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Customers select the product they think is a superior value (benefits minus price). Competitive advantage is *delivering* a superior value to enough customers at a low enough cost to generate wealth. So a business is a system for superior value delivery: *choosing* a superior value proposition, and *echoing* it through the business system by *providing* and *communicating* it. And managing this delivery is top management's primary job.

A BUSINESS IS A VALUE DELIVERY SYSTEM

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IBM has dominated general business computers, with products rarely considered superior, yet costing more. This apparent paradox is often explained as "superior marketing." The sales force is so slick, they talk data processing (DP) managers into parity products at premium prices.

Recently, however, the Digital Equipment Corporation (DEC) has made remarkable inroads into IBM's market share. A key reason is that DEC has aggressively focused on "interconnectivity," designing equipment to easily interface with other equipment, including other manufacturers'. IBM has dragged its feet on this issue.

How big a threat is DEC? If superior marketing overcame inferior technology, why does it not overcome interconnectivity? Perhaps because IBM's historical success is <u>not</u> explained by "superior marketing."

A DP manager and satisfied customer of IBM would more likely explain that she was buying IBM's reliability, not state-of-the-art technology. She believed IBM's products, using adequate technology, could be relied on to stay up and running. Beyond the product, moreover, even if 3:00 a.m. on Christmas Eve, IBM people would get there to correct a breakdown. And they would actively help her plan growth and ensure she had the hardware and software to expand over time without major interruptions. For this key benefit, she would not only forego a more powerful, faster or more user-friendly machine, but also would pay modestly more.

IBM understood a fundamental benefit that an attractive customer group wanted and would pay a higher price to get. IBM delivered a superior value (benefits minus price) as perceived by the customer.

Achieving this perception was the net result of all that IBM did. Product engineering took a spare-no-cost approach to design, but the object was superior reliability at modestly higher price, not "leading edge technology," superior power or greater user flexibility. Manufacturing also focused on this, using assembly rather than original proprietary manufacture. IBM's famous obsession with customer service emphasizes fast, effective response to breakdowns (but not particularly, for example, innovative solutions to DP problems). Finally, sales and advertising have hammered home the idea that IBM means service and have clearly communicated the superior reliability benefit.

So what about DEC? "Superior marketing" will not solve IBM's new problems. DEC may have found a way to deliver a value proposition superior to IBM. What customers want is changing for the worse for Big Blue in two respects: advantage in reliability is becoming more difficult and less important as equipment improves and systems are designed with more redundancy; and interconnectivity is fast becoming a high priority benefit as the office and factory of the future emerge, whereas IBM can only provide it at risk to its customer control.

The traditional customer has been the DP or top general manager, to whom reliability of large main frames was the key benefit. IBM oriented its business system wholly around this customer and benefit. With the growing miniaturization of the technology, however, has come decentralization of processing into mini and microcomputers. End-users are becoming influential, demanding more flexibility, control and thus interconnectivity. IBM's problem is not that the Sales Force is failing lately to fool those gullible customers. Rather, IBM probably must change its value proposition to keep winning, and delivering it may require major business system redesign.

1. SUPERIOR VALUE DELIVERY:

THE ESSENCE OF COMPETITIVE ADVANTAGE

A winning strategy consists of that integrated set of actions that leads to a sustainable competitive advantage. Competitive advantage exists when customers will select enough product or service, at a high enough price over cost, that the business unit achieves adequate profitability and growth (i.e., generates wealth). Understanding why customers make one selection over another is thus critical to achieving competitive advantage.

To make any selection, customers use two basic criteria, balanced against each other: benefits and price. (The benefits that matter are those that the customer thinks are important. Similarly, "price" means whatever the customer sees as being paid for the product or service.) If a customer finds, in a product or service, benefits which in net outweigh the price, then this represents a positive value. That is, value equals benefits minus price. Customers select the product or service they believe is the superior value compared to competing alternatives.

