## Contents

<table>
<thead>
<tr>
<th>Page</th>
<th>Section</th>
<th>Authors</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>Introduction: Perspective and Ideas for 14 Industries</td>
<td>Thomas A. Stewart</td>
</tr>
<tr>
<td>8</td>
<td>Aerospace &amp; Defense</td>
<td>Randy Starr, Jono Anderson</td>
</tr>
<tr>
<td>12</td>
<td>Automotive</td>
<td>Scott Corwin, Evan Hirsh, Jan Miecznikowski, Brian Collie, Mike Beck</td>
</tr>
<tr>
<td>18</td>
<td>Chemicals</td>
<td>Dennis Cassidy, Jayant Gotpagar, Marcus Morawietz, Richard Verity</td>
</tr>
<tr>
<td>24</td>
<td>Consumer Packaged Goods</td>
<td>J. Neely, Richard Rawlinson, Matthew Egol</td>
</tr>
<tr>
<td>29</td>
<td>Financial Services (Capital Markets)</td>
<td>John Plansky, Kelley Mavros, Tracie Redd, Hector Nelson</td>
</tr>
<tr>
<td>34</td>
<td>Financial Services (Retail Banking)</td>
<td>Paul Hyde, Ashish Jain, Corey Yulinsky</td>
</tr>
<tr>
<td>38</td>
<td>Financial Services (Wealth/Asset Management)</td>
<td>John Rolander, Srinivasa Venkateswaran, Gauthier Vincent</td>
</tr>
</tbody>
</table>
42 | Healthcare (Payor/Provider)
    Gary Ahlquist
    Gil Irwin
    Minoo Javanmardian
    Jack Topdjian

48 | Healthcare (Pharmaceutical)
    Peter Behner
    Rick Edmunds
    Dr. Marcus Ehrhardt
    Greg Rotz

54 | Industrials
    Barry Jaruzelski
    Arvind Kaushal
    Dan Holland
    Marian Mueller

62 | Oil & Gas
    Viren Doshi
    Andrew Clyde
    Christopher Click

68 | Retail
    Nicholas Hodson
    Karla Martin
    Deniz Caglar
    Marcelo Tau

73 | Technology
    Alex Koster
    Toshiya Imai
    Dr. Pierre Peladeau
    Matthew Le Merle
    Kenny Kurtzman

78 | Telecommunications
    Karim Sabbagh
    Roman Friedrich
    Michael Peterson
    Bahjat El-Darwiche

84 | About the Authors
Introduction

Perspective and Ideas for 14 Industries

Living with uncertainty has become a way of life for business leaders. The year 2011 saw many aspects of the world seem to slip out of control: We experienced political turmoil in the Middle East, the financial crisis in Europe, partisan clashes in the U.S. government, regulatory change in many industries, skittish consumers around the world, rising commodity prices, environmental and energy-related disasters, the rise of disruptive technologies, and the slowing of GDP growth in emerging economies. Although many business leaders have learned to manage in this environment, they don’t necessarily do so by making good choices. There is always a temptation to respond by hunkering down: cutting costs, holding back from new investment, and refraining from hiring. Or leaders may seek growth in an incoherent way by taking on multiple new projects, hedging bets, and then pulling back at the first sign of difficulty. Unfortunately, those strategies lead to wasted efforts, poor investments, and unfulfilled opportunities.

An alternative exists. You can chart a coherent path for your company, based on the capabilities that will serve you well, in the markets that need you most, with the tailwinds that will move you forward in your own industry. That means taking stock of the particular challenges and opportunities in your sector right now, as well as your own innate strengths and capabilities, and then making specific choices and sticking to them, driving investment to reinforce your chosen direction and letting go of investments elsewhere. Companies that do this gain a premium; they don’t just ride the waves of uncertainty, but rather define the direction of their industry. Indeed, the health of the overall economy probably depends on business leaders in each industry developing this sort of effective strategy over the next few years. This electronic book is our guide for doing just that. Compiled by more than 50 of the industry experts at management consulting firm
Booz & Company, it represents a comprehensive effort to sort out the trends facing industries at the start of 2012, along with insights about the coherent strategies that can help you define your destiny.

In each of 14 industries, including oil and gas, consumer products, healthcare, financial services, and others, we lay out the specific trends that are most important right now. For example, pharmaceutical companies are contending with a dramatic wave of patent expirations on blockbuster drugs—at a time when overall growth is slowing and R&D productivity is slumping. Chemical industry dynamics are being altered by the sudden boom in natural gas from shale rock, which is producing a surfeit of raw material for making ethylene-based plastics inexpensively. The retail banking industry is transitioning from a high-margin business to a lower-margin one. And in commercial aerospace, the Boeing–Airbus duopoly is vanishing as a host of foreign companies, some with state support, are readying to compete.

Then, for each industry, we look at the strategies that can help companies win in this environment. Inevitably, this means singling out the capabilities—the combination of processes, tools, knowledge, skills, human capital, and organization—that companies can deploy in realizing those strategies. Particularly in difficult years like those we’ve experienced recently, it’s not enough to base a strategy on market conditions or external factors. Every corporate leader should be asking “What strategy will make the most of the capabilities we have? And do we have all the capabilities we need to win in this way, in our industry, going forward?”

All companies need at least two types of capabilities. The first group of capabilities are prerequisites for success in a sector, and every serious competitor must have them. Kellogg School of Management professor Tom Hubbard calls these “competitive necessities”; Booz & Company sometimes calls them “table stakes.” For example, every consumer products company must manage a supply chain; every oil company must meet environmental and safety requirements; every telecom operator needs to develop and reliably maintain its network.

Distinctive capabilities make up the second group: They are unique to each company, linked to its strategy, and hard for competitors to copy. A company’s investment decisions, operating model, and product and services mix align to support and enhance these differentiating capabilities. Disney’s excellence at marketing to youth and Amazon’s proficiency with online retailing are two examples. In successful
companies, these combine into a mutually reinforcing capabilities system, defining what the company does well, and being applied explicitly to everything it does: every product and service it offers, every market it enters, and every deal it makes (including M&A). Companies with a coherent strategy and a well-honed capabilities system become the leaders of their industries. Other businesses gravitate toward them. Whether in aerospace, consumer products, or telecom, companies that succeed in building such a system are invariably better positioned to outperform competitors.

We have written about the general principles of a capabilities-driven strategy in several places — see, for example, the book *The Essential Advantage*, by Paul Leinwand and Cesare Mainardi (Harvard Business Review Press, 2011). We also cover the strategic approaches regularly in our magazine, *strategy+business* ([strategy-business.com](http://strategy-business.com)) and on our firm’s website ([booz.com](http://booz.com)).

But in this electronic book, for the first time, we’ve taken that lens of coherence and capabilities and applied it directly to the choices facing your business. Fourteen of the industry teams at Booz & Company applied broad forward thinking about the challenges and opportunities their client companies are likely to encounter in the months and years ahead. The resulting “end of year” letters, collected here, reflect a concerted emphasis on identifying the capabilities systems that are most likely to result in success both in home markets and around the globe.

Not surprisingly, some recurring themes emerge. Capabilities that enhance a company’s digital platform loom large in consumer packaged goods, retail, retail banking, and wealth management. In the automotive industry, healthcare, and pharmaceuticals, capabilities that allow a company to operate more efficiently and effectively, rendering it “fit for growth,” in Booz & Company parlance, are of central importance.

We hope this collection provides business leaders with ideas and perspectives about what capabilities they can develop as they set forth to make their companies grow stronger.
Aerospace & Defense

The global aerospace and defense industry is undergoing dramatic change. In defense, the deepening downturn has many companies evaluating moves into adjacent markets, while in the growing commercial aerospace market, suppliers are strengthening their position with airframe manufacturers. “Look before you leap” is sound advice in an evolving market. Here are a few considerations for the year ahead—both for changes that are already apparent, and for others that may be less obvious.

The Defense Dilemma: Finding Growth Opportunities

In defense, large segments of the industrial base may disappear as spending shifts from investment in research, development, and production of new capabilities toward services and support for older platforms and systems. Our analysis suggests there are scenarios in which military investment spending on new acquisitions and R&D could decline from US$253 billion in 2008 to as low as $150 billion in 2016. With backlogs continuing to erode, underinvestment in R&D threatens to create a hollow industrial base lacking the essential capabilities to develop innovative technologies and build new weapons systems.

As the defense industrial base weighs the implications of these changes, four capabilities will be necessary to establish essential advantage.

First, the Pentagon’s emphasis on affordability for developing and acquiring new systems has attracted an influx of nontraditional players for ground vehicles, ships, unmanned aerial platforms, and other systems. There will always be a need for “exquisite” systems, but not in sufficient numbers in the near term to sustain traditional platform builders and their suppliers. Those that wish to compete in today’s climate must focus on improving affordability and maintaining cost fitness while establishing long-range plans grounded in the grim realities of the next five to 10 years of reduced demand.
In particular, companies that anticipate program reductions and employ a business model that variablizes overhead and manages it down as direct labor hours decline will be better positioned in this market environment.

Second, in the coming years, defense markets will offer fewer avenues for growth, and many companies are evaluating both commercial and governmental adjacent market opportunities. But new markets—with different acquisition approaches, regulatory demands, selling cycles, and customer expectations—will require new operating models, and may significantly change the role of the corporate center. In many cases, defense companies may need to shift from a central operating model to a portfolio management model that allows individual business units to adapt to the unique requirements of their markets. Differentiation could start to emerge as some companies develop a corporate center model capable of providing strategic and financial guidance to a broader portfolio of business units and go-to-market models, while imposing central costs no higher than those realized by stand-alone specialist businesses. In some cases, this could mean significantly scaling back the size and role of large corporate centers.

Third, as corporate leaders plan their expansion into new markets, they will need to develop an investment and diversification strategy that builds confidence in their ability to bolt on adjacent businesses in a way that creates value without adding complexity. This will require careful understanding of the value creation mechanisms that are best suited for new markets, and identification of those that are beyond the capabilities of their own legacy defense businesses.

Fourth, not all defense programs will thrive—or even survive—the continuing downturn. No one likes to think that their program will be in jeopardy, but top-down budget pressures ensure that some programs will indeed be affected. While defense companies are known for their ability to execute large, complex programs, the responsibility for evaluating the broader risk across all the programs in the corporate portfolio must reside outside and above the programs. Business unit and corporate CFOs should fill this role, but may require a higher level of dynamic risk management capabilities. These capabilities would allow the CFO to “peer into” programs and develop an integrated view of overall portfolio risk.

The Commercial Opportunity: Exploiting Record Growth

In commercial aviation, the industry is poised for renewed growth, but its structure will continue to evolve. In recent years, the Boeing–Airbus duopoly has wielded considerable power over a somewhat fragmented supply base,
but the duopoly is vanishing as a host of foreign companies, some with state support, are poised to enter a market that exceeds $200 billion and is expected to grow annually at a rate of 3.6 percent over the next 20 years.

Emerging airframe competitors are already beginning to see a shift in the competitive landscape, including a shortening of the innovation cycle and an increase in R&D spending. In addition, the service life of aircraft will be reduced as airlines opt to buy newer, less expensive narrow-body aircraft rather than further extend the lives of existing aircraft. While total cost of ownership will continue to be the principal metric for differentiating airframes, new approaches will become essential. For example, Commercial Aircraft Corporation of China Ltd. (COMAC) could emerge as a low-cost value player, and others may choose “co-opetition” models in which competitors on one platform cooperate on another. Airframe manufacturers should fully explore the impact of different competitive models to understand how customer choices could affect their traditional base.

Suppliers will also see dramatic changes requiring measured responses on their part. They should plan for a shorter services stream on installed base, due to the shorter service life of aircraft in the future. In addition, market power is shifting toward suppliers, due in part to the consolidating supplier base and growing number of airframe manufacturers. As a result, suppliers should expect more risk-sharing partnerships with original equipment manufacturers (OEMs). Equally important, Tier Two and Three suppliers, particularly those that provide standardized products, could increase the amount of value they capture in this new market, while Tier One suppliers may see a decline if they start aligning exclusively with OEMs. Given this expected development, Tier One suppliers should consider where the power lies in the supply chain structure and, where appropriate, consider a shift down the value chain to increase their profitability. In doing so, suppliers will need to aggressively manage changes in demand and inventory levels to provide appropriate levels of service.

United Technologies Corporation’s agreement to buy Goodrich Corporation for $16.5 billion is the latest signal of supply-base change. With the purchase, UTC’s revenue will exceed $60 billion, giving it considerable heft in dealing with airframe manufacturers. As consolidation continues, Boeing and Airbus will need to think strategically about their supply chain relationships and determine whether closer strategic alignment with suppliers will help maintain advantages in future designs. In addition, many would like to see Boeing and Airbus respond to the new airframe challengers with radical narrow-body designs, but airlines need efficiency improvements sooner rather than later. Consequently, many of those improvements are coming
from the supply base, offering a significant opportunity for suppliers with the strongest capabilities in research and innovation.

Finally, we should note that maintenance, repair, and overhaul (MRO) companies may also need to adjust their models as the airlines begin retiring aircraft sooner and relying on new, low-cost narrow-body aircraft. The earlier retirements will require MROs to develop an integrated product and service approach that enables them to extract value for their capabilities over shorter time frames in an increasingly global market.

Addressing these challenges will require different competitive models and capabilities than airframe manufacturers and suppliers have employed in the past. Incumbents will have to adapt their “way to play” (their approach to creating value in the market) by anticipating potential competitive scenarios and sharpening their value proposition.

Look Before You Leap

Even in a growing market, changing conditions require companies to carefully assess their positions to determine the best course of action. Whether companies pursue new markets or attempt to expand globally, they should resist the temptation to simply target the largest opportunities. Successful companies begin by carefully considering their differentiating value proposition and “right to win” capabilities—that is, the qualities and characteristics that create value for their customers and distinguish them from their competitors. They should ensure that their operating model and product and services mix are aligned to support and enhance these core capabilities. This strategic alignment—which we call the coherence premium—enables companies to invest wisely and to execute effectively. Coherent companies also are better prepared to target customers that will value and reward their products and services the most. By focusing on what they do best, they are well positioned to assert their right to win in evolving aerospace and defense markets.
For U.S. automakers and suppliers, the past year can best be described as 12 months of mixed results, leaving unanswered questions about the future direction of the industry and what is required for manufacturers and suppliers to thrive.

In 2011, U.S. car and light truck sales will exceed 12.5 million units, a nice bump from 11.6 million in 2010 and 10.4 million in 2009. And though the most optimistic analysts forecast that U.S. vehicle sales will rise to more than 14 million in 2012, that’s a far cry from 17.3 million at the turn of the millennium. Last year’s U.S. sales figures might have been higher if not for the tsunami and earthquake in Japan and flooding in Thailand, which forced Toyota, Honda, and, to a lesser extent, Nissan to curtail production in virtually all of their assembly plants around the world. Auto sales growth is far more rapid in emerging nations such as China and India, with average annual sales gains since 2001 of 23 percent and 15 percent, respectively.

All of this should be good news for U.S. automakers, which have restructured their operations to be profitable at lower volumes in the U.S. General Motors, Ford, and Chrysler gained market share at the expense of the Japanese manufacturers, and the Detroit Three have now posted several quarters of consistently strong operating performance. Whether these improved earnings are short-lived will depend on a number of unknowns:

- As their output returns to normal, will Japanese companies reclaim their market share?
- Will the Detroit Three maintain their focus on new vehicle development and launches and continue to practice pricing discipline, which favors maximizing profits over volume or market share growth?
• How will rapid introductions to the U.S. market of highly competitive new models from automakers around the globe, combined with slow growth, play out? How will automakers differentiate their vehicles and earn the pricing and volume they need? What will they do to ensure that each program delivers an attractive return on invested capital?

• How will automakers serving the U.S. market protect themselves against the risk of disruption (such as the supply chain disruptions we have seen in Japan and Thailand) and will they do it at an affordable cost?

Automakers will also face technological challenges. For example, advances in braking, parking assistance, propulsion, sensors, and other critical areas are bringing us closer and closer to the era of self-driving automobiles; indeed, Google has already logged well over 100,000 miles on its unmanned robotic vehicle. In urban areas, in particular, these innovations could improve traffic flow, provide revenues (through “smart tags” and traffic congestion pricing), and reduce accidents through vehicle-to-vehicle communication and coordination.

Meanwhile, vehicle-based mobile communications technology continues to produce breakthroughs in voice-activated telephony, GPS, information, and entertainment. For example, GM customers can now use the automaker’s OnStar (driver communication) and RelayRides (vehicle location tracking) systems to rent their personal vehicles to others and charge fees based on usage. Both original equipment manufacturers (OEMs) and suppliers will have to anticipate which new technologies and add-on services will justify the cost of innovation. Clearly, anything that consumers are willing to pay for, that increases safety or functionality, or that reduces cost has the potential to be successful. At the same time, OEMs must be careful to integrate new technology into vehicles effectively and only when it is perfected, or risk adding features that are annoying or, worse yet, prone to breaking down, which could negatively affect consumer perceptions about the quality of the automaker’s products.

