What Value Leaders Do?

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CEB Working Paper N° 04/031
November 2004
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Recent years have seen performance problems at once industry-leading companies. Some have become the victims of corporate greed. Others had poor control systems which allowed some far flung outpost to skew the risk profile of the firm. Some others just blamed the tough industry environment or worsening macroeconomic conditions. Though these issues do have some effect on the firm’s performance, the real reasons can be found in the managerial misunderstandings as to what leadership means and what their strategies are supposed to achieve.

Some companies tend to prosper for a while before they turn out to be one of the industry’s also-rans, such as Ford in the auto business. Others such as Fiat fare even worse. Some others such as the Belgian movie-theater operator Kinepolis that invented an industry, by going against the industry’s conventional wisdom, and had a spectacular debut at the stock market when it launched its IPO, has seen some difficult times as the company’s performance deteriorated. The question managers at successful companies face is how to stay on top of the industry for sustained periods of time, even as industries face the forces of convergence and globalization, on the supply side, and the forces of changing demographics and incomes, on the demand side.

These companies, among many other examples, offer lessons for what it means to be a leader. What emerges from years of research, both ours and others, is that long-term value creators define leadership differently. Instead of focusing on industry leadership, these firms tend to focus on value leadership. To achieve value leadership, these companies build their strategies on two interrelated dimensions - creating value for customers and capturing value for shareholders (see the insert on ‘What is Value Creation and Value Capturing?’). Companies that ignore this attribute of strategies tend to lose their perceived competitive advantages over time, and those that focus exclusively on only one dimension risk making their strategy don’t unsustainable. But, more importantly, leaders tend to have a different perception of what the industry itself means to their strategies.

Types of Industry Leadership
Many managers consider leadership in terms of being the number one firm in their industry. Industry leadership (see the insert on ‘What is Industry Leadership?’) is often the holy-grail for any company. But there are different types of leaders. Some leaders, apparently highly profitable, suddenly face declining revenues and strong competitors. Other types of leaders with apparent market success find profits elusive. Both these types eventually find their leadership position under threat. And the causes are often found in where these firms place emphasis on: value creation or value capturing.

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1 This research is presented in the following two papers:
**Monopolist Leaders: The Value Capturing Trap**

It is instructive to look at how these questions play out in certain types of industry leadership. One type of industry leader can be seen in the lower right corner of a value Creation and Value Capturing framework (see what is value creation and value capturing?). This represents a situation of above-average performance. But this leadership is due to monopoly advantages that may be due to regulation. As with monopolies, firms in this category have little incentive to create customer value, but the monopolist is still profitable. High value capturing is accompanied but low value creation: it is supposedly easy to ‘make money’ (capturing) without having to create the necessary level of net customer utility (low value creation), i.e. a ‘dream’ of a business.

These companies are, in fact, trying to escape the question of creating value to their customers. Companies or even entire ‘industries’ could be found in this, rather ‘convenient’, position. Typically regulated industries, such as the old telecoms, utilities or banking industries, probably belonged there for quite some time – as long as it lasted in the ‘good old days’…. Indeed all monopolies or colluding oligopolies can be placed there: De Beers in diamonds, OPEC, IBM in the eighties, and even Microsoft in the software industry, if you believe the anti-trust authorities. In such dream conditions, returns apparently were secure by the non-competitive and often regulated market structure. To some observers, such firms may look to be as industry leaders as their performance tends to be above the industry average. But leadership in this scenario is built on the leverage of a dominant market share, possibly due to regulatory protection or past market success, in a market that may be changing in fundamental ways.

While dreams may last for a while, sooner or later reality takes over. If the monopoly advantages are eroded by de-regulation or technological change or ‘globalization’, the nice and cozy situation of the lower right comes to an end as the winds of competition sets in when new entrants or better competitors compete for the company’s customers as the barriers of regulation or technology come down. The ability to capture without creating much comes under serious threat and it often comes to a squeaking halt in the lower left corner. In other words, the monopolists, when the regulatory or technological conditions change, end up being the industry’s value loser.

