

MANAGING FOR SUSTAINED GROWTH AND PROFITABILITY

UNDER RAPID CHANGE AND UNCERTAINTY:

INSIGHTS FROM AN INTANGIBLES-BASED VIEW

ON ENTERPRISE AND ECOSYSTEM MANAGEMENT¹

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Abstract

An intangibles-based view on enterprise and ecosystem management makes the value creation economics of today's enterprises better transparent than traditional financial control-based approaches. It especially provides useful information for managers to support them in managing for 'Sustained Growth And Profitability Under Rapid Change And Uncertainty'. Based on some practical examples, the author demonstrates in this article how an intangibles-based view can help to answer the following questions from a managerial perspective: How to best *balance* growth and profitability? How to manage for *sustained* growth and profitability? How to manage for sustained growth and profitability *under rapid change and uncertainty*?

Problem description

After an intensive phase of restructuring and cost reduction, many companies have recently shifted their focus back to growth. But in contrast to similar situations in the past, the CEOs, who are in search for growth, see the need to maintain tight control over costs at the same time. In addition, due to a more open global economy, they are confronted with increased competition, with rapid change in general and thus with growing uncertainty. This is raising the question, whether and how a company will be able to sustain growth and profitability for a longer period in such an unstable environment.

Capital markets reward the capability to manage for sustained profitable growth with a considerable premium on a corporation's share price. Other stakeholders, such as employees, customers and suppliers or nongovernmental organizations (NGOs) usually regard economic 'sustainability' as the foundation for the capability of a company to satisfy stakeholder needs and meet also non-financial stakeholder expectations. And they reward this by attributing the company with a much better relative reputation – creating a strong incentive for additional stakeholders to engage with the company. So there is plenty of managerial motivation to manage for „Sustained Growth And Profitability Under Rapid Change And Uncertainty“. But the question is: How?

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Unfortunately, traditional enterprise management concepts based on the financial control paradigm are not well prepared to support managers in this task. They are designed to measure financial performance after the event and do not shed much light - beyond the cost economics of industrial mass production - on *how* today's enterprises are creating value ('outcome') and financial results/profit ('output'). They can also not explain, how the enterprises of today can *grow profitably* and how they can prepare for *maintaining* this capability in an uncertain environment.

Introduction to an intangibles-based view on enterprise and ecosystem management

Today's buyers' market is much different from the sellers' markets that dominated the industrial economies in the first half of the 20th century, when the foundations of the traditional financial control-based enterprise management approach were developed. Low costs and the ability to produce efficiently are no longer sufficient as the sole performance factors. When customers have a choice and consumers have enough disposable income, they will not choose a product simply because it has the lowest absolute price. They will choose the product that, from their perspective, provides the best price/performance ratio. As a result, the sole focus on the efficiency of enterprise management is obsolete.

The decisive factor today is suiting the customer's taste and, from the customer perspective, setting oneself apart from the competition – in other words, external effectiveness. Companies try to become more effective and set themselves apart from the competition by investing in ongoing innovation (e.g. in research and development), in expanding customer relationships and enhancing customer loyalty, and in its capability to continually adapt to changing markets and customer requirements. It is these specific expenditures and activities that create intangible assets, which represent the foundation for this effectiveness from the customer perspective and which constitute the foundation of a company's competitive edge. The consequence is clear: we cannot use anymore the traditional financial control concepts, because they are based on a different enterprise model that doesn't reflect reality anymore and that does not support management in identifying and managing the true success factors and value levers of their companies (see diagram 1).

An intangibles-based view on enterprise and ecosystem management provides managers and stakeholder with a more comprehensive insight in the value creation process and system of the enterprise and its wider ecosystem (i.e. including partners and their 'production factors' through which they contribute to value creation). It makes the economics of today's enterprises better transparent than financial control-based approaches and thus helps to get a systematic grasp on the actual value drivers and value creation processes. It can provide information on the following in equal measure: the status of all relevant *resources*, the status of the *value creation processes* (effectiveness in establishing future potential, efficiency in resource management), and the overall effectiveness – that is the financial and intangible *results* of the entire value creation system from the relevant stakeholders' perspective (see diagram 2). Based on the perspective of an intangibles-based view on enterprise and ecosystem management we will now investigate the three topics addressed by the following questions and will try to formulate proposals for managers to manage for „Sustained Growth And Profitability Under Rapid Change And Uncertainty“:

- How to best *balance* growth and profitability?

- How to manage for *sustained* growth and profitability?
- How to manage for sustained growth and profitability *under rapid change and uncertainty*?

How to best balance growth and profitability?

