Evolving Business To Create Value

Quality in a service or product is not what you put into it. It is what the client or customer gets out of it.

-Peter Drucker

A business or an enterprise exists to create value. That is the objective of every promoter or management behind starting and running of the enterprise. A management's prime goal is to increase shareholder value by generating returns on investments in excess of the cost of capital. While every management sets course for its business in this direction, it has to evolve a traditional business into a more dynamic, value-creating enterprise. How does a management achieve this complex task? The answer is to migrate from one business category to the next. This effort delves into the topic and discusses three broad business categories a business must evolve through while addressing what it takes to evolve a traditional business into a more dynamic, value creating enterprise.
There are many companies that claim to be customer centric. Many less that truly earn that reputation … Walt Disney, Zappos, Dell, Amazon, just to name a few that we focus upon.

The customer is the priority without hesitation. Because gaining confidence of your customers builds relationships and building relationships with customers gains their trust. Customers select businesses most often through their trust in the business and its people.
There have been instances of some businesses achieving multifold growth in their market capitalization as compared with their competitors, that too over remarkably short periods. These success stories beg an important question: What does it take to successfully evolve a traditional business into a more dynamic, value-creating enterprise?

This journey of an enterprise or business can be understood or explained in four parts :

1. **The economics of value creation** : Creating shareholder value – earning returns on new investments that exceed the cost of capital – remains management's prime goal. Measures like customer satisfaction, manufacturing excellence and employee motivation are means to this end. We emphasize the significance of customer loyalty – a loyal customer base leads to much more value creation than one that churns constantly.

2. **Business category evolution :** We define three business categories – physical, service and knowledge – and show how each has different properties and characteristics. The implications are twofold. First, a company's economic characteristics change as it evolves from one category to the next. Second, the management challenges are different for each category. Both present opportunities and challenges.
3. **The new mindset :** Business category evolution requires a fresh look at some old issues. Companies must be willing to define their businesses differently, treat employees in a new way, and rethink standard investment rules. We find that while most executives intellectually understand business category evolution, their companies are not organizationally prepared for the journey. This preparation is largest challenge facing most senior managers.
4. **Measuring improvement :** We enumerate a number of metrics we look for in judging whether or not a company is successfully transitioning. These include customer satisfaction, customer retention, return on invested capital improvement and accelerating growth.

The Economics of Value Creation

A corporate management team's ultimate goal is to maximize long-term shareholder value. In the context, customer satisfaction, manufacturing excellence, and employee motivation are a means to an end. These metrics are important in driving value, yet they are not sufficient in and of themselves. Notwithstanding all of the talk of "new" valuation paradigms, we believe that the fundamentals of value and value creation are unchanged. Value for any financial asset equals the present value of future free cash flows. Free cash flow is the difference between a company's inflows (sales) and its outflows (operating expenses and investments). It does not matter what accounting standards a company chooses: cash is cash.

Value creation occurs when a company earns a return above the cost of capital on its new investments. These investments may be balance sheet related (working capital growth or capital expenditures) or income statement related (research and development, marketing).

One of the keys to business model evolution is an ability to "scale" a business model, or the capacity to grow sales at a faster rate than costs. When a business model scales, free cash

flow expands sharply. We find that there are several important ideas that underlie this strong free cash flow growth:

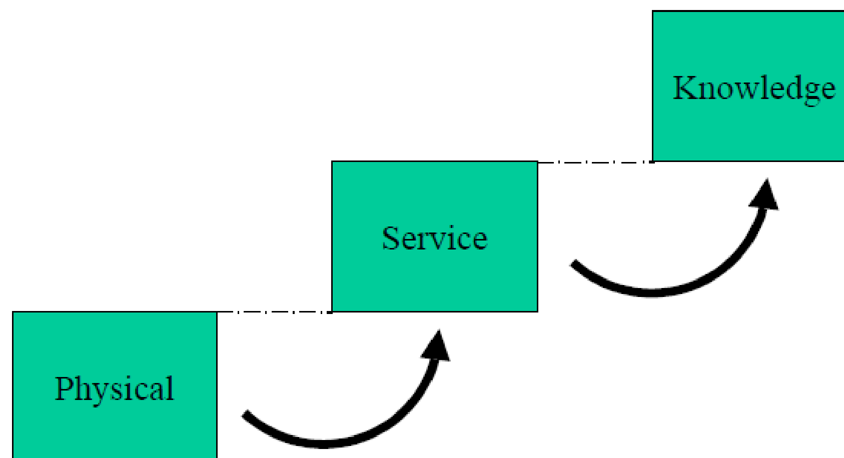
- It is important to seek opportunities to accelerate top-line growth. We find that companies that successfully transition their models often redefine the market opportunity.
- Scalability is closely linked to a company's business category. Knowledge based businesses are the most scalable.
- Scalability does not come without a cost. The management skills required to build and sustain a scalable model are much different from the skills required to manage a more traditional, manufacturing-based business. More specifically, the focus must shift away from managing assets to managing people. Further, cost cutting is rarely the path to long-term riches, although cost management is vital.

