augmented reality glasses), Plus (a social network to rival Facebook), Buzz (a social platform to rival Twitter), Health (a platform to store health and wellness information) and Wave (a document collaboration tool).

For Amazon, the success they've had with Amazon Web Services (AWS), the Kindle Reader and Prime almost makes us forget the big failures the giant had with the Fire Phone (a smartphone), Destinations (a site to sell travel deals), Wallet (an app to store gift and loyalty cards), endless.com (a high-end fashion store) and WebPay (a peer-to-peer payment service).

To your answer then, my counterattack would be "*Then why are they in so many industries? Why are they going after markets where they are not, and will never be, the leader? Isn't the classic advice to master a craft until you create a "Competitive Advantage" that enables superior profits, then stick to the things you are best at*?"

If your answer is something along the lines of "*Well, things have changed*" or "*These companies are wired differently,*" then you basically agree with me that there's a need for a new take on strategy. A new model that takes into account the fluid dynamic and context of current markets, both global and local, and that recognizes the need for leadership visions that are multidimensional in nature.

The rapid growth of these large but nimble organizations is not because they are tech-related, but because they are *managed* differently.

Their behavior may seem erratic to an observer looking through the lenses of conventional business approaches, but it all makes sense when you consider the rapid change in markets and competition that they face every day. The same fast changing conditions that you may already be facing in your market, and if not, that you will be facing soon.

As we explain later in this book, global competition, connectivity and lots of cheap money are accelerating the pace of competition and shortening the life cycle of many industries around the world. Even classic industries that seemed static for a while like oil, soft drinks, energy and tobacco are now seeing the signs of change.

This acceleration will eventually touch every market. I know this first hand since for the last 15 years I've been leading the development of new markets, businesses and products.

In trying to figure out strategy, I have come to realize that classic concepts have grown widely dispersed and confusing, making it next to impossible to think about business and strategy in an organized fashion.

To make things worse, there is a fundamental disconnect between what we executives need today when it comes to making strategic decisions and what researchers and scholars produce.

My goal with this book is to solve that "unfitness" problem, so that you can re-learn strategy from a clean slate.

This book is a self-contained framework that builds a modern knowledge of strategy from the ground up. It includes an updated definition of strategy's core concepts, and provides a map - a checklist if you will - to the many decisions that you need to make as a business executive.

From that, there are at least three ways in which you can use this book:

1. **As an analyst:** To benchmark the strategy of any given company, and quickly see which of the strategic moves in the map it is using and which ones it is not. This will give you a quick tool to measure the performance of an organization's strategy in any market and the room that it has for improvement.
2. **As an investor:** To evaluate the growth potential of an organization. You could take any company, publicly or privately held, and quickly come up with ideas about how it could defend its market position, and multiple ways in which you could help it grow. This type of analysis makes a lot of sense when you are evaluating potential acquisitions or private equity investments.
3. **As an executive:** Last but not least, you can also use this book to help speed up the decision-making process in your organization and create well-rounded, deliberate strategies faster and with more clarity.

These are all roles that as a modern executive you have to play to some extent if you want to remain competent in the 21st century, and this book will give you the fundamentals to help you do it.

It will build your strategy knowledge from the ground up and will provide you with a guide to the multiple strategic choices you need to make.

In that regard, this is the only strategy book that you'll ever need.

Why a dated edition?

You may have noticed that I appended the book title with a "2019 Edition" which might seem a bit odd in a business book, but the reason I decided to date the edition is to make a commitment to you, the reader, that I will keep improving its content based on my own experience and observations, and the feedback I get from you and other readers.

I truly believe that to master the lessons contained in this or any other business book, you have to read its content more than once, let it sink in for a while as you try to implement the ideas, and get some feedback if you get stuck. That *learn-implement-get feedback* cycle is what takes you to a mastery level, and it is no different with strategy.

I have made every possible effort to ensure that this book contains a complete compendium on strategy so that you don't need to read any other book on the subject. I know it is far from perfect, especially this first edition, but with your help it can get better.

I will be actively participating in all the discussions in our LinkedIn and Twitter communities, answering questions and collecting feedback from our followers, and will personally respond to every single email I get from readers at sun@strategyforexecs.com.

Alternatively, if you have a Gmail account, we may also have a chat conversion through their Google Hangouts service. Just go to hangouts.google.com and click "New Conversation", then enter my email address above. Of course, because of my schedule and depending on your time zone I may not be able to answer immediately, but rest assured that you will always get a response from me as soon as I become available.

So, if you do have something to say, ask, suggest or even dispute - I really want to hear about it.

With your help I can make this book the most complete strategy book ever written, and probably the only one written from practitioners´ experience and implementation feedback. That will help you, me and all other readers to benefit from our collective experience.

With that being said, what I recommend is that rather than reading this book one time and putting it away, you go and implement what you learned after you read it, and reach out to me via email or chat if you get stuck, have questions or if you have some recommendations to improve future editions.

Then revisit its content from scratch whenever new revisions come out. In the end, the electronic version of the book is free (and will always be free) to download, so there's no good reason not to have it. Along with the book files, we also send you instructions in the same email so that you can upload it to your Kindle or iBooks app, or to any other pdf reader on a mobile device.

In my own experience, to truly master a subject you're better off working with one single comprehensive framework that you learn well, rather than dividing your attention across multiple frameworks that you only manage to partially understand.

So think of this book as a kind of strategy *software* that you'll need to update in your system every 1-2 years to stay at the top of your game.

That's my goal with this book: keeping you at the top of your game.

Finally, in case you are wondering, there's no catch. I'm not planning to make any money off the book, so there's nothing I'm planning to sell you. Not now, nor later.

My business model will be around speaking engagements once I have the time for it, so as a reader you are not at risk of being asked to buy anything from this project. But you can help me make this content better for you, for other readers and for myself by providing feedback and suggestions based on your own experience.

So please join me in this journey, and let's put a dent on the universe, together.

I expect to hear from you soon.

Sun.

Book downloads and companion website

I have partnered up with an outstanding marketing team to publish a great deal of strategy-related content and different tools based on the original manuscript of this book free of charge at: strategyforexecs.com.

Depending on your particular interests, you may find some of the links below useful:

- To download a complimentary pdf version of this book: strategyforexecs.com/pdf.
- To download the most recent version of the strategy mindmap: strategyforexecs.com/mindmap.
- To watch a webinar where I cover some of the most important ideas of this book: strategyforexecs.com/webinar.
- To find a number of resources for executives, consultants, educators and other strategy practitioners: strategyforexecs.com/resources.

Find a list of all the above links and more on the site at: strategyforexecs.com/sitemap.

Get support and give feedback

We've made every effort to ensure the content of this book and its companion website are comprehensive yet practical and free of errors. If you get stuck in any way through the implementation of the concepts of this book or discover any errors, please contact our support team at contact@strategyforexecs.com or visit the book's website and send us a message through the contact form.

Your satisfaction with this book is my top priority, and your feedback the most valuable asset.

GET MORE JACK WELCH: Jack Welch is one of the greatest CEOs of all time. To learn more about his management style, leadership quotes, his books and to watch some of my favorite Jack Welch videos visit strategyforexecs.com/jackpot.

Stay in touch

Let's take this conversation to social media! We're on LinkedIn at Linkedin.com/company/strategyforexecs/ and on Twitter @BizStrat4Execs. Our account is managed by our marketing team and its content moderated by me, Sun Wu.

Part I

Understanding Strategy

1

The Building Blocks of Strategy

In this chapter we will:

- Provide a modern definition of strategy
- Explain the differences between corporate and business strategy
- Introduce ten fundamental rules of business strategy
- Explore the typical life cycle of an industry
- Explain the evolution of basic strategy concepts
- Discuss the implications of strategy in a dynamic context

Jack Welch was a "Jack" of all trades. During his 20-year tenure as the CEO of General Electric (NYSE: GE) he grew profits from $1.5 billion to over $15 billion, and increased GE's market valuation by a factor of 30 from around $14 billion to over $400 billion. If you had invested a thousand dollars in GE stock when he took over as CEO in 1981, that money would have grown to $50,000 by the time he stepped down in 2001.

As soon as he took over, Jack insisted that GE had to be number one or number two in every business they were in, or else get out. By number one or number two he meant GE had to be the leanest, lowest cost, worldwide producer of quality goods and services. With this mantra, he positioned GE as a leading company in most of its markets and took over new ones both at home and overseas, selling and closing poor performing units by the dozen along the way. In his mind, underperforming units, that is, businesses where GE was not number one or number two in their respective markets, had to be "*fixed, sold or closed*".

Under his command, GE entered markets that were previously considered to be away from its industrial manufacturing core like real estate and financial services and launched hundreds of new products that took over entire markets both in the US and internationally.

Jack promoted cutting-edge initiatives that produced important cost efficiencies, like the implementation of

Motorola's *Six Sigma* program and the digitalization of the procurement process which in GE moved several billion dollars a year.

He reinvested the money from business sales and cost saving programs into aggressive expansion plans to take the company into new business markets, and successfully executed more than 600 acquisitions including very public ones like RCA and NBC.

Jack Welch was looking for rapid growth, whether part of GE's core business or not.

During his period as CEO, Jack Welch managed GE with a firm hand and wasn't afraid of making unpopular decisions. He implemented the infamous "rank and yank" program through which the company fired the bottom 10 percent performing managers every year, regardless of whether they performed well or not.

He also took GE through a major reorganization that dismantled the reigning corporate bureaucracy and laid off over 120,000 people, earning him the moniker "Neutron Jack" (as in a neutron bomb that eliminates people and leaves buildings intact).

Jack would make unexpected visits to GE's plants and offices and was always looking for opportunities to talk to people and provide his views on leadership and the direction he thought the company should be heading. He was well known for writing personal handwritten notes to employees to congratulate or correct them.

He was probably one of the first CEOs who comfortably and "profitably" pursued aggressive growth beyond their "core business".

GET MORE JACK WELCH: Jack Welch is one of the greatest CEOs of all time. To learn more about his management style, leadership quotes, his books and to watch some of my favorite Jack Welch videos visit strategyforexecs.com/jackpot.

Even critics admit that Jack Welch was the extraordinary driving force behind GE's explosive growth during these years. He was without doubt the Jeff Bezos of his era, and his results speak for themselves: he outperformed the S&P 500 Index by 3.3 times and was named "Manager of the Century" by Fortune Magazine in 1999.

Jack Welch's results as CEO of GE were by any metric outstanding, setting the bar truly high for those who aspire to reach the top job in other large organizations. But if you believe that he was an avid student of formal strategy theories you are dead wrong.

He was a very pragmatic, cut-to-the-chase executive who established a no-BS culture at GE that always looked at facts and numbers coldly. His leadership style was very straightforward, and as he calls it "obsessed with reality". If he was an avid student of anything, it was of GE's inner workings and numbers.

In fact, Jack criticizes the complexity of established frameworks, which according to him approach strategy as a "scientific subject".

In his book *Winning*, he says about strategy gurus: "*The way these experts tend to talk about strategy—as if it is some kind of high-brain scientific methodology—feels really off to me… In real life, strategy is actually very straightforward. You pick a general direction and implement like hell.*"

Rather than being the result of a complex, intertwined system, in Jack's mind strategy is done in three easy steps:

- **Step 1:** Come up with a smart, realistic way to gain a sustainable competitive advantage.
- **Step 2:** Put the right people in the right jobs to drive Step 1 forward.
- **Step 3:** Actively seek out the best practices to achieve the goal set in Step 1, whether inside or out of the organization, adapt them and continually improve them.

With a few exceptions, not many large companies have achieved the exponential growth that GE experienced under Jack Welch. Amazon.com however is one of those exceptions.

Amazon (NASDAQ: AMZN) started out in 1994 as an online bookstore focused on less popular "long-tail" book titles and has rapidly grown into a behemoth of global ambitions, making its CEO Jeff Bezos the richest person on the planet.

On the day of its Initial Public Offering (IPO) on May 15, 1997, Amazon's share price opened at $18, and at the time of writing it is approaching the $2,000 mark, becoming the world's second trillion-dollar company, behind only Apple (NASDAQ: AAPL) but ahead of Alphabet (NASDAQ: GOOG), parent company of Google, and Microsoft (NASDAQ: MSFT).

Its market capitalization has grown more than two thousand times for an outstanding compound annual growth rate (CAGR) of around 45 percent during its 21 years as a public company. If you had invested $1,000 in Amazon's IPO, that investment would have been worth more than $1.2 million in August 2018 when it reached the trillion-dollar valuation.

During this period, Bezos has led Amazon to become one of the largest companies in multiple markets. The company is currently the world's largest player in eCommerce (through its Amazon.com marketplace) ahead of Walmart (NYSE: WMT), Target (NYSE: TGT) and Costco (NASDAQ: COST), web services (through Amazon Web Services) and voice assistance (through its Alexa device). It is also the 10th largest grocer through its Whole Foods acquisition and the second largest video streaming platform through Amazon Prime, second only to Netflix (NASDAQ: NFLX) but bigger than Disney (NYSE: DIS) and HBO.

Despite its undeniable success, Amazon keeps adding new businesses and services to its portfolio at lightning speed. It currently owns more than 70 in-house brands and has completed over 85 acquisitions including notable ones like Audible in 2008, Zappos in 2009 and Ring in 2018.

Just like Jack Welch, Jeff Bezos has taken Amazon.com way beyond what was classiB cally believed to be its "core business", measuring market potential more in terms of the capability of its people and the opportunities at hand than in topical skills and expertise. "*Your margin is my opportunity*" is a phrase usually associated with Bezos that perfectly captures the way he thinks about the scope of his business.

Both CEOs have demonstrated versatile maneuvering and unconventional thinking that put them ahead of their peers.

They are what I call *multidexter leaders*[2] who see strategy as a multidimensional game where *brains* and *people* matter more than seniority or "years of experience".

They are not biased by conventional boundaries in established industries which we know limit the creativity of organizations and the markets where they do business. For these leaders, a dollar is a dollar and they are ready to go and get it wherever they can leverage their resources and people.

Multidexter leaders are difficult to find and even harder to predict. They are jacks of all trades but masters of none. They take their companies in multiple directions and get involved in many things at once, but just at the right level of depth where they don't get emotionally attached to the process nor fall in love with things that can become obsolete like technology, people and products.

They are expert generalists, who leave the details of execution to the real experts. They are not in search of intellectual wins, but of good old earnings.

Multidexter leaders are not formal strategists, but empirical practitioners who follow their guts when they see a good opportunity and run experiments until they crack the code. Their management style is not based on complex theories and frameworks but in practical common sense. They move along multiple paths and change direction as needed based on their continual assessment of the space.

Their thinking is, by nature, at odds with those of formal strategy gurus. "*When it comes to strategy, ponder less and do more*" is Jack Welch's advice to aspiring CEOs.

In his view, executives must be quick on their feet when making strategic decisions and should never stop their work by trying to absorb overly complex information and facing paralysis due to over analysis.

In *Winning*, he sends a clear warning: "*You just should not make strategy too complex. The more you think about it, and the more you grind down into the data and details, the more you tie yourself in knots about what to do*".

As executives, I agree we need to learn how to be comfortable making decisions with information that is just good enough, then implement the strategy with a feedback loop that facilitates adjustments as we go.

Some critics may argue that the bias to action observed in multidexter leaders like Welch and Bezos leads them to make a handful of expensive mistakes here and there, because of the high speed with which they make decisions, and there's probably some truth in that. But if you look at the stories of success and failure in your industry, you'll probably come to the conclusion that making a well thought out decision that turned out to be bad is way better most times than not making any decision at all.

With that, the one mistake that you'll seldom see these multidexter leaders make is not making a decision.

In this first chapter, we will provide a contemporary definition of business strategy, and will offer some clarifications to help understand the concept in the context of hyper-competitive markets. We will also discuss the distinction between a "corporate" approach to strategy and the strategy needed at the level of the business unit, and will provide ten fundamental principles that must guide the strategy of any business. Finally, we will review modern literature to revisit strategy concepts that have changed over the last 40 years.

> **EXPAND YOUR KNOWLEDGE:** For a broader understanding of strategy and its underlying constituents, visit our strategy glossary at strategyforexecs.com/glossary, where you will find expanded definitions of the concepts reviewed in the book, along with complementary videos, and many downloadable tools.

What is strategy?

In this book, we define business strategy as "*a compendium of deliberate choices that an organization makes to maximize its value over a given period of time*".

This definition, although quite different from classic ones, embodies in my opinion a contemporary vision more in line with the dynamics we see in most markets today. Let's dissect its main components to understand why.

To start, this definition makes clear that strategy is all about choices. At any given time, executives face decisions that need to be made - forks in the road where they must decide to turn left, right or do nothing, and their job is to manifest the company's vision through those choices.

Second, those choices must be intentional. Even companies that don't plan their strategy end up having one, but a *deliberate* effort will always increase the chances of getting the results they want. In the end, if you don't know where you want to go, you will most likely end up somewhere else.

Third, maximizing the value of an organization implies that you must manage your business to extract the most you can from your available resources. These resources include money, people, knowledge, assets, relationships, intellectual property and anything else that can be leveraged to increase your organization's value.

Finally, establishing a time frame when creating a strategy helps you set a reference for making decisions. For example, to choose to pass on short term opportunities and focus instead on others that may take longer to realize but that will deliver a higher value for your organization in the long run.

Without reference to a time horizon, you cannot really measure what "maximization" means in the context of your business. With respect to what?

A time window also forces you to set some boundaries in terms of "how" the strategy is achieved, especially when it comes to business ethics and non-business factors that could jeopardize your strategy efforts. It makes you question the "sustainability" of your actions.

When you see strategy as an effort with benefits to be reaped and measured within a time horizon, let's say five to ten years, you need to make sure that your decisions are sustainable over that period, and next quarter's pressure should not be an excuse to ruin your company's ability to achieve its goals over the long run.

The old ways

Classic strategy thinkers define the goal of strategy as to "*outperform competitors within a given market*". While the idea captures the essence of the competitive thinking taught over the last 40 years, it doesn't reflect the nature of today's dynamics.

First, by defining their goals in terms of competitors' performance, executives might well be leaving money on the table. In fact, keeping your attention on competitors' behavior may prevent you from identifying other potential sources of value, resulting in a shortsighted strategy.

Do you think that Amazon's CEO Jeff Bezos wakes up every day feeling that he has nothing to do because he already outperforms Walmart and Barnes & Noble in online retail and book sales?

You don't have to believe me, just take Bezos' own words. In an interview on the Four Peaks TV show, he said "*Let's say you're the leader in a particular arena, if you're competitor-focused and you're already the leader, then where does your energy come from?*".

What if all your competitors suck, or had a bad year? Would you feel satisfied because you made 1 percent more return than a poor-performing business?

I don't think so. You must stop believing what *theorists* say, and start paying attention to what *practitioners* **do**.

Corporate strategy vs business strategy

In a company with a single business the goal of its strategy is fairly straightforward: maximizing the valuation of that business over the foreseeable future. But in a company with multiple products or business “units” the boundaries of its strategy are sometimes not that simple.

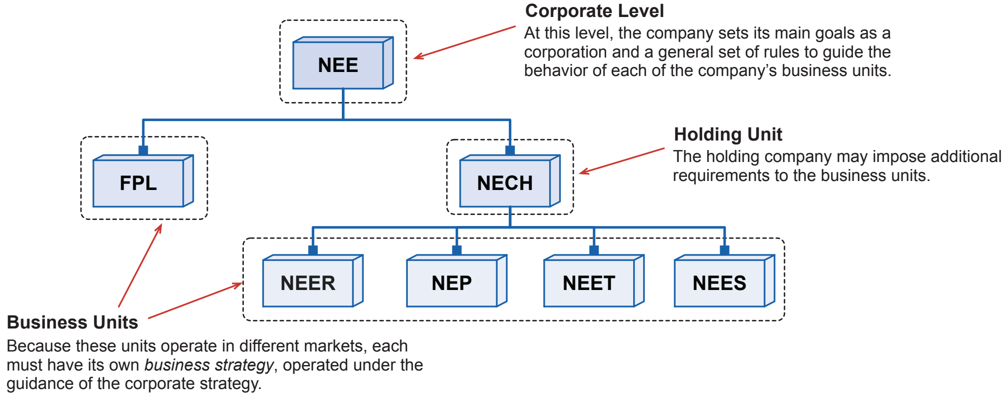
While the difference between a “corporate” and a “business-level” strategy may seem evident and to some extent trivial, keeping a clear distinction between the two is necessary for a good understanding of strategy.

Most of the concepts that are typically associated with strategy such as *competition*, *market forces* and *disruption* usually refer to the strategy of a particular product or business unit. But when we talk about a “corporate strategy”, we are referring to a set of guidelines that govern the behavior of a company that owns more than a single business unit.

While each unit must have its own strategy set at the business level, taking into account the particularities of the market and its incumbents, a *Corporate Strategy* must still be set at the “mothership” level to guide the general behavior of the corporation as whole and of each of its business units.

Take Florida-based NextEra Energy (NYSE: NEE), an American power company that serves markets in the US and Canada.

The company has several subsidiaries, among them: NextEra Energy Resources (NEER), a power generation business; Florida Power and Light (FPL), a power utility company; NextEra Energy Partners (NYSE: NEP), a publicly traded company that owns and operates wind and solar projects in the US; NextEra Energy Transmission (NEET), a company that builds and operates power transmission assets in the US; and NextEra Energy Services (NEES), an electricity retailer serving residential and commercial customers across the US. All are under control of NextEra Energy Capital Holdings (NECH) with the exception of FPL.



Corporate versus business strategy in NextEra Energy

Each of these subsidiaries is treated by NextEra Energy as an individual business unit, and because they operate in different markets each must set its own strategy, under the guidance of the general corporate strategy set at the top.

In a multi-business corporation such as NextEra, its executives will seek to maximize its value as a whole, even if that means sacrificing some of its business units to favor others that are more promising.

For example, at a given point in time they may decide that it is better to reinvest profits from a strong business, that happens to be in a dying industry, onto a weak unit that's getting traction in a fast-growing market, rather than trying to protect the market position of the dying business.

Because the goal is the maximization of the organization's value as a whole, its executives must sometimes pursue this type of cross-business optimization, even if that means achieving suboptimal results in a particular business unit.

There are other examples that may be more familiar to you. Amazon, for example, runs its massive eCommerce platform as a standalone business, while owning other businesses like Amazon Web Services (AWS), a cloud computing business; Zappos, an online shoe and clothing retailer; and Whole Foods Market, a brick-and-mortar supermarket chain specializing in organic food. These operate as independent business units.

Because these units each operate in different markets and face a completely different set of conditions and threats, each must have its own business-level strategy, but operate under the guidance of Amazon.com, the corporation.

A corporate strategy establishes a series of choices that an organization makes with respect to how it will create and distribute the value extracted from its business units. From that, it is implied therefore that a "business" strategy must be designed to co-exist with the corporate strategy at the top.

From this, we can conclude that to really extract the most out of your company's resources, you must adopt a kind of portfolio approach to how you manage the units and allocate resources, a subject that we cover later in Chapters 6 and 8.

Ten fundamental laws of business strategy

To an outsider, strategy might seem like an ever-changing subject, a moving target of some sort that only those who make it a full-time job can master. Although book publishers and authors want avid readers to always fear they're missing out on something, it should not feel that way.

In reality, the basic ideas around business strategy haven't changed much over the last few decades. The fundamental concepts that have been taught in business schools since the 1980s are still the pillars that support most of today's frameworks.

At the end of the day, the profit equation has only three components: price, demand and costs, and consequently, a good strategy is one that either helps us sustain premium prices or superior levels of demand, or that focuses on lowering costs.

For that reason, rather than having changed, our knowledge of strategy has "evolved" significantly as we have now had the opportunity to witness longer periods of competition and to observe the rise and fall, sometimes miserably, of companies once regarded as the most innovative like Sears, Circuit City, Toys R Us, RadioShack, Blockbuster, Pets.com and Borders Books.

With that premise, and in the light of today's fast changing markets, we can synthesize the last forty years of strategy-making into ten fundamental rules that must support the strategy of any of your businesses:

1. The aim of any business is to find a market position that is both profitable and defendable in its market of choice (explained in Chapter 3).

2. A market position that is both profitable and defendable can only be achieved through differentiated products or lower relative costs, that is, by either doing different things from competitors, or doing the same things in different ways (we'll explain further in Chapter 3).

3. Differentiation should translate into higher prices, higher demand or both. Lower costs, on the other hand, should translate into lower prices (which should lead to higher demand), higher margins or both.

4. To defend its market position, a business must deliver its *value proposition* at a lower cost than anyone else (we'll define value proposition in Chapter 2).

5. What erodes a business's ability to remain profitable is *commoditization*, not competition. Commoditization can happen to a product's particular set of benefits and features, or to the ways in which those benefits and features are created.

6. Because the process that leads to commoditization is systematic in nature, a profitable market position is only defendable on a temporary basis, making strategy a *process* that must *continually* readjust itself.

7. Although profits eventually lead to cash, the value of a business, and therefore the success of a strategy, must ultimately be measured through cash, not profit.

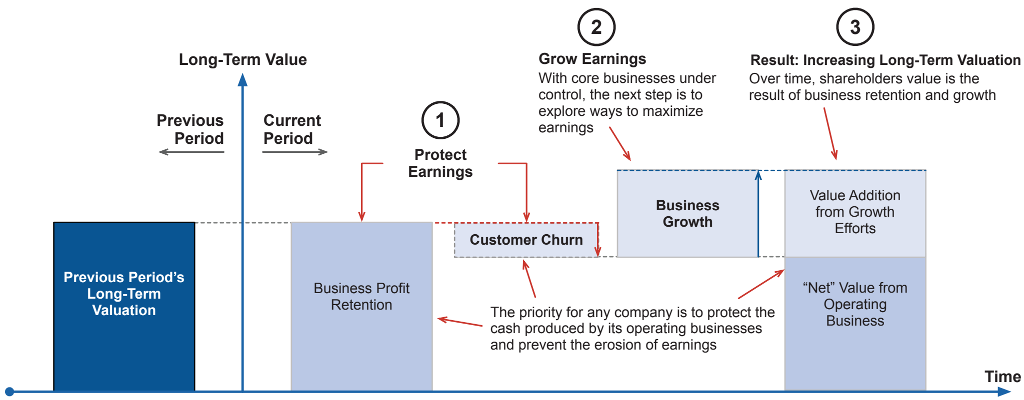
8. An organization should persistently look for ways to reduce costs even if its strategy is not based on low prices. Conversely, it should always look for ways to increase revenues, even if its strategy is not based on differentiation.

9. The design of an organization must fit its strategy, not the other way around. This necessarily means that a change in strategy must drive a change in the design of the organization.

10. A strategy can only deliver its benefits if it is well implemented. Therefore, an integral part of the strategy must be a "system" to ensure its *systematic* execution.

Take these as the ten immutable commandments of a business strategy. Violate any of them and see how your business loses profitability over time.

Finally, we stated in the introduction that the two things a CEO must do well are to protect earnings from the operating business and to maximize earnings' growth over the foreseeable future. That combination of defend-and-grow is what builds up your organization's valuation over time, like a boxer advancing over his opponent through jabs and hooks.



Maximizing shareholders' value takes a combination of initiatives to both defend and grow core earnings. That combination is what grows a company's valuation over time

From these principles and the ten "strategy commandments" we introduced above, we can conclude that to be a successful, a company must have these three strategic plans at hand:

1. A plan to protect operating business from erosion,
2. A plan to maximize business growth over time, and
3. An "operating system" to ensure that 1 and 2 happen.

These are the ideas and principles upon which strategy is developed throughout the rest of the book.

The old ways

A common point of confusion when it comes to strategy is because of the term "Competitive Strategy". For many, especially those trained in the old school mindset, competition means a bloody fight between rival companies, and brings to mind images of price wars and value destruction.

"*To be successful in a competitive environment,*" the old advice goes, "*you need to find a way to differentiate your products from rivals and offer unique value*".

But isn't differentiation, the idea of offering products and services with a unique value proposition, a way to *avoid* competition with other companies?

I mean, if what you really want is to "compete" all you have to do is to copy exactly what others are doing.

The only reason why you want to differentiate your products from other companies' (instead of just doing what they are doing) is to find a position in the market where you can make superior profits for a longer time or, in other words, find a position of low or no competition.

The word competition, therefore, should be reserved for cases when other companies try to take business from you, or when you try to take business from others. But differentiation and uniqueness are just ways to find spaces of low (or no) competition.

A competitive strategy as taught by classic frameworks is then, in reality, a plan to *avoid* competition, not a hand-to-hand combat instruction to pick competitive fights as many, confused, believe.

Industry evolution: The crash course

Before we dive into the core ideas of this book, let's take time to review the dynamics of industry evolution and its structural implications for strategy.

Many times, we visualize strategy as an interplay of operating businesses fighting each other over a limited market pie - companies engaging in all kind of maneuvers, price wars, deceptive marketing and other dark magic tricks to win over a few customers.

Although that description may well fit an industry in decline, there's much more to it. In reality, if we look backwards in time, the origins of an industry have a lot to do with how it behaves at any future state and how incumbents "compete" over time.

What researchers have come to observe is that the adoption of products and services in an emerging industry follows a pattern that to some extent repeats itself over and over again in many industries.

It is important that we understand this process, at least in general terms, since the strategy of any business works best if adjusted to the particular stage its industry is going through.

The cycle usually starts with the introduction of a new solution, an innovative product or service that solves an existing problem in a way that's different from incumbents' solutions. Think about MP3 players in the late 1990s or the Bessemer process, the first to enable manufacturers to mass-produce cheap steel in the mid-1800s.

Some of these solutions were so radically different from incumbents' products that when they first appeared they created their own category, as was also the case with the iPod, Viagra and Netflix's streaming services.

This introduction marks the *Emergence* of the industry: the stage where a handful of innovators start putting together primitive versions of the product, trying to find a sizable market for it, in the pursuit of getting a pioneer advantage in the upcoming industry.

During the Emergence phase, it might not be clear yet to the developers which target customers the product fits best, and they may not even know what problem it solves. But as they keep working with early adopters, testing multiple hypotheses and iterating different versions of the product, the industry starts converging towards a *dominant design*.

In the automobile industry, for example, early entrants experimented with numerous design ideas and fuel alternatives from steam, kerosene and coal, to oil, electricity and gasoline. Over time, the industry evolved and gravitated towards the gasoline-fueled internal combustion engine as the industry's dominant design.

That point, when a commonly accepted design or standard emerges and is adopted by the dominant players, is called by some the *annealing* point of an industry, a term coined from metallurgy that relates to the heating of metals to make them malleable. The analogy suggests that an industry has reached its annealing point when it has converged towards a dominant design.

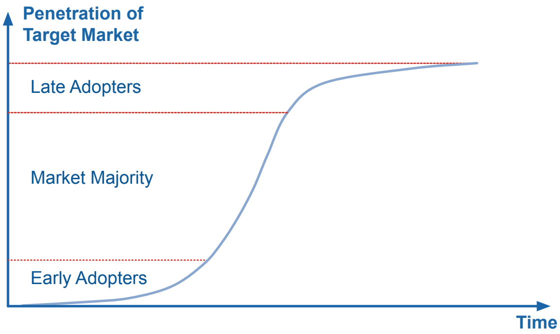
In the videotape's format war between Sony's Betamax video cassette recorder standard and JVC's VHS, the annealing point was reached when the VHS emerged as the dominant standard.

Reaching annealing could take years for many industries, and it is common that small players lacking the funds to survive have to exit the market before getting to that point.

But with its annealing, an industry is poised to transition into a *Growth* period, leaving its Emergence behind as the adoption of the dominant design starts gaining traction and the revenues of the industry grow, in many cases exponentially.

During Growth, innovators try to make their products more appealing to larger audiences within the market, to capture bigger slices of the demand the new industry is creating.

In some industries, particularly those with a high technology content, the growth phase may happen in a very abrupt, rapid way, giving origin to a particular pattern which many have come to call an "S" adoption curve or the *hockey stick* because of its steep slope.



Typical product adoption curve. As you will see later, this curve "shapes" the evolution of an industry

Official intervention is usually weak during the Emergence and Growth phases as regulators try to get their heads around the new solution and its implications for society (and their constituents).

As government becomes more knowledgeable about the market, they explore ideas of how to control the behavior of the industry and its players, opening up opportunities for savvy players to work with lawmakers in shaping the way the industry will be regulated.

Car sharing service Uber, for example, is well known for its aggressive lobbying efforts trying to shape how its nascent market should be monitored and controlled in the relevant jurisdictions.

Early overestimation of growth

When an industry starts to grow fueled by a generally accepted dominant design, its potential for profit usually looks very good from the outside. Here's why: the growth potential of a market, as taught in most business schools, is measured by the number of potential buyers for whom the solution could be a good fit.

For example, let's say that an industry is emerging around a new insulin-delivery technology to help diabetic patients of age 65 and up (a population of 12 million in the US) automate the intake process. If at a given point in time 25,000 units have been sold in total (0.2 percent of the addressable population), marketing people would say that the technology's "market potential" is around 11.9 million people in the US, or 99.8 percent of the addressable population.

This way of looking at market potential (measuring the approachable customers who don't have the product yet), when an industry is in its early stages, in almost all cases overestimates the markets that could be *effectively* reached.

With the numbers looking so attractive, a host of new players are drawn to the opportunity, hence the growth stage of an industry is usually characterized by a large number of companies which fight for early dominance, trying to establish themselves as the leaders in the upcoming market.

As an industry reaches critical mass, turning the more conservative and cost-conscious non-customers into customers, they usually pass through a *shakeout* period where some companies can't keep up with the pace of the new reality and have to close their doors, while others are absorbed through mergers or acquisitions.

This shakeout produces a consolidation of the industry which converges towards dominant *business models,* and that's how the incumbent players of the industry emerge. These companies, armed with refined products and proven business models, are now set to dominate the industry for the years to come, during its *Maturity* phase.

With the maturity of the industry, margins also tend to diminish to a steady level. A mature industry is characterized by stable profitability, clear regulation and a predictable business environment.

The soft drinks, oil and power industries as we have come to know them are good examples of mature industries. Their incumbents know their markets so well that they can predict them with some accuracy, and regulation is very clear about the cans and cannots.

Companies operating within mature industries face competition, but they still find ways to differentiate their products and benefit from credible barriers to new entrants, moderated growth and a steady inflow of predictable demand.

The view ahead may be bumpy, but smooth and clear.

Maturity is usually the longest phase in most industries, lasting for decades or even centuries in some cases like in construction and fine dining.

After some time however, an industry's potential for additional growth may start to slow down and differentiation becomes more difficult to achieve, which inevitably agitates competition and rivalry among competitors, clear signs that the industry has already passed its prime.

Beyond this point, the industry starts its *Decline* stage, a period of slow or negative growth, shrinking margins and loss of market relevance.

During Decline, the picture we described at the beginning of the section comes to life: businesses fighting with each other over a limited market pie, engaging in all kind of maneuvers, price wars, deceptive marketing and dark magic tricks to win over customers.

In most cases, the transition from Maturity to Decline happens at a very slow pace, so inconspicuous that it may go unnoticed to incumbents for years, especially powerful players whose dominant position allows them to produce healthy margins even when the warning signs are evident, and while the less fortunate go out of business.

It seems that the decline of an industry is sometimes initiated, but always accelerated, by the Emergence of new solutions that move upmarket along a different life cycle – an upcoming wave of market entrants armed with innovative solutions which have emerged as the dominant design in those markets and that have gotten some traction with a sizable fraction of the potential user base.

These new entrants have a lot to fight for. Because they usually overestimate the profit potential of the market, which exaggerates the size of the prize, they will do everything at their disposal to point their business towards the main market, accelerating the decline for incumbents.

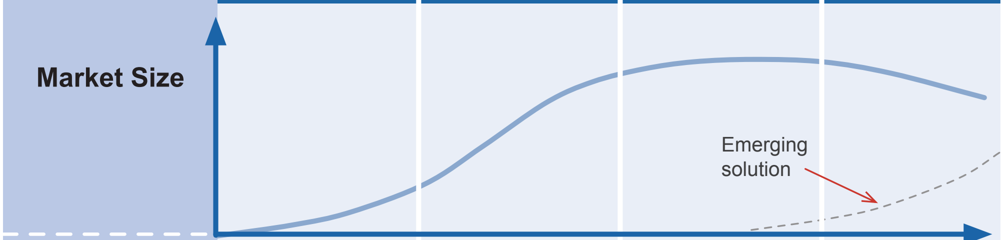
As growth slows down, incumbents in declining industries increasingly see competition as a win-lose game and their strategy gravitates towards marketing budgets, price wars, economies of scale and size.

The transition from the Decline of an incumbent industry into the Growth phase of the emerging one usually happens through a *discontinuity* in the adoption curve, which many call a "disruption" pattern, which leaves the old curve and its players in the past giving way to a fresh group of incumbents, who could later become the ones disrupted when the next wave of disruptors comes in.

That story describes *in general terms* the evolution and death of many industries and will keep prescribing the fate of existing ones.

Just as film photography was disrupted by digital cameras, and digital cameras were later disrupted by smartphones, the story will continue to repeat itself.

It will repeat not because the adoption curve happens to have this shape but because *it is shaped* this way by the systematic forces and behaviors that interact underneath, throughout the evolution of an industry.



	Emergence	Growth	Maturity	Decline
Indicators	High growth potential, limited or no regulation, no direct competition	Fragmentation, no dominant player, shapeable regulation	Low growth, high concentration, stable regulation, mature industry	No growth, restricted financing, losses
Rivalry among players	Low (high product differentiation)	Increasing (weak buyers, low entry barriers)	Strong (stronger buyers, higher entry barriers)	Extreme (many exits, price competition)
Strategy focus	Innovation	Ability to grow	Market share, lower costs	Ramp down, disengage

Industries evolve following somewhat predictable patterns because of the forces acting on them. In other words, the industry evolution curve "is shaped" this way by the underlying forces at play

And here's a final heads up: it is now more frequent that you see the decline or even the end of existing industries, something that a few decades ago wasn't that common. Centuries-old industries like oil and tobacco are for the first time facing clear signals of their inevitable demise.

The rapid penetration of computing technologies, advances in data analysis, changes in customer preferences, social connectivity and virtual communications among other factors are accelerating the pace of evolution in many industries and shortening their life cycle at speeds not seen before.

Your role as a business executive is to understand how these "natural" factors act on each of your businesses to properly leverage or mitigate them.

If these factors shape the industry, they should also shape your strategy.

Strategy in a dynamic context

No other business subject has been more talked about, researched and discussed over the last 40 years than strategy. Business schools, management consultants and individuals have all jumped into a never-ending race to come up with the best practices of this so-called "art".

That creates a huge and still growing body of research and data that keeps pushing the boundaries of our knowledge about how organizations work, evolve and decline, and keeps piling up information about customer behaviors, product design, pricing theories and a thousand other subjects.

But the most fundamental shift in our understanding of strategy is that in almost all industries the conditions under which it is defined are now changing at a faster speed.

That changes everything.

The dynamic context we face today forces us to see strategy, along with all its moving pieces, as a picture in motion rather than the static view that the classic tools taught us to observe. That changes the way in which we executives must approach strategy and how we will be evaluated for our jobs.

Everything we know about strategy, from industry structure to customer preferences and product development, is moving faster than ever and now we must see our organizations more like living organisms which must adapt to these changing conditions in order to survive.

Firstly, industry and product life cycles are now getting shorter, influenced by abundant information, good technology and lots and lots (and lots) of cheap money, which accelerates rivalry among competitors and drives profits to a minimum incredibly fast.

With that, it will be more common now to see the decline of entire industries and markets, and to survive, incumbents will need to innovate and evolve faster.

Think about the short life of portable power banks, the external batteries that many of us used to give our smartphones a charge boost when we couldn't find a power outlet.

They appeared in the market and gained traction very quickly as a complement to smartphones, but they also rapidly became obsolete as the internal batteries of mobile devices improved exponentially between one generation and the next. Nowadays, I'm sure that if you have a modern smartphone you don't feel the need to have that kind of external power source any more.

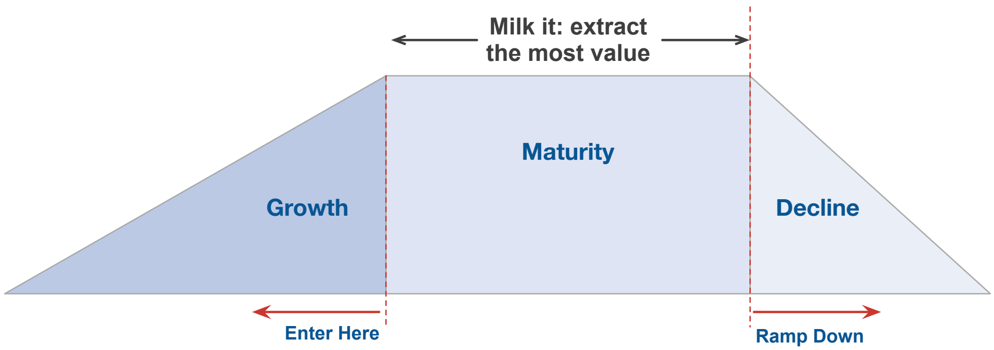
The same happened with handheld GPS units which became very popular a decade ago as a way to provide drivers with turn-by-turn directions, but were quickly replaced by the increasing capabilities of smartphones.

If companies and industries die more often now, you will have to accept the decline of a business more naturally and with less upheaval, where you just ramp everything down and reallocate resources to other activities that show growth potential.

This dynamic also implies that the so-called *competitive advantages* have a temporary nature, so you must learn to "milk" businesses while you can, and let them go when the time comes.

An emerging way of looking at businesses is by visualizing them as "waves" of opportunities that arise at one point in time, grow to their maturity, stabilize for a while and then start to decline until they die.

Your goal as an executive in charge, then, is to ride those waves and extract the most from them while they last, before they disappear.[3]



A more pragmatic but contemporary view of the life cycle of an industry sees it as a natural sequence of three stages: growth, maturity and decline

To ride a wave profitably you must continually rethink your business and find new ways to expand it. You can expand your products by making linear or radical improvements to them, you can expand your services by adding complementary features so that buyers need fewer third-party solutions, you may integrate backward or forward getting into the business of your vendors or your customers, or enter adjacent markets to offer a more comprehensive solution to buyers.

Your job as a business leader is to find any possible way to ride that wave profitably, because as former Intel (NASDAQ: INTC) CEO Andy Grove famously said, "*only the paranoid survive*".

Paranoia in business is not a far-stretched exaggeration. It is increasingly becoming the new way of doing business, and only those willing to look at the evidence will survive the new zeitgeist.

In his book *AI Superpowers: China, Silicon Valley and the New World Order*, data scientist and Venture Capital (VC) investor Kai-Fu Lee explains how Chinese companies manage to survive the cutthroat, hypercompetitive environment in China.

In a country of sketchy intellectual property protection, where rivals can quickly copy what others are doing, companies must continually leapfrog and expand their products' ecosystem to remain profitable and ahead of VC-funded competitors.

For example, he explains how DiDi, an Uber-like ride-sharing company, has already begun buying gas stations and auto repair shops to service its fleet, and how Tujia, an Airbnb copycat, now owns and manages a large portfolio of its own properties and has already integrated additional services for hosts like cleaning the properties after each rental, restocking supplies and installing smart locks. He also explains how DianPing, a cross between the US's Uber Eats and Yelp, began hiring and managing its own fleets of scooter-riding teams to deliver orders from restaurants to doorsteps since 2013.

By observing this behavior, we can see in fast motion what well-funded competition looks like and what's coming to your markets. How quickly do you believe Disney could catch up with Netflix in online streaming, or Walmart catch up with Amazon in online retail?

The only way that you can stay ahead of deep-pocketed competitors is by rapidly expanding your businesses and extracting value fast from the opportunity wave. Because the wave itself may also come to an end at some point.

Probably the most radical reflection that results from envisioning opportunities as being transitory in nature is that organizations must stop relying on a single "core" business as a way of living, and instead seek the origination and development of multiple ones while their main business is still flourishing.

That mentality is what has made Amazon and Apple the stories of success they are today - they are building multiple cores, and have become less dependent on the success of their original "core" businesses.

That is way easier said than done though. Multicore thinking requires moving away from "good practices" and making very uncomfortable decisions.

For example, you may have to allocate funds to business opportunities of uncertain future, rather than reinvesting those resources into the core business, which in most cases would yield a safer and more predictable return.

But building the future takes a lot of zigzagging and seemingly counterproductive decisions.

With multiple cores, executives will also have to understand and face competition in more than one market. Amazon is now a competitor in the food retail space through the acquisition of Whole Foods, and a competitor in the content streaming space through its Amazon Prime service.

That's okay, and is the way it should be. You just need to think about it as the new way of doing business and becoming a long-lasting organization.

Finally, the same dynamics imply that you must embrace disruptions as a necessary part of the game.

New products will come and go now faster than ever. Some will make it and others won't. Those that do may just end the business of the companies that once were the incumbents, and then become the new incumbents. Disruptors become disruptees and so on.

Disruptions are like thunder and lightning in a storm. They may come and go really fast, and some will cause damage.

The good news is that you don't need to have the best systems in place to predict disruptions, but just the right mindset to make the tough decisions when the time comes.

For those who understand the game and embrace it for what it is, not for what they wish it was, I wrote this book.

Now let's get down to business.

Understanding Profits

2

Cystic Fibrosis is a genetic disorder caused by genetic mutations that affect a protein called the *ion channel* which operates at the cellular level to move salt and moisture around the body. When these channels get "broken" by these mutations, salt and moisture can't be efficiently distributed throughout the body and thick mucus accumulates in the lungs, pancreas and intestines, affecting breathing and digestion.

It is estimated that around 30,000 people in the US are affected by some kind of CF, as the disease is usually referred to, and between 4 and 5 percent of them (around 1,200 people) are affected by a specific mutation called *G551D*. In those patients, although the proteins are actually present, they are "turned off".

In 2012, the US Food and Drug Administration (FDA) issued approval of *Kalydeco*, a new drug manufactured by Boston-based Vertex Pharmaceuticals, which treats the underlying cause of the condition in those affected by the G551D mutation. Simply put, Kalydeco "turns on" the channels that deliver salt and moisture.

The drug, which cost over $6 billion to develop, is provided to patients at a price of $311,000 per year, and the company offers a less effective product called *Orkambi* that sells at $272,000 per patient per year.

Since patients will be taking the drug for the rest of their lives, it costs millions of dollars to keep them on Kalydeco,

In this chapter we will:

- Explore the relationship between value, profit, and cash
- Explain the concept of a Value Proposition
- Discuss a business's Value Chain
- Understand a company's business model
- Discuss the external factors that limit profitability
- Explore Porter's five tests of a good strategy

but despite the exorbitant price, patients love it. "*I still pinch myself everyday… I can take deep breaths. I can run without coughing,*" said patient Emily Schaller, a user of the drug, to the New York Times.

While the target population for Kalydeco is pretty small (a bit over 1,000 people in the US), the company is still able to make profits from it and their stock has soared more than 300 percent over the last five years. Its customers love the product and since they pay for it through health insurance they don't really care about how expensive it is.

Mark Sleeper, another patient, told Forbes *"I hate that it's expensive, because it makes it hard for people to get… but I kind of get it, because if they make money, they make better drugs. As someone who has CF, I see it both ways."*

A high-margin business helps compensate for a narrow customer segment. Legal advice, design firms and dental practices are all well known for yielding high margins. They are highly-skilled practices that are difficult to replicate which allows them to co-exist with other practices that target other customer segments or different geographies.

In contrast, low-margin businesses, retail for example, need to handle large volumes of demand and move inventory quickly in order to make a healthy profit.

When retailers like Walmart and Kmart entered the market in the late 1960s, they were able to make profits at gross margins of about 23 percent, a lame cut compared to the 40 percent that fully-staffed department stores were making at the time.

However, Walmart and Kmart were able to get higher *returns* on their investment by implementing a business model that allowed them to turn over their inventory more than five times a year, contrasted to only three times a year for large department stores and catalog retailers like Macy's and Sears.

The discount retailers' strategy was based on carrying low-margin items such as hardware, kitchenware, toys and sporting goods in barely-staffed stores. Because buyers of those items already knew what they were looking for, the companies could save a lot in staff costs and achieve higher turnover of inventory.

It is not that Walmart and the other retailers were less profitable than the department stores and catalog retailers, but instead their business models enabled them to make money at lower profit "per unit". In other words, they were more "profitable" while having lower margins, and that's how those upcoming players later came to dominate the retail space and became the new incumbents.

Understanding profitability and how its underlying mechanisms work is critical for strategy, because in the end, *superior profitability*, not market share nor margins or killing your competition, should be the final goal of your strategy.

In this chapter we introduce important concepts that form the building blocks of modern strategy. Because strategy serves as a common language for an organization, it is important that we get these definitions right. We cover basic concepts like *Customer Value*, *Willingness to Buy*, *Value Propositions*, *Value Networks*, *Value Chains*, *Economies of Scale* and *Learning Curves,* and explore fundamental tools including Michael Porter's Five Forces model, *Environmental Analysis* and *Scenario Planning*. Finally, we wrap the chapter with a few reflections about what makes a good strategy.

LEARN MORE: Get free access to the different tools explained in this book, along with videos and other resources, at strategyforexecs.com/resources.

How profits are created

The profit equation only has three variables: price, volume and costs. Price times volume produces revenues, and revenues minus costs produce profits.

That means that to increase profits all you need to do is to increase sales (either by increasing prices or driving more demand), reduce costs, or achieve some combination of the two.

That seems like a very simplistic definition, but the underlying implications of these relationships go well beyond that formula since profits, as we will see, connect to everything a company does.

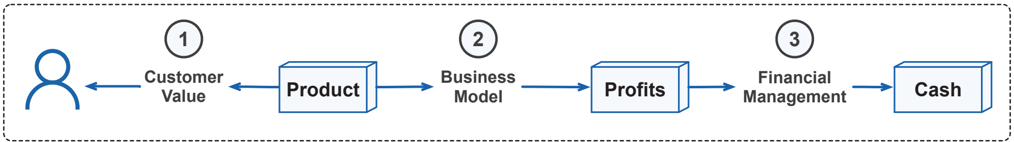
For example revenues, through sales, connect a company's products and services with its customers, its distribution channels and its sales force, while costs on the other hand interface a company's offering with its operations and supply chain.

The way you create wealth for a company is by maintaining a healthy balance between revenues and costs over time.

In general, the wealth-creation cycle happens in three steps. First, you sell products and services that create *Value* for customers. Second, you retain a piece of that value in the form of *Profits*, and third, you transform those profits into *Cash*, which, as we saw earlier, is the ultimate goal of strategy.

With this cycle in mind, you could define profitability then as a measure of the *wealth* that a company gets to keep for itself from the creation of value for customers.

That wealth, however, must later be converted into cash, which is the final prize. It is hard cash, not profits, that you can use to pay bills, grow the company and pay earnings to shareholders, therefore cash, not profit, is the ultimate goal of strategy.



The wealth cycle starts by creating "Value" for customers. From selling value to customers we capture "profits" that are later converted into "cash". Because cash, as we saw before, not profits, is the ultimate goal of strategy

The role of strategy, therefore, is in providing a plan that helps a company retain as much value as possible in the form of "cash", provided that such a plan is sustainable over the long term.

The profitability that a company is able to achieve in any given market will be restricted or "constrained" in some way by the influence of different factors that work inside and outside the organization, including:

1. **Business choices about product design:** Decisions about the features and benefits that your products and services offer, and how well those align with the identified needs of your target customers. Since you are only able to capture a fraction of the value created, the more value your products create for customers the more you can target to keep for yourself.

2. **Structural factors in our core markets:** The relative power of the players in the markets where your products and services are sold defines to some extent how the value that you create must be *shared* with those other players. If you are a powerful incumbent, you get to keep a bigger share of the value you create; if not, better positioned players will command a bigger piece of the action. More on that later.

3. **Structural factors in adjacent markets:** Similarly, the nature of adjacent markets or industries where your competitors, customers, vendors, substitute products and complementary offers operate influences their power to claim a bigger share of your product's core market. Vendors that are powerful in their industry, for example, can make you pay more for their products, taking a bigger bite of your profits.

4. **Official regulation:** Regulators, in the form of government, lawmakers and others, can limit the profitability of an industry through laws, taxation and incentives. Mature industries will naturally have the most established regulation frameworks, but in emerging ones regulation will be weak or even lacking, presenting an opportunity for savvy executives to be part of how that regulation is shaped.

5. **Non-market factors and trends:** Factors outside the market itself such as prevailing industry standards (or lack thereof), state of technological development, labor and unions, predominant working style and cultural norms may influence how value, and in turn profit, is created. Similarly, observable trends and industry evolution might also affect the potential profits in the foreseeable future.

Each of these factors can affect your ability to claim a bigger share of the value you create for your customers, and your strategy is in a way your response to your understanding of those factors, which means you should really understand them very well before you can come up with a winning strategy.

It is your job as a business leader to understand how these factors are having an influence on your company's performance. You may have the best strategy and still get poor results if your market sucks, in the same way that you could get great results with a poor strategy in a thriving market.

But at any given time, you should be able to say what is driving unusual performance of the market. Is it because of a market trend? Competitors behaving more or less aggressively? Regulators tightening or loosening things up? Or is it because the market is growing too fast or too slow?

Common misconceptions about profits and profitability

Before we move on, it is important that we clarify a few misconceptions about critical concepts when it comes to strategy and profits.

Market share and sales DO NOT guarantee profits: Increasing sales and market share doesn't automatically mean higher profits. Any company could increase sales significantly by pricing products and services below cost (losing money of course). Sales and market share only provide an indication of *revenues*, but revenues alone don't make profits, as they don't take into account the *costs* associated with those sales.

Being bigger doesn't guarantee profits: Another misconception is that being bigger than everybody else, because of the economies of scale you create, is how you beat competitors. Jack Welch's words "*Either be number 1 or number 2 in your industry, or get out!*", helped perpetuate that belief, but most people misuse his idea. In reality, scale alone cannot ensure higher profits. Economies of scale do exist and are very important, but as we will see later in this chapter, they dissipate fairly quick in many industries, and once that happens they no longer provide a competitive edge.

Beating competitors doesn't guarantee profits: Kicking rivals out of business will not ensure higher profits unless you beat ALL your competitors out of the market. Being unique and achieving superior returns should be your goal, but beating rivals is not a strategy.

Innovation doesn't guarantee profits: Innovation is expensive, difficult and can't ensure your products will be overnight hits. In fact, as we will explain in Chapter 6, most innovation attempts fail by big numbers. Betting too big on innovation could actually drag a company down as it did to many whose names you can't even remember.

How value drives strategy

For the purposes of this book, we define *Value* as a measure of all of the benefits (tangible and intangible) that a customer receives from a product or service.

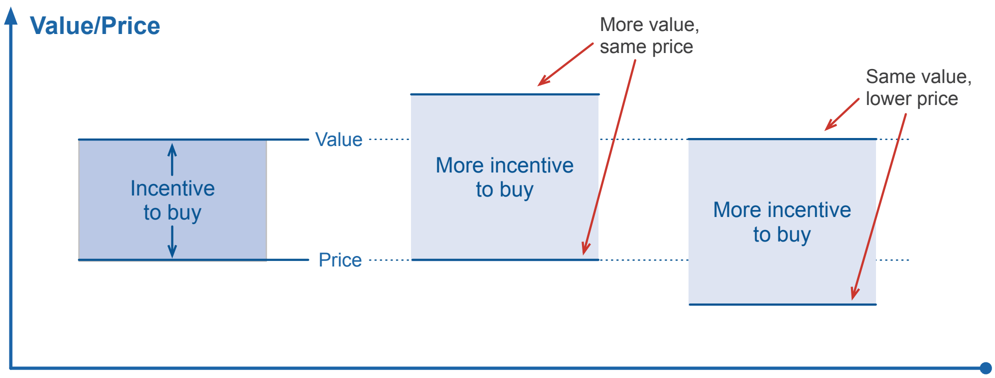
With this definition, we imply that the value for customers doesn't change when we raise or lower prices, but what changes instead is the customer's *willingness* (i.e. incentive) to buy the product.

Our theory here, which may differ from conventional models, is that when we lower prices customers still get the same benefits from the product; however, they will be more inclined to buy because the value they get back for every dollar spent is higher.

When making buying decisions, customers compare their *incentive to buy* (i.e. the difference between the perceived value of the offer and its price) across the different alternatives under consideration.

These alternatives, however, may or may not belong to the same marketplace. For example, if taking a short trip, customers may be evaluating whether to rent a car or take a cheap flight.

At the end, all this means that the only two ways you have to influence customers' incentive to buy your products are by increasing their perceived value, lowering their price, or some combination of the two.



Another distinction to be made here is that benefits and value, although related, are not the same thing. A Porsche 918 Spyder, for example, accelerates from 0 to 60 miles an hour in a little bit over 2 seconds. That is a fact and a tangible benefit, but its "value" is different for an 18-year-old single college student than it is for a middle-class, 40-year-old female accountant with four kids.

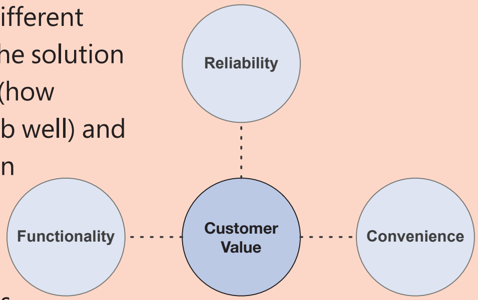
While the quick acceleration of the Porsche will be appreciated (and noted) by the accountant, it is probably not an important feature for her, and she probably values the space and safety of a minivan more.

For those reasons, *value* is therefore a relative term and depends on who is on the receiving end of the product's benefits, and the alternative solutions that are available to the buyers. That's why we sometimes refer to it as *perceived* value.

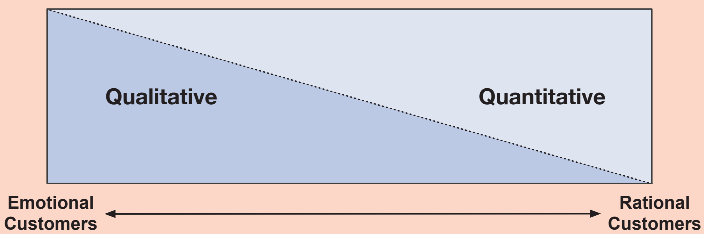
In other words, while *benefits* refer to what a solution offers to potential customers, *value* is what they pay for, and no one could have put it better than the late Peter Drucker when he said that "*Customers rarely buy what the company thinks it's selling*".

Other Facts about Value

Customer Value is created along three different dimensions: *Functionality* (the job that the solution does and how well it does it), *Reliability* (how consistent the solution is at doing the job well) and *Convenience* (how accessible the solution is to customers and how easy it is to use).



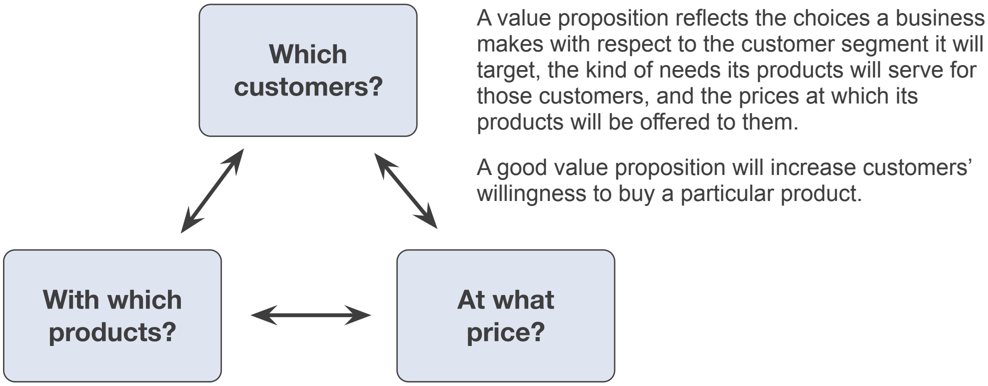
Sophisticated buyers, like those found in business-to-business (B2B) transactions, will tend to pay more attention to quantitative factors such as price-cost benefits, performance and efficiency, while more emotional customers, like those for consumer products, will pay more attention to features that are more difficult to measure quantitatively such as brand, form factor and color.



The business's value proposition

From the discussion above about value, we can make a clear conclusion: companies have three levers to act upon when trying to influence customers' willingness to buy their products. They can choose the customer segments they will target, the needs they will offer to serve for those customers (i.e. through the design of their products and the benefits they offer), and the price at which their products will be offered to those customers.

The decisions you make with respect to that triad of factors (customers, products and price) form the *Value Proposition* of the business for that particular customer segment.



A value proposition has three components: customer, product (benefits and features) and price. Together, they influence your customer's willingness to buy your products

The goal of a value proposition, consequently, is to create a "perception" of value in the minds of your target consumers which influences how much they will be willing to pay to get the benefits of your products.

Because *value* is a relative term, you can see how a single product can have multiple value propositions based on the type of customers it is being promoted to. For example, you may promote solar energy to global-warming activists as a way to reduce global emissions, and then offer the same energy to homeowners as a way to reduce their electric bill. Same product, different customer value propositions.

The old ways

Many classic business frameworks define a Value Proposition as some kind of *statement* outlining the benefits of the product. Things like "*Get whiter teeth*", or "*Faster downloads*".

In reality, that's a simplified definition that doesn't really exploit the value that a more serious effort could have for strategy.

In my view, a good value proposition must be the result of thorough research to "prove" the superior benefits of a solution with respect to its competing alternatives in measurable (e.g. monetary) terms.

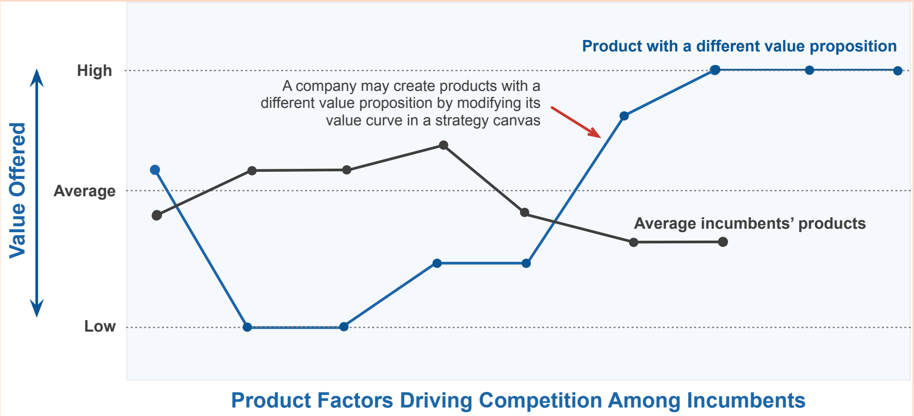
You then use the results of that research to make strategic decisions about product development, marketing and sales (i.e. the product's value proposition for its different customer segments), and from that information you can also create *messaging campaigns* and a series of brand positioning statements to use in marketing and promotion.

But the value proposition itself must be an *internal* appreciation of the company's approach to a particular market, which evaluates consumer choices and proposes a marketing strategy to make customers buy, and for that reason it is not something to be shared with the external world.

To learn more about this approach to value propositions, I recommend *Value Merchants: Demonstrating and Documenting Superior Value in Business Markets* by James C. Anderson, Nirmalya Kumar and James A. Narus.

As you work on your Value Proposition, it can be useful to see how the solutions you propose compare to others available to the same customers. A great tool to do that visually is the Strategy Canvas, a tool introduced by W. Chan Kim and Renée Mauborgne in their book *Blue Ocean Strategy*.

A Strategy Canvas plots the *product* factors that a sample of incumbent products compete on, and the value that a particular customer segment receives from them, in a two-dimensional chart.



The strategy canvas is a great tool to explore changes to a product's value proposition

The idea behind comparing solutions against each other is to identify factors on which the incumbents are competing and brainstorm ideas for products with a different value proposition.

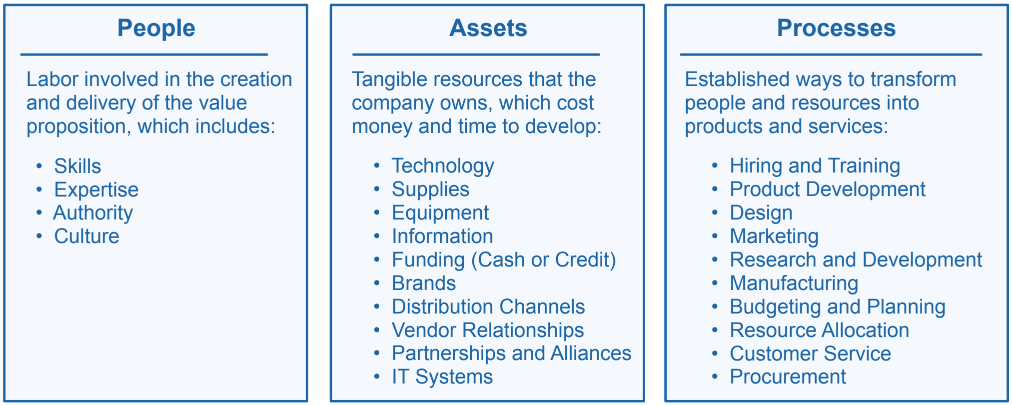
We'll revisit this in Chapter 7 as we brainstorm ways to create differentiated products.

LEARN MORE ABOUT THE STRATEGY CANVAS: To learn about how to create and use a Strategy Canvas, with real-life examples and a downloadable template, visit strategyforexecs.com/canvas.

