MVP | *Market Value Partners*

The Market Value Process White Paper

August 1999

Introduction

Virtually every business publication overflows with stories of wild entrepreneurial successes, as well as the accounts of dramatic business failures. We look to these stories for the reasons to explain the differences between victor and vanquished.

There are many examples of companies that are capable of building “great products”. These companies continue along a path of technical innovation to maintain technical leadership. However, these same organizations may struggle to build profitable and sustainable enterprises. Market Value Partners’ research and experience indicates that many companies do not always have the analytical tools required to clearly define their target markets, to develop market strategies to meet their customer needs, or to effectively adapt to an ever changing competitive landscape.

In this white paper we discuss the “Market Value Process.” The Market Value Process consists of a suite of tools to help entrepreneurs and product marketing teams effectively evaluate market strategy alternatives and to assess a company’s relative competitive market position. The following topics will be discussed in this paper:

- Creating customer value
- Creating shareholder value
- Optimizing customer and shareholder value to win
- The tools used
  - to examine a company’s market position relative to its competitors in defined market segments
  - to assess a company’s strategy options through the examination of probable market scenarios
- Examples of organizations that have struggled to “get the formula right” and why they either succeeded or failed

The Market Value Process supplies a suite of valuable tools for:

- Entrepreneurs who need to:
  - write a winning business plan
  - raise capital
  - launch a new company
- Product marketing teams who need to:
  - design a marketing plan
  - launch a new product
  - price products and services to win
  - reposition an existing product line
- Business or management teams that need to:
  - reposition a company or turn around a company’s market position
  - get the most out of their engineering, marketing, and sales spending

The Market Value Process is used to examine a company's product and service offerings, with the goal of investigating alternative market strategies.

The Market Value Process is also used to examine whether a chosen market strategy will succeed in delivering the desired revenue growth and the profit margins that a company needs to beat the cost of investment capital, thereby building wealth for shareholders.

Value Creation

To succeed in business, companies need to build market strategies that truly meet their customers' and shareholders' needs. Market Value Partners (MVP) offers a practical process called the *Market Value Process* that enables organizations to build these winning strategies. The process transforms concepts like "customer value" from empty slogans to precise measurements and action plans for increased profit and cash flow.

Business strategists often take the position that customer value drives shareholder value. They assert that if a company serves an enthusiastic set of customers, shareholder value will fall into place almost automatically. The second viewpoint takes an opposite position: shareholder value is a company's first priority. Those holding this view assert that focusing on maximizing shareholder wealth automatically necessitates pleasing customers.

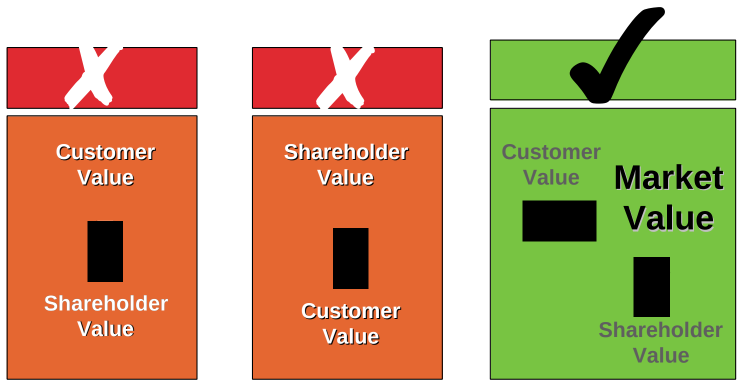
Neither value discipline *necessarily* leads to the other. An enterprise's management team must work equally intensely on building value for customers and for shareholders if it hopes to deliver superior results. The building blocks are:

"customer value"
: The value or degree to which a customer's product and non-product needs are satisfied with a particular purchase versus a competitive purchase

"shareholder value"
: The increase in a company's valuation as a result of its business strategy

Customer value is a necessary but insufficient condition for shareholders value. The loyalty of customers and the allegiance of shareholders must be created in distinctly focused and carefully coordinated efforts. We depict these value paradigms in Exhibit 1 on the next page.

