valkre

A Value Based Approach To Management

A Value Based Approach To Management

Customers don't buy products and services. They buy value, the total package of product performance, access, experience, and cost. Enterprises that understand how customers define value across these dimensions consistently achieve superior long-term profitable growth. Unfortunately, many enterprises are not well aligned to understand their customers.

This paper unveils a concise three-step approach that enables companies to:

1. Define and quantify what customers value.
2. Systematically deploy their resources to deliver greater value than the competition.
3. Capture a greater share of the value delivered to customers.

Enterprises that follow this approach over time consistently see an increased flow of value to their bottom line.

Setting the Stage

Most enterprises have a product-centric view of their business. Often, their history and cultures are defined by the development of a single product or service innovation that a founder created to fulfill an unfulfilled need in the market. This and other management realities often combine to create an inside-out culture where the enterprise is convinced that it can imagine and create the products and services that its customers and markets will want.

As shown in Figure 1, enterprises often create a product and push it to the market while expecting their customers to accept it. These enterprises often lack a deep understanding of whole context in which their customer consumes an offering. They often lack a strong understanding of customer needs. This leads the enterprise to create value propositions that are focused on how a product performs rather than on the elements of an offering that create value for the customer. Incomplete and often vague value propositions do not allow the enterprise to differentiate its offerings from competitor products.

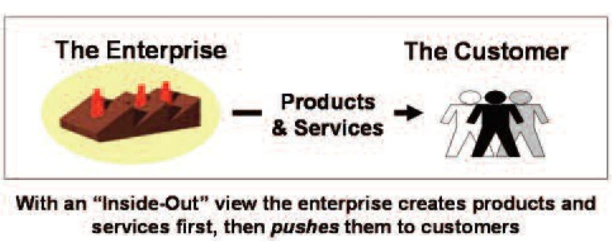

Figure 1: Common View of Customer Relationships

There are inherent pitfalls caused by this all too common inside-out approach: First, customers begin to narrowly define the enterprise and what it is capable of contributing based solely on today's products. Why is this a challenge? The competitive market continuously changes and value migrates from one step in the value chain to another. Competitors and other market influencers create discontinuity by introducing new products and developing alternative business models. The enterprise has an increasingly difficult time trying to break out of their existing product lines as new alternatives emerge.

Second, the enterprise begins to define itself based on its current customers. These are often customers that it acquired through coincidence, rather than through a planned and measured effort. In their drive to satisfy existing customers' demands, managers often fail to consider if their customers are the right ones. Is the customer base the most profitable one available in our market? Are the company's assets and capabilities well suited to serve current customers?

Managers think narrowly about their business as one that delivers products. As products age and become more commoditized, they often run short on ideas about how to grow their business and are often sucked into the vortex of price cutting strategies where they cut price to gain more of the same type of customers. This has a negative effect on the profitability as the enterprise continues to attract undesirable, unprofitable customers that are price buyers and exhibit little to no loyalty to the enterprise. Over time, the enterprise finds itself constrained with less and less available capital as it fails to earn competitive returns above the cost of capital.

A Value Based Approach To Management

Without a real understanding of how its customers consume a company's offerings and without true customer-focused innovation, the enterprise faces irrelevance and extinction.

There is a path out of this myopic, product-centric view. The enterprise must focus on the customer needs that it fulfills today and those that it can fulfill tomorrow—with little regard to any specific product or service that they might currently offer. As shown in Figure 2, the enterprise must change the lens through which it looks at the market and to focus on the value it exchanges with customers versus the products it delivers during transactions.

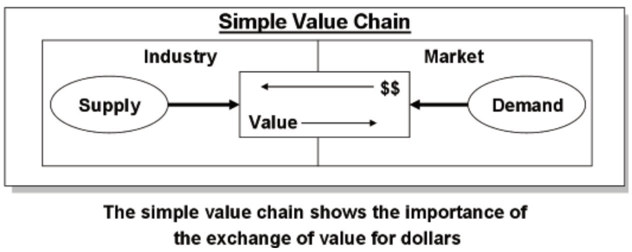

Figure 2: Value Chain Example

In short, managers must shift their view from "In side-Out" to "Outside-In". In the new view, actual products and services become only one part of the total value that the enterprise creates and delivers to its customers. With this view, it becomes clear that not all customers are the same; that different customers value different elements of the enterprise's offerings; and that customers have radically different contexts in which they consume an enterprise's market offering.