The business's value chain

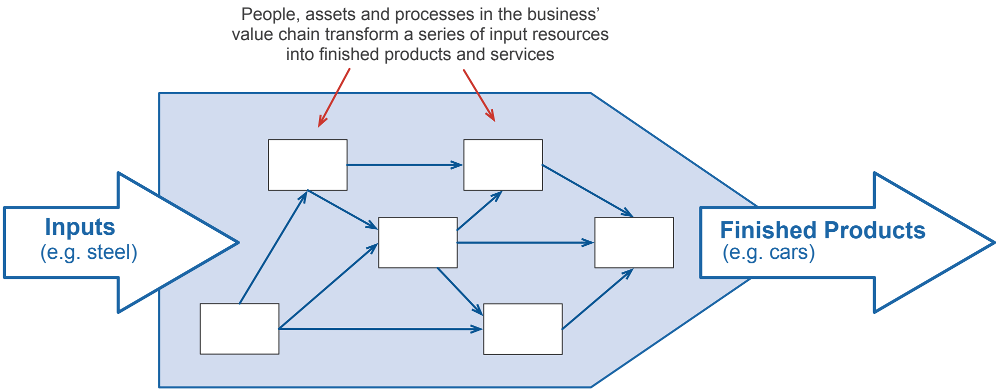
While a *Value Proposition* explains the benefits that a particular set of customers receive from a product or service, the *Value Chain* represents the activities involved in creating that value proposition.

A business's value chain describes the activities, resources and business functions involved in the creation and delivery of your company's offering, usually grouping them into three major categories: *People*, *Assets* and *Processes*.



A business's value chain integrates all the company's resources involved in delivering a value proposition including people, assets and processes

Every business has a value chain, represented by how it takes inputs from external sources (e.g. steel) and converts them into final products (e.g. cars), adding value to them as they move through the process.



A business's value chain transforms input resources into final products and services

There are multiple ways to make a product and deliver a value proposition, and in deciding how to do it, a company engages in a series of tradeoffs of important strategic implications.

For example, selecting a cutting-edge manufacturing technology may increase efficiency and reduce labor needs, but it could come at a higher cost and bear a higher risk of obsolescence or unused capacity if the product doesn't sell as expected.

These decisions may compromise your company's ability to execute its strategy and the flexibility your business will have to change direction in response to changing environments.

Some components of a value chain can support more than one line of products at a time. Amazon's huge cloud of data servers scattered around the world, for example, support the company's eCommerce platform and its Amazon Web Services (AWS) divisions at the same time.

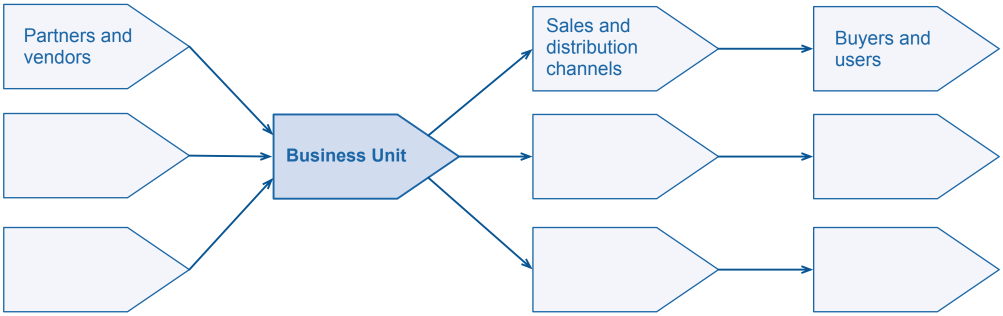
Similarly, in a dynamic context, as companies try to build more than one core business, some may find themselves operating two very different, even competing, value chains at once.

Netflix, for example, built its streaming platform while its DVD business was still at its peak. At some point they saw streaming as the future of their business and went ahead and built a powerful streaming value chain ahead of everybody else, developing the capabilities and strengths they needed to thrive in that future environment.

Content streaming has now put the final nail in the coffin of the traditional movie rental business, one that Netflix can now safely leave behind if needed.

A closer look at value chains reveals how the inputs of one are the outputs of another. For example, the steel that's an input into a car manufacturing operation is the product, or the *output*, of a steel manufacturing value chain.

Taking a broader view, we can see how an entire industry is no more than a huge concatenation of value chains, working as a self-contained network of businesses transacting with each other.



An industry is a large network of value chains transacting with each other, and each incumbent must decide where to "sit" within it

Within this network, incumbents must decide which parts of what they do will be done in-house and which ones will be outsourced to other value chains, and it is from those decisions that an *operations strategy* is created and a value chain emerges. They are the result of making choices about what the company will and will not do.

These *make-or-buy* decisions have deep implications for strategy. To start, outsourcing a critical task to an unreliable third party can put your entire operation at risk down the road if, let's say, a vendor struggles financially or goes out of business.

Apple, for example, decided to negotiate for cobalt, a mineral critical for its batteries, directly with the miners, to ensure that its battery manufacturing partners can get access to the scarce material at competitive prices.

While Apple has deliberately decided to stay out of the battery manufacturing business (a decision about what it will NOT do), it is protecting itself from ending up with vendors that become unreliable for not having the scale to negotiate good deals with the miners, who are also signing juicy deals with the likes of BMW, Volkswagen and Samsung SDI for the construction of electric vehicles.

Second, the way you configure your value chain (i.e. your people, assets and processes) to deliver a particular value proposition determines how easy it will be for other companies to imitate the products and services that your value chain produces.

Put simply, any company trying to copy your products and services would need to replicate your company's value chain, meaning that the more unique and "aged" your value chain is, the more difficult it would be to copy your products and services.

That's how a value chain can help avoid competition and keep copycats at bay, and that's why for a market position to be both profitable *and* sustainable, it needs to be supported by a *distinctive*, hence difficult to copy, value chain.

Finally, there's a clear distinction between a value chain that is *distinctive*, and one that is *efficient*, or what Professor Michael Porter describes as *Operational Effectiveness*.

A distinctive value chain refers to a number of activities and functions that are particularly needed to create a product's value proposition which work together in a way that is different from what others are doing and difficult to replicate.

Operational effectiveness, on the other hand, refers to best practices that continually improve business processes and reduce costs. The key difference is that unlike a distinctive value chain which is unique to an organization, anyone can reproduce operational improvements and best practices.

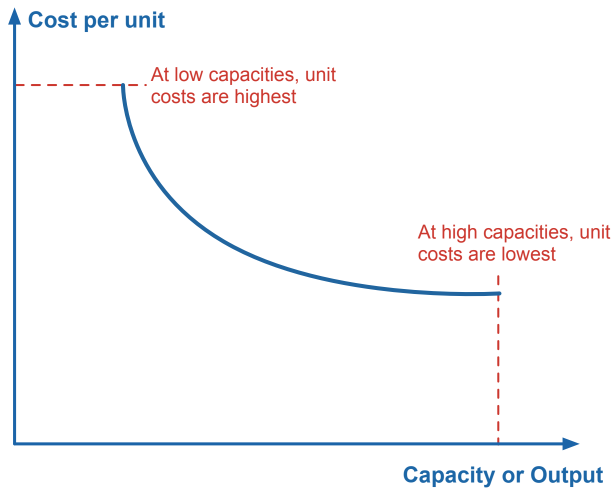
While operational effectiveness is necessary to stay in business, it is not enough to produce sustainable differentiation. We cover operational effectiveness and other areas of operations in more detail in Chapter 5.

Economies of scale and learning curves

Two characteristics of a value chain that are fundamental to understanding a company's ability to compete with others serving the same segment are *Economies of Scale* and *Learning Curves*. Let's review them briefly before we move on to more advanced concepts.

The economies of scale of a value chain, or the *Experience Curve* as more traditional thinkers call them, explain how costs *per unit* reduce with an increase in production. For example, economies of scale enable a large drill manufacturer to produce drills at a cost per unit lower than a small manufacturer.

In short, we say that if your cost per unit decreases as your demand increases, then economies of scale exist in that process. If, on the other hand, your cost per unit goes up with a production increase then *diseconomies of scale* are taking place.



Typical cost behavior in a value chain with economies of scale

Economies of scale are more significant in processes with a large portion of fixed costs, which may include capital investments and marketing among others. As the production of a process or operation increases, its fixed costs, which the company has to incur anyway, are spread across a larger output volume, hence reducing the final costs of running the operation for each unit produced.

Larger operations can also negotiate better pricing terms with vendors, helping reduce the final cost of each unit even more.

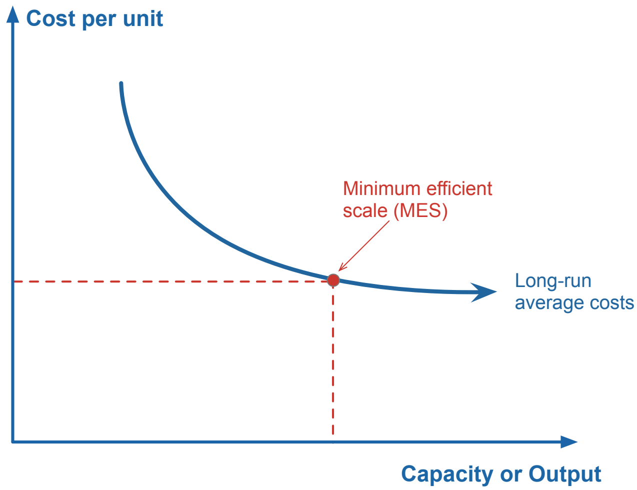
One important component of economies of scale is the *Learning Curve*, which explains how a more experienced value chain can produce lower costs over time. Learning curves exist because as individuals and teams repeatedly perform the same tasks their efficiency at them increases, reducing the time and cost of executing those tasks.

Learning curves, therefore, may produce significant advantages in processes with a high content of repetitive tasks like those found in some manufacturing operations, and in some software applications where data is used to learn patterns.

For example, in machine learning applications where algorithms must be trained with data to do their job, larger data sets can help "age" the value chain faster, reaping the benefits of learning curves sooner. We cover data analytics and machine learning applications in more detail in Chapter 6.

Economies of scale and learning curves exist in almost every industry, but they don't grow indefinitely. In fact, in many operations they may dissipate quite rapidly. In the end, there's only so much advantage that scale and experience can add, especially in a market with a number of equally-sized companies who relentlessly re-evaluate the optimal sizing and efficiency of their operations.

It is usually said that there is a *minimum efficient scale*, or MES, in every industry that a company has to achieve to get most of the benefits of economies of scale and operate competitively. Conceptually, economies of scale slow down above the MES, improving only slightly with the addition of new capacity.



Above the MES, economies of scale will only improve slightly

Because of its direct relation to size and to the level of investment that's needed to be competitive, the minimum efficient scale affects the number of players in an industry. If the MES is low, as in retail or fast-food for example, the industry will tend to be fragmented with a large number of participants. If the MES is high as in, let's say, the oil industry, the number of players will be low.

The nature of the economies of scale and the MES in a particular industry can have important implications in the strategic decisions its incumbents make.

When electric vehicle (EV) maker Tesla Motors (NASDAQ: TSLA) decided to manufacture its own lithium-ion batteries, it faced an industry of massive MES. To target mass markets, Tesla had to make EV models in the $30-40,000 range and the only way to do this was by reducing its battery costs 30 percent, but to achieve such dramatic cost reduction, they needed to build a gigantic battery factory with enough capacity to serve half a million EVs a year, ten times the number of cars the company was making at the time.

This required a massive sales and manufacturing commitment from Tesla. It had to go from being a boutique car maker to becoming a mainstream player. Tesla partnered up with one of its vendors, Panasonic, to build the $5 billion facility in Nevada which came to be called the *Gigafactory*, which we cover in more detail in Chapter 5.

Another way to use economies of scale is to "forward-price" your products and services. That is, setting your prices based on the target capacity that your value chain *will have* in the future, rather than on the actual costs at the moment. With that, you seek to accelerate demand and get ahead of competition.

Finally, although they are not the norm, *diseconomies* of scale are also very frequent, and are usually found in operations that grow larger than management is able to handle. In this case, inefficiencies created by inexperienced or unprepared executives managing a more complex, larger operation, will tend to increase the costs per unit of the entire operation.

Of course, both economies of scale and learning curves are characteristics of a value chain that someone trying to copy a business's products and services would have to replicate in some way. More about that subject later in this chapter.

Be practical

When analyzing an industry, you can quickly get a sense of its economies of scale and MES by asking three basic questions:

1. How big is the *smallest* profitable player in the industry?
2. How big is the *largest* profitable player?
3. What's the difference in the production costs *per unit* between the two?

This information can usually be obtained from the financial statements of public companies.

Value networks

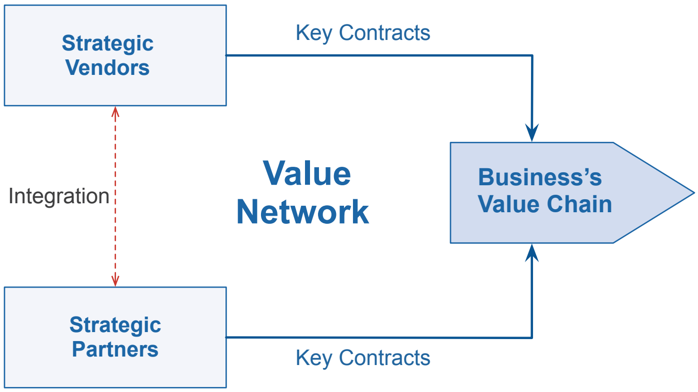
Outsourcing some of the activities and resources needed to produce a particular value proposition does not make those activities less important. In fact, in a well-optimized business operation each piece of the process, either produced internally or sourced to third parties, is assumed to play a critical role (otherwise it would have been cut out already).

The concept that best captures the way a company's value chain interacts with external companies in the creation of the business's offerings in a synchronized fashion is the

Value Network, an idea introduced by Harvard professor Clayton Christensen in his seminal book *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail*.

Christensen defines a value network as a "*collection of upstream suppliers, downstream channels to market, and ancillary providers that support a common business model within an industry*".

In other words, a value network is a kind of "ecosystem" of companies which has been optimized to support a particular value proposition.



A value network describes how a company's value chain interacts with its partners and vendors to satisfy the needs of a particular market

The idea of an optimized ecosystem implies that the members of a value network are bound in some way by clear agreements and understandings (usually in the form of contractual terms), based on each party's interest, which enable co-ordinated collaboration among them.

One of your goals as an executive of your organization is to create businesses that are supported by well-optimized value networks since, in the end, the final product our customers receive is the result of the work of the network, not just the business's value chain.

Just like any other business relationship, the optimization of a value network requires considerations of a strategic nature since the performance and long-term sustainability of your business could depend on how these networks are structured.

Giving third parties too much control of functions or supplies that could become critical to competing in the future could put you in a difficult situation later on, since that third party will use their bargaining power to reduce your company's potential profits.

An ideal situation is one where you secure access to key supplies and services without making unbreakable commitments that would prevent you from making a quick transition towards a new value chain architecture if needed.

The business's business model

A business model is a description of how your business makes money within a given market, through a particular product or service.

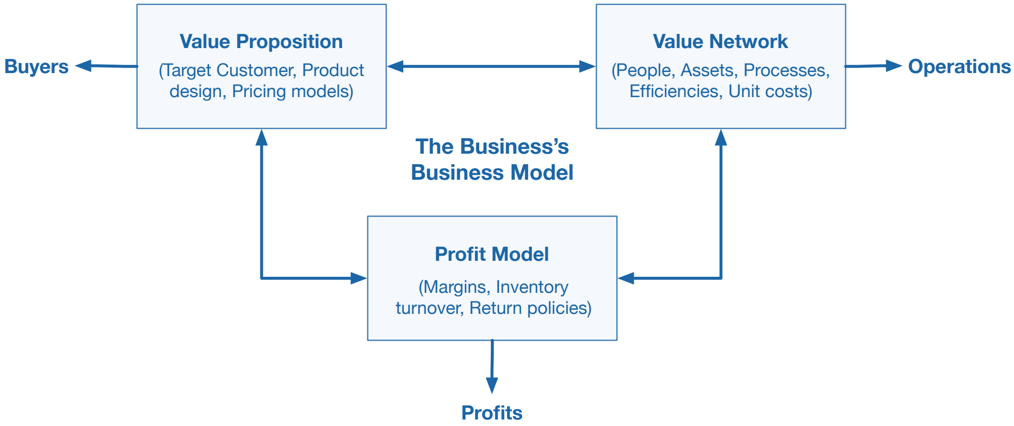
At a deeper level, a business model is just a "theory" of how your company transforms (or plans to transform) customer value into *profits*, interlinking your value proposition, value network and profit model.

The classic example of a company's business model is Gillette's razor and blade. Under this model, Gillette offers a razor handle at no margin but makes its money from selling the disposable razor blades that are needed to use the handle.

A business model results from asking questions about the type of value that your products will offer (its value proposition), how that value will be created (its value chain) and how your company will retain a piece of that value for itself (its profit model). For example:

- Who are the target customers?
- What buyer needs will the product offer to serve?
- At what price or pricing models will the product be available to the chosen buyers?
- What other pricing alternatives are available to the selected target customers?
- What are the purchase terms?
- What kind of assets, people and processes do we need in-house to deliver this value proposition?
- What partnerships and supply agreements do we need to deliver this value proposition?
- What is the cost of delivering this value proposition?

A company's business model interacts with the business's customer base on the one side and with its operations on the other, becoming the linchpin that delineates how profits are created.



When we talk about pricing, we are referring to more than just a tag with a number. What we really mean is different ways in which customers could afford a particular product.

For example, a few years ago Rolls-Royce launched a program for its jet engine products called TotalCare where customers would pay for every hour of *uptime* delivered by the engines, rather than paying an upfront fee. Rolls-Royce collects extensive operational data and performs proactive maintenance on the units to maximize uptime and minimize disruptions.

Through this program, Rolls-Royce expanded its business model to accommodate the needs of a segment of customers that could not afford hefty acquisition fees, but that can manage reasonable *operational* costs.

The program was a big success, helping Rolls-Royce increase its bottom line from a market that would be otherwise buying from other vendors.

Membership options, all-you-can-use, take-or-pay, freemium (a free basic version to promote a paid upgrade) and a no-question return policy are all forms of pricing that seek to accommodate your company's offering to the particular needs of a number of customer segments.

Disciplined experimentation in this area can help you uncover latent sources of demand that may exist in your market. We discuss different ways to optimize revenues in Chapter 6.

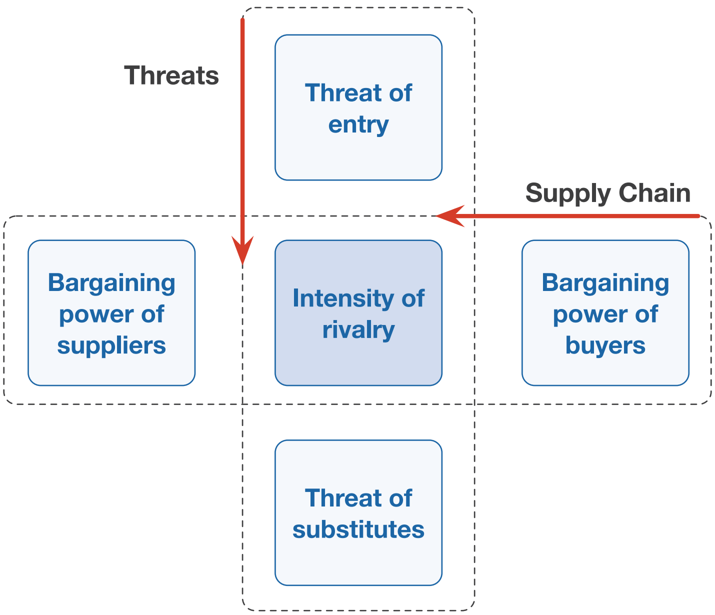
Forces limiting profitability

In any market, there are fundamental interactions at play that drive supply and demand: between buyers and sellers, between competing products and between companies targeting the same customers.

The dynamics at play in these interactions sometimes get in the way of an effective conversion of the value created by a company into profits.

Harvard Business School's Professor Michael E. Porter, through his Harvard Business Review article *How Competitive Forces Shape Strategy* published in March 1979, and his books *Competitive Strategy* and *Competitive Advantage*, provided a robust framework to understand the fundamental forces that affect the ability of an organization to produce and protect its profitability within a given industry.

Porter identified the bargaining power of buyers and suppliers, the threat of new entrants and substitute products and the rivalry among competitors, as the five *Forces* that prescribe how profits will be distributed among the players of an industry.



Michael Porter's Five Forces framework provides a model to understand the profitability of an industry, based on the relative strengths of these forces

In short, Porter's model establishes that the stronger these forces are, the more they can limit the profits a business can make in an industry.

If you look deeper, you realize that Porter's five forces are in essence a categorization of the different types of "competition" that a company could face within a given market. In other words, the forces are the five categories of companies that will try to compete with you for the same "profits", so based on how well positioned your company is to retain a bigger share of the interaction with these companies your profitability can be predicted.

Powerful buyers, for example, will try to use their power to pay less for products, while powerful vendors will try to get paid more for theirs, so in essence, the five forces model describes a power play where industry participants compete with each other to claim a bigger piece of the pie, and each player's success depends on how well it is positioned in its respective industry.

The model also explains how products coming from different industries, specifically substitutes and complements, can also influence the ability of a company to claim a piece of the value the industry creates.

Substitute products, for example, i.e. products of a different nature that offer the same benefit and functionality, set a limit on the prices that an industry can charge for its products. The rates that ride-sharing services like Uber and Lyft charge, for example, put a cap on the prices that conventional taxis can charge for services. If taxi services are priced too high, more people will switch over to ride-sharing alternatives, and vice versa.

In a similar tune, the "threat" that powerful outsiders could enter the industry if it looks too profitable from the outside limits the profitability of the incumbents who will be happy to invest in creating barriers to block or deter the entry of such players.[4]

The five forces described in Porter's framework are present in any industry since they result from predictable choices its players make to maximize profits.

A subtler observation, however, is that those forces are actually interacting with our industry in response to what is happening in *their* respective markets. Vendors, for example, are competing with other companies in their own market, and their interaction with our industry is influenced by the five forces acting on *their* industry.

A price war or lack of differentiation in your vendors' industry will be reflected as lower costs in yours, and will give you more bargaining power when negotiating with them. Similarly, if some of your customers are competing with other companies on the quality or performance of their products, you may be able to charge them higher prices in exchange for features that can help them compete along those dimensions.

The same forces that are at play in your markets are also acting, although in different proportions, in the forces' markets. Understanding this context can help you position your businesses better and take advantage of opportunities that may arise as conditions in those adjacent markets change.

In fast-paced industries, you may (and probably should) narrow the scope of the five forces analysis to understand the profitability of a particular *market* within an industry, or a particular *opportunity* within a market.

For example, within the automobile industry, Kia and Porsche serve different *markets*, and in serving each they will face a different set of forces, therefore executives can use the model to understand the behavior of the players and the profitability within that particular *market*.

How government and regulators limit profitability

Government, through its multiple institutions, will naturally try to regulate the behavior of the players in an industry, limiting the profitability that companies in those markets can achieve by increasing the costs of doing business as an incumbent.

In healthcare, for example, regulators require lengthy and very expensive procedures that every drug must go through before it can be accepted for human use, which can take years and billions of dollars to materialize. Government also oversees incumbent behavior to prevent monopoly-like conditions where a single player could become too powerful.

Import duties, permits, certifications, tax incentives and price controls are just a few of the tools that government has at its disposal to influence players' behavior.

It is important that you understand how regulators and elected officials could limit incumbents' profitability now, and how regulatory and environmental trends may drive changes in the future, not only in your core industry but also in those where your buyers, vendors and partners participate.

As we saw in the industry life cycle, nascent markets are notable for a lack of regulation in their early days. As a business leader, you must take advantage to educate government officials and other stakeholders and *shape* regulation in a way that favors the development of your industry.

Uber, for example, has become a lobbying powerhouse around the globe, and one of its main efforts is to avoid official requirements to treat drivers as employees, instead of what it calls "associates".

Rather than waiting for the government to learn and create rules on its own, Uber is working with officials to shape the regulation in a favorable way.

In Chapter 9 we discuss the management of important stakeholders (including government officials and regulators) in more detail.

Environmental factors and other trends

Most industries are influenced by a series of changing factors that can alter the dynamics of markets over time. An *Environmental Analysis* can help you understand how these factors can influence the long-term profitability of our businesses and the industry in general.

An environmental analysis seeks to evaluate how trends and high-level factors could affect the potential for profits within a given industry by tracking their influence on regulation, industry structure or in the ability to differentiate products.

Trends, as we use the term here, are factors that move in a well-known direction. For example, we all know that computing power in smartphones is increasing, that consumers are increasingly more interested in electric vehicles, that tobacco sales are shrinking and that renewable energy is getting cheaper. All of those are trends where we know clearly where they are heading.

While you may not be able to quantify the influence that a particular trend will have on a market, you can clearly see its direction. You can see whether it is going up, down or if it has stalled.

While Porter's five forces analysis offers a snapshot of a market at a given point in time, an environmental analysis on the other hand cares more about the *direction* of the forces – where consumption habits, customer preferences and regulation among other factors are heading, and how they will influence our margins over time.

Professors Michael Lenox and Jared Harris of the Darden School of Business at the University of Virginia classify the factors that need to be included in an environmental analysis as:

1. **Demographic trends:** How the distribution of the consumer population is changing within an industry. This part analyzes the age distribution of each buyer group, how groups are segmented, and their geographic migration patterns among other factors.

2. **Sociocultural influences:** How the factors that affect consumer choices *at the social level* are evolving. For example, things like personal values, beliefs, behaviors and sexuality among others that affect how consumers want and do not want to be seen.

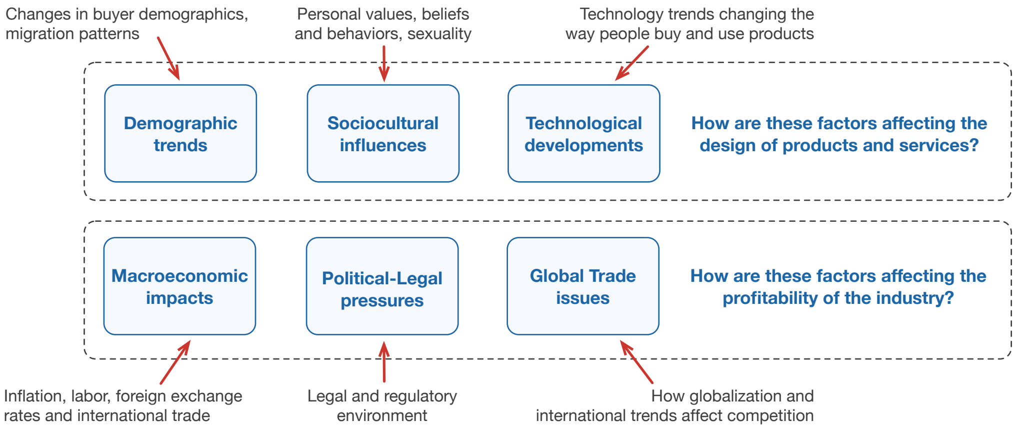
3. **Technological developments:** What are the technology trends that could affect how customers choose and buy products? What convergence of technologies is driving changes in customer behaviors in ways never seen before?

4. **Macroeconomic impacts:** How macroeconomic factors such as inflation, exchange rates, employment, international trade and others may have an impact on the margins of the industry.

5. **Political-legal pressures:** What's the state of the regulatory environment, and what are legal bodies and politicians thinking about how the industry should evolve and how it should be regulated?

6. **Global trade issues:** How globalization and international trends are affecting local competition and profitability.

Every industry is different and so is the relative influence that each factor has on the incumbents' businesses.



Factors that must be included in an environmental analysis

An environmental analysis may take some work, but it will provide you with the necessary context to help explain where things stand today, but more importantly where they may be tomorrow.

Scenario planning in strategy

While an environmental analysis seeks to understand how the direction of identifiable trends may affect a company's ability to profit in the future, there are, unavoidably, some "uncertainties" that no one can predict with accuracy. For example, things like the results of a presidential election, the content of new legislation, or the standards that an industry will adopt.

There's no way to predict the future, but as executives we still have to make decisions even if important factors are not well known.

To deal with these uncertainties and make better educated decisions, you can test the strategy through the lenses of different *scenarios,* based on the things that you DO know about the future, and the potential outcome of those uncertainties.

This technique is called *Scenario Planning* and is used to create alternative probable "futures" which we can use to test our strategy.

The technique has been around since the mid-1960s and is very popular in companies like Royal Dutch Shell and Microsoft among others.

In its simplest version, you would come up with a pair of uncertainties, and define two potential outcomes for each that could happen by the end of the period of evaluation, usually five, ten or fifteen years. When you cross the two variables against each other (each with two possible outcomes), it results in four different combinations.

These four combinations, along with the trends that you identified in your environmental analysis, each form a potential *scenario*, which is just a *probable* version of the future.

For example, let's say that as part of an environmental analysis you have some doubts about whether or not electric vehicles would get national approval to operate in self-driving mode within the next five years.

The penetration of electric vehicles (EV) in the US is advancing increasingly fast, and there's no doubt that these will become more and more popular over time. That makes EV penetration a *trend*, because you can accurately predict where it is going: up. However, getting national approval for driverless circulation in the next five years is an *uncertainty*, since no one can provide a definitive answer for it.

To complete the analysis, let's pick oil prices (whether they will be high or low) as your second *uncertainty*.

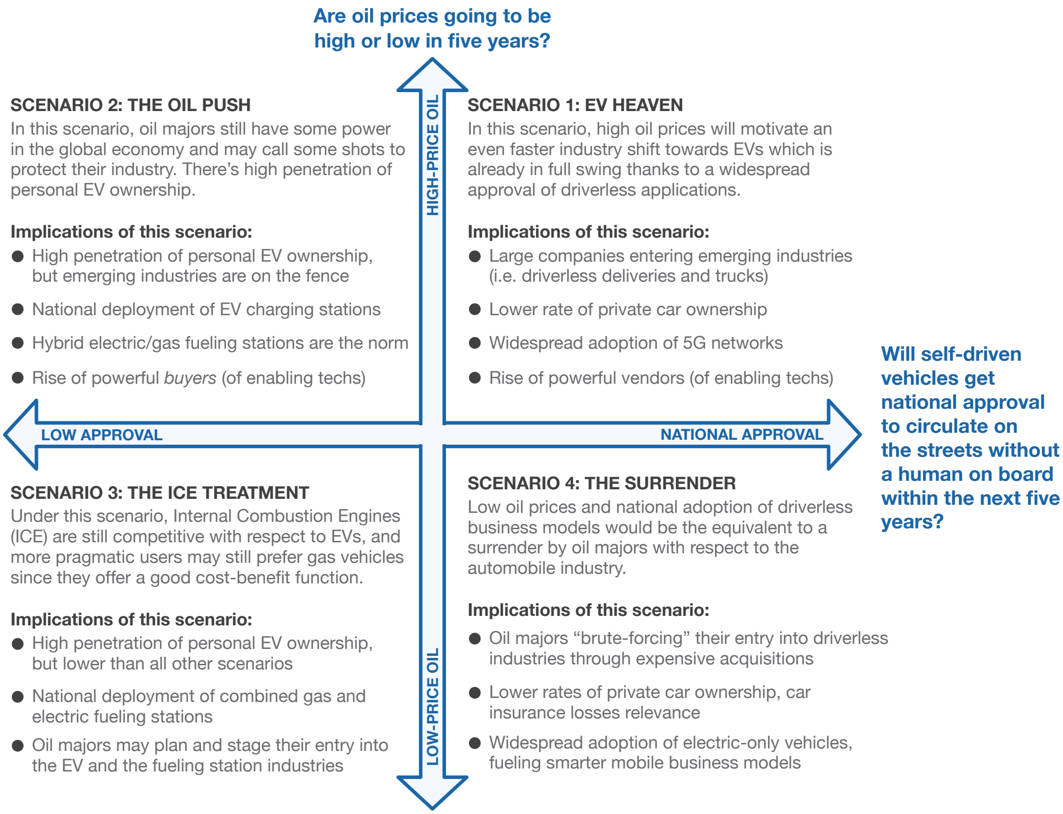
By crossing your two uncertainties against each other, you get four combinations of things that could happen by the end of the fifth year:

1. National approval with high oil prices,
2. National approval with low oil prices,
3. No national approval with high oil prices, and
4. No national approval with low oil prices.

The final step is to think about the *implications* of each of the combinations above and complement those with the future state of the *known* trends.

For example, if the EV industry gets national approval for driverless cars, *AND* oil prices are high (case 1 above), then you could assume that under that scenario the penetration of EV charging stations across the US will be extremely high, and that leading vendors of enabling technologies such as Lidar sensors and other vision equipment used in driverless navigation will become powerful.

Next, you follow the same process for each of the remaining combinations, and document each scenario based on the known information and the implications of the particular intersection of uncertainties.



Scenario planning matrix: Will EVs get official approval to operate in all states in "self-driving mode" within the next five years? What about oil prices, will they be high or low?

You can now use these scenarios to *test* your strategy against each and adjust your plans accordingly if needed. For example, from scenario 1 above, an EV manufacturer may conclude that they need to invest in a promising Lidar startup now to mitigate the negotiation power that vendors may have if that case materializes.

Scenario planning exercises can be highly complex and take months to complete, even years for companies in the oil and power industries. Because of this labor intensity, there are industries where the benefits don't justify the effort.

But in cases where an uncertainty could make or break the business, it can be a powerful tool to help you make good strategic decisions.

Five tests of a good strategy

As we wrap this chapter, I think it's a good idea to reflect on what makes a good strategy, based on our learning so far. First and foremost, we have made clear that a business strategy is about maximizing profits in a sustainable fashion, not about beating rivals, innovation or market share.

The success of capturing a market opportunity, as we learned, is in putting the right product in the hands of the right customers, and doing it in a way that is difficult to replicate.

We saw how a company must arrange the activities in its value chain to create products and services that enable an optimal relation between the company, its partners and customers, an idea best captured by the company's business model.

We also explored how understanding the industry and markets where your businesses operate is fundamental to maximizing profitability. While a company's value chain and its business models enable the creation of value, forces outside the organization can limit how much of that value your business gets to keep for itself.

Through his extensive research on competitive strategy, Professor Michael Porter came up with five tests to help identify a good strategy, which in my opinion have to some extent endured the test of time. According to Porter, a good strategy must have:

1. **A unique Value Proposition:** A good strategy is based on a clear understanding of how a company's solution delivers value for customers. As we saw, a good value proposition aligns customers, benefits and price in a way that delivers something unique and valuable for buyers.
2. **A distinctive Value Chain:** A value network (a concept of which the value chain is part) must be deliberately and specifically tailored to satisfy the needs of a particular customer segment. A Value Proposition that can be delivered without a distinctive value chain, Porter says, can be copied by anyone - thus it will not produce a *sustainable* advantage.

3. **Clear tradeoffs, and decisions about what NOT to do:** Strategy is fundamentally about deliberate choices, and these choices involve not doing things that others are doing, while doing some things that others aren't. BMW, for example, has decided not to make a cheap car, while Porsche has decided not to make a sedan. Choices about what not to do produce a remarkable distinction for products and provide focus to the business.

4. **A Value Chain where activities reinforce each other and fit together:** A Value Chain is a synergistic system where activities are linked together to produce a value proposition. Therefore, a value chain where people, processes and assets are arranged to work well together, and that is supported by selected good vendors and partners, will create more value for its members than a value chain that is too flexible or that is designed to accommodate a wide range of options.

   In a budget airline, for example, everything from the online booking system to the availability of only a few destinations, lack of fancy in-flight meals and off-peak schedules produces a tight value chain that is very difficult to copy.

5. **Continuity:** If you change your strategy every year, you will not have enough time to build a value chain that is difficult to copy. Remember how economies of scale and learning curves help *age* a company's value chain, but they need time to do that. The more consistent you are in the pursuit of your strategy, the stronger the links in your value chain will be, the deeper the business will go down its learning curve, and the harder it will be for other companies to copy it. Time, therefore, is the final ingredient that makes strategy happen.

We revisit these tests in Chapter 5. Now let's move on to the protection of your core businesses, the subject of the second part of the book.

Part II

Protecting Earnings

Protecting Profits

3

"*We're not trying to do the most, more is not better, only better is better*" is how Richard Plepler, Chairman and CEO of Home Box Office, Inc. (HBO) reflects on his company, long regarded as the gold standard of quality in the entertainment industry, facing competition from upcoming rivals like Netflix, Hulu and Amazon which have flooded the market with big content and big dollars.

Netflix alone invested over $6 billion and launched around 30 new shows in 2017, followed by Amazon with $4.5 billion in original content for its Amazon Prime streaming service, and Hulu with $2.5 billion.

HBO is third on the list with $2.7 billion, however instead of trying to outcompete Netflix and the other guys in dollars invested, HBO chose the path of being a highly differentiated network and becoming more selective about the content it invests in.

Although it only possesses a few more than 20 original scripted series, those include widely successful hits like *The Sopranos*, *Sex and the City* and *Game of Thrones* which have all become cult hits among fans. That number is still low however compared to Netflix's almost 100 original scripted shows, but HBO strikes additional revenues by cutting deals with cable providers and other outlets.

To put these companies' numbers in the right context, Netflix's revenues ($11 billion) already doubled HBO's

In this chapter we will:

- Explain the goals of strategic positioning
- Discuss differentiation-based competition
- Discuss price-based competition
- Explore ways to mitigate market forces

($6 billion) in 2017, but its profits ($800 million) were a bit over a third of HBO's ($2.15 billion) in the same period. That doesn't mean that HBO's strategy is better than Netflix's; they are just at different stages and following different game plans.

Both HBO and Netflix are very successful in their own terms. HBO is achieving high profits through a strategy based on differentiation and a business network built on more than 40 years in operation, offering content that is unique and considered high quality by their consumers, while the fast-upcoming player Netflix on the other hand is pursuing rapid growth, reinvesting earnings aggressively in new content to cut dependency on other companies.

With a different strategy, Amazon Prime, which started out as a more conservative player, has canceled low-budget niche shows like *I Love Dick*, *One Mississippi* and *Jean-Claude Van Johnson* to pursue more mainstream titles along the lines of HBO's *Game of Thrones* and *The Lord of the Rings*, but it has made clear that its intention is not to be the king of content but to have a healthy portfolio that is appealing to its customers.

Can HBO outcompete Netflix at online streaming? The simple answer is no, and it doesn't need to. HBO's value chain has been optimized to extract value from premium cable subscriptions and licensing deals with TV networks, so arguably it would be highly inefficient to try to outcompete Netflix in online streaming.

Netflix's streaming business model has been entirely designed since its inception to be an "over the top" (OTT) service, that is, to operate as a standalone business that streams content online directly to users, bypassing conventional broadcasting channels such as cable television.

That means that Netflix's model has been optimized from A to Z to deliver a great online experience and all buyers need to use its service is a reliable internet connection, which makes Netflix's potential market huge.

To support its business model, Netflix was a pioneer in the implementation of "recommender" algorithms that crunch massive amounts of users' data to make accurate recommendations, and introducing streaming techniques that optimize content quality even at slower internet speeds. In 2009, the company awarded $1 million for the creation of its recommender algorithm in a widely publicized competition.

HBO, on the other hand, initially saw its online presence as an extension to its premium cable offer which for decades has been the core of the company's revenues. It launched its HBO GO app in 2010, three years after Netflix launched its streaming service, and only HBO customers could stream through the app. Until then, the market potential for HBO was people with cable who could afford their premium subscription service.

It wasn't until 2015 that the company launched its HBO Now service offering the network's premium content directly to users who were not subscribers to its cable service. However, because of HBO's licensing agreements, the service was not available worldwide.

Although HBO has been streaming online for over a decade now, it stills lags behind in terms of its online functionality, features and availability worldwide, and its service is priced above Netflix, even though it features only a fraction of the content volume.

That's because global online streaming is not HBO's core business, and its main users for decades have been consumers of cable TV and the networks around the world who license its content. That means that most of its revenues come from premium cable subscriptions and licensing deals.

HBO is highly profitable with a boutique approach to curated content, where it carefully hand-picks what it features, while Netflix on the other hand has gone shotgun hunting after the masses and is buying content in chunks from acclaimed directors and producers.

They are both profitable at what they do, and each has come to master its business model. However, HBO faces a problem that Netflix doesn't: demand for cable TV is shrinking, and market growth seems to be happening abroad as more users around the globe get access to reliable internet, so the network needs to rethink its strategy to deal with these new realities.

The real goal of strategy is not to beat rival companies out of business but to maximize profits, and the first step towards that goal as we saw in Chapter 1 is to have operating businesses under control. That means that those businesses must occupy a market position that is both profitable and defendable, which can only be achieved by 1) offering differentiated products, 2) achieving lower costs per unit than competing alternatives, or 3) a combination of both.

That seems like a simplistic set of moves, but the choices involved in getting strategy right can be quite complex and have important repercussions for the company.

To start, what works well for a particular company might not work for others, for example, while Apple has decided to design and manufacture its own processor chips to offer customers higher performance, Dell Computers on the other hand has decided to outsource them to lower its unit costs and be able to offer customers lower prices.

Each strategy is successful, and they are both right, but they just happen to focus around different things: Apple bases its strategy on differentiated value while Dell does it on price.

Similarly, a market advantage today may not be an advantage tomorrow as customer preferences and markets evolve. For example, some banking institutions in the US are now starting to "in-source" customer service from overseas, in response to dropping satisfaction rates and as American customers demand better and faster service provided by native speakers, reversing a trend that started over 20 years ago when companies in the US massively outsourced their customer service needs to companies overseas.

A good strategy always starts by asking a simple question: *What business are we in?*

That means that to come up with a good strategy, you must have a good understanding of your industry, your markets of choice and the dynamics of competition within those, which is the subject of the previous chapters.

With that understanding, you are ready to answer a second question: *How are you going to compete?*

And with that, you set out to find a market position for your business that is both profitable and defendable, based on what you know about those markets (i.e. the answer to the first question).

To find such a position you need to make decisions about two things: the value proposition that your products and services will offer, and how that value proposition will be created and delivered to your target buyers. That involves decisions about the optimization of your value chain to ensure you extract the maximum value from the opportunity and retain that position for the foreseeable future.

Making those decisions is the subject of Part II.

In this chapter, we cover strategy from a static point of view as we explain the goals of strategic positioning, discuss differentiation and price-based competition, and review a few ways to compete against Porter's five forces. In Chapter 4 (the next chapter), we press the *play* button and see strategy in a dynamic context, discussing the process that leads to commoditization, how to protect profitability and introducing the idea of a *multicore* strategy. Finally, in Chapter 5 we explore the connection between strategy and operations, covering specific decisions about the parts of the value chain that can be outsourced and testing the defensibility of our strategy.

Keeping control of the core business

The first line of business for any established company is to protect the profits created by its core business or businesses. Before thinking about new products, growth paths or the latest management trend, you must have a solid but realistic plan to protect that core source of value and fight, bite and scratch to defend it if necessary.

A company that doesn't have its core business under control, or that prioritizes other areas, growth for example, is at risk of failing at both.

Operating profit is the fuel that keeps your business's engine running and without it your company can't pursue any growth, innovation or anything else. Therefore, protecting that profit is THE top priority of any organization.

We say that a business unit is under control when its financial performance surpasses the metric that you choose to use as a benchmark, which can be anything from a particular stock (another company), a sample of shares (i.e. an index made up of companies from within or outside the company's industry), a market index (e.g. the S&P 500) or a particular investment instrument (e.g. Treasury bonds).

In addition to being profitable, your business must also be *defendable* which means that your *profitability* is sustainable, and that your company has the tools in place to remain profitable in the foreseeable future.

When your business occupies a market position that is both profitable and that you can protect, we say that it has been *strategically positioned* within its market, and as we saw in our strategy principles, there are only two ways to create such a position: through differentiated products, or through lower *relative* unit costs.

Differentiation means that your products and services are both unique and valuable to your target consumers, while lower relative costs on the other hand mean that those products and services are *produced* at a lower cost per unit than competing solutions.

Without getting too deep, the idea is that products that are unique and valuable should give your business the ability to command higher prices or create more demand. Price and volume (demand) are the two factors that drive sales, hence revenues, up.

Correspondingly, lower unit costs when compared to similar solutions should help the business reduce its prices (which increases sales) or increase margins, once again producing a positive net effect on the business's profits.

Differentiation and lower relative *prices*, therefore, are the two ways in which you may decide to position your products in a competitive marketplace, and which one you pick will define the focus of your strategy and how your business has to be optimized to succeed. The implications of each approach are discussed in the next sections.

Differentiating products and services

The main goal of a company pursuing a differentiation strategy is to influence the perception of value about its brands in the minds of target consumers. Being *perceived* as being more valuable than other alternatives by those customers is what drives the company's ability to raise prices or sell more, and without that perception a differentiation strategy will not succeed.

In general, there are four levers that you can use to influence such perception:

1. **Differentiated products:** Offering products and services that are both unique and valuable to target customers. These products may be continually improved and augmented along dimensions that matter to customers, to reduce business erosion.

2. **Differentiated promotion:** Experimenting with different promotional tools and messaging campaigns, or testing proven campaigns with new customer segments. Strong brands can play a big role in differentiating a company's offerings, especially in crowded markets.

3. **Differentiated sales and distribution channels:** Distribution channels and sale efforts bring prospective buyers and customers together. In the end, the real demand reachable by a product is not the number of people who would like to buy it, but how many of them the product can reach.

4. **Differentiated Pricing:** In most markets, price can be used to influence demand and adjust customers' expectations of value. Companies must intimately know their markets and use pricing strategically to target both consumers and non-consumers.

You can use these four levers to influence the perception of value in the minds of your target consumers, however, what really gives you an edge is not whether or not your products actually deliver more value, but the *perception* that they do.

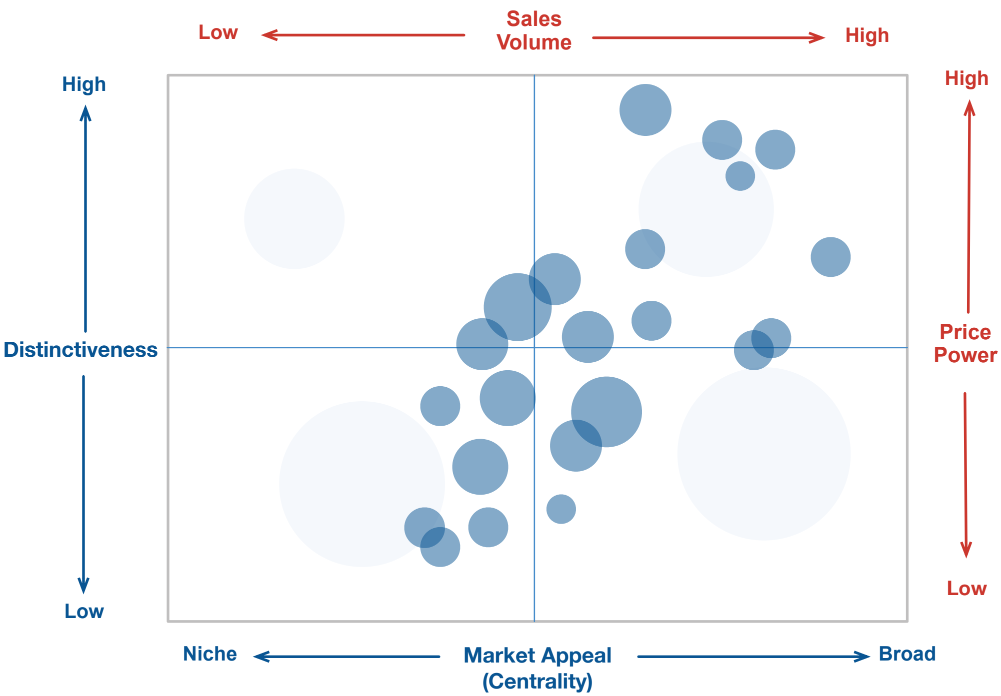
As a business leader, you must continually monitor this perception and take proper action when necessary.

Levers to influence perception. These are what have been classically known as the "Marketing Mix" or the "Four Ps of Marketing"

The teams out in the field must produce reliable information about these perceptions, to enable executives to make educated decisions. They must keep their ears on the ground, tracking changes and trends in the marketplace, and use their knowledge and expertise to produce information that can be acted upon.

There are many tools available, perception maps for example, that can help measure the positioning of a given brand in the minds of target consumers, relative to other products serving the same market.

To see how this works, let's take a look at an indicative perception map which presents competing products along two dimensions: "Market Appeal" or the product's *Centrality*, and *Distinctiveness*.[5]



This is an example of a DistincEveness-Centrality map. The size of the circles in blue could represent sales volume or price. In general, the more distinctive the brand, the higher the premium it can charge, and the smaller the approachable market will tend to be. Gray circles in the background indicate the gross of customers within that quadrant

In this case, *Centrality* measures the segment of the market that consumes the product going from broad (mainstream) to narrow (niche), while *Distinctiveness* on the other hand measures the degree to which a brand stands out from others and becomes distinguishable (i.e. "unique") in the minds of target customers.

Ideally, the more differentiated or distinctive a product is, the better the company is positioned to charge premium prices or create more demand. However, highly distinctive or unique products, especially if high-priced, will usually appeal to a smaller segment of a market that will be able to appreciate or effectively use the extra value.

Conversely, the broader the target segment, the fewer opportunities for differentiation will exist since the product will need to appeal to a bigger audience. Products targeting broad segments will also need to be priced accordingly (usually low) to reach those markets effectively.

On the map I have also plotted gray circles in the back of each quadrant to represent where the gross of the market lies in that specific quadrant; you may do the same you to help you see where you are with respect to the largest number of customers within that segment.

You can use such perception maps to see where you stand in your target consumers' minds, who your real competitors are and how safe you are in your current market position. It is a great visual aid to help you guide any strategic effort.

As we mentioned before, the goal of a differentiation strategy is not to *compete* with rivals and take them out of business, but to find a position that is both profitable and defendable, and in that position you may co-exist with other companies within the same market.

Dr Pepper Snapple Group (NYSE: DPS) owns more than 50 brands of flavored beverages including 7Up, Canada Dry, Snapple, Mott's, Hawaiian Punch, Orange Crush and Sunkist, all of which occupy leadership positions in the very crowded and competitive refreshment drink shelves.

These products however are unique and well positioned in the minds of buyers as top brands in what they offer, and DPS didn't need to destroy Coke or Pepsi to achieve this position.

Differentiation is by nature a relative term hence the movement in a perception map depends on the efforts that other players are making. While the map is a snapshot at a given point in time, the picture is always moving in real life as incumbents continually try to reposition and gain ground.

Other types of map may provide more granular information on customer perception, with the most popular being those that plot two factors against each other at a time, for example *Customer Service* and *Stylishness* for a fashion brand. Others, normally through specialized software, allow comparison of multiple factors or *vectors* in one single chart.

In my experience, you don't need the most advanced tools but a handful that you understand well, and from there expand your toolkit as you go. Some companies in fact may find that developing their own tools in-house works best for them, as it allows them to make better and faster decisions.

Competing on price

Despite what many might think, competing on low prices doesn't mean selling a crappy product but quite the opposite. An effective low-price strategy must always start with a good product.

While the success of low-price positioning hinges on rigorous cost discipline, low prices should not be the result of watering down good products, but from focusing on the most basic needs of price-sensitive buyers.

A low-price provider avoids extra features and frills that are only valuable to higher-end buyers, and instead delivers a basic solution that does a job that is just good enough.

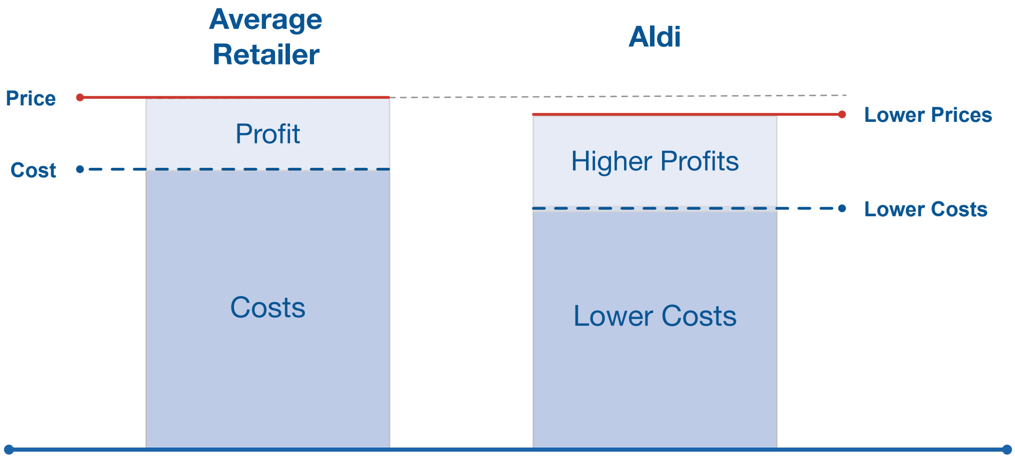
Procter & Gamble's Ivory soap bar, Ikea's furniture, and JetBlue in the airline industry are all examples of low-price players. Their success is not in making comprehensive products cheap but in carrying a basic, stripped-down offer, doubling down on the features that price-sensitive buyers need, and delivering that value proposition cheaper than anybody else.

A second misconception about cost-based competition is that low prices mean lower margins. That's absolutely not true, and as we mentioned before, low-cost players like Walmart outperformed high-end players by making money through a different business model, in that case faster inventory turnover (selling the same items more times than competitors within the same period).

Successful low-price competitors target customers who are willing to pay less to get a more basic offer and operate super-efficient value chains that minimize all costs. Aldi, a supermarket chain with more than 10,000 stores around the world, runs a very efficient supply chain that allows it to achieve extraordinary cost advantages.

To start, it carries a very narrow product selection which helps it negotiate better prices with vendors and minimize logistics costs while increasing turnover on those items. It builds stores in inexpensive locations, products are displayed on pallets and customers have to bring their own bags.

Despite these seeming inconveniences and its low average markup of 13 percent (compared to 25-30 percent for other retailers), Aldi outperforms its rivals year after year on a return on investment basis. Its success is due in part to a low-cost operation that de-emphasizes factors that don't add value for price-sensitive buyers and focuses instead on improving factors that are important for those buyers, like having fast and efficient checkout.



Low-price leaders can outperform competitors by changing the profit "formula". To do that, they would either have to increase margins per unit (by reducing their costs) or drive higher levels of demand (i.e. rotate inventory faster)

When running a low-cost operation, every penny counts, from the cost of manufacturing, packaging, distribution and advertising, to how employees are incentivized and how the company carefully invests in R&D and customer acquisition.

In the case of Ivory, for example, the air bubbles that helped the soap float also helped reduce costs because it needed less materials, which in addition to basic wrapping, lack of deodorant and fancy scent ingredients and low promotion, helped the brand achieve cost advantages over other soap bars.

For low-price competitors, frugality becomes their way of life and something of a religion, and it must be well-rewarded by management. This penny-pinching mentality, which translates into highly efficient business models, permeates everything a company does and is the most valuable asset of low-price competitors.

Their success relies on continually challenging cost assumptions, sometimes defining their own metrics of quality and performance, just like JetBlue has done in the budget airline space.

In addition to cost efficiency, "speed to market" is the next most powerful tool of low-price competitors. To create new sources of growth, these low-price incumbents must continually bring their low-cost business model upmarket, integrating features and offers only available in higher-end solutions as a way to temporarily increase their margins.

For example, McDonald's has added Angus beef burgers and grilled chicken sandwiches to its menu, Walmart and Costco began selling tires and offering car repair services, and Pepsi and Coke have added higher-margin drinks like Gatorade and Powerade to their portfolios.

These are all cases of low-price players bringing their low-cost business models to capture value from higher-end offers.

"*Your margin is my opportunity,*" is how Amazon's Jeff Bezos best describes this strategy, as his company brings its low-cost business model upmarket in all directions to chase higher margin opportunities, sending waves of fear through every market it enters.

The speed at which low-price competitors embed higher-end solutions into their low-cost business models is what makes it so hard for high-end providers to compete with them.

The role of sales and distribution channels

The success of your product strategy relies in part on how good your company gets at putting the right offer in front of the right customers, because one thing defines the other: the customers you target define the products you need to create, in the same way that the products you create define the customers you should target with them. That is the two-way street.

With that being said, there's no such a thing as "a great product" unless you specify who the target customer is. A modern arc-flash industrial oven may be a great novelty, but useless for a plastic surgeon.

Putting the right product in front of the right customers implies that sales and distribution channels are a critical component to make your strategy work. In the end, you may have people willing to buy your products, but if the product is inaccessible to them, they can't be considered as *demand*. A great customer segment that you can't reach is as bad as reaching the wrong customer with the right product.

Promotion efforts, on the other hand, may also play an important role, pre-selling the benefits of your offer to your target consumers, since for sales to happen buyers must first believe that the solution can deliver its promise.

Advertising, mass and direct marketing, product information, public relations and other forms of promotion are used to affect the perception of the product in the target customers' minds in a way that maximizes its sales.

A company can have the greatest salespeople in its workforce, but if the messaging about the solution is out-of-synch with the expectations of target customers, sales efforts will be wasted. The role of the promotion effort is to disseminate relevant information that helps differentiate products and services in the eyes of target consumers.

Sales and distribution channels, along with promotional efforts, expand the scope of your product's value proposition and convert mere target buyers into *demand*. Together, they help position the solution in a competitive market.

This is where serious market research really pays off, and why defining a customer value proposition simply as an "statement of value" falls short of its true power in demand creation. To quote marketing guru Peter Drucker, "*The aim of marketing is to make selling superfluous. The aim of marketing is to know and understand the customer so well that the product or service fits him and sells itself*".

Mitigating Porter's forces

As we explained in Chapter 2, Michael Porter's model of competition identified the bargaining power of buyers and suppliers, the threat of new entrants and substitute products and the rivalry among competitors as forces that, based on their relative strength, could limit how much your company may get to keep from the value your products create for buyers.

Powerful buyers, for example, could limit how much money you make from your products by using their power to get lower prices, while powerful vendors can also squeeze your margins by raising prices.

The power of these forces depends to some extent on the dynamics happening in their respective markets, but their effect can have an important influence on your ability to run a profitable business.

Before the Five Forces framework, the prevailing tool for strategy was the SWOT analysis, an acronym for *Strengths*, *Weaknesses*, *Opportunities* and *Threats*, which listed a series of factors about the competitive environment in a particular market or industry and the capabilities of an organization and its competitors.

The tool was a good exercise to understand opportunities and threats (still used by some companies), but it didn't offer a structured framework to help *prescribe* strategy and make executive decisions.

When Porter started publishing his framework in the late 1970s, the scope of his work focused almost exclusively on the analysis of *industries* and the companies that operated within them.[6] However, subsequent work by other researchers and by Porter himself have refined this model and expanded it to consider other forces.

Let's quickly review each of Porter's forces in more detail and discuss some ideas that can help us mitigate their effects on profitability before discussing other equally important factors.

Intensity of rivalry among competitors

This is Porter's most enigmatic force, and what most people think of when talking about strategy. In essence, rivalry refers to the level of *aggressiveness* and hostility with which incumbents compete within a given market. The "rules of engagement" if you will.

Are incumbents aggressively investing in marketing? In new production capacity? Engaging in price wars? Continually introducing new products? All these questions can help us build an idea of how protective of their businesses incumbents are, hence how tough the game will be for anyone trying to compete head-to-head with them.

The intensity of rivalry is different across industries and varies throughout the industry life cycle, but it tends to be higher in slow-growth industries with a high number of players, especially if the incumbents are of similar size.

There are other factors that may boost rivalry among players. For instance, if incumbents have high levels of idle capacity or high fixed costs in their value chains, or if they face large exit costs such as expensive specialized equipment, special licenses or patents that they would have to forgo if they left the industry. Any of these factors could motivate incumbents to put up a fight and stay in operation for as long as they can rather than exiting the market and *stranding* those costs.

In highly competitive markets the best decision you can make is to find ways to *avoid* competition, something that's most effectively done through differentiation.

You must find a particular market position where you can enjoy superior profitability and keep expanding your products and their ecosystems to retain that position and remain ahead of nasty, bothersome and noisy competition.

Competing against powerful vendors

Powerful vendors will always try to keep a bigger piece of the action on their side of the table. If they are well-positioned in their industry, they may leverage their position to raise prices and enforce changes in the quality and volume of their supplies, limiting the profitability you are able to extract from your businesses.

In general, vendors tend to be powerful if:

- The vendor has a dominant position in its market, for example through exclusive access to key components and resources, or if there is a very limited number of equivalent vendors, leaving your company without many options.
- The quality of the vendor's offering is critical for the final performance of your products and services.
- There's a credible threat that vendors can integrate *forward*. That is, if vendors can leverage their privileged position to set up their own shop and compete with you for the same consumer segments.

- Your business faces high switching costs to move to a different vendor. For example, if you would have to invest in expensive software or new equipment if you wanted to buy from a different source, it may give you tangible reasons to stick to a vendor.

You must find ways to prevent the rise of powerful vendors and mitigate their ability to dictate the rules of the game.

Netflix's aggressive plan to produce its own content is a move to reduce their business's dependency on powerful content networks. If they hadn't done that, they would have been in deep trouble when Disney (who later bought all of Fox's content including Marvel Universe and other franchises) decided to pull their content to build their own streaming service.

The power of vendors can be mitigated through a combination of the following:

- **Incentivizing competition between vendors**: A company is always in a better negotiation position when it has multiple vendors to choose from. For an online retailer like Amazon, for example, it would be in their best interest to help the US Postal Service to become a competitive player against FedEx. At the end of the day, the customer (in this case us) always benefits from rivalry among vendors.
- **Integrating backwards**: Some companies may be well-positioned to start producing key inputs themselves as a way to reduce reliance on another company's strategy. Apple, for example, has started creating its own processor chips to avoid being choked by powerful vendors like AMD and Intel.
- **Competing with vendors**: A variation of the previous point is what Walmart, Aldi, Target, Costco and other retail players are doing: having their own in-house brands compete with vendors'. That move will keep vendors at bay, minimizing any threat of price increase or scarcity.

You must always see the relationship with your vendors as a *strategic negotiation* where you carefully plan and brainstorm the best ways to do business with them.

To rephrase a popular negotiation approach, in planning your negotiation with vendors you must make sure to "*involve the right parties, in the right sequence, to deal with the right set of issues, each facing the right consequences of walking away if there's no deal*".[7]

Competing against powerful buyers

Powerful buyers, especially rational ones like those found in B2B transactions, will do everything they can to pay less for your products and services. In fact, just like you do with your vendors, their strategy may be to prevent YOU from becoming a powerful vendor to them and erode your ability to raise prices. You would do the same to them, right?

Powerful buyers will always try to pay less and get more, threatening your ability to produce sustainable profits.

In general, the bargaining power of your buyers is higher if:

- There are not many buyers in the market or if they represent an important portion of your company's sales.
- The buyer has multiple alternatives to source the solution, or if your product is not critical to their business. For example, if they can get what you offer from ten other businesses under similar terms, they will have the final word on who they choose.
- The cost of switching to another vendor is low. If a buyer can switch vendors and buy from another seller without incurring costs or hurdles, they will be able to switch vendors back and forward, picking the one that offers them the best terms each time.
- There's no credible threat that you may integrate "forward". If company A sells a critical supply to company B, and company B uses that supply to sell products to company C, a credible threat that company A could set up its own shop and sell directly to company C will keep company B in check and limit its bargaining power.

You must understand the influence that powerful buyers may have in limiting your profitability and find ways to mitigate it. For example, by offering highly differentiated products, or embedding proprietary components into them.

Here are some recommendations that can help:

- **Offering differentiated value**: Of course, customer retention always starts with a good product. If well-developed, your product should be responsible for a good part of sales and retention. In a B2B context you may hit a sweet spot if your products stand out with qualities that are critical for the quality or performance of buyers' final products and services.

- **Increasing switching costs:** Creating an environment that your buyers would miss if they switched to a different vendor. Manufacturers of health monitor bands, for example, usually build a companion website to store users' historical health data in the cloud. Users could think twice about switching to another vendor and leaving their data behind.
- **Increasing the social costs of using other solutions**: Promote your products among influential people in the buyers' circles, getting key endorsements when appropriate.
- **Using pricing strategies to increase retention:** For example, lower prices for current customers or long-term membership deals.
- **Offering complementary services:** You can trap customers into your business model by offering after-sale services they find valuable.
- **Personalizing customers' experience:** An extension of the previous point is to personalize your customers' interaction with the product and the company. The more personalized their use of your product is, the harder it is for them to switch over to a different solution.
- **Offering attractive "upgrades" at the end of contracts:** If an agreement is coming to an end, you may offer an attractive upgrade if customers renew. Think about how phone companies offer free upgrades to the latest smartphone every two years.

You must mitigate powerful buyers even if your relationships with them are in good standing. Remember that the real threat is them *being able* to use their power, not whether they use it at the moment or not.

The worst position to be at in any given market, however, is being "sandwiched" between powerful buyers and vendors, so you better prevent that at all costs.

Deterring new entrants

There is a threat that exists in pretty much any industry: if profits seem high from the outside, others will come, and a more crowded market will in almost all cases lead to vendor segmentation and lower profits.

In general, the attractiveness of a market and in turn the threat of new companies trying to enter, will be *lower* if:

- **There's a high risk of stranded costs:** This happens if new entrants have to make investments that would be hard to recoup if the business doesn't go as well as they expected. If they needed to invest in specialized machinery, for example, their investment may be at risk of becoming a capital *sunk cost* they may not be able to recover.
- **Incumbents have a privileged position:** For example, exclusive access to distribution channels, large economies of scale, intellectual property or strong brands.
- **Incumbents are known for being aggressive to new entrants:** If at least one of the incumbents is well known for retaliating aggressively against new entrants, that could be a deterrent for companies tinkering with the idea of entering the market.

What prevents potential entrants from attacking a market is their perception of the existing balance (or lack thereof) between the risks associated with pursing the opportunity and the profitability associated with it.