Increases in a product's share of a market's profits almost always reflect a perception by customers that the product is a superior value. This can be displayed graphically for any market (or segment) with a "Value Map" (Exhibit 1, page 4). Any product left of the diagonal line going through the reference product (Domino's in this case) represents a superior value, while any to the right are inferior. Domino's Pizza offered a consistently good tasting pizza, guaranteed delivered hot within 30 minutes of order, all at a moderate, 10 to 20 percent premium. Drawing the Value Map for convenience oriented pizza lovers, Domino's has a value advantage.

A business unit promises customers some value, a combination of benefit and price. It thus offers a value proposition. We believe that behind any winning strategy stands a superior value proposition. If a customer group finds a business unit's value proposition superior, the business unit can be said to have delivered a superior value to that group. Exhibit 2 (page 4) shows some examples of superior value propositions.

Therefore, at the business unit level a useful definition of sustainable competitive advantage is: the sustainable ability to deliver a superior value to a large enough customer group, and at a low enough cost relative to the price, to produce adequate returns and growth.

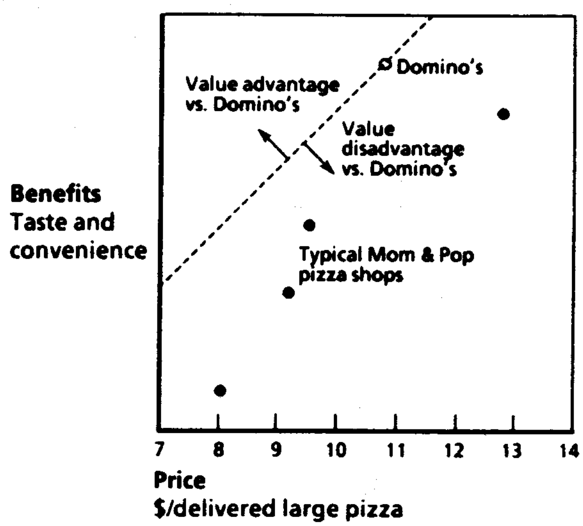
Thus, delivery of superior value is at the heart of a winning strategy. We believe superior value delivery, in turn, consists of two key actions:

- Explicitly and rigorously choosing the superior value proposition (what precise benefit or benefits at what price will be offered to what customer group, at what cost?)

Exhibit 1

THE VALUE MAP*

ILLUSTRATIVE



* Drawn for convenience- (delivery-) oriented pizza lovers

Exhibit 2

EXAMPLES OF WINNING VALUE PROPOSITIONS

Company/ product	Target customers	Benefits	Price
Canon Camera	Instamatic users wanting more professional quality	35MM quality/mystique, yet simple to use	< $200; > Kodak, ≤ other 35MM
Service Masters	Institutions (e.g., hospitals) and large businesses	Superior janitorial services rented - Better cleaning - More reliable	Less than previously paid
Volvo station wagon	Safety and durability-oriented upscale families	Superior safety and durability	20% premium over U.S. wagons
Domino's Pizza	Convenience-oriented pizza lovers	Guaranteed speedy delivery, consistently good-tasting, hot pizza	10-20% premium
Perdue Chicken	Somewhat upscale consumers wanting better taste	More tender taste, supported by consistent golden skin color	10-30% premium

¶ Echoing the chosen value proposition in every activity of the company (how can each element of the business system help provide or communicate the chosen value to the target customer group?)

These two steps can be iterative. Management may choose a value proposition but find it infeasible to provide or communicate. They then reformulate their choice. Often, management actually discovers that the company already delivers a superior value proposition, then builds on this discovery. Conceptually, choosing comes first, although in practice it may not.

2. CHOOSING THE VALUE

Reading the business press, there seems to be an endless list of things top management "must" do. However, we observe that top managements frequently do not put nearly enough time and energy into choosing the value. This task is often delegated to "marketing," "planning," or some other group that will leave top management free to do other things. Yet, until a winning value proposition is fully developed, we believe managements' dominant activity must be directing this critical and usually very difficult work.

THE IMPORTANCE OF THE RIGHT VALUE PROPOSITION

In the late 1960s, Frank Perdue pulled off his well known transformation of chickens from a classic commodity to a differentiated, much more profitable business (at least for Frank). One way of understanding what he did is that he found a distinctive, superior value proposition and aggressively delivered it. Perdue believed that customers desired more specific benefits than implied by the industry-standard concept of "quality." He thought many wanted, above all, a consistently more tender tasting chicken. Experiments said they would pay a 20 or 30 percent premium, too.