Exhibit 1 — Value Creation Paradigms
Two That Don't Work and One That Does Work



The Market Value Process is used to help companies examine the product and service offerings that will meet customer needs, thereby creating customer value. This process is used to ensure that a chosen strategy also succeed in delivering the desired revenue growth and the profit margins needed to beat the cost of investment capital, thereby building wealth for shareholders.

Putting Customer Value Before Shareholder Value

An enterprise increases the probability of maximizing both customer and shareholder value if they focus on customers first and shareholders second—not the other way around. Customer value opens the opportunity for shareholder value.

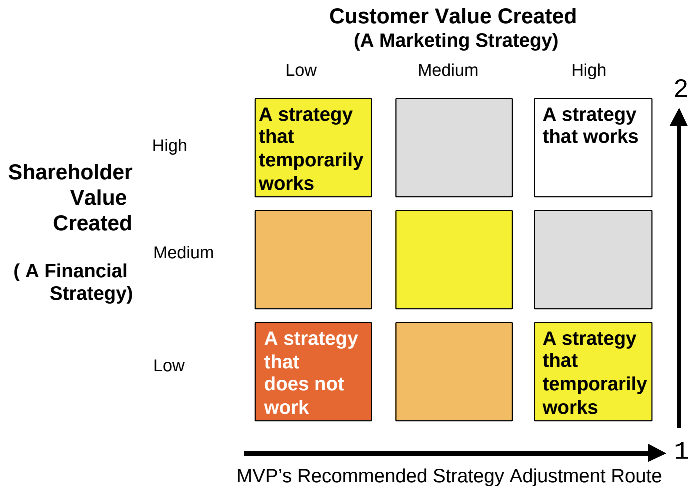
In many successful enterprises, customers come first, employees come a very quick second, and shareholders are third. This does not suggest that shareholders are unimportant. Instead, it says that it is imperative for an enterprise to focus on serving an ever-growing number of enthusiastic customers. To properly serve these customers, an enterprise must have empowered and well-informed employees who implement well thought out strategies to keep customers happy.

The Customer and Shareholder Value Map, shown in Exhibit 2 depicts the combination of customer value and shareholder value that creates a more viable business strategy.

Market Value Partners measures customer value—the results of an organization's marketing strategy—along the horizontal dimension. We measure shareholder value—the results of the financial strategy—along the vertical dimension.

The measure of shareholder value is the present value of the cash flow that a strategy generates. If the net present value of the cash flow is less than zero (<$0), the company's market strategy is not working. The company has both low shareholder value and low customer value, thereby landing in the darkest square found in the bottom row in the left-hand column of Exhibit 2.

Exhibit 2 — Customer and Shareholder Value Map



An enterprise typically wants to develop a market strategy that creates high value for both customers and shareholders—placing the company in the upper-right, white box.

Let's take an example of a company with a business strategy that does not work (i.e. a company stuck in the dark, bottom left corner in Exhibit 2). The company obviously needs to improve its market strategy. It would be ideal to go straight from a low customer value and low share holder value position to the best position, a high customer value position and a high shareholder position. Many hopeful organizations envision this happening, but it is typically very difficult to do. It's also not immediate. MVP advises that organizations set out to increase customer value before improving shareholder value.

An organization that cuts costs instead of focusing on customer value creation will temporarily improve margins. Unless, the enterprise can then immediately put customer value in place, this financially-driven business strategy will work only temporarily. Soon the enterprise will end up back in a market strategy situation that does not work, because short-term financially driven fixes are destined to fail. One of the examples is cited in the sidebar on MAX Systems, Inc.

To increase both customer and shareholder value, it is always best to put customer value in place first. The enterprise must still react quickly and put in place strategies that generate sufficient profit margins to create shareholder value. This is obviously easier to do when an enterprise's sales are growing as a result of the organization providing high customer value than when sales are tumbling.

