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—Kevin M. Blakely, Executive Vice President, Risk Management Group, KeyCorp

Failsafe Strategies

Profit and Grow from Risks That Others Avoid

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Failsafe Strategies

Profit and Grow from Risks That Others Avoid

Sayan Chatterjee

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This book is dedicated to my parents and my wife, Anita.

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The central thesis of this book emerged from a gradual convergence of ideas from two sources. The first source is my research on risk and value creation. The second source is my consulting and executive development experience. Chance encounters have played a major role in some significant directions that I have taken in my life, and it is fair to say that had Michael Lubatkin not started the conversation in the late 1980s about looking at risk from a strategic perspective, I may never have been drawn into this stream of research on risk. I may have written a book on strategy, but that would not have been half as interesting to me as the risk management lens of strategy.

Although the notion of risk provides the architecture, the bulk of the concepts relating to designing and implementing strategy have come from trying out these ideas on my executive audience and corporate clients. These are the people who have shaped the ideas to the point where I was willing to try and put it into practice. In particular, some people deserve my deepest gratitude. In no particular order

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INTRODUCTION

UNDERSTANDING RISK: THE REAL KEY TO COMPETITIVE STRATEGY

This book is aimed at practitioners and scholars of business strategy. Whether you are a CEO of an organization or a functional-level manager, you need to understand not only how to take risks, but also how to navigate around those risks to capture the rewards that prompted the risk-taking in the first place. More importantly, you need to know your role in reducing these risks. You may argue that the responsibility of a strategy lies at the leadership suite, but it is becoming increasingly apparent that the success of a strategy is determined by how much the rank and file understands their role in the strategy. The risks in any strategy are not just in the execution, but also in the design.

The genesis of this book comes from the extensive executive education and consulting we have been involved in over the past 15 years. Many of our session participants have asked us to develop a book based on the concepts developed in these sessions. These concepts have been field tested and refined over the years through our

consulting engagements. Teaching strategy to experienced executives in a one- or two-day session is an extremely different challenge from teaching strategy to MBA students over an entire semester. Executives are extremely intolerant about academic theories that they cannot apply immediately to their day-to-day concerns. Our challenge, therefore, was to develop bite-sized examples that help these executives internalize the concepts we were developing in the sessions, while at the same time making the concepts general enough to apply to a wide range of business situations. Our solution was to write numerous short cases that a busy executive could easily read while including enough detail to illustrate key concepts. You will find these short cases throughout this book. We are hoping to re-create the same experience that participants in our executive sessions typically get from studying these cases.

In the remainder of this Introduction, we provide an overview of how this book is organized. This book has two broad sections and an Appendix. The first section develops concepts that allow a firm to clearly understand the nature of the risks in a given business. The second section expands this framework to growth and diversification strategies. The Appendix presents a detailed analysis of the rise and fall of Enron using the risk management lens.

An Overview of the Book

This book develops a set of concepts that allow you to design business models where the risks can be reduced to practical proportions. The risks in any business come from not knowing the demand, threat from competition, and not having the appropriate capabilities.[1] The basic theme repeated over and over again is that to reduce risk, you need to have clarity regarding where the risks are and create choice, or options, in tackling those risks. We use numerous examples of business strategies to illustrate the concepts. But more to the point, the

concepts developed in this book enable you to quickly visualize successful strategies as well as avoid the common pitfalls. However, by no means are we claiming that the strategies we use as examples were developed using our frameworks. We are very aware of academic "after the fact" analysis of famous strategies that in no way portrays the reality of how those strategies were developed. Notable examples are Honda, Wal-Mart, and Southwest. This is where our book differs. Rather than looking backward to try to understand these famous strategies, which is often the case with academic analysis, we use these example as "exercises" to help you re-create these strategies using our framework and methodology—a process that should help you internalize our concepts faster.

Section 1
Designing Strategies for Avoiding Risk

Business risks can manifest at two different stages. Risks in the execution of a strategy will always exist. However, quite often the risk is not in the execution but in the design of the strategy that predisposes it to failure. Our operations colleagues tell us that 80% of the life-cycle cost of a car is locked in at the design stage. A well-designed strategy is not immune to execution risks, but very few firms consider capability risks at the design stage and, thus, compound the risks during execution.[2] A major thrust of this section is to demonstrate that firms often miss out on strategies that can avoid or minimize capability risks while designing the strategy. This is precisely the debate surrounding the Iraq liberation. The proponents point to the goal of a democratic Iraq as a high-return venture. Very few people can argue with this objective if it can be attained. However, critics contend that the strategy did not take into account the capability risks, and the objective may have been attainable at much less cost.

Chapter 1
How to See Gold Where Others See Risk: Identify More Choices to Get the Gold

To embrace ventures that are considered to be too risky by others, you need to be more proficient than your competitors in understanding the nature of the risks before you actually invest in a venture. To do this, you need to have a framework that allows you to understand the sources of risk at a high level and a methodology that allows you to avoid the risks that scare your competitors. The first step in this process is the ability to conceptualize multiple business models that can exploit the same market opportunity. This chapter gives you a framework to identify options that isolate your firm from key risks.

We call this framework "outcome-to-objective." This framework exposes the inherent risk of relying on core competencies and how this perspective leads to an inside-out view of strategy. This chapter also demonstrates why giving lip service to customer needs is not enough, and how the concept of desired outcomes allows you to break the inside-out mindset. Finally, this chapter shows you how to identify *multiple* competitive objectives, the logic behind your business model, that can deliver the same desired outcome while capturing some of the value for your shareholders. When you begin to identify multiple competitive objectives, you take the first step to put distance between you and your competitors in your ability to profit from risky ventures. In summary, this framework increases the odds of profits by enabling you to do two things. First, it allows you to consider opportunities that others would avoid because of the perceived risk and, thus, have the field to yourself. Second, you are able to differentiate your firm from your competitors by reducing the likelihood of loss because you have many more choices at your disposal to help you avoid risk than your competitors.

