The End of the Village Store

Henry Ford once quipped, "Any customer can have a car painted any color that he wants so long as it is black." Ford would hardly recognize today's fussy customers or the value chains that deliver the goods to them. In an era of specialization, the traditional one-size-fits-all value chain is becoming as outdated as the Model T.

IMAGINE TAKING A WEEK'S VACATION IN a tiny rural village, with only one store to supply your needs, from food and drink to clothes and hardware. Such forced simplicity can seem not only bearable but delightful—because when the week is over, you know you can return to civilization and buy what you really need at your favorite niche outlets, on the Internet, or at the mall. Goodbye simple life; hello specialization.

The metaphor is perhaps unoriginal, but it neatly illustrates how we as customers have embraced this trend of specialization, demanding and rewarding further iterations and permutations of choice. Of course, other factors were required to bring such possibilities our way in the first place. In the case of the village shop, these were better roads, more cars and public transportation, and most recently the Internet, all of which helped bring sufficient customers within easy reach of niche shops. This dynamic is becoming increasingly relevant to a wide range of industries. Just as better transportation and the Internet spoiled the game for the village store, we can see that globalization, the Internet again, modular value chains and the growth of economies such as China's and India's threaten to spoil the game for established companies in the West. In fact, it can be argued that the shift toward specialization is materializing faster than some big firms can adapt. Especially at risk are companies that continue to view their customers as non-overlapping segments, rather than grasping that today the same customer may demand different flavors of a product or service at different times *(see sidebar: The Limits of Customer Segmentation)*.

In this article, we give examples of the challenges posed to various industries as new fronts of specialization emerge. We then propose a novel strategy for first, discovering such fronts, and second, developing both preemptive first strikes and successful counterattacks. Our focus is on the company value chain: We believe that rather than stick to the traditional idea of tuning and augmenting a single ultra-flexible chain, an established company can compete most effectively if it creates a number of specialized value chains. The question is how to do so, given the magnitude of such a transformation.

The Limits of Customer Segmentation

One reason we're tempted to stick with traditional ways to improve business in the face of focused competition is that a key tool for understanding the market—classic customer segmentation, such as market size or income—is no longer very useful.

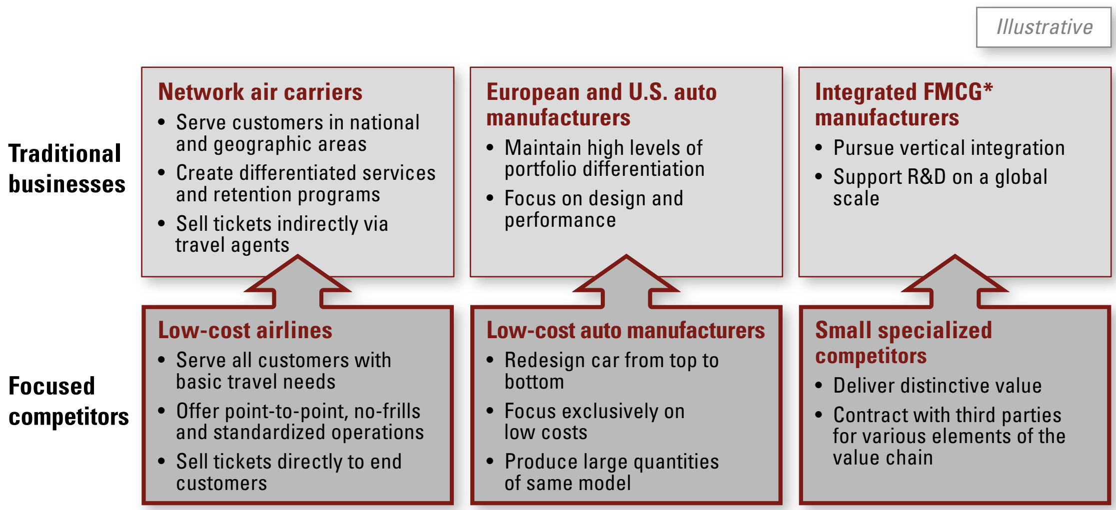
Most air travelers, for example, don't limit themselves to charter, network or low-cost flights. They treat air travel as a smorgasbord and choose based on their present need. Likewise, people buying books and CDs from Amazon.com are also likely to frequent Waterstone's or Barnes & Noble. Here they can handle books and CDs in reality rather than virtually, enjoy browsing for chance discoveries, and get together with buddies for a Starbucks coffee and muffin. It is a complete shopping and leisure experience.

In such cases, thinking in terms of mass customization or the notorious "customer segment size of 1" can only cloud our thinking about real customer needs. We will mistakenly continue to believe that our value chains should be responsive, agile and lean and mean, all at the same time—rather than realize that value chain specialization and scale re-evaluation would be far more effective.

The answer is simple: Give up the old assumptions and start segmenting in terms of customer needs, not individual customers. Then the dialog on value chain specialization can begin in earnest.

FIGURE 1

Specialized competitors are shaking up traditional business models



Source: A.T. Kearney

** FMCG is fast-moving consumer goods*

Who Is at Risk?

As our examples will show, it's not the small, fast-growing, focused companies that are at risk. They're the ones agilely surfing the specialization wave. Those in danger of drowning are well-established firms, in particular those that cling to old assumptions. Behaviors to watch out for include:

- Serving customers the same old way, not realizing these customers are changing their expectations—for example, wanting newer, faster and better services and products at the high end, while expecting better quality at lower prices on the low end.
- Fighting back via business improvement alone, since this is always easier than radical structural changes. Despite the comfort level, such efforts treat the symptoms, not the disease, and offer no guarantee of success. You may find yourself making continuous improvements with little to show for it, even as you lose more of your business to focused competitors.
- Failing to recognize that things can and will get worse. It's like being gripped by a python: The pressure is light now, but will slowly increase until you suffocate. Even if today you can cope, tomorrow you may find that focused competitors have pinched the low or high end of your business so successfully that you lack the setup to fight back.

