Chapter 1

Today's Flood of Change

Several years ago, the front page of the *New York Times* reported that two Columbia University geophysicists had found clear evidence of ancient villages lying beneath hundreds of feet of water on the seabed of the Black Sea. Their investigations, later narrated in a fascinating book, *Noah's Flood*, revealed that a sizable portion of what is now the Black Sea had once been a giant freshwater lake, filled with meltwater from Asian glaciers.[1]

About 7,600 years ago, as the last ice age waned and the waters rose, the Mediterranean Sea breached a high mountain barrier, and a monumental flood rushed through the Bosporus valley, running through what we know today as Istanbul. Ocean water poured into the lake with historical force, destroying and submerging all life in the area, and formed the Black Sea. This was the actual event that storytellers memorialized as the biblical flood.

Today, business is transitioning from one major era, the Age of Mass Markets, to another, which we call the Age of Diverse Markets. The two ages could not be more different, and the change is as inevitable and disruptive as the flood that created the Black Sea. While the transition began some time ago, it is rapidly accelerating, and the seismic shift is leaving managers scrambling for a practical pathway to succeed in a new, very different world.

A New Era

The Age of Mass Markets, which extended through most of the prior century, was characterized by fast-growing homogeneous markets. Railroads and roads integrated diverse geographic markets, and many large national enterprises emerged. This was the age of the "generals"—General Electric, General Foods, General Motors, General Dynamics—and this management paradigm continued into the 1980s and 1990s, with big-box retailers like Walmart, Best Buy, and Staples.

These companies were characterized by massive economies of scale in nearly every business function (production, distribution, advertising, and so on), which ensured that as they increased their sales, their unit costs dropped, giving them ample profits to invest in getting more sales and in further reducing their costs by increasing the efficiency of their production and distribution systems. Both prices and distribution costs were relatively uniform, so reporting tools based on averages—like aggregate revenues, costs, and gross margins—were sufficient.

The key management imperative was to get big fast. The rules of thumb were that all revenues were good and all costs were bad. Companies segregated their functional departments to individually optimize their revenue-maximizing or cost-minimizing objectives, and they coordinated them at the top through periodic planning sessions and period-end financial reports.

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[1] William Ryan and Walter Pittman, *Noah's Flood* (New York: Simon & Schuster, 1998).

Today's Age of Diverse Markets, which began its widespread acceleration around 2000, is completely different. Today, there are very few mass markets, while there are more and more diverse markets where product offerings, pricing, and service packages are uniquely configured, if not by individual customer, than at least by highly segmented target markets.

Today, markets are heterogeneous and fragmenting down to the individual customer in many cases. Throughout our economy, pricing is becoming much more varied, both within market segments and even between one customer and the next. In parallel, the cost to serve each customer is becoming increasingly diverse, depending on the customer relationship, product-service mix, and other factors. This change has already overtaken the business-to-consumer (B2C) markets, and it is rapidly transforming the business-to-business (B2B) markets as well.

In the Age of Mass Markets, products were "king." To a large extent, companies succeeded by selling the same products to as many customers as possible. In the Age of Diverse Markets, in contrast, customers are "king." Companies succeed by micro-targeting particular customers and tightly specified market segments and providing them with tailored packages of products and related services.

In the prior era, companies won with top-down management processes that kept their revenue-maximizing and cost-minimizing functions separate. Today, companies win by choosing customers who fit their strategic positioning and serving them with highly integrated sets of products and services that are delivered through decentralized organizations and processes—while at the same time remaining flexible and adaptable to all types of change. In the past, managers needed only aggregate metrics, while today, they need to understand the relationship between revenue and cost for literally every product sold to every customer every time.

The rise of the digital giants originated with their ability to market directly to customers, which enabled them to create micro-segments and to configure offers to individuals at scale using Big Data and algorithmic recommendations based on captured customer information.

Today, as the Age of Diverse Markets tsunami rushes in, industry after industry is being disrupted by digital giants like Amazon, Uber, Google, Facebook, Apple, and Alibaba and by savvy incumbents that have staked out a strategic high ground and generated sustained profit growth.

The wave is gathering speed and is pushing through the consumer landscape and into the B2B markets. Amazon is experimenting with placing Alexa, its voice-controlled device, throughout hospitals and in key manufacturing plants where supplies are ordered and used. Uber's rapidly growing Uber Freight is displacing many traditional trucking companies. Google acquired Fitbit, spearheading the company's move into the personal health and medical industry. The time frame for managing significant business change is three to five years, so organizations that are under siege from these forces must devise and initiate a response very quickly. The digital giants are moving fast, and even the pandemic crisis has not slowed them down.

As we wrote this book, the COVID-19 pandemic was raging throughout the world. The crisis accelerated the relentless drive toward digital commerce and diverse markets, which made

it even more urgent for companies to reposition for long-term success to compete with the digital giants. In Chapter 4, "Manage to Thrive in a Period of Crisis," we explain how to create short-term profits and cash flow during a crisis, while at the same time repositioning for the long run. The steps that you need to succeed in a crisis—whether it's COVID-19 or anything else—are the same that you need to prosper when it ends.

The biggest problem in business today is that all too many managers are not embracing the Age of Diverse Markets success elements that will enable them to prosper. Instead, they are doubling down on tactical innovations and tuning up old practices from the Age of Mass Markets—usually with diminishing results. Savvy managers, on the other hand, are realizing that the new disruptors are not winning by doing old things better but instead, by doing new things that incumbent companies are simply not capable of doing with their current business practices.

The key to success in the Age of Diverse Markets is choosing your customer. This has three imperatives:

- **Choose:** Define a defensible strategy that your company can dominate, choose the customers who fit, and say no to those who do not.

