Are You Creating or Capturing Value? A dynamic framework for sustainable strategy

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A dynamic framework for sustainable strategy

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Introduction

Is value the holy grail for every company? Definitely it is something executives, investors and researchers are interested in since decades. If we only look at 4 major strategy journals over the last 20 years (Strategic Management Journal, California Management Review, Harvard Business Review and Sloan Management Review), together they published 189 articles with the word value in the title, meaning that on average about every month a new article was published focusing on the concept.

Yet, value is perhaps one of the most used and misused terms in the history of management literature. To say the least, a lot of confusion persists not only about the meaning of the term, even more about ways to achieve it in a sustainable way.

In this article, we start from a clear distinction between value creation and value capturing and propose a simple and intuitive framework showing the critical role of managing the interaction and the dynamics between these two strategic imperatives for achieving sustainable success for any company. We illustrate the framework with recent data from companies across a variety of industries providing further support for the relevance of the model.

The Value Creation – Value Capturing framework (VC^2)

We define *value creation* as the perceived benefit to the customer. This is in line with the microeconomic concept of the utility of a company's offering for its customers, whether it enhances the quality of life for a final consumer (B2C) or increases the profitability of a company (B2B). If a product or service is failing to do so, obviously there is no point in bringing it to the market after all.

Offering a useful product or service alone is not sufficient. The pricing and cost structures will have to accommodate sufficient *value capturing*[1]*.* The provider has to generate sufficient revenue and profits for its shareholders. If the value created by a private enterprise is not sufficiently captured, there is no long term viability of the offering. Zooming in on the distinction and interaction of these two dimensions of value creation and value capturing, leads us to the following dynamic model[2] which is to be seen as a framework to help us understand the strategic challenge affecting a company's situation in a given market or industry.

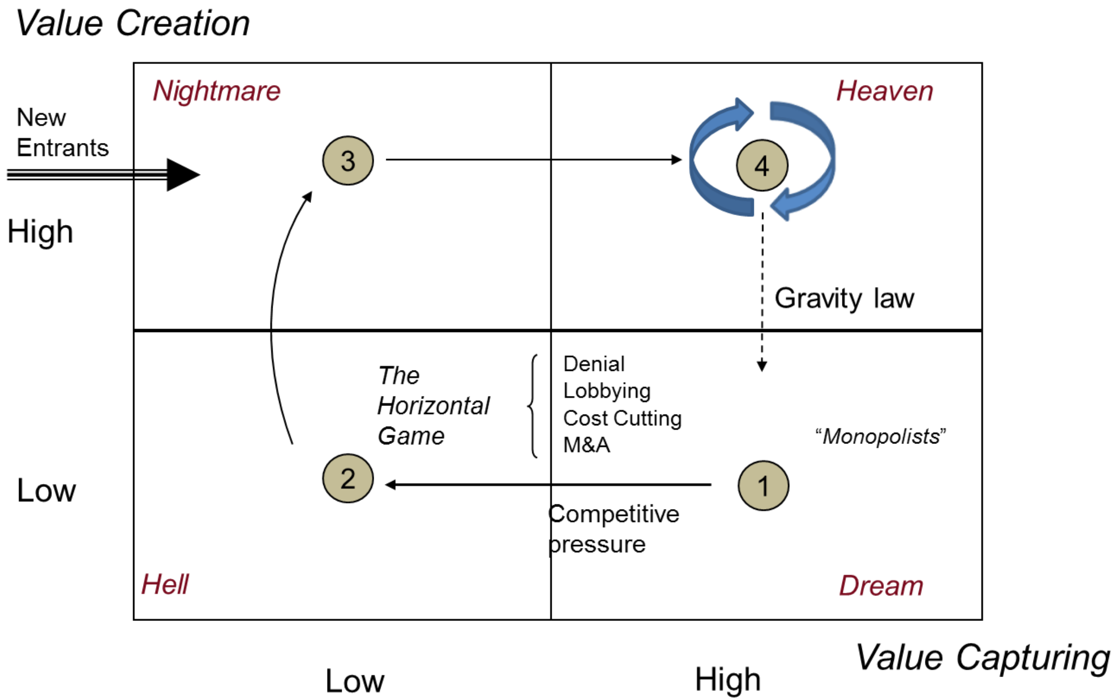

Figure 1: The Value Creation-Value Capturing (VC2) framework.

Waking up from the Dream

Let us start in the "dream" situation (bottom right in Fig. 1) where well established companies generate substantial profits even if the value they create may be relatively limited or even shrinking. This seems to hold for quite some companies with strong market positions or (quasi-) monopolies, such as was the case for many players in telecommunications, utilities or postal services before de-regulation and for the oil majors in the 1960'ies, IBM in the 1980'ies and Kodak or De Beers up to the 1990'ies.

They all had been happily enjoying the benefits of their position, until anti-trust, de-regulation or new competitors showed up, putting pressures on prices and margins. The appearance and sudden growth of many newcomers, particularly those benefiting from technology and internet based opportunities, provide many more examples of nicely profitable businesses or industries under threat from creative newcomers, be it in the taxi-business, hotel industry, financial services or retail sector. Pressures from (de)regulation or "disruptive" innovators invariably push established companies to the bottom left of figure 1 also known as "hell".

At first, the pressure will go unnoticed and companies tend to be blinded by denial: "this won't happen to us"; "it will last our while"; "let's enjoy the good times while they last"; "business as usual" or "you don't understand, we are different!". However prices and

margins will be under pressure and provide a wake-up call, leading probably to some strategic reflection and reaction. In reality, however, inertia often takes over, and the tension between short term optimization and long-term strategic change often resolved to the benefit of the former. The eternal fear of "cannibalization" clearly fits into this mold.

