CHAPTER 1

RESPONSIVENESS TRUMPS EFFICIENCY

By Michael Hugos

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Today's global economy squeezes profit margins more efficiently than ever before. Electronically connected global markets are doing what markets do so well; the commodities traders and stockbrokers call it "efficient price discovery." That phrase means global markets are constantly finding the lowest price for all basic commodities and services based on current supply and demand—everything from blue jeans to fuel oil, and hotel rooms to accounting services—and constantly resetting those prices as conditions change.

This market driven efficient price discovery tends to relentlessly reduce profits and drives the prices people can charge for products and services closer and closer to their cost of production (sometimes even below their cost of production). Companies are always moving their production to low-cost labor markets and outsourcing activities in a scramble to lower the cost of production so that they can still make a profit at price points set by the market.

For this reason, the best profits for most companies no longer come from standard or commodity products; the best profits are now to be found in new and creative products and services. If these new products catch on, for a while they have no competition and there is lots of demand so prices stay high. But products and services are new and innovative for only a short time. Then they become commodities because they get copied and offered at lower prices. And when that happens, profit margins drop again.

Most profitable opportunities in the global economy are, by definition, short-term opportunities. Companies need to respond and act quickly in order to capitalize on opportunities that arise. This has always been true, but now it is critical if a company is going to maintain its long-term profitability.

The World Behaves Like a Stock Market

The Internet and the search engines and the trading and procurement systems that make global markets possible also do something else. They provide massive and continuous flows of data the likes of which we used to see only in connection with financial markets, such as stock and futures markets. Now our economy everywhere is generating similar flows of data. Companies generate data flows from their internal systems; e-commerce and supply chain networks generate more data flows that go between companies; and the Internet moves all this data from anywhere to anywhere 24 hours a day, seven days a week.

These real-time data flows cause the whole world to behave like a giant stock market with all the volatility and uncertainty that goes along with such markets. And because real-time data is available, we are all doing business in real time now whether we know it or not. Just as stockbrokers use real time stock market data to constantly monitor and react to their markets, so too can people in business use available real-time data to monitor their own markets and react quickly as situations change.

The very fact that more and more companies are connecting up with e-commerce and electronic trading networks means that the markets they work in are becoming more volatile. Because information is available in real time, people are learning to react more quickly. Change ripples through markets much faster than ever was possible in the industrial economy. Supply and demand data for products and services are communicated quickly so the prices of those products change quickly (just like stock prices). Gone are the days when people could confidently predict the price of any commodity for more than a month or two.

Companies that succeed are learning to make continuous small adjustments in their operations to respond as conditions change, and they are learning to continuously enhance their products and services with new features as their customers' desires evolve. They learn to make money from many small adjustments and from some occasional big wins—just as stock traders do.

Companies must attain and maintain a level of "good-enough" efficiency, but unless a company is the low-cost leader in its market, it cannot use efficiency alone to generate profits. For the most part, it is now customer responsiveness that generates profits in the form of customers paying slightly higher prices for products and services that they find more responsive to their needs. Since these products deliver more value, people are willing to pay more.

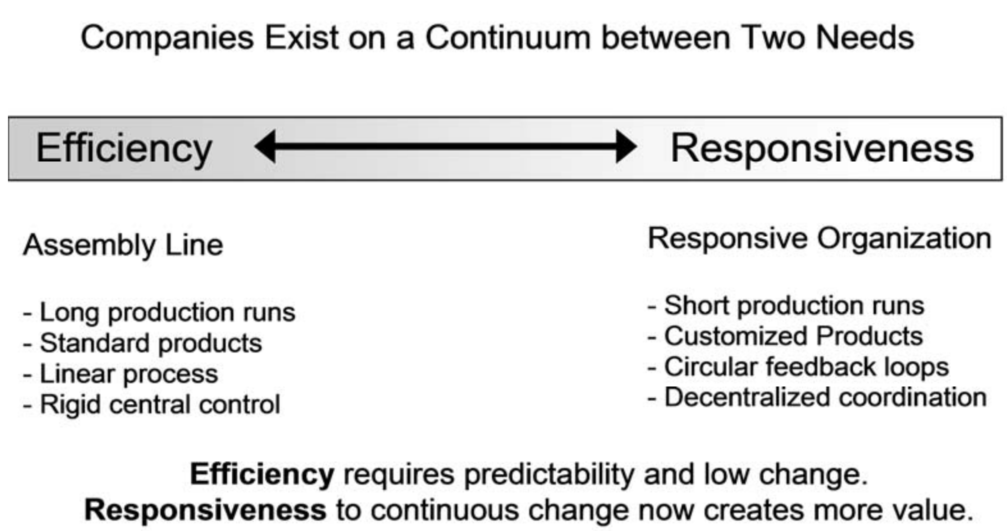
Opportunities to make money by being responsive have exploded. There are far more ways to use responsiveness to attract customers than there are ways to use efficiency and low prices. This is because there are so many different kinds of customers, and each is looking for slightly different mixes of products and services. Constantly changing environments and customer needs enable responsive companies to offer continuously evolving mixes of new products and services.

