

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

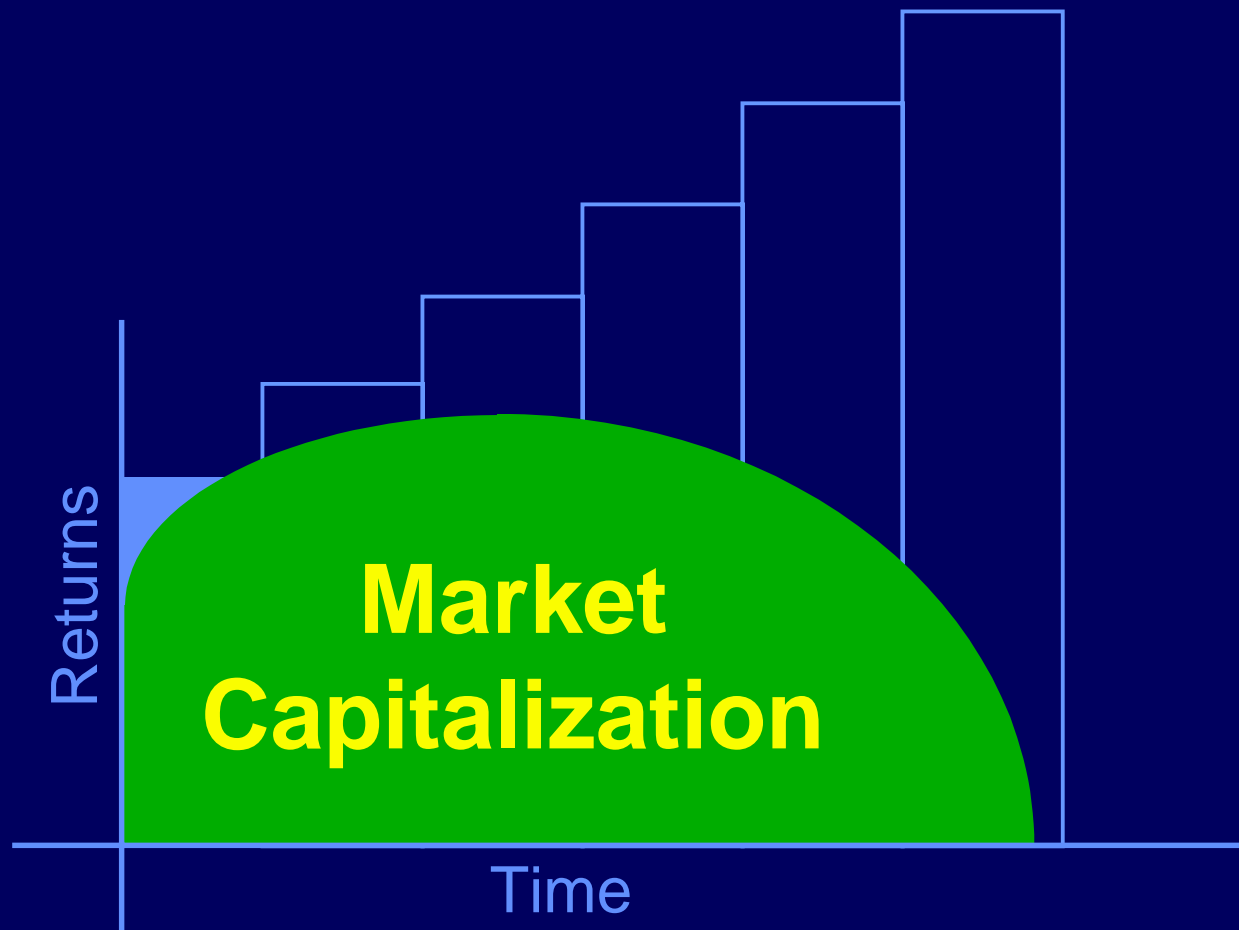
- **The total value of a company is equal to**
 - The present value of
 - All its future profits
 - Discounted for risk