Furthermore, a variety of stop-gap measures are at their disposal to try and avert or at least delay the immediate pressures, potentially aggravating the eventual crisis in the making. Such measures appear in different shapes and forms: price-fixing, colluding or forming cartels, smuggling in hidden price increases[3] or – just the opposite – cutting prices in panic mode; cost-cutting and restructurings (without a cost-based strategy); the usual suspects of "cross-selling" (even when the customer may not be interested in "cross buying"), "one stop shopping" (even when the customer does not stop) or "value added services" (without any value added); targeting "customer lock-in" rather than creating true loyalty based on superior customer value; lobbying for more regulation; and last but not least: mergers and acquisitions aimed at buying the competition rather than beating them (in the name of economies of scale, synergies or "industry consolidation") just to name a few (all variations on what we call playing the "horizontal game", moving sideways in the lower part of the model).

Sooner or later defensive measures may not suffice to avert the fate of customer, competitive or public pressures, pushing further towards the lower left corner: this is "hell"! It is characterized by commoditization i.e. low value creation as well as low value capturing (often referred to also as "commodity hell", "the commodity trap" or "the commodity magnet"[4]). This may be the plight or the final stage of companies in declining industries before they end up in bankruptcy (e.g. American Airlines) or being taken over (e.g. Nokia's handset business).

Climbing out of Hell

The only way out of this situation is to start (re)focusing on creating more customer value by making the offering more convincing towards customers. Such re-orientation requires climbing the wall of innovation, represented by an upward move along the vertical axis of our model, perhaps the most important strategic priority ever as stated for example by former CEO Samuel Palmisano from IBM: "Either you innovate or you are in commodity hell".[5]

Creating and innovating value to customers of course requires hard work and long-term investments. They are at the heart of strategic success, or at least the ultimate source or key driver of it. And, as recent studies have argued and illustrated, and some based on empirical evidence, there are only two ways to consistently add and create value successfully: either by becoming the low(est)-price champion (requiring continuous "cost innovation)" or by focusing on superior customer value (aiming for high price, requiring continuous value innovation)[6].

Simply put: unless you intend and manage to become the Wal-Mart or the Ryanair of your industry offering the lowest – and ever lower – prices, your strategy should aim to continuously offer better value – better than before, and better than competitors. Some of the most recent findings seem to support the view that focusing on value in most cases is the better way to go, rather than on price[7]. This allows capturing some of that value by way of higher prices, while the low-price strategy should allow capturing more thanks to ever lower costs (and the resulting volume increases).

We include here any kind of value innovation, covering the full spectrum from marginal to radical or disruptive improvements in products, services or the business model[8], as long as they create additional value to the customer. It may be noted in passing that the now so popular term of "disruptive" innovation in fact unduly reveals some defensive or inward-looking bias, as in our view there is nothing disruptive or being disrupted for the customer or consumer, only new opportunities and value added and the potential disruption refers in the first place to the company offering it or being affected by the new offering that risks being 'disrupted'[9].

It should be clear that value is created at the level of a company, not at the level of an industry as Ted Levitt aptly argued now more than 50 years ago in his seminal article "Market Myopia": *"In truth, there is no such thing as a growth industry, I believe. There are only companies organized and operated to create and capitalize on growth opportunities."*[10] Since then it has also been repeatedly shown in a host of studies and approaches that industry and other external factors in fact only explain only a small part of the profitability variation across firms[11], much in line with this perspective.

From Nightmare to Heaven

Value creation is a necessary but not sufficient condition for sustained superior performance. If all you do is deliver value to customers and not keep enough in the

process you are obviously not in a good place, a situation that looks like a "nightmare": you work really hard at it, but do not get rewarded.

Such seems to be the situation of some established companies that manage to come up with innovations that customers value but are not (yet) able to reap their benefits, because of an ineffective business model or defective value proposition particularly in highly competitive conditions (e.g. Philips).

Most if not all startups share this challenge. They may have large amounts of "eyeballs" (see the dotcom bubble of 2000 or Facebook till recently) or even buyers (e.g. Amazon) but little or no profit and can only survive as long as the investors keep holding faith that sooner or later they will get handsomely rewarded (and thus move over to the upper right as Facebook is).

By no means are we claiming that *only later* should we worry about value capturing, since it may be hard to convince customers to start paying (more) later. As a principle it seems that we should be able to align our pricing as much and as closely as possible with the specific value bundle or value proposition we are offering. Paypal for instance managed to adapt its pricing structure gradually in line with the features it was adding over time and this may be at least one of the reasons for its success where other have failed[12] When you are able to do just that, you are well on the way to "heaven".

Capturing value means that you should be able to turn your value creation (as realized in a concrete value proposition) into a sustainable business, by means of what we usually call a "business model" Strategy scholar David Teece for instance put it like this: "The essence of a business model is in defining the manner by which the enterprise delivers value to customers, entices customers to pay for value, and converts those payments to profit".[13] This is the point where pricing becomes crucial[14]: the means to capture a share of the value created to assure sustainability by providing return and resources for further investment.