Managers have to realize and respond to the new circumstances. Often they do not even realize, and in some instances managerial myopia denies the change that is playing out in the competitive environment. In this ‘denial’ scenario, companies tend to delude about the decline in their competitiveness. What one sees, in a variety of industries, is that the first reaction when confronted with deteriorating financial performance, is often one of denial of a collective nature - “this will not happen to us! Even if something is happening, it will not be so fast! Why should we bother when profits are still pouring in? Why should we cannibalize our own products and services?” Such scenarios are aimed essentially at what we call perpetuating the ‘horizontal game’ i.e. trying to push back to the lower right corner and stay there. The argument is that our industry is different and the critics do not understand the industry economics.
The Horizontal Game of Value Capturing

Other responses companies can be to ignore the fundamental changes required, and instead to look for short-term solutions to long-term problems in competitiveness. One scenario is to resist the deregulation, a key force in many industries in recent years, by trying to prevent it happening in the first place. Lobbying against de-regulation can be seen in the pharmaceuticals, telecom, airline or electricity businesses in Europe and the US. Companies may be subtle in the ways they push for regulation to protect their competitive positions. In some cases, it may be accompanied by a plea for re-regulation! In other cases, they may push for setting of proprietary technological standards to exclude foreign competitors with a different standard, or argue for export subsidies to be competitive in international markets. Even ‘green’ strategies may be used for safeguarding the position of the incumbents. However, sooner or later, the pressures will take over and often the longer it lasted, the higher the resistance, the bigger the shock may be.

And then, there is of course always an instrument of last resort, if all else fails: buy the competition instead of beating them! This has been clearly and explicitly the motivation behind a good deal of the mergers and acquisitions (M&A) of the last several years, propelled and supported indeed by a buoyant stock market. Such logic is based on a flawed understanding of the value of size in creating competitive advantage or the underestimation organizational complexities. When managers believe that “only a few big players will survive” in their business or the ‘inevitable industry consolidation’, they embark on acquisitions of whatever few targets that may be left, with little understanding of the sources of value creation and capturing from a combined entity. ‘Bigger is better’ logic can often be a recipe for value destruction. But ‘better’ can lead to a ‘bigger’

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2 One CEO recently observed that, “If our existing business was going nowhere, it would be easy to reason that here is a great opportunity to create a quick fix”. (James Crosby, CEO, HBOS, after abandoning the take over Abbey National, a domestic rival in UK).
company – many industry leaders such as Wal-Mart and Toyota are also the largest firms in their industry segments. The key point is that instead of getting bigger to become better, these companies target getting better to become bigger.

The result of the M&A boom we now know all too well: value destruction even for those shareholders who initially thought they would win because of huge ‘restructuring’ costs and expenses, and after years of ‘integration’ efforts in search of ‘scale economies’, ‘complementarities’ and such by cutting ‘overlapping’ activities or businesses, (re)selling unfitting businesses. And if all else fails: an outright 180 degrees turn after the initial euphoria. Like Glaxo Smithkline Beecham, which after arguing that innovation is costly and scale sensitive, merged one empty pipeline of new drugs (Glaxo) with another empty pipeline (Smithkline Beecham) to create one big empty pipeline of new drugs and quickly turning to split or even spin off some of its newly acquired ‘scale’ in research and development! In most cases, the more time spent away from the market requirements and the customers, the more opportunities there are for newcomers or focused players to get ahead.

One can also look at the recent experience of Unilever, a company that dominates many consumer segments along with its main competitor P&G. The company has been focused on what is essentially a value capturing strategy. While the reduction in the number of brands and other cost cutting measures helped the bottom line, revenues have fallen down, which may be an indicator that the company’s customer value creation is lagging behind. Companies playing the ‘horizontal game’ do not recognise or respond to signals that the industry is changing in fundamental ways, either because of demand and/or technology shifts. Such firms eventually enter a dogfight where they try to capture more and more of a dwindling value creation pie. A downward spiral speeds up the entry to ‘hell’ where low value creation leads to low value capturing, and the firms respond by cutting prices or adding features to their products that increase costs without increasing customer value to the same extent.

