GET INSIGHT INTO YOUR 3RD PARTY SUPPLIERS.

SURPRISES IN RETAIL ARE NEVER A GOOD THING

A CLEARPRISM WHITE PAPER

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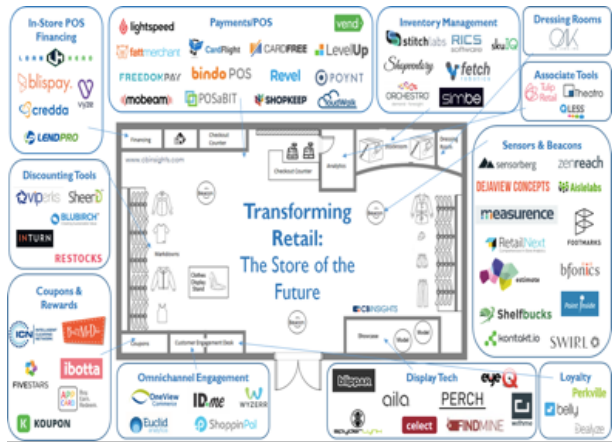
Digital Transformation—or Stalled Execution?

The Retail industry, like others, is being nibbled away changing its competitive landscape in terms of where value is being created, and destroyed – the result of new technology capabilities, shifting customer expectations and emerging new business models. The figure below depicts this well.

Different types of players are nibbling away the profit pools in the industry formally known as retail. As a result, the core areas that made up the retail industry are being unbundled and re-bundled in new ways. Understanding how this bundling and unbundling is happening will clarify what opportunities… and challenges… face both existing and new entrants in the retail domain. Insight into key implications of its shifting competitive landscape suggests pragmatic perspectives of what might be done about them. Such insight needs to start with a brief distillation of what is commonly known about some of the dramatic change roiling the retail industry.



Source: CBInsight 2016

So, what do we all know?

We all know that many retailers are closing their doors. We also know that nearly 20% of malls in the United States are considered “troubled” or “unhealthy” in terms of sustainable growth and profitability. We also know that significant investments are being made by the large retail players to counter these challenges. Many are investing to merge online with offline supply chains; in addition, many (most?) are expanding their eCommerce capabilities or using new features to lure folks in the door such as food courts, coffee bars or micro-localized banking services.
Part of this search for “what else might we do” includes investments in technology and start-ups as a way to speed up new capabilities into their existing business operations and thereby slow down the pace of the (inevitable) nibbling away of key elements of their business.

CBInsight, an analyst firm that focuses on venture and private equity capital flows to differing industries and technologies, distills some of their analysis regarding the retail industry as “Big Tech vs Big Retail.”

One of their key findings?

- **8.7x**
  Deal activity is low **OF** retail into technology compared with technology into retail. The top 50 technology companies acquired nearly 9 times the number of retail-relevant start-ups than did the top 50 retail firms and made 21 times the number of investments into retail-relevant start-ups compared with retail firms. (In 2015, the number we’re talking about involves 165 acquisitions and 361 investments – more than a few!)

Here’s another number to keep in mind when talking about key shifts occurring within the retail industry:

- **3x**
  3x, as many in the industry well know, is the multiple of revenue that Amazon receives from Prime vs non-Prime customers. In other words, Prime members generate 3 times the revenue of non-Prime members. Which does what? Helps to improve Amazon’s margins by increasing the returns on their significant fixed investments in their distribution networks.

What underlies the 3x of Prime? Convenience. Ask yourself, if you're a Prime member, how many times do you go to Amazon to purchase something because the convenience of finding and frankly, the shipping ease via Prime? Or the stickiness of additional services you can take advantage of being a Prime member – e.g., whether watching Amazon videos or other content Prime members have access to. I know I do – as, clearly do millions of others – hence the 3x and the strategic importance of Convenience as a competitive strategy. (For now. More on this later.)

In short? What's going on in retail?