He proceeded to innovate across all elements of his business system to provide and communicate this superior value proposition. However, the most important conceptual, creative step he took was choosing a genuinely new and superior value proposition.

We do not know the extent to which Perdue did this deliberately by a methodical process versus instinctively. Often, as management discovers it has a winning value proposition, the real learning and insight come after the fact. What distinguishes the winners, though, is that they do find, develop, or recognize that winning proposition. In contrast, consider a few value propositions poorly chosen even if by some successful companies.

Apple Computer's first product had been a smash success and its initial follow-up, the Lisa, was a technical piece of wizardry. However, it provided no advance in benefits-delivered for its higher price, and failed.

MCI offered cheaper long distance. It hoped customers would not mind too much that voice reproduction quality, operator assistance, wrong-number credit, ordering and billing service, scope of geography served, and a few other benefits were inferior to AT&T; wait until customers could pay less! With less than ten percent of the market, MCI is still waiting.

Before congratulating AT&T, though, we could ask just what value proposition those guys had in mind when they first eagerly launched themselves into the computer business.

Edwin Land's Polaroid instant camera was certainly an inspired invention. Unfortunately, the company's later heavy investment in an instant movie camera was a fiasco due to the superior value proposition available in video technology.

P&G's Pampers, in its first test market, actually failed. It was too expensive and was offered only as a convenience, such as for taking vacation. Only when the manufacturing process got the price down and Pampers was offered as a full time diaper that would keep babies <u>drier</u>, did it become a billion dollar winner.

Walter Mondale probably had little chance against the Great Communicator, Ronald Reagan. Mondale's value proposition (benefit: reduction in an abstraction called "the budget deficit"; price: higher taxes) pretty well assured that he had <u>no</u> chance.

DEVELOPING A VALUE PROPOSITION

Some successes happen because an entrepreneur has a clear vision (such as Land's Polaroid camera). In other cases a product breakthrough drops in on a company (like 3M's Post It Notes). For a company needing to deliberately sit down and develop a winning strategy, however, our experience indicates a three-step approach that can be effective: 1) analyze and segment the market by values customers desire; 2) assess opportunities in each segment to deliver a superior value; and 3) explicitly choose the value proposition that optimizes these opportunities.

Analyze Value In The Market

This first step consists of two activities: deeply understanding the benefits and price levels desired in this market; and, segmenting customers by the variation in these desires. It corresponds to the front end of the process known within McKinsey as Demand Analysis.

Deeply understand benefit/price desires. We find managements often underestimate the difficulty and importance of understanding the benefits customers want. A typical euphemism for "we haven't thought about it too much" is to assert that the most important benefit is "quality" or, in service industries, "service." These terms are useless for formulating strategy. Does quality in bluejeans mean "no deviation from manufacturing standards" or something more specific, such as "durability," "consistent color," "better fit," etc. Even more specific descriptions of benefit can still be too vague. "Performance," for a car does not distinguish, for example, between acceleration, cornering, top speed, steering response, etc.

Understanding benefits does not yield easily to a cookbook approach. In some markets, several benefits may be truly important, versus only one or two in others. In some categories, such as entertainment or cigarettes, key benefits are only subtly connected to the product and consequently exceedingly hard to define or quantify. In industries of fast changing technology such as telecommunications, it may be necessary to project what customers are likely to want in the future.

Price too can be hard to define. It may mean purchase price or lifetime cost. This may require research to understand fully. Price sensitivity and how it varies by customer group, given the same benefits, is often not obvious, requiring some kind of demand elasticity analysis.

Understanding these issues deeply enough, and significantly better than competition, requires more management time and effort than typically assumed. Most important, it requires a real commitment, by management, to asking the relevant questions and insisting on thoroughly thinking through the answers. In principle, it almost always calls for quantitative market research, intensively analyzed by management. However, being "close to your customer" does not always mean huge quantities of analysis. Endless reams of market research can obstruct more than clarify a view of the customer.

