Breakthrough Thoughts
by Jan Dyer Torsilieri and Chuck Lucier

Climbing Up the Value Ladder

Companies never capture all the value they create. To become wildly profitable, you have to assume more responsibility for your customers.

Everybody wants more: your customers, your best people, your shareholders. Your competitors are ready to give it to them. You've already done a lot: Your costs are low, you're focused on core capabilities, you're leveraging the Internet. You're taking advantage of the declining cost of bits and bytes to create more value for customers than ever before: offering your customers exciting new services, working in new ways with your suppliers, and entering entirely new businesses. Despite all this, you're not delivering enough profitable growth.

Capturing the value you create is today's central strategic challenge — and tomorrow's competitive necessity. The problem is that the same forces that enable value creation also make the sources of value — knowledge and information — increasingly available free. It's the same dynamic that Adam Smith observed about water. Although water is essential, it is free because it is so abundant and available at nearly zero cost. Today, companies in mature and emerging industries alike face a growing gap between how they create and how they capture value.

Inside this "value gap" lie some startling and potentially counterintuitive conclusions. Sell your stock in business-to-business exchanges, dot-coms, and biotechnology companies that believe they can prosper by selling information or knowledge. Evaluate whether the bottled water businesses of the New Economy — companies trying to sell branded information — can grow large enough to justify their stock price. Be suspicious of established companies that are investing heavily to bundle information or knowledge with their products and services; it's unlikely they will be able to realize any return on that investment. Demand that companies in mature industries accelerate their growth in earnings by capturing the "knowledge-cash" they are leaving on the table.

The most successful companies will focus on capturing value, not just creating it. While it may seem counterintuitive, the most powerful strategy is to leverage knowledge to take increasing levels of responsibility for ensuring your customers' success.

Companies that adopt this strategy will build a portfolio of

Jan Dyer Torsilieri
(torsilieri_jan@bah.com) is a principal at Booz-Allen & Hamilton specializing in the strategic application of knowledge and learning. Formerly Booz-Allen's director of intellectual capital, Ms. Torsilieri currently helps drive the firm's IC development and works with clients on knowledge and learning efforts.

Chuck Lucier
(lucier_charles@bah.com) is a senior vice president and the chief marketing officer of Booz-Allen & Hamilton. He is responsible for Booz-Allen's brand and for the creation and commercialization of the firm's intellectual capital. His client work focuses on strategy and knowledge issues for consumer products and health companies.

businesses that gives customers a choice of how much responsibility they assume — and how much they are willing to pay for.

The Value Ladder

We visualize the portfolio of businesses as a ladder. On the lowest rung, a supplier sells products and services, but leaves it to customers to apply their own knowledge to assemble what they require and to use it effectively.

Up one rung, a supplier takes responsibility for value-added integration using its superior knowledge to integrate and sell an interdependent system of products and services — a "solution," in consulting lingo. Customers still have to create and capture the end value from the combination.

On the ladder's next rung, a supplier assumes responsibility for the customer realizing a benefit, but leaves the ultimate value creation to the customer.

Finally, at the top of the ladder, a supplier can actually take responsibility — either in part or in full — for the customer's success.

Some companies are already climbing this value ladder. Honeywell's energy group, for example, has developed businesses on the first three rungs. To some customers it sells thermostats and other components; to some it offers integrated energy-management systems; and to some it assumes responsibility for reducing energy costs. Honeywell could, if it desired, offer services at the highest rung of the ladder by taking equity stakes in manufacturers in energy-intensive industries, capturing directly the benefits of the customer's improved cost position.

Climbing the value ladder in this way brings a company closer to the real needs of its customers — Honeywell's customers want comfort with low energy costs, not thermostats — and uses growing knowledge about customer needs to simultaneously create new value and increase the proportion of that value the supplier captures.

Occupying multiple steps on the ladder in this way requires a firm develop new skills, and shifts the risk of value realization from the customer to the supplier. For this reason most companies operate only on the lowest rung, selling products or services, and depend on the customer to select, assemble, and apply the products to become more successful. The customer's ability to use products effectively and its uncertainty about how much additional value will be achieved limits the supplier's opportunity to capture value. For example, in the seed industry, when a supplier like Pioneer Hi-Breed International Inc. develops a higher-yielding hybrid, the rule of thumb says it captures only about one-third of the value it creates; farmers get the rest through higher yields.

