Living on the Fault Line
Managing for Shareholder Value in the New Economy

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Agenda

• Managing for Shareholder Value

• Core versus Context

• Rethinking Outsourcing
Managing for Shareholder Value
Valuing a Company

- A share of stock entitles you to a share of the future profits of a company

- If you own all the shares, you are entitled to all the future profits of the company

- What would that be worth?
The Formula

• The total value of a company is equal to
  
  • The present value of
  
  • All its future profits
  
  • Discounted for risk
Visualizing Market Valuation

Forecast of future profits

Discounted for present value

Discounted for Increasing risk

Returns

Time
Visualizing Shareholder Value

Market Capitalization

Investors: *Make the green area bigger!*
What Makes the Area Bigger?

Competitive Advantage Gap
- Better offers than competition’s
- More sales, higher profits

Returns

Competitive Advantage Period
- Strategic advantages over competition
- GAP with a future

Time
GAP versus CAP

• Examples of GAP
  – New product introduction
  – Lower priced offering
  – Superior customer service

• Examples of CAP
  – Proprietary technology
  – Market share leadership
  – Brand popularity
It’s All About Competitive Advantage

• **GAP = Execution Advantage**
  – Did you meet or beat your *revenue* forecast?
  – Did you meet or beat your *profit* forecast?

• **CAP = Strategy Advantage**
  – How much life is left in your category?
  – How strong is your position within it?

Valuation is about power
The more power, the higher the stock price

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The Limits of Managerial Control

Sector Valuation

Company Valuation

Category Valuation
Managing for Shareholder Value

• **Managers cannot control sector valuation or category valuation**
  – Function of macro-economic factors
  – Set by the bid/ask mechanisms of the market

• **Managers can control company valuation**
  – By choice of categories
  – By performance within category
Choice of Categories

- **Texas Instruments sold off half its company and raised its market cap 7X**
  - Exited computers, defense, consumer
  - Focused on DSP chip business

- **Corning did the same for a 20X gain**
  - Exited consumer, lab testing
  - Focused on fiber-optic business

**Investors want to put their money into competitively advantaged categories**
Performance within Category

• **Measured in relation to**
  – Expectations set by management
  – Performance of direct competitors

• **Valuation changes when**
  – Your performance is unexpected
  – Your competitors’ is unexpected

• **Two critical success factors**
  – Set expectations
  – Set up your competitors
Key Takeaway:

Managing for shareholder value = Focusing on competitive advantage

not Engineering the quarterly report
Core versus Context
Definitions

- **Core:**
  - Any process that contributes directly to competitive advantage (GAP or CAP)

- **Context:**
  - All other processes required to fulfill commitments made to one or more stakeholders in the enterprise

Only core can raise stock price
Prioritizing Resources

• **Core**
  – Goal is competitive advantage
  – Invest to differentiate
  – Spend scarce resources here

• **Context**
  – Goal is to meet market standards
  – Differentiation adds no value
  – Extract scarce resources to redeploy above

*Over time most processes become context*

*Here’s why*
Core Becomes Context

- Component traceability
- Supply-chain visibility
- Build-to-order
- Just-in-time delivery
- Assembly
- Manufacturing
- Raw material production

Scarce resources get trapped in low-value processes
Context Build-up

Context

Core

Youth

Core

Context

Age
Consequences

- Wastes scarce resources
- Alienates investors
- Demotivates talent
- Creates inertia that blocks change
- Company misses next wave
- Stock price decays
Prescription

Outsource the Context

Insourse the Core
## Core/Context Relationship

<table>
<thead>
<tr>
<th>Core</th>
<th>Context</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hamburger</td>
<td>Bun</td>
</tr>
<tr>
<td>Actors</td>
<td>Stage</td>
</tr>
<tr>
<td>Gift</td>
<td>Wrapping</td>
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<tr>
<td>Ideas</td>
<td>PowerPoint</td>
</tr>
</tbody>
</table>
Three Lessons

1. Core and context interact to create quality—both are necessary.

2. Whatever your context, it can be someone else’s core.

3. Context is just core in the wrong location.

Outsourcing is the key enabler
This *is* the New Economy

- Network of cooperating companies creating end-to-end solutions
  - Each company contributes best-of-breed core
  - No company does context work

- Advantages over old economy model
  - Capital not tied up in low-value work
  - Maximum returns to investors
  - Attracts additional capital at favorable terms

So why aren’t we seeing more of it?
Rethinking Outsourcing
The Big Challenge

• **Outsourcing doesn’t work!**
  – Ask anybody
  – (Except Cisco, Dell, Enron, Solectron, ADP, SABRE, . . .)

• **OK, outsourcing does not work reliably**
  – Lack of best practices
  – Internal anxiety over dislocation, job loss
  – Loss of control over mission-critical processes

Needs a better model
Outsourcing Model

Core

User Interface Design

Context

Manufacturing Line

Supporting

Advertising Campaign

Mission Critical

Facilities Security

Four different relationships with Third-party service providers
Management Strategies for Third-Party Relationship

These are easy

These are hard

Core
Engage

Context
Disengage

Engage & Control

Control & Disengage

Engage & Entrust

Entrust & Disengage

Mission
Critical
Control

Supporting
Entrust

Supporting
Entrust

Engage & Entrust
Mission-Critical Core: Engage & Control

Customer
Manages the project
Staffs the team

Service Provider
Provides scarce expertise
Supplements the team

Integrating the expertise

Biggest challenge

User interface design
Supporting Context: Entrust & Disengage

Customer
Selects the provider
Inspects work periodically

Service Provider
Manages the process
Staffs the work

Ensuring day-to-day quality

Biggest challenge

Facilities security
Supporting Core: Engage & Entrust

Customer
- Provides key inputs
- Supplements the team

Service Provider
- Manages the project
- Provides expertise

Work product acceptance

Biggest challenge

Ad campaign
Mission-Critical Context:
Control & Disengage

Customer
Selects the provider
Sets the service level

Service Provider
Manages the process
Staffs the work

Keeping in control

Biggest challenge

Manufacturing line
Mission-Critical Context: Control & Disengage

- **Current practice is not stable**
  - Entrust and disengage
  - Creates unacceptable risk
  - Culminates in lose/lose antagonism

- **Best practice**
  - Build controls *before* outsourcing
  - Retain visibility *after* outsourcing
  - Constantly monitor risk position
Focus on Control Systems

• **Current practice**
  – IT oriented toward *productivity improvement*
  – Issue is *quality control*
  – Must refocus (outside-in instead of inside-out)

• **Best practice**
  – Build and debug the controls before going live
  – Outsourcers must lead (investment leverage)
  – Customers must fund a *project* (customization) before transferring the *process* (outsourcing)
Gaining Goal Alignment

• Customer
  1. Reclaim scarce resources
  2. Retain continuous control
  3. Cut costs

• Third Party
  1. Speed adoption of outsourcing
  2. Retain customer base (avoid churn)
  3. Increase revenues and profits
Recap

- **Managing for shareholder value**
  - Migrate to advantaged categories
  - Perform vs forecast and competition

- **Core versus context**
  - Core becomes context
  - Outsource context to make room for core

- **Rethinking outsourcing**
  - Focus on mission-critical context
  - Control, then disengage
Thank You
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