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Notes on Designing Your Company & Strategy:

An Integrated Framework-of-Frameworks for Creating, Delivering, & Capturing Value

Kevin J. Boudreau

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Notes on Designing Your Company & Strategy

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Kevin J. Boudreau*

These notes set out a step-by-step process for designing—or equally, analyzing and evaluating—a company's design and strategy. They apply as much to newly conceived entrepreneurial ventures as to established, continually evolving enterprises.

At the core, three minimum conditions must be met to sustain an economically viable enterprise. On a practical level, the notes provide a field-tested process for articulating and refining strategy. At the same time, they integrate and distill what are often treated as disparate economic concepts and frameworks into a single, cohesive guide. The result is a roughly 100-page synthesis of what is known on this topic.

Strategy, entrepreneurship, business model design, innovation, and competitive dynamics are often taught through fragmented frameworks and separate courses. These notes aim instead to summarize the core concepts and their interconnections within an integrated "framework-of-frameworks" and a series of design steps. The goal is to provide clarity and synthesis without resorting to artificial simplification.

The notes are structured as follows:

1. Foundations of Value & Business Model Design
2. External Analysis of Market & Surrounding Industry Ecosystem
3. Short- and Long-Run Competitive Dynamics, Technological Change, Disruption, & Innovation
4. Financial Evaluation & Strategic Value

Taken together, these notes serve as a field guide, teaching tool, and research map, designed to complement standard textbooks and articles in the areas of strategy, business model design, entrepreneurship, and innovation.

* Professor, Northeastern University (School of Business, College of Computer and Information Science, College of Social Sciences); National Bureau of Economic Research (Productivity, Innovation, and Entrepreneurship). kevin@northeastern.edu These notes evolved over more than twenty years of teaching materials prepared for courses at HEC Paris (Haute École Commerciale), Harvard Business School, London Business School, and Northeastern University, spanning master's, executive, and advanced undergraduate programs. The motivation came from the practical need to provide students with a distilled guide that could integrate ideas scattered across economics, entrepreneurship, strategy, business model design, finance, and even several thoughtful popular books. Increasingly, the study of business strategy and business model design is stretched across multiple fields; the goal here is to provide a reference that draws these contributions together into a coherent whole. While each source offers valuable insights, most present only partial accounts or emphasize one perspective in isolation. These notes aim to connect and integrate those perspectives into a framework-of-frameworks, helping readers better navigate and link back to other references, textbooks, and works in the field. An abbreviated version of these ideas was previously captured in Harvard Business Review. I am grateful to colleagues, students, and collaborators for their feedback and insights along the way (listed inside). Any errors or omissions remain my own responsibility. I welcome further comments or suggestions at kevin@northeastern.edu.

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1. Introduction

Aiming Higher

Whether you are launching a new venture or planning for your existing company, nothing beats having a compelling product that customers love. Traditional "good shop-keeping" wisdom emphasizes strict management and control systems to keep costs down while pushing revenues upward.

But this is not enough. The bar for excelling in a competitive market environment is higher. Will the business succeed in the face of competition? Is the company capable of not just earning an accounting profit, but surpassing its opportunity cost to justify continued investment? Is the business optimized to attain its greatest value-creation potential—today and tomorrow?

Good products and sound management are necessary, but not sufficient. A deeper grasp of strategy and economics is essential to determine whether—and how—the company can consistently meet this higher bar.

Narrowing the Gap

The goal of these teaching notes is to provide managers and students with a clear but rigorous explanation of strategy. These pages are longer and denser than popular "airport bookstore" strategy books, but more integrated and theoretically grounded than most textbooks or scattered articles.

Reading isolated articles that address fragments of the puzzle is not enough. These notes emphasize integrating key ideas in Strategy, Business Models, and Entrepreneurship into a coherent "framework of frameworks." Designing a company cannot be done piecemeal.

The purpose of the following chapters is not to replace your favorite business strategy book or latest article, but rather to complement them by showing how they fit into a larger thought process. To that end, these notes describe a step-by-step process for designing your company so that it can create, deliver, and capture economic value—three necessary conditions for long-term sustainability, whether you lead a start-up or an established corporation.

They are intended as a field guide, teaching tool, and research map—complementing rather than replacing textbooks and articles.

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Timeless Principles

While the business world often highlights the newest frameworks or the latest buzzwords, the foundations of sound company design rest on timeless principles. These principles derive from the laws of economics and the accumulated insights of academic research in business strategy and related fields. They remain relevant across industries, technologies, and eras because they capture how value is created, delivered, and captured under conditions of scarcity and competition.

At their core, these principles emphasize that:

- Firms must define a position in the marketplace that addresses real customer needs and differentiates them from alternatives.
- Operating models succeed when choices and practices complement each other, forming coherent systems rather than disconnected tactics.
- Sustained success requires mechanisms that prevent easy replication, whether through strategic assets, organizational capabilities, or advantageous positions.

What matters most is not adopting a checklist of popular frameworks but understanding how these principles integrate into a complete design. Strategy is less about choosing among fashionable tools and more about applying enduring economic logic to fit together positioning, operating models, and sources of advantage into a coherent whole.

Strategy as Deliberate Coherence

Any effective strategy is about bringing together a very large number of decisions—across products, operations, markets, people, and policies—into a coherent whole that achieves economic performance. No short checklist or canvas can substitute for this act of integration.

Some sources may present lists of areas to "pin down" and that is entirely fair. Those may be useful reminders, but they risk creating a false sense of completeness at a mezzanine level of detail. Without clarity on the deeper logic of value creation, delivery, and capture, such lists remain tactical fragments.

Approach

- **Strategy as Design**: Think of your company as a system — a designed artifact where each part must fit.
- **Timeless Principles, Not Trends**: Ground your design in enduring economic logic (value creation, complementarities, uniqueness), not just today's buzzwords.
- **Iterative Process**: Strategy design is not a one-time plan but a cycle of refinement as markets, technologies, and competition evolve.
- **Field Guide Approach**: Use the exercises, examples, and references in these notes as tools to sharpen your design.

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DESIGNING YOUR COMPANY

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2. What Is Your Company's Design?

What makes up my company's "design"? What is the minimum set of issues I need to figure out to set all other priorities? before making other decisions?

Rather than wait until after reading these notes to begin your design, it is more useful to get started now. Begin sketching your design now, refining it with each section as stricter criteria are introduced.[1] These three questions form the blueprint of your company's design:

The Design of Your Company

There are three necessary economic conditions for a viable, value-creating, economically sustainable enterprise:

1. **How will you create value?** Who, precisely, is your customer or "user"? What is the "use-case" or "application" or "problem" you are solving—and your precise value proposition in serving this problem? The answers to these questions define your firm's position in the marketplace**.**
2. **How will you deliver value?** What is your plan for delivering the value proposition to your intended customers at lower cost or with higher differentiation?[2] What is the signature combination of procedures and practices embedded in your firm that will make this possible? The answers to these questions define your firm's operating model.
3. **How will you capture value?** If you turn out to be successful, what will stop competitors from copying you? On what basis do you expect your company's profits to exceed regular returns despite competition? How can you possibly charge a price that will not be competed down to costs? The answers to these questions define your firm's sources of uniqueness and competitive advantage.

Three Necessary Conditions for an Economically Sustainable Enterprise[3]

Guidance on how to approach these questions tends to be scattered across different books and articles on strategy and business model design. For example, some authors focus on positioning,

[1] The focus here is on deliberate planning to achieve the best design possible, despite unavoidable uncertainty. We will discuss uncertainty and experimentation later on. Note, too, that whether you are conscious of it or not, and whether you have an explicit planning process or not, your company will have some implicit design or pattern of choices.

[2] For a range of related practitioner frameworks covering different aspects of these conditions, see Markides (2000), Porter (1996), Casadesus-Masanell and Ricart (2011), Osterwalder, et al. (2010). The related academic research literature stretches across Industrial Organization Economics, Organizational Economics, Organizational Sociology, Organization Studies, and a number of other fields.

[3] Markides' Who-What-How framework is a superb practical and intuitive guide to points 1 and 2.

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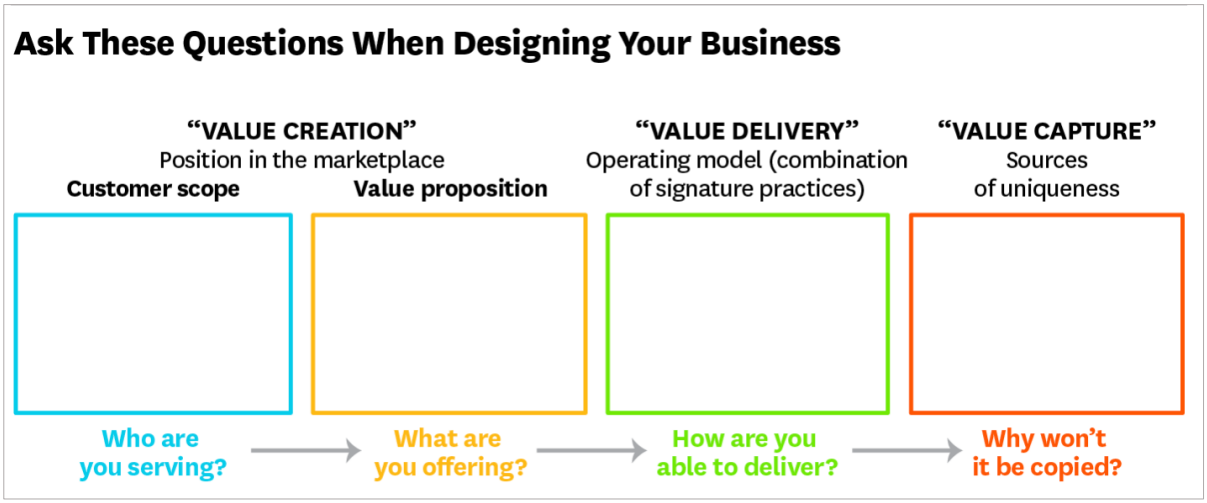
others on the details of the operating model or value chain design, and others emphasize sources of uniqueness and sustainable competitive advantage. There are also authors who focus on tactical questions, such as revenue models, without necessarily speaking to competitive advantage.

Some works focus only on positioning, others on operating models, still others on sources of competitive advantage, or even just on narrow tactical issues such as revenue models.

To completely specify the economic blueprint of your company, you need must consider all three conditions simultaneously together as an integrated system.

Get Started

Here is a basic template to help you begin to detail your company's design—whether it involves a new business concept or a new description of an existing company:



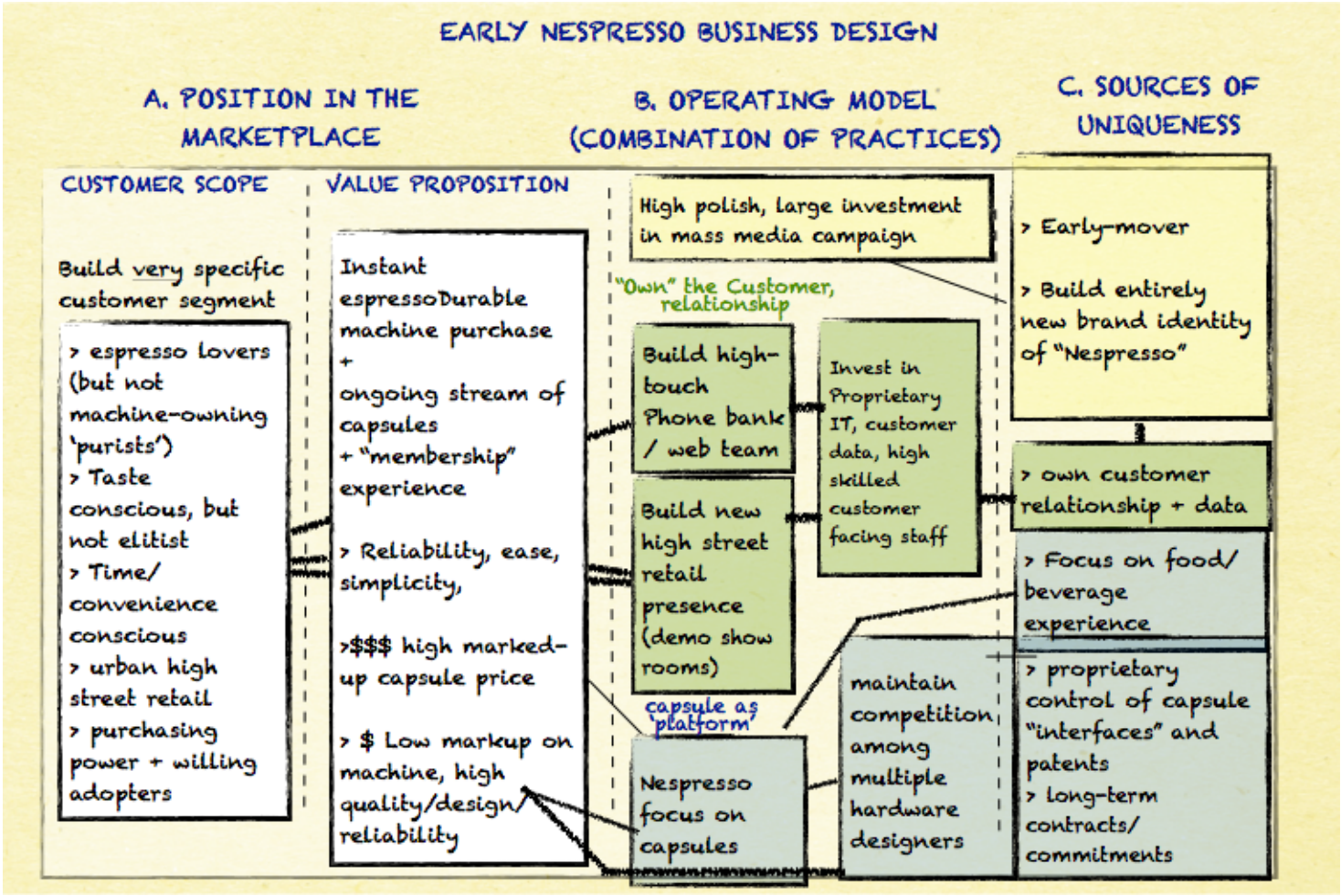
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Company Design Template for Getting Started

Examples

LinkedIn Business Model Design			
Value Creation Position in the Marketplace Customer Scope *Who are you serving?*	Value Proposition *What are you offering?*	**Value Delivery** Operating Model *How are you able to deliver?*	**Value Capture** Sources of Uniqueness *Why won't it be copied?*
- passive users - job seekers ..... - "experts", consultants - advertisers - recruiters	- free personal website - "Rolodex" collection of professional contacts - curated communities - access to 1000s of job postings ..... - reach large, curated audience, incl. senior decision-makers - extraordinarily structured, data-driven search and placement functionality - socially and professionally legitimate	- low cost to join (free) - highly structured interactions - near-zero variable costs - existing users attract new users - incentives to interact and share information - tiers to match different user needs, with price discrimination - carefully manage information flow and access rights	- early mover dominating the English-speaking market - scale and reinforcing network effects - increasing switching costs (data history, connections) - massive, continually updated, exceptionally structured data set - massive, unusually attractive installed user base - data and analytics capabilities

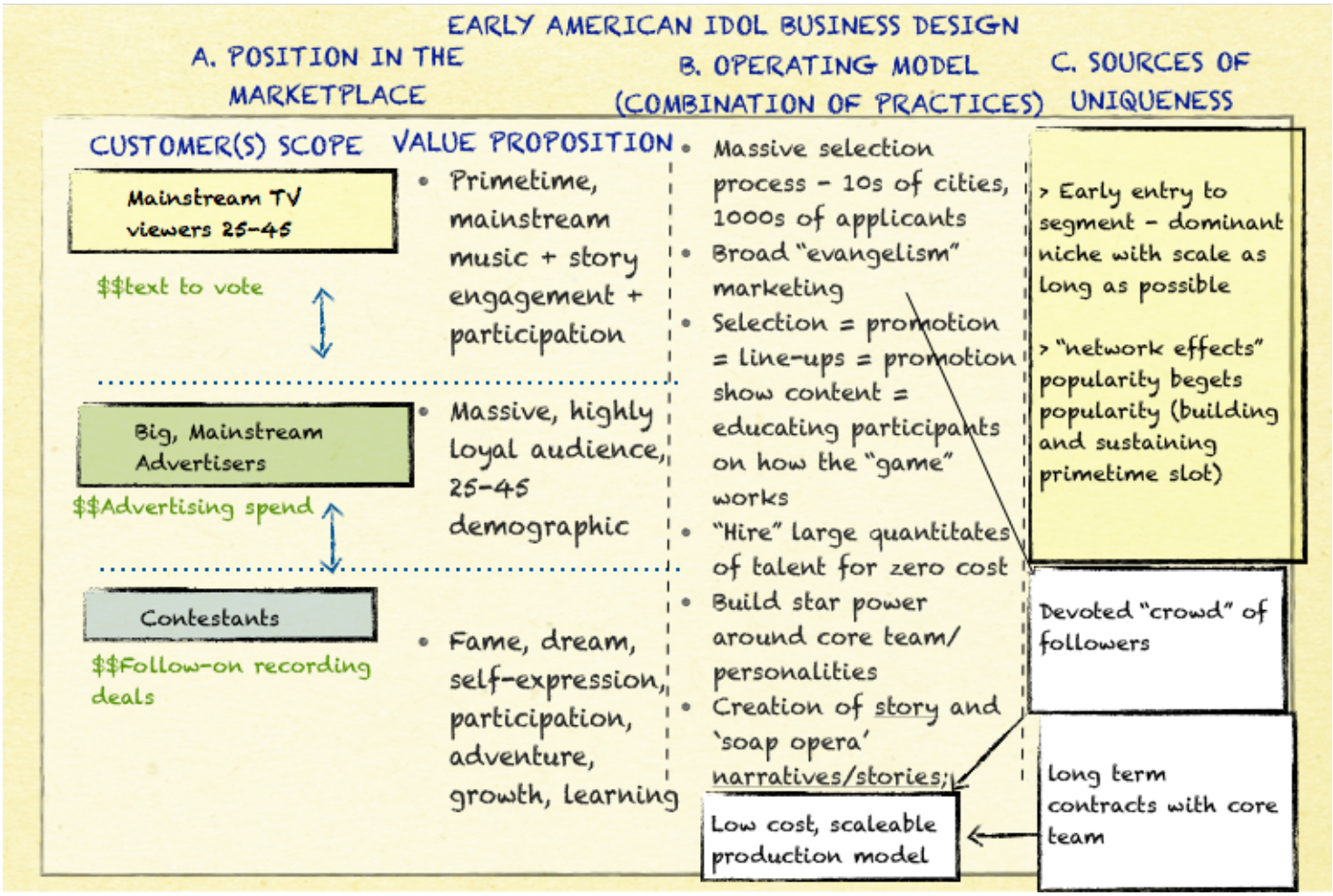
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TopCoder Enterprise & Algorithm Crowdsourcing Business Model Design			
Value Creation Position in the Marketplace Customer Scope *Who are you serving?*	Value Proposition *What are you offering?*	**Value Delivery** Operating Model *How are you able to deliver?*	**Value Capture** Sources of Uniqueness *Why won't it be copied?*
<u>Buyer Side of Platform</u> - specialized, sophisticated - large but willing to invest in crowdsourcing - focus on repeat, long-term enterprise relationships ..... <u>Solvers Side of Platform</u> - highly competitive - software developers, algorithm designers - expertise in mathematics, software architecture	- find the "best possible" solution via crowdsourcing - siphisticated, bespoke enterprise software - fully intergated systems/products -fixed platform access fees, ad hoc client investment - lower price than IT firms ..... - emphasis on competition, personal development - payments for top solutions - precise, validated skill rating - challenging problems - learning and community	- expert, small staff - focus on small-scale, long-term client relationship development - proprietary project management tools - thoughtful contest design - IP library management - careful incentives management - community contact and outreach - "abstracting" problems to "expose" the widest set of expert solvers	- large, engaged core of skilled regular contributors - accumulation of meaningful skill ratings, routines, and methodologies - credibility and reputation - low costs - optimal contest designs - capability of delivering integrated solutions

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Other Short-Form Examples of Essential Three Elements of Business Models

Value Creation *(Who / What Served?)*	Value Delivery *(How to achieve?)*	Value Capture *(Why not replicated?)*
TikTok Who: Users seeking entertainment; creators seeking reach **What:**Personalized short-form video feed, global visibility	**How:** Mobile-native short video platform; proprietary recommendation algorithm; easy creation tools; near-zero marginal cost per user	**Why:** Strong network effects (creators → users → advertisers); proprietary algorithm and engagement data as strategic assets
Spotify Who: Music listeners, podcasters, advertisers **What:** On-demand access to vast libraries; personalized playlists	**How:** Streaming platform with cross-device integration; licensing deals; freemium pricing tiers	**Why:** Established nexus of difficult-to-replicate contracts, network effects, accumulated data, advancing algorithm and data and ability to personalize
Airbnb Who: Travelers seeking affordable lodging; hosts seeking income **What:**Peer-to-peer marketplace for lodging and experiences	**How:** Asset-light platform; trust systems (reviews, insurance, payments); scalable global marketplace	**Why:** Two-sided network effects; brand trust; complex arrangement of business model elements that "work together," regulatory positioning
Duolingo Who: Global language learners **What:**Free, gamified mobile-first language learning	**How:** AI-driven adaptive learning; gamification; community contributions; cross-device access	**Why:** Accumulated network and brand and goodwill, accumulated alogrithms and know-how

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3. How Do You Create Value? Establish an Attractive Position in the Marketplace

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How do I make sure I am choosing a sensible position relative to what my customers want and to what competitors are offering?

Designing Value Creation and Defining Your Position in the Marketplace

The value you intend to create in a marketplace is akin to a position on a game board you would like to take. Ultimately, you will want to understand how you create value for your customers relative to their needs and preferences—the things that they care about—and relative to the alternatives that are offered (competitive and substitute offers). This section provides steps to clarifying your thinking around these issues.

Who is your "User"? The answer to this question defines your firm's customer scope. This refers to the particular kind or kinds of customers you wish to create value for. This is your intended customer. There might be any number of relevant factors in differentiating among possible target users: businesses, industries, individuals, geographical differences, psychographics, behavioral orientations, income, demographics. Be careful to recognize whether the user is the buyer and decision maker. (This may add more than one party to your analysis.)

What is the "Use Case"? The answer to this question defines your firm's problem-to-be-solved and its intended application in a scenario where you create customer value. Ultimately, to be successful, your entire company design and all its details should be geared to the chosen customer. However, for the moment, it is useful to ignore that larger problem and instead to walk in the shoes of your customer, your user. What is *their* problem, expressed in terms of the customer's need to be fulfilled (not necessarily in terms of a product you are selling)? For example:

- User: urban commuter; Use Case: getting to work every day
- User: married professional couple; Use Case: feeding my family on weekdays
- User: doctor (buyer: hospital system); Use Case: having deep and complete knowledge of my patient's health history

What are the "Dimensions of Value" the user cares about? Once you define your user(s) and use case(s), it is important to go farther and attempt to discern the key factors that the user cares about. What are the ways in which the user's problem can be solved? In other words, what are the dimensions of value of a good solution? The answer to these questions defines your firm's dimensions of differentiation with respect to customer preferences and needs. For example, in the case of an urban commuter attempting to get to work every day, they should care about dimensions of value such as: cost, reliability/timeliness, safety, comfort, and perhaps pollution generated by the commute.