Chapter 2
Three Steps to Design a Low-Risk Strategy

In Chapter 1, you are exposed to techniques for visualizing multiple possibilities for exploiting the same risky profit opportunity—the choice dimension. Chapter 2 forces you to come to grips with the constraints in exploiting these possibilities—the clarity dimension. Chapter 2 guides you through three steps to crystallize the constraints and the risks of overcoming these constraints as you design the business model. At the end of this process, you will have complete clarity as to what you *need* to deliver. This by no means suggests that you *can* deliver what you need, but at least you will have better clarity about the risk that you may not be able to acquire the required capabilities to deliver what you need to.

The first step to develop this clarity is to understand the broad competitive objective by which a strategy will deliver value to the customer *while capturing some of the value for the firm's shareholders*. Hopefully, with the techniques developed in Chapter 1, you will have many more broad competitive objectives to choose from to profit from the same opportunity as your competitors.

After deciding on the initial broad competitive objectives, you have to take the critical next step of developing core competitive objectives. We define core objectives as a set of specific and measurable deliverables for the business model. Using short sidebar examples, this chapter shows how to precisely define a strategy's core competitive objectives. This precision gives you a much better clarity on the nature of the risks that you will be facing. This precision allows you to track the risks in real-time, so you can pull the plug in case you made a mistake in your assumptions or logic before the strategy completely unravels. The examples also illustrate how companies have overlooked the true risks of a business model when they didn't take time for this precision. Finally, this precision is critical to clearly understand the constraints a firm will be facing to deliver its objectives—its capability requirements. Basically, at this point, you will

have clear choices about what you *can* do. Many strategies have gone awry because of the lack of precision in defining the core objectives. With precise definitions, you will be able to avoid the more risky options at the design stage rather than during execution.

Chapter 3
Identifying Multiple Capability Configurations

In this chapter, we develop techniques to identify alternative capability configurations that allow you to learn from a successful strategy and apply it in a different context. We demonstrate this by contrasting the strategies of JetBlue and Southwest, and how JetBlue's strategy has developed with very different inner workings, even though most people think it is basically similar to Southwest. This example should be helpful in understanding how two successful companies in the same business can have different core objectives and supporting capabilities. Further, we also demonstrate that the same core objectives can be used as the business logic in totally different industries. Clearly, the capabilities to deliver these objectives would vary across firms in different industries, but if you can understand the common theme that is observable across such strategies, you may be able to apply the same principle to your own business. We use five short sidebar examples to illustrate this point.

Chapter 4
Designing Strategies with Low Capability Risks

Up to this point, you will have seen how to clearly understand the logic of a business model and how to identify many choices that can *theoretically* allow a firm to deliver value to its customers while capturing some of that value for itself. So far, we have developed frameworks to identify multiple options for what you need to do to be profitable and a subset of these options that you feel most comfortable in your ability to execute. However, the risk becomes a reality

when you select one of these options and choose to implement it. Once you make a choice, your firm has to make the necessary resource commitments to build up the capabilities. In this chapter (and in Chapter 5), you learn how you can minimize your risk by using existing capabilities to deliver the core objectives you have identified. So, if you can address the capability risks efficiently, your business model has a much higher probability of success.

This chapter also addresses situations in which a firm cannot leverage its existing capabilities. Those situations are inherently more risky because of the additional investments that have to be made for acquiring new capabilities. This chapter gives you some ideas on how to identify "white space" or "sweet spot" opportunities (we will define these terms later) where the risks of making such new investments are minimal.

Chapter 5
Lowering Capability Risks with Visible and Invisible Outputs

A corollary to the frameworks that you will learn in this book is time-to-insight. Basically, if you can consistently identify business models faster than your competitors, this by itself will allow you to stay a step ahead of competition. However, there are other things you can do besides developing a completely new business model that will make it difficult for competitors to catch up with you. The framework that is developed in Chapter 5 allows you to fine-tune your firm's capabilities by simultaneously making it more efficient, as well as deliver more of the outcomes desired by the customers. The core insight of this chapter is based around the concept that customers value what you can see and touch. If you realign your firm's capabilities so you can offer more of the things that are visible to the customers, you will be able to differentiate your offerings from that of the competition. On the other hand, the components of your capabilities that are invisible to the customer can be reengineered for greater efficiency, which adds to your profit margins. Variations of these concepts are

developed in greater detail in Chapter 5 and illustrated with numerous examples. This framework is a very low risk way of modifying capabilities to put distance between a firm and its competition.

This chapter concludes with a discussion on two other sources of risk. These risks can come in two guises—errors in assumptions and errors in logic. In any business opportunity, you have to make certain assumptions about the future. The assumptions that surprise most firms (negatively and positively) is with regards to customer preferences and market demand, because no one can predict the future with 100% accuracy. However, this is a risk you must get used to taking; otherwise, you will be constantly gun shy of taking on any new opportunities. On the other hand, when it comes to assumptions about the capabilities needed to deliver the core objectives of the strategy, a firm has to strive for more accuracy. Often, mistakes in assumptions regarding capabilities reflect a lack of clarity and should be easy to correct with the techniques developed in this book.