- **Align:** Identify and build the capabilities that will enable your company to achieve high sustained profitability with your chosen customers in your target strategic group (that is, the set of firms pursuing the same strategy), and focus your resources to quickly excel in your strategic direction.

- **Manage:** Develop your organization so your managers can seamlessly coordinate to identify and support your chosen customers, and to meet their diverse and rapidly evolving needs.

The objective of this book is to explain the currents of change that are creating today's disruptive tsunamis and to give managers a realistic pathway to success—one that involves managing in a new, creative, data-driven, and much more interesting way. In our experience across a range of industries, we have seen successful companies achieve long-term industry strategic leadership and sustain 10 to 30 percent annual profit growth—even while so many of their peers have run aground, victims of the devastating competition from the digital giants.

The Case of Edison Furniture

Perhaps the easiest way to explain the enormous pressures on business today—and how to overcome them—is with an example. We begin with a story about one of the oldest businesses undergoing a forced reinvention: the furniture business.

The retail furniture industry is facing an upheaval. Mattresses are a major profit generator. However, focused new competitors, including specialty off-price retailers, "mattress in a box" internet retailers, and manufacturers opening their own retail stores are grabbing market share from traditional multiline incumbents. The company we will name Edison (this is an actual company, but we are disguising the name) was under pressure from all sides. A majority of its

customers were demanding that it match or beat the competitors' prices, so it responded by running TV ads featuring low prices.

There appeared to be no way out of this price war, which the company seemed destined to lose because its higher cost, brick-and-mortar stores were competing with the internet sellers' much lower costs.

In response, Edison decided to look more carefully at its data. Using transaction-based profit metrics and analytics, it created what was essentially a full, all-in P&L for every transaction (that is, invoice line: literally, every time a product was bought by a customer, which we will explain in the next chapter)—to determine which parts of its business were making or losing money. When they saw the results, they nearly fell off their chairs:

- About 18 percent of their customers, which we call their Profit Peaks accounts, accounted for about half of their revenues but produced over 130 percent of their profits.

- About 30 percent of their customers, their large money-losing Profit Drains, accounted for about one-third of their revenues but drained off about 50 percent of the profits earned by the rest of the company.

- About half of the company's customers were Profit Desert customers who accounted for about 20 percent of the revenues and produced less than 10 percent of the profits.

When Edison's managers saw this, they immediately understood that their price war strategy was a response to the profit-draining customers' demands, while they were essentially ignoring their critical high-profit customers.

In fact, a few months earlier, they had conducted a marketing survey which had concluded that two-thirds of their *high-revenue* customers (a group that included both large Profit Peak and Profit Drain customers) were price shoppers. However, when Edison's managers saw the new transaction-based profit information, they realized that this new survey was fatally flawed because it neglected to discover how many of these customers were high-profit customers, and it failed to investigate what those high-profit customers really wanted. Were they just shopping on price, like the profit-draining customers, or were they looking for something else?

In response, Edison sent a short, quick survey to a sample of its high-revenue customers, but it carefully segregated the Profit Peak customers' responses from those of the profit drainers. What they saw was startling: each group was homogeneous, but the two customer groups could not be more different:

- The Profit Peak customers were very store loyal. They liked to shop at the store, and they often had a trusted sales rep who guided their purchases. They referred their friends and family to the store (and that is how they had found it), and while they were not wealthy, they were relatively insensitive to prices.

- The profit drainers, on the other hand, were classic price shoppers. They often started shopping at one of the company's stores, then went comparison shopping at the off-price and internet retailers. They finished by returning to the company's store to demand that it match the lowest price they had found and deliver the strong service that Edison was known for.

This led Edison to change its competitive positioning to respond to the onslaught of low-cost, low-service internet competitors. It focused on building its business with the Profit Peak customers in several ways:

- It fed the Profit Peak customers' identities into its Salesforce customer relationship management system, so that they were recognized as soon as they entered the store and were sent immediately to their favorite sales rep, who had on his or her iPad a history of the customers' buying preferences, both for style and accessories like high-profit warrantees.

- The Profit Peak customers were offered special services, including after-hours appointments with their favorite sales reps and customer concierge services to help with appointments, answer questions, and respond to requests.

- Edison instructed its best product managers to develop "store brand" private-label products, which were much more profitable than branded products and which the high-profit customers actually preferred.

- The sales reps were instructed not to negotiate price discounts with the profit-draining customers, whom they could recognize from the notations in the Salesforce system.

- Advertising themes changed from low prices to high service and quality "store brand" products, and the company started holding regular "friends and family" after-hours wine and cheese parties for its Profit Peak customers and their guests.

- Delivery services were changed to focus customer service on high-profit customers. The director of delivery noted that about one-third of the drivers were very good at customer service, while the other two-thirds of the drivers simply liked to drive. He stationed the service-sensitive drivers in neighborhoods where the Profit Peak customers lived and had the other drivers shuttle trucks of furniture to them. This freed the master drivers to do all the Profit Peak customer interactions, including noting other furniture needs and preferences that they could report to the sales reps, who would follow up.

The best news was that when Edison Furniture looked at the currents of change that were buffeting the industry, it saw that it had carved out a defensible, high-growth, high-profit strategic group that the powerful digital and off-price competitors could not enter with their low-price, low-service strategies.

Edison's executives noted that their high-profit customers required more costly service, but they realized that this was a great investment as the extra cost was easily justified by the

accelerated profits. They also realized that simply maximizing *revenues* by pursuing profit-draining customers was causing them to lose money hand over fist.

