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survive and thrive

winning against strategic threats to your business

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missing the real competition

Michael Ryall

Evan Kristen Specialty Foods (EKSF) was an entrepreneurial venture that offered an innovative line of fresh herbs for distribution through retail grocery chains. The novelty of the product was in its ready-to-use nature: herbs such as basil and thyme were offered fresh, washed, de-stemmed, and sliced. To deliver on its consumer promise of year-round availability with a two-week shelf life, EKSF had to find innovative solutions to issues of technology (a proprietary processing facility to wash, de-stem, and slice delicate herbs), distribution (an inventory-management system that used FedEx to bypass the standard produce channel and deliver overnight to the retail location, thereby increasing shelf life by several days), and sourcing (identifying the only microenvironment in the continental United States capable of supplying a wide range of high-quality herbs year-round).

The early results were promising. At a time when grocery test-market sales of four to five cases per week per store were considered a success, test market sales averaged fifteen cases per week and, in some instances, more than twenty. Moreover, the margins on these products were far beyond anything being offered in the produce department. This meant that, for the first time, a produce entry could sustain a marketing program of sufficient substance to build a strong brand identity. In addition, the complex set of interlocking technologies and supplier relationships required to produce, process, and deliver the product to market meant that potential imitators would require considerable time to fit all these pieces together, and by then, EKSF would have the lead on building a national brand identity.

All of this pointed to the kind of investment opportunity that any venture capitalist would jump at, yet as the EKSF management team concluded its presentation to its venture backer E.M. Warburg Pincus, the reception was anything but enthusiastic. "I agree that these retail results are impressive," said the Warburg partner managing the case. "Even so, your business plan is fundamentally flawed. We may need to pull out as your venture capitalist."

What had happened?

fundamental strategy flaws

The EKSF situation highlights a feature present in many business settings, but especially in consumer products. Managers focus strongly on the customer end of the value chain, spending millions on market research to gauge the demand for new or updated products. Develop a product for which millions are willing to pay a hefty premium, with no imitators on the horizon, and success is guaranteed, right?

Wrong. The fundamental flaw in EKSF's strategy points toward a more general problem inherent in any partial analysis of a firm's competitive situation. By "partial," I mean an analysis that focuses on the competitive dynamics in one segment of the value chain (for example, consumer demand) at the expense of another (for example, input supply). Companies miss the real competition. Proper assessment of one's strategic position requires a refined understanding of *competitive intensity*—an understanding that must be grounded in a *complete* theory of value capture under competition.

The material in this chapter is motivated by a new and growing line of research in strategy that aims to refine our understanding of firm performance in competitive environments. The essential tool in this line is a mathematical framework known as the value capture model (VCM). Although this stream of work is relatively young by academic standards, it has already highlighted a number of important misperceptions and strategy blind spots with respect to how competition works.[1] In order to appreciate these and then to grasp the specific strategy flaw in the EKSF example, we must first step back and take in the picture of competition as conceived under the VCM framework.

a new perspective of competition

How much of the profit made by your firm is *guaranteed* by competition? It's an interesting question to ask, because most managers see competition as a persistent corrosive force on profitability. Competition may also have a positive, profit-boosting effect on performance, however. Which of these effects dominates for a given firm will depend on a balance in the productive powers of all the agents in its market. This is the overarching insight that arises from VCM's new perspective of competitive dynamics.[2]

Consider that firms create economic value by engaging in productive activities with other agents. When a firm is alone, its creative capacities are latent, unrealized. Only in the presence of other agents with creative capacities of their own can the potential to create economic value ever be actualized. In the simplest case, a firm has the potential to sell a product. This potential is worthless, however, without a buyer. Buyers are a particular class of agent—those with the potential to enjoy the use or consumption of products offered by other agents. Without sellers, these potentials are latent. Only together, when exercised through a sale, are the potentials of buyers and sellers actualized to produce real economic value.

An essential aspect of VCM is that it conceives of the firm and its transaction partners (customers, suppliers, and so on) as each possessing latent powers of value creation. A specific transaction identifies which agents actualize which of their potentials for what share of the resulting value created. Typically, an observed transaction is only one of myriad possibilities. Thus, the value captured by the agents in a transaction can be thought of as the inducement sufficient to voluntarily actualize the potentialities required of *that* transaction while leaving the others latent.