Nike is such a company that succeeded in creating more value for its customers by approaching sequentially different sports through a "category offense"[15] strategy while focusing strongly on the customer experience rather than on the functional benefits. Although at a lower level of both value creation and value capturing than Nike, Singapore Airlines as well as Southwest Airlines or Ryanair at the other end of the spectrum outperform their direct competitors on both dimensions thanks to a clear and ever

improving value proposition, remaining very profitable in a harsh industry and economic environment.

In so doing we can arrive in "heaven" at last – however it is not a heaven where you can sit back and relax. Even though the temptation will be there, especially when you have been successful and you have created your new product, market, industry and gained a respectable position, you cannot rest on your laurels. As more and more markets and cases show, there hardly ever exists an inherently sustainable advantage. Ultimately sustainability will result from our ability to constantly innovate, uphold and improve our value (proposition) to the customer (as increasingly illustrated and argued, e.g. in the recent contributions on "transient advantage"[16] and "repeatability"[17]).

If you focus too much on the value capturing at the expenses of continued value creation, you risk of falling into the trap of "the failure of success". Most companies have encountered this at some point in time, and many of them have not been able to keep up their position or the record of success. For instance, only 13.4% of the companies that were in the Fortune top 500 in 1955 are still there today[18] and the average number of years a company survives on that same list is now less than 15 years[19].

There seems to be a certain "law of gravity" which pulls us invariably down from heaven, by weakening our relative value creation efforts and putting us to sleep (in the dream scenario), as we become too focused on optimizing the capturing (reflected in misleading metrics like percentages margin, market share etc.) We may even *increase* our capturing, while our value creation is going down, by milking, harvesting, improving short-term financial results, while cutting investments and losing sight of future value creation, until de-regulation, anti-trust, and/or new competitors show up pushing us into the defensive, and eventually challenging our survival.

This type of movement can occur very quickly as shown by recent examples such as Nokia and Blackberry in the mobile phone handset business, and it seems that the time between the comfortable "dream" and a scramble for survival in "hell" has been shrinking at a rapid pace, particularly in those areas where new technologies (and internet-based models that often exhibit "winner-takes-all" features) increasingly dominate. Our empirical results below on a large group of Fortune 500 companies illustrate and elaborate on these points.

The dynamic picture

In sum, looking back at Fig. 1, for existing companies there is a natural clockwise flow from the dream (lower right box) to the heaven (upper left box) through the intermediate stages of hell and nightmare. From dream to hell we are pushed by the inability to react to competitive or regulatory pressure. Successful companies find new ways to create value for their customers and move vertically. If they also succeed in monetizing their offering the shift towards heaven will occur. Once arrived in the heaven situation, continuous improvement is needed in order not to become complacent and resist the continuous temptation of slipping into a dream.

Most successful new entrants enter in the upper left: they found a new way to create value for a number of customers who appreciate and are buying the product or services. Unfortunately, quite a lot of these companies (even large ones like Amazon) do not immediately succeed to extract a substantial profit from their offering and risk to disappear if they do not deliver or manage to uphold investors' expectations.

This tension between creation and capturing culminates to the point where we realize that the only reliable way to know and test whether we are actually are creating sufficient value remains… whether we are able to capture (enough of) it in the wake of increasing competition. It is therefore not even "willingness to pay" but ultimately whatever the customer is actually paying or has paid for, that matters most.

Measuring value creation and value capturing

While our framework is essentially conceptual, and at first sight perhaps no more than a formalized "metaphor", we can illustrate it empirically with actual data from major companies across a variety of industries.

Even though clearly there are no "perfect" measures for both axes, we propose a simple methodology to quantify the dimensions of value capturing and value creation at company, yielding rather illuminating and sensible results supporting the key messages and interpretations of our model.

For *value capturing* we refer to known measures of profit or profitability. For our purpose, and since we are interested in operational results rather than financial leverage, we use net profit divided by total assets as an indication of how much value (profit) a firm is able to extract from the used resources (assets). It is a broadly used measure, is relatively robust to financial market fluctuations or financing strategies[20] and can be used for comparisons with other studies.

Finding an appropriate measure for *value creation* is less obvious. If an appropriate and generally accepted or applicable measure existed, value creation would have long been better considered and integrated in strategy development and day-to-day management. Actual value received or perceived can never be directly measured as micro-economic theorists have long realized. Only by deduction can we conclude that if customers are buying and paying the price, their expected value should exceed the price they paid.

Given these conceptual issues we turned to brand value as a reasonable proxy representing the value creation as intended in our framework. As a "stock" or "strategic resource" concept rather than the "flow" aspect of "expenses", it can be seen as an indicator of all the value that has been created over time and therefore has the benefit of not depending on short term fluctuations or budget manipulations. True to the long-term dynamic nature of our framework, and within the limits of available data, we collected observations over a five year period (2008-2012). A more detailed description of the methodology, the data sources and the list of companies covered, can be found in the appendix.