MAX Systems, Inc. Temporarily Created Shareholder Value Without Creating Customer Value

A good example of a financially driven fix is the story of a computer server company that wanted to dramatically improve its profit margins. MAX Systems was the #2 in the U.S. UNIX server market, but management was dissatisfied with the company's stock performance. Certainly, MAX Systems was not in the worst corner of the "Customer and Shareholder Value Map." It was in the middle.

In any event, MAX System's management embarked on a purely financially-driven strategy to improve the company's situation. Management needed to shore up the income statement and decided to cut expenses and increase margins by using less expensive components with cheaper off-shore board assembly and just-in-time delivery to final assembly. Coincidentally, they analyzed the balance sheet and decided to reduce the assets tied up in the final assembly and test, by cutting the purchases of test equipment and the time spent in final systems test.

Sure enough, over the next couple of quarter's profit margins and asset turnover increased, and the stock price jumped. But then something unexpected happened in the marketplace. Customers noticed that MAX System's servers weren't as reliable as the previous models they had purchased. Existing customers started to buy from competing vendors. New customers disappeared after a number of devastating product reviews in various trade magazines. The stock price plunged, and MAX Systems ended up in the bottom left corner of the "Customer and Shareholder Value Map", having destroyed both customer and shareholder value.

It took MAX Systems years to recover and they never truly regained their former market position. This is a classic example of the danger of focusing solely on the shareholder financial value before customer value.

There are, however, companies who also fail to make shareholder value improvements. The Piedmont Software story in this second sidebar gives an example of creating customer value without shareholder value. Having a position in the lower-right hand corner of the matrix also means having a market strategy that works only temporarily.

Bottomline, an enterprise's market strategies must create value for both customers and shareholders. Initially, it is not possible to create value for both constituencies, it is better to create customer value first. It is easier to move from a position of high customer value to a position of high combined value.

Successful enterprises begin their strategy process by determining how they can meet specific customer needs more effectively than their competition.

Successful enterprises don't focus solely on how they can use new technology . . . even in this fast moving, technology fixated Internet era.

Piedmont Software Temporarily Created Customer Value Without Shareholder Value

Piedmont Software was the early leader in the software quality tools market with a very popular, C and C++ debugger. Software developers loved Piedmont's product, so Piedmont had a large and fast growing customer base. In the early 1990s, an end-user license sold for $7,500. At this time, growth was constrained by the number of qualified salesman that were versed in selling such a tool to developers. To solve this dilemma, Piedmont spent significant money and time expanding and training its direct sales organization. Unfortunately, just as the new sales organization was starting to be productive, Piedmont's well-funded competition, Fremont Software, landed a deadly blow. Fremont had been in the process of acquiring numerous quality tool products. They were now in a position to offer a bundled suite that included a less popular but "satisfactory" de-bugger along with a coverage tool and a performance measurement tool. Fremont Software's bundled suite was also very aggressively priced at $4,500. Over the next year the end-user license price fell to $1,500. Eventually, the price dropped below $750. In the face of this competitive bundling strategy, Piedmont was forced to significantly lower their prices. They were never able to turn their loyal customer base into acceptable shareholder value. Market leadership eventually passed to Fremont Software.

Piedmont temporarily created customer value without delivering shareholder value.

Once a company has identified the strategic markets to successfully pursue, they examine alternative strategies for reaching those strategic markets (such as alliances, product adaptation, channel adjustments, or additional service offerings). It is then appropriate to do financial modeling by "strategy alternative" to determine whether the strategy also creates shareholder value. Understand markets first, then apply the technology. Don't apply technology to an undefined market.

Entrepreneurs start from a base of seeing an existing need or imagining a potential need. National Geographic made this point in a story about Alexander Graham Bell: Impressed by Thomas Edison's "invention factory", Bell *tried* to replicate it on a small scale. But his approach to invention was different. Edison tried to identify a commercial need and then look for a way to meet it. Bell was more likely to be struck by a physical phenomenon and then look for a way to use it. This piece of wisdom is timeless. The idea of putting the customer value first applied in the era of Edison and Bell; it still applied in the Internet era.