Consider the case of a polyethylene manufacturer who sells polyethylene to two types of customers – plastic bag manufacturers and food packaging companies. The two companies may currently buy the same product today, but the plastic bag manufacturer buys primarily on price and has little value for the polyethylene supplier's ability to deliver innovations. The food packaging company on the other hand, is always looking for innovation that will extend a food's shelf-life or freshness. They are more willing to pay a premium to maintain a relationship with an innovative polyethylene supplier. An enterprise that takes the same approach to serve these two very different types of customers will end up performing sub-optimally for both.

Understanding the Value Creation Cycle

Companies who continuously grow profitably follow this concise, three step approach to growth management: First, they develop a complete understanding of the way they create value for their customers today, and how they can best create value in the future. Successful companies not only define customer needs, but also take their understanding one step further by quantifying the value they provide to their customers. They link each source of value to their customer's balance sheet and income statements.

Second, they develop a deep understanding of how value gets delivered through the value chains in which they compete. They understand the true drivers of demand, the current profit pools at each value chain step and most importantly, the steps where profits will pool tomorrow. They create operational processes from the "Outside-In". This keeps the customer at the center of the transformation and ensures they are aligned to deliver optimal value to the most valuable customers.

Third, having optimized the creation and delivery of value, companies must take a disciplined approach to capture as much value as possible for their shareholders. First, companies should seek to optimize the share of profit per transaction. Next, they should strive to maximize share of their customers' wallet, or the share of like transactions in which their customer participates.

Last, but not least, they should optimize their share of the overall market to increase shareholder wealth.

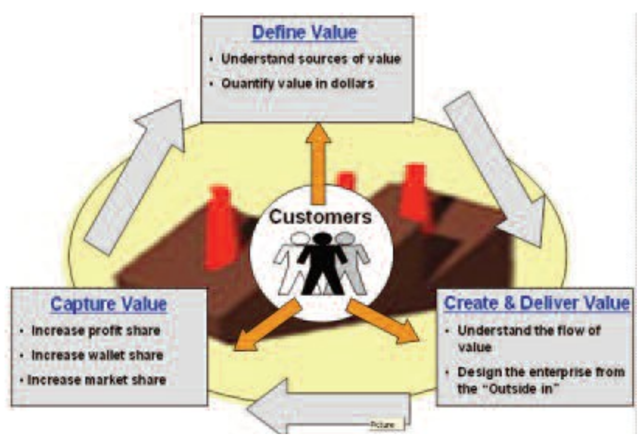

Figure 3: The Value Chain Cycle

A Value Based Approach To Management

In the remaining sections of this paper, we examine each of the three steps in the Value Creation Cycle and we outline the tools and approaches that leading companies use to maximize shareholder wealth.

Create Value

It is extremely important to fully understand the key elements of value in the eyes of the customer. As companies go through this exploration, they realize that customers perceive value in many areas that are readily visible. Leading companies don't stop at uncovering these new value delivering attributes of their offerings. The best companies not only understand the value that customers place on the various attributes of their offering, but also quantify them in real dollars and cents. Without this detailed understanding many enterprises are left to hang their hats on benefit statements that are attached simply to their product's specifications. These often fail to articulate the real value they deliver.

In most cases, a procurement agent does a detailed analysis of technical specifications to ensure that a product meets the customers' technical requirements. However, without a quantitative metric for the differential value that a supplier adds, the procurement agents is left to focus on the one quantitative measure he finds on the bid sheet— Price. This is a key driver for the ongoing downward pressure on prices that many companies experience.

To make their value clear, leading companies group the value that customers receive from an offering under four broad categories – Product, Access, Experience, and Cost.