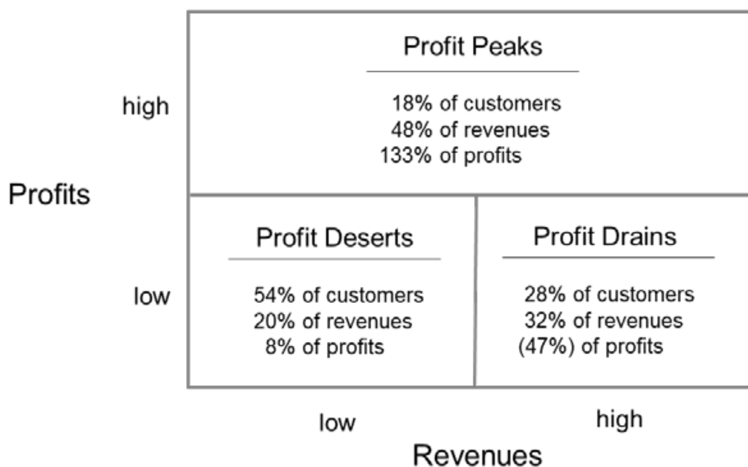
Edison's management made the brave strategic decision to abandon the revenue from its Profit Drain customers and to stop their old practice of meeting the lowest price in the market. They were pleasantly surprised to find that a significant number of the Profit Drain customers eventually purchased from Edison at full price anyway so they could get Edison's legendary great service.

Importantly, since most of the key elements of this strategy were already present in the company, it could manage the transition to the new strategy by using its current resources. Management was delighted to find that the new strategy generated significant new cash flow from the start, which paid for the additional changes needed to complete their strategic shift.

Edison succeeded because it **chose** its customers by identifying its high-profit, defensible strategic group; it **aligned** its resources around the processes and technologies that supported its chosen customers; and it **managed** the coordination of its key functional areas—sales, products, and customer relationships—to meet its customers' needs and not to maximize all revenues and minimize all costs.

Edison's customer profit segmentation—dividing the customers into Profit Peaks, Profit Drains, and Profit Deserts—was essential to **choosing** its strategic group. When Edison's managers used their transaction-based profit metrics and analytics to determine the actual all-in profit of every customer (and product, store, and so on), they saw that their customers clustered naturally into these three profit segments. Figure 1.1 provides a *profit map* (that is, a summary characterizing a set of profit segments) of Edison's customers.

Figure 1-1: Edison Furniture's Profit Segments



Once Edison's managers examined the company's profit map, they determined that their Profit Peak accounts formed an existing and defensible core set of customers that would endure in the transformed industry (as the currents of change played out), so they could anchor their

choice of strategic group in this customer set. As a result, they could figure out the tactics that would enable them to secure and grow their Profit Peaks, convert as many Profit Drains as possible into Profit Peaks, and focus on lowering the cost to serve their Profit Deserts. This gave them a clear game plan for **aligning** and **managing** the company.

The Case of Baxter

A second example of how companies can reinvent their priorities, beat back competition, and discover astonishing new sources of profit comes from the medical industry, specifically a hospital supplier named Baxter.

We highlight this case because it was one of the landmark innovations that started the transition to the Age of Diverse Markets and because it shows how Baxter, in its healthcare business market, paralleled the situation that Edison faced in its B2C market: intense competition, pricing transparency, and a seemingly no-win situation. Like Edison, Baxter had to shift its focus from selling traditional products to creating innovative ways to meet its customer needs. And, just as it was for Edison, choosing its customers and realigning its organization were the keys to Baxter's success.

Baxter was stuck in the mud. The company sold a variety of hospital supplies, like intravenous (IV) solutions and plastic sets to deliver drugs and fluid to patients. The business was wracked with constant price wars; a five-year hospital contract would hinge on whether the price was, say, $1.05 versus $1.03 per liter. The decision-makers were hospital pharmacists, who were price buyers.

Baxter's management found that its core strategy of selling commodity products with minimal and identical services to all customers was creating chronic price wars with giant competitors that were doing the same thing. The company needed a way to break out of this shrinking strategic box and redefine its business.

Baxter assembled a small team to investigate how to raise its profitability. The team carefully examined the company's sales and operating costs. They saw that the company was quite efficient; it appeared that there was little that could be done.

Then the team had an inspired thought: all their cost-reduction work had naturally focused on the activities within Baxter's "four walls," just as their competitors were doing. During a brainstorming session, the team had a quirky thought: they wondered what happened to the products within the hospital from the time they were received until they were administered to the patients. They thought that this information might provide a way to break out of their shrinking strategic box. Surprisingly, the team had little knowledge of these activities.

Soon, the team fanned out to visit several hospitals, pursuing their hunch that they might find something useful. They were amazed to find that in hospital after hospital, the products flowed through a series of internal supply chain steps, many of which replicated those that took place in Baxter. Moreover, the steps were poorly organized and were accomplished at volumes that were too small to achieve even a minimum efficient scale.

The team conducted a study at a major hospital to measure the cost of each supply chain step. They divided the supply chain into a set of discrete steps (for example, deciding what to order, determining how much to order, transmitting the order) and interviewed all relevant hospital personnel (for example, purchasing personnel, materials management personnel, nurses) to determine how much time each person spent on each step in a typical week. They scaled these numbers by the loaded labor rate to calculate the hospital's supply chain cost by activity and department, giving them transaction-based profit information.

The study's results shocked everyone on the team and in the hospital: for many important products, the total cost of the supply chain activities exceeded the cost of the supplies. Departments that were not thought to be involved in supply chain activities, like nursing, constituted a surprisingly large proportion of the costs. For the nurses in particular, the time and cost of supply chain activities nearly equaled the cost of patient care—an immensely important insight in this period of skilled nursing shortages.