In general, a strategy that is focused on value capturing with minimal value creation places the firm on a slippery slope. Ultimately there is no escaping the necessity to concentrate more on creating value, before and ahead of capturing. This goes to the heart of this model: there is no financial value to be captured (‘shareholder value creation’) in a sustained way, if it is not preceded, supported and sustained by value creation in the business, in the market, for the customers.

*Value Innovation Leaders: The Value Creation Trap*

A second type of industry leader is one which is in the top left-hand corner of the VC² framework. In contrast to the monopoly industry leaders, the value innovation leaders operate in a competitive market structure. However, in this scenario, the company is rated as a success from a product-market perspective, but performs poorly in terms of rewarding investors. This is very much the case, when a company sells a product that is a big success in the market place, but the company cannot make sustained returns greater than its cost of capital. These are innovative companies that are considered leaders in
terms of customer choice, but with poor profits. This is a nightmare, since managers cannot understand why the company that seems to have great products is unable to generate the required returns on investments.

New entrants typically enter straight into the upper left hand corner of the VC\(^2\) framework, undeterred by the structures and the business models from the past. Entrants with a new value proposition may sometimes be in a ‘second mover’ or ‘newcomers’ advantage, unimpeded as they are by existing markets, products, interests. They do not have to fear cannibalizing their existing business, nor have to face internal conflicts of interest between new and existing businesses. Entrants can rethink what exactly is a value creating proposition from the customer perspective and do not have to be bound by industry conventional wisdom. The experience of Kinepolis, the Belgian movie theater operator, is a great case study of an entrant that redefined the industry and has achieved industry leadership. By creating a whole new level business model by challenging the industry logic, the firm created a new market and established itself as the leader of the new industry. However, the company has not been as profitable as its leadership would suggest. Here the leadership is one based on value creation, and with a limited focus on value capturing.

Those entrants who stay in this corner for too long risk into falling into what we call the ‘value innovation trap’. In this position, while enjoying tremendous customer response, the company is unable to convert market domination into profits. This is a trap because companies, having created a new market or a new industry segment, believe that profits will follow. If the monopolist industry leader leverages market share to create above-normal profits, then the value innovation industry leaders strategy is built on the expectation that market share will lead to above-average profits.

Many dotcom firms fell into this trap. Some of the original value propositions of the ‘new economy’ were simply ‘too good’ to be true and therefore quickly disappeared with the dotcom bust, while others survived only with the destruction of shareholder value. Amazon is a typical value innovation case from the customer perspective. It offered a new value proposition that arguably had positive net utility value. An activity model that was different from the bricks and mortar incumbents was able to create and deliver the value proposition. While customers benefited from low prices, and employees from stock options, Amazon realised that some of the assumptions about its cost advantages did not materialise. It involved investments in expensive IT systems and logistics. Still the competencies and the associated first mover advantages it built were not sufficient enough to prevent competitors from offering similar services, i.e. the barriers to entry were minimal. The company declared its first operating profits of $64 million only in 2002 after investing over $6 billion in equity and around $2.5 billion in debt. Even this operating profit of $64 million has been contested by business analysts. A great return on invested capital indeed! Shareholders of many other dotcoms were even less fortunate.

Even more well-known companies have managed to get to this trap and stay there for sustained periods of time, much to the aggravation of their shareholders and sometimes even their customers, since it is not in the customer’s interests when companies do not
manage to pick the fruits of their rewards and make enough money to reinvest in further improving, innovating and re-inventing the business. An example is Philips, which is not only well known for its innovations that it put out on the market, but also the many financial problems that it went through, unable as it were to capture a sufficient part of the value created to the customers (or indirectly it shared the value with its competitors who either copied their innovations).

While value creation is an important part of any strategy, it is not enough. If investors do not get a slice of the value creation pie, other stakeholders are likely to get it. Customers, employees and suppliers may capture more value than they contribute to the company’s value proposition. Value, in financial terms, is the combination of volumes and the difference between price and costs, i.e. margin, where costs include the capital costs of financing the firm’s assets. While value innovation leaders may be having a large volume of sales, thereby dominating the industry in terms of market share, the margins on these sales are not what would earn them an appropriate return.