The other source of errors comes from poor logic. You have to apply logic to determine which core objectives you will focus on and which set of capabilities you will draw on to deliver the objectives, depending on your risk preference. Unfortunately, even the best companies succumb to logical errors. For example, Dell Computer now admits that its move into retail channels was a logical error because its direct mail capabilities did not match the capabilities needed to deal with retail channels. This chapter goes on to suggest why Dell might be making a similar error at present. Hubris is one reason why even successful companies still make logical mistakes—they have an exaggerated belief of what they can do. In fact, success itself can lead to overconfidence that in turn might lead to a lack of discipline in applying the framework before committing to a venture. The last section of this chapter develops some ideas about how to avoid assumptions and logical errors.

Chapter 6
Organizations That Can Benefit from the Outcome-To-Objectives Framework

One reason why precisely defined core objectives can reduce the risks of failure is because everyone in the organization has clarity regarding what he or she needs to do to make the organization move toward its competitive goals. However, before there is a convergence around a set of core objectives by the rank and file, the wording of the objectives has to be tested to see that those who will implement the strategies can relate to the objectives. In this chapter, we illustrate this step with many examples to demonstrate how successful companies have gone about this process. If an organization defines its core objectives clearly, it will find that its batting average will go up significantly. Even when a firm makes mistakes, it will be able to learn from them.

Section 2
The Risks in Growth and Diversification Strategy

In the first section of this book, you learned how to develop a low-risk strategy for a specific business. This section develops frameworks for understanding the risks in growing the core business or entering markets that are new to a firm. In Chapters 7 and 8, the book develops frameworks to understand the risks of entering an existing market or adapting to a market. In Chapter 9, this book considers the risks in creating a new market or shaping a market. In Chapter 10, we take a dynamic look at how the risks in a strategy evolve over time and how this can be managed by multiple migration paths.

Chapter 7
When and How to Use Differentiation Entry Strategy

The basic risks in adapting to a market are the same as an existing business. You need clarity on how you want to compete (core objectives) in the new business and the capabilities that you need to deliver the objectives with the least risk. However, there is a critical difference when you are entering as an existing business. You have to overcome entry barriers. In Chapter 7, this book develops frameworks to overcome the entry barriers without taking on undue risks. Basically, as a new entrant, a firm needs to attack parts of the value chain where the incumbents are likely to be vulnerable and where it can leverage its existing capabilities. This chapter provides some ideas about how to carry this out with minimal risk. This chapter also presents the argument that early in the lifecycle of a market or in a market characterized by a few players, the low-risk entry objectives for most entrants should be differentiation, and in the mature stage of the lifecycle, the low-risk entry objectives should be low price. This is true irrespective of the generic description of the market you are entering. For example, Lexus entered the luxury segment of the car market in 1989 with a low-price strategy. On the other hand, in 2000, JetBlue airlines entered the low-price segment of the point-to-point passenger air-transport market with a differentiated strategy. There will be entrants that may attempt a different entry strategy. However, apart from a few exceptions, such as Xbox taking on PlayStation with a low-price strategy, we suggest that even for the strongest entrants, such an entry strategy increases risk.

Chapter 7 also develops frameworks to understand the capabilities needed to execute a differentiated or low-price entry strategy, and the risks that the entrant has to consider ex-ante. Chapter 7 explores the differentiation entry strategy in depth, and Chapter 8 does the same with the low-price entry strategy.

Chapter 8
When and How to Use a Low-Price Entry Strategy

The basic risk in a low-price entry strategy is you lack or cannot develop a low-cost capability. In Chapter 8, we use the example of Dell Computer to demonstrate how a firm can leverage parts of its existing capability set by attacking bloated cost structures of well-established incumbents in mature industries. However, Dell has not always succeeded in its low-price diversification strategy, and there are some important takeaways here. The two most important takeaways are the need to have complete clarity in the kinds of markets where a low-price entry strategy is likely to succeed, given a firm's unique capability sets. Deviation from the ideal market profile will increase the risks of failure. Even for Dell, high-margin markets that we argue are not conducive to a low-price entry strategy, such as storage, have proven to be problematic. Also, if a firm absolutely must enter a new segment where it cannot leverage its capabilities, it may be able to reduce the risks under specific situations. We use Dell's entry into the service business as an example to illustrate these situations.

This chapter concludes with an analysis of Dell's and Sony's strategies for dominating the consumer electronics market. Based on the frameworks that you will have learned up to this moment, we encourage you to make a prediction about which of these two strategies is likely to succeed.

Chapter 9
Strategies to Shape Markets: Products, Process, and Platform

Chapters 7 and 8 develop frameworks to understand the kind of entry strategies that the vast majority of companies will be involved in throughout their lifetime—entry into existing businesses. However, a few companies pursue much grander ambitions to shape or create a market from scratch. These types of strategies are inherently very

risky because, by default, firms have to acquire new capabilities to succeed in a market that does not exist. Chapter 9 identifies the critical objectives that must be met to give you a chance in succeeding in market-shaping and how to reduce the risks in the significant investments that you must make to develop the capabilities to shape markets. This chapter considers three broad market shaping strategies and how to manage the risks in each. These are using a new product, using a new process, and using a new platform. We not only consider the risks when initiating one of these strategies, but also how to sustain it in the long run if and when competition becomes an issue. An example of a product-based market shaping strategy is the Blackberry. An example of a process-based strategy is a repeatable acquisition process, such as Cisco Systems or Banc One, or a technology infrastructure that enables one firm to take risks that others are unable to handle. An example of a platform is Microsoft DOS or Windows.