Another central dimension of value creation is the sustainability of competitive advantage. We call this "competitive advantage period", or CAP, and define it more formally as the period of time a company can generate excess returns on their new investments. CAP expands when companies build information-based networks, which become more-and-more valuable as more-and-more people use it. One common theme found with companies that successfully transition their business models is a relentless focus on the customer or, more accurately, customer solutions. Providing customer solutions almost always leads to enhanced customer loyalty. The Loyalty Effect, a book by Frederick Reichheld, lays out a powerful framework for thinking through how and why customer loyalty leads directly to higher shareholder value. Reichheld estimates that a 500 basis point increase in customer retention leads to a near doubling of customer net present values.

Business Category Evolution

We now turn to the crux of the analysis, business category evolution. The point of this discussion is straightforward and very relevant for investors: each business category has different characteristics and managers require different skills to operate in each of them. These categories are by no means all encompassing, and all companies have dimensions of each. But the categories provide a powerful way to think about various business activities. We define the categories as follows :

- **Physical:** Tangible assets – manufacturing facilities, stores, inventory – are the prime source of competitive advantage for these businesses. Sales growth is tied closely to asset growth.
- **Service:** People are the main source of competitive advantage for service businesses. Services are generally delivered on a one-to-one basis. So sales growth relies on employee growth and productivity.
- **Knowledge:** Knowledge businesses also rely on people as the main source of competitive advantage. But unlike service businesses, knowledge companies generally create intellectual content once, and replicate it over and over. This severs the link between sales and costs and creates potential for a business model to scale.



Let us now see how these categories differ :

- **Source of advantage:** While physical companies depend on tangible assets, both service and knowledge businesses rely on people. So as a business makes a transition from physical, it must be able to manage both physical and human capital.
- **Investment trigger**: Physical and service businesses typically invest back into their business in order to add capacity. Growth is tied to capacity. For example, a physical business like a retail store must build new stores to generate ongoing sales growth. A consulting firm needs new employees to produce additional sales. In contrast, knowledge businesses generally invest as the result of product obsolescence; there are

no effective constraints on selling more of a current product. Yet the rate of change for knowledge industries is high, and there is little or no "residual" value for an outmoded knowledge product. Software is a good example. If a company produces a hot selling program, it only needs to print new disks to satiate demand. But once a better product is out, the old one has little or no value. An established user base mitigates the downside of obsolescence.

- **Scale economies:** Physical and service businesses do benefit from scale economies. Importantly, however, these economies are generally supply side driven. Once the growth inputs are tapped out (i.e. capital or labor productivity is at its peak), a company has to acquire new resources to grow. In contrast, scale economies are often demand-side driven for knowledge businesses. This demand-side function is generally the result of network effects. Network effects exist when the value of a good or service increases as more people use that good or service. Once established, the network becomes dominant. The network helps turn customers into a huge asset.
- **Accounting treatment:** Physical companies capitalize their investments, including inventory, factories, and warehouses. Service and knowledge companies, in contrast, expense most of their investments, like research and development, training and employee compensation. The result is that it is potentially very misleading to compare the earnings of the various business categories, because earnings give a potentially distorted view of cash flow.

We can now describe the value-creating path for a traditional manufacturing business: evolve up the business category scale. Take the example of a Medical Services company whose products include X-ray, CT-scan and MRI equipment. How does this company harness the business category evolution in order to create shareholder value. Here is the path :

- **Physical**: The company starts with world-class products. In this phase, the company improves its market share through the physical products. This market share gain is both the source, and contribution, to a virtuous cycle; more scale means higher investment spending, more market share, more scale, more investment spending, etc.
- **Service:** The company views its role as providing solutions to its customers. And since only a fraction of a health-care provider's budget is hardware, broadening the company's focus beyond products to services opens up huge market opportunities. For example, only about 10% of a radiology department's budget goes to capital

equipment, with the other 90% going to operating expenses – the radiologist, technician and consumables. The company not only does multi-vendor service, it extends its operational quality practice for the benefit of its customers.

- **Knowledge:** The company uses its large user base to leverage into the knowledge category. One example is development and distribution of customer-oriented software. This business category is tremendously scalable; as the company adds new customers, it spreads its development costs over a larger base while its incremental replication and distribution costs are basically nil. This is a key way the company taps network effects. When the company tries to lure a new customer, it isn't its hardware versus its competitor's hardware, it's its network versus the competitor's network. And the larger and better the company gets, the more reason customers have to do business with them.

The New Mindset

The prospects of business category evolution are certainly exciting, but very few companies have been able to embark on the journey. The primary barrier is organizational structure. Most large corporations have long histories, substantial pride, and stacks of established procedures. But business category evolution requires a new mindset in at least three key areas – business definition, employee relations and standard investment rules.