No one had even imagined that this picture would emerge. Careful studies in multiple hospitals confirmed that this was the norm.

The cost landscape of hospitals surprised and amazed all those involved. To illustrate, if the cost to the hospital of a liter of IV solution was about $1.00, the total cost by the time it was administered to a patient was about $7.00, and of the $6.00 difference representing the cost within the hospital, about half, or $3.00, was avoidable. While the suppliers and the hospital were bickering over a few pennies, about $2.00 to $3.00 in cost reductions were hidden but addressable through process improvements.

When the hospitals' top managers saw this cost picture, they came to Baxter and essentially said: "We just have two questions: First, can you really do this? And second, can we trust you?" As one of the largest and most reliable hospital suppliers, Baxter could authentically answer yes to both questions. Besides, Baxter's managers had the advantage of creating the new system, and their careful efficiency calculations showed them the exact ways to reduce costs that later imitators never saw.

This new strategy allowed Baxter's managers to shift the decision-maker buying their products from the price-oriented pharmacist to the hospitals' top managers. For the first time in many years, they found themselves in the driver's seat of their hospital relationships.

Based on the comprehensive hospital study information, verified in a number of hospitals, the team suggested a new system that would integrate the supply chains of Baxter and the hospitals. Baxter called it the "stockless system" (now called "vendor-managed inventory" or VMI), later rebranded as ValueLink. It still is a critical element in Cardinal Health's hospital supply services (this portion of Baxter's business was eventually spun off and later purchased by Cardinal Health).

Under the stockless system, a Baxter materials management coordinator was resident in each hospital. The coordinator was not a sales rep but rather, a floor supervisor from Baxter's distribution center (DC). Using a new, efficient protocol, the coordinator counted the products in

each of the hospital's patient care areas and clinics and transmitted the order information for each patient care area and clinic to Baxter using a handheld device.

At the Baxter DC, a special section of the warehouse was devoted to the stockless system. It was carefully designed for picking individual items like two boxes of bandages, which are called "eaches," in contrast with the main sections of the DC that were set up to handle bulk items like cases and pallets. After receiving the hospital orders at the DC, a dedicated set of DC personnel packed each order into a set of special totes, with each tote addressed to the specific hospital patient care area or clinic that generated the order.

At the end of the day, the totes were loaded onto delivery trucks and brought to the hospitals. They were received using *statistical receiving* (that is, inspecting a sample of high-value products), made possible by highly audited Baxter shipping verification protocols, and then moved to the respective patient care areas or clinics at night. The Baxter coordinators put the products away and returned the totes to the stockroom for transportation back to Baxter the next day.

The new stockless system resulted in three major benefits: one expected, another a surprise, and a third completely unexpected.

First, the stockless system *reduced the hospital's supply chain costs by over 30 percent.*

It reduced costs in several ways: by eliminating the redundancies between Baxter and the hospitals; by substituting the use of Baxter's systems operating at efficient scale; and by identifying and rectifying inefficiencies in the prior hospital operations (for example, eliminating the massive amount of time nurses had been spending going to the stockroom to get missing supplies).

Baxter had found a way to escape from its shrinking strategic box by "building a bigger box around its business," which opened a new world of possibilities for expanding what we call its *customer value footprint* (that is, the value that a company provides to a customer). In the process, Baxter redefined its business.

Second, the Baxter managers were surprised to find that *their own operating costs dropped by over 30 percent.*

Baxter now controlled the hospital order pattern. Baxter's managers could balance the hospital inventories with the ordering pattern by building a little more stock of inexpensive supplies, which helped reduce order frequency; by spotting early trends and proactively building inventories to avoid expediting costs; and by directing hospital staff to alternative stocking locations within the hospital when needed.

Third, and completely unexpectedly, *Baxter's product sales rose by over 35 percent, even in the most highly penetrated hospitals in the country.*

This massive sales increase was driven by the efficiency and performance of the stockless system, which greatly eased the burden on all the hospital personnel involved, especially the nurses. Just as important, a very strong working relationship—rooted in ongoing problem solving

and jointly finding ways to improve the system—developed between the head nurses and the Baxter coordinators. This effectively made Baxter the preferred vendor.

When it became clear that the stockless system was a major revenue generator, the sales reps, who previously tried to keep the team out of their important accounts, did an about-face. They quickly tried to get all their accounts to the head of the line for the new system because they expected huge commissions on the big sales increases.

It soon became clear that the company needed a more systematic way to decide which accounts would get the new system and a way to prioritize the accounts in light of Baxter's limited capacity to implement the new system. For the first time, Baxter had to choose its customers—and this ran completely counter to its established practice of treating all customers alike.

The answer was what we call *market mapping*—matching customers to the relationships that they *should have*, not necessarily to the relationships that they initially want.

The market mapping process involves sales managers, marketing managers, and supply chain managers. Once the market mapping team decides on the right relationship that the company should have with a customer, it is the job of the sales rep, often in combination with the supply chain manager and other members of the multicapability account team, to sell the account into that relationship over time.

In targeting accounts for these relationships, the team found four key factors: (1) the amount of the potential profits at stake; (2) the operating fit; (3) the account's willingness and ability to partner; and (4) the account's buyer behavior (that is, relationship versus transactional). The team also saw that it needed to define a small number of alternative relationships—which we call a *relationship hierarchy*—for accounts for whom full integration did not fit.

Through this process, Baxter was able to align its sales process, product-service mix, and organizational processes to fit the respective needs of its various target customers.