This perspective leads to several insights, some of which turn our assumptions about competition on their heads. First, competition arises from the mutual need of all parties engaged in a joint, economically productive activity to convince one another to actualize their latent powers in a certain way rather than some other way. This implies that there is *one* force of competition (not five, for example) that operates similarly throughout the market: on the firm as well as on its rivals, suppliers, and buyers. The iconic image of competition as a firm contending for buyers against its rivals omits the fact that in a symmetric sense, buyers may be similarly required to contend for transactions with the firm! This is all the more apparent in supplier, employee, and distributor relations.

Second, conceptualized in this way, we see that competition determines a *minimum* quantity of economic value that each agent *must* capture in order to ensure that it does not exercise its creative powers in other ways with different agents.[3] Here is the key: *The more substantial and extensive are a company's latent powers of value creation relative to the ones exercised in its actual transactions, the greater is this minimum—and the more competition works in its favor*. Because competition operates similarly for the firm's transaction partners (there is one force, remember), it increases the partners' minima as well. Holding the transaction constant, more competition of this kind reduces the value available for capture by the firm and hence imposes a *maximum* quantity of economic value the firm may capture in order to ensure that its transaction partners do not exercise their creative powers in different ways with other firms. Typically, all agents must part with some value to induce their partners not to actualize their creative powers in alternative transactions.

competitive intensity: determining the gap between floor and ceiling

The range of value-capture possibilities for a given agent is determined by this interplay between the latent and actualized productive capacities of everyone in the market. Competition for your transaction partners places a ceiling on the value you can capture. Competition for you creates a floor. The former corresponds to our traditional intuition. The latter is new. Taken together, they imply a novel conception of *competitive intensity*, namely the extent to which competition closes the gap between floor and ceiling. For a given agent, competition is at its most intense when the floor and the ceiling are equal—that is, when competition fully determines the quantity of value an agent must capture. At the other end of the spectrum, competition is least intense when it has no effect on an agent's value-capture possibilities.

The two ends of the spectrum are exemplified by two textbook cases: "perfect competition" and "pure bargaining." Perfect competition has come to mean situations in which free entry causes prices to be driven down to marginal cost, with the result of zero profit at the firm level. Under such conditions, the firm cannot demand more value, because competition for its buyers is so intense. If it does not relinquish all of the economic value created in its transactions with buyers, those buyers will simply exercise their creative powers with other firms. In other words, the firm's ceiling has been driven down to meet its floor at zero capture of economic value. Alternatively, in the textbook case of bilateral monopoly, only one buyer is interested in acquiring a product or service and only one seller exists to provide it. Here there are no alternatives for either party (other than abstaining from the transaction). In this situation, any split of the value created is consistent with competition (as there is no competition).

It is worth noting that the grim case of perfect competition, which is the one that normally comes to mind when we think about intense competition, is itself one-sided. There is another textbook case of intense competition that most firms would happily invite: monopolistic provision of a product under perfectly elastic demand. The key feature of perfectly elastic demand is that the firm's buyers are completely substitutable. Once again, as in the perfect-competition case, the firm's floor equals its ceiling, and competition fully determines the amount of value the firm captures. Now, the intensity is all on the side of the firm, with buyers vying for transactions with it, resulting in competition that guarantees that the firm can capture 100 percent of the value created. In other words, intense competition can work both ways.

Rarely, if ever, do real-world interactions fall at one extreme or the other. Generally, competition determines a *range* of value-capture possibilities for an agent. The narrower the range, the more intense is the competition surrounding an agent's actualized, economically productive interactions. The wider the range, the less intense is the competition for that agent and/or its transaction partners. When an agent's interval is nontrivial (that is, when its upper and lower bounds are not equal), we say the agent faces *competitive slack*. Again, most, if not all, agents face some competitive slack.

To summarize, competition for the firm guarantees it some minimum quantity of economic value (which may be equal to but is typically greater than zero), while competition for its transaction partners limits its capture to some maximum level (which may be equal to but is typically less than all the value created in the market). The exact amount of value a firm actually captures, then, is equal to the minimum guaranteed by competition plus some quantity of the slack between the minimum and the maximum. This formulation has implications for strategy.

competitive slack and the role of "persuasive resources"

We now know that the economic value captured by a firm—its economic profit—is equal to some amount guaranteed by competition plus some portion of its competitive slack. The total slack is determined by the firm's productive resources, the productive resources of the other agents in the market, and the interplay of the potentials of all these resources to create value through joint economic action. The portion of slack that the firm ultimately manages to capture is due to a category of resource that strategy scholars refer to as *persuasive*.