Define Business Differently

Before embracing the benefits of category evolution, a company must be willing to define its business in a fundamentally different way. Here are some examples of these mental shifts:

- **From product-centric to service-centric:** Many manufacturing and resource companies grew up with the attitude that if they created a superior product, everything else would take care of itself. What companies realize today is that customers do not just want products, they want solutions. And often providing solutions means evolving into service businesses.
- **From asset-centric to knowledge-centric:** For decades, a world-class manufacturing facility was a badge of honor. And having great manufacturing is still critical today. But it is not enough. Companies must realize that the primary source

of value creation is shifting from asset based to knowledge based – or more accurately a balance between the two. A shift away from an asset-centric view sets off a focus on the economics of knowledge goods. Management's focus on optimization becomes balanced with a focus on adaptation. This requires mental agility.

- **From radial to interactive networks:** In a radial network, a central hub, reaches out to a number of nodes. Network effects exist, but they are muted: one customer doesn't really care if another customer is using the product or service. In an interactive network, the nodes get to communicate with one another, and the more the participants, the more valuable the service. Building interactive networks requires a different mindset, but allows for demand-side driven growth.

Treat Employees Differently

Think of an old-fashioned production line – one hand could be easily swapped for another and show would go on. The world today is fundamentally different, as people have become the core of value creation process. Managers can no longer dictate narrow procedures and policies because they no longer understand the whole system. So they must identify the major initiatives, and let the employees figure out how to best implement them. Here are some pointers to the new mindset relative to employees :

- **Decentralize decision-making:** The idea is that too much determinism and command-and-control creates rigidity in a system, so that when circumstances change, the system collapses. Not enough structure and the system is not cohesive, it's too disorganized to get anything done effectively. The way to achieve the right balance is to set forth some strong decision rules (eg. act with integrity, work hard, customer focus, profitability, etc.) and let individuals work collectively to achieve its goals. So employees must be "empowered" to create value within the band of the decision rules.
- **Increase diversity:** Its is important to have a diversity of ideas, no matter where they come from.

- **Raise the bar:** Bright, talented employees look for a challenge. The degree to which a company is willing to provide an open internal market, where there is a match between best and brightest employees and the most exciting opportunities, is important.
- **Reward the stars, prune the underperformers:** Just as it is critical to develop and reward star employees, it is necessary to crop the underperformers.

Rethink Standard Investment Rules

We are big believers in the importance of adhering to sound finance principles. Yet a new mindset requires looking beyond standard net present value calculations in order to understand the true value potential (or risk) of various actions. Investing in strategies, not projects; considering real options; not ignoring innovation in assessment are some of the vital attributes a management must adopt.

Measuring Improvement

The final step of the process is to know if a company is on track to successfully evolve from one business category to the next. Here are some metrics which help :

- **Customer satisfaction:** Customers want solutions to their problems, and nothing increases satisfaction like solving problems for them. This is the core idea of business category evolution – companies can create lots of growth and value for themselves if they create growth and value for their customers. But customer satisfaction should not be an end in and of itself. It is a means to an end – sustainable shareholder value creation.
- **Customer retention:** A satisfied customer is loyal, which triggers the value creation.
- **Return on invested capital improvement:** As we noted at the outset, the economics of a company that succeeds in business category evolution often gets progressively more attractive as it goes. Knowledge businesses, which are solidified by service and physical bases, offer sharp increases in ROICs.
- **Accelerating growth:** Combine the step-up in addressable market with the scalability of knowledge businesses, and there is potential for an acceleration in growth rates.

Example of Dell Computers

How does Dell make sure being customer centric is rule 1?

1. Focus on customer needs … not his wallet. If you meet his needs consistently over time, the wallet may even pay a premium. They employ more employees listening and engaging customers on-line than any other company we have come across.
2. Inspire employees … to care about customer service. Then delegate authority to them to act in the best interest of the customer … and train them in making wise decisions.
3. Build customer … confidence, relationships, and trust.
4. Continually look to … gain new customer insights through listening and observing closely. Customer insights are one of their most important assets reflecting their investment in social media.
5. Continuous improvements in all aspects of customer touchpoints … based on these new insights.
6. Establish customer segmentation based on their needs. This permits Dell to target their customer needs and objectives better.
7. View the customer base … as portfolio of customers segments. Understand the needs of each.
8. Never overlook details as 'unimportant'. Quite the opposite is true … the details are where the good insights reside.
9. Always dig deeper into customer understanding and decision making.
10. Validate and continually refine all insights. Gaining good insights is a continuous process.

The organizational challenges of business category evolution are huge. However, when a management decides to do so, it is important to carefully assess own capacity to lead such a transition. There are many examples of large businesses who have successfully made this transition by creating huge value through business category evolution. In fact, a company may actually shrink its share of the addressable market while creating never before growth opportunities.

This paper, thus, identifies factors like customer satisfaction, customer retention, return on invested capital improvement, etc for better share market and importantly to assess its performance in the field of competition.

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