In addition to research, understanding these issues can be helped by a range of other ongoing analytic activities such as: quantitative product testing; systematically listening to customers, distributors, sales reps, and others about what customers want; analyzing and reanalyzing real marketplace behavior; and test-marketing new benefit and/or price concepts.

Segment the market by value desired. This deep understanding of value should be used to segment the market. For example, in the mid-1970s, Canon apparently recognized three camera segments, as illustrated in

Exhibit 3

VALUE SEGMENTS IN CAMERA MARKET 1975

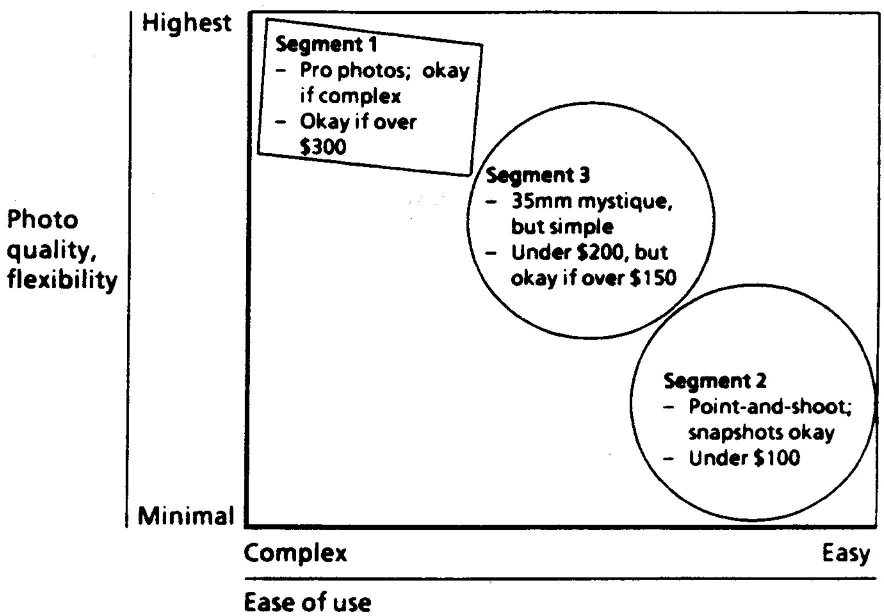


Exhibit 4

1975 CAMERA VALUE MAPS

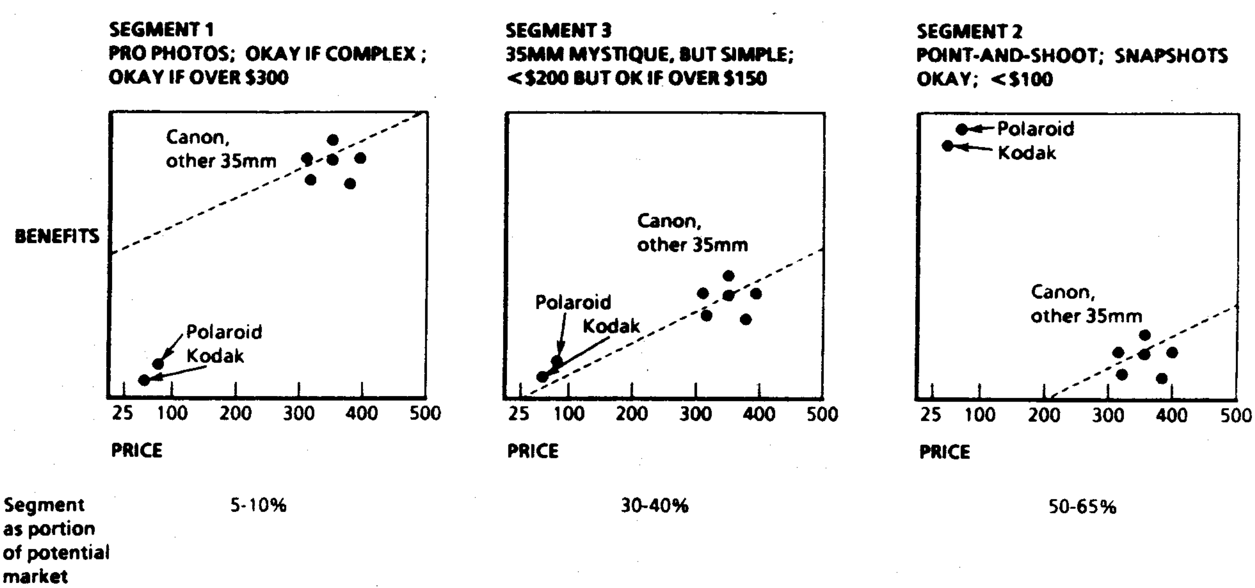


Exhibit 3. 35 MM cameras like theirs were then used primarily by professionals and other serious photographers prepared to accept prices well over $200 and somewhat difficult operating procedures. This segment was a small portion. A much larger segment wanted the simplest possible use and a price under $100. Canon thought it recognized a third segment in the middle, wanting the mystique and sharp quality of 35 MM but in simple-to-use form, willing to pay up to $200. Canon believed this third segment could potentially be very large and could give the 35 MM a mass market. Canon invested heavily in developing and mass marketing just such a camera, the AE1, and the rest is history.

In contrast, during the 1970s, Xerox treated the copier market in an undifferentiated manner. On average across the market, customers were sensitive to copy quality, speed, reliability, and service. Savin, however, discovered and sharply targeted a segment willing to sacrifice copy quality and speed, if reliability and service were excellent and price lower.

Techniques for value segmenting vary. Common sense and quantified understanding of benefits-desired/price-sensitivity can work. So can sophisticated statistical methods, such as Conjoint Analysis. Insist on an approach you can understand and which produces clearly defined groups of customers, distinguished by their desire for a unique value proposition.

Assess Opportunities By Segment For Superior Value Delivery

Usually, the potential to deliver superior value varies by segment and only one or two segments can be pursued successfully by one business unit. Having segmented by value-desired, the next key step is therefore to rigorously assess the opportunities in each segment.