A NEW PLAYING FIELD:

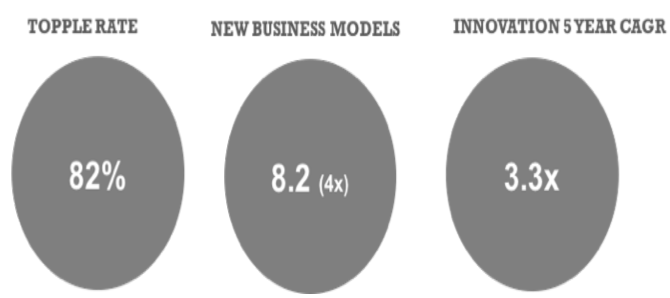
And here it gets interesting, because as we all know, change ALWAYS creates new winners and losers. Consider these numbers:

- **82%:** Topple Rate of Industries from the Fortune 500 over the past 20 years.
  The topple rate reflects the number of companies that "fall" from their industry position on the Fortune 500. Nearly 4% of companies fall annually - or topple – from their industry position; that's 80% over the past 20 years – and it is a rate that is only accelerating over the past few years.

  Ask yourself, is this something you're seeing in your industry or others that you follow? Are you seeing new competitors, shifts in their competitive position? Challenges to your maintaining your position within the industry? Any "yes" to these questions merely reflects the inevitability – and increasing acceleration – of the topple rate that impacts every industry.

- **8.2**: The market multiple of new business models.
  Deloitte Assurance (2016) published a report classifying 4 different types of business models (defined simply as methods of orchestrating capabilities to serve a market need) and their corresponding market multiples of revenue. Each differing business model reflected a different market multiple. Briefly, (using their terms), they are:

  - 8.2: Platform-enabled, business-ecosystem models – such as Amazon, TripAdvisor, Etsy…
  - 4.8: Technology Creator – e.g., Microsoft, Amgen…
  - 2.6: Service Providers – e.g., United Healthcare, Deloitte… and
  - 2.1: Asset Builders – e.g., Ford, Nike, General Electric.

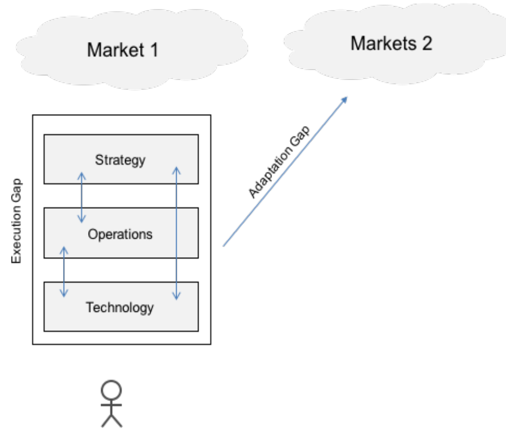


  We have written much elsewhere on the rise of business ecosystems as the new competitive landscape of tomorrow. What is now striking is that enough data points, based on sustainable financial results, exist such that we can model the dramatic differences of: a) differing business models and b) the striking financial differences among them. The anecdotes of emerging business models is now being complemented with quantitative analytic – and financial – insight.

  8.2 is a striking market multiple; it is 4x the market multiple of a business model that formed the basis for much of yesterday's – and today's – competitive landscape. Insight into what underlies these differing business models is critical to:

  - Understand how these different models orchestrate capabilities to drive different market multiples and thereby,

- Figure out if and how to capitalize on these insights to capture new sources of value in new ways – and what capabilities to bring to the table to do so.



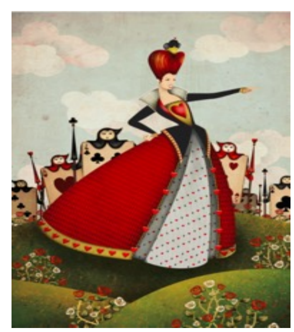
- **3.3x:** The multiple of revenue growth that companies with an effective innovation program represent compared with those who don't have such a program.
  There are three common questions we hear over and over again regarding innovation from companies, irrespective of size, industry and geography:
  - How do we get started regarding setting up an innovation program?
  - How do get more out of the programs we have?
  - What's next and what do we do about it?