Companies respond to evolving needs and desires of specific groups of customers by wrapping their products and services in tailored blankets of value-added services. Occasionally they find opportunities to introduce entirely new products and services. As profits on old products decline, profits are always to be found by creating new products that respond to new needs.

Responsiveness enables a company to consistently earn an additional gross margin of 2 to 4 percent (and sometimes more) than what it would otherwise earn for its commodity product or service alone [1]. This responsive focus on customer and market specialization is now the most promising and the most sustainable source of profits in our fluid, real-time economy. These ideas are summarized in Figure 1.1.

In this high-change global economy, *responsiveness trumps efficiency*.

Figure 1.1



Efficiency Is Only Half of the Equation

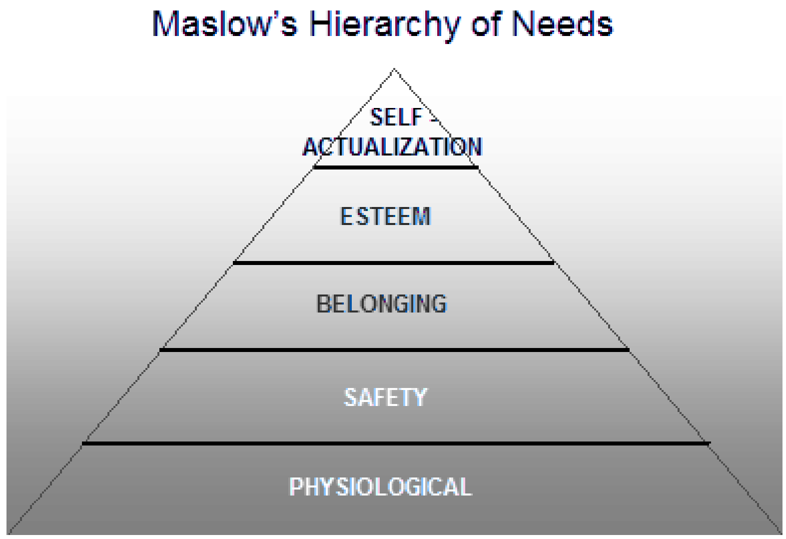
For the last few hundred years, the most important consideration in business was efficiency: producing products at the lowest possible cost. But now we are all part of a global labor force, and there are countries in Europe and North America that can no longer compete on efficiency alone because their labor costs (also known as people's salaries) are so high compared to labor costs in countries in Asia, Africa, and South America.

What is to be done? Will the economic boom for some countries be economic doom for others? That might be the case if the only economic force we considered is efficiency. But we are missing something important when we do this; in addition to efficiency, there is another economic force called responsiveness. Efficiency provides us with basic products and services at the lowest price. Responsiveness wraps those products and services in a blanket of value-added services that customize them to our particular needs and, in doing so, makes them more valuable to each of us.

Everybody has needs that go beyond efficiency. As soon as people are able to acquire the basics, they want something more (see Maslow's Hierarchy of Needs[2] as presented in his classic article "A Theory of Human Motivation"). A basic pair of sneakers costs about $20, but there are a whole lot of people willing to pay $100 or more for sneakers that respond to their other needs. A basic new car costs about $16,000 (or less), but there are many millions of people willing to pay much more to get cars that respond to their other needs.