A return to competition based on innovation is a refreshing change from the dismal situation the industry faced just two years ago. And while the Detroit Three focus on producing more exciting and attractive vehicles, they can take comfort in having addressed a perennially problematic issue through a new and mutually beneficial four-year labor agreement with the United Auto Workers. By being able to pay newly hired workers at rates comparable to those paid by Asian transplants in the U.S., GM, Ford, and Chrysler have taken another important step in narrowing the gap with their rivals on manufacturing costs.
Suppliers are also relatively well positioned after several difficult years. Many suppliers were very profitable in 2011; they have emerged from the recession (and, in many cases, Chapter 11) with restructured balance sheets and lowered breakeven points. Moreover, supplier relationships with GM, Ford, and Chrysler have improved, according to the annual Planning Perspectives OEM–Supplier Working Relations Index. But there is more work to do: Chrysler and GM still score in the “very poor–poor” range.

There are some dark clouds for suppliers, though. Raw material prices, already elevated, may continue to rise, and many suppliers are struggling to find the capital to ramp up production to meet increasing demand. Moreover, most suppliers must continue to deal with what has become an endemic issue: a talent shortage, as top-flight engineers willing to work in the auto industry are increasingly hard to find.

**A Capabilities Strategy for OEMs**

Against this backdrop of an industry still in flux, this is the perfect moment for OEMs and suppliers alike to invest in developing the capabilities that allow them to achieve and sustain a leading position around the world. We define capabilities as the distinctive strengths a company has, or should develop, to set it apart from competitors. Each capability is built on a combination of processes, tools, knowledge, skills, human capital, and organization.

**Prepare for Black Swans**

There is a natural tendency following horrific events such as the Japanese tsunami to evaluate a full range of risks and prepare contingency plans. But most black swans are the result of a cascading series of events; it is the cumulative impact that makes them so catastrophic. It is not justifiable to build costly, fully redundant supply chains, when the chances of another complete disruption are fairly small. Companies would be better off developing a risk preparation capability: Analyze the impact of potential disruptions and prioritize responses by magnitude and chance of exposure, expense, and ease of implementation. For example, manufacturing key electronic components in one location may yield attractive economies of scale but also significant risk. Options to mitigate the risk include splitting global volume across at least two facilities in different regions, or maintaining centralized production with backup capacity, possibly with a different supplier that can be brought up quickly. Recent experience has proven that having transparency and visibility several layers deep in the supply chain—that is, controlling and managing activities and risk among a supplier’s suppliers and their suppliers—is very difficult and yet essential. Therefore, automakers must do their best to protect themselves with nimble, agile
response mechanisms, systems, and processes. (For an in-depth examination of this topic, see “Are You Ready for a Black Swan?”)

**Build an Adaptive Innovation Engine**

In mature markets such as the U.S. and Europe, success depends on bringing to market ever-evolving new vehicles that consumers enthusiastically want and would be proud to drive. But the best ways to do this are rarely clear. For example, powertrain technologies are evolving rapidly; most manufacturers are thus trying to manage balanced portfolios of internal combustion, hybrid, electric, and fuel cells until there is greater clarity about the future. The challenge is exacerbated by fluctuating fuel prices and inconsistent government policies that make setting a long-term course and sticking to it extremely difficult and costly. Therefore, manufacturers need to develop distinctive practices—which might include open networks, frugal engineering, more intensive partnerships with suppliers, or other refinements—to out-innovate the competition at an affordable cost.

**Operate in a Global Marketplace**

Emerging economies such as the BRIC nations (Brazil, Russia, India, and China) offer the potential for high growth and opportunities to build strong positions in the biggest consumer markets of the future. By contrast, North America and Europe have high volumes but much more limited growth potential. Given this divide, OEMs need to tailor and customize their product portfolios to meet the disparate requirements of both mature and emerging markets, which have fundamentally different consumer needs and preferences, competitive dynamics, and economic returns. For example, manufacturing strategies for emerging markets should evolve over time, with long-term investment horizons and factories producing less expensive, less profitable automobiles now but geared for assembling higher-priced, higher-return vehicles in the future.

**Manage Inventory Well**

In a highly competitive market, it is more critical than ever for automakers to provide a mix of models and trims on dealer lots closely matching customer demand, although given the permutation of vehicles necessary to meet distinct customer needs, 100 percent inventory coverage is neither possible nor practical. Providing the right inventory means at a minimum continually improving distribution and sales forecasting capabilities to make sure inventory in each region is adequate, but not excessive, based on potential sales. More ambitiously, smart inventory strategies may involve transitioning to a more sophisticated mix of build-to-stock for popular combinations and build-to-order, with more rapid and certain delivery than today, for unusual combinations. This could generate significant cost savings and better align vehicles with customer preferences.
Maintain Pricing Discipline
Capacity issues have essentially been addressed in the U.S.; factory utilization rates are quite high for most OEMs in the NAFTA region. High-capacity utilization brings less pressure to offer discounts and incentives, and OEMs have taken excellent advantage of this situation to enjoy higher realized prices and profits. But as competition increases, automakers must maintain this rigorous and dispassionate approach to pricing and incentives, using advanced modeling to understand price-volume trade-offs and to estimate residual value effects of first-transaction decisions. And they must be willing to prioritize medium- and long-term profitability over immediate market share.

Focus on Customer Experience
As vehicle and quality differences narrow, automakers are increasingly exploring ways to create differentiated experiences for customers throughout the vehicle life cycle. This is fertile territory for revenue and earnings growth but requires a well-defined OEM capability. You must define the experience you want to provide, make it consistent with your brand heritage, and make every aspect of your product and service ecosystem more customer-centric—including in-store experience, warranty and ongoing maintenance and repair, and financial services options and execution. Over the past decade, there have been numerous attempts at this, often with high expectations; most have fallen short. We believe that in an era when consumers seek value, OEMs that can master and execute this capability best will gain a major competitive advantage.

Primary Capabilities for Suppliers
Drive Innovation
One excellent way for suppliers to capture value is to offer OEMs something that others don’t and can’t. Indeed, when suppliers create end-user pull around their intellectual property, they can build market share and earn high profits. For example, one company has held a very large share of the global market for auto-dimming mirrors for years, with exceptionally high profits for a Tier 1 supplier as a result. In other cases, process and supply chain innovation can drive durable cost advantages, even for products that are commodities or close to it. Successful suppliers must understand the opportunities for innovation of both types to create and capture value, and invest accordingly.
Refine the Factory Footprint
The economics of manufacturing in low-cost countries are shifting. With Chinese wages on the rise and an artificially strong renminbi, the tide of production shifting to Asia has slowed. In fact, for some products that do not ship well or have relatively low labor content, regional production footprints—factories in Asia, North America, Europe, and South America, for example—are increasingly preferable. The question to ask is what factory network will allow you to meet forecasted demand for your products most cost-effectively—and more cheaply than the competition.

Ruthlessly Manage the Portfolio
All too often, suppliers try to be everything to everyone—and, in doing so, design products that fail to meet the needs of anyone. To avoid this trap, suppliers must develop the market insight necessary to understand fully the varied requirements and purchase decisions of different OEMs and different market segments. With this knowledge, suppliers can determine which segments are most attractive based on their core skills, strategic outlook, and business and operating models. This prioritization allows suppliers to target resources to business units with the potential to create sustainable and strong market positions and stop subsidizing weak businesses with little or no strategic value. Suppliers with this sophisticated knowledge of their businesses also know when to walk away from bids and programs when the economics are not right—they know that pursuing programs with poor economics to fill factory capacity in hopes of someday increasing prices and margins is chasing after fool’s gold.

Leverage M&A Potential
Large M&A deals have been rare among auto suppliers during the post-recession restructuring period, but the pace of consolidation will pick up during 2012 as private equity and strategic buyers return to the market. In fact, a Booz & Company survey of automotive executives earlier this year (see “Is the U.S. Auto Industry Ready for Economic Recovery?”) found that 60 percent of automotive suppliers are actively pursuing acquisitions. Suppliers must assess their positions in this context—are you a buyer or a seller—and in turn work to build the necessary supporting capabilities. For example, if you are a buyer, how do you assess which targets are the most attractive to your organization, and how do you overcome the operational, customer, financial, and change management challenges to ensure that you are able to capture the full value of an acquisition? And if you are a seller, how can you secure the most attractive valuation for your company?

The authors wish to thank Booz & Company senior associate Patrick Mulcahy for his contribution to the research and thinking in this letter.
Not long ago, the center of the global chemical industry seemed destined to be moving to the Middle East from North America and Europe, propelled by the ready availability in the Arab world of relatively inexpensive oil as a feedstock. That idea has now been turned on its head. A wave of drilling activity has unearthed giant supplies of natural gas in shale rock around the world, but mostly in the United States, creating a surfeit of raw material for making ethylene-based plastics inexpensively even as the cost of oil skyrockets. Indeed, with this sudden boom in natural gas capacity, the price of Henry Hub futures dropped about 13 percent in the first nine months of 2011.

This has altered chemical industry dynamics in significant ways. For one thing, demand for most ethylene-based petrochemicals—including polyethylene—is skyrocketing as their price falls in line with that of natural gas. This demand boom is particularly strong in fast-growing markets in emerging nations. As a result, many of the large integrated majors like Exxon Mobil, Dow Chemical, Shell, and Chevron are quickly adding to their natural gas reserves in North America with the goal of manufacturing ethylene polymers locally and shipping them to factories around the world, where the chemical can be used for everything from sandwich bags and cling wrap to car covers, squeeze bottles, water pipes, and cable insulation.

This trend could force Middle East chemical companies to think twice before increasing their petrochemical capacity but also may in time create an ethylene price war and profit margin pressure for the chemical companies with the most invested in this commodity. Indeed, the possibility of an impending price war is further punctuated by activities in China, where natural gas resources are substantial and ethylene factory capacity is increasing at a rate equal to that of the rest of the world combined.

Meanwhile, some petrochemicals are facing a far different set of conditions. Higher-end oil-based chemicals—essentially, the propylene polymers—are
losing their attractiveness as the price of oil continues to be high and volatile. And as the tilt toward natural gas exacerbates, the demand for propylene feedstock will likely continue to spiral downward. The riskiness of this chemical sector was a big reason that Dow Chemical sold its polypropylene unit in July to Braskem, Brazil’s biggest petrochemical company. With this deal, Braskem became the biggest U.S. producer of polypropylene and Dow exited an uncertain sector while generating cash to pay down debt and fund growth in other areas. There’s likely to be much more industry consolidation of this type in the immediate future.

And as the dynamics in the basic chemical sector fluctuate, specialty chemicals continue an inevitable march toward commoditization in much of the world. Just a decade ago, gross margins for specialty products including additives, pigments, and personal care items were extremely attractive; thus, many companies—even many large ones—were motivated to participate in the specialty segment. But today, specialty chemical margins have tumbled to historical lows.

The reasons are painfully obvious, if difficult to address. As more and more competitors seek to take a piece out of this still highly profitable market and put pressure on prices to improve their market share, specialty chemical providers are compelled to move into lower-margin applications in hopes of expanding and creating new markets for their products—often overlooking the fact that these less profitable applications and additional R&D expenditures may not be warranted.

In several cases, the specialty chemical company suddenly finds itself in a race toward the bottom. Further, the sector is weakened by improvements in downstream design and manufacturing processes that allow customers to eschew specialty chemicals in favor of more standardized feedstocks for their products. With all of these challenges, a long and costly price war—or, in this context, commoditization—is the unavoidable result.

To overcome these handicaps in the specialties niche, diversify portfolios, and enhance scale and breadth of existing businesses, companies are turning to acquisitions to swell their specialty offerings relatively quickly without the enormous up-front R&D costs that ultimately demand a long-term commitment to the product in order to realize a satisfactory return. For example, DuPont purchased the Danish niche chemical firm Danisco last May for US$6 billion to gain access to Danisco’s synthetic enzyme technology, which can be used in cleaning supplies, textiles, food, and animal feed, as well as Danisco’s strength in cellulosic ethanol research, which complements DuPont’s interest in carbon reduction products. And just a few months earlier, Belgian-based Solvay acquired Rhodia, a French producer of specialty
chemicals for cosmetics, personal care, water treatment, and plastics, for nearly $5 billion. This deal will give Solvay direct access to emerging markets in Asia and Latin America, where Rhodia has strong distribution and supply chain networks. That could be an enormous coup for Solvay, particularly in China, which has few specialty chemical facilities and relies primarily on imports for its rapidly expanding specialty needs.

If nothing else, these transactions show that many specialty chemical companies are still feeling positive about their prospects, even if a big part of their business model is to stave off commoditization. Decent revenue and earnings growth, primarily in emerging markets, has allowed them to build up cash and minimize debt, making this period of business expansion relatively pain-free financially.

And as 2011 comes to an end, along with these clear conditions and trends, signs of instability and uncertainty bedevil the chemical industry—chiefly, in demand growth. Though demand will certainly rise over the next few years, the steepness of the curve is impossible to predict. With GDP growth in developed nations projected to be well below 3 percent under the best scenarios in the next few years, the chemical companies are counting on emerging countries—especially China and India—for robust revenue and profit streams. But even in these markets, hints of trouble are apparent. In both China and India, inflation is rising and growth is slowing. In September, China’s inflation rate rose about 6 percent, well above the government’s 4 percent target, while third-quarter GDP gains dropped to 9.1 percent from 9.5 percent in the prior three months. As business conditions tighten in these regions, chemical demand will be a victim. Consequently, chemical companies must develop well-thought-out strategies and skills to deal with the changing dynamics in emerging countries, including establishing reasonable production and R&D footprints in Asia to best compete with local suppliers for both market share and talent.

A Capabilities Strategy

Although the industry landscape is so clearly risky and may be difficult to navigate, chemical companies are facing a set of real opportunities. But to take advantage of them, chemical outfits need to revisit the capabilities they already have and should have—to differentiate themselves from competitors in the race for profitability and improved performance. These capabilities are sets of tools, processes, systems, or skills that combine to drive a company toward its strategic goals. In our view, the following capabilities should be the main priorities for chemical companies in 2012 and beyond:
• **Choose the Right Business and Operating Models**

Tailored business streams (TBS), in which distinctive management approaches are designed for products and regions, depending on customer preferences and product life-cycle status, are already essential today but will become even more critical as commoditization escalates in the chemical industry. By adopting TBS, a company would, for example, dedicate direct sales teams to selling specialty chemicals to key customers. These teams would, in essence, serve as embedded experts to help customize the chemicals to meet specific client product needs and to upsell other specialty chemicals that may fit the parameters of future products that the client is developing. The goal would be to earmark the lion’s share of the chemical company’s expenditures for driving higher volume and market longevity for specialty products that command a premium price. At the same time, this chemical company might opt for a far different business model for its commodity products, selling them through third-party distributors and devoting just a sliver of the overall R&D budget to advancing these low-margin items.

Regional differences should also be taken into account when choosing the right business model. Uppermost in mind should be emerging economies with their potentially large markets. Companies need to develop plans not merely to grow in these countries but to outpace the rate of growth in local markets. Consequently, tailored business streams should be developed to target unique aspects of the local business environment and customer behavior and buying patterns.

In all cases, business requirements and management approaches chosen under the TBS umbrella must also be translated into operating models that support the tailored business streams.

• **Embrace Natural Supply Chains**

There are certain things that chemical companies can’t change about their supply chains to any significant degree: for example, where your customers are, and where you buy your raw materials. And external forces determine the cost of fuel for shipments. But it is possible to control logistics and storage or inventory costs. In fact, the best way to do that is through an approach we call natural supply chains: a combination of rigorous market-back and product-forward supply chain strategies.

Under this approach, chemical companies segment their product and customer base into organic categories—specialties, commodities, and petrochemicals—and then segment them further by their value to the
company, and then design their supply chains to best suit each of these individual buckets. The goal is to leverage and scale common supply chain elements across the enterprise when market requirements allow—for example, when there are long lead times and standard designs and supply volumes. Alternatively, special supply chain services can be applied to products that have unique requirements—shorter lead times, plenty of variability, smaller volume, order flexibility, and numerous potential configurations depending on customer needs.

Natural supply chains have consistently been shown to better support business requirements and drive increased value through lower operational costs. For example, after implementing natural supply chains, one large chemical company improved lead time fulfillment by 20 percent, reduced inventory by 40 percent, and slashed operating costs by about 20 percent.