In its pure form, a persuasive resource is an item that does not create any economically productive potential for the firm. Rather, its sole function is to convince the firm's actual transaction partners to part with some of their own slack. Note the distinction: Competition is about a tension that arises between (1) the value created by actualizing the productive potentials among a set of transacting parties and (2) the need to identify a distribution of that value such that each of the parties has sufficient incentive to play the role necessary for its creation; persuasion is about bargaining over the share of remaining value once the implications of competition are fully resolved. For example, in the bilateral monopoly (one buyer and one seller), there are no appeals to competition; by definition, neither party has any alternative to the contemplated transaction. Here, an appeal to "fairness"—that is, to share the value equally—is an attempt at persuasion. An example of a persuasive resource would be an experienced salesperson with a special talent for convincing potential buyers to pay prices above their reservation values.

In the real world, resources typically embody both productive and persuasive capacities. For example, the services provided by salespeople—aligning products with customer needs, acting as go-betweens for clients and systems designers, expediting customer service, and so on—may create value with the firm's buyers and hence a resource that is productive. At the same time, the salesforce could be well trained in the art of persuasion. This productive/persuasive distinction is real and important. For example, even the most effective persuasive resources in the world would have no effect on value capture when competition is at its most intense (that is, when a firm's floor touches its ceiling and there is no slack at all). Other things being equal, the return on investment in persuasive resources is lower in settings of intense competition. In contrast, investing in productive resources that reduce the relative value of alternative options for the firm's transaction partners (for example, creating switching costs)—a move designed to increase the firm's competitive slack by reducing competition for the partners—is less attractive when the firm's persuasive resources are weak. Note that the efficacy of a firm's persuasive resources is always relative to the strength of the persuasive resources of that firm's transaction partners.

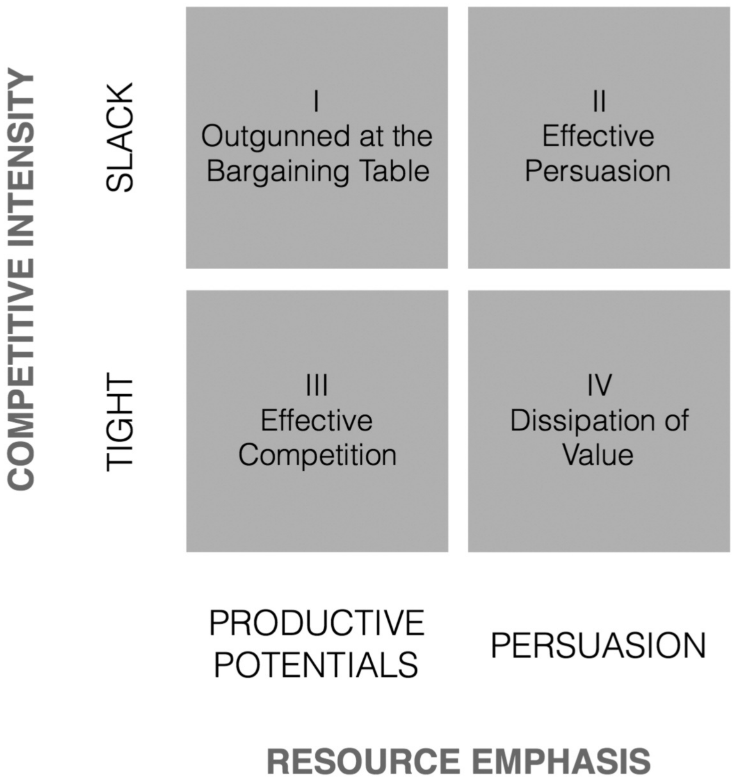
Finally, keep in mind that what counts as persuasion is everything that determines value capture outside of competition. Thus, while personal charm, appeals to fairness, and other forms of literal persuasion obviously fall into this category, organizational mechanisms and industry norms also count. For example, the sales technology may not allow pricing negotiation (for example, online retail), or deals might typically be determined through a sealed-bid auction (for example, construction projects). These institutions and norms have significant effects on the distribution of competitive slack. When we speak of persuasive resources, then, we mean to think in the broadest sense of how the competitive slack gets allocated (that is, even when we may not be able to point to special resources, per se).