If they feel that they can enter a good market with reasonably low risks they will most likely do that, but if instead they perceive that the risks of losing money and reputation are high, they will be more likely to stay out.

Here are some ideas that can help you keep entry risks high:

- **Investing aggressively in promotion:** The risks of competing in a market against high spenders should deter the intentions of potential entrants. Your promotion efforts should be directed at brand recognition, deepening connections with your current customer base and making your products accessible to as many potential buyers as possible.
- **Investing aggressively in fixed costs:** It may seem counterintuitive, but investing in specialized assets that could give you a competitive edge, such as lower unit costs or higher performance, would increase the cost of competing in the market, helping you diminish the intentions of potential entrants who would be afraid of ending up with high stranded costs if they later decide to get out and can't sell their assets.

- **Securing exclusive access to key sales and distribution channels and resources:** One advantage you have being an incumbent is that you already know the channels and partners that work and the ones that don't. Securing *exclusive* access to some of these key channels or resources (locations, key inputs, etc.) can be enough to keep new entrants at the other side of the fence.

- **Building strong relationships with key stakeholders**: Having good standing relationships with key influencers, regulators, media, customer groups and others can go a long way when trying to deter the attack of new entrants.

If a new player actually tries to enter the market, you and other incumbents should retaliate aggressively against the new player, even if small, to send the message to other potential entrants.

You should, however, avoid using price as a deterrent to new entrants, for example lowering prices to make the market look unattractive.

As we saw earlier, if the new entrant is a low-price competitor, it will most likely be able to make money through a lower-cost business model, which may be not possible for you to compete against with your existing value chain. Because of that, lowering prices will probably not get rid of them, since they may be able to survive a price war longer.

Competing against substitute products

Substitutes are products that do the same job for your target customers although they are different in nature to your company's product.

Butter and margarine, beer and wine, coffee and tea are all classic examples of substitute products. They are a threat to profitability because they put a cap on the prices that you are able to charge for your products and services.

The threat of substitute products tends to be low if buyers face high costs when switching over to the substitute. For example, if a company outsourcing its graphic design wanted to do the work in-house, they would need to consider the cost of buying specialized software licenses, powerful graphic computers and other tools when evaluating the switch, and the higher the cost of internalizing the design work, the lower the incentive to switch. For that reason, the vendor (in this case the design company) must keep its prices low enough to make the buyer's decision to switch a bad financial decision, but high enough to maximize its margins.

A new take on identifying substitute products is Professor Clayton Christensen's *Jobs to be Done* framework. This framework proposes the idea that products are "hired" by customers to do a job that they need to get done.

A low-carb diet for example can help a young woman lose weight quickly, but we could also say that the "job" the diet does for her is to make her look in better shape for a wedding next month.

This alternative way of thinking can help you see how diets then compete with products from other industries like apparel, corsets, make-up and others that could also make the buyer look better in a short time.

Focusing on the "jobs" that need to be done, rather than just segmenting a market by demographics, helps you see the true competition that your products have.

No one could have put it better than legendary marketing professor Theodore Levitt when he said "*People don't go to a hardware store to buy a quarter-inch drill. What they want to buy is a quarter-inch hole in the wall!*"

We get back to the jobs theory in Chapter 7, as we explore some ways to find ideas for new products.

Complementary products - another force?

Another factor that could influence a company's ability to capture profits from its products is the role that complementary products play in the value creation equation. These "complements", as they are also referred to, are products used in combination with or as a consequence of using your products or services, so their price and demand are interrelated.

From an economist's point of view, two products (or goods) are complementary if a change in the price of one moves the *demand* for the other *in the opposite direction*.

For example, if the price of DVD movies goes down, the demand for DVD *players* goes up, and if the price of ink cartridges goes down, the demand for printers will go up. But the opposite is also true: if the price of DVD movies goes up, the demand for the DVD player goes down, and if the price of the ink cartridges goes up, the demand for the printers will slow down.

Because of that interrelation, complements can play an important role in your ability to make profits effectively and consistently. For example, if the complement is unique and exclusive, its vendor could have the power to limit your ability to sell your products. In other words, by not being available to all of your "potential" customers, the complement would put a cap on the demand that YOU are able to capture.

Let's say a company makes coffee pods that can only be used in a particular brewing machine made by a different company. The maker of the machine has power over the capsule vendor because it controls where and to whom the brewers are sold, and because they also grant the licenses to make the capsules, limiting the profitability that capsule makers can achieve.

This is happening in the video games industry, where the makers of PlayStation, Xbox and Nintendo and other consoles control game prices and take a cut of the games' revenues. Because of that, the profits that game developers can aspire to is limited by the strategy of the console makers.

Whenever you are selling a product that depends on a complementary solution in any way, you must pay special attention to how much the complement is needed to use your product, and how accessible the complement is to *YOUR* target buyers.

If your buyers need a complement to use your product, you must build assurances in your business model to prevent giving control of your profits to the makers of the complement.

We will review these ideas in more detail as we discuss the creation of new products and services in Chapter 7.

Protecting Profitability

4

We saw earlier how in the early days of an industry innovators experiment with multiple value propositions, trying to find benefits-price combinations that click with a sizable number of customers that the company could serve profitably.

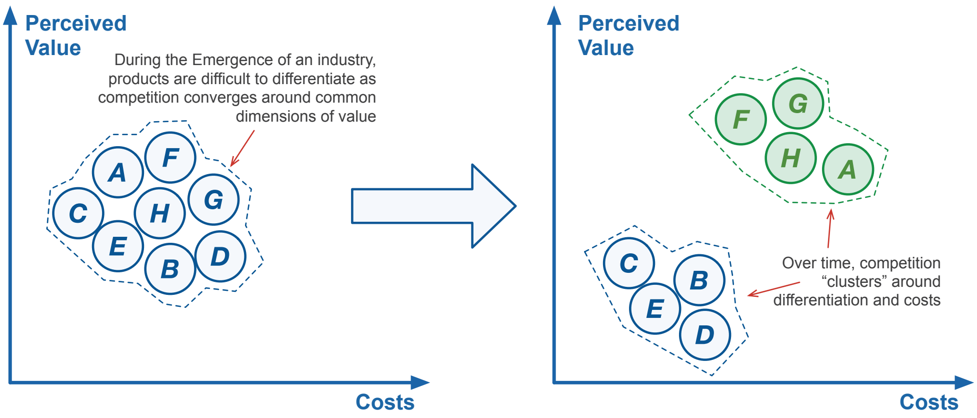
But as an industry grows and products go mainstream, incumbents usually gravitate towards one of two generic strategies: one group will compete on *value* (i.e. differentiation) while others will try to compete on price.

This pattern can be seen in many industries, from retail (Walmart and Sears), to computers (Mac and Dell), Beer (Stella or Heineken and Budweiser) and automobiles (Ford or GM and Toyota or Honda), creating two major clusters that over time lead to the *commoditization* of the very factors they compete on.

Let's explore how that happens.

In this chapter we will:

- Explain how to play strategy "fluidly" and remain profitable
- Discuss the power of brands and reasons for their decay
- Explore analytics-based competition
- Introduce multi-core thinking as an emerging strategy mindset



The process that leads to commoditization usually follows some pattern of clusterization (adapted from Sherman, Leonard. See bibliography for more information).

On the one hand, companies offering more value usually do so along dimensions that are known to be important for customers, that is, things like *whiteness* in toothpaste, *download speed* in internet services, or *storage capacity* in computers for example.

These incumbents will keep pushing performance along those dimensions as a way to differentiate from competitors, and at some point their products will be delivering more value in those dimensions than most customers really need.

When that happens we say that that dimensioned has been *commoditized*.

Commoditization means that the gross of the market is no longer willing to pay premium prices for more value. They can already get more than they need from any vendor, turning to price as the decisive factor to pick a product.

For example, it would be more difficult today to find customers willing to pay premium prices for more whiteness in toothpaste, faster internet speed or more storage capacity in personal computers than it was 10 years ago, since now even the most basic offers deliver more than most people need. The gross of buyers in those markets now turn to price to select vendors.

Early in an industry, and while products are not yet good enough for the most demanding customers, incumbents can get away with charging higher prices for more value and exclusive dimensions, but as the value delivered by those solutions increases and exceeds what mainstream customers need, customers will be less willing to pay a premium for something that is way better than needed.[8]

Companies competing on low price on the other hand face a different problem.

In the pursuit of being more cost competitive, these incumbents *fragment* their value chains, outsourcing *subsystems* to specialized third parties and creating vendor competition at the subsystem level. To compete, subsystem vendors keep pushing the boundaries of costs and performance until their contribution to the costs of the entire system is only marginal.

This has happened to some extent in the personal computer industry where large manufacturers like Dell and Hewlett-Packard outsource their processor chips to specialized companies like Intel and AMD. Because of the scale and specialization that chip makers are able to achieve, computer makers can buy high performance processors from them at a very low cost.

However, computer chips have already become so powerful and so cheap that they don't produce an important cost advantage that helps computer vendors offer lower prices, and once again the gross of buyers in the personal computer market are turning to price to decide which computer model they buy.

Is a low-price strategy sustainable?

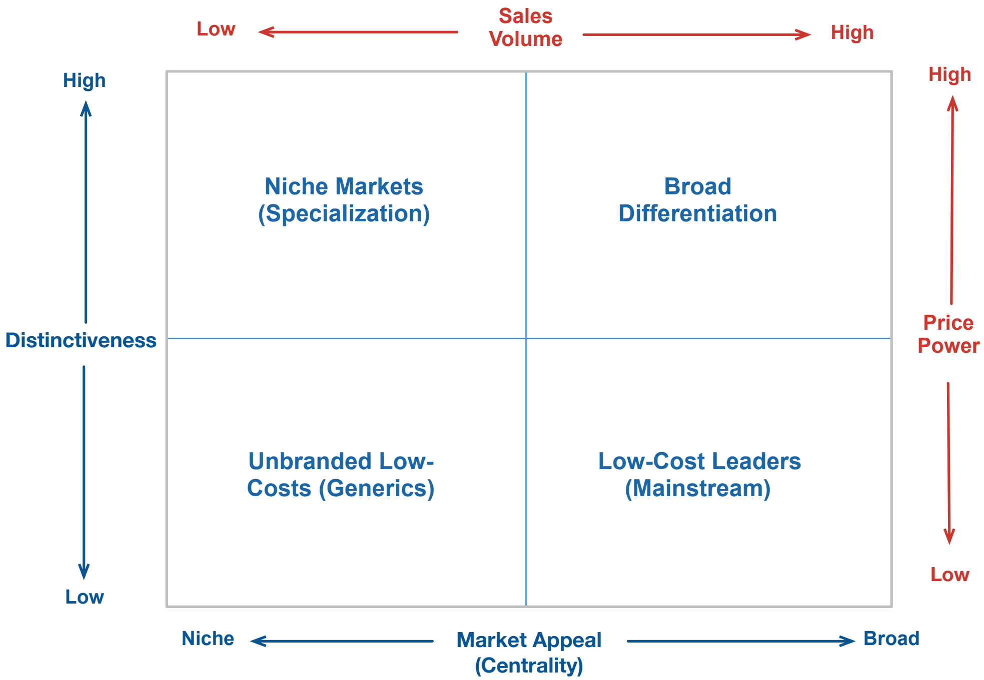
A low-price strategy only gives you an edge while there are higher-price competitors in the market. As soon as those competitors disappear (either exiting the market or moving on to other segments), all remaining low-cost producers will be forced to fight against each other on price, reducing margins over time.

As differentiation and price become less effective at providing a safe place, a solution is to rethink your value proposition and shift your strategy to serve a different set of needs or a different set of customers.

This strategy may take many forms. For example, you could focus on a narrower customer segment with particular needs, like toothpaste for sensitive teeth (a sub-market of the toothpaste market) or ultra-fast internet services for gamers (a demanding subset of internet users), or you could specialize your value chain above the industry standard, for example a construction company that specializes in bridges, malls or theme parks.

MORE ABOUT COMMODITIZATION: Commoditization is a process that works at both the value proposition and the cost sides of a business, pushing margins and profits to a minimum. That makes commoditization, not competitors, the real nemesis of profitability, and thus the main subject of strategic positioning.

If we return to our perception map, we easily see how this can play out. Players may decide to be more central, appealing to larger audiences, or they can try to be more unique, appealing to audiences who care more about a particular set of features and benefits.



A Distinctiveness-Centrality map gives you two dimensions to move your market positioning strategy around

These two dimensions give you an entire two-dimensional plane where you can move around and find a suitable position. In general, to reach a market position that's both profitable and defendable in either of the quadrants a business would need to focus on a particular set of factors, for example:

Quadrant I - Broad Differentiation: Companies in this quadrant appeal to a wide group of buyers but manage to keep their products highly differentiated, allowing them to charge higher prices. These are the "Differentiation Leaders" of the market.

Brands that fit this quadrant include BMW in cars, Apple's Mac in computers, and Heineken in beer.

To position in this quadrant, the solution must demonstrate high performance along all or at least most of the dimensions that are important to the most demanding customers in the market, and place a heavy emphasis on customer satisfaction

To succeed, these companies will need to invest aggressively in intellectual property, either through in-house research and development (R&D) or licensing deals and in recruiting top talent.

Differentiation leaders usually need to invest more in marketing and branding, to explain the unique value and benefits of their offer to target customers.

Finally, being broadly differentiated doesn't mean a license to let costs go out of control. In fact, broad differentiation requires strict control of your supply chain to avoid overspending, especially on those costs related to differentiation and product development which can easily grow out of proportion.

Quadrant II - Mainstream Leadership: Companies in this quadrant are the absolute kings of demand generation in their markets, and they are usually the most well-known brands in that space. Products in this group are not differentiated among competitors but they are able to make their numbers because of the high sales volume and rapid inventory turnover. To achieve this position, they must become low-price leaders in their category.

Coca-Cola, McDonald's, Walmart and Toyota are all companies well positioned in this quadrant.

To succeed in this quadrant, a company must pursue the absolute minimum costs, and their products must be widely accepted by mainstream customers and the mass of the markets where they operate. These solutions tend to be highly standardized and with minimal or no customization.

To achieve mainstream leadership, companies must have tight and strict control of their supply chains, with ongoing plans to improve operational efficiencies, cutting costs wherever they can, outsourcing frequently and minimizing investments in activities that don't help lower costs, such as product R&D and marketing. For these companies, low price is usually their main marketing investment.

Economies of scale, efficiencies, automation and standardization usually play a big role in the ability of business units to retain a position within this quadrant. A deeper analysis of how they operate and manage their supply chains highlights how absolutely everything they do is aimed at supporting their low-cost leadership position.

Quadrant III - Undifferentiated Low Cost: These companies have decided not to compete for the mass markets, and instead focus on a narrower segment of customers who are indifferent to brands and frills, looking for a product that just offers great value for the money.

This is the quadrant of "me-too" and generic products. They don't pull the volume of mainstream brands, nor command the price premium of exclusive offers, but they can sit in a market position where they can make good money without the need of heavy R&D investment or an aggressive marketing budget.

Budget airlines fall within this bucket as they target highly price-sensitive customers who only travel between a handful of specific locations and don't need a wide selection of destinations. For these buyers, price is all that matters, and they don't have any emotional attachment to the brand. Customers expecting full in-flight services such as nice meals, entertainment, internet or a wide destination menu will need to look somewhere else.

A challenge for companies in this quadrant is in generating sufficient economies of scale and operational efficiencies within the limited scope of the market.

Quadrant IV - Specialists: These are the companies that achieve the highest level of distinctiveness and are highly specialized in the needs they serve.

Products in this group are highly differentiated and appeal to a more exclusive group of customers who know what they want, and only want the best. These customers are willing to pay more for products that deliver a *truly* unique value proposition.

Tesla and Porsche in cars, as well as Dos Equis and Stella in beer, are products that belong to this quadrant.

A specialist strategy is in most cases associated with companies that offer high-end and exclusive solutions, and their approachable market is usually smaller, as it only includes those consumers who are willing or able to pay premium prices. For companies in this quadrant, narrowing their focus is their way of achieving specialization, and how they reach higher levels of product "fitness" with the interests of a particular population.

To achieve success as a specialist, companies must invest in specialized research to better understand the needs of the target segments, and in proprietary access to exclusive differentiation features while keeping costs down.

A Centrality-Distinctiveness map gives you a two-dimensional playground that helps you visualize your market positioning strategy, making it easier to find opportunities to be *unique* in your own terms, and to some extent "make" your own markets (since you have the freedom to choose your customers). What you need to do is to identify a particular set of customers for whom your products and services can create superior value, or narrow your focus onto a set of needs in the customers you already serve that you can specialize in.

Crafting your own market, where you can be unique and hard to copy, is probably the safest way to a position that is both profitable and sustainable over a long term. Within that space, you can create the rules and decide how value is defined.

But however you decide to compete, whether in your own market or in someone else's, through a differentiation approach or focused on lower prices, adopting a dynamic mindset when you adjust directions based on changing market positions will help you protect the *profitability* of your business.

In this chapter we will review what strategy looks like in a dynamic landscape. We explain a fluid approach to positioning, or "re-positioning" and explore how powerful brands and analytics can help us remain profitable even in the presence of competition. Finally, we introduce some ideas about a "multi-core" mentality that I feel is emerging.

Finding and protecting a market position

One challenge that you continually face as a business executive is the persistent threat that other companies could copy what you do once you have found a market position where you make superior profits. The problem is not so much that they could copy your strategy, but that competition along the same product dimensions, as we explained earlier, leads to *commoditization* and with that comes a shrinkage of margins.

A lot of information about a company's strategy and its financial performance, especially for public companies, is available to the world at large, making business strategy a little bit like a quiz competition where all participants know the right answers. Your competitors know the dimensions of value that you focus on, your customer satisfaction rates, the names of your employees, who your partners are and your prices, and with a little bit more research they may also get to know your costs, so they could therefore get to know your margins and measure the success of your whole strategy.

So the challenge for you as a business executive is to carve out a position where you can make good margins and lift some competitive advantages that keep copycats at bay. These advantages may be in the form of strong brands, robust distribution, exclusive access to key resources or channels, or just a very distinctive (e.g. proprietary) way to make and deliver your products and services.

If you think about it, Pepsi knows Coca-Cola's strategy, the same way that Target knows Walmart's strategy and just as any furniture vendor knows Ikea's, yet they have all managed to find a position in their respective markets where they are profitable and difficult to challenge or imitate.

Commoditization can happen to product features (e.g. computer memory and toothpaste whiteness), to the products themselves (e.g. fast internet and generic drugs) or to how products are made (e.g. computer assembly and manufacturing), so strategic positioning must therefore be an iterative *process* to continually monitor the businesses' performance and adjust their strategic direction accordingly.

In general, the process to find a profitable market position can be described in four different steps:[9]

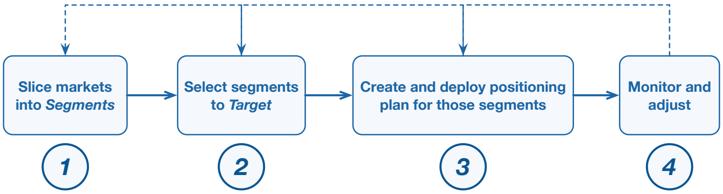
1. **Market segmentation:** Find effective ways to classify potential customers and slice the market into groups sharing common characteristics that make them approachable through the same value networks.

2. **Choose target segments:** Based on your segmentation of the market and your value proposition research, select the segments that you are going to target within those markets.

3. **Craft your market positioning strategy:** Make decisions about how you will position your products with the selected target consumers, which as we saw in Chapter 3 can be done through product features and benefits, pricing models, sales, distribution and promotion efforts.

4. **Monitor and adjust:** Once your strategy has been deployed, measure the traction you get with your target consumers and the performance of your marketing efforts, validate previous assumptions and adjust your market positioning preferences accordingly as new information becomes available.

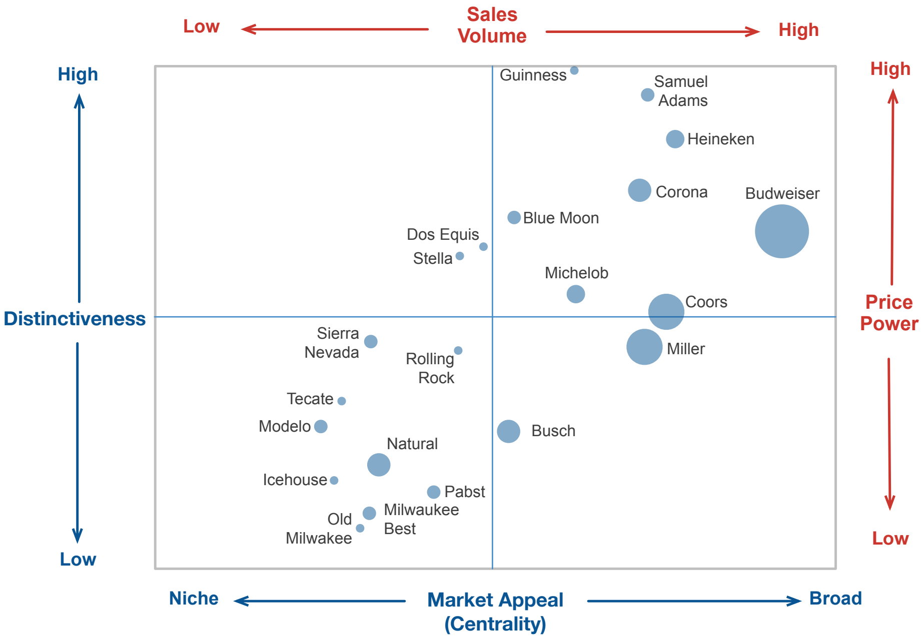
The goal of this iterative process is to find a profitable position where it is most difficult for your business to be challenged by potential competitors and where your products and services are less likely to be commoditized.



Finding and protecting a profitable market position

You don't need to destroy a competitor to win in a competitive market. The beauty of strategy comes from its diversity, which is what allows multiple players to win at the same time within the same industry.

You may track the results of this process in your Centrality-Distinctiveness map if you wish. To see how that would work, take a look at the following fictitious map for the beer industry at a given point in time.[10]



A fictitious Distinctiveness-Centrality perception map for the beer industry (adapted from Niraj Dawar and Charan K. Bagga)

From this map, managers at Anheuser-Busch InBev, owner of the Stella Artois brand, can view a picture of their industry and realize that Dos Equis is a closer competitor than Heineken.

They may also realize that to move right on the map (to make their product more mainstream), they would need to do a better job selling their more complex product to segments that may not appreciate their thicker texture, consumers more familiar with mainstream brands like Miller or Coors.

In the mid-1960s, Procter & Gamble (P&G) saw how new deodorant soaps and so-called "beauty bars" were attacking the soap market that its product Ivory had reigned over for a long time.

For decades since its introduction in the late 1800s, Ivory enjoyed a privileged differentiation leadership position, being the brand that defined and resembled what "cleanness" meant in the soap category. That position allowed P&G to command premium prices and retain a large share of the market for a long time.

But when under the attack of fancier entrant solutions, P&G decided to reposition its iconic brand to become the low-price leader in that space, rather than engaging in head-to-head competition with the new entrants.

In essence, the idea is to *zig* when others *zag*. If competition for a particular segment is tough, you must move onto a different market position or just switch customers.

The same process can also be used to expand into new markets and segments that are sub-optimized. If Stella finds out their brand is not clicking with the female segment, for example, they can launch a marketing campaign with strong female figures to increase the traction with women.

The success of this iterative process is in finding a position where you can produce superior profitability in a sustainable fashion and *pinning down* the business's products and services there.

How to become an "insightful" executive

Here's something I do that may help you really understand your markets better. I sit down every morning to read the news in my industry. I have created a number of keyword alerts and subscribe to multiple newsfeeds that bring relevant information my way every single day.

As I read through the news, I keep track of moves and announcements that could reveal strategic intentions from a sample of companies I keep tabs on, and save key pieces of information (relevant figures, executive statements, charts, documents, etc.) in a mindmap of the industry that I have on my computer. I usually ignore what a company says, and only pay attention to what they *do*.

In this way, every time I see something that gets my attention, like an acquisition, a product launch or a partnership announcement, I go to my mindmap and try to make sense of the move by looking at what I have on the entire map.

Why are they doing that? What do they know that others don't? What would need to be the truth for this move to make sense?

From asking these questions, sometimes I come up with my own conclusions on their strategy. Of course, that map is for my eyes only, as it prepares me to have better arguments and ideas in my day-to-day job, and I would never share it with anyone else (would you give away your secret weapon?).

Creating your own game

Sometimes we can get away with creating a unique offer just by simply changing the *metrics* the market uses to measure performance in a way that favors us. When well-executed, this move can help differentiate products and services over the long term.

Take Procter & Gamble and its Ivory soap bar again for example. In the late 1800s, Harley Procter came up with his own metric of purity: 99 $\frac{44}{100}$ *Percent Pure*. That number, which didn't actually mean much scientifically, was a metric invented by Procter to, in his own words, "demonstrate" that Ivory was purer than castile soaps, the standard of excellence at the time.

The new metric was later appended to Ivory's classic slogan "*It floats!*", which was an earlier attempt by the company to create a performance metric based on a differentiated feature, in that case around the fact that unlike other soaps on the market, Ivory could actually float on water, making it easier to use.

Ivory wrapping in the mid 1950s. See how it features its "purity" metric, accompanied by its core slogan "It floats!" which became a classic (source: Wikipedia)

In a similar move, American sunscreen company Coppertone created the *Sun Protection Factor* system, or SPF, as a measure of sun protection in the 1970s. The metric was later formally adopted as the industry standard by the Food and Drug Administration (FDA).

The SPF standard helped position Coppertone's products in a remarkable way since they were the first to carry a label with a measure of the protection they offered. Buyers in the market for sunscreen could now compare different Coppertone products against each other but couldn't do so with competitors' solutions.

Both moves were successful attempts to define the way that product performance would be measured in the industry, giving their implementers the lead advantage.

This game is played in sometimes subtle ways that are difficult to spot. For example, people for years have been using *Omeprazole*, a generic drug to treat gastric-acid conditions such as heartburns, esophagitis and some minor ulcer problems. In a nutshell, Omeprazole is used to reduce the amount of stomach acid.

The drug is mostly known in the United States under the brand name *Prilosec* but is also available under other brand names and as an off-the-shelf generic solution.

Esomeprazole, on the other hand, is another drug used for the same purposes as Omeprazole, but mostly sold under its brand name *Nexium*®, patented and commercialized by Swedish biotech company AstraZeneca.

Both drugs are based on the same active ingredient, but since Astra was able to patent a purer variation, it sells Nexium at four to eight times the price of Omeprazole-based products, a hefty premium for a product that offers the same functionality as its generic competitor.

Other companies reset the game by continually changing the definition of an entire category, so that competitors find it hard to catch up.

Go to your favorite food chain and see how they continually add new, exotic products appealing to the health-conscious consumer: maca powder, turmeric, kombucha, chia seeds and a hundred others are continually added to the shelves, re-setting the metrics of performance for buyers. Food-conscious consumers seeking to achieve peak performance continually need to add the latest tool to their arsenal, and those are only sold through specialized stores.

That continual addition of features and "add-ons" are just another way to keep redefining the metrics of performance within a market segment. Yes, goji berries are a type of superfood, and so are broccoli and spinach - but these two can't add as much exciting growth to the bottom line as a new thing.

Finally, there are some companies that decide to change how the game is scored entirely and define a new way of competing.

For example, some farmers in the state of Iowa in the United States are raising silvery barramundi, a type of fish that delivers the same nutrition benefits as salmon with the flavor of red snapper, but that can be grown at a fraction of the cost as it tolerates a wide set of environments and flexible diets.

These farmers expect to position barramundi as a product comparable to salmon to command premium prices from a product that can be raised fairly inexpensively. Some are even suggesting they label the fish as "Iowan Salmon" and price it just below the real salmon to compete directly for its consumers.[11]

Rather than competing on price with a lesser quality fish, they are picking a competitor from the top of the market and positioning themselves at the top too. If they succeed, this will be remembered as a great case of vendors *selecting* their competition.

The value of powerful brands

Powerful brands can help you defend your market share, slow down customer churn and retain a profitable position in your market. They can also help you through price wars and finding growth when you go through tough times.

However, brands also can lose power over time. Professor David Aaker of Berkeley's Haas School of Business provides three reasons why brands lose relevance:

1. A decline in the relevance of the product category,
2. A decline in the relevance of the brand with respect to other brands in its marketplace, and
3. The emergence of a reason not to buy.

Let's go through them one by one.

To start, if the product category is in decline, it will be hard to find growth even if the product is highly differentiated or is the cheapest on the market. Sony's Walkman might well be the best MP3 player ever made with a reputable name in the space, but its relevance is in decline because so is the entire product category (MP3 players).

If you face decline in one of your product categories you have a few options. You can continue to extract any value left in the category through innovation and the positioning levers until it naturally phases out, you may try to reposition the brand, or you can just exit the market, either by closing the business or selling it out.

The second reason for losing relevance relates to the brand itself losing ground and visibility with respect to other brands in the market. This is a case where the category is strong, but your brand delivers weak results and loses share to others.

This decline might be relative to some extent. For example, a brand could be losing relevance with respect to particular consumer segment, like Facebook lagging behind in the preference of younger crowds who prefer Snapchat and Instagram to connect with friends, or the brand could be losing relevance in an entire market like Levi's declining market share in apparel.

When your brands are losing relevance in strong markets, you need to pay special care to identify the drivers of the decay and act energetically to fix problems before is too late. Among the actions to fix a brand degradation you may want to consider are major rebranding efforts, which might include piggybacking on more established brands, and/or promotion through sponsorships, partnerships and other programs.

Finally, a brand might be affected by the emergence of strong reasons to stop using the product.

For instance, concerns about health risks have diminished sales of tobacco-related products over the last two decades. In a more recent example, many users have stopped using Facebook because of the network's seemingly weak response to scandals involving Russians meddling in the US presidential elections and the manipulation of the network to influence indecisive voters.

Bad reputation is one of the hardest things to clean off once it's ingrained in consumers' minds. To deal with it, my recommendation is that if you are affected by something damaging your reputation - and you actually have some responsibility for it - you should engage in open, fact-based discussions to reveal any truth behind the headlines and get the accounts straight moving forward.

Negating facts rarely works. If something is broken, you are better off acknowledging it and quickly proposing a path to right the wrongs. If you do the right thing people will usually forget faster.

Powerful brands are some of the most valuable assets in your portfolio and must be handled with care as they can be destroyed in a blink.

If your products are losing relevance you must try to understand the reasons driving the decay: Is it because of a *category* decline? Or is the "brandable" value moving to other product features? Is it because your products are becoming obsolete, or falling behind competitors' solutions that offer more value and fresher innovation? Or is the decline associated with a growing bad reputation of your products or your company? If so, what are you going to do about it?

You must ask these types of questions and always come up with realistic, fact-based answers and never try to mask a bad situation. Always face the bad news, acknowledge when needed and move on quickly.

Analytics-based competition

Advancement of computing capabilities, mostly powered by cloud-based systems along with huge improvements in data analytics and artificial intelligence, has brought a new game to many industries: data-driven competition.

Data analytics has been around for a while, but it is only now that the intersection of these powerful technologies enable affordable integrations that it can have meaningful impact on a company's competitive capabilities. And because of its relatively low penetration in some industries, business-driven analytics can still deliver an edge to those willing to explore and exploit its potential.

When we talk about data-driven competition, we refer to the use of data analytics to improve your earnings and increase profitability. As we explained in the previous chapters, there are basically two ways to retain a profitable position: differentiation and lower costs. Data analytics can help you with both.

For example, IBM is using data analytics to improve diagnostics in the healthcare space, helping some practices achieve superior accuracy over human-only diagnostic centers.

In one case, IBM's Watson computer analyzed 20 million research papers on cancer and correctly diagnosed a 60-year-old woman with a rare form of leukemia. The woman had been receiving other treatments without meaningful results, but Watson's diagnostic pointed to the specific treatment she needed, helping doctors finally improve the patient's health.

A more widely known case of using analytics to gain a market advantage is Alphabet's web search engine Google, which uses thousands of parameters and signals to show the best search results based on the individual's particular interests and other parameters like location and the quality of web pages.

That accuracy and personalization is one of the main reasons why Google became the dominant web search service, outperforming rival engines like AltaVista and Yahoo! who were the pioneers in the space.

On a different note, data analytics is also helping companies lower costs across multiple industries. One of the most notorious examples is how Walmart, a giant retailer that moves around $32 billion a year in inventory across 70 countries, has developed an advanced supply chain analysis platform which has now been extended to vendors and suppliers and is helping the company keep logistics costs down and retain its low-cost leadership position in retail.

And once again Google, through its machine learning company DeepMind, has developed algorithms that together have reduced energy consumption in the company's data centers by over 40 percent.

Data analytics can also be used to uncover customer preferences and understand user behavior to increase your sales and improve customer retention. Amazon.com for example uses data analytics and sophisticated algorithms to make personalized product recommendations to buyers based on a series of factors including the user's purchase history, pages visited and products placed in the shopping cart.[12]

In a similar application, Netflix's recommender algorithm which presents their users with accurate recommendations based on their historic behavior and crowdsourced factors is just another example of how data analytics and machine learning can help make personalization (understanding customers better) part of a business's business model.[13]

In general, data analytics systems are divided into three types based on their functionality:

1. **Descriptive systems:** Evaluate data *ex-post* and produce insights about past behavior, providing relevant metrics and performance indicators that can be used to make decisions later. For example, Microsoft has saved millions of dollars a year in energy consumption by using software and sensors in a descriptive analytics application that helps them see where energy is being used, identifying opportunities for improvement.

2. **Predictive systems:** Use historical data to find patterns and predict future behavior. For example, many banking institutions are using predictive systems to measure the probability of delinquency and default on credit customers.

3. **Prescriptive systems:** Use historical data and sophisticated algorithms to recommend actions and behaviors. For example, UPS's ORION platform evaluates the company's deliveries to be made every day and provides drivers with the specific routes that they must follow, generating the company millions of dollars every year in fuel savings.

Data analytics is the new secret competitive weapon that many companies are using to find and seize profitable positions in their markets. There's a lot of value that might be hidden in your data that is just sitting there, waiting to be created.

A good way to start thinking about potential data analytics applications for your organization is by using a table like the one shown below, where you can brainstorm with your team the different ways in which you could create a competitive edge. All you need to do is to try to complete each of the empty spaces with applications for your company.

Goal/ Application	**Descriptive**	**Predictive**	**Prescriptive**
Differentiate or increase sales	Banks provide users applications that provide a breakdown of their expenses so they can see where their money is going.	Netflix's algorithm provides accurate recommendations to users.	IBM has been using analytics and machine learning to improve its M&A activity.
Lower costs or improved efficiency	Microsoft has been using data analytics to break down energy consumption by device and optimize costs in data centers.	Banking institutions have been using analytics to predict defaults and delinquency.	UPS's ORION system provides turn-by-turn instructions to drivers saving millions in fuel costs.

A table to brainstorm ideas for data analytics applications. It has been filled out with real-life examples for reference.

Because these applications will need data, this exercise must be complemented with a *data gap* analysis, where you first identify the kind of data that is currently available, and then point at the additional data that would need to be collected in order to make those applications perform as expected.

An alternative *reverse-engineering* approach to identifying potential data analytics applications would be to identify the data that is currently being collected, then see what additional data *could* be collected, and then figure out which applications you could create with that amount of information.

Data analytics tools are designed to extend human capabilities to help make better decisions, and strategy is not out of their scope.

Essay: Multi-cores and the perennial pursuit of opportunities

Conventional wisdom is so embedded in how strategy is taught and practiced that sometimes it is hard to argue with well-established lines of thought without feeling that you're wrong, but the fast-paced environment that companies face today requires fresh thinking and sometimes a detachment from the old ways of approaching business.

Modern strategies, in my view, must embrace change as the only constant, and persistently fight biases from old ways of thinking that might be limiting their ability to explore further.

Many of the old prescriptions can lead great organizations to failure. In fact, you may learn more about so-called *best practices* in a bankruptcy court than in your local public library.

The problem, however, is that as humans, it is very hard to argue against an idea that makes sense, especially if it is simple.

A particularly established school of thought, that in my view limits managers in their pursuit of fresh business ideas, has to do with favoring the things that we know about, and rejecting those that we don't, as in a tale where "good management" ends up preventing innovation.

This tale has already been told in different ways and by different authors, notable among them Clayton Christensen and Rita McGrath, but I want to tell my own from a practitioner's point of view and connect it to the work throughout this book.[14]

In a vivid example of "good practice" advice, authors A.G. Lafley and Roger Martin in their book *Playing to Win: How Strategy Really Works* define strategy as the answer to the following questions:

1. What is the aspiration of the organization (the company's guide, its vision)?
2. *Where* will the company achieve these goals (product segments, geographies, channels, product categories)?
3. *How* will the company achieve these goals (value proposition, competitive advantages)?

4. What capabilities will the company need to achieve these goals (people, resources)?
5. How will we manage the organization to achieve these goals (metrics, incentives)?

This is a solid approach from any perspective and is very hard to argue against what seems like a clear path forward to strategy: you start by defining ambitious goals, then establish clear boundaries of where and how you will compete, and finally make sure that the choices you make are executed well.

While I appreciate how sound this plan is, it is in my view only suitable for companies with well-established operating businesses, in pursuit of opportunities around a set of "core" capabilities that they already own and master.

This is the purest embodiment of classic strategy advice: established players define what they are good at, then go and double down on their efforts to strengthen that position.

The approach, however, pre-assumes that managers already know all the existing opportunities that there are, and that they already know the best ways to capture them

In my view, this advice may blindside companies and prevent them from creating *new* opportunities that could be available to them, just because they decide to focus on their core business, which is, by the way, always a good thing to do.

But this classic thinking is a perpetuation of the idea that a business must be built around a core *competitive advantage*: you find out what that advantage is for your business, get better than anyone else at it, and then line up the organization to perfectly execute it.

That is, once again, good conventional advice, but I'll argue that in a fast-paced industry, companies will need to develop some level of "multidexterity" and continually seek to develop more than one core business, which may or may not reinforce each other.

To put that idea in context, think about Netflix's decision to build their streaming service while still at the top of their physical DVD business.

They saw streaming as the future of their business and decided to put their efforts into developing a new core in a market that didn't exist yet.

Being at the top of the movie rental industry, Netflix could have decided that they needed to protect their core business and re-invest all their earnings into the competitive advantages of their DVD business to extend it as much as possible. In fact, all financial indicators would support that idea since, in the end, why would you invest any money in a market that you don't even know will exist, when you could put all that money back into your already thriving business and get a safe, predictable return?

But instead of rejecting the idea because it was financially less attractive than re-investing earnings back into their ongoing DVD business, Netflix moved ahead with it because it saw streaming in the context of what it *could* be: a threat to the DVD business.

Content streaming could have been owned by Blockbuster today, in the same way that the iPod could have been Sony's, Android mobile software could have been Microsoft's and Walmart could have owned online retail.

But all those billion-dollar markets were created right under these incumbents' noses.

Entire companies that followed the classic advice of conventional wisdom went down with their products because they only had one core business, with Research in Motion (makers of the BlackBerry), Kodak, Polaroid and Novell being just a few.

These companies were so focused on exploiting their core businesses that anything beyond the reach of their "competitive advantages" would have been white noise in the background and had to be passed on.

By all conventional metrics, incumbents did the right thing, but they also missed the chance to ride great opportunities. In fact, Blockbuster turned down an offer to buy Netflix for $50 million in 2000.

Netflix today has a second core business that thrives in the new reality of the market, while at the same time they are still milking their DVD business as it goes through decline.

If you have a static view of strategy and you see your company in a privileged position within a mature industry, reaping steady, high returns for every dollar you put in it, there's no reason to think about a second, let alone a third, core.

Any emerging opportunity that is not aligned with your core strengths might be seen as a distraction, a waste of time and money pursuing something that 1) is not big enough to move the needle, and 2) is going to take your focus off the things that make you the real money.

But if you fast forward and see everything in motion, you may come to realize that opportunities arise and disappear within industries along with the businesses that serve them, making competitive advantages only relevant in a temporary context.

Opportunities are like waves on a pond that go up and down in response to the natural forces of competition and the convergence of multiple trends, and these trends often develop around the evolution of technology and customer preferences.

The advice to "stick to your guns" is only useful in slow moving markets, which are becoming increasingly more difficult to find nowadays. Once a market starts declining, you want to have something to hang onto. If the goose laying golden eggs dies and the cash cows get skinny, you still have to eat.

The nurturing and development of more than one core business allows you to ride new waves through while others die down.

Take Garmin Ltd. (NASDAQ: GRMN), an American electronics manufacturer best known for its wearable devices and navigation systems, which saw an opportunity to enter the market for automotive Global Positioning Systems (GPS), leveraging its previous experience developing similar products for aviation and marine customers.

Its Nüvi GPS series included advanced features such as a color screen and voice directions, and helped Garmin capture an important share of the market, making a name in consumer products.

Garmin was able to ride the automobile GPS wave, successfully extracting massive value from it, until advancements in location-based functionality on smartphones made the portable GPS category obsolete. At that point, Garmin pulled out of that market and stayed focused on its core business around navigation systems for their more demanding customers.

Had Garmin's business been based solely on portable products, it would have disappeared when smartphones became everybody's GPS.

A smooth way to develop additional cores is through *spinoffs*, or organizations that start out as a division of a company but later become independent businesses with their own organizational structure, employees and assets.

Spinoffs (or *spin-outs* as some call them) enjoy more independence from inefficient bureaucracy and tight controls at the mothership level, a feature that comes to be of great help when operating in fast-paced markets against other small, more agile companies.

Spinoffs, because of their size and more flexible structure, operate with a more entrepreneurial spirit than corporate offices and are a tax-efficient way to deploy capital gains.

A good example of a successful spinoff is Yum!, a restaurant company created by PepsiCo to own and operate their KFC, Pizza Hut and Taco Bell brands. The company was spun out in 1997, and since then its share price has delivered a *Combined Average Growth Rate* (CAGR) of over 14 percent, a success in the highly competitive fast food industry.

The number of core businesses that you can (or should) pursue depends on the speed at which your industry is moving. Managers in slow moving industries, like mining and oil for example, have the advantage of seeing new waves coming from a thousand miles away, getting enough time to react and ramp down honorably.

Companies operating in faster-paced markets, on the other hand, like those driven by computing power and many other consumer segments, need to think about developing more than one core faster.

In my experience researching this book and talking to people in the industries I do business in, industry evolution never progresses as fast as predicted by outsiders, nor as slow as "felt" by incumbents' executives.

From this, probably the golden rule we can deduce is that we must always seek to extract as much value as we can from an operating business for as long as it lasts, while at the same time we must always be looking ahead for opportunities to develop dominant positions in emerging waves.

To do that, you must adopt an opportunity-driven mentality, where opportunities drive strategy AND the other way around.

Instead of defining the strategy only around the opportunities that we know exist, you should use the strategy process to also *find* new opportunities wherever they could be, and once you find them, you must identify the best ways to explore them and get the most out of them.

For example, we could go through the strategy map we presented in the introduction, asking questions that could reveal existing opportunities, for example:

- Are there opportunities to expand our operations in core markets?
- Are there opportunities to enter markets internationally either by exporting directly or by partnering a foreign company?
- Are there opportunities to bring our products to other customer *segments*, even if that means changing the product a bit to fit them better?
- Are there opportunities to create new *markets* by targeting customers that are not well served by our current offers?
- Can we create entirely new markets at the edges of our industry and markets?
- Are there opportunities to partner another company and bring our products to other industries?
- Are there opportunities to develop products leveraging our value chain?
- Are there opportunities to develop solutions that are complementary to our products and services and that could be used together?
- Are there opportunities to develop complementary products or services along the product sale cycle?
- Are there opportunities to increase sales by implementing new pricing options?
- Are there opportunities to reduce costs?
- Are there opportunities to implement new business models?
- Are there opportunities to invest in other companies to learn about other industries?

Instead of sticking *only* to your core businesses, the *perennial pursuit of opportunities* is what should drive strategy.

A multi-core mindset keeps feeding the company with ideas for the expansion of core businesses and the creation of new cores, but most importantly it keeps us aware of trends in our markets, mitigating the blind spots that have prevented great companies from appreciating amazing opportunities as they emerge.

Emerging opportunities may not look as appealing as more established ones when they first show up, because they are not something *yet*. They are just signs of "a thing" that might turn out to be a good opportunity in the future, or not. But that's how they should be treated.

It is true that we are living a world of confusion, with a lot of false-positives and hype. Every day we are asked to pay attention to some new thing that will disrupt the industry and change the world forever. Virtual and augmented reality, chatbots, 3D printers, cryptocurrencies, machine learning, deep learning, Internet of things, biochips, big data, the sharing economy (the "Uber" of every market), wearables, Bitcoin, Blockchain and smart grid are just some of the new words that have been added to our dictionaries and competing for our attention over the last few years.

It is very difficult to keep track of everything happening around us. But think that out of this cloud of noise might come a deadly bullet that puts the end to your business.

You shouldn't go and test everything, of course, but you must pay close attention to any credible proposition and understand its *fundamental* components. How they work, and how they are expected to create value.

Finally, in the same way that we look for opportunities to get into, you should also *relentlessly* explore opportunities to get out. You need to be aware of changing conditions in your market that might be signaling its decline or that game-changers are coming.

An ability to see new waves to ride early enough, is just as important as understanding when it is time to ride the wave "down".

From Market to Operations

5

In July 2014 Tesla Motors, along with its partner the Japanese manufacturer Panasonic, announced the construction of the *Gigafactory 1*, a $5 billion manufacturing facility to produce the lithium-ion battery cells, packs and modules for Tesla's electric vehicles and stationary energy storage products.

The plant will be the largest building in the world by footprint, extending for over 10 million square feet (930,000 square meters) of usable space, enough to fit 100 Boeing 747 jets inside its 71-foot-tall structure.

The gigantic factory will allow Tesla to lower its battery costs around 30 percent, a reduction that will make possible Tesla's $35,000 Model 3, its affordable car targeting the masses. The factory will support the production of Tesla's vehicles and its growing energy division, which develops the company's home storage solution, the Powerwall, and its commercial battery, the Powerpack.

At the time the Gigafactory was announced, Tesla was making around 35,000 vehicles a year, but meeting its target of half a million vehicles per year would have required the entire worldwide production of lithium-ion batteries.

To support its market goals and reach the scale it needed to bring the costs of its battery down from $274 to around $196 per kilowatt-hour (kWh), Tesla decided to build its own battery manufacturing facility and picked Panasonic, already a battery supplier to Tesla, as a partner.

In this chapter we will:

- Explore the linkage between strategy and operations
- Discuss decisions on in-house making versus outsourcing
- Test the defensibility of a strategy from an operations point of view
- Revisit Porter's tests, this time considering the lessons in the previous chapters

3D rendering of completed Tesla Gigafactory 1 in Nevada (provided by Tesla, Inc.)

According to a Tesla Gigafactory tour handout: "*Panasonic brings experience in high volume cell manufacturing, while Tesla provides creative, first principles thinking, clear vision, a rapid pace of execution, and the end product design and demand*".

The Gigafactory's output was planned to reach a capacity of 50 GWh a year by the end of 2018, and three times that volume by the end of 2020, equivalent to 1.5 million Model 3s a year.

The facility will be powered by 100 percent renewable energy, in part through a combination of a 70 MW solar rooftop array and solar ground installations, with the rest being provided by nearby wind farms. To force itself to stick to its *only renewables* goal, the company has decided not to build a natural gas pipeline to the factory.

A large portion of its heating will be provided by heat waste recovered from production processes and a closed-loop water system, with six different treatment stages which will allow the plant to reuse 80 percent of the water.

The Gigafactory is Tesla's *operational* answer to its ambitious *market* goals and has been entirely designed to support the company's *market strategy*. Let's review a few key decisions that reflect the connection between Tesla's market strategy and the Gigafactory's operational design.

Site selection

The Gigafactory announcement attracted a lot of attention and interest from different states who wanted to host the plant expected to create 6,500 jobs and $5 billion a year in economic impact, mainly from wages.

Tesla's initial siting shortlist included five states in the western United States: Arizona, California, Nevada, Texas and New Mexico. Almost a year before the official Gigafactory announcement, the company sent a *Request for Information* (RFI) to each of the short-listed states, so that they could propose specific sites along with incentive packages and accommodations to make those sites attractive for Tesla.

According to some accounts, Reno (Nevada) was never one of the top choices for Tesla. The company finally settled for the Tahoe-Reno Industrial Center (TRIC) in Storey County due to a combination of regulatory speed, the state's tax incentive package, the ability to sell cars directly to buyers (which is prohibited in Texas and Arizona), proximity to lithium production and direct rail access to Tesla's assembly plant in Fremont, California.

"*It's really a get-things-done state*" said Tesla's CEO Elon Musk during the location announcement.

Tesla's battery packs weigh close to 1,000 pounds each so transportation costs from the plant to vehicle assembly facilities would be an important factor to consider. The site is also around 200 miles from Silver Peak, Nevada where the mine that will provide the lithium for the plant is located, so the location has favorable inbound and outbound transportation features.

The state of Nevada is also offering a juicy tax incentive package which includes no corporate taxes, 20 years free from sales taxes, 10 years free from property taxes and $200 million in transferable tax credits. These incentives will help Tesla reduce its production costs and offer affordable models to mass markets.

Capacity selection

The Gigafactory's initial capacity will allow Tesla to meet its production targets by 2020. The company initially purchased 1,000 acres for the initial phase and executed an option to buy twice as much for future expansions.

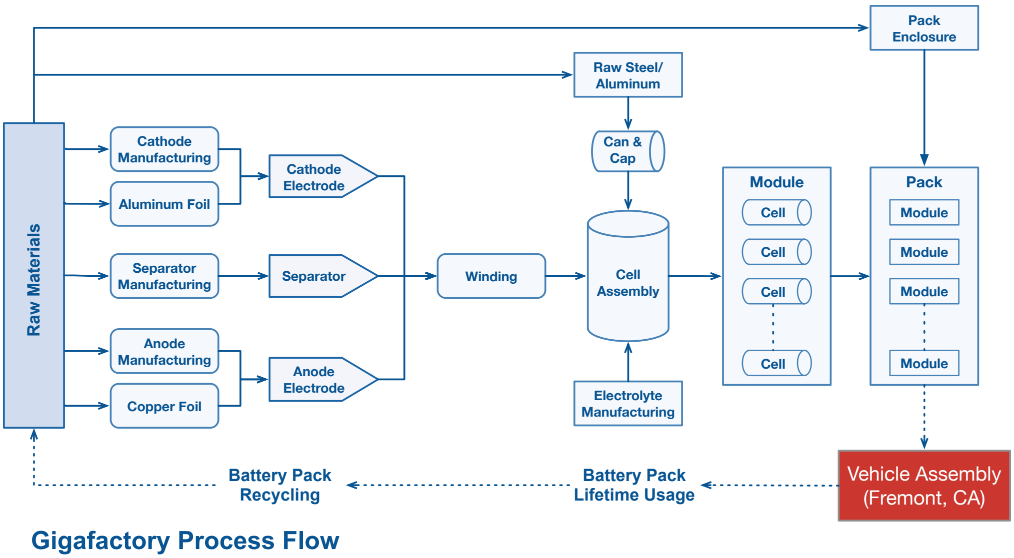
Its modular architecture and in-house *design-and-build* approach facilitates low cost replication and rapid expansion. The facility has also been designed to accommodate future battery chemistries and packaging configurations, minimizing stranded asset risks.

The construction has been broken down into phases to facilitate short-term manufacturing and continue expansion works simultaneously.

Operations and cost optimization

The Gigafactory 1 is a fully integrated battery manufacturing facility. It takes raw materials like lithium, aluminum, cobalt and nickel and produces fully-assembled battery packages.

Within each factory module, three production lines work around the clock to produce the three basic components that make a battery: the cathode, the anode and the separator. These components are later combined with the electrolyte in an assembly line that produces Tesla's 2170 lithium-ion battery cells, which are later packed and stored ready to be shipped out.



Tesla's Gigafactory process flow. Adapted from information provided by Tesla, Inc.

The entire process, from raw materials to cells, happens at heart-stopping speeds. "*Cells will be going through that thing like bullets from a machine gun. In fact, the exit rate of cells will be faster than bullets from a machine gun*" Musk said during an analyst call.

The entire process has been highly automated to increase efficiency and reduce costs. Mobile robots called *Automated Guided Vehicles* (AGVs), will roam around the factory moving parts from one place to another following a magnetic tape on the floor helped by laser sensors.

Both Tesla and Panasonic understand the challenges they face in trying to achieve the target costs and have gone to great lengths to minimize capital investments and cost per kWh. Some of these decisions include:

- They have designed the facility to maximize output per square meter and to accelerate production *throughput*.
- Design and construction have been kept in-house to facilitate market expansions, rapid replication and fast improvements.
- Design, layout and construction have been optimized to reduce capital and operational expenses.
- They have re-engineered their supply chain to increase volume and quality while reducing costs per kWh.
- They improved cell design and moved from the old cell model 18650 to the new 2170, and
- Increased automation to enhance production and reduce waste.

The end result is a highly-optimized operation that will support Tesla's market strategy of producing affordable under $35,000 models for the masses.

A company's operations must be optimized to support its market strategy and make this sustainable. Although some argue that the opposite is also the truth, that there are cases where a market strategy must adjust to constraints found in operations, I'd argue that a successful strategy always results from finding market needs that need to be served and then optimizing the value chain to meet those needs well.

Whatever the case, a successful strategy always requires good alignment between the market strategy and the company's operations, and in this chapter we explore these connections in more detail.

The link between a market strategy and operations

We mentioned previously how a strategy that is both profitable and defendable is only achievable through a differentiated value proposition or a distinctive value chain. In plain English, that means that your products should be different AND valuable to your target consumers, or to some extent they should have something that is difficult for your competitors to imitate.

Strategic positioning therefore demands clear decisions about the value that your products and services will offer, and how those products and services will be produced by your company *profitably*. It requires a *market* strategy that identifies and defines opportunities, and an *operations* strategy that makes decisions about how your company will configure its value chain (assets, processes and human resources) to capture that opportunity profitably.

Strategic Positioning

Strategic positioning makes decisions about the value that a company's products will offer, and how that value will be created by the organization.

To occupy a market position that is both profitable and defendable, a business must make decisions to differentiate its products and services from other solutions, or make products differently from competitors.

Market Strategy

Defines how a business plans to position its products and services in the minds of target consumers, making decisions about product design and pricing models as well as sales, distribution and promotion efforts.

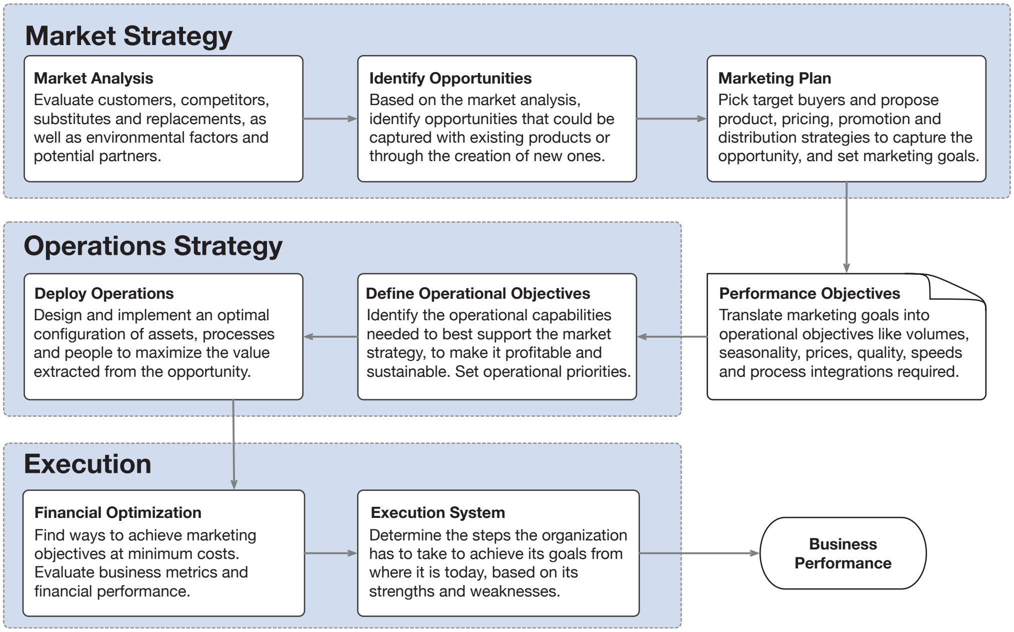
Operations Strategy

Makes decisions about how the business will align its resources (people, assets and processes) to deliver the products' value propositions and support its market strategy profitably.

Good strategic positioning requires alignment between a company's market strategy and its operations

Although each case is unique and depends on the specific type of company and the industry where it operates, we could say that *in general* the strategy process follows a sequence that usually starts at the market level through some kind of market research or discovery process. It then leads on to the definition of a target market, value proposition and business model, and from there it moves upstream to optimize the activities in the business's value chain that will support the capture of those opportunities.

Although many rightly argue that a “forward” approach is also feasible, where an organization analyzes its capabilities and then goes out to find opportunities that fit its strengths, that doesn’t seem to be the norm, and I’d say that’s more a *sales* effort than a pure strategy formulation. Ideally, the process should flow from market opportunities to operations.



Simplified sequence of a typical strategy planning process

Once you understand your market positioning intentions clearly, you can define the metrics that will measure the performance and/or constraints of your operations. Things like demand forecasts, seasonality and prices must be translated into capacity needs, dependability, flexibility and maximum allowed costs for the operational teams.

With that information, you can then set your *operational priorities*, that is, the factors that your operational teams must focus on to support your market strategy. If the strategy is based on differentiation for example you may have to put more emphasis on the factors that make your products different.

In the case of Uber, to use a familiar example, the company must focus on developing the capabilities that supports its business model, in this case data analytics, geo-location and artificial intelligence, and leave cloud servers (the hardware where its application is run), car insurance and other non-critical businesses to third parties that can do a better job at them.

You need to have a clear understanding of your operational priorities, and put the corresponding plans in place to support, develop and invest in those capabilities.

With those priorities well established, you can do a better job at configuring and optimizing the activities in your value chain, defining more specific things like project capacity and making location decisions.

You must be extremely careful when evaluating capacity investments, since hard assets could eventually become stranded costs if your business doesn't succeed as expected. You should also consider how your proposed capacity plans could play out with the capacity plans of other companies attacking the same segments. If too much capacity accumulates in a market, its players may be forced to start price wars as a way to stay in business.

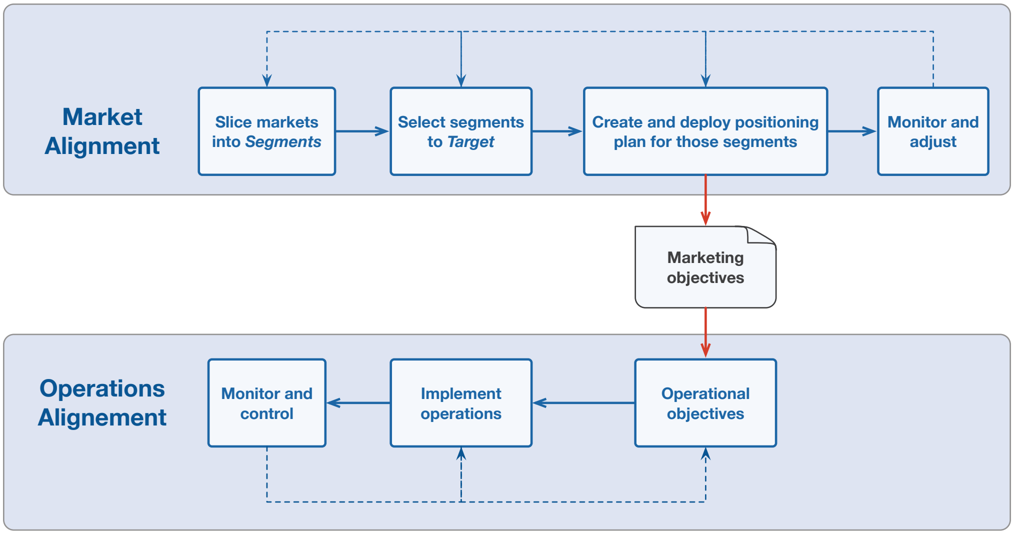
Boeing and Airbus have several times engaged in races to produce the largest planes, but they both know there is not enough market capacity for two aggressive players producing huge planes.

Sometimes the numbers would suggest that very large scales are needed to turn a profit (like with Tesla's Gigafactory), but the larger these numbers are, the higher the risks of dragging out large fixed costs for a long time (or even forever) if demand never catches up as you expect.

Other important value chain decisions involve the labor needed, in both quantity and quality. Highly skilled labor is sometimes hard to find, and so is cheap labor in high quantities, so those considerations must also be seriously pondered.

Operations is usually seen as a technical subject but it should not be. It is a fundamental component of strategic positioning and is all about making the marketing plans, hence the strategy, happen. Without a good operations strategy, there would be no competitive advantages, superior profitability or sustainability.

In a dynamic environment, operations and marketing must be always aligned to ensure that the organization is efficient at using its resources and that profitability is always maximized.



Keeping alignment between marketing and operations is critical to making your strategy both profitable and defendable over time

To do that, you must have a clear understanding of the markets and opportunities you are going after and ensure that your value chain is optimized to capture them. Any changes in the market, or in your operations, that require modifications in who you target or how you target them, must be properly addressed and looped back in.

Making our buy: Value chain integration choices

Integration choices are the decisions that need to be made about which activities, among those involved in producing and delivering products and services, will remain in-house and which ones will be outsourced.

There are strategic implications in these decisions that sometimes force you to make serious tradeoffs. For example, in a fully integrated value chain where you do everything in-house, you could make products that achieve the highest performance and deliver the best customer experience, since every single piece of the process is under your control, but this would come at a higher cost.

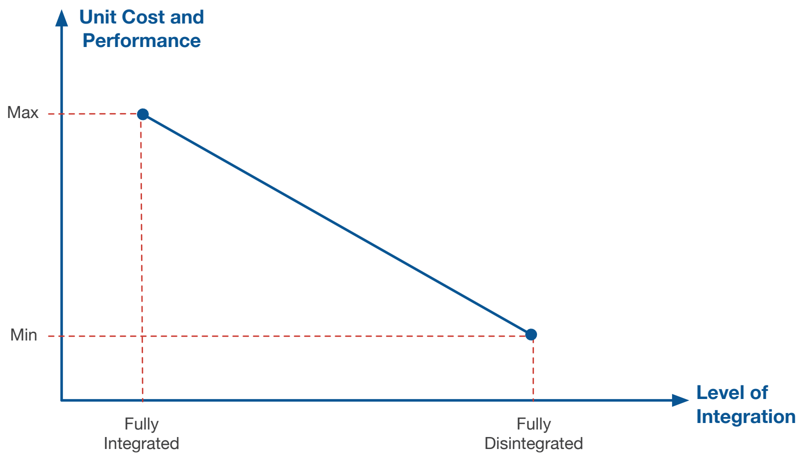
At the other extreme, if you had a fully disintegrated value chain where everything was outsourced, you would probably achieve the minimum costs per unit possible but would sacrifice the quality of the final products and the customer experience.

In most cases, assuming more or less control of the production process involves a tradeoff between the cost and the performance of the final product, and the best option is not always straightforward. But there's a factor that complicates the decision even further: how flexible your value chain would be in responding to a change in your strategy based on these decisions.

For instance, how difficult would it be to integrate new product features in response to changing customer preferences, or how expensive would it be to switch to an entirely different product?

Those kinds of decisions make the selection of your integration choices a critical component of your strategy.

Usually, the more you do in-house, the more control you have on the quality of the final product and your customers' experience, but the less flexible your value chain becomes to change strategies down the road. Those tradeoffs must be taken into account when selecting the activities that will stay in and those that will stay out, because what might be a success factor today could become a deadly pill tomorrow.



A fully integrated value chain, i.e. becoming specialists in every component, would give you the highest performance possible, while a fully disintegrated value chain, i.e. outsourcing everything from specialized companies, would achieve the lowest possible cost. In making integration and disintegration choices there's always a strategic tradeoff that must be considered

There is generally a consensus that companies must retain control of any combination of activities that drive performance along dimensions that matter to customers and outsource the rest. In other words, that you must keep in-house the activities that are important for your customers as long as you can make them *better* than third parties, and outsource other activities that are less critical that third parties can do *cheaper* than you.[15]

A natural cycle for critical activities is to keep them in-house while they can help differentiate your products, until specialist companies emerge that can do those activities cheaper, then outsource those activities to them as they become commoditized. For example, Microsoft kept its Microsoft Press team, which published product-related books, as part of its organization for more than two decades. Microsoft Press was a key complement to the company's products that helped educate its users and helped the company keep its leadership in multiple segments with products like Microsoft Office, Windows, Microsoft Access and many others.

At the height of the computing publishing industry Microsoft Press employed more than a hundred people, but in 2009 the company decided to outsource its entire distribution to O'Reilly Media, which also became a co-publisher of the technical titles.

Microsoft Press will still continue publishing books to complement Microsoft's products, but those titles will no longer be developed in-house as now specialists like O'Reilly and Pearson, which became Microsoft Press's official distributor in 2014, can handle those tasks more efficiently and at a lower cost.

Value chains that allow the disintegration of non-critical tasks sometimes sacrifice quality and performance to reduce costs and to gain higher flexibility to respond faster to market changes. These decisions are critical for strategy and they can make or break your business down the road, so you must take them seriously.

Is your market position defendable?

To test the defensibility of your strategy *from an operational standpoint*, you have to benchmark your operations against those of other companies, especially potential competitors, to gauge whether they would have cost advantages delivering *YOUR* value proposition with *THEIR* value chain.