Visualizing Market Valuation

Forecast of
future profits



Visualizing Shareholder Value

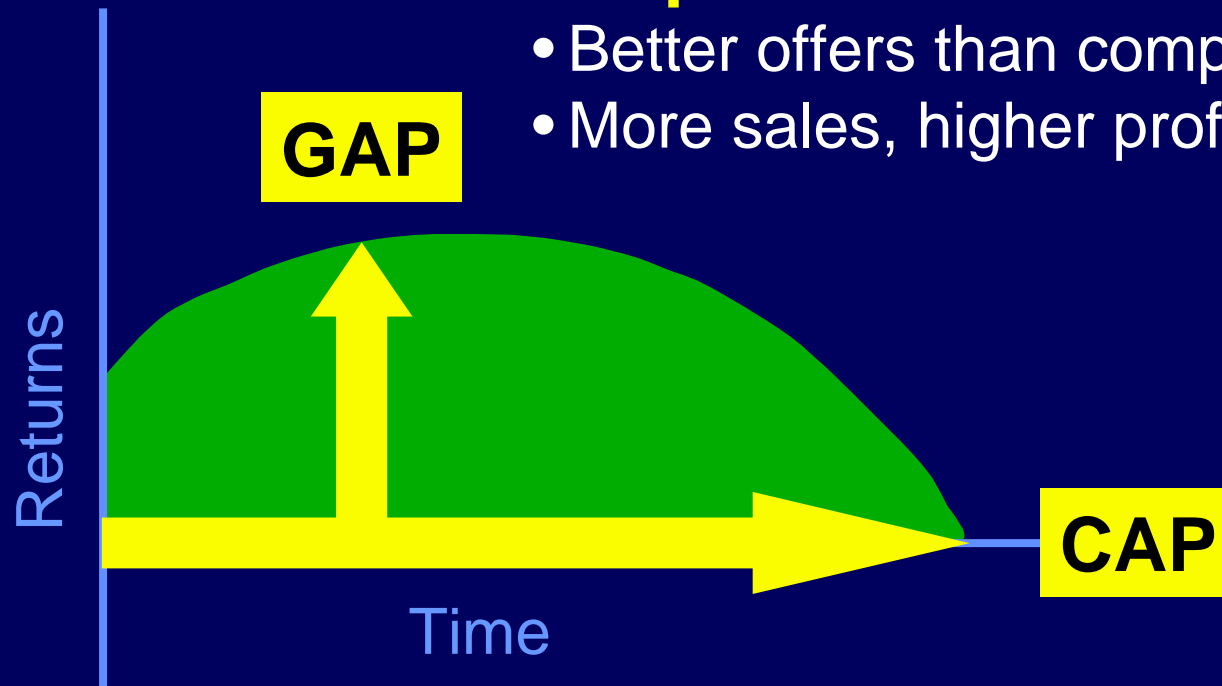


Investors: *Make the green area bigger!*

What Makes the Area Bigger?

