Creating and Capturing Value: The Strategic Drivers of Performance

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Industries have their winners and losers. Just think about Wal-Mart and K-Mart, Dell and Compaq, Southwest Airlines and United Airlines, Peugeot and Fiat, Nokia and Ericsson, Nucor and Corus. One may think that these are isolated cases of lucky winners and unlucky losers. But our research into more than 50 industries over 10 years indicates that performance shows some systematic patterns across industries.[2] Most industries have a small set of leaders and losers that dramatically outperform and under perform the industry average.

But the challenge with industry leadership is that it is much harder to stay on top of the industry for sustained periods of time. Industries are littered with examples where initial innovators and long time leaders fall on hard times, as the competitive process ruthlessly weeds out the winners and the losers. However, competitive process also offers the chance to poorly performing companies to renew their stay in the industry. Some poorly performing companies even in industries considered structurally 'unattractive', such as Peugeot-Citroen and Nissan in the car business, have managed to overcome their competitive disadvantages and become industry out performers. A long-term perspective on these performers has enabled us to explore the conditions when industry domination can be sustained and also cases where companies that were once considered as perennial value losers are able to rejuvenate themselves and their competitive advantages in the industry.

In the next sections we discuss the different challenges of winners and losers in an industry and how companies outdo the competition because their strategic choices are innovative along two dimensions - value creation and value capturing. We explore value creation and value capturing in a dynamic context to show how industry leaders may fall on hard times and also how industry laggards can overcome their competitive disadvantages.

Understanding Competitive Advantage in terms of Value Creation and Value Capturing

To understand the dynamics of leaders and losers in industries, it is important to understand the key elements of strategies – the goals and choices and how the choices relate to the goals. Strategies may be deliberate or emergent, planned or opportunistic in how they arise. But no matter how strategies emerge and take shape within the organisation, successful strategies have the creation of long-term shareholder value as the central goal. Long-term shareholder value in competitive markets is driven by a set of two strategic choices so as to gain a competitive advantage over industry rivals. The two key strategic choices are the nature of the value proposition and the activity model. The role of value propositions is to address a viable segment of customer demand. It asks the question of 'what business are we in' from the customer perspective. It places the 'who is the customer' question together with the 'what are the product and service attributes' that can not only satisfy current demand but also address latent demand.[3] The second aspect of a firm's strategic choice is the firm's internal activity model that transforms a variety of inputs into the value proposition. In general, the activity model indicates the firm's make or buy choices with regards to activities. The activity model determines how the firm will create the value for its customers by performing certain activities and not performing others and how it will manage to do so at a cost that compensates its shareholders for the opportunity costs.

[2] See Appendix 1: Background on Industry Leaders and Losers Research

[3] See Markides (1999)

Independently, the choices do not create competitive advantage. The intersection of the value proposition and the activity model is what managers have come to regard as the 'business model'. The two strategic choices together determine the markets the firm will serve and activities it will perform. Bundling these two together is important because ignoring the link between customer needs and the company's offering in the market makes value propositions dysfunctional and hence decreases customer value creation. Not all firms succeed in a given business model – in discount retailing while Wal-Mart is able to achieve a cost leadership position, K-Mart has been unable to match the cost advantage. Whether the business model is one oriented towards competing based on costs or differentiation, only a few firms have been able to make money while many other just manage to do the industry average and a few others under perform the average (see appendix 1). The difference between a business model that provides the company with a competitive advantage and one that condemns it to mediocrity is largely determined by the ability of the firm's business model to create and capture value.

Value creation stands for the value a company is able to create in the face of the customer. Value capturing, on the other hand, is how much of this customer value can be appropriated to compensate for the opportunity costs of capital invested in the value creation process.[4] Value creation and capturing are, in the first place, to customers and shareholders respectively.[5] In a broader context, creating and capturing value applies to all stakeholders involved in the activity of the firm, i.e. employees, managers, suppliers, except for customers.

Definitions are often important to clarify concepts, but more than being a technical concept, the important insights of the value creation and value capturing framework lies in the intuitive approach to understanding competitive advantage. The most useful way to get a feel for this approach is to represent the two essential dimensions of strategy in a two-by-two matrix with value capturing on the horizontal axis and value creation on the vertical axis, what we call the VC^2 framework of understanding performance (see figure 1). The value creation and value capturing matrix is a tool that illustrates why some firms are able to achieve and sustain competitive advantage in a given position.[6]

In a static sense, the framework provides insights into why firms in an industry may be creating or destroying shareholder value. Some firms may be doing well in terms of customer satisfaction, but would be hardly earning a return that will compensate the opportunity costs. Other firms may be in a position to deliver impressive profits without being perceived as customer focussed. Four broad positions, each depicting a particular combination of value creation and capturing, can be illustrated in the matrix.

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[4] See Appendix 2: The Economic principles linking Value Propositions and Activity Model with Value Creation and Value Capturing

[5] The interpretation provided here for value creation differs from one traditionally associated in financial markets. Value creation usually implies wealth creation for the firm's investors. In our framework, value capturing indicates wealth creation for investors, after the firm's other stakeholders have been paid their respective rents (see appendix 2).

[6] See Appendix 3 for an economic interpretation of the VC^2 Framework.

Value Creation

HIGH	Nightmare	Heaven
LOW	Hell	Dream
	LOW	HIGH

Value Capturing

Figure 1: Company Position on value creation and value capturing

A 'dream' of a position is where the company does not create much value for its customers, but still remains a profitable firm. One immediately comes to think of monopolies, such as utilities, that score poorly on customer value creation, but remaining profitable because of a lack of choice for customers. 'Hell' is where one does none of this, such as the case with Fiat in the car industry. The car firm's products, or broadly its value propositions, were not competitive enough and as a consequence the firm lost market share even in Italy, its core market.[7]

A 'nightmare' of a position is where companies, although they create significant value for the customer, do not manage to capture a fair share of the value created. The dotcom experience is a vivid illustration of companies being able to create customer and other stakeholder value such as employee value, but no shareholder value. 'Heaven' is where one scores high on customer, shareholder *and* stakeholder value creation. In this position, the company is profitable *in spite* of customer choice. Many small and medium sized companies in Germany, for instance, dominate by means of extreme specialization in highly niche engineering business.[8] Such companies have remained at the top of their business despite intense competition from Asian rivals.

Leaders, Losers and the VC² Framework

The sources and sustainability of both above-average and below average industry performance can be seen from the VC² framework. Above average industry performance arises from the leverage of either market power or resource power. This distinction between the sources of superior performance is important because it has specific implications for the sustainability of above average performance in the industry. Consider the lower right corner of the VC² framework. This represents a situation of above-average performance due to market power. 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.