People want what they want. They want a good price, but that doesn't mean they want the lowest price. People usually also want a tailored bundle of additional services and features wrapped around the basic product. They will pay extra for these other features as long as they meet expectations. Maslow's Hierarchy of Needs in Figure 1.2 shows that once a lower-level, basic need is filled, people aspire to filling higher-level needs.

Figure 1.2



Even the most basic commodity product can be wrapped in a blanket of value-added services that increases its value to particular customers because those value-added services provide features customers want. For instance, we have all seen how a commodity product like the coffee bean can be wrapped with a blanket of value-added services and so give rise to a whole industry. People will pay more for a good cup of coffee made just so and served in a cozy setting. And if the quality of the coffee and the coziness of the setting start to decline at one company, customers simply go elsewhere. People will pay more for a good product but they do not pay extra if they are not getting what they want.

Good customers (and most customers are good customers when you figure out what they really want) will pay a few percentage points more in order to get a carefully tailored bundle of goods and services from you that either solves an important problem of theirs or enables them to enjoy a major benefit. Who are the good customers in your business? How will you get more of them? What are the tailored solutions you offer them? How will you evolve these solutions over time to keep up with good customers' changing needs?

And here is another thing to think about: If you don't have many good customers, how will you keep your bad customers from destroying your profits and your business? Is efficiency alone a sufficient answer to this question?

Traditional Business Models Are Coming Up Short

Many large, established companies are demonstrating that their traditional focus on efficiency no longer shields them from market fluctuations, nor does it deliver the profits it once did. Their business models need to be redesigned. They follow business strategies based on twentieth-century industrial concepts of efficiency, such as spreading fixed costs across huge numbers of units sold, scheduling long production runs, and assuming there is a steady, predictable demand for their products.

In reality, things such as stability and predictability are conspicuously absent from our global economy. Yet companies continue their old industrial strategies and continue to struggle with rigid multiyear plans and projects as they drift farther and farther away from alignment with constantly changing market conditions.

Then, when the alignment between company operations and actual customer demand becomes seriously out of balance, when finances drift deep into the red zone, companies have no other options for responding except to make sudden and drastic cuts in their operating expenses. They sell off businesses, and close down factories, and disband whole groups. They lay off thousands of employees at a time.

These bouts of corporate cutting and restructuring happen with regularity now; they happen in good economies and bad economies. And individual companies go through these restructurings not just once but repeatedly. Why is this necessary? It would seem that something about the business models these companies follow, something about the way they are managed, must be seriously out of line with current realities.

The relentless focus on efficiency is the legacy of a frame of mind inherent in the culture of the industrial economy and its great invention: the assembly line. That mind-set attempts to organize every activity down to the lowest levels of detail. It makes rules and regulations for everything and then tries to run each activity over and over, faster and faster without changing anything. This is how you get economies of scale: greater and greater productivity at lower and lower costs. This is what we call efficiency. But this model is breaking down.

The assembly line requires things to stay the same long enough to churn out large quantities of predefined products and services. It is the best way to deliver masses of standard products and services at the lowest cost. But what happens when people no longer want standard products and services? What happens when product life cycles are measured in months instead of years? That lack of predictability throws a major wrench into the gears of the industrial efficiency model.

Business strategies that emphasize efficiency and economies of scale no longer yield the profits we seek because they are so vulnerable to unexpected and sudden changes. The efficiency model does not allow for much responsiveness since it concentrates on removing all extra capacity and reducing operating expenses to the absolute minimum.

Efficiency without Responsiveness Will Kill Your Company

Responsiveness calls for flexibility, and flexibility calls for maintaining some extra capacity and for budgeting additional money to be available when needs and opportunities arise. A single-minded focus on efficiency views this extra capacity and funding as wasteful and strives to remove it. So in the name of efficiency, companies give up the flexibility and responsiveness they need to handle unexpected situations.

The fast pace of events now overwhelms the assembly-line operating model and the efficiency mind-set that goes along with it. Companies spend years organizing work, writing out rules and procedures, and putting systems and facilities in place. Then the world changes in unpredictable and uncontrollable ways, and their plans don't work out because they become irrelevant so quickly.

I once worked for a chief executive officer (CEO) who was forever attempting to screw down operations as tight as a drum—cut staff and squeeze out the last ounce of cost in the name of ultimate efficiency. He would look at me with a maniacal gleam in his eyes and laugh as he chopped away at headcounts and budgets. His plan was always the same: In every situation, it was to cut costs and run operations hard and fast, day and night, and thus reap the profits of ultimate efficiency. That is the assembly-line mind-set.