- **Provide Solutions and Services**
  As a growth lever, this capability involves using a company’s deep knowledge of its customers and of chemical applications and technology to develop new offerings that go beyond the basic chemical value chain, including solutions based on performance-driven pricing. Companies that implement this strategy successfully can enjoy the types of sustainable and stable revenue returns that the so-called razor-blade model offers; that is, after the initial sale, customers are likely to keep coming back for refills over a long period of time. Pricing and promotions management is critical, however, to make this strategy work. Products must be offered at prices that customers perceive as on par with the value of these new solutions and materials.

  Overall, a move into providing solutions and services requires a significant upgrade of a company’s go-to-market capabilities—it’s critical to identify the markets in which you can gain and sustain leadership—as well as prolific idea generation, cross-functional and regional cooperation, a disciplined process that holds project managers responsible for strategy execution, and ruthless portfolio management. While most companies are good at some of these dimensions, very few actually attempt real portfolio management—to their detriment.

- **Enhance M&A Management**
  With acquisitions and partnerships certain to play a more prominent role in the chemical industry, particularly for expanding operations in emerging nations and for increasing the specialty chemical presence in a portfolio, effective postmerger integration or joint venture
management is increasingly essential. Strategies for manufacturing, R&D, staff recruitment, talent development, and customer service must be developed that take into account the combination of multiple organizations into an efficient, seamless operation. In addition, chemical companies need to develop proficiency in valuing potential acquisitions or joint ventures, based on accurate readings of the dynamics of emerging markets and on credible forecasts of demand and pricing for individual products and raw materials.

- **Design a Robust Innovation Strategy**
  As the chemical industry becomes more challenging globally, innovation as a core capability is increasingly a determinant of success. However, innovation is much more than R&D; it is a company-wide strategic thrust driven by a culture that encourages and rewards new ideas in all aspects of the business, from design to marketing, from manufacturing to talent development. Indeed, according to the Booz & Company Global Innovation 1000 annual study, the firms in all industries voted the 10 most innovative by global corporate executives outperformed the 10 companies with the largest R&D budgets by 33 percent in revenue and 20 percent in EBITDA margin averaged over five years. In fact, only three of the top 10 innovators were among the 10 biggest R&D spenders.

At the heart of a successful innovation strategy is well-developed and insightful knowledge about what customers need, with a process for using this information to lead market-back product development. The result of this exercise might be to provide unique offerings for specific regions or niche segments. To support turning customer ideas and preferences into products, there must be highly visible leadership commitment for innovation, including investment pools for novel ideas and ambitious targets for innovation-driven growth across the organization to encourage entrepreneurialism. Moreover, direct exposure of business managers, including the CEO, to markets and customers is critical, as is establishing application development and production facilities and customer relations centers in the areas (such as emerging nations) where market growth is expected to be strongest and where proximity to customers can be a significant advantage.
Consumer Packaged Goods

Although merger and acquisition activity has not yet returned to the peak levels of the mid-2000s, the restructuring of assets is still one of the industry’s most notable trends. Expansion in emerging markets, of course, remains a major driving force: Witness PepsiCo’s acquisition of the Russian dairy product and fruit juice maker Wimm-Bill-Dann; Diageo’s purchase of the Turkish spirits group Mey Içi Sanayi ve Ticaret; and H.J. Heinz’s deal for an 80 percent stake in the Brazilian tomato sauce and condiment maker Coniexpress.

A less heralded but even more significant trend in this industry is the realignment of portfolios around capabilities. Many companies—including Kraft Foods, Fortune Brands, and Sara Lee—turned in 2011 to splits and spin-offs as tools for focusing their businesses. (We also saw this in other sectors, with companies such as McGraw-Hill, ConocoPhillips, and Hewlett-Packard announcing or contemplating splitting into parts.) This suggests that the days are gone when bigger was better and consolidation was seen as inevitable because it provided the asset and scale base to win in a category. Instead, the leading consumer product manufacturers—whether they explicitly think of it this way or not—are reshaping their portfolios to better build and deploy the systems of capabilities that make them distinctive.

For example, Kraft’s recent announcement that it would split itself into two separate companies—a US$32 billion global snacks business and a $16 billion North American grocery business—surprised many observers. After all, this came after a run of acquisitions, highlighted by the purchase of Cadbury for $19.6 billion in 2010. But the acquisitions and the split followed the same competitive logic: making the most of capabilities systems. The new snack business to be spun out of Kraft, focused on chocolate and impulse consumption, will take advantage of go-to-market capabilities such as direct store delivery and execution in immediate consumption channels, deployed across several valuable global brands. The remaining Kraft business will be able to focus on the different capabilities system needed for grocery products.

The Fortune Brands split, separating its spirits business from its home and security products business, was another capabilities move. Similarly, the continued breakup of Sara Lee has restructured the company into smaller
units that can develop capabilities systems more tailored to their product categories. Most recently, Sara Lee has divested its international fresh bakery business, mainly to Grupo Bimbo, and sold off its North American food service beverage business to J.M. Smucker. In 2012, it plans to split into two companies: a North American meat business and an international food service beverage company.

On the surface, SABMiller’s acquisition of Foster’s seemed aimed at scale in the consolidating global beer industry. But SABMiller downplayed the importance of global brands. Instead, the company is focused on applying its capabilities, most notably in marketing, to turn around historically underperforming companies.

The real magic of capabilities—the interconnected people, knowledge, IT, tools, and processes that enable a company to execute better than its competitors—is how they align and integrate to form a mutually reinforcing system. A winning capabilities system, which usually comprises a select handful of capabilities, creates coherence because it links tightly with the company’s strategic position: its “way to play” in the market. In a world where products become obsolescent and patents expire, coherence enables a company to endure and prosper.

CPG companies have seen this dynamic firsthand. Whether they are large or small, companies earn a premium when they achieve coherence. Our research shows a correlation between coherence and shareholder returns, with companies that have managed to stay coherent for a sustained period of time, such as Coca-Cola and Church & Dwight, delivering higher returns to shareholders, and other companies, like Procter & Gamble and Sara Lee, gaining profitability as their coherence rises. (For more detail, see “Consumer Packaged Goods: Escaping the Consolidation Mentality,” by Steffen Lauster, Elisabeth Hartley, and Samrat Sharma; strategy+ business, June 2011.)

The link between coherence and performance is particularly evident in M&A. As part of a cross-industry study, we recently identified and evaluated the top 40 deals by transaction value in the CPG industry since 2002. Deals aimed at leveraging or enhancing capabilities—whether the acquisition was intended as an adjacent product or geographic move or as a consolidation play—outperformed others by a 7 to 8 percent CAGR over two years—a very healthy premium.

Along with investors, leaders in the industry increasingly recognize the value-creating potential of coherence. In PepsiCo’s third-quarter analyst call, for example, CEO Indra Nooyi provided an explanation of the company’s coherence by pointing out the value of its go-to-market, procurement, and
marketing capabilities across its hundreds of brands and multiple product markets. Similarly, Unilever CEO Paul Polman has spoken about the link between the company’s performance and its application of capabilities across a variety of markets in both emerging and industrialized economies. The company is aggressively pursuing global investments in such capabilities as customer insight, differentiated innovation, and trade promotion management.

Intensified competition from coherent, capabilities-driven companies will play a major role in persuading more diversified holdouts to restructure—and some major companies will have to define, strengthen, and communicate their capabilities coherence. For this reason, the current restructuring trend is likely to continue until consumer markets settle into a “new normal.”

In short, while the macro themes driving industry M&A are growth categories and access to emerging markets, especially the BRIC countries (Brazil, Russia, India, and China), the underlying glue is capabilities. The increasing complexity and customization required to access consumer markets around the world require greater skill, not scale. Scale economics still matter, to be sure, but many companies have attained it. It is excellence and distinction around capabilities rather than assets that will differentiate the winners in CPG during the next few years.

Your Capabilities Agenda

If a select set of mutually reinforcing capabilities is the key to a successful future, which capabilities should your company focus on developing? We think this is the most salient question you can ask this year.

Your answer will be unique to your company. As the wave of portfolio restructurings attests, no single group of capabilities will serve all CPG companies—the sector is too broad and diverse for that. There are competitive necessities—in effect, “table stakes”—in most CPG sectors. They may not, in themselves, provide the right to win in your category, but they confer the right to play, and they establish a platform on which leading companies build their more distinctive, differentiated capabilities systems. For example, at some level all CPG companies need to be capable of developing and leveraging consumer and shopper insights, bringing new products to market, and executing efficiently and effectively.

From there, however, the specific capabilities vary by subsector. For instance, an over-the-counter healthcare business needs capabilities that enable it to secure advantaged molecules; to support its products with clinical claims; to market these benefits to consumers and influencers, such as pharmacists, regulators, and medical professionals; and to manage a supply chain that
meets good manufacturing practice standards for pharmaceuticals. A personal care products company, on the other hand, needs capabilities that enable it to identify unmet consumer needs and shopping trends; to execute rapid innovation cycles with high rates of product turnover; and to manage a high-volume, fast-moving supply chain.

Even within subsectors, the winning capabilities systems will vary by company. If every company develops the same capabilities, they will have little to compete on except price. Only a strong set of things that “we do better than anyone else” can confer competitive differentiation.

In this short letter, we don’t have room to describe all the potential capabilities that CPG companies need, but we must highlight two interconnected areas that will require capability development in most consumer-oriented companies: digital media and shopper marketing. Proficiency in these still-emerging arenas, especially when combined effectively with established brand marketing and trade promotion practices, offers an unusually rich opportunity to create competitive advantage for the companies that get it right.

Digital media represent an exciting new frontier in which CPG manufacturers can engage consumers anywhere on their path to purchase. Leading marketers recognize that with the right mix of content, utility, community, and product, they can attain valuable benefits in terms of branding, relationship building, and repeat purchase. They are using proprietary websites, retailers’ sites, social media, and mobile apps to transform their digital presence into powerful direct media channels. In some areas, such as cooking, fitness, and parenting, CPG manufacturers already generate more traffic than media companies.

The rise of marketers as publishers coincides with increased emphasis on extending shopper marketing investments outside the store, providing manufacturers with new avenues for collaboration with retailers aimed at winning the trip and driving a larger shopping basket. To achieve this heightened level of performance, CPG manufacturers are using shopper solutions. For example, ConAgra Foods developed a menu-based shopper solution program, “Give Every Night New Flavor,” that offered recipes for popular meals, such as a stir-fry and pasta, and all the products needed to prepare them in a single display. The company built shopper awareness outside the store by creating a microsite for the solution, providing digital coupons, and using paid search and digital advertising, as well as gatefold ads in print media. In the store, it used stanchion signs and coupon books that led shoppers to pallets that featured the recipes and their ingredients. The solution delivered double-digit growth in units, dollars, and profit over
the prior year, as well as significant market share gains for a leading grocery retailer across participating brands and categories. The latter benefit points to the retail barter value of solutions: By creating wins for retailers, manufacturers can use solutions to gain more valuable opportunities in and out of the store, such as more and better display space, visibility on retailer websites, and access to retailers’ loyalty program members. (For more on the latest developments in shopper marketing, see “Shopper Marketing 5.0: Creating Value with Shopper Solutions.”)

As yet, no consumer company has figured out all the ramifications of digital media and shopper marketing or created the capabilities required to fully exploit them. But many companies are trying hard. For instance, one reason that PepsiCo and Coca-Cola acquired their North American bottler operations (in 2009 and 2010, respectively) was to integrate their capabilities in assortment planning, in-store marketing, and product supply with the more sophisticated and granular view of the consumers that is now available. This kind of integration will prove much easier within one organization than across companies.

As CPG companies recognize and pursue a strategic focus on capabilities, they will reorganize and reallocate resources accordingly. They will explicitly articulate a winning capabilities system; define their core businesses, brands, and markets in line with that system; and allocate people and funds accordingly. They will tune their business processes—from R&D to sales and marketing—to support this focus, and embrace a talent development strategy centered on recruiting, training, and retaining employees skilled in the capabilities that matter most.
Financial Services
(Capital Markets)

As the economic recovery takes a fragile hold, we see several powerful market trends significantly altering the economics of the financial-services industry. In response to these trends and to remain competitive, many companies will need to reassess their business models, operations, and technology infrastructure. This will entail a rigorous but vital process, given the magnitude of the forces at play—margin pressure, regulatory changes, globalization and complexity, and fast-moving technology innovation.

Tackling any one of these trends would be a challenge. Combined, they demand a vigorous response. Margins continue to be under pressure as asset values decline, net inflows for assets under management remain low, and investors continue to press for lower expense ratios. On the regulatory front, the push in the U.S. and Europe to increase transparency and risk management is driving up the costs of compliance.

Meanwhile, increased globalization and complexity mean that financial institutions need to offer a wider array of investment strategies and increasingly complex products (for example, OTC derivatives) to a global client base. Finally, technology innovation such as cloud computing and the need for on-demand data is speeding upgrade cycles and pushing companies to continually invest.

To navigate these trends and position themselves for growth, we at Booz & Company believe, companies should pay close attention to their capabilities and how they fit together to form a mutually reinforcing system. Three elements make up a capabilities-driven strategy.

1. **Way to play:** How you choose to face the market and create value for your customers.

2. **Capabilities system:** Your foundational capabilities (basic competencies necessary to operate in a particular industry or market) and
differentiated capabilities (the key strengths that set your company apart from its rivals).

3. **Product and service fit:** Based on your chosen way to play and capabilities system, which elements in your portfolio will grow—and which should go?

Together, these interlocking elements create a coherent company. Only a coherent company—one that pursues a clear strategic direction, builds a system of differentiating capabilities consistent with that direction, and sells products and services that thrive within that system—can reliably outpace competitors. The advantage of a coherent capabilities system is that it adds value beyond the sum of its components, and it is almost impossible to copy.

Ours is a complex industry with many kinds of companies playing many different roles. Each has a distinct set of ways to play. We recently took a close look at how two of these groups could use a capabilities-driven strategy to their advantage. The first is the investment management community, which includes institutional investment managers, subadvisors, mutual fund complexes, and hedge fund managers, all of which face pressures to perform and manage risk in a challenging margin environment. The second is the service provider community, which includes large global custodians, local market bank custodians, technology platform vendors, and outsourcing service providers, all of which are deeply dependent on cutting-edge technology to provide their services.

**Investment Management Landscape**

In the investment management community, companies can choose among five emerging ways to play, based on their market orientation—retail, institutional, or some combination of the two—and the breadth of their product offering. These five ways to play are the following:

- **Retail product experts:** Companies such as Aviva and Dreman that manage a range of products and offer an array of investment styles
- **Supermarkets:** Companies such as Fidelity, Vanguard, and Charles Schwab that provide access to many in-house and third-party brands and products
- **Off-the-shelf shops:** Companies such as Federated and Aberdeen that provide a wide range of ready-made investment products for institutional and retail clients
• **Institutional pure plays:** Companies such as Wellington Management, Conning, and Research Affiliates that manufacture products in-house and offer advice to institutions and family offices

• **Smart customizers:** Companies such as BlackRock, Dimensional Fund Advisors, and Russell Investments that offer separately managed accounts and other customized products in addition to a range of standard investments

All investment managers, regardless of which way to play they choose, require a core set of capabilities in performance management, risk management, talent management, market access, and data analytics. However, to build a sustainable “right to win” in today’s environment, investment managers must move beyond these “table stakes” capabilities and pursue at least one (and usually two or three) of four distinct capabilities.

**Smart execution:** The ability to leverage standard, electronic, and private trading platforms to execute investment strategies and manage liquidity efficiently. This capability is most important for institutional specialists, institutional pure plays, and smart customizers. For example, institutional specialists require speed and agility across multiple markets and product types.

**Continuous product innovation:** The ability to continually drive fact-based product innovation and speed-to-market through management of the full end-to-end product development process. This capability is vital for retail product experts, off-the-shelf shops, and smart customizers. For example, smart customizers require seamless management of the innovation process to speed time-to-market.

**End-to-end operating model management:** The ability to align technology, organization, and processes across the internal and supplier value chain so the company is efficiently leveraging its operating model. This capability is critical for supermarkets, off-the-shelf shops, institutional pure plays, and smart customizers. For example, supermarkets need to manage a complex value chain through lean-led design and execution.

**Customer-centric sales and service:** The ability to deliver best-in-class, end-to-end client experiences through efficient and preferred channels. This capability is most relevant for retail product experts, supermarkets, off-the-shelf shops, and institutional pure plays. For example, institutional pure plays need to focus on key consultant metrics and service.
As previously noted, ways to play and capability requirements will vary depending on the type of financial institution.