¶ In each segment, map the value propositions offered. Canon saw the 35 MM cameras then available as clearly dominating the first, "professional quality" segment (Exhibit 4). The second segment, wanting "point and shoot simplicity," accepting snapshot quality and demanding less-than-$100 price, was dominated by the Kodak Instamatic and Polaroid. The third segment, wanting 35 MM mystique/quality, but reasonable simplicity, for up to $200, really was not served well by any camera. Clearly, if someone could deliver a product meeting those demands, there was room in the third segment for a major competitive advantage.

The Value Map can be a powerful framework for determining what value proposition would be necessary, in any segment, to deliver superior value. It helps integrate benefit and price into the one

Exhibit 5

CHECKLIST FOR VALUE PROPOSITION

1. Benefits explicit, specific, clearly stated
2. Price explicitly stated
3. Target customer clearly identified
4. Clear how this value proposition is superior for target segment
5. Evidence of adequate demand
6. Evidence of acceptable returns
7. Viable in light of competitors' value propositions
8. Achievable with feasible changes in current business system
9. The best of several value propositions considered for this company
10. Clear and simple

idea of value. It also pushes one to attempt the most accurate quantification practical, under the circumstances, of benefit importance and price sensitivity.

¶ Evaluate value-delivery ability by segment. Having determined what value proposition is required in each segment, the manager must determine its feasibility and cost. This requires understanding relative ability to deliver specific benefits compared to competition, now and in a projected future. It also requires understanding the cost structure and dynamics of competition. This calls for the rigorous techniques we commonly use for analyzing industry economics, such as competitive cost analysis, cost curves and quantitative use of Michael Porter's model of industry structure.

Canon had to decide whether it could develop the technology that would provide the needed benefits at the target cost, then convince millions of non-35 MM consumers that the AE1 did this trick, all enough ahead of competition to create sustainable advantage.