mapping strategic positions

These two dimensions—competitive intensity and strength of resources (both productive and persuasive)—have significant implications for strategic positioning. As shown in Figure 10.1, the two dimensions map out four broad environments in which a firm may find itself operating. In the figure, the *x*-axis indicates the relative balance of a firm's resources. On the left, the firm is relying heavily on the resources that create potentials to generate value. This implies a strategic focus on fostering competition for the firm, pushing that ceiling as high as it will go. Firms on the right side of the *x*-axis have well-developed persuasive resources. They are positioned to capture any value that remains unaccounted for by competition—that is, the value in their competitive slack. The *y*-axis indicates the degree of competitive intensity surrounding the firm as it participates in its complex systems of relations to produce economic value. Moving from top to bottom, competitive intensity is increasing, and with that movement comes a corresponding drop in the efficacy of persuasive resources. Breaking the space into four broad categories of competitive position results in the following quadrants.

QI: Outgunned at the Table. In the upper left quadrant, a firm encounters substantial competitive slack. The problem, however, is that its persuasive resources are weak. In essence, the firm's persuasive resources are out of alignment with the competitive intensity it faces, and the firm ends up "leaving money on the table." A natural reaction to being in this location is to pump up one's productive resources, to increase the potential to create value outside of the firm's present set of transaction partners in order to foster

Figure 10.1: Strategic Positioning



competition *for* the firm and thereby to push its minimum upwards. Notice that to the extent such a strategy is successful, the firm moves to QIII. Examples of such moves include vertical product differentiation (by increasing the appeal of the product throughout the market, beyond the set of active buyers, competition for the firm increases) and capacity consolidation (eliminating some capacity increases the competitive intensity for that which remains). Alternatively, the firm can shift its emphasis to develop strong persuasive resources—an attempt to move to QII. When General Motors invests in salesperson training for its dealers, for example, the automaker is increasing its persuasive resources in hopes of swaying actual car buyers at the point of sale to part with value above and beyond the prices at which the dealers could surely sell to some other potential buyer (i.e., the minimum prices determined by competition for GM automobiles).

QII: Effective Persuasion. In the upper right quadrant, persuasive resources and competitive intensity are well aligned. Here, value capture is high, as persuasive resources enable the firm to capture a large share of the overall value, most of which is open to persuasive efforts because of the low level of competitive intensity. The canonical example is a situation in which each member in the network of transacting firms is equally necessary for the project to proceed (as might be the case in the production of an innovative technology platform). This is the quadrant in which simply finding ways to "add value"—without worrying at all about simultaneously increasing the potential to create value with others so as to foster competitive intensity—works.

QIII: Effective Competition. In the lower left quadrant, firms foster high competitive intensity with little focus on persuasive resources. This is an efficient quadrant in which to operate because the development of persuasive capabilities matches (and fosters) the competitive situation. When competition is tight, persuasion is of little value. In this quadrant, competition works to ensure a large share of the economic value (for example, the monopolist facing perfectly elastic demand), which is a very desirable position, indeed. Here, the typical dynamic is a virtuous cycle in the sense that competition prevents the development of any gap between the firm's maximum and minimum, which prevents movement toward QI, thus ensuring that a firm has no reason to strengthen its persuasive resources.

QIV: Value Dissipation. In the lower right quadrant, a firm's persuasive resources are, again, out of sync with its competitive situation. Here, the firm has strong persuasive resources but little competitive slack upon which to applythose resources. As long as the firm remains in this position, whatever costs it incurs to develop or maintain its resources are wasted. One option for the firm to move to QII is to create more economic value with its present partners, which has the effect of raising its maximum above its minimum. The resulting slack is then available for capture via the firm's superior persuasive resources. Another possibility in moving to QII is to neutralize the latent potentials of its transaction partners—that is, to reduce or eliminate its partners' alternative opportunities to create value in exclusion of the firm. One such approach is the creation of switching costs. For example, when pharmaceutical companies create specialized equipment required for the delivery of their products to hospital patients, the potential of current hospital clients to create value with alternative pharmaceutical suppliers is reduced (because the switching costs must be factored in). Finally, a firm in QIV moves to QIII by shifting its resource emphasis to the productive side and away from persuasive resources. For example, between 2009 and 2013, pharmaceuticals witnessed massive industry-wide reductions in sales teams. One of the significant factors contributing to this was increased competitive intensity resulting from a major shift from individual physician-prescribers to large health plans. That shift forced pharmaceuticals to compete for big-buyer business, which moved them from QII to QIV. As the pharmas reacted by eliminating their persuasive resources, they were moved from QIV to QIII.