General Overview

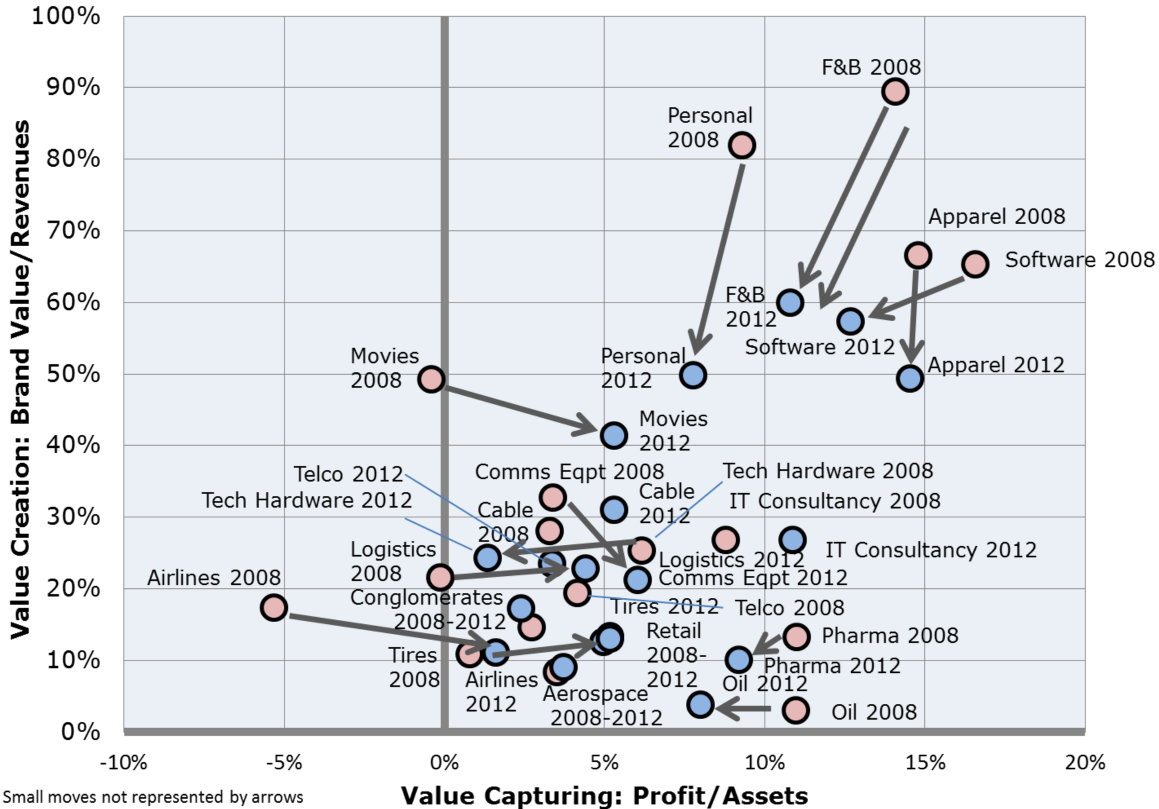

Figure 3: Companies' position and movement (by industry) in the VC2 framework (2008-2012). F&B=Food and Beverage

In the above scatter graph we grouped the firms into 18 industries or sectors[21] (Fig. 3). The X-axis represents Return on Assets as a measure of Value Capturing, and the Y-axis represents Brand Value over Revenues as a measure of Value Creation. For each sector we provide the companies' position at the start of the observed period (2008) and at the end (2012), with arrows indicating the sense of the movement over this period.

Clearly companies in sectors like Airlines, Telecom, Tires and Rubber and Conglomerates seem to be struggling in "hell" (bottom right), more recently joined by those in Retail, while Pharma, Cable and of course Oil companies seem to be more favorably positioned in the "dream" scenario, indeed sectors that are traditionally characterized by a limited competition (thus relatively less pressure to innovate and create value as a condition for their continued value capturing). Companies in Apparel, Food and Beverage, Personal Care, as well as Internet and Software seem to be much higher up (upper left).

At this aggregate level, it seems significant to observe that the majority of companies have been moving down on both the value capturing and the value creation dimension over the period observed, in what is probably a very clear manifestation of the "economic crisis" during these times. Not only has value capturing clearly suffered during the crisis it may be seen just as well as *a crisis of value creation*.

The slashing of investments in innovation, R&D, management development, and the coinciding hoarding of cash especially on the balance sheets of most large established companies is undoubtedly related to this general drop in value creation. In only few industries in our sample were companies able to increase both their value created and captured over this period of time (see companies in logistics, aerospace & defense, rubber and cable).

Far more interesting is it to zoom in on the situation and the movements of individual companies over the given period, as illustrated next.

Specific companies within their respective industries

a. Retail Companies

As noted above, most retail companies seem to be struggling in "hell" as shown in Fig. 4 below. Two of the main contenders in the US, Wal-Mart and Target are doing significantly better than their main competitors, the latter scoring somewhat higher on the value creation dimension. Tesco that was up in heaven showed early signs of

deteriorating in our framework probably just the precursor of the big slide that was just around the corner.

In the meantime some of the also-rans in the lower left have initiated attempts and strategies to try and climb out of the black hole, most notably Carrefour, aggressively restructuring major international operations to refocus on domestic improvement. Initial results seem to be positive if still subdued, only underscoring the difficulty of moving up the vertical axis, especially under tough competitive pressures.

Although Amazon is not in our database (because too small in 2008) we mark their 2012 position up in the high left, way off the chart, showing poor financial performance, while obviously creating a lot of perceived value for its customers and leaving the question how and when they will move over to the upper right.

