



The Trillion-Dollar Race to “E”

A Handicapper’s Guide to Dots and Giants

By Charles E. Lucier and Janet D. Torsilieri

FROM THE SMALLEST dot-coms to lumbering global giants, companies across the world are lining up for the biggest, fastest set of economic races in history: contests in every industry to create — and prosper in — the new Internet-based world of “e.” The stakes are enormous. Based on the belief that some of the contestants will change the world, the United States stock market was valuing an index of 133 leading “Dots” at roughly \$410 billion at mid-1999, according to Red Herring magazine. Add the value of e-busi-

nesses at established American companies and the cyber-bets of investors around the world, and the overall wager approaches the trillion-dollar mark. Wild speculation? The folly of too much cash chasing too few opportunities?

No.

The valuation of New Economy players represents a bet by the world’s financial markets that a few companies will leverage the Internet to fundamentally change the competitive game in their industries. It is a gamble that powerful, low-cost business mod-

els will emerge; that new businesses will rise from disintermediated value chains, and that some companies will exert such influence that they will generate extraordinary long-term shareholder returns.

We cannot predict the winners of the e-races any more than we could have foreseen in 1948 that the McDonald’s Corporation would push the globe into a fast-food frenzy, or in 1975 that the Nucor Corporation would eventually humble Bethlehem, Armco, LTV and Inland. We can be sure that the winners in this race will be few and the losers many; in the races that created the American automotive industry, only three of thousands of startups survived. Hence, even if the world’s financial markets are correctly valuing “e” in the aggregate, they are overvaluing most companies — the eventual failures — while significantly undervaluing the few companies that will succeed in changing the world.

By studying the companies that tried to “break out” from the competitive pack and redefine their industries, and then by adapting their experiences to the Digital Economy, we

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believe we can both understand the rules of this race, and handicap the Dots and established Giants during this current, first leg. Through research of attempted breakouts in 55 industries in the United States from 1965 to 1995, and interviews with 45 successful breakout innovators (i.e., those that have achieved shareholder returns in the top decile over one or more decades) in the United States and Europe, we have identified four rules for breaking out to win an economic race. These rules applied for would-be breakouts in an economy characterized by equilibrium; they are relevant for all companies in this economy of continual disequilibrium.

Rule No. 1: Ideas are not enough to win. Strategy gurus often assert that winning comes from “thinking out of the box” or “reframing the problem.” They are wrong. Across the 55 industries we studied, only four common ideas accounted for 80 percent of successful breakouts: power retailing (Home Depot, Circuit City); bypassing one or more steps in the value chain (Frito-Lay, Dell Computer); focusing, simplifying and standardizing (McDonald’s, Nucor); and mega-branding (Disney).

The big winners weren’t even the originators of the ideas; they were the first to make an existing concept work on a large scale in a new industry. Power retailing is a good example. Power retailers were at least partially successful in transforming toys (Toys “R” Us), appliances (Circuit City), and tires (Sears’ Tire America) in the early 1980’s; home centers (Home Depot) in the late 1980’s, and now office prod-

ucts (Office Depot), home furnishings (Bed Bath & Beyond), pet supplies (Pets-Mart), computers (CompUSA) and video rentals (Blockbuster Video).

Unlike so many Dots, these and other successful breakouts turned a good idea into a real business. Today, making ideas work means transcending the current financial moment, when paper concepts become red-hot market caps seemingly overnight.

Rule No. 2: Serve fundamental customer needs with unprecedented levels of performance — while generating huge profits. A contestant in an e-race must learn from history’s Giants that for a powerful idea to work, it must consistently deliver great performance that matters to customers, raising customers’ expectations and forcing all competitors to respond; generate rapid growth by delivering the powerful value proposition to more and more customers, and produce superior returns for shareholders by sustaining earnings growth of more than 20 percent per year for a decade or more. To do this, it needs as its foundation an integrated business system that “pushes boundaries beyond where our industry’s conventional wisdom suggested we could go,” as Home Depot Inc. co-founder Bernard Marcus put it.

How far beyond? At the start of their breakouts, McDonald’s, Midas, Nucor, Home Depot and Southwest



Airlines all had 30-to-45 percent unit-cost advantages over competitors.

Like a complicated organism, a business system integrates different, valuable pieces — business processes, an economic model and a value proposition targeted at a set of customers — that have power only when linked together. The McDonald’s business system, for example, includes the concept (consistent, good food at low prices); the explicit policies and processes that enable unskilled workers to deliver exactly the same Happy Meal to children all over the world; partnerships with suppliers of both food and equipment, and economics that guarantee that McDonald’s and its franchisees win together. The totality of the interrelated parts, some big and many small, make the business system work. Take away one and the whole system will only limp along.