For the purpose of this investigation we define ‘growth’ not just as ‘extension of the business’, i.e. increase in sales volume, but as ‘topline growth’, i.e. increase in sales volume *and* revenue, and as ‘real growth’, i.e. triggered by an increase in ‘customer value added’. With ‘customer value added’ we mean the difference between the total value of an offering and the price the customer has to pay for it. With ‘total value added’ we mean the difference between the total value of an offering and the total costs to produce it. With ‘profitability’ we mean the difference between sales revenue (price) and total costs to produce it as well as the objective that each (additional) sales is adding an amount of revenue that exceeds the total cost it generates – i.e. our objective is to generate profitable growth. And in order to manage for profitable growth, we have to answer these three questions: What drives topline growth?. What drives profitability? How to balance both activities?

To answer the first question, we have to investigate how customers or potential customers decide to buy or not to buy. Customers and potential customers make a very individual equation before they make that decision: they ‘value’ the offering, of e.g. a car dealer, from their subjective perspective and compare the ‘total subjective value’ with the sales price in order to determine, if there is enough added-value for them. Part of this ‘subjective valuation’ is usually: the car’s (technical) functionality in general, attractiveness of new technical solutions, quality and reliability, driving experience, image of the brand, image of the car, service reputation of car manufacturer and car dealer etc.. Only if the result is positive compared with similar offers from competitors (and if the person can afford to pay the price) it is likely that the potential customer will buy. But there are other conditions as well, which are the more critical, the more competitive the market place for sellers is: Is the seller able to communicate the value of the offer to potential customers? Do potential customer understand the value of the product and are they able to translate the value proposition into their ‘world’? Does the potential customer get the impression that sales and service people at the car dealer value her personally and understand her issues? etc.. The former aspects are an outcome of R&D and manufacturing processes, the latter an outcome of marketing and sales activities.

To answer the second question, we have to investigate what drives revenue and what drives total costs. Revenue is driven by sales volume and sales price, which are both driven by the same aspects as the decision of the customer to buy (see above): these aspects also determine, how much the customer is willing to pay and how much she is willing to leave of the total value added to the seller (sales price divides total value added in customer value added and profit). Total costs are mainly driven by the activities of the company in designing, making and selling its products and administrating its business (assuming that raw material prices are the same for all competitors in a specific market).

Balancing growth (and the creation of value = growth potential) with profitability requires trade-off decisions between investments in value creation (that generate direct or indirect costs) and low costs/operational efficiency. The traditional approach to this task is, to focus on cost reduction and/or to try to raise sales prices in order to maximise profit (inside-out approach) – because only this part is visible in the traditional accounting/management system. The problem with this approach is, that one risks with the former to knowingly or

unknowingly reduce (customer) value added. This is lowering the willingness of customers and potential customers to buy and to pay the requested price and is thus destroying growth potential. The latter has the same effect: raising prices without increasing value is reducing the value added for customers.

The intangible view is providing us with the means to do a better job in balancing growth and profitability, because it makes the entire value creation system visible and enables us to apply a systemic approach to enterprise and ecosystem management that leads to better trade-off decisions. First, it allows optimising the trade off between value creation/growth and profitability/costs in the detail, i.e. in the operational processes in each value creation subsystem (design/R&D, manufacturing/fulfilment, sales&marketing/customer relationship management) by applying both parts of the equation in each single operational decision. In the R&D operation of a car manufacturer, it helps to answer the question: What is the possible value contribution from a customer perspective of e.g. a new engine technology and what costs do we generate through it? Or in sales&marketing: What is the likelihood that customers perceive the value of the new engine technology and are willing to pay a price premium for each of the different possible sales&marketing approaches and activities compared with its costs? etc.. Second, it also allows to optimise the overall system by better managing trade-offs between the different subsystems and the trade-off between inhouse activities and partner-activities (see diagram 3).

How to manage for sustained growth and profitability?

Growth, also profitable growth, creates over time disruptions in the value creation system of an enterprise. The reason for this is that growth puts an enterprise's resource base under pressure and often capacity limits are ignored – especially of intangible resources and capabilities.

Take the example of AOL, the Internet Service Provider. After the company went public in 1992 it started an aggressive growth strategy and spend a good portion of the raised money for traditional advertisement campaigns. Month after month the company acquired more customers than it lost – creating additional revenue and profits. But this were 'bad profits' based on 'unreal growth': in reality customer value added declined, because AOL was not able to serve the higher number of customers properly, which culminated in summer 1996 in a full day 'black out' of AOL's servers. As a consequence, millions of customers left AOL. The result: 40% decrease in revenue as a consequence of this 'growth strategy'. What went wrong in the AOL case? First, they underestimated the capacity needs to support the growth strategy and didn't properly plan for growth. Second, they didn't focus on 'real growth' based on an increase in customer value added, but just on getting customers on board through advertisement. As a consequence, customers were not very loyal and left at the first occasion to competitors. In contrast, eBay had a different strategy: eBay focused much more on word-of-mouth than on traditional advertisement, based on the experience of extraordinary customer value added by users. As a result, eBay's customers are not only more loyal, the company was also able to turn 70 percent of its customers into promoters, who recommended eBay to their friends.