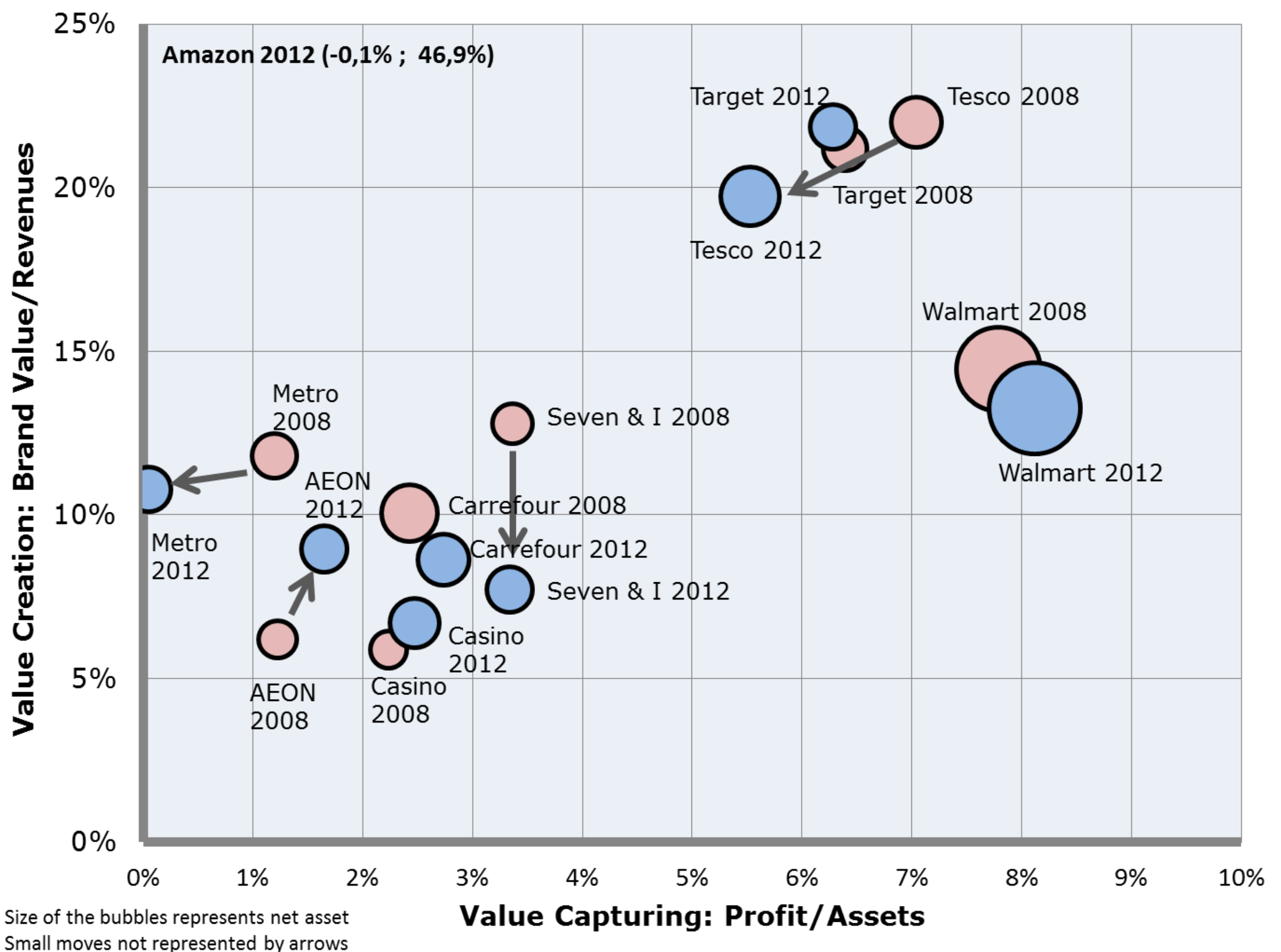

Figure 4: Retail Companies in the VC2 framework.

b. Technology Hardware Companies

A different picture emerges for technology companies (Fig. 5), with the demise of Blackberry and Nokia apparent in our framework, almost straight from “heaven” into “hell”, where they meet Sony and HP still facing the challenge of moving up. Apple obviously keeps enjoying a position in “heaven”, continuously innovating even though the actual financial performance has even been improving over time in spite of “the crisis”. The Japanese players Sony and Panasonic saw their figures turning red over the observed period. Nevertheless, Panasonic is the only player on this chart that enjoyed a (slight) increase in value creation.