Many companies or even entire 'industries' can be located in this rather 'convenient' position. Typically regulated industries, such as the old telecoms, utilities or banking industries, probably

[7] The metal can industry in the 1980s was another case where firms sustained losses, and where value propositions among industry players became less and less distinctive.

[8] See H. Simon (1996). *Hidden Champions: Lessons from 500 of the World's Best Unknown Companies*, HBS Press.

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.

The incentive to create customer value is absent for firms in the 'dream' position. But it would be myopic to think that firms can, in a competitive market, earn sustainable above industry average profits in the long-run without creating value for customers. While dreams may last for a while, sooner or later reality takes over. De-regulation, technological change or 'globalisation' brings increasing competition often in a discontinuous manner. In other words, the nice and cosy situation of the lower right comes to an end as the winds of competition pushes the monopolist to the lower left ... profits are no longer guaranteed, they are taken away by new legislation, new technology or better performing competitors or even new entrants. 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 this position, the monopolist is not able to capture value as easily as before, while also find it difficult to create a culture of creating value. This is hell!

Industry Leadership and the Horizontal Game

Companies in such positions may be slow to realise that fundamental changes are required if they want to regain industry leadership. However, the temptation to look for short-term solutions to long-term problems in competitiveness is strong. Even if the pressures of deregulation, technology and globalization are felt or seen coming, companies initially tend to resort to one of the three options: denial, prevent the change or buy your way out of it. 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. In the '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 cannibalise our own products and services?" This denial can be self-serving, as it can still be a matter of years before the effect of the competitive pressures really start showing up in the bottom line. This does not make the case for change easier to sell and easier to do, quite the contrary...

Consider the insurance industry or even banking in many countries, particularly in Europe, where they were in dominant positions because of regulatory protection. How long it took them to realise that their underlying profitability is poor or non-existent, while at least for a decade the pressures were building up, primarily because of regulatory changes from the single market programme and technological changes. Only it took a big crisis like the one the insurance business is going through lately, mostly as a result of the stock market bust for companies in this sector to face reality and start cleaning up and refocusing on how to become more intrinsically profitable businesses, and not just depend on the short-termism of the horizontal game of value capturing.

A second scenario is to resist the deregulation 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. It does not take rocket science to figure out what will come and how – only the timing and the specific incident or trigger that will make all 'hell' break lose may be difficult to predict.

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. When managers believe that "only a few big players will survive" in their business, 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.

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![9] In most cases, the more time spent away from the market requirements and the customers, the more opportunities there are for newcomers or focussed players.

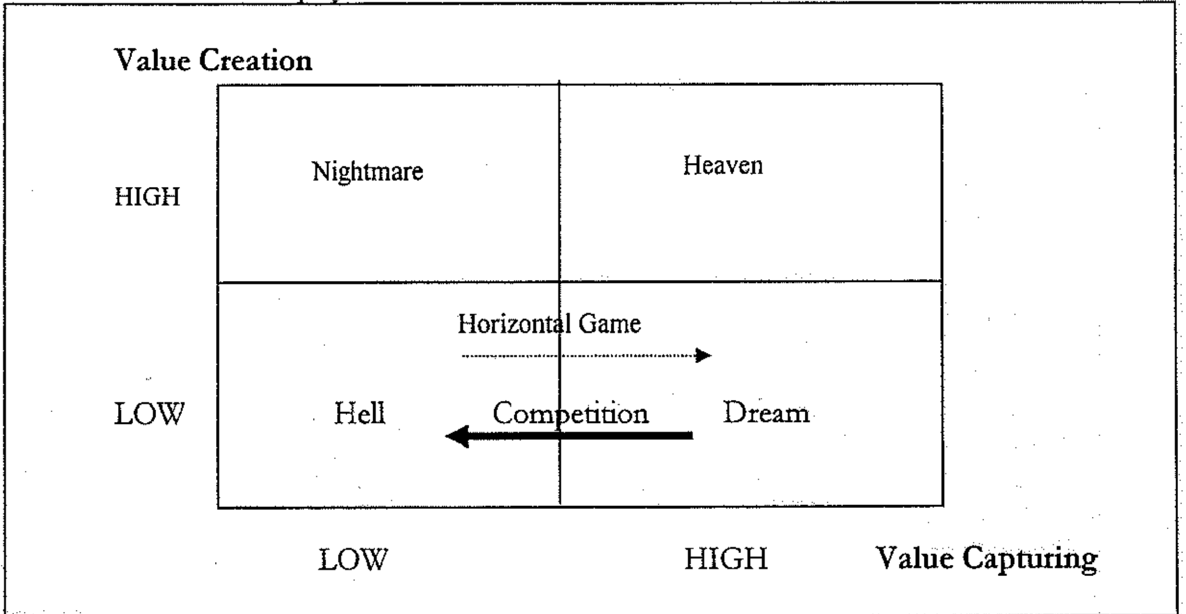

Figure 2: The Horizontal Game of Value Capturing

[9] See Financial Times, 'Big pharma sees the beauty of thinking small', April 1, 2001.

The key problem for industry leaders whose leadership is built on market dominance is that they mail to understand that the industry is changing in fundamental ways in terms of new value propositions demanded by customers and the activity required to create these new value propositions. This is irrespective whether the disruptive change comes out of the blue or whether the signs of change were there. In fact, disruptive change very often does not occur suddenly. For instance, developments in computing and communications technology while rapid were hardly sudden or unpredictable. Evolutions in information technology while very prominent in the 1990s had their origins back in the 1950s.

Usually, there are signals in the horizon that forebode fundamental shifts in demand, in technology, or regulation, which are likely to shift the bases of competition. Companies playing the 'horizontal game' instead of waking up to changes in the fundamental forces driving industry structure tend to ignore, prevent or buy their way out of their future. Failures to frontally respond to changes in the 'old logic' of competing in the industry eventually keeps pushing the company back in to 'hell'. That is because even the most successful acquisition strategies eventually run out of steam, if only because they need ever bigger, more expensive and less obvious (i.e. less strategically relevant) targets and therefore sooner or later end up in megalomania in need of justification as 'diversification', 'one-stop-shop' 'integrated service supermarket', 'value-added services' and the like which we know where they eventually will end up: on the sales shop or the auction block of corporate restructurings.

Or at the very least companies playing the 'horizontal game' may be overtaken by new entrants who 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.[10] 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 (no fear of 'cannibalisation', no internal conflicts of interest, no sunk costs or 'strategic investments' or other liabilities from the past to pay off). Perhaps some players in the lower right hand quadrant may try to buy every single start-up entering into the upper left corner, and potentially posing a threat to them in the long-run if the start-up's innovation will succeed. Of course this also requires investments and requires the ability to integrate such start-ups with a different culture with the monopolist's culture of relaxed existence. To the extent the purpose is to limit the competition in the sector and prevent others from innovating, it will sooner or later run into the limit of anti-trust regulation. Such approaches may help in preventing the slide along the slippery slope in the short-term, but in the long term it only postpones the inevitable move to becoming a value loser.