A second big issue that arose was whether to offer the service only for products that the hospital bought from Baxter or to offer the service for all hospital products. This discussion was heated, with the sales and product managers adamant that the service was a critical incentive for selling Baxter products and should be offered only for Baxter products.

Baxter's president thought about this issue and reasoned that the stockless system was creating a pipeline flow into the hospitals that helped hospitals reduce costs, eliminate redundant personnel, and free up nurses' time. Unless Baxter handled all the hospitals' products, the hospitals could not achieve the full cost savings and efficiency improvements made possible by the stockless system. Therefore, stockless had to handle all hospital products.

A related question arose: should Baxter charge for the stockless system, or should the company offer it as a "perk" to large-volume customers? Again, the sales and product managers argued that it should be considered a sales incentive and be made available at no cost to big accounts.

The president turned down this argument, explaining that because hospitals would have to make significant internal changes to implement the system, charging for the system would force them to acknowledge the value they would be receiving. Moreover, it would provide an incentive to make the changes.

With these important strategic decisions in hand, Baxter rolled out the stockless system using multicapability teams tailored for each target hospital. As expected, the teams encountered some operating issues, but importantly, the system produced major benefits.

Stepping back, what did this fundamentally new way of doing business signify for managers?

The stockless system, just like other forms of close supplier-customer integration and cooperation, heralded a major shift in the nature of business and contributed to the Age of Diverse Markets.

First, it unleashed huge new profits by eliminating the inefficiencies that lay hidden for decades between companies, rather than addressing only issues within companies.

Second, the stockless system created decisive strategic differentiation. It enabled Baxter to integrate with its most important customers, which fostered very strong operating ties. Baxter created a new, lucrative strategic group, which was defensible against both traditional and digital competitors. Moreover, this strategy invited and underpinned critical hospital strategic initiatives.

For example, prior to this partnership, hospitals were reluctant to develop remote facilities and clinics because they lacked confidence in their managers' ability to support these complex operations. The Baxter partnership gave them confidence to do this, which transformed hospital strategies. Competitors with arm's-length strategies (for example, only shipping in bulk to hospitals' receiving docks), even digital giants with Big Data, could not possibly match Baxter's rapidly evolving customer value footprint.

Third, this innovation was not about the products. It was all about Baxter developing enduring strategic advantage and financial gains from its customer-oriented go-to-market innovations—one of the hallmarks of the new Age of Diverse Markets.

Fourth, when Baxter used transaction-based profit information to guide its own business, it discovered its prices and cost to serve varied widely depending on the customer relationship, the service package, and other salient factors. Without its granular new transaction-based profitability information, Baxter managers would not have been able to select the right target accounts, match those customers to the right relationships by aligning their cost to serve with the customer's profit potential, and develop the right custom-tailored packages of products and services to fit their target market segments and customers.

Like Edison, Baxter succeeded because it **chose** its customers by identifying those who fit its high-profit, defensible strategic group; it **aligned** resources around the processes that supported its chosen customers; and it **managed** the coordination of its key functional areas—sales, products, and customer relationships—to meet its customers' needs. Like Edison, Baxter

understood that the old model of maximizing all revenues and minimizing all costs was a losing proposition.

Who Wins Big

Today, every market is changing rapidly with most companies reducing their supplier base by 40 to 60 percent. The all-important question of who stays and who goes is rarely made on product characteristics alone, or even price. The decision on who wins big and who gets pushed out is almost always determined by a supplier's go-to-market capabilities—namely, the ability to choose its customers, to produce more essential customer value through an innovative value footprint, and to create new profits and strategic advantage *for the customers*.

The overriding management issue is that this change in business eras is creating a critical need for a shift from broad-market targeting to focused-segment—and even customer—selection. In today's Age of Diverse Markets, "choose your customer" is the most important theme.

In order to succeed, companies have to abide by the three imperatives we highlighted before: (1) **Choose:** Define a defensible strategic group that your company can dominate, and select the most lucrative customers within it; (2) **Align:** Identify and build the capabilities that will enable your company to achieve high sustained profitability in your target strategic group; and (3) **Manage:** Develop your organization to enable your managers to seamlessly coordinate to meet your chosen customers' diverse and rapidly evolving needs.

This shift, in turn, requires much more granular profit information—in essence, a full P&L on every transaction—and a shift to an organization that can create and supply tightly coordinated packages of products and services aimed at a company's increasingly divergent market segments, and even individual customers.

In a nutshell, this is the key to success today. But most managers have been blinded by their experience in the fading Age of Mass Markets in which all revenues are assumed to be good and all costs are seen to be bad. This is the overriding management problem that our book is designed to address.

The Currents of Change

In Chapter 2, we describe in detail the currents of change that are ushering in the Age of Diverse Markets. Managers must understand and address these changes in repositioning their organizations. The five currents propelling this tsunami of change are these:

- **Rapid technology innovation:** Technology is revolutionizing industry after industry. Think about this: computers, mobile commerce, and even the internet were not in widespread use until the tail end of the prior century. Now smartphones have more computer power than was packed into the *Apollo* spacecraft. Drones and self-driving cars are on the near horizon, and less-known but equally revolutionary technologies like robotics and *additive manufacturing* (in which devices are "built" with powdered metal under heat treatment, rather than "sculpted" by metalworking parts) are capturing increasing market share. At the same time, artificial intelligence (AI) and machine

learning are enabling managers to optimize their companies and customer relationships in powerful new ways—in many cases, getting every transaction right every time. All these are making the mass customization of products and services both possible and competitively necessary.