In considering these positions, it's important to note that moves from one side of the *x*-axis to the other are typically quite difficult. After all, a firm's present balance of resources is the consequence of a complex, history-dependent evolution of factors involving relationships between the firm's technology, its knowledge resources, its culture, its reputation, the structure and norms associated with its partner transactions, and so on. Although every situation is unique and should be attended to with careful discernment, movement from QI to

QIII and from QIV to QII are going to be the most strategically efficacious.

the problem for EKSF

Returning to the example in the introduction of this chapter, what the company's managers failed to grasp (and the Warburg partner apparently did) was that EKSF's strategic positioning was fundamentally flawed. Situated high in QI, EKSF faced a serious misalignment: massive slack on the one hand, and a total emphasis on competitive resources on the other. To appreciate this, note that, although the close-fitting pieces of the EKSF business model may have kept imitators at bay, they also had a crucial effect on the strategic positioning of the company. The EKSF promise of year-round availability could be met by supply from only a *single* farm—the only farm that happened to grow herbs in the aforementioned microenvironment. In order for EKSF to create full value with its retail customers, it *had* to actualize its own productive capacity in conjunction with *that* particular farm. In effect, the incredible competitive intensity for EKSF products on the retail side was really competitive intensity for the EKSF-farm pair. Although competition would ensure that enormous value would be captured from consumers (in the form of high prices for EKSF products), it provided no determination of how that value would be split between EKSF and the farm. The two parties needed each other in this endeavor, and perhaps EKSF was more dependent on the farm than the other way around, because the farm already had an ongoing business to which it could always revert. That is, the farm had a potential to create value without EKSF.

Consider the following scenario. Everything runs smoothly during the early stages of a nationwide EKSF rollout. Then, as the level of market success becomes clear, it dawns on the farmers just how critical they are. At this point, threats and demands for higher raw-material prices suddenly appear. Warburg was right to be worried. Dependence on the farm implied a potentially unsustainable position for EKSF—one that had the potential of destroying the return on Warburg's investment. One possibility would have been a contract designed to lock in raw-material prices (that is, an attempt to move from QI to QII); however, should EKSF become as successful as anticipated, the incentive for the farm to renege on such a contract might prove irresistible. Another solution would have been to backward-integrate by purchasing the farm, but this would have required even greater funding from Warburg. Or EKSF could have, in parallel with its national rollout, convinced other nearby farms to divert some production capacity to herbs. This would then have created new potentials for EKSF to create value, thereby increasing the competitive intensity surrounding its operations in a positive way. Each of these last two strategies would have involved a strategic move from QI to QIII.

Had the EKSF management known of the fundamental flaw in its strategy, it could have acted proactively to solve these issues in advance. Unfortunately, though, the initial focus was on proof of concept for the production and retail dimensions of the business model. As the model came together and as the size of the potential value pie became apparent (the latter implying a huge incentive for the farm to hold up EKSF), the experienced Warburg partner clearly grasped the danger. Ultimately, funding was pulled, and as a result, EKSF ceased to exist.

Although the story of EKSF is an extreme (and somewhat oversimplified) example, many firms have fundamental flaws in their competitive strategies. Like EKSF, they might be residing high in QI, unaware that their suppliers could soon be abandoning them. Or they might be located in QIV, wastefully investing precious resources in persuasive capabilities that provide no return. The VCM framework presented in this chapter can help managers identify and avoid missing the real competition. That said, VCM is a relatively new approach, and the field of strategy is a complex domain. I expect that future refinements of the framework will enable leaders to better chart the strategic directions of their organizations.

endnotes

1. 1. Interested readers are directed toward the pioneering contributions of A.M. Brandenburger and H.W. Stuart, "Value-Based Business

Strategy," *Journal of Economics & Management Strategy* 5, no. 1 (1996): 5–24; and A. Brandenburger and B. Nalebuff, *Co-Opetition* (New York: Doubleday, 1996). The former is directed to an academic audience and the latter to business practitioners. For a recent review, see J.S. Gans and M. Ryall, "The Value Capture Model: A Strategic Management Review," *Strategic Management Review*, 2017 (forthcoming).

2. For an introduction, see M.D. Ryall, "The New Dynamics of Competition," *Harvard Business Review* (June 2013).
3. Note that "economic value captured" means the same thing as "economic profit." The "value captured" formulation is useful in highlighting the connection between the creation of economic value and its distribution among the agents involved in that creation.