**Service Provider Landscape**

In contrast to investment managers, service providers can choose from among six emerging ways to play based on market orientation (local or global focus) and the breadth of banking services offered. These six ways to play are as follows:

- **The universal bank**: Companies such as J.P. Morgan and Rabobank that leverage their balance sheets and provide value through product bundling and low cost

- **Securities service expert**: Companies such as BNY Mellon that drive down costs through massive global scale and leverage high-margin businesses on top of core securities servicing

- **Market specialist**: Companies such as HSBC, Standard Chartered, and Société Générale that understand local or regional markets exceptionally well and leverage bank services beyond securities services to gain scale

- **High-touch servicer**: Companies such as Brown Brothers Harriman and Northern Trust that offer seamless, consistent customized service to clients of any size and focus on securities services to the exclusion of other corporate banking functions

- **Niche player**: Companies such as U.S. Bancorp, China Construction Bank, and ICICI Bank that operate in local markets and are protected by special regulations, long-standing ties to markets and clients, or limited global asset flows

- **Platform providers**: Companies such as Bloomberg and SunGard that offer automated and integrated platform solutions and provide outsourcing services

As with investment managers, all financial securities service providers, regardless of which way to play they choose, require a core set of capabilities. These table-stakes capabilities include relationship management, internal connectivity, risk management, and regulatory and compliance management. Like investment managers, financial securities service providers must build beyond these foundational capabilities for a sustainable right to win by pursuing at least one or two of five unique capabilities:
Organizational integration: The ability to organize leadership teams and provide transparency and coordination across regions, business units, and product lines. This capability is particularly important for universal banks and market specialists. For example, universal banks must integrate business units to streamline service and bundle products.

Product development: The ability to develop and manage complex products as financial instruments rapidly evolve. This capability is critical for high-touch servicers and platform providers. For example, platform providers must continuously analyze market trends to develop new instrument servicing requirements.

Market expertise: The ability to provide deep market expertise and anticipate changes in customer needs and regulations. This capability is vital for market specialists and niche players. For example, niche players must implement retention policies for talent, knowledge, and data as well as gauge market trends.

Data-centricity and analytics: The ability to apply technology to leverage data and provide advanced analytics. This capability is necessary for securities service experts and platform providers. For example, platform providers must deliver data aggregation across all components and provide leading analytics capabilities.

Low-cost operating model: The ability to drive down costs through economies of scale and automation. This capability is key for universal banks and securities service experts. Both must become cost leaders by leveraging scale and efficiencies through lean practices, business process reengineering, and automation.

The process of identifying, building, and deploying strategic capabilities is challenging and will take a concerted, enterprise-wide effort led by the top of the organization. But we believe strongly that this approach will be necessary if a company is to outperform in the years ahead.
Financial Services (Retail Banking)

As we all know, growth is hard to find, revenue is under intense pressure, and the cost of doing business continues to increase. Four forces are shaping this reality: the economic climate, with high levels of unemployment, low interest rates, and a feeble housing market; consumers, who are borrowing less; regulators, who are both curbing fee-based income and increasing the cost of compliance; and technology, which is enabling nontraditional, low-priced competitors in areas such as payments.

Since the financial crisis, many in the industry have assumed or just hoped that these revenue challenges would be a cyclical phenomenon. But there is a creeping realization that this is not the case. It’s our belief that a structural, secular shift is under way; the industry is transitioning from a high-margin business to a lower-margin one.

As significant as these secular shifts are for profitability, they are not the only forces reshaping the retail banking environment. Over the next five years, we expect that two megatrends will force retail financial institutions to rethink their operating models: digitization, which is de-integrating the front- to back-office value chain; and consumer expectations, which are relentlessly rising. Banks will need to invest in these technology advances—specifically, cloud computing, analytics, broadband, and social tools—to meet customer expectations, which are increasing as innovative nonbanks step into the space and solve common, long-standing customer “pain points.”

To navigate this difficult environment and position themselves for future growth, leaders of retail financial institutions need to answer five critical questions:

1. How are we going to compete in this new customer demand-driven environment?

   With limited avenues for growth, the banking sector will be hypercompetitive for the next three to four years. In this environment, it’s critical for each bank to be very clear on how it will compete and win in the market. We believe that the winners will retain their profitable
customers and capture a bigger share of their wallets. Adroitly targeting specific customer segments, creating products that go beyond deposit and checking accounts, and delivering those products through highly competitive (physical and virtual) sales forces will be competitive necessities.

As the banking value chain rapidly digitizes, banks will need to raise their game in technology and partnering to differentiate themselves. Specifically, banks need to significantly improve the user interface/customer experience by leveraging analytics in the front office and partnering with retail and technology firms to personalize offers, market to customers, and build loyalty.

2. What capabilities do we have to build?

Banks have traditionally focused on financial management, human capital management, risk management, operations, IT infrastructure, and acquisition and integration capabilities to differentiate and win in the market. The financial crisis and the current competitive environment are quickly making these capabilities table stakes. For a sustainable “right to win,” banks must pursue differentiating capabilities.

Investing in certain capabilities will allow retail financial-services companies to address four common customer pain points that have dogged the industry for years: Dealing with a bank is complicated and time-consuming; the customer receives impersonal treatment and little recognition; the customer is not in control or empowered to make decisions; and the customer gets no help engaging with friends and family on financial matters. By providing better solutions, banks can improve their ability to demonstrate value to consumers, which is essential for increasing pricing power and acceptance.

Four capabilities that banks can develop to address these pain points and outperform competitors are a **seamless multichannel experience** (deliver an end-to-end customer experience); **analytics-driven decision making** (drive fact-based decision making and anticipate customer needs using deep insights from customer data); a **customer-focused value proposition** (deliver highly tailored product and service offerings that include standardized and individualized solutions); and **internal and external collaboration** (work across organizational boundaries to deliver enhanced customer experience).
3. **How fast can we and should we drive out costs?**

Those who believe that the industry’s current challenges are cyclical will drive out some costs while maintaining the same operating model. On the other hand, for those who believe, as we do, that a secular shift is under way, a more aggressive approach is necessary. Investing in the new capabilities will be expensive, and funding will need to come from wringing costs out of the operation. Banks will have to continuously focus on expense control — on *how work gets done* as well as what work to do — using lean and technology-enabled process redesign to build more flexible, responsive operating models.

In the process, banks should take advantage of emerging technologies to drive out complexity and improve the customer experience while also reducing costs — recognizing that these seemingly divergent objectives can now be simultaneously achieved. Structural adjustments to the operating model will be required to capture scale and bring variability to cost structures through consolidation and outsourcing. A more granular assessment of costly multichannel distribution networks will reveal where expense is not creating value. In addition, banks have to become nimbler and reduce bureaucracy in decision making by optimizing their organization structure through a reexamination of roles, spans of control, and management layers.

4. **How can we get short-term revenue?**

Given the challenging revenue climate, most banks are tempted to raise fees on customers to compensate for the shortfall. But imposing new or higher fees without extreme care is a recipe for trouble. First, and perhaps most obviously, higher fees risk alienating customers. The industry’s attempt to raise debit card fees offers indisputable proof of this danger. The outcry was intense, from consumers and politicians.

The inclination to raise fees can also reveal a narrow, transactional view of the interaction that too often fails to take into account the value to consumers. Additionally, it overlooks existing and emerging ways banks can — and will need to — make money in coming years. Banks often provide skills and information to customers, particularly in commercial and small business sectors, as bundled add-ons or even as loss leaders. Yet some of these can be “unbundled” in a way that provides value to customers and more effectively monetizes the bank’s existing capabilities.

For example, banks could aggregate information for the marketing and sales efforts of middle-market and small businesses; leverage deep
financial and operational risk management expertise for middle-market and small businesses; offer white-label analytics for other financial institutions and business-to-consumer companies; or perform white-label outsourcing and transaction processing services.

Banks need to evaluate these ways to create new revenue streams by leveraging their existing information, expertise, and distribution capabilities and assets. Companies ranging from Amazon to American Express to GE to UPS have converted capabilities originally built to drive core businesses into new revenue sources. In these times, every bank should be doing the same.

5. How do we sustain the change?

Long-term success is achievable only if the changes adopted by the organization endure. Our experience shows that there are four pillars to sustainable transformation: senior direction and sponsorship, with a focus on augmenting capabilities in concert with cutting costs; ongoing performance management, including a shift in efficiency philosophy toward one that emphasizes continuous improvement; redesign of core processes via strategy planning and investment prioritization to address sustainability requirements and track progress; and leadership behavior to ensure that leaders set the right example and close skill and competency gaps.

Tackling these five critical questions won’t be easy. But we believe that banks that make the effort will more clearly see how to cut costs and where to invest for growth, positioning themselves to outperform in the years ahead.
Financial Services  
(Wealth/Asset Management)

As we all know, these are hard times for investors. The stock market correction during the summer was brutal, dashing hopes that the markets had finally turned a corner. Several persistent macroeconomic forces are shaping this reality: the U.S. economic climate, with low growth, high levels of unemployment, and low home prices; the European debt crisis, which alternately simmers and boils; and fears of asset price bubbles in the emerging markets and commodities. What’s more, monetary and fiscal policies in the U.S. bode ill for savers and investors. Interest rates are minuscule, and taxes on dividends and capital gains are likely to rise as the U.S. is forced to cope with budget deficits and entitlement programs.

Investors seem to have no place to hide, no safe haven. Many are adrift, uncertain about where to put their money and whom to trust. They need sound advice like never before, but they have been badly burned in the last four years and their patience and trust have worn thin. This skeptical attitude is hardened when blue-chip investment managers make high-profile wrong bets that garner substantial media attention.

But if being an investor in this climate is challenging, so too is operating a wealth management firm. Top-line growth is elusive even as a new regulatory environment is driving up compliance and risk costs. As grim as this picture is, we believe that wealth management firms should resist the temptation to batten down the hatches and wait for the storm to blow over. In fact, we see two rare and significant opportunities for those firms willing to brave the adverse conditions: the first is to exploit rivals’ vulnerabilities and stake out a new competitive position in an unusually fluid market; the second is to use emerging technologies to significantly enhance the customer and advisor experience.

As noted, investor satisfaction is at an all-time low. Although generally skeptical after four tough years, investors are still searching for new ideas and are more willing to test new relationships. Now is an ideal time to pounce on competitors’ vulnerabilities and peel away clients. For example, trust companies, which have a reputation for conservative investment
philosophies, can explicitly target the clients of private banks that have lost money on opaque, capital markets–based structured products.

It’s also a good time to capture talent, which, like customers, is available and open to change. Some advisors are unhappy about the way their firms treated them in the early years of the financial crisis, others might come from adjacent industries such as investment banking, and still others might be willing to try a different sales format at a different type of wealth management firm—for example, moving from a broker/dealer to a private bank, or from an RIA to a wire house.

Overall, this more fluid wealth management environment means that the competitive positions of long-entrenched wealth management firms are less secure. But money alone will not lead an advisor to leave his or her current employer. To change firms, advisors need to believe their clients will be better served and they will be more successful at the new firm with its different platform and value proposition. To attract new talent, wealth firms need to clarify their value proposition for clients and advisors and pursue this opportunity aggressively and creatively.

Coincidental to the economic and financial woes creating this fluidity in the industry is the emergence of new technologies that can significantly improve the client and advisor experience. Investing in these technologies is the second major opportunity we see in today’s environment. The danger is that wealth management firms struggling with top-line revenue growth and increased regulatory costs will under-invest at this critical juncture. We believe that could be a grave long-term error.

New technologies that have been slowly developing over the past two decades seem to have reached a tipping point and now have the potential to transform the relationships that wealth management firms have with their clients. Tablets and other new devices have sprung up, along with rich interfaces and new displays. Clients can access a wealth of information in real time, and firms have new tools to gain client insights from a trove of unstructured data that had previously been too difficult to tap. Networks, including 4G, are more powerful than ever, and new infrastructure, notably public and private clouds, allows firms to run their operations and engage with clients in innovative and more efficient ways.

These new technologies are powerful and worth investing in because they can elegantly address four principal customer “pain points” that have dogged wealth management firms for years:
• “It’s a hassle”: Dealing with a financial firm is risky, complicated, and time-consuming. For instance, statements are confusing, service is often inconsistent, and processes like client onboarding and opening new accounts can be cumbersome.

• “I’m undervalued and exploited”: The person gets impersonal treatment and little recognition. An example would be high-net-worth clients not getting the high-touch services they expect or their financial advisors not being aware of their banking transactions with the parent company.

• “I’m in the dark”: The customer is not in control or empowered to make decisions. For instance, customers don’t have access to real-time information and advice, or performance reporting is difficult to understand.

• “I’m on my own”: The customer gets no help engaging with friends, peers, or family on financial matters. Generally speaking, wealth management firms have not empowered their clients or relationship managers to take advantage of social media capabilities and connections that are widely used by investors in their personal lives.

By taking emerging technologies and applying them to these pain points, wealth management firms can change and enhance the customer experience—and the advisor experience as well. It’s possible to envision a future where the relationship between the client and the firm is personalized and the client has access to advice and information on a continual basis; where clients and advisors use a rich user interface—intuitive, paperless, and digitized—to communicate with one another and the firm; where the client’s connection with the firm is fast, always on, and full-service through multiple channels; and where these engagements are collaborative and secure—possibly with peers as well as advisors—using social media. (Click here to see a demonstration of how a client and advisor could discuss and execute a stock trade via a real-time video interface as important news is breaking.)

There will doubtless be regulatory considerations in how advisors interact with their clients, but there is little doubt that these and other new technologies will fundamentally change the nature of this interaction. So what should a wealth management firm do to reach this enviable future state, given that investment resources are limited? First, it must exercise discipline and focus in choosing which opportunities to pursue and where to invest in technology. That is no mean feat. The range of products to consider across the entire technology stack, from devices and interfaces to networks and infrastructure, is formidable. And within each element of the stack are still
more layers of complexity. How do you make sense of this universe of new technologies? How do you prioritize opportunities and investments?

In our view, a sound methodology starts by clearly articulating the client pain points. Next, stitch together technology solutions across the stack in a way that aligns with those pain points, thereby using them as a guide to choosing and prioritizing opportunities and investments. This process helps the company invest appropriately in the right capabilities. With careful planning, the result will be a transformed client and advisor experience enabled by a digital, lower-cost, and more flexible operating model.

A fundamental question is how to balance innovation and practical implementation. In response, we offer these five guiding principles:

- Solve real pain points for customers by deploying new technology;
- Collaborate with third parties to obtain new technologies;
- Recognize what the future might bring while grounding near-term actions in reality;
- Make the tough decisions to rationalize the ongoing project portfolio (no “sacred cows”); and
- Ensure that innovation business cases are realistic and yield results incrementally.

This is a challenging time for our industry, but it is also rich in opportunity and promise. We believe that firms can take advantage of general investor dissatisfaction to challenge competitors, exploit their difficulties, and claim new competitive positions. Coincidentally, new technologies are maturing that can create new standards for the client and advisor experience. These technologies also have the potential to transition the entire operating model from an industrial one (with multiple branches, lots of paper, and branch-based compliance) to a digital, low-cost, and flexible one that enables richer client and advisor experiences. We believe that firms that invest to harness these new technologies, even in this depressed environment, will benefit hugely when markets recover.
Healthcare (Payor/Provider)

The news in 2011 for the healthcare industry wasn’t entirely bad, although it offered little resolution to a long list of ongoing challenges and dilemmas. As we have done for more than a decade, we would like to take this opportunity to share our thoughts about the year ahead. We predict that the coming year will reward leaders who can navigate uncertainty—not only by taking reasonable risks, but also by building strategic foundations that are adaptable to a future that is still evolving.

2011: No Fun, but Reasonably Profitable

2011 was a year of generally good profits for providers and payors. Yet the year also provided more questions than answers about the future of the U.S. health system. The uncertainty won’t go away soon—or all at once. The Supreme Court has declared its intention to hear challenges to healthcare reform in March 2012, so a ruling is unlikely before mid-2012. Some aspects of reform may be bargained away by the super committee charged with making major cuts in the deficit and national debt. And the national elections may dramatically alter the political landscape.

Generally speaking, 2011 was a challenging year for providers. Guidelines for accountable care organizations (ACOs) kept shifting, implementation of new IT proved difficult, and overall use rates held steady or fell in most markets. On the plus side, most states’ Medicaid funding remained robust, boosted by federal stimulus dollars, and years of consolidation and cost containment combined to maintain or improve margins for most.

Meanwhile, providers forged ahead with existing strategies—market consolidation, vertical integration, physician acquisition, IT investments, and cost management—but with an increasingly common twist. While they continued assembling positional assets—hospitals, most commonly—their motivation evolved away from negotiating leverage with payors and toward a new basis of competition. Providers are preparing for a world where access (to doctors and diagnostics, primarily), care management, and cost control
will matter more to their overall success and financial health than having a hospital in every part of the market. Furthermore, as care management and cost control have become increasingly important, so too has the need to forge new relationships with payors.