The complexity of the interre-

lated business system provides its defense against competitors. Builders Square and Home Quarters hired executives from Home Depot and tried to replicate the format, but were never profitable.

Profits count. Any company that serves an important customer need can generate rapid growth if it loses enough money. But to win the economic race, a company has to create a business system with such strong advantages that it can offer prices low enough to rapidly attract new customers while still making the superior profits that Wall Street requires.

Since its advantage rests upon the business system, not upon scale, a successful breakout is profitable even when it is small. For example, recent successful breakouts like Dell and Schwab have been profitable throughout their history.

The inability to create an economic model that provides sufficient profitability is responsible for nearly half the failed breakout attempts in our sample. The Thomas & Betts Corporation created a business system that reduces transaction costs and inventory for its customers, electrical distributors. Although T.&B.'s value proposition to those customers has been attractive enough to gain it market share, T.&B. has not earned superior profits. Without them, the company has not been able to pay for the acquisitions that would enable it to consolidate the fragmented electrical product industry.

Rule No. 3: Relentlessly improve. Years after a breakout, academics and journalists tend to agree on a simple

explanation for its success, but it is rarely apparent at the start. Who knew during the first five years of Sam Walton's leadership that Wal-Mart's logistical system would lead to whole new levels of performance?

Our interviews suggest that from the first, the leaders of successful breakouts share:

- The conviction that significantly better levels of performance can be offered to customers without compromising financial returns.
- The belief that it is less risky to establish new ways to do business, new value propositions and new economic models than to be forced to react to the successes of others.
- A drive to achieve unprecedented, industry-leading levels of performance, over and over again.

The hallmark of the successful breakout is relentless improvement. No strategic breakout has all the elements of the business system correct at the outset; all evolve significantly. When Frederick W. Smith launched Federal Express, he had the hub-and-spoke business model, a value proposition for overnight delivery and powerful economics. But he incorrectly assumed that the best customers would be manufacturers and distributors of high-value products like drugs and machine parts. During the company's first year, Mr. Smith discovered the market for next-day delivery was mostly in documents. He modified the business system, and FedEx's business volume exploded.

Rule No. 4: Run the first leg of the race first. The race to change the rules of the game in an industry has

two distinct legs. First, the company works toward perfection of its complex business system — learning to achieve industry-leading levels of performance, tuning its value proposition and developing a viable economic model. In our sample, the first leg required an average of 4.5 years. That was the time it took FedEx to refocus its business system on next-day delivery of papers. McDonald's spent an equivalent period developing a replicable model for operating restaurants, learning what sort of franchisees were most desirable and anchoring its economics in royalties and rent overrides from successful outlets.

Once the business system is perfected, a breakout company must run the second leg: explosive growth through replication of the business system.

Sustained growth in earnings in excess of 20 percent per year — typical of companies changing the rules of the game — requires disciplined reproduction of a powerful business system along one of three tracks: acquisitions, the way it has been done by NationsBank, Tyco and Shaw Carpets; geographic expansion, as demonstrated by Wal-Mart and Coca-Cola; or expansion into new market segments, undertaken by Nucor. During this second leg, the business system is extended to include the capability to grow rapidly along the selected track (to acquire and assimilate companies, for example, or to open a large number of new outlets). But to consistently perform at these levels, a company can manage only one of these three growth tracks.

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When Home Depot departed from its track of opening outlets in new geographies and tried to grow by acquisition, it stumbled. So do most companies that experiment with a second track.

How will an e-race differ? Certainly it will be faster. Schwab and Dell ran their first legs in under two years, less than half the time of earlier breakouts. Can the legs be combined? America Online (AOL) and eBay have perfected their business models while simultaneously growing explosively through acquisition. But our view is that AOL and eBay are exceptions. Their economic models are all based on “network economics” — that is, the benefits that accrue to their customers increase as the number of customers increases, thus driving profit growth. At eBay, for example, the more sellers offering products, the greater the value to buyers; the larger the number of buyers, the greater the value to sellers; the more buyers and sellers, the larger the profit to the company. Where network economics are significant, rapid growth can be an essential element of the integrated business system, and the difference between the two legs of the race is obscured.

However, network economies are rare, even in a digital world that cites the theory for support in every other I.P.O. Network economies occur when there is value in connecting people — either in creating a market (as with eBay) or in developing a network (like AOL’s chat rooms). But network economies do not occur in the vast



majority of industries — the places where almost all the growth in the New Economy will take place. There are no network economies in direct selling (Schwab and Dell), retailing (Amazon.com) or wholesaling (Grainger). In these industries, we anticipate that the two legs of the race will remain distinct. Schwab, Dell and Grainger, for example, have all perfected e-business systems that they are now rapidly replicating. Amazon.com is losing hundreds of millions of dollars because it tried to skip that first leg of the race, and is now experimenting with three different business systems at the same time, in the hope of finding a viable model.