In other words, could your closest competitors make the same products that you make – but cheaper – if they wanted to?

This type of introspective analysis can help you understand how much of your performance has to do with a cost advantage and how much is due to differentiation.

For example, if you realized that a potential competitor would have a cost advantage delivering a product that's identical to yours, that would be a signal that the sustainability of your market position could be at risk.

It means that your profitability is based on non-product factors. Things like strong brands for example.

In response, you could help protect your position against a potential attack by investing more in non-product (i.e. market positioning) efforts such as branding and promotion, or by improving relationships with strategic customers. If what makes you profitable is non-product factors, then you must double down on those.

An example can probably help clarify these points. Let's say that executives at Dr Pepper Snapple Group, owners of the Sunkist soda brand, realized that Coca-Cola could deliver a similar product at lower cost per unit. If that was the case, Sunkist should use the positioning levers to improve at *non-product* factors that make its product stand out with its buyers such as branding, flavor and distribution.

If on the other hand it does this exercise and concludes that Coca-Cola couldn't deliver a similar product cheaper, then Coke is not a current threat to Sunkist and it can stay focused on tangible factors such as operations and keeping that cost advantage.

IS YOUR STRATEGY DEFENDABLE? Go beyond market forces and do a full competitive analysis. Learn more about it at strategyforexecs.com/competitive.

Porter's tests revisited

In Chapter 2 we introduced Michael Porter's five tests of a good strategy. Let us now revisit these in light of the lessons we have covered so far.

Test No. 1: Your business must have a unique value proposition

It is more than clear by now why you need a good understanding of how your products and services deliver value to customers, which is best defined by their value proposition. However, in a fast-moving environment, a value proposition becomes a *dynamic* concept that must be closely monitored and continually adapted to ensure it still clicks with its target consumers.

Sometimes, classic demographic approaches such as gender, age and income brackets are not enough to understand why people buy, so you'll probably need to find other ways to slice the market. When none of that works, then you need to consider moving out to target other consumers or completely different markets.

Finally, different consumers may need to be reached through different channels and sometimes with different product presentations. Market conditions are not static any more, and customers are increasingly dissimilar to each other.

Test No. 2: The business (still) needs a distinctive value chain

A distinctive value chain is still at the core of a successful strategy, but it should not be so rigid as to prevent evolution with market changes.

A highly-integrated value chain (i.e. where most is done in-house) could make sense during the early stages of an industry, because that might be the only way to deliver a high-quality product, and because customers are willing to pay more for better solutions.

But over time, as competition increases and products deliver more than what customers need, you need to think about "modularizing" your value chain and outsourcing what is already good enough, keeping only the subsystems that create the dimensions critical for customer satisfaction.

A decade ago many people would pay top dollar to have the latest microprocessor and the largest hard drive in their desktop computer. But today it is more difficult to find buyers willing to pay premium prices for those even though they perform many times better nowadays.

Test No. 3: A strategy must have clear tradeoffs, and decisions about what not to do

This is completely true; however, what doesn't work today *may* actually work tomorrow. Kodak invented digital cameras but decided not to pursue them through a different business model, and that's why the story didn't end very well for them.

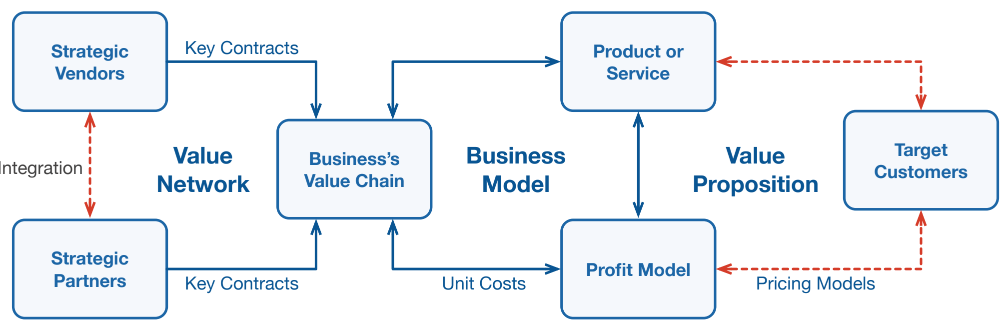
What you must realize is that industry environment, customer preferences and technologies evolve, and they may intersect at some point in the future to present opportunities that didn't previously exist. Apple didn't invent the tablet, but it was ready to take over the market when the conditions were right.

Assumptions change, and so must decisions, and your job is to continually check the conditions under which decisions to NOT do something were made, and validate whether or not those fundamentals are still in place.

Test No. 4: A business must have a value chain where activities reinforce each other and fit together

A better view of your business is by thinking in terms of a customer *Value System* within which value is created by your business's products and services and consumed by your customers. Within that value system your vendors, partners, sales and distribution channels, retailers, value chain, business models and customers all interact to create an efficient ecosystem.

The Building Blocks of Customer Value



Each customer segment must be served through a value system that has been optimized to meet its needs in the most effective and profitable way

Value systems are specifically designed to address the needs of a particular customer segment with a particular product. A beer company, for example, sells its products to women, young men, sports fanatics and other groups, but each segment must be approached through a distinctive and unique value system.

Described this way, it is the entire value system from vendors to product disposal that needs to be optimized when seeking to maximize the value we extract from an opportunity.

Test No. 5: Strategy must have continuity

While it is true that consistency can help improve learning curves and economies of scale, both important components of a sustainable strategy, you must also recognize when it is time to let go. The ability to *align and disengage* as needed is probably one of the most important capabilities you can develop as a modern executive.

Leaders must be able to see the signs of industry decline early on and take the proper actions to slowly disengage while doubling down on other cores. Thinking across more than one core business doesn't come naturally to most executives, but it is a trait that differentiates multidexter leaders from the rest.

When buying NBC, Jack Welch was continually criticized by expert analysts and other CEOs because the deal would put GE into foreign waters. He was constantly advised not to pursue the deal, because he didn't know anything about movies or TV shows. But to his critics, Jack Welch gave the multidexter answer: "*Well, I can't build a jet engine, either. I can't build a turbine. Our job at GE is to deal with human and financial resources. The idea of getting great talent, giving them all the support in the world, and letting them run is the whole management philosophy of GE, whether it's in turbines, engines, or a TV network.*"

Test No. 6: When in doubt, move in the customer's direction

This is our addition to Porter's quintet: adopting a mentality of *helping customers improve*. For years, most of the strategic advice that leaders and managers received has been focused on being best at something you are already good at.

That mentality is a centralized and outdated piece of advice, product of an industrial era when the United States was fighting highly efficient Japanese competitors. Managers trained under these frameworks tend to put more emphasis on *upstream* activities like supply chain and manufacturing, and less on *downstream* work like sales, customer service and post-sales support.

Their core idea is that the more you sell the more money you make, so under this mentality managers keep trying to find ways to sell more units of the products and services they make, to increase utilization factors of their assets and spread their fixed costs. In a way, it is like trying to tell customers what they should want based on what you can sell.

Because most companies are still influenced by those process-centric approaches, it creates opportunities for *downstream* value creation: companies which, instead of thinking about what they want to sell, start trying to find out what customers actually want to buy.

To quote Niraj Dawar, author of *Tilt: Shifting your strategy from Products to Customers*, *"companies must shift the center of gravity of their businesses towards customer-value activities instead of keeping going the other way to upstream and cost-focused jobs"*.

A more customer-centric approach, which pay serious attention to buyers' needs and wants and that seriously researches what, why and how people buy, will usually be better equipped to defend your market position over the long run.

In the early days of Amazon.com, when confronted by mortified book publishers angered by all the bad book reviews that users were posting on the site, Jeff Bezos responded "*We don't make money when we sell things, we make money when we help customers make purchase decisions*". That can help understand the market position where Amazon is today.

Part III

Growing Earnings

Growing the Core

6

Align Technology (NASDAQ: ALGN) is a manufacturer of 3D medical scanners and orthodontic devices, mostly known for its brand of clear aligners Invisalign, a transparent, plastic form of dental braces used to adjust teeth. The company was founded in 1997, introduced Invisalign in 2000 and went public in 2001.

Since going public, Align's stock price has seen an astonishing one thousand percent increase, making it one of the hottest stocks and a new darling in Wall Street. During the last five years alone, ALGN's stock price has increased 300 percent, and its current market cap is reaching $20 billion.

The Invisalign treatment, which costs between $3,000 and $8,000, has been purchased by more than 5 million people around the world.

Most of this recent value gain, however, is not attributable to new products or disruptions, but to an aggressive growth plan targeting a new market segment: teenagers, and an entry into what turned out to be a huge international market for the product – China.

Growth, especially when it comes from the core, should always be well received, but what's more surprising about Align's story is that all this growth has been extracted from a single product: Invisalign.

The company has masterfully used the rest of the positioning levers (price, promotion, sales and distribution)

In this chapter we will:

- Discuss growth and core business expansions
- Explain the different ways to enter international markets
- Describe different approaches to optimizing revenues and costs
- Explain how to use data analytics to optimize earnings
- Introduce three ways to grow a business inorganically
- Explain how to create a strategic plan for growth and measure its results

along with business model innovation to grow its core business, bringing its one product to new segments, new customers and into entirely new markets both at home and overseas. Align is squeezing this opportunity as much and as fast as it can, all with a single product.

Contrast that with IBM (NYSE: IBM, LON: IBM), an innovation powerhouse that's been churning out cutting-edge products for decades, yet its stock hasn't grown in the last five years.

It is not that IBM has run out of good ideas; in fact it has pioneered applications in machine learning, cloud computing and forecasting, spends around $6 billion a year on research and development (R&D) and its Watson computer is arguably one of the most powerful in the world. But investors have lost confidence in the company's ability to produce significant growth, even though they all agree IBM has plenty of great products.

For public companies, a factor that usually carries a lot of weight for investors and analysts is not whether the company can grow, but *how much* it can grow.

When companies become public they usually do so seeking capital to expand and grow, but that money comes with some strings attached: when investors value a stock, they already factor in how much they expect that company to grow, so anything short of that expectation is considered a *loss*. These growth expectations are influenced by the experience and previous performance of the management team on board, and the "temperature" of the market where the business operates.

More demanding investors will set the growth bar higher for management and will punish the stock if they receive anything short of their expectations, even if the company outperforms its peers in the industry. For investors, a company they expect to grow 10 percent that only delivers 8 percent *feels* like delivering a 2 percent loss, even if the company's market only grew 6 percent on average.

Once a company becomes public it begins a race against a number of factors. In addition to competing with the usual forces (rivals, powerful vendors and buyers, and substitutes), now it also has to compete *at the stock level* with companies from within and outside its industry, and with the growth expectations of shareholders.

It is very difficult to win that race on all the fronts all the time, and in fact many companies like Dell Computers and Burger King have decided to leave the market and go back to private ownership, unable to cope with the street's expectations.

Consequently, part of the job of the executives in charge, especially the CEO, is to manage the external expectations of how much the company will grow, being straight up with the more aggressive shareholders and at the same time cultivating relationships with the right type of investors for the organization.

For executives looking to maximize value for shareholders, growth becomes both a necessity and a risk-bearing factor. Grow too fast and see how your cash quickly burns before turning a profit and your customer satisfaction decreases; grow too slow and watch as competitors eat your lunch.

Sustaining high growth is very hard. In fact, according to some accounts, fewer than 10 percent of the Fortune 500 companies have managed to outperform the market for a sustained period.

Just like in real life, there's no love story that lasts forever in Wall Street. In the end, there's only so much that a business can grow profitably. Take Facebook, for example, a company that has come a long way since its humble beginnings in a dorm room at Harvard to become the modern, fully-fledged social platform that it is today.

In its pursuit of growth, Facebook has been creating and adding innovative ways to increase advertising to its massive user base which currently exceeds a billion users, giving marketers more control over who they target and what's shown in users' timelines.

On an ad-supported platform like Facebook, where users' data is the product, revenues come mostly from increasing two factors: the number of active users, and the time each active user spends on the platform. Facebook uses machine learning techniques to learn about the type of content its users consume the most, and continually updates its algorithms to increase the time that each user spends per sign-in.

As of today, estimates put the average Facebook user at spending around 120 hours a year on the network, with users in the US spending twice as much time on the platform.

At the same time, Facebook has expanded the number of ads it shows to each user through its *ads within videos*, and by employing *retargeting* techniques that allow advertisers' ads to follow Facebook users when they leave the network and visit other websites.

To increase its user base, Facebook has made important acquisitions including social apps WhatsApp and Instagram and is now trying to bring internet access to 4 billion people in third world countries, hoping that those will eventually become Facebook users and in turn a source of revenue for the platform.

But despite the slick moves and the efforts to create greener pastures, there's a limit to how much Facebook, as a social network, can "fast-grow". It competes on time-share with Twitter, YouTube, email, content streaming, other social media, work, and with life itself. In the end, there are only 24 hours in a day, and there's a limit to how many ads it can show to users without ruining their experience.

One of the ideas we promote in this book is that you should think about growth efforts as a diversified *portfolio* of initiatives, where you can exploit your company's strengths across multiple fronts at the same time as it develops new strengths that will be exploited later.

At the beginning of the book we introduced seven different paths to pursue growth in any organization. In this part, we explore these in more detail and provide some guidelines that can help each one succeed based on my own experience and research.

Your seven possible paths to growth

We start this chapter with a few clarifications about what is considered *good growth* and discuss the possible reasons why some companies may decide to keep growing even if their efforts are not producing positive results. We also explore the different ways to expand our core business including internationalization, earnings optimization and non-organic efforts. Finally, we close the chapter with an exercise where we break down the sources of growth within a given period to understand what is really driving it.

In the next chapter, we will cover the creation of new products and services in greater detail as we introduce some fundamentals to complete a solid innovation strategy.

The growth mindset

When market analysts and sites like Seeking Alpha or Fool.com talk about *growth* they are usually referring to a percentile increase of *revenues* (aka the *top line*) during a given period of time, normally a quarter or a year. But for the purposes of this book, when we talk about growth we are exclusively referring to *Net Earnings* (also known as *the bottom line*) or "Free Cash Flow" (usually just referred to as FCF), concepts that we review in more detail in Chapter 8.

NEED A REFRESH ON FINANCIAL STATEMENTS? In Chapter 8 we dive deeper into the company's financials but if you need a quick refresh before getting there, visit: strategyforexecs.com/financials.

In an ideal world we'd expect executives to only go after growth initiatives that are beneficial to their organization, but in reality we've all seen how pressure from demanding shareholders and investors, and misguided incentives, can lead a company to sometimes pursue growth *at all costs* even if doing so destroys value over the long term.

In general, I'd say that a growth opportunity makes sense if a combination of the following conditions is met:

1. It increases the company's bottom line over time,
2. It produces an attractive return on investment (ROI),
3. It leverages the company's value chain,
4. It builds a new critical capability, or
5. It improves the business's strategic positioning.

Not all growth is created equal and sales alone don't tell the whole story. In other words, growing your top line (revenues) doesn't necessarily means that you're growing your bottom line (profits).

For that reason, you must always pay careful attention to the costs of a growth effort (both financial and non-financial) and to how sustainable you expect these efforts to be over the long term. Over and over again we've seen how companies keep trying to grow even though their efforts are creating negative returns on their money or destroying their teams' morale.

Take solar energy for example. By all metrics, it is a zero-star industry. Companies developing and operating solar projects face powerful customers who can buy clean energy from many other sources at very low prices. This competition comes from companies of all sizes and includes aggressive, deep-pocketed players, large power corporations and even oil majors now jumping on the wagon.

The final product, solar energy, also faces serious and credible substitute products such as wind power and clean-fuels-based generation. Solar power is becoming so cheap that many utilities are trying to de-incentivize its installation to prevent the instability problems that a large proportion of intermittent energy resources could create in the power grid.

But move one slot upstream in the solar value chain, and you'll face the most aggressive market – in the manufacturing of the solar modules. Many of these companies, mostly from Asia, have been working in the red (at losses) for years hoping that it will get better at some point. In the meantime, the panel manufacturing industry is inundated with excess capacity and sunk costs, imposing bitter exit costs. Incumbents prefer to stay in the fight, waiting and hoping that consolidation and bankruptcies will clear the space at some point.

Prices for solar panels have been consistently declining for the last 20 years with an *accelerated* decline over the last decade. Analysts predict that prices will continue to drop an additional 20 percent annually over the next 5 years.

The price of solar panels has been dropping so fast that project developers won't place their orders until the time of installation (usually a few months after beginning of construction), afraid that ordering too early would leave money on the table.

But none of this has stopped aggressive competitors that still seek to grow fast in this market, even if that means taking lower returns on new projects. In fact, companies in this space are reportedly making low one-digit returns, sometimes under 5 percent.

Solar developers are clearly playing the scale game, trying to build huge portfolios that create sufficient economies of scale through centralized operations, in the hope that it will reduce unit costs in the long term. However, this decision comes at a huge financial cost in the short term and creates a lot of uncertainty for the people involved in those efforts.

Not everyone has the stomach for it.

There are of course cases where sustained losses are a justifiable way to build a longer-term vision, something that we now see more often as a result of global competition and the abundance of cheap money.

Amazon.com, for example, has reportedly been losing around $2 billion a year from its retail business, which gets subsidized by major gains the company is making in other areas like Prime and AWS.

Whatever the case, you must always think about a growth strategy in terms of the time window that you are planning for, always considering *all* the costs involved, be they financial or otherwise, and ultimately building an organization that lasts long enough to harvest what it has sown.

Expanding the core

A good growth plan always starts by exploring the expansion of our core business(es) as much as feasibly possible. That is, finding ways to do more of what's already working.

If your company sells products and services you must find ways to sell more of those; if it's a social network, you must find ways to increase your user base or find ways to increase the number of paid members if it's a subscription service. Whatever the case, you should always be looking to find ways to do more of it *profitably*.

In general, business expansions are possible along three dimensions:

- **Market penetration:** Selling more to your existing customers or targeting new customer "segments" within the same markets (with your existing products).
- **Market development:** Selling existing products into new *markets* or entering similar markets internationally.
- **Product development:** Selling new products and services to existing customers.

A collateral benefit of an expansion strategy is that sometimes an increase in the capacity of the value chain could drive lower unit costs due to economies of scale. However, and this is something we already explored in Chapter 2, if the value chain is constrained in any way an increase in production could create *diseconomies of scale*, raising unit costs and driving margins down.

I'd like to provide a few ideas here to help explore different ways to grow your business across each of the three dimensions above.

Increasing market penetration

In many ways, trying to increase market penetration is a bit of a win-lose game where every new customer you make is a customer loss for another company that's targeting the same market. Put simply, increasing your market share implies serving customers that would otherwise be served by a competitor (aka *stealing other companies' customers*).

In Chapter 3 we discussed how you could use price, promotion, sales and distribution efforts and the product itself to influence the perception of value in the minds of your target customers, and hence to improve your sales. Not surprisingly, these are the same levers you may act upon when trying to increase market share and gain more traction in the markets you are already in.

Without trying to repeat ourselves, here's how these levers can help you increase penetration:

1. **Offer differentiated products and services:** The main piece you have at your disposal to increase market share is the product itself. Products that are both unique and valuable to target customers can enjoy premium prices or higher levels of demand. To find areas of improvement, try to understand why some customers select a competitor's product over yours, and what makes those other products unique.

2. **Differentiate promotional efforts:** You should also explore new ways to promote your products (or "brands") with potential buyers and to better connect with them. For this to work, of course, you must deeply understand the target customer's *needs and wants*, and the context of *their* reality. As we mentioned previously, it is very important that you keep track of the results of any promotional efforts and the return on marketing investment, documenting what works and what doesn't with each segment.

3. **Differentiated sales and distribution:** Sales (including post-sales) efforts and efficient distribution channels can also help convert customers who are currently buying from other vendors. See how other companies are using these resources and how your company's effort compares against them. In plain English, what could be learned from the way competitors sell and distribute *their* products that you could use to successfully target *THEIR* customers?

4. **Price differentiation:** Hopefully we can avoid price wars, but in price we have just another tool to target competitors' customers. Remember, this is not just about low prices but *differentiated* pricing, which could include discounts, payment plans, different pricing options or offers targeted specifically to competitors' customers. Some mobile carriers, for example, have been successful by opening special agreements to customers who convert from other carriers.

In trying to gain market share it is critical that we understand what's driving customers to pick your competitors' products over yours. What are they doing differently that their customers are selecting them?

It is in these differences, not the similarities in products and services, that you can find the information you need to successfully get to their customers.

Remember from Chapter 5 that you must optimize the entire *value system*, from vendors to final product disposal, to maximize the value you extract from an opportunity. This is one case where we can apply that advice to its fullest by creating an ecosystem that's perfectly designed to target and capture competitors' customers.

I'd say that with perhaps just a few exceptions, there's never a good reason not to pursue a bigger share of the market as long as you get a positive return on your efforts.

Targeting new customer segments

Along the same lines, you can also expand your core business by making your products more appealing to different *segments* within the same market.

For example, yogurt maker Chobani has introduced different presentations for its yogurt offers that go well beyond its popular fruit-in-the-bottom presentation. It now features Flip®, a yogurt-based snack that students and office workers can grab "on the go", and a yogurt drink that has amassed avid fans among sport enthusiasts who consume it as a post-workout drink.

In a similar move, Miller (the beer brand) invested heavily in advertising campaigns featuring popular male athletes to make its light beer more appealing to the male population during the 1970s, a time when the brand was mostly connecting with women because of its less filling texture. This is a case where a *positioning* effort became a growth initiative in itself.

Keep in mind that *customer segments* are just categorizations that *YOU* choose and there are many ways to go about it. For example, you could be segmenting a given market through classic approaches like demographics or geography, but you may also want to experiment with other non-conventional approaches such as situational and contextual ones.

Of course, before you go after a new segment you must validate that the fundamentals to win that segment are in place, otherwise you may be pursuing an unrealistic target.

Entering new markets

When we talk about entering new markets, what we are looking for is groups of people who could use the benefits of your products, but who for a number of reasons haven't been targeted by your current customer segmentation. Usually, to target those customers efficiently, you'll need a different value system.

Consider the case of a motor oil company that makes and distributes lubricants for the automobile industry. To serve its markets the company has distribution deals with auto repair shops, department stores and gas stations, since those are the places where their target customers, i.e. car owners, usually buy motor oil.

In an expansion effort, the company could decide to create a new brand of oil targeting trucks and the heavy machinery industry. Although the underlying product is relatively the same, its distribution channels, customers, pricing policies, presentation and even its business model will have to be different because the company will be now attacking a different *market*.

In this new market, the company will have to deal with a different set of rules, customer behaviors and competitors, and its strategy will need to be adjusted accordingly.

Once again, when exploring the idea of entering a new market, thinking in terms of a *value system* may really pay off, since that concept gives you a full set of components that can be optimized to extract the maximum value from those new customers.

In addition, you must also understand how external and internal factors may affect your ability to profit in the new market, something you can learn about through the environmental and five forces analyses that we covered in Chapter 2.

Selling new products to existing customers

In a way, when you try to sell new products to existing customers, you are using your brand as a kind of "distribution channel" to reach those customers and make them buy the new thing.

For example, when ride-sharing app Uber introduced its food delivery service Uber Eats, it leveraged its vast user base to promote the service and millions of their existing customers immediately downloaded the new app within a few hours. Any other food delivery service trying to compete against Uber Eats will be at a big disadvantage if it has to build its audience from scratch.

On a larger scale, think about the way cosmetics companies like Sephora and MAC keep bringing a plethora of new products to their customers. Every time their customers visit a store, there's always something new for them to try and take home. Doing this on a massive level like Sephora and MAC do requires great data analytics skills and direct contact with customers to understand what they buy, when they buy and how they buy.

A special case for this strategy is when the new product replaces the old one, which is how companies in the automobile and smartphone industries operate. When a new model comes out, enthusiasts and captive customers will upgrade to the product's latest version, leaving the old model behind. In this case, the strategy is in improving existing products linearly, increasing their performance over time along dimensions that are critical for recurrent buyers.

We explore this and other innovation strategies in more detail in the next chapter.

Alternative ways to expand the core

Through my research for this book, I identified three interesting ways to help expand core businesses that may not be too evident at first sight: *creating complementary products*, *"productizing" the value chain*, and *switching between buyers and users*. Let's quickly review each one.

Creating complementary products

A potentially great way to increase sales in operating businesses is through the development of complementary solutions that help increase demand for your products. Think about Nestlé's success with its Nespresso machines which multiplied sales of its coffee products and helped the company leapfrog in the very competitive coffee space.

Nespresso turned out to be a great "vehicle" to deliver Nestlé's coffee products, making it a perfect match for the company, reminding us a little of the success of Gillette's famous razor and blade business model that we mentioned earlier.

The strategy around complements may take multiple forms and we can't cover them all here, but one of the examples that I find most fascinating comes from Intel (NASDAQ: INTC), the computer chip manufacturer.

In the late 1990s, long before corporate venture capital (CVC) was in vogue, Intel created an investment arm to fund companies whose products required increasingly powerful computing capacity, such as complex video, audio and graphics hardware, in an effort to accelerate the obsolescence of computer microprocessors and stimulate sales of Intel's Pentium chips.

When brainstorming ways to grow your core business organically, take a look at the entire life cycle of your products and see whether there are opportunities to develop complements that could help you increase or capture a sizable piece of the market.

Productization of the value chain

Another area that's usually ignored, but that could offer important growth opportunities, is what I call the *productization* of the company's value chain. In other words, taking something that the company is very good at and offering it to third parties as a standalone product or service.

Amazon Web Services (AWS) is a good example of this model. The service allows companies around the world to use Amazon's vast array of servers and cloud computing tools for their own purposes.

AWS leverages a technology platform that Amazon already needed anyway to run its own operations and makes it available for third parties to use for a fee, giving Amazon the opportunity to scale this operation to levels it would never have reached on its own. The computing systems of many large organizations, including Netflix, Amazon's competitor in the content streaming space, run on AWS.

The productization of core capabilities in your value chain allows you to reap the benefits of economies of scale, larger investments and specialization that would not be possible otherwise, producing lower costs and better margins for the business without the need for increased demand in core markets, lifting serious barriers to competition along the way.

From customers to buyers or vice versa

You may find space for growth by exploring the relationships between buyers and users that exist in your markets. In the healthcare space, for example, some companies have stopped promoting their products to doctors, which most providers do, and instead refocused their efforts to reach patients directly through targeted advertising and promotional efforts.

If the people who buy a product or service are different from those who use it, you should explore whether switching from one to the other can give you better results.

In the end, the goal is the same: to help increase the capacity of your company's operations so that it benefits from doing more of what it already does.

Entering international markets

An internationalization effort sets your sights on countries and cities where local markets show strong fundamentals that make them attractive for an extension of your business.

Some of the factors that can help you decide whether or not a particular country (or city within a country) is attractive may include the growing demand for a given set of products, language preferences, competition (or lack thereof) in the product category, industrial affinities, access to distribution channels, presence of known solid partners, availability of qualified labor, a favorable regulatory environment, the risk profile of the host country and economic growth.

In general, there are three ways to enter a new market overseas:

1. By exporting the goods or services,
2. By making a direct investment in the foreign country, or
3. By partnering with local companies.

Each strategy entails particular ways to approach the business that must be discussed to increase the chances of success. Let's briefly review each of them.

Exporting products and services

This is by far the most common way to internationalize a business. It involves transportation of final products (or the delivery of services) from the country where they are produced into the host (now importing) country.

Exporting finished products allows you to take full advantage of economies of scale in the originating country and is a good idea when costs or speed to market are critical factors for the success of your business.

You could, for example, set up a large operation in a country with low cost of labor or favorable tax incentives and serve multiple markets from there with proven products through a centralized manufacturing operation.

A downside of exporting finished products is that as an exporter you don't have a lot of flexibility to customize the offer to the particular preferences of the target market, which along with the costs of transportation and import duties may put you at a disadvantage with respect to local players.

Another issue is that distribution partners (the importers in the host country) will prioritize their efforts based on their own interests, which may change over time and without notice.

An obvious upside is that you keep full control of the intellectual property that goes into the product and its production process, and that you can exit the market quickly if it doesn't work out as expected, without the burden of a high sunk investment.

Direct investment

Companies looking for a more permanent approach to entering a foreign market should consider a direct investment to set up operations there. By direct investment I mean doing business directly in the host country.

For a company that makes physical products, for example, this would mean building a manufacturing facility in the target country to compete with local players on a similar cost basis. For a service company like a consulting firm, a direct investment would entail opening a local office (or a number of them) to serve clients in that country locally.

Direct investment allows full "location" of your products (i.e. adapting your product to local preferences), tight control of intellectual property and complete discretion over marketing, sales and stakeholder management efforts.

A downside related to this approach is obviously the higher risk associated with an investment in a foreign country, and the inability to transfer all the benefits of economies of scale and experience from your host country.

Finally, when entering a market as an international player, you must consider additional stakeholder and marketing efforts to mitigate any natural rejection by locals of a foreign company and a disproportionate retaliation from local incumbents.

Partnerships and alliances

If you're looking for more control over local efforts but aren't willing or ready for a direct investment in a foreign country, then you should consider partnerships or alliances with locals. The structure of an internationalization alliance varies depending on your goals and those of your partners, but this option offers a good middle point that offers benefits from both the exportation and direct investment alternatives.

These partnerships can take many forms; for example, it could be an exclusivity agreement with a distribution partner where they only promote your products within a given category, or a specific region, or could take the form of a licensing agreement where the local partner manufactures or sells your product under particular specifications.

A franchising agreement, where a local company buys the rights to operate under the foreign company's brand, is another special case of a partnership.

One advantage of partnering a local company as an entry strategy is that you usually don't require a heavy upfront investment, and that you get to leverage the established infrastructure of the local partner, which allows a quick "test of the waters" before engaging in a direct investment.

The obvious downside of an entry partnership is that the profits generated by the joint effort must be split between the partners.

When there's intellectual property involved that needs to be shared with the local partner, it puts you in a difficult position since that partner could use that information to compete against you later, if for some reason the partnership dissolves and you decide to make a direct investment instead.

Nonetheless, a partnership with a local is in most cases a less risky alternative when compared to a direct investment and offers better commercialization results than an exporting plan.

	What it is?	Example	Advantages	Disadvantages
Export	Delivery of finished goods and services to foreign country.	Selling and shipping finished gadgets from the US to Asia.	Quick market entry. Low investment risk for seller. Full control of Intellectual Property.	Cost associated with shipping and distribution. High *localization* is impractical.
Direct Investment	Owning operations in host country.	Building a manufacturing plant in a foreign country to enter that market.	Full product localization. Retain control of Intellectual Property. Compete with local companies on the same competitive grounds.	High investment risks; must write off capital investment if business goes bad. Higher costs than competitors for being a foreigner.
Partnership	Partnering a local company to market our products.	A manufacturing partner makes our product locally under license.	Low upfront investment. Leverage partner's infrastructure and networks.	Must share profits with local partner. May put IP at risk.

Comparing international entry options

Reverse internationalization

Before we go, let's briefly cover what I call "reverse" internationalization. That is, helping a foreign company enter a market where you have presence.

Strategically, this move could have multiple exploitable angles. For example, you may decide to import a product that's used as a complement to your own products, gaining more control over the complement's distribution and eliminating potential speculation by other local vendors.

Another strategic reason could be to test the solution with customers you have access to, just to learn more about its intellectual property (its "special sauce"), to later decide whether or not you should make something similar locally.

As a final comment about internationalization in general, you should never skip thorough market research when evaluating entry into a foreign market, paying special attention to any precedent where international players previously tried to enter that market and how the preferences of locals may be different from those in the markets where you currently have a presence.

We all know a story of an international company that failed miserably when it tried to enter a foreign market even when the fundamental success factors seemed to be in place. To mention one case as an example, the widely successful international coffee chain Starbucks failed for a long time in its efforts to win in the Australian market, mainly because its menu didn't fit the preferences of the locals, who preferred a variety of espresso options over sugary drinks.[16]

The classic advice here will never get old: *Think globally, act locally*.

> **LEARN MORE ABOUT MARKET ENTRY:** To watch a collection of videos about success and failure stories of companies trying to enter international markets, visit strategyforexecs.com/international.

Optimizing earnings

When we think about growing our core businesses a few things come to mind: increasing sales, targeting new markets and continually launching new products. But there's a type of growth that doesn't get the credit it deserves and that is the potential increase of *earnings* that we can get from experimenting with new pricing and business models or from cost improvement initiatives.

A continual improvement of the business operations is like a discipline that you religiously practice and get better at over time. It becomes part of your culture and could evolve into a serious advantage when competing with less disciplined incumbents.

We cover each these optimizations in more detail next.

Optimizing revenues

We mentioned earlier that a few years ago Rolls-Royce launched a pay-per-use program for their Jet engine products called TotalCare, where customers would pay for every hour of *uptime* delivered instead of buying the engines for a large upfront cost.

To make this business model work, Rolls-Royce collects operational data from the customer engines to predict their performance and to create preventative maintenance schedules that seek to maximize uptime and minimize disruptions (since they are now paid based on uptime).

This is a good example of how a business model made products available to a market that couldn't stomach hefty upfront acquisition fees but that can swallow a more digestible pricing model, increasing Rolls-Royce's revenues along the way. No need to say that those revenues would be going into a competitor's pocket otherwise if Rolls-Royce hadn't come up with this option.

In a similar move, some companies use price to penetrate a market segment that would be otherwise unreachable. Apple, for example, offers its Music service to students in eligible schools at half the regular price, helping Apple compete with Spotify and Pandora for the young adult space. Arguably, a good portion of those students will eventually convert into permanent users of the service after college.

Recent advancements in data analytics and predictive models are now making it easier to experiment with multiple options and customize pricing based on a buyer's individual characteristics. For example, AXA, the global insurance company, is using machine learning to analyze driver data like age, residency and vehicle type along with the user's driving history to predict the chances of having large loss accidents and pricing its insurance policies accordingly to reflect those risks.

Mass customization, micro-experimentation and price discrimination are all possible now and they can all be of great help in trying to increase the top line of the business.

Optimizing costs

On the cost side, you must be always looking for opportunities to improve your overall business performance and find better ways to use the resources of your organization, especially people and money.

This goes beyond the classic view on cost reduction where managers monitor productivity changes and act *reactively* to correct deteriorating performance. What we mean by cost optimization is *actively* finding ways to reduce costs in a meaningful way, making your operations leaner and producing a positive net effect on your bottom line.

While it is true that some cost reductions may lead to a productivity drop, I'd say that as long as the tradeoff seems to deliver a positive net effect to your bottom line, you should pay attention and deliberately decide what to do about it. There can be subtle inefficiencies that get so embedded in the culture that sometimes you can't even see them.

To spot opportunities for cost improvements, my recommendation is that you imagine a very cost-conscious investor buying your business for big dollars. If that was the case, which costs would that investor *immediately* get rid of to justify the high acquisition price tag? How would that investor optimize the way things are currently done?

When you look at the business through the eyes of an external observer whose job is to improve the way things are currently done, you can move beyond personal and emotional attachments that may be preventing you from seeing better ways of doing things.

Just to give you an idea, there are four areas that new owners would normally investigate to reduce costs in a newly acquired business: non-key personnel, operations and the optimization of debt and taxes.

The optimization of the organizational structure, i.e. personnel and staff, is probably the most conflicting and sensitive topic of this list because of the personal attachments we may have to the people there, but as an executive you must be upfront about it and address any inefficiency without hesitation if you really want to succeed and be profitable in the long run. That's what you are paid to do.

The general rule is that overheads should continually go *down*, as you get deeper into learning curves and age your value chain, but never the other way around. If you think about it, the more experience you accumulate in a process the fewer people you should need for it.

Another way to reduce overhead costs (per unit) is by increasing the utilization of fixed assets, for example property, machinery and software. A restaurant that is only open during lunch and dinner, such as Chipotle Mexican Grill (NYSE: CMG) in the United States for example, can effectively reduce its unit costs by using its facilities and brand to open its branches for breakfast, or enabling drive-thru sales. The more you use the facilities, the lower the costs of each *unit* of revenue produced by those facilities, which increases business profitability.

Inefficiencies and poor performance should never be allowed in any business and must be dealt with vigorously. Leaders must always be on the lookout to find the optimal way of running things and keep people accountable for their performance.

There are only three ways to deal with poor-performing businesses. They must be fixed, sold to a company that puts a high valuation to them (one that can build synergies with the business or that can fix it), or they must be closed. There's no other way around it, only the "fix, sell or close" options that Jack Welch popularized in the 1980s.

With respect to operations, you have to go beyond operational effectiveness. First, you must be a cost leader in everything you do by implementing the best practices out there. It doesn't matter if your strategy is not based on low prices, you must always do things at the lowest cost possible and never ignore inefficiencies.

When it comes to financial costs such as debt and taxes, you must also dig relentlessly and extract every drop of savings possible. Believe me, sometimes there's a lot of value hidden behind financial loopholes and gray areas.

You must always be looking for cheaper sources of debt and replacing them as needed. Sometimes you may get better deals just by telling lenders that you are shopping around for other offers to replace their debt.

Finally, bringing in a third party from time to time to propose cost optimization plans may provide fresh views on your company's operations, and is a good way to mitigate the risk of being trapped within comfortable bias zones.

Using data analytics to improve earnings

Data analytics is increasingly becoming one of the most powerful technologies at helping executives optimize costs and revenues. Companies now use data analytics tools to analyze customer and operational data and suggest improvements.

Probably the most well-known example of data analytics being used to boost sales comes from Amazon's product suggestions algorithm which makes recommendations based on a user's individual behavior on the site and their purchase history. In one of its patents, this is how Amazon describes its personalized shopping algorithm:[17]

"*A computer-implemented service recommends items to a user based on items previously selected by the user, such as items previously purchased, viewed, or placed in an electronic shopping cart by the user...*"

"In one embodiment, the service generates the recommendations using a previously generated table that maps items to respective lists of "similar" items. To generate the table, historical data indicative of users' affinities for particular items is processed periodically to identify correlations between item interests of users (e.g., items A and B are similar because a large portion of those who selected A also selected B). Personal recommendations are generated by accessing the table to identify items similar to those selected by the user. In one embodiment, items are recommended based on the current contents of a user's shopping cart."

On the cost side, there are many ways in which companies are using data analytics to boost their profits. UPS, for example, developed a prescriptive analytics model called ORION (On-Road Integrated Optimization and Navigation) to provide turn-by-turn directions to drivers, minimizing mileage and fuel on delivery routes.

This application has avoided over 100 million miles and saved 10 million gallons of fuel, a combined saving that exceeds $400 million every year, which as with all other cost savings drops directly to the bottom line.

Data analytics tools, when well-developed, can help you improve business performance by helping you:

1. Understand customer behavior to improve customer service and retention,
2. Identify cost optimization opportunities,
3. Identify opportunities for new offers, and
4. Identify the decline of an industry by monitoring margins shrinkage, price reductions and a drop in product usage.

In my opinion, there are two key reasons why companies must now explore the implementation of data analytics applications.

First, because some of these applications are still relatively new, they can still provide an edge if competing with companies that haven't yet found a way to implement them.

Second, analytics applications usually get better over time, as more data is collected, analyzed and provided feedback on, making the "experience curve" of the application a differentiator by itself. Kind of the same effect as an aged value chain as we reviewed earlier.

That's why data analytics tools are always best if implemented sooner rather than later, since those taking the lead now will have the most intelligent systems of the future, and may build serious barriers for later entrants, just with the amount of data collected alone.

How to grow inorganically

I have found that most definitions of inorganic growth (also known as *non-organic* growth) try to limit it to mergers and acquisitions (M&A), however they leave out two alternatives to M&A that I believe should be evaluated *before* considering an acquisition: strategic alliances and corporate investment.

To make sure we are not limiting ourselves too much, let's define inorganic growth as any growth that results from controlling another company's resources, rather than developing those resources ourselves. In most cases, you will go the inorganic route as a way to produce rapid and strategic results, catch up in a market where you were left behind, access key assets and intellectual property, or to build synergies to put your company in a favorable position against competitors.

This means that inorganic moves are almost always of a strategic nature and involve certain levels of risks, especially M&A, but those risks can be mitigated by testing the waters first through one of the alternatives.

Let's briefly review each of these alternatives before diving into M&A.

Strategic alliances

At its most basic level, a strategic alliance is a collaboration agreement between at least two companies to pursue a common set of goals and is usually a cost-effective alternative to an acquisition or a merger.

A common case of a strategic alliance is two firms forming a partnership to tackle a particular market segment with a combined offer that incorporates complementary capabilities of each partner.

This is what car manufacturer Ford and clothing retailer Eddie Bauer did when they joined forces to create the widely successful Ford Explorer Eddie Bauer Edition, which featured premium leather seats and other luxury perks in an effort to compete with Japanese companies in the luxury SUV market.

One reason to consider a strategic alliance instead of a full-blown merger is that an alliance can achieve most of the same goals without the commitment and complexity of the real thing, making it a good alternative to see how the companies work together before making bigger commitments.

The obvious downside of a strategic alliance is that we have to share the profits that the collaboration produces, and the fact that managing the combined effort as two separate companies may turn out to be more difficult.

But in the cases that work, a strategic alliance is a great alternative to M&A and in some cases may be the best way to test one BEFORE making an irreversible commitment.

A particular form of strategic alliance is the *Joint Venture* (which is normally referred to simply as a JV), where two or more companies co-invest in a new entity to undertake a new business or tackle a market together. Unlike conventional strategic alliances, a JV entails the creation of a separate entity with its own governance and organizational structure to manage its operation.

A JV can be executed between private companies only or it can exist between government and private entities, an arrangement that's usually referred to as a *Public-Private-Partnership* or PPP. These are very popular in developing countries to promote private participation in public projects.

Strategic alliances work best when the capabilities of the companies are complementary in nature, and not competitive with respect to each other. For example, a company that provides industrial equipment could partner up with an engineering firm that provides design and construction services. In that way the partnership could offer a bundled solution including all the equipment and services needed for a project under a single roof.

Just as you'd do for a merger or an acquisition, you must do extensive research and due diligence on the potential partner to make sure their goals for the partnership align with yours, and that the final agreement will be manageable.

Corporate investment

Another way to test the waters without getting too wet is by investing in companies that operate in a space that's attractive for us. This is somewhat popular in large corporations and is a judicious step prior to a full acquisition.

These investments can be done by directly acquiring a minority piece of the target company, or by allocating money in common investment funds (e.g. private equity funds) which find and screen companies operating in a particular space.

Through the investment you gain insights into that industry and how that particular company operates, which is a great way to learn more about a company before pursuing an acquisition.

A new trend that's becoming popular for making direct investments in early stage companies is by creating a *Corporate Venture Capital* (CVC) arm inside your company that finds and screens potential targets in need of seed, growth or expansion capital.

Through a CVC program, you create a fund to invest in startups in the form of equity. With this, your company becomes a shareholder in the entrepreneurial company as a way to keep a close watch on its developments and progress.

A CVC program is an in-house effort that allows you to seek (and be pitched by) startup companies with relevant technologies or business models in your business space.

It is startups, not large corporations, that usually redefine industries and change the ways of doing business. Our corporations are usually slow, bureaucratic and careful, while startups are agile, creative and fearless.

By investing in startups, you can tap into that stream of creativity and energy and extend your innovation engines. If well structured, a CVC plan should be a win-win for both sides: the startup gets access to funds and markets, while the corporation gets to expand its product portfolio with cutting-edge developments without the risks and costs of an in-house innovation effort.

Another benefit of playing the role of an investor is that you only bet on the companies that you like, and you also get to distribute money across a number of companies, some of which are competitors.

For example, through its Vision Fund, Japanese tech company SoftBank Group has made important investments in both Lyft and Uber, two companies that are fighting fiercely for leadership in the ride-sharing market. Independent of who wins the ride-sharing space there is one sure winner: SoftBank.

A number of major tech and biotech companies already have a CVC division that actively looks for new startups to invest in.

In my experience, the skills needed to run a successful CVC effort are not commonly found within a business organization, so any company trying to start this kind of investment program may need to bring in new talent from the outside, most likely from the banking, venture capital or private equity worlds.

We cover CVC investments in more detail in Chapter 8.

Mergers and acquisitions

Mergers and acquisitions (grouped under the single expression *M&A*) are by far the most common way to seek inorganic growth since they usually provide the quickest way to enter new markets, obtain key capabilities or improve a competitive position.

Acquisitions are by definition very simple: a company buys another company and makes it part of itself. But in reality, acquisitions rarely go as smoothly as expected and most of them destroy value for shareholders. In fact, Harvard Business Review estimates that at least 60 percent of all acquisition attempts fail, and that number could be up to 83 percent according to KPMG.

At least in theory, the general rule for any acquisition is that the value it produces for the buyer should exceed the cost paid for it. This may sound like common sense, but we all know that's not always the case. In fact, most times it is actually very hard to even try to measure that.

The first challenge with an acquisition is that to put a price tag on a target you must consider the *strategic* benefit of the target for you, but that value is pretty much in the eye of the beholder, so it will be different for different companies.

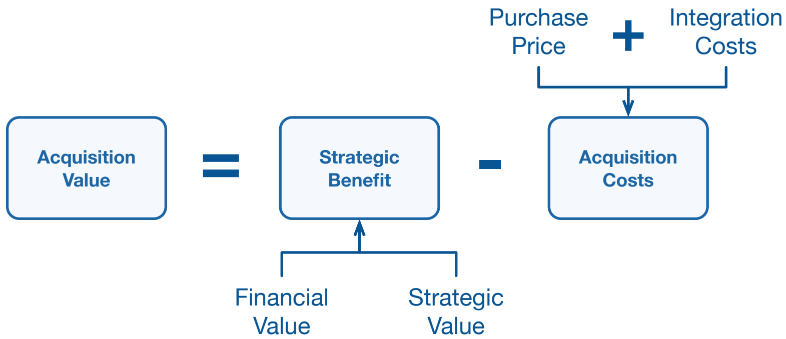
For example, in 2011 Microsoft paid $8.5 billion for Skype, an online communication app that only two years earlier had been acquired by a group of investors from eBay for $2.9 billion. In the eyes of Microsoft, the kind of synergies that Skype could create with its other professional tools justified the high price.

The price that a company puts on a target then is a combination of *financial* factors (e.g. measured by the target's cash flow) and *strategic* factors (measured by how the target's assets, both tangible and intangible, could create value for the buyer), where things like key contracts, exclusivity agreements and intellectual property among other things can help improve the target's position in the negotiation.

The second challenge is that the buyer's strategic interests change over time. When Cisco Systems (NASDAQ: CSCO) bought Pure Digital, the company that made the popular Flip video cameras in 2009 for $590 million, it did so with the intention of expanding its product offering and showing the market that it was making the right moves in the consumer electronics space.

But success in the consumer market turned out to be harder than Cisco expected and two years later in 2011 it decided to close the business and stop selling the Flip products to "*refocus on their network-centric platform strategy*". Nice way of sugarcoating a half a billion dollar mistake.

When evaluating an acquisition, in addition to the price of buying the shares, you should take into account the cost of integrating the new unit into the mothership, which in some cases has turned out to be higher (and way more expensive) than expected. The costs of terminating people, integrating software platforms, training for acquired employees, public relations, lobbying to get the transaction approved by regulators, re-branding, advertising and others might seem small things but they all add up and can become a sizable number.



When evaluating an acquisition, your costs to make it happen should never exceed the longterm benefit you estimate that you would get from it

The most common downside that comes out of an acquisition is that as the acquirer you will, in many cases, overpay for the target. That obviously sucks, but sometimes you just have to accept it as the cost of making the transaction happen. The truth is that unless you're the only buyer and the seller is desperately trying to get out of the business, it would very difficult to get a "fair" valuation.

We see acquisitions happening these days at 80 percent or even 100 percent goodwill (overpayment), but as we said earlier, the details are not in the face numbers but in the strategic value that the target creates for the buyer.

A not-so-common type of acquisition that I found while reviewing some of Jack Welch's transactions as part of the research for this book is companies "trading" businesses, that is, giving one of your business units to another company in exchange for one of theirs. For example, in the late 1980s, France's government-owned electronic company Thomson and GE made a trade where GE gave its TV manufacturing business to Thomson, in exchange for Thomson's medical device division and $1 billion in cash.

At the time, it was a win-win for both companies. On the one hand Thomson had a subscale TV operation which would get better if merged with GE's TV business, and on the other GE had no participation in France, a market it wanted to enter and where it could create synergies by integrating Thomson's medical device unit into its own.

Diversification

At a fundamental level, diversification means *variation*, which in business can be translated into a number of things. It could mean selling different products, or selling them to different markets, or investing on different businesses. That's why when someone talks about diversification without giving much detail, it can be a little confusing because it could mean one of many things.

What I want to do in this section is to explain a few ways in which diversification could help expand your core operations.

First, you have *product* diversification. That is, selling different products to different types of customers.

Take the French company BIC for example, maker of the popular brand of ballpoint pens, razors and lighters. BIC's products are sold to very different markets, but they all share common "manufacturing" characteristics: for example, they are all made by plastic extrusion, are disposable in nature, and they are almost always sold through channels that sell impulse goods, most times near checkout counters.

That gives BIC a great diversification of its *revenues* since the markets they come from are somewhat uncorrelated, while maximizing economies of scale and operational efficiencies in its value chain (since the products share a lot of the same manufacturing processes and expertise).

Another type of diversification is achieved from selling products in new markets, for example internationally. Internationalization provides an additional layer of diversification that protects against macroeconomic downturns in particular markets.

After a crisis in Brazil that lowered its revenues from the country by 64 percent, Rotoplas, an international manufacturer of water storage solutions, initiated a diversification plan to spread the company's revenues across multiple countries and sectors.

As part of this effort, they went from generating half of their revenues from government customers to less than 5 percent, and more than doubled their sales from the US and Canada.

Finally, there's also *investment* diversification, where you try to invest across multiple industries in a way that creates synergies with the business. DuPont's acquisition of Sunoco in 1981, for example, was made as a hedge to protect DuPont from oil price inflation, the same reason that led GE to buy Utah International in 1977. They stepped out of their comfort zones and invested in a different *industry*, in this case seeking the protection of their core business.

Executives' preferences are diverse when it comes to diversification. For example, many companies have one core business or market that drives most of their revenues, but there are other executives who prefer to distribute their company's revenues more evenly across multiple products and markets.

In either case, you must really understand what your most important risk factors are and explore ways to diversify or hedge them.

Creating a strategic plan for growth

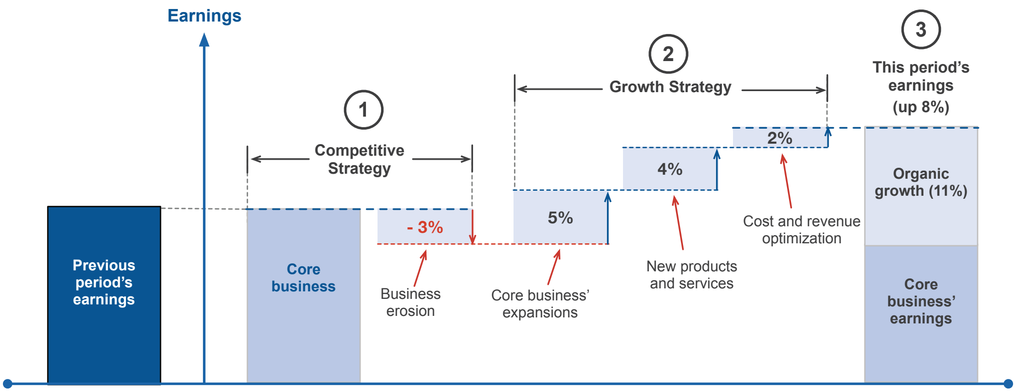
While a growth strategy can be generally described as a group of business initiatives aimed at increasing a company's bottom line, I prefer to talk in terms of an executive plan for the *strategic* growth of the organization, which contains the initiatives that the executive team has handpicked to maximize value within the foreseeable future.

Not all growth paths will have the same impact on a business, and for that reason executives must narrow down the universe of initiatives they *could* go after to the handful that would deliver the most impact within a given period, with the least amount of effort and resources.

That's why your plan for growth must be strategic in nature, because in the end no company has unlimited resources or management bandwidth to pursue all the opportunities that are presented to it, so you must carefully select the things you will spend attention and resources on.

Consulting firm McKinsey & Company found that organizations that distribute growth efforts across three buckets *Expansions*, *Creations* (new businesses) and *Optimizations* are best positioned to outperform market peers over time.

That translates into a growth plan that seeks to do more of what's working, get better at it, and find new ways to create value, which results in a synergistic and balanced approach to growth.[18]



According to McKinsey, companies which pursue growth in more than one "bucket" outperform those that only focus on one dimension in almost half of cases. See chapter references for more information

I have also found this categorization to be useful in explaining the sources of growth in executive meetings and for making better resource allocation decisions.

But beyond the categorization of growth opportunities, a more fundamental problem you often face is the actual selection of the growth initiatives that you should focus your strengths on.

I always feel that the best way to start a growth discussion is by estimating the growth "gap" that we need to fill in with new businesses.[19]

For example, let's say that you are planning your strategy for the next five years and that your goal is to grow 15 percent a year. If your operating businesses are expected to produce $100 million this year in net earnings, and you expect them to grow at a rate of 9 percent per year, then you can easily calculate the type of earnings that your new businesses will need to create every year.[20]

Year →	Current	1	2	3	4	5
Core Business Earnings	100	109	118.8	129.5	141.2	153.9
Target Earnings (15%)	-	115	132.3	152.1	174.9	201.1
Growth Gap (difference)	-	6	13.4	22.6	33.7	47.3

Calculating the growth gap

DOWNLOAD IT: To download an Excel file with the calculations of the growth gap, visit strategyforexecs.com/gap.

Having an indicative number for the earnings gap can help you understand better the type of growth initiatives that you have to go after.

For instance, in the case above you'd then know that the growth initiatives you pick should be such that they can deliver $47 million in net earnings by the end of year five, which can help you prioritize and facilitate their selection.

A good way to brainstorm initiatives that could be pursued is to go through each of the growth paths we mentioned earlier, asking simple questions like:

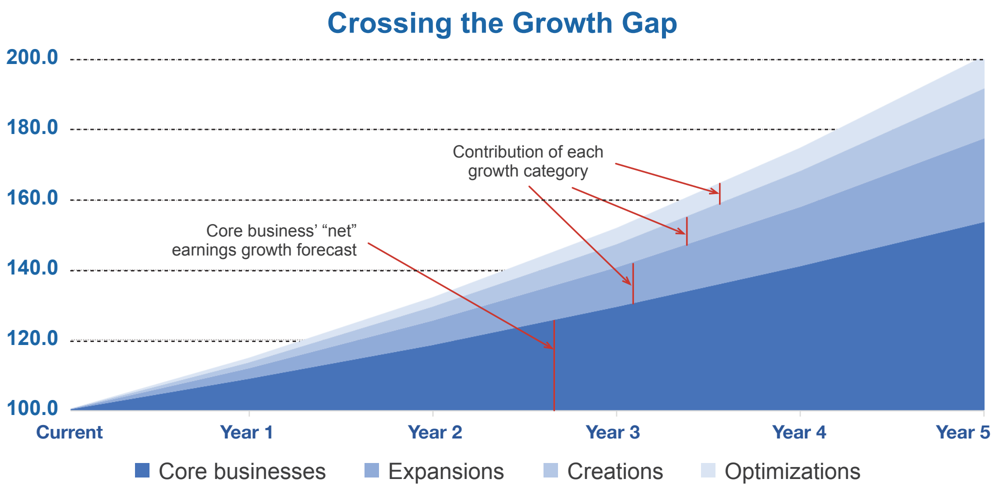
- Could you originate and develop growth opportunities that would be both profitable and defendable following this particular path?
- Are there other incumbents doing it? If so, how?

- Which capabilities in your value chain could you leverage if you decided to pursue this approach? If none, how could you then succeed in that market? Pioneer advantage? Through partnerships, maybe?
- Would this path create synergies with your other business units?
- How significant could this path become for you in terms of potential net earnings? What would be the expected returns?

The ideas that show the most potential can then be further developed to get a better sense of the type of profits they could create, the level of investment needed, partnerships and capabilities to be built, and so on.

There's no perfect approach to selecting growth opportunities since the selection must comply with a variety of company preferences (including returns) and meet the strategic goals of the moment.

My recommendation is to select a handful of the most important investment parameters for your company (e.g. net earnings, investment required, returns, inventory preferences or just for strategic reasons), then "fill the growth gap" starting with the initiatives that promise to perform best at those parameters until the gap has been closed.



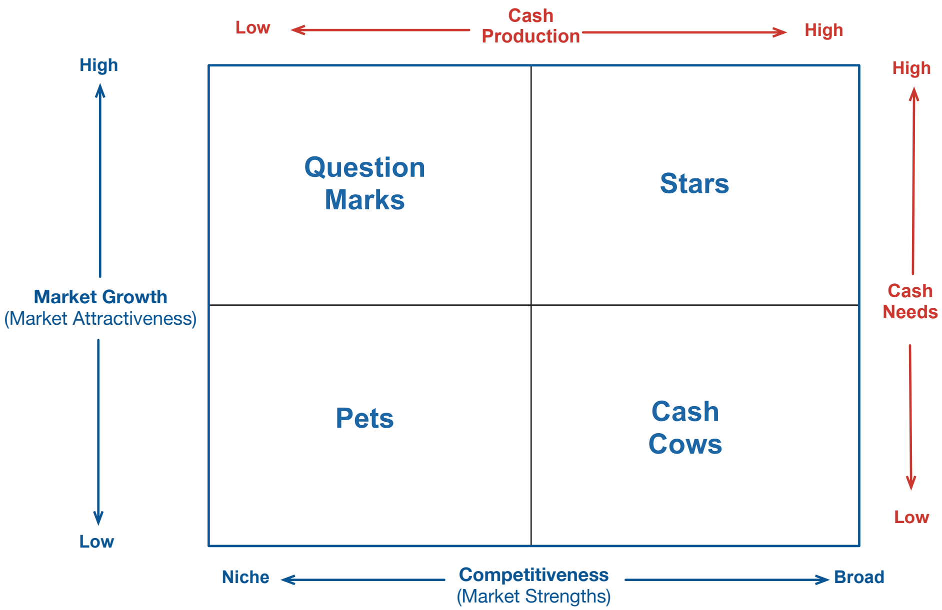
Visualizing a growth strategy and how each initiative would contribute to close the "growth gap"

In an ideal situation, you would end up with a balanced portfolio across all three of McKinsey's buckets (expansions, creations and optimizations), but in reality you will most likely end up with a strong bias towards a particular category, based on the prevailing strategic goals of the moment.

Implementing a portfolio approach to growth investments

When it comes to *managing* different business units, you can (and probably should) adopt a *portfolio* mentality, where you seek to maximize the value that the portfolio creates as a whole over a period of time. That will help you to better balance efforts across the different business units and make better capital allocation decisions.

You can do this by placing business units in a four by four matrix based on their competitiveness and the growth potential of their markets.



A Competitiveness-Attractiveness matrix can help you make better capital allocation decisions, by adopting a portfolio mentality in how you manage your different business units

Those familiar with classic strategy tools will note that this is an updated take on the *Growth-Share Matrix* introduced by the Boston Consulting Group (BCG) in its early days, where we are using competitiveness and market potential as proxies for the original dimensions.[21]

Following BCG's naming convention for each of the quadrants, we can define each business unit as one of these:

1. **Cash cows:** Businesses with a strong market position in a low growth market. These units produce a healthy cash flow that can be used to fund other businesses.

2. **Stars:** Units with strong positioning in high growth markets. These businesses usually need lots of cash to retain their share of the market and will eventually become cash cows when the market reaches its maturity. Because of their strong position, they yield high returns on the company's money, so they must be an investment priority.

3. **Pets:** These are business units with a weak position in a low-growth market. Pets usually yield a low return on the company's money, the reason why many experts call them "cash traps", so by Jack Welch's rules these business units should be either sold or closed.

4. **Question marks:** These are businesses with a weak position in a strong market. They need cash injections to fund their growth, but that investment won't yield high returns until the business achieves a stronger position. By Jack Welch's rules they should be fixed (e.g. by funding their growth) or sold.

To select where each business fits in the matrix you can assess its competitiveness based on its ability to defend a profitable position in the foreseeable future, something that's usually related to factors like margins, size, recent growth, market share, profitability, technological position, intellectual property, reputation, image, brand strength and people.

One idea behind the growth matrix classification is that each of the four quadrants have a different *investment profile* in terms of the returns they produce. For example, cash cows behave a lot like bonds, an investment instrument that gives you a steady cash flow every year, and that maintains its value over time. If you decide to sell it, you get your original investment back.

Stars behave more like a savings account, where you put money in and this compounds every year. You don't get an annual cash flow but at the end you get your investment plus a return. Pets, on the other hand, behave much like a mortgage where as the holder (in this case as the owner of that business) you get a return on your investment and you get your money back, but at the end of the period it is worth nothing.

The power of positioning businesses in this matrix is in helping you see how the different units can help each other to produce the maximum growth as a whole.

For example, the cash flow coming from cash cows is best used to finance the growth of stars and question marks. The question marks that are not selected for growth money, then, must be sold to other companies for which they could create some synergies.

The question marks quadrant is also the best candidate for mergers and acquisitions. Since those units are performing poorly in a market that shows strong potential, a quick way to gain the strengths you need to make them stars is through strategic M&A or JVs.

Pets are units that are performing poorly in a weak market, so unless they are strategic in nature (e.g. being used to develop a key technology) they should be closed or divested. Alternatively, some pets could be *repositioned* to target a different market where they could perform better.

How to track growth efforts

Before we wrap this chapter, let's talk about tracking your growth efforts and evaluating your results after the fact. Unless you can say how much each effort is contributing to the final business success you won't be able to get the maximum out of them. You know, when Peter Drucker said that "*What gets measured gets managed*", he may well have been talking about growth.

If you understand how each business unit, product or optimization experiment is contributing to your growth, you can double down on the things that are working, pay attention to things that are not, and find opportunities for improvements.

I found a great tool to help break down and track growth efforts called the *Sources of Revenue Statement*, or just SRS, published by Michael Treacy and Jim Sims in their Harvard Business Review article *Take Command of Your Growth*. Making the statement is pretty straightforward but its insights are very useful.

First, you start by tracking down the sources of *new* sales, breaking them down in whatever way you want to present them. In this example we do it as follows:

1. **New products:** Sales of *new* products across all segments.
2. **New markets:** Sales of core products into *new* markets.
3. **Revenue-optimization efforts:** Revenues from initiatives to improve sales, for example new pricing models, memberships or premium access.

For the sake of the example let's say that your sales for each of these sources during a given period are as follows:

Revenues from New Initiatives	
New products	$ 10
New markets	$ 7
Optimization of revenues	$ 2
Total New Revenues	$ 19

Tracking sources of new sales (numbers in millions)

Next, you calculate the revenues from your core business by subtracting the total of new sales (the $19 million above) from the total of sales that the business made during the period.

If sales during this period were $400 million for example, up from $347 million in the last period, it means that your core business contributed $381 million (which is the difference between $400 million and our *new sales* of $19 million), and with that information you can now complete the breakdown of the business's top line.

Sources of Revenues	Previous Period	Current Period	Percentage of Sales	Percentage of growth
New Products	-	$ 10.0	3%	3%
New Markets	-	$ 7.0	2%	2%
Revenues Optimization	-	$ 2.0	1%	1%
Revenues from Core Businesses	-	$ 381.0	95%	10%
Total New Revenues	$ 347.0	$ 400.0	100%	15%

Tracking sources of sales

Now, here comes the tricky part. When you look at the numbers above and say that your core business grew 10 percent (by going from $347 to $381 million), you may be tempted to believe that such growth resulted from a higher market share and your sales efforts, when in fact that growth may have been driven by a generalized *market* growth.

If you don't understand how those numbers break out you might be taking credit for external factors and things that were market driven, not *strategy* driven. To adjust these numbers properly then, you must subtract the growth portion that was driven by general market growth.

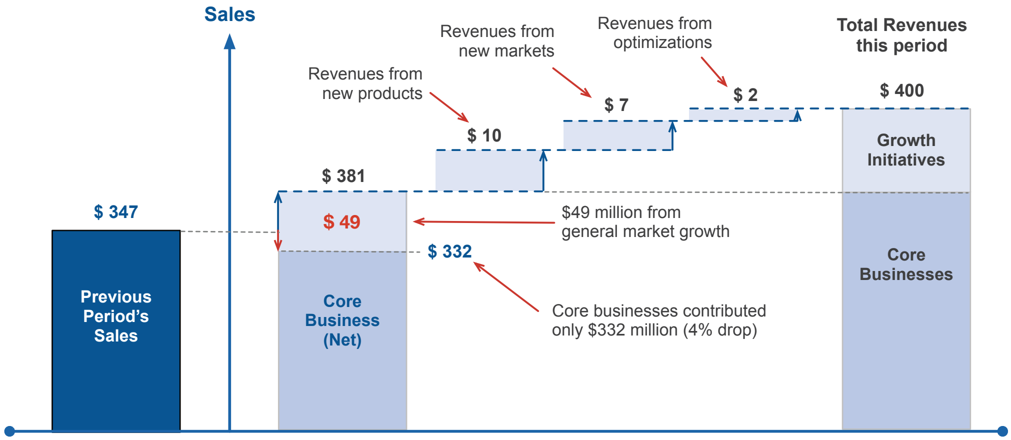
For example, if you know that the market grew on average 14 percent during that period, you can then deduce that your current sales of $381 million include *$49 million* that were driven by the general market growth (which is 14 percent of the $347 million in sales you made over the last period).

That means that your core business in reality only contributed $332 million this period, which is a 4 percent *drop* in sales. Now you should be worried because instead of growing your core business *lost* $15 million in sales, a serious churn rate. At that rate it will take only a few years for the entire business to disappear.

That finding alone is a growth project on its own: track down what is driving customer churn and loss of market share, find ways to fix it and once done you'll get yourself a nice bump in sales.