Of course the question always arises whether one cannot just enjoy the comfortable dream position as long as it lasts, and then when rough weather starts showing up quickly moving up the right hand side of the picture from dream to heaven? The morale of the story is that it is exactly that move that practically seems to be impossible to make! Because innovation and value creation, re-focusing on the customer and the market requires a whole different mindset, organisational logic and behaviour, than the value capturing approach. It usually takes hard and painful overcoming of mainly internal organisational and cultural barriers to make that change of focus and attitude happen. Disruptive change may then eventually set in as the firm gets more interested in safeguarding its existing business model rather than to fundamentally rethink the model's basic premises. In most companies it takes a real life-or-death crisis in order even to get started, let alone to get there!

[10] See Christensen (1997)

The morale of the story should become clear by now: when competitive pressures shows up in otherwise sleepy and 'dreamy' industries, some companies may try to ignore the changes, or prevent them or oppose them by joining forces with competitors through mergers or acquisitions or even more subtly 'acquisition or partnerships'. Such reactions amount to what we call 'playing the horizontal game', along the value capturing axis. Ultimately however 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. There are all sorts of financial 'value creation' tools or tricks to extract the value created in a business for the shareholders and improve or optimise the financial results in the short term, but this is not a viable option in the long-term because what is not created cannot be extracted or optimised! Indeed, recent examples and events have rather dramatically illustrated this in more than a single case: Enron, Worldcom, Tyco, Ahold, among others. In fact, one could even argue that companies that claimed to have had a single minded focus on shareholder value creation have exactly failed to do just that because they often put the lure of short-term profits ahead of the long-term benefits of customer value!

In general, a strategy that is focussed on value capturing with minimal value creation places the firm on a slippery slope. Companies playing the 'horizontal game' do not recognise or respond to signals that the industry is changing in fundamental ways either because of a change in the nature of the value propositions demanded or the activity system needed to compete or both. They cling to the old logic of competing and fail to understand that the industry, as understood, is on the verge of a disruptive change due to deregulation, technological change or globalisation. 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.

Industry Losers and Revival
Under-performance by firms is a result of low value creation and low value capturing. But some of the under performers manage to turn around, even in industries that are considered structurally 'unattractive', such as the automobile industry. The cases of Peugeot-Citroen and Nissan are illustrations of how companies that were once considered as industry losers can be revived back to competitive health. The first challenge is to exhaust the value creation potential from restructuring possibilities. Restructuring may be necessary to correct the mistakes of past actions such as ill-advised strategic acquisitions, expansions in to foreign markets, strategic alliances and so forth, which though important, emphasizes the value capturing aspect of strategy – reduce costs and improve margins – and hence are part of the logic of the 'horizontal game'.[11] Once such relatively easy pickings are exhausted, the next challenge is to find ways that make the company's exit from sustainable.

Routes for Revival
While strategies focussed on better value capturing through restructuring is a starting point, the real challenge is to find ways of increasing the value creation part of the firm's strategy. But doing that is not as obvious or even when done will help the company move out of underperformance. This because firms have two options to increase value creation. One is to

[11] Saatchi and Saatchi is an example of a company that went through a drastic value capturing oriented restructuring following disastrous diversification and international expansion.

move vertically upwards along the value creation axis and then capture value at a later stage, i.e. a move to the upper left first followed by a move to the upper right of the VC^2 framework.

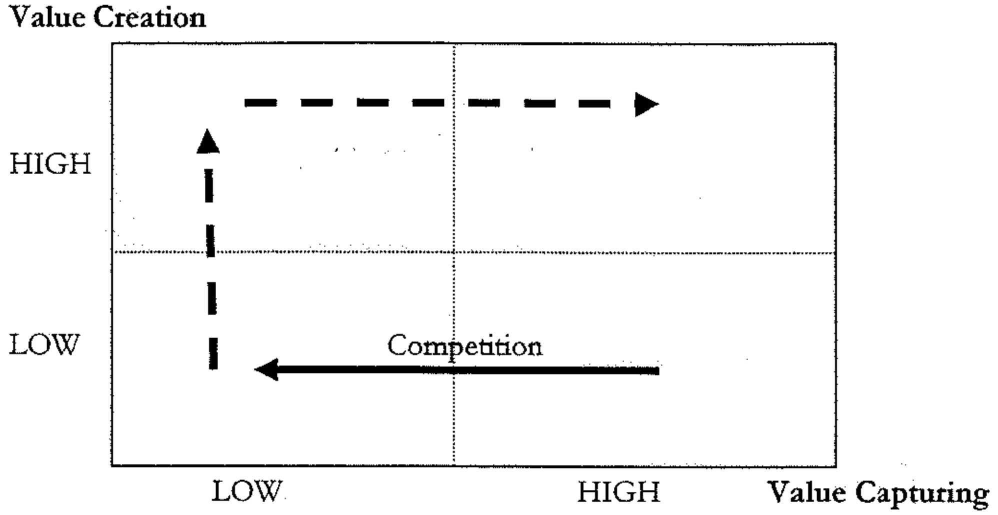

Figure 3: An Unsustainable Route to Heaven

Such breakthrough value creation, or a value innovation, while creating customer value does not necessarily imply the creation of shareholder value. Value innovation is a hard task. Especially as the rewards will be far from immediate – that is why all this is strategic in the real sense. It needs attention before the urgent need demonstrates itself, it takes investment ahead of return and all this is not obvious, often even in conflict or tension with the 'old logic' of value capturing. That this is an unrewarding journey at first is illustrated by the fact that this move up from the lower to the higher left corner is intended to increase value creation capabilities, but not necessarily create value capturing opportunities. That is why the upper left corner is still called 'a nightmare': one needs to work hard to get there and even need to work hard to stay there, and no money is coming in, yet!

Such is the situation of companies that may have been good at providing value to their customers, but are in no position to reap the rewards. Some companies have managed to get to this stage 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).

Many dotcom start-ups ran into the problem of this quadrant, dreaming up new and innovative value propositions, but unable to capture sufficient value to stay in business.[12] Some of the original value propositions of the 'new economy' were simply 'too good' to be true and therefore

[12] See Amit and Zott (2001) for an overview of the different value creation logic, from the customer perspective, of dotcom firms – novelty, bundling, low cost, customisation, among others. Each tried to create customer value by distinct combinations of customer attributes and innovative activity models.

quickly disappeared with the dotcom bust. Many companies created value for customers but this happened only by keeping prices below average costs or even offering the products for free. But offering free products does not generate profits. Many companies also overpaid their employees, thereby further appropriating capturing some of the value from shareholders.