The important question for all of us — as investors, employees, entrepreneurs, managers, consumers and citizens — is what we should expect in this, the first leg of many races to the new land of “e.” As the lithe and fast Dots line up against the mighty,

well-heeled, established Giants, where should we place our bets?

THE GIANTS

A recent Booz-Allen/Economist Intelligence Unit survey confirmed that C.E.O.’s of established Giants understand that “e” is more than information technology — it is a whole new set of business processes. These Giants are achieving significant cost savings from their digital initiatives, with Boeing and G.E., for example, claiming billions in savings. And the markets are waking up to the truth that while “e” really is new, the rules of the economic race have not changed. Experience still counts. Accordingly, popular wisdom and investment betting have begun to swing away from the upstart Dots. Maybe the Giants can win after all.

Don’t sell your Dot stocks too quickly, though. History is not on the side of the Giants. During the past 30 years, market leaders rarely broke out. The vast majority of successful breakouts were actually startups (McDonald’s, Home Depot, Dell, Southwest). Of the remaining successes, most — including Nucor and G.E. Capital — started as small players in their industries. Others may have been leading global players, but were only a small local presence when they changed the distribution game within a country; in the United States, Mazak in machine tools and Canon in copiers fit this category. Established Giants like Disney, Frito-Lay and Grainger were responsible for fewer than 15

percent of breakouts.

Strong and proven, basking in their brands, owners of superior capabilities, loved by their customers and guided by experienced management teams, why have established Giants been so unsuccessful in breaking out? The biggest reason is complacency; they tend to rest on the unrealistic hope that yesterday's successful business system can evolve gradually. Unfortunately, history proves that trying to evolve through a discontinuity is like walking across a chasm; leaping may seem risky, but it is the only chance. Complacency is reinforced by the reluctance to compete with customers and channel partners, and the inertia of a large organization whose culture, measurements, incentives and processes reinforce the old way of doing business.

C.E.O.'s of established Giants sound increasingly complacent. They are not facing the fact that their digitally achieved cost savings, no matter how large, will quickly be competed away once all the major players in the industry adopt the same cost-saving processes. Because "e" restructures value chains, the reluctance to compete with customers is proving particularly debilitating. And the challenge is only slightly less if the competing channel is in-house, like Merrill Lynch & Company's brokers.

Which Giants are likely to win? The early favorites are all companies that were already running the second leg of a non-"e"-based breakout when the digital revolution began, among them Cisco, Dell, Schwab and Granger. The additional cost reductions

possible through "e" increase the advantage in their established, breakout business systems. Where channel conflicts have arisen — for example, when Schwab's brokers complained about Schwab.com's pricing — a management committed to changing the rules has reaffirmed its dedication to the new system.

So if you are wagering, bet against the Giants that choose not to enter the race. Not every one will be a loser — not in the next decade. But if they don't race, they will not take home any of the trillion-dollar prize, either. Worse, they will put their future in the hands of tomorrow's versions of Nucor and Home Depot.

THE DOTS

Young, ambitious, full of ideas, supported by wealthy angels, the darlings of Wall Street's early digital gamblers, the Dots are not weighed down by prior success. Yet the little Dots face a much tougher race than they and the investors backing them understand. They cannot choose whether to run; for a Dot, it's win or die. Sure, a Dot might run the first leg and get acquired. But as the few winners of the e-races become clear and capture most of the market cap, the bubble will burst and acquisition prices will decline. That means the breakout Dots will have to be profitable — not "at some point," but soon.

To handicap your favorite Dot's chances for profitability, ask:

- Will its "e"-based processes produce unit-cost advantages equivalent to those achieved by McDonald's and Nucor in an earlier era?

- Will it be able to make the other, non-e-business system innovations necessary to win?
- Is the complexity of its e-business system great enough to sustain its competitive advantage over others, and simultaneously maintain superior profitability?

Which Dots will win? We are betting on the ones that are already profitable, either because they enjoy real network economies or because they are successfully completing the first leg of the race. We are betting against the Dots that are running the wrong race — those companies inappropriately depending on network economics or naively hoping for profitability once their "unusual" marketing costs decline.

To survive, both Dots and Giants will have to pioneer new business systems, recognizing that the risk of running an unending race is preferable to the certain obsolescence of failing to compete. In the past, only a few companies chose to run a breakout race. Most companies played by the existing rules and, because we lived in an economy of equilibrium, many survived. In the New Economy of disequilibrium, the only way to win will be to run a succession of breakout races. We will put our money — and working lives — on the Dots and Giants that are committed to those races, that rapidly perfect new business systems and that drive explosive growth through replication.

Do the current leaders meet the standard? Do you? SB

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