Each question reflects a different starting point of what to do and how to do it. All of them reflect the criticality of figuring out how to, at a minimum, capture the 3x revenue growth compared with companies without an effective program.

So What? Three Observations:

What might we make of the data described above? And, more importantly, what might we do about it? Below, we make three observations pulled from the data. Regarding what you do about it depends on your response to the observations.

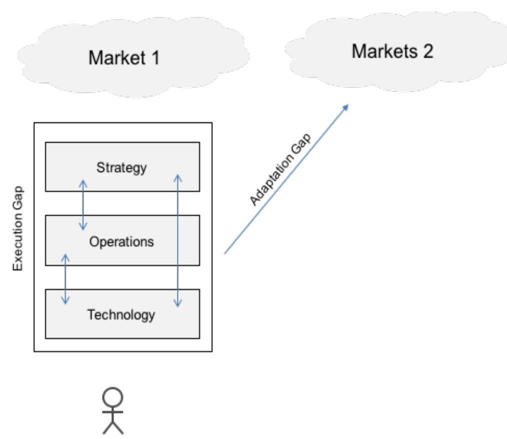
Observation #1: Businesses are often optimized for a world that no longer exists.



The Red Queen is a character from Lewis Carroll's *Alice in Wonderland* and *Through the Looking Glass*. She is the character who runs faster and faster, but stays in the same place. She is an apt metaphor for much of we what see in how businesses invest in their innovation programs. Merely replace the phrase "the same place" with "the same competitive place" and the reason we use her becomes clear. Let's try to make it clearer.

If nearly everyone company is investing in the same set of new technologies, say the "CLAMS" (of cloud, location, analytics, mobile and social), then it is no surprise that many of those companies will likely be in the same relative competitive position in x years time. Doing more of the same, better, faster, cheaper, is a tough competitive stance to take; that is a strategy of (attempting to) out-execute everyone else – a difficult competitive game to play over time.

The adjacent figure highlights this point – and was one of the foundations for our second book on how to bridge the gap between strategic intent and execution.



The execution game requires bridging the gap to drive alignment among the different parts of any and all business – across strategy, operations and technology. Think about it; all organizations have folks who focus on strategy, those responsible for running the business – the operations side of the house – and those accountable for technology. Getting executional alignment across these different folks with their different perspectives, processes and, often, incentive structures is often a challenge – yet critical to do to get done what needs to get done. Hence the frequent focus on alignment, on closing the execution gap - optimizing their performance in service of meeting the needs of a specific market.

Yet markets shift.

Technologies evolve, customer expectations change, and new business models emerge. This is what we mean by businesses are optimized for (competitive) worlds that no longer exist. This is what we mean by the adaptation gap. While energy is being spent on driving alignment across strategy, operations and technology to serve the market that made one successful, markets often shift, creating a fundamentally different type of gap that needs to be closed. Yet, closing that adaptation – or market shift – gap is hard; it **always** requires new capabilities, new skill-sets, most certainly a new mind-set, and frequently, adaptations to a business model to do so.

With what implication?

Businesses – and organizations – frequently fight yesterday's competitive war. Hence, the accelerating topple rate we already discussed, the rise of new (types of) competitors and the emergence of new market multiples based on new types of business models.

Let's take an example.

In the retail industry, the Big Tech vs Big Retail challenge is only heating up. Much discussion – and dollars are being spent – on Digital and eCommerce. But, here's a question: digital and eCommerce… in service of what? What's the business problem we're trying to solve with digital and eCommerce?

This question matters for a simple reason, and it ties directly to the Red Queen race and the two figures we just explored. Let's look at this in more detail.

What does eCommerce allow you to do? What's the business problem it solves? Sell more products; certainly. Make it more convenient for customers both to buy and to receive products; absolutely. Digital and eCommerce capabilities then, at their core, aim to solve the business problems of providing more CONVENIENCE and SPEED to get products to the customer's home or business.