- **New buyer behavior:** New forms of buyer behavior are emerging, upending traditional sales and marketing relationships. In addition to the new internet retailers and distributors bringing powerful B2C processes like omnichannel retailing (which takes a lot of experience to perfect), disruptive companies and their millennial customers are moving toward higher levels of price transparency and service expectations. Managers responding to the former must offer carefully constructed sets of products and services, creating hard-to-follow packages, while managers facing the latter must create new forms of mass customization, especially involving highly integrated customer relationships. Managers have to create alternative approaches that the internet competitors and other disruptors cannot follow.

- **Channel boundaries breaking down:** In industry after industry, channel boundaries are blurring, and new players with new strategies and capabilities, including powerful network effects, are rising to dominance. While Amazon is the poster child for this, consider CH Robinson, a major national transportation carrier. For years, it moved most of the fruit flowing from the Pacific Northwest to markets around the nation. A few years ago, CH Robinson decided that since it had a dominant position moving fruit, which was a low-profit business, it should become a distributor and take ownership of the fruit, which is the high-profit part of the business. The company contracted with several major food companies to use their brands, and today if you buy Tropicana, Welch's, or Mott's fresh fruit, you are buying food that was distributed by CH Robinson.

- **New metrics and analytics:** In the Age of Mass Markets, product prices and cost to serve were relatively uniform from customer to customer. In today's Age of Diverse Markets, all this has changed: prices and cost to serve vary widely from customer to customer, and even within a customer. Transaction-based profit metrics and analytics allow managers to see exactly where they are making money and where they are losing it—and this detailed understanding of customer, product, and process profitability enables managers to create sharply focused and highly effective initiatives.

- **New company capabilities:** Companies have not been standing still either. Managers are making tremendous leaps forward in marketing, sales, and supply chain management. In marketing, Big Data enables managers to pinpoint evolving buyer patterns customer by customer and product by product in real time, allowing them to create compelling segment-specific "extended products" (that is, a full set of products and services that provide a unique customer value footprint, like Baxter's stockless systems, in which physical products were delivered to the hospitals' internal points of use). In sales, electronic data interchange (EDI) offers important cost savings; customer relationship management (CRM) systems focus sales resources; and dedicated multicapability teams specialize in providing packages of products and related services to a company's respective profit segments. In supply chain management, the internet of things (IoT) and other digital innovations are speeding up responsiveness, while new forms of vendor-

customer integration are allowing managers to build closer ties and switching costs with key customers.

Build Your Strategic High Ground

The pervasive fear felt by so many incumbent company managers is rooted in the false assumption that the currents of change, of which Amazon is emblematic, will completely disrupt industries and leave no place to hide or prosper.

In fact, hundreds of studies of industry profitability in the industrial organization economics literature show the opposite. The most profitable overall industry configuration is one with a relatively small number of competitors, with each having a different strategy and each being very profitable—some serving small customers, others serving large customers; some offering arm's-length service, others building integrated customer relationships; and so on. In fact, contrary to popular belief, the industry model of a big winner and a lot of losers consistently provides low overall profits to all industry participants.

Today, the winning strategy is "choose your customer." For example, while Amazon is destroying many traditional brick-and-mortar businesses, the company has dominant strengths along only a few dimensions: arm's-length digital services mostly to small customers with prodigious network effects. This leaves a large, lucrative, open playing field.

In Chapter 5, we describe how Zara, a Spanish retailer, created a dominant strategy in "fast fashion" by **choosing** customers who wanted the latest styles; **aligning** their marketing, merchandising, and supply chain activities around those customers' needs; and **managing** their organization to produce this focused offering.

The overwhelmingly important problem for all too many managers in incumbent firms is that they are stuck in the obsolete strategic paradigm of the fading Age of Mass Markets in which the primary goal is to maximize all revenues while minimizing all costs. In essence, they are choosing all possible customers, which is no choice at all.

This objective is completely wrong today because transaction-based profit metrics and analytics consistently show that only a small portion of revenues are highly profitable (where the cost to serve aligns with the customer's profit potential). These metrics and analytics show that the cost to serve high-profit customers is often higher than average because giving them high service is a great investment.

In most companies today, traditional metrics, such as aggregate revenues, costs, and margins—which show managers *whether* their companies are profitable—actually prevent managers from understanding *where* they are profitable. While this granular profit knowledge was unnecessary in the Age of Mass Markets (with its homogeneous prices and costs), in today's increasingly heterogeneous markets, this is a life-or-death problem.

Continuing to act on the obsolete assumption that all revenues are good and all costs are bad leads all too many managers to dilute and waste resources trying to hold onto all of their business, rather than choosing their customers and focusing on building their high-profit,

defensible business in their target strategic group. This is the single most important issue in business today, and most managers do not even see it.

Three Imperatives

How can managers choose their customers and build their strategic high ground? What information, processes, and organization do they need to compete effectively against the digital giants? The answer lies in the three imperatives that form the theme of this book.

Choose

In order to succeed against the digital giants and other aggressive competitors, you must have a different strategy rather than trying to beat them at their own game. To succeed against competitors with strategies similar to yours, you must get all the details of your business right.

In order to define a defensible strategic group that your company can dominate, three principles are critical:

- **It is all about customer value.** The customer value you create both positions you against your competitors and provides the basis for compensatory pricing. For example, Chapter 5 contains the section "Win the Customer Value War," which says to turn the price war into a customer value war, and when you have the lead, step on the gas. While the digital giants have some strong advantages, there is plenty of room left to create a unique customer value footprint that will provide long-term strategic dominance and sustained high profitability—just as Walmart is doing now with its healthcare initiative (providing healthcare and related services *in their stores*).