¶ Estimate profit/growth attractiveness of each segment. Having understood the business unit's ability to deliver superior value in each segment, it is essential to combine this with a quantified understanding of the profit/growth potential of each segment. What is a share point, one percent of the total, worth in this segment? Beyond the difficulty of estimating the total market volume in each segment, the problem here is complicated by the fact that the value of each share point depends also on the price and cost assumed.

A business can trade off between the degree of superior value offered and the attractiveness of the price/cost relationship. Clearly, one could always maximize the value offered, and thus market share, by providing some extremely low price, but resulting in lower profitability than needed. Conversely, a very high profit margin is possible with an extremely high price or low cost, but resulting in low value delivered and consequently low market share. The optimal position maximizes wealth in a given segment.

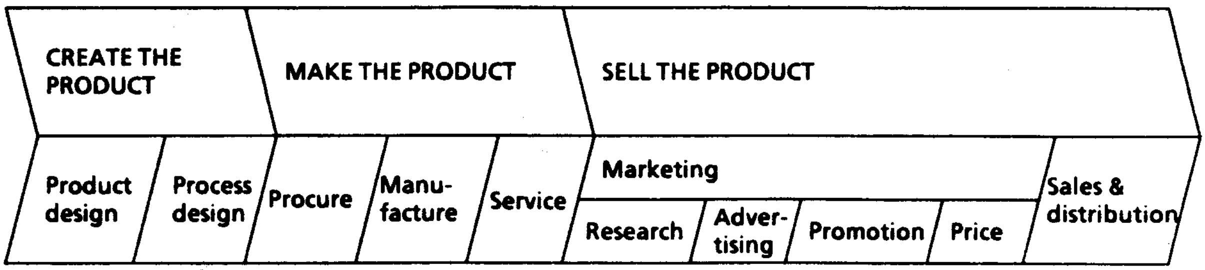
Explicitly Choose The Value Proposition

The business unit at this point determines which combination of one or more segments is most productive to pursue. It then chooses the appropriate specific value proposition. The checklist shown in Exhibit 5 gives criteria by which a value proposition can be judged. Does your business unit or company have a winning value proposition?

Exhibit 6

THE BUSINESS SYSTEM AS A VALUE DELIVERY SYSTEM

TRADITIONAL PRODUCT-ORIENTED SYSTEM



VALUE DELIVERY SYSTEM

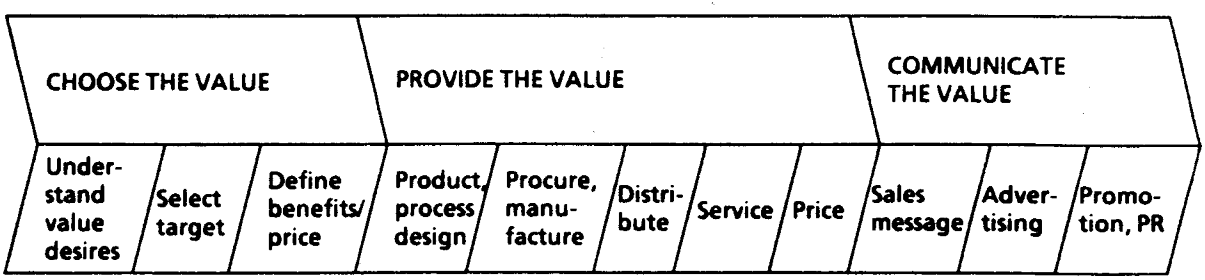
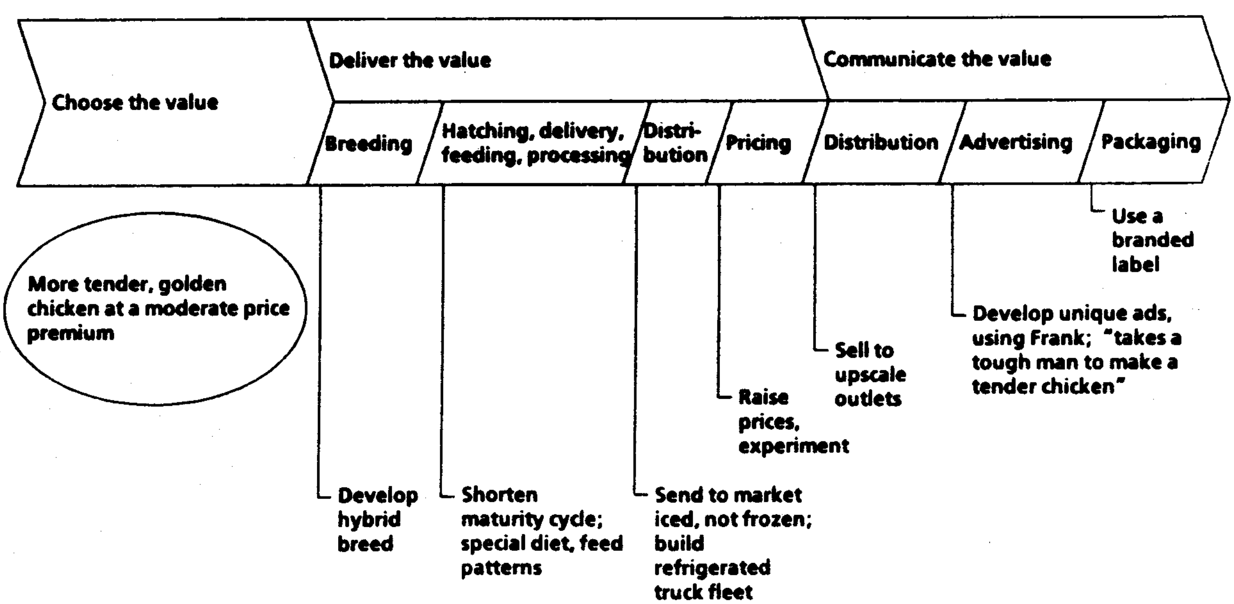