The problem was that in spite of his best-laid plans, the world would change in unforeseen ways, and then he had no reserve and no flex in his operations with which to respond. So instead, he would pound the boardroom table at our monthly management meetings and insist there was no change; and if there was, well then everyone should just work harder (but we were already working at full capacity; he had seen to that).

The more he cut budgets and focused on efficiency, the less able we were to respond to customers' changing needs. We missed profitable opportunities to grow the business, and some of our biggest customers came to believe we were no longer capable of keeping up with their evolving business needs. They became dissatisfied with our service and began looking elsewhere for more responsive business partners.

Customer Relationships Are the Most Valuable Asset

That CEO forgot that the customer is the ultimate asset these days, not buildings or equipment or products. Those things can readily be acquired from many different sources, but by far the hardest thing to acquire is customers. The opportunity in business now is to apply what you know about your customers and what you know about your products to create a tailored bundle of products and value-added services that constantly evolves to best fit their needs.

As you combine your knowledge of your customers and your knowledge of the products you sell, you become, in effect, your customers' purchasing agent. You're someone constantly seeking the best mix of your products and services to fit your customers' changing situations. You are no longer just a clever gadfly trying to sell them something they don't really need. Your fate is now much more tied up with that of your customers. If they don't grow and prosper, you won't either.

Think of your customers as your capital and think of responsiveness as the way to earn interest on that capital. The bigger your base of customers, the more the opportunities there are to be responsive to their changing needs (and earn a higher rate of interest). Opportunities these days quickly evolve into other opportunities; one opportunity usually leads to another. Learn to ride the waves of change. Develop a reputation for responsiveness; your customers will seek you out for that very reason.

The Value-Added Paper Cup

Let me provide an example of tailoring products and services to respond to customer needs. For six years I was the chief information officer of a national distributor (Network Services Company) of food-service disposables and janitorial supplies for restaurant chains, healthcare facilities, and grocery stores. We're talking paper cups, plastic forks, paper towels, and floor wax. These are humble products, and a paper cup is a commodity product if there ever was one. What do you suppose is the profit margin on a paper cup? The answer is "not much," and it gets lower all the time.[3]

So our challenge was to make our products more valuable and earn a higher profit. I led a project team from the company's sales, customer service, information technology, and finance organizations, and we devised a menu of about 50 different value-added services that salespeople could mix and match to meet specific customer needs. This enabled us to earn an additional 2-4 percent gross margin from many of our customers.

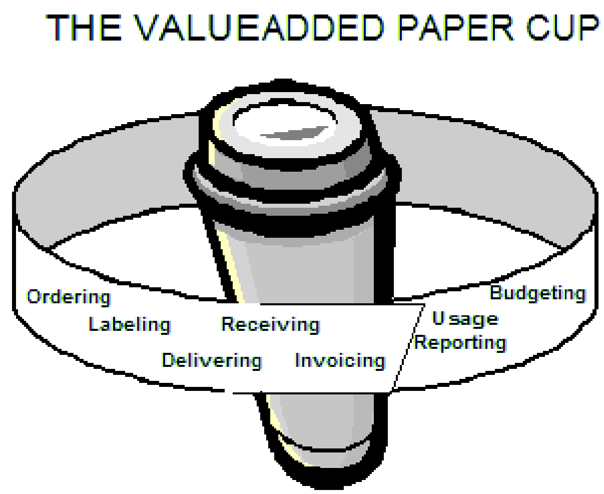
We made it very easy and convenient for customers to find and order our cups by providing an online product catalog that let them search on many different product parameters (size, strength, color, materials used, etc.). We also set up the product catalog to remind them to order other items that normally go along with cups, such as lids and sleeves.

We let customers place and track their orders online so they could know when their supplies would be delivered. We also created customized labels and packing boxes so that when cups were delivered, customers could quickly receive, store, and retrieve them.

We enhanced our billing system to streamline the processing of invoices by customers and reduce their costs of doing business with us. We sent invoices in whatever format customers wanted so they could automatically import them into their accounts payable systems. We even preprocessed invoices, inserting customers' general ledger codes into every line item on invoices so those costs could be automatically disbursed to their general ledger systems.