- **Strategy is defined by what you say no to.** If you treat all revenues as equally desirable, you don't have a strategy. Strategy is about choices. Amazon competes along only a few dimensions in which it can provide a unique customer value footprint with strong network effects, and it avoids strategies where it can't provide unique customer value. The same is true of Walmart, Facebook, FedEx, Apple, and all the rest. Most importantly, if you don't have a detailed understanding of where your business is making and losing money (through transaction-based profit metrics and analytics), you can't select the right strategic group that will provide you with high sustained profit growth, even in the face of massive changes that are transforming the industrial landscape. This is the root cause of so many companies failing today.

- **You have to be best at something.** If you are not the best at creating a winning customer value footprint and focusing your resources on developing your target market, you are destined to be overtaken by a competitor who is. This is a moving target—the pace of change is accelerating, so fast response is an increasingly critical competitive advantage. If you are not constantly improving your customer value footprint and refining your customer targeting, you will be left in the dust by competitors who are. Just look at Amazon's new initiatives to place Alexa in hospitals and manufacturers. The ability to

innovate your customer value footprint at high speed must be a core capability of your company—but it is impossible to do if your company is targeting all revenues indiscriminately. This is what separates the winners from the losers.

Align

Alignment is the second imperative. You have to identify and build the capabilities that will enable your company to achieve high sustained profitability in your target strategic group. This has three core components that must be tightly coordinated and not managed independently:

- **Products:** This book explains the process of developing effective extended products. These can range from delivering products directly to hospital clinics through vendor-managed inventory, to providing well-specified customer-specific programs of maintenance for precision ball bearings, to posting product review and Q&A sections on the digital giants' websites. Extended products are an essential part of an effective strategic response to digital giants and other disruptive competitors that can address only a specific dimension of the available market. After all, how could an internet competitor replace Baxter's deep relationship with the head nurses?

- **Customers:** As markets become increasingly heterogeneous, customer needs are fragmenting. In the Age of Mass Markets, companies could provide a narrow range of products with minimal customization services to the entire market. Today, companies must understand the needs of specific segments of their markets for integrated products and services, and they must be able to deliver packages of well-targeted, well-coordinated products and services to each segment. This requires focused initiatives in selecting and managing accounts, and not simply providing a homogeneous set of products to as many customers as possible—or trying to defend against the digital giants by digitally offering arm's-length products to the same customers. As your product-service packages get more complex, price optimization must become much more sophisticated, reflecting not just price maximization but also in many cases trading price for operating-cost reduction.

- **Relationships (supply chain and channels):** As customer needs get increasingly diverse and customer integration becomes more critical, supply chains must become more diverse and specialized as well. Companies need to develop multiple parallel supply chains reflecting the growing disparity in customer importance, product criticality, degree of integration, and other factors. This is an extremely efficient configuration, and it creates a hard-to-follow competitive advantage. Similarly, as companies open more channels (that is, forums through which companies engage their customers) ranging from stores, to direct sales, to distributor sales, to internet sales, companies can achieve critical differentiation by using omnichannel management to coordinate their channel offerings and employing artificial intelligence and machine learning to anticipate and shape customer buyer behavior.

The objective of strategy is to aim and align the company. The choice of a strategic group aims the company, and the alignment imperative ensures that the three core areas—products, customers, and relationships—are not only managed well but are also tightly coordinated to devise and offer the right sets of integrated products and services to the right customer segments in the right way. As markets become increasingly heterogeneous, this becomes a critical issue for companies. Without transaction-based profit metrics and analytics, managers cannot identify and target the right strategic group and align their resources and activities to capture their focus market segments and customers.

This book provides essential advice at two levels: things that you *have* to do to compete with the digital giants and other aggressive new competitors, and things that you *should* do to maximize your profitability within your chosen strategic paradigm.

Manage

Organizational effectiveness is the third imperative. As markets become more fragmented and heterogeneous, managers must coordinate in diverse, segment-oriented, or even customer-specific, teams to understand and meet increasingly divergent customer needs.

In a recent MIT supply chain management executive program class, Jonathan started by declaring that focusing on improving the efficiency of your supply chain was the worst thing that a supply chain manager could do. The class, which included about 80 top executives from the United States, Europe, and Asia, gasped in response.

After a lengthy pause, Jonathan asked, "Are all of your orders equally profitable to serve?" The participants shook their heads. "What determines which orders you have to fulfill?" The answer was simply that once a sales rep booked an order, it had to be fulfilled. "So, what determines which orders the sales reps book?" The answer from the class was that the sales reps were paid to bring in any business that added to revenues, regardless of the profitability—in other words, that was how they "chose" their customers. The bottom line was that the cost to serve was someone else's problem—and that someone else was sitting in the MIT executive classroom.

Jonathan then explained that he opens his graduate supply chain management and strategy course by asking the class, "What do you think is the objective of this course?"

Usually, the students politely answer, "To teach us supply chain management, of course," to which he responds, "No, it is to make you *effective* supply chain managers—and if you waste resources fulfilling unprofitable orders, you are not being effective. Your job is to link with your counterparts in sales, marketing, and finance and use transaction-based profit metrics and analytics to determine which orders will be profitable—even in the presence of digital giants and other aggressive competitors—and then structure your supply chain to fulfill them. This is an issue of choosing your customer: clearly identifying your target strategic group and teaming with your colleagues to align all of your activities to achieve that objective."

Organizational effectiveness has two dimensions: business processes and organization structure.

Business Processes

In Chapter 3, we discuss the four cornerstone business processes that are essential for success:

- **Strategic positioning and risk management:** Transaction-based profit metrics and analytics enable managers to evaluate and reshape their companies' competitive positioning and risk profile as the currents of change transform their respective industries.