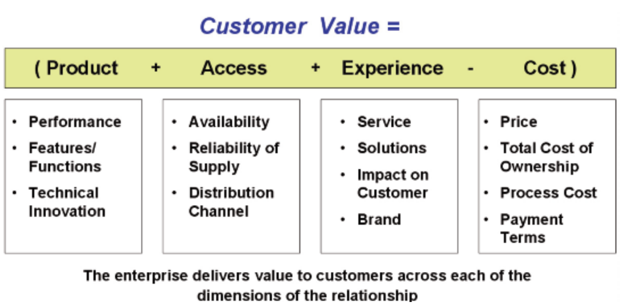

Figure 4: Elements of Customer Value

Product Attributes

Of the four elements of value delivered to customers, product attributes is the category that enterprises relate to most easily. After all, most enterprises tend to have large number of people in R&D, engineering, product design and operations.

These people configure and reconfigure their product's features and functions to gain a competitive edge. Unfortunately, we find that they spend more than 90% of their time focused internally. They are not out in the market understanding customer requirements or the value that customers place on performance features or the trade-offs they are willing to make. This inward focus drives products that are over designed and loaded with features and functions that add to manufacturing and other costs while offering little or no added utility to the customers. A good example of this rampant over-design are typical office productivity software packages where 80% of the functions remain largely unused by the majority of customers.

Access Attributes

The second category of value drivers is defined by how accessible an enterprise's products and services are to the marketplace. Many enterprises fail to recognize this source of value that they provide to their customers. Dell Computer is a good example of this point. Ask Dell about the value of accessibility of supply. Dell requires suppliers to deliver orders 15 minutes after order placement. A single unavailable component can bring an assembly line to a grinding halt. When selecting a supplier, proven availability and reliability are key elements in the selection of one supplier over another.

By developing a clear understanding of the different access requirements of each unique market and customer, leading enterprises optimize the deployment of their resources to ensure that their operations can deliver their customer's accessibility and availability requirements. For example, the enterprise that knows its products are critical to its customers and that they maintain low inventories often keeps safety stock. The customer comes to rely on the supply consistency and will often pay a premium for the availability.

A Value Based Approach To Management

Experience Attributes

The third category of value drivers is defined by the overall experience that customers have as they use an enterprise's products and services. Experiences are initially shaped by impressions of the enterprise's brand and are more strongly influenced by each direct interaction between the customer and each of the enterprise's employees. These interactions take place at many stages of the buy-pay-use cycle.

Leading enterprises pay close attention to the way they design their customer facing processes, how they train their service organizations, and how they build their brands. The enterprises that pay careful attention to customers' experiences across transactions reap the benefit of superior pricing, higher margins, and the creation of higher switching costs. The perception of quality that the computer marked "Intel Inside" carries is an example of brand value In the PC industry. Couple this with the easy nature of a transaction with Dell, and it is easy to see why Dell continues to build market share in the face of better performing alternative products from suppliers like AMD.

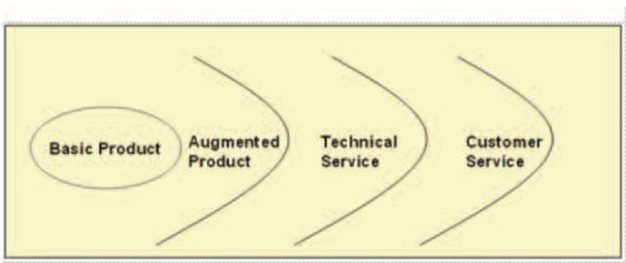

Figure 5: Affecting The Experience

By developing a deeper understanding of the overall context in which customers use products and services, the enterprise can uncover customer needs that are not being fulfilled by competitors. In filling these needs through a uniquely designed solution that leverages the enterprise's products and services, accessibility, and experience, leading enterprises build up the value that customers perceive as being above and beyond what the competition has to offer.

In many markets, integrating the product sales with after sales service contracts offers companies an opportunity to de-commoditize their core business.

A good example is the copier market and the services offered by IKON. Over the last decade, IKON has transformed itself from a distributor of copier products to a service company focused on helping companies manage document flows and efficiency. IKON wraps around a world class collection of copiers and printers with a superior service offering that ranges from document management services to financing services.