The Process For Measuring and Mapping Customer Value

"Customer Value" as the value-for-a-price, is a powerful concept. Market Value Partners has an equally powerful, highly sophisticated methodology for measuring and mapping customer value and thereby moving it from the conceptual arena to specific market and business strategies.

Measurement is important, because, without measurement, concepts such as customer value become fuzzy at best. At worst they become empty slogans. The visual impact of mapping what a management team believes to be the market reality is profound. The surrounding discussions are the underlying foundation for developing strategic options. Mapping also provides a visual record of an organization's rate of progress toward meeting market needs, and this record can provide insights that lead to invaluable action.

We can see how to measure and map customer value by examining the Customer Value Map shown in Exhibit 3. This map shows RELATIVE QUALITY along the horizontal axis and RELATIVE PRICE along the vertical axis. The Market Value Process measures both quality and price relative to the competition. The zero point along the relative point axis does not mean rock-bottom quality. It means quality that is *the average* of the quality offered by the key competitors in a market, including the enterprise itself. The zero point along the relative price axis doesn't mean the product or service is given away for free. It means a price that is *the average* of the prices offered by the key competitors.

Exhibit 3 — Customer Value Map

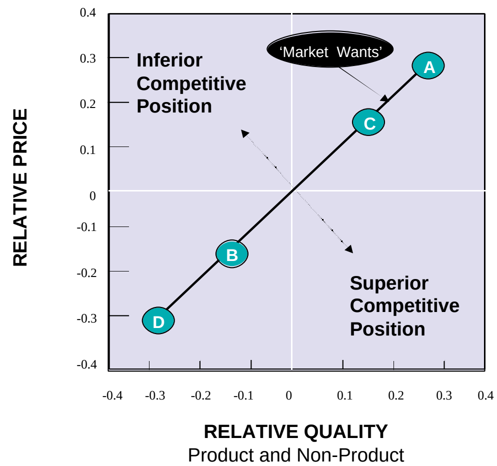
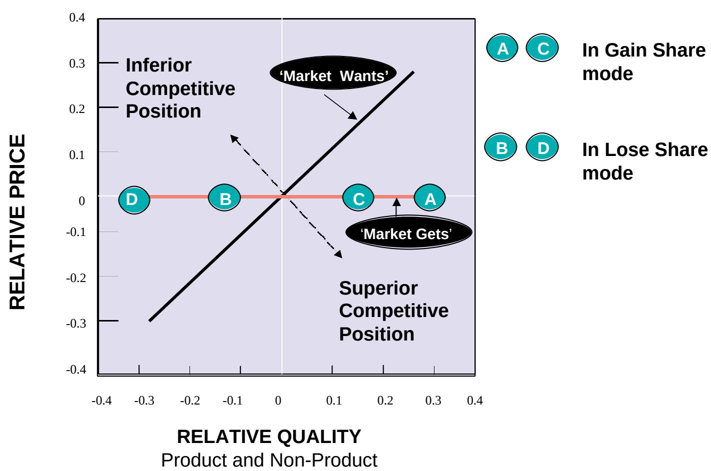


Exhibit 3 above depicts a Wall Street investment bank whose customers are equally sensitive to price and quality (which we define as the degree to which a customer's product and non-product needs are satisfied). This means that if our investment banker or one of its competitors is offering a package of services that is 10% above the average in quality, its customers will accept a price that is 10% above the market average. We show this equal tradeoff that customers consciously and unconsciously make all the time between quality and price. We call this line the "market wants" line. This line depicts the tradeoff between the perceived quality and price that the customers in this market are prepared to accept. Now suppose that competitors A, B, C (our investment banking firm), and D are, respectively, 30% above, 15% below, 15% above, and 30% below average on quality and price. In this case they will all fall on the "*Market Wants*" line. Market shares are stable, because each competitor's package offers a relative customer value, a-particular-quality-for-a-particular-price, that customers are willing to accept.