What is your "Value Proposition"? The answer to this question defines the unique value your firm creates in the marketplace. Having narrowed down a set of users and use cases and come to understand the dimensions of value that those users care about within the relevant problems to be solved or use cases, the question becomes how you can create unique value and do so relative to

alternative offers. A complete analysis of a value proposition will include those dimensions of value you will want to outcompete alternative offers on, those dimensions of value where you will be at parity, and those dimensions of value where you will be inferior to alternative offers. For example, public transportation is less costly than automobile ownership and less polluting (i.e., superior), however it is less comfortable (inferior).

What Defines an Attractive Value Proposition and Position in the Marketplace?

The best imaginable position in a marketplace is, of course, when your company offers a product that is highly valued and demanded by customers—and unique.

In practice, you do not need to outperform all competitors along all relevant dimensions of value to build a successful enterprise. Instead, most companies *design their value proposition* by choosing to prioritize only some dimensions of value and aiming to outperform competitors along these. If your company can identify and connect with customer groups with matching priorities, this too might represent an attractive differentiated position allowing you to maintain some degree of uniqueness.

Even if your position is not entirely unique, and you share the same basic template for customer scope and value proposition as other suppliers (as in the case of financial services companies or restaurants), you might differentiate at least slightly along dimensions such as location or relationships.

Certain industries might see less than perfect competition, despite multiple competitors making similar offers. This may occur if there are capacity constraints, the industry is served by a stable oligopoly, or other reasons why competition is restrained.[4]

Good Business Ideas and "Design Thinking"

A good business idea is one that can be successfully executed and implemented and is able to create, deliver, and sustainably capture value. This means "solving" a challenging problem with lots of pieces that must fit together—by definition a problem of design, where you must carefully consider how endless details and choices "fit together" to work. It is for this reason that these notes encourage you to start designing from the first page and to continue to refine your design as you see new and increasingly stricter criteria applied to your design from section to section. (This is akin to starting out with a piece of clay and gradually adding more and more detail until you finally resolve a working design to your sculpture.) Design is, therefore, any complex, multi-variable problem-solving process. This is also why a combination of *both* creativity *and* disciplined thinking is useful. A good deal is known about theoretical processes underlying complex design problems from cognitive science, design theory, artificial intelligence, systems engineering and product management.

Distinct from research on design is a recent set of practices and even a movement referred to as "Design Thinking." This is distinct from research on design in that rather than a study of design,

[4] Coordinated restraint of competition is illegal and dealt with by antitrust law. Society enlists a market capitalist system with the intent of creating wealth and welfare. Restraint of competition and high degrees of monopoly power can be antagonistic to that goal.

it is a set of *practices* and *heuristics* that are largely geared towards understanding user preferences and associated processes for thinking up solutions and engaging in imaginative product development.

This brings together ideas of empathetic user research, customer anthropology, empathy "mapping" of customer needs, ideation, and structured brainstorming, along with prototyping, trialing, and experimentation. Thus, the emerging "Design Thinking" and "Design School" movements nicely and practically package together a number of practices from a handful of fields.

Therefore, the practices used in Design Thinking might often serve as useful tactics to better solve for capturing value. However, solving for value creation on its own, without solving for value delivery and value capture, is not enough.

Get Started

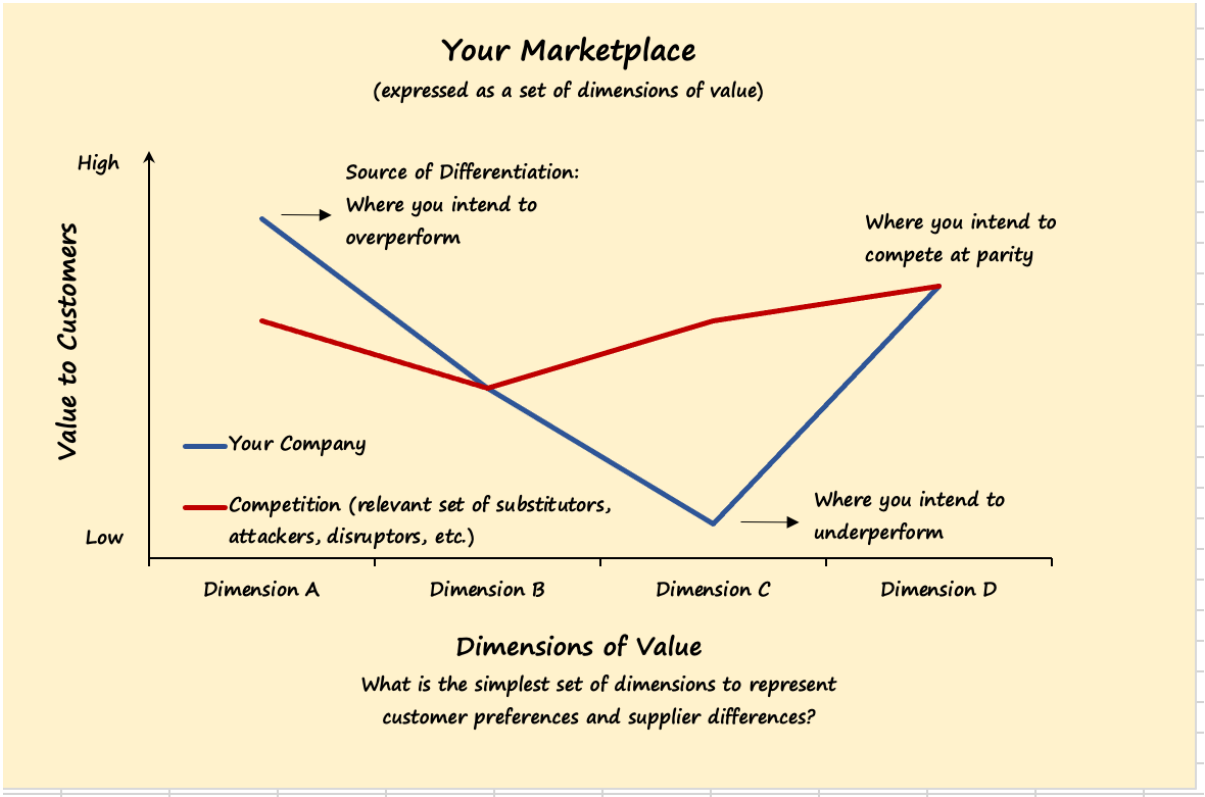
Once you have identified users and use cases to be addressed by the business, you can proceed to analyze and design the desired position in the marketplace and value proposition—using "Value Curves":

1. Identify the user's dimensions of value.
2. Identify alternative offers (i.e., those of competitors and substitutes).
3. Plot how alternative offers score along each of the user's dimensions of value—this represents each alternative offer's "Value Curve." (Note: plot so that higher value is higher in the y-axis – so low price/cost is high value for users.)
4. Precisely clarify how you can create value for users that is distinct from alternatives (i.e., how will the shape of your company's value curve differ from those of alternatives).

Given your analysis, pay special attention to which competitors and substitutes are potentially closest to serving the same user group(s) and use cases(s). More generally, step back and reflect on the following points for insights:

- Who competes with whom—and how (on what bases of differentiation)?
- What are the inherent tradeoffs in the designs and models of different suppliers?
- What do customers really care about and what is going to set different value curves apart?
- What are the dimensions on which you can plausibly "win"? What are the dimensions on which you will *not* win?

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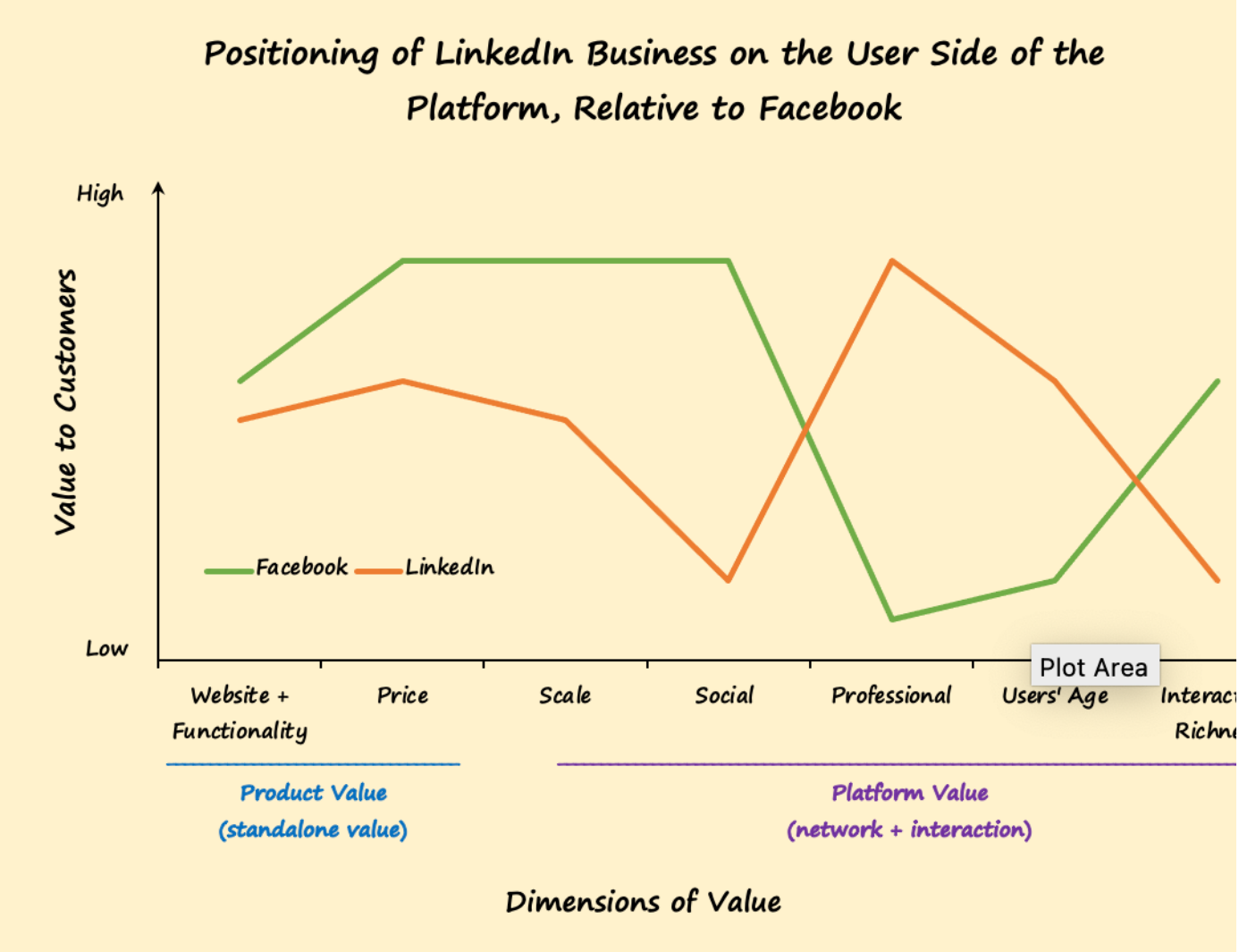


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Your position within the marketplace relative to buyer wants and preferences and relative to competitors and substitute offers[5]

[5] The idea that products and firms compete in a differentiated market space is as old as the study of economics itself but was given greater formalization in its explanation of how market competition works in the last century by authors such as Lancaster, Hotelling, Dixit, Stiglitz, Salop, and others. More recently, popular writers have helpfully begun to diffuse these ideas by evocatively relabeling differentiation as "blue ocean" strategies, meaning building a position in the market that is differentiated from others. As we will later see, positioning oneself in some differentiated market position, on its own, is not a sufficient basis for delivering or capturing value—and thus having a sustainable economic enterprise.

Examples


Positioning of LinkedIn Business on the User Side of the Platform, Relative to Facebook
High
Value to Customers
Low
Facebook
LinkedIn
Plot Area
Website + Functionality
Price
Scale
Social
Professional
Users' Age
Product Value
(standalone value)
Platform Value
(network + interaction)
Dimensions of Value

Translation to Practice, Popular Books, & Articles

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4. How Do You Deliver Value? Design a Combination of Practices to Make Up Your Operating Model

What is a combination of choices and practices making up your organization that allows you to successfully deliver your intended unique value proposition?

Combinations or Systems of Choices

Any company can be thought of as a collection of design decisions—that is, a combination, or system, of choices, some more important than others. For example, a local restaurant's way of delivering its promised value proposition to customers is defined by a myriad of choices such as the type of cuisine, the interior, the prices of meals, the quality of ingredients, the size of the menu, the hours of operation, staff uniforms, and so on. This system of choices must be in internal alignment with the restaurant's targeted position in the marketplace.

Similarly, your company can hold its intended position in the marketplace only if it has successfully implemented a series of practices and choices in its operating model that allow it to deliver on that position. Thus, the position and the combination of choices and practices designed into the value chain—the operating model of the company— constitute two sides of the same coin.[6]

While the general theme of this section is of internal alignment (across position, operating model, and sources of competitive advantage and uniqueness), the operating model is itself an area in the field of strategy where there has been especially intense focus on "fit" in choices and practices. [7]

The basic idea here is that the economic returns to implementing a particular practice or choice in the design of the company depend on the other practices also in place.

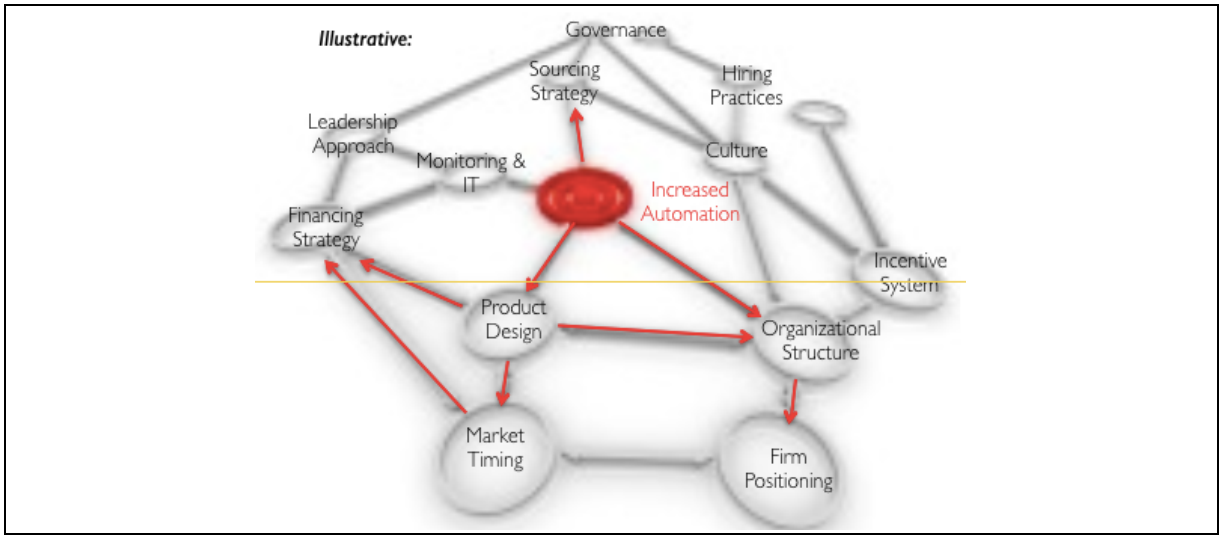
The ability of an operating model to deliver superior economics to a given position therefore depends on the *combination* of choices and practices implemented in that model—the system of

[6] For example, Porter's classical "generic strategies" (i.e., differentiation versus cost leadership) do not distinguish between position in the market and underlying practices in the operating model, as the correct assumption is that the choice to implement, say, low cost, implies a necessary set or combination of practices and choices that must be designed into the underlying model or value chain to deliver on that position.

[7] The age-old idea of "fit" shows up in any number of old frameworks from the "4P's" of marketing (price, product, promotion, and place) to McKinsey's old "7S" framework (skills, system, style, staff, structure, strategy, shared values.), "value loop diagrams" in describing business models, and in Porter's description of "activity systems" that are designed in complementary ways. Within the academic research, there are a number of substantiating empirical studies that now document the economic importance of "complementarities" in company practices and investments, related studies of internal practices, and fit between types of workers and given organizations. Moreover, *by definition*, it directly follows from logic alone that a failure to account for fit and complementarities in company design will lead to suboptimal value creation.

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choices. The productivity and performance (generating lower costs or higher willingness to pay) at a given position will be determined by the *overall* complementarities of these interdependent choices rather than a result of any one investment. Conversely, *lack* of fit amplifies costs and contributes to value destruction in a company's design. This is the basis behind the truism that strategy and business design are not just about what you choose to do but also what you choose *not* to do.



The economic returns to any one choice or practice depend on the web of other decisions.

As a result, while strategy is surely to some degree about moves, maneuvers, and contingent plans, it is more about overall patterns or combinations of decisions throughout the value chain—and the overall ability of your operating model design to deliver intended value to the targeted position in the marketplace.

Design problems with multiple interacting decisions can sometimes produce multiple solutions. That is, as you begin to work through the design of your operating model, you may find that alternative sets of interdependent decisions can fit together in different ways. This is why there can sometimes be different business models even within the same industry. For example, Southwest Airlines and British Airways are both successful enterprises within the commercial aviation industry, but their business and operating models have little in common. Southwest provides a national-only, no-frills service targeted at the pragmatic business traveler, while British Airways appeals to a much wider range of customers and offers full service and more variety.

Indeed, one of the toughest decisions a strategist or entrepreneur can face is having to choose between alternative combinations of decisions—effectively a choice between equally attractive strategies and combinations of choices (while pursuing both at the same time might be value destroying).

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Designing or Discerning the Overall Operating Model Is Like Solving a Tricky Puzzle

Designing the operating model—the combination of choices and practices that constitute the operations of your company across its value chain—means sorting out choices across the entire enterprise that need to work together.

This is a wide range of issues that can include decisions like which technologies to deploy, the types of staff to hire, where to locate, and whether to institute a corporate societal mission. It might even turn out that seemingly mundane issues like hours of operation or the corporate colors turn out to be important in some way.

It is tempting to begin with a recipe or set of steps, but the risk is that doing so could do more harm than help in figuring out how to solve this puzzle. Instead, you first need to take a step back and figure out:

- Which (among many) decisions in the organization are key drivers
- How these key decisions interact
- The best way to make these decisions work with each other and with the rest of the business design

This process is akin to trying to solve a complex puzzle or Rubik's Cube. Solving these sorts of problems calls for decision makers who combine deep knowledge of industry details with creativity and disciplined logic—whether in trying to "break the code" of an existing business or designing a new business altogether.

While these problems can begin as a long list of complex interactions you might not wholly understand, often the core set of decisions in the best performing businesses can ultimately be summarized by a simple and even elegant logic that guides the overall design (again, akin to solving a Rubik's cube).

Get Started

In creating a new operating model design, you might begin by trying to identify a core set of interacting choices and then gradually loop in more choices. When analyzing an existing company, the task is akin to scanning through thousands of decisions to discern the core set of choices and practices that are essential to the business's workings and economics.

The level of detail you wish to use in formulating an operating model design is up to you, and the level that is most helpful or productive may depend on the situation. But whatever the approach or detail, here are some ways to get started:

1. Describe the different **functional areas** or steps of the "value chain."
2. Begin to document the "**signature practices**" and choices in each area.
3. Clarify how these signature practices and choices relate to one another. Where are the **complementarities** (where the value of the practice becomes greater in the presence of other practices and choices)?
4. Evaluate how the combination of these practices and choices explicitly links to the targeted position in the marketplace. Are the practices driving cost advantages (translating to lower price) or differentiation and willingness-to-pay advantages?

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The following examples show a range of approaches to answering these questions.

	The Design of Your Company's Operating Model		
	Different Steps or Parts of the Business		
	Activity A	Activity B	Activity C
What Are the Signature Practices and Choices within each Activity?	What are the key practices that appear to distinguish the company?		
Where Are the Complementarities/ Synergies between Choices?	How do these practices fit to create more value together? Is the whole worth more than the sum of its parts?		
How Do These Choices Affect Cost and Differentiation (Value Curve)?	How, precisely, does this overall collection of choices -- your operating model design -- deliver your intended value proposition?		

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Systematically breaking down what makes the operating model special, in order to deliver on its position.

Examples

A hotel chain can include signature practices that combine to given unique business economics, as in the case of La Quinta.

La Quinta's Hotel Operating Model

	Different Steps or Parts of the Business		
	Infrastructure & Facilities	Operations	Sales & Marketing
What Are the Signature Practices and Choices within each Activity?	- Location: highway, close to restaurants - Thick walls - No architectural design appeal - Standard parts and amenities	- Standardize and simplify operations to the extent possible - Run by a couple - Avoid operating a restaurant	- Focus on repeat relationships - Large regional brand - 'Roadside' customer acquisition (e.g., highway billboard)
Where Are the Complementarities/ Synergies between Choices?	- Simple procedures can feasibly be learned by just two people (the couple operating) - Long-term couple have incentives to stay for a long time and invest in learning the procedures - Roadside location is ideal for the target customers, collocating with restaurants, and not providing a restaurant in-house - Simple, no-frills concept makes it possible to train a couple to manage the hotel, adopt a low cost infrastructure, and use standardized parts bought at scale		
How Do These Choices Affect Cost and Differentiation (Value Curve)?	- Scale, multiple standard locations - Bargaining power with suppliers - Low cost on real estate - Very quiet - Standard, consistent experience	- Low training costs - Avoid catering expense - Low maintenance costs - High loyalty workers - Repeat customer relationships - Standard, consistent experience	- Economize on customer acquisition - Highly loyal clientelle - Scale, regional dominance

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Many signature practices and historical elements explain the sustained success of *The Economist*. A very simple, highest-level, steady-state depiction of what drives its economics:

The Economist's Reinforcing Combination of Practices in Its Operating Model

	Different Steps or Parts of the Business		
	Brand	Hiring	Work Culture
What Are the Signature Practices and Choices within each Activity?	- Carefully curated - cohesive perspective - aspirational internationalism - economic liberalism	- Brand attracts especially bright, articulate workers, especially Oxbridge grads - Manage local "stringers"	-Concentrate power in weekly "editorial meeting" - Draw members from internal ranks - No bylines - Contributors paid below their productive output
Where Are the Complementarities/ Synergies between Choices?	- A strong, well-known brand attracts suitable candidates, which enables effective hiring - Effective, selective hiring enables low cost relative to output and ensures contributors as a whole take a cohesive position - The work culture ensures no one person is critical and enhances quality management		
How Do These Choices Affect Cost and Differentiation (Value Curve)?	- A strong, well-known brand commands a high willingness to pay from readers - Low hiring costs - Relatively low marketing costs	- Contributors willing to accept lower pay to join the newspaper - Selective hiring produces high quality, cohesive material, which in turn commands a high willingness to pay from readers	- A team-oriented work culture where no one person is critical keeps labor costs low

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5. How Do You Capture Value? Create and Manage Sources of Uniqueness and Competitive Advantage

How can I safeguard profitability and prevent replication by others? How can I achieve and maintain sufficient returns to justify investment in my company?

