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GROW TO BUILD PROFITS, NOT JUST REVENUES

Deregulation, globalization, and the Internet are fueling the growth of commoditization in just about every industry. We chose our title because we believe that to grow profitably, you must let go of traditional control mechanisms and organizational practices typified by the common value "chain." Instead, you need to open up your business by building and participating in value *webs*, where value is built by a number of companies coordinating their individual capabilities to create a whole new business ecosystem.

Value webs are very different from value chains, which rely on a company's own organization and tightly controlled contracts with suppliers. Value webs are dynamic linkages across firms that adhere to four main areas of letting go:

1. Opening up the firm to source and coordinate capabilities both internally and externally, utilizing dynamic processes rather than transactions
2. Accessing specialist services even in "core" business areas
3. Creating new collaborations in research, design, manufacturing, and customer services
4. Enabling innovations by customers, suppliers, and business partners so that their growth fuels the firm's own growth and vice versa

Letting go means following these management principles.

- **Componentize your business**—Business components are reusable, interchangeable building blocks of functions, processes, and services that may be accessed through standardized "interfaces" across your firm, offered as services or outsourced, and used to create new business configurations in such areas as supply chain management, customer service, and similar areas.
- **Integrate your components end-to-end**—Getting the components to fit together as a business platform turns commoditization from a cost problem to a growth opportunity. The platform then gives a company the ability to synchronize business components across its value webs. Supply chain management leaders, for instance, are moving closer and closer to real-time, zero inventory and on demand customer service via integration. They minimize time, waste, and overhead by integrating their processes, processes that their competitors handle on a piecemeal basis—one piece at a time, process by process.
- **Expand your growth space through collaboration**—The componentized company can use the same components in many different ways and make its platform an integral part of many value webs. How large can FedEx, UPS, and Amazon become as "companies"? They expand their value web business through new clients and partners, new services built on their componentized platforms, and the number of countries their platforms reach. The end result makes each company an integral part of a massive ecosystem, with each new value web relationship opening up yet another growth opportunity. The growth of UPS and FedEx is thus built upon the growth of their clients. UPS and FedEx grow because they're willing to share and collaborate rather than hoard and withdraw.
- **Liberate your cost structures**—Value webs enable companies to balance fixed costs with variable costs. The former come with all the risks of capital investment and lead time, whereas the variable costs—services on demand as needed, where needed, and when needed—come with lower margins but lower risks. Componentized platform companies have cost options

that change the entire financial profile of growth businesses; fixed assets are no longer the driver of scale and operations, and balance sheets look very different, with far fewer fixed assets and lower working capital. Companies can now acquire capabilities, including research, manufacturing, distribution, and even product development, on a pay-as-you-need basis. These companies substitute balance sheet "assets" for value web relationships, transforming both their capital efficiency and business agility—their ability to move on demand.

Businesses should allocate their resources so that they can innovate and grow. You want your company to focus all of its efforts on these important objectives. After all, wouldn't you like the freedom to allocate more of your precious resources to drive growth rather than tread water in an increasingly competitive business ecosystem? By structuring your company into components and implementing the Let Go to Grow philosophy, you can.

- **Provide leadership that fosters innovation**—Announce the changes needed to move the company from value chain to value webs and from business functions to business components. Leaders see the changing marketplace as an opportunity to innovate and reinvent the entire company. For organizations to let go of the traditional value chain and its organizational and cultural priorities, leadership must establish the need for componentization, decentralization, appropriate centralization, and value web integration—in other words, to define and implement the organizational structure that enables growth. This transformation will not happen by accident.
- **Drive productivity**—In most companies, there is a strategic focus on either efficiency at the risk of growth or the reverse. Productivity is an invention of the Industrial Age, but post-Industrial Age companies are rapidly evolving from businesses based on hard assets to businesses based on people. For this reason, our definition of productivity needs to evolve as well. A focus solely on either revenue or cost independently is a detriment to the business. A focus on driving balance between the two—how to take your costs and use them to maximize revenue and growth—is our definition of productivity.

What if you could deliver significant growth without adding to your cost basis? For that matter, why can't you create more growth while simultaneously reducing costs? Componentized business platforms permit parallel and focused investments that accomplish both of these together.

- **Fit the pieces together**—Differentiate and integrate via governance and policies that ensure that the enterprise platform and supporting resources are in place.

We begin with the premise that commoditization is a reality. It might not be as prevalent in the space you occupy today, but if not, it will be soon. Well-run companies will always look for sources of invention and innovation but need to make commoditization an integral part of their growth capabilities instead of trying to push it away or give in to it. In many instances, value web invention and innovation turn commodities into sustained competitive advantage; that is the message from the now decades-long dominance of Wal-Mart and Southwest Airlines in businesses where just about everything is a commodity—except how growth leaders fit the pieces together.