Chapter 10
Develop Multiple Migration Paths

In the final chapter of this book, we develop a framework of avoiding risks in a more dynamic context. You need to get comfortable with embarking on a course of action even though you have not managed to clarify all the relevant uncertainties. The good news is that some of these uncertainties become clearer over time. This chapter provides some ideas about how a firm can navigate its way to its competitive objective by avoiding risks that it clearly did not anticipate in the beginning.

The basic concept developed in this chapter is that you do not need to close off all options that you identified while designing a strategy using the techniques from Section 1. The really good companies keep as many options open as long as possible and make the decision regarding closing options based on information that they receive in the future. Even using the frameworks developed in this

book, you will never have as much information as you would want to have to avoid all the risks in the options that you do decide to pursue. However, many times, the quality of information improves over time. If you can keep some options open, you can re-evaluate the options at a later date as more precise information becomes available in the future. This will further reduce the risks of undertaking an option that is beyond your capabilities. We call this technique managing the migration paths (to your ultimate goal). This chapter develops frameworks for managing migration paths for adapting to a market, shaping a market, and for developing platform capabilities.

Appendix

In the concluding section of this book, we present a case study on Enron. We realize that most people have a negative impression about Enron and justifiably so. However, there are some things that you can learn even from the likes of Enron, specifically what *not* to do, even if you are successful initially. We argue that Enron first represents a strategy failure because the company did not understand the risks it was taking and then tried to cover up its mistakes by techniques that have been found to be fraudulent. In the context of this book, Enron has succumbed to the risks, and it may be useful to dig below the headlines to understand why and how the concepts developed in this book can be applied to understand Enron's strategic failures.

Some Concluding Thoughts

We thought long and hard before deciding to write one more book on strategy. We genuinely feel that the issue of risk has not been given as much attention as it deserves in the strategy literature. Further, thoughtful strategy practitioners and academics are waking up to this idea of focusing on business risks, and we see an opportunity to stimulate this discussion. The basic message of this book is that to avoid

the risks that others may succumb to, you need to have clarity and choice. You need to clearly understand and communicate where the sources of risks are. You need to give yourself more choices than your competitors in navigating your way around the risks. All the frameworks and heuristics that we develop in this book will help you with these twin goals of clarity and choice.

However, we do wonder if by focusing on risk instead of returns we will be perceived as taking a negative perspective on strategy—how we can avoid loss instead of how we can exploit a profit opportunity. If anything, the central thrust of this book is exactly the reverse. We urge you to look for profitable opportunities. The caveat is that most profitable opportunities are profitable because they are too risky for most to exploit. The only way to really exploit a profitable opportunity is to retain most of the profits without succumbing to the risks that keep competition away. Once you understand risks in profitable opportunities, then you can expand your opportunity frontier, which can only lead to increased shareholder value in the long run. You can profit by seeing the profits in risks that others will avoid.

True to this principle, we have taken on a risk that most other management books avoid. Most management books use examples of past successes and failures to justify their frameworks. Of course, this is necessary, and we have also done that to a large extent. However, we have also gone out on a limb and made predictions about the strategies of the best companies in the world. Some of these predictions are not favorable, but if we believe in our frameworks, the true test will have to come in their predictive ability and not by looking in the rearview mirror. Imagine if someone had predicted Enron's problems in 1999!

Endnotes

1 Academics may suggest that there are risks form the five forces identified by Michael Porter. Our argument is the risks are a problem only if a firm does not have the appropriate capability to position it against the forces.

2 Readers familiar with manufacturing techniques will no doubt relate to the concept of FMEA (failure mode effects analysis) that tries to anticipate what can go wrong in implementing an operation. This is obviously harder at the strategic level and precisely why this can lead to a competitive advantage because so few firms do it.

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1

How to See Gold Where Others See Risk: Identify More Choices to Get the Gold

"Strategy formulation involves the constant search for ways in which the firm's unique resources can be redeployed in changing circumstances."

—Richard Rumelt

In most industries, the major players are well aware of what customers are looking for (generically, more value for money). Yet at any given point in time, many of the customers' desired value propositions (whether price, quality, quantity, and so forth) remain unfulfilled because existing business models are incapable of delivering these values in a manner that is also profitable for the firm. However, if a firm can solve this trade-off, then the profits are almost guaranteed.

Many firms take a linear approach in trying to solve this trade-off—through R&D (research and development) or other resource-intensive processes. Clearly, there is a place for R&D and other forms of capital investments. However, there are several drawbacks in taking a linear, resource-intensive approach. First and foremost, focusing on R&D or capital investments as a solution is inherently more risky simply by virtue of the capital commitment. Second, because this linear approach is the most common, it will most likely force your firm to play in the same playing field as everyone else. Thus, even if your firm develops the capabilities to deliver a value proposition profitably, the differentiating factor amongst competing firms is likely to be execution. This chapter develops a common sense but different way of approaching these issues that should complement the linear approach. Yet, very few firms consciously adopt this approach as part of their strategic planning processes. *The principle underlying this approach is very simple: If your firm can consistently identify more options that can deliver the same value proposition, it will likely be able to reduce the risk of failure by choosing an option where the risk can be managed to practical proportions.* This chapter recommends that the brute-force approach should be adopted only after you have exhausted less resource-intensive options. In the following pages, a framework is developed for identifying multiple options that require much less resource investment.