Making More than "Regular" Returns

If you have a world-class company, in a competitive industry (with other world-class competitors), in principle, you should make a "fair" return—one that reflects your opportunity costs. This is a "competitive return" or one with zero "economic" (excess, supranormal) profits.

Companies earning more than competitive, regular (zero economic profit) returns can do so for one of two reasons.

The first possible reason is that competition is "soft," as when competitors forebear from setting wholly competitive prices.

The second possible reason for earning more than competitive, regular returns is that there is something unique about your company, a competitive advantage that makes your company somehow better able to create and/or capture value.[8] Sources of uniqueness and competitive advantage are discussed here.

Uniqueness and competitive advantage are often the least obvious things to explicitly design into your company. Position and operating model are hard enough to master. And, if those are successful, it will take some time for entry and replication to happen anyway. It is also often the case that operating with a successful product alone can help you with value capture, as you grow a loyal installed customer base, gain experience and greater efficiency, and build network effects. You probably also secured patents and copyright, without questioning whether it was necessary. This section simply makes such considerations explicit, so you might take greater control of them.[9]

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[8] Many treatments of company design in popular practitioner books do not deal with this topic. Most Strategic Management textbooks at least rhetorically emphasize competitive advantage. Most Economics textbooks emphasize soft competition.

[9] There are many points here that are typically ignored in strategy discussions but are nonetheless important for your company. For example, "only" making regular returns is far from failure. If you were to build a new value-creating business whose position and operating model were fully optimized, but a new entrant competed profits down to "regular returns," you would still be paying salaries and providing investors with regular expected returns on a risk-adjusted basis—while providing a novel and valued offering to society.

One rationale for the importance of supra-normal returns is that establishing any new and value-creating position tends to come with significant risk and (sunk) cost in innovation and entrepreneurship that will not necessarily be

Analyzing Competitive Advantage: Start by Identifying the Sources

When figuring out whether your company might have a competitive advantage, the best place to start is not by directly looking for differences in productivity but by looking for the underlying reasons why you might develop an advantage.

The sources of competitive advantage are the underlying mechanisms that can account for productivity differences. All enduring differences in performance should ultimately be explainable in terms of the sources of competitive advantage.

A firm that appears to be particularly innovative, for example, should ultimately be so for some underlying reason, be it related to organizational capabilities, scale, flexibility, key staff, or something else. Getting at these root causes is essential in developing your thesis of how the business works.

Without a clear thesis of these mechanisms—the underlying sources of competitive advantages that set the productivity of your company apart—you should expect competitors to enter and replicate your design at prices and costs that yield regular returns. Free entry, replication, and competition will also lead less productive suppliers to make less-than-competitive returns and eventually force exit.

Two Broad Categories: Position- and Resource-Based Advantages

Position-Based Advantages

Position-based advantages derive from how the "game" plays out. Even companies that are inherently similar in how they carry out their business may enjoy different sorts of advantages depending on their position within the game. For example, two companies might be identical inherently, but one may manage to capture a greater share or enter earlier than the other. It is often useful to distinguish between three kinds of positional advantages, those related to being big, being first, or being small.

The first, and most commonly mentioned category, relates to getting big—or achieving **scale advantages**. The essential idea behind this is that market success is not just an outcome but is also a cause of further market success, resulting in **positive feedback.** For example, fixed costs can be spread across more units in supply-side scale advantages. These might also grant greater

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wholly recovered if free entry and competition immediately follow. ("Regular" returns of follow-on entrants may be lower, as they do not bear the initial risk and investment of innovating.) This might be especially important, for example, in modern digital industries where competition and replication are relatively high. (It is also the case in many modern digital industries that many innovators are willing to accept returns that fall below true opportunity costs because they value "being their own boss" or the process of digital entrepreneurship.)

Monopoly power and profit gouging in the absence of innovation tend to destroy overall economic value and welfare created in society. At the same time, it is naïve to suggest that all highly profitable companies should be subject to antitrust investigation. Most strategy books and popular practitioner materials are silent on these questions of overall economic efficiency and welfare.

A related nuanced issue that is most often ignored in strategy discussions is that under free entry conditions, an optimized position and operating model are necessary, because new entrants will compete out any suppliers who fail to optimize. With some degree of monopoly power, there is greater scope for slack and suboptimal operations.

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bargaining power or perhaps the ability to implement new methods or greater standardization. Achieving such advantages will also make it increasingly more difficult for smaller companies to catch up. Other forms of scale advantage might come from experience or learning. Apart from supply-side advantages, there might also be demand-side scale advantages, as when a product or platform becomes more useful and valuable to users once there are greater numbers of others also consuming the product or platform—a network effect. These advantages place priority on moving first, making strategic investments in scale, and perhaps also taking losses in the short run to propel longer-run performance.

Another source of advantage relates to "owning" a niche—resulting in **incumbency advantages**. The essential idea here is that the first entrant to a given niche (position) has productivity advantages on this basis alone. For example, whereas the first entrant has the incentive of capturing monopoly profits from a given position, the next entrant might only look forward to splitting the market and accepting lower prices and profits—which means less than half of monopoly profits. When there are large, fixed entry costs or few prospects of attaining minimum efficient scale, the situation can dissuade entry, as incentives to follow the first entrant are lower. The case for directly entering and competing intensively against an incumbent might be particularly unattractive if the incumbent has already attained a minimum efficient scale, is able to serve the entire market with existing capacity, or has taken preemptive measures, such as building spare capacity or established a reputation for aggressive retaliation.

There are also advantages to having seemingly no advantages at all, which we can refer to as **strategic agility**. Whereas the incumbent or large company must always bear in mind its existing business, a small player can proceed flexibly and with much less to lose. In the extreme, a small player can use its flexibility to exploit an established large player's momentum and inertia against them.

Resource-Based Advantages

Resource-based advantages derive from a firm's ownership, control, or exclusive access over unique factors of production (resources, core competencies, capabilities, scarce factor inputs, strategic assets, etc.). That is, even if companies do not differ in their positions, they might still differ in their inherent productivity in executing on a specific position because of the factors and assets they can bring to bear.

Of course, any number of assets might be necessary in a company. However, strategic assets—the bases for resource-based advantages—are those scarce assets that confer unique productivity—high willingness to pay or low costs—to one firm over others.

You should think broadly when considering tangible and intangible assets that might separate your company from others. These can include secret processes, organizational routines, intellectual property (patents, copyrights, trademarks), a scarce license or contract, company culture, shared vision of employees, proprietary data sets, unique ability to analyze and derive value and insights from data, "sticky" customer relationships, and so forth.

What sets apart the strategic assets that are a basis of uniqueness and competitive advantage is that they must be **Valuable, Rare** or scarce, **Inimitable** and nonreplicable, and **Durable**"— **VRID** assets. Strategic assets should also be "(**O**)rganization-specific," meaning that their value inside the company should be greater than if they were deployed elsewhere. In other words, strategic assets should somehow be more complementary (have greater fit) with your company than with

another. Otherwise, it would make economic sense to sell the strategic assets to the other company, since you would fetch a higher price than the value of continuing to operate with the asset. Therefore, you can distinguish strategically important assets—the basis of uniqueness, competitive advantage, and excess returns—using the **VRIDO** criteria.

Among VRIDO assets, it is often useful to distinguish organizational capabilities and intellectual property from the broader list of other scarce factors of production. While all must adhere to the VRIDO criteria, intellectual property and organizational capabilities can have special additional considerations.

For example, **formal intellectual property rights** are meant to protect proprietary knowledge and the intangible assets of your company from being copied or used. There are a number of special considerations that arise when protecting knowledge, given the particulars of institutions supporting patenting, copyright, and so forth.

Organizational capabilities refer to those that involve transforming individual workers' human capital into organizational assets. Human capital is distinct from other sorts of assets in that a company does not own its workers' human capital. Moreover, a worker can bargain for the value of their human capital, as they can go to the market to redeploy it—or at least the general and re-deployable component of their skills. It is therefore only the value derived from the organization-specific aspects of a worker's human capital that the company can capture.

The Special Case of Organizational Capabilities

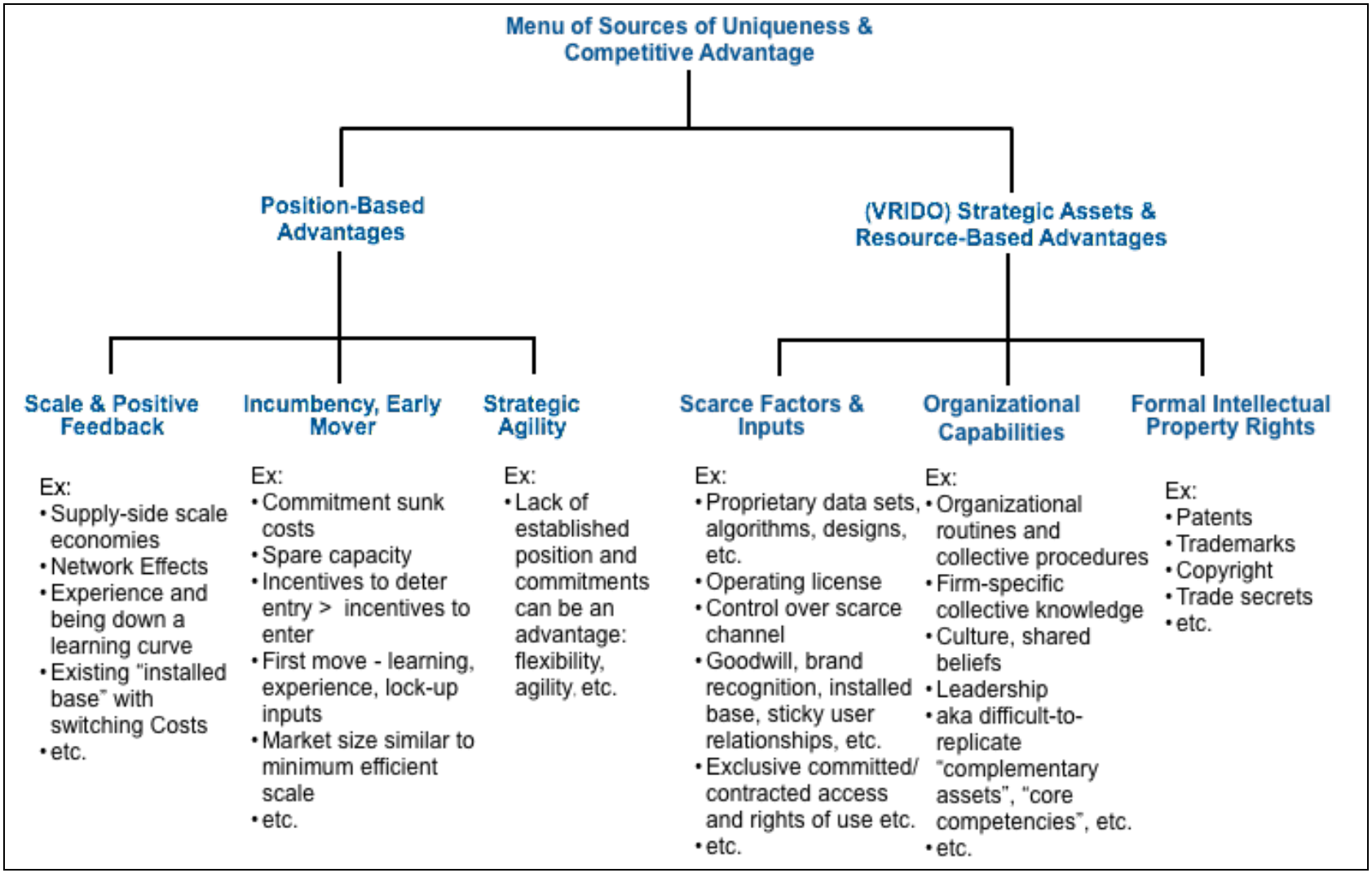
Organizational capabilities are the "can do" and "know-how" of an organization that set it apart from other organizations—and are often among the most important sources of competitive advantage. How does a firm build an organizational capability (strategic asset) based on individuals' own human capital—that the firm does not own? This makes it a special case.

Your company cannot own human capital as it can own other assets. Workers can take their general, redeployable human capital elsewhere and receive the market wage. Therefore, general, redeployable human capital—no matter how talented—cannot be a basis for value capture; it cannot be an organizational asset. (It may still be part of the operating model to create and deliver value and leverage the rest of the business, however.)

Only human capital that is specific to your company can be the basis of value capture and therefore considered a strategic asset. Firm-specific human capital that can be the basis of profitability comes from such things as workers knowing the "way things are done around here," familiarity with proprietary systems and procedures, trust and relationships with coworkers and stakeholders, culture and fit, alignment with the mission of the organization, the special relevance of workers' skills to proprietary systems, and any other factors that drive a wedge between the value of workers inside and those outside your company.

Therefore, the bottom line is that whereas most assets must be **VRID** to be strategic and **VRIDO** to be worth holding onto, human capital must be **VRIDO** to be a basis for organizational capabilities and value capture. Human capital must rise to a higher standard to be a source of uniqueness and competitive advantage.

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Menu of Sources of Uniqueness and "Competitive Advantage"

In principle, a single source of competitive advantage that protects a single narrow function within the overall web of practices in a business design may be sufficient to establish the uniqueness of a business model. Given imperfections in protections and changing conditions, most successful businesses tend to be supported by multiple sources of competitive advantage.

Get Started

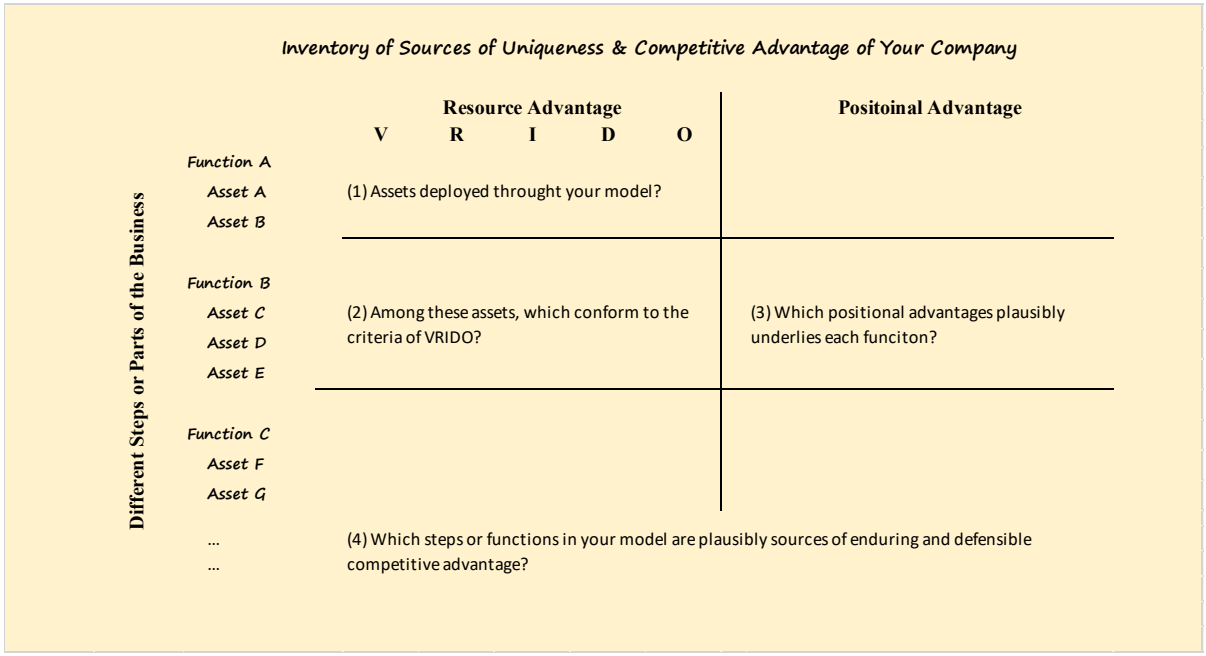
After defining your strategic position in the marketplace and the combination of choices and practices that allow you to execute on the position, you can proceed to evaluating whether there is a basis for presuming that your business won't simply be copied if it is successful. Most likely, you will need to assess the inventory of sources of competitive advantage to pinpoint where you need to collect more precise data to better ascertain any advantages and begin to take deliberate steps toward consciously curating and managing these parts of the business design.

Steps for getting started:

1. Describe the different **functional areas,** or steps of the value chain. Identify the key functional areas where your organization creates value.
2. Assess potential sources of competitive advantage:
    - **Resource-based advantages:**
        - List the assets and factors in the inputs, both tangible and intangible, that affect the ability and levels of productivity your operating model can attain.
        - Assess each asset relative to each of the VRIDO criteria. Only those assets that conform to VRID are strategic assets and a basis for enduring competitive advantage. If an asset is VRID but not VRIDO, that means there can be a profit opportunity from selling or licensing that asset.
    - **Position-based advantages**.
        - For each function or step in your model, identify plausible sources of position-based advantage (see earlier taxonomy for guidance).

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Create an inventory of sources of uniqueness and competitive advantage

Proceeding through these steps should allow you to begin to assess the location and sources of competitive advantage that exist within your existing or prospective design. Given the importance of these questions, it is helpful to go a bit further than the initial assessments to pinpoint those areas where additional **supporting data** and research better substantiate the existing sources of uniqueness and competitive advantage.

It is helpful also to take an additional analytical step to precisely identify whether and **how the operating model itself allows sources of competitive advantage to be renewed** and strengthened while operating.

For example, advantages in scale economies—a positional advantage—will, by their nature, tend to become stronger as the company succeeds and captures greater share. However, a point may come when critical scale is attained, and the market grows well beyond twice the critical scale—in which case a second entrant might enter at scale.

In a counterexample, the original technological or innovation assets that a firm develops could lead it to grow to scale around those assets in a way that does not result in ongoing innovation and renewal of those assets.

Examples

Swiss Watch Industry in the 20th Century

Different Steps or Parts of the Business	Resource Advantage V	R	I	D	O	Positional Advantage
Design						
Mechanical design	✓	✓	✓	✓	✓	A century of going down the learning curve!
Aesthetic design	✓	✓	✓	✓	✓	
Manufacturing						
Precision mechanical manufacturing capability	✓	✓	✓	✓	✓	Learning curve, scale
Marketing						
Brand (quality, precision, beauty, luxury)	✓	✓	✓	✓	✓	Incumbency and early established position
Distribution relationships	✓	✓	✓	✓	✓	

Swiss manufacturers in the 20th century were exceedingly strongly defended by multiple resource-based and position-based advantages.

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Swiss Watch Industry in Today's Era of Smartwatches

Different Steps or Parts of the Business	Resource Advantage V	R	I	D	O	Positoinal Advantage
Design						
Mechanical design	✓	✓	✓	✓	✓	Learning curve advantages now less important, given modern manufacturing approaches
Aesthetic design	✓	✓	✓	✓	✓	
Electronics, hardware, Software, Systems, Data Application Knowledge	No existing assets or capabilities, let alone strategic ones					
Manufacturing	Manufacturing capability no longer exclusive					
Precision mechanical manufacturing capability	✓			✓	✓	Industrial scale advantages
Marketing						
Brand (quality, precision, beauty, luxury)	✓	✓	✓	✓	✓	
Distribution relationships	✓		✓	✓	✓	

Swiss manufacturers today have fewer sources of competitive advantage in relation to the smartwatch threat & opportunity… must consider how to build on these

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Barne's & Noble Inventory of Sources of Uniqueness - Prioir to Internet Disruption (1990s)

Different Steps or Parts of the Business	Resource Advantage					Positoinal Advantage
	V	R	I	D	O	
Sourcing Books						
Expertise, people	✓	×	×	×	×	Scale conomies (bargaining power)
Relationships	✓	×	×	×	×	
Logistics						Scale economies (spread fixed costs, efficiencies in holding variety at scale; warehousing across country; scale drives investment incentives)
Warehouse capacity	✓	×	×	×	×	
IT systems	✓	×	×	×	×	
Marketing	How strong are these, really?					Incumbency/scale: existing position to leverage message, customer relationship
Custmer loyalty	✓	✓	?	?	✓	
Brand	✓	✓	?	?	✓	
Client data/insight	✓	✓	?	?	✓	Is this being exploited much?

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STATIC SNAPSHOT INDUSTRY ANALYSIS

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6. Refine your Design by Turning Attention to the External Industry Environment

How do the choices you make in your (internal) company design exploit opportunities and negate threats in the (external) industry environment?

Analyzing the external environment is a way of sorting out whether in your earlier analysis of company design—position, operating model, sources of uniqueness—whether your might have missed something. Explicitly analyzing the structure and characteristic of the industry might, for example allow you to better sharpen your pencil when say choosing your position and operating model and sources of uniqueness, in view of added challenges or opportunities that might better come to light.

What Is External Alignment?

External alignment consists of formulating a best response to the many opportunities and threats in the industry environment. This includes adjusting to the choices and strategies of other players, while they too adjust to yours—a best response to best responses. This can also often involve making anticipatory commitments, contracts, and investments to reshape the rules of the game. Therefore, this section provides added layers of filters, screens, and tests to help you improve your company design and strategy.

Essentially—by understanding what "forces" are shaping the industry environment, now and tomorrow, you can make choices today about how to best harness those forces.

A Simplifying Set of First Steps: Describing Snapshot "Forces" Shaping Industry

Industries are enormously complex, where consumer preferences and psychology may interact with technologies and institutions, shifting investments and more. These factors are not only interconnected, but can be expected to change and evolve over time.

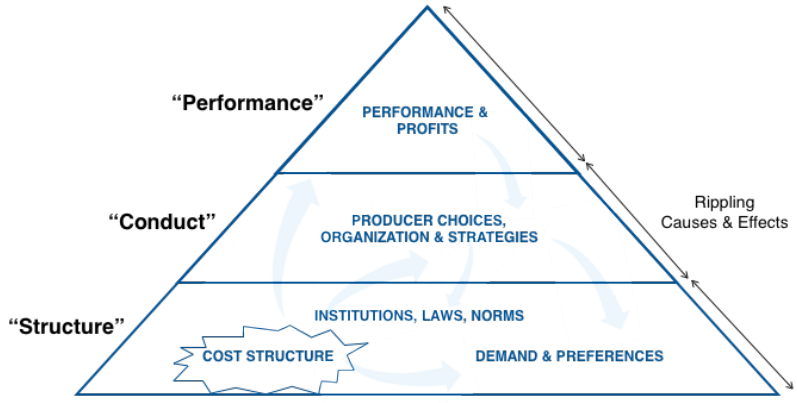


Figure 1 An Array of Complex, Interacting "Variables" Shaping Industry Outcomes

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Most popular approaches to industry analysis radically simplify the true goings-on in order to make progress in understanding the most basic "forces" shaping industry and, thus, the performance of individual firms.[10]

[10] Most popular practitioner Strategy frameworks have historically focused on what a best responses to static given features of the environment might look like—taking the environment as given, as in say the Five-Forces framework or early research in the mid-20th Century in early Industrial Economics referred to as "Structure Conduct Performance". Mckinsey's SCP framework follows this logic, as well. This might be the case for say a small competitor whose actions have no influence on the industry.