Exhibit 7

THE CHICKEN VALUE DELIVERY SYSTEM REDESIGNED BY FRANK PERDUE



3. ECHOING THE CHOSEN VALUE

The other half of Value Delivery is taking the chosen value and echoing it throughout the business system, using every resource of the business to reinforce delivery of the superior value. The Value Delivery System (VDS) is a useful framework for thinking about the echoing process. While new value propositions can certainly lend to winning strategy, so can superior "echoing" of an ordinary value proposition. Beyond strategy, moreover, the VDS can be a helpful integrating framework to guide all functions in the same direction.

THE VALUE DELIVERY SYSTEM

A value proposition may be successfully delivered without echoing it through every function of the business, but the chances are improved the more that each element of the business reinforces the same objective. A framework we find very useful in thinking about superior value delivery and especially echoing the value is the VDS, shown in Exhibit 6. The business system consists of the functional elements, such as product design, manufacturing, pricing, and distribution. A traditional way to view and utilize the business system orients it around the product (or service). In this perspective, the business system elements are divided into three basic functions: create the product, make the product, and sell the product. The VDS is an evolution of this approach, orienting the business system around superior value delivery: choose the value, provide the value, and communicate the value.

Returning to our chicken entrepreneur, Frank Perdue reoriented the entire chicken business system around delivering his unusual value proposition (Exhibit 7). He changed all elements involved in providing a more tender tasting chicken. He forward-integrated to become a broiler processor himself, coordinating egg hatching, chick delivery and feeding, broiler processing, and delivery to the market. He developed a hybrid chicken with a propensity for consistently yellow skin (connoting tender taste) and for a shorter breeding cycle (saving cost). He determined precise formulas for feeding at each stage in the chick's life, optimizing the efficiency of converting feed into growth with the right degree of "plumpness" and the consistent golden-yellow skin color.

Frank noted that his operation was only an overnight truck ride away from the entire northeast market. Conventional distribution froze the bird before delivery to retail. Frank invested in his own refrigerated trucks, allowing him to supply his market with chickens that had never been frozen, helping actually make them more tender tasting.