As we have discussed in the last section, real growth is triggered by the attractiveness of the offering (by the 'customer value added' promise). Because customer value added is always relative (relative to the value added provided by competitors), to win with customer value added, requires a vendor to differentiate. This 'differentiation' is based on some unique, ie.

scarce capabilities (processes and resources, such as in product development, fulfilment and/or customer relationship management). They usually have been developed in-house, meaning that they cannot be bought on the market, if available capacity is reaching its limits. And development of further resources or adaptation of processes to handle higher volumes without losing value/quality takes considerable time. The result is, that the normal growth curve looks like as depicted in diagram 4, left: slow growth at the begin (preparation phase), acceleration (growth phase), and decline (reaching capacity limits). How can enterprises avoid this decline, i.e. un-sustained growth? They have to monitor capacity usage for all its resources – also intangibles – and have to invest in time to extend resource capacity and/or to move the entire value creation system to the next level.

The problem is, that intangibles, such as the capabilities, on which important value creation processes are based, relationship capital (supplier relations, relations with distribution partners etc.) or other intangible resources, are not included in the traditional corporate planning process like tangible assets. Usually, also no ‘inventory management system’ for intangibles exists, that shows, how much capacity is actually used, and that allow to make an estimation, how much demand an expected volume growth will place on a specific intangible resource in order to prepare for that growing demand. An intangibles-based view on enterprise and ecosystem management will provide this information through a comprehensive monitoring and planning system that includes the intangible resources and capabilities. It allows not only to plan the further development of single resources, but also the ‘innovation’ of the entire value creation system. This makes it possible, to prepare the enterprise to ‘jump’ in time with its major resources and the design of its value creation system to the next level, in order to master the ‘inclination points’ of growth and to end-up with steady, sustainable overall growth (see figure 4). This requires a strategy management process that focuses on developing all the capabilities in time that are required to support the growth strategy of the enterprise as well as a performance management process that balances this with short term performance. Both processes are supported by appropriate strategy implementation and performance measurement systems (see figure 5).

How to manage for sustained growth and profitability under rapid change and uncertainty?

But even if a company is able to handle internal disruptions and manage the inclination points of growth through a planning approach that includes intangible resources and capabilities, it doesn’t mean that growth will be sustainable. External disruptions, such as changes in the market or in technology creates uncertainty from a managerial perspective and represent a threat to sustained growth and profitability, because managers cannot foresee them and therefore cannot plan for them. The only way to master (external) change and uncertainty is not to plan for it, but to organize for it.

The first building block for ‘organizing to master rapid change and uncertainty’ is to focus the organization on creating loyal customers by delivering superior customer value-added (see above). Customer loyalty is playing an important role in mastering change: even if for a short periods the value offering is not 100% o.k., customers may not walk away immediately. This is leaving time for the company to ‘adjust’. The second building block is to become a ‘sense&respond organization’: an organization that is able to anticipate and sense change and to adapt to it quasi automatically. The third building block is to partner and to share resources and capabilities within a larger ecosystem, i.e. a group of company that are providing together services to customers.

An example for a sense&respond organization is Fujitsu Services, a provider of IT outsourcing services (see Marr and Parry, 2004). In 1999 Fujitsu Services found that 40-90% of incoming service requests were entirely preventable. This highlighted where Fujitsu were incurring unnecessary cost, and more importantly, where they were not meeting the needs of customers, i.e. not creating customer value added. Fujitsu found that the existing 'central command and control' system to improve services and provide new services was not effective enough to enable the organization to react to changing customer demand and preferences or to eliminate unproductivity in the service process. As a consequence, Fujitsu Services started to redesign its organization and subsequently also its performance management system. The new mantra now was to increase constantly customer value added and to drive through this growth and profitability. This required first the empowerment of frontline people, who work everyday with customers and are the best prepared to 'sense' what customer really want and to decide, how customers are best served and to improve customer service. The objective of people in a call centre was not any more to finish calls as fast as possible, but to solve the problem of the calling customer, if possible, during the first call. A second objective was to understand 'unproductive' demand, i.e. a customer request that was preventable, and to take the necessary steps to prevent it in the future, such as to propose the customer to replace an old equipment or to trigger an improvement in the service delivery process of Fujitsu Services. Second, it required organizing processes in the company from the front office to the back office and not vice versa. Customer demand should trigger activities of frontline staff. Frontline people needs and activities should trigger support units activities etc.. The hierarchy within Fujitsu Services was essentially turned upside down. The role of managers was changed from one of authority to one support. Their task from now own was to 'create purpose', to 'create capabilities' and to 'empower'. The task of frontline staff from now own was to create and to improve customer value added. Fujitsu Services was now able to offer many clients reduced annual costs because they are confident about removing (unproductive) demand. This approach positively impacted customer and client satisfaction and loyalty, as well as employee satisfaction and operating costs. But the most important consequence was that Fujitsu Services was now able to 'sense&respond' as an organization and to react to changing customer demand and to innovate quasi automatically without explicitly planning for it.