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. The company made its first operating profits of $64 million only in 2002 after investing over $ 6 billion in equity and around $2.5 billion in debt. A great return on invested capital indeed! Shareholders of many other dotcoms were even less fortunate.

That is why however hard and challenging is this value innovation route, it may be unsustainable. The more demanding challenge is to turn it into a profitable business model or proposition. 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. 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 fall back to 'hell'.[13]

A Sustainable Route for Revival

A more sustainable route for companies in 'hell' is where the companies evolve a more step-by-step approach to increasing value creation and capturing simultaneously or in sequence of moves that closely follow each other. Such an approach has proved to be rewarding for companies that have managed to understand that both value creation and value capturing are essential. In some industry settings, the steps have started by increasing value creation first followed by value capturing, and in other cases the proceeds from value capturing has been reinvested to improve value creation.

Consider the car business. The industry is a highly competitive business, with huge capital investments and fixed costs. The industry has in recent years seen a wave of consolidation to adjust surplus capacity, as demand matured in most developed markets. To compete effectively, firms need a variety of capabilities along the activity chain, for instance, R&D capabilities to bring out new models, manufacturing capabilities that are able to produce quality products efficiently, and strong marketing and distribution skills. Such capabilities need heavy investments and time – investments tend to be lumpy and also take time to transform the investments into capabilities.[14]

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[13] See also Hawawini, Subramanian and Verdin (2001).

[14] The last decade has been one of increased global consolidation in the industry as many of the players exited through mergers. This should not be surprising from the VC^2 framework perspective. For instance, some of the companies that exited through whole or part mergers such as Rover, Daewoo, Samsung, Chrysler have been living in 'hell', particularly at the time of their exits. With low customer value creation in increasingly competitive conditions brought about by liberalization of their domestic markets, the firms were having trouble to capture value that was important for reinvestment in the business.

For many of the European players such as Fiat, Rover and initially Peugeot and Renault, the reason that they fell into 'hell' was that they had been used to be living in a 'dream'. Most had captive national markets that were protected from foreign competition. Government benevolence also came in the form of direct subsidies and ownership funds, as well as indirect subsidies, as local government agencies almost always purchased from their national car manufacturers. Even in a single European market, car manufacturing was considered prestigious and employment intensive, and national governments were keen to create a national champion. In some cases like Renault, the French government was (and is) the largest shareholder.

Several forces were changing the structure of the industry. Greater liberalization, such as the EU single market program, and globalisation increased competition as European and Japanese car manufacturers started penetrating the markets. New innovations along the activity systems, such as just-in-time manufacturing, further changed the economics of car manufacturing. Other innovations followed, as Japanese competitors increased the speed of product development. The more recent disruptive innovation came in the form of platform manufacturing as some innovative car manufacturers were able to bring new models at not only reduced times to market but also at reduced costs. A platform formed the core for a particular family of cars, and new models in that particular category were developed around the core.

The old national champions in Europe fared badly as the basis of competition changed and moved to a qualitatively new level over time. A long stay in hell was facilitated to a large extent by government support, but as the competitive basis became increasingly sophisticated and capital intensive, the poor value capturing abilities of the losers made reinvestment difficult. But companies such as Peugeot-Citroen and Nissan who were written-off as losers still managed to exit from 'hell'. Their journeys started with increasing value creation after the initial restructuring gains. In the early 1990s, Peugeot-Citroen was a number two player in its national market. It had two competing brands, and adopted different designs and manufacturing facilities and processes for the different brands. The company had a poor image and many expected, and some hoped, that it would merge with one of the big boys, perhaps even with Renault to create a French national champion.

Instead the company has been one of the best performers in the recent years. The company's approach was to question some of the industry's key assumptions – that global scale was the key, mergers and acquisitions were necessary, and competing with a broad product portfolio of mass and luxury segments was essential. Instead the company focussed on identifying its strategic market, streamlining its two main brands, standardizing platforms within segments. Peugeot-Citroen focussed on a European scale, competed across the mass market, avoided costly mergers and acquisitions preferring instead alliances to plug strategic asset gaps and remained independent with a shareholder willing to take a long-term view. The new strategic focus provided a framework for the firm's innovation and activity model to deliver on new products and increased efficiency. Instead of going for a merger or a large acquisition, the company embarked on a long route of steady innovation and efficiency improvements.

Similarly, in recent times, Nissan has moved from a position of 'heaven' to a position of 'dream' and later to 'hell'. In the 1980s when it was at the forefront of the first and the second disruptive innovations as it took market share from its rivals, particularly in the US market. However, in the 1990s, the company's offerings became increasingly out of tune with customer demands, while its activity systems, based on tight linkages with its suppliers, hampered rapid and cost effective new product development. The first move for Nissan similar to Peugeot-Citroen came in the form of restructuring that corrected past excesses and then followed by a movement vertically to reflect increasing value creation. While the company may be making losses as it was in the 'hell' position, at least now it has hope to capture part of the customer value creation. For a company of its size, the change to a new culture and mindset was done quite rapidly and the company was soon able to capture value. The lesson is that moving from 'hell' required both restructuring and a fundamental rethink on value creation in the business.

PayPal, the online payment systems company, has done a similar exit out of the 'hell' that characterized the dotcom industry, an environment that is radically different from the car industry. The key problem of the dotcom industry as a whole was a culture of value creation with little or no value capturing to compensate for the opportunity costs of capital. PayPal on the other hand took an approach of incorporating some amount of value capturing even in the beginning stages of its growth. It had progressively started to moving step-by-step by increasing the value capture which was followed by further improvements in its value propositions to increase value creation. By capturing some of the value created through its value innovations, the company was able to reinvest in to innovation. The company emerged as one of the survivors, and one important reason was that it understood that both value creation and value capturing are essential for its viability.[15]