Perdue also rethought all aspects of communicating the value, making sure that everything he did reinforced the tender taste story. He aimed distribution at butcher shops and smaller chain food stores to connote an upscale image consistent with his target customer. And, of course, he branded his chickens, placing a distinctive tag on the wing, naming the chickens, surprisingly, "Perdue." Finally, to this he added outstanding advertising. For example, from his television campaign:

> "A chicken is what it eats. And my chickens eat better than people do. I store my own grain and mix my own feed. And give my Perdue chickens nothing but pure well water to drink. That's why my chickens always have that healthy golden-yellow color. If you want to eat as good as my chickens you'll just have to eat my chickens. That's <u>really</u> good. SUPERIMPOSED ON SCREEN: It takes a tough man to make a tender chicken."

<u>IMPORTANCE OF ECHOING</u>

<u>Often, the difference in a winning strategy is NOT the choice of value proposition but the thoroughness, single-mindedness, and innovation with which it is provided and communicated</u>. In the U.S., many retail banks are drawing similar conclusions: focus on providing tailored, customized personal service to the affluent/wealthy individual and the small/middle-market business customer. Differentiating the winners is the extent to which this value proposition is echoed in the business system, through changes in branch service delivery, new products, systems that provide integrated information to customers and those serving them, relationship pricing, etc. Executing these changes is more difficult than choosing the value but also provides formidable obstacles to imitation. Thus, in an industry where product innovation is rarely proprietary for long, providing and communicating the same value proposition better can be the key to sustainable competitive advantage.

VDS AS INTEGRATING <u>ORGANIZATION FRAMEWORK</u>

In addition to providing a framework for executing strategy and making it more competitively powerful, the Value Delivery System is helpful in integrating functions within a company. Traditional attitudes have often led managers to believe that if they perform their function well, by their own functionally defined standards, they are doing their jobs well. They often are not, however, doing the best job of value delivery.

In the 1970s an agricultural chemicals company had a leading-share patented-formula product which killed weeds in wheat fields. However, the soil in about 20 percent of wheat fields retained enough of this herbicide that when these fields were used the next year for a different crop, the herbicide killed it. Farmers had to remove the weeds manually in these wheat fields. A competitor discovered that a weaker formula would kill the weeds pretty well, yet not kill the new crop the next year. Since this formula was chemically similar to the market leader's, the competitor asked the leader to make it in their plant. The leader did this, and rather casually charged a very high price.

The R&D department in the leader company was not interested in nor concerned about this weaker formula - it was, after all, clearly inferior. The competitor, however, soon tired of the high price and built their own plant. After the leader's patent expired, the competitor found it easy to make the now unprotected stronger formula, soon took a large share of the market and eventually became leader. Had the chemists been focussed primarily on defining and providing superior value, rather than developing impressive new chemistry, they likely would not have made this major error.

Managements and consultants often recognize this organizational problem, leading to exhortations: everyone is henceforth to work together as a <u>team</u>. The Value Delivery System provides a framework by which management can add specificity to this general command. Once a value proposition is chosen and clearly articulated, management can demand that all departments, every employee and manager, specifically act so as to directly contribute to delivery of this chosen value.

Providing the chosen value may mean manufacturing has to sacrifice their cost efficiency record in order to allow simultaneous introduction of a new formula and fielding of a major new promotion. The advertising agency may have to focus on developing some advertising that actually effectively communicates the value proposition rather than the new, possibly award winning creative (but irrelevant) idea recently developed by their staff. These changes in focus are much easier to produce if management is able to relate them directly to execution of strategy, which the Value Delivery System facilitates.

* * *

In summary, customers select a product or service because they believe it is a superior value. Hence, the heart of running a business is choosing a winning value proposition, then gearing all functions in the business to profitably deliver it. An explicit value promise must be chosen and articulated, reflecting a rigorous understanding of the benefits customers want, their willingness to pay for those benefits, our and competitors' ability to deliver these benefits, and the cost structure of the industry. That value proposition must then be maximally delivered and reinforced by the providing and communicating functions of the business system.

When considering your next strategy, then, ask yourself:

"Have we chosen, rigorously and explicitly, a superior, profitable value proposition?"

"Has the value proposition been echoed throughout the business system?"

"Do all key managers understand the value proposition and see providing and communicating it at a profitable cost as their real mission?"