Loss of market share is a serious but usually systematic problem that affects companies sometimes irreversibly, and the causes must be researched with the care and attention of a mechanic checking his own beloved car.

Finally, you can use the numbers from this exercise to create a nice waterfall that shows how revenues break down for the period which is very useful to gauge growth efforts and reallocate resources.



Keeping tabs on your growth efforts

You could probably make a similar breakdown for profits or net earnings if you had enough information to allocate costs and prorate some accounts, but this statement of sales can give us a good starting point to understand where our profits are coming from.

Now let's shift our attention to another great source of new earnings: the creation of new products and services.

6

Creating New Products and Services

7

"*It's like putting wheels on your feet,*" is how Doug Field, then Director of Engineering at DEKA Research & Development, described the company's latest innovation, a secret project to develop a revolutionary transportation device they code named *Ginger*.

"*It's going to change the world,*" said Dean Kamen, DEKA's founder and owner.

Coming from someone with Kamen's reputation, one of the world's greatest innovators of all time, that claim meant serious business. In fact, calling Kamen an inventor is a major downgrade and a plain offense.

Dean Kamen has some innovation marvels under his belt including the first portable dialysis machine, the first portable insulin pump, the first drug infusion pump and the first all-terrain wheelchair known as the iBOT.

Winner of the National Medal of Technology, Kamen is also a member of the National Inventors Hall of Fame and the National Academy of Engineering, received honorary Doctor of Engineering degrees from the Rensselaer Polytechnic Institute and Kettering University, and honorary Doctor of Science degrees from Clarkson University and the University of Arizona. He has also received honorific doctorates from the Wentworth Institute of Technology, North Carolina State University, Bates College, the Georgia Institute of Technology, the Illinois Institute of Technology, Plymouth State University and Yale University.

In this chapter we will:

- Describe the disruption process
- Present a few ways to improve products
- Explain different ways to create new products and markets
- Discuss some alternatives to in-house product innovation
- Provide some ideas to introduce new products
- Explore technologies creating product opportunities
- Introduce network effects and multisided platforms
- Provide some final ideas about product development

Yet according to Kamen, Ginger was his most ambitious project ever: a revolutionary self-balancing human transporter that promised to change how people moved around forever. Afraid of imitation from Asian companies, he kept it under wraps in high secrecy, and only showed it to very select people who first had to sign a long confidentiality and non-competition agreement.

The device was a bimotor scooter, balanced by a moving body weight on two parallel wheels controlled by a gyroscopic stabilization system. Its use was very simple: riders would just need to balance their weight in the direction they wanted to go, and the device would take them there.

It was a remarkable piece of mechanical engineering, powered by a cluster of ten modern microprocessors each making hundreds of calculations every second. It packed the computational power of three personal computers into a very light frame.

All the hoops and behind-the-scenes talk were well justified according to Kamen, since his new device would change everything we knew about mobility. In his own words: "*I would stake my reputation, my money and my time on the fact that 10 years from now, this will be the way many people in many places get around... If all we end up with are a few billion-dollar niche markets, that would be a disappointment. It's not like our goal was just to put the golf-cart industry out of business...*" *and* "*[Ginger] would prove so wildly popular that they would quickly fill the pavements of congested cities.*"

According to Kamen, it was *how people would move in the future,* a story so compelling that he was in talks with Hollywood director Steven Spielberg to feature Ginger as the main means of transportation is his upcoming movie *Minority Report*, a science-fiction film set in year 2054 starring Hollywood superstar Tom Cruise.

But don't just take Kamen's own words for it. The project had gotten the blessings (and money) of renowned high-tech investors like Steve Jobs and Jeff Bezos, and top venture-capital powerhouses like Kleiner Perkins Caufield & Byers led by superstar venture capital investor John Doerr who backed Netscape and Amazon.com in their early days. They were all fighting to get a piece of the project that took Kamen ten years of hard work and more than $100 million to develop.

But that investment was just pennies compared with the value the device was expected to create for its shareholders. One of the early estimates projected demand at 40,000 units per month after only the first year, and a total of 22 million units sold by year 10.

They would be shipping around 2,000 units a day, the estimates went, and the supplier of the electric motors would have to build an entirely new factory to cope with demand.

Ginger would be profitable within the first year of production based on their numbers, putting a $26 billion valuation tag on the company by year five and $73 billion by year ten.

But by 2003, two years after its launch, the Segway, the official name under which Kamen's invention was promoted, had only sold around 5,000 units. It took DEKA *eight years*, until 2009, to launch its 50,000th unit, falling way short of its estimates.

The device was widely ridiculed in the media, with some calling it a gimmick and even a "cosmic fart".

But what went wrong? How come all these tech heavy hitters got it so wrong and invested so much in a flawed product? Is it possible that these tech titans fell so much in love with the technology powering the Segway that they didn't pay attention to the *business* aspects of it? Could a more business-oriented (and less techy) investor have predicted that it wouldn't work?

To answer that, let's see what happened with another potential breakthrough product: Jamie Siminoff's Doorbot.

As Jamie was getting ready for his pitch to CNBC show *Shark Tank* in 2013, his hands were shaking and sweaty. He had spent weeks and over $10,000 building props for the show, money and time that his bootstrapped startup didn't have. But he knew this was his shot at finally getting the investors he needed to take his company, Doorbot, through the safe line.

He practiced his opening pitch more than a hundred times: "*Next time your doorbell rings, wouldn't it be nice if you could look at your smartphone and see who's there?*" as a picture of his camera-enabled doorbell ring would be shown on a big screen for the "sharks".

Doorbot allowed users to see who was at the door from any smart device and enabled two-way communication with visitors. "*It's like a caller ID for your doorbell*" said Jamie. "*When someone rings the Doorbot, you can see them and decline if its someone you don't want to talk to… just like a regular call.*" The sharks laughed.

He was seeking a $700,000 investment for 10 percent of his company, a $7 million valuation. His total sales at the time were one million, of which $250,000 had been made in the previous quarter. The product sold at $199 online, and cost $81.83 to make, a 41 percent markup.

In one of the quickest turnarounds of the show, Doorbot was rejected by every single shark. Tech guru and investor Mark Cuban declined to invest saying he "*couldn't see the progression to become an $80 million company*".

Online security expert Robert Herjavec said, "*It is a consumer device, but you're pricing it at $199, and that price is going to start dropping quickly as your volumes go up*".

Jamie left *Shark Tank* without a deal. He was devastated and so worried that the eight-person company operating out of his garage would fail that he cried after he left.

Looking back, Jamie says "*I will never forget leaving the set without a deal. It was horrible. I could not believe that we had done all of that work and were walking away with nothing. Sure I thought if we aired (the episode has a lower chance of airing without a deal) that we would get a little bit of traction, but I did not think it would be enough to make a real difference for us*".

Fast forward five years to 2018, and Amazon was announcing the acquisition of Doorbot, later rebranded as Ring, for a whopping $1 billion. The company now offered a full suite of security products and counted billionaire Richard Branson among its investors. The $700,000 investment that Jamie was asking for in 2013 would have been worth $100 million by the time it sold to Amazon, a 14,000 percent increase!

Except for Cuban, the sharks were not tech geeks like Kamen, Jobs, Bezos and Doerr. These were pure business "investors", whose only job was to pick winners and ditch losers from a long list of proposals that ranged from cricket energy bars,[22] custom cat drawings[23] and urinal golf clubs[24] to horror entertainment[25] and smart breathalyzers,[26] yet they missed a lifetime opportunity with Doorbot.

With both Segway and Doorbot the product was no less than outstanding. Dean Kamen was awarded the Lemelson-MIT Prize for his invention of the Segway, and not even the sharks could deny the novelty in Doorbot. "*I like the product*" said an excited Mark Cuban in the Shark Tank episode when it aired in 2013.

The thing is, getting innovation right is extremely difficult, and not even the most experienced people can predict with certainty which products will be hits and which ones will flop.

Google Glass, Sony Betamax, New Coke, Apple Newton, Ford's Edsel model, the Facebook phone, BlackBerry's PlayBook tablet, HD DVD, McDonald's Arch Deluxe, Google+, HP's TouchPad, Windows Vista, Starbucks' Mazagran soda, Life Savers Soda, Netflix's Qwikster, Nike's FuelBand, Ben-Gay's Aspirin, Donald Trump's Trump Steaks, the Iridium Satellite Phone, Watermelon Oreos, Cheetos Lip Balm and Colgate's Kitchen Entrees are just a few of a large list of products that their developers believed could work but didn't.

The road from idea to market is many times a long one, and even a great product can't guarantee commercial success since there are many other factors at play that could turn the effort into a failure.

Innovation "per-se" or launching cool new products is never the end goal when it comes to business strategy, improving the bottom line is.

Many executives enjoy having the word innovation in their arsenal and spread it around in earnings calls and press releases, but they sometimes use it in ways that are completely meaningless for shareholders. In fact, the term *innovation* has been so abused and overused that it has almost lost its meaning.

Ironically, although it is commonly associated with growth, some research suggests that launching new products is the least successful way to achieve growth with a failure rate that exceeds 80 percent by some accounts.[27]

The truth is that, as a process to bring new products to markets, innovation carries multiple risks. To start, innovation efforts consume resources that could be otherwise used in other profit-generating activities, for example managing our cash cows.

Second, innovation forces companies to make bets on things that they believe could work like in the case of Segway, but experience shows that in most cases the innovators' gut is not enough to ensure a product's success.

Take the race for online music streaming between Pandora, the pioneer of the space, and second movers like Spotify and Apple Music. Pandora bet on a future where online *radio stations* would be the norm, therefore it created its platform around music recommendations and the creation of personalized *stations* based on a few seed songs. Spotify, on the other hand, made a different bet and gave users full control over what they wanted to listen to, creating personalized *playlists* and providing a huge music library.

In that case Spotify's turned out to be the right bet and today its user base is 20 times bigger than Pandora's. Looking back, in retrospect many would argue that the right choice was evident and that the loser was dumb, but as a good friend of mine likes to say, "*being a historian is way easier than being a prophet*".

To give innovators some credit, it is very hard to predict successful products because the only reference we have when creating new products is *existing* ones.

The idea of "looking forward" is very difficult when it comes to innovation. Let me give you an example: if someone had come to you 10 years ago with an offer to invest your retirement money in a new app that would create a "*platform to connect private car owners with people in need of a ride, and that the platform will profit from making the connection*", would you have invested in it?

Back then, it was near impossible to predict that something like that could actually become what Uber is today, as it has come to be one of the most successful startups of all time. Nevertheless, it would have been even more difficult to convince executives in a well- established taxi company to divest money and resources from proven projects into that unproven idea.

They would never have imagined that a simple app that doesn't own any cars nor hire any drivers could put them out of business.

When an innovative product or service succeeds, as in the case of Uber, it becomes an extraordinary source of growth for a company. But "betting on the right horse" is, whether some like it or not, part expertise, part guts and part plain luck.

However, having a set of guidelines in place to originate and validate product ideas can improve the odds of succeeding and help us get luckier more often.

There are many playbooks out there on creating new products. For some, companies should focus on creating *disruptive* products that beat incumbents out of the market, while for others it should be more about creating entirely new markets where companies can reap first entrant advantage and enjoy low competition for a while.

For us, it is a simple decision: you need to pursue both, and then some. In this chapter we will look for opportunities for new products and services where they usually hang out and will find ways to make them good business for us.

You should never fall in the trap of theorizing around innovation frameworks or picking sides. As long as you can create value and convert a piece of it into profits in a sustainable way, any opportunity is a good one for you. That's it.

Reviewing existing frameworks for the identification of new product opportunities was one of the most challenging tasks I faced in writing this book, especially when trying to reconcile them all into a unified ideology.

I decided to start this chapter with a description of Clayton Christensen's theory of disruption, since I feel it provides a good foundation to understand different *types* of innovation, and because it can help to better understand the development of new products and services when we only have existing markets as a reference (which is always the case).

Finally, as we go through this chapter, keep in mind that earnings, which are the ultimate goal of strategy, are created by *businesses*, not by products or services. You can embed new products and services within an existing business or create an entirely new business for them, but products alone will never make you money unless you have a good business around them.

With that in mind, let's get to it.

How innovation and disruption happen

In the mid-1990s, Harvard professor Clayton Christensen and his colleagues researched the reasons behind the failure of once successful companies and introduced the term *Disruption* to explain how new market entrants, equipped with what by the industry standards looked like low-performing, unattractive innovations, got to displace and beat the incumbents at their own game.

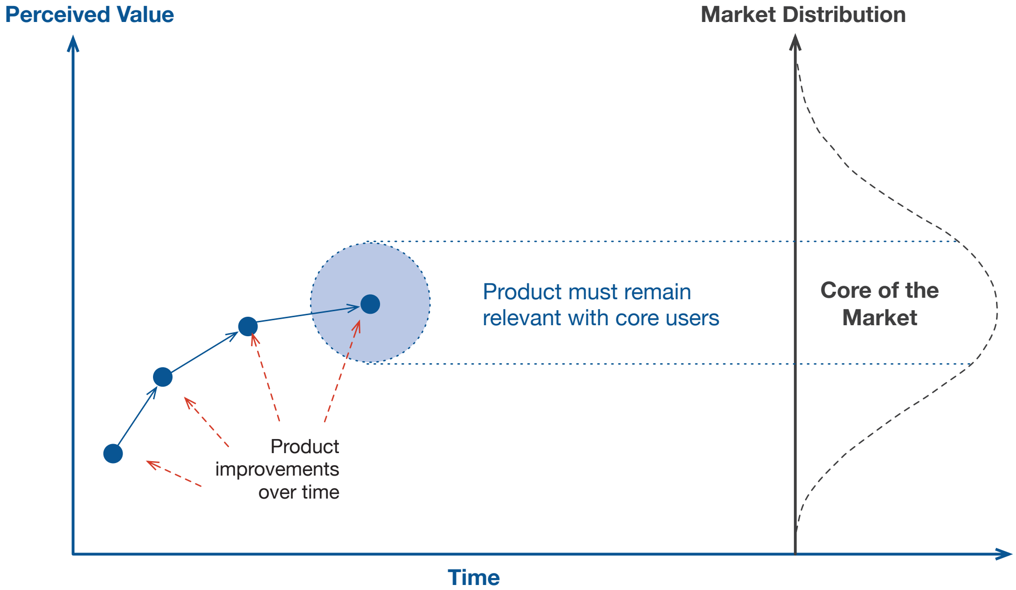
Through Christensen's work we have gotten to know better how innovation works and the process that leads to what he calls *disruptions*. There are four types of innovation identified by Christensen's work: *sustaining innovations*, *low-end disruptions*, *high-end disruptions* and *new market disruptions*.

Let's cover each of them one by one to understand how they work.

Sustaining innovations

Christensen explains that in most markets competition over time converges around a common definition of who the target market is, and that in response, companies specialize in serving the needs of those segments which they protect at all costs.

To retain market share as customer needs increase, companies must actively innovate, continually launching improved versions of their products to increase their perceived value for customers. If a company stops improving its products, or if the pace of improvements is lower than the rate at which customers' needs increase, the product will lose relevance within that segment.



Sustaining innovations: to retain relevance with your target consumers you must continually improve your products and services

The gradual improvement of existing products over time is what Christensen calls *Sustaining Innovations*, since they follow a linear trajectory that is to some extent predictable, the "better, cheaper, faster" approach that we are used to. For example, we are all familiar with how computers and smartphones try to gain ground with their more demanding customers through the linear improvement of their products offering faster processors, more storage capacity and so on.

For companies in mature industries, especially in high-tech markets, sustaining innovation is usually the main form of growth, but it is not exclusive to high-tech or consumer products. Procter & Gamble, for example, has to continually improve its products – think of its laundry detergent Tide, improving its formula to keep it relevant with target customers and retain its market position.

To uncover opportunities to improve a product linearly, you must analyze the reasons why customers use them, why they pick one over another, how products are used in combination with other solutions, and what "dimensions" of value customers appreciate the most, along which we could extend our offer to make our products more attractive to them.

Additional opportunities for improvement might come from the optimization of the user experience. For example, can you integrate features and factors that your customers are finding elsewhere into your offer? How can you improve the experience that customers have before, during and after purchasing your products?

This form of growth is largely what we saw in the previous chapter (which we dubbed "Product Improvements"), improving products to get more traction with current users, new customer segments and new markets.

Low-end disruptions

So far, we have discussed at great length how a distinctive value chain is key for a good positioning strategy. However, that strength almost always creates a weakness: as a value chain gets better at satisfying the needs of a given set of customers, it becomes less good at satisfying the needs of others.

That may seem like a logical outcome and a price that any company would happily pay in trying to serve a segment profitably, but according to Christensen it is this specialization that puts companies in a position where they can be *disrupted*.

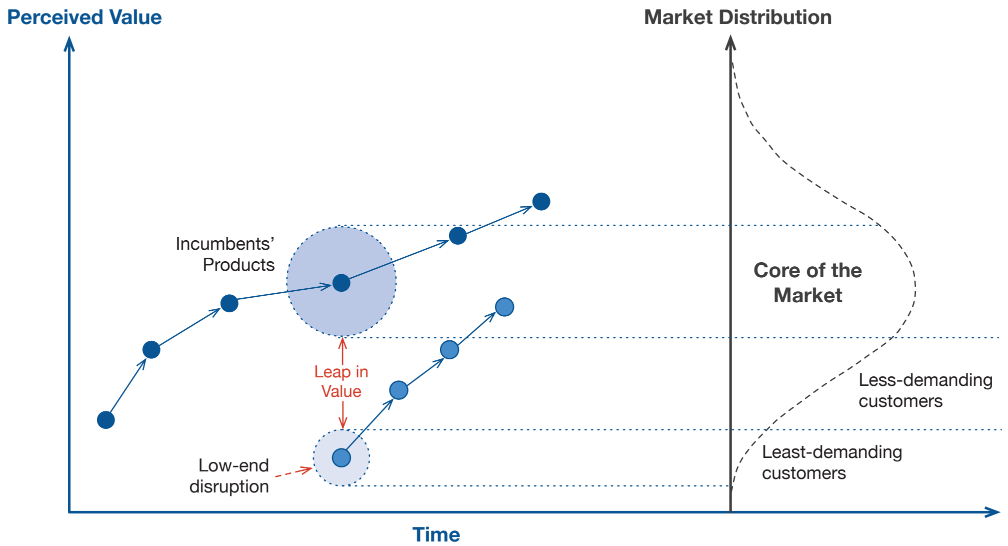
What happens, Christensen argues, is that as companies focus on serving the needs of their best customers, they leave other groups of people at the *low-end* of the market unsatisfied. These are buyers who really don't need all the benefits and features the solution currently delivers and who would be happy to pay less to get less, or for whom the solution is out of reach for some reason.

The company can't serve these customers effectively even if it tries hard, because its value chain has been optimized to serve its best customers.

That opens a back door for upcomers, usually entrepreneurs, who enter the market by specializing in serving the needs of these very people with products that, although of lower quality and performance, are more affordable and reachable to them.

Executives of incumbent companies see the attack at the low end of the market, but as it is not targeted at their best customers they don't feel the entry as a threat, therefore they don't fight back.

The problem is that over time these new entrants increase the performance of their products way faster than incumbents' (since they have more room for improvement) and get to the point where their products become a serious threat for incumbents.



Low-end disruptions enter the bottom of a market with solutions that are worse than incumbents', but over time improve faster and could become a serious threat for incumbents

By the time incumbents decide to react, they can't defend their position. Their value chain is just not good enough to compete with the emergent business model and the momentum of the upcoming entrants.

The same pattern repeats over and over again in many industries: new companies enter the market attacking *low-end* (less demanding) customers with solutions that seem lousy at the outset, but over time improve so fast that they kill the incumbents.

When Amazon.com launched its online bookstore, it became the preferred choice for customers looking for out-of-print titles and books in obscure niches. The internet, with its inexpensive cost of inventory, provided a perfect platform for a business model that offered a large selection of low-demand titles, contrasting with the strategy of brick-and-mortar bookstores like Borders and Barnes & Noble, which focused on selling a limited number of high-demand titles.

Amazon's value network was optimized since its inception to facilitate the search process, making recommendations based on previous purchases, and cutting out the middlemen between books and buyers. The brick-and-mortar bookstores' business model, on the other hand, tried to maximize the velocity of their in-store inventory by only carrying the titles with the most demand, which their internal systems helped identify.

But Amazon's platform improved its reach, efficiency and popularity so fast that by the time Borders and Barnes & Noble realized that the future of book sales was online, they were already late to the party. They had way too much to learn and to invest in. Barnes & Noble, although still around, was left in the dust and hasn't been able to catch up with the giant since, while Borders went out of business in 2011.

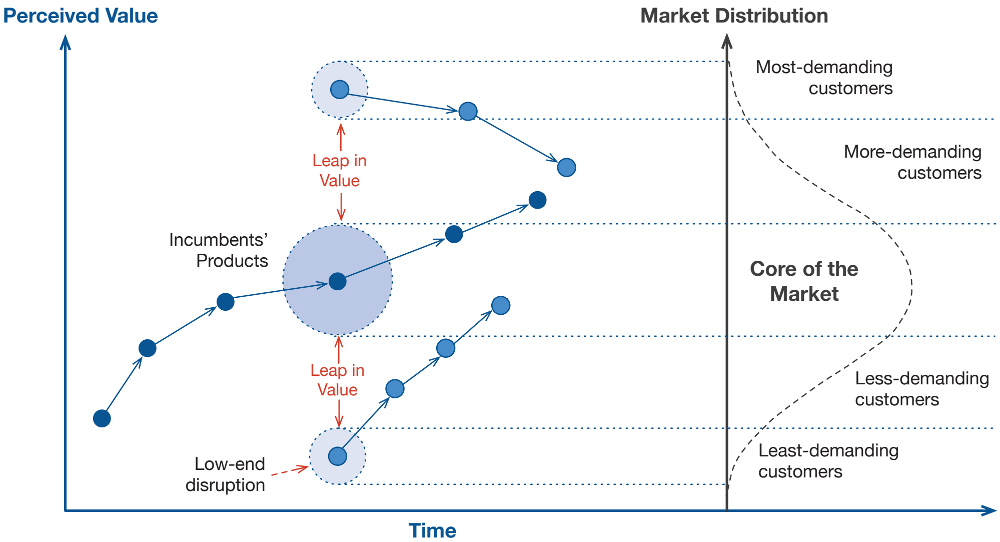
Following a similar dynamic, film photography got *disrupted* by digital photography, Walmart and other discount retailers disrupted large department stores and Canon's portable photocopier disrupted Xerox's centralized photocopy units.

What we have come to understand by now, through these experiences, is that disruptions happen all the time and will continue to happen more frequently because they result from the predictable behavior of incumbents (aka *good practices*).

High-end disruptions

Although Christensen's work focuses mostly on low-end disruptions (and a third type, called "market" disruption which we will see later), we can say that a similar behavior is observed with solutions that enter the market from above, as *high-end* disruptions, targeting customers who would be happy to pay more, to get way more.[28]

Just as with their low-end counterparts, high-end disruptions improve their model over time to make it more accessible to mainstream customers, usually through lower prices and simpler products.



High-end disruptions enter the "top" of the market with solutions that are much better than incumbents', but over time become more affordable and accessible for mainstream customers

For example, FedEx first entered the parcel delivery space with an overnight offer (a novelty at the time), priced higher than regular mail. Corporate customers, for whom time is critical, were delighted to pay more to get important documents delivered the next day. Similarly, when Amazon introduced its Kindle Reader, a solution of far superior performance to existing e-Readers, it was priced at $399 at launch, way above the existing solutions at the time.

Following the usual disruptive trajectory, both FedEx and Amazon later introduced new solutions targeting more mainstream customers. FedEx introduced a two-day delivery option priced lower than its overnight offer, and Amazon launched a lower-cost Kindle device sold at $79.

There are some special cases where a product is a high-end solution for one group of customers and at the same time a low-end solution for another, with Apple's iPhone being one of them.

When it first came out, the iPhone was a superior product compared to RIM's BlackBerry and other smartphones, but an inferior solution for computer users who still needed computers for more demanding applications such as document editing and spreadsheets.

Over time, however, as the performance of the iPhone improved it got more traction with both groups: it leaped ahead of smartphone competitors by adding features that their more demanding users would value and functionality that mainstream computer users would find useful. For a long time Apple led the market with the addition of new features and options appealing to both consumer groups and competitors were forced to play catch-up.

To identify opportunities at the high or low end of a market, you must search for clues on both customers and incumbents: that is, trying to identify customers who would be happy by either paying less to get way less, or people willing to pay more to get a lot more, or finding products with which incumbents are having a hard time trying to make money.

When you spot any of these taking place, you must act quickly and try to come up with product solutions and business models that would be more efficient at targeting those consumers while capturing a piece of the value created for them.

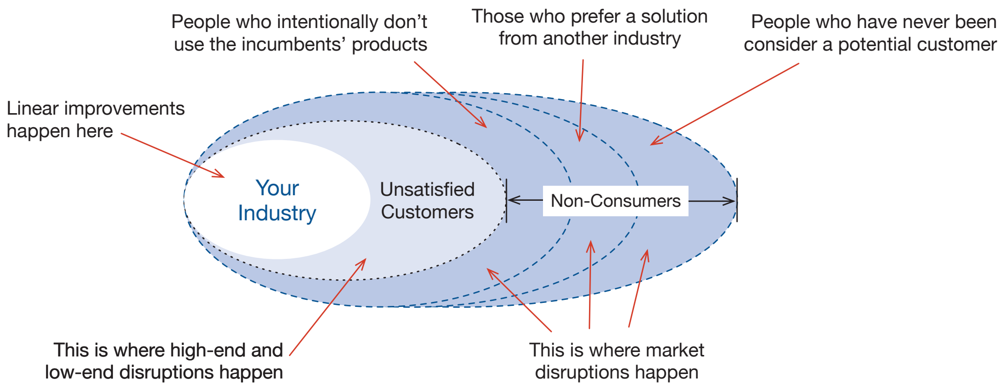
How non-consumers can start a new market

A third bucket of opportunities for new products can be found by targeting people who for some reason are not consuming the incumbents' products, the so-called *non-customers* or *non-consumers*.

Because they could add new demand, non-consumers can be seen as a market on their own, and for that reason many people refer to opportunities targeting non-consumers as *new market* opportunities or *new market disruptions*, like RIM did with its Blackberry smartphone which created an entirely new phone category for corporate users.

The reasons for non-consumption might be related to a lack of skills or wealth to use the incumbent solutions, or due to issues related to accessibility or convenience among other factors.

Non-consumers fall within three buckets: 1) People who have intentionally decided not to use the solutions that are currently available (they are aware of the products but don't use them), 2) People who prefer a solution from another industry (an alternative), or 3) Those who have never been considered customers of the industry, but for whom the product, or a component of it, could be valuable.



The different groups of non-consumers

Consider credit card processing service Square (NYSE: SQ), a company which became popular for enabling small businesses to accept credit card payments from mobile devices by inserting a small card reader into the audio jack of any smartphone or tablet.

Before Square, credit card payments were exclusively handled through networks like Verifone and others that charged businesses high processing fees. These fees were too high for some small businesses, with some of them operating at margins so low that they couldn't afford to accept cards at all.

Square created a new market around the existing credit card processing market by pulling a lot of non-consumers into its business. The first group of non-consumers it appealed to were small businesses and independent professionals who found the fees charged by the incumbents excessive and had intentionally decided not to accept credit card payments.

For these consumers, Square offered a very attractive value proposition compared to their alternative of not accepting credit cards.

A second group of non-consumers that found Square attractive were individuals needing to send money to other people. Those were never considered target customers of incumbent credit card processing services, but they turned out to be a great market for Square.

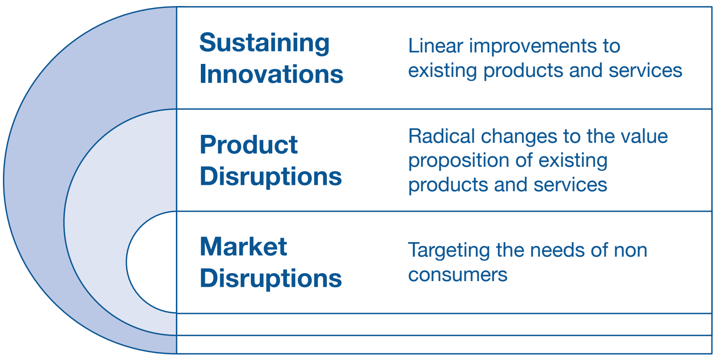
Over time, as Square was getting traction and becoming more and more popular, it started to pull users of the incumbent products into its vortex, eroding the customer base of incumbent players. The company later expanded into person-to-person payments and other financial applications, leveraging its already increasing user base.

To capture opportunities to create new markets you have to continually explore the reasons why people are *not* consuming the products of an industry (or not consuming as much as they could), and come up with solutions that bring them the same benefits but in a way that they can afford and access.

Market opportunities are not easy to find and may require some lateral thinking, but those who can seize them can open the doors to massive value for customers and for the company itself.

Creating new products and services

Before we wrap this section, allow me to summarize for you the ways in which the disruption framework helps us explore the creation of new products and services around existing markets: 1) By linearly improving existing products (sustained innovation), 2) By radically changing the value proposition of existing products (creating low-end or high-end disruptions), and 3) By targeting the needs of non-consumers to create new markets (market disruptions).



These are in general the fundamental ways in which new products usually emerge. Throughout the rest of this chapter we explore five different ways to approach each of these, and towards the end we conclude with a set of general recommendations to improve the *value system* of the opportunities you find.

Product innovation: Five ways around it

We have reviewed important business concepts throughout the previous chapters and it's easy to see how we could play around with some of them to improve existing products and services or even create new ones. Here are my top five:

1. "Revert" the value proposition
2. Explore reasons for consumption and non-consumption
3. Improve the buyer's experience cycle
4. Move from products to *solutions*
5. Leverage digital business models

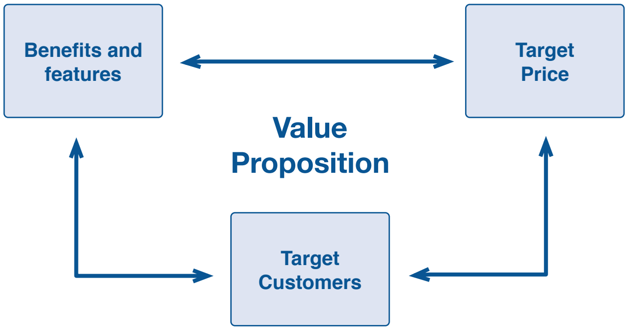
Each one of these approaches can help you realize innovation opportunities that may be hidden in your business. Let's go through them one by one.

Reverting the value proposition

We saw in Chapter 2 how part of the success of any business is in putting the right product in front of the right customers at the right price. Together, these three levers (product features, target customers and price) can be played around with to change the value proposition of any product.

What many don't realize is that you can come up with entirely different products and even radical innovation ideas just by changing the *sequence* in which you approach each of these three levers in the exploration of new products.

For example, you could start by defining the customer you want to target, and from there figure the benefits and the price that would make that specific customer buy a product. Or you could reverse the sequence and instead start by defining a target price at which you would like to sell a product, then see what other solutions are available within that price range, which features they offer (and which they don't) and who buys them.



You can play around with the levers of the value proposition to come up with a good number of innovative business ideas

There are many ways to go about it. What you want at the end is a complete offer that specifies product characteristics (benefits, features, etc.), target customer and price, but you can play around with each of these, trying them as entry points and coming up with entirely different combinations.

The idea is that you use one of the three levers as a starting point and then figure out a combination of the other two that makes sense.

When brainstorming new product ideas and differentiation factors, do not limit yourself to just the evident competing products. See how solutions from other industries could do the same jobs or *functions*. Remember that web conference services are a serious competitor to short business flights, so don't be afraid to compare solutions of a different nature as long as they solve the same problem (in other words, focus on the *problem* that needs to be solved).

Similarly, as you start shaping your product idea, try to identify pockets of people who have never been considered customers of that industry, but who could find the new solution useful. Remember how Square created new demand in the person-to-person payment market, a buyer group that had been completely ignored by the incumbent credit card companies.

Finally, always think strategically about price and see it as a way to create demand, accelerate market penetration, and also as a *limit* to the costs of making and delivering the product. We talk in more detail about price and the introduction of new products later in this chapter, but for now keep in mind that your pricing must strike a balance between profitability and *speed* of market penetration.

Exploring reasons for consumption and non-consumption

Many times you may find product innovation ideas just by exploring the reasons behind customer consumption, but equally important is to understand why sizable groups of people *DO NOT* consume the existing product.

Let's start with the consumers. What makes them buy a particular product? Which features, factors or functions make them select one product over another? What are the things they value the most in those products? Is it price, a particular job the product does, or is it something else?

The answers to those questions can help identify the factors for which buyers *really* pay.

Then flip your attention to non-consumers. Why do people who could be customers decide not to consume the products available? Is it because they don't have the skills, time or money to use them? Or is it because the products are not available to them?

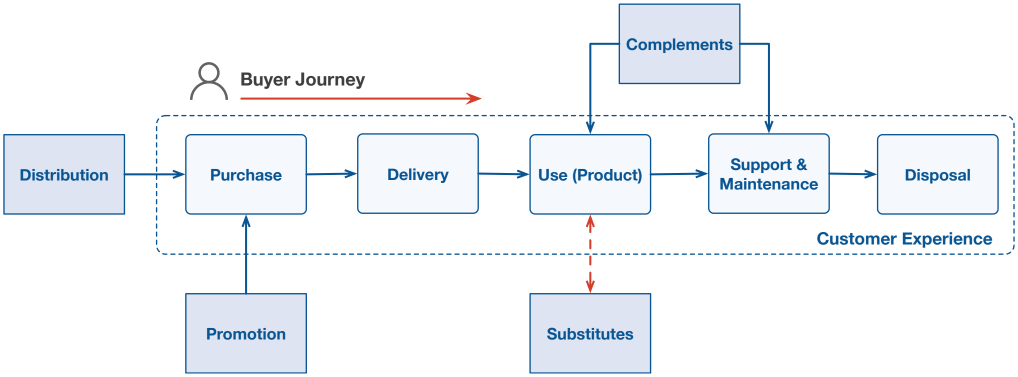
Behind the reasons of non-consumption you will find the barriers that the new product must overcome.

What about customers who *switch* product categories? For example, people who switch from gasoline vehicles to electric ones, or those who choose organic products versus non-organic.

Exploring the reasons why customers move up or down market within the same industry or across industries can provide powerful insights about what they *really* value (beyond what they *say* they value). You can then use those insights to improve your products and services.

Improving the buyer's experience cycle

An easy way to come up with ideas to improve or even create new products is by exploring the series of interactions that your customers experience as they go through the different stages from product purchase to product disposal.



To maximize the value you extract from an opportunity, you must review the entire cycle of customers' interactions with your product

What about your competitors? What can you learn from *their* buyers' experience?

This exploration can help you find a number of ways to improve your customers' experience through product enhancement or by incorporating additional services.

The existence of key complements or substitutes, for example, might uncover opportunities to improve a product by incorporating additional functionality that eliminates the need for (or importance of) those other solutions.

Similarly, products that require customer support can become a source of additional revenue by implementing new maintenance or membership models.

Picture the entire journey of your buyers from the moment your product first shows up in their lives through purchase to final disposal of the product, and try to identify some areas where you could make improvements.

Moving from products to *solutions*

Sometimes you may find opportunities for innovation by pushing existing products into fully-wrapped solutions.

When compared to a standalone product, a *solution* presents a more comprehensive offer which may include some things that your customers need to get a product up and running, such as installation, as well as other complementary components like monitoring, maintenance, disposal and others needed to get the full benefit of the product.

If well designed, solution-based offers should be a win for both sellers and buyers. Sellers get to sell their products, sometimes more of them, and buyers get a fully optimized application of something they need.

There are successful cases of physical and software products that are sold as services, with Rolls-Royce's TotalCare and Amazon's AWS being two examples that we have mentioned before.

Leveraging digital business models

Nowadays, more and more companies find success from implementing new business models leveraging the power of digital technologies such as *Multisided Platforms*, *Online Communities* and *Gamification*, concepts that we review in more detail later in this chapter.

These digital models are here to stay and are becoming more common over time, so they should become part of your book of tricks to improve products and services.

For example, one business model that's been getting a lot of traction recently is *Omnichannel*, which means that the company delivers an integrated customer experience across all its platforms.

An omnichannel strategy *synchs* the buyer experience between brick-and-mortar stores with the business's online and mobile presence so that the experiences are the same at each point of interaction.

This delivers a uniform and continued interaction across all channels. For instance, customers could browse on a business's website from a desktop computer and start a chat with a customer representative then switch to a smartphone and continue the conversation there. Or they could see a company's product on social media, click a picture to add it to their cart, buy it on a computer and pick it up at a store nearby.

There are many ways to improve customer experience through an omnichannel approach.

Five ways to create disruptive products

With our knowledge about disruptions we can now reverse-engineer Christensen's framework and come up with a few ways to create successful disruptions. Here is a list of the five most important:

1. Avoid targeting the incumbents' best customers, at least at the beginning.
2. Price disruptions lower than the equivalent *solution*.
3. Create asymmetric value chains.
4. Spin off disruptive efforts.
5. Shape the industry early.

These are fairly self-explanatory so let's briefly dive into each one.

Avoid targeting the incumbents' best customers, at least at the beginning

Successful disruptions usually enter the market targeting customers that are not the core source of income for powerful incumbents. There lies the key to their success.

Because they only target customers at the "outskirts" of a market, disruptors can operate under the radar for a while without incumbents feeling the pinch. That's why it makes sense when you are trying to enter a market with powerful incumbents to focus on low- or high-end customers and non-consumers.

If you enter the market with a product that's just a linear improvement with respect to incumbent solutions (for example, entering the gaming industry with a better console), you will be by default targeting the gross of someone else's market and those incumbents will have a motivation to fight back if they see that you have the potential to do some damage. The last thing you want is aggressive competition from incumbents while you are in the early stages of a new business.

This can help explain how Tesla now faces serious competition from conventional vehicle makers who must defend their markets and are consequently launching their own electric vehicles. My guess is that Tesla will have a hard time trying to stay afloat.

Price disruptions lower than the "equivalent" solution

Disruptions usually introduce an innovative price-value tradeoff that makes sense for an initial group of customers, but in general new products must be priced relatively lower than an equivalent solution in order to get disruptive traction.

This means that the price must be lower than getting those benefits elsewhere.

For example, when FedEx entered the market with overnight delivery, it was more expensive than conventional parcel delivery services, but its price was lower than taking a flight to deliver the packages, which was the equivalent alternative to get the same delivery speed (overnight).

So, when coming up with your ideas for new products, think about the different solutions that would need to be combined to deliver a similar experience, and price your product below that.

Create *asymmetric* value chains

An obvious part of the success of any disruption is making the underlying solution hard to be copied by incumbents. That means that the more "asymmetric" your value chain is, the more difficult it would be for incumbents to replicate your value proposition.

Value chains require particular coordination between a company and its partners and vendors, something that is not easy to replicate overnight, posing a real barrier to competition.

Asymmetry in a value chain is achieved by strengthening areas where your competitors are weak and avoiding competition on factors where they are strong.

When creating new products, you must implement processes that prioritize improvement on those asymmetries. In other words, you must continually improve on factors that are hard for competitors to replicate using *their* value chain, and improve features that are important to their least attractive customers (which are by definition the target of your disruptions).

What you want is to create and expand strategic asymmetries that make it hard for others to catch up once your solution starts getting traction.

Spin off disruptive efforts

If you are running an established company, emerging opportunities will rarely look like good investments when they first show up. They are usually too small or too far out on the horizon for you to pay attention. So one way to make your disruptive efforts more effective is by creating small separate entities that are specifically created to pursue those opportunities. In Clayton Christensen's own words, these spinoffs "*must fit the size of the opportunity*".

Spinoff companies must be created so that they have almost full autonomy to make decisions and move fast in the new space. It is favorable to have a relatively flat structure without a complex chain of command or too-highly defined job descriptions, but they must reward experimentation and hypothesis testing.

Managers in charge should have experience dealing with new businesses and grappling with the issues of emerging markets.

Shape the industry early

Once you see signs of a market that could get traction you must try to look forward into the future and see how your team can start shaping the way the industry will be regulated.

Startups usually ignore the importance of good stakeholder and government relations until they need it, but by then it is usually too late. You must build your support networks *BEFORE* you need them, and that's why you must always be ahead of the regulators, "helping them" shape the industry through education and continual engagement.

We cover these topics in more detail in Chapter 9.

Bonus factor: Get lucky

Not many people are willing to say it, but behind the success of many high-growth companies good old luck has played a major role. Luck, in this context, means that some businesses arrive at just the right time and under the right conditions to thrive.

The success of Facebook as a social network would have been different if the company was launched two years earlier, or two years later. You might say the same of many other tech startups or "unicorns" that have made it big in the last few years.

How to get lucky? Keep working hard, keep working smart.

Five ways to create new markets

Originating ideas for new markets is with no doubt the most difficult innovation task since it entails thinking about products that don't exist yet, for customers that we don't know who they are, and to satisfy needs they don't yet know they have.

Think about the market that Pfizer created with its Viagra product. The product was so different from any other existing drug that that it created a new category of lifestyle drugs when it launched.

What many people don't know is that Pfizer's success with Viagra was not the result of a deliberate effort. In fact, the effects of sildenafil citrate, the active component in Viagra, on male subjects were discovered almost by chance while they tested the drug to treat hypertension and some types of heart disease.

While there's no good process to guarantee successful new markets, there are some ways to help you with a good exploration of the unknown and come up with a few good ideas. Here are my top five:

1. Contextualize around the "jobs" that are being done.
2. Approach user or incumbents' dissatisfactions with existing products.
3. *Divert* from incumbent products.
4. Use your value chain to enter "adjacent" industries.
5. Take advantage of industry shifts.

These ideas are certainly not based on an exact science, but they should put you on the right track. Let's quickly expand on each as we did before.

Contextualization around *jobs*

When a product's functionality is seen in light of the "job" that it does, an entire new universe of opportunities for business innovation arises.

Focusing on the *jobs that need to be done* (aka JTBD) means that the unit of analysis for the creation of a new product or service is not the customer, as marketers usually use, but instead is the "job" that the product is designed to do.

The idea behind the JTBD framework originated from the work on product strategy and planning of consultant Tony Ulwick,[29] but was popularized by Harvard professor Clayton Christensen who coined the term (the same disruption guy).[30]

The JTBD framework honors what marketing professor Theodore Levitt once brilliantly said: "*People don't go to a hardware store to buy a quarter-inch drill. What they want to buy is a quarter-inch hole in the wall!*"

Probably the best example of how to use the JTBD framework to help you find opportunities for product innovation comes from Christensen himself. Reflecting on how the job "*I need to get this there as fast as possible, with perfect certainty*" has changed over the years, he said:

"*Julius Caesar had this job on occasions, and he'd use a horseman and a chariot to get the job done. Queen Victoria had the same job and she used a telegraph or a railroad. Winston Churchill found that on occasions he had the same job to do, and he could hire an airplane to do it. We now can hire DHL or the internet to do it*".

He then adds his final reflection: "*The product sold to do the job is very different [in each case], but the 'job' to be done was very stable over time.*"

The lesson here is that you can study the nature of the "needs" that existing products satisfy through the lenses of the JTBD framework and try to come up with better ways to meet them, even if that means an entirely different solution.

7

Further down in the analysis, think about how the intersection of technology, knowledge and resources that we have today could be combined to produce a new solution to an old problem.

Through this approach you can explore solutions even from different industries and try to come up with new ways to get those same jobs done.

Approaching user or company dissatisfactions with existing products

Another way to identify opportunities for innovation in business is to spot sources of customer or incumbents' dissatisfaction with the existing products.

User dissatisfaction may be discovered by observing customers' use of existing solutions and trying to understand *the problem* they are trying to solve.

Akio Morita, the legendary chairman of Sony who led the development and launch of the company's most successful products including the first portable pocket transistor radio, the first portable black and white television and the Walkman, was well known for devoting a lot of his time to observing customers interact with products.

From his observations came the insights that led to the creation of those powerful consumer products.

To spot these opportunities, you must scan the market for customers and users who are not happy with the incumbents' solutions within an industry, or who have to reluctantly use the existing products.

Customers' hesitation may be due to the complexity, the price or the inconvenience to purchase and use the product.

Next, you must shift your attention to products that are known to be sold at low margins or that represent some kind of inconvenience for the sellers. When this happens, it is usually because incumbents want to build or keep relationships with customers to sell them other things later, not because they are satisfied selling these products.

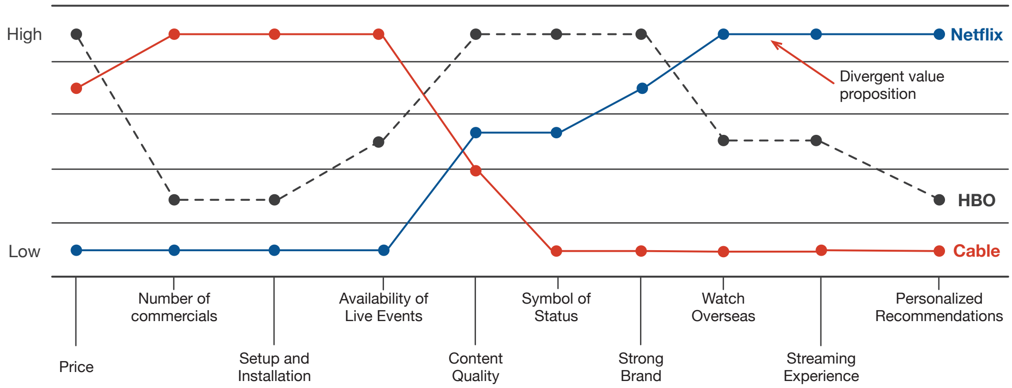
This is a unique opportunity for innovation because you already know that the product is selling, the problem is that sellers are not making money with it or are not happy with the sales. The first question you must ask yourself is: what would it take to sell those products efficiently and profitably? Could you make, sell and distribute them cheaper? Can you find a business model that would move the inventory faster so that you make your money from higher volume rather than from higher *margins*?

User and incumbent dissatisfaction are two potential sources of value for those who can crack the market and come up with innovative ways to capture those customers profitably. It might not be easy, but *difficulty* is what makes it *profitable*.

Diverting from incumbent products

Another powerful way to uncover ideas for market-creating products is by looking at the factors upon which incumbents are competing and either focusing on doing different things or on doing things differently. As the old saying goes, *when they zig, you better zag*.

A good way to see this is by using the Strategy Canvas we introduced in Chapter 2 to look at the factors that a few of the products compete on and try to think about how a divergent solution could create value for a particular set of customers.



You can use a strategy canvas to produce a divergent value proposition and create entirely new markets

By looking at the canvas, you can quickly see which factors incumbents believe customers value the most, so by reviewing them you can try to come up with ideas for products with a totally different value proposition that serve a particular set of customers within that market.

The creators of the Strategy Canvas, professors Kim and Mauborgne, highlight three existing opportunities to create products with a divergent value proposition using their tool:

1. Opportunities to further increase customer value along factors the incumbents compete on, and that are most appreciated by customers,
2. Opportunities to eliminate or reduce the factors where the players compete today that would produce an important cost reduction, and
3. Opportunities to create new elements of customer value that the customer has never received before.

While looking at your Strategy Canvas, keep thinking about the reasons why people consume these products and why non-consumers don't. This exercise can help you find new ways to create value, and potentially an entirely new product category or market as Pfizer did with Viagra.

LEARN MORE ABOUT THE STRATEGY CANVAS: to learn about how to create and use a Strategy Canvas, with real-life examples and a downloadable template, visit: strategyforexecs.com/canvas.

Use your value chain to enter *adjacent* industries

Another set of new market opportunities may be uncovered by looking across your company's value chain to uncover any overlapping of capabilities that it may have with adjacent markets or industries. Put simply, you look for adjacent industries where you could use any part of your value chain to make money.

Adjacent industries are those that sit right at the edge of your current market, where incumbents exhibit similar capabilities to those that you have.

The idea then is to find a few of them where you can leverage the people, assets and processes that you already have in place.

For example, in the early 2000s, Amazon.com needed a lot of computing infrastructure to run its eCommerce operations. In a typical Amazon move, it found that there were other industries that could use the same computing platforms, and that's how Amazon Web Services (AWS) and the whole *cloud services* division, now one of Amazon's most important business units, came to be. It was a successful expansion into an adjacent market, using capabilities Amazon already had in its value chain.

That enabled Amazon to operate this piece of its value chain at a level it couldn't have reached on its own.

Take advantage of industry shifts

Market opportunities come and go, and most times only those paying attention can jump ahead of the pack and get a piece of the action while enjoying pioneer advantage.

For more than a hundred years, all power grids around the world have been operated *in real time*, with energy being produced at the same time that it is consumed.

That makes the grid the world's largest real-time supply chain, all based on the fact that the cost of storing the energy (in the same way other supply chains store commodities) was so prohibitive that producing the electrons every time you flipped a switch was the most economical way of running the grid.

That belief changed a little over a decade ago, when a handful of companies started experimenting with large-scale grid energy storage systems, starting an industry that's now worth several billion dollars.

These pioneers saw that advancements in lithium-ion batteries were making energy storage a viable solution for power grids. They first started out with 15-minute storage applications, and nowadays it is very common to see multi-hour systems being deployed in power grids around the world.

In many cases, the intersection of multiple trends is what creates the potential for innovation and the creation of new industries.

For energy storage systems, it was a drop in the costs of advanced battery systems combined with increased performance in smart inverters. For smartphones, it was an increase in portable computing power along with the rise of applications like email, digital calendars and others that digitalized the corporate life. For artificial intelligence it is the convergence of cheap cloud computing and advancements in data intelligence, and for self-driving cars it is a combination of improved machine learning algorithms, mobile platforms and sensor technologies.

In each one of these cases, it was not just a single trend that gave foot to a new industry but the *convergence* of a few that made them possible.

There are conventional beliefs in many industries with roots that go back many decades, even centuries. But those fundamentals need to be continually challenged under current conditions and with the new possibilities, because at some point they'll stop being truth, and only those paying attention will profit.

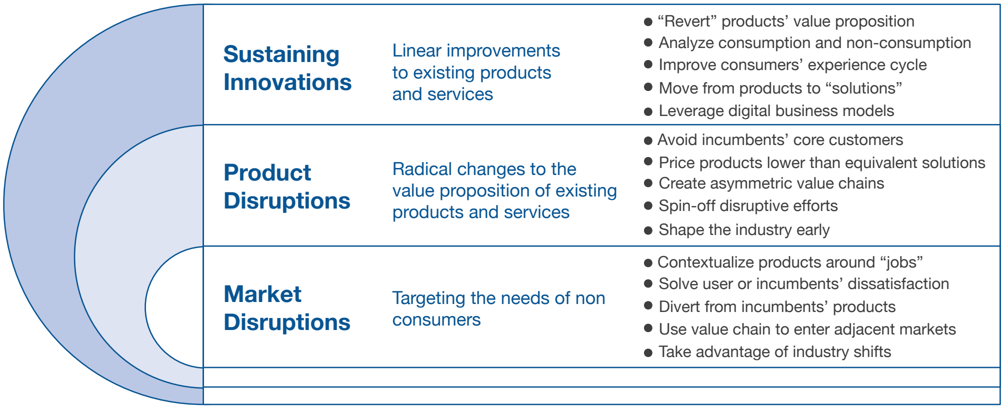
When working on your environmental analysis, look for signs of trends that are irreversible and that could produce powerful changes ahead. Project the future of those and other trends over the next 5, 10 or even 15 years, then reason backwards to see any innovation paths that your business should be pursuing now.

That's how you start creating create the future, today. Literally.

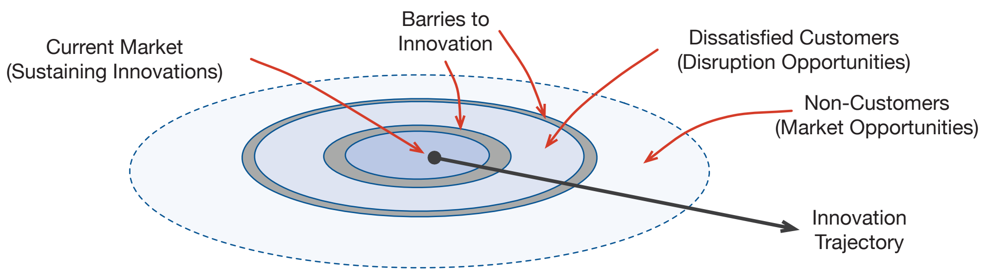
Putting it all together: An optimized customer value system

To recap, in this chapter we have reviewed different ways to improve existing products, create new products and even to come up with ideas for new markets.

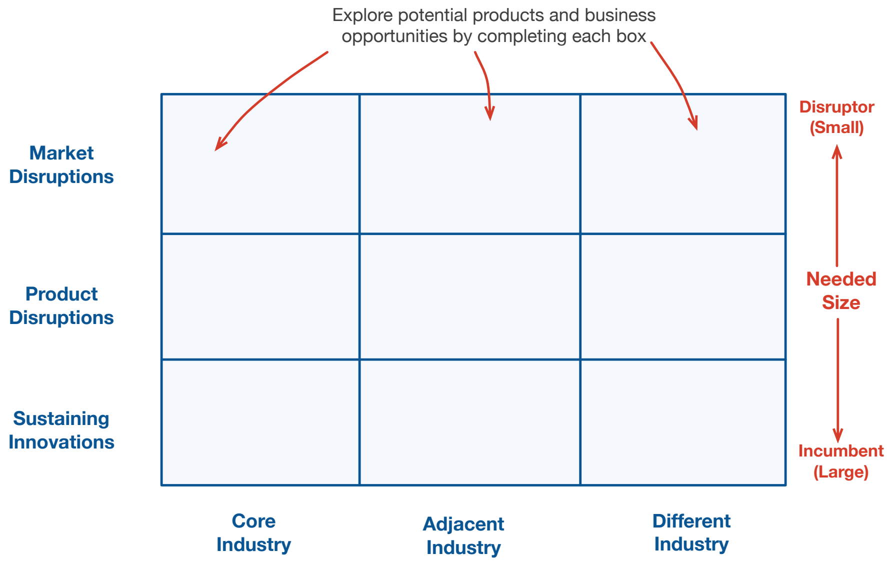
Thinking in terms of those three dimensions can help us put mental order to the chaotic process of product development, which is a fundamental piece of our innovation plan.



Whether you see things as an industry incumbent looking to improve its current product portfolio or trying to disrupt itself, or if you are planning to enter someone else's market, you can always approach the origination of ideas along these three dimensions (product improvements, new products or new markets).



To further widen the scope of your research and force yourself to look beyond your core markets for ideas, you may expand the analysis horizontally and look into adjacent or even entirely different industries for growth opportunities with new products.



A 3x3 matrix, where you look for product development opportunities within and outside your industry, can help you seek ideas beyond the obvious places by trying to fill in all the spaces

By thinking hard about potential product ideas within each box as shown above, you ensure that you will be scanning in all possible directions.

Finally, when thinking about creating new products, it is good to keep in mind that products usually create the most value when they operate within an ecosystem that has been optimized to serve the needs of a particular type of customer, or as we called it before a *value system*.

Within that value system, vendors, partners, sales and distribution channels, retailers, value chain, business models and customers all interact to create an optimal business.

One painful lesson from the failure of many companies is that "transplanting" a business model from one product to another is sometimes a recipe for failure. Instead, each new product or business opportunity must be run on its own value system, entirely optimized for the customers it serves.

When Kodak tried to enter the digital camera space in the late 1980s, they wanted to do it in their own way. For almost a century, the company had made most of its money from film products, and ever since its beginning their business model was clear: they would make money from consumables, not from hardware. Cameras were sold at relatively low prices since Kodak would make its money selling its photographic film, for which it owned the intellectual property.

In the minds of Kodak's executives, they were a film company, which meant that every time customers said "*cheese*" they would make money.

Not surprisingly, when they entered the digital photography space they did it in a way that resembled that thinking. In collaboration with Philips, they developed the Photo CD, a film-based digital imaging product. Customers would take their pictures with their cameras the same way they did before, but now they would take the film roll to a photofinisher where the images, rather than being physically printed, were stored on the Photo CD to be viewed later on a computer or TV.

The product, although sketchy by today's standards, reflected Kodak's prevailing thinking: they still wanted to get paid every time their customers said cheese.

Looking back at what they did, you can probably point at many things that were wrong with that approach, but one point that sticks out is how they wanted to transplant their profit model (each photo pays) into a new value system.

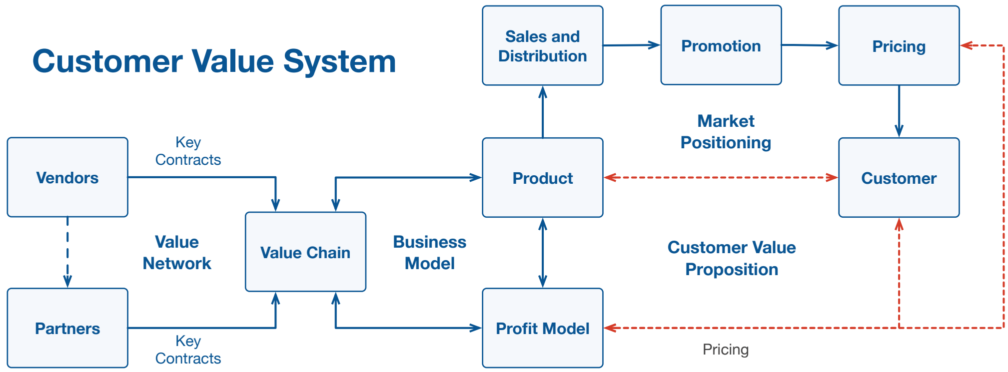
Their mistake was not recognizing that digital photography needed a different ecosystem to prosper, one with the right profit formula and a new business model specifically designed for it. In fact, they probably needed a new type of customer for the new product: geeks and teenagers for example.

That kind of tunnel vision creates deadly blind spots for incumbents.

Kodak's decisions back then reflect a way of thinking that's still prevalent in many industries today: executives evaluate new products through the lenses of their existing business models, leading to underperformance of new products or failed launches.

To prevent tunnel vision and get the most out of new products you must embrace the fact that both products and customers must reside within a value system that is specifically designed to maximize the value that can be captured from a particular opportunity.

Within this value system, you must find a value proposition that creates customers' incentive to buy, a market positioning plan that sells those benefits and makes them available to the right customers, a value network that's optimized to deliver the promised value and a business model that captures a piece of the value created and converts it into *profits*.



The value extracted from products and services is usually maximized when your business is optimized to serve the needs of your products' target consumers

When developing new businesses all decisions count, from the selection of the right customers, and the optimization of the job the product offers to do for them, to the determination of the right pricing for those customers, picking the right vendors and partners and the selection of the right sales and distribution channels. Everything counts and that's why each one of these decisions has to be thought out to maximize the value of the particular opportunity that's been captured.

In the end, it is the entire value system that must be optimized, from vendors to product disposal, if you want to maximize the value that the product creates for its users and for your company.

7

Alternatives to in-house innovation

Innovation, especially when it comes to the development of new products and services, is one of the most exciting activities in any organization and the one that usually gets the most attention. But as we saw, it bears some risks and the failure rate is astonishing by all counts.

There are, however, other alternatives for coming up with innovative products without the risks that a full innovation effort carries. In particular, there are two that I feel deserve to be discussed in some detail because they can be extremely effective as an alternative to in-house efforts and could even be more profitable.

One of these alternatives is the "emulation" of other companies' products and services, especially those created by the players leading the space. Through emulation you can mitigate the risks associated with failed innovation bets by becoming a fast *second mover* that only enters a market once it has proven to work for somebody else.

A second alternative to in-house product development is striking licensing deals with developers of intellectual property to incorporate it into your products. This can go from the integration of a particular subsystem into your value chain (like a battery in a mobile device for example) to licensing entire products to be sold under your brands.

These two alternatives can be very effective as they eliminate the guesswork when it comes to originating business ideas. The next sections expand on each of them.

Emulation: The sincerest form of admiration

Think about the following statement: "*Innovation is great for organizations which, through the creation of ingenious products and services, get to originate and capture entirely new markets and enjoy long-term pioneer benefits which helps them stay ahead of their competition.*"

That may sound like something you hear and read every day, right? However, it's far from being true. In reality, early pioneers, the people who invent stuff, almost never get to conquer the markets they originated with their innovation.

GE didn't invent the CT scanner and Amazon didn't invent online sales in the same way that Apple didn't invent tablets nor Facebook invent social networks, yet they all ended up dominating those markets and making more money in them than whomever came up with the idea in the first place.

There's nothing new here. Time after time and industry after industry we see that late-comers can come to dominate entire markets originated from somebody else's ideas.

What if I told you that more than 80 percent of self-made billionaires made their fortune in already established and "non-tech" industries?[31]

The truth is, there's a big difference between creating a product and creating a *business*, and nowhere is that difference more prominent than in the dynamics around market pioneers and fast late movers.

Kodak invented the digital camera in 1975 and four decades later was disrupted by it. It just couldn't make a good *business* out of it, even though it was the pioneer in the *technology*.

In a sense, emulators bypass early experimentation stages and skip ahead to the end after the product has proven to work (in a technical sense) and most importantly after it has proven to *sell*.

Being a fast second mover doesn't mean being a follower. Good emulators improve value and reduce costs, while mixing and matching the product with innovative business models to improve the original solution's value proposition. In a way, good emulators "innovate" the innovation – they make a good *business* out of a *product*.

Music service Pandora (NYSE: P), the pioneer in online digital radio, created an entire market with its innovative service, but it has been left behind by fast second movers like Spotify (NYSE: SPOT) and Apple's Music which quickly introduced innovative features and controls making Pandora look like grandpa's old radio station. At the end of 2015, Pandora had almost five million *more* active users worldwide than Spotify, and by the end of 2018 it was around 100 million users *behind*.

A fast second mover strategy means taking ideas that pop up in the market as innovations and using your company's own capabilities to improve those ideas and beat the innovators themselves at their own game.

Software companies have been doing this for years. When Microsoft launched Excel, its spreadsheet application, it was emulating Lotus 1-2-3, and Lotus was emulating VisiCorp's VisiCalc, the first spreadsheet program, launched in 1979 for the Apple II.

In fast-paced industries, as in smartphones for example, continual emulation is needed just to keep up with the pace of advancements in the market and in customer preferences. If you are in such an industry, you should probably plan to be a pioneer in some things and a fast second in others. That's how the game must be played when products continually change.

A fast second mover strategy works best when the original innovators can't get tight legal protection of their invention. Since they can't appropriate the innovation, they will try to bring it to market as fast as possible using *speed* as the main advantage over potential competitors. But savvy seconds can quickly catch up and use their value chains to get ahead in the game with an innovative *business*.

Finally, to become a fast second mover, your organization must develop *Absorptive Capacity*, i.e. an internal ability to identify, assimilate, transform, and apply complex knowledge generated outside the organization into the development of new products and services.

Think about all the research and knowledge that is created outside your organization that can be exploited by anyone with the appropriate tools and skills. To develop absorptive capacity, we must develop the internal resources (people, assets and processes) to understand and decode that information in a way that can be put to work in the development of new things.

Emulation is one of the most powerful alternatives to in-house innovation, but only those who can wrap products into innovative businesses can benefit from it.

Licensing deals

A second alternative to in-house innovation is licensing technology and products from third parties. That means that, instead of making a product, you get a license (i.e. a permit) to make the product under a different name or to use somebody else's product as part of yours.

This is more common than we might think. Renowned beauty company Estée Lauder licenses fragrances and cosmetics from other well-known names such as Tommy Hilfiger, Donna Karan, Michael Kors, DKNY and Tom Ford.

It is actually through licensing that most products created by individual inventors make it to market and the model is very popular in the toy industry. The inventor signs a licensing agreement granting manufacturing rights to a large company who will pay a royalty (a fee) for each unit sold.

A variation of a licensing agreement is private labeling, where a company has the maker of a product slap its own brand on the item. You may be surprised to know that Amazon.com owns more than 70 private label brands. In fact, most products sold under store brands like Walmart's Great Value and Target's Simply Balanced are made under private (also called white) labeling agreements.

A licensing deal can of course work both ways, that is, you may use it to get access to another company's innovation, or to give other companies access to yours. In either case both the licensor and the licensee benefit from the transaction.

Introducing new products and services

Although the focus of this book is strategy and not so much specific implementation "tactics", there are a few things about the introduction of new products that I feel should be discussed as part of the product development process.

Earlier in this chapter we talked about how targeting customers that are being served by powerful incumbents could be a huge risk for less-powerful market entrants, who may become the target of hostile retaliation from those players and may even be forced out of the market.

That should be a powerful warning to avoid targeting the wrong type of customer when starting out. However, equal care must be put into selecting the *right* group of customers that will be targeted early on.

In fact, when it comes to introducing new products and services, the *sequence* in which you target customer segments from the go matters. People that you target first will be a reference for the people you target next, so if the first group of buyers love your product, they will be a good referral for future customers, but if they don't, you may have some issues trying to expand your business.

That's why you need to think about the sequence in which you introduce new products, and try to begin with the customers that will value them the most, even if they are not a majority.