Modern game theory, Industrial Organization Economics, economic analysis of institutions, and research in Strategy instead take it for granted that strategic actions and choices will most often shape the industry itself, and the best responses of all other actors—and therefore external alignment is better characterized as a best response to best responses (apart from any given structural features of industry). The structural characteristics of your industry might themselves be shaped by strategic choices, commitments, and investments. Few popular practitioner frameworks begin to grapple with these issues. Exceptions are the "Coopetition" and closely-associated "Value-Net" frameworks, which can be understood as updates of ideas in the classic Five Forces framework. This is indeed one the areas where the gap between popular books and modern academic research and training are greatest.

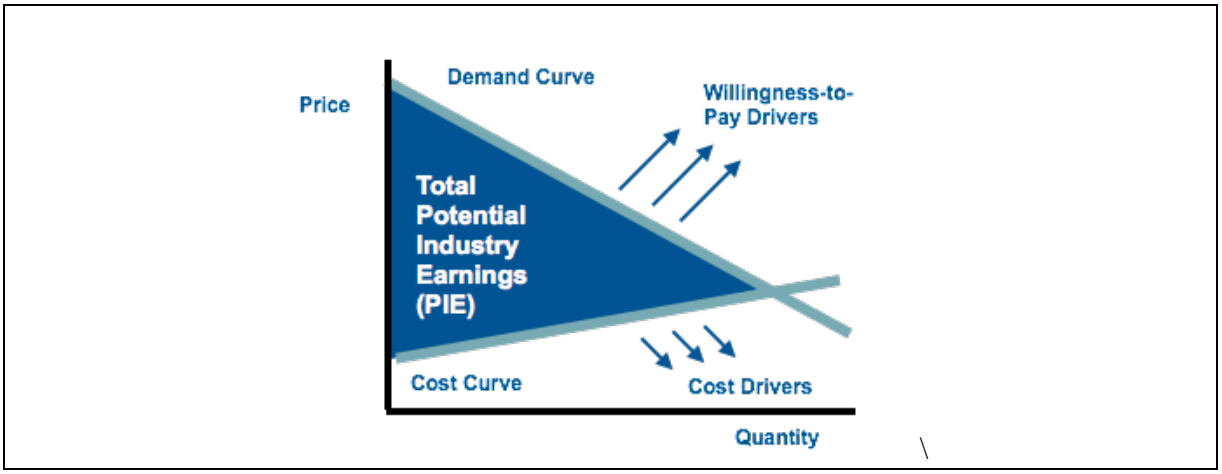
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7. Industry-Level Value Creation "Forces"

Most strategy textbooks and practitioner guides rush to value capture—how profits are divided among rivals, suppliers, and buyers (as in the well-known Porter's 5-Forces framework). That's premature. It is useful, however, to first plot any industry-level forces that shape the creation of value in the first place. (This may repeat some of the value creation logic from Chapter 2, but here we are trying to understand broader industry currents beyond what might be the focus of your own business.)

Think of the total size of the PIE—potential industry earnings. By definition, the PIE represents the total economic value that could conceivably be extracted as profit if a firm could (hypothetically) practice perfect price discrimination, capture every dollar of consumer surplus, and face no competition.

Graphically, the PIE is the area under the industry demand curve (aggregate willingness-to-pay across all customers) and above the industry cost curve (the resources required to produce and deliver the offering). This framing highlights that **value-creating forces are anything that shifts demand upward (greater willingness-to-pay) or drives costs downward.** Before strategists consider who captures what slice, they must understand what expands or contracts the overall pie.



Value Creation Forces: Willingness-to-Pay (WTP or Differentiation) and Cost Drivers

At the industry level, the central question is not how one firm creates more value than its rivals, but rather what forces make the industry as a whole capable of generating more or less value. This perspective yields insights that are easy to miss if we focus only at the firm level. The rise of smartphones, for instance, was less about Apple or Samsung's competitive moves than about the industry-wide expansion of demand made possible by app stores and wireless data networks.

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Similarly, the shale gas revolution transformed the energy sector not through firm positioning but through a technology-driven collapse of costs across the board. Demographic shifts, regulatory changes, and evolving infrastructures can all expand or contract the potential size of the pie—altering whether firms are competing in a shrinking, stagnant, or booming market. Understanding these forces also highlights interactions between value creation and capture, such as how video game consoles depend on the co-evolution of hardware and software ecosystems. Crucially, industry-level value creation dynamics shape not just the size of the opportunity but also the strategic orientation of competitors. In periods of rapid growth, firms are often oriented toward active value creation and differentiation, focusing on expanding the market rather than fighting over each other's margins. In more mature or stagnant industries, by contrast, attention shifts to value capture, cost-cutting, and defensive moves. For these reasons, mapping the drivers of the total industry PIE is a necessary first step before analyzing how it gets divided.

Given the definition of PIE, the strategist's task is to identify the broad macro drivers that shift the industry demand curve (aggregate willingness-to-pay) and the industry cost curve. These are the forces that expand or contract the total economic value available in the industry.

Willingness-to-Pay / Demand Drivers
The industry's demand curve is shaped by how customers perceive value and by the conditions that enable adoption. Strategists should consider:

- **Customer needs and value dimensions:** What needs are being served, and what dimensions of performance, convenience, or experience—if improved—would raise willingness-to-pay?
- **Market boundaries and size:** How do demographics, adoption rates, and complementary infrastructures shape the ultimate limits of demand?
- **Price sensitivity and adoption dynamics:** What determines elasticity, switching costs, uncertainty about quality, or risk perceptions that make customers hesitant?
- **External influences:** How do business cycles, industry life cycle stage, or social trends (fashions, fads) shift demand up or down?
- **Ecosystem dependencies:** To what extent does demand depend on complements, platforms, or broader infrastructures that must co-evolve?

Cost Drivers
On the supply side, strategists must understand what determines the level and shape of the cost curve:

- **Input intensity:** Which inputs dominate—capital, labor, technology, or raw materials—and what is the mix of sunk, fixed, and variable costs?
- **Scale and learning effects:** How do costs behave with volume? Is there scope for economies of scale, scope, or experience curves?
- **Volatility and risk:** How do uncertainty, input price fluctuations, or supply chain bottlenecks affect costs?
- **Regulation and external constraints:** Do environmental rules, energy prices, or safety standards raise baseline costs across the industry?

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- **Adjustment frictions:** What specialized skills, training, or workforce constraints limit the ability to adapt?

Clarifying these broader forces allows you to see beyond your own firm's positioning and recognize the structural conditions shaping industry-wide value creation. This wider lens reveals not only how much value can potentially be created, but also how the industry context will influence the strategic orientation of competitors. For instance, in periods of rapid industry growth, most firms will tend to emphasize differentiation and expansion to enlarge the pie, while in mature or stagnant settings, the same firms may pivot toward cost control and value capture. In this way, an analysis of PIE drivers provides both a map of the industry's potential and a window into the likely strategic behaviors of rivals.

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8. Industry Value Capture "Forces" & the Industry Ecosystem

In the twentieth century, industries were typically organized in a linear fashion: upstream suppliers, focal producers, and downstream buyers. Competitors were other producers offering similar or differentiated goods, while complementors were peripheral. Within this context, Michael Porter's **Five Forces framework** became the most widely used tool for analyzing industry profitability. It was itself a simplification of decades of work in industrial economics, which examined how market structures shaped rivalry, entry, substitutes, buyer and supplier power, and the distribution of profits.

Today, however, many industries no longer conform to this simple chain. Ecosystems, platforms, and networked relationships blur the lines between competitors, complementors, and partners. The Five Forces remain a valuable starting point, but they need to be **generalized** to account for the ways industries are actually structured. The task here is twofold: (i) to map the **actual structure** of the industry or ecosystem; and (ii) to analyze the **forces shaping value capture** within it.

At its core, the framework highlights two broad categories of players:

- **"Competitors"** (rivals, substitutors, entrants), who shape **competitive intensity**.
- **"Partners"** (suppliers, buyers, complementors, employees, alliance partners), who shape **bargaining power and dependence**.

With this structure in mind, we can work through each of the classic "forces" in turn, keeping in mind both their traditional logic and their modern extensions.

Why value capture is contested

The players that **create value** in an industry are not necessarily the players that **capture profits**. As industrial economists have long emphasized, competitive markets often drive value creation and value capture apart. Firms may invest in innovation or efficiency, but the resulting surplus can be dissipated by rivals, appropriated by powerful suppliers or buyers, or siphoned away by entrants and substitutors (Scherer & Ross, 1990; Tirole, 1988). Strategic management research built on this idea by emphasizing the problem of **appropriability**—the conditions under which a firm can retain returns from its activities (Teece, 1986).

The lesson is that understanding where profits flow requires looking beyond head-to-head rivals to all parties with whom a firm has **economic interactions**—not only competitors but also suppliers, customers, complementors, employees, regulators, and alliance partners. Each of these actors has claims on the value generated.

Moreover, it often takes **just one unfavorable force** to erode profits. A highly innovative company may still struggle to capture value if suppliers hold monopolistic positions on key inputs,

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if buyers wield disproportionate bargaining power, or if substitutors aggressively redefine price–performance tradeoffs. The analysis must therefore consider **each force individually**, and then integrate across forces to understand the overall balance of pressures on value capture.

From linear industries to ecosystems: Porter as baseline

In the mid- to late-twentieth century, many industries could be represented as a **linear production chain**: upstream suppliers → focal producers → downstream buyers. Competition was largely analyzed among peer producers offering similar products, with substitutes and entrants representing predictable extensions of the same logic. Within this context, Michael Porter's (1979, 1980) **Five Forces framework** became the standard field tool for managers.

Porter's framework itself was a **practical distillation of industrial economics research**. Decades of work in IO had studied how market structure shaped rivalry (Bain, 1956), barriers to entry (Stigler, 1968), the impact of substitutes (Hotelling, 1929; Lancaster, 1979), and the bargaining power of suppliers and buyers (Williamson, 1975). Porter's innovation was to **bundle these insights into a simple, managerially usable diagnostic tool**.

Yet industries today no longer fit a simple chain. With the rise of **platforms and multi-sided markets** (Rochet & Tirole, 2003; Parker, Van Alstyne, & Choudary, 2016), **ecosystem and complementor dynamics** (Jacobides, Cennamo, & Gawer, 2018), and **global supply webs** with fragile interdependencies, the roles of players and the boundaries of industries have become less clear-cut. Value creation often involves distributed actors whose contributions are interdependent, and value capture reflects bargaining power, network effects, and governance across the system.

We therefore **build on Porter—not discarding it—by generalizing its application**. The first step is to **map the actual structure** of your industry or ecosystem: identify who the players are, how they interact, and what roles they play. The second step is to **analyze the forces** shaping value capture within that structure: competitive intensity on one side, bargaining power and dependence on the other.

Mapping structure before analyzing forces

The first step in extending Porter's logic is to **map the actual structure of the industry or ecosystem**. In the classical view, this was straightforward: identify suppliers, producers, and buyers, and then examine rivals, entrants, and substitutes around the focal producer. Today, however, industries often involve more complex constellations of actors, including platforms, complementors, specialized partners, regulators, and global supply networks.

Strategic research on ecosystems emphasizes that many of these relationships are not neatly upstream or downstream, but rather **mutually interdependent** (Jacobides, Cennamo, & Gawer, 2018). Platforms depend on developers; automakers depend on suppliers of specialized technologies; pharmaceuticals depend on alliances with biotech startups and universities. These interdependencies mean that the boundaries of industries are less fixed than in Porter's time.

Managers must therefore ask two questions at the outset:

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1. **Who are the relevant players?** List all actors who contribute to value creation or can influence value capture: direct competitors, potential entrants, suppliers, buyers, complementors, regulators, labor markets, and alliance partners.
2. **How are they connected?** Draw the actual map: are ties linear, modular, networked, or mediated by a platform? Where are complementarities critical? Where does bargaining power or dependence emerge?

Only with such a map in hand can the classical forces be applied and generalized.

Two categories of forces

For analytical clarity, it is helpful to group industry actors into two categories.

- **Competitive intensity**: players that influence customers' purchase decisions by offering competing alternatives. These include direct rivals, substitutors, and potential entrants. Their interactions shape the level of rivalry and the rate at which value is eroded through competition.
- **Bargaining and dependence**: players that transact with the firm as suppliers, buyers, or partners. Their influence comes not from offering alternatives to the customer, but from their ability to set terms of trade or withhold complementary inputs. Here the logic of bargaining power and dependence, rooted in transaction cost economics and bargaining theory (Williamson, 1975; Gulati & Singh, 1998), becomes central.

This twofold structure provides a generalization of Porter's original framework: the five forces remain intact, but we recognize that some operate through **competitive intensity**, while others operate through **bargaining and dependence**.

Competitors

Strictly speaking, **rivals, substitutors, prospective entrants, and disruptors are conceptually identical**: they are all alternative suppliers who threaten some degree of competition by offering customers other ways of meeting their needs. They differ mainly in **closeness to your business** and in the **mechanisms through which they pressure your margins**.

The Five Forces framework usefully distinguishes among these subgroups—rivals, substitutors, and entrants—but managers should remember that they are all part of a **continuum of competitors**. At one end are direct rivals, offering nearly identical products. Further along are differentiated substitutors and disruptors, who may reframe the basis of competition entirely. Entrants can appear anywhere along this spectrum, sometimes as copycats, sometimes as radical new players.

In all cases, these actors shape **competitive intensity**. Interaction is often indirect, taking the form of **influencing buyers' choices** by changing the available alternatives. The salient question is always the same: *To what extent do industry characteristics give these competitors—whether close rivals or more distant substitutors—the ability and incentives to expand by undercutting your business?*

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Your earlier analysis of **positioning** should have already considered how your firm is similar to or differentiated from competitors. The analysis here extends that by asking how **industry structure** shapes the entire landscape of competition: when does differentiation isolate firms from head-to-head rivalry, and when do structural factors intensify pressures among rivals?

(1) Intensity of Direct Rivalry

Key question: *Do industry characteristics give rivals both the ability and incentives to grow their business by undercutting competitors—or do they encourage softer competition?*

Relevant factors to consider include:

- Number of suppliers.
- Balance among competitors (equally sized vs. dominated by one or two).
- Similarity or differentiation of offers.
- Demand- and supply-side economies of scale.
- Spare capacity.
- Exit costs.
- Rate of market growth.
- Switching costs, relationship stickiness, contract length.
- Potential for collusion, accords, or cartels.

(2) Threat of Substitutors (including disruptors)

Key question: *How close are substitute offerings, and how likely are they to pull customers away from your company?*

Conceptually, substitutors are competitors too—the only difference is that their offers are more **distant or differentiated**from the focal industry. A substitute may be a slightly different product, a functionally distinct alternative, or a disruptive technology that redefines the value–price tradeoff.

Relevant factors include:

- **Closeness of offers**
  - Functional merits and value dimensions of substitutes.
  - Buyer tastes and preferences.
  - Price–performance trade-offs.
- **Strategic orientation of substitutors**
  - Cost structures, aggressiveness, returns to targeting your customers.

Modern research adds that **disruptors** (Christensen, 1997; Tushman & Anderson, 1986) may start with weaker performance on traditional dimensions but create new bases of competition, threatening incumbents over time.

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(3) Threat of Entrants

Key question: *How contestable is the market? Even if no entry occurs, does the mere possibility of entry discipline prices and margins?*

Entry can come from established firms in adjacent markets, entrepreneurial startups, or global competitors moving in. The key issue is whether entry is **foreclosed** or whether new players can enter at scale and compete effectively.

Relevant factors include:

- High fixed or sunk costs.
- Capital requirements (especially in imperfect capital markets).
- Incumbent control of scarce inputs.
- Locked-in customer agreements and contracts.
- Brand loyalty and switching costs.
- Economies of scale and scope.
- Experience, learning curves, accumulated know-how.
- Network effects and data advantages.
- Legal and regulatory barriers.
- Credibility of incumbent retaliation.

In short: rivals, entrants, substitutors, and disruptors are all variations of the same underlying force: **others trying to do what you do, to varying degrees and in different ways**. The Five Forces framework helps separate these categories for analysis, but conceptually they are all competitive intensity.

Analysis of Other Players: "Bargaining Power" vs. "Dependence"

A second set of players, distinct from the various sorts of competitors, includes upstream suppliers and downstream buyers. It also includes a wider range of actors that go beyond the original five forces, such as complementors, key employees, alliance partners, and other ecosystem participants. Regulators may also matter here, not because they claim value directly, but because they shape the rules of the game and thus indirectly affect how value can be captured.

What these other sorts of players have in common, apart from not being one form of competitor or another, is that they are part of the same supply chain or system of players delivering value to customers—often creating value together, but also negotiating over how that value is divided. Whereas the earlier issue to evaluate was competitive intensity, here there are two countervailing issues to resolve when determining value capture: bargaining power and dependence.

An implicit tug-of-war for value and profits will exist between your company and each of these players, first determined by "bargaining power." Borrowed from Economics, the term does not imply literally haggling among all players across the ecosystem. Rather, bargaining power speaks

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to the relative strength of players with respect to setting terms or influencing the game in ways that extract more value from a trade relationship.

The simple economic prediction is that value will tend to flow to parties with relatively greater bargaining power consequent to their size, importance, and, most significantly, the relative attractiveness of outside options.

However, apart from the value that one set of players can extract and capture from others, each player might still leave the other party with a share of value, depending on its levels of dependence on the other actor. For example, a powerful platform owner might depend on app developers to invest in innovation, and leaving app developers with a share of profits may give them greater incentives to pursue costly and risky innovations.

(4) Supplier Power

Key question: *What is the balance of bargaining power between competitors in the focal industry and upstream suppliers?* This largely relates to how much each set of actors depends on the other and who has the better outside options if they were to leave the relationship.

Relevant factors to consider include:

- Number of other suppliers, number of other competitors in the industry (and other possible buyers for suppliers).
- Relative size and importance of suppliers, relative size and importance of competitors in the industry.
- Intensity of competition among buyers, and competition among competitors in the industry.
- Price sensitivity/elasticity on either side of the negotiation.
- Ability of either upstream suppliers or competitors in the industry **to** coordinate bargaining, form a syndicate or cartel.
- How crucial or valuable the input is.

(5) Buyer Power

Key question: *What is the balance of bargaining power between competitors in the focal industry and downstream buyers?* This largely relates to how much each set of actors depend on the other and who has the better outside options if they were to leave the relationship.

Given the relationship with downstream buyers is symmetric to the relationship with upstream suppliers, relevant factors to consider are identical:

- Number of other suppliers, number of other competitors in the industry (and other possible buyers for suppliers).
- Relative size and importance of suppliers, relative size and importance of competitors in the industry.

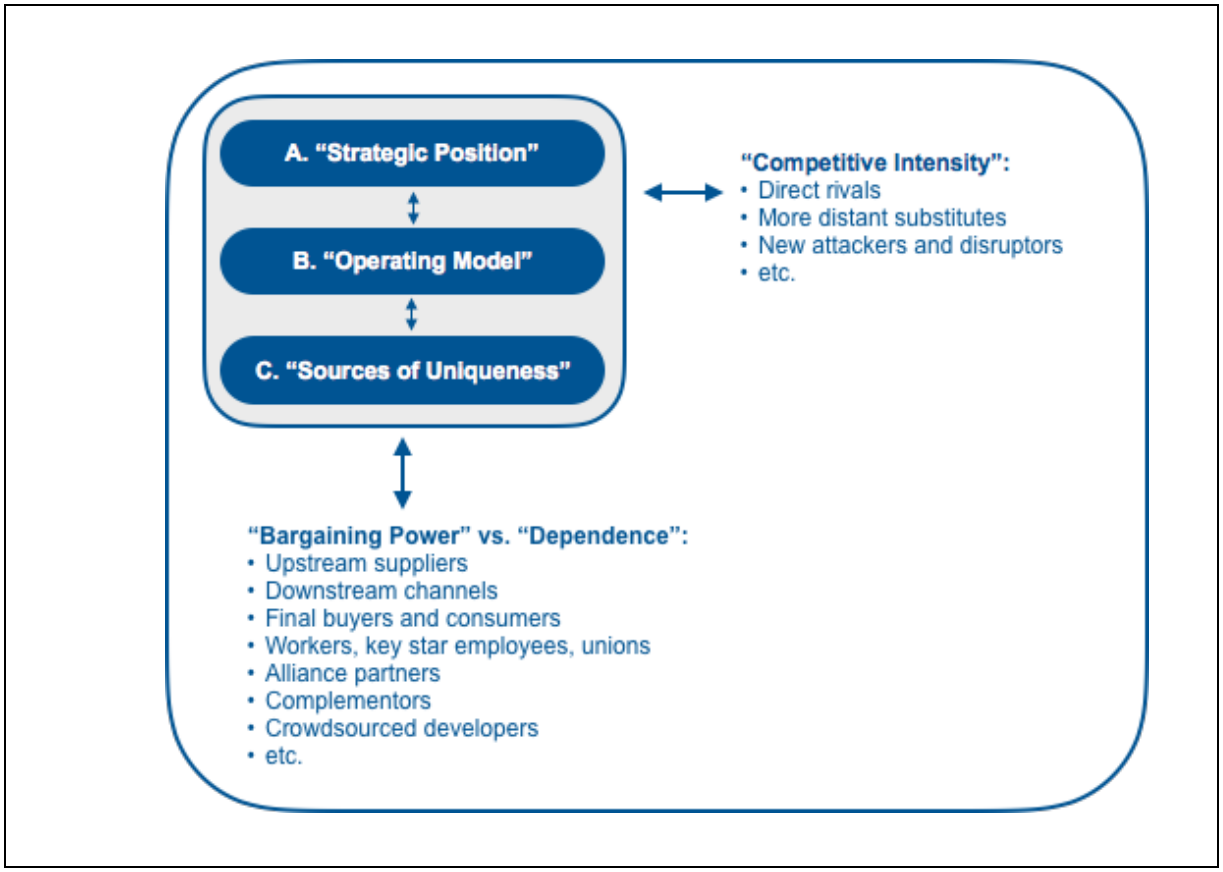
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- Intensity of competition among buyers, and competition among competitors in the industry.
- Price sensitivity/elasticity on either side of the negotiation.
- Ability of either upstream suppliers or competitors in the industry **to** coordinate bargaining, form a syndicate or cartel.
- How crucial or valuable the input is.

Beyond suppliers and buyers

Other actors may also influence value capture, even if not part of Porter's original five forces.

- **Complementors**: whose products or services increase the value of your own, with the division of value depending on relative indispensability and outside options.
- **Alliance partners**: firms with whom you jointly develop technologies or markets, raising questions of appropriability.
- **Employees and talent**: in knowledge industries, human capital holds bargaining leverage through mobility and scarcity.