This has been the logic of the $3 billion acquisition of Jet.com by Walmart – strapping on a powerful eCommerce engine to the powerful logistics capabilities that underlie Walmart's domination of what represents, in the "gap" image above, Market 1.

From our perspective, and experience, there is one problem and one significant implication of this logic. First, the problem. Markets shift; technology capabilities evolve catalyzing new customer expectations and consequently where they are willing to spend their time and dollars. Second the implication. While many, including Walmart in our admittedly broad-brush example to make a point, are focused on getting products more conveniently and faster TO THE HOME, Amazon has shifted the competitive playing field, represented in our diagram above as Market 2. They've done so asking different strategic question – namely, how do we (Amazon) use our insight into customer behaviors and predictive capabilities to understand what do people **do** with the products they buy, when and how frequently they consume them, and how can we shape **that** behavior?

This question extends their execution focus from delivering goods TO THE HOME (or business) to the point of their consumption IN THE HOME (or business).

This explains their strategic intent to "own the home" (and business, which we'll come back to) rather than getting products "to the home." Amazon is no longer competing (primarily) on logistics, speed or convenience, but on ***enablement*** of whatever it is you – the consumer – want to do, when you want to do it and however you want to do so.

This is where Amazon's Alexa comes in – to do for the front-end of "everything commerce" what Amazon's AWS (Amazon Web Services) is for the back-end of "everything commerce."

Think about it. AWS was started, as is well known, to support the fulfillment of Amazon's eCommerce business. It has become the backbone of much eCommerce for firms, leveling the playing field between small and large players. As Social+Capital's founder, Chamath Palihapitiya, has characterized Amazon's strategic intent: "AWS is a tax on the compute economy. So, whether you care about mobile apps, consumer apps, IoT, SaaS etc., more companies than not will be using AWS vs building their own infrastructure." AWS, in short, has a specific objective: to help companies "enable anything" they want to do on the internet. The "tax" Chamath refers to reflects Amazon's revenue model of taking a slice of every transaction that relies on the use of AWS – irrespective of what people want to use AWS for.

Amazon's Alexa reflects the same strategic intent. Amazon's Echo is merely the first of what Amazon hopes to be thousands of different products based on the voice API services that make up Alexa. Their resulting revenue model? Take a slice of every transaction that relies on the use of Alexa – irrespective of what people want to use Alexa for.

In short, Amazon's overall – and extraordinarily consistent strategy – is to be the Gateway and Enablement of ANYTHING CONSUMED – or TRANSACTED – online.

So. While much of the retail industry is focused on convenience and speed **to the home**, the new competitive landscape – and market – has shifted to insight, customer intimacy & enablement. ***From this perspective, Walmart is playing yesterday's competitive game while Amazon has already shifted it.***

The bottom line here is blunt: The Red Queen is a tough force to content with. We all need to be wary of the competitive race we are running, and the questions we ask regarding what the strategic game is to engage. Ben Thomson, a brilliant analyst, wrote that "all… those analysts who assumed Walmart would squish Amazon in e-commerce thanks to their own mastery of logistics were like all those who assumed Microsoft would win mobile because they won PCs. It turns out that logistics for retail are to logistics for e-commerce as operating systems for a PC are to operating systems for a phone. They look similar, and even have the same name, but require fundamentally different assumptions and priorities." And reflect fundamentally different business models, we would add. To modify what Ben later wrote. "Walmart promised… to invest... billion[s] in technology and logistics, but given Amazon's [new competitive playing field, Walmart] has far more money than time." Walmart, from the perspective laid out here, is playing yesterday's competitive game, running the Red Queen race, running it well, but running it nonetheless with significant (challenging) implications over time.