Competitive Advantage Gap

- Better offers than competition's
- More sales, higher profits



Competitive Advantage Period

- Strategic advantages over competition
- GAP with a future

GAP versus CAP

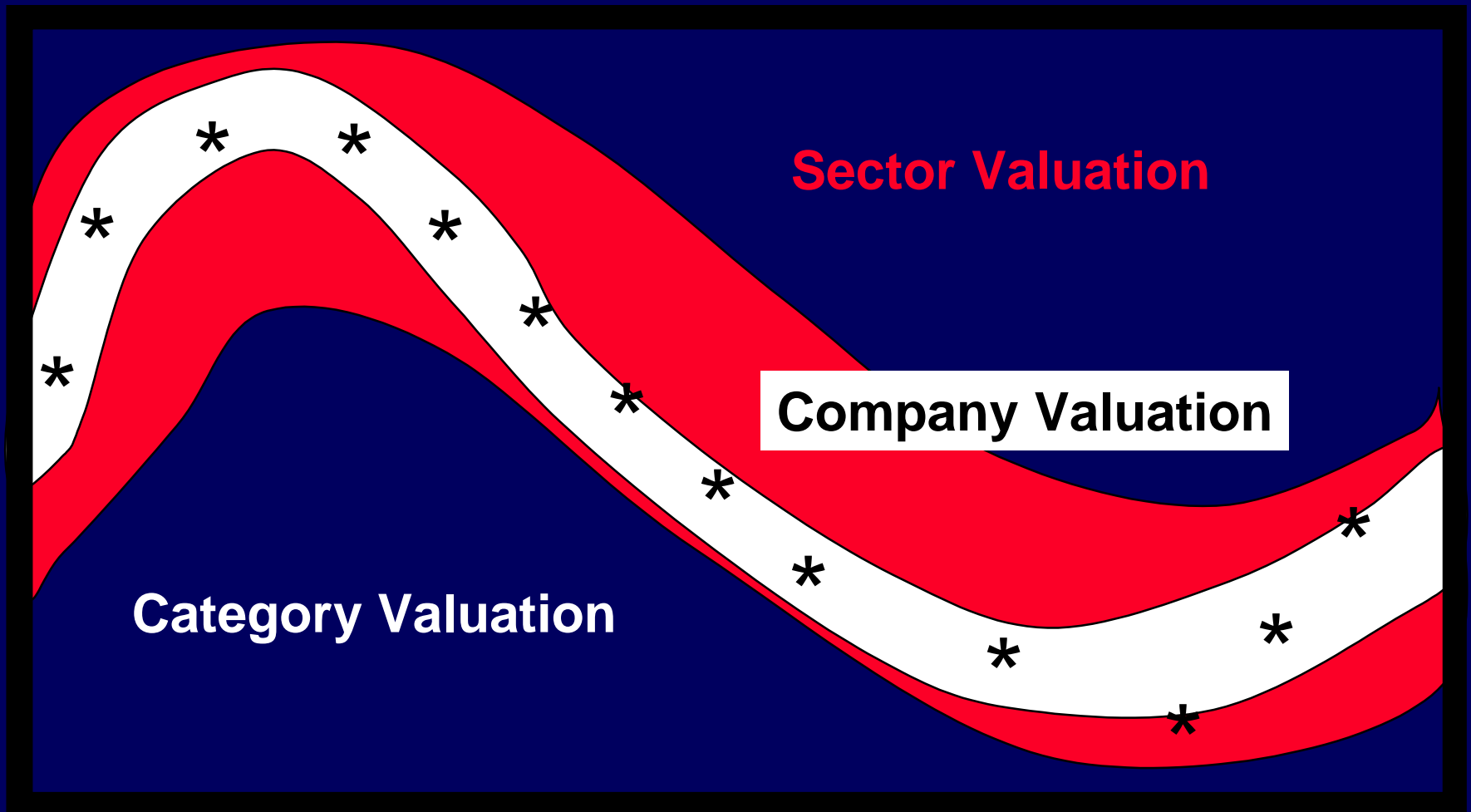
- **Examples of GAP**
 - New product introduction
 - Lower priced offering
 - Superior customer service
- **Examples of CAP**
 - Proprietary technology
 - Market share leadership
 - Brand popularity