Let Go To Grow appears at the end of one of the worst nongrowth periods in modern business history. Regrouping after several years of costcutting, price erosion, and aggressive new global competitive challengers, companies are looking to grow again, profitably. That goal will not be easy to attain, because it never has been. The odds of your company's sustaining a growth rate above that of the overall economy is less than 10 percent—regardless of its size, industry, or current status.[1]

- Of the 172 companies that appeared on the Fortune 500 list between 1955 and 1995, only 5 percent grew their revenue above the overall inflation rate.
- Just 13 percent of a sample of 1,854 companies grew consistently over a ten-year period.
- Only 16 percent of 1,008 companies tracked from 1962 to 1998 survived.

- Of the 68 companies still on the original Forbes 100 list announced in 1917, only one (General Electric) had surpassed the average return on the S&P 500.[2]
- From 1997 to 2002, the 30 firms that constitute the Dow Jones index grew less than 5 percent in revenue and gross profit and just 0.5 percent in after-tax profit. When the top 5 performers (which include Wal-Mart, Microsoft, and Merck) were subtracted, the other 25 companies had a 2.3 percent annual revenue growth and a 1.6 percent gross profit increase essentially just matching the rate of inflation.
- The average lifetime of a firm is now one-third of what it was in the 1930s; on average, large companies in North America and Europe now fail within just 20 years.[3]

The challenges of growing profits, not just revenues, are compounded by the need for every business to define its value proposition for the marketplace through differentiated components. Letting go of components that have become standardized or commoditized, focusing on those that differentiate, and integrating both is how companies will ultimately derive value.

Componentization in a Nutshell

The pressures of economics and competition drive componentization; standardized interfaces for both products and business capabilities become a requirement for efficient business and intercompany coordination. An example of the impact of componentization is the Universal Serial Bus (USB). The USB standard enabled digital cameras, scanners, PCs, printers, PDAs, external disk drives, and many other devices to connect. USB helped create the mass market for digital cameras by making it simple to link them to printers and PCs. This "open" standard—as opposed to the proprietary standards that dominated the information technology and consumer electronics fields—made the camera a component and pushed the race to commoditization. By

contrast, the toner for the printer to which your camera is linked by USB is not a standardized interface but a proprietary (and very profitable) product. That is sure to change.

- Componentization rationalizes processes and fuels the growth of value webs. Cellphones are another everyday example. Early products were manufactured by such engineering-rich companies as Motorola, Ericsson, and Nokia. Now cellphones are assembled from a common set of physical components. If the physical components are the same, why can't a common interface be built so that production can be outsourced to multiple companies, exploiting the economies of scale and specialization? That is exactly what has happened. Because of standardized manufacturing interfaces, more than 60 percent of cellphones are outsourced to companies in the Electronic Manufacturing Services (EMS) industry, changing the core dynamics of the industry. A firm like Nokia, which once competed on manufacturing, now competes on design, a design that includes the blueprint for sourcing components.
- A process, activity, or business function is not a component unless it is clearly bounded and has a well-defined interface. According to the Association of American Manufacturers, only 10 percent of large manufacturing companies can process an order electronically; there is no "clean" process interface to provide a "seamless" link between processes and value web players.[4] Healthcare claim processing is an extreme example of the resulting process and administrative muddle; there is no standardized interface for handling the many different documents, codes, and plans.
- Components are more marketable when businesses perceive market value in the capabilities that the components add to their base; otherwise, components are just commodities. Supply chain leaders increasingly pick component providers that can deliver on very tight time, cost, and quality constraints. Their logistics coordinate capabilities that are in turn built on basic commodity components. This is why FedEx and UPS are no

longer just package-delivery firms. Rather, they provide the components that help clients create supply chain excellence, on demand customer service, and organizational agility. A package is just a package, but FedEx and UPS are growing because of how they link the package-delivery component into clients' customer service, supply chain management, inventory management, and electronic commerce operations.