The challenge then is to turn innovative products to profits. In fact, managers often find that even though innovating is hard, there are even fewer rules as to how to make the upper right move in the VC2 framework – where in the firm starts capturing profits. The danger of not starting to capture value at some point is that the firm does not generate enough cash profits for reinvestment. No firm can in the long-run sustain in this position, and will eventually become a value loser.

From Industry Leadership to Value Leadership
The problems with the types of industry leadership examined above are both conceptual as well as one of measurement. Conceptual because the industry leadership is based on uni-dimensional advantages – the monopolist industry leader is high on value capturing, and the value innovation industry leader is high on value creation. Unidimensional strategies ultimately prove to be unsustainable – in both types of leadership, the firm ends up becoming value losers, where the company neither creates value nor captures value. Because focusing on capturing value through pricing without delivering the perceived benefits is no more sustainable in a product market competitive context as the strategy of creating value for customers without making profits in capital markets. Another problem is whether the traditional way of defining industry leadership in terms of a single dimension – profitability or sales growth – informs the wrong type of firm managerial objectives. A focus on increasing sales, while creating growth, may happen at the expense of profits. On the other hand, a focus on increasing profitability may lead to asset sales or underinvestment that can engender long-term competitiveness.

Instead, true leadership of companies that tended to outperform their notional industry peers has come from increases in two types of value – value creation and value capturing. But doing this across industry changes and business cycles usually involves more than trying to play the existing industry structure. Wal-Mart, Southwest, Toyota had been able to both create and capture value over time. At least three key aspects dominate strategic thinking in such firms.
Customer Value Zones
We find in our research that, leaders tend to exist in industries with varied structural
classifications – whether capital intensive auto business or the research-intensive
pharmaceutical business or the distribution-intensive consumer goods businesses.\(^3\) If
companies can perform irrespective of industry conditions, then the issue is indeed the
appropriateness of considering leadership in terms of industry peers. Further, industry
definition is often a matter of debate – are Ryan Air and Easy Jet, low-cost carriers in
Europe, in the airline business or in the transportation business? Defining industry
leadership, when industries are undergoing rapid demand, technological and regulatory
changes, can be a difficult exercise.

In short, an industry focus may be useful in the short-term, but often can make the firm
myopic in the long-term and in danger of missing out fundamental changes taking place
in the market. Instead, successful value leaders tend to keep their focus on identifying
emerging customer segments that may require fundamentally new value propositions than
the ones currently part of the firm’s offerings. A value leader like IBM once missed out
on the PC boom, but was quick to reposition itself as a solutions provider rather than
providing a range of hardware and software products.

Identifying a new emerging segment is usually not enough. The firm also needs to have
worked out an appropriate activity configuration that will be allow the firm to develop
and deliver the value propositions. For instance, when IBM in the 1990s identified that its
focus will be on providing solutions, it reconfigured the way it sells its hardware and
software. Motorola has recently developed a vision around mobility, where by it will
focus efforts on developing devices around mobile communications, computing,
entertainment. This requires it to bring in a set of complimentary capabilities and new
activity configurations to realize the changing vision.

Shareholder Value Zones
Customer value zones only show a potential for value creation. They do not necessarily
mean value capturing for shareholders. The shareholder value zones provide a filter to
understand whether the firm can actually make money out of the emerging customer
segments. Two factors are likely to narrow the customer value zones into forming the
eventual shareholder value zones. One will be the costs of creating the customer value as
employees need to be paid and suppliers will claim at least their marginal contributions.
The second factor that narrows the shareholder value zones is potential competition. The
more unique the underlying assets and activities, and more difficult it is to acquire such
assets in factor markets, shareholder value zones will be less narrow than otherwise.