An example for an ecosystem is SAP, the world leader in the enterprise software market. SAP is teaming up with many partners on the product side (so-called complementary software providers, who complement the SAP offering with their software products) and on the customer-facing side with consulting partners, who own 80% of the consulting implementation business for SAP software, and value-adding resellers for the small and midmarket. Especially the partnership with consulting partners and the presales and consulting resources of these partners that increased SAP's field organisation fivefold, enabled SAP to grow fast enough in the 1990s, when the ERP market has been created, and when it was critical to grasp quickly market share in order to become the market leader in ERP software. In a situation of rapid change (creation of a totally new market segment) the SAP partner strategy created the precondition for the company to leverage this change to grow. Other examples for an ecosystem approach are pharmaceutical companies like Roche and recently also consumer product companies like Nestlé that apply a similar approach in product development in order to increase agility and to share risks.

What is the benefit of an intangibles-based view on enterprise and ecosystem management in building these three building blocks for mastering growth and profitability under rapid change and uncertainty? The benefits of such an approach for creating creating customer loyalty

(through creation of customer value added) that has been already explained in previous sections. The advantage of applying an intangibles-based view for creating a sense&respond organisation is, that only the intangibles-based view provides the insights into the value creation system that allow to decide, which tasks should be executed at the frontline, which tasks can be 'mass customized' in the back-office, and which tasks are merely support tasks. The advantage of applying an intangibles-based view for creating an ecosystem of partners is, that only the intangibles-based view provides the insight into the value creation system that allows to decide, which tasks are core tasks and resources should be kept/developed in-house and which tasks and resources can be shared with partners. (see figure 6).

