

Cautionary tales

By Jane C. Linder and Susan Cantrell

In the volatile new economy, responding to market changes with the wrong business model can be fatal. But it happens all the time. Here are 10 traps to avoid.

Throw out your old management textbooks—especially the ones that told you about creating “sustainable advantage.” In the volatile new economy, there’s no such thing.

So how can you be sure your company will still be around five years from now—or next year, for that matter? By being able to nimbly adjust your business model as markets change.

Easier said than done, to be sure. It’s hard enough to make the right strategic decisions these days. It’s just as important, however, to avoid making the wrong ones. Some strategic decisions can land a company in business model quicksand, dooming it to years of struggle—or even an untimely demise.

We have identified 10 business model traps that can nail your firm’s strategic shoes to the floor. As you think through how to adapt and adjust your own model, be alert to these potential problems, which can be

broadly categorized in two main groups: 1) getting stuck with an outmoded business model when the market shifts, and 2) proactively changing your business model, but in the wrong direction.

Today’s market, yesterday’s model

Being devoted to the wrong customers

The insurance industry knows this problem well—the more people need insurance, the less appealing they are as customers. Now commercial banks are wrestling with the same dilemma.

Take the case of one commercial bank, which did most of its lending to traditional companies because they were less risky. As the economy changed, these client relationships became less valuable precisely because the clients were not involved with anything risky, particularly anything in the high-tech sector. Cementing relationships with traditional companies anchored the bank to a

low-growth market. Meanwhile, the bank's clients that had invested in new technologies became more appealing to investment banks—and were more likely to take their business elsewhere.

What to do? As your market changes, adjust your business model to win the customers you want instead of just keeping the customers you have. In mature, price-competitive sectors, this will almost certainly mean taking on more risk. Assess clients' future risk and reward profiles as well as their current profitability.

Slipping down-market

No matter how unique or innovative a product or service seems today, it eventually will come under price pressure. Competitors will catch up, new technology will render it obsolete, or substitute products and services will emerge. The result? Shrinking margins will limit a company's ability to invest in more profitable models.

Pure-play Internet exchanges are likely to fall into this trap. Transaction fees will be squeezed until only the largest and most cost-efficient operations will remain standing. (See "B2B eMarket Space: Understanding Developmental Phases," *Outlook Point of View*, December 2000.)

To remain profitable while this transition occurs, a company has two choices. One is to lead the way by relentlessly driving down operating costs and increasing scale to become the lowest-cost producer. Goodyear Tire & Rubber Company took this approach when it transformed itself from a maker of high-performance tires into a mass merchandiser.

Alternatively, a company can wrap value-added services around its offerings to boost the value proposition. For example, AT&T bought IBM's

global networking arm to provide total networking solutions—instead of commodity leased lines—to its business customers.

The lesson? Proactively change your business model before your war chest is drained.

Getting stuck with the wrong partners

Now that many companies have seen the benefits of direct-to-customer distribution, why don't they adopt it?

Because it raises the ugly specter of channel conflict. In some industries—computer equipment and insurance come to mind—companies inadvertently gave control of their business model to their channel partners and could not adjust quickly enough when consumers became savvy enough to buy direct.

A major aircraft manufacturer hit the same kind of speed bump with its parts suppliers. To break into the Japanese market, it helped local companies learn to manufacture its highly engineered components.

The problem is that now the manufacturer is looking to enter the Chinese market—and wants the same warm reception. Unfortunately, the company itself no longer knows how to manufacture its high-tech components because its own experts have all left—and chances are its Japanese partners are not going to share their knowledge willingly.

How to avoid this trap? For a start, systematically and relentlessly assess the longer-term changes in your industry through scenario planning. This will help you identify both the right partners and the right type of relationship with each. And be sure to invite your trading partners to participate in the identification process. The right partners for you will be the ones

that are willing to navigate the changes together.

Choking on physical assets

Physical assets have to pull their own weight. If owning the assets doesn't give your company substantial benefits over borrowing, sharing or paying for their use, they will drag down your performance.

Don't get us wrong. We do not advocate a one-size-fits-all, no-physical-assets financial structure. But it is important to get value from assets you do own.

For example, one midsize firm that manages clinical trials for pharmaceuticals companies sought to build a one-stop-shopping model. To maintain control over staffing and quality, it elected to own all its facilities. Meanwhile, its competitors pulled together loose networks of physicians whose overhead was covered by normal patient visits, which enabled them to set low prices based on the marginal cost of providing an incremental service. The firm found its cost structure unsustainable.

Heilig-Meyers stumbled over its physical assets for a different reason. The home-furnishings retailer traditionally located its stores in rural areas where customers did not have access to easy credit. In fact, the company made all its profit by providing financing. But when credit-card companies offered its customers lower—yes, lower—interest rates, Heilig-Meyers found itself stuck with physical outlets in what were now unappealing locations. As a result, in the past five years the company's stock price has lost about 90 percent of its value.