Observation #2: The landscape is shifting… quickly

The most successful, and new high growth, business leaders – whether Tesla or Tencent, Amazon or Alibaba, Uber or Oculus, Google or GE or most of the other companies generating explosive growth – all reflect our new competitive reality - namely:

the new competitive landscape will be framed less by competition between industry giants than by land grabs by ecosystem-centric business models.

This is the basis of the 8.2 market multiple discussed earlier. According to the market research firm, IDC, by 2018, more than 50% of large companies – and more than 80% of those with advanced digital capabilities – will create and/or partner with ecosystem-centric, platform businesses.

The **adjacent image** (where is this?) is pulled from the IDC report. This is no anomaly. Business ecosystems are being designed, and implemented, in all industries – from real estate to eCommerce, from financial services to entertainment. And most certainly in Retail.

Here is where it gets interesting. To modify a quote from Leo Tolstoy, a giant of Russian literature, each of the business ecosystems being developed is unique, but they are unique in similar ways. Yes, different flavors of these models are emerging; and distinct patterns are emerging in terms of which of these work given one's strategic intent and capabilities. We have identified seven different patterns to date, each effective in their own way, all sharing common elements that underlie these models. Therefore, key questions for all of us to ask include:

- Which of these models is appropriate for our business objectives?
- What role might we play within them?
- What new capabilities will we need to do so?
- And how do we begin to do so, given our current focus and existing set of capabilities?

Answers to these questions are not easy. But they do need to be asked. And answered.

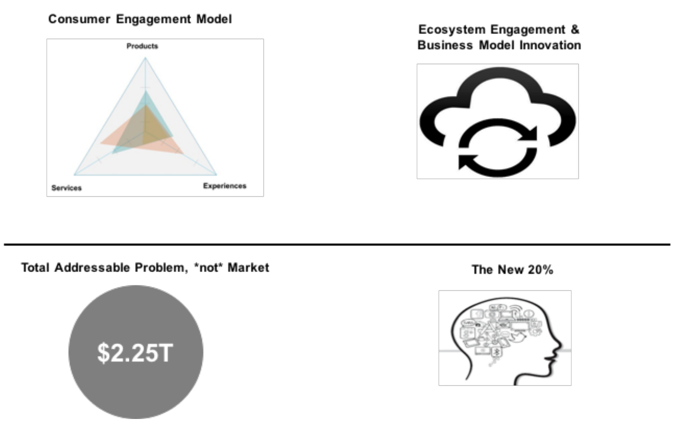
Observation #3: Common elements underlie the new models

Business models are simply different ways of orchestrating capabilities to serve customer's needs. Business ecosystems, then, simply reflect the orchestration of different capabilities from a broad set of actors to capture new sources of value in new ways. That's it in a nutshell. Pragmatically, there are four common elements underlying the seven different types of business ecosystems.

1. New types of consumer engagement models.

   Customer experience is shaped by a blend of products and services. Figuring out what the appropriate blend is, and clarification of what services are or the new products to create need to be becomes key. But the blend is key – and something nearly every firm is wrestling with. Ask yourself a question: what product companies do you know of that are not wrestling through what type of services to offer, or even what services mean for a product-based business? And for service companies, a common question is how to productize their offerings. For both, it is the blend that matters – with implications on how to engage customers, design new types of revenue models and enable new forms of customer experience.

2. Ecosystem engagement & business model innovation.



   Figuring out how to orchestrate capabilities to meet the new expectations that market shifts always create is the key to effective ecosystem engagement. Amazon's Alexa is based on providing APIs to any product that cares to exploit it in service to meeting specific customer needs. Alexa, again like AWS' focus on enabling businesses to use its application services for whatever it is those businesses want to do, is dependent on other firms bringing specific capabilities to the table. Alexa-as-utility reflects a specific capability within a specific type of ecosystem – with its own revenue stream, method of sharing risk and capturing value among the various other companies who make up the Amazon "own the home" strategy. Other models exist. The point? Clarity of what type of ecosystem to engage it will determine what role to play and what type of value to capture.