- **Profit river management:** *Profit rivers*, major segments of a company that have similar management imperatives, are a company's prime sources of profit or loss. Typically, they have three characteristics: (1) each is important, (2) each is relatively homogeneous and somewhat different from the others, and (3) each has a natural cross-functional management constituency.

- **Transition initiative management:** These initiatives are essential in repositioning a company for increased profitability and success in its transforming industry.

- **Profit-driven process management:** Transaction-based profit information is necessary to maximize the performance of a company's core set of business processes that are essential for managing customer, product, and supply chain activities.

Together, these four cornerstone business processes enable managers to maximize their companies' performance in the near term, in the long term, and in the transition period in between.

Organization Structure: Managing at the Right Level

One of the most thorny and difficult management problems is managing a level too low, as we explain in Chapter 8. This occurs when a manager is promoted and spends an inordinate amount of time tuning up the work of his or her subordinates. Not only do the subordinates lose the opportunity to improve but, more importantly, the manager's new work does not get done.

In the Age of Mass Markets, managing by tuning up subordinates' work was in fact the most important thing a manager could do. In that era, markets were stable and homogeneous, and most interfunctional coordination took place at the top of the company in periodic planning sessions. Managers were largely left with the task of tuning up their subordinates' technical skills at maximizing revenues or minimizing costs.

Today, the situation is completely different. Markets are increasingly fragmented, diverse, and fast changing. The key to success is to form multicapability teams that can create and produce sophisticated packages of products and services to meet the needs of respective target segments and even individual customers. This need to respond fast enough to emerging or changing customer needs must be every manager's prime focus. The company's organization and processes have to foster this mindset. This is one of the most important keys to success in the Age of Diverse Markets

In essence, companies today need to be managed at three levels: top management, upper management, and operating management.

Top Management

Since the time frame for managing major change in companies today is about three to five years, top management's highest priority is to design the company as it will need to be in three to five years and to bolt a transition plan in place—and not to focus inordinately on tuning up the current day-to-day business. As we have seen, the biggest challenge facing companies is to choose a strategy that will enable the company to achieve industry dominance and accelerating profit growth for a decade or more. The parallel issue is to form an aligned organization composed of multicapability teams that can discern and fulfill the evolving needs of the company's increasingly fragmented, diverse, rapidly changing target customers. This is the essence of top management's job.

This is a particularly challenging task for most top managers who have spent their careers in functional stand-alone departments of mass market companies, and it is an underlying reason why so many major incumbent firms are failing to keep up with newer competitors.

Upper Management

The upper management team, primarily directors and some vice presidents, should be the locus of both ongoing strategic positioning and alignment. In our experience, this is best accomplished through a multicapability committee, which we call the Managing Profitable Growth (MPG) Committee. Responsible for successfully putting the company's strategy into action, the MPG Committee must be furnished with regular profit scans using transaction-based profit metrics and analytics. With an understanding of the company's internal profit landscape, these managers can gauge the impact of the currents of change on the company's segments in terms of current and prospective strategic defensibility and sustainable profitability. This forms the basis for building and managing a transition plan, including forming and overseeing multicapability teams to address the evolving needs of target segments and customers.

Operating Management

The sales and operating managers run the company's day-to-day sales and operations. In the Age of Mass Markets, this meant focusing on a single department, like sales or distribution. But in the Age of Diverse Markets, this means teaming with one's counterparts from other functional areas to design and provide the integrated package of products and services that will meet the target segments' and customers' needs. The difference could not be more marked, and communications and coordination throughout the company must undergo major changes to adapt successfully.

The enormous chasm between managers' jobs at all three levels in the fading Age of Mass Markets versus the current Age of Diverse Markets means that the Manager of the Future has to have a very different skill set, and even personality to succeed.

The Manager of the Future: Value Entrepreneur

In the past, managers were more or less technical specialists with single-dimension capabilities. The caricature is that sales reps were "lone sharks swimming in the ocean," while marketing managers sat in conference rooms poring over broad-market statistics and focus group

results to design products, and supply chain managers were largely confined to their warehouses ensuring error-free shipments.

Today, all of that has changed. Each manager needs a base of broad multidisciplinary technical skills, but more importantly, he or she needs deep insight into understanding evolving customer needs. After all, if a company does what a customer requests, it is a good supplier; but if the company does what the customer really needs (even if the customer does not see it yet), it is a long-term strategic partner. And once a customer team understands customer needs, it must be very skilled in change management—that is, managing change within the customer—and in coordinating in unique and dynamic ways to meet evolving customer needs.

It all starts with choosing your customer, or, as we put it, selecting your strategic group and then aligning and organizing your functional capabilities to meet your diverse and rapidly changing customer needs.

The Manager of the Future must be adept at what we call Value Entrepreneurship, which we define as teaming with peer managers to constantly push the envelope of the company's customer value footprint in its diverse target market segments in a tight but flexible way. We explain this in Chapter 9.

This profile has enormous implications for management education, training, and career tracking. The book describes this emerging need in detail, and in the process it provides a portrait of the Manager of the Future and a concrete program for managers to develop their skills and experience to succeed in today's Age of Diverse Markets.

The ultimate purpose of this book is to enable managers at all levels—both current and prospective managers—to understand how to manage in today's revolutionary business era, and to give them a clear, practical pathway to success.

Things to Think About

1. What competitive pressures over the next three to five years are causing you to reevaluate your business?

2. Have you selected your customers strategically in light of your new competitive threats?

3. Are you still trying to compete on your traditional strength?

4. Have you identified and prioritized the transformational resources you will need to win in your new environment?