- Components get their value from applications and relationships. Realizing their potential requires a platform for synchronizing deployment and interdependencies. Business growth leaders make this their platform differentiator. Amazon is astonishing in how many ways and for how many clients and partners it extends what looks like an online shopping mall. Amazon's online infrastructure gave Toys "R" Us a strong online presence, displaying the merchandise and taking and fulfilling the order while Toys "R" Us selects the toys and manages the inventory. The Amazon infrastructure gave Borders the online capability that it could not afford to build, operate, and scale. Amazon ships an online order on Borders' e-commerce web site directly from its own fulfillment center or reserves a book for pickup at the nearest Borders store. Amazon is the platform base for innovations by many retailers seeking to get rid of excess stock. Amazon also is the free software platform for 35,000 individual programmers. "Third-party" transactions—value web links—amount to close to a quarter of Amazon's revenues and a far higher percentage of its margins. These transactions generate almost as much revenue as does Amazon's "core" business of selling books, videos, and CDs. Right from the start, Amazon's founder has always made it clear that he was building a platform with the goal of Amazon Anywhere, Anyone. Amazon spent $800 million between 1995 and 2002 to build the platform and then move to profitability.[5] It takes just months to add new value web components, such as top-quality jewelry or gourmet foods from thousands of specialty stores.

The result of componentization for the customer is commodity heaven and, for most companies, commodity hell.

Standardized interfaces enable manufacturing, services, and processes to be broken into components that can be bought, sold, integrated, and assembled on a market basis. When this process is applied mainly to the production of commodity goods, it has relatively little impact on the competitive positioning of large companies. Componentization has now moved up the knowledge and skill chain to research in pharmaceuticals, information technology development and operations, engineering, design, and administrative processes. Standardization of manufacturing platforms has become the dominant force in the car industry, and the old high-tech hardware PC, storage, server, and printer businesses are now almost entirely componentized.

Some competitive ecosystems—consumer electronics, for instance—are componentized in terms of product parts and resulting value webs utilizing Electronic Manufacturing Services providers. Others, such as telecommunications, have resulted in a phone call being a component that can be handled by just about any standard network, with payment through prepaid phone cards or internationally via such free Internet "peer-to-peer" services as Skype (note the term "free"). In retailing, Wal-Mart and other supply chain maestros force componentization and standardized interfaces throughout their supply chains. Amazon has used standardized interfaces to precious-gem providers to make this previously well-guarded, high-markup retail specialization—jewelry sales—into another component of its catalog and its customer service platform. As for manufacturing, Asia has become the component provider to the world, and prices dropped by a fifth in five years.

Componentization takes time and cost out of the customer-delivery chain—time to market, manufacture, distribute, and service—and the cost of parts, labor, inventory, and overhead. But it does so only for a relatively small number of firms, whose experiences provide the basis for the recommendations that we present in our book. The good news for those growth leaders who create a business platform to coordinate components and synchronize their deployment inside and outside the company is that they create a significant advantage over their median

competitors in key financial metrics: overhead, working capital, and margins in particular.

Componentizing businesses also enables key processes to become at least one time unit faster: What took a week is now done in days, and multiday processes now take hours. Most critical of all is that years become months, which creates a sustainable growth edge in design, new-product innovation, global competition, response to customer demand, and shifts in taste and preferences. One measure of the beneficial impact of the componentization and integration of supply chains is that the fraction of U.S. gross domestic product tied up in logistics dropped from 16.2 percent to 8.7 percent between 1980 and 2003.

The bad news for the laggards is that they become commodity companies, with a corresponding loss of product and service differentiation and the inability to maintain prices or pass on production price increases to customers, including the increased costs of fuel, raw materials, and employee benefits. The coming decade will see an increase in costs without companies, being able to raise consumer prices commensurately.

Increases in costs used to mean increases in prices. Now it is more likely to mean erosion of margins. Airlines saw fuel costs reach record levels in 2004, and although prices did not keep up, competitive intensity certainly did. The chairman of one major carrier stated that 70 percent of its customers now have a choice of a low-cost airline on its routes, compared to 14 percent in 1990. Airline customers switch if there is price differential of even $5. When several major carriers announced a $10 fuel surcharge, other airlines rejected the price increase, undermining the move.

Costs do not determine prices in competitively intensive, open markets. To customers with choices, your cost is your problem, not theirs. Cost inflation only makes the commodity player's plight even worse. An unexpected bottleneck in the global supply chain, for example, can suddenly create a cost jump. China's construction boom in 2004 led to the cost of shipping coal and metals tripling, and tanker capacity could not match demand. Australian coal prices could not increase, though production idle time increased as mines sat for days at a time waiting for ships to become available.

Cost inflation will become a major problem if the cost of basic materials increases. The trend is ominous for firms in commodity hell. The spot price for hot-rolled band steel—a key component in construction, kitchen appliances, and many other products—fell from $352 a ton in 1994 to $210 in 2002.[6] In June 2004, it hit a peak price of $590.