\(^3\) See Hawawini et al., (2003, 2004)
Continuous Innovation
To keep with the ever changing customer requirements, supplier issues and competitor moves, companies need to keep innovating their value propositions and activity configurations. However, Innovation for innovation sake is unlikely to keep the value leader from falling into either the value capturing or the value creation traps. Poorly managed innovation can lead to market success but not much success in creating shareholder value. If maintaining the status quo pulls leaders down to the monopoly industry leader, an emphasis on value creation by innovation that is easily replicable or substitutable by competition risks pushing the company into the value innovation trap. Consider once again the case of Philips. The company was once a leader in the consumer electronics business, but during the 1990s it lost leadership positions to Japanese and Korean competitors. All along, its strategy focus has been on more innovation, with the aim of maintaining (and later recovering) its leadership positions in the different segments of the consumer electronics business. Instead, the company has for long been in a value innovation trap, where its leadership positions do not necessarily earn it the required return on investments.

In both value creation and value capturing approaches, the leaders use innovation as a key element to maintain their leadership. But this is a different type of innovation. One difference is that innovations are done within a broad framework whereby they reinforce the firm’s strategic positioning. For instance, Wal-Mart’s innovations tend to focus on improving its low-cost advantages, while that of speciality retailers such as ‘theory’ focus on improving their differentiation. A second difference is that innovations also align the firm with industry shifts. McDonald for a while failed to understand that customer tastes are changing towards more healthy and innovative food. The more creative leaders tend to create shifts that favour them more than their competitors. For instance, Wal-Mart’s move in to toys and groceries aligned well with its capabilities of operating highly efficient supply chain systems and the changing trends of increasing number of price sensitive customers for a wide range of products. Theory’s international expansion towards other developed markets also tunes into a sizeable niche of anti-fashion consumers in some European markets.

A third key difference is that the innovation does not occur in a uni-dimensional manner, but rather against a backdrop of enlightened self-interest and survival. Enlightened self-interest because the leaders understand that innovation that creates value for customers, without the required capturing for shareholders, is unsustainable in the long-run. Enlightened survival because these leaders know that without value creation for customers, they would not survive to make money for their shareholders.

An Organization for Industry Leadership
Organizational issues, in addition to the strategic issues of value creation and capturing, may determine whether a company actually achieves its aim of industry domination. Studies have shown that value management is not only a strategic but also a key
organizational issue (Haspeslagh, Noda and Boulos, 2001). One factor that is critical is corporate culture and shared values of how the organization ‘thinks’ and ‘acts’, both strategically and on a day-to-day basis. A culture where employees across all levels provide ideas and drive programs that focus on value creation and capturing will be one of the key assets that will be difficult to replicate or open to purchase by competitors.

Another factor that will be critical will be the incentive systems. One of the biggest factors that contributed to the accounting problems at well-known leaders is widely regarded to be the pervasive influence of stock options and the overt focus on short-term profits. Designing the incentive systems in tune with a value creation and value capturing approach may mean that employees not get rewarded for bringing in profits, but also for their efforts in enhancing the value creation capabilities of the company. For instance, at monopoly industry leaders the performance system may be skewed towards essentially bottom line measures, while in value innovation leaders, it may be skewed towards top line measures.

But whatever the organizational choices made, they need to be aligned with the ability of the underlying strategy to create and capture value. Any other focus is likely to mean that companies will lose leadership over time. Too many once proud companies have been consigned to history and business school case studies for failing to adhere to this basic but essential principle of strategy.

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What are Value Creation and Value Capturing (VC2)

Value creation and capturing can be measured in relatively simple fashion using basic economic concepts. We use a value equation and a value diagram to illustrate this. While profits per unit of sales are the difference between two elements, i.e. between price and costs, the value equation has three elements: gross value that occurs from customer utility, the price charged and finally the costs incurred to create the customer utility.

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V = \text{Gross Utility Value} - \text{Price} - \text{Cost}
\]

The value diagram is a depiction of the above value equation.\(^5\)

There are two types of value: customer value and stakeholder value. Customer value is the value creation as seen from the customer perspective. Economists call this the utility value derived from the firms’ products by the target customer. We can also call this as the gross value of the customer’s utility. Gross levels of utility are influenced by the nature of the value propositions – high levels of customer satisfaction, specific to a particular strategic position of costs or differentiation, would lead to higher levels of customer utility. Gross utility value therefore is the maximum price that the customer is willing to pay or the maximum value that can be captured by shareholders in the absence of competition and costs.