The Five Forces Contain Essentially Two Different Types of Players and Forces

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9. Using Static Industry Analysis to Improve your Company's Design

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"Is this an Attractive Industry?"

One of the most frequent uses of industry analysis in practitioner frameworks is to ask whether this is an attractive industry to enter and operate within. Even if all the forces might initially appear to be attractive (or unattractive), here are several reasons you might think twice about choosing the industry on this basis:

- More important than the passive features of an industry is the question of whether you have actively taken actions to externally align to the industry. In the absence of actions taken to exploit opportunities and mitigate threats, you will not be able to compete successfully in even the most attractive of contexts.
- Conversely, much of the greatest innovation and entrepreneurial successes have come from companies determining new ways to create strategic alignment in supposedly unattractive industries, such as taxi service (Uber), deliveries, furniture sales (Ikea), and general retail (Amazon, Walmart, Target).
- The most fundamental point of all is that what makes an industry attractive, in general, and to your company in particular depends on the strategies you choose and implement.
- Strictly speaking, industry structure does not tell you about competitive advantage. In the absence of insight on company-level orientations and decision making, this industry-level analysis might only provide some suggestion of the possibility that suppliers might play nice and practice oligopolistic forbearance. Therefore, by its nature, industry-level analysis is better geared to clarifying issues to which your company should align than it is at predicting company profitability.

Gaining External Alignment Through Anticipatory Actions

It is by taking committed, pre-emptive actions that you align your company with the environment. This includes establishing reputation, signing contracts, making sunk and enduring investments, and so forth. You can think of this as reshaping the rules of the game or as anticipating these rules and playing them to maximize opportunities and to negate threats.

For example, if a supplier's bargaining power poses a threat, you might choose to establish a long-term contract with that supplier. Under a long term agreement, both parties might then be more likely to seek friendly resolutions to disputes that will surely be encountered along the way—as you both aim for a long and highly productive and profitable relationship lasting into the future. Therefore, the upfront agreement can change the way each player chooses to play.

Smaller competitors nipping at your heels? Perhaps you can outspend rivals on R&D because you are a larger firm and you can spread fixed costs across a greater number of customers. But this means you are also likely to get larger still. Anticipating that you are going to eventually outspend and outgrow them, your competitors might even slow their investments. Credibly signaling that

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you are going to aggressively overspend on R&D and capacity might even lead these smaller competitors to exit or never to enter at all.

In another example, in the presence of incentives to compete fiercely with relatively undifferentiated competitors, some firms might establish a cartel to forgo aggressive competition and to coordinate their actions or play nice. This is what the Organization of the Petroleum Exporting Countries (OPEC) does when it is not engaged in production disputes. Internal to most countries, coordinated behavior among cartels and trusts is illegal and viewed as an outright means of firms to capture value from consumers without commensurate value creation.

Get Started

Your existing design—having defined value creation for your precisely-defined customer, a set of signature practices to deliver value, and some source(s) of uniqueness to capture value—might already imply a good deal of external alignment.

However, take the time to go further to explicitly consider external alignment:

1. Note the broad set of factors that shape **value creation in your sector**—willingness-to-pay and cost-drivers—to broadly frame your analysis of what is going on in the industry
2. **Map the industry ecosyst**em—all of the relevant groups of players. Clarify the linkages and relationships among players, and particularly to your company.
3. Describe the **main structural forces** shaping value creation and capture, and the payoffs of players.
4. Rough out the pattern of choices that constitute the **best-responses-to-best-responses** across players.
5. Review and consider broader **institutional factors** that are playing a role in shaping the rules of the game.
6. Determine **your best response to this environment**—particularly the anticipatory actions you can take—iterating through earlier steps again if this might reshape the strategic response of other players.

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Augment your Analysis: Macro/Institutional Forces

Your earlier analysis likely made a great many assumptions regarding macroeconomic and institutional factors beyond the industry itself. Although the unit of analysis in the preceding step is indeed the industry, you might surface some of these assumptions and study them explicitly. This does not mean building a separate analysis but rather deepening your analysis of these factors to better understand their impact on value creation and capture, where this cannot be taken for granted from your earlier analysis.

Walk through a list of typically considered forces in the macro environment to surface the assumptions in your previous analysis. These might include, for example, **political**, macro**economic**, **societal**, **technological**, **environmental**, and **legal** and institutional factors (PESTEL).

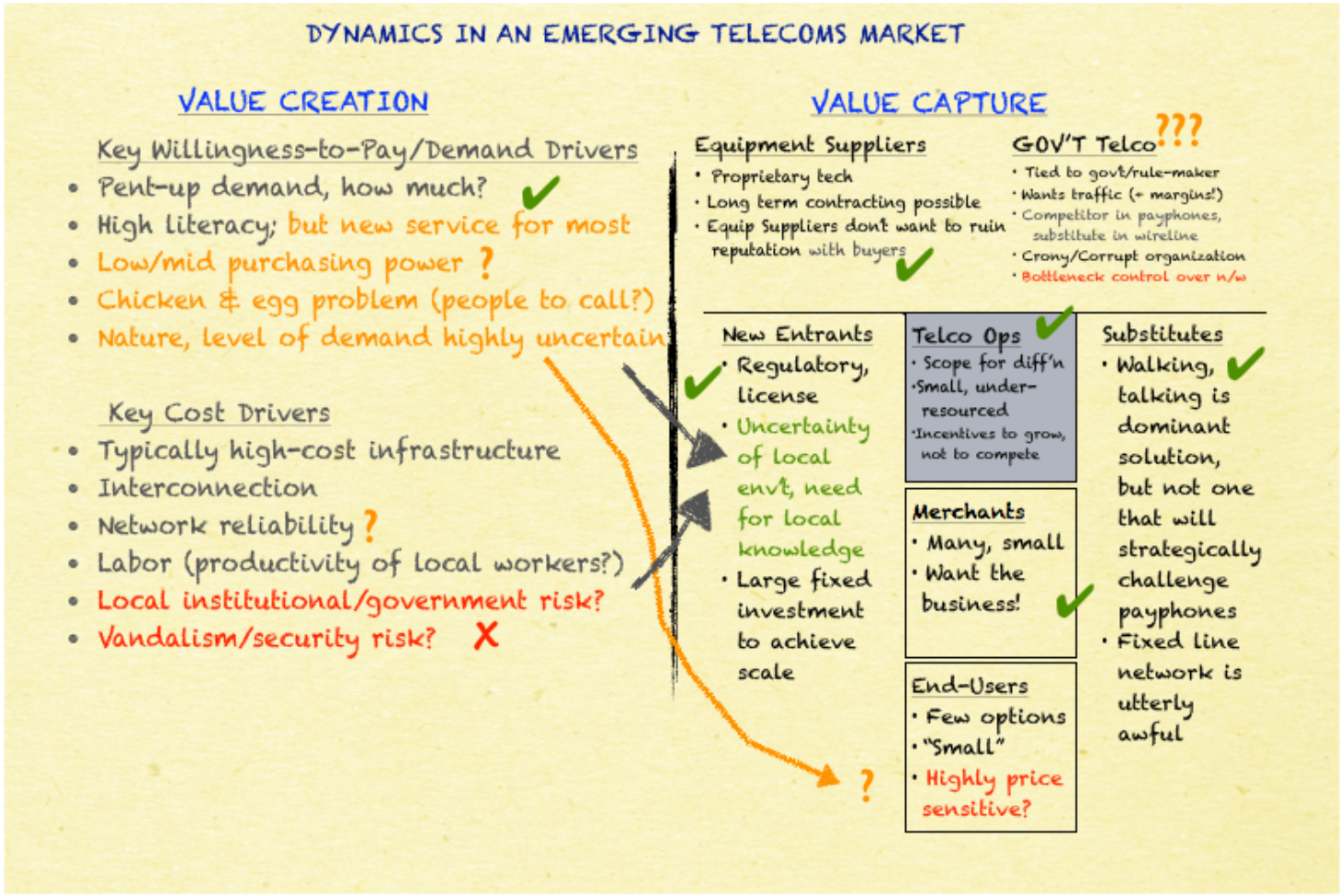
Just as in analyzing other forces shaping an industry, one way to analyze these factors is to consider how the given state and changes in these factors shape the industry.

However, a more complete analysis also considers the logic of best responses to best responses, as your actions in relation to these broader forces and actors beyond the industry might also interact with and respond strategically to your actions, as in "non-market strategies," involving government, social actors, etc.—to change the rules of the game.

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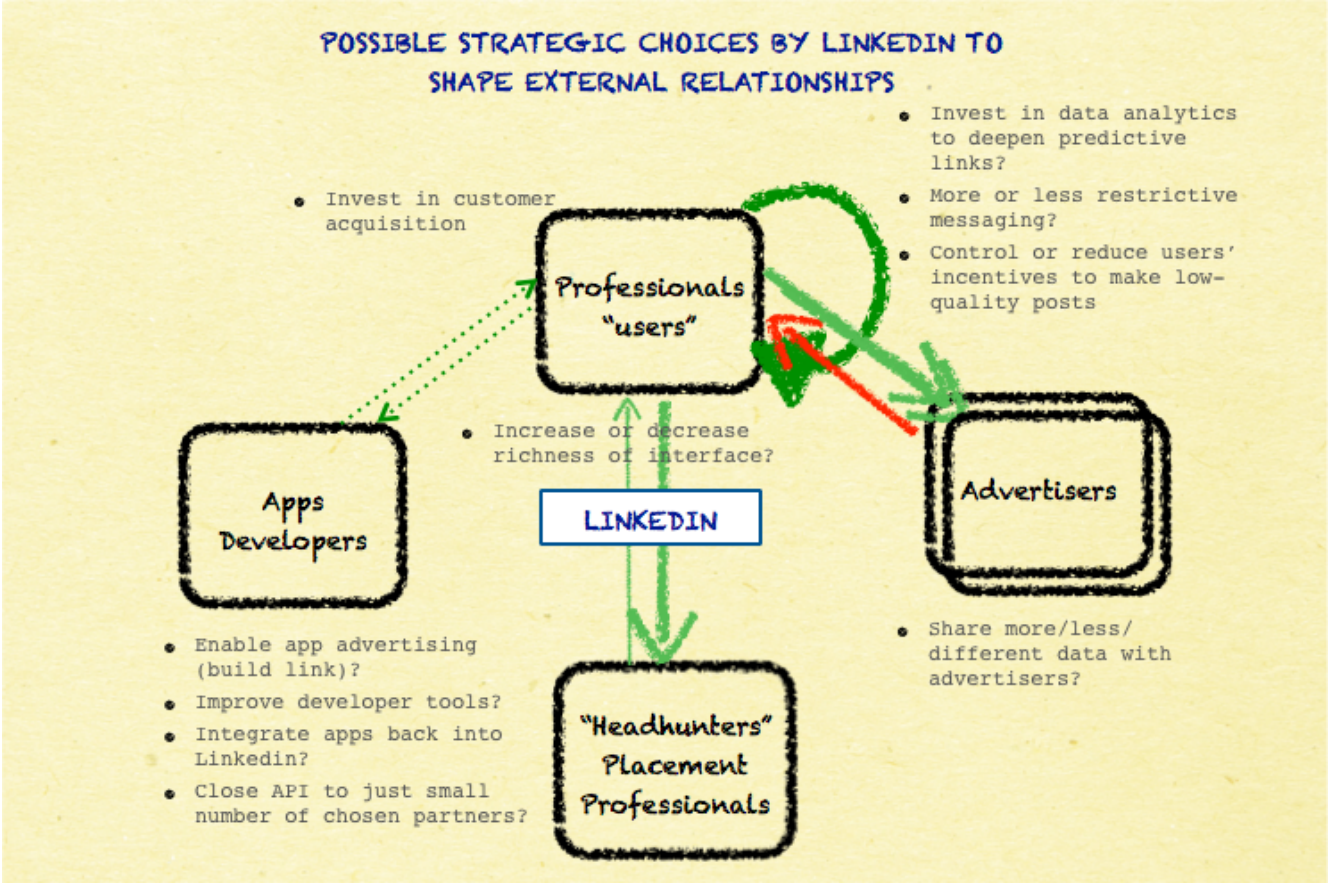
Examples

In entering, creating, or building many industries, much of the story relates to value creation, apart from value capture (and the interactions between these things).



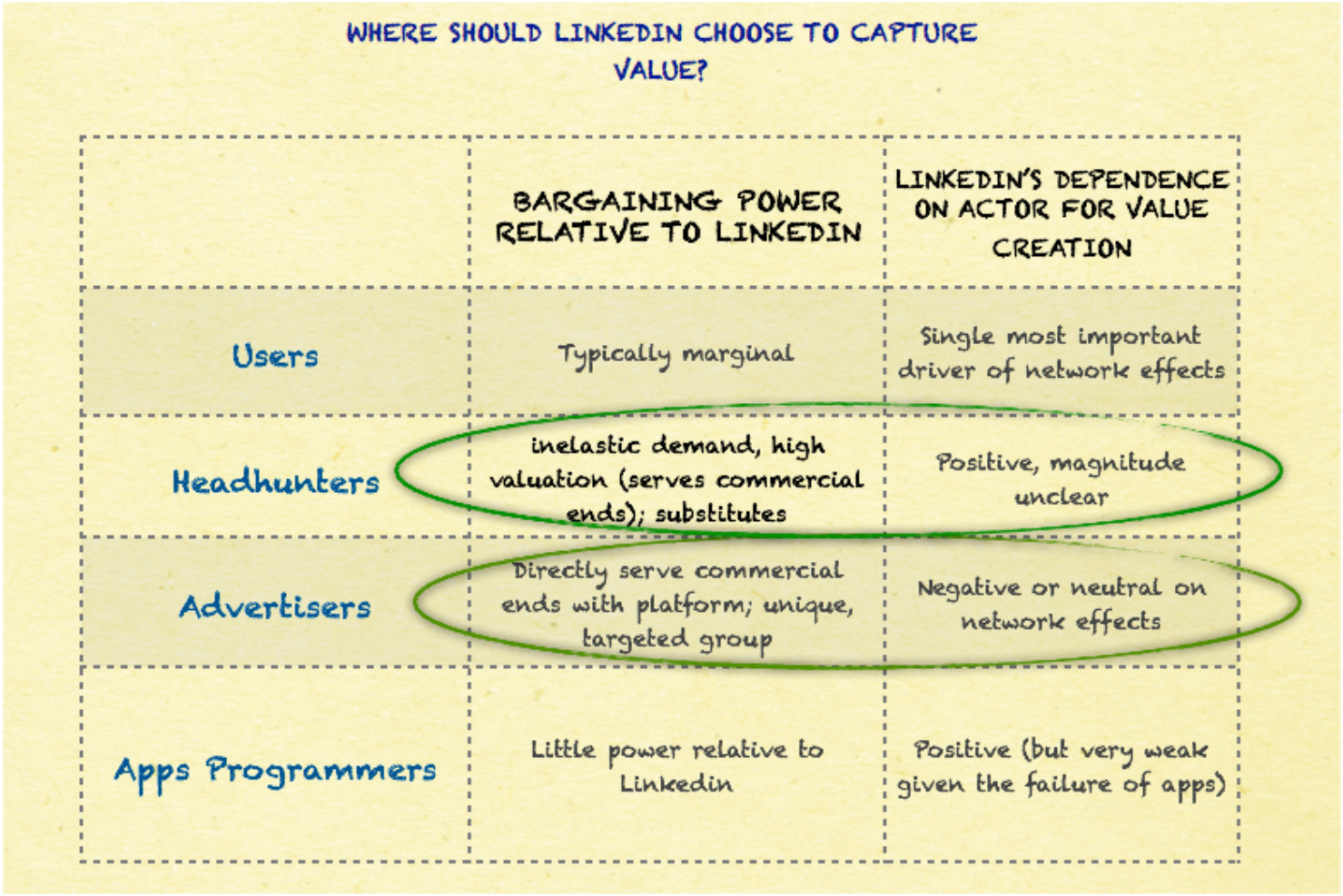
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Externally aligning requires clearly understanding the many players and how they relate—and shaping the company design to best balance value creation and capture. There may be endless tactics to consider, so it is crucial to begin with an understanding of the simplest economic drivers.



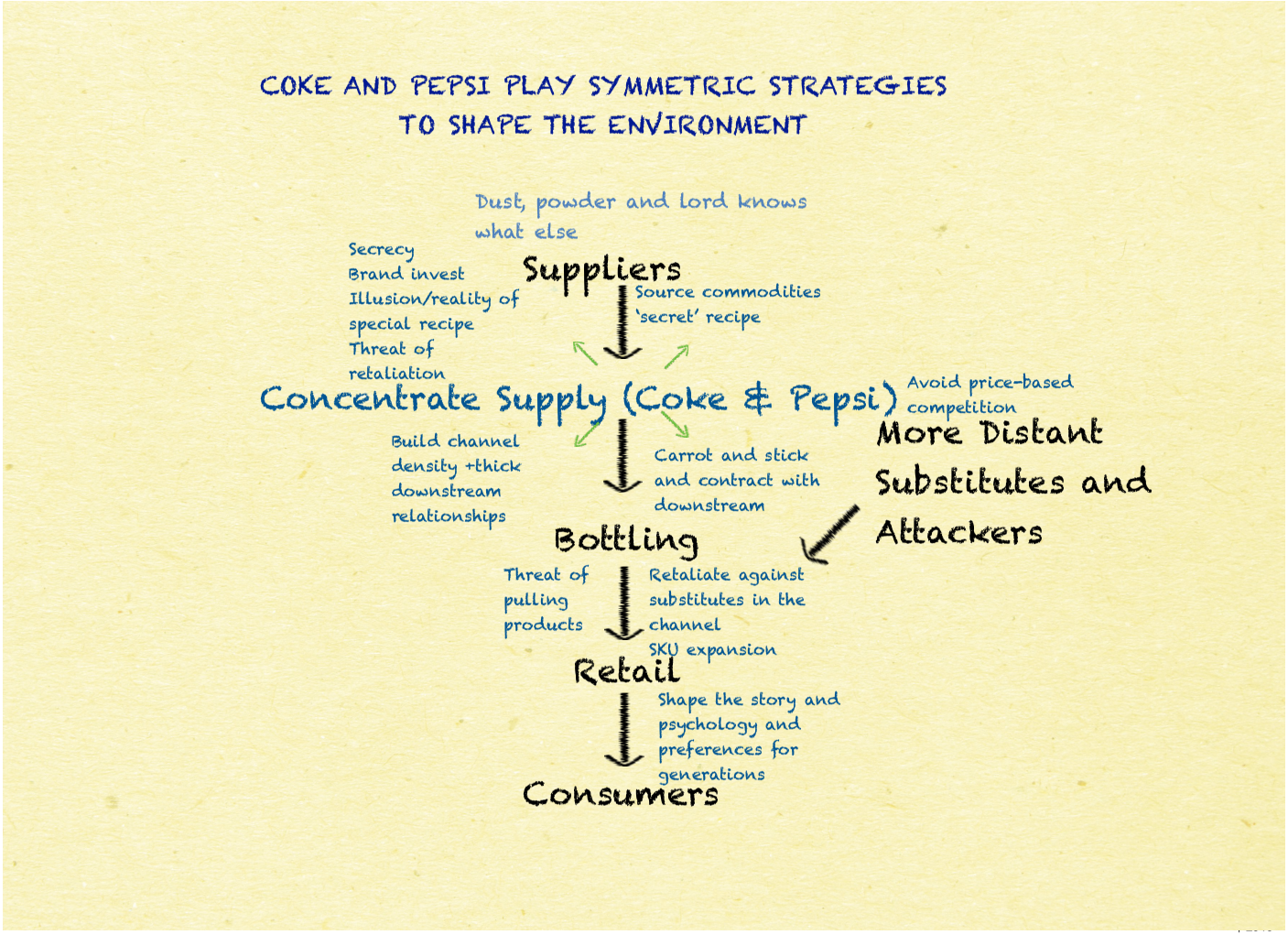
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Typically, multiple sets of parties together create value in a given system. The distribution of profits should depend on the balance of bargaining power and dependence.



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The attractiveness of an industry is hardly solely determined by exogenous factors and structure. How you play the game helps determine the structure itself.



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SHORT-RUN DYNAMIC INDUSTRY ANALYSIS

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10. Gaming Out Short-Run Change: For-Every-Action-there-is-a-Reaction

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How can I predict changes from the external environment that might impact my organization? How do I anticipate limits and frictions that might challenge its ability to adapt?

Even in seemingly stable and unchanging industries there is *always* some change and innovation, so you will need to further refine your earlier analysis with these dynamics in mind. Consider, for example, these questions:

- *How can I predict and evaluate changes in the external environment?*
- *How do organizational dynamics predictably shape and constrain strategies over time?*
- *What should I do today to align with, or affect, tomorrow's changes?*
- *Should I make investments and commitments today or maintain flexibility and options?*

Dynamics are inherent in questions of strategy, and one of the most complex. Here are some basic considerations with respect to the dynamic alignment of a company's strategy and design.

Shocks, changes, and trends (e.g., new technology, looming regulation, evolving competitive environment, shifting consumer preferences) may originate in any corner of the external industry or may change internally (e.g., evolving asset base, growing experience and efficiency, strengthening or weakening market position). Such changes in fundamentals, or even changes in competitors' strategies, can alter a company's internal and external alignment and generate new threats or opportunities.

For example, the introduction of new enabling technologies, or shifting preferences, or diminishing returns in existing research often create incentives and opportunities for new investment in innovation and product development. More radical is the need or desire to fundamentally alter a company's design, as with business model innovation.

It is important to gauge and account for all changes going on in the environment and to consider opportunities that might result from not only of your company's likely response but also from the likely responses of other players in the industry.

Map the Direct Effects of Changes

Given their myriad possible points of origin, you'll need to scan your company, the surrounding industry, and the wider environment for shocks, changes, or trends that might impinge on your business strategy or design. Map whatever you can identify onto the earlier snapshot analysis of your internal design and the relevant external environment, working backward from changes external to the industry, as in the macro environment, to where they fit relative to changes in the industry or your business design.

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For example, technological change and the entry of new competitors may shape industry dynamics as well as your evaluation of the attractiveness and defensibility of your position in the marketplace. Or an antitrust ruling may shape your expectations of competitors' future conduct and its possible ramifications. Scaling your company may yield new sources of competitive advantage while perhaps rendering other sources of uniqueness less sustainable.