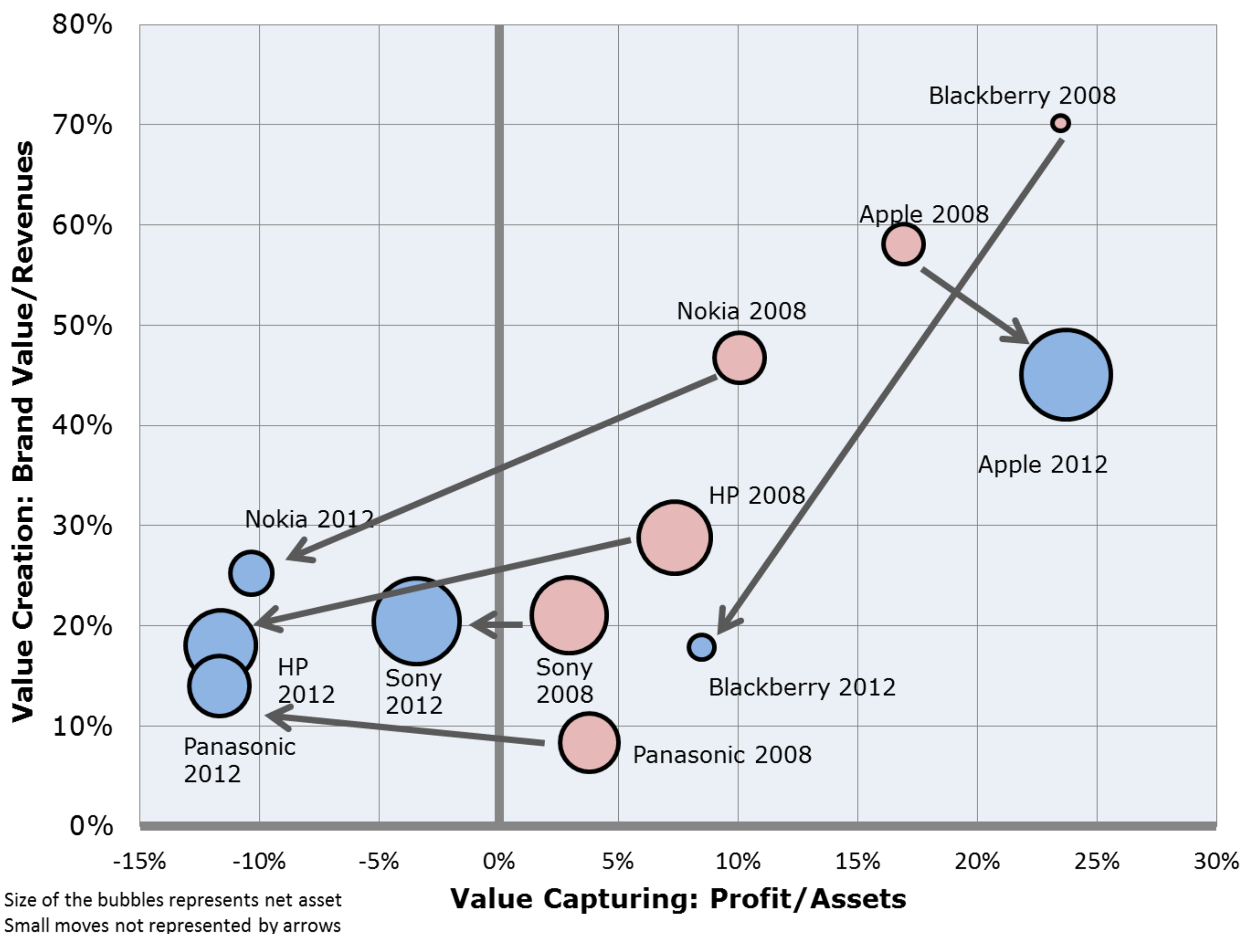

Figure 5: Technology Companies in the VC2 framework.

c. Pharma companies

No surprises for most pharma companies covered, as they are or were clearly enjoying a "dream" situation, more recently coming under pressure from expiring patents, diminishing returns from research efforts and the lack of new blockbuster drugs, the buying and/or regulatory power of insurance or government organizations and the entrant of new (non-prescription) competitors. Some have already moved into "hell", but none have been able to go back to "heaven", J&J perhaps succeeding better than others, however this may be due to their different "business mix" including personal care.

The race of traditional pharma to merge or buy bio-tech can clearly be seen as an illustration of the horizontal game as described in our model, i.e. trying to save costs or time, respectively to speed up and fill the innovation pipeline faster through take-overs or alliances. Opportunities for value creation to the customer (patient) have clearly multiplied over the last several years however most pharma companies have not been able to capitalize (yet) on this by turning it into a new value proposition and accompanying business model on a sufficiently large scale. The "heaven" quadrant is still wide open…