Cost Attributes

Cost attributes are often the most difficult ones around which to build consensus. Too often, both the enterprise and the customer take a myopic view of cost by limiting the discussion to the purchase price. The most astute buyers and sellers realize that the invoice price is the tip of the total cost associated with using a product or service. Both the enterprise and customer focus on the customer's total cost in buying and consuming an offering. This allows the enterprise to better communicate the value of its offering over its entire useful life and allows the customer to make a more economically sensible purchase decision.

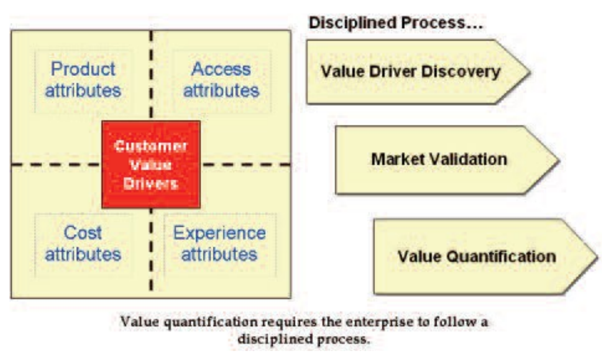

Figure 6: Quantifying Customer Value

Customer's incur a whole range of costs as they consume an offering that include: search costs associated with finding the right product and right vendor, vendor management and legal costs associated with contract negotiations, product disposal costs associated with getting rid of used product or waste, personnel costs related to training with the product, and finally, the performance difference between the product and a competitive alternative. The enterprise that understands value management will understand each of these costs and their impact on a customer's ability to make money. thereby add additional value to their customers.

A Value Based Approach To Management

Leading enterprises work with customers to reduce the total system costs experienced in the consumption life of an offering and thereby add additional value to their customers.

A Commercial Printer Masters the Value Creation Cycle

Take the example of a commercial printer which had traditionally played in the Procure and Produce step of the print value chain associated with retail inserts. Retail inserts are one of the primary demand generation vehicles for retailers, who use these to drive store traffic. One retailer saw their store traffic drop by 20% over a one month period after they decided to stop printing inserts.

In this value chain print was fast becoming a commodity and, like its competitors, the company was looking for growth strategy amidst declining margins. An analysis of the value chain revealed that while the print component of the value chain was fast being commoditized, value was pooling at the front of the value chain with the players who delivered the insert to the end customers.

	Media Planning and Budgeting	Creative Services	Print Production and Paper	Logistics	Insertion	TOTAL
%Spend	5.0	6.0	34.0	5.0	50.0	100.0
Market Spend ($MM)	750	900	5100	750	7500	15000
Opportunity Prioritization	High	High	Low	Low	High	N/A
Value Potential	Medium	Medium	Low	Low	High	N/A
Suggested Solutions (Ranking)	Solution 3, Solution 5	Solution 2 Solution 4	Solution 6		Solution 1	N/A
Cycle Time	14 Weeks		1 Week	3 Weeks		18 Weeks

Figure 7: Value Chain for Retail Inserts

The pain experienced by the retailers was so high that they committed to co-developing a solution that would introduce a discontinuity in the value chain and redirect the pooling of value back to other participants of the value chain. The printer managed to escape the commodity trap and position itself towards profitable growth.

By understanding how each of the attributes of product, access, experience, and cost contribute to the overall value received by the customer allows the enterprise to effectively differentiate from their competitors based on total system value.

Deliver Value

Let's shift the focus now from how the enterprise understands customer value to how the enterprise actually creates and delivers value to their customers. There are two common missteps that companies take in creating and delivering value. The first is that they take a supply-chain oriented view of value delivery versus a value-chain oriented view. In the value-different markets, enterprises can leverage value-based segmentation and fine tune their offerings to each market's unique situation. This chain view is a complete 180 degree shift for most enterprises. The second misstep is having internally focused business processes that sacrifice the flexibility in meeting varying customer needs in favor of standardization to drive down total costs.

Value Chain versus Supply Chain

Figure 8 depicts a typical supply chain associated with a hypothetical process manufacturer. It shows the flow of product from raw material procurement to end-product distribution.