See Beyond Just the Static Analysis: Game Out Best-Responses-to-Best-Responses

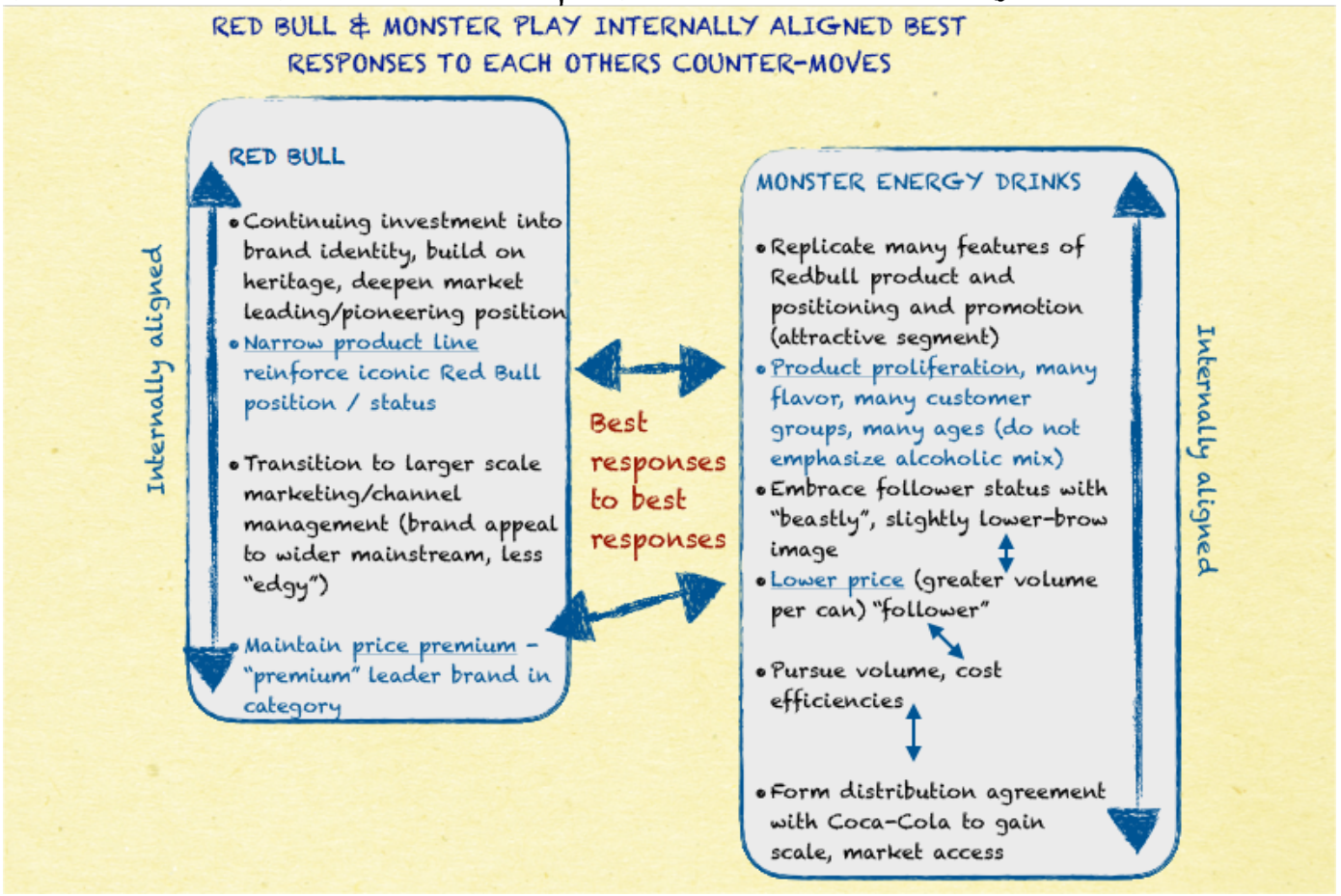
As noted earlier, any strategizing to achieve alignment with the external environment must be a best response, not only to changes detected in the industry but also to other players' best responses to those changes, recognizing that they, too, will be formulating best responses not only to the changes but also to what they anticipate your (and other players') best responses will be. The aggregate result of these responses and responses to responses will be a new competitive equilibrium or sustained pattern of competitive interaction.

Of course, not every change in the environment will inevitably provoke or necessitate a response or adjustment in strategy and design. The performance of many companies, particularly that of market leaders, seems to be uncompromised come what may.

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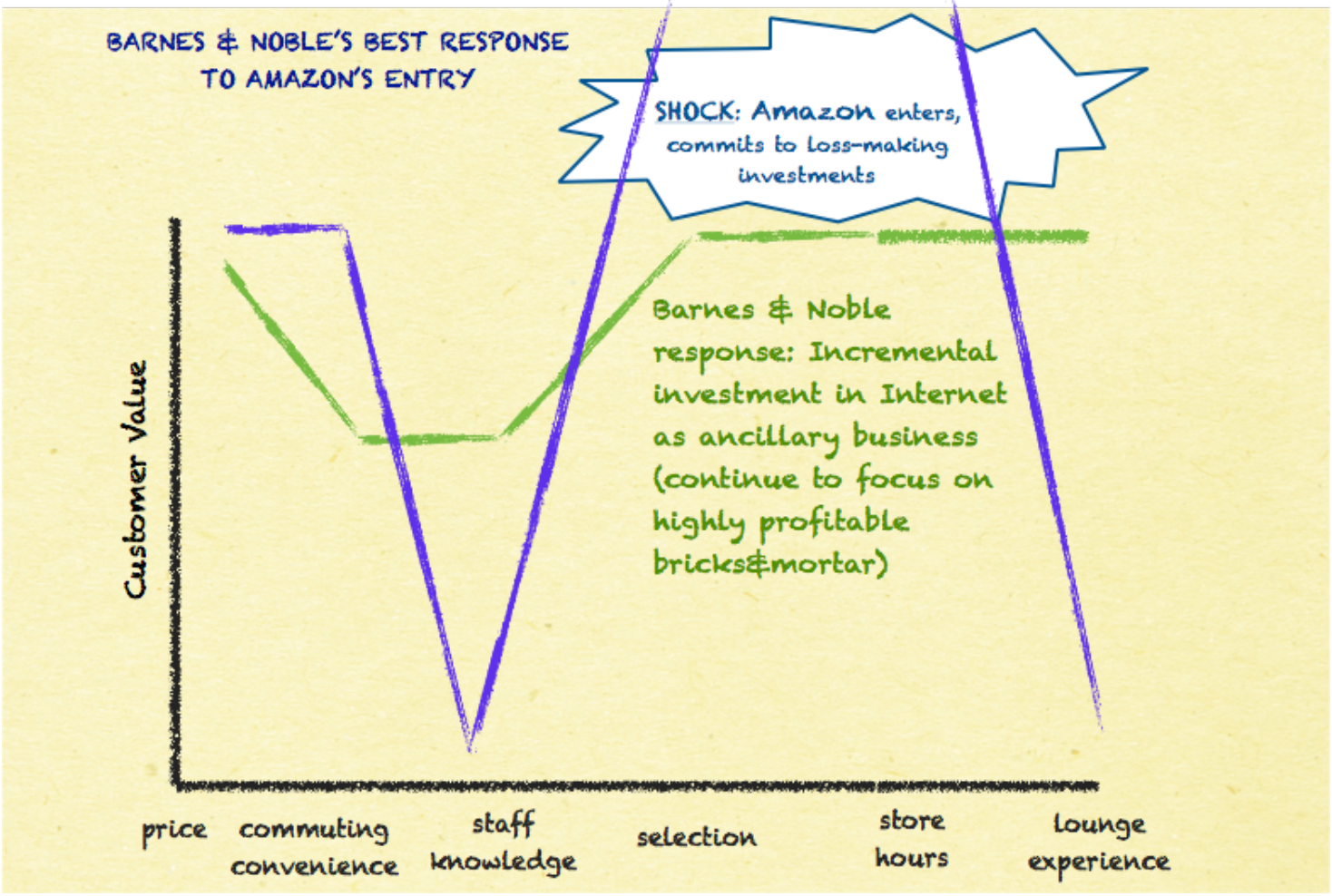
Examples

The evolution and scaling of both Red Bull and Monster is resulting in each pushing the other to refine and drive further into unique flavors in their strategies.



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Once Amazon entered the arena, the profit-maximizing strategy for B&N was certainly NOT to throw out its existing $billion bricks-and-mortar business. Moreover, the financing and governance structure would NOT have allowed a high-growth/risk Internet-scaling strategy.



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11. Predictable Organizational Dynamics, Evolution & Inertia

In principle, we might imagine an instantaneous adjustment by all players under fully informed conditions. Indeed, this is the usual presumption of most economic and game theory models.

However, organizations are notoriously bad at change and adjustment of most kinds. Even so, successful organizations tend to become progressively better at what they are already good at, which we can term accretive change.

For example, market leadership may create higher incentives for the leader to reinforce its position, mainly to stay a step ahead of competition (given that any fixed investments might be spread across more units of volume). Growing efficiency and experience in this direction may lead to added refinement of processes and of the overall business model, with progressively more decisions and practices aligning to the intended strategy over time. This might be associated with growing investments in workers' human capital along the lines of that model as well. The growing success in the position will then allow a greater focus of business activities, management attention, organizational information, and processes on that one successful model and increasingly excelling in that position.

Organizational Inertia Standing in the Way of Best Responses

Therefore, an additional—often critical—refinement to make in gaming out the future and fully seizing opportunity is to anticipate imperfect adjustments and sometimes the failure to change, at all.

By judging and calibrating inertia, you can assess the extent and pace at which other players or your own organization will fail to implement the ideal best response.

In the case of your own organization, you can also judge whether it is economical to attempt to override sources of inertia.

To Anticipate Organizational Inertia, Understand its Sources

Organizational inertia retards adjustment and realignment through several mechanisms, both at the level of individual employees and for the organization as whole.

1. **Inertia in Accumulating the Various Sources Competitive Advantage.** By definition, any basis of competitive advantage may be scarce and difficult to acquire economically. (See earlier discussion on sources of uniqueness and competitive advantage.) For example, acquiring organizational routines or culture may be through a gradual, accretive process. Scale and network effects must be earned through successfully establishing a position. Other than organic accretion, strategic assets and resources or positional advantage in some new areas of adjustment might be purchased via mergers or acquisitions (M&A). See the Section 8 on valuations to assess whether you can acquire capabilities and position for a price that is less than their benefit to you.

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2. **Structural Inertia.** Even in a situation in which the leaders of an organization fully understand the impetus for change and adjustment to reestablish a best response, structural features of an organization may conspire against change.

   For example, incentives may work against change where there are existing vested interests, sunk investments and the prospect of stranded capital, or the possibility of cannibalization of the existing business.

   There might also be challenges of coordinating change, given that deviating from the existing strategy and design to establish a new pattern may mean undoing existing patterns of interacting decisions and practices that might have taken years to finally establish. Making matters worse, common understandings, culture, and routines will have been built around the existing pattern.

   At the level of individual workers, vested interests, sunk human capital investments, career concerns, and political coalitions may be difficult to work past.

3. **Cognitive Inertia.** A third category of inertia relates to either the organization as a whole or its senior management not seeing or understanding an impetus for change.

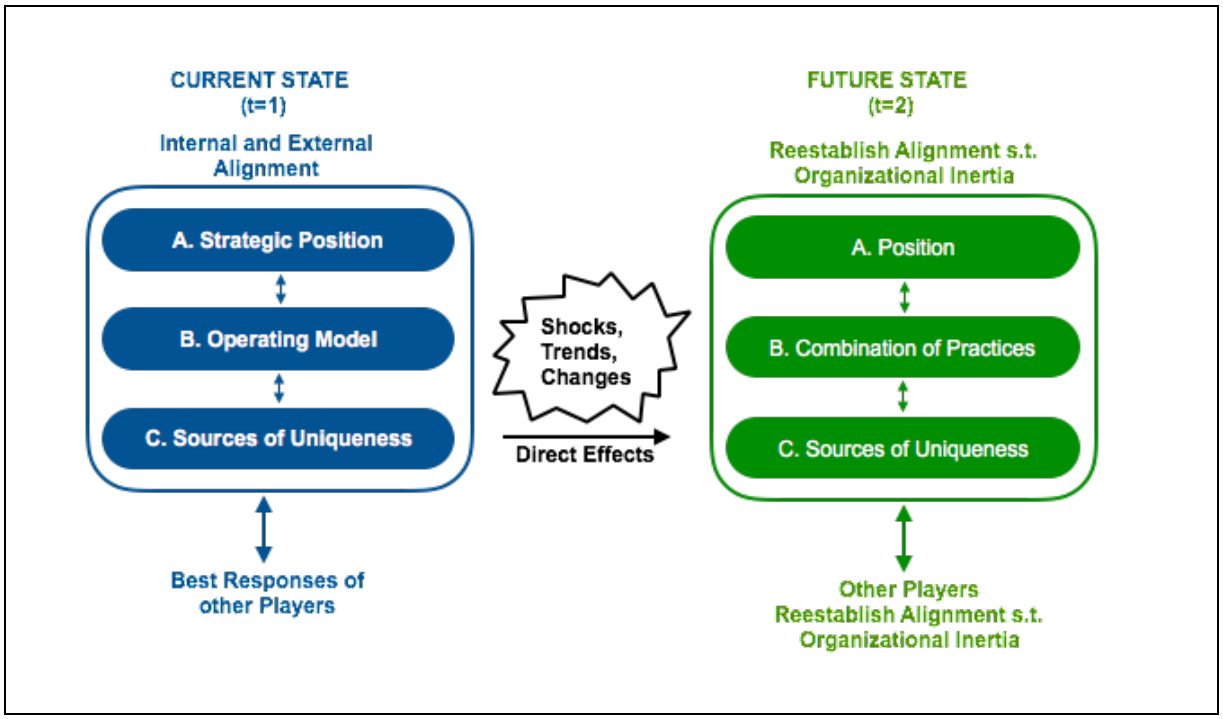
   For example, to the extent an organization becomes increasingly successful in its position, its incentives to scan for novelty and to experiment will progressively decrease. Focusing on existing customers, with existing product architecture and with a deepening and improving operating model, will tend to narrow the range of external information scanning and processing.

   Increasing improvement and configuration of choices and practices in the operating model will also tend to encourage specialization, resulting in the narrowing of information gateways through the organization, further impeding wide-eyed information processing from the environment.

   The combination of deteriorated organization-level information processing and years of success in following a particular set of patterns also can severely impair senior managers' individual abilities to properly construe a changing situation. This might come, for example, from an overly simplistic framing of the strategic situation or brittle and flawed mental models (something these notes are intended to combat) or from over-confidence or other sources of bounded rationality.

Impediments to and lags in adjustment not only affect the time it takes to reach a new competitive equilibrium but can also engender opportunities—for example, affording small suppliers without an established position greater strategic agility and the ability to focus relative to larger, more successful suppliers.

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Anticipate change by cataloguing shocks and trends, assessing their direct effects, and then gaming-out best responses—***and inertia impeding the theoretically best responses***

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Get Started

The question of dynamics can be approached by a series of narrow and specialized topics, particularly regarding innovation. The following approach is disciplined and encompassing and yet general enough to be useful for any dynamic issue being faced.

Steps for getting started:

1. Generate a thorough, rigorous, and complete static/snapshot analysis of the current situation, existing strategy, and company design.
2. Identify the set of shocks, trends, and changes occurring in the environment, clarifying both internal and external changes.
3. Evaluate the pattern of best responses to best responses across players.
4. Revise your projection of the pattern of competitive outcomes, based on your analysis of each player's sources of organizational inertia.

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More Readings on Industry Dynamics

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LONG-RUN DYNAMIC INDUSTRY ANALYSIS

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12. Long-Run Industry Change in how Value is Created and Captured—and Disruptions

How can I anticipate longer-range changes or those at the frontier of technology and innovation? How do I deal with these questions strategically?

Long-Run Change Accumulates from a Series of Short-Run Changes

Of course nothing is static or stays the same over time in any industry. Even in seemingly stable and unchanging industries, change is ongoing. Even where companies seem to follow a standard template, at least gradual incremental change is occurring. Positions and value propositions and operating models are always evolving, typically advancing the value delivered to customers, however slowly. The changing structural features of an industry can also sometimes lead to painfully disruptive changes. Rules of the game, regulatory environment, customer preferences, and any number of other features also predictably change.

Precisely gaming out longer run changes in an industry can be trickier, complex, and more subject to errors, so using a rougher and simpler longer run model of industry evolution can therefore have its advantages.

The long run models referred to in this section are empirical models, that is based on empirical regularities rather than on air-tight economic logic and reasoning. The saving grace of these models is that they have been documented time and again across many industries. They are also logically robust in the sense that a wide range of underlying economic mechanisms can account for the patterns described here. A final saving grace is the modesty of claims: The models described in this section suggest a possible sequence of changes and make no claims on the pace of that change. That is for you to analyze and assess.

Long-Run Tendencies: The Industry Life Cycle

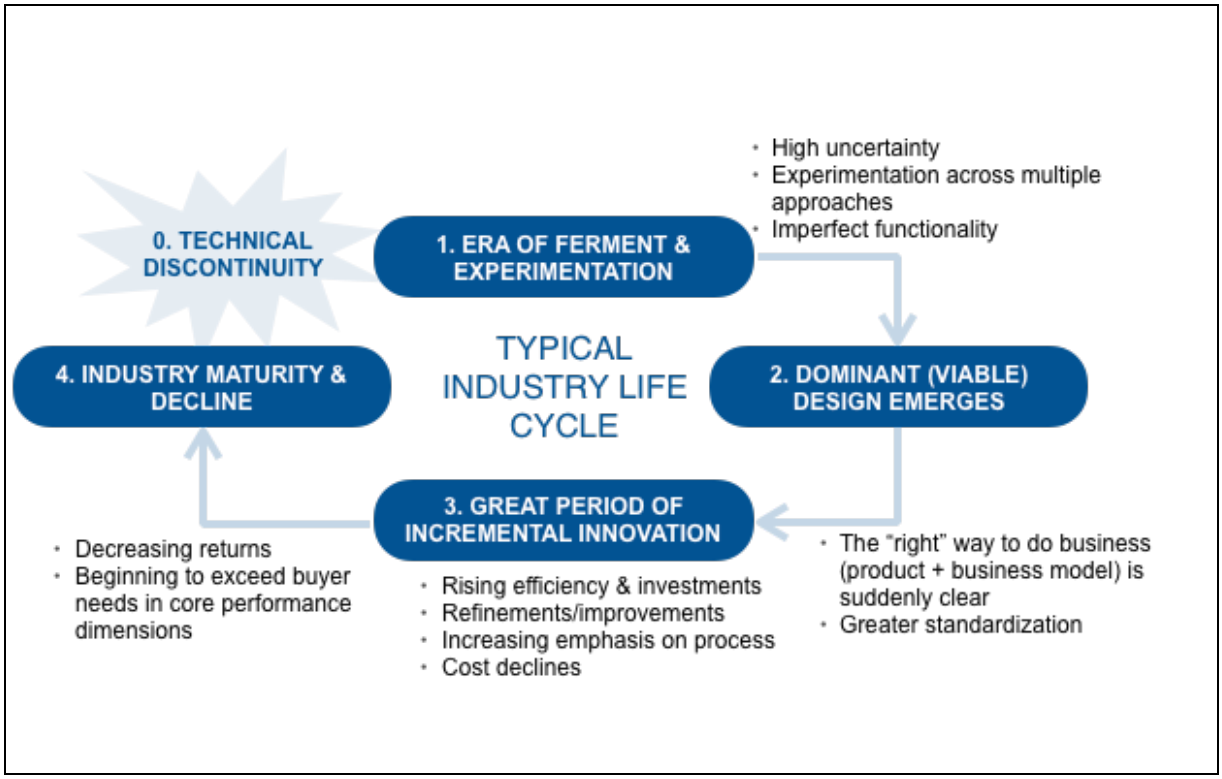
Several bodies of empirical research have established that, in the long run similar broad patterns of change tend to occur: patterns of investment, entry and exit, innovation, prices, uncertainty, rates of adoption, and so on.[11]

The regularity of patterns of change that have been documented across many industries can be useful in providing a rough map of how industries tend to evolve and of the stages they progress through. This provides signposts for the major changes in an industry and how competition is likely to play out over different epochs.

[11] The deeper reason why we might see somewhat regular patterns in economic change may relate to underlying drivers of economic change—foundational technological change. Technological advances tend to proceed somewhat predictably and regularly, such as in episodes of radical creation and advance followed by long periods of predictable incremental technological advance, as several research papers that examine the industrial and technological histories of many industries have described.

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The rough descriptive model of long-run industrial change is often referred to as the **Industry Life Cycle Model**.



(1) Industry Creation/Technological Discontinuity. A new enabling technology unlocks the prospect of serving some previously unmet set of needs, solving a previously unsolved problem. This is the creation of a new, plausible, value proposition (Section 2). It represents a discontinuous advance from preceding possibilities. Often value capture is established at this stage (where value is captured at all) with a combination of secrecy and formal IP rights, as in patents.

(2) Era of Ferment and Experimentation. The plausible new value proposition attracts entry and investments. Uncertainty remains high as to the best-use new enabling technologies to serve demand but not how to configure business models. Precise markets and applications are not yet well understood. Given this situation, competition is less about stealing business and substitution and more about searching for viable solutions. Disproportionate investment in product development and in scanning for ideas are common. Product offers are often imperfect, limited, and costly. Relevant regulatory and institutional frameworks, infrastructure, complementary services, and so forth may yet need to be defined and put into place. Often value capture is established at this stage (where value is captured at all) with a combination of first- or early mover advantage, secrecy and formal IP rights.

(3) Establishment of Dominant (Viable) Design. Amid the process of searching for viable ways of connecting supply with demand (e.g., different possible combinations of technological approaches, customer groups, application areas, business model approaches), at least one competitor might finally hit upon a viable solution . This radically reduces uncertainty and creates incentives to implement the viable dominant design, where this design is the entire model for value

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creation and delivery. (Value capture and source of sustainable competitive advantage are often not necessarily worked out at this stage.) Therefore, the dominant design at this juncture is much broader than just the technology or product. As a dominant design is a market-triggering event, being an early firm directly associated with the dominant design can be an important advantage, at least from the outset..

(4) Incremental Improvement. The period of incremental innovation following the establishment of a dominant design leads to heightened investment. Not only has uncertainty plummeted but also the availability of a viable design triggers demand to expand beyond the earliest adopters into a wider mainstream. Competitors' racing to capture a share of the growing market can also incite investment and innovation. While there is now more incentive to invest in rising efficiency and refinements, much early investment and innovation remains focused on product and business model improvement; the initial viable dominant design is by no means necessarily yet optimized—it is merely a working approach. These conditions generally lead to a rapid advance of technological performance and the ascent and improvement of the value proposition that can be delivered. As some firms become more successful than others, this period of incremental improvement is often accompanied by shakeout. It may take years, be characterized by rapid and relatively low-risk innovative advances and by rising market power for those who succeed—an exciting time of great change. This period might also come with advances and reconfigurations of business models that release additional value. Typically, organizational capabilities and routinized efficiency in processes or repeated product generation can become important sources of value capture in this period. (These sources of uniqueness, along with scale and other advantages can become formidable `barriers to entry' in the language of early strategy textbooks.)

(5) Industry Maturity and Decline. Predictably, the ongoing ascent of technical performance that any model delivers is likely to eventually encounter diminishing returns. This may happen because technical advances encounter diminishing returns, where increasing investments make progressively less progress in improving the position and value proposition to customers, because of technical diminishing returns or the needs of customers becoming satisfied. Or diminishing returns might occur because incentives may shift toward taking costs out of the business with process improvements and greater process routinization. The market might also shrink as price declines can finally outweigh volume growth. Efficiency and execution in organizational processes and unique production assets will often be especially important.