To Visualize More Options, You Need an Outside-In Perspective

Consider a journey by car to a new city that a traveler is unfamiliar with. The traveler has charted out a route plan but suddenly finds herself at a roadblock. She has to figure out a way to get around the roadblock to reach her destination. Because she is in uncertain territory, her odds of taking a wrong turn are significantly increased. However, if she uses GPS (Global Positioning System) to navigate her

to the destination, she will be able to see multiple possibilities and choose the one that best fits her driving style and allows her to reach her destination on time. The framework developed in this chapter first considers the big picture (in this case, GPS), which allows your firm to see many possible routes to its ultimate objective, understand the risks inherent in each route, and then work back to the set of capabilities that can minimize the risks while still reaching the destination. With this approach, your firm considers its own capabilities only in the context of the capabilities identified for the different routes. This process highlights the key difference from traditional frameworks, such as SWOT (Strengths, Weakness, Opportunities, and Threats). Traditional frameworks are intuitive and appealing because of their simplicity—concentrate on your strengths or core competencies and identify a strategy that fits with your strengths. In other words, most firms utilizing traditional frameworks first focus on their core competencies and then try to see if these competencies can be used to reach the destination. You will soon see why it is virtually impossible to see multiple options with this traditional approach. Moreover, there is a real danger that the traditional approaches may very likely blindside a firm from the true risks of the business because it almost always results in an inside-out perspective.

The Traditional Frameworks Lead To an Inside-Out Perspective

Case 1: The Space Pen

When NASA first started sending up astronauts, it quickly discovered that ballpoint pens would not work in zero gravity. To combat the problem, NASA commissioned Fisher to develop a (space) pen that would write in zero gravity, upside down, underwater, on almost any surface, including glass, and at temperatures ranging from below freezing to 300C.

The Soviets used a pencil!

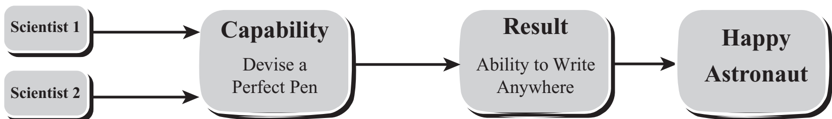
This is a classic illustration of the inherent risks in being focused on your existing competencies. It leads to an inside-out view of strategy. It precludes other options that can deliver the desired goal more efficiently. Typically, this perspective is characterized by the following:

- Alternatives are defined by the problem.
- Focusing on existing competencies/strengths/resources to solve the problem.
- Managers quickly get locked into one option.

The lesson from the NASA story is that just because you have the resources available to develop a space pen does not mean that it is the optimal strategy (see Figure 1.1). Unfortunately, companies do this all the time.

Case 2: Anticipating Competitive Risks

A business equipment firm (such as Xerox) knows that its good service network allows it to enjoy competitive advantage. Xerox has determined that it is difficult for new entrants to develop a comparable service network. How would Xerox determine whether this competitive advantage is sustainable?



"Inside Out": Based on Resources Already Controlled

FIGURE 1.1 Inside-out focuses on the problem at hand.

In this case, if you focus on studying how your existing service network compares to the competition, you are likely to get blindsided. This may happen even if you are making every effort to continually improve your service network. You may think you are focusing on your unique resources or competencies and making them even stronger will keep competitors at bay. Perhaps, but you are not asking whether these are the *relevant* strengths to protect you in the future or if there other ways competitors can undermine your advantage. This is the trap of inside-out thinking—focusing on what you do best and not if this is something that you *should* be thinking about.

> **"This internal focus has wasted our time, wasted our energy, frustrated us, made us so mad some nights over some bureaucratic jackass boss that we'd punch a hole in the wall."**
>
> **—Jack Welch[1]**

Basically, inside-out is the wrong way to think about strategy.

Focus on Desired Outcomes to Identify Multiple Options

Just about everyone these days talks about starting with the customers' needs first. However, if you and your competitors all start with customers' needs, it is highly likely that you all visualize the same value chain. Following through, if you and your competitors basically work from the same value chain, it will come down to an execution battle fought with the same business model. On the other hand, after you have identified multiple value chains, you can use frameworks such as SWOT or core competencies to pick the one that plays to your strengths. In other words, you have reduced the competitive risk by not only choosing a business model that is different from your competitors, but also execution risk because the business model

matches either your existing capabilities or capabilities that you can acquire inexpensively. Unfortunately, focusing on customer needs is of little help in visualizing multiple business models.

Simply asking customers about their needs cannot start this process. Customers are unable to phrase their needs in a way that lends itself to multiple business models. Of course, you need to talk to your customers, but to identify multiple business models, you have to *rephrase* the needs and priorities. As an aside, this is one reason why we do not recommend using focus groups when designing a new strategy. Focus-group participants invariably translate their needs into existing products or services. The moment you start thinking in terms of concrete products or services, you have lost your edge by way of your competitors.

To get away from the customer needs-driven mindset, you need to spend more time thinking, "What is the ultimate outcome the customer is looking for?" Customers have needs, but what they are really paying for are outcomes. You will find that by focusing on the outcomes, you are able to identify multiple business models and increase the odds that you can come up with a solution that is simpler, more efficient, and less risky to implement. Traditional market research and focus groups are not very useful in identifying outcomes. You are much better off observing customer behavior and rephrasing their needs in terms of outcomes.

Case 3: Multiple Options for Developing Stents

Stents are one of the major medical innovations of the 1980s. They are used to prop open blocked coronary arteries to prevent heart attacks. However, stents quite often had to be replaced because of scar tissues that form around it, increasing the risk of reblockage. In March 2004, Boston Scientific Corp. of Natick, Mass., won Food and Drug Administration approval for a coronary stent coated with the cancer drug Paclitaxel. Paclitaxel prevents tumor growth and thus prevents scar tissue from developing around the

stent. Angiotech holds the patent for this coated stent and licenses the product to Boston Scientific.

