Profit Patterns
30 Ways to Anticipate and Profit from Strategic Forces Reshaping Your Business

By Adrian J. Slywotzky, David J. Morrison, Ted Moser, Kevin A. Mundt, James A. Quella
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Introduction

Twenty years ago, the business world was taken by surprise when the work pyramid was up-ended. Suddenly customers were on top and a flattened corporate hierarchy made front-line workers responsible for understanding and satisfying the customer’s every whim. Today, we’re poised for the natural sequel to that revolution. It’s time to focus on keeping workers satisfied — or at least engaged in their work.

Doctors, chess grand masters and football quarterbacks share a trait: the ability to recognize patterns and learn from them. A doctor can connect symptoms to causes and use that to make a diagnosis and offer a prescription. Top quarterbacks and grand masters can sense the shape of unfolding play, and profit from that knowledge.

Great managers are also skilled at pattern recognition. Every industry is reshaped by patterns of strategic change that can dramatically shift profit and power. Today, as change speeds up, it’s even more important to anticipate how your company’s strategic landscape is changing. It won’t help you to predict the future with 100% accuracy. But it will prepare you to exploit change.

This book presents 30 patterns that are changing the landscape of every business. Understanding them can help you make moves and countermoves that lead to sustained profit growth.
The patterns fall into seven categories: Mega, Value Chain, Customer, Channel, Product, Knowledge and Organizational.

**Mega Patterns**

**No profit:** Once-profitable businesses may become profitless due to changes in their industry. This can happen from an overabundance of the same business design within an industry, leading to deteriorating economics and commoditization, or from the unexpected removal of profit support within the industry. Some examples of profit supports:

- Lower interest rates, which make “all boats rise” in the housing industry.
- The next big product launch in the consumer electronics industry.
- Cost reductions through mega-mergers or another bout of re-engineering in many mature industries.

*How to profit:* Walk away or invent a new way of doing business.

**Back to profit:** Business design innovation brings an industry back to profitability after one or more players create a paradigm shift. This has occurred in coffee, watchmaking, grocery distribution and film-making.

*How to profit:* Look harder at your customer base, see undiscovered needs and build a new business design to meet them.
Convergence: Frontiers fall and the rules of competition change as companies from previously distinct industries start competing. This has happened in such industries as materials, financial services, life science and retail. The convergence takes place on three fronts: suppliers, products and “complementors,” in which two products or two industries (or elements of an industry) converge.

How to profit: Identify the new rules, define your best opportunity space and become its leader.

Collapse of the middle: Companies must provide lower cost or superior benefit or focus. Once it was possible to fudge and fall into the soft middle ground. Now that middle ground is collapsing.

How to profit: Be the first to go to the extremes.

De facto standard: Customers crave compatibility — if you can provide the industry standard you’ll receive high value. Apple’s failure to follow this rule shifted more than $100 billion in shareholder value to Microsoft.

How to profit: Create the standard or ally early with the emerging standard.

Technology shifts the board: Technological innovations happen daily but some are so powerful they fundamentally reshape the playing field and create a large-scale redistribution of power. Examples are the car, television, personal computer and the Internet.

How to profit: Go where the power will be.
Value Chain Patterns

Disintegration: The vertically integrated model in an industry disintegrates through outsourcing and other factors, and specialization takes hold.

*How to profit:* Specialize and dominate an important cell of the new, fragmented value chain.

Value chain squeeze: The growing strength of neighboring suppliers and customers can trigger a squeeze on the step in the value chain where a company and its competitors are operating. The squeeze can be so intense that it leaves no opportunity for profit growth. U.S. television is an example, as affiliates and content producers catch the networks in their pincers.

*How to profit:* Improve your performance faster than your neighbors and pre-empt or limit their strength by encouraging new entrants.

Strengthening the weak link: Companies transform inefficiency in one element of the value chain in an exclusive fashion by working with suppliers. McDonald’s Canada did this when it went into Russia, strengthening the beef and potato industries.

*How to profit:* Fix the weak link — exclusively — tying its success to the success of your business design.

Reintegration: Expand the scope of your business model to include activities that were once viewed as upstream or down-
stream. The Gap — once a single store — did this through vertical integration. Although manufacturing is outsourced, The Gap designs its own clothes.

*How to profit:* Reintegrate the parts of the value chain that matter because of profitability, customer information or strategic control. Don’t acquire unless essential. Instead, use contracts, relationships or minority ownership.

**Customer Patterns**

**Profit shift:** Not all customers are profitable. With declining gross margins and increasing variability in costs, many companies target profitable customers and discourage the unprofitable.

*How to profit:* Build a customer profitability system and use it to change pricing, service and investment levels.

**Microsegmentation:** As suppliers identify characteristics that distinguish customers, they are starting to serve them in microsegments — sometimes as small as a single customer. This is made possible by changes in technology.

*How to profit:* Identify the most profitable sliver, offer tailor-made options, then build a fence around them so competitors find it too expensive to move in.

**Power shift:** Power shifts between customers and supplier, giving one of them the upper hand. This can happen through cus-
Customer consolidation, the formation of purchasing groups, greater availability of information about suppliers’ costs, or a lack of differentiation among suppliers.