Lessons learned? Know why you own the physical assets on your balance sheet, and watch out for market changes that sap their value.

Clinging to a weak value proposition

Companies can get stuck with a losing value proposition when competitors attack from a better angle.

A developer of e-commerce software fell into this trap. Its software is built on an industry standard; it is easy to set up and use, and it fits in neatly with a wide array of enterprise software. This product positioning resonated with information technology people, who were the decision makers in the early days of e-commerce.

Later-to-market competitors took another tack. They used business-focused advertisements and sales presentations to appeal directly to Internet marketing executives—the new decision makers. Despite their technical disadvantages—proprietary platforms, the need for expensive software setup and customization, and poor ease of use—they won business. Although the original software developer was the first to market, it just kept talking to techies—and suffered a stunning loss of its first-mover advantage.

What to do? Avoid this trap by relentlessly analyzing lost sales and keeping your value proposition in step with the market as it grows.

Nice try, no cigar

Creating false synergy

Adding new capabilities in the hopes of creating a distinctive position can be particularly treacherous.

For example, one large commercial bank spent millions acquiring an investment banking boutique to get into the Wall Street deal flow, only to discover that the strategy didn't work. The investment bankers resisted what they saw as the commercial bank's attempt to dilute their efforts. They were reluctant to share information and help pursue a target

What is a business model, anyway?

Despite all the hype about new business models, most of us don't have a clear idea what a business model is. And we're not about to get it from the media.

We read that "free" is almost a default business model on the Web, and we gather that a business model is an approach to pricing. Then we hear that there are two basic business models—companies either compete on price or they compete on quality—and we conclude that a business model is a value proposition.

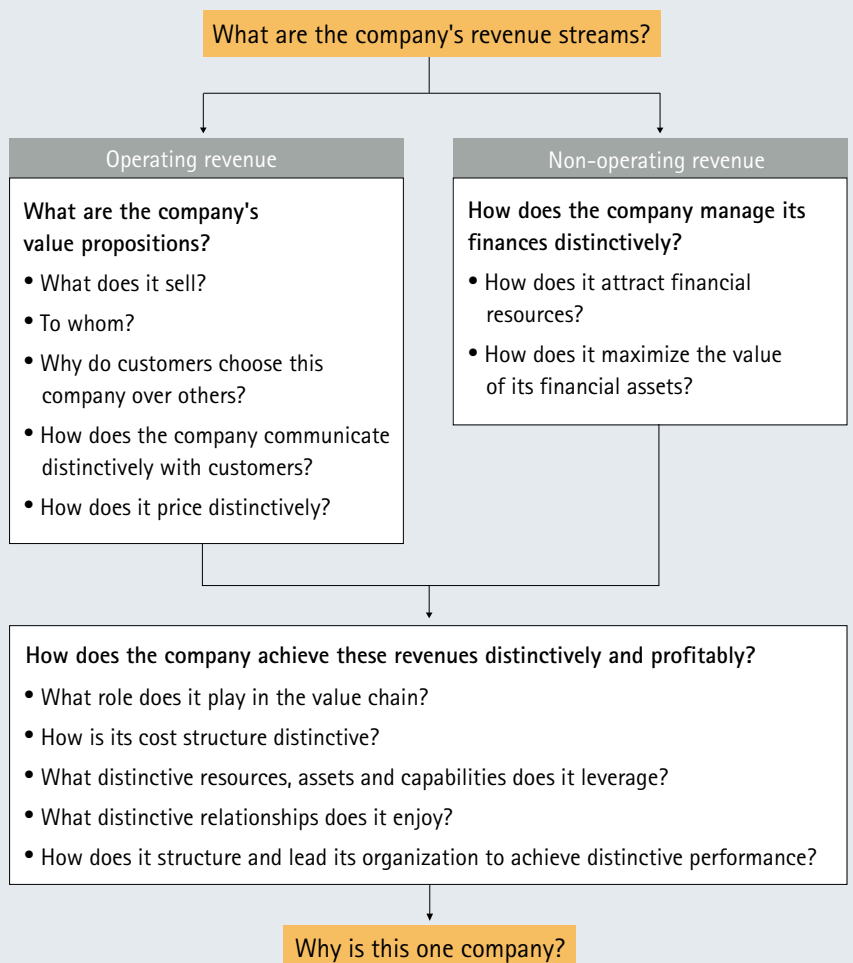
To further our confusion, we're told to consider skunk works, standing

steering committees, new business units, spin-offs and outsourcing as business models. So are business models really organizational forms?

In fact, each of these definitions gives us only part of the picture—because a business model includes all of these elements and more.

So what is a business model? It's an organization's core logic for creating value. For profit-making enterprises, it tells what the organization does to make money.

To help you define a business model, we developed a framework.