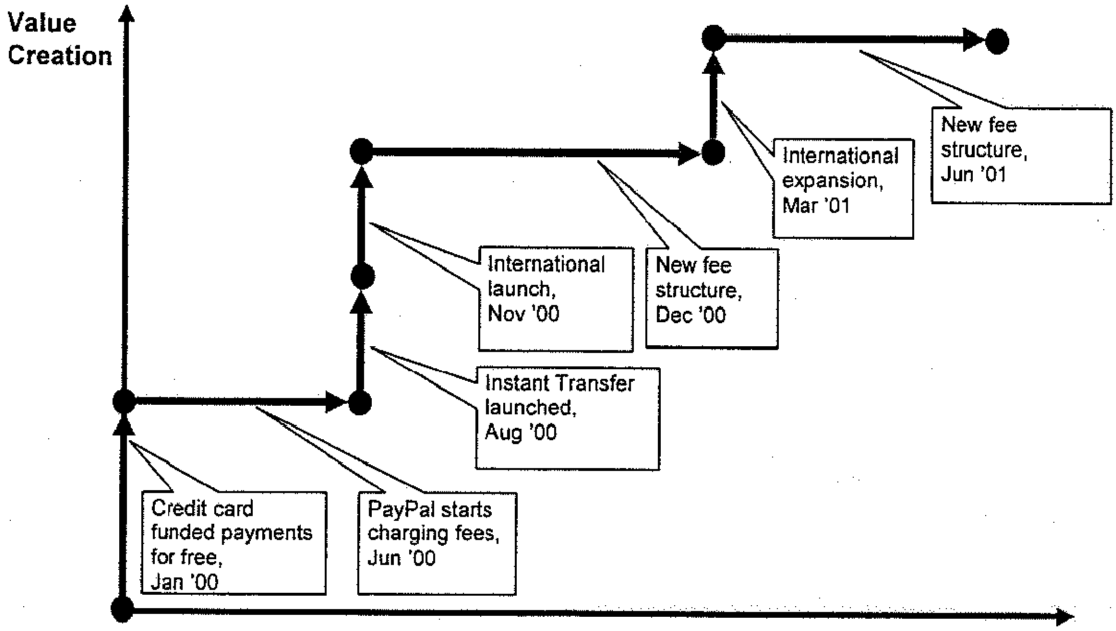

Figure 4: PayPal's route along Value Creation and Value Capturing

In summary, the only sustainable way to the upper right corner is to take what we would call the *long hard route* (figure 5) which extends across to the top-right hand corner. What is required is, more than anything else, what one could call 'value innovation' from the customer perspective, which is accompanied by value capturing in some measure. This is the important challenge for companies that have exhausted the short-term options of the 'horizontal game'. These means playing both the 'vertical' and the 'horizontal' games, pushing up along the vertical axis to increase customer value and try to capture part of the value created. It is thus in a certain sense, a benign or optimistic hell we were talking about: where one *can* escape. But escaping from hell by following the 'long hard route' requires often a complete rethink of the way the firm is competing

[15] See Nysten and Verdin (2003).

and the related strategic choices. Companies that do come out emerge stronger and often lessons are learnt from the fall from heaven to hell.

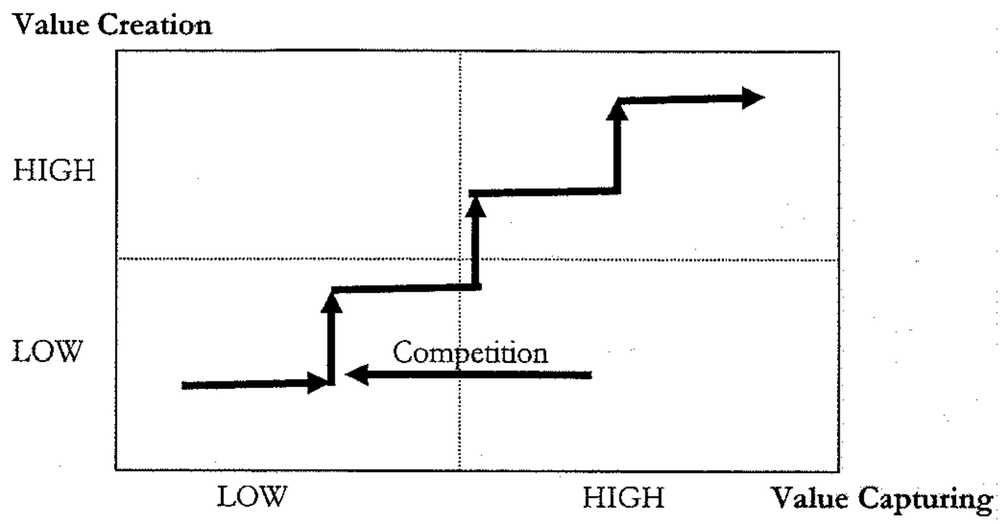

Figure 5: The Long Hard Route to Heaven

Managing in 'Heaven'

Every industry offers the opportunity for superior performance. One invariably finds profitable companies in unattractive industries just as one finds poorly-performing companies in attractive industries. Wal-Mart, Dell, Southwest Airlines, Toyota, Sony, Nokia, Nucor are companies that have been leaders in very diverse industries and have been able to be at the top of their industry over long periods of time. In fact, Wal-Mart is an excellent example, as it can be shown that roughly for every penny they manage to further reduce costs in their systems (by continuously improving their business model), they pass on about half to their customers through lower prices while keeping half to themselves thereby increasing margins and profits. The growing market share due to the everyday lower price is a bonus and further turbo in their strategic strength and thus their financial performance.

But this is a 'heaven' where one still has to work! This requires that leaders do not turn off the innovation engine. Just as hell was not irrevocable, so is heaven: doing nothing is not an option because in today's competitive markets, imitation of a successful value innovation is almost inevitable. Industries are littered with tales of innovators and lead firms falling on hard times. Budget airline People Express, in the 1980s, while showing strong initial profits, went out of business as competition imitated and improved on its low cost model. The Belgian movie group Kinepolis was successful in the 1990s with its value innovation along the customer perspective, but has fallen on hard times in recent years as competitors were able to replicate the key aspects of its business model. Even though the initial value innovation may have had distinctiveness, all distinctiveness over time is slowly eroded as competition eventually catches up. The best defence against losing the value of innovation and be able to stay in heaven is to keep innovating the business model along the two key dimensions of value propositions and activity model.

Ultimately the way to win and keep winning is to try and get into this quadrant and *deliberately* stay there and perhaps even keep pushing the boundaries of the framework! That is the challenge and that is why so few companies manage to stay up there for sustained periods of time. This usually implies a whole lot more than one-shot deals or one-time restructuring attempts, which rather belong to the horizontal game. As demand changes and as competition catches up to the new standard, the leader is constantly forced to innovate, sometimes incrementally and sometimes in radical fashion. Innovations may occur from the firm's ability to sense changes in demand before the competitors do or manage to create new activity models that serve existing demand in more competitive ways.

Industry leaders can be in the advantageous position of being able to change the industry structure in directions that enhance their advantage. By influencing the basis of competition, leaders are in the position to dictate how value flows in the industry and also how the industry will evolve. However, for industry leaders, the challenge lies not in anticipating the incremental changes, but in anticipating and preparing for the structural breaks that completely changes the basis of competition in the industry and keeping pushing the envelope of the Value Creation and Value Capturing framework (figure 6).