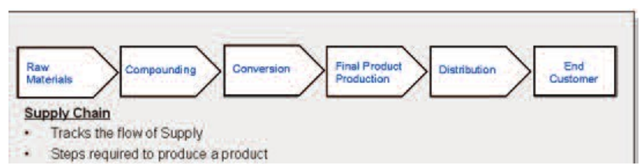

Figure 8: Typical Supply Chain

Depending on the level of detail, this view captures all the steps needed to produce and deliver a product to the end customer. It exposes the inventory positions, cycle times, and different throughput requirements at every step. Enterprises that fully understand the supply chain are well positioned to squeeze out all of the costs that can be removed from the system.

However, while the supply chain does a great job in tracking the flow of supply, it fails miserably in capturing the flow of demand from the end customer up the chain.

Analyzing the demand value chains in which the enterprise participates reveals the true sources of demand and enables the company to track the flow and pooling of value at different steps. enterprise to define where each of its opportunities to create value reside, and to determine how close these opportunities are to the enterprise's core competencies. This view also highlights the market players who control the flow of demand and shape the economics for all participants. The enterprise can only shape the position of the profit pools by developing a deep understanding of the value chains. By developing expert insight into their value chain economics, the enterprise can transform itself from a supplier of inputs to a power partner of choice.

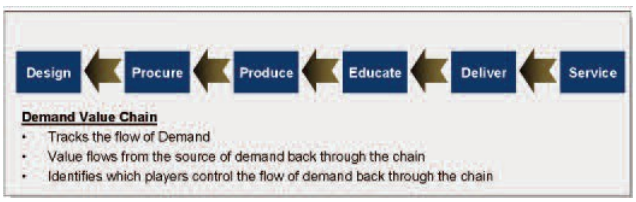

Figure 9: Typical Value Chain

For the true value-chain mastering enterprise, this view identifies arenas beyond the enterprise's current focus into which it can expand and significantly change its revenue, profit, and competitive profile.

Re-engineering Operations from the "Outside In"

In the 80s and the 90s, many enterprises jumped on the quality band wagon and implemented TQM or Six Sigma programs. They worked hard to remove all of the causes of variance and defects from their business processes. For many enterprises, and even entire industries, this movement lead to dramatic improvement in production efficiencies. However, what was often lost along the way was a focus on those things that matter at the point of competition—the customer. Unfortunately, for every enterprise that got Six Sigma right and applied it based on true customer requirements, there were many others that blindly applied statistical tools and techniques to remove variance from their processes.

The science of determining what customers really need and what they will pay for was often put to the side or omitted entirely. The leading enterprises are redesigning processes with the realization that these processes impact each of the value creation categories discussed earlier. They are designing their operating processes to serve customers faster and better and the ability to reap rewards in terms of improved customer satisfaction and profitability of their businesses.

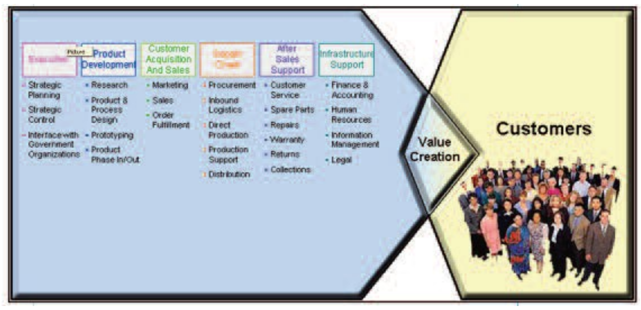

Figure 10: Re-engineering the Organization from the "Outside-In"

Take the case of one of the largest telecommunications carriers in North America which decided to incorporate the voice of the customer into its internal processes. Customer surveys revealed that a major challenge that business customers faced was in the way they accounted for the service usage between their internal departments. The customers received a single bill and were forced to parse the costs out to the individual departments manually. The telecommunications company worked with business customers to design a new bill format that delivered department level detail to the customer in the bill. The telecommunications company achieved a 20% increase in customer satisfaction scores by delivering more value with minimal investment.

Capturing a Greater Share of Value

The next phase in the Value Cycle is Value Capture. Executives that do not excel at capturing the maximum value from the market leave money on the table and in so doing fail to provide their shareholders with the best possible return. The enterprises that succeed at value capture are rewarded in the financial markets with higher shareholder returns than their competitors. Every enterprise has three levers available to capture value for their shareholders. They include: customer profitability, share of wallet, and number of customers.