Payors generally fared well on the bottom line, partially masking the profound changes taking place in the sector. Risk pools moved past the first wave of demand from individuals who had been facing imminent unemployment, high-deductible plans grew, and continued utilization management helped fuel a good year for most players. Investment returns strengthened most balance sheets, but evidence of major structural change was afoot. After two decades of unraveling HMO ventures, one insurer (Highmark) announced a merger with a provider system (West Penn Allegheny Health System). While designed to increase provider competition in the near term, the longer-term structural significance of this merger is also clear.

Meanwhile, more consolidations, partnerships, healthcare industry utilities, and even mergers are proceeding—motivated by the need for scale to afford new patient-focused and interactive IT systems. In addition, payors continued their promising experiments with providers to offer end-to-end, high-service products to consumers—often with a fixed or narrowly bracketed price. Finally, the importance of the Medicare segment (big and getting bigger) and the need for capabilities that can flex based on decisions about ACOs and Medicare Advantage can be seen in Cigna’s acquisition of HealthSpring.

Something well beyond business as usual was occurring within and across the provider and payor sectors of the industry. For providers, the move away from fee-for-service dominance and the introduction of risk continued to be strong, and the traditional business-to-business orientation of major payors continued to migrate to more consumer-centric approaches and capabilities.

**2012: Despite Continued Uncertainty, a Strategic Tipping Point**

We don’t anticipate any meaningful resolution to the uncertainties resulting from healthcare reform until at least early 2013; however, the same forces that shaped our industry for the last 30 years will continue to drive fundamental change. A de facto consensus is emerging that the traditional structure of the industry’s sectors and its business models must change. The vagaries of the Supreme Court process and the 2012 elections would usually have a paralyzing effect on major business decisions, yet we see little reason to doubt that certain trends will continue. For providers, these include the following:
• The momentum for step-change in cost performance is strong and will be addressed by enhanced care management and coordination.

• Some, perhaps many, states will establish insurance exchanges for individuals and small groups.

• IT investments by providers will move forward to take advantage of incentives and meet regulatory needs, despite some risk that federal reimbursement could be partially defunded.

• Regardless of the forms that ACOs take, the momentum for coordinated, patient-focused accountable care will continue as it addresses core cost and quality needs.

• New state-of-the-art ambulatory care centers are likely to supplant inpatient facilities as the preferred strategy for market access and penetration.

• Provider systems will continue to vertically integrate by employing increasing percentages of their medical staffs.

Meanwhile, these payor trends will be present in the coming year:

• Payors, long comfortable with selling to large accounts and managing millions of claims transactions, will continue to seek vertical integration opportunities, hoping to develop defensible value propositions in the new competitive landscape.

• The need to invest in new high-cost, consumer-centric business and IT systems capabilities will take many forms, from utility collaboration all the way to mergers.

• Employer-sponsored health benefits will not rapidly disappear, even if healthcare reform survives. Their dominant form may migrate further toward managed care and high-deductible health plans, but the major source of funds will continue to be employer-based.

We believe that meaningful cost reduction will be the not-so-invisible hand driving change in healthcare financing and delivery. Long-term cost reduction in the range of 20 to 25 percent will be necessary to make a return on what will be a sharply increasing Medicare patient mix and ongoing recessionary and consumer-driven cost pressures. As scary as this number may be, leading players will get there and will be rewarded.
Guidance for Industry Players: Invest in Deep Capabilities

The uncertainty ahead lies primarily in the details, not in the larger forces shaping our industry. Nothing will stop the baby boomers from aging and getting sick. Nothing currently imagined will fundamentally change the fact that Medicare will account for ever-increasing percentages of patients and revenues. Whether ACOs, HMOs, or HMOs-by-another-name become the dominant format is less important than the likelihood that accountable, coordinated, and finance-integrated models will take hold as the vehicles most likely to achieve meaningful cost reduction. There also should be no doubt about the long-term efficacy of sophisticated IT systems and their ability to increase clinical efficiencies and expedite virtually all transaction-driven activities (clinical e-consultations, for example). These expectations provide sufficient certainty for industry players to develop and pursue long-term strategies for success.

We believe that a capabilities-driven platform for strategy formulation is ideally suited to the high-level near-certainties and detail-level uncertainties faced by payors and providers. “Capabilities,” in this context, refers to deep, defensible proficiencies that not only serve today’s markets and segments but can be extended to other segments (adjacencies). When properly assembled and deployed against existing businesses, competitors, and new opportunities, a robust suite of capabilities acquires “coherence.” Coherent capabilities not only drive performance but create hurdles to competitors’ efforts to catch up. Virtually every leading competitor in every sector of the world’s business has developed deep and coherent capabilities and continues to invest in them.

The least uncertain reality facing our industry is the need to significantly reduce costs. Meeting this goal is not just a competitive necessity for the players but also imperative for the industry’s long-term fiscal health and global competitiveness. The types of capabilities needed to move forward are reasonably clear. For example, providers—the sector where the great majority of costs are determined and incurred—will need to focus on distribution, IT optimization, clinical protocols/standardization, and new arrangements with payors. Additionally:

- Distribution—putting the right assets in the right places with the right linkages—will shift from a hospital-centric model to one more focused on ambulatory services. Reformatting ambulatory care and diagnostics will become the new starting point for care management, with many healthcare systems choosing some variant of patient-centered medical homes.
• Investment in next-generation IT systems will continue. The full potential of new clinical systems will not be achieved until most diagnoses, procedures, and results have been codified and an infrastructure for information exchange established.

• New arrangements with payors are needed if the full potential of innovations in distribution, clinical management, and IT systems is to be realized. We expect continued investment in arrangements that enable “productization,” especially of high-cost inpatient services and chronic disease management. System-level coherence across stakeholders will be key: Shared incentives and seamless interactivity for providers, payors, and patients will be the goal—with some players combining with payors in new financing and delivery ventures.

Some providers, such as academic medical centers (AMCs), will have special challenges. As one AMC CEO told us, “I think I know how to cut 10 percent to 15 percent of costs, but the next 10 percent will have to come from research and teaching outlays.” Finding ways to streamline and properly allocate research and teaching costs should be top priorities for AMCs.

Payors face major challenges in developing winning capabilities. Though the trends shaping the industry haven’t changed significantly, the solutions are no more obvious and no easier for payors’ leadership to develop than they were a year or more ago. Assuming continued interest in state insurance exchanges and the ongoing growth of managed care, the segments to be served will continue to expand and shift. While all segments will require capabilities in customer analysis, care and risk management at the “population level,” and innovative product design, there are also segment-specific needs, such as managing Medicare and Medicaid populations across multiple sites of care, developing new ways of engaging patients, and reaching individuals via new or revamped retail channels. The traditional emphasis on selling to large accounts and managing transactions will still be necessary, but not sufficient, to win.

We believe there are three potentially winning positions, the choice and mix of which will vary by market and player:

*Segment-specific models* will be the best option for low-scale payors to compete in selected markets. The decision about which segments to serve will then guide capabilities development and investment. This is the easiest play, but it is vulnerable to new, focused entrants.
Coherent multi-segment models will fit best for moderate-scale payors targeting two or three major segments. Market and product rationalization will be needed to develop focus and maintain scale.

“Portfolio” models will be the most likely course for large, diverse plans with scale in multiple markets and segments. A set of portfolio-level capabilities—such as capital management, medical informatics, and shared IT services—that achieve coherence across all segments is imperative. Scale is also key, since multiple operating platforms may be required to support all segments efficiently.

These high-level strategic choices need to be explored alongside structural challenges, including the degree to which a given payor will vertically integrate with care delivery, large-scale connectivity issues among all stakeholders, and business model migration strategies. We suspect that for many big players, vertical integration will get serious attention as Kaiser Permanente–like strong-form HMO models continue to succeed. Health information exchanges are critical to any thorough solution, but there is still no consensus on a business model. Finally, even once a future state is determined and payors craft a plan to develop capabilities, migrating the organization and its customers to the new model will be difficult. We expect to see more payors follow a path initiated by one of our clients: form a new organization dedicated to the future state of the market and gradually move resources out of the old organization into the new one—until the new structure manages the bulk of the plan’s business.

The year ahead probably won’t be any easier than 2011, but we expect leading players to formulate winning strategies despite the uncertainty and begin placing large bets on their visions of the future.
To the drug industry, November 30, 2011, is the landmark date that Lipitor, the most successful drug ever, began to face generic competition. Lipitor’s loss of patent exclusivity is a sharp reminder of the patent expiration wave making its way through the industry, increasing pressure to cut costs and improve productivity and innovation. As The Wall Street Journal said on June 15, 2011, “white-knuckled investors have been hoping that drug makers would have found replacement products by now or adequately diversified themselves to withstand the impact.”

Pharmaceutical companies confront these patent challenges at a time when growth in the overall industry is slowing and demand is shifting to generic segments and emerging markets. We expect these trends to continue in 2012, along with persistent regulatory hurdles; increasingly demanding stakeholders, including payors, providers, pharmacies, and others; and challenges throughout the value chain—from slumping R&D productivity to supply shortages.

While the industry faces serious problems, companies can survive and thrive if they adopt highly differentiated strategies. Differentiation goes beyond a shift from “me too” products to novel breakthroughs. True differentiation stems from the presence of carefully nurtured distinctive capabilities throughout an organization that endure and are tough to copy.

As pharmaceutical management teams turn the calendar to 2012, we pose a simple question: Is your company building capabilities that are truly differentiated and consistent with the changing demands of the market? In answering, consider four critical and rapidly changing aspects of the industry—research, commercial operations, supply chains, and networking—that require specific, highly developed capabilities.
The Capable R&D Engine

Many R&D transformation programs do not meet their potential because they comprise a broad set of uncoordinated and overlapping initiatives that are not underpinned by an overarching strategy. A clear focus on a few specific differentiating capabilities can act as a “guiding star” for innovation. Our research and experience with clients suggest five key capabilities to power a capable R&D engine:

**Value-driven clinical program design** with a focus on explicitly and transparently assessing trade-offs among development cost, risk, and revenue, based on an understanding of value in the eyes of all major stakeholders, and the design characteristics that drive cost, risk, and revenue.

**Scientific and clinical leadership development** that builds a highly effective cohort of discovery and development “managers in the middle” who have extensive external networks, broad disease and pathway understanding, and decision-making authority given established scientific and clinical targets, coupled with performance measures that encourage collaboration and overall portfolio optimization.

**Disciplined portfolio management** based on assessments against rigorous, forward-looking target product profiles that have been externally tested against market and competitive trends.

**Targeted therapy development** involving systematic and early identification of targeted therapy options, analysis of trade-offs, and selective design of tailored drug development programs to focus on patient subpopulations, including codevelopment of diagnostics as appropriate.

**Scale-up of next-generation clinical development** that focuses on rapid and broad rollout of new approaches such as building access to high-quality electronic medical record data for protocol modeling and patient recruitment, remote data collection, and novel approaches to data quality risk monitoring, as well as aligning the design of outsourcing partnerships with strategic development goals.

We find less debate among our clients on what needs to change than on how to make change happen broadly and systematically across complex, global organizations. Rather, our experience has been more focused on developing key capabilities at scale including, for example, performance management systems for functional and therapeutic area teams, and partnership agreements with outsourcing firms.
The Commercially Capable Company

Over the past two decades, large pharmaceutical companies relied on a sales and marketing approach aimed at prescribers in the world’s largest markets— the United States, Europe, and Japan. The model spawned blockbusters such as Lipitor and created unprecedented value. Now, however, it is no longer generating growth.

Going forward, four trends will require not just more significant cuts in traditional resources, but a focus on building distinctive new capabilities: First, cost containment continues to create a more restrictive market access environment with greater pricing pressures, additional reimbursement restrictions, and new or altered drug procurement systems. Next, new product launches are increasingly focused on high-value specialty indications. Third, trade liberalization is opening new opportunities in distribution and trade channels. Finally, emerging markets—which have very different healthcare models for marketing authorization, pricing, reimbursement, and distribution—are forecast to make up 30 percent of the global pharmaceutical market by 2015, compared to 19 percent in 2010. Our work with clients in the past year suggests that certain go-to-market capabilities will be critical in confronting these trends:

**Payor engagement capabilities** to address market access, pricing, and reimbursement (including innovative pricing agreements); joint disease management programs; and the provision of additional patient services that enhance the value of the product. These services may include compliance management programs supported by nurses, or telephone hotline services, among others. Of course, our deep experience here also shows the need to know where value can really be attained rather than over-investing in marginal benefit.

**Multi-stakeholder marketing capabilities** that target all relevant players in the healthcare system including prescribers, nurses, pharmacists, formulary committees, and payors. Multi-stakeholder marketing requires close coordination among medical, sales and marketing, market access, and pricing teams to secure pricing and utilization that reflect the value of each product. It calls for joint planning and decision-making processes, as well as coordinated execution. Though there is agreement in principle with this, it is the organizations that are truly ready to redefine how they plan and operate that are realizing benefits at scale.

**Commercial trade channel (CTC) capabilities,** to engage more closely with key stakeholders in the distribution chain, including wholesalers, pharmacists, and patients. CTC capabilities include new distribution models,
such as direct-to-pharmacy (DTP), in which manufacturers sell straight to pharmacies, enabling a direct trade relationship and paving the way for targeted loyalty programs. Other CTC examples include patient loyalty card schemes, which are common in Mexico, Brazil, and many other large emerging markets. The success of these new CTC models depends on close collaboration among product supply, marketing, and commercial trade functions, as well as the management of new partnerships with specialist third-party service providers (for example, to provide logistics services for DTP or to operate loyalty card programs).

_Tender and contract management capabilities_ to respond to this increasingly important method of pharmaceutical procurement, which now makes up 27 percent of the global market. These capabilities include new customer-facing roles to interact with buyers, analytic capabilities to review tender opportunities, and new planning and tracking processes to manage the tender business. In particular, it requires close collaboration among commercial functions, pricing, and product supply. Top-tier pharmaceutical companies are leading the way: Four of the top five pharmaceutical firms have invested in developing tender and contract management capabilities in the past year. Inevitably, the rest of the industry will need to catch up.

**The Capable Supply Chain**

Moving forward, a capable supply chain will be one that is tailored, agile, and cost-efficient. Rising complexity—the result of new SKUs being added to a portfolio of traditional ethical drugs and more and more generic “mature” products—is placing new stress on the supply chain. Meanwhile, new and more complex distribution channels, including online ordering and direct-to-consumer delivery, continue to evolve. And pricing pressure—from generics companies gaining share in cost-conscious developed markets and financially strapped developing economies—continues to intensify. Together, these industry dynamics add to the urgency for more sophisticated supply chains than the pharmaceutical industry has relied on in the past.

Booz & Company’s long-standing cross-industry experience in supply chain management suggests four key capabilities for pharmaceutical companies to consider for added investment and development:

_A set of tailored supply chains_ that addresses segment-specific needs. In the pharmaceutical industry, “one size fits all” supply chains are obsolete. In their place, firms need to construct a series of individual supply chains tailored to products, markets, and customer segments. For example, high-volume products with steady demand—the old “blockbusters” that are coming under cost pressure from generics—could be manufactured in low-
wage countries and with lean inventory management. Meanwhile, pricing on patent-protected drugs for less common medical conditions could justify manufacturing in factories close to markets in sufficient volume to allow for short lead times and avoid expensive stockouts. The two types of supply chains may be utilized simultaneously at the same company.

*Agility in the supply chain* enables a pharmaceutical manufacturer to respond to variability in demand for a drug—for example, from one country or region to the next—and also to maintain less inventory (thus minimizing costly write-offs) while still meeting demand. Postponement, wherein drugs are packed to order, is one increasingly popular strategy that is supported by an agile supply chain.

*Flexibility in product supply and manufacturing* allows a company to better respond to volatile manufacturing capacity requirements, such as those associated with tenders, and to minimize underutilization of capacity. Building flexibility into supply chains requires the right product supply setup, the right production footprint, and management of strategic supply relationships with contractors.

*Integrated planning capabilities* increase alignment of key supply chain parameters, such as capacity, inventory levels, and lead times, with market demand. For example, as generics enter the marketplace, company planners must correctly gauge their impact on individual branded drugs to guide the business side in managing inventory size, returns liabilities, and write-offs if sales drop. Pharmaceutical companies must deploy a disciplined business planning process that supports the company’s portfolio management strategy and product transition plans.