Dr. Hunter, the CEO of Angiotech, traced the innovation of the coated stent from the manner in which his company asked doctors about their needs regarding stents.[2]

> "Medical equipment makers typically ask surgeons, 'How can we build a better stent?' and then get the answer, 'You should make it more flexible, easier to see and stronger,'" Dr. Hunter notes. "But we've been asking, 'What does the body do to these stents and why do they fail?' When you ask that, you get to the scar-tissue problem."

Outcome To (Competitive) Objective

Even though Angiotech did not call it as such, in effect, the company was asking the doctors what the ultimate outcome was they were looking for. By asking the customers (users in this case) about the current product, it is usually impossible to get ideas for new products that will satisfy the customers' needs when they see it. Most companies try to focus on marginally improving the existing internal outputs (which lead to the current products or services) by investing in new capabilities. However, if you do this, you are invariably taken to the same playing field as your competitors, and you become vulnerable to competitive risks. You want to deliver what the customer truly wants by using a product or service configuration that is different from existing competitors. This reduces competitive risk without being vulnerable to demand risk. By considering outcomes instead of outputs (products or services), you increase your odds of visualizing multiple internal outputs that lead to new, sometimes radically new, product or service configurations that other competitors are not considering. To design a low-risk strategy, simply select the output that *you* can deliver with the lowest risk.

Case 4: Multiple Options for Developing a Longer-Lasting Hearing-Aid Battery

A battery manufacturer was considering investing in a major research effort for a longer-lasting hearing-aid battery. It assembled a focus group of older people to find out about the size or shape of the battery that would most likely appeal to them. The company's real insight did not come from what the focus group told them but from observing the process by which the participants went about replacing their batteries. The company realized it is very difficult for older people to replace a small hearing-aid battery. Of course, one solution to the problem is spending research dollars to come up with a battery that is longer-lasting. However, the outcome that hearing-aid users really wanted was simply to have a hearing aid with a working battery all the time. The battery manufacturer decided to develop a package that made *replacing* the battery foolproof. Not only did they save the research dollars, but they were selling more batteries in larger packets.

The basic difference between the inside-out/core competency view and an outcome-focused view is the starting point. In the outcome-objective view:

- Alternatives are defined by the desired outcomes.
- It is easier to identify multiple fronts on which you can compete.
- Competitive objectives (this includes your outputs that satisfy the customers' desired outcomes) are stated with greater clarity. (This is the kernel of your business model.)
- Focusing on outcomes makes it easier to identify multiple competitive objectives.

Consider the NASA example again. Instead of *devising a perfect pen*, NASA could have rephrased the desired outcome as *recording information*. This leads to the objective indicated in Figure 1.2. Now

you can deliver the outcome without undertaking costly investments, such as the space pen. You can use off-the-shelf products like a pencil or a cassette tape recorder to deliver the desired outcome.

Outcome-Objectives: Begins with Customer Outcome—Presumes Necessary Capabilities Can Be Obtained or Developed

FIGURE 1.2 Outcome to objectives framing of a market opportunity.

Case 5: Multiple Options for Competitive Risks—Branded Home-Maintenance Products

In the late 1990s, two branded home-maintenance products produced by Company X and Company Y were vying for shelf space with Home Depot and Lowe's Corporation. Company Y had recently started airing a series of ads with a prominent Cincinnati Reds baseball player. Company Y expected the ads to produce a brand awareness that would give it some leverage over Home Depot. Company X, which was recently acquired by a holding company, did not have the marketing dollars to respond.

Company X's product has been around for a long time and is well-known to the public, whereas Company Y was trying to build awareness for its relatively new product. Home Depot wanted to carry Company Y's products given its recent ads. Further, Home Depot wanted to have more than one vendor of the same product to increase its leverage.

Company X noticed that Home Depot tended to organize its shelves by brand name in long, 18-foot shelves. Company X

continues

Case 5: Multiple Options for Competitive Risks—Branded Home-Maintenance Products (Continued)

suggested to Home Depot that it reorganize their stores by categories instead of brand names. Company X suggested that keeping similar products in one area will facilitate the end-consumer's shopping experience. Home Depot had always distinguished itself by being extremely user-friendly for the do-it-yourself consumer and, therefore, this suggestion was quickly implemented.

After Home Depot went into the shelf arrangement by category type, it quickly realized Company X was selling more, and economics justified carrying only one product, so Company Y was dropped by Home Depot.

Clearly, the goal of Company X was to be the sole supplier to Home Depot. The problem that Company X was facing was simply competitive risk from a well-financed new entrant to a space that Company X had basically owned for a long time. If Company X had the financial wherewithal, it might have launched a counter advertising blitz. However, the company did not have the money and had to identify a different way of reaching its goal. Of course, Company X could have tried to use the franchise value of its product to convince Home Depot not to carry Company Y's product. More than likely, such an approach would have been seen by Home Depot as a way of regaining supplier power that Company X had lost because of the new brand introduced by Company Y. Therefore, Company X had to figure out other options to reach the same goal.

Let us analyze this situation through the lens of the outcome-to-objective framework. Company X decided to leverage the outcomes desired by Home Depot—reduce its inventory and improve inventory turnover—to its advantage. However, if Company X simply offered Home Depot its services in managing Home Depot's inventory, Company X might have been sidetracked by standard supply-chain issues of delivering its product just-in-time or helping with store

display. The business model that Company X had to develop was delivering this inventory management outcome in a manner that *also promoted the sale of Company X's product*.