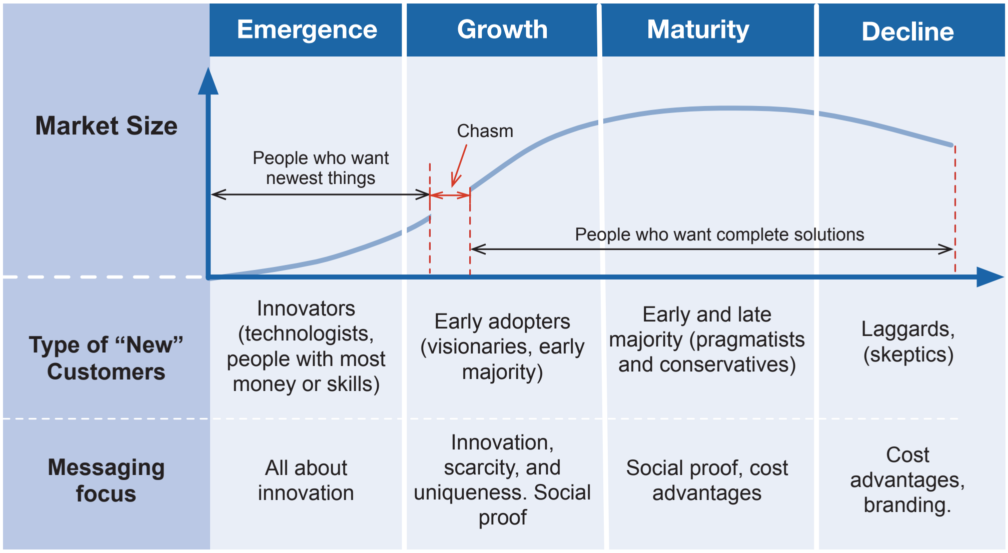
In his widely popular book *Crossing the Chasm*, author and consultant Geoffrey Moore divided the universe of potential users of new products into different groups that shared the same "mentality". What Geoffrey found was that there were two groups of users that were critical for the success of a new product, the *Early Adopters*, enthusiasts who see themselves as visionaries, and the *Early Majority*, a pragmatic but larger adopter group that makes purchases based on factual cost-benefit analysis.

In the book, Moore tries to solve the problem of how to "cross the gap" (the chasm as he calls it), that is, transitioning from *Early Adopters* to the *Early Majority*, since the former is not a good reference for the latter.

What's interesting about Moore's work is how he documented these groups of customers, who buy the same products but for different reasons, and how he identified the challenges in trying to move from one to the other.

Early adopters are motivated by the fresh ideas around the new product, so your messaging when targeting them should be all about innovation and the cutting-edge aspects of the product. The early majority, on the other hand, will expect to pay a fair value for something that's proven to work for others, so your messaging for them should highlight any social proof you may have (from targeting other segments) and the uniqueness of the product.

Although Moore's work mostly focuses around high-tech products, I'd argue that there are early adopters and an early majority in pretty much every industry, therefore identifying those pockets of people and sequencing them in the right order should be part of the work we need to do when developing and launching any new product.



There are early adopters in most markets. You must find out who and where they are and target them first, even if the product has to be adapted to fit them better

Early adopters can be critical to the future success of a new product, especially when the product has room for improvement when it is first launched. These buyers are usually more interested in the innovation aspects and won't mind if they get a sketchy product, because all they want is to try it out before mainstream users do.

With enough care and the right ecosystem, they can even help you improve the product, providing constructive feedback and usage data.

If you put a product that is not yet finished in the hands of more conservative customers, like those found in mature industries for example, the feedback you will get from them (and in turn the referrals you build) will be negative, because they expect something that is already good and they would never pay for a work in progress.

Microsoft famously introduced raw early versions of its Windows products and used feedback from early adopters to quickly improve them as it approached more mainstream customers.

With all that being said, the reason why it's important to think about the introduction sequence during the product development process is because you may need to customize the product or its *value network* to better fit the needs of the early adopters, since you probably want to reach them first.

Product development teams must be able to recognize when the introduction sequence could make a difference, and when it does, draft it in such way that the accumulated feedback you get is increasingly positive and helps boost introduction efforts with other segments.

Targeting the wrong customers early on could be a drag, and negative feedback could destroy the team's morale. Part of the initial success of Facebook as a social network may have been due to the initial customers they targeted: college students who were happy to have a platform where they could meet their peers and find out what was going on around the campus, even if that platform was a bit sketchy.

One way to improve your chances of success when developing a new product is integrating key customers in the development process, where they provide feedback and help incorporate their needs into the finished product. In the end, if they are part of the product development effort, they won't really have a good reason not to use it when it launches.

Finally, once you have a clear idea of the value proposition of your new products, you must always craft powerful accompanying "statements" that explain the value proposition to each of your target customers.

Remember from our early chapters that *value* is a relative term that can mean different things to different people. For that reason, you should have as a minimum one value proposition statement (VPS) for each customer segment you are targeting.

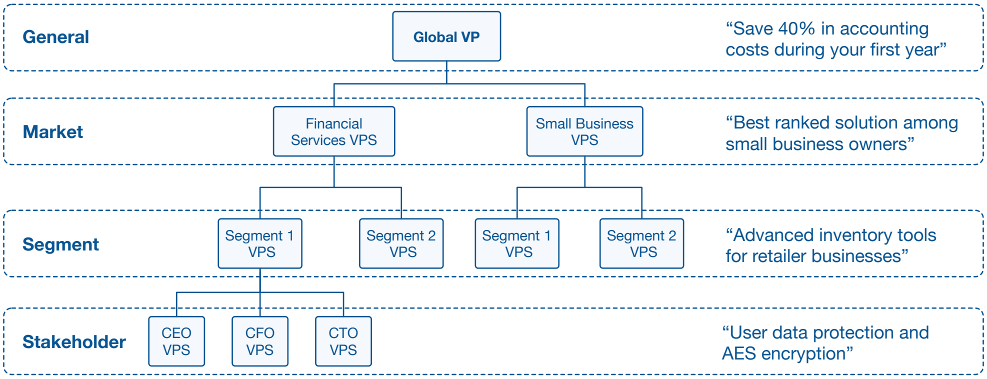
For example, a value proposition statement for online accounting software may describe why the product is a good alternative for small and medium size companies compared to in-house accountants and other software solutions.

You could use that general message in broad communications and general messaging campaigns, but you should also craft specific statements targeting other important customers and key stakeholders that you will find in the market.

For example, one positioning statement could target Chief Financial Officers (CFOs), in which you highlight the financial indicators the software is able to track, while another statement could specifically target Chief *Technology* Officers (CTOs), who care more about user data protection aspects.

These stakeholders, although they may be part of the same company, have different lenses through which they evaluate a product, therefore you must create specific statements targeting each of them, to increase your chances of effectively converting them into customers.

In the same way, you could create multiple positioning statements to tackle different industries, executives within those industries, or even to attract the interest of particular individuals with the same product.



Creating value proposition (or positioning) statements (VPS) for each market, segment, stakeholder or relevant unit can help you personalize messaging and improve traction with buyers within those groups.[32]

Finally, we must embrace the idea that it is okay if a product doesn't satisfy the needs of a group of customers that is NOT your main target for it. In the end, no product can satisfy all customers, so making some people unhappy is implicitly a key part of the success of a product strategy.

Technology trends creating new product opportunities

Technological trends permeate everything we do, from how we work to how we interact with other people. Emerging technologies can enable functionality and capabilities that never previously existed, creating opportunities for the creation of innovative products and markets.

Here are five emerging technologies that show a lot of potential to improve many of today's applications:

Artificial Intelligence

Artificial Intelligence (or just AI) is the ability of a machine to behave in ways that seem intelligent, replicating cognitive functions that we would normally associate with human behavior.

The most popular uses of AI at the moment are *Machine Learning*, *Computer Vision* and *Natural Language Processing* (NLP). These functions enable software-based machines to learn, see and understand language, new abilities that will have huge implications for business.

For example, we saw earlier that IBM's Watson can already improve cancer diagnostics. Similarly, NLP applications are now being used to automate customer service by powering *chatbots* and monitoring the company's reputation through sentiment analysis tools.

Robotics

For the purposes of business applications, we define robots as "*automated devices that perform physical tasks in the real world*".[33] As a physical extension of AI, the field of robotics is showing significant advances, changing the way people think about machines and processes.

Advances in robotics and AI have enabled the raise of autonomous driving vehicles, and for many years the field has been a main driver of cost reduction in automated manufacturing applications.

More recent applications include automation of warehouse activities[34] and of repetitive processes like food preparation.[35]

Advanced materials

Another field creating opportunities for the development of new products and services is material science. From companies producing consumable animal products in laboratories[36] to 3D printing of human organs.[37]

Through advances in material science we will be able to develop applications that we couldn't even imagine before. For example, the Chinese government recently completed a prototype of what they call an "intelligent highway" which uses a layer of transparent concrete to cover an underlying layer of solar panels, allowing the highway to charge electric vehicles as they pass through.[38]

Blockchain

Behind the buzz surrounding Bitcoin and other cryptocurrencies hides *Blockchain*, a powerful technology that can change how the world transacts. In a nutshell, Blockchain is a digital ledger in which transactions between the members of a network are recorded.

The power of Blockchain is that a complete database containing all the transactions is stored at every node of the network, and each transaction is validated and recorded through complex encryption algorithms.

Because every node of the network has access to all the transactions that are made, the platform provides an almost incorruptible database since it would be near impossible to alter records across all the nodes.

Blockchain has risen as a tool to add trust to exchange platforms and is being applied to industries beyond cryptocurrencies, like in the power sector to trade solar roof power between grid users[39] and to validate real estate transactions.[40]

We expect the number of Blockchain-based applications to dramatically explode over the next few years, as users and businesses become more familiar with the technology and with the help of open-source platforms like Ethereum which allows users to create digital contract applications.[41]

Large scale simulations

Finally, a technological development that's been flying below the radar for a while is advanced simulation platforms. These tools allow you to recreate digitally complex systems found in real life so that you can test applications, hypothesize and make better decisions.

Simulation environments vary from one industry to another, from application-specific environments to test the performance of autonomous vehicles[42] to more advanced platforms that can create virtual worlds.[43]

Next time you find yourself brainstorming the development of new products, go through this list of emerging technologies and explore whether they could help you create differentiated value for customers or reduce costs.

Multisided platforms and network effects

A business model that's become very popular in many industries is *Multisided Platforms*. In essence, a platform is a digital space where groups of people connect to share something that's valuable for at least a portion of them.

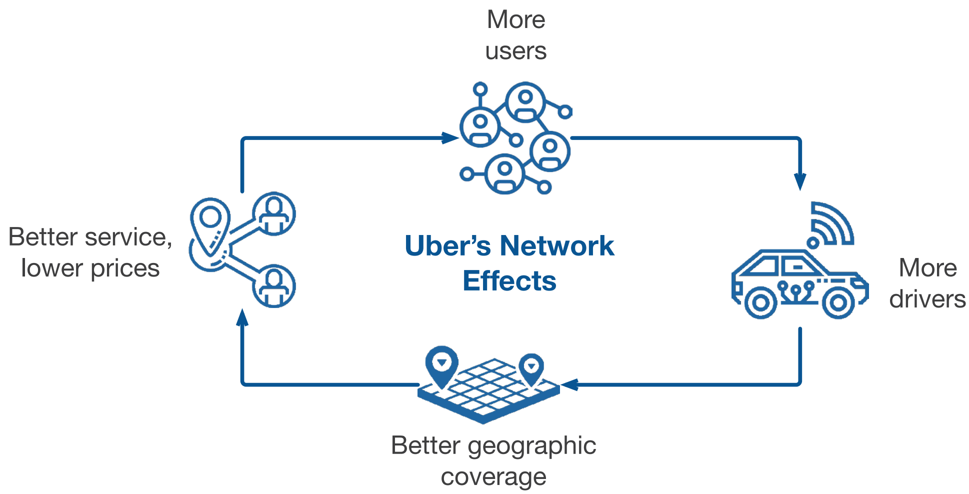
One familiar example of a multisided platform is Uber, the ride-sharing company. Through Uber, car owners who happen to have some time to spare can connect with people who need a ride, all in real time. The platform then, through geolocation and billing systems, makes the connection between the two possible and facilitates a commercial transaction.

A similar application of multisided platforms can be found in other businesses including Amazon, where sellers around the world connect with buyers; in social media, where people share stories with friends and family; and app stores where app developers connect with mobile users.

The power of multisided platforms lies in the "Network Effects" they create, where the value for their users increases with the number of users.

The classic example to explain network effects is the landline telephone. There was not much incentive for the first telephone user to have one since she didn't have anyone to call, but as the user base grew the value for all users increased as they had more people they could speak to.[44]

Network effects produce virtuous cycles that reinforce the value of the network for its users. In the case of Uber, for example, having more drivers attracts more users, while more users attract more drivers. The same happens in an app store, where more app developers attract more users, and more users attract more developers.



Multisided platforms make the creation of network effects possible, and vice versa

In some instances, the platform collects data from members and transforms it into *information* that's useful for all users. Google Maps for example uses data from individual mobile devices to assess traffic and provide accurate directions.

There are some cases of platforms being successfully used in industrial and business-to-business (B2B) applications as well. Cohealo, for example, is a platform where healthcare providers share specialized equipment with other facilities for a fee.[45] Similarly, intelligent thermostat Nest uses information from its user network to improve its performance for all its owners.

In most cases, a platform connects a group of people that owns something that's valuable for another group and facilitates the exchange of that information, most times adopting the role of curator or matchmaker, so it's pretty easy to see how this could be used across a wide number of industries.

Platforms are in most cases a business model on their own, with most of them charging a transaction fee of some sort to capture part of the value created by the transaction they enable.

In some cases, you may improve the value offered by your products and services and leap ahead of competition by wrapping them into an efficient platform with positive network effects. For example, Chinese internet security company Qihoo 360 has created a platform around its antivirus product 360 Safeguard which collects data from its large user base to help improve malware detection for all users. The more people use their product, the better it gets at detecting viruses for everyone.

Platforms can be great value amplifiers for some business models, especially during the emergence and growth phases of an industry when they can help captivate a large user base, something that could later become a competitive advantage for the products.

A downside of platforms is that they need a lot of care. They cannot just be created and left to their users. They need to be continually updated, improved and taken care of, since a platform that is not well managed could negatively affect a company's brand and become a liability instead.

Platforms can be greatly improved in many cases through the implementation of machine learning algorithms to help understand, classify and curate the information for users.

Finally, let's make a few clarifications about some concepts that are usually confused with platforms.

First, *a platform is not a community.* Online communities are spaces where users can interact with other users, normally in an open format such as forums.

A platform on the other hand is a space that facilitates a *transaction* of valuable information between users. In some cases, the platform will provide users with tools to amplify the value they create (e.g. filters on Instagram and Snapchat), or the platform itself will use the data to produce valuable information (as Google Maps does for example).

On a platform, users can usually switch roles as they wish. On eBay, for example, a buyer can become a seller whenever she wants and vice versa, and can even play both roles at the same time.

Communities are great tools to help companies engage with customers and users of particular products, but they are a passive means of interaction, whereas on a platform there is usually some data curation involved.

Second, *gamification is also not a platform***.** Gamification is another term commonly mixed up in the whole platform conversation, but gamification and platforms are not the same. They are in fact entirely different business models.

In a gamification business model, users usually interact with an application to generate some scoring system that drives loyalty. Most loyalty programs which give customers miles and points are examples of gamification applications.

There are many ways to use gamification for business purposes. Verizon Wireless for example encourages community members to write reviews and help other users to earn points. Those with the most points gain recognition and authority within the community while helping build Verizon's brand.

In another example, American footwear and apparel company Nike launched a gamification platform called NikeFuel Missions where users of their app and wristbands can compete against each other based on the amount of physical activity they log on the system. The community features specialized advice from professional athletes like Calvin Johnson, Allyson Felix, Alex Morgan and Neymar Jr. who help users achieve new levels and gain points in the game.

Gamification works around the idea of making interaction with the company fun and can truly help companies build brand loyalty. Platforms, on the other hand, focus on the *exchange* of valuable information with or between users.

They both have particular uses and applications, but they should not be confused since they are very different things.

Working with external startups

It is through startups that many innovations originate and make it to market. Because of their lack of bureaucracy and extreme focus, these small companies are innovation powerhouses that change markets around the world.

We already discussed a few ways to bring innovation in from the outside through emulation and licensing deals, as well as through private equity investments.

Two other ways to boost your internal innovation efforts are by working with startups to either embed their products into yours, or yours into theirs.

Let's quickly explore these two approaches and see how your organization could benefit from them.[46]

Outside-in innovation programs

Through an "outside-in" approach you invite startups to pitch ideas of how to use their innovations to create value for your organization or your customers. You then select the ideas that you believe have the most potential, and dedicate corporate resources to work with the startups to create a *proof of concept* to demonstrate their implementation into your business.

These proofs of concept, once implemented, are then presented to the company's executives along with their results, so that you select with which of the startups you wish to expand your relationship, usually through a supply agreement, joint venture, partnership or an equity investment.

Inside-out innovation programs

In this case you create an ecosystem where your company helps startups use your products in the creation of theirs. As an example, imagine PayPal, the online payment platform, working with startups to help them integrate PayPal as their core payment gateway.

This could have multiple benefits for your company. By getting your product embedded into a startup's solution, you can *prove* how effective the product is for similar companies, at the same time that you lock-in captive demand.

Through these two programs, you can accelerate the pace of your innovation engine by leveraging the speed of invention and creativity of external startups, and getting a front row view of emerging developments and technologies that could change the way you do business, opening multiple doors to create sustainable superior value for your shareholders over the long term.

Creating a successful product development strategy

I'd like to end this chapter with a few thoughts about how to foster a successful product development strategy and keep the innovation engine always on.

These reflections are mostly based on my personal notes and recollections from working with exceptional people and companies. Although my experience is somewhat biased towards high-tech industrial products, these ideas can be implemented in any industry.

Innovation is hard, and the failure rate is of heart-stopping proportions, but the rewards of a well thought out innovation strategy can be extraordinary and lead to superior growth.

Here are my final recommendations about product development and strategy:

Check continually for value creation

You must actively monitor to check that your products are always delivering the value proposition that your customers expect, and that there aren't other dynamics in place that could be threatening your profitability. You must always ensure that customers and products are a good match for each other and use as much information as possible to make sure that it stays that way. Remember Peter Drucker when he said that "*We should know the customer so well that the product sells itself*".

Encourage a product ecosystem that supports the buyer and mitigates risks

Some customers are more risk-adverse than others, and the easier you make it for customers to purchase and mitigate those risks the more likely it is that they will buy.

To guarantee that, you must ensure that people always have the best experience when trying to buy your products, and that all the infrastructure and complements needed to use such products are available to them when they buy. You must also provide proper support staff to answer pre-sales questions and to walk new users through issues after they buy.

Develop a strong technical position

You must deliver your value proposition at a lower cost than anyone else, or your market position will be compromised. For that reason, you must align your people, processes and assets to ensure they are always optimized to deliver the best experience to customers at the lowest possible cost.

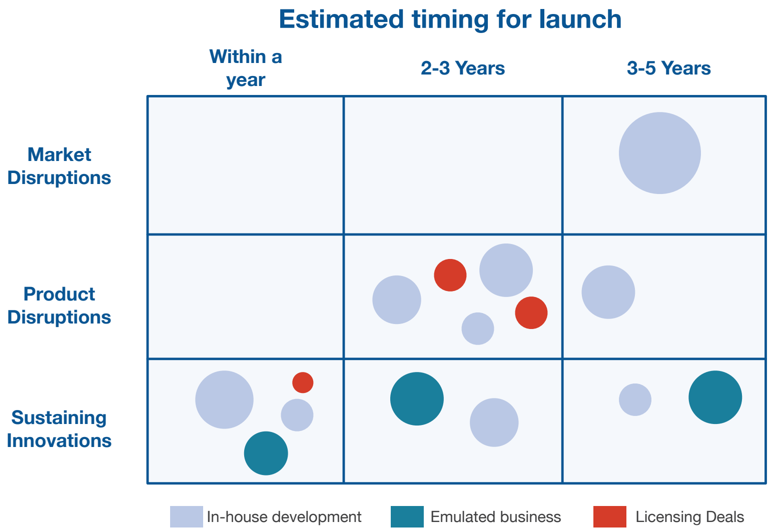
Think strategically about standards

If you are in a high-tech industry and your product relies on standards that are not yet fully developed or that aren't yet good enough, think about creating your own. By having your own standard, you decide its technological direction and who can use it.

Maintain a "portfolio" of innovations

Putting all your eggs in a single basket is always a risk, and while it is true that many companies have won big betting on new products and technologies, there's a difference between betting "big" and betting "all".

As a company, it makes sense to have a *portfolio* of innovations across multiple markets, business units and products that can be launched at different times in the future.



Mapping your innovation portfolio can help you better balance your efforts and resources. Circle size represents revenue potential

By creating a map of your innovation pipeline, you can easily keep track of opportunities to improve existing products, capture dissatisfied customers or create entirely new markets, better balancing resources across each of them.

Keep expanding your knowledge base

In his book *Leap: How to Thrive in a World Where Everything Can Be Copied*, IMD Business School professor Howard Yu explains how Procter & Gamble (P&G) went from a humble beginning as an artisanal maker of soap and candles, to master *Mechanical Engineering* with the introduction of mass production and automation, and how it kept learning about its markets and later expanded its knowledge base into *Consumer Psychology* through the implementation of professional marketing tools such as data analytics and rule-based decision making.

This is a great example of how an organization keeps pushing the boundaries of its knowledge base to expand its businesses and grow in other directions.

What P&G is today is the result of its mastery of those three knowledge foundations: mechanical engineering, consumer psychology, and organic chemistry. That combination is what made possible the creation of leading brands like Tide and hundreds of others.

Don't try to ship perfect products. Just ship.

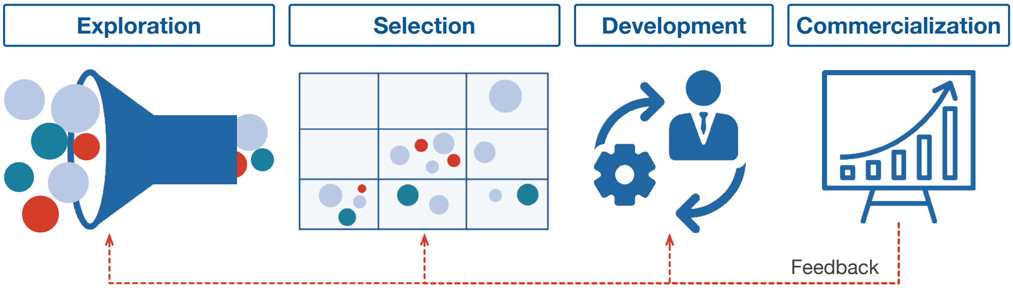
I know we're probably divided on this one, but I feel that sometimes in trying to ship perfect products some companies drag their launch for so long that they miss big opportunities.

Unless a new product or service is out there in the hands of customers it is hard to predict what their reaction will be. In some markets, early adopters could even help you make the product better as we saw earlier in this chapter. That's how Microsoft suffocated every single competitor, making its CEO the richest guy in the world for a long time: they would just ship products at the right time, even if customers had to help debug them.

In reality, there's no such a thing as a perfect product, just perfect customers.

Mainstream customers will be more demanding, of course, but the product will already be improved by the time you put it in their hands. The focus of early innovation efforts is not to ship a perfect solution, but to ship to the right customers.

Finally, you must keep the innovation engine continually running, managed by a systematic effort with clear governance and stages.



Your innovation engine should be always running, transforming raw ideas and market signals into effectively captured opportunities

That's how innovation becomes a source of differentiation or, to use a classic term, a *Competitive Advantage*.

Postmortem: Deadly mistakes and near misses

In 1997, Larry Page, then CEO of Google's early company called BackRub, tried to sell his company to a popular internet portal called Excite for $1.6 million. Back then, internet search engines like Excite, Yahoo! and AltaVista made most of their money from advertising and featured news on their busy home pages.

Excite turned down the opportunity to buy Google (then BackRub) because it would "*send users off the site too quickly*" which would be bad for their advertising business model.

A few years later in 2005, Verizon rejected a deal with Apple to be the exclusive distributor of the then expensive iPhone device over discrepancies on the phone distribution terms, sending the deal directly to Cingular's lap, one of Verizon's top competitors in the US. The iPhone turned out to be a great product hit, forcing Verizon and other companies to play catchup.

Going back in time more than 100 years to the late 1800s, Western Union, which back then controlled the telegraph business, passed on the opportunity to buy Alexander Graham Bell's patents on telephone technology for $100,000 (around $2.5 million in today's money). When presented with the opportunity, Western Union's president William Orton asked pleasantly "*What use could this company make of an electrical toy?*".

By 1910, more than a million phones had been sold, and Bell's telephone company, which had been renamed as American Telephone and Telegraph Company, or just AT&T, acquired a controlling interest in Western Union, evidencing the big mistake the once dominant telegraph company had made by ignoring Bell's invention.

NEAR MISSES: Microsoft almost bought Yahoo! in 2008 for $45 billion in a failed hostile takeover, and a few years later Verizon bought Yahoo! for $4.5 billion. Google almost bought Groupon in 2010 for $6 billion, and Groupon's valuation today is around $2.3 billion.

Part IV

Making Strategy Happen

Capital Allocation

8

In the first few pages of this book, we reinforced the idea of measuring the success of a CEO in terms of the value created for shareholders, and in that regard there is no doubt that Jack Welch, whose performance we covered in Chapter 1, has been one of the greatest of all time: as the CEO of GE, Jack grew the company's profits tenfold and outperformed the S&P 500 Index by 3.3 times.

Those are exceptional results by any standard, earning Jack his spot on the list of the greatest, but with most references pointing at his performance in GE as the go-to example for a well- managed organization, we couldn't help but wonder whether any other company has had an equal or superior performance to GE under Welch.

That is the question that Harvard Business School professor and venture capital investor William Thorndike set out to answer. He worked with his second-year students at Harvard to look for companies and CEOs that achieved superior performance when compared to Jack Welch's GE and their industry peers. The results of Thorndike's research, published in his book *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success*, became an instant hit among executives around the world.

Looking through the archives of the Harvard Business School, Thorndike and his students established two basic tests that a CEO had to pass to be considered exceptional: first, the stock had to have better performance relative to

In this chapter we will:

- Explain the differences between profits and cash
- Find the right financial metrics to measure strategy
- Justify the centralization of cash management
- Discuss the evaluation of capital allocation decisions
- Explore Corporate Venture Capital investments in more detail

the S&P 500 than GE under Jack Welch, and second, they had to materially outperform their peer group.

Surprisingly, Thorndike's research found eight companies that passed those two tests: Capital Cities under Tom Murphy (1966-1996), Teledyne under Henry Singleton (1960-1989), General Dynamics under Bill Anders (1991-1993), TCI under John Malone (1973-1998), The Washington Post under Katharine Graham (1971-1993), Ralston Purina under Bill Stiritz (1981-2001), General Cinema under Dick Smith (1962-2005) and Berkshire Hathaway under Warren Buffett (since 1965).

When compared to the performance of this exclusive group, GE's results under Jack Welch look pale. On average, these fairly unknown CEOs outperformed the S&P 500 *over 20 times* and their peers by *seven times*, which sets a much higher bar for what "outstanding" means when it comes to the job of the CEO.

Over the following years Thorndike, with the help of his students at Harvard, dissected the management practices of each of these CEOs to understand what made them so successful and not so surprisingly, they found that they all shared one thing in common: they were great *Capital Allocators*. They were all masters in the art of managing the company's financial resources to maximize value for shareholders.

CEO	Company	Period as CEO	Stock's Compound Annual Growth Rate (CAGR)	Factor by which the stock outperformed the S&P 500
Jack Welch	GE	1981-2001	20.9 %	3.3 Times
Tom Murphy	Capital Cities	1966-1996	19.9 %	16.7 Times
Henry Singleton	Teledyne	1960-1989	20.4 %	12 Times
Bill Anders	General Dynamics	1991-1993	23.3 %	6.7 Times
John Malone	TCI	1973-1998	30.3 %	40 Times
Katharine Graham	The Washington Post	1971-1993	22.3 %	18 Times
Bill Stiritz	Ralston Purina	1981-2001	24.0 %	4 Times
Dick Smith	General Cinema	1962-2005	16.1 %	16 Times
Warren Buffett	Berkshire Hathaway	Since 1965	20.7 %	Over 100 times

Performance of the stock under each of Thorndike's outsider CEOs.

In general, there are some common factors that separate Thorndike's outsider CEOs from other executives:

- They religiously devoted an important amount of their time to making capital allocation decisions.
- Their favorite metric for growth was long-term value *per-share*, rather than sales growth or market share.
- They rarely paid dividends, considering them tax inefficient, and instead compensated shareholders through large stock buybacks.
- Their management focus was not sales or operating margins but *cash*.
- They seldom relied on the advice of external consultants, and instead based capital allocation decisions, including acquisitions, on their own analysis and the work of their in-house teams.

Notable within this group of CEOs is Warren Buffett of Berkshire Hathaway, who for many experts is the greatest investor of all time. During his time as CEO, he has outperformed the S&P by more than a hundredfold, and the value of his company's shares has grown at an average compound rate of 20.7 percent per year.

A $10,000 investment in Berkshire Hathaway in 1965 would have been worth $88 million by the end of 2017, an outstanding result compared to the $1.3 million that the same investment would be worth had it been made in the S&P 500.

Warren Buffett has always talked openly about his investment decisions and over the years has offered some insights that executives paying attention can use to improve their own businesses. For example, Buffett has a preference for businesses that can produce lots of cash, with strong brands or a dominant market position and low levels of debt, and he loves companies that can make money through franchises (like Coca-Cola for example).

Buffett also prefers to invest heavily in industries that he knows well rather than diversifying across multiple industries, and notably keeps capital allocation decisions tightly centralized at the headquarters.

Success as a capital allocator depends to some extent on the ability to raise cheap money and redeploy it onto higher return activities with perfect timing, a seemingly simple maneuver that has a profound impact on a company's bottom line.

In this chapter, we will explore some of the best capital allocation practices and provide a few ideas that can help evaluate capital allocation decisions. We also review fundamental concepts in the art of managing cash and end the chapter with a reflection on company priorities when it comes to managing resources.

> **NEED A QUICK REFRESHER ON FINANCE?** This chapter explores a number of financial concepts that are truly important for strategy. If you feel that you need a quick refresher on Financial Statements and important financial metrics, head over to the **Appendix** where we provide a crash review of these subjects.

The truth about profits, cash, assets and non-assets

Most strategy frameworks have been developed around the idea of maximizing profits, and even in this book we have talked about profits and profitability as the main goal of a business strategy. However, although profits are a direct measure of the financial gain a company obtains from running a business, the truth is that you can't pay your bills or buy raw materials with profits; for that you will need *cash*.

There is a big difference between the profits and the cash that a business creates, and it is important that we understand this difference in order to plan and execute a strategy properly.

Let's quickly review a few important concepts about profits and cash, and some not-so-evident truths behind the numbers that you find in a company's financial statement:

1. **Sales are just an estimate:** Under the Generally Accepted Accounting Principles (GAAP) *sales*, or *revenues*, have nothing to do with cash coming through the door. Accountants are just required to record a sale when it has

been *earned*, but it is up to them to decide the moment when a *sale* is considered to be a *sale*.

They could say, for example, that a sale happens when a contract is signed, when the product is delivered or when a service is completed – even if buyers have not paid yet. In most cases, what is recorded as revenue in an *Income Statement* does not match the period when the funds are actually received.

With the exception of cash businesses, revenues are the accountants' best guess of when sales were *earned*, even if no money changed hands.

2. **Costs are an estimate:** For the same reasons, costs are also an estimate. When elaborating a company's income statement, accountants stick to what they call the *matching* principle which says that costs and expenses are those the business incurred in generating the sales recorded during the reporting period.

   That means that a company that buys a truck for $100,000 and plans to use it for 10 years will only record $10,000 every year on its income statement as the cost of the truck, even if it was paid in full upfront.

   In another classic example, a company that makes $10 million in sales in a given year and pays out 10 percent in bonuses to its salesforce has to record the $100,000 bonus as a cost during the year the sales were made, even if the bonuses are paid out the following year.

   Accountants also get to decide whether a piece of equipment will last 10 years or only 5 for financial purposes, which for the reasons stated above has an important impact on the business's reported *profitability* during that period. Doubters will have to wait 10 years to prove accountants wrong.

   GAAP rules give accountants a lot of discretion in preparing a company's financial statements. They get to decide what goes here or there, and the moment when costs and revenues should be recorded.

3. **Cash is still king:** If 1 and 2 are true then *profits* (i.e. the difference between revenues and costs) are as a result an estimate, but not a measure of the business's bank accounts. In fact, you may find a number of companies that show great numbers in their income statements (meaning that they are *profitable*) but don't have the *cash* to survive another quarter.

Therefore, success in managing a company is due in part to the ability to convert *profits* from the Income Statement into *cash* in the balance sheet (see the Appendix if you need a quick review of financial statements).

For that reason, executives must pay close attention to cash, understanding how it is created and how it is used, and they must also develop cash-based performance metrics that provide a more realistic view of the true financial performance of their organization.

Net Profit (also known as *Net Income* or *Net Earnings*) was for many years Wall Street's favorite metric, making the phrase "what's the bottom line?" popular among investors and executives. But using profits alone to guide strategy may produce a distorted view of the business.

After a number of cases of accounting fraud and trickery, market analysts and investors are shifting their preferences towards cash-based metrics, and for that reason we recommend that executives familiarize themselves with these metrics and incorporate them into their management toolkit.

Accounting rules make every profit metric no more than a good guess, except cash. Cash is cash, and money in the bank is really hard to fake.

4. **Not owning assets might seem like a good strategy (at least on paper):** Accounting rules and financial ratios can slowly push companies into spirals of long-term value-destruction, by suggesting that owning assets is a burden.

   Many of the favorite financial ratios used by analysts to measure a company's performance such as *Return on Net Assets* (RONA), *Return on Assets* (ROA) and *Return on Invested Capital* (ROIC) are calculated as a ratio of some measure of *Net Profit* divided by a metric of capital investment or net assets.

   As with any ratio, there are only two ways you can make them go up: either increase the numerator or decrease the denominator. But because increasing the numerator (Net Earnings) is difficult, some companies have "discovered" that owning fewer assets (hence reducing the denominator) is an equally good way to improve their financial performance in the eyes of the market.

   Other familiar metrics, like *Internal Rate of Return* (IRR) and the *Payback* period, put a premium on investments that return money to investors faster, which makes some executives prioritize profit optimization activities and linear product improvements over investments to create new products and markets, which almost by definition will take longer to unfold and create value for shareholders.

These metrics create an illusion that going *asset light* is a good thing. And it actually is, but only through the eyes of pure financial metrics, and if you let those metrics lead your strategy, you may be leaving your company without the tools to grow and face market changes later on. Outsourcing strategic processes and activities for the sake of "looking" more profitable can lead to serious consequences down the road.

5. **Intangible assets can work as an insurance policy during rough times:** Non-tangible assets such as strong brands, strategic relationships with key customers and good management can serve as a kind of immunization to help navigate tough times.

   For example, during the financial crisis of 2008 American Express (NYSE: AXP), the world's largest card issuer, faced a crisis of its own as payment defaults climbed through the roof and consumer spending plummeted.

   Ken Chenault, the CEO in charge at the time, launched an aggressive recovery plan to lead the company through the bump which included an aggressive cost-cutting and restructuring effort that shredded 10 percent of the workforce, temporarily reduced senior management salaries and dramatically cut the budget for marketing and professional services.

   Amid this crisis, Chenault needed money to keep the company afloat, so to raise new sources of funding he launched a new deposit-gathering business and in just a few months raised over $8 billion.

   This type of crisis would have crushed any other organization, but AMEX's trusted name and strong relationships with vendors and customers helped the company survive this harsh period, but you wouldn't find any of these elements in a company's balance sheet even though they are worth a lot.

   Companies with strong brands, dominant market positions and seasoned executives are more trusted by customers, vendors and investors, which serves as a kind of insurance policy to protect profitability when things get rough. These companies can get away with price increases and raise money in ways their rivals can't, and this is one of the reasons why Warren Buffett has invested in companies like Coca-Cola and See's Candies, where those elements are well in place.

Together, these ideas should serve as a word of caution to remind you that not everything that financial indicators say is entirely true, and that as we saw earlier in this section, profits are just an estimate, cash is king, assets are strategic and non-assets can be good business.

Choosing the right strategy metrics

How would you measure the performance of your strategy over a period of time? In answering this question each company and its executives will have their own preferences based on their particular circumstances and competitive reality, and they should, but I'll take a shot at what *I* believe should be the fundamentals to picking the right metric.

Although *Net Earnings* and *Earnings per Share* (EPS) are good metrics to measure the *profitability* of a company or a business unit, from the concepts we just reviewed in the last section I'd say that a *cash* metric would make the most sense to guide strategic efforts since in the end it is cash, not profits, which will ultimately create value for shareholders.

With that in mind then, *Free Cash Flow* (also known as FCF) is probably a good place to start, as it measures the amount of cash that a company creates after making the required investments to keep the business running.

A company with a healthy, growing FCF can finance its operations and growth plans and is well positioned to see its share price increase over time if it is publicly traded.

Some authors, including strategy legend Michael Porter, have argued that the only metric that can measure strategy in its true dimension is *Return on Invested Capital* (ROIC) which we cover in the Appendix. According to Porter, "*ROIC is the only measure that matches the multidimensional nature of competition: creating value for customers, dealing with rivals, and using resources productively*".

While I agree with the statement, the fact that both components of the ROIC formula (Operating Earnings and Total Capital) are subject to accounting preferences as we saw earlier, means they could be manipulated to *look* good.

Margins and profits are not tangible things. Cash is. The volume of cash a company creates is not an estimate and is not subject to anyone's judgment, it is reality and there's no way to look at it any differently. There's no "realer" reality check than looking at the real thing, and in that regard, cash provides a more realistic, no-BS view of how the business is doing.

With that being said, the absolute *volume* of cash a company creates is the first thing to check on, and FCF gives us a good indication of how big of a "cash-machine" the company is. If FCF is growing we know the business is growing, and if this is combined with a high ROIC then we know that the business is growing *profitably*.

A second parameter to look out for is the number of outstanding shares, as this can also influence the value that is created for each shareholder. In short, the more shares there are, the more "diluted" the company value will be.

When Apple announced a massive $100 billion stock buyback program in 2018, Warren Buffett told CNBC "*We own about 5 percent. But I know I don't have to do a thing and probably in a couple of years we'll own 6 percent without laying out another dollar. Well, I love the idea of having 5 percent go to 6 percent*".

Strategic buybacks reduce the number of outstanding shares, increasing the value "per share" for the remaining shareholders. That is one of the secret formulas of Thorndike's outsider CEOs to increase shareholder value: they prevented the dilution of the stock by avoiding new issues (unless strategic) and by systematically pursuing perfectly-timed buybacks.

Just as with FCF, there are no two ways about it: the more shares there are, the less value each share carries, which means that in the search for our "true", no-BS metrics for strategy, the number of outstanding shares is a good second metric to watch closely.

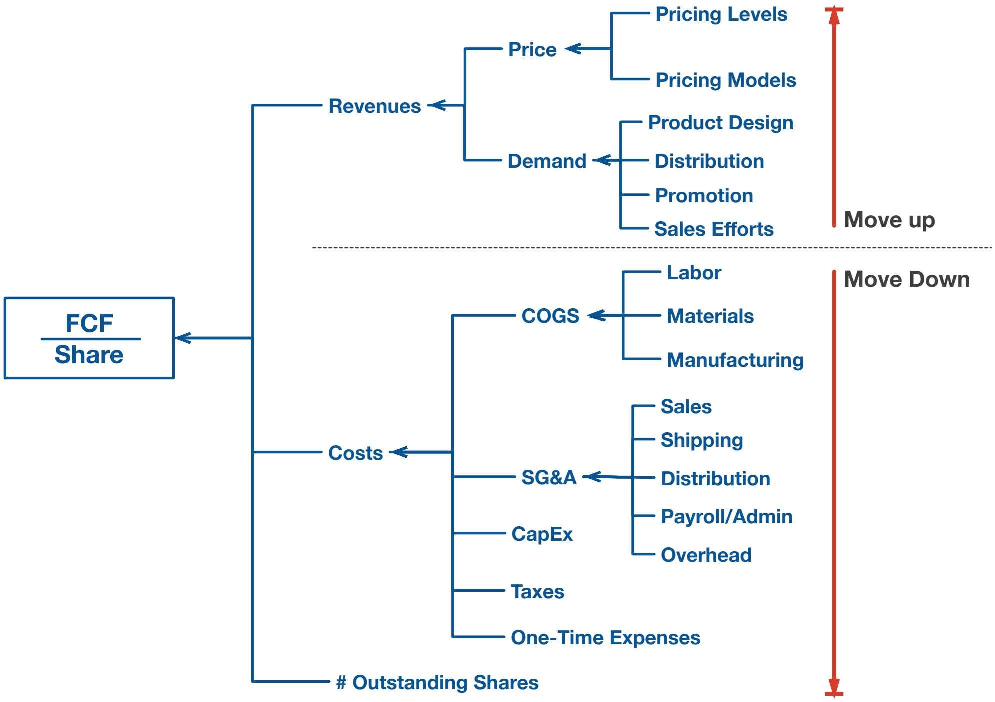
The same holds true for privately held companies with multiple investors. If management buys some of the investors out, the value for the rest of the investors will be less diluted.

Combining both metrics in one ratio, we get Free Cash Flow per share:

$$\text{FCF per Share} = \frac{\text{Free Cash Flow}}{\text{\# of Outstanding Shares}}$$

That metric, when looked at over a period of time, should serve well as an indication of the true value that a company creates for its shareholders, and can tell a lot about a company's ability to support its operations, pay its debts and finance its growth, and the optimization of the business in general. For that reason, it is probably a better metric to measure strategy performance over time.

By understanding how this metric works and how its underlying drivers make it go up or down, you can identify the levers that you need to act upon to push your company's financial performance in the right direction.



Strategic levers to influence FCF per share (for indicative purposes only). Acting upon these levers can help you improve growth and valuation over time

Of course, FCF per share doesn't tell the whole story and it must be complemented with other metrics so that *together* they provide you with a more rounded picture of the business's performance over time. For instance, you might combine FCF with some of the metrics we explain in the Appendix to better understand the margins, liquidity, debt coverage, working capital and returns of each business unit.

But here's a word of caution about cash-based metrics and management: while it is good to develop familiarity with these metrics and even complement them with your own based on your particular industry and experience, they might lead you to behave in ways which might seem contrarian with respect to what other companies, including competitors, are doing.

That means that these metrics may tell you to zig when others zag, which is not a bad thing, but it's human nature to feel uncomfortable when acting against the herd.

The trust that you put in your metrics and fundamentals should provide you with the strength you need to hold tight in position when making decisions, and to resist the winds of critics as they try to blow you out. That's the only way you can make a real difference.

My advice is that the intelligence upon which you make strategy decisions must be *owned* by your organization and not borrowed from anyone else, not even from the most expensive consultants.

Just remember that Warren Buffett became the most successful investor of all times by relying on his own logic. The man himself put it best when he said, "*investment success is about being fearful when others are greedy, and greedy when they are fearful*".

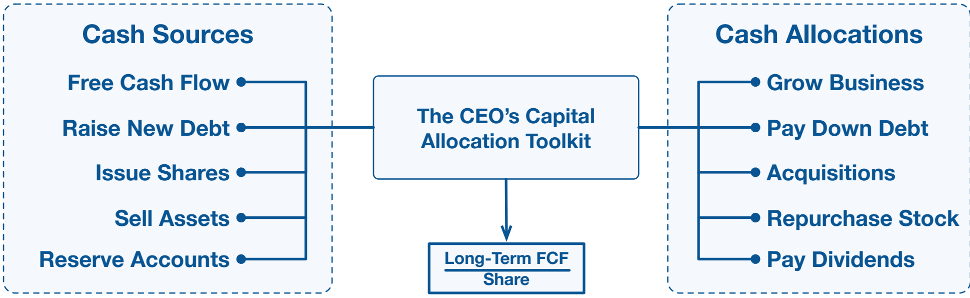
The capital allocator toolkit

In trying to optimize a company's financial resources there aren't many things that a CEO can really do. To raise capital, for example, CEOs only have five options: they can use the company's cash flow, raise new debt, issue new shares, sell assets or tap into any kind of cash reserve accounts the company has such as pension funds.

Similarly, there are only five things they can do with that money: they can reinvest it in the business, pay down debt, buy other companies, repurchase stock or pay dividends.

The long-term value that a company creates for shareholders is greatly influenced by how its CEO manages these ten levers. To put that in perspective, two companies with the same *operating profit* (EBIT) will get totally different results in terms of their long term FCF per share, based on how the CEO manages these options.

The challenge for the CEO then is how to use this 10-lever toolkit to maximize shareholder value over the long run.



The CEO's Capital Allocation Toolkit. The long-term value that a company creates for shareholders depends a lot on how its CEO manages these ten levers

Pragmatically, the true magic of capital allocation is in creating positive *tradeoffs*, that is, using money for business activities that yield a higher return than what that money cost.

That may sound like a too-basic rationale, but it is what capital allocation is all about: taking low-cost money and re-investing it in areas of higher return. That's the only way to create wealth, and the capital allocation in a company is no different.

If a company raises debt at a 4 percent interest rate and invests that money in a business unit that produces a 13 percent return on that investment, it will be creating shareholder value.

A good example of this mentality is how Warren Buffett has famously used insurance *floats* (the money that insurance companies collect from customers, which usually sits in the insurers' bank accounts waiting to be paid out on claims), to invest in other companies. He takes very cheap money and uses it to pursue investments that yield high returns.

That type of opportunistic thinking is a key component of every good capital allocation decision. If you have reason to believe that your stock is undervalued, go ahead and buy it aggressively using the cheapest money you can find. If instead your stock is trading above its true value, then issue new shares to finance strategic acquisitions, then buy those shares back when they hit a low point again.

Good capital allocators are always on the lookout for opportunistic tradeoffs to make, and when they find them they move fast. For example, Henry Singleton, at that time

CEO of Teledyne Technologies, used the company's pension funds to buy back bonds the company had previously issued, when those started trading abnormally low, paying off its debt ahead of time.

In each case the logic is the same: finding opportunities to allocate lower cost money from one source into a higher return opportunity.

But that "king of management" approach needs an opportunistic mindset, fluid decision making and decisiveness to act fast when opportunities show up, traits that don't come naturally to many executives who prefer a more systematic and predictable approach to managing the company's financial resources.

A good example to explain this contrast is by observing how companies approach stock buybacks (purchasing their own stock). In most companies, buybacks are planned over long periods of time, usually several years, and are implemented by allocating a certain amount of money that will be spent *uniformly* on stock every year.

I understand how this approach is more predictable and comfortable for management to implement, but I don't see how you can plan to buy something when you don't know how much it is going to cost, or even the returns you will make from buying it.

"*Can you imagine somebody going out and saying, we're going to buy a business and we don't care what the price is?*" is how Warren Buffett criticizes this approach, and that's *exactly* what a company does when it plans a buyback program over several years.

Opportunistic executives, on the other hand, *only* buy their stock when it is trading at prices that are truly below its real value, and when that happens they buy it aggressively.

We can find a similar contrast when it comes to acquisitions where companies go out on shopping sprees just because they have the cash to spend. Good capital allocators, on the other hand, only buy when the time and the conditions are right, and sometimes wait for years until they get the right deal.

I know you may be thinking "Well, not everyone has all the time in the world to wait," and that's true. However, overpaying for an acquisition is one thing, but making a *bad investment* quite another. You may have to overpay for a business that you like, but you should at least get your money back from the synergies you create. That's why the more you overpay, the more strategic that target should be.

Probably the best example of the opportunistic mentality in full display is how Henry Singleton, arguably the most successful among Thorndike's CEOs, approached acquisitions and buybacks. During his first 10 years as CEO, the stocks of conglomerates were trading historically high and Singleton relentlessly used the stock to finance *over 100 acquisitions* by actively issuing new shares.

In the early seventies, as he approached the end of his first decade in office, the conglomerate sector crashed and stocks were trading at historically *low* points. Henry Singleton never bought another company. Instead, he fired his M&A team and shifted his focus to share buybacks, acquiring *90 percent* of the company's outstanding shares over the next decade.

That opportunistic mindset is what drove Teledyne's superior performance during Singleton's almost 30 years in charge.

Sometimes you may realize that your best investment opportunities are showing up *inside* your company and not outside, as in the case of opportunistic buybacks or paying off debt early as we saw earlier, and that should be fine as long as you are making the best use of the company's resources.

In fact, one of the most impactful moves that good capital allocators can make is to *re-allocate* resources from poor-performing areas into high-growth businesses. When you *simultaneously* cut costs and resources in low growing areas inside your company and direct those resources to the units that are growing the fastest, the effect on your bottom line is multiplied.

Take a look at the following statement issued by Amazon with regards to a massive layoff in early 2018: "*As part of our annual planning process, we are making headcount adjustments across the company, small reductions in a couple of places and aggressive hiring in many others. For affected employees, we work to find roles in the areas where we are hiring.*"

That's resource re-allocation at its best. A continual adjustment of the company's value chain to double down on the things that create the most value and eliminate poor performing activities.

This has a multiplying effect on profitability, because at the same time that the business is divesting from low-performing areas, which alone should increase profitability, it is also *re-investing* those same resources in activities with a higher return within the same balance sheet.

I hope you can see the hidden opportunity here, to 1) go out and find areas of high growth and 2) reallocate underperforming resources to go bullish on them. But don't take my word for it, just read Jeff Bezos' comment when Alexa, Amazon's cutting-edge voice assistant product, helped his company achieve its first $2 billion quarter:

"*We don't see positive surprises of this magnitude very often, expect us to double down*".

Centralized cash management

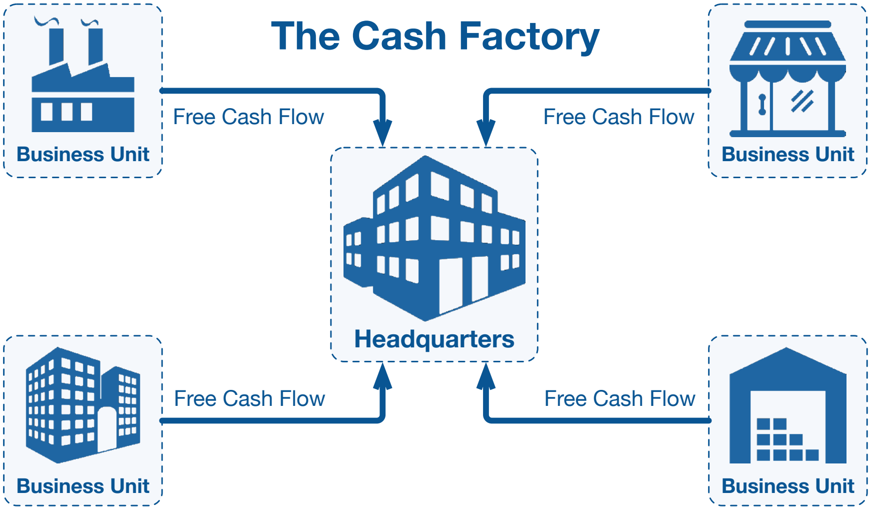
If you run a company with multiple business units, product divisions or maybe a few international operations, you necessarily have to give each one the freedom to make strategic decisions. At the end of the day, a business strategy is no more than the answer to the threats it faces, and each market will need a different game plan to win.

For that reason, you must give the executives in those units the leeway they need to do their jobs. But there's one exception to that rule: capital allocation decisions must be centralized.

While those units may operate as standalone businesses with their own full-time personnel and balance sheets, the decisions about how the money they make is spent must be done at a higher level, usually at the corporation's headquarters.

Companies with a more serious approach to capital allocation enforce a centralized management of the cash produced by each individual unit, even if those operate as individual businesses. In plain English, the cash those businesses produce must be sent to the headquarters where it will be reallocated in the way that executives at that level understand will create the most value for shareholders.

We can envision this approach to capital allocation as a "cash factory" where the company's individual divisions are seen purely as cash machines whose only job is to produce cash and send it over to the headquarters, and the corporation at the top level decides how that money will be distributed across all operations or invested towards new areas.



The cash factory. Each business must be allowed to make strategic decisions that respond to the reality of its particular market, but capital allocation decisions must be made at the corporate level

Here's why this centralized approach works: part of the success of a CEO is understanding the *timing* of the company's businesses. When a market is growing and you have a *star* business in it with good potential, you must invest aggressively to capture a sizable piece of that action. As markets mature and profits shrink, the CEO must emphasize cost optimizations, keep an innovation pipeline and reinvest carefully in that business as it becomes a *cash cow*. But when they see clear signs of market decline they must recognize the right time to let go, and squeeze those businesses as much (and for as long) as feasible.

By sitting at the center of the cash factory, CEOs can make decisions to properly balance resource allocation across business units in the way that creates the most value for shareholders. They can move the money produced by cash cows into star businesses, or into other growth areas to finance longer-term plays.

Amazon, for example, subsidizes its aggressive retail division which loses money in heart-stopping proportions with money from successful cash-making businesses like web services (AWS) and Prime.

And here's a final thought about this cash centralization: when you envision a corporation as a network of cash-generating machines sending their cash flows to the headquarters, you appreciate how the financial performance of the company as a whole can be measured as the *weighted average* of the individual performance of each unit.

That means that poor performing units will affect the performance of the corporation as a whole, just as one defective production line affects the performance of a large manufacturing operation.

That's why you must always deal energetically with areas or business units that don't perform as expected. A division or business that underperforms its market peers must be fixed, sold or closed, there's no other way about it. An employee who's not getting the job done must be dealt with in a similar way or just let go.

No company can afford to pay right for something that's wrong, that would not be fair to the company nor its shareholders, as it could drag the performance of the whole factory down.

The same happens with dying businesses. If any of your businesses are showing poor results because their industry is in decline, there's not much you can do about it. You may try to fix them and keep them running, but in the end there is irreversible damage. You know in your heart that the party will end at some point.

You must embrace the decline for what it is and extract as much value as you can from those businesses, using the cash they produce to grow other promising businesses, buy other companies or enter new markets. That's the beauty of capital allocation: understanding that good opportunities come and go and that your job is to ride them for as long as they are profitable and get off while you can still make a profitable exit.

To quote Warren Buffett one more time: "*Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely more productive than energy devoted to patching leaks.*"

Evaluating investment opportunities

In the Appendix we provide a description of the most common metrics that are used to evaluate a new investment opportunity from a purely financial standpoint, including the usual suspects that you may have heard of like *Net Present Value*, *Internal Rate of Return* and *Payback* period.

However, in this section I'd like to provide a more general framework to evaluate new investment opportunities, which could be anything from the development of new, innovative products to the construction of new facilities, entry into an international market or the acquisition of another company.

When faced with such opportunities, more than just a dry financial evaluation to *measure* its potential returns, what your teams need to produce is a *plan* to make it work, or as I call it a *feasibility strategy*: a proactive effort that rather than measuring feasibility, "creates" it.

A feasibility strategy is a combination of seven different *tactical* plans that you must put in place to optimize the project from different angles, improving the chances that it will turn into an attractive *investment opportunity*. These plans are:

1. **Marketing and positioning:** This plan defines the positioning strategy, including the definition of target markets and value propositions that will make it a successful project. It is based on a comprehensive analysis of the market, the industry and the environmental forces that could affect profitability as we saw in Chapter 2. This plan also describes in some detail the company's approach to the market in terms of product, price, sales, distribution and promotion of the final products and services.

2. **Technical:** This plan provides an optimized arrangement of the value chain to ensure the success of the project, including the selection of optimal technologies, vendors, product architecture, supply chain, configurations, standards, maintenance and all other technical matters that are relevant for the project. For opportunities that require the construction of new facilities you also discuss and optimize here the size (capacity) of the installations, locations, machinery type, maintenance, process efficiencies, operations management and how future expansions will be made among other subjects.

3. **Organizational:** This plan identifies the best organizational structure for the project and defines, at least in general terms, critical job positions that will make the project a winner including support and administrative staff, management and critical skills needed for each job.

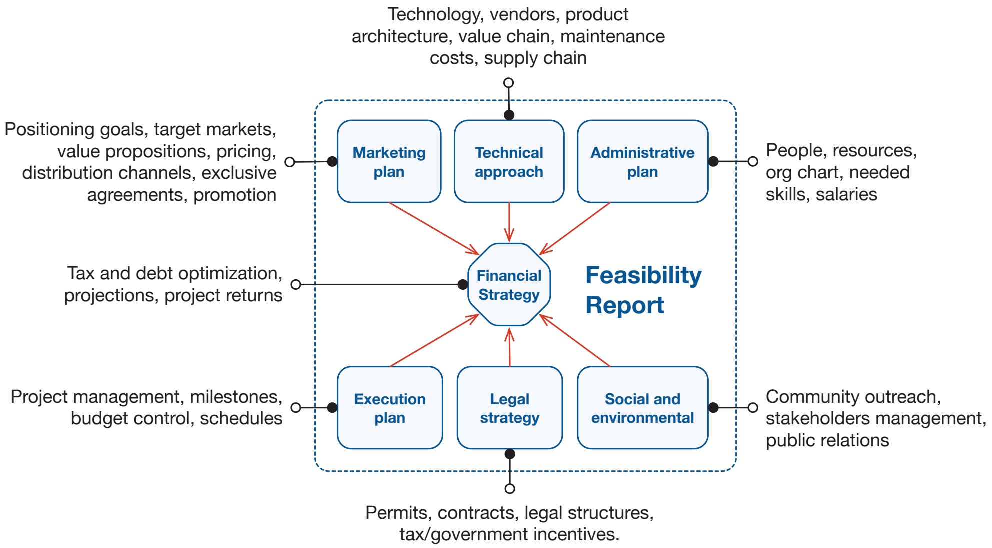
4. **Legal:** This plan proposes the best legal structure for the project entity and identifies permit requirements, tax treatments and any government incentives that apply to the specific type of project. When needed, this plan also provides some idea of potential legal hurdles that the project might have to face.

5. **Social and environmental:** This plan is especially important in projects that require the construction of physical infrastructure, as it identifies the communities that will have direct or indirect interaction with the project during construction and operations, pointing to the key stakeholders within each one. It also provides a measure of job creation and potential outreach programs, budgeting them accordingly. When applicable, this plan must also include mitigation actions in case unexpected situations arise during construction or operations that could put the project in jeopardy.

6. **Implementation:** Every good strategy always includes a serious discussion of how the team will guarantee its *execution*. This part of the plan defines the metrics that will be used to measure progress, including milestones and a schedule of how it will be developed and implemented.

7. **Financial:** This section provides the project's financial projections, which have been optimized to minimize the impact of taxes and other negative effects, optimizes debt service, and takes advantage of any tax incentives and benefits.

The financial plan feeds off the budget and projections of each of the other plans and calculates the financial metrics of the project.



The seven parts of a feasibility strategy

8

Making these plans may seem like a lot of work, but capital-intensive investments need to be well evaluated before they are put up for approval. The trick here is not doing all the heavy lifting at the beginning, but only as the project progresses through approval stages.

The final project report may include each of these plans as "chapters" of a single document, making it a great support to document any investment approval.

Investing in external companies

In Chapter 6 we introduced *Corporate Venture Capital* or CVC as an internal effort to invest corporate funds as equity in external entrepreneurial companies. The objectives behind a CVC program are diverse, but they usually fall within one of two categories: they can be strategic in nature, or just based on a financial interest.

CVCs are considered to be strategic if what you are seeking is to better understand the innovation landscape in your operating markets, get early access to ideas that could create synergies with your in-house capabilities, or improve your competitive positioning in the long run.

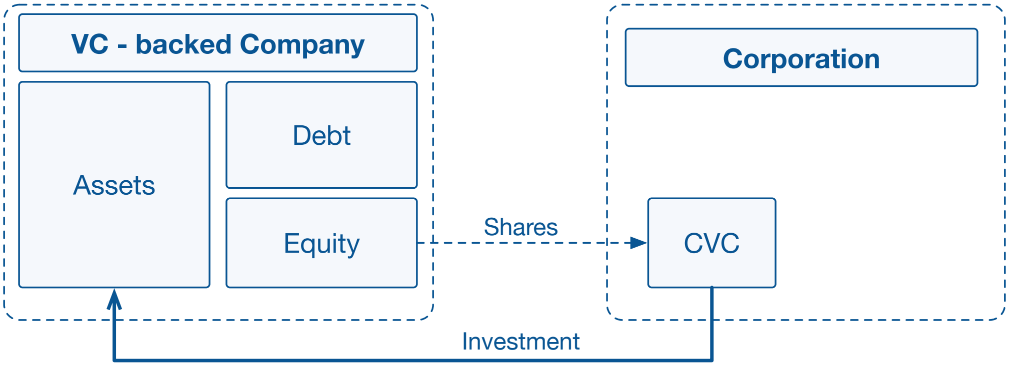
Since the beginning of the twentieth century corporations have invested in startups as a way to improve their own businesses, but it wasn't until the mid-1960s that the investment modality became popular.

Market research firm CB Insights reported that during 2017 alone Corporate Venture Capital groups provided over $30 billion of funding across 1,791 deals globally, a 19 percent increase with respect to the previous year.

Well known corporations that have an in-house CVC arm include Dell Technologies, Intel, Salesforce, Citigroup, Cisco, Comcast and GE, all of which have been very active over the last few years.

CVC investors usually provide *seed* (less common) and *early growth* (more common) funding, preferring companies with a proven product on the verge of an expansive phase.

The way in which most CVC deals work is through a direct acquisition of *new* shares of the target company. These shares are usually issued in big chunks or *investment rounds* by the startup that's seeking capital, and the corporation provides funds to the company in exchange for a portion of the shares, making the corporation a shareholder of the target.



Each CVC team has its own process, but a typical deal funnel starts with an initial interaction of some sort and a preliminary discussion, which then moves through different *Due Diligence* (DD) stages where all the assumptions and the startup's information are validated, concluding with a final negotiation of a term sheet that defines the general terms of the transaction.

The non-written law in venture capital circles, known as the *10X* rule, is that as an investor you get to see a hundred companies, invest in 10, but only one makes it big.

Typical terms that are negotiated in a term sheet include the type of shares that are being transacted, the number of shares to be issued and their unit price (the "size" of the round), as well as governance matters, pre-money valuation and the proceeds *waterfall* that will be in place in case of a liquidation.

In many cases, as an investor you may negotiate a purchase option with the target company that allows you to increase your equity position in the target if a series of pre-defined conditions occur. That gives you a viable path to acquire a controlling stake in the target if at some point you see it as a viable move. That's how Google Ventures' early investment in smart thermostat company Nest became a full acquisition for Google.

If you later decide that the target company no longer represents a valuable asset, you can exit the company by selling your shares to other shareholders, or on the market if the company has already gone public.

One of the most sensitive matters when dealing with a potential CVC investment is the price tag that you put on the target company, or its *Valuation* as it is usually referred to, since in the end that number determines how much you end up paying for a given proportion of the company's shares.

This valuation intimately depends on the views and assumptions that each investor has about the future of the company (for example, how much the business will bring in free cash flow every year) and it is subject to the appreciation and experiences of each evaluation team.

Seasoned investors will usually combine multiple valuation methodologies to determine a fair valuation, but in general, there seems to be a widespread preference around the use of "multiples" to compare the entrepreneurial company (which is still held privately) to a group of similar publicly traded companies. We briefly describe the use of multiples in the Appendix.

9

Execution: Where the Rubber Meets the Road

In this chapter we will:

- Highlight the importance of execution for a company's success
- Introduce the Execution System
- Explain a few ways to ensure your strategy is ready for execution
- Learn how to set strategic priorities
- Seize any execution gaps that may exist
- Create lead levers to ensure execution
- Discuss how to design and to align the organization for execution
- Explain the importance of following through and providing feedback

After years of rumor and speculation, GoPro (NASDAQ: GPRO), the American manufacturer of the popular action cameras, announced the company's plans to launch its very first drone, the Karma, at a target price point of $800. The black and white quadcopter would be able to capture aerial footage using a mounted high-definition GoPro camera sold separately.

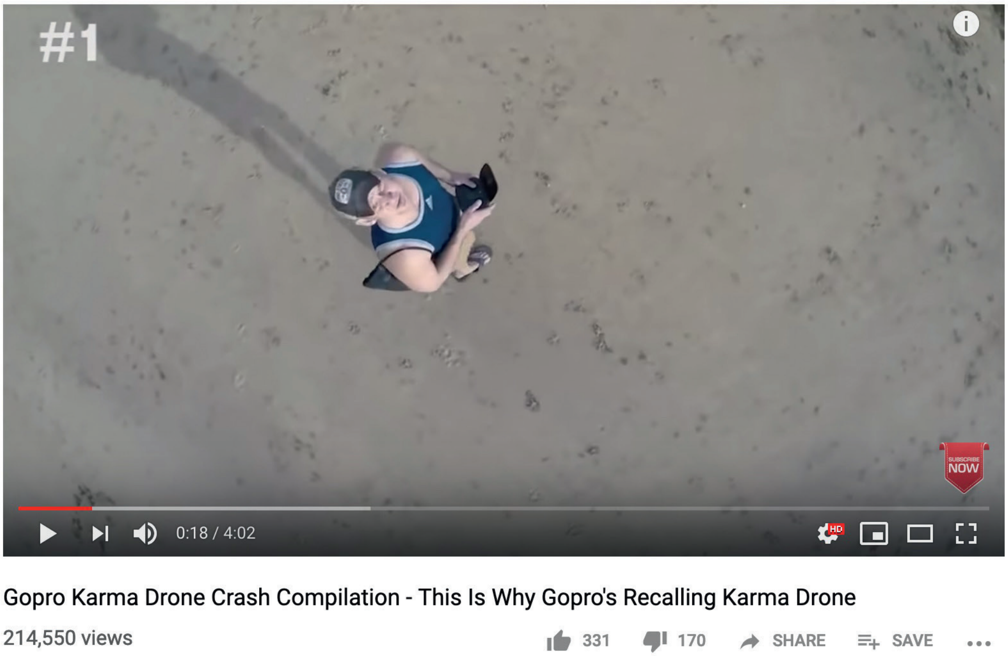
The company, which went public in 2014, experienced a lot of growth in its early years due in part to the popularity of viral videos shot with their products which were continually posted on social media. But in the two years leading to the announcement, the company had struggled with sales, growth and inability to deliver new, innovative products. They desperately needed the next big thing and Karma was the answer.