Now let's change the example to one portrayed in Exhibit 4. Suppose the government puts a regulatory process in place requiring the four competitors to sell at a single price—one lower than company D is currently charging. Suddenly, all competitors have a zero relative price because they all are charging the same low, mandated price. Relative quality positions, however, remain unchanged. We call this new competitive lineup the "market gets" line. The market, however, remains willing to view quality and price as a 50-50 tradeoff, so the "market wants" line remains unchanged. Then competitors A and C will gain market share at the expense of companies B and D, because of course companies A and C offer the customer superior relative value.

Exhibit 4 — Customer Value Map at a Constant Price



The power and reality of Customer Value Maps becomes evident, particularly over time.

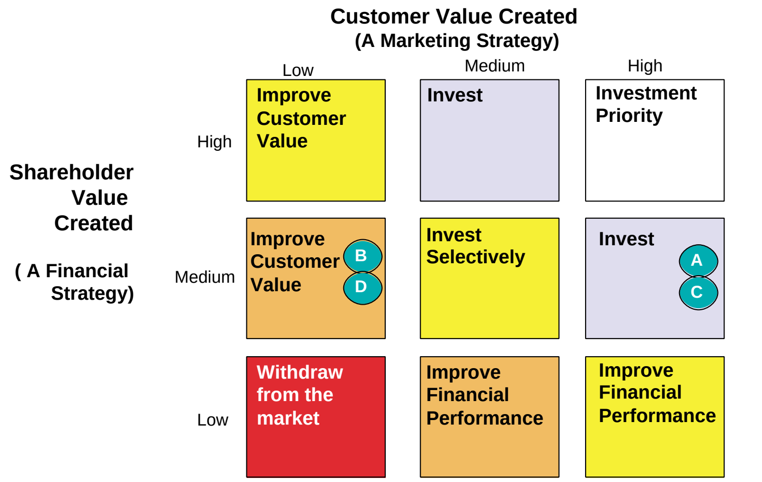
Market Maps provide powerful insights; they show the position of each competitor in a particular market—at a particular point in time, and they also indicate the directional changes in market share that will take place as a result of certain market strategies.

Any competitor positioned below the "market wants" line is offering superior relative value—a better value-for-the-price tradeoff than the market requires—and will therefore gain market share. Any competitor positioned above the "market wants" line is offering an inferior relative value—a worse value-for-the-price tradeoff than the market requires—and will lose market share. In Exhibit 4 above, the current value level of company B is in a lose-share position. A moderate improvement in value/quality will take it halfway to B and leave it in the dead-center of the market map, therefore indicating the company will hold market share position. It will take a significant value/quality improvement to raise D to C's gain-share position.

We saw earlier that the measure of shareholder value is the present value of cash flow that a market strategy generates. Now we know how to measure customer value as well. The measure of customer value a competitor's strategy creates is the distance the competitor is positioned above or below the "market wants" line. Since customer value is low for B and D, they would land in the left column of Exhibit 5, the Customer and Shareholder Value Map. Customer value is high for A and C, so they would land in the right column.

In examining competing market strategies, we map the value that each strategy delivers. This allows a company to identify the winning strategy in each market—the strategy that creates the highest value for both customers and shareholders. An enterprise then establishes the marketing programs that support the winning strategy. This enables a management team to identify the best market strategies for a particular market.

Exhibit 5 — Customer and Shareholder Value Map



Evaluating customer and shareholder value to select winning market strategies, set objectives, and allocate resources.

It is important to realize that the functional plans and marketing messaging are set at the end of the Marketing Mapping strategy session(s). Conventional wisdom holds that entrepreneurs and management teams should set their marketing objectives on some intuitive basis. However, an entrepreneurial team now has a rigorous analytical process to help analyze their market intuition. With the Market Value Maps, entrepreneurial teams can then be confident that they have fully examined viable alternatives and can be confident that they are proceeding with the best solution for customers and shareholders.

Finally, enterprises can extend the combined-value test beyond looking at a single market to identify the best among several markets in which to compete. To do this, it simply compares the combined value created by the winning strategy and the supporting strategies in the different markets. The market in which the winning strategy delivers the highest overall combined value (customer and shareholder) gets the first priority of resources. Consequently, by measuring and mapping combined value, an enterprise can both select the best strategic path in each market and set priorities for resource allocation among multiple markets. By following the Market Value Process, an enterprise covers all the strategies needed to propel itself to leadership in the markets where it can deliver the most value to both its customers and its shareholders.