To develop the business model, Company X focused on a second outcome desired, not by Home Depot, but by the end-consumer. In simple terms, Company X wanted to make it easy for the end-consumer to buy what he or she needed quickly and with confidence. This outcome for the end-consumer was also an important internal objective for Home Depot, so this suggestion was well-received. Company X then went about operationalizing this suggestion using its store display strategy described in the sidebar. Instead of trying to convince Home Depot to not carry Company Y's product, Company X reformulated its competitive objective by developing a store display strategy that (a) satisfied the desired outcome of the end-consumer, and (b) made it obvious to Home Depot that it wasn't economical to carry two brands. Thus, by focusing on two outcomes—purchase flexibility for the end-consumer and inventory rationalization for Home Depot—Company X managed to become the sole supplier to the largest do-it-yourself store in the country[3] without countering Company Y's ads.

Even though the story ended to the satisfaction of Company X, this strategy was not without risks. Company X made some critical assumptions before it formulated the design of the business model. Company X strongly believed that its product had a better brand-name than its competitor, Company Y, despite its recent ads. Company X believed that if the end-consumer saw the two products side-by-side, then the end-consumer would choose Company X's product. If this assumption were incorrect, placing its products alongside competitors' products at Home Depot would be a grave logical error. The category management strategy is a low-risk option only if the franchise value of Company X's product overcame the recent advertising by Company Y.

There is a postscript to the story. The competing brand, Company Y, went to Lowe's Corporation and persuaded Lowe's to carry its products as sole supplier as a buffer against Home Depot. Unfortunately, Lowe's soon found out that Home Depot was cornering most of the sales in this product category. This resulted in Company Y's product being removed from Lowe's, and Company X became the sole supplier to both Home Depot and Lowe's. Clearly, the objective of Company X was to increase its market share with Home Depot and Lowe's. There were many ways that it could have tried to achieve this. The more expensive and risky options would have been to get into an advertising battle. Equally expensive would be to cut prices or take over the inventory management function of Home Depot and Lowe's by integrating with their supply chains. Both of these choices are risky because they either jeopardize the financial viability of the company or require additional investment. What Company X did was very similar to our outcome-to-objective process (of course, it did not call it as such). Company X managed not only to attain its objective, but it did so without investment in new capabilities.

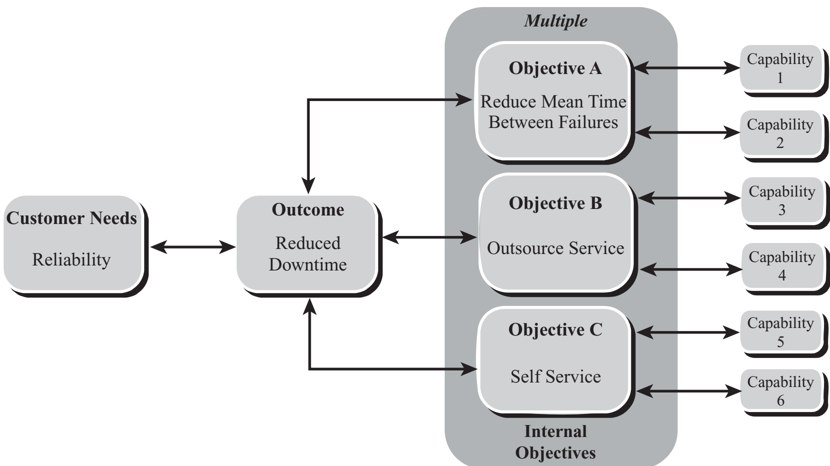
We Can Anticipate Competitive Risks Better by Focusing on Outcomes

Consider the service network case (Case 2) once more. It is not enough to analyze the difficulty of a competitor imitating the service network. Rather, it is necessary to figure out whether the service network is the only way a new competitor can match the incumbent's competitive advantage. Using either SWOT or a core competency framework, this becomes a completely open-ended question.

However, if you move away from viewing the competency (the service network) as the basis of the competitive advantage, and instead look at how you can deliver the outcome that customers desire, the vulnerabilities of the current strategy are easy to understand. In this case, customers would be loyal to Xerox not because of

its service network per se, but because the service network prevents downtime. If you start the analysis by questioning whether others can deliver the same "uptime" outcome, possibilities beyond mere imitation of the service network open up (see Figure 1.3). A competitor may be able to deliver the same outcome of reduced downtime through a different resource, such as by manufacturing excellence (so that a machine needs few repairs) or by designing a machine that customers can service easily by themselves. Canon's entry into the personal copier market and the office equipment market utilized both design and manufacturing strategies to get around its lack of service and other infrastructures in the copier market (see Chapter 4 on Canon's actual implementation).

The outcome-to-objective framework is a thinking style that can be applied in just about any situation where you can benefit from identifying multiple options. In the following case, this framework illustrates how operational efficiency can be attained by avoiding resource-intensive solutions.



An Outside-In Approach Opens the Door to Develop Multiple Alternatives Objectives for Delivering Value to Customers.

FIGURE 1.3 The outcome-to-objectives approach.

Case 6: Rephrasing Outcomes of an Operational Problem

Large efficiency costs result when an assembly line has to be stopped for any reason. Crown Cork and Seal ran into this problem when it found its assembly-line supervisors had to run from the can seamer end to solve problems at the labeling end because of problems with the labeling machine that the labeling-end worker was not trained to solve. The minute or two that it took the supervisor to reach the other end of the assembly line was enough to cause a blockage and, therefore, the line had to be stopped even though the problem itself could be resolved in a few seconds. How can you try to solve this problem most efficiently, so the line does not have to be stopped?