Finally, we provided customers with easy-to-use Web-based reporting that let them see how many cups (and other products too) they ordered at each of their ordering locations over any period of time, from one day to two years. They could monitor their spending and get detailed data for planning and budgeting, along with real-time insight into usage patterns and purchasing trends (see Figure 1.3).

Figure 1.3



Surround commodity items with tailored blanket of value added services

We negotiated a set of service-level agreements (SLAs) with customers and then used a simple business process management (BPM) system and some Web-based dashboards to track our actual performance against customer SLAs. The business process management system compared customer purchase orders with our advance ship notices and invoices to automatically calculate the performance statistics displayed on the dashboards (things like order fill rates, on-time delivery rate, and perfect order rates). These dashboards were updated every 24 hours and could be accessed on our Web site by customers as well as our own people.

We also experimented with customer contracts where, if we met or exceeded our SLA targets in one quarter, we had the right to raise our prices by a fraction of a percent in the following quarter. This was a way for customers to share a bit of the extra value we delivered to them by our high service levels. And a way to motivate us to maintain our high service levels.

In short, we turned our products into tailored solutions that solved important problems for our customers. And therefore, we could sell our paper cups for a few percentage points more than our competitors. We did so by making strategic investments in information technology (IT). This is an example of employing IT as a profit center instead of as a cost center. This is what the future looks like.

Every company has its equivalent of the paper cup. Figure out how your company can take its otherwise commodity products and tailor them to respond to your customers' changing needs. Once you start this process, it can take on a life of its own; your company will find itself engaged in a process of continuous response to change and that process can transform your business.

A Most Amazing Innovation

The most profound innovation since the assembly line is staring us right in the face. But we don't see it because we are so busy looking for something else. For most of us, the word "innovation" still conjures up images of new gadgets, such as technology to turn water into gasoline, black boxes to project moving 3-D holograms from our TV sets, and biotech breakthroughs that reverse the aging process.

Of course, some of these things will come to pass. But in our fixation on individual gadgets, we are missing an innovation that is based more on process than it is on technology. Consider this: A hundred years ago there was a process-based innovation in business so profound it became the basis for the economy of the industrial age. That process was the assembly line. The assembly line delivered a new level of efficiency that became the basis for prosperity in the industrial economy.

Another process-based innovation is once again sprouting in our midst. It is a business operating model coming to be known variously as the agile enterprise or real-time enterprise or responsive organization[4]. Companies using this operating model are delivering customer value and operating profits that will become the basis for prosperity in the real-time global economy. The responsive organization is a human-driven organization whose primary assets are the relationships that exist between its employees and its customers and suppliers. It is capable of endless adaptations and reconfigurations; it evolves as its customers evolve. It is enabled by the technology it uses but is not controlled or dominated by its technology.

With markets constantly moving and product life cycles often measured in months, companies can no longer hope to fine-tune their operations to fit some existing set of conditions and then expect simply to run those operations unchanged for years and years. That was the old industrial model; we need something more responsive now—something that constantly adjusts to changes and opportunities.

A responsive organization constantly makes many small adjustments to better respond to its changing environment. In doing so it reduces costs and increases revenues every day. No one adjustment by itself may be all that significant, but the cumulative effect of all of them over time is enormous—just like the effect of compound interest over time.

Traditional organizations are now caught in an inexorable squeeze as profit margins on their commodity products and services are relentlessly ratcheted down by the global economy. The agile enterprise is an enterprise that has learned how to make profits from many small adjustments and some occasional big wins. Soon enough those companies that cannot earn profits from constant small adjustments (and a few big wins) will hardly be profitable at all.

Just as we recognize the efficiency of the assembly line as the great wealth producer of the industrial economy, we will see the responsiveness of the real-time enterprise as the great wealth producer of the information economy.

Using Information Technology to Make Money

We need to change our thinking about what information technology contributes to an organization. In the industrial economy of the last century, we were used to viewing computing as a back-office function—a cost center. The reality now is that IT is part of the production capacity of a company; if used well, it is a profit center. We need to ask ourselves what we can do with IT that our customers will pay us for; what value-added services can we provide them, and how can we use IT to deliver those services?