For an example of an enterprise that used the combined-value test, we turn to a young company that offers both software tools and consulting services to the market.

This was a small privately-held company that was strictly self-funded. The company is composed of two divisions. The Consulting Division had a number of large on-going contracts and was profitable. The Product Division had a rather lackluster software product on the market. The Product Division however was looking to change its fortune with the introduction of a major new product release. This new product release added many advanced features. As we can see from the graph in Exhibit 6, the company used the Market Value Process to examine its pending product and market strategy.

Let's focus on what the Market Value Process told them. As the Market Map indicated in Exhibit 6, the market for the company's existing and upcoming product had become a classic commodity market. This can be seen in the flatness of the "Market Wants" line. In such a market, there are many competing products that offer similar and sufficient value to the customers. The market's attention has shifted from new features to price. With such a market, customers are typically less willing to pay premiums for new features or product improvements. Customers are typically more interested in the most cost-effective purchase.

Bottom-line, the sophisticated product features combined with the relative high price would not achieve the company's goal of gaining market share. As with any commodity market, in order to compete, the company would need to lower the price to match or beat the competition's price and would have to put significant funds toward marketing. Even these actions however would only produce minimal market share gain. The company would have to raise outside funds if it wanted to build a successful product strategy beyond this limited product offering…something the company's president was unwilling to do.

Exhibit 6 — Customer Value Map
New Product Release

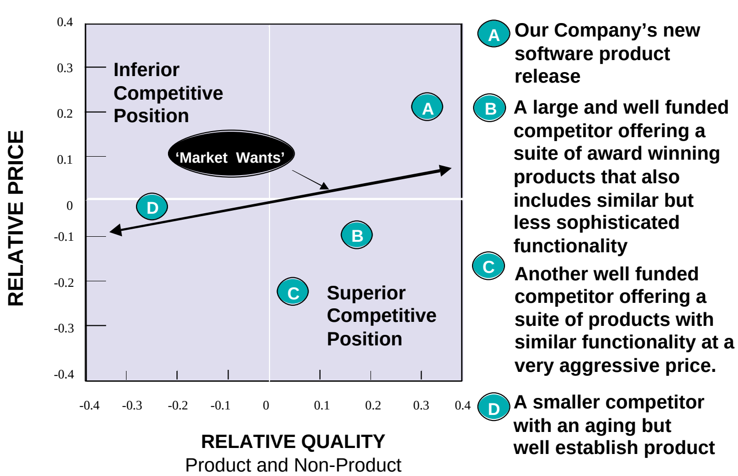
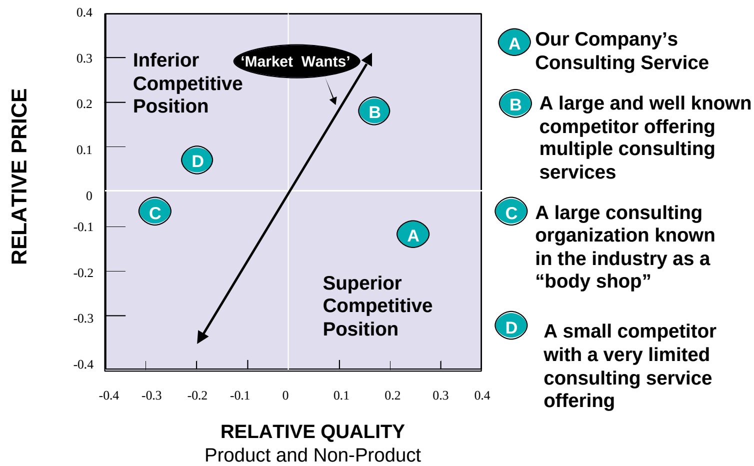


Exhibit 7 — Customer Value Map Consulting Service



The company then went on to examine their Consulting Division's market position relative to the competition. They found these results more reassuring.