SOURCE: ACCENTURE ANALYSIS



client if it would be the commercial bank that ultimately won the business. The investment bankers were particularly unenthusiastic about making joint calls to help sell a product that was going to cost less than their own services.

The lesson? Don't count on synergy unless you can take it for a test drive before the acquisition. Use simulations and role playing to assess whether your organizations are likely to collaborate effectively.

Looking too far ahead
Executives' long-term vision for their businesses frequently involves creating a foothold in a market, then leveraging it to expand or improve profits. But sometimes companies that use such a two-step business model can get stalled in phase one.

A biopharmaceuticals firm, for example, planned to start off with a diagnostics business, then step from that platform into drug development. The original strategy was to use the profits from diagnostics to fund the move into therapeutics. Bad idea. The diagnostics business has poor margins; it's virtually impossible to lock up this market because there are simply too many ways to test things. This company became so preoccupied with trying to make diagnostics profitable that it never got to phase two.

Many of today's Internet service companies are using a similar model to grab market share with pricing that is attractive in the short term. When the market shakes out, they figure, they will raise prices and recoup early losses. But successful companies will determine how to make money at the current prices.

What should we take away? Do not pursue a two-step plan unless both

business models are independently viable.

Having shortsighted pricing

Some startups have been remarkably uncreative in the way they price, cutting themselves off from the profits they need to fuel growth.

One company that builds transaction software for the electric utility industry planned to set prices according to the number of regions that will use its system. This was shortsighted in two ways. First, regions are consolidating; second, most startup utilities cannot afford the purchase and setup price of the software. It would make more sense for the software company to price by the kilowatt—the more business its customers do, the more they pay. This approach would allow the software maker to grow as its customers grow.

What to do? Design your business model around pricing mechanisms that not only give you a foothold in the market but also give you access to the market's upside potential. Consider what we call activity-based pricing: Set your prices based on your customers' activity—even when your cost structure is fixed.

Offering low-margin products to high-maintenance customers

Companies that compete in high-service, premium price sectors can suddenly find themselves in low-margin territory.

To cement its relationships with long-standing or powerful customers, one high-end insurance company offers run-of-the-mill corporate products as well as its more distinctive, high-margin ones. Unfortunately, its high cost structure guarantees that the price-competitive add-on business will operate at a loss. Perversely, the company's "best" customers be-

come its least profitable ones. And paring the business back to its profitable core would involve taking a substantial and unpalatable cut in revenue.

How to avoid this trap? Make the cost structure of each business line competitive and build an overall competence in pricing.

Overdoing outsourcing

Stripping away a firm's non-core activities can be taken too far. Even though a particular process or capability might be ancillary to your current strategy, outsourcing it today could look like a big mistake when the smoke clears tomorrow.

An electronics and high-tech company, for example, outsourced its extensive human resources function to cut costs as its core business faltered. A large distribution firm took the opposite approach. When its suppliers shifted 50 percent of their business out of the channel and direct to retailers, it bundled HR capabilities with distribution and logistics, then offered these management services to Internet retailers. Amid the disintermediation, it created an opportunity for profitable growth—an opportunity that is no longer available to the electronics and high-tech firm.

What to do? Use real options to help you evaluate the costs of outsourcing and partnering opportunities, and play out the scenarios before you do the deal.

Surefooted

Succeeding in the new economy means dodging both kinds of business model traps—the ones that snag slow movers and the ones that catch the hasty. To stay on your feet in the obstacle course, you should make sure that everyone in your company knows how and where you make money.

Sounds obvious. But we spoke with executives at one old-line industrial manufacturer who said that the company had just done such an analysis for the first time. To the company's credit, management concluded the exercise by plastering the walls with posters that communicated exactly what priorities drove profitability.

Are you wondering how solid your staff's understanding is? Try taking a walk through the call center or the warehouse and asking employees to describe your firm's business model. If they know the answer, you've done a good job communicating it.

You will also want to monitor your pace. To avoid being trapped by slow response to market changes, you must be on the move. Check your speedometer to be sure you're keeping up.

How? Identify the good new ideas that hit your industry over the past two decades—like total quality management, reengineering, build-to-demand and product simplification. Use a literature search to pin down when the idea first appeared, and interview company veterans to sort out when your company first adopted it. A large and/or increasing time lag spells trouble. To pick up the pace, bring the future into better focus through scenario planning and competitive war games.

Finally, you can avoid business model missteps by trying out new approaches in contained settings. A major automobile manufacturer is experimenting with direct-to-customer sales in areas where it has no dealer network. Tera-dyne, an automatic test equipment and software supplier, launched an ersatz startup—a sort of business within a business—to pursue a radical new technology instead of assigning its development to an existing division. Likewise, a major chemical company has set up profit centers to make

businesses out of engineering services it used to give away.

The nimblest companies change before they are forced to change. In fact, they proactively lead change. And what do they do with their lead? Set traps. ■

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