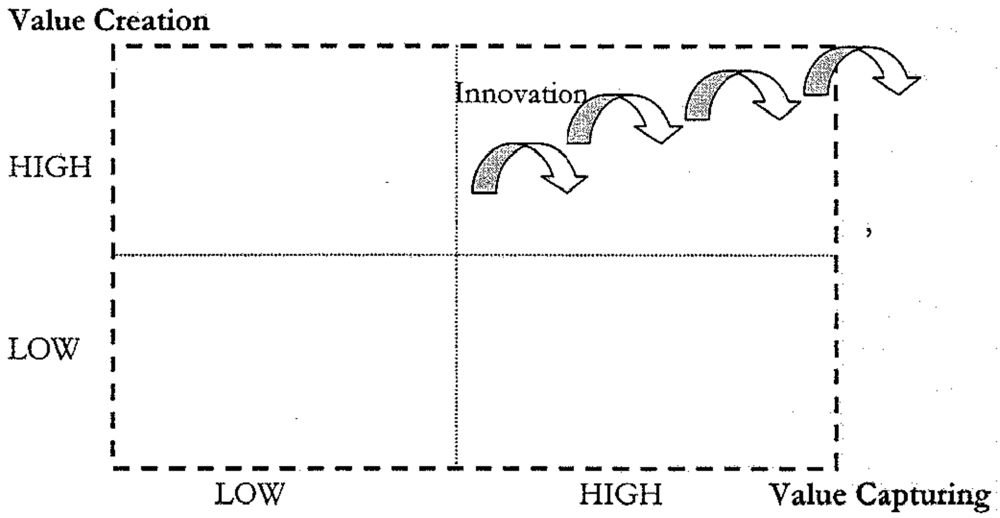

Figure 6: Managing in 'Heaven' and Pushing the Envelope

Conclusions

Industries may vary in terms of the types of business models that firms have to develop to achieve a competitive advantage, but the success or failure of the business model depends on the ability of the strategy to pass the value creation-value capturing test. Value creation reflects the ability of the business model's value propositions to create customer value. Value capturing reflects the ability of the business model's to retain part of the value created.

The simple intuitive template of value creation and value capturing provides a way to examine the underlying causes for performance of a company in an industry. Each of the four positions in the VC^2 framework is, essentially, competitive traps. The 'dream' position is a monopoly trap – where current performance is a poor indicator of future performance and competitiveness. 'Hell' is a trap by itself – it is a position that unless something drastic is undertaken, the firm is likely to be fighting for survival. The nightmare position is one of the 'value innovation' trap, where a rapid and large growth in revenues may mislead the company to think that it is a successful business that will create shareholder value. Finally, 'heaven' is not a trap yet, but full of potential traps that can occur because of inertia and the temptation to focus on value capturing because of market power that can accompany resource power.

Industries have different types of winners and losers. Some of the above-average performers are not the stars that they look like – they can be in a state where underperformance and a period of corporate upheaval may be just around the corner. However, many strategies of such firms tend to be aimed at value capturing games that present a misleading picture of competitiveness. The point is that the more competitive an industry, market or business gets, the less appropriate value capturing games become, the more emphasis should be put on the value creation side. Hence we arrive at the pervasive paradox that "the more competitive a business gets, the less one should focus on the competition"! What we mean is essentially that the *only* way out of long term competitive increase is to focus on adding value to the customer.

At a practical level, the framework is a tool to tease out managerial assumptions about where they find their business in the industry.[16] Our template suggested certain process by which the analysis can be done. To study why some firms succeed in a particular strategic position while others in the industry struggle, we should unbundle such positions in terms of value creation and capturing. We can then plot the different firms in the industry (leaders, losers) in the VC^2 matrix, which provides a static picture of what firms are doing to explain their current performance. The goal remains to be 'up there' to the right, and in quite a few industries, *no one* has achieved that position *yet*, but as we look at long-term winners (value leaders) we can see how they got there and are doing everything to stay there, even though the temptation is great to sit back and relax and slip back into the lower right corner, where one becomes vulnerable to renewed competitive attack.

Strategies should not only be focussed either on value creation or value capturing, but on both. Innovating without capturing value is no good (nightmare) and every innovation eventually has to be translated into a proper sustainable profitable business model. Capturing value at the expense of customer value is a 'dream' in a competitive market that will disappear at the first wind of competition. Even if the firm manages to the top right hand corner where it both creates and captures value, there is no guarantee of continued success, as the 'failure of success' sets in again and again: complacency, overconfidence, stodginess, inertia and unwillingness to face the need for change. All this is an ongoing perpetual mobile.

Acknowledgements
This paper benefited from the ideas contained in the working paper by Paul Verdin and Nick Van Heck (2000). Helpful comments by Eline Van Poeck, research assistant K.U.Leuven and Steve Nysten, research assistant Solvay/ULB are gratefully acknowledged. Prof. Filip Caeldries' (Tilburg, TIAS Business School, NL) ideas on value, price and costs also helped to formulate the concepts in this paper.

[16] See Appendix 4: Practical Use of the VC^2 Matrix

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Appendix 1

Background on Industry Leaders and Losers Research

A number of studies over the years have investigated whether industry or firm factors matter more to performance. Usually, accounting measures such as Return on Assets and data sets on US companies have been used in this research.[17] Accounting measures are flawed for several reasons. Firstly, they may not reflect cash flows. Net income is an accounting profit that usually does not correspond to cash income. Secondly, such measures do not account for the cost of capital and for the opportunity costs of the investments in the assets used to generate the profits. Finally, accounting conventions such as the expensing of R&D and managerial discretion in choosing between policies such as inventory valuation can dictate how profitable a firm can appear to investors.

Our own research over more than 10 years investigated the effects of some of the common external influences, such as macro-economic and industry effects for over 500 of the publicly listed firms in the US.[18] As measures of performance, we used two measures – Economic Value Added (EVA®) and Market Value Added (MVA®).[19] EVA is the firm's after-tax operating profit adjusted for a capital charge that takes account of the opportunity cost of capital invested to generate the profits. MVA is a similar residual income measure at the market level. It measures the difference between the market value of capital (both equity and debt) and the amount of capital invested into the business over the years.

We used a random effects model, where the external factors influencing performance were macro-economic and industry effects. Macro-economic factors proxy those factors that have an economy wide impact such as interest rates and exchange rates. Industry factors are of two types. One type is related to the effects of structural factors such as the level of scale economies, the importance of marketing assets like brands and distribution channels, the relevance of technological assets like investments in R&D and so forth. A second type of industry factor is related to sensitivity of the industry's performance with the business cycle. Internal effects were modelled through a composite firm factor that captured differences in performance that occurred due to firm-level differences.