The net utility value for the customer, i.e. the consumer surplus in economics terms, is the difference between this gross value and the price paid. Net levels of utility or value creation, depends on where the eventual price will settle down, which in turn depends on the intensity of competition. The company that has the highest levels of value creation, i.e. highest levels of net utility, has an advantage over competitors in terms of value creation. Winners, for instance in cost-based positions, are able to offer the same level of gross utility as the average industry competitor but at a lower price. Winners in differentiation-based positions are able to offer the higher levels of gross utility at average industry prices.

How much of grow customer value creation does the firm’s owners eventually capture? Shareholder value creation or value capturing is given by the difference between the customer surplus or value creation for customers and the value creation or capturing by the firm’s other stakeholders. Value capturing is simply the difference between price per unit and the cost per unit. Economists call the difference between the price charged and the cost incurred as ‘producer surplus’.

\(^5\) Similar expositions are illustrated in Brandenburger and Staurt (1995) and Besanko, Dranove, Shanley and Schaffer (2003).


**What is Industry Leadership?**

Very often it is not clear what is meant by industry leadership. Is it the firm that is considered innovative, or is it the firm that is perceived to have the best customer service, or is it the firm that claims the highest growth rate in sales? Whether a firm is considered an industry’s leading firm may also depend on the perspective of the stakeholder examining it. Managers and investors may have different views of whether a company is an industry leader. Managers may like to emphasize market share, i.e., success in the product market. Investors, on the other hand, may be interested in how well the firm performs in terms of increasing the value of capital when compared to its industry peers. Are these views contradictory, i.e., how does market leadership (market share may be an indicator) and leadership based on increasing the value of capital related, if at all?

Industry leadership is when a firm(s) is able to increase the value of the capital invested more than any other firm in the industry. But this type of performance is only an indication of something more fundamental, which is the firm’s competitive advantages in the product and geographic markets it competes. In other words, domination in the product markets is important if the firm can outperform its industry rivals in the capital markets. So, industry leadership would mean dominating customer choice in selected product markets, as well as the highest increase in the market value of capital relative to the industry competitors.

There are also different types of industry leadership, depending on the way the company perceives and maintains its leadership. The two-by-two matrix of value creation and value capturing provides a framework for understanding the different leadership types.

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<th>Value Creation</th>
<th>Value Capturing</th>
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<td>HIGH</td>
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<td>Value Innovation</td>
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<td>Monopolist Industry Leaders</td>
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In non-competitive regulated markets, as was the telecommunications or the insurance industry in Europe, companies enjoy leadership from a monopoly over specific product categories (respectively the fixed line voice services and life and non-life insurance sold only by insurance companies) and over specific geographic areas (typically their national markets). This is one type of industry leadership, where customers buy a company’s products due to a lack of choice created by regulatory barriers. In this type of market, the firm has a leadership position because it is on the right side of regulation. But such leadership leads to welfare loss, as the monopolist in interested in maximizing its own profits rather than enlarging the industry’s value pie. These are what we call the monopolist industry leaders.
A second type of leadership, one which is achieved in competitive markets, is when some companies dominate customer choice in their product markets. Leadership here occurs because of the firm’s products are perceived to offer a greater utility to customers than competitive and substitute offerings. But here the leader is a success from a product-market perspective, i.e. may have a large market share, but has poor economic profitability. These are what we call the value innovation industry leaders.

A third type of leadership is where companies dominate their product markets as well as geographic markets in a competitive context. Like value innovation industry leaders, these companies have a leadership that occurs in their markets in spite of choice. However, in addition, they also are considered to be an industry leader by capital markets, i.e. they create more value for their investors than any other firm in the industry. These are what we call the industry’s value leaders. Finally, we have companies in many industries that stand out as value destroyers. They perform poorly in terms of customer value creation, but also in creating value for investors. These are an industry’s value losers.