The business press in mid-2004 cheerfully announced that for the first time in years, businesses might regain their ability to increase prices. Industry optimists who thought that they would regain some modicum of price control jumped from 2 percent of CEOs surveyed in 2003 to 22 percent in 2004. More than three-quarters of the executives surveyed remain pessimists. Inflation will not help lift their hopes, because price increases are not margin increases in an inflationary economy. Nor are revenue increases profit enhancements. Even in good times, revenue growth may not turn into profits. That is one of the lessons of the dot-com era. Markets today are in such a state of flux that traditional business strategies produce a firm built to survive, not one built to grow.

Commoditization pushes firms to be reactive, not proactive, in their business strategies, and they struggle to regain control. Growth leaders handle global sourcing as a proactive opportunity to add capabilities, whereas other companies respond with cost-slashing survival tactics. Componentization then continues to put pressure on them and increases commoditization, a truly debilitating cycle.

Growth in and of itself is not necessarily the answer. Fewer than half of all mergers and acquisitions create shareholder value, yet M&A is one of the most widely used vehicles for generating growth. Even in good times, sustaining growth is the exception, not the rule. Growth also produces a massive up-front penalty, loosely termed "restructuring costs." Until recent changes in accounting rules, these costs did not show up as reductions in operating profits and could be allocated as "extraordinary" items on the income statement. When these costs become ordinary, they are a burden paid in advance for the opportunity to grow, without any guarantee of success. There are many examples of firms that have incurred restructuring costs of $500 million to $1 billion by writing down fixed assets that are no longer seen as strategic contributors to the firm or because of the impact of M&As on operations and staffing.

One of the most important contributions of value webs to business agility is the cost optionality it permits. The previously mentioned companies—and most of the rest of the Fortune 1000—frequently need to jettison fixed-cost burdens so they can move ahead. Let Go to Grow companies can move more quickly and without being trapped carrying the burden of so many fixed-cost balance sheet items. Cost optionality requires componentization, however, because if a process or a product does not have a standardized interface, there is no option other than keeping it in-house.

Companies need options in cost structures, capability sourcing, scaling of operations, and relationships. The challenges of managing costs and growth are daunting at the strategic and operational levels of the business. In good times, business strategy can reduce the reliance on cost stability, but the first years of this new century have not allowed any large company to coast along; management vigilance, governance, and focus on execution remain critical.

Don't give up hope, however! There are still very big winners in this new and dynamic economy. *Let Go To Grow* distills their experiences into practical management principles that will improve your chances of building and sustaining growth at better than the historical average of 10 percent. These firms consistently and profitably drive very rapid growth. They grow in bad times and in good times. They innovate on an everyday basis and are highly cost-efficient. In the most commoditized industries, they find new process and service innovations. They grow their revenues and profits with relatively little increase in capital investment or organizational size.

How they accomplish these goals is the topic of our book, a 21st-century business construction manual for executives. *Let Go To Grow* is a guide to creating a business structure and set of organizational configurations explicitly focused on growing your company continuously and profitably through the componentization transformation. What stands out among business leaders is not that they have any specific strategic insight or proprietary advantage or common business model but rather that they *configure* their organizations to link strategy to execution. They view their businesses at all levels and across all operational areas as a *platform* built on a set of components: building blocks that

turn business functions, activities, and processes into capabilities that can be mobilized, linked, shared, reused, and coordinated instead of simply carried out. They reject the value chain model, which was built on in-house operations and tight control, to create roles in value webs—a structure enabled by componentization, where the key value is the ability to coordinate components, integrate them with other players' platforms, and synchronize services and processes in realtime.

A few examples of such companies and how they exploit componentization are listed next. In later chapters, we examine how these leaders have built to grow. These examples give you just a hint of the growth opportunities created by leveraging componentization:

- **GE**—By centralizing and standardizing process components globally, GE has moved many of its administrative and overhead functions to a Lego-block approach. GE is building what we call a Coordination value web, a synchronized orchestration of relationships and on demand services.
- **eBay**—The company is a platform for a wide community of large and small players to add their own services and capabilities to the overall business offering. These services range from reverse logistics (auctioning of retailers' returned goods) to government auctions and auction brokers. As an Enabling value web, the eBay platform offers new opportunities for innovation and invention.
- **TAL**—This Hong Kong apparel firm coordinates hundreds of factories, shippers, and other players in a global value web that enables retailers to order goods on demand in small units and with minimum inventory. It is a massive Services value web in an industry that gets more and more componentized by the year, while TAL gets more and more profitable.
- **Cemex**—The Cemex Way coordinates nine major business components that can be moved into new acquisitions within weeks and has helped the firm grow to number 3 in the cement industry (from 35th in the early 1980s) and to be by

far the most profitable player in the world. It has made component coordination its strategic edge in customer service, manufacturing, and international operations. Cemex was one of the first transnational firms to recognize that the information technology platform is not "systems" but the core vehicle for the coordination of people.