"Customer profitability" measures the share of economic value that the enterprise is able to is "number of customers", which is aimed at optimizing the enterprise's market share.

A Value Based Approach To Management

Most enterprises focus on capturing value from one or two axes of the Value Cube. As a result, they end up missing much of the value they can extract from their market place. The Value Cube framework allows the enterprise to map out its current position in the total value space. The "Could be" state represents the additional value-capture potential that exists for the enterprise with a large capital investment. The more practical "Should be" state shows what value could be attained in a one to five year horizon with a more focused investment approach.

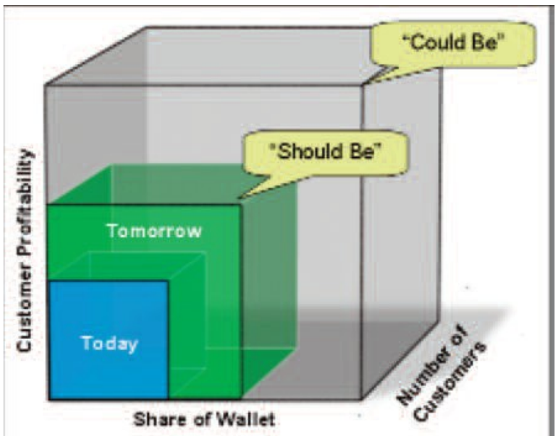

Figure 11: The Value Cube

Understanding the space the enterprise occupies "today" in its value cube is the first step towards increasing value capture. The shape of the company's current Value Cube, and the desired future shape helps to prioritize the strategic initiatives the enterprise should undertake. For example, the enterprise that has a high share of wallet and a high market share should focus its resources increasing customer profitability. Customer profitability improvement opportunities present themselves in the form of cost reduction or price improvement.

Customer Profitability	Share of Wallet	Number of Customers	Operational / Strategic Priorities
High	High	High	Defend
High	High	Low	Exploit Channel Opportunities
High	Low	Low	Offering Innovation Cross-Sell
Low	High	High	Reduce Cost/ Raise Price
Low	High	Low	Consolidate Product Portfolio
Low	Low	High	Exploit Channel Opportunities / Consolidate customer base
High	Low	High	Identify New Products & Services / Cross Sell
Low	Low	Low	Restructure business

Figure 12: Basic Strategic Alternatives

Benchmarking a company's operations against competition can uncover areas where cost reduction is possible. Figure 13 contains the results of a competitive financial assessment of a Fortune 500 industrial company versus its competitors. The study highlights areas where the company's operations were best in class and others where improvements were appropriate.

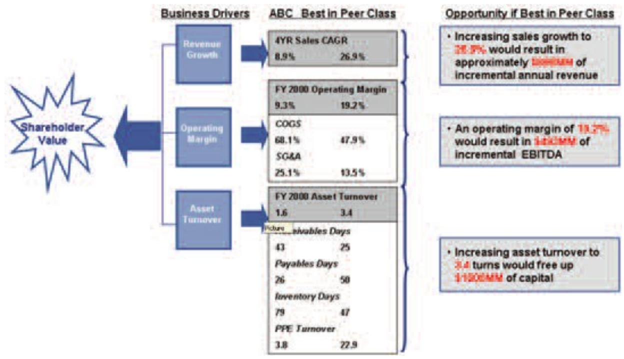

Figure 13: Competitive Financial Analysis

Conclusion

A customer-value based approach to management can help companies instill a fact based decision making process in the enterprise. This promotes faster growth through differentiated customer investment. It ensures that the highest return initiatives are prioritized. Enterprises using this disciplined three step approach will be well positioned to better understand value potential, creating value, delivering value, and managing their market position to maximize the value they capture. Enterprises that are attuned to the Value Creation Cycle build deep moats around their customers that competitors find difficult to cross. Mastering the Value Cycle enables enterprises to win in both the customer markets and the financial markets. In short, it leads them to long-term profitable growth.

valkre

www.valkre.com