One company’s capable supply chain is likely to bear little resemblance to that of even its closest competitor. Big global pharmaceutical companies with their own production networks might rediscover manufacturing as a competitive advantage, while small firms or pure innovation players rely fully on outsourcing. But the overall importance of a sophisticated and capable supply chain is clear. Accordingly, the awareness of the need for a fundamental shift in supply chain design is increasing within the industry; several leading pharmaceutical companies are starting to fundamentally rethink their supply chain strategies. Companies with strong, agile supply chain capabilities can enjoy a competitive advantage over their peers.
Enabling the “Networked Enterprise”

In the coming year pharmaceutical leaders will be focused on developing and stitching together this complex array of capabilities. Certain capabilities, including major outsourcing arrangements, matrixed organizational models, and collaborative partnerships with stakeholders, point to the need to effectively manage a networked enterprise. Success in this area depends on putting in place the right combination of formal and informal mechanisms that define and influence networked organizations.

Clear decision making, organization design, compensation systems, compliance, and business planning are important formal mechanisms for enabling accountability for results. They are generally the first levers employed by executives to enhance effectiveness. However, our research suggests that informal enablers—such as norms, social networks, mentoring relationships, and mind-sets—have even more power to drive, or undermine, the enterprise’s capabilities and results. Too often, these informal dynamics are thought to be uncontrollable. Capable management of a networked enterprise deliberately cultivates the right informal organization. No amount of boxes, lines, or processes can ever address the complexities of the cross-boundary, cross-functional, and even cross-company work that characterizes today’s global pharmaceutical firms.

In the future, winning pharmaceutical companies will be capable pharmaceutical companies. Those that pursue strategies based on developing and investing in targeted capabilities will successfully differentiate themselves in the marketplace. So, we end where we began, with a simple question: Do you have a capable pharmaceutical company, well-equipped to create and sustain a lasting advantage through these challenging times?
Call it the age of uncertainty—this post–Great Recession environment when a weak recovery and any number of troubling signs globally cast shadows on relatively strong recent profit results. The future for industrial companies is a somewhat confusing blend.

On the plus side, industrial revenues (unadjusted for inflation) in the first nine months of 2011 topped levels last seen in the peak year of 2008, and earnings in this period were up 25 percent compared to January through September 2010. Average net profit margins at industrial firms are relatively robust again: about 6 percent now, a 6 percent improvement over last year. Emerging economies drove most of this growth, as real GDP gains in developed nations slowed to a meager 1.5 percent in 2011. In addition, the Dow Jones Industrials Index was down only 5.7 percent compared to an 11.4 percent drop in the overall stock market during that period.

The bad news, though, is that there is bad news—and it can’t be easily ignored. For one thing, consumers and companies are still hesitant to spend their money—the Purchasing Managers Index tumbled in the first nine months of 2011, to 51 from 61—and unemployment remains stubbornly high. Concerns persist that a second global recession—a double dip—is increasingly possible. Perhaps even more disconcerting, no matter what happens in the developed economies, GDP growth is already slowing in the most important emerging nations.

Given this uneven blend of trends and forecasts, it’s little surprise that industrial companies have been conservative strategically. This can be seen, for example, in the pace of mergers and acquisitions. Although at the end of 2010, industrial outfits were relatively flush—cash on hand surpassed 14 percent of revenue compared to an average of about 9.5 percent during much of the past decade—the popularity of M&A has flagged recently. In the first nine months of 2011, the number of deals fell by at least 25 percent.

Instead of acquisitions, most successful industrial companies have been content to cut costs, prune their product and business unit portfolios, deleverage, and hoard cash. While that approach has perhaps put these
companies in a position to navigate uncertainty, it is nonetheless a questionable tactic. Simply put, if industrial firms sit on the sidelines with their cash for too long, they may end up underinvesting in their businesses and innovation—and minimizing their growth prospects.

Over the next few years, we believe, industrial companies should view the glass as mostly half-full. They should have enough cash on hand to weather a crisis or two, but more important, they should use this time to put their money to work, particularly when many of their rivals will likely be reluctant to make bold moves. In other words, this is a perfect moment for smart industrial companies to invest in developing the capabilities, assets, and strategic intelligence that allow them to achieve and sustain competitive advantage and that prepare them to take a leading position in their industrial sectors when opportunities for growth emerge.

A Capabilities Strategy

We define capabilities as the three to six distinctive strengths your company has (or should develop) to set it apart from competitors. Each capability is built on a combination of processes, tools, knowledge, skills, talent, and organization. While we strongly believe that it is crucial for every company to make conscious choices about the capabilities that they need to develop or acquire, there are general capability guidelines for industrial companies that could be the starting point for a differentiated business model in this current dicey environment. For example, industrial companies are discovering that functional capabilities—like IT, talent development, and managing supply chains—cannot improve organizational performance in isolation, no matter how strong these functions are. Instead, the future belongs to companies that distinguish themselves by integrating and blending capabilities from their most critical functions in smart and unique ways. The following capabilities stand out as the most essential for industrial companies to develop and align:

- *Agile Product Development and Strong-Form Product Management*
  Product life cycles are decreasing as the pressure of competition and technology breakthroughs drive frequent product upgrades, if not entirely new offerings. The problem is that nearly 50 percent of all products launched fail to live up to expectations because product design tends to be a rigid, linear process, in which customer input and preferences, technology, materials, and features are virtually locked in stone up front and then a long development and planning cycle ensues. By the time the product comes out, customers may have moved on to other interests or been satiated by another company’s product. Moreover, numerous design, technology, specification, and
materials changes have probably added costs to the manufacturing process, which reduces margin potential.

To overcome these obstacles and radically improve the chances that product launches succeed and keep pace with rivals, agile product development is critical. Long a staple of the software industry, this approach focuses on getting more feedback from customers up front, perhaps through crowd sourcing and beta versions, and making numerous design iterations in the earlier phases, as well as having a definite idea about what the product’s core attributes should be and how the product should be made before the back-end development stages actually begin. This ensures that customer preferences are met and technology and materials decisions are made more intelligently in the initial stages, thus driving down uncertainty in the latter part of product development and making that phase less costly and more efficient. Considering the role that communications technology, networking, and software play in virtually every industrial product, including cars, microwaves, and heavy equipment, borrowing a set of efficient development techniques from high-tech industries is a logical evolution.

But agile product development will be for naught if product management is given short shrift. And this is the case at too many manufacturing companies, where core product management decisions are fragmented across a variety of functions: Sales may decide which products to maintain or kill; R&D may determine when an enhanced version of a product is ready for release; and operations may have the final say in choosing suppliers. Meanwhile, product managers are little more than administrators without decision-making power; their main roles involve managing channel decisions, overseeing formulation of changes and other incremental innovations, and taking account of customer needs and preferences to fine-tune individual products and services over the course of their revenue-producing lifetimes. This siloed approach often results in wasted customer insights, slow innovation, and disappointing product profitability.

A better course is something we call strong-form product management. Under this approach, product managers are elevated to a role above the other functions and given the authority to make decisions about the timing of innovations, pricing, channel strategy, and everything else that affects the success of product portfolios. At its best, strong-form product management is an accountability model—a way of assigning responsibility for results to a single individual who can take a full portfolio or life-cycle view, rather than to a series of people
without a holistic perspective. At a time when competition and customer demands have both intensified, it can be a differentiating capability, fortifying the connections to customers and increasing the odds that a company will make the right trade-offs.

Strong-form product management is also a way of ensuring that high-level strategy makes its way into the products and services that a company sells. At a company practicing strong-form management, product managers become the focal point for strategy. The product manager’s job at a low-cost manufacturer is to nix new, too costly features developed by R&D that are nice but unnecessary. At a company that distinguishes itself through the experiences it provides, a strong-form product manager resists lifetime cost-savings initiatives proposed by operations if those cost savings would erode the customer’s sense of exceptional service.

• **Cost Fitness**
  For many years, industrial companies have focused on cost cutting—sometimes to the detriment of their businesses. Through top-down, across-the-board budget cuts of, say, 5 percent or more a year, operational expenses may be trimmed to the bone, but to what end? Are strategically critical activities axed too deeply because they are lumped together with more wasteful overhead items that actually deserve to be slashed by 50 percent? A more logical approach is what we call *cost fitness*; this involves analyzing costs separately by activity, diligently determining which business operations are directly responsible for meeting the company’s strategic goals, and supporting those operations with adequate budgets. There are two areas in industrial firms that have generally been victims of cost cutting in the past that deserve reassessment in light of their potential contribution to improving a firm’s performance:

  1. **Supply Chains**
     Decades of relentless focus on cost cutting have left industrial supply chains vulnerable to disruptions like the earthquake and subsequent tsunami in Japan and the floods in Thailand this past year. Severe material shortages occurred primarily because Japanese, European, and American manufacturers had not diversified their supply base sufficiently to have a backup when their Japanese suppliers were forced to cease production. More than ever before, we recommend that you reevaluate your supply chain, plan better for geopolitical risks, have multiple sources for critical products and adequate backups for less essential items, and not focus solely on cutting costs.
In doing this, manufacturers should also reconsider their outsourcing/insourcing strategies. Certainly, factory capacity provided by third parties has gotten cheaper over the last few years, but China is increasingly not the best option if low wages are the key criterion. Places like Vietnam and Thailand may be better choices. Indeed, the Chinese government recently released a plan to raise the minimum wage rates for manufacturing employees by 13 percent in the next five years.

But equally important, outsourcing should be assessed through a holistic lens—that is, the decision should not be based solely on the price of labor but also on critical elements like logistics, risk, quality, scheduling, and customer preferences. For example, when customers in developed countries are willing to pay for advanced service levels or top-quality output, industrial companies are increasingly manufacturing products in their own factories in these higher-cost regions, where they can also take advantage of skilled labor, modern infrastructure, the ability to drive innovation with world-class R&D, and capabilities like new manufacturing technologies or innovative lean production systems.

2. Information Technology

In the industrial sector, IT has typically been viewed as a cost to be managed and minimized. But that’s not viable anymore, as companies must begin to look at IT as a capability and not purely an ancillary or support function. For one thing, in focusing on becoming more efficient, industrial companies should realize that significant structural cost is tied up in legacy processes—processes that often vary from business unit to business unit. Consequently, standardization of business processes and consolidation of IT systems around a common enterprise solution are more and more critical. In the past, these efforts have produced only mixed success. But what appears to be different now in companies that have undertaken IT-enabled business transformations is the degree of broad senior leadership engagement. Top managers outside IT are taking lead roles in ensuring that the future-state operating model, processes, and execution road map for systems-driven transformation programs are aligned with the company’s overall strategy and capability development goals. More strategic development of IT can foster a greater focus on
digitization of the value chain using technology to provide a deeper level of integration with suppliers, customers, and employees.

- **Digitization Strategies**

  Rapid advances in new digital technologies offer industrial companies a wide swath of tools that can be used to take advantage of new opportunities ranging from improving equipment productivity to customer data management and analysis. For example, customer service can be improved by incorporating GPS, SMS texting, and mobile Web apps in logistics systems to provide real-time freight management for product and parts distribution. Or digital sensors can be embedded in mining trucks or HVAC systems, among many other pieces of equipment, to warn of potential malfunctions before they occur and disrupt operations at customer sites. When problems are detected, these systems can automatically schedule repairs. This translates into lower cost of ownership for the user, while the industrial firm can charge a premium for the product and reap additional sales from replacement parts, which in some industrial companies can amount to 50 percent or more of total revenue. Moreover, high-quality service and maintenance can help to create enduring customer relationships that give industrial companies a leg up for the next cycle of product purchases.

  But even beyond these service improvements, digitization has the potential to be the centerpiece of long-term innovative sales strategies targeted at improving customer loyalty and the potential for up-selling. This is critical because during the next few years, industrial companies will face customer markets (OEMs or end-users) that are either shrinking or growing more slowly. Consequently, manufacturers must approach customers more smartly than ever before by, for example, upgrading CRM systems to deliver useful and valuable data and insights internally. These more advanced applications should provide sales leads or real-time information about existing customers (their preferences and their needs for the immediate and longer-term future) that can be regularly reviewed by global sales teams and shared across functional silos to ensure coordination in the pursuit of customers and marketing support differentiated by types of customers.
Media mix also needs to be addressed in the context of digitization. As digital channels become more prevalent and popular, the importance of trade shows and print advertising may need to be reassessed. Even companies in a business-to-business sales environment should take advantage of social media like Facebook, Twitter, and YouTube to build product awareness and interest. Product demonstrations or interactive online sessions with engineers and designers could be powerful tools for talking directly to prospective customers and for improving productivity in sales efforts.

**Winning the Talent War**

Despite high unemployment rates in developed countries, the supply of skilled workers who can engineer, design, sell, and service industrial products is meager at best. In the U.S., the unemployment rate for people with a four-year college degree (or higher) is 4.3 percent. Consequently, it's critical for industrial firms to make their jobs more attractive to smarter and younger workers by, for example, offering more collaborative workplace experiences that engage workers and give them opportunity to continuously improve and seek productivity gains, or by targeting specific demographic group preferences (studies have found that members of Generation Y want more time off and are less concerned about money). In addition, manufacturers should proactively seek talented employees by participating in campus recruitment events and industry job fairs, increasing the number of college internships, forming partnerships with local colleges and universities to identify and sponsor talent, inviting students of all ages on factory tours to show that manufacturing can be a rewarding career, and partnering with other manufacturers to jointly support specialized training programs or attend far-away recruitment events.

**Developing the BRIC Markets**

The BRIC economies may be slowing a bit, with less than 7 percent GDP growth forecast through the end of 2012, but for many industrial companies they represent the best opportunities for growth. Still, making a substantial profit in those countries is not easy. Overcoming the impediments to profitability — which can include navigating local rules, regulations, and cultural differences; competing with government-favored domestic companies; recruiting sufficiently skilled workers; and overcoming inchoate infrastructure and logistics networks — requires building a globally effective organization and operating model with more dispersed governance structures and decision making than has been typical of industrial multinationals in the past. Manufacturers should focus on acquiring, managing, and
sustaining an increasingly global and diverse talent base across multiple geographies; building practical mechanisms to support global collaboration; and driving a cost and process structure that is lean and flexible.
Never has the old adage that “the only certainty is uncertainty” been truer for the energy sector.

In just the past 12 months, we’ve seen a strong emphasis on green energy evaporate as country after country withdrew support for renewables. While the green imperative slipped, natural gas took center stage—particularly in the United States, where a raft of new shale gas production has put the country on course to be a net exporter rather than an importer of natural gas. If that transition takes place quickly, European and Asian gas distributors and users that had locked in long-term, oil-price-related contracts could be vulnerable.

Japan’s Fukushima earthquake has tainted the prospects for nuclear energy, once considered by many to be the answer for abundant clean power. Germany has already banned nuclear utilities, and we can expect a slowdown in nuclear plant development in virtually every country.

Oil will remain extremely sensitive to political turmoil in the Middle East, risks of potential environmental accidents, the dollar’s value, and the notion that it is a dwindling resource—all contributing to ongoing price volatility and supply uncertainty. In North America, the debate over the Keystone XL pipeline project further highlights the uncertainties facing this industry, as political decision makers balance concerns over energy security, the environment, jobs growth, and consumer prices. Another great unknown affecting oil price and availability is the extent of future production from producers outside the U.S., such as Brazil, Canada, Iraq, Russia, and West Africa. Biofuel, improved gas mileage, and the increased use of hybrid and electric vehicles will further nibble away demand.

All these factors will contribute to the uncertainty with which companies in the energy sector will have to cope. Most energy companies will find that their current operating models, strategy and planning processes, and optimization practices are inadequate for this new environment. They will need new capabilities to enable them to meet whatever the future holds, rather than taking the risk of betting on one particular outcome.
Four types of capabilities are particularly important:

- Strategy and long-term planning
- Managing the inherent risks in joint ventures
- Capturing information and insight
- Supply chain optimization

Let’s look at each in turn.

**Strategy and Long-Term Planning**

Leading an energy company in the next few years will be like sailing. At any given moment, companies will need to look at the way the wind is blowing and execute an integrated plan to align the sails in the right direction—while remaining alert to any changes in the wind’s direction and rapidly adjusting the strategy as required.

In other words, we believe that energy companies will need to develop dynamic strategy development capabilities. These involve betting on a set of integrated options, any one of which can be switched on or off depending on results and how the business environment evolves. This involves integrated option planning.

Integrated option planning is often overlooked because companies don’t usually think of it as a capability they must develop. They believe (wrongly, most of the time) that it is simply a part of the normal course of business, something that they already do routinely, perhaps on an annual basis. They think that coordinating disparate elements of the business to operate in sync is a natural by-product of organization. But, in fact, it requires a concerted investment of time and resources to create the structure that can coordinate a complex set of elements, behaviors, and analysis at a very high strategic level. This is particularly true if a company may suddenly need to change course to a different direction at short notice. For example, there could be a shift in financial, supply chain, and human capital resources toward more liquids-rich gas basins and away from dry gas fields or a shift in capital deployment based on geopolitical changes.