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

The Limits of Managerial Control



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

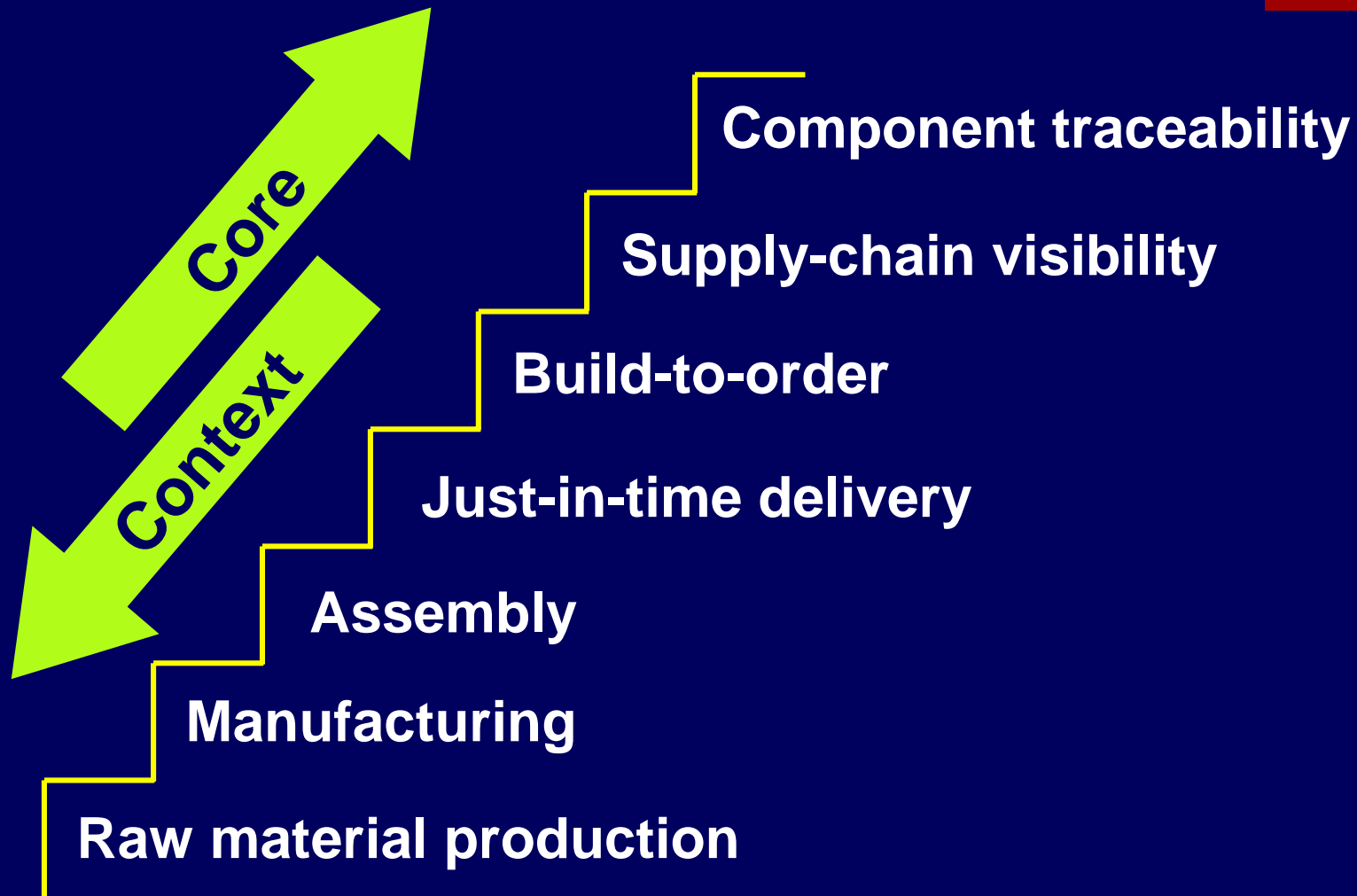
Only core can raise stock price

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

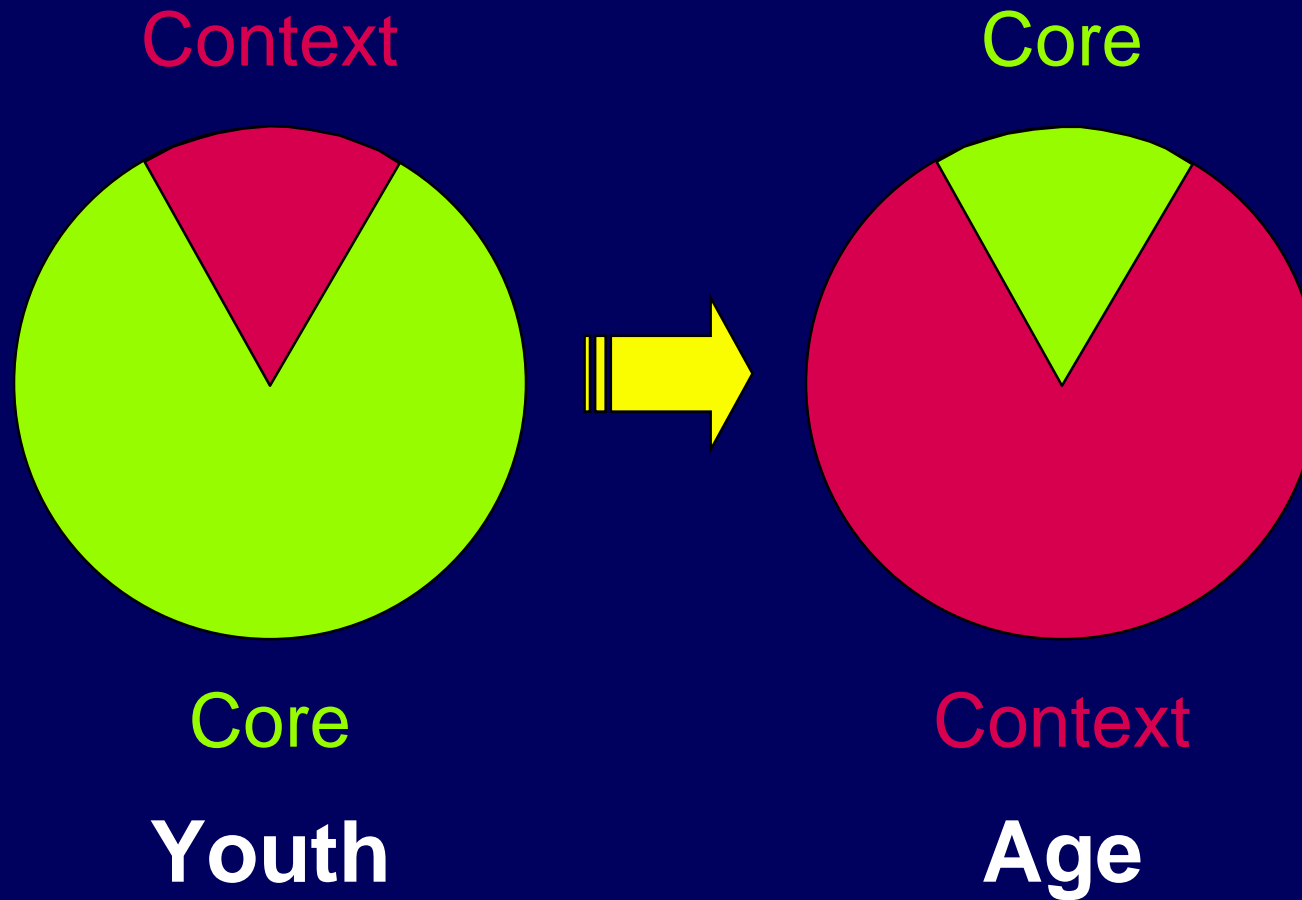
**Over time most processes become context
Here's why**

Core Becomes Context



Scarce resources get trapped in low-value processes

Context Build-up



Consequences

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

Prescription

Outsource the Context

Insource the Core

Core/Context Relationship

Core

Context

Hamburger

Bun

Actors

Stage

Gift

Wrapping

Ideas

PowerPoint

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?