As the number of competitors in an industry increases, the proportion of value created that is captured by any one player declines. In the consulting industry, we estimate that we capture only 6 to 10 percent of the value we create with our clients.

The second rung of the ladder — selling a solution — offers the opportunity for greater value capture. Here, a supplier provides the integration that customers used to do for themselves, but still relies on them to use the solution to create value. In the automotive industry, vehicle manufacturers traditionally designed and assembled car interiors using components purchased from several manufacturers. Today, Johnson Controls Inc. is demonstrating that vehicle manufacturers are more successful if they purchase complete interiors, which JCI is able to produce using its own understanding of consumers and systems engineering.

Second-Rung Responsibilities

The critical difference between the first two rungs of the ladder concerns who takes responsibility for making the system work to the customer's benefit. On the first rung, a supplier's value proposition centers on the features and benefits of its products. Of course, its sales force will claim that its products enable the interdependent system to function more effectively and efficiently. But the customer (or another vendor it hires) is responsible for making the system work and realizing the benefits. When Agilent Technologies Inc., the technology and testing spinoff from Hewlett-Packard Company, was simply in the equipment business, it pointed out that its machines enabled patient monitoring. Then it moved from the first rung — equipment sales — to the second rung. Today, it actually links various products and provides the stream of information about patients from their homes to health-care professionals, dramatically easing the management of congestive heart failure and reducing related hospitalizations by as much as 90 percent.

To earn superior profitability at the second rung, a supplier has to be able to make the interdependent system work better than the customer, acting solo, can. One-stop shopping, an oft-cited customer benefit, doesn't qualify as a second-rung service offering: The cost of searching for products (especially on the Internet) is too small. Instead, the major opportunities to earn superior profitability at the second rung occur when the supplier has:

• Better knowledge about best processes for the customer — Shell Brazil uses its expertise in lubricants to manage machine performance — or the needs of the customer's customer (JCI has this knowledge, in automotive interiors);

• Better economics in doing the integration because of its deep understanding of how to apply and link key components; its ability to develop products more tailored to the integrated environment; or its ability to structure software that can be leveraged across multiple clients.

Customers — both busy consumers and businesses focusing on their core competencies — are looking increasingly to suppliers for second-rung value propositions. But few suppliers are seizing the opportunity. For example, most consumers interested in remodeling their homes want a company not only to sell them products but also to ensure that they are properly installed. Although Sears, Roebuck & Company (and recently The Home Depot Inc.) created a second-rung business by offering some installed products, most manufacturers and retailers, unwilling to assume the risk of installation, limit themselves to selling products and giving consumers a list of contractors with whom they can work. There's a great opportunity in the building products industry to develop a scalable way to offer installed products. (If you're an interested CEO, send us an e-mail.)

Third-Rung Risks

On the third rung of the value ladder, a supplier becomes accountable for

> Honeywell recognizes that its customers want comfort at low cost, not just thermostats. It's built a portfolio of businesses around this value proposition.

the customer achieving an underlying benefit, leaving the customer to use the benefit for its own success. Imagine if Home Depot took control of your household water supply. That's effectively what Grupo Cydsa, the Mexican petrochemical and textile conglomerate, does when it builds (and operates) chemical plants for customers, guaranteeing them a certain cost per unit of output. In another third-rung value proposition, the Enron Corporation has made big profits by selling energy services to large companies, ensuring them electricity at set prices, and using its own knowledge to source the power more cheaply, pocketing the difference.

Another way to think about the third rung is that the supplier is offering the customer the opportunity to outsource, guaranteeing a certain level of performance while reducing cost. Many companies have opportunities to offer an outsourcing value proposition: in overhead functions like payroll, information technology, and training (The Forum Corporation), or in noncore value-added functions like manufacturing (the Solectron Corporation) and sourcing of maintenance items (W.W. Grainger Inc.).

The third rung, though, is a big, risky step. Consider a component manufacturer: It can claim it produces significant bottom-line benefits for customers, but on the third rung those benefits really have to be delivered — even when environmental factors or the customer's own behavior stand in the way. Typically, assumption of responsibility requires the development or acquisition of new capabilities. Often, a different sales force is required because the buyer within the customer organization is different. When Honeywell moved to the third rung and began offering lower energy costs, it discovered that it had to sell not to its traditional customers (maintenance managers), but to the CEO or COO level, where few members of its sales force were effective.