A company with a strong integrated option planning capability is accustomed to laying out multiple options and linking strategic choices—such as which projects to pursue, which markets to focus on, and which regions to target—to the appropriate operating models, including supply chain, logistics, workforce planning, and capital management. With a holistic
integrated planning capability in place, a company can react quickly to uncertainties, responding dynamically to changing upstream and downstream conditions (including price and other market signals) and redirecting resources, technology, talent, and capital toward areas of opportunity and away from risk.

For many energy companies, this is an elusive capability. With so many different layers and business operations to manage, few organizations have systems that fuse the right processes, people, and data to drive profitable outcomes on a consistent basis. But the lack of integrated option planning can often lead to missed opportunities. For example, one oil company hoped to broaden its Middle East operations with a series of investments. Focusing solely on the financial angle, the company spent months developing a “can’t-miss” capital structure for this expansion, including an inexpensive approach to building the new plants. But management completely neglected the substantial costs of hiring and training the skilled workers that would be needed—and it did not put in place contingency plans for the potential spread of political disruptions in the Middle East. Already, it’s clear that this company will not get the return on investment projected by its initial one-dimensional plan. A more risk-mitigated plan would have built in a variety of options, including the ability to withdraw at various checkpoints if certain criteria were met, without fear of writing off sunk costs.

Managing the Inherent Risks in Joint Ventures

In periods of high uncertainty, delivering on multiyear capital projects requires unique risk management capabilities. Energy projects tend to be big, complicated, expensive, and risky—and for those reasons, they are often best pursued through joint ventures and other multi-owner entities. Indeed, for some energy companies, minority stakes or joint ventures to spread project risk are the only practical way to access resources and build portfolio diversification.

But the success rate of joint ventures is stunningly low. Often the varied owners have different conceptions of—or outright misunderstandings about—their respective roles in the project. Sometimes the partners’ agendas (what they each hope to gain from the project) work at cross-purposes, ultimately affecting the smooth running of the operation. Insufficient attention may be given to governance or assigning accountability. The decision-making processes are typically not designed to deal efficiently with complex, multi-stakeholder issues, let alone to flexibly redeploy or redirect investment in response to changing market conditions.
Moreover, the Macondo incident of 2010 brought attention back to operational risks for all offshore assets, and the fracking debate continues to intensify for shale gas and oil. The public battles over environmental impact highlight the need for well-honed operational capabilities and incident preparedness—particularly for operators that have until now lacked the scale and focus to build those capabilities, and that typically conduct their work through joint ventures on capital-intensive projects. Many of these companies, pursuing opportunities without a coherent view of their strengths and strategy, have built up project portfolios that have become overly broad and incoherent over time.

Dramatic improvements in joint venture management capabilities can be gained by any energy company. Those that have this capability have learned to invest the time to understand the strategic intent and objectives of partners and make sure that these objectives are aligned. They identify in advance the capabilities that the projects will require and the roles played by each operating and nonoperating partner. They then allocate assignments for each entity based on the capabilities it has or can develop. They also develop the influencing and communication skills needed to guide operating partners toward best practices. Finally, they have a governance and decision-making model in place that lets each owner protect its strategic agenda and that maximizes the efficiency of joint decision making; this model also establishes processes for information sharing, performance review, and flexible capital allocation.

Capturing Information and Insight

This capability can make the difference between earnings and losses, especially where oil products and gas inventories are involved (as in the downstream) or where there is high dependency on third-party suppliers (as in the upstream).

Companies that have been diligently pursuing the more traditional paths to prosperity—for example, by executing multiple rounds of cost cutting and restructuring—may well find that any gains in their earnings are dwarfed by the impact of price volatility. These companies need to invest in the capability of capturing information and insight and putting them to use.

At the heart of this capability is an integrated information base that covers every aspect of the marketplace and of operations, and that is available to every business and function, spanning the traditional silo structure that exists in many companies. Skilled people on the front line can now make split-second decisions about opportunity and risk. They have updated information, for example, about where the tanker ships are located, how
much stock is available, what will be left after each shipment, whether demand is rising or falling, where customers are located, which are fixed-versus variable-contract customers, how much profit they can make under different options, and much more.

For example, a “strategic pilot” working within this capability might say, “I won’t meet a customer’s suddenly increased demand today, because I can’t get enough product in time and still make a profit. However, tomorrow, if the price goes up, I’ll have shipments and a new contract ready.”

The capability to leverage information and insight can create value and reduce risk across the oil and gas value chain and across functions. A “control tower operator” role for supply chain and logistics can improve coordination and avoid unnecessary expediting costs. Rig movements within and across fields can be better optimized to increase asset utilization and worker productivity.

This capability is not just an IT tool. It also involves the shift in decision making that ensues, with all the appropriate risk-managed processes, authorities, and commercial and technical abilities required to make it work in the front office. These abilities are equally required for managing third-party procurements.

Supply Chain Optimization

As much as 80 percent of the operational budgets at most oil and gas companies is earmarked for supply chains—primarily for materials and services provided by third-party suppliers. Because of the size of this percentage, many companies have over the years targeted supply chains for cost cutting and efficiency improvements. And though these campaigns have led to incremental, short-term successes, most oil and gas companies are poorly equipped to take the big-picture steps that would drive supply chain management improvement.

A powerful way to address this shortcoming, particularly in companies with diverse business models, is with a concept that we call natural supply chains. In our experience, we have typically identified five or six natural supply chains within today’s complex and highly integrated oil, gas, and chemical companies. Natural supply chains exist across traditional business units, such as upstream, deep water, and refining and are made up of business activities that have inherent similarities based on their respective requirements. Once a company’s natural supply chains are noted, the supply chain operations can be tailored to meet the distinct needs of each. An appropriate set of capabilities—roles, processes, and tools—is matched with the requirements of
each natural supply chain to leverage scale while providing a customized solution that maximizes value.

Human resources, information technology, and contract support can probably be shared across the organization. But other supply chain activities must be managed individually, in a way that empowers the front line to be agile.

For example, one part of an energy company’s portfolio might demand services such as maintenance logistics to support an overarching objective around production uptime. A pressure pump truck may be needed every 30 days in each of several different locations. To manage this schedule, the company would establish an exclusive arrangement with its trucking suppliers, with incentives and penalties based on meeting deadlines and on the quality of work. For this part of the business, performance and safety imperatives outweigh all other considerations, including price.

Another business in the same company may center on major capital projects—for example, pipeline construction. As it buys 400 miles of pipe for half a dozen projects scattered across a continent, the company will negotiate low-priced bid contracts with a primary focus on delivered cost. There would not need to be as much emphasis on narrow delivery windows, because of access to warehouses and staging locations. The difference in priorities is explicit, and if people move from one part of the business to the other, they easily manage that shift because it is clear to everyone in the front line.

**Putting It All Together**

The subject of building capabilities to deal with uncertainty is particularly important in the oil and gas sector. Many independents are already running up against the limits of their scale, struggling with the clash between their small-company cultures and the process and bureaucracy inherent in large projects. They are scrambling to manage an increasing portfolio breadth that stretches the limits of their existing capabilities. For the large companies, continuous rounds of cost cutting and restructuring have failed to yield sufficient profits, in part because gains in earnings are often offset by price volatility, and also because they have not invested in building the essential capabilities and agility they need in order to grow in these uncertain times.
Retail

The U.S. economy wobbled in 2011. The year started on a high note after a strong holiday season in 2010. But then disturbing macroeconomic factors—stubbornly high unemployment, rising inflation, government debt crises in Europe and the U.S., and stock market volatility—raised fears of a double-dip recession and caused consumer confidence to sink again.

The impact of these events varied according to consumer income levels. Our annual consumer survey found that spending was most constrained among low-income shoppers, who continued to feel recessionary pressures. As one might expect, shoppers at the higher end felt less squeezed. This was reflected in performance: Retailers such as Wal-Mart, Target, and Kohl’s struggled with same-store sales growth, while Saks, Nordstrom, and Neiman Marcus recorded same-store sales growth of 8 to 12 percent, and high-end luxury retailers, such as Louis Vuitton and Hermès, again enjoyed double-digit growth.

Though more optimistic than in the past few years, the National Retail Federation is forecasting a “mild” holiday season with same-store sales growth of 2.8 percent. Stock market losses, which tend to more acutely affect wealthier customer segments, have caused luxury retailers to reduce their predictions for holiday sales. Moreover, higher-income consumers who are still buying are shifting to online channels, which will lead to lower traffic, revenue, and profits in bricks-and-mortar stores. As a result, all retailers will have to continue to be aggressive in seeking opportunities for top-line growth, while maintaining the strength of the bottom line by driving operational efficiencies.

We believe that capabilities in four areas will be important to your efforts:

1. **Format innovation**: The ability to manage new formats, optimize the existing footprint, and strengthen capabilities in the growing online channel will be critical for retailers going forward.
Retailers continue the long-term task of exploring store formats that will enable them to penetrate new geographies and consumer segments. Wal-Mart is innovating in formats with mixed results: The retailer recently closed down its Marketside pilot (smaller-format grocery stores) and is now experimenting with Wal-Mart Express, a scaled-down version of its core format designed for space-constrained urban markets and low-population rural markets. Rite Aid has partnered with Save-a-Lot to combine pharmacy capabilities and low-income assortments in certain geographies. As formats proliferate, retailers will need to pay special attention to integrating them, to properly serve target customers and exploit white spaces in the market.

Other retailers are reinventing what they do inside the box in order to enhance their appeal. For example, Walgreen is adding fresh food to many stores, upgrading its beauty offerings in select locations, and redesigning its pharmacies to improve the customer experience (by making it easier to interact with pharmacists, for instance).

Retailers are also reevaluating their footprints, given the new realities of consumer demand and the rising use of online channels. Best Buy and Gap announced the closure of up to 20 percent of their stores, and some retailers, including Sears and Target, are renting excess space to other retailers.

The growth in online channels is and will remain the big story in retail, with some categories, such as electronics and books, more affected in the near term than others. To capitalize on this trend, retailers will need to go beyond the basics, such as easily navigable websites and liberal return policies, and develop new capabilities that enable them to innovate and gain competitive advantage. For instance, Safeway is developing its digital shopper marketing capability and is currently rolling out the “Just for U” personalized deal generator, which taps customer purchase histories from its loyalty card program to deliver digital coupons.

2. Curated merchandising: In an era of frugal consumers, developing the capabilities required to place the right product in the right store at the right price is essential to fuel top-line growth and profitability. Furthermore, customers are demanding a more “curated” selection; they want the right styles, prices, and experience all in one format.

To get the most out of their stores, retailers will also need to tailor them to better reflect local tastes and preferences. This localization effort leads to a better shopping experience, increasing traffic, revenues, and loyalty.

To achieve this, retailers will have to accurately answer a set of tough questions: How many and which SKUs in each category should each store
carry? How should product assortment in each store differ by region and by the unique demographics and characteristics of the trade area? How much space should be dedicated to one category or product versus others? What should be the base price of SKUs in a given category? How should they be promoted, and when? There are a vast number of choices.

Localizing each store and getting the merchandising right is a herculean task with no apparent shortcuts. Many retailers will need to upgrade their merchandising capability holistically by integrating systems (store trait database; point-of-sale systems; pricing systems), analytic engines (demand analytics; price elasticity; promotion returns; store clustering), processes (basic assortment planning; promotions; campaign tracking and performance measurement), organization (business alignment around the right “center of gravity”; clear and well-defined roles, responsibilities, and decision rights), and people (analytic talent). The returns for undertaking this effort can be dramatic: We’ve seen retailers improve their top line by 2 to 3 percent over the base case for their sector.

Right now, while the economic outlook is still sluggish, effective promotions are critical, especially in the fiercely competitive and spending-constrained lower- to middle-income market. These frugal consumers are highly sensitive to pricing and frequently use coupons. Leading retailers are investing in shopper marketing and loyalty programs, acquiring and analyzing consumer data, and better tailoring their promotions to their customers. They are partnering with manufacturers to design, tailor, and refine promotional events. And many are developing the measurement and analytic capability needed to better evaluate the performance of their promotions.

3. **Customer experience:** All of a retailer’s efforts are ultimately directed to providing a shopping experience capable of attracting and retaining customers. A compelling shopping experience is also a highly effective differentiator that confers competitive advantage. Witness the continued success of the experience-focused retailers, such as Zappos.com and REI.

In developing compelling experiences, retailers must understand the varying expectations that arise in different formats and retail settings, as well as among the different customer segments across those formats. Further, retailers must calculate the cost of providing a specific customer experience (including the implementation cost and the ongoing operational cost) and weigh it against the targeted returns.

Customer experience is driven by multiple levers: the layout and the look and feel of the store; product assortment, pricing, and stocking; and interaction with employees. The first two drivers can be fairly easily copied, but high-
quality service is hard to replicate and can be a true competitive advantage. Retailers must leverage both formal and informal levers to help employees deliver the desired customer experience. Formal levers define employee roles and behaviors, develop employee characteristics and skills, create performance measures and incentives, and establish store processes. Informal levers include the leadership behaviors needed to individually motivate employees, such as immediate and public recognition, constructive coaching, and staff empowerment. For example, Publix, the regional grocer known for its customer service, hires employees to meet its service standard and “trains them on all the little details,” ties incentives directly to store performance, and publicly recognizes employees who receive compliments from customers. Ritz-Carlton makes customer satisfaction every employee’s responsibility and provides them with discretionary funds to resolve service issues.

4. Social media: Forward-looking retailers are focused on social media, which is likely to become the next generation of e-commerce engines and a powerful new sales channel. In a 2010 survey by Booz & Company, 27 percent of consumers said they would purchase goods through social networking sites, and 10 percent said such transactions would likely be incremental to their regular shopping.

The sales volume in social media is still small, but we expect it to grow to US$30 billion by 2015, nearly half of which will be in the United States. Almost all sizable retailers are already using social media, such as Facebook and Twitter, to connect with customers. Some have already started to build a commercial presence in the new channel. For instance, 1-800-Flowers has a fully functioning store on Facebook.

Though the long-term revenue prospects in social media are appealing, the direct revenue it generates will be only a small fraction of sales for many retailers in the near term. However, to prepare for the future, retailers should be thinking about capabilities they will need to commercialize social media. They should be monitoring the social conversation around their brands and using social media as a channel for building customer intimacy, understanding, and loyalty. Further, they should be considering how to make the leap from getting customers to “like” them on Facebook to getting them to make repeated purchases. (For more detail, see “The Coming Wave of ‘Social Apponomics’.”)

The specific capabilities that retailers develop to address these four areas—format, merchandising, experience, and social media—will differ among companies. Not every capability is suitable for every retailer; your company must carefully consider how its way to play differentiates it from its
competitors, and how it can take best advantage of its unique strengths. In doing so, you can identify your company’s best growth opportunities and begin to capture the premium that accrues from strategic coherence.
The technology industry has long been characterized by change, but 2011 stands out as a year of shocks and surprises—and we expect more in 2012. Former industry leaders have been stumbling in the face of missed trends, while others have made enormous gains in creating new value. Asian players like Samsung, Huawei, and HTC are rising fast, even as service disasters humble several established providers. And many of the largest global companies have faced unprecedented leadership challenges.

Against this backdrop of crisis and chaos, the main trends that we observed at this time last year continued unabated throughout 2011, and we expect they will continue to be important throughout 2012.

Digitization—the pervasive adoption of connected, cloud, and mobile technologies across industries—is transforming every company’s interactions with its customers, its suppliers, and its global talent. This is playing out in several ways. Consumerization has penetrated further into the enterprise technology ecosystem, with Apple and Android-based smartphones and tablets gaining traction and eating into corporate sales of PCs. The use of social media is increasing both within the enterprise and as a tool for marketing and sales, even as e-commerce offerings are built out further. And no such offerings can thrive anymore without a workable mobile component.

In tandem, the movement toward cloud computing is forcing the technology industry and its customers to rethink established ways of doing business, although most have yet to fully tackle the practical challenge of operating hybrid solutions and handling the transition from their legacy systems to new cloud models, with all the complexity that entails. According to a recent Booz & Company study, 60 percent of small and medium-sized businesses in the U.S. and Europe remain cautious about moving to the cloud. Yet despite concerns about security in the cloud, and the security risks associated with software-based ecosystems, the shift from hardware- to software-based business models is accelerating.
Large players are scrambling to take advantage of these new areas of opportunity quickly by acquiring newer, smaller players—though rapidly rising valuations have slowed this activity somewhat. And the patent wars, particularly over control of critical mobile technologies, have led to renewed large-scale mergers and acquisitions—witness Google’s US$12.5 billion acquisition of Motorola Mobility—and fierce legal struggles such as Apple’s successful suit to stop Samsung from selling devices in Germany and Australia. Meanwhile, legislators and regulators have spent much of the year trying to determine what their role in the industry’s evolution should be. Their approach to the industry—which shaping it, managing it, or leaving it alone—will be a matter of critical concern for information and communications technology (ICT) companies.