You can identify solutions that involve training the assembly-line worker, hiring a new supervisor for the labeling end, or buying a more robust labeling machine. However, then you have basically applied a competency-based solution to the problem: acquire competencies to develop competitive advantage, in this case, by reducing downtime costs. In terms of SWOT, managers have identified a weakness in their value delivery system, and they get rid of the weakness by acquiring the skills. The SWOT or other traditional frameworks focus on the current output—keeping both machines running 100% of the time. Therefore, the obvious solution is to invest in better machines, more training for its workers, and perhaps a second supervisor. This is an inside-out approach, which would have added other risks because of the increased commitment. However, let us consider the situation by isolating the cause of the line stoppage. The outcome that actually triggers the stoppage is not the failure of the machines but the inability of the supervisor to reach the labeling end quickly enough to prevent a blockage. With the outcome–to-objective framework, you now need to focus on avoiding the adverse outcome of

the supervisor's inability to have access to both ends quickly. The objective that follows from this desired outcome is an assembly-line configuration where both ends can be accessed simultaneously *without costly investments*. Considering this desired outcome, it is easy to visualize the unorthodox, creative, and inexpensive solution that Crown Cork and Seal came up with. They made the assembly-line U shaped. This does not mean the U-shaped option is the optimal one. It is only optimal if this is the least expensive option without any adverse consequences in the desired outcome. All we are saying is that if you focus on outcomes, such as lack of downtime, instead of the means to deliver it, such as a service network, you will be able to visualize multiple business options and, by extension, multiple business models. This ability is the first step in avoiding unnecessary business risks.

An Aside on Creativity and Choice

You may feel that the concepts here are similar to creative thinking, and there is some truth to this. Creativity occasionally leads to breakthrough innovation, but the bulk of creative business models usually just uses existing ideas in a different context. For example, a design group in IDEO saw the possibility of using the heart valve used in medical products to design a "slit valve" for a bicycle water bottle. To see the possibilities, however, you have to ask the questions that can lead you to see the choices. This is exactly the approach that Dr. William Hunter, CEO of Vancouver-based Angiotech Pharmaceuticals, wants his employees to take. According to Doctor Hunter, "The difference between good science and great science is the quality of the questions posed."[4] By focusing on outcomes, you can improve the quality of the questions you ask as you design a strategy.

Decide on Objectives Based on How Your Firm Wants To Compete

To summarize, the notion of competitive objective allows us to understand the logic of the output that we can deliver (different from our competitors) in order to satisfy the customer-desired outcomes. But how do you decide which objectives to focus on? In Chapter 2, "Three Steps to Design a Low Risk Strategy," you will consider a three-step methodology that distills the essential logic of how you are going to compete. However, this is not necessarily a linear process. By using the outcome-to-objective framework, you are able to identify multiple internal outputs that reduce competitive risks. However, you still may not be able to deliver the new output with capabilities you possess or can acquire at a cost that allows you to make a profit. The competitive objective should be designed not only to ensure that your outputs can deliver the customer outcomes, but also to avoid any increased risk of loss. This is an iterative process that leads to the final competitive objective that you should settle on and clearly articulate when designing a strategy.

In the case of the hearing-aid battery maker, the company finally decided to compete on the basis of packages and not product. The battery company clearly understood the logic of why packages can allow it to deliver the same desired outcome instead of creating a new product. Compared to the uncertainties involved in developing a new product the option of focusing on a competitive objective by developing a package has tremendous appeal. This objective avoids competitive risks (no one else has thought of it yet) and has a higher probability of being developed (they are more likely to come up with a packaging innovation than a new product) without costly and uncertain R&D investments. In the case of the coated stent, the company decided to compete on existing coating technology with an existing drug rather than new mechanical engineering. The competitive objective for Company X was to persuade Home Depot to adopt category management. Persuading Home Depot to adopt category

management is a much lower risk than investing in expensive advertising or a supply-chain management capability. Basically, all of these examples repeat a theme you shall see used by many low-risk strategies that we use as examples in this book. In all of these cases, the companies might have considered other product or service configurations, but the option of using existing or off-the-shelf capabilities swayed the final decision.[5]

This brings us to the final concept, which you will explore further in Chapter 2. Even if you manage to reduce competitive risks by identifying a competitive logic that is distinctly different from competitors, you are still vulnerable to capability risks. Do you really have the capabilities needed to deliver the outputs dictated by this logic? This is where many strategies sow the seeds of failure. They do not simply take the time to think through what the firm has to do to make its business model work, and in failing to do so, they implement a strategy that is difficult to execute. To mitigate execution risk, you need a dashboard that alerts you to the failure of critical components of your business model in real-time. This dashboard, in conjunction with the outcome-to-objective framework, allows you to seek out gold where others see risk.

Endnotes

1 Stratford P Sherman. "Inside the Mind of Jack Welch." *Fortune* 27 Mar. 1989: 38.

2 Carol Hymowitz . "The Best Innovations Are Those That Come From Smart Questions." *The Wall Street Journal* April 13, 2004; Page B1.

3 This example also illustrates the power of creating value by making the attributes of your product or service visible to the customer. This framework is developed in Chapter 5.

4 Hymowitz. Op. Cit.

5 We need to emphasize the difference between the outcome-to-objective framework and the traditional core competency frameworks. Our framework considers a firm's core competency, but only after identifying multiple objectives using an outside-in process that starts with customer-desired outcomes.

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