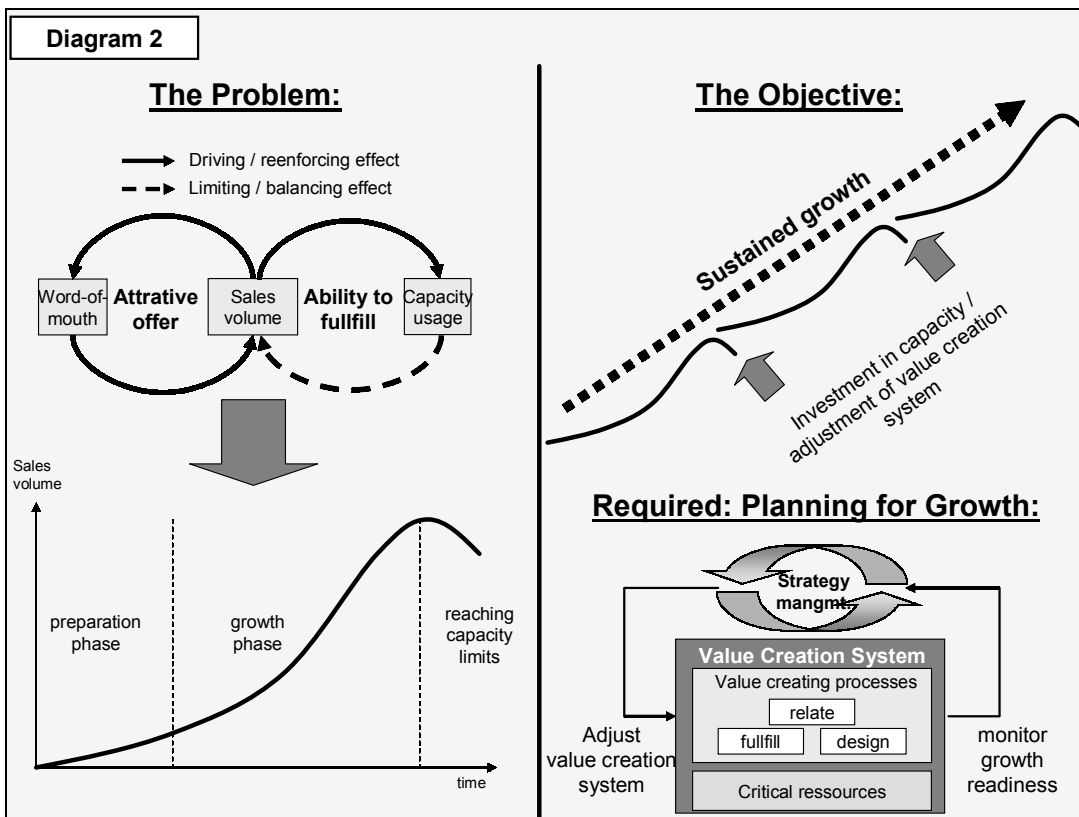
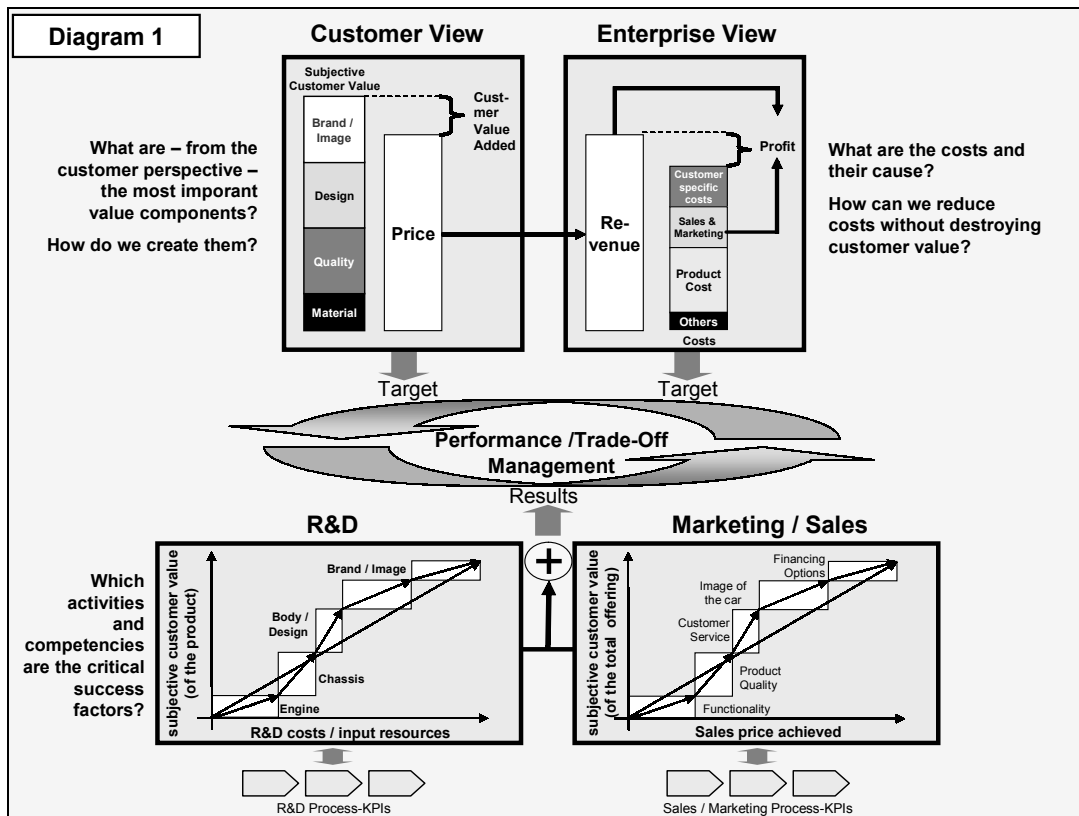
Conclusion

An intangibles-based view on enterprise and ecosystem management can provide valuable insights in the value creation process of an enterprise or ecosystem in order to manage for profitable growth and to maintain growth – even under rapid external change and uncertainty. This has to start with a thorough analysis of the existing value creation system of an enterprise from an intangibles-based view (see Daum, 2004). This approach can also bring the necessary degree of rigidity and discipline into the rating, measurement and reporting of intangible, qualitative performance ('customer value added') because it set the qualitative and subjective (intangible) dimension into the context of the financial dimension. This is important because intangible, qualitative value creation factors can create only value added and growth, when they are connected to world of cost economics. The gained insight can be used to support strategy and performance management through appropriate measurement systems and processes in order to enable managers to manage 'Sustained Growth And Profitability Under Rapid Change And Uncertainty'.

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Diagrams



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