Bundling their high-definition cameras with high-tech drones, another product segment that was hot at the time, would be a powerful expansion of their core platform, and would bring GoPro a step closer to its goal of becoming a *media* company.

But shortly after Karma's launch their dreams starting to fall fast and hit the ground – literally. Within just a few days of its launch, angry users started posting videos on the internet of Karma drones crashing for no apparent reason. As enthusiasts began flying their new devices, they seemed to hit a hard stop after gaining height, as if the power source was suddenly unplugged, leaving the unmanned vehicle on its own up in the air until the owner witnessed a painful free fall as the drone crashed to the ground.

Unfortunately for GoPro, everything was recorded in high-definition video. All of a sudden, the sky was falling for the camera maker's new product.

Within a week, more and more crash videos were posted everywhere under the hashtag *#KarmaCrash* and "Karma Crash Compilation" videos went viral on YouTube. As more videos popped up, the company had no other choice but to issue a recall of the drones.



We may never know everything that went wrong in making this product a failure, but poor execution seems to have been one of them.

Rumors about the company's entry into the drone market began to air in 2014 as the company initiated discussions with the Chinese company and soon-to-be competitor DJI for a private label deal, where DJI would manufacture the drones to be sold under GoPro's brand. The deal fell through after GoPro, at the time the fastest-growing tech company, kept pushing to get two thirds of the profits from the joint product.

DJI's reluctance to the deal was obvious, since as they would be the ones making the drones they would expect to get a bigger share of the profits. In the end, why would GoPro make all the money if all they were bringing to the table was a name?

After negotiations with DJI failed, GoPro turned to 3D Robotics (3DR), a popular US drone manufacturer co-founded by former WIRED Magazine editor-in-chief Chris Anderson, to pursue a similar deal. This also turned out to be a tense relationship since even after the deal was signed GoPro kept hinting at its plans for developing its own drone and becoming a serious competitor for 3DR. Of course, it didn't help that GoPro's CEO Nick Woodman hired a 3DR project manager to lead its internal drone development program.

The GoPro-3DR joint effort produced the *Solo* drone launched in 2015, starting the timer for GoPro's in-house drone development effort.

GoPro rushed to develop and ship its own drone on time for the 2016 holidays, with a performance that raises some flags about their execution DNA. In short, the company seems to have overspent on research and development, set unrealistic deadlines that had to be pushed back and *readjusted* several times, hired people who lacked the right experience to lead the efforts, and didn't care too much about optimizing the design of the final product since they needed to hit the shelves in time for holiday shopping season.

The results speak for themselves. The Karma launch ended up with a recall of more than 2,500 units, leaving behind a PR mess for GoPro and putting its management in a very weak position with investors.

Let's try to break down what could have gone wrong.

The development of autonomous vehicles is a highly technical endeavor, and not many companies have the ability to deliver the products and features that hardcore enthusiasts demand. For instance, the operating system of these vehicles, called the Flight Controller, relies in most part on open-source software of extremely basic capabilities.

Companies like DJI and 3DR develop their proprietary operating systems by building additional *layers* of features and functionality on top of that basic core. They invest years, and a lot of money, in the development of these features which get better over time through a lot of trial an error.

This long experience enables these veteran companies to release almost-perfect products out of the box, but in reality it took them years of hard work and fine tuning to get to that point, so it is not clear to outsiders how GoPro planned to enter and take over the market without this learning curve.

GoPro underestimated the complexity of the drone technology and tried to execute a strategy that it didn't have the tools for. It set its sights on the final goal, and then went on to mobilize the company's resources *hoping* it would get there, but without making sure first that it had what was needed to get the execution right.

In this chapter we will see how companies that have demonstrated good execution records relentlessly insist on the *realism* of their plans. They continually measure their execution *gap* and ensure that the right people, resources and tools are always in place to achieve their goals. In fact, measuring the ability to execute *before* you set your goals is an important part of setting the goals themselves. By no means should this prevent companies from setting aggressive goals, but this is a reality check that needs to be made to ensure that management can execute the company's mission.

If you don't assess your execution gap first and adjust your plans accordingly you may end up setting unrealistic goals, sending your troops directly into the hands of failure.

Increasing revenues 20 percent might be an enticing goal for any company, but in understanding what that bump would entail is where the rubber really meets the road. For a large retailer, such a sales increase could mean fifty additional stores, and that would imply finding enough feasible locations, getting permits, finding suitable labor and adjusting for logistics costs. If that goal means two new product lines by the end of the year, then management better have those products functional and ready for showtime.

For a B2B company, a significant revenue increase could mean hiring a hundred more salespeople and flexing out its return policy. But more people means more recruiting efforts, salaries, bonus packages and incentives and other processes that will need to be in place to ensure it is hiring the right people. More flexible return policies, on the other hand, might require re-negotiation with suppliers, optimization of inventory, changes in working capital and so on.

For a drug company, such a goal could entail a painful entry into previously avoided market segments, or the associated costs of lobbying, management of stakeholders, public relations and finding labor among others.

Increasing revenues 20 percent, therefore, cannot be part of your strategy until you can ensure that you can achieve it. Even the best strategy can be no more than a wish list if the company can't ensure its execution.

But let's make something clear here: execution is *not* a strategy. Execution is the ability to make the strategy happen, and as such, it is an intimate part of it, but not the strategy itself. While the strategy planning process defines *what* the company wants to achieve, execution takes care of defining *how* it is going to do it.

These distinctions are important so you better get them right. GoPro's approach was a case of bad execution, but they did have a good strategy: looking into drones as an expansion of their core business and to get one step closer to becoming a media company.

The opposite can also be true: we can find companies with a great execution of the wrong strategy. Take the now extinct international books and music retailer Borders Group, which at one point operated more than 500 stores worldwide where they offered a wide catalog of books and music to customers who enjoyed visiting their stores and spent hours there (I was one of them).

In response to the emergence of digital forms of books and music, and the success of Amazon's online efforts and Apple's iTunes, the company doubled down on its efforts to expand into physical books, CDs and DVDs as the world was going digital.

Borders *intentionally* didn't embrace the internet wave and instead bet its money on the real-life experience, expanding its physical footprint, refurbishing stores and outsourcing its online sales to Amazon.[47]

The strategy was perfectly executed, but its fundamentals turned out to be wrong. By the time Borders realized that the internet was the right wave and they had missed it, it was too late. The company was so loaded with debt from its physical expansions that even if it wanted to make a move and embrace digital (like Barnes & Noble did) it couldn't afford to. All it could do by then was watch things come to an end, and hope it happened fast.

If your strategy is right, you had better get the execution right as well, or you may not make it out alive. But if your strategy is wrong and based on an "unrealistic reality", it will take you nowhere, as happened with Borders.

Now, is it possible to get both the strategy and the execution right, but still fail? Well, let's look at a case that suggests so.

When Apple launched its HomePod smart speaker, in response to the success of Amazon Echo and Google Home, it made a lot of sense strategically. In the end, these devices are hardware extensions to the companies' digital assistants (Apple's Siri, Amazon's Alexa and Google's Google Assistant) which give them access to a bigger share of their users' lives, and wallets.

By all accounts the HomePod is a handsome piece of hardware, with great sound that spills out from seven internal tweeters and a high-excursion woofer that picks up the lower frequencies, all powered by Apple's own powerful A8 chip. It is also a slick way to anchor users deeper into Apple's ecosystem of hardware and software.

There's no doubt that the HomePod has great strategic value for Apple, and as a piece of hardware it was perfectly executed by Apple's design and development teams. But the device was not the big success that the company expected. The problem: it was created around a poor performing platform, Siri.

At launch, the Siri-powered HomePod couldn't do even the most basic functions that similar solutions did with ease such as looking up recipes, making phone calls or playing something on TV.

Once a pioneer in the space, Apple's voice assistant has grown old quickly and has been left in the dust by Alexa and Google Assistant, which were developed on more advanced speech recognition platforms. In the HomePod, those deficiencies are brought front and center since the device relies entirely on the voice assistant for pretty much everything.

One of the benefits of being a late mover into a space is that you get to learn from others' mistakes, which gives you the opportunity to fix problems before your product is launched. But Apple obviously didn't take advantage of that with the HomePod and launched a product that performed poorly by the industry current standards, leading to bad reviews and dissatisfaction from customers who paid twice as much for a device that does half of what others do.

But one of the problems with being an early entrant to a space, like Apple was with Siri, is that you may end up making a bet on the wrong platform. With Siri, the problem seems to be that its core technology doesn't work well with some of the more recent developments in the fields of Natural Language Processing (NLP) and Artificial Intelligence, and its development teams had to continually find ways to *force* new features into its core and patch things up to make Siri functional.

When you face a structural misalignment, even if your strategy and execution are right, you will "systematically" fail at both. Because you can't keep up with the pace of others that have been built *differently*. You are pretty much handicapped in the race.

When you are faced with those problems, what you need to do is to make the hard decisions (for example, not to launch the HomePod) and cut the problem off at the root (for example, remake Siri from scratch). Case in hand, a similar problem happened to Apple with its Maps application and it decided to redo the whole thing from scratch.

Good execution is in the end the ability to *systematically* implement your strategy effectively, but if you have core problems you will systematically get it wrong.

The worst case, however, is not having a strategy at all, because if you don't know where you're going, you'll probably end up somewhere else.[48]

In the late 1960s, Paramount Studios obtained the Star Trek franchise through the acquisition of Lucille Ball's production company Desilu, and was desperately trying to make some money from it. Following NBC's cancellation of the show after only three seasons, Paramount licensed its syndication rights (the rights to broadcast the show through other networks) which revamped public interest in the show.

With a new and growing fan base, demand for the show merchandise exploded, putting Paramount in a good position to squeeze the franchise. But since all they wanted was to make a few bucks with it, Paramount decided to license the sales of show-related merchandise to pretty much anyone who wanted to take a shot at it.

That decision flooded the toy stores' shelves with products like the Star Trek Freezicles, where kids could make Mr. Spock-shaped popsicles, and with others that didn't have anything to do with the show, like the Star Trek parachuting characters (Star Trek's characters never parachuted in the show).

What happened was that with the success of the franchise and the low barriers to licensing its products, any toy maker could convert an existing toy line into Star Trek merchandise by just slapping the logo on it, making millions along the way, but Paramount didn't seem to care.

One of the companies that made a fortune through Star Trek merchandise was toy manufacturer Mego Corporation, who bought a license from Paramount for $5,000 and made over $50 million in sales with it. Mego was famous for taking "liberties" in the design of franchise-related products so it could reuse its existing molds from other action figures.

A good example of Mego's "creative" work was the action figure of the Gorn, a green lizard character that appears in one of the initial Star Trek episodes. To make the Gorn action figure, Mego used the head of Marvel's Lizard (a figure it also made), the body of General Ursus of Planet of the Apes, and an outfit of the Klingons, a fictitious species created by the Star Trek franchise.

"*We took some poetic license*," is how Martin Abrams, Mego's president answered angry fans who complained about the merchandise.

Paramount never seemed to have a strategy for Star Trek, and that took it to places it didn't plan to be, leaving fans outraged and enabling smaller companies to profit unevenly off the franchise.

When reflecting on the millions he was able to make from the Star Trek franchise with just a $5,000 investment, Abrams says "*that was a trip*".

The focus on execution

As a leader, you must pay great attention to how your teams are executing your company's strategy. To be successful at this implementation you must create an environment that encourages high performers and provide the tools that people need to excel at their jobs.

To create a *culture of execution*, there are a few traits that leaders must nurture. First, they need to know their business inside out. Great leaders know their numbers to the cent and recognize a good opportunity when they see it. They don't rely on external consultants for strategy advice, because they don't need to. They know what competitors are doing and how the game's being played.

Second, execution-oriented leaders know their people. In fact, knowing people's strengths and weaknesses is one of the most appreciated skills of a great leader. Executives that succeed at execution nurture and promote A-players and put poor performers on the backburner because in the end, when it comes to getting things done, the company is only as good as the people working in it.

As we will see later in this chapter, decentralization is key for good execution, but it is not possible unless the company's different units are in the hands of high performers that the leaders can trust.

Third, execution needs focus. Leaders cannot pursue all things at once. They must clearly distinguish what's important from what's urgent, and always put the long-term wellbeing of the organization and its people first.

At the highest level, leaders' focus must be on just a handful of goals, probably three to five, clearly defined with numbers, people and timing. Those main goals are then broken down into their underlying drivers which become the goals of other teams downstream.

In pursuing these goals, leaders must proactively follow through to ensure that things are always on track, and deal with roadblocks earlier rather than later.

At the end of the day, good execution comes down to a few principles:

1. **Decentralization is critical for strategy**: Because individual business units reside within the realities of their own markets, each must craft its own strategy, steered by a set of fundamental guidelines from the mothership.

2. **Leadership must not be biased by conventional wisdom but must be guided by experience:** Leaders and their respective teams must know their own minds about the realities of their markets so that they can challenge the herd, especially when things get rough and during times of confusion. It is very easy to be biased by herd thinking so having an opinion and "mind-ownership" are traits that leaders must nurture. At the same time, you do want to leverage the experience that you and other leaders have accumulated as it could be a highly valuable asset.

3. **Execution must be based on leading not lagging metrics:** As we will see later in this chapter, execution is more effective when instead of measuring results after the fact, you get in the habit of tracking *the path* to get to the results.

4. **Good execution is flexible:** No one can predict the future, and even the most serious plan to implement a strategy must provide a way to deal with uncertainty and respond to changes and unexpected situations that may occur.

5. **The organization must be aligned to execute its strategy:** Strategy is the result of a team effort, and the company is on a better track to succeed when its people are working with the same goals in mind. For that reason, clear communication and a compensation structure that's aligned with the strategy are both critical to making execution happen.

All these pieces must work together in order to achieve an organization's strategic goals. These ideas will be re-visited and expanded throughout the chapter.

The execution system

Execution is about making strategy happen and doing so entails processes and systems to ensure that goals are being achieved. Without execution, strategy has no meaning and that's why any serious effort to design a company's strategy must take into account its ability to execute it.

A lot of good material has been written about execution which makes it a bit difficult to come up with a single, unified system, but based on my review of the different frameworks out there and my own experience, a good execution approach:

- **Has the right people in the right jobs:** Execution-focused leaders don't cut corners to ensure that the right people are occupying the right jobs. This is one case where *knowing your people* really goes a long way. That means that as a leader you must be reachable and in direct contact with your subordinates to develop an active sense of *awareness*. Asking questions and honestly listening to the answers are powerful techniques that pay off big time when implementing your strategy.

- **Rewards high performance:** People who perform well at doing their jobs must be rewarded better than those who don't. It is that simple. A company may have great, smart talent, but if they don't understand their jobs or are not focused on achieving high performance the company will be wasting time and money, and may never reach its goals.

- **Manages the trajectory, not the end point:** Most organizations set goals during business reviews, then everybody goes back to work and comes back a few months later to see whether they met their goals, but by then is too late to act if something didn't go as planned. High-performance organizations, on the other hand, track the execution of the underlying tasks closely, so that there's no surprise when the results come in, giving executives the chance to act immediately if something goes out of whack.

- **Establishes clear accountability:** Providing clarity on what needs to be done, by whom and by when is very important when it comes to execution. That is perfected by keeping clear accountability during implementation, so that all key people know who's on target and who's falling behind. While many companies operate in silos with clear goals defined *vertically*, *horizontal* alignment is also important and makes coordination across teams more efficient.
- **Provides and encourages feedback:** Providing feedback is essential to keep high performance on things that are going well and correct poor performance on time. In this sense, feedback must be bidirectional, coming from leaders to all people in the organization, and from people on the front lines of execution back to the leadership to report how things are going and provide early notice of changes that could affect results down the road. If feedback is provided in a kindly, non-bullish way, people will be more open to sharing things that are not going well or that could become a problem later. No one can fix a secret, so you must encourage people to speak up and get the help they need when they need it.
- **Provides flexibility and allows agile pivoting:** The *plan-then-do* approach to execution may have worked well in the past, but in a more dynamic environment agility, flexibility and the ability to regroup when faced with unexpected roadblocks can give companies an execution advantage in the different markets where it operates.

Execution is the linchpin that makes strategy happen, and unless it is pursued with intensity and consistency the strategy is a waste of time.

Based on these ideas, we could think of a series of activities, steps if you will, that if implemented *systematically* can help ensure that the strategy is well executed, providing early signals about things that could be getting off track. These activities include:

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1. **Challenging and fine-tuning the strategy:** Streamline the strategy and get it ready for execution by challenging its fundamentals and assumptions, exploring the different ways in which it could be achieved and finally selecting the best way to execute it.
2. **Extracting strategy priorities:** Identify leadership priorities from the strategy and break them down into their main underlying drivers. Those drivers will become the levers that the individual units must act upon to achieve their individual goals.

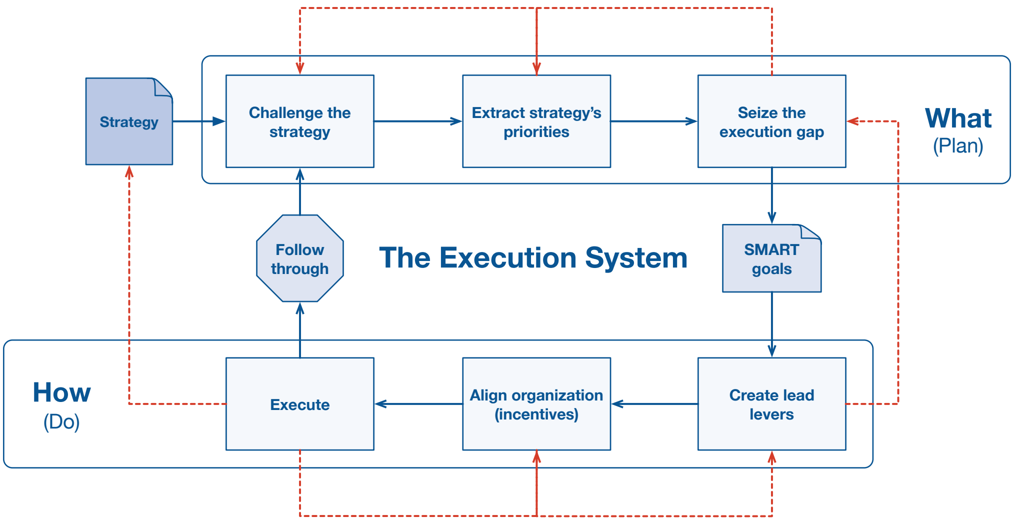
3. **Seizing the execution gap:** Evaluate your ability to execute the strategy and look for gaps or missing links that could create confusion or derail your implementation efforts.

4. **Managing through lead levers:** Identify the *leading* metrics that should be used to track execution and create a system to monitor progress.

5. **Aligning the organization for execution:** Create the right incentives to align individual interests with the strategy of each division or business unit.

6. **Executing and following through:** Set execution in motion, continually monitor the implementation of the strategy, and quickly react to changing environments. Keep your ear to the ground for emerging opportunities.

Over the next sections we discuss each of these steps in more detail and provide some advice for their implementation. As we suggest in the figure below, rather than taking this system as a rigid sequence of steps that must be followed in order, it is better to envision it as a kind of *closed loop* where each task is continually running and supporting the rest, and which actively incorporates new learning and adjusts to changes in the environment that could affect the way you do things.



The execution system. This is not a sequence of one-time steps but a continuous loop that adjusts to the changing environment

Your execution system must be a fluid process that continually challenges the fundamentals of your strategy and the system itself. This is how you add resiliency and agility to your strategy, and how you get your organization to behave more like a nimble living organism codified for survival in adverse environments.

No strategy survives contact with the enemy, the old saying goes, warning strategists about the risks of unexpected events that may (and most likely will) occur. But embracing uncertainties is part of the game of business, and the key is to develop fluid strategies that can morph as you execute and learn.

Challenging the strategy

Before you take your strategy as a given, it is important that you take the time to challenge its fundamentals. In the end, any good strategy is only as good as the information and assumptions that went into its development, so you want to make sure that those assumptions still hold before you go out to implement your strategy.

I have identified four ways in which you can challenge the strategy to make it clear and simple enough for execution:

1. Being specific about the things that you will NOT do,
2. Challenging the assumptions, not the projections used in the strategy,
3. Considering potential contingency scenarios, and
4. Considering options to deal with uncertainty and limit risks.

Let's go through them one by one.

Choosing what not to do

You don't have a good strategy unless your people are absolutely clear about the things they will NOT do. You can't have it all ways. You must at some point realize that unless you keep some things off-limits you will not have the focus you need to execute successfully.

If you can't compete on price, you must make it clear that you won't, and focus instead on creating a clear differentiation strategy and make sure everyone understands that.

By no means should you or anyone in your organization spend time trying to outprice the leader if it is part of your strategy NOT to do that.

That is what General Electric (GE) did by getting out of the lithium-battery business. Although the market for those specialized batteries was clearly going through massive growth, they figured it would be so competitive that manufacturers would have a hard time trying to make money, a lesson they learned from their time making solar panels, another industry they got out of as a manufacturer.

Instead, GE created an Energy Storage division, as part of their power business, that integrates batteries from other vendors into customer projects, taking advantage of price competition among battery suppliers.

In a similar move, we mentioned previously that Apple has been negotiating deals for cobalt, a key component of the batteries that power its devices, directly with miners to ensure its manufacturing partners always have access to the mineral. Batteries are an important part of Apple's devices, but the company has intentionally decided to be a strategic *buyer* of them rather than a manufacturer.

The key is to make clear the things that the company will not do, saving people's time and promoting a more effective decision-making process.

Giving assumptions a reality check

In many organizations, projections of earnings are the result of a long negotiation between business development teams and the headquarters, and not necessarily the result of a careful analysis of market dynamics and competition. In fact, it is pretty common that financial forecasts are done *without* any active involvement from marketing or strategy teams. I have seen it and you probably have too.

That means that when you later use those projections to set your company's long-term goals, the information upon which you are making decisions may not reflect the reality of your markets.

To avoid this bias, execution-oriented organizations make sure that the *assumptions* feeding long-term projections reflect the dynamics of their respective markets and the past performance of the business relative to competitors.

One way to do this is by creating cross-functional teams whose only job is to develop a realistic set of assumptions based on the thorough analysis of the dynamics in your different markets, and your business's previous performance relative to your peers. Those assumptions are then used to feed into the financial projections used in your strategy process.

The idea is to produce more reliable projections by taking a more realistic approach to preparing the assumptions that go into the projections, rather than focusing on the projections themselves.

Planning for different scenarios

"*Everyone has a plan 'till* they *get punched in the face*" said boxer Mike Tyson after the then undefeated heavyweight champ was knocked out in the 10th round by James "Buster" Douglas, but the same words could have been used to describe the relationship between strategy and execution.

Something about being too good at one thing is that you become less good at others, and as you optimize your people and processes to execute your strategy, you may be limiting your capabilities to respond to unplanned or atypical events.

For that reason, when planning strategy you may want to think about unexpected situations that could arise and how the company could pivot out of them successfully.

The scenario planning techniques that we discussed in Chapter 2 may come in handy to help you challenge and test your strategy against a few possible contingencies and to identify concrete steps that you would need to take to adjust direction if any of those scenarios actually happened.

This may seem like a lot of work when things are running smoothly, but when the stuff hits the fan this type of planning can pay off big.

The "real" value of real options

Strategy decisions must be based on more than just financial numbers, and sometimes, the *opportunity* to do something in the future carries more weight in a decision than a higher IRR today.

When you need to make decisions under some level of uncertainty, one approach that can help is to break down larger milestones into smaller stages, which you can use as "checkpoints" where you validate your results up to that point, and then decide your direction moving forward based on what you have learned. That can help you take action today and move forward with more confidence, even if some factors are still uncertain.

Let me give you an example. Let's say that you are running a logistics company building a distribution center near a big city. If there are reasons to believe that the demand for products may grow within the next five years, you may want to consider buying a second piece of land right next to it.

By buying the contiguous parcel you would be getting an *option* to build the expansion and serve new demand from that location if it increases as expected, and if not, you can sell the land in five years.

This is a case of what are known as *Real Options* (to distinguish them from their financial parallel), where most of the value of buying the land for you is in the *option* to build the expansion there in the future, and not so much in the land itself.

Integrating a real option mentality into your planning process can be an effective way to deal with uncertainty about the future and can help you move forward faster while capping potential losses.

Take Google for example. Since its public IPO in 2004, the company has invested in over 200 companies and technologies across a wide range of industries. Some have been big hits like Android, YouTube, Docs, Waze, Chrome, Nest and Uber, while others like Google Glass and Google+ have been big flops.

Their approach, however, is to manage these investments as a portfolio of *real* options that they continually monitor and make decisions to kill or double down on as they see them evolving. By treating these opportunities as real options (i.e. options to do something in the future) Google has avoided committing too early to unproven ventures or arriving too late to a hot market.

In the dynamic environment that we face in many markets today, speed of decision making is a competitive advantage and getting good at it means that you must learn how to move forward with incomplete information.

Drafting an execution path through a series of real options, where decisions are not only made based on their financial contribution at face value but in terms of their *strategic* value and the ability to test-then-decide, is a powerful way forward.

Setting strategic priorities

I know you've heard it a thousand times already, but clarity and simplicity are key to execution, and they can both be achieved by focusing on just a handful of carefully selected strategic priorities.

Strategic priorities are not mantras, like "customers first" or "being number one or number two". Instead, they define a specific target that the company wants to achieve within a given time, more like *grow bottom line earnings by at least $200 million by December 31st*, *cut per-unit costs 10 percent by the end of the fiscal year,* or *raise customer satisfaction ratings to 85 percent by the end of the year*.

These priorities are clear targets, explained in simple terms that define *what* and *by when*. They are best set by using the classic *SMART* approach where goals must be *S*pecific, *M*easurable, *A*chievable, *R*esults-oriented and *T*ime-based.

Remember, clarity precedes good execution. These goals and the corresponding actions to achieve them will need to be communicated to the rest of the organization and we can't leave room for interpretation. Unless you know specifically *what* you need, you won't be able to decide specifically *how* you'll do it.

Closing the execution gap

No strategy can be successful without taking into account your organization's ability to execute it first, and this step seeks to understand any limitations that may exist and make the proper corrections. This is one of the most critical steps in the execution system and where the rubber really meets the road.

Closing the execution gap means that you evaluate your company's ability to implement the strategy as proposed and make the changes that are necessary to ensure you can achieve your strategic goals. If you can't then you have to rethink those goals.

This step is a reality check that separates *hopes* and *wishes* from *achievable goals*.

For instance, if one of your company's strategic goals is to increase sales 10 percent next year, then you must ask questions about the company's ability to meet that target: *Do you have enough people for this? If not, who will do the job? If yes, are they the right people to meet these numbers? What technical, financial, training, infrastructure or other resources will they need to effectively achieve these goals? How much would that cost? Are you able to spend the money to do it? How long will it take? Is the goal realistic based on the budget and time that's required? How can you keep these people accountable for their success?*

Answering these questions will give you a better idea of how close you are to really achieving your goals, pointing to any implementation gaps that may exist. If you find hurdles that are impossible to tackle at the moment, for example not being able to find enough qualified people to do a specialized job, then you must to go back to the whiteboard and rethink or readjust the goal.

This step makes you face reality. You must poke any holes you can find in the strategy, or reality will do it for you, and by then it will probably be too late. If you don't get this step right, you'll be out there just *hoping* that you can make your numbers.

Creating lead levers

While the strategic goals set the targets that a company needs to meet by the end of a given cycle, let's say a quarter or a year, for most companies the moment of truth comes at the end of that period when they go to see whether they met the goals.

Unfortunately, that's how most corporations around the world measure performance against their targets: after the fact. They set a goal, then go to work and at the end of the cycle they come back with their numbers to see whether they passed or not.

This ex-post measurement of success is what FranklinCovey's consultants Sean Covey, Chris McChesney and Jim Huling, authors of *The 4 Disciplines of Execution: Achieving*

Your Wildly Important Goals call "Lag" indicators. They are metrics of performance over a given period of time in the past such as *Revenues*, *Earnings* and *Costs*.

Lag indicators are a good way to measure performance after the fact, but we should not use them to *guide* execution because by the time you get the results you can't retroactively correct the factors that drove them. The opportunities to act upon them occurred in the past.

Instead, to have a more proactive control of execution, the authors suggest the implementation of "Lead" indicators, or a measurement of *the trajectory* to achieve a given Lag target. In short, *Lead* measures track the most important tasks that teams must do to achieve the *Lag* indicators.

The classic example to explain the difference between Lag and Lead measures is weight loss.

In a weight loss plan, the number of pounds that you lose within a given period is a Lag indicator, which is measured at the end of that period, let's say after week or a month. Lead measures, on the other hand, set a limit on the number of calories that you can eat, and the amount of time you exercise every day.

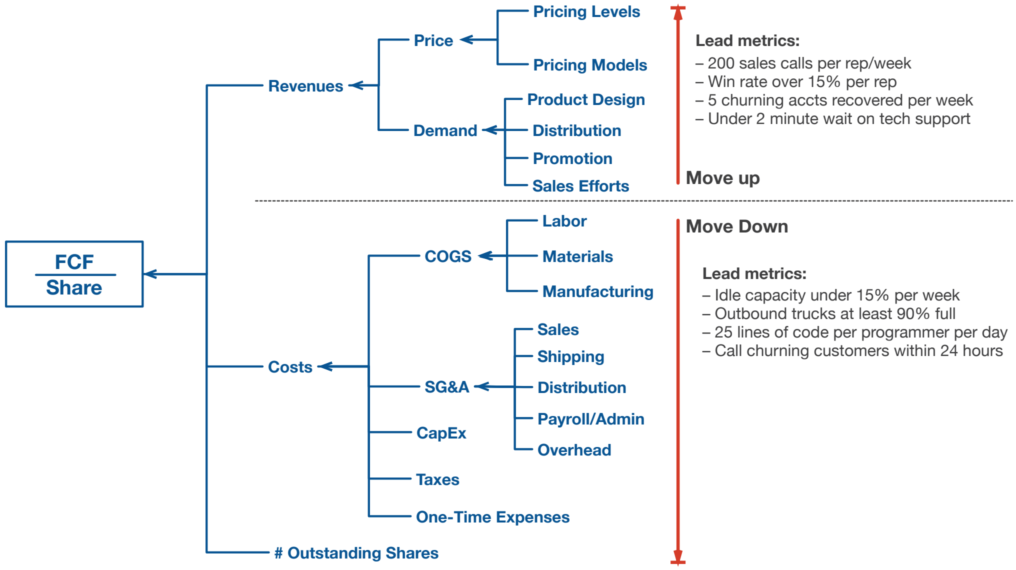
The difference is clear, by the time you measure your weight it is too late to correct it, while controlling what you eat and how much exercise you get can help you keep on track to your end goal.

A core characteristic of lead measures is that they must be *predictive* of achieving the goal and can be influenced by your people.

For example, if the Lag target is to reach $10 million in sales by the end of the year, a Lead measure could be sales people making 10 calls a day or attending at least one customer conference per month.

While Lag indicators provide a measure of success over longer periods of time, a Lead measure forces you to think about the things that you need to *do* every day or every week that will lead to the end goal.

In the previous chapter, we explained how you could break down a financial metric like free cash flow (FCF) into the main levers that you need to act upon to improve it over time. You can now expand that idea and add *Lead* indicators to control the work that's done on those levers to ensure they move in the right direction.



You may use lead indicators to proactively increase performance on your selected financial metrics

In helping you select the right Lead measures to focus on, it is probably a good idea to do some kind of sensitivity analysis to see which ones would produce the highest impact on the final outputs. That would help you be even more effective at prioritizing team efforts by only focusing on the factors that have the most impact on your bottom line.

Finally, you should create an internal record, a dashboard if you will, to keep track of Leading measures, where team leaders can see where they stand against their peers at any given time and who's lagging behind.

Accountability is an important component of execution. A scoreboard keeps the record straight, and you can use this type of tool in review meetings to keep people accountable for their performance.

Aligning your organization for execution

Even the best processes can't be effective if people's interests are not aligned with the organization's, which is why a critical step in the implementation of the strategy is ensuring that your people's interests *are* aligned with those of your organization. In general, leaders have three powerful tools to do it. They must:

1. Persistently communicate the strategy,
2. Provide people with the necessary tools and training to do their jobs, and
3. Reward performance in a way that aligns personal interest with the organization's.

Strategy language and buzzwords can fall through the cracks, especially down the chain of command. Some people might feel that strategy is the responsibility of a selected group of people upstairs and that it is not part of *their* job to pay attention.

Leaders must break this vicious misalignment by continually communicating why strategy is everybody's job and how it affects everyone in the organization. Everybody is important for strategy, otherwise their jobs wouldn't exist in the first place.

Additionally, you must ensure that your people get the skills and tools they need to succeed at their jobs. You may have people with great intentions but if they don't have the right experience or lack the necessary tools they will not do a good job. Good intentions can only get you so far.

Having people with the right skills and attitudes is critical to being a top performing company. A company that fights hard for talent, and that nurtures and promotes its top talent, will definitively have the strengths to get an edge over any competitor and be able to survive the toughest times.

Finally, the company must reward people accordingly, and compensate them based on their true contribution to the organization's success. Personnel compensation may use a combination of base salary, cash bonuses, grants and stock options among others, always distinguishing the best people and punishing poor performance.

Following through

Your job as leader is to ensure that the organization as a whole is always moving in the right direction and at the right pace, and for this you must actively follow through, providing feedback and coaching as needed to reinforce positive actions and correct poor performance.

You must continually talk to the people in the trenches either through recurrent meetings, casual "drop-bys", personal calls or a combination of these. These encounters serve to continually provide feedback and to identify potential deviations from your plans, but more importantly they serve to keep people accountable for their results.

The follow-through step is in a sense a continual revisiting of all the previous points and is the permanent state of everyone involved in the implementation of the strategy, especially the CEO.

Effectively following through means:

- Continually challenging the strategy and its underlying assumptions, actively exploring options to stage your progress and trying to minimize risks as you move forward.
- Validating strategic priorities, and continually adjusting the way these are translated and broken down into strategic *levers*.
- Ensuring that the company always has the people, skills and tools needed to execute the strategy, quickly taking care of any execution gaps that may be forming.
- Keeping on top of Lead indicators, and continually validating that they still make sense.
- Ensuring that reward and compensation systems remain aligned with the organization's goals as you execute, making adjustments whenever needed.
- Ensuring that all operations are running smoothly, with the right systems in place to identify potential issues that could derail your efforts.

This is a continual process that never ends. Plan, do and adjust. The execution system keeps the company alive and always progressing towards its strategic goals.

As an executive in charge, you must always insist on *realism* and keep all records facts-based. This is critical nowadays when companies keep succumbing to the trap of positive thinking and truly "unrealistic" reality.

According to some accounts, part of the failure of GE under CEO Jeffrey Immelt (Jack Welch's successor) was a culture of unwillingness to hear the bad news and executive overconfidence in a flashy view of the company that was not supported by reality. In short, he didn't seem to insist on *realism* as his predecessor did, and shareholders paid the price.

Insisting on realism doesn't mean being a pessimist or negative thinker. It is a determination to be fact-based and BS-free. If goals are unreachable, then you need to do something about it. Either the systems to achieve them or the goals themselves must be revisited and adjusted. If cash is running out, leaders need to take quick action because money doesn't grow out of income statements.

Hoping and believing, while avoiding the bad news, is not a way to make things happen. Facing reality and embracing the solution, whatever it is, is.

Designing your organization for execution

Agile organizations pay attention to how their internal structure influences their ability to make decisions. Silos and compartmentalization promote fragmentation, cultural divisions and clusterization of information, undermining an organization's ability to react quickly to changes in its business environment.

In today's super-connected world, companies must encourage faster decision-making processes, quick experimentation and multifunctional teamwork. Modern businesses are now shifting towards open spaces, remote working and hyper-collaboration where less form is better.

Ideally, there should be no more than two levels between any employee and an executive who is part of the strategy team. In general, flatter organizations promote faster and more robust decisions, elements that are critical in fast-moving industries. An extreme case of this is observed in high-tech startups where many people don't even have a job title.

In agile organizations *generalism* is increasingly being more appreciated and multi-core thinking more frequent, resulting in formal job descriptions making less sense than they did 10 or 20 years ago.

Decentralization is another element of a company's strategy that can help achieve even more ambitious goals. For companies operating multiple core businesses for example, decentralization of some of those business units is an absolute requirement to ensure that each can remain competitive in its own market.

Decentralized business units have the freedom to make decisions at the unit level that would usually be centralized such as recruiting, training, product development and sales. Because each individual business is competing within a different market context, with its own realities and business cultures, it makes sense to allow some independence in how it decides to play its game.

That doesn't mean that the individual units can't benefit from or leverage the resources and value chain of the main company, but it does mean that some strategic decisions, especially those related to market assumptions and key competitive capabilities, must be taken at the unit level and not centralized.

Part of Amazon's success has been in bringing its low-cost business model and scale to new industries, but new business units still piggyback on Amazon's vast network of resources while enjoying some execution independence.

An extreme case of independence from the mothership is the *spinoffs* we mentioned previously, where companies are completely detached from the main corporation and managed as independent business units. Leaders of the spun units enjoy more autonomy but also assume more accountability for their results.

Stakeholder management

Although the core purpose of an organization is to maximize long-term returns for its shareholders, it is also expected to meet the interests of different groups of *stake-holders*. Some of these stakeholders have a direct participation in the company's business and therefore a financial incentive for its wellbeing, but others have more of an indirect interaction with the company and may have different interests.

It is very important that as an executive of the company you manage the expectations of key stakeholder groups that may exist, taking into account their particular interests and goals.

In 1989, Exxon Valdez, an oil tanker owned by the supermajor ExxonMobil Corporation (NYSE: XOM), struck a reef that tore open the tanker's hull and quickly spilled 11 million gallons of oil into the waters of Alaska's Prince William Sound over just a few days.

Beyond the huge environmental mess, what really put Exxon on the spot was how their executives handled the situation with seemingly erratic and contradictory statements, a late acknowledgment of their mistakes and trying to manipulate the media to minimize the damage.

In the eyes of both public opinion and lawmakers, Exxon wasn't handling the situation at the level it should. In fact, it took its Chairman three weeks to pay a visit to the affected area.

In the Exxon Valdez fiasco, poor management of stakeholders and public relations cost Exxon billions in publicity and market capitalization value that took years to recover.

Contrast that with how Johnson & Johnson (NYSE: JNJ) managed a crisis of its own when seven people died in Chicago in 1982 after taking cyanide-laced capsules of Extra-Strength Tylenol, the company's leading brand.

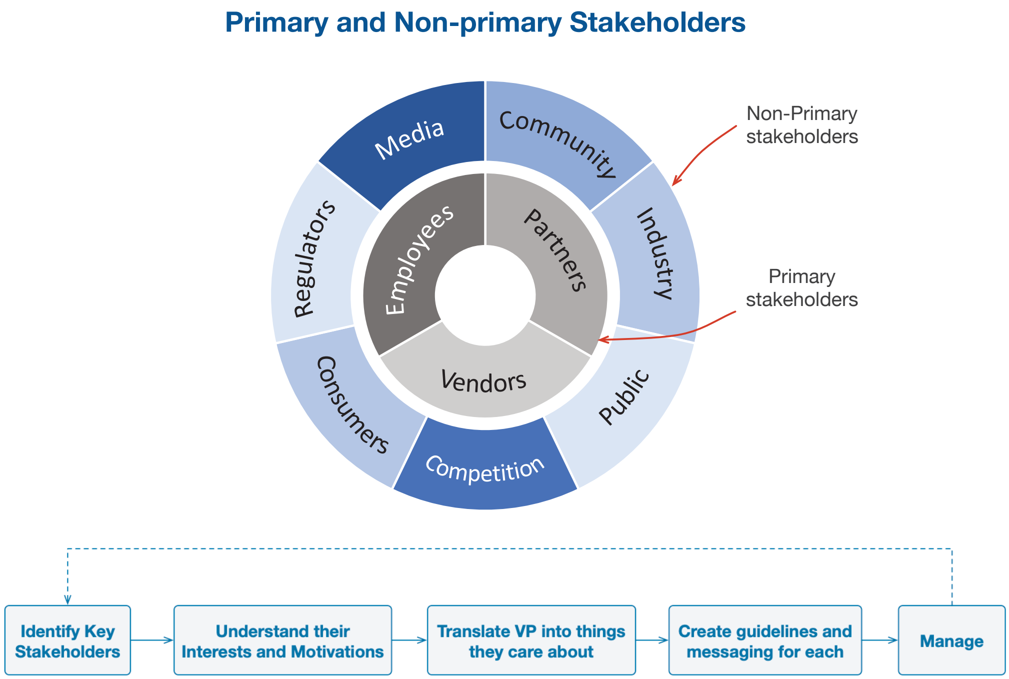
Without even knowing who was behind the attacks, instead of using its power to minimize the damage in the public opinion Johnson & Johnson took the painful and expensive decision of recalling 31 million bottles of Tylenol and offering replacement products in a safer bottle, a move that cost them more than $100 million.

Johnson & Johnson's share of the analgesic market dropped dramatically, and the stock took a brief hit as a result, but over time most analysts and investors agree that they made the right call by putting buyers' safety first.

Your job as leader of a modern organization is to understand the *real* interests and expectations of each stakeholder group, not just what they *say* they want, and to manage relationships with them in a way that enables long-term value creation for the organization.

A good stakeholder management plan is one of those things that you really must have in place *before* you need it.

To simplify your work with stakeholders, you may classify those that benefit directly from the company's operations such as employees, vendors and partners as *primary* stakeholders, and group all others under a common *non-primary* category, which may include larger groups such as government, media, employee representatives, the community, industry and associations, competitors, non-consumers and the general public.



Classifying primary and non-primary stakeholders

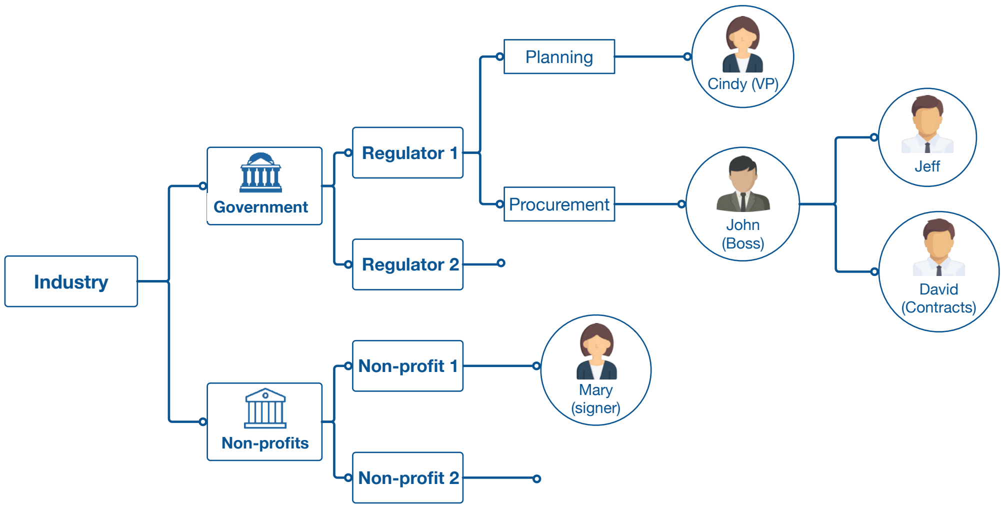
When working with primary stakeholders, your main goal is to align their particular interests with your company's strategic goals, something that you do through your execution system as we explained earlier in this chapter. But when it comes to non-primary stakeholders on the other hand, what you want is to manage their *perceptions* around your company and what you do.

Managing the expectations of non-primary stakeholders can really smooth your ride and is especially helpful when your company is under public scrutiny or going through major transitions.

Since you can't motivate non-primary stakeholders financially (and you probably shouldn't try), the game with them has to be played in terms of *political capital*. Understanding who is connected to whom, and who has a key stakeholder's ear, goes a long way when trying to "*let them have your way*".[49]

One way to help you understand key relationships among non-primary stakeholders is to visualize a map of how they are connected to each other and to the organizations they represent. A visual representation of non-primary stakeholders can really help you see connections that may not be so evident at first, making it easier for you to connect the dots.

Understanding these types of connections can entirely change the way we approach our strategy with each of the key players.[50]



Simplified map of stakeholders for a particular market (adapted from a real case)

One common mistake is thinking that managing stakeholders is the job of the public relations team and not realizing that these relationships are key for the execution of the strategy, which is by definition everyone's responsibility.

9

Building strong coalitions

When things get tough in your industry, you may need a little bit more than just a good strategy and great intentions. For example, when an entire industry is stuck pending new regulation but regulators don't seem to be taking action fast enough. Or when you need to join forces with vendors and customers to make a big deal happen.

Just like these, there are many instances where your company could benefit from building coalitions, and you may have to be the one orchestrating them.

Coalitions leverage the power of group efforts to get things done and are sometimes the only way to break through roadblocks and cross a finish line. Successful CEOs usually have a good record of building coalitions, and are not shy of working with others, including competitors, for a common goal that would benefit their company.

This is actually very common in the early and growth phases of an industry when regulations are being shaped. Uber and Lyft for example have joined forces several times to get ride-sharing regulation moving in some markets.

It is okay to be competing fiercely in one arena and collaborating harmoniously in another, or as my boss likes to say, “rubbing hips while keeping an arm’s-length” (yes, I can’t picture that either).

If you find yourself thinking about building a coalition, here are a few tips that can help:

- **Leverage social influence:** Do everything you can to add credible people with influence in their inner circles into your coalition efforts. Opinion leaders and influencers may be a good fit for this.
- **Sequence commitments from smaller to larger ones:** Rather than setting ambitious goals right at the outset, get people to commit to smaller battles first and then move them on to larger ones. That makes it easier to convince them to join and slowly makes them a more committed part of the group.
- **Promote shared thinking:** People are more likely to promote ideas when they own them. Involving people in the diagnosis of issues that need attention and in the search for solutions makes it more difficult for them not to support the decisions that come out of those efforts.
- **Rethink the scope:** Look beyond the obvious set of parties and seek other people who could have different motivations to join your coalition. Look outside for insiders, influential parties, consultants, industry experts or any others who could bring a different angle to the common effort.
- **Sequence your efforts:** Think about the best way to sequence your coalition efforts so that every new battle leverages the value created in the previous ones. For example, lining up a reputable congresswoman might add high value

to your cause, but to get her support you may need to do joint research with other players first, and then go to her with results that support and validate your cause.

Finally, in the same way that you create coalitions to help execute your strategy, you may also have to block adverse coalitions from forming. In many industries, like oil and tobacco, there are always adverse coalitions in the making. If you ever see such coalitions forming, you must immediately take energetic actions to neutralize them and put in barriers to prevent them from shaping up and getting more traction.

The Human Factor

10

A recurrent pattern I found throughout this research was the relentless effort of top organizations to only hire, promote and retain top performers, or *A-players* as these extraordinary people are usually called.

Probably one of the most opinionated leaders about hiring only A-players was former Apple CEO Steve Jobs. He repeatedly said that if you hired B-players they would hire C-players, and that it would start a performance decline because after a while the vicious cycle would continue until the company has become a B- or a C-class company.

A-players on the other hand, Jobs said, only like to work with other A-players, so by hiring them you ensure that only the best people work in the company because these A-players will self-police the company and only hire and retain similar top performers.

Another big advocate of only hiring the best is Amazon's Jeff Bezos. In *The Everything Store: Jeff Bezos and the Age of Amazon*, journalist Brad Stone tells the story of Nicholas Lovejoy, a former colleague of Bezos at hedge fund firm D.E. Shaw who came to work for Bezos and wanted to move from part-time to full-time in the early days of the company.

Until then, Lovejoy, who had been with the company since its beginning working as a recruiter, had only been working thirty hours a week and enjoyed the rest of his

In this chapter we will:

- Explore the goals of a talent management system
- Discuss some practices to help retain top talent
- Introduce the components of a corporate culture
- Explain the goals of an internal academy for executives
- Introduce the idea of internalizing consulting services
- Explain the role of the multidexter leader

time playing frisbee, kayaking and hanging out with his girlfriend. Bezos couldn't see how Lovejoy's relaxed lifestyle would fit into his vision of Amazon's hard-working culture and turned him down several times. Under Lovejoy's continued insistence, Bezos asked him to find his own replacement.

Bezos was, from the earliest days of Amazon, committed to only bringing in the best people he could hire, and for years interviewed new prospects himself. Hiring the best was, in Bezos' mind, how his vision for Amazon would become possible.

I found this relentless, almost obsessive pursuit of top players to be a pattern that repeats itself in top-performing organizations from GE, Capital Cities and Google, to Netflix, McKinsey and Comcast. In almost all cases, recruiting and retaining only the best people, providing them with unique tools and knowledge, running the company on a healthy winning culture and the existence of a performance system that ensures teams are always at the top of their game, was a kind of success formula.

That's why small and unprepared companies can't resist the attack of aggressive entrants that have these tools in place when they advance into their markets, like Amazon entering the food space through the acquisition of Whole Foods, and Apple entering the music industry with iTunes.

Weaker incumbents will be forced to fight back with all they have just to keep their doors open. They must streamline their business models, target different markets or just face death by irrelevancy.

It is happening right now in many industries and it will keep happening more frequently, as cheaper money is poured into every market and aggressive players look for new markets in their search for world domination. Only those with great people will be able to fight back, shift direction and stay afloat.

So, if you know how the movie ends, what are you going to do about it?

In this chapter we will explore the human side of the organization through a series of short lessons that cover specific topics that are critical for a good strategy implementation.

What to look for in a talent management system

The most important component of execution is your people. They will face reality every day and use their judgment to make decisions based on what they believe is in the best interests of the company.

For that reason, as a leader, you must ensure that you always have the right people, in both quantity and qualities, to execute the company's long-term vision, and to do that you'll need a talent management system that develops the talent and skills that your company needs now, and that it will need later.

No leader wants to run an organization without the talent to execute. That's a recipe for failure.

Your Human Resources (HR) division must actively build a pipeline of talent that satisfies the company's different needs, and must ensure that they remain competitive, engaged and properly rewarded.

In general, an organization's talent management system has important responsibilities:

- **Sourcing:** Continually bring in the right talent, based on your company's different needs and the markets where you operate.
- **Onboarding:** Introduce new people to the company's culture and continually reinforce positive attitudes and behaviors.
- **Development:** Provide adequate training, coaching and succession paths, so that people who perform better move through the ranks faster, and people in positions beyond their capabilities are properly adjusted.
- **Rewarding:** Ensure that top performers are properly rewarded and nurtured, while poor performers are fairly warned, punished or moved out of the organization.
- **Retention:** Create incentives and programs aimed at preventing the organization from losing good people.

In the execution of its long-term strategy, HR becomes leaders' closest ally and confidant. In multidexter organizations, HR is not a passive player but has an aggressive role that vigorously fights to recruit, promote and retain top talent. In an agile, execution-oriented organization, HR is without doubt management's most powerful secret weapon.

Steal talent like a pro

Let's face it, the people you want are already working for someone else, but that shouldn't stop you from getting them anyway. Why should you settle for anything less than what you think is best for your company?

Good people are rarely unemployed, so if you are fortunate enough to identify some outside your organization, you should go ahead and lure them in without even blinking. That's what the pros do.

Between 2015 and 2017, Amazon stole 30 executives from Microsoft, while Google also snapped up 5 others during the same period. Does that talent have anything to do with Amazon's superior performance during that time? ... you bet.

Great talent is very difficult to come by, so when it shows up you must be ready to act quick and snap it up. Remember what we said before: your people are the most valuable asset in the execution of your strategy, and if you take strategy seriously then you should fight for the right people and that includes getting them from wherever they are.

Amazon's management is not shy about stealing talent from competitors, and the company is well known for paying juicy signing bonuses which in many cases exceed $100,000. It wants to collect the best pool of talent and moves heaven and earth to make it happen. If the pros are doing it, why wouldn't you?

As the old saying goes, "*If you think that hiring A-players is expensive, try hiring rookies*".

Ranking and yanking: Dropping the bottom weight

Leaders who compensate poor performers in the same way they treat their best people will not get the best of either. Performance, as defined by the organization, must be rewarded accordingly. That means that good people should be nurtured and promoted, while recurrent poor performers should be purged and let go.

GE and the now bankrupted power company Enron famously implemented "peer-review" compensation programs, where best performers (usually the top 20 percent) were given outstanding bonuses and promoted, while bottom 10 percent performers were given no bonuses at all and put on a watch list for another period (12 months in GE and 6 months in Enron). People who remained in the bottom 10 percent for another cycle would be automatically removed from the organization.

Despite the bad rap that these reward systems created for their promoters, in this case Jack Welch and Jeff Skilling, both companies thrived and attracted the best talent during the time this system was in place.[51]

In essence, the system seeks to sort out the A-, B- and C-players and compensate them in proportion to their contribution to the organization's success. In the case of GE, A-players embodied what Welch called the "Four Es of GE Leadership": high *Energy* levels, ability to *Energize* others, the *Edge* to make tough decisions, and the ability to consistently *Execute* and deliver. For Enron, the company sought to reward "*brains, innovation and dedication*".

Under this performance-based system, A-players could get up to three times the raises and bonuses of B-players, while C-players would get nothing.

Amazon has implemented a variation of this system called *pay to quit*, where they offer people in their fulfilment centers up to $5,000 to leave the company. According to Amazon's executives, the goal of this program is to ensure they only retain people who are committed to their jobs.

Letting people go is a very unpopular way of increasing performance standards in an organization, but is probably the most effective for creating and maintaining elite teams that win all the time. No CEO has been successful by avoiding tough decisions, and in the end, if your favorite sports team consistently passed on opportunities to bring in and retain the best players, would you still root for it?

Netflix, another company well known for only hiring top talent, considers working for it like being part of an "Olympic team", where being cut off while disappointing is not shaming at all. It's just that the employee is no longer a top performer among their peers, but at some point they were. In the end, dismissed employees get a generous severance package and in most cases they will be quickly hired by another company.

Monitoring performance closely and dropping the bottom of the pot is how you keep it always fresh. This performance system, however, must be protected to keep it pure and prevent misuse as happened in Enron where it was used for personal vendettas and group agendas.

But when well implemented, the "rank and yank" as many call this system can keep the company's engine always working at optimal speed and continually outperforming itself.

To encourage effective execution, your reward and compensation systems must be carefully designed to produce the behavior your company needs to nurture a winning culture. We will talk about these efforts in more detail later as we get into in-house talent development alternatives.

The role of effective corporate governance

Corporate governance encompasses a series of mechanisms and rules that dictate how a company operates internally. It specifies the rights and responsibilities of the company's executives, including its board of directors, and defines an organization's reporting and decision-making structure.

The goal of a corporate governance system is to align the interests of all internal stakeholders, providing a good mechanism to support the company in the execution of its strategy and serving as a tool to deal with executive misbehavior and ethical violations.

There's no current agreement with respect to what makes corporate governance effective and supportive of a company's interests, and most systems in place are unfortunately plagued with group interests, misalignment and short-term myopia.

For example, many board members nowadays are elected every year, which contrasts with management's need for long-term vision. How can a board member elected for only one year adopt a long-term view? Go figure.

Public companies already have enough short-term myopia in trying to satisfy Wall Street's demanding analysts and investors, who want bigger numbers every quarter, so if the board is also short-sighted it makes the job of the CEO and the executives in charge an uphill battle.

Short-term focus is a real roadblock to long-term growth, and one of the reasons why Michael Dell took Dell Computers private in 2013. He needed to restructure the company in response to the new challenges the company faced, but realized he couldn't do it if he had to worry about quarterly reports and investors all the time.

Corporate governance with staggered boards, where only a third of the members are elected every year, enable a longer-term view of the company but are widely opposed by shareholder activists who claim that this structure makes companies unattractive for unsolicited offers and hostile takeover attempts, since the acquirer would have to wait longer to replace the target's board.[52]

In trying to execute a company's long-term view, an effective corporate governance system can be your best ally or your worst enemy. That's why you must closely watch the way this system is structured and how the board of directors is staffed if you really care about getting things done. If you find that the structure is not appropriate, then you must find ways to push it in the right direction.

In the end, if you go through the hard work of creating a good strategy but can't do your job to implement it, that's just as bad as having a lousy strategy. Behind the story of any country that's gone through a major change towards progress you'll find a leader who took the bull by the horns and restructured the incumbent system into one that would allow him to do his job.

Just be careful when you open that door, because in the same way that you may try to get rid of your board, your board may try to get rid of you.

Nurturing the right culture

I fully agree with management guru Peter Drucker when he said that *culture eats strategy for breakfast*. A company's culture characterizes the way work is done in an organization and is very important for strategy, but much more so for its execution.

While strategy planning sets a general direction (by defining the *whats*) and execution sets the implementation gears in motion (deploying the *hows*), it is the company's culture that ultimately fuels and lubricates the efforts to get things done.

The math behind it is simple: with a positive culture you will get more for every effort your people put in, while a bad culture will drag efforts downs and even bring them to a halt.

Rather than just being a common set of beliefs, behaviors and attitudes that prevail in an organization as many define it, multidexter leaders use their corporate culture as a weapon to achieve corporate goals. Instead of taking it as it is, these leaders "shape" the culture of their organizations to achieve their goals, changing beliefs, behaviors and attitudes along the way.

In fact, I truly believe that company culture is one of the most powerful ways to differentiate a company from its competitors, since a thriving culture is very difficult to imitate.

In the 2000s, Delta and United Airlines went out to take lunch money from Southwest and JetBlue, at the time the most profitable discount airlines. To do this, each created a new subsidiary – respectively called *Song* and *Ted* – offering low-price flights and friendly brands that would compete head-to-head with Southwest and JetBlue.

But despite their expensive and well-publicized efforts, they couldn't make a dent. Delta filed for Song's bankruptcy protection in 2005, while United shut down its Ted business in 2009.

From the outside, United and Delta's plan was fairly simple: since they were industry insiders, they knew Southwest and JetBlue's numbers fairly well. So they set out to build similar operations following the same strategy and business models, with flight options within the same price range and even targeting the same customers. If it was working for them, why wouldn't it work for us, right?

Well, no. Culture and perceptions can make a big difference. A business model is one thing but how you make it work is another. All of Ikea's competitors know their strategy, yet no one outcompetes them at their market position.

United and Delta underestimated the value of a winning culture and a customer-centric mindset, and both failed miserably. They ignored that part of the success of Southwest and JetBlue as low-cost providers was in their friendly customer service and how they made their customers *feel* when they flew with them. Customers didn't buy the idea of a scaled-down version of the larger inefficient airlines.

Transplant a high-tech startup into a bureaucratic conglomerate and see how it gets nothing done. Put a high-ranking executive of the conglomerate in to lead the high-tech startup and she won't make it to her first paycheck. Their cultures will just not fit.

You must pay close attention to a company's culture and persistently work to make it the right one. This is one of the hardest jobs of a leader, but that hard work is also what makes it a great differentiator.

There are a few elements that come into the mix in the "making" of a corporate culture:

- **Vision:** Corporate culture starts with the company's vision, a high-level statement of purpose that guides every decision an organization makes. For Google, that vision is "*To organize the world's information and make it universally accessible and useful*".
- **Core values:** While the vision offers a view of the company's purpose, its corporate values provide the operating philosophies and behaviors that guide everything employees do in pursuing that vision.
- **Narrative:** How the company's vision and values are communicated and reinforced. Every company has a unique story, and how you tell that story has a lot to do with how your culture is shaped.
- **Community:** How people treat each other and how they feel about belonging to the company's internal *community*. This includes all the things that could affect the work *ambience* inside the organization, such as team members' respect for others' opinions, personal relations, celebrations and camaraderie.
- **Policies:** The internal rules that an organization establishes with respect to things like vacations, maternity leave and sick days among other things affect

employees' perceptions about the friendliness of the company and its work environment.

- **Responses:** How the company responds to external and internal situations influences how employees behave and how they feel about being part of the company. From the way changes are communicated and the care that executives show about personal events in the employees' lives to how they respond to a team member wanting to quit, everything counts when it comes to culture and employees' perceptions of the company.

- **Consistency:** A lot in a corporate culture has to do with traditions. Recurrent behavior and consistency influence what people expect from the company when things happen or when employees behave in particular ways, which ultimately influences their behavior. It is the executives' consistency in their responses to such events that sets those expectations.

- **Workspace:** The architecture and nature of the workspace might affect how productive employees will be. Open floor spaces for example can promote more collaboration among team members, while remote working can give employees more flexibility in terms of schedules and attire.

Something I need to point out here is that these components don't make culture good or bad, they are just the ingredients to make one, and your job as a leader is to mix and match them in the right proportion to influence the behavior of your employees in a way that works well for you.

Netflix is widely known for a very flexible and open culture where employees can take as many vacation days as they want, and where everyone has access to strategic and salary information. Apple on the other hand promotes compartmentalization and secrecy, and for decades has been known for having internal groups that operate in complete isolation from the rest of the company.

Both Apple and Netflix have the culture that they feel fits their strategy best, and neither is better than the other.

The truth is, a company will always end up having a culture, whether intentionally or not. So instead of letting it emerge by itself you had better embrace it and *shape it* in a way that works for you, so that rather than getting in the way of execution it helps make execution happen.

Just like economies of scale and learning curves, a corporate culture takes time to get right but over time it can become either an asset or a liability for a company.

In-house schooling for managers and executives

One of the most effective ways to create a thriving culture and qualified talent is through an in-house talent development center. What I mean by that is having an internal training center, or academy if you will, where the company's best prospects are brought in to be trained and taught subjects that are highly relevant for the company.

Some of the things that your company can use an in-house training center for include:

- **Communicating the strategy:** In an in-house academy, company leaders, including the CEO, explain in their own words the organization's vision, the strategic choices the company makes and what they expect from the execution efforts in the foreseeable future. There's no better way to learn why the company does what it does than hearing it from the horse's mouth.
- **Transferring technical knowledge:** The academy can also be used to teach employees task-specific knowledge that is needed to perform their work. This promotes a continual specialization of the workforce, and a common source of knowledge upon which technical and operational decisions are made.
- **Deep-diving into company-specific subjects:** An in-house training center can be a great place to analyze problems and situations that are unique to the company, to work on company-specific case studies, and explain how some particular, less-common situations have been treated in the past, by whom and why.
- **Enhancing absorptive capacity:** You can also bring in external experts to discuss relevant topics or emerging trends that could affect the business in the future. At a minimum it should be used to promote internal discussions of relevant industry topics that could affect the company in one way or another in the near future.

One of the most widely known examples of an in-house development center is GE's Crotonville Management Development Institute in Ossining, New York. The center, founded in 1965 and majorly upgraded by Jack Welch in the early 1980s, trains around 12,000 employees every year on areas from management skills to technical training and the discussion of trending topics like Blockchain and Artificial Intelligence.

Crotonville was fundamental to Jack Welch's famous deployment of Six Sigma and other radical implementations at GE. It became a talent factory that still provides top performers for the company.

Reflecting on how fundamental Crotonville was for GE's success during his tenure as CEO, Jack Welch says "*Ultimately, Crotonville became a boiling pot for learning. Our most valuable teachers there became the students themselves. Through their classwork and field studies, they taught the company's leaders and one another that there often was a better way. Crotonville became, in fact, our most important factory... Without Crotonville, I didn't think we had a prayer*".

Internalizing consulting services

I have nothing against strategy consultants, but in my own experience many of them are "experts" on things they have never done themselves. They will tell you what products you should develop, how to approach your customers and how to manage your people, yet they have never developed any successful product, don't know your customers and never had to fire anyone.

I think companies can make a bigger impact if they stop relying on strangers to run their businesses and instead move towards the "internalization" of their most critical consulting needs.

By internal consultants I mean top talent, employed full-time by an organization, entirely dedicated to researching the company, the markets where it operates and its competitors. A group that develops case studies to deep-dive into critical subjects that matter to the company and its executives, to promote better understanding of the internal "mechanics" of the organization.

Don't take my word for it – there are in fact many successful implementations of internal consulting teams, take a look at the following for example:[53]

- Samsung's Global Strategy Group[54]
- IBM's Global Business Services[55]
- Deutsche Bank's Group Management Consulting[56]
- Cisco's Corporate Strategy Office[57]
- Google's Business Strategy Googlers[58]
- Siemens Management Consulting[59]

All these are good examples of companies that have created internal groups to specialize in subjects that matter to the company and the executives. These consultants will be experiencing first-hand what your people face every day, trying to keep a fresh perspective, bringing external insights and best practices to solving internal problems.

I would argue that a team of top talent working as internal consultants could also be offered as external services to customers and vendors, helping foot the payroll bill along the way. In fact, if your company outsources a lot of consulting work, developing an internal team fully dedicated to strategic matters might be a cheaper way to get the same work done.

With a good team of internal consultants, the external ones would only be used to validate the conclusions of your teams and provide feedback to them, build benchmarks on industry practices or to provide an independent view on certain matters.

Think about it this way. To get the most from external consultants you need to have the ability to challenge their work, and to do that you need people who understand the subject as well or even better than them, because otherwise they will shove boilerplate lingo and acronyms down your throat, and you have to take their word for it.

Therefore, if you agree that even to *work* with external consultants you need to develop internal talent to challenge what they do, then why not take the whole job over? If you have to deep-dive anyway, why rely on external judgment to make important decisions?

There's a reason why some of the CEOs that have delivered the most extraordinary results like Steve Jobs and Warren Buffett never used consultants for strategic decisions.