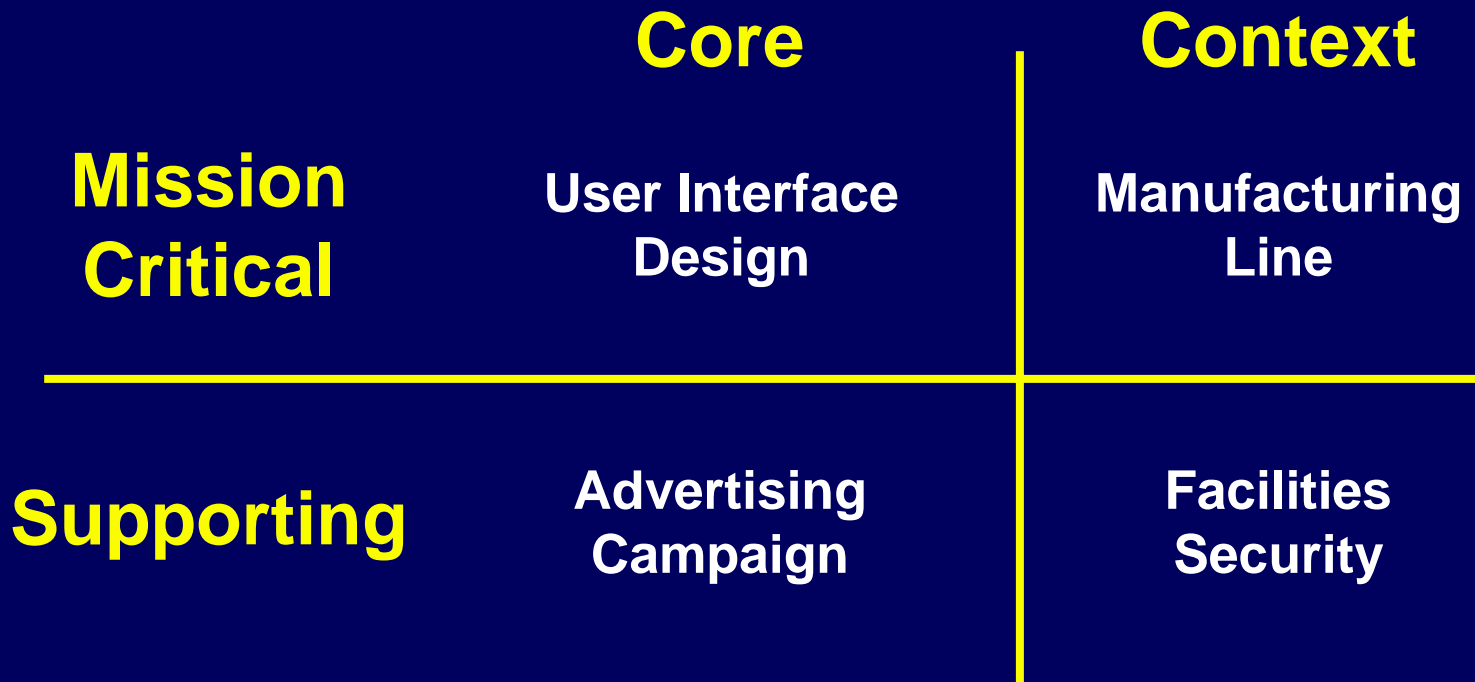
Rethinking Outsourcing

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

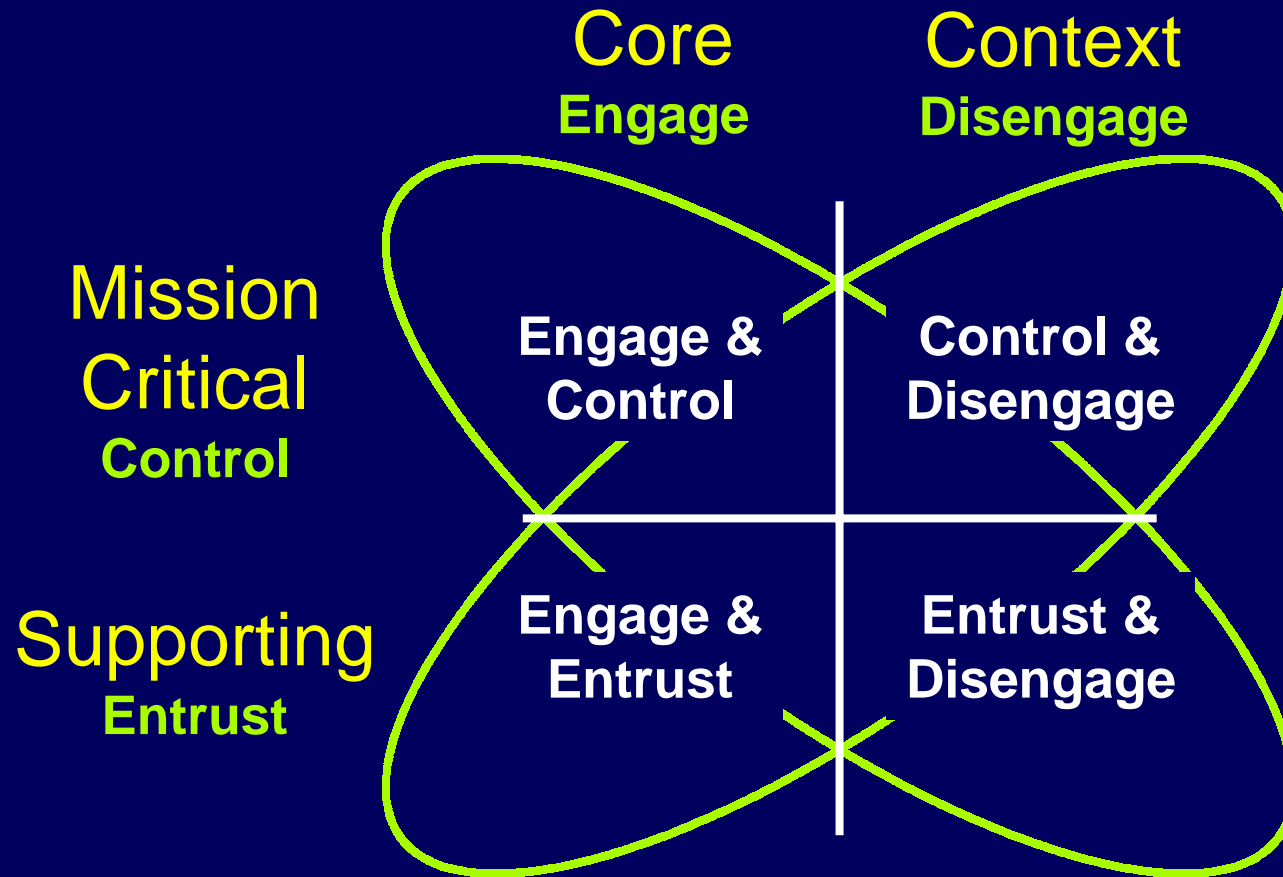
Needs a better model

Outsourcing Model



**Four different relationships with
Third-party service providers**

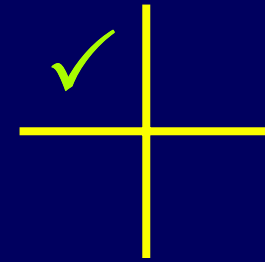
Management Strategies for Third-Party Relationship



These are hard

These are easy

Mission-Critical Core: Engage & Control



Customer

Manages the project
Staffs the team

Service Provider

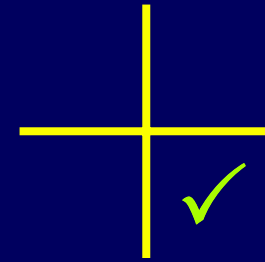
Provides scarce expertise
Supplements the team

Integrating the expertise

Biggest challenge

User interface design

Supporting Context: Entrust & Disengage



Customer

Selects the provider
Inspects work periodically

Service Provider

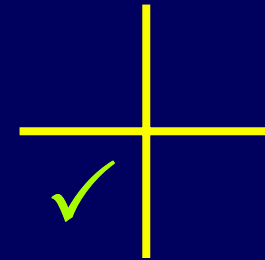
Manages the process
Staffs the work

Ensuring day-to-day quality

Biggest challenge

Facilities security

Supporting Core: Engage & Entrust



Customer

Provides key inputs
Supplements the team

Service Provider

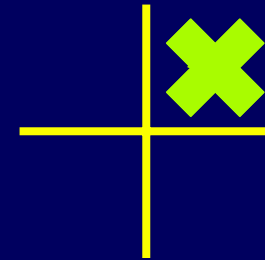
Manages the project
Provides expertise

Work product acceptance

Biggest challenge

Ad campaign

Mission-Critical Context: Control & Disengage



Customer

Selects the provider
Sets the service level

Service Provider

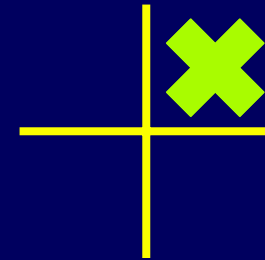
Manages the process
Staffs the work

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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