(6) Technological Discontinuity—and Perhaps Substitution or Disruption: The cycle may start anew at any time with the arrival of a discontinuous innovation that again upturns the conventional technology of production and dominant design and business model. However, this may be more likely to occur in a period of maturity, when the industry is no longer a moving target and where incumbents may have progressively lower incentives to innovate the product, greater inertia, and less flexibility. The existing value proposition might have already moved well past the needs of most customers. Under such conditions, it may be possible to offer a viable alternative that is simply good enough in core dimensions of value. This may then encourage the entrance of more substitutes into the industry, and perhaps the substitutes will usurp incumbents—a disruption and redefinition of the industry that will start the cycle anew. A combination of unique and relevant productive assets to build on, along with strategic agility can give a firm better changes of succeeding in this stage, as noted in discussion of following sections.

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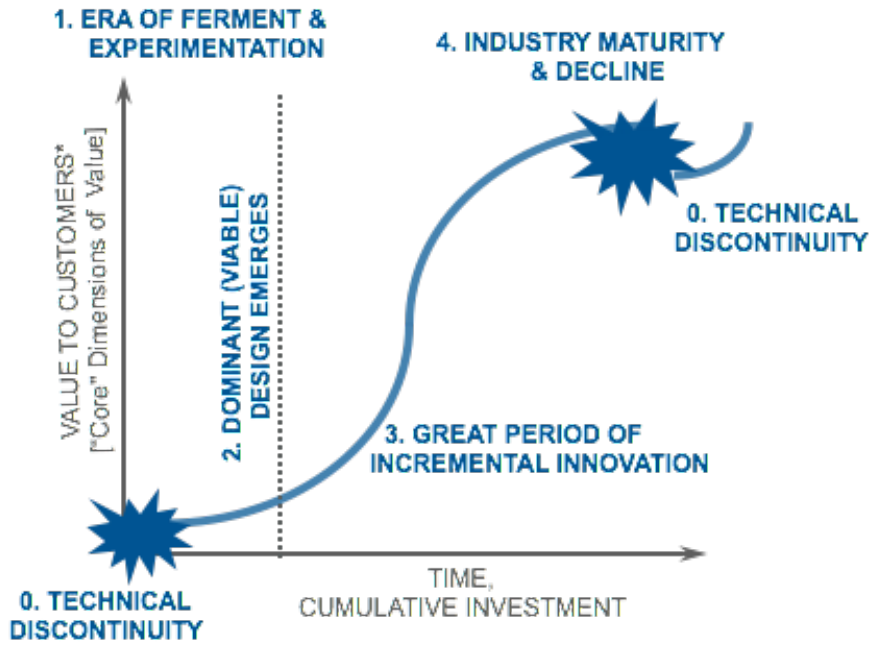
Step A: Map your Industry Life Cycle to Better Contextualize Industry Dynamics

To begin to understand industry dynamics and issues that might be faced and to better contextualize the environment in which you now operate, it is useful to understand where you sit in the Industry Life Cycle.

It is especially helpful to ground your analysis in terms of the evolving state of technology—and advancing value proposition that is possible—in your industry. In terms of the value proposition curves drawn in Section 2, you can think of these as getting progressively higher as you better serve customers over time and as the basic enabling technologies and supporting business models improve over time. The ascent of these curves should accelerate particularly after the establishment of a viable commercial approach or dominant design, whereas the ascent of value propositions should slow as the industry matures.

The particular shape of the curve—the rate at which innovation occurs and the technology of production advances—will depend on the industry. But the dynamics of the industry life cycle broadly predict a rate that will initially accelerate and then decelerate—an S-curve. While it is helpful to draw a single curve to represent the advance of the offer, in reality (as we know from Section 2), this is a simplification. The multiple dimensions of a value proposition are collapsed to a single curve to more easily depict the patterns of advance through the life cycle.

The industry life cycle, expressed as advancing/improving value proposition over time



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Step B: Revert to Tools from Earlier Sections for More Precise Analysis

Nothing beats detailed analysis based on careful analysis of internal, external, and precisely gamed-out dynamic alignment. These signposts add further context and emphasis on issues that arise at this later stage of the life cycle and the nature of competition and dynamics you are now facing. You will have a better idea of what is around the corner and of how industry dynamics may change from ways you have gotten used to.

For example, competition in the early period of ferment is of a very particular kind, and a large number of experimenting firms are likely to persist (with little profit) for some time. Failing to anticipate that this situation could rapidly change, or not having in place a view of what moves to play once a dominant design is established or how to survive a shakeout, would be a clear oversight. The task here is simply to take the broad signposts of industry change to further inform, deepen and better align your current strategy.

Therefore, it is often useful to carry out a rough characterization of broad-based industry dynamics before proceeding to a more refined and precise analysis and gaming out of dynamics in positions, models, and sources of competitive advantages and industry dynamics such as were described in the earlier section.

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13. Managing Technological Discontinuities—Sometimes Disruptions, Sometimes Not

Which substitutes and new technologies on the horizon should I worry about? Are there any pat solutions to dealing with technological discontinuities? What are my options—and how can I carefully choose?

Incumbent suppliers can readily absorb many technological and organizational innovations that emerge in an industry, and these advances propel the existing S-curve and value propositions upward.

Technological discontinuities are distinct changes in enabling technology that represent a fundamental departure from past approaches and do not fit with the existing model and therefore cannot be incorporated without significant cost (e.g., Skype-style VoIP and high-price telecom network access). Thus, the technological discontinuity presents an alternative way to carry out the work in an industry—and therefore represents a substitute. The question is what impact this new substitute will have on the industry—whether it will represent a new opportunity (for some) or threat (to others).

Of course a discontinuity in technology is not automatically disruptive, undermining the position of incumbents. Most technological experiments are not consequential at all and turn out to be commercially insignificant.

Most Technological Discontinuities Are "Attacks from Below"

Most new technologies represent "attacks from below." These technologies are, by definition, unrefined, lacking accompanying business models, and caught up in a period of ferment and experimentation.

Therefore, it would be surprising in most cases if a new technology, for its first few years of existence, would not be inferior to an existing refined solution in at least one dimension of the traditional value proposition.[12]

This is why most technological discontinuities, when drawn in terms of an S-curve, will most often appear as an attack from below, where the new S-curve is depicted as beginning some distance below the existing S-curve and is inferior in at least one of the traditional dimensions of value of the existing technology and existing customer scope.

[12] For example, while Skype is extremely cheap and conveniently integrated on the PC as a "phone" service—and even offers conference calling and sharing screens—it is in many cases less reliable and has lower-fidelity sound reproduction than does a traditional fiber optic wire telephone connection.

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In the rare cases of an "attack from above," the new technology S-curve is superior to the old in all dimensions of the value curve. This means game over for the old S-curve.[13]

Distinguish Reinforcing Innovations from Technological Discontinuities

Most technological change can be spotted in the pages of public journals and company labs from years away. They are no secret. The challenge is to systematically comb the frontier for goings on and to identify technologies and assess their types.

Are they **reinforcing technologies** that only serve to affirm the existing model and S-curve (i.e., the current technological trajectory)? How can they be incorporated in the model? How do they mesh with existing position or operating model or sources of competitive advantage? How can they be incorporated in a best possible way? How to best manage uncertainty?

Do they instead represent **technological discontinuities**? Here you can simply revert to the existing playbooks in analyzing substitutors, as traditionally studied by Porter (or more recently by Christensen). As outlined in Section 3, the first and most basic question is how functionally proximate the substitutors will be. For example, is the S-curve (or value proposition) likely to come into close proximity to the existing offer? Especially important here is to game out the precise future dynamics that need to be aligned externally.

For example, if a new technological discontinuity is not incorporated into the existing S-curve and it manages to find a viable model (a dominant design), it is likely to attract considerable investment and will advance and improve. As it advances and improves, it will likely improve in any number of dimensions of its value proposition—including some of the dimensions that were important to the old technology S-curve. Further, where added to this substitutors have a strategic intent to pursue the business of an existing S-curve, the intensity and proximity of substitution will only become more intensive.

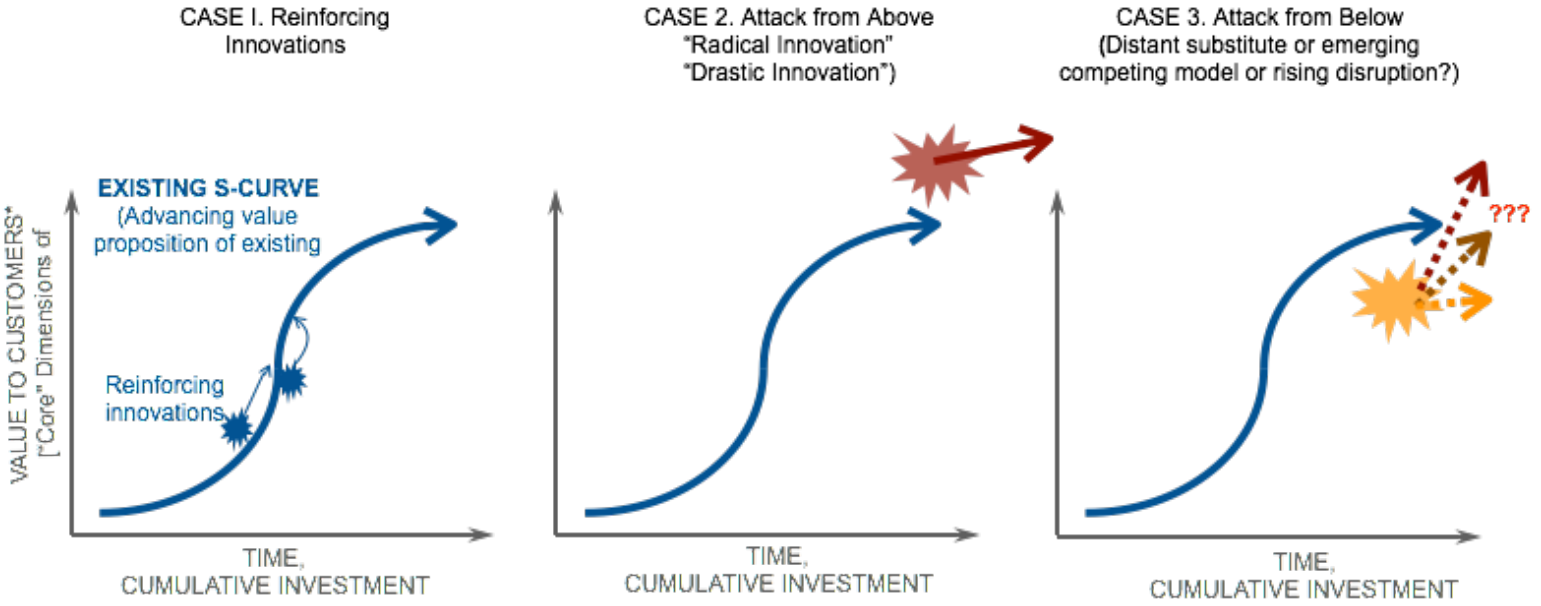
Therefore, the technological discontinuity, which might become a substitution and possibly grow to be an intensive disruption of the existing business, closely follows the earlier analysis steps.

By the same token, new entrants attempting to disrupt incumbent players or industries (S-curves and value proposition curves) need to game-out future encounters with incumbents to anticipate which technologies are worth pursuing in the first place.

[13] Even when technological discontinuities are clearly superior, profit opportunities might remain in the period before the existing business eventually dies. For example, many business software systems based on COBOL language continue to operate and require some degree of servicing, even twenty years after superior technologies have superseded these systems.

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New technological discontinuities can be attacks from above or from below the S-curve



e.g., big data and machine learning in the insurance industry

Reinforcing innovations, whether enhancing willingness to pay or reducing costs, can be incorporated into the existing model in a complementary fashion, without challenging the internal logic of the business.

e.g., A.I. and computational imaging analysis in relation to traditional radiology

Where, in rare occasions, new technologies are created that are simply better in all core dimensions, even in relation to past models and approaches, the new approach will eventually lead incumbent approaches and technologies to exit.

e.g., Internet messaging relative to telecoms networks

New technologies are born all the time that might have the potential to serve as a substitute, and which cannot be incorporated into the existing model in a complementary way. It remains a question whether a new approach will become a close or more distant substitute, or whether it will come to disrupt the business—eventually providing a superior value proposition.

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Strategizing Across an Existing Business and a New Way of Doing Business

The appearance of a new discontinuous technology does not necessarily imply competitive substitution (disruption) without recourse. From an incumbent's perspective it might even be an opportunity to exploit a new technological paradigm and trajectory for a new era of growth.

At the highest level, the incumbent faces three categorical choices:

1. **Defend Existing Business**: Stick to the existing business (S-curve) and anticipate that the new business might become a substitute or competing model (e.g., U.S.-based taxi cab intermediaries have watched while Uber offers a new app-based dispatching platform and fundamentally distinct combination of practices and technologies to undermine and expand the taxi business)[14]
2. **Jump to New Business:** Move the new business (S-curve) and compete on a new basis; renovate the company design (e.g., IBM sheds hardware business and moves to the cloud and related services).
3. **Ambidexterity:** Balance resources across both old and new businesses (S-curves) (e.g., IBM launches IBM PC as a separate unit apart from its mainframe business; London cabbies effectively collaborate with Hailo, offering an app-based dispatching platform that counters Uber).

There are no easy solutions to this problem. Each approach is rife with paradoxes and an unavoidable set of certain costs and risks amid possible advantages. In association, there are no simple ready-made answers. You will need to game-out and run the numbers of each scenario to best estimate the most value-creating strategy. This means completing an internal, external, and dynamic analysis of each scenario. Some of the various tradeoffs that can be expected in any of these approaches are shown below.

[14] Popular disruption theory might be read to suggest that any time that an existing business sticks to its existing model or S-curve that this is a case of disruption. However, if indeed the new model and S-curve do in fact become substitutes with the existing business at some point, it is not necessarily the case that countering the new model or jumping onto the new curve is necessarily profit maximizing.

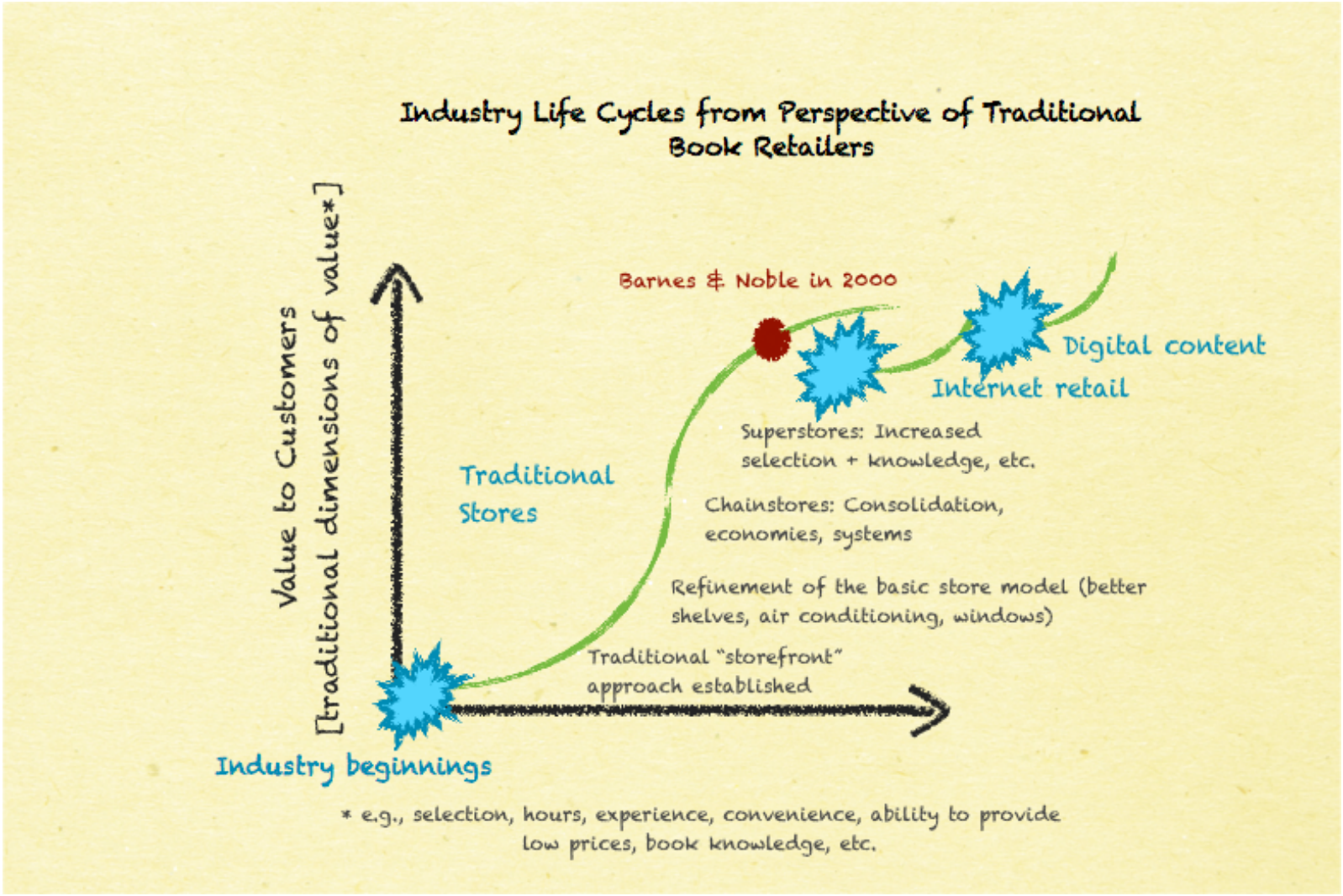
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	FOCUS ON EXISTING MODEL (S-CURVE)	**AMBIDEXTERITY MODEL** (BOTH NEW AND OLD S-CURVES)	**FOCUS ON NEW MODEL** (S-CURVE)
STRATEGIC BENEFITS	• Focus on immediate profit-maximization • Exploiting existing assets • Economies of focus • Avoid self-cannibalization of existing business • Redouble efforts to accelerate ascent of existing S-curve	• Hedge bets, income "smoothing" Buy real option to enter into new S-curve • More learning about new approach • Possible economies of scope and asset reuse across approaches • Economies of scope between existing and new businesses	• Directly face oncoming competition • Economies of focus • Exploit (some) existing assets • Possibly avoid "standing on sinking ship"
STRATEGIC COSTS	• Substitutors may compete unabated on new S-curve • Forego long-run business opportunity on new S-curve	• Divided focus, attention and resources • Possible diseconomies of scope • Cannibalization • Often requires separating new and old businesses into separate organizations	• Strand many existing assets • Strand usefulness of existing operating model • Face a more "level playing field" and lose some advantage of incumbency • Inherent uncertainty and risk in period of experimentation

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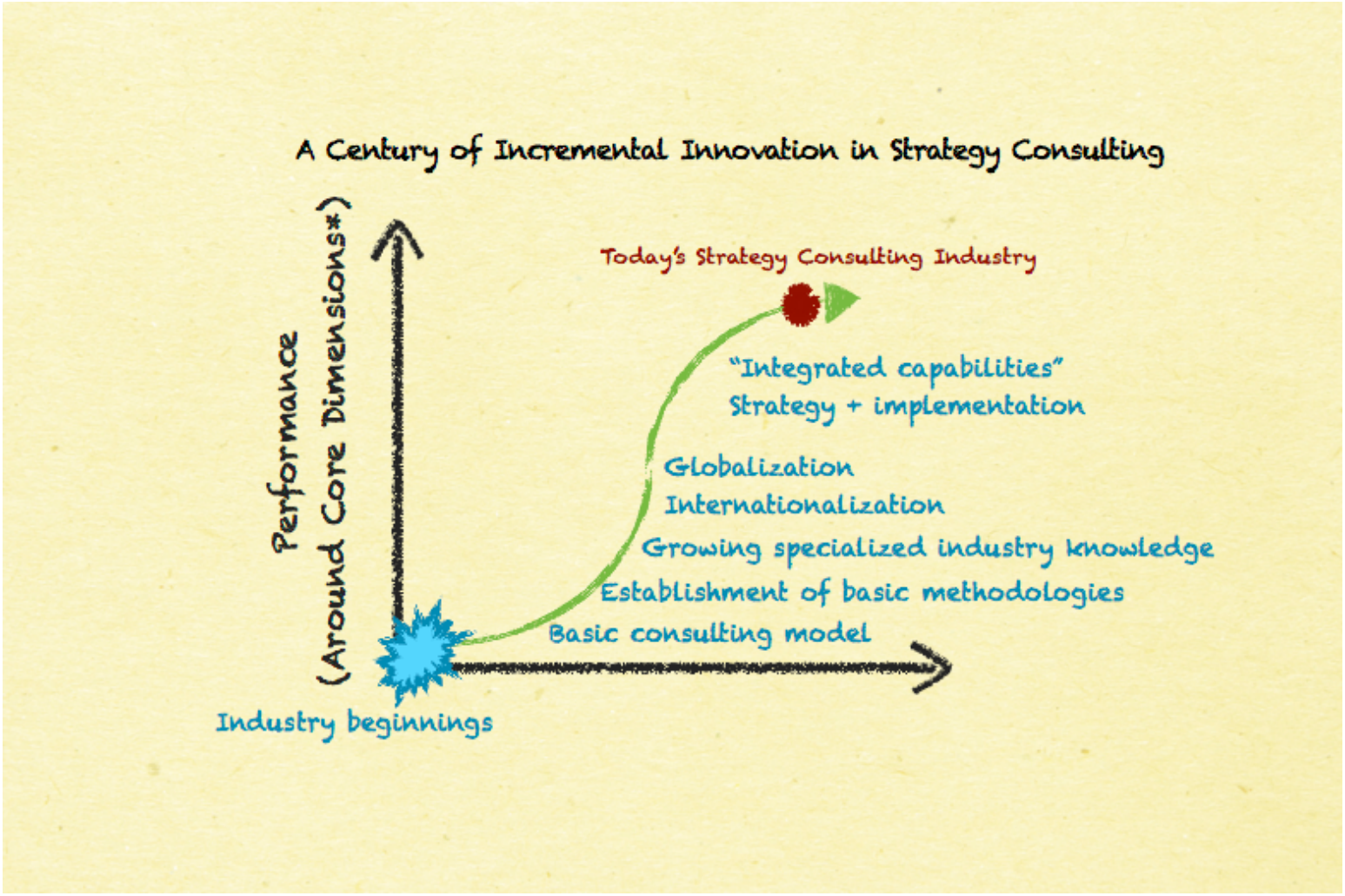
Examples

The coming sequence of changes in book retailing were foreseeable by 2000.



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Will today's trends of big data, empirical management methods, and new models such as platforms and digital business add to or substitute for the long-mature strategy consulting models?



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Translation to Practice, Popular Books, & Articles

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RUNNING THE NUMBERS

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14. Linking Strategy to Financials

Are You Making at Least Regular Returns? How Does This Reconcile with Your Thesis of the Business?

It is always a good idea to validate—with the usual *pro forma* numbers—the conclusions and suppositions of your analysis.