3. The New 20%.

   Shifting the competitive landscape to capture new sources of new ways always depends on new capabilities. We call this "the new 20%" – whereby 20% of new capabilities are critical to capture 70% of the new sources of value. Back to Amazon. "Owning the home" as compared with getting products "to the home" faster and cheaper – reflecting Amazon's shift of the retail competitive landscape – rests less on logistics expertise than on predictive analytic insight and platform services that other firms can take advantage of as, and whenever and however much they need. Not that logistics aren't critical. Clearly they are – as reflected by both Walmart's Jet.com acquisition and the significant investments Amazon continues to make in localizing distribution hubs. But the new sources of value – being able to "tax" – or take a slice of "anything consumed or transacted online" requires an additional set of capabilities. For Amazon, this "new 20%" which is changing their competitive landscape makes up the "new foundations of value" – again, the new 20% - of capabilities that will capture the lion's share of the new sources of value being created.

4. The new strategic question.

   The new models are based on what we call "the new strategic question." Each of them answers it differently. However, all of them power the 8.2 ecosystem-centric models that underline their growth. Underlying each of these new models is a ***change in the unit of focus*** – from a particular business or even industry to the ecosystem in which they are engaged. Detroit, in the summer of 2016, was host to the annual global car show where new automobile – and business models – are trotted out. This summer was witness to the automobile industry acknowledging that other industries, other capabilities, were critical to the new playing field that make up the sector formerly known as transportation. As such, they redefined their industry as a Mobility rather than a Transportation industry, based on the reality that their ecosystem of partnerships and capabilities consisted of new types of players with new sorts of capabilities critical to capture the wallet of tomorrow's customers. The same is happening in Retail – hence the earlier point of Big Tech vs Big Retail. With this as context, the new strategic question becomes clear:

   where is value being created… and destroyed… in the ecosystems in which you and your customers engage… and what do you do about it?

   In the new world of competing ecosystems, the traditional ways of assessing competitive advantage are becoming increasingly irrelevant – reflecting running of the Red Queen execution race. While many firms will continue to pursue traditional sources of advantage, they will be increasingly vulnerable to disruption from competitors taking an "ecosystem" approach. This is no minor change; it catalyzes fundamentally new ways to deliver value to your customers, stakeholders and markets within the new competitive environment in which we all engage. Just ask Amazon?

Now What? Lessons and Relevance for Retail Innovation:

The competitive imperative is clear:

1. Stop running the Red Queen race
2. Focus on lessons from the 8.2 market multiple business models
3. Mobilize around your new 20% of critical capabilities to capture 70% of new sources of value.

Easier said than done? No. The objective of this article is to suggest:

- That there is a new competitive playing field
- How to start "making sense" of this new field so you start "taking action" on it.

That retail is undergoing so much change now means that lessons exist from other industries of direct relevance. Every industry is facing the new competitive landscape, itself the result of shifts, as we mentioned earlier, of new technology capabilities, shifting customer expectations and the rise of new business models (and, for some, changing regulatory policies as well). For this reason, looking elsewhere – particularly at other companies from other industries and geographies – becomes a way to catalyze insight into how to capture new sources of value in new ways.

For retail, specifically, we would suggest looking at Microsoft, Amazon's Alexa and Etihad airlines for insight into how they are seeking to shift their competitive playing field; at Boeing and General Electric for how they are re-orchestrating their global supply chains and shifting the role they play within their existing – and emerging - ecosystems; to Cisco and Tesla for how they have exploited the new strategic question and what it means for their "new 20%" of capabilities; and to Tencent and Converse (among many potential others) for emerging new models of engaging their customers with provocative new ways of blending products and services to engage their consumers differently.

Each of these companies has specific insights and potential lessons for anyone within Retail. All of them are based on the new strategic question and the implications that answers to it raises. The critical point is to ask it, and begin the journey that its answers will highlight.

About ClearPrism:

We are a math and data science-based solutions company that helps retail organizations predict, quantify and reduce risks, algorithmically. Contact us to find out how.