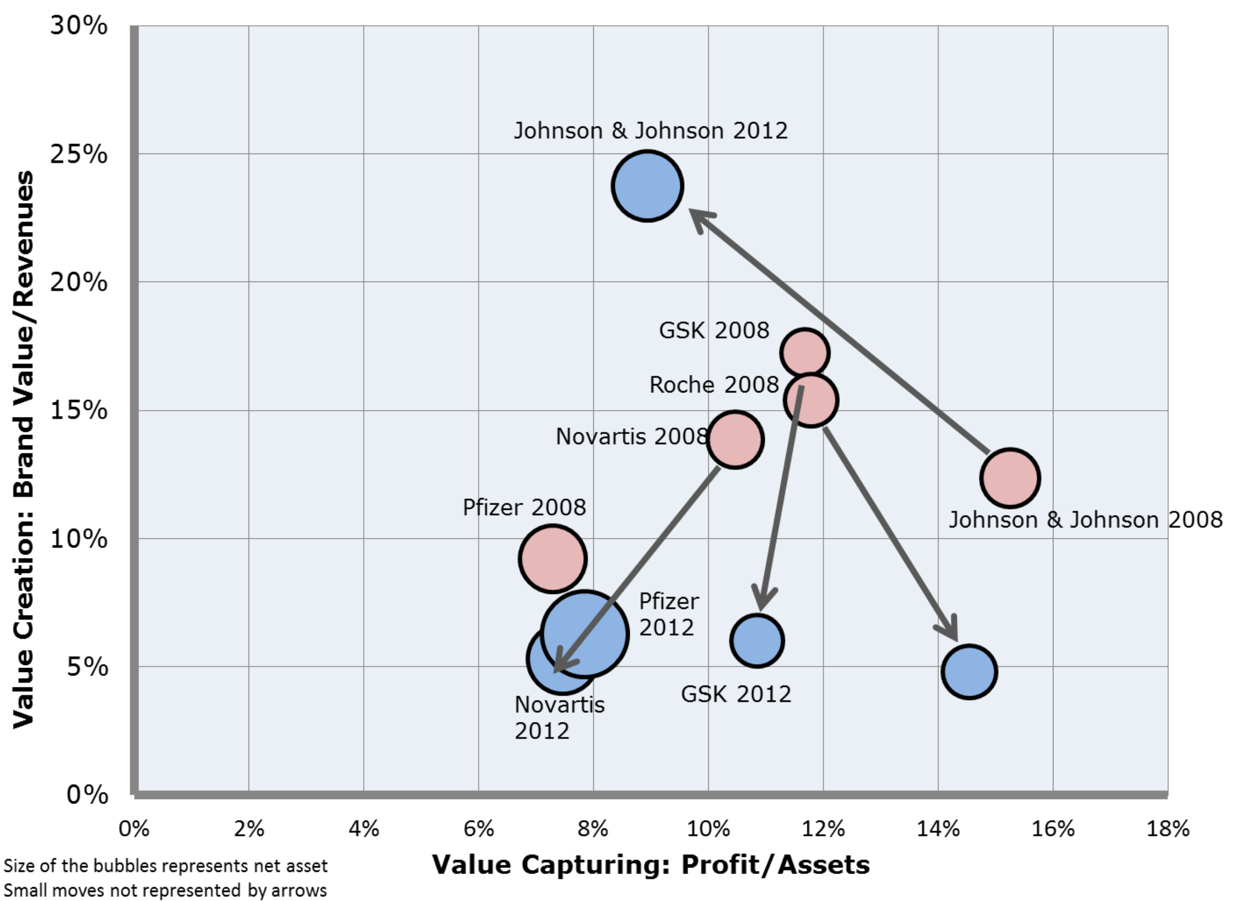

Figure 6: Pharma companies in the VC2 framework

d. Telecom companies

Speaking of a fiercely competitive sector where quite some players had difficulties to get out of commodity hell in the recent past, this seems to be one, as can be seen in figure 7. China Mobile is a clear exception as not being confronted with the same competitive pressures as some of the other major companies in the US and Europe.

More mobile oriented players like Vodafone and Orange are perceived as more appealing by the customers and recently some of the (born)fixed players succeeded to catch-up in part thanks to the fixed-mobile convergence movement. Making a substantial profit remains challenging and none of the players is ending up in the favorably attractive upper right at this moment in time.

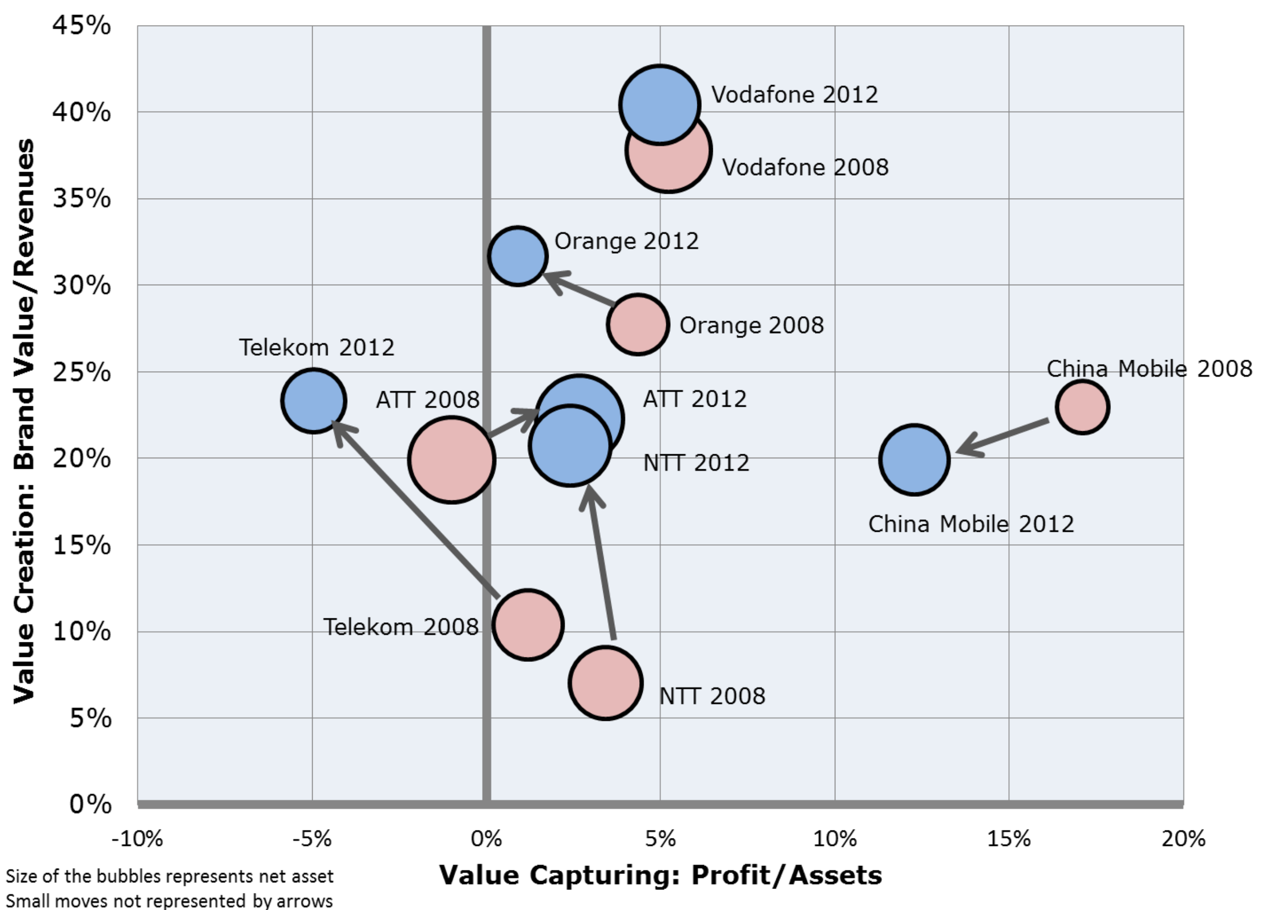

Figure 7: Telecommunications companies in the VC2 framework.