First, any claim of an opportunity to create and capture value and derive profits should be clearly borne out in historical financial or be clearly related to forecasts.

Second, it is important to simply ask whether a venture is worth it. Is the company profitable not just in the sense of returning above zero accounting profits but in meeting as well the hurdle of returning economic profits that exceed opportunity costs? Might it make more sense for a company earning at least regular returns to devote that capital to a mutual fund (on a risk- adjusted basis)? Most profoundly, are you creating or destroying value in the economy? Would that capital be better employed elsewhere?

Economic profitability assumes the profit stream exceeds the total opportunity costs paid to acquire the company. Thus:

Economic Profits = Profits – Opportunity Costs of Capital Employed

This is a considerably higher hurdle than achieving a simple (positive) accounting profit.

The circumstances and data available in your situation may inform how best to approximate your economic profitability. Here are some starting points for making a rough estimate of economic profits based on standard reported accounting data.

Using standard accounting profit data, the flow of profits over a particular period (e.g., one year) can be approximated as ***operating income***. Operating income is earnings, that is, revenue less the primary fixed and variable costs incurred to deliver it. Subtracting depreciation and amortization (D&A) as well from earnings enables operating income to take the cost of capital into consideration.

Operating income here does not include taxes or interest, as taxes arguably take us steps away from understanding the underlying health of the business from a purely economic standpoint.

The opportunity costs of capital are related to, but different from, the typically reported accounting estimate of interest and other financing charges. The total opportunity cost entailed in operating a company is an amount reflecting what could have been done with all existing assets had the assets been redeployed to next best alternative uses. The financing charges that appear in standard

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reporting simply cover explicit charges when the accumulation of assets has been financed by some external party.

To get closer to a rough approximation of at least the order of magnitude of the total opportunity cost for all capital employed in your business, you need to consider all assets and capital employed. On an annualized basis, the cost of this total capital employed can be approximated by ***total capital employed or assets, multiplied by the average cost of that capital.***

Basing your calculation on all assets and capital the firm employs, not just those outside investors finance, is necessarily an accounting approximation. However, it at least gets you closer to the relevant economic question when trying to reconcile financials with your strategic analysis: Is the company design yielding something above regular returns?

You can then estimate the cost of maintaining capital and assets in their current use on an annualized basis can by multiplying by the company's weighted average cost of capital (WACC). This should, in principle, reflect the baseline rate of using capital and any appropriate risk adjustments to reflect the company's risk and economics.[15]

[15] The alternative to attempting to more directly approximate whether income from the business exceeds total costs of capital and the company makes economic profits is to proceed with a series of indirect ratios and comparables. For example, financial ratios can measure whether a company is doing as well as its peers with indirect measures (e.g., P/E. ratios), whether certain measures of profits are positive or high (e.g., EBITDA) without a clear hurdle, or hurdles that are internally set (e.g., project level decisions based on IRR above some threshold, imposed by internal managers rather than the market assessed risk-adjusted rate).

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DISNEY'S DIP. Restored movie-making and better management restored Disney's performance by the mid-1980s. Movie-making fell apart again by the late 1990s. The acquisition of ABC networks at the time kept the appearance of growth and performance up by many measures but not any estimates of economic profitability. The company began destroying billions of dollars of enterprise value.

$MM's	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996 a	1997	1998	1999	2000
Total Assets	3,121	3,806	5,109	6,657	8,022	9,429	10,862	11,751	12,826	14,606	36,626	37,776	41,378	43,679	45,017
Net Income, before corporate SG&A															
Theme parks and resorts	404	549	565	785	889	547	644	747	684	861	990	1,136	1,288	1,479	1,620
Studio Entertainment (film)	52	131	186	257	313	318	508	622	856	1,074	895	1,079	749	154	110
Consumer Products	72	97	134	187	223	230	283	355	426	511	577	893	810	600	455
Media Networks	0	0	0	0	0	0	0	0	0	0	871	1,699	1,757	1,580	2,298
Internet & Direct Marketing	0	0	0	0	0	0	0	0	0	0	0	-56	-94	-93	-402
Corporate Selling, General, & Admin.	66	70	96	120	139	161	148	164	162	184	309	367	282	244	350
Operating Income	462	707	789	1,109	1,286	934	1,287	1,560	1,804	2,262	3,024	4,384	4,228	3,476	4,133
Est./Assumed WACC	13%														
Est. Total Opportunity Cost of Capital	406	495	664	865	1,043	1,226	1,412	1,528	1,667	1,899	4,761	4,911	5,379	5,678	5,852
Est. Profits - Opportunity Costs	56	212	125	244	243	(292)	(125)	32	137	363	(1,737)	(527)	(1,151)	(2,202)	(1,719)
Other Performance Measures															
Net Income, incl. tax	247	445	522	703	824	637	817	300	1,110	1,380	1,214	1,966	1,850	1,300	920
Operating Margin (%)	21%	25%	23%	24%	22%	16%	17%	18%	18%	19%	16%	18%	16%	13%	13%
ROA (%)	8%	12%	10%	11%	10%	7%	8%	2%	9%	9%	3%	5%	4%	3%	2%
ROE (%)c	17%	24%	25%	26%	25%	17%	19%	6%	21%	23%	11%	12%	10%	6%	4%
Total Debt/Assets	18%	15%	9%	13%	20%	23%	20%	20%	23%	20%	34%	29%	30%	27%	22%
Stock Performance															
Index Disney Stock	394	471	563	1,165	906	960	1,447	1,460	1,545	2,195	2,647	3,499	3,387	3,011	3,226
Index S&P 500	231	215	252	325	300	353	399	428	416	562	701	903	1,089	1,295	1,218

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15. Valuation: What is the Sale Price of Your Company?

How is the financial valuation different from the actual price you can get from a strategic investor? How does this relate to your strategy and company's design?

Three Sets of Factors That Can Be Influenced Strategically Determine The Price of Your Company

Up until this point our discussion has been about strategy and company design, that is, the determinants of a company's enterprise value, or economic value. This is the usual notion of company value—the sum of discounted future cash flows.

This section examines how these points relate to valuations and acquisition prices in mergers and acquisitions (M&A) and the basic economic factors determining how the price of your company is set and what you can do to influence this.

The key starting point is to understand that the price you are offered is not the true valuation in any deep economic sense. By definition the transaction can happen at a band, or range, of prices, if it can happen at all. This band occurs below the maximum price the acquirer is willing to pay and above the minimum price at which you are willing to sell.[16] A bargaining process then determines the eventual price.

Step A: Estimate the Price Floor: Stand-alone Enterprise Value

The discussion in these notes up to this section have effectively focused on how to maximize the enterprise value of your company, as a stand-alone enterprise. All actions you can take to sharpen strategic alignment of your company will serve to increase this value from what it would be otherwise.

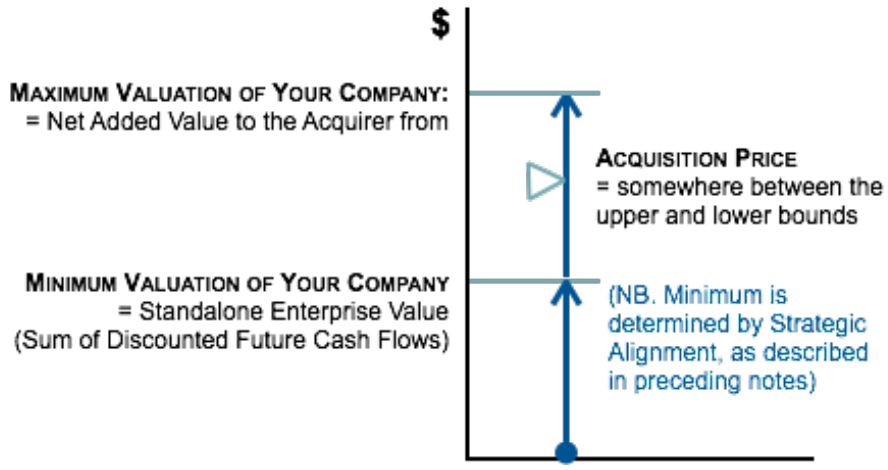
By definition, any acquisition should be priced at some value higher than the stand-alone enterprise value. In principle, you should be indifferent between selling and continuing to operate at a price that is merely equal to the sum of future discounted cash flows.[17] Therefore, the bare minimum possible acquisition price is the equivalent of the current enterprise value. (Exceptions can exist if the owner of the business has some idiosyncratic reason for wanting to get out of the business.)

[16] Asset prices only collapse to a single price (from a band) in cases where there is competitive bidding on at least one side of the market (i.e., when there are large numbers of identical bidders, large numbers of sellers of comparable assets, or both).

[17] Valuation will be the same as enterprise discounted cash flow (DCF) value, in principal, in the case of nonstrategic investors, such as investors on public equity markets (where there are no expectations of strategic investors who might influence the price).

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The economics determining the price and valuation of your company



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Step B: Estimate the Price Ceiling: Total Net Benefit for the Acquirer

If the minimum viable offer must be higher than the stand-alone enterprise value, where must this extra willingness to pay by the acquirer come from? And what is the maximum value the acquirer will be willing to pay?

The maximum price an acquirer will be willing to pay for your company is simply the net benefit to be gained by making the purchase, that is, the difference between the acquirer's value with and without acquiring your company:

$$Price\ Valuation = \Delta Value = Value_{acquirer}\ (buying\ your\ company) - Value_{acquirer}\ (not\ buying)$$

All else being equal, the net benefit of acquiring your company should at the very least be the **stand-alone value of your company**. Therefore, so long as there are no diseconomies or value destruction from changing ownership, then at least this basic level of value is achieved. (If there is some degree of value destruction and acquisition risk, then the economics of the acquisition must be made up in other sources of value.) .

It is also possible that the acquisition might add positive **synergies**, boosting your company's enterprise value and therefore boosting the maximum price that the acquirer should be willing to pay. For example, if your company were to gain access to complementary proprietary technologies, distribution channels and capabilities, and customer relationships, this might enhance the strategic alignment of your company, yielding more value.

All sources of synergies can be understood through the lens of earlier discussed dimensions of strategic alignment. Where the acquisition creates synergies, it must take the form of some

combination of: internal alignment (improved position, improved operating model, improved sources of competitive advantage) or external alignment (reduced competitive intensity, increased bargaining power, reduced dependence), and certainly improved alignment over time.

Sometimes the greatest leverage in price overall will come not from the economics and strategy of your own business but through how the strategy of your company interacts with the value of the acquirer. This can result in especially substantial leverage if the acquiring company is very large and your company is relatively small.

Again, the boost in value—synergies—to the acquirer might be understood through the lens of internal, external, and dynamic alignment and the impact of the acquisition on these things for the acquirer.

Whereas your company's baseline value plus synergies influence the maximum price, for the acquirer, who already owns the baseline enterprise, only the synergies come into play.

Another difference is that the net value from acquiring or not acquiring your company should include not just the possible upside synergies from making the acquisition but also the avoidance of downside from failing to make the acquisition. Downsides could be that your company remains a competitor in the market or perhaps falls into the hands of a rival, or in the situation where the failure to acquire the capabilities available through your company would lead the acquirer to fall out of dynamic alignment with trends in the industry.

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Which price will be chosen between the floor (minimum) and ceiling (maximum) price? Power in negotiations is a complex topic. However, a most basic economic determinant of **bargaining power** that can further shape the range of negotiations depends on what options the parties on either side of the negotiation have. Therefore, for example, both sides of the negotiation might prefer to build a market of multiple targets or, alternatively, acquirers at the time of sale. However, there might also be a considerable level of dependence between the companies (who will later work together). Therefore, this balance of bargaining power and dependence becomes relevant once again, just as in the analysis of relationships with buyers and sellers in the analysis of the external environment. Getting deeper than these basic economic determinants requires a more nuanced discussion that goes beyond the scope of these notes.

How to Influence Your Company's Price with Strategy

Strategy can influence the price your company fetches through any of three ways:

- The minimum floor price (stand-alone enterprise value)
- The maximum ceiling price (total net value creation for the acquirer)
- The split of value between floor and ceiling (as determined by the bargaining process)

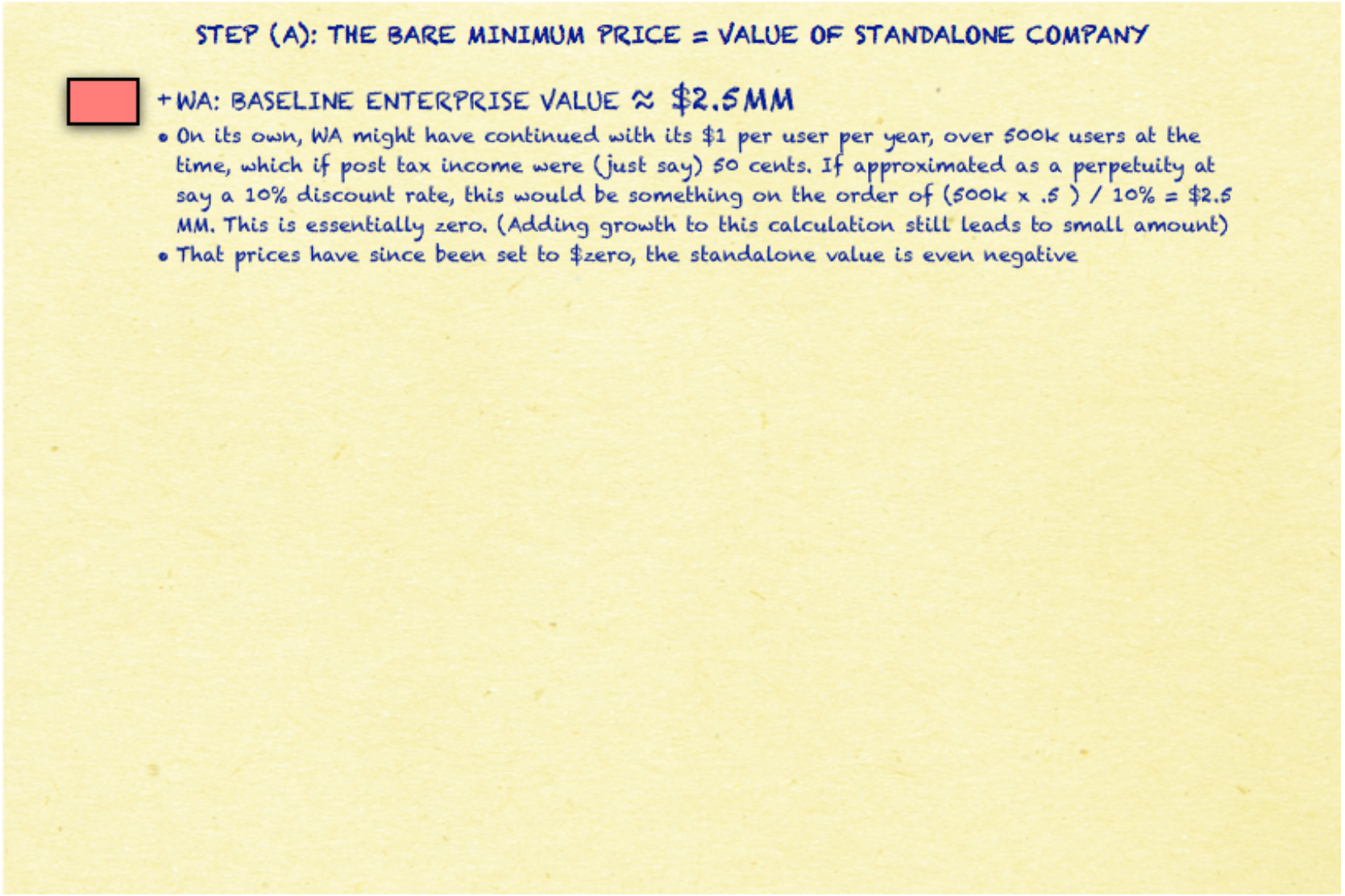
Shaping the minimum floor price involves focusing on maximizing enterprise value, as it is achieved by enhancing strategic alignment (internal, external, and dynamic alignment), as elaborated upon in the preceding Notes.

Shaping the maximum ceiling price involves deeply understanding the strategy and economics not just of your own company but also of those of your prospective acquirer—and then anticipating how your strategy and conduct in the marketplace might influence synergies, upside and downside, for all players in a merger. Enhancing this driver of valuation could, for example, lead you to compete more closely with a potential acquirer, or potentially to focus on areas that are complementary with potential acquirers than might otherwise be optimal.

Shaping the bargaining process around the sale of your company is perhaps one of the most nuanced and perhaps crucially determinant aspects of price setting and goes beyond the scope of these notes.

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A Look of the Whatsapp Acquisition, from the Time of the Acquisition



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STEP B: THE VERY MAXIMUM POSSIBLE PRICE OF WHATSAPP = GREATEST NET BENEFIT TO FACEBOOK

+WA: BASELINE ENTERPRISE VALUE ≈ $0

- On its own, WA might have continued with its $1 per user per year, over 500k users at the time, which if post tax income were (just say) 50 cents. If approximated as a perpetuity at say a 10% discount rate, this would be something on the order of (500k x .5) / 10% = $2.5 MM. This is essentially zero. (Adding growth to this calculation still leads to small amount)
- That prices have since been set to $zero, the standalone value is even negative

+WA: SYNERGIES BUILT FROM ACQUISITION ≈ $0

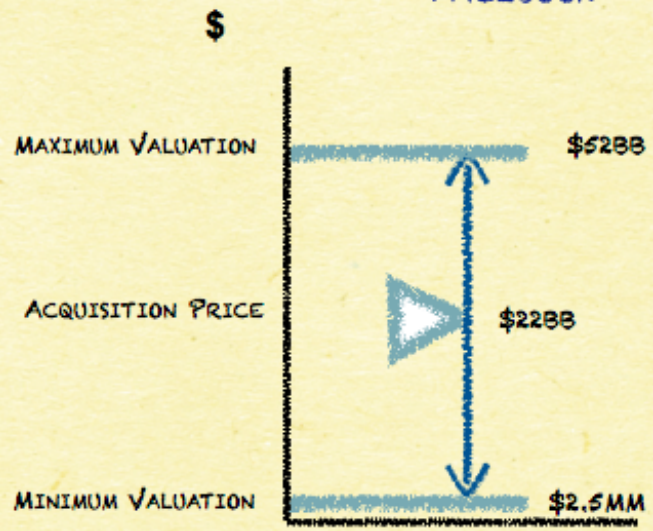
- Internal Synergies: Adhering to privacy, no advertising policies, maintaining independent operations eliminates many channels for synergies; the engineering team is highly productive without additional capital; loss of some independence to FB might be destructive; FB might either raise or hinder adoption (either way, price is now zero)
- External Synergies: Common ownership: soften competition between WA and FB Messenger? WA growth was not hindered previously by messenger and the conflict remains with two messaging apps under FB

+UPSIDE (SYNERGIES) AND DOWNSIDE (LOSS AVOIDANCE) FOR FACEBOOK ≈ $52BB

- Internal Synergies/Upside: "Front end" integration would violate independence of WA, but the company may be tempted to do back-end integration to exploit WA data to improve FB advertising; ex: improving advertising by 1% x $200BB FB valuation = $2BB
- External Synergies/Upside: If integration can somehow reduce users leaving the FB platform to message, could fortify FB – in conflict with commitment to WA independence
- Loss/Downside Avoidance: FB losing in developing markets, on mobile, in younger demographics; risk of WA being acquired by Google or Microsoft
  ex: potential loss of 25% x $200BB FB valuation = $50BB (or smaller, with risk adjustments)

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STEP C: FORCES AND INTERACTIONS SHAPING FINAL PRICE OF WHATSAPP TO FACEBOOK



+FACTORS SHAPING FINAL PRICE NEGOTIATION/BARGAINING

- Bargaining Power:
  - Presence of a outside offers
  - Commitment of WA team to the "mission" and willingness to walk away without clear assurances
- Dependence:
  - FB requires the WA team to stay intact and productive
  - FB requires the ethos of WA that made it popular (privacy, simplicity, etc.) to credibly stay intact—and therefore requires team to remain powerful and independent
  - Personal relationship among principle negotiators

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CONCLUSION

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16. Strategizing & Designing your Enterprise Effectively

Beyond Just Good Management

Imagine if each of the heads of the various business functions in your company—from marketing to finance to product development and operations—were to separately and independently optimize the management of their respective departments within the company to the best of their abilities. Unfortunately, this effort and good planning will not, on its own, amount to a larger set of coherent choices and practices.

Innovation, business planning and your company design requires contouring decisions across business functions and across the wider company and assuring these cohere. Once you have a sense of the ideal pattern of choices and practices that make up your company's design, you can judge how the current implementation of your company can be improved and be made more profitable.

Whatever approach you choose in making the big decisions in your organization, there are standards you should hold yourself to:

- **Deal with choices across your entire company.** There are tens of thousands of decisions taken in your company every day. An equally large web of practices and procedures defines how your organization works. Which of these decisions and practices are most important? How do they relate to one another? What pattern of choices—what company design—is best? It is only through your thorough analysis that you can decisively say which among the many possibilities are the key driving decisions in your case. Be careful not to assume the answer before you start.
- **Make sense of everything and quickly cut through to the most important issues.** How is it possible to know and appreciate the fine details, from production technologies to HR policies to financing structure, of all internal matters? How is it possible to simultaneously be expert in changing customer preferences, arcane regulatory issues, conditions of local labor markets, and other external matters? It's not possible. It is only with a structured and comprehensive approach that you can frame the issues, simplifying the problem so you can feasibly then solve it. Be careful not to proceed with blind spots or with the false confidence that you already know and see all relevant issues.
- **Base your thinking in enduring economic principles to ensure you can tackle any novel situation.** If it were possible for you to adopt the same formulas and best practices of the best of your competitors, you would each lose uniqueness, and profits might well be competed down to zero. Competing effectively most often means not trying to do things just better but to clearly choose what you will do differently, how you will innovate and deviate from current templates.
- **After properly thinking through and framing the problem, seek evidence, and run**

the numbers. A thesis of the business and of strategic alignment is just a thesis until it is backed with evidence. A strategically aligned may be the best possible design and combination of practices for serving a given position, but you need to run the numbers to assess whether best possible is indeed profitable. These Notes provide systematic starting points for thinking through these questions.

Your Responsibility

Making the best possible decisions (given the available information at the time) can have life-size consequences. Your ability to rise to meet this higher bar can mean the difference between the creation of enormous value and welfare for society—or not. It can mean the difference between providing vitality and livelihoods to your community and stability for your employees—or not. It can mean the realization of the dreams and aspirations of builders and creators—or not. Failure may mean that you are leaving a large share of value unrealized.

To judge whether you are achieving the best possible economic outcome, you can't simply look to accounting profits or even stock price. Only if you have a clear thesis of your business and its design can you judge the current state of your company against what the company (design) *should* look like.

This is hard. Making the best possible decisions based on the information available at the time requires constant discipline, inquisitiveness, and humility. It is easy to defer to authority, to employ a simple ready-made analysis and paradigm, or to rely on your intuition and how things have "always been done around here." It is harder to take on your shoulders the awesome responsibility of making sense of everything and solving your economic puzzle in earnest.

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