Here's a tip not many people know about. There are companies out there like AlphaSights,[60] Guidepoint[61] and GLG[62] that will go out and find subject matter experts in pretty much any field and arrange an interview with you in a matter of hours. These are real experts working in their respective industries who will answer any question and give you their opinions on relevant topics for an hourly fee.

You don't even need to reveal your name or your company's. These are more like "blind dates" where you get to vet the prospects beforehand.

Think about all the information you can collect about the market from real field experts for a relatively insignificant amount of money, to develop your own internal knowledge base before making any important decision. In fact, this is how many consulting firms get industry insights on the fly, so why not skip the middleman and go directly to the source?

Finally, there's another downside of working with external consultants that you need to pay attention to: *confidentiality*. You must understand that good ideas are the currency of the consulting business, and most of their success is in bouncing the good ones around with their customers.

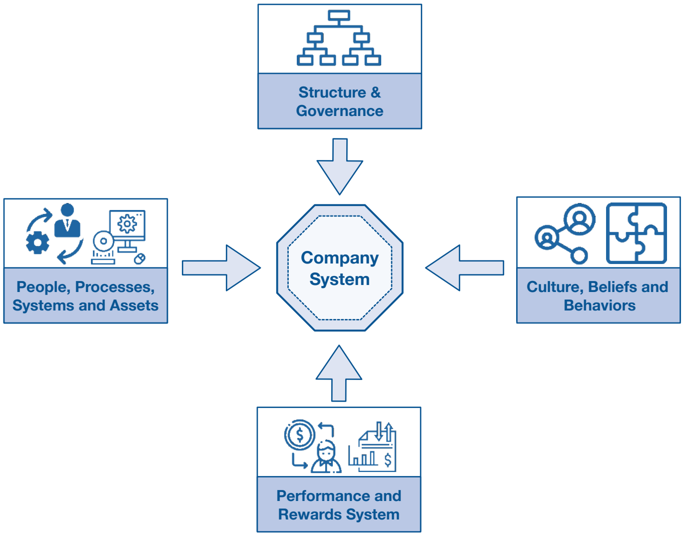
The ideas you discuss with consultants will most likely end up on other companies' plates, in the same way that other companies' ideas are ending up on yours, all catered by your favorite consulting firm.

This becomes a more sensitive matter if your strategy depends on a level of surprise or perfect timing to be effective. Strategy firms tend to commoditize business ideas over time, making them more predictable and less effective in some cases.

That doesn't mean that you shouldn't use external consultants, but they should only play a role that's *complementary* to your internal insights, not central. In the end, your strategy must be yours and not someone else's, so instead of relying on strangers for things that matter to your organization, you must think about developing talent that you can trust and having them run that show.

The company's operating system

Based on what we have seen so far, you could think of a company as a kind of *cash machine* which runs on an operating system that's unique to it. This operating system defines the company's capabilities and how the work gets done, including both the *soft* and the *hard* components that make a company unique.



The company's operating system. This is what a CEO is handed when taking the job

This operating system is what would be handed over if you were brought in as the new CEO of an organization. Your job then is to marshal these resources to maximize the company's value over the foreseeable future.

A company's long-term vision can only be achieved through a compelling, reality-based strategy, where the "reality" part is based upon its ability to execute it, or in other words, on the efficiency of the company's *operating system*.

All these pieces come together to support the company's vision, and just like vital organs in a living organism, they can make the company agile and resilient, capable of surviving changing conditions and continually adapting to its surrounding environment.

The good performance of this operating system must be preserved at all costs by continually monitoring its health and ensuring that all its components are running smoothly, providing proactive maintenance and updates, and quickly acting on anything that seems to be out of synch.

That is your job as a leader.

The role of the multidexter leader

The role of a leader is to *lead*. Leading the creation of a vision for a company, leading the development of a strategy to reach that vision, leading the execution of that strategy, and finally, leading change.

No organization has been successful by remaining static, in the same way that none has been successful by changing strategy too often. While consistency is a good thing for a competitive strategy, it can also make you incompetent if you don't recognize the right time to disengage.

A company's long-term plan must have the flexibility to allow pivoting if things go wrong, but must also have the focus to get things done and become better over time.

Your responsibility as a leader committed to long-term growth is to pursue the right amount of change. No more, but also no less. And that's why you need a strategy. Because a good strategy will prevent you from pursuing too many things at once and getting distracted. It will force you to focus on the few achievable goals that create the most long-term value for your shareholders and your people.

In order to achieve these goals, you'll need good execution to ensure that the right people have the right incentives to do their part. If the strategy is right, a good execution system will guarantee progress towards these goals. If the strategy is wrong, a good execution system should raise a red flag in time to allow reconfiguration.

These are not easy tasks. As a multidexter leader you must have the long-term creativity to create a vision and the short-term energy to execute it.

You must keep your sights firmly locked on the final target while leading your teams through the small steps that will take you all there. You must stay focused on the "whats" of strategy while leading people through the detailed "hows" of execution.

To avoid biting off more than they or you can chew, you must keep your focus on a limited set of significant long-term goals, which must be translated into a higher number of shorter-term goals downstream.

As a multidexter leader, you understand that you must become the main vehicle to *channel* the strategy throughout the organization, so you must also become a *multidimensional communicator* as well, who adjusts the message to the context and reality of the listener, to deliver your message more effectively. Multidexter executives like you are the true Trojan horses of culture and vision.

Communicate your vision every chance you get. In leadership meetings, in random visits to employees, in the company's newsletter, in staff meetings and even in informal discussions. Always find a way to explain to people how everything they do is tied to that main vision and ask your subordinates to do the same.

Make it a priority to know your company, businesses and people like no one else. Become a part of the organization's system, one who shares each employee's pains and understands the realities of those at the front line implementing the strategy.

Try to be reachable by anyone, and never miss an opportunity to coach and talk about the strategy with employees of any level. Stop giving orders, and instead help people get things done.

Ask questions that force people to think for themselves and speak their minds. That's how you will make those people smarter and how you will get to know them better, understanding their strengths and weaknesses. Use communication as your *little trick* to always be in touch with reality, because above all you must always insist on *realism*.

Without a reality-based mentality, the strategy might just be an illusion, and if the strategy is not realistic everyone, including you, will fail.

Finally, pick your own strategy metrics and once you have them, push through to make them better like nothing else matters, because it doesn't. Remember that every organization needs its *own strategy* based on its *own vision*, unique set of capabilities and the opportunities in front of it. What works for others may not work for you, what worked in the past may not work today, and what will work in the future, the place we are all heading into, is being created now.

By you.

Remarks: That human thing

Elizabeth Holmes was the founder and CEO of Theranos, a company that claimed major science breakthroughs after announcing a quick, cheap “fingerprint” blood test technology that would accurately measure chemical levels in humans using only few drops of blood. In promoting Theranos’ breakthroughs, Holmes appeared in all major media outlets including Vanity Fair, Bloomberg, Forbes, Fast Company, CNBC, The Economist and WIRED Magazine.

Elizabeth Holmes was “*America’s new Steve Jobs*” read a cover of Inc. Magazine.

Holmes and Theranos used this momentum to attract more investors, signing deals with large consumer health companies and raising more than $700 million, putting on the company an outstanding $9 billion valuation tag in 2015, making Holmes the first self-made female billionaire.

Elizabeth Holmes was America’s golden girl.

Her company was well connected at the highest levels thanks in part to its board of directors which included powerful names such as former Secretary of State Henry Kissinger, former Secretary of Defense Bill Perry, former Secretary of State George Shultz, former US Senators Sam Nunn and Bill Frist, former Navy Admiral Gary Roughead, former Marine Corps General James Mattis, and former CEOs Dick Kovacevich of Wells Fargo and Riley Bechtel of Bechtel.

The company seemed to be on track to becoming the largest IPO in biotech history. However, there was one big problem: Theranos’ technology didn’t work as advertised, and the company had been faking its blood test results.

According to Wall Street Journal reporter John Carreyrou, Theranos’ device was never close to becoming a reality and its results were never accurate, even though the company’s executives always maintained that they were, and kept using them on patients, some of them with risky conditions.

Theranos’ actions put patients in enormous harm, and now Holmes and her number two and ex-boyfriend Ramesh Balwani, who was already a millionaire before the Theranos saga, are both facing criminal charges and up to 20 years in jail.

A similar case involved another polarizing figure, Martin Shkreli, former hedge fund manager and CEO of biotech company Turing Pharmaceuticals. Shkreli made headlines when his firm Turing acquired the manufacturing rights for *Daraprim*, a drug used to treat patients with AIDS, and raised its price from $13.50 to $700 per pill, earning him the title of "*the most hated man in America*".

When asked about the price increase, his usual answer was "*we did it because we could*" or "*I should have raised prices higher and sooner*", and when he came to testify in front of Congress he behaved like a total jerk, smirking throughout and invoking his Fifth Amendment rights.

Shkreli was arrested in 2015, accused of running a Ponzi-like scheme while working at a previous firm, MSMB Capital Management, and was later convicted on two counts of securities fraud, sentenced to serve seven years in jail and pay $7.4 million in fines.

Although organizations are designed to create wealth for their shareholders, there's a human side to them that we should never lose sight of. An organization in the end is no more than a bunch of people working for other people, and no position gives anyone the right to mistreat others, let alone put their lives or future at risk.

Unfortunately, executives at the highest levels, including CEOs, sometimes get so blinded by power and the feeling of being untouchable that they forget about the consequences of their actions. While we executives do want a high-performance organization and will bite and scratch to build that, there are lines we should never cross. Take my word for it, it is not worth it.

One of my early idols, Jeff Skilling, former CEO of Enron, considered by many as one of the most brilliant minds in business and who became a partner at McKinsey in record time (a huge achievement on its own), served 11 years in prison after being convicted of federal felony charges related to Enron's financial scandal.

Enron executives pocketed millions of dollars in bonuses through off-the-book shenanigans, while they encouraged employees to invest their retirement savings in the company stock, knowing that those employees would be left with nothing, not *if* but *when* the house of cards collapsed.

Skilling was making over $100 million a year as CEO of Enron, but in jail he wasn't even allowed to touch money - that could earn him a week in solitary. His youngest child John Taylor, heartbroken, distraught and devastated at his family's tragedy, died of a drug overdose in 2011 at the age of 20. Jeff Skilling was denied the request to attend his son's funeral.

As I write this piece, Skilling has just been released from prison and is in a "re-entry facility" looking for job. In the meantime, he's also trying to figure out what Uber is.

Afterword

Who comes first, shareholders, customers or employees?

As he was approaching the IPO of his company, the Alibaba Group, Chinese entrepreneur Jack Ma wrote a letter to soon-to-be investors explaining his vision for the future of the company and sharing some of his management philosophies.

In that letter, he included a section titled "How We Set Priorities" that is worth reviewing here as we wrap up this book.

The section reads:

> "*I have said on numerous occasions that we will put "customers first, employees second, and shareholders third." I can see that investors who hear this for the first time may find it a bit hard to understand.*
>
> *Let me be clear: as fiduciaries of the company, we believe that the only way for Alibaba to create long-term value for shareholders is to create sustainable value for customers. So customers must come first.*
>
> *Next come our employees, because in today's knowledge economy, employees are most important in having satisfied customers. Without talented, happy, diligent and passionately committed employees, our commitment to serving customers will be empty. A company that does not have satisfied employees will not have satisfied customers, and without satisfied customers, we could not possibly have satisfied shareholders.*
>
> *Our company will not make decisions based on short-term revenues or profits. Our strategies will be implemented with mission-driven, long-term development in mind. Our people, capital, technology and resources will be utilized to safeguard the sustainable development and growth of the Alibaba ecosystem. We welcome investors with the same long-term mindset.*"[63]

In that letter, Jack Ma tries to give potential investors a glimpse into what to expect from his company. In short, he's saying: our focus is on customers, so growth initiatives and reinvesting in the business will have the highest priority when deciding how to allocate gains.

Then comes the company. We will try to create a competitive environment where people have the tools to advance the company and where they can find the challenges that our A-players need to stick around.

Third, dividends have the lowest priority on our list. There's just so much to do and so much growth to capture that we can't think of taking money out of the company, so all of your gains in the foreseeable future will be through the appreciation of the stock, and we will support that gain with an aggressive growth plan.

That vision is somewhat in line with Jack's parallel in the US, Jeff Bezos of Amazon.com, who also preaches relentless customer focus as his core mantra. In a rare interview with Harvard Business Review's Adi Ignatius, Bezos said:

> "*When things get complicated, we simplify by saying what's best for the customer? And then we take it as an article of faith if we do that, it'll work out the long term. So we can never prove that. In fact, sometimes we've done price elasticity studies, and the answer is always we should raise prices. And we don't do that because we believe– and again, we have to take this as an article of faith– we believe by keeping our prices very, very low, we earn trust with customers over time, and that actually does maximize free cash flow over the long term.*"

Then when asked about how much he cares about the stock price he added:

> "*I care very much about our share owners, and so I care very much about our long-term share price. I do not follow the stock on a daily basis, and I don't think there's any information in it. Benjamin Graham said, "In the short term, the stock market is a voting machine. In the long term, it's a weighing machine. And we try to build a company that wants to be weighed and not voted upon.*"[64]

In their view, both Jack Ma and Jeff Bezos, who at this point own the global online retail market, share a vision where customers come first, the company second, and shareholders, at least in terms of capital distribution, go last.

In their view, their companies have the goal of helping customers achieve more, and they will do that by re-investing their earnings back into the business.

In the case of Alibaba, most of that reinvestment will go into improving their sellers-buyers ecosystem, and for Amazon it will go to support new businesses and entry into new markets.

In the end, the *long-term survival of the corporation* is the dominant view driving the strategic efforts of modern organizations. Amazon could raise prices and make tons of money for shareholders in the short term, but that would go against its long-term survival as Bezos said.

Investors who don't share your vision should be welcomed to get out of your stock and find other places to put their money. You should not want them there.

I'd like to wrap with some words from Jack Welch, who after writing this book I still think has been the greatest CEO of all time, and who was an inspiration for me as I wrote it: "*If you told me I had to run this company, and I only had three measurements, here's what they'd be: customer satisfaction, employee satisfaction, and cash flow. You give me [those] three measurements, and I'll give you a business that will win big*".

Conclusion

What did I learn from writing this book?

Writing this book has been a great personal experience. It has taken me to places I never thought I would be looking into, and helped me look at things that happen in my day to day job in completely different ways.

It has, however, consumed a lot of me. To say that I underestimated the work involved in transforming all those random thoughts, notes and loose documents into a readable book would be a huge understatement.

Writing this book has been by far the most time-consuming, challenging and tedious task I've even taken on. I spent over 3 years just organizing the information and writing the manuscript.

Every time I ran into a new framework or idea that contradicted what I had already written, I would go back and poke around until I figured out where the difference lay. Of course, the fact that I'm not a writer, and that I'm not a born English speaker, didn't make things any easier.

However, I'm finally proud of the final product and the learning I gained from it. A few important lessons that stuck with me from researching and writing this book include the following:

- There are still only two ways to compete in any market, differentiation and low prices. We wish there were more, but there aren't. That's it.
- Don't be complacent. It is okay to disagree as long as you believe in something, but that belief should only come from spending time on problems.
- Know your business inside out and better than anyone else. That's the most important masters degree you need to get.

- Don't go to business school. Instead, learn about the business by studying your company and industry. That's a better use of your time and effort. Yes, many good CEOs have some formal business education, but the greatest CEOs of all time, the ones that you and I truly admire, don't.
- In making strategic decisions, trust your gut 20 percent and the data 80 percent.
- You don't need to be a rock star executive, just a disciplined, reality-based money maker. The best performing CEOs didn't even talk to the press often.
- Continually question what the industry has historically been doing. At some point, long-believed "facts" will no longer be the truth.
- When making decisions, think slow, but act fast.
- Be patient when it comes to long term goals, but impatient with short term ones.
- If there's no reason to wait, act, but if there's no reason to act, wait.
- 80 percent good is good enough. Beyond that is called *perfectionism*, a common disease that great executives rarely get.
- When it comes to costs, be cautious, but never be cheap.
- Key positions must be in hands of A-players. Giving them to B-players will be more expensive over the long run. It may even cost your job.
- Make people more intelligent by asking questions that challenge their beliefs.
- There are only three areas where CEOs must spend time: running the business, capital allocation and investor relations.
- Be skeptical and challenge everything that comes your way. If you do that, I bet you'll be right at least half the time.
- If you are not willing to disagree with people, you're not ready to be CEO. No successful CEO was a yes person.
- As a general rule, when talking to people above your pay grade be strategic, when talking to people below your pay grade, be tactical.

- Always deal with the important problems first. That alone should get you close to meeting your goals.
- When in doubt about what business direction to take, move towards better customer satisfaction.
- CEOs must have significant ownership stakes in the businesses they run. They must *be owners* to think like owners.

We executives are not royalty; if we were, we wouldn't be working here or even reading this book. We are hard workers, who get our hands dirty and work our way through, blowing through obstacles like dynamite clearing a beaver's dam.

My final piece of advice to you is that you must love what you do, but read that line carefully – because I didn't say that you must do what you love.

It's all part of a game where if you don't make a few mistakes here and there you're probably not going fast enough.

Now go put a dent in the universe.

Appendix

A quick review of financial statements and corporate investments

This appendix is an effort to provide a short review of the most important financial statements and their role in strategy, but is by no means an attempt to serve as a replacement for a more thorough source on the subject.

Although most executives are familiar with one or another financial statement, this short appendix can serve as a common language that can help us all start on the same page when discussing the financial side of strategy.

While we will try to stick to the Generally Accepted Accounting Principles (GAAP) with which all public companies must report their financials, bear in mind that both public and private companies are also free to present their numbers in non-GAAP statements.

Now let's do a quick review of a company's Balance Sheet, Statement of Income and its Cash Flow Statement followed by the introduction of the most important financial indicators. Finally, towards the end of this appendix we also include other financial subjects such as the Time Value of Money and the evaluation of investment decisions.

Balance Sheet: The gatekeeper

A company's balance sheet is a financial report that provides a view of the company's assets, its liabilities and stakeholders' equity at a given point in time.

Shareholders' equity, which is the value of investors' stake in the business, is calculated as the difference between what the business *owns* (its assets) and what it *owes* (its liabilities) at that particular time.

A balance sheet therefore always adheres to the basic formula:

Assets = Liabilities + Shareholders' Equity

Or put in other words:

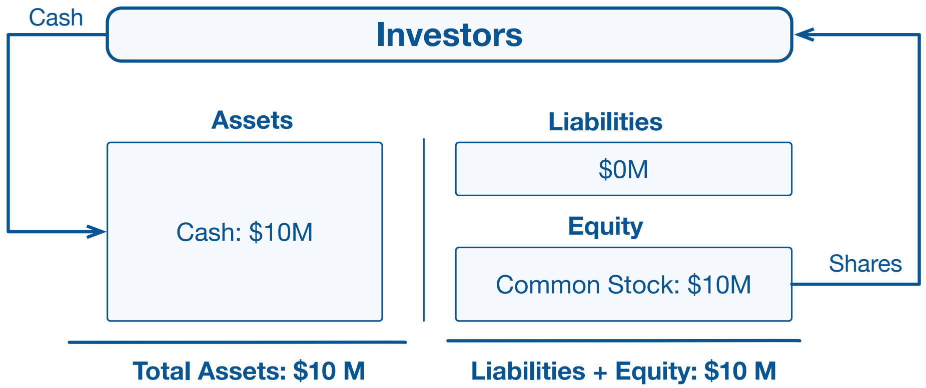
Shareholders' Equity = Assets – Liabilities

The general rule of the Balance Sheet is that the company's Assets must always match its Liabilities plus Shareholders' equity. *The balance sheet always balances* is what any accountant, veteran or not, will tell you.

Why does it always balance?

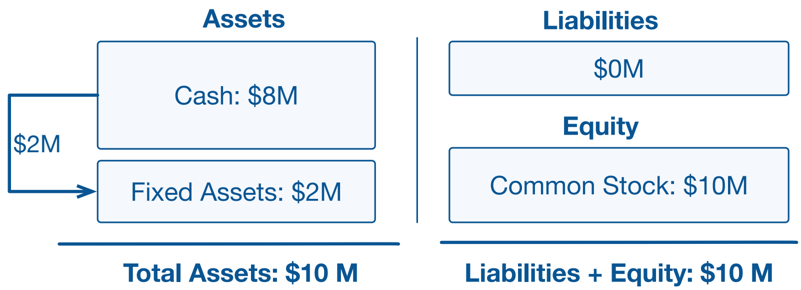
Simple, because it does. Let me give you an example. Let's say that a company starts out with a capital injection of $10 million from its investors. At that point, the balance sheet of the startup will show $10 million in *Cash* as assets, and $10 million in the equity section.

That means that at that moment the total equity of the shareholders is $10 million in cash.



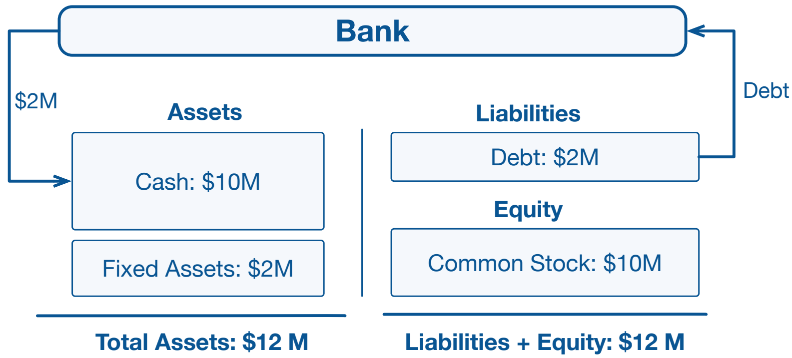
Why the Balance Sheet Balances (1/4): Investors provide $10 million as a capital contribution to start the company, getting shares in return.

Now let's say that executives spend $2 million in cash buying a truck. As soon as the transaction is recorded, the balance sheet will show only $8 million on the cash line, while $2 million will go to *Fixed Assets*. *Total Assets* are still $10 million ($8 million in cash plus $2 million in Fixed Assets), and match the $10 million we have in equity at the other side of the balance sheet.



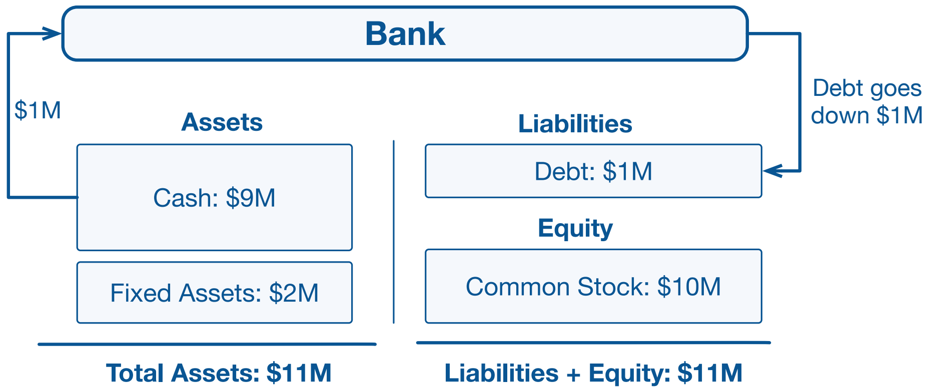
Why the Balance Sheet Balances (2/4): If a company buys equipment, it converts cash into other types of assets, shifting values around on the Assets side.

Now let's say that the company borrows $2 million through a commercial loan. Since the loan is received in the form of cash, the *Cash* line in the balance sheet goes up to $10 million again which, added to the $2 million we already had in *Fixed Assets*, totals $12 million. At the same time, the loan creates a *Liability* (in this case an *Account Payable*) which along with the $10 million we had in common stock adds up $12 million, equalizing the asset side.



Why the Balance Sheet Balances (3/4): If a company borrows money, the cash received as a loan is recorded in the Cash Line, while the debt is recorded on the liability side as an Account Payable, balancing both sides at $12 million.

Now, for the sake of the example, let's say that the company decides to pay its lenders $1 million to cut its debt in half. Now its Cash line will go down $1 million (to $9 million) and its *Debt* line will also go down by the same amount (to $1 million) to reflect the payment made.



Why the Balance Sheet Balances (4/4): If the company makes a loan payment using cash, its Cash line goes down by the same amount as its Debt on the liability side, balancing both sides.

Every transaction that's recorded will move things around but in the end both sides will always balance out.

The Assets side of the Balance Sheet is usually divided into *Current Assets*, which are those that can be converted into cash within a year, and *Non-Current* or *Long-term Assets* which would take longer than Current Assets to be "cashed" or liquidated.

The most common categories to break down the Current Assets section include:

- **Cash and Cash Equivalents:** This includes money at hand (in bank accounts) and other "liquid assets" that could be turned into cash in a short time, something like a day or so.
- **Marketable Securities:** Sometimes referred to as *Short-Term Investments*, this line includes equity securities that can be traded in a liquid market such as common stock, commercial papers and treasury bills.
- **Accounts Receivable (A/R):** Money that customers owe the company. This is in most cases related to products that have been sold but haven't been paid for yet.
- **Prepaid Expenses:** Expenses that have been paid in advance but are being spread over a period of time, for example an insurance plan or rent that's paid upfront, or an advertising campaign that will benefit the company for multiple years.
- **Inventory:** Goods ready to be sold, or in the process of production.

Long-term Assets on the other hand include those assets that would take more than a year to liquidate and are usually classified as:

- **Property, Plant and Equipment (also PPE or Fixed Assets):** All physical assets the company owns including buildings, vehicles, land, computers and others.
- **Long-term Investments:** Securities that can't be or that are not expected to be liquidated within a year.
- **Intangible Assets:** Non-physical items such as intellectual property, research and development costs and "goodwill" (excess money paid to buy an asset or a company).
- **Accumulated Depreciation:** This is usually a negative number on the Assets side of the balance sheet, to account for the loss of value that buildings and equipment accumulate because of their use in the business operations.

At the other side of the Balance Sheet, the Liabilities section is usually split into Current and Long-term Liabilities.

Current Liabilities are those that need to be taken care of within a year, and include some of the following items:

- **Current Portion of Long-term Debt:** The part of the long-term debt that is due within the current year.
- **Accounts Payable:** Money that the company owes to its vendors that hasn't been paid yet.
- **Short-term Liabilities:** This line includes other short-term payments the company has to make, but that hasn't yet, for example payroll.
- **Deferred Revenues or Customer Prepayments:** Money received from the sale of products or services that have not yet been delivered to customers.

Long-term Liabilities on the other hand are usually broken down into:

- **Long-term Debt:** This includes the portion of the long-term debt (loans) that is not due within the current year.
- **Long-term Liabilities:** Long-term liabilities other than loans such as deferred bonuses, taxes and pension funds.

Finally, the Owner or Shareholder equity section is usually broken down as:

- **Retained Earnings:** After-tax profits that have been earned but not paid to shareholders because they have been reinvested in the business or used to pay off debt (in short, this is money that could have otherwise been paid out as dividends to shareholders).
- **Preferred Stock:** Shares that received special payment schedules, usually of higher priority (or *seniority*) than *Common Stock*.
- **Common Stock:** These are the shares that represent common ownership of the company, and usually the voting rights.

Just as a reference, the next figure shows Amazon's simplified Balance Sheet for the year ending December 31st, 2017.[65]

Amazon Balance Sheet (Simplified)

Assets	12/31/17	12/31/16
Cash & Short Term Investments	30.986	25.981
Short Term Receivables	13.164	8.339
Inventories	16.047	11.461
Other current Assets	0	0
Total Current Assets	**60.197**	**45.781**
Long Term Investment	0	0
Net Property, Plant & Equipment	48.866	29.114
Goodwill	US$13.350	US$3.784
Intangible Assets	0	0
Other Assets	8.897	4.723
Total Assets	**131.310**	**83.402**

Liabilities	12/31/17	12/31/16
Short Term Debt	0	0
Accounts Payable	52.786	39.048
Other Current Liabilities	5.097	4.768
Total Current Liabilities	**57.883**	**43.816**
Long Term Debt	24.743	7.694
Other Liabilities	20.975	12.607
Total Liabilities	**103.601**	**64.117**

Equity	12/31/17	12/31/16
Total Shareholders Equity	27.709	19.285
Total Equity	**27.709**	**19.285**
Total Liabilities and equity	**131.310**	**83.402**

Simplified Amazon balance sheet for the period ending December 31st, 2017 (numbers in millions)

The Balance Sheet is considered by most experts as the most important financial statement as it presents a snapshot of a company's ability to pay its duties and make money. It is very important that you read any footnotes when reviewing the balance sheet of publicly traded companies as they may reveal information that is critical for a good understanding of the numbers.

Balance Sheet Financial Metrics

From the information shown in a company's balance sheet, we can calculate important metrics that can help us assess its financial health. One of these metrics is the *Current Ratio*, calculated as Current Assets divided by Current Liabilities.

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The *Current Ratio* is a quick indication of the *liquidity* of the company at a given point in time as it measures whether the company could get enough cash within a year to pay for long term liabilities.

A Current Ratio that's lower than one indicates that the company could run out of cash to cover its obligations within the next 12 months, and for many its optimal value is somewhere between 1.2 and 2.0 but it varies across industries and companies. Nevertheless, this metric only provides a quick indication of liquidity and should not replace a more thorough analysis if evaluating a company's real ability to pay its bills.

A more conservative measure of the company liquidity is the *Quick Ratio*, which subtracts *Inventory* from the *Current Ratio* calculation:

$$\text{Quick ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

The Quick Ratio may be a better indicator for some companies who may not be able to realize the full value of their inventory within the short term.

Another important metric that can be calculated from a company's Balance Sheet is its *Working Capital*, or the amount of money it needs to finance its operation in the short term. It is calculated as the difference between *Current Assets* and *Current Liabilities*.

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

A low or positive Working Capital is usually preferable, but just like most metrics it varies across industries and the particular preferences of a company.

As you may guess, Working Capital is directly influenced by the payment terms negotiated with vendors and buyers, where the sooner we get money from buyers and the later we pay vendors the less money we need in the form of Working Capital to finance operations.

One company that created a whole business model by challenging the way Working Capital was used in its industry was Dell Computers. When it first came out with its *build-on-demand* business model, where customers would pay for computers *before* they were made, it put Dell in a favorable position against its competitors who had to spend a lot in Working Capital to make their computers that would later be placed on the shelves of their distribution channels.

Under that model, manufacturers wouldn't get their money back until 30 or even 90 days after the computers were sold to *final customers*, which meant they had to finance the whole operation during the time it took to manufacture, distribute and sell the computers.

But by getting the money *before* the computers were made and the parts ordered, Dell flipped the conventional use of Working Capital from negative to positive, providing the company with a strong financial advantage to quickly grow and expand its operations.

As you may have noticed, the formula used to calculate Working Capital is similar to how we calculated the Current Ratio in that they both use Current Assets and Current Liabilities. For that reason, the *Current Ratio* is also commonly referred to as the *Working Capital* Ratio.

Finally, one of the most utilized balance sheet metrics is the Debt-to-Equity ratio, which compares a company's Total Liabilities to Shareholder's Equity to measure how much of the value that the owners have invested in the company is being financed by vendors, lenders and creditors.

$$\frac{\text{Debt}}{\text{Equity}} = \frac{\text{Total Liabilities}}{\text{Shareholders' Equity}}$$

Although a low debt-to-equity ratio may be preferable, it may flag an inefficient capital allocation practice.

The Income Statement: Where profitability comes from

In a nutshell, the Income Statement estimates the *profit* that a business makes during a particular period. It provides a summary of the business's revenues and its costs, breaking these down into those related to the actual goods sold and the costs related to running the business.

An Income Statement calculates three types of profit:

1. **Gross Profit:** This represents the gross margin made by the business from selling its products and services. It is calculated as the different between sales (revenues) and the cost of the goods or services being sold (also known as COGS for *Cost of Goods Sold*).

2. **Operating Profit:** Also known as EBIT (*Earnings Before Interests and Taxes*), this is calculated as Gross Profit minus *operating expenses*, which is a major category including all direct and indirect *Selling, General and Administrative* expenses or SG&A (some people call it *overhead*), amortization and depreciation.

3. **Net Profit (also known as "Net Earnings"):** This is what is left after taxes, interest expenses and one-time charges are deducted from the Operating Profit (EBIT). This is the "bottom line" of the income statement and is used to calculate key company metrics such as *Price to Earnings* (P/E) and *Earnings per Share* (EPS) which we explore later in this appendix.

Through the Income Statement we can measure the *profitability* of a business unit or product division. *Gross Profit* for example measures the margins that the business makes from selling its products, while Operating Profit measures how much the company earns from running the *business*.

In the same way, we can also argue that since *Net Earnings* account for taxes and interest payments they are a measure of the *financial management* of the business. This financial management is super important when it comes to business because taxes and debt, if not optimized, can become a burden to growth.

When Toys R Us filed for bankruptcy in September 2017, it disclosed that the company had around $5 billion in debt and was spending somewhere around $400 million a year servicing that debt, which prevented the company from investing in innovation and the improvement of their facilities.

We must sometimes go an extra mile in order to optimize these costs. One of the reasons Amazon located its headquarters in Seattle was that because of the relatively low population it would only have to collect taxes from a minor percentage of customers (as merchants in the US are not required to collect taxes from out-of-state sales).

For illustration purposes, the next figure shows a simplified version of Amazon's Income Statement for the year ending December 31st, 2017.

Amazon Income Statement (Simplified)

Period Ending	12/31/17	12/31/16
Total Revenues	US$177.866	US$135.987
Cost of Revenue	(US$111.934	(US$88.265)
Gross Profit	US$65.932	US$47.722
SG&A	(US$61.826)	(US$43.536)
Operating Profit	US$4.106	US$4.186
Interest Expense	(US$848)	(US$484)
Income tax	(US$769)	(US$1.425)
One-time Income/expenses	US$548	US$190
Earnings/Loss from subsidiaries	(US$4)	(US$96)
Net Income	US$3.033	US$2.371

Simplified Amazon income statement (numbers in millions)

Important Income Statement Metrics

The income statement provides a lot of insights into the profitability of a business unit or organization, and there are a few metrics that we can calculate from it that can help us extract even more useful information.

One of these metrics is Gross Margin, which calculates the percentage of sales that is retained in the form of profit from the sales of products and services.

$$\text{Gross Margin} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

A similarly important metric is the Operating Margin, which calculates the profit that a company makes from running the business measured as a percentage of sales.

$$\text{Operating Margin} = \frac{\text{Operating Income}}{\text{Net Sales}}$$

Following the same approach, we can also calculate the *Profit Margin* ratio, to measure the percentage of sales that the business is producing after accounting for interests, taxes and one-time charges.

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

We could argue that the difference between the Operating Margin and the Profit Margin has a lot to do with the *financial* management of the business and how well this is optimized to minimize the impact of taxes and debt in the value created for shareholders.

From a company's income statement we can also calculate the business's EBITDA (*Earnings Before Interests, Taxes, Depreciation and Amortization*), a non-GAAP investors' favorite metric that provides a general view of the performance of the *business* by itself, before accounting for its financing.

The formula to calculate EBITDA from an income statement is fairly simple:

$$\text{EBITDA} = \text{Net Income} + \text{Depreciation} + \text{Amortization} + \text{Interests}$$

As you can see, a company's EBITDA adjusts Net Income for non-cash expenses such as depreciation and amortization, and for other expenses related to how the business finances its operations (by adding back interests and taxes), making the metric neutral in terms of capital structure choices.

Finally, two metrics that are very popular among investors in public companies are the *Earnings Per Share* and *Price to Earnings* ratios.

Earnings per Share (EPS) measures the amount of money that each shareholder would receive if the company paid all of its earnings during a given period as dividends and is calculated as the Net Income minus preferred dividends divided by the number of outstanding shares of the company.

$$\text{EPS} = \frac{\text{Net Income} - \text{Preferred Dividents}}{\text{Number of Outstanding Shares}}$$

Preferred dividends are a special type of stock which grants dividend rights for the holders, so to measure the earnings that would be available to *common* shareholders, they must be subtracted from the total Net Income.

The *Price-to-Earnings* or P/E ratio on the other hand calculates the relative value of a company stock at a given point in time, with respect to its EPS. This ratio is also commonly known as the price or earnings “multiple”. As you may expect, the P/E ratio is calculated by dividing the stock price by the company’s EPS.

$$\frac{P}{E} = \frac{\text{Market Value per Share}}{\text{Earnings per Share}}$$

Both EPS and P/E are used by investors and market analysts to assess the value of a stock, as they benchmark the ability of a business to produce earnings with the price of its stock at a given time.

Cash Flow: The “real” reality check

The Cash Flow Statement has been part of the official financial reports that public corporations must make available since 1987. In short, a cash flow statement summarizes a company’s inflows and outflows of cash during a given period, so in a sense, when you look at it you’re basically taking a peek at the company’s bank accounts.

A cash flow statement is different from the income statement in that it only accounts for *cash* transactions, so credit or non-cash expenses such as depreciation and amortization are not accounted for.

A cash flow statement is broken down into three sections in the following order: *Cash Flow from Operations*, *Cash Flow from Investment Activities* and *Cash Flow from Financing Activities*.

The first part of the statement, *Cash Flow from Operating Activities*, includes the cash the business received from customers or any other sources, and the cash *payments* the business made during that period.

There are two ways to calculate cash flows from operating activities. A *direct* approach records all major cash transactions, both in and out of the business, such as cash sales, debt collections, and cash spent paying vendors, payroll, utilities, rent and others during the period.

An *indirect* approach begins with the bottom line of the income statement (*Net Earnings*) and adds and subtracts differences in key accounts such as accounts receivable, inventory and accounts payable, and in non-cash transactions like depreciation and amortization, to reflect the real movement of money.

Most publicly listed companies prefer to use the indirect approach to report their cash flow statements.

A healthy operating cash flow means that the company can finance its growth with minimum or no need for loans and cash injections. Remember how "*low capital needs*" is one of the metrics that Warren Buffett likes to see when looking at a company, and this can be measured from the operating cash flow.

The second part of statement, *Cash Flow from Investment Activities,* reports all the cash investments made by the company during the reporting period, including any purchases and sales of equipment, land or financial securities.

A company with a low balance of investment activities relative to similar peers suggests that management might not be re-investing enough in the future of the company. They might be either struggling to find growth opportunities, or just "milking it while it lasts" which is typical in declining industries. In a growing industry, however, this number usually needs to be high and growing (see Amazon's simplified cash flow statement at the end of this section).

Finally, the third section of a cash flow statement, *Cash Flow from Financing Activities*, includes cash that moves in and out of the business in relation to debt, loans and transactions with shareholders such as dividend payouts.

We mentioned in Chapter 8 that good capital allocators use debt strategically (for example to finance opportunistic acquisitions and share repurchases), avoid paying dividends and decrease the number of outstanding shares over time through opportunistic buybacks, activities that are reflected in this section of the cash flow statement.

As an example, the figure below shows Amazon's simplified cash flow statement for the period ending December 31st, 2017.

Amazon Cash Flow Statement (simplified)		
Period Ending	12/31/17	12/31/16
Net Income	US$3.033	US$2.371
Depreciation	11.478	8.116
Other Adjustments	4.096	2.869
Accounts Receivable	(4.786)	(3.367)
Changes in inventory	(3.583)	(1.426)
Liabilities	8.196	8.709
Net Cash from Operations	18.434	17.272
Capital Expenditures	(11.955)	(7.804)
Investments	(3.789)	(3.023)
Other Investment Activities	(12.075)	951
Net Cash from investments	(27.819)	(9.876)
Net borrowings	9.860	(3.740)
Net cash Flow - Financing	9.860	(3.740)
Effects of exchange rate	713	(212)
Net cash flow	1.188	3.444

Simplified Amazon cash flow statement (numbers in millions)

Popular Cash Flow Metrics

Just as with the other statements, the statement of Cash Flows can produce powerful indicators to help us understand the real financial health of a business unit.

One metric that has become increasingly popular with Wall Street analysts is *Free Cash Flow* or FCF, which measures the cash a company is able to generate after accounting for all capital expenses needed to maintain its asset base.[66]

FCF can be calculated from the cash flow statement by subtracting capital expenditures (also known as CAPEX) from the company's operations cash flow.

FCF = Cash Flow From Operations – Capital Expenditures

A longer version would work its way from the Operating Profit (EBIT) in the Income Statement and make the proper adjustments to correct for cash and non-cash transactions, for example:

Operating Profit × (1 – Tax rate)
+ Depreciation
+ Amortization
– Change in working capital
– Capital expenditure

= Free Cash Flow or FCF

For analysts, FCF represents the cash that a company can use to enhance shareholder value and is used to provide a measure of the true profitability of a business. In the end, you can't pay your bills with *Net Earnings*.

Another popular ratio when it comes to cash flows is the *Operating Cash Flow to Sales* or *CFO/Sales* which measures the ability of a business to convert sales into *cash*.

$$\frac{\text{CFO}}{\text{Sales}} = \frac{\text{Cash Flow From Operations}}{\text{Net Sales}}$$

An obviously important ratio that can be calculated from the cash flow statement is the *Free Cash Flow to Operating Cash Flow* which measures the amount of free cash that the business produces that could be used to boost its own growth.

$$\frac{\text{FCF}}{\text{CFO}} = \frac{\text{Free Cash Flow}}{\text{Cash Flow From Operations}}$$

These are both important indicators not only from an investor's point of view to value the stock, but also for the management of the company since cash is in the end what makes everything else possible.

Crossed Financial Metrics

Let's review a few important financial metrics that use information from more than one statement.

Let's start with *Coverage Ratios*, which measure the ability to serve debt and other liabilities with the cash the business produces. The two most used are the *Current Liability* and *Long-term Debt* coverage ratios.

To calculate the Current Liability Coverage Ratio, we divide the cash flow from operations by Current Liabilities.

$$\text{Current Liability Coverage Ratio} = \frac{\text{Cash Flow From Operations}}{\text{Current Liabilities}}$$

Alternatively, you could use only short-term debt as the denominator to get a measure of the business's ability to pay its debt within the next year.

$$\text{Short Term Debt Coverage Ratio} = \frac{\text{Cash Flow From Operations}}{\text{Short Term Debt}}$$

Similarly, to calculate the Long-term Debt Coverage Ratio, we divide our Cash Flow from Operations by the total Long-term Debt.

$$\text{Long Term Debt Coverage Ratio} = \frac{\text{Cash Flow From Operations}}{\text{Long Term Debt}}$$

To get a measure of how a business manages its assets to produce cash we can calculate the *Asset Efficiency Ratio* as Cash Flow from Operations divided by Total Assets.

$$\text{Asset Efficiency Ratio} = \frac{\text{Cash Flow From Operations}}{\text{Total Assets}}$$

Similarly, we can calculate the *Return on Assets* (ROA) by using Net Earnings instead of Cash Flow From Operations as in the previous formula.

$$\text{ROA} = \frac{\text{Net Earnings}}{\text{Total Assets}}$$

Another metric that is very popular among investors and market analysts is the *Return on Invested Capital* or ROIC which measures the return that investors are making on their investment in the company.

ROIC is best calculated by dividing the *Net Operating Profit After Taxes* (NOPAT) by the *Total Invested Capital*.

$$\text{ROIC} = \frac{\text{NOPAT}}{\text{Invested Capital}}$$

NOPAT is calculated from the income statement by subtracting taxes from the operating income (also known as EBIT):

$$\text{NOPAT} = \text{EBIT} \times (1 - \text{Tax Rate})$$

There are multiple ways to calculate the invested capital from the balance sheet but probably the most direct approach is by subtracting Current Liabilities and Cash from the company's Current Assets, then adding Long-Term or "fixed" assets:

Current Assets
– Current Liabilities
– Cash
+ Fixed (Long-term) Assets

= Total Invested Capital

Finally, let's review a business metric that can tell us a lot about a business's operations: the *Cash Conversion Cycle* or CCC. In short, CCC measures the amount of time it takes a company to convert its investment in raw materials into cash. In essence, the CCC can be calculated as the sum of the days to convert raw materials into *sales* plus the number of days it takes customers to pay, minus the number of days that the business gets from vendors to pay for raw materials.

CCC is most well known by its formula:

$$CCC = DIO + DSO - DPO$$

Where,

DIO = Days Inventory Outstanding
DSO = Days Sales Outstanding
DPO = Days Payable Outstanding

For example, if we say that on average it takes the company 15 days to convert raw materials into sales, and that vendors require payment within 30 days after delivery of raw materials while customers have 60 days to pay for final products, then the CCC can be calculated as:

$$CCC = 15 + 60 – 30 = 45 \text{ days}$$

That is the number of days that this operation must finance its operations. In other words, the company has to pay vendors for raw materials *45 days before* it receives the money from the products made with those raw materials.

If the company makes $10 million a year in sales, which on average means sales of around $27,000 per day, it means that the business would need around $1.2 million (or 12 percent of sales) in working capital to finance customers.

When information about *Days Inventory Outstanding* (DIO), *Days Sales Outstanding* (DSO) and *Days Payable Outstanding* (DPO) as these metrics are formally known is not available, they can be approximated from the information in the business's financial statements.

To estimate DIO (inventory), we can take the *average inventory* from the balance sheet and divide by the *average cost of goods sold* (COGS) per day which can be obtained from the income statement.

$$\text{DIO} = \frac{\text{Average Inventory}}{\text{COGS per Day}}$$

To calculate the DSO (Days Sales Outstanding), we can use the average Accounts Receivable from the balance sheet and divide by the average sales per day (which are obtained from the Income Statement).

$$\text{DSO} = \frac{\text{Average Accounts Receivable}}{\text{Revenue per Day}}$$

Following a very similar approach we can calculate the DPO as:

$$\text{DPO} = \frac{\text{Average Accounts Payable}}{\text{COGS per Day}}$$

A higher CCC means that a larger amount of money will be trapped in the business financing customers, while a negative CCC means that the business holds onto customer cash before serving the products, which in a way is like saying that customers are financing other customers.

Time Value of Money

A final concept we want to briefly refresh here is the Time Value of Money, the idea that one dollar today is worth more than a dollar tomorrow, and that consequently one dollar tomorrow is worth less than a dollar today.

To understand how this works, let's assume that you make an investment today that yields a certain percentage return rate "*r*" per year. At the end of the first year, that investment would have gained some interest, and it would be worth:

$$I_1 = I_0 \times (1 + r)$$

Where 0 and 1 represent the beginning and the end of the investment period respectively. That means that the investment at the end of the period (I_1) is higher than the initial investment (I_0) by a factor of $(1 + r)$.

If we leave the money in that investment for another period, the money will gain interest again and now the amount of money at the end of the second period will be:

$I_2 = I_0 \times (1 + r) \times (1 + r)$, which can also be represented as $I_2 = I_0 \times (1 + r)^2$

Following the same logic, we can then say that the value of the investment at the end of any period n in the future, can be calculated as:

$$I_n = I_0 \times (1 + r)^n$$

I_n is what in finance we call the *Future Value* of I_0 and is the basis of many interest-based investment calculations. From the same formula, we can deduce that the *Present Value* I_0 of a given amount of money in the future I_n is then:

$$I_0 = \frac{I_n}{(1 + r)^n}$$

That's how financial analysts calculate how much a given cash flow in the future is worth in today's money. For example, an investment that produces cash flow for three years in the future can be calculated on today's basis as:

$$I_0 = \frac{I_1}{(1 + r)} + \frac{I_2}{(1 + r)^2} + \frac{I_3}{(1 + r)^3}$$

Where I_1, I_2 and I_3 represent the cash flow generated by an investment during periods 1, 2 and 3 respectively.

The factor $(1 + r)^n$ is the basis of introducing Time Value of Money into any financial calculation, and is used several times in this appendix.

Evaluating investment decisions

When evaluating capital allocation decisions, the decisive factor is the *Return on Investment* also known as ROI. In practice, there are multiple ways to calculate the ROI of new projects but the most widely used is a combination of *Net Present Value*, *Internal Rate of Return* and *Payback*.

Each one provides a unique view of returns that can be used to determine overall financial feasibility, but none is by itself a replacement for the other two.

The Net Present Value (NPV) of an investment calculates how much the future cash flow produced by an investment is worth *today*, and discounts from that value the investment itself, hence the word *Net* in NPV. In other words, the NPV is the cash *excess* or *deficit* measured in today's money that a project creates after paying off all of the costs associated with it, including its initial investments, and after yielding investors their expected rate of return.

A positive NPV means that the value of the projected cash flow exceeds the anticipated costs and expected returns in terms of today's money, therefore it indicates a feasible investment. A negative NPV on the other hand measures the cash *loss* that the project would produce to investors (again, in terms of *today's* money), indicating that the investment is not financially feasible.

As with any other financial indicator, the accuracy of the NPV is only as good as the information used to estimate the project's cash flows, but the metric is a good indication of the net *volume* of money created by an investment based on the information available at the time.

As implied above, the NPV is also affected by the *return* required by investors, also known as the discount or "hurdle" rate *r* in the Time Value of Money formula that we reviewed earlier.

Because the NPV measures the *leftover* cash after paying off initial investments and returning investors their desired rate of return, the higher the rate that investors demand the lower the NPV (the leftover) will be. If you increase the hurdle rate enough you will get to an inflection point where the NPV becomes negative, indicating that the project will no longer produce what investors require.

The hurdle rate *exactly* at the inflection point is the *Internal Rate of Return* of the investment, or IRR. Unlike the NPV, the Internal Rate of Return provides a *percentage* metric of returns. It is the hurdle rate that makes the NPV zero.

In a nutshell, the IRR tells investors how much they would have to increase their desired return rate before the project becomes unprofitable, meaning that the higher the IRR the more attractive an investment is for investors.

Our final metric, the Payback period, is different to both the NPV and the IRR in that it only measures the time that it would take investors to get their money back. In its most popular version, the Payback time is calculated by determining how many periods of free cash flow are needed to accumulate enough cash to pay the original investment back.

For example, an investment of $2.5 million that produces $500,000 a year in free cash flow will have a 5-year *simple* Payback period. That calculation however, although frequently used among investors, does not take into account the Time Value of Money.

A time-adjusted version (which is the one I use and recommend) considers the Time Value of Money formula to calculate the Payback period in terms of today's money.

That of course increases the Payback period but is a more precise calculation as it takes into consideration the "opportunity costs" of the investment.

In either case however the Payback period should never be used in isolation to make investment decisions as it doesn't provide any indication of critical investment parameters such as return rate and the ability to create cash. With that being said, NPV, IRR and Payback are best used in combination to evaluate a potential investment, since *together* they produce a more rounded view of the quality of the investment and its return to investors.

Success in the evaluation of capital allocation decisions is due in part to a good understanding of how these return metrics work, what they mean and their limitations. The rest relies on the shoulders of the evaluators, who must ensure that the information used to make these estimates presents a good representation of what could actually happen.

Even the best metrics can't be accurate if the projections are wrong, or if the project is not properly structured. To use a principle from computing science: "*Garbage in, garbage out*".

Using Enterprise Value (EV) for a Comparable Company Analysis (Comps)

In Chapter 8 we explained that there is a preference around the use of "multiples" to evaluate entrepreneurial companies by relating them to a group of similar publicly-traded companies. In short, the methodology looks to calculate a few specific financial parameters in comparable *public* companies that investors can use as *proxies* to estimate the value of private ones.

In a nutshell, this method, which many refer to as *Comparable Company Analysis* or "comps" is based on the assumption that similar businesses of about the same size within the same industry will have similar valuation *multiples*.[67]

To start, evaluators must define a *peer group* that will serve as a reference for the analysis, which consists of a sample of companies they consider to have similarities with the private company.

The sample will normally include companies of similar size, operating in the same industry and when relevant, within the same geography as the target.

The next step is to calculate the factors that will be used to compare the companies. One of the most commonly used methodologies uses ratios that take into account the *Enterprise Value* (EV) of the companies, since its calculation is usually very straightforward for both private and public companies.

The EV is a metric that estimates the purchase price of an organization and provides a more comprehensive view on what a company is worth to an investor than market capitalization or other metrics.

To calculate the EV of publicly traded companies, we start with the company's market capitalization at the moment of evaluation, then add and subtract some items to reflect the true value that an investor would have to pay for the company.

Market Capitalization
+ Preferred Equity (Market Value)
+ Minority Interests (Market Value)
+ Debt
– Cash
– Short-term Investment

= Enterprise Value (EV)

The easiest way to calculate the EV for a private company (which in this case is an entrepreneurial company) is through the present value (PV) of the company's projected financials. These financials represent our view (not necessarily the company's) of the company's future performance.

The general formula to calculate the EV of a private company is through the sum of the present value of the company's cash flows over a given period, normally three to five years, plus what is called the *Terminal Value* (TV) of the company, which is an indication of the cash flows the company generates beyond the evaluation period.

$$EV = PV(CF_{1-n}) + TV_n$$

Terminal Value is usually calculated as the present value of a "perpetual" annuity that grows at certain rate, based on the company's sales forecast.

Besides the estimation of the actual cash flows that we expect the target company to produce, there are two variables we need to pay close attention to when calculating EV: the discount rate by which we will discount its cash flows, and the growth rate at which we consider its sales will grow.

These two numbers have critical implications for the final valuation and investment decision. The peer group that we compare the target company against is also of great importance as it sets the reference for the benchmark.

The EV is used to calculate the ratios with which we will determine whether the pre-money valuation (before we invest) is appropriate, with respect to what we see in the market. The most used ratios are *EV/Sales*, *EV/EBITDA* and *EV/EBIT*.

If we know for example, that similar *public* companies trade at an *EV to Sales* of three to four, we would expect the valuation of the *private* target to be within that range. If not, there have to be clear, provable reasons that explain the difference.

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How to access the online glossary

To ensure that you always get access to an updated list of terms, ideas and concepts related to the content of this book, we have created a virtual glossary and made it available on our website at: strategyforexecs.com/glossary.

About Sun Wu

I have been practicing strategy as part of my day to day work for the best part of the last 15 years, during which I've had enough time to play around with different ideas and depurate my understanding of the subject.

With my previous employer, a Fortune 200 company where I spent almost 15 years, I was lucky enough to play a central part in the creation of a number of business units and innovative technology platforms. As part of that role, I led the development and construction of the world's first large-scale advanced-battery project almost a decade before Tesla and others entered the space.

In that regard, we were the pioneers of a new industry and always thought strategically about how we would develop and promote our products and services to customers.

At the time I left the company, I was overseeing a large region with five countries under my supervision.

I moved on and nowadays I'm the head of business development for a Fortune 500 company where my job is almost entirely dedicated to finding companies and projects to invest in. It is a smaller company, but still a big one, and I believe here I have a better chance of reaching the top seat.

I decided to write this book under a pen name to avoid potential conflicts among my executive peers.[68] I believe that the power of the ideas in this book should be enough to make an impact on my career, and that I shouldn't need the branding that comes from being known as its writer to move up the ladder.

In that sense, I will experience the implementation of these ideas, and the pushbacks that will naturally come with them, in the same way that you will.

I get a lot of requests to attend conferences and business events to talk about strategy, but because of my current duties I can barely make time for them.

However, I do deliver somewhere between 5 and 10 in-house workshops on strategy for executives every year for companies in different industries around the world, where I cover the core concepts of the book in a full day session. For companies that are serious about strategy, I think that day-long session is a good investment as it provides the common language the organization needs to understand, develop and communicate a winning strategy.

If you or someone in your organization are interested in scheduling one of these sessions, please get in touch with the support team at support@strategyforexecs.com or download a brochure at strategyforexecs.com/bookings.

Finally, if you have any questions about the content of this book, need some references to explore any of the concepts further, or if you find concepts that should be corrected or integrated in future editions, you may write me directly at sun@strategyforexecs.com.

Sun Wu
Author

Notes

1 My original interest in this field took me to pick my master's degree in Operations Management, and to get a Diploma in Formulation and Evaluation of Industrial Projects. Latterly, as I took this research more seriously and started to build up this framework, I completed the following programs: Strategy and Innovation Executive Certification with MIT Sloan School of Management, Business Strategy Specialization with Darden School of Business at the University of Virginia, Marketing Strategy Specialization with IE Business School, Financial Management Specialization with University of Illinois at Urbana-Champaign and Artificial Intelligence: Implications for Business Strategy Executive Program with the MIT Sloan School of Management.

2 Obviously a friendlier version of the word "multidexterous".

3 For more information about these views, see Rita McGrath's works, including: McGrath, Rita Gunther. *The End of Competitive Advantage: How to Keep Your Strategy Moving as Fast as Your Business*. Harvard Business Review Press. Kindle Edition.

4 Michael Porter made clear that it is "the threat" of other companies entering the market that keeps prices low, not whether those companies actually enter the market.

5 For more information about this type of perception map, see: https://hbr.org/2015/06/a-better-way-to-map-brand-strategy

6 Despite the title of Michael Porter's seminal book on the subject *Competitive Strategy*, fifteen out of its sixteen chapters are about "industries", not businesses. Chapter 2, "Generic Competitive Strategies", the only chapter that covers strategy, was written last and almost by chance, after Porter had completed the rest of the book, which features a comprehensive work on market forces and industry analysis. Close to the last moment, Porter admits, he realized that he "*needed to say something about positioning, about how a company should seek to locate itself within an industry, given the array of those forces*", and that's how that chapter came to be. So our first modern book on strategy almost didn't say anything about how to create a "business" strategy and taught a lot of "industry analysis" as strategy, which in my opinion caused much of the confusion around the subject. For more information about this story, check: Kiechel, Walter. *Lords of Strategy: The Secret Intellectual History of the New Corporate World.* Harvard Business Review Press. Kindle Edition.

7 To learn more about this negotiation approach, check: Lax, David A; Sebenius, James K. *3-D Negotiation: Powerful Tools to Change the Game in Your Most Important Deals*. Harvard Business Review Press. Kindle Edition.

8 For a detailed analysis of this commoditization model, see: Christensen, Clayton M.; Anthony, Scott D.; Roth, Erik A. *Seeing What's Next: Using the Theories of Innovation to Predict Industry Change*. Harvard Business Review Press. Kindle Edition.

9 Adapted from: Hooley, Graham; Piercy, Nigel; Nicoulaud, Brigitte; Rudd, John M. *Marketing Strategy and Competitive Positioning*. 6th edition (Jan 2018). Pearson.

10 Adapted from: https://hbr.org/2015/10/a-simple-graph-explains-the-complex-logic-of-the-big-beer-merger

11 For the sake of transparency, I'm the one proposing that.

12 See original patent for Amazon's recommender system at: https://patents.google.com/patent/US7113917B2/en

13 See an explanation of Netflix's multiple algorithms at: https://dl.acm.org/citation.cfm?id=2843948

14 To learn more about these authors' opinions on the subject see: McGrath, Rita Gunther. *The End of Competitive Advantage: How to Keep Your Strategy Moving as Fast as Your Business*. Harvard Business Review

Press. Kindle Edition, and Christensen, Clayton M. *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail* (Management of Innovation and Change). Harvard Business Review Press. Kindle Edition.

15 To learn more about these frameworks, see the "Value Chain Evolution" (VCE) theory in: Christensen, Clayton M.; Anthony, Scott D.; Roth, Erik A. *Seeing What's Next: Using the Theories of Innovation to Predict Industry Change*. Harvard Business Review Press. Kindle Edition.

16 To learn more about this story, watch: https://youtu.be/_FGUkxn5kZQ

17 See Amazon's full recommender patent at: https://patents.google.com/patent/US7113917

18 Not surprisingly, the same McKinsey survey also found that at least 70 percent of top performers among a group of 600 had built data analytics capabilities, an insight in line with our earlier conversation. For more information about this survey see: http://www.mckinsey.com/business-functions/marketing-and-sales/our-insights/invest-create-perform

19 For a more detailed analysis of the growth gap calculation, see: Anthony, Scott D; Johnson, Mark W.; Sinfield, Joseph V.; Altman, Elizabeth J. *The Innovator's Guide to Growth: Putting Disruptive Innovation to Work*. Harvard Business Review Press. Kindle Edition.

20 To estimate earnings in a given year, all we need to do is multiply the net earnings of the previous year by $(1+r)$, where r is the expected growth rate.

21 To learn more about BCG's Growth-Share Matrix, visit: https://www.bcg.com/en-us/publications/2014/growth-share-matrix-bcg-classics-revisited.aspx

22 See: https://chapul.com/

23 See: http://iwanttodrawacatforyou.com/

24 See: http://www.uroclub.com/store/index.php

25 See: http://tenthirtyoneproductions.com/

26 See: https://www.breathometer.com/

27 See this one for example: http://www.nielsen.com/us/en/insights/news/2014/how-to-flip-85-misses-to85-hits-lessons-from-the-nielsen-breakthrough-innovation-project.html

28 Christensen does not like calling these innovations "high-end" disruptions, and refers to them as "radical" innovations, but for obvious reasons we disagree.

29 See: https://strategyn.com/tony-ulwick/

30 See: Christensen, Clayton M.; Dillon, Karen; Hall, Taddy; Duncan, David S. *Competing Against Luck: The Story of Innovation and Customer Choice.* HarperCollins. Kindle Edition.

31 This may come as a surprise to you, as it did to me, since most "famous" billionaires come from tech fields and from innovation. But PwC partners John Sviokla and Mitch Cohen extensively researched self-made billionaires in their book *The Self-Billionaire Effect*. Two other points from their research that got my attention are that, despite what we conventionally believe, these self-made billionaires are not huge risk takers, and most of them made their fortune after 40. To see more about this study, check: Sviokla, John; Cohen, Mitch. *The Self-made Billionaire Effect Deluxe: How Extreme Producers Create Massive Value*. Penguin Publishing Group. Kindle Edition.

32 Adapted from: Barnes, Cindy; Blake, Helen; Pinder, David. *Creating and Delivering Your Value Proposition: Managing Customer Experience for Profit*.

33 This definition of robots has been taken from Thomas Malone, Director of MIT Center for Collective Intelligence, "Artificial Intelligence: Implications for Business Strategy" program, Module 4: "Robotics in Business", MIT Management Executive Education

34 See Kiva Systems: youtube.com/watch?v=6KRjuuEVEZs

35 See pizza-making robot: http://fortune.com/2016/09/29/this-robot-made-pizza-is-baked-in-the-van-on-the-way-to-your-front-door/

36 For example, see Modern Meadow: www.modernmeadow.com and Finless Foods: https://www.finlessM foods.com

37 For example, see Prellis Biologics: https://www.prellisbio.com

38 See: https://www.nextbigfuture.com/2018/01/china-built-2000-meter-long-solar-highway-with-transparent-concrete-over-solar-panels.html

39 See: https://www.newscientist.com/article/2101667-blockchain-grid-to-let-neighbours-trade-solar-power-in-australia/
40 See: https://www.forbes.com/sites/laurashin/2017/02/07/the-first-government-to-secure-land-titles-on-the-bitcoin-blockchain-expands-project/#78b7a7da4dcd
41 See: https://www.ethereum.org
42 See: https://righthook.io
43 See: https://improbable.io
44 For a more detailed understanding of platforms, see: Choudary, Sangeet Paul; Parker, Geoffrey G.; Van Alstyne, Marshall W. *Platform Revolution: How Networked Markets Are Transforming the Economy and How to Make Them Work for You*. W. W. Norton Company. Kindle Edition.
45 See: https://cohealo.com
46 To learn more about these approaches, see: Weiblen, Tobias; Chesbrough, Henry W. *Engaging with Startups to Enhance Corporate Innovation*. California Management Review. Vol. 57, No. 2, pp. 66–90. 2015.
47 Outsourcing their website operation to Amazon is the clearest indication of how much they didn't care about its online business and the internet space in general. Many people argue that this move alone actually prevented Borders from becoming a serious competitor in the online retailing market.
48 The phrase "If you don't know where you are going, you'll end up someplace else" is attributed to major league baseball manager Yogi Berra.
49 In a quote attributed to Italian diplomat Daniele Varè "Diplomacy is the art of letting someone else have your way."
50 I've gotten into the habit of mapping stakeholders in every market I work on, and every single time this exercise has provided insights that would otherwise be hidden from me.
51 It'd be too easy to hold it against Enron and say the system was proof of the dog-eat-dog environment that took the company down. But the SAME system was also curiously used effectively by Jack Welch, America's most beloved CEO, and a similar system is currently being used by Amazon. Coincidence?
52 For more about this idea, see: Subramanian, Guhan. *Corporate Governance 2.0*. Harvard Business Review. March 2015.
53 See an expanded list here: https://hbr.org/2015/09/why-and-how-to-build-an-in-house-consulting-team
54 See: http://sgsg.samsung.com/main/newpage.php?f_id=gsg_whyGsg
55 See: http://www-935.ibm.com/services/us/gbs/consulting/careers/mbagrad/
56 See: https://www.db.com/inhouse-consulting/content/en/why_join_db_inhouse_Consulting.html
57 See: https://www.cisco.com/c/en/us/about/corporate-strategy-office/strategy.html
58 See: https://careers.google.com/teams/business-strategy/
59 See: https://www.smc.siemens.de/global/en/home/smc-people.html
60 See: https://www.alphasights.com/
61 See: https://www.guidepoint.com/
62 See: https://glg.it/
63 Excerpts taken from: https://www.forbes.com/sites/ryanmac/2014/09/05/as-alibabas-ipo-approaches-founder-jack-ma-pens-letter-to-potential-investors/#7bdedf52685c
64 Excerpts taken from: https://hbr.org/2013/01/jeff-bezos-on-leading-for-the
65 Source: https://www.nasdaq.com/symbol/amzn/financials
66 See: https://www.investopedia.com/terms/f/freecashflow.asp
67 See: https://www.investopedia.com/terms/c/comparable-company-analysis-cca.asp
68 I chose my pen name to honor one of the first strategists known to humanity.

Now that you've read the book...

Tell us what you think!

Was it what you expected?
Is it applicable to your company?
Is there room for improvement?

Let us know at: contact@strategyforexecs.com

Your feedback goes directly to our staff at Strategy for Executives, and to the author Sun Wu. We read each and every one of your messages.

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