**How to profit:** Rebalance the power equation or, if that’s impossible, redefine the customer.

**Redefinition:** Sometimes the only way out of a strategic cul-de-sac is to redefine your customer. Bang & Olufsen, a consumer electronics firm, did this when it hit a profit-growth wall in the 1980s. It moved from serving knowledgeable audiophiles to the luxury-seeking segment, promoting its products as status symbols instead of emphasizing technical quality.

**How to profit:** Look beyond your current customers to more profitable ones.

### Channel Patterns

**Multiplication:** Channels of delivery are proliferating — look at coffee shops and bookstores. This is triggered by technology and by customers who want to buy in different ways and don’t want to compromise.

**How to profit:** Use the new channels early, or launch new channel designs that respond to your market.

**Channel concentration:** A newcomer brings economies of scale to a fragmented, high-cost market by consolidating small
outlets into larger units. Customers don’t mind because they can get better value and service.

*How to profit:* Lead the concentration process.

**Compression/disintermediation:** The classic multi-step distribution system in an industry — wholesaler, distributor, retailer — contracts as redundant steps are eliminated. This is driven by the search for greater value and convenience by consumers and greater efficiency by manufacturers.

*How to profit:* Create direct links to customers early.

**Reintermediation:** In a few cases, the ousted distributor or new players come back into play in another role. Priceline, for example, has inserted a new step by helping travellers find unused airline seats or hotel rooms, offering consumers lower prices and service providers higher utilization.

*How to profit:* Use the new channel early, saving money. As the new channel, act boldly to minimize the opportunity for the next entrant.

**Product Patterns**

**Product to brand:** Companies are less able to differentiate themselves by products and functionality, so they turn to branding. Turning a product into a brand builds trust and loyalty.

*How to profit:* Build a brand.
Product to blockbuster: In some industries — film-making, pharmaceuticals, publishing, investing and network TV, for example — the successful business design depends on creating a consistent series of blockbusters.

How to profit: Develop a system to build blockbusters consistently.

Product to profit multiplier: In some cases, companies can successfully reuse an asset to generate exceptional profit. Disney does this with movies, creating an array of related products. Bloomberg LP does it with daily financial information, delivering news in various forms — and selling the desktop machine on which much of it is received.

How to profit: Develop spin-offs for your product, brand or skill.

Product to pyramid: Instead of focusing on a single product, companies can create a product pyramid having multiple levels of price points, brands and styles. Barbie is an example, with a wide range in price. The pyramid pattern allows a company to serve both low and high ends of the market.

How to profit: Build a firewall at the bottom, profit maximizers at the top and, if necessary, key layers in between.

Product to solution: Companies develop bundled offerings of products, services and financing, creating more value for customers and suppliers than merely selling “boxes.”
How to profit: Study your customers’ systems and look for unique solutions to help them.

Knowledge Patterns

Product to customer knowledge: Suppliers develop new profit streams through their deep, systematic knowledge of customer preferences and behavior. This can arise from category management, since knowledge about customer behavior rather than the product itself is often the key. It can come through precision merchandising, which Wal-Mart pioneered. And it can come through dramatic increases in the innovation success rate, as GE has demonstrated.

How to profit: Listen to what your transactions tell you about customers. Use this to create new offerings, develop new systems and improve customers’ economics and your own.

Operations to knowledge: Some traditional industries are seeing profit disappear from their traditional, asset-intensive operations. In response, they build unique knowledge positions. A common form is selling contract services. Marriott no longer owns hotels, but concentrates on management services. American Airlines’ SABRE information system is outranking airline operations as a source of value.

How to profit: Translate operations experience into unique knowledge and find a way to sell it.
Knowledge to product: This is the counter-trend — experience, expertise and knowledge are transformed into a product. It’s particularly common in information technology, with consulting firms or software houses like SAP and PeopleSoft that provide products based on their information expertise.

How to profit: Identify the most valuable knowledge your organization has created, crystallizing your expertise into a replicable structure that’s easy to sell, train and improve.

Organizational Patterns

Skill shift: When yesterday’s skills become a cost burden rather than a source of advantage, companies engineer radical changes in their skill mix to match the market and beat competitors. The skill shift may be functional, as value shifts from manufacturing, sales and R&D to channel or account management, or licensing; technical, as value shifts from hardware to software; or managerial, as the focus shifts from cost to service.

How to profit: Look at how the customer is changing and identify tomorrow’s skill.

Pyramid to network: Companies maximize their external focus by opting for a network organization rather than the traditional pyramid. The Virgin group is an example — whenever a unit reaches about 50 people, it’s spun out into a new company.

How to profit: Maximize the external exposure in your
organizational structure.

**Cornerstoning:** Companies overcome limited resources and create maximum value growth through a careful progression of opportunities. Microsoft started with BASIC, leveraged that into DOS, moved on to Windows, advanced to office suites and then shifted from desktop to enterprise systems with Windows NT. In each instance, the company must choose the best new option — the one with the lowest incremental investment and highest next stage of profit.

*How to profit:* Search for the best next space.

**Conventional to digital business design:** By moving information and communication to electronic forms of management, companies can achieve huge performance improvement. Digital business design can also allow customers to segment themselves, as with Dell’s online configurator or Charles Schwab’s mutual fund evaluator; enable customers to finance business operations, as with Amazon, which has operated with negative working capital; and allow customers to self-report behavior.

*How to profit:* Expand what can be managed electronically.
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