Our analysis shows that of the various external factors, structural industry factors have the largest impact on firm performance. Yet, while structural factors tend to persist over time, their importance in explaining variation in performance is, on average, only around 4%! Business cycles also have a minor impact in explaining long-term firm performance while the influence of macro-economic factors is less than 2%. The results also show that, on average, a typical firm's performance is largely influenced by its own decisions. It is management that matters. Across several countries, including the US, UK and Germany, we find that factors that are specific to the firm, those that are under the control of managers, drive performance differences between firms.[20] Irrespective of the industry or the country, the firm's ability to shape and adapt to its industry and its wider environment is more important than the context itself. When industry factors play such a limited role, the importance of being in the right industry has relatively less importance than pursuing the right strategy for the industry.

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[17] See Rumelt, 1991; McGahan and Porter, 1997 for works using accounting measures.

[18] Also see Hawawini, Subramanian and Verdin (2003) for a full treatment of this research.

[19] EVA and MVA are registered trademarks of Stern Stewart & Co.

[20] See also Hawawini, Subramanian and Verdin (forthcoming) for evidence on industry and firm effects across several countries.

Our empirical research further shows that, in most industries, performance differences between firms tend to follow a specific pattern. A few firms dominate the industry's profit pie, while a few firms tend to under-perform the industry considerably. External factors are even more marginal to explaining performance differences between such firms. In other words, for firms that deliver above average returns, factors internal to the firm are central to its competitive advantage. Our research also shows that in fact industry factors matter if you want to follow the industry's rules of the game. The pattern identified by us also suggests that most firms in an industry fall into this category of average firms. Such firms tend to move with the industry's overall performance. If for instance the industry was experiencing a cyclical downturn, the performance of these average firms went down as well.

The marginal impact of external factors is linked to the systemic nature of such factors. They influence the performance of all firms in their environment. For instance, firms in a cyclical industry, such as the airline industry, face the same changes in external conditions, like a demand shock, as happened post-September 11. For most managers the limited influence of external factors to explain performance is a surprise, in particular with regard to industry factors. Managers often frame issues in terms of what works in the industry. Their mental maps are often a product of their experience in the industry and their choices are usually influenced by what they consider are the industry's success factors. When certain industries are considered attractive because of their profit potential, managers may even choose to diversify as many did during the dotcom boom in the mid-to late-1990s.

While superior strategies that focuses on value creation and capturing is clearly the dominating influence on industry leaders (and losers), it does not necessarily mean that one can underestimate the impact of industry factors, even for the leaders as the leaders tend to posses a superior understanding of the current industry structure as well as likely changes that will effect on the basis of competition. Superior understanding of the structure is key to be able to change the industry dynamics to the company's advantage.

Appendix 2

The Economic Principles linking Value Propositions and Activity Model with Value Creation and Capturing

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 a profit equation is 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.

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

The value diagram is a depiction of the above value equation.

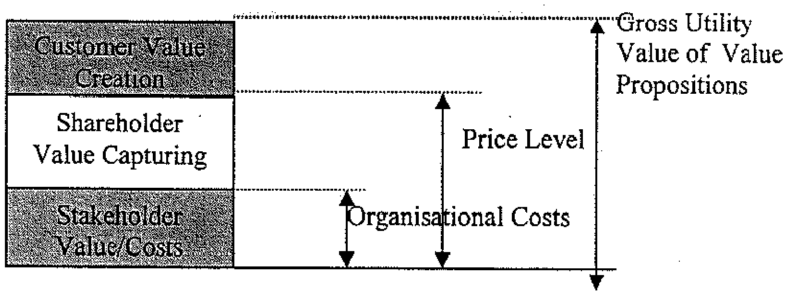


Figure: Value Diagram

There are three types of value: customer value, shareholder value and stakeholder value.[21] *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 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.

A second type of value is what is called as stakeholder value. This is the value created and also captured by the firm's stakeholders, with the exception of customers and shareholders. Such stakeholders are primarily the firm's employees, its suppliers and complementors that are linked

[21] Similar expositions are illustrated in Brandenburger and Staurt (1995) and Besanko, Dranove, Shanley and Schaffer (2003). However, there are two differences relative to this framework. Firstly, we also include the stakeholder value creation and capturing and secondly, the illustration is made in terms of value creation and value capturing.

to the firm's value propositions either vertically (suppliers) or horizontally (complementors). These stakeholders not only create value for the firm but also capture value from the firm as they get paid for their services. The stakeholders also capture value because the firm has to reward the stakeholders for their effort. Economists explain this in terms of the marginal principle – in perfectly competitive factor market conditions value creation by stakeholders should be equal to value captured by the stakeholders. However, stakeholder markets are prone to imperfections and hence depending on their bargaining power (unions, skills, legislation, supplier monopoly), the stakeholders may be capturing more or less value than they create.

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'.