Most business responsiveness comes from customizing existing products and services with a mix of value-added services, and most value-added services are information based. That's because they must be customized to meet particular needs of particular customers. What is valuable to one customer in one situation is not valuable to another customer in a different situation.

Opportunities to make money by being responsive have exploded. Constantly changing environments and customer needs enable responsive companies to offer continuously evolving mixes of products and services. As profits on old products decline, profits are always to be found by creating new products that respond to new needs.

Get to know your company's customers; go on sales calls; take note of how your customers talk about your products and the questions they ask. Concentrate on what customers like and don't like about your products.

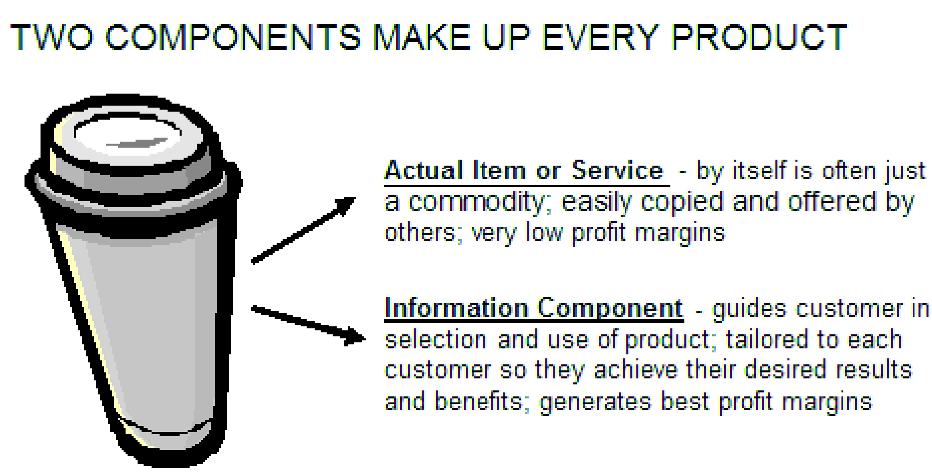
Find out what your competitors are doing. How do their products' features and prices compare with yours? Think about what will make the products your company sells more attractive. How can IT improve the things customers like and reduce those that they don't like?

All Products and Services Have Two Components

As you ponder these questions, remember that all products have two components. The first component is the basic product or service itself; the price for that is set by the market, not by individual companies. And products quickly become commodities because your competitors have or soon develop similar products, so the prices you can charge get ratcheted down.

The second component is made up of the information about your product and the value-added services that surround it. This is what enables customers to find and evaluate your product, to understand how to use it, and to get the results and benefits they want from it (see Figure 1.4).

Figure 1.4



This second component is where above-market prices and profits are to be found. Through creative use of the information component, you can wrap any commodity product with a mix of value-added services that make it more useful and for which customers will pay a little extra. Information technology lowers the cost and expands capacity to deliver the information component. This is where skillful use of IT enables a company to earn higher profits.

Figure out how to leverage information about the products your company sells and information about whom it sells these products to. Figure out how to use IT to deliver a mix of value-added services tailored to your customers' changing needs so that you deliver more value to customers, and you will see your IT organization become a profit center.

And your company can take that straight to the bottom line.

Notes

[1] Since 1993 in executive positions at director and vice president level in distribution companies Anixter International (www.anixter.com) and Network Services Company (www.nsconline.com) and in multiple consulting engagements, I have participated in successful initiatives to increase gross margins by 2-4 percent and sometimes more through use of focused customer responsiveness as discussed in this book.

[2] Proposed by Abraham Maslow in his paper titled "A Theory of Human Motivation," *Psychological Review* 50 (1943): 370–396.

[3] This section was first published by the author as "Show Them the Money," *CIO Magazine,*Vol. 19/No. 21,pg. 36-38 15 August 2006.

[4] In this book I will most often use the phrase "responsive organization" to name a type of organization that continually senses and responds to changes, threats and opportunities in its environment. However, I also use this name synonymously with other similar names such as "agile enterprise" and "real-time enterprise". There are subtle differences between these names but there are far more similarities than differences, and this book will focus on those similarities.

Michael Hugos, principal at Center for Systems Innovation [c4si], mentors teams in agile systems development and delivers seminars and briefings on business and IT agility. He can be contacted at www.MichaelHugos.com

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