- **P&G**—This old-line firm reinvented itself, creating a new style of operations that included componentizing its previously closely guarded portfolio of patents by licensing them to competitors on a royalty basis. Now every P&G patent is available for license to any outsider as long as that patent has existed for at least five years or has been in use in a P&G product for at least three years, whichever comes first. P&G has replaced its tight control of in-house operations and now expects half its product innovations to come from outside the firm.[7]
- **BMW**—The top-of-the-line carmaker does not make or assemble any of the parts of its popular X3 sports utility vehicle. Magna Steyr handles this on a contract-manufacturing basis, saving BMW a billion dollars in plant investment and avoiding a five-year delay in releasing the car to market. By making car manufacturing a variable cost, BMW reduces its risks and is able to focus more on design, marketing, and sales.
- **FedEx and UPS**—These former package-delivery companies have become the logistics arm, shipping department, and distributor for a vast number of other firms. Why should other companies build facilities and invest capital when these two companies can handle repairs, inventory management, and even financial services?

Growth comes from letting go and moving from control to value web relationships. The business platform, leadership, and governance principles of these firms allow them to fit the components together in new ways rather than have to invent new pieces in-house or expand existing ones. This integration of components lets them thrive in the on demand world of faster, cheaper, better. Uncertainty, change, and risk become their ally, not the enemy they are for companies that are built only to survive.

Leaders exploit their componentization capabilities and choose how to source their value options, opportunistic collaboration with clients, suppliers, and partners. Leaders may decide to outsource components, offer them as a value web service, cosource them through tight collaborations, or configure them in completely new ways. There is no one best option here. The key point is that Let Go to Grow companies have choices that traditional value chain companies lack. Let Go to Grow means "welcome to the options economy"—options on sourcing, cost structures, relationships, and scale.

Growth without profits is a gamble, one that so many dot-coms took in the hope that growth would create revenues that would eventually create profits. In contrast, Let Go to Grow companies focus on profits right from the start. They can move quickly and flexibly to locate and integrate the next profitable opportunity. They manage their cost structures via cost "optionality," the choice of variable versus fixed costs and expense versus capital, with an emphasis on external process assets instead of internal operations. By focusing beyond their own value chain, they target value webs where they also share in partners' growth. This is the capability-driven, relationship-adept, agile firm that is built to grow regardless of the economy, industry, and competition.

These companies are also technology enabled. Their modular componentization, ability to build collaborative and integrated value webs, and cost optionality opportunities allow responsiveness to markets, customers, and environmental shifts. This is what we call *on demand*, "as and when needed or opportune" but also "end-to-end across processes, partners, and services" and "most productively and cost-effectively." All of these capabilities require on demand technology: available as, when, and where needed, immediately integrated, and financially productive, not just technically efficient. A componentized business needs componentized technology. For every business characteristic of letting go to grow, there must be a corresponding technology equivalent: agility, cost variability, speed, opportunistic collaboration, relationships, and end-to-end integration.

It is only in the past few years that this correspondence between business strategy and technology has become practical and scalable for even large-scale operations. Although it is management principles that

define Let Go to Grow, this new set of technology platforms and tools are a vital underpinning of on demand, synchronized value webs.

In providing examples of these principles and platforms in action, the opening chapters of our book answer the question, Is this for real? and respond with a never-ending, Yes, it is. This is not a theoretical business strategy book but the very immediate present for just about any industry. Right now, industry leaders are driving up their profits even where their margins are under pressure, whereas the built-to-survive players continue to face revenue erosion and respond with never-ending cycles of cost cutting. The growth experts create new premium capabilities, products, and services through their value webs, leaving the commodity-only players trapped competing on price alone. They use the new global on demand talent base of process and service providers to build tightly integrated and perfectly synchronized value webs while their competitors outsource based on cost with no real advantage or value for themselves, their clients, or their business partners.

It is time for you to join these leaders, for your organization to accelerate the pace and scale of your value web creation and relationships. Don't look back; your competitors will be running in place. Look forward and make sure that you move to the front of the race—one of the pacesetters.

Summary

Growing your business in this new century is going to require that you let go of traditional control mechanisms, give up on value chains, and instead move your company to a new way of thinking about your place in your business ecosystem. It's what we call a value *web*, and it allows value to be built by a consortium of coordinating firms pooling their capabilities and resources.