**Facing an Uncertain Future**

These broad industry trends are stimulating a further round of globalization and consolidation as the largest players seek new pastures for growth and a variety of underlying technologies make it possible for them to reach parts of the world previously unconnected. The nature of innovation is changing, with talent, venture capital, and government spending increasingly moving to China, India, and other rapidly emerging economies; indeed, the level of VC investment in China in recent years has reached new highs. Furthermore, innovation is now more likely to happen in the context of ecosystems that cannot be controlled by any single player. The long-heralded era of open innovation and the extended enterprise is clearly upon us; in response, technology companies are redefining themselves in a more extended way, relying on broader ecosystems of partners and collaborators, and adjusting their global supply chains and operations in light of these shifts.

The results, however, have not been entirely positive: To take just one example, the tragic 2011 earthquake and tsunami in Japan provided a stark illustration of the interconnectedness and vulnerability of the global technology supply chain. The resulting production problems cut off delivery of many popular products. In the coming year, large technology companies will be looking to mitigate the effect of these improbable “black swan” events on their operations.

Overall, executives remain bullish about their industry’s growth prospects. Recent Booz & Company interviews with industry leaders worldwide suggest several avenues of growth: Cloud computing and security technologies will be leading drivers, followed closely by the increasing impact of digitization on other industries. Technology companies must develop a wide variety of innovative, industry-specific applications if they are to benefit from these large and untapped profit pools.
At the same time, there is some concern that the ICT industry may not be the primary beneficiary of this trend, but that entirely new players will emerge to grab much of the value now on the table. Will another “Apple moment” occur, perhaps in the field of smart-grid infrastructure or big-data analytics, enabling an unexpected competitor to abscond with much of that new value? Even now, valuations are soaring for several promising new companies in these and other areas.

**Urgent: Build Capabilities Now**

As these trends gain momentum in 2012, a common theme is beginning to emerge. Established ICT players are discovering that the capabilities that made them leaders in the past will not ensure their success in the future—despite the strong prospects for even greater growth. A shift is taking place, and every company in the industry will need to rethink the importance of the capabilities that defined success in the past, build entirely new ones, and manage this transition in real time while their ongoing businesses are under intense and increasing competitive pressure. The ability to do so will be what separates the future winners from the also-rans. We believe that the following capabilities will be critical for all players in the industry—though their relative importance will vary depending on the sector each company operates in, and its position on the industry value chain. And every company must keep an eye open for additional new capabilities that will emerge as the process of digitization moves forward.

**Deep customer insights:** The first of these new capabilities is proximity to and insight into the digital consumer—especially Generation C, that cohort of the global population that will begin entering the workforce over the next decade. Already constantly connected through broadband and wireless, and at ease with shopping, consuming, and sharing personal data online, this generation will be the early adopters of new ways of doing things as yet unimagined. Generation C could also stand for China, where the number of Internet users in 2011 was larger than the entire U.S. population. The geographic and cultural diversity of the next generation of consumers will be an important consideration for tech companies. They must have a thorough understanding of demand-side consumer dynamics, which will lead to improvements in innovation and competitiveness—but only if companies are light on their feet in meeting the needs of this generation. A further benefit of this insight is a better understanding of the next generation of talent, how to manage those employees, and the kinds of mobile, connected workplaces and cultures that will let them mix work and life.

**Ability to leverage the ecosystem:** Technology companies will also need to understand how digitization is transforming the ICT industry ecosystem
itself, to reimagine how one’s company fits into it, and to take advantage of the changes. As delivery mechanisms change, companies will have to reassess their interactions with upstream suppliers, downstream sales channels, go-to-market partners, customers, and the extended supply chains that connect it all. The ability to manage the ecosystem is also key to enabling an end-to-end customer experience.

**Flexible product portfolios:** These emerging capabilities, however, will not bear fruit if high-tech firms cannot bring outstanding products and services to market quickly. The classic technology development cycle on which large companies have long depended is increasingly being outpaced and outsmarted by smaller, more agile firms. Few players can claim that they still provide their customers with workable end-to-end solutions—and their customers increasingly don’t want them anyway. The third critical capability, therefore, will be to operate within a context of increasingly global partnerships, joint ventures, and M&A activity, and to act fast when opportunities to improve the product portfolio arise. This will become especially important as more customers demand open, flexible platforms on which to develop their increasingly digitized businesses.

**Compelling vertical strategies:** All of these capabilities will be relevant as whole industries are transformed by ubiquitous broadband, mobility, and new platforms, services, and applications. Massive amounts of customer data are becoming available to financial-services institutions and retailers; automakers and manufacturers will soon be performing digital prototyping; and every industry will come to rely on entirely paperless supply chains. Thus, a further, equally essential capability for technology companies will be to understand the process by which industry verticals will themselves be digitized, to devise specific strategies for developing the products and services that will serve these vertical needs, and to take action, aligning and mobilizing people and the organization with respect to each vertical the company plans to serve.

This exercise will involve answering potentially far-reaching questions: What does this imply for the ICT industry as it serves each of these verticals? And how will the transition take place? A device manufacturer might, for example, decide to carry out a specific strategy to serve the financial-services industry with products and services such as e-wallets and identity and authentication systems. Vertical strategies will be essential if companies are to capture a share of the value that will be created as more and more industries go digital.

**Redesigned internal operations:** Technology companies would also be wise to shine the light of digitization on themselves, developing a capability that
would enable them to look at their own various corporate functions, from IT to human resources to finance, and see how digitization might transform them as well. Business technology at the enterprise level has been dominated over the past two decades by offshoring, outsourcing, and shared services; now it is time for technology companies themselves to apply new technologies to dramatically change how they go about their business. This in turn will help them make the transformation to the extended virtual enterprise. And ultimately, it will give them the experience necessary to sell internal digitization as a service to their own customers as well.

**Effective governmental interaction:** Finally, given how quickly digitization is taking place—not just in technology but in every industry—it is no surprise that governmental efforts to affect the process are gaining momentum. The Internet is a case in point: The possibility of stronger regulation of both privacy and copyright protection has the potential to affect how personal data is collected and content is created and distributed. And this in turn could have a serious impact on the Internet’s primary economic engine—paid advertising. Similarly, issues involving content, patents, and other forms of intellectual property are affecting not just how companies earn revenues but the M&A landscape as well; Google’s recent purchase of Motorola Mobility, as noted, is widely viewed as a move primarily to control the company’s many valuable mobile telephony patents. In light of such impacts, a final, crucial capability every technology company will need involves ensuring a clear understanding of the policy and legal environment in which it operates, and developing an effective voice for influencing the future course of that environment.

As the trends discussed above become more firmly embedded throughout the technology industry, we are confident that the theme of capability transformation is the right one for ICT industry leaders and their executive teams to ponder over the holiday break. Technology companies must demonstrate a true appreciation of the complex ecosystems, the industry-specific requirements, and the real benefits of digital innovation, and then translate these into the new capabilities that they will need to build (and the old capabilities that will need to be scaled back). Those that successfully take on this task will be the best positioned to capture the value being created in the brave new world of digitization.
In 2011, the telecom industry has finally managed to come to terms with two major global shocks that have threatened it lately. The first, of course, was the global economic downturn that continues to adversely affect the performance of operators in markets around the world. Growth naturally slowed, abetted by constrained credit markets, and thus accelerated the commoditization of traditional telecom services, while reducing the valuations of operators large and small. As a result, operators focused on cutting costs and increasing operational efficiency to protect profitability. The increase in caution has also led to a significant slowdown in mergers and acquisitions.

The second shock has been the disruption caused by mass digitization. Customers—both consumers and businesses—are becoming more demanding, expecting always-on service everywhere, and forcing operators to boost network capacity and connectivity. All manner of industries are also becoming increasingly digitized and demanding a variety of new services like mobile payment platforms and cloud computing. The market for mobile applications continues to grow rapidly, creating yet another disruptive force that operators must learn to benefit from.

At the same time, the integrated technology value chains on which operators have long depended, including critical applications and service platforms, are growing increasingly modular and open. As a result, the telecom ecosystem is becoming much more competitive, as new entrants from adjacent industries look to exploit both new customer expectations and technological openness.

Yet despite—or perhaps because of—all these challenges, much of the telecom industry has finally reached a consensus on how to move forward to transform itself. That transformation will take the form of a fundamental shift among operators from the integrated business models that dominated the industry for most of the past century to four distinct, though by no means mutually exclusive, open business models designed to take full advantage of the opportunities now opening up: the reliable, cost-efficient network guarantor; the flexible, integrated business enabler; the innovative, customer-facing experience creator; and the wide-ranging, synergistic global...
multimarket.\textsuperscript{1} The effort to create and perfect these models will also require an ongoing process of cost restructuring to align costs more tightly with business goals.

Nascent versions of each of the four models are already beginning to bring benefits. Early implementers of the network guarantor model are benefiting from the accelerated deployment of broadband networks and better monetizing their network investments. Business enablers are generating revenues by offering services such as virtual networks, machine-to-machine and cloud computing platforms, and platforms for specific verticals, including financial services, healthcare, and retail. In turn, new experience creators are capitalizing on such services to provide attractive user experiences, while generating revenues by selling applications and content. And several large operators are working hard to build the scale and synergies needed by true global multimarketeters.

But much work remains to be done. In the coming year, operators must begin making the strategic choices necessary to determine their future direction, deciding which of the four models—or combination of models—works for them. This decision should depend both on whether they can effectively leverage the capabilities they already possess and on careful consideration of their ability to build new ones.

**Network Guarantor**

In this model, operators focus on offering their network infrastructure and related services to other players, differentiating themselves through four key capabilities:

- Cost-efficiency in the operation of their infrastructure
- Scalability in replicating their technology platforms and operating models
- Reliability in terms of network and IT availability and quality
- Smoothly integrated IT platforms and applications

Developing these capabilities may require operators to make large investments in new fiber and LTE infrastructure, which may limit the field to government-led networking companies and operators willing to share costs with other like-minded players. And the level of investment required to

\textsuperscript{1} For further details on the models, see “The Future of Telecom Operators: Capabilities for Rapid Change,” by Bahjat El-Darwiche, Roman Friedrich, Pierre Peladeau, and Karim Sabbagh (Booz & Company, 2010).
follow this strategy will likely lead to more consolidation among these players than we have seen in the recent past.

A number of operators have already begun building these capabilities. In 2010, T-Mobile UK and Orange UK joined forces to create EverythingEverywhere, which now offers their 28 million total customers the ability to switch back and forth seamlessly between the joint venture’s two highly reliable mobile networks, while T-Mobile and Orange remain separate brands. The goal is to manage costs by sharing network maintenance, which is expected to lead to annual savings of US$712 million beginning in 2014, and by jointly rolling out new network technologies and cloud-based applications, leading to cumulative savings in capital expenditures of $989 million between 2010 and 2014 and an annual $160 million thereafter.

Australia’s government is taking a different route, building out a new national broadband network designed to provide open access to all operators and ISPs, and paying Telstra, the national incumbent, to transfer all its customers to the new network. A key capability will be the highly reliable and operationally efficient network and the ability to scale up platforms and services to meet the many partners’ needs.

**Business Enabler**

Business enablers look to monetize their assets by opening up their infrastructures and extending their strategy from providing services directly to businesses and consumers to helping businesses serve their own business and retail customers more effectively. To that end, they provide open and reliable virtual networking and cloud services to host and support an increasing number of specialized service and application providers, and offer them access to targeted customer segments.

Operators entering this space must develop the capabilities needed to create a range of platforms and service offerings for specific verticals, including financial services, healthcare, and retail, among others, by supporting these business customers in their efforts to attract consumers, and by selling excess capacity to third parties. Those capabilities include the following:

- The ability to broker and manage relationships with many different partners, offering tailored services to each
- The flexibility needed to cater to the needs of different partners with different business models
- A capacity for aggregating platforms and services into attractive packages for business partners
AT&T’s strategic business services unit is already pursuing this model; it is opening up its entire infrastructure and operations to third parties, offering a range of services including billing and collection services, virtual private networks, hosting and cloud computing, and security and business continuity to other carriers, wireless service providers, cable providers, ISPs, and content providers. For AT&T, flexibility has been key. Its partnership with Google to allow mobile customers to pay for Android apps via their monthly wireless bill is a case in point. As AT&T builds its service portfolio, it is also creating the capability to aggregate its various platforms into packages to be sold into different verticals. Revenues from the unit totaled $4.7 billion in 2010, an impressive 16 percent increase over the unit’s 2009 revenues.

A further capability needed by business enablers is the willingness to partner with others to augment their portfolio of offerings. That is what has enabled Telefónica to build up its BlueVia business, a new global program that helps developers take their apps, Web services, and ideas to market. The program, which already boasts more than 4,000 developers, depends on a standardized development platform, and provides the means for other operators to bill their users for apps and then share the revenues with the app’s developer.

**Experience Creator**

Experience creators look to offer customers—or particular customer segments—the best possible combination of targeted applications and content, and a level of user experience that sets the operator apart from competitors. These companies will need to gain deep insights into relevant customer segments and their needs and preferences. This space is particularly dynamic, however, and the competition, from both device makers and new entrants from the digital arena, is moving fast. So it is critical that operators choosing to join the fray make sure they are well prepared, with attractive offers for the right sets of customers. The capabilities needed to compete in this difficult space include the following:

- The ability to develop innovative new applications and services
- Dedication to creating the best customer experience possible, including the ability to develop world-class user interfaces
- A capacity for excellent customer management and service

NTT Docomo—the Japanese provider of mobile voice, data, and multimedia services to more than 58 million customers—is an early player in this space. It offers a wide variety of innovative services, including an e-wallet, an advanced personalized information app combining data from a variety of sources, and access to music, video clips, and games. And it is gaining
expertise in offering equally innovative services to industries as diverse as industrial equipment, automobiles, information appliances, and broadcasting.

Key to NTT Docomo’s success has been its ability to leverage its complete end-to-end control of the value chain into a strong pipeline of new product offerings and service delivery schemes. It now boasts the top ranking in its market for customer satisfaction, a major contributor to the rapid growth of its customer base. This satisfaction is evident in the success of its offerings: For instance, the personalized app “i-concier” has signed up 6.2 million subscribers since its launch in late 2008.

The model isn’t suited only to the most advanced telecom markets, such as Japan, as Türk Telekom, Turkey’s largest telecom operator, is proving. Its TTNET unit provides a variety of Internet offerings—including telemedicine services, voice services for children’s music and fairy tales, and two e-learning portals—through a simple user interface, as well as innovative devices such as a video-calling device for the home. The telemedicine subsidiary alone brought in $18 million in revenue in 2008.

Global Multimarketer

The largest telecom operators have a real opportunity to expand their businesses into multiple segments and markets, through a combination of the three models discussed above. The goal: to build value by creating synergies among different segments and markets, by managing portfolios effectively, and by replicating the necessary capabilities from market to market. Success with this model will require two key capabilities:

- Proficiency in going global—organizing, operating, and marketing across many different geographies, and thus thinking both globally and locally
- The capacity to develop different business models and accompanying capabilities that can be replicated in different markets without increasing overall complexity

UAE-based Etisalat has taken this message to heart. Over the past seven years, it has grown into the world’s 16th-largest mobile operator, with a customer base of more than 135 million. The company’s success in pursuing the same business model in different regions, and in targeting the right service to the right audience in the right market at the right time has led to rapid growth in virtually every market it enters—in Benin, for example, its subscriber base grew 107 percent in just the past year.
For operators that have not done so already, 2012 is the year to determine which model or combination of models will work best for them, and how quickly to begin making the transition. This, of course, will depend on where they currently play, on the capabilities they already possess, and on how successfully they can match those capabilities with the new ones that will be needed. We expect that the network guarantor model will appeal primarily to incumbents that already operate large-scale infrastructures in either mature or developing markets, or both. The most likely candidates for the business enabler model include incumbents that have already begun opening up their networks and assets to third parties, or plan to do so, and new challengers that have already embraced the concept and can now build on their partner management and wholesaling capabilities.

The experience creator model may be the most difficult for telecom operators to follow, given their lack of experience and questionable track record in creating truly innovative new businesses. Moreover, the competition is already fierce. Competition among the global multimarketers will likely be limited to those that already have significant scale and the willingness to reorganize to push that scale even further.

All in all, we expect the year 2012 to be one during which the trends now transforming the telecom industry will come into sharper focus, allowing greater clarity into the future roles of every operator.
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