Appendix 3

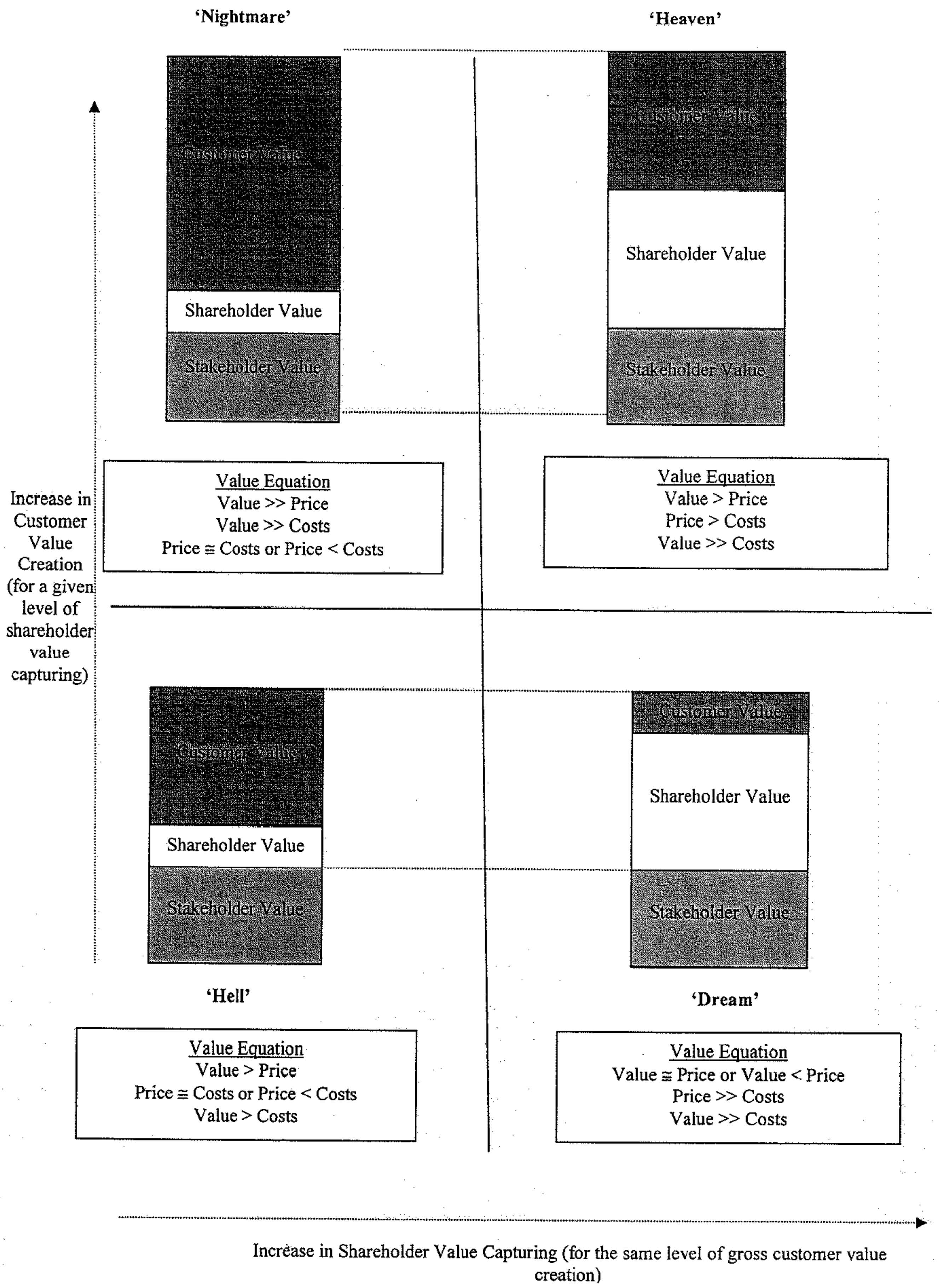
The Value Diagram and VC^2 Framework
The value diagram shows the economic consequences of the choice of value propositions and activity systems. It also provides the economic interpretation of value creation and capturing. The VC^2 (value creation and value capturing) matrix shows how firms in an industry may have different combinations of value creation and capturing. Here we provide the value diagrams for each of the four positions in the VC^2 matrix to provide the economic interpretation for the different positions in the framework.

Value Creation			
HIGH	Nightmare	Heaven	
LOW	Hell	Dream	
	LOW	HIGH	**Value Capturing**

Value Creation and Capturing Matrix

Companies in most industries can be found in any of the four positions in the matrix. In some positions, companies are creating customer value (such in the top half of the matrix), and in others they are creating shareholder value (such as in the right-half of the matrix). A movement along the vertical direction is an indication of an increase in customer value creation and a movement along the horizontal is an indication of an increase of shareholder vale capturing. This is illustrated more clearly by interpreting the VC^2 matrix in terms of the value diagram.

Each of the different positions on the VC^2 matrix may also be illustrated in more precise terms. Firms in the 'dream' position, such as monopolies have little incentive to create value. Firms in the 'nightmare' position may be creating substantial value for its customers but they are unable to appropriate value from their innovations. Such firms create large positive consumer surpluses. They may also have negative producer surplus as average prices may tend to below average costs, or at the best with very small margins. Firms in the 'hell' position may be creating value for its customers by under pricing its products, even at the risk of allowing its prices go below its average costs. A final position is opposite of the 'heaven' position. Firms in this position create customer value and capture part of this value for its shareholders at the same time. Such firms create both consumer and producer surpluses.


'Nightmare'
'Heaven'
Customer Value
Shareholder Value
Stakeholder Value
Customer Value
Shareholder Value
Stakeholder Value
Value Equation
Value >> Price
Value >> Costs
Price ≅ Costs or Price < Costs
Value Equation
Value > Price
Price > Costs
Value >> Costs
Increase in Customer Value Creation (for a given level of shareholder value capturing)
Customer Value
Shareholder Value
Stakeholder Value
Customer Value
Shareholder Value
Stakeholder Value
'Hell'
'Dream'
Value Equation
Value > Price
Price ≅ Costs or Price < Costs
Value > Costs
Value Equation
Value ≅ Price or Value < Price
Price >> Costs
Value >> Costs
Increase in Shareholder Value Capturing (for the same level of gross customer value creation)

Appendix 4

Practical Use of the VC2 Matrix
In strategy discussions, corporate or business workshop or 'day away', we have found it often very useful to provide this framework to frame or jump start basic strategic discussions, either as an opener or at the end of a lengthy analytical process (depending on the specific needs of the context) to bring the discussion back to an intuitive and, we believe, still at a highly relevant strategic level.

Some questions to ponder
Of course, managers right away start wondering where they think they are right now in this matrix, but we believe the best way to get started is to first address the question: where are *others* in our market or industry located? And how are they moving? What are they doing to be there or are they trying to get into a different position? Who are our role models? And what should we do in order to get there?

In quite a few cases, it may appear that in the upper right corner, *no one* has already arrived, which only increases the opportunity and the challenge: those that manage to get their (first) may reap enormous rewards! The field may still be wide open, as is the case in industries that have really not been very competitive for some time. For instance in the insurance industry in Europe, still most players would position themselves in the lower right or more recently surely in the lower left corner. And newcomers like MLP in Germany or Skandia have had a hard time getting out of the nightmare box. Very few dotcom start-ups managed to get into the upper right in e-business and it appears that now incumbents have been able to pick up some upper left players to try and move them over to the upper right, with varying success. Some companies have gone through this cycle a few times.

Appropriate level of analysis?
At what level should this model be used (company, business-line, product?). It is clear that the best level to apply it at is at the relevant business unit level where the business unit faces direct competition and indirect substitutes. Especially for large diversified or multi-business companies, the level of analysis should be done at the business unit level as different businesses will usually have different positions at a given time in the matrix depending on the competitive conditions of the market and the particular business unit's position in that market.

Another Portfolio Model?
This brings us to the question whether the model can be viewed as another kind of portfolio model: should companies have a 'balanced' portfolio when you assess their different product or business lines? The answer – as with most portfolio models – is clearly: *No*! For *every* business the goal is to be up there (top right), but of course they may be at a given point at different stages of the journey! But there is nothing intrinsically beneficial about having a 'balanced' portfolio, as indeed the misconception is with many of these matrices (there is nothing virtuous about having some excellent businesses 'balanced' with some rotten apples!!!) ... but of course as we are focusing on long term innovation and competitive strength we may have different projects or business lines in different positions at a given time, or even our innovation 'pipeline' may imply that some projects are in the lower left only starting off, while others may have reached strategic maturity moving into the upper right, but the notion of 'portfolio balance' is all to static and wrong-headed in many instances as the right focus of strategic development