The good news is that the third rung allows a much higher proportion of value to be captured — in outsourcing, 50 percent or more — both because the benefits that customers realize can be quantified more easily, and because few competitors are able or willing to supply at the third rung.

It's very difficult to assume responsibility and risk for *all* possible customers. The best approach is usually to target a segment of customers in which the risk is small or diversifiable; where the supplier's knowledge is especially powerful; or where a scalable business model can be developed. Select one or two customer segments in which the risks are manageable, learn to achieve superior profitability in those segments, and then expand into additional segments.

On the fourth rung, the company bears responsibility for its customers' success. Here, the supplier leverages its knowledge with equity. Examples include an investment bank trading on its own account, the Intel Corporation's venture capital activities, or Booz-Allen & Hamilton's initiatives to launch incubators, take equity in exchange for some fees, and develop new businesses in partnership with clients.

At the fourth rung, the company captures all the benefits of the value it creates by applying capitalized knowledge. Of course, this rung requires the company to develop the most new capabilities and assume the greatest risk.

The Ladder Portfolio

Because the best way to capture the value of information and knowledge developed in a business is to use it to create businesses on other rungs of the ladder, successful companies will construct a portfolio of ladder-related businesses. Customers can then choose the rung — and the value proposition — they prefer. For the provider, higher rungs involve much greater value added (and captured) for a smaller number of more targeted customers.

More than a way to capture value from knowledge and information, simultaneously building businesses on several rungs of the value ladder is an unusually powerful strategy. First, success on one rung improves profitability on the other levels. A company can leverage core knowledge and capabilities across multiple businesses, creating a cost advantage over competitors who participate at only one rung. Businesses at higher rungs also purchase products and services from those at lower rungs, providing a base load of demand.

Second, a company with a portfolio of knowledge-leveraged businesses should be a more successful innovator. Because upper-rung businesses capture more of the benefits of superior new products, these companies should be early adopters, demonstrating the benefits of innovations and providing rapid feedback about any problems. The upper-rung businesses, dealing at a higher level in customer organizations, also provide deep insights into what customers really need.

Finally, profitability can be shifted from one rung to another, disadvantaging competitors that participate at only one rung. For example, consider a two-rung software company that both sells products and provides consulting-based solutions using its products. To win against competitors that sell only software, it can charge a minimal price for its software and make all of its profits on consulting solutions.

For companies in fast-growing industries, a ladder portfolio provides additional earnings to finance innovation, increases the impact of innovation, and reduces the likelihood that customers will move to competitors during those inevitable periods when a company's products aren't superior. For companies in slower-growing industries, a ladder portfolio can provide accelerated earnings growth while reinforcing competitive advantage in the base business.

How to Climb the Ladder

We use the ladder metaphor because the rungs are discrete: adding incrementally to your offerings at one rung doesn't move you any closer to the next rung, nor does it make a firm more profitable.

The Thomas & Betts Corporation is an unfortunately good example. A manufacturer of electrical products, T&B developed computer systems and processes powerful enough that it could have offered its distributor customers an interdependent system to reduce inventory. Indeed, T&B could have used its systems to assume responsibility for reducing customers' inventory, capturing for itself increased price realization. Instead, the company maintained a first-rung value proposition; it continued to sell products, while taking on the costs of its acquisitions and value-added systems. T&B may be providing more valuable goods to its customers, but its financial performance has been poor.

Are you adding costs to deliver extra value to customers without changing the value proposition to secure the benefits? If so, you're to be credited for your sensitivity — but condemned for your shortsightedness. The way to climb the value ladder successfully is to look toward the next rung, identify a customer benefit, define the capabilities and knowledge required to meet that need, and then identify and address the gaps.

Companies that climb the value ladder as a continuous growth strategy will define new industries, shaping tomorrow's economy by reconstructing value chains around their deep knowledge of customer needs.

Taking responsibility for customers is the fundamental organizing principle for the New Economy, replacing core competencies, linear value chains, and even customer needs as the way to define individual businesses and entire industries. +

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