Conclusion: Strategy, Value creation and "the Einstein issue".

Value creation and value capturing have increasingly been targeted in discussions and publications on strategic management. Given the increasing and increasingly fast-moving competitive pressures across markets and industries, and the search for renewed economic growth, especially since the financial crisis, the need for (re)focusing on the *creation* part of the equation has never been greater and more apparent. The data shown for leading companies across a variety of industries support and illustrate this point as well as the resulting strategic challenge.

We would argue that "The more competitive your business, the less you should focus on the competition." It is your capacity to continuously innovate and add value to the customer that will determine strategic success and that will decide whether you will be able to 'beat your competition' in the process. This view is clearly in line with (the need for and recent publications about) the required shift in strategic focus for most if not all companies from defensive or 'value capturing' tactics towards creating and maintaining the key conditions for sustained value creation.

Creating value in a sustained way (a better, cheaper or faster offering than that of the competitors) is a key condition for sustained capturing. Yet, we do not have equally generally accepted measures for value creation as those generally used and accepted for the *capturing* part, if only because 'value' is an elusive and multi-dimensional concept that greatly varies with time, place and relevant customers, users or citizens.

In this paper we reverted to a carefully constructed and multi-dimensional concept of brand value as an adequate proxy for value creation towards the customer. It is up to the customer to decide what is compelling and what is not and to what value is attributed after all. At the end of the day, these decisions of the company and its customers determine what value is attributed, what price is charged and how much profit will result.

This goes back to what we like to call the "Einstein issue" inspired by the famous quote: "Not everything that counts gets counted, and not everything that's counted, counts." Perhaps no better and succinct summary of the key strategic challenge facing any company (and other non-profit or public organizations alike[22]). As long as organizations do not fully embrace the key strategic challenge of addressing both dimensions and their interaction, sustained success and economic growth will remain elusive.

Appendix : Data sources and Methodology

We started from the largest 500 brands in the world as calculated by Brandfinance (Brandfinance, 2014). Brandfinance uses a royalty relief methodology as described by ISO 10668. Such a methodology has numerous advantages, including taking into account industry specific valuations and is accepted by fiscal authorities[23].

The brand value obtained through this methodology is the result of the product of "brand strength index", a royalty rate and revenues attributed to the brand. Underlying the brand strength index are 30 attributes that represent different stakeholders (customers, staff, financial and external). We focused on brands that were amongst these largest brands in 2012 and/or 2008 – as we are also interested in how companies evolve. We added available brand values for companies owing multiple large brands. It is to be noted that as such smaller brands are neglected and the brand portfolio is not necessarily the same for all companies in all years.

For the financial data we referred to the Thomson Reuters database that collects data of companies that publish their financial results. As such private companies were excluded from the dataset. Industries in which most of the companies manage a portfolio of unrelated brands like tobacco or packaged foods were not withheld. We also excluded banks, mainly because their key financial metrics are different and by their mere size, including them would skew the averages on these metrics. If reporting currency is other than USD, figures were translated by Thomson Reuters EIKON to USD using the fiscal year end date exchange rate.

In the end, we considered 18 industries consisting of the same 119 companies in 2008 and 2012. These companies owned in 2012 in total $10,087 Bio assets, made $563 Bio of profits and had a combined brand value was $1,301 Bio.

As a proxy for value creation we use the brand value as explained above, which we divide by revenues to correct for size but also as it seemed to us the most logical from a value creation perspective: how much value does the customer attributes (brand value) for his or her money spend (revenues). We use a one year time-lag between the brand value and the financial data. The logic behind this approach is that the value created at the beginning of the year is compared with the value captured throughout the year. The proxy we use for value capturing is profit/assets. The net profit, divided by the total asset gives a good representation of potential shareholder return.

Number of companies across different industries.

Industry	Total Assets	Number of Companies
Aerospace & Defense	312.877	5
Airlines	122.630	4
Apparel	59.628	5
Cable	211.557	4
Communications Equipment	205.262	4
Conglomerates	1.051.172	6
Integrated Oil & Gas	2.731.697	11
IT Consultancy & Other Services	185.508	4
Logistics	113.415	3
Movies & Entertainment	222.115	4
Personal Products	69.027	5
Pharma	569.536	5
Restaurants & Soft Drinks	204.418	4
Software	258.064	5
Supermarkets	676.795	13
Technology Hardware & Consumer Electronics	752.136	11
Telecommunication Services	2.260.375	23
Tires & Rubber	80.464	3
Total	**10.086.676**	**119**

Total 2012 assets in Mio of USD

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[14] Pricing and the pricing literature is mostly about capturing; however pricing can become an attribute of value creation (perception) in some cases: (i) in luxury markets (ii) for intangibles as a signal for expected value and (iii) at the margin and in a dynamic context price movements may be used to influence quality or value perceptions.

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[21] It is to be noted that the “industry” data referred to here is the sum of the individual companies in our dataset active in that particular industry and not on (total) industry wide data.

[22] The relevance of the model for public services and non-profit organizations is being investigated in further research.

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