As seen above in Exhibit 7, the Consulting Division found itself in a very strong market position. Unfortunately, the company's consulting organization was small. Therefore, they were limited in the number of clients they could service at anyone time. Relative to their larger and well-funded competitors, the company's Consulting Group was also not widely known. The company allocated neither marketing nor advertising funds for its consulting services. All business came from word of mouth or from successful customer referrals. Whenever the head of sales would go out to find more business, the Consulting Division was soon at it's execution capacity.

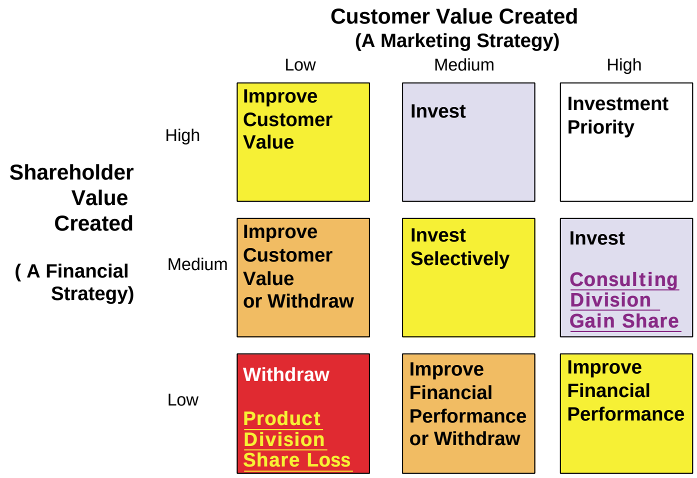
By fully examining the market potential of both the Product Division and its Consulting Division, the company was in a position to decide where to allocate its limited resources.

Highest allocation of resources should go to the market strategy that promises the highest combined customer and shareholder value.

The highest combined customer and shareholder value is the strategy located closest to the white, upper-right corner of the chart.

As seen in Exhibit 8, the Consulting Division can more easily succeed in its gain-share objective. On the other hand, the Products Division found itself in a market share loss position. To move beyond this market share loss position would require aggressive pricing for the new product and a significant amount of additional funds spent on market and new product development.

Exhibit 8 — Customer and Shareholder Value Map



By examining the chart above, we see that the strategy supporting the gain-share objective in the Consulting Division is closer to the upper-right corner and therefore delivers greater combined value than the strategy of supporting the Products Division.

The Market Value Process analysis indicated that management had the following two options:

1) Cancel the pending product release and properly fund the Consulting Division or
2) Raise outside funds to expand the product line and properly fund the Consulting Division

Despite this seemingly rational analysis, the company continued to bring the next product release to market without seeking outside funds to expand the product line up. The company's president focused on the advice of his banker that "a products company" would have a higher multiple and a higher valuation than a consulting company, should the company ever choose to go public.

This *temporary* lack of market resolve hampered the Consulting Division, hindering its capacity to grow despite strong market demand. Not surprisingly, the Product Division continued to drain the company's limited funds. In relatively short order, the company was forced to stop all support for the Products Division and to focus solely on the Consulting business. The company struggled to get back on track, but was able to recover. The Market Value Process allowed the management team to more fully understand the evolving market dynamics and catch the error in their decision process before it became fatal.

Well Thought Out Market Strategies

The Market Value Process allows entrepreneurial teams to measure and map customer and shareholder value. The process also allows a team to build a suite of market strategy options based on various market scenarios.

Entrepreneurs need to set priorities for investment in their chosen market segments based on a combination of customer and shareholder value. Using a suite of tools to examine a companies real market opportunities, the market strategy that creates the most customer and then shareholder value can be rationally chosen. The chosen market strategy allows companies to offer the right product at the right price with an optimized business model, thereby pleasing the customers. Once the strategy is well understood across the entire management team, the tactical market execution becomes that much more efficient. Successful market strategies ultimately deliver strong sales growth and higher profit margins, thereby ultimately satisfying shareholders by increasing a company's overall valuation.

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