Let's look at some typical examples of challenges in various industries, showing both why these have arisen and why existing companies find it so difficult to respond *(see figure 1)*.

Infrastructure made easy: airlines and retail computers. The airline industry was traditionally dominated by network carriers that focused on serving customers in national and geographic areas. Customers flew business or first class on a business trip, and accepted lesser comfort in the rear of the aircraft when traveling on holiday. Since all airlines operated more or less the same way, this played out reasonably well.

Then came the focused competition. The first specialization was charter flights embedded in competitively priced package holidays. The real onslaught came with the entry of low-cost airlines. These took advantage of (and helped create) consumer demand for short, no-frills foreign travel. Crucial to the airlines' success was the ability to find customers via new, cost-effective channels such as call centers and the Internet, bypassing the travel agent model with its high costs and high service levels.

What a blow this was to the traditional airlines. They'd achieved the impossible in terms of optimizing every aspect of their operations—deploying loyalty schemes, outsourcing their catering, pooling maintenance, forming elaborate code-sharing agreements and more. Then along came low-cost competitors to make a mockery of such adaptations. A new customer need was identified, yes, but this didn't make life easier for network carriers. Their volume has been eaten away regardless, and passengers have become more price conscious. For example, low-cost airlines have taken more than 16 percent of the market share in Europe.

Another example of enlisting new channels to cultivate new customer expectations comes from the PC retail business. Remember the old days when IBM once happily sold laptops and PCs through a leading network of retailers. The strength of this channel made it difficult for new entrants to break into the market. Then Dell discovered it could bypass the reseller channel altogether by selling online, and in the process expand customer expectations for configurability and price. IBM was in a quandary as to how to respond. If it followed Dell down the direct channel route, it would instantly cannibalize its existing reseller channel. As we'll see later, channel conflicts are sure signs that specialization is out there and must be addressed.

Globalization and low-cost competitors: light bulbs and autos. Another challenge is the focused low-cost competitor that is capitalizing on globalization, innovative customer development and specialization *(see sidebar: The Low-Cost Threat)*. An example is the lighting industry, particularly the lamps market. Until a decade ago, this market was dominated by General Electric, Osram and Philips Electronics. These companies built their dominance in part on their ability to supply every conceivable light

The Low-Cost Threat

One area where specialization is highly visible is the low end of the market spectrum. New technologies, the global playing field, the ability to leverage individual resources and diverging customer expectations are all stretching the hybrid models of established companies to the breaking point.

In the coming years, industries such as automotive, packaging, financial services, pharmaceuticals, chemicals and many others will increasingly feel this low-end pressure. Indeed, in our latest discussions and projects with mechanical engineering and electronics companies in Germany, we found that despite the current boom, they are deeply worried about future positioning. The high end of the market continues to demand specialized solutions for complex requirements. Yet the low end, which used to subsidize at least some of the high end, is increasingly being taken away by specialized low-cost competition. What's a company to do? Possible strategic moves include:

- Escaping toward high-end niches. This can be done temporarily, but it remains to be seen whether it's an effective long-term solution.
- Splitting up value chains to offer both high-end solutions and no-frills products in parallel but clearly differentiated ways.
- Developing down-market products and battling with competition from around the world.

Regardless of the exact strategy, specialization of one sort or another will clearly be required. Anyone attempting to hold a safe middle position, or straining to do everything except real differentiation, will be in trouble.

source to meet every possible lighting need—not just basic incandescent lamps in all shapes and wattages, but specialty lamps, including sophisticated energy-savers.

But as lamps became more sophisticated, they also became more expensive. A high-end energy-saving lamp, for example, can be more than 30 times as expensive as a basic incandescent lamp, depending on shipping and transportation costs. New companies in China seized this opening to begin exporting halogen and energy-saving lamps to Europe and North America. These entrants focused on producing only the most popular wattages, avoiding the costs of a more varied operation. They also found they could make a slightly less-sophisticated product at much lower costs without being hurt—for example, cheaper energy-saving lamps that don't come on instantly, but flicker for a few moments before burning convincingly.

The large do-it-yourself chains and furniture chains such as IKEA have happily adopted these low-cost lamps in their assortment of front-runners, while still keeping the full range of the market leaders on their shelves to satisfy every demand. For example, in the European Union, Chinese manufacturers currently supply almost 70 percent of the market for energy-saving bulbs. The result is uncomfortable margin pressure for GE, Osram and Philips.

Cars provide another good example. We're accustomed to specializations such as SUVs, sedans and sports cars. But this is child's play compared to a low-cost value chain specialization that looms ahead. In India, the Tata conglomerate is working on the Rs. 1 lakh (or 100,000 rupee) car—a car that costs roughly $2,500. It will cost so little because it is 100 percent engineered to do so, and because it will be produced in numbers befitting a market with more than 1.2 billion people: not a few hundred thousand cars per model, as we're used to, but millions of cars per model. Clearly this will require a specialized value chain not only to engineer, source, produce and assemble the cars, but also to sell and service them.

Such a car should constitute competition only in India and other emerging world markets—but in fact, the trend is extending to the developed world as well. We know this from the success of Dacia's Logan MCV (multi-convivial vehicle) car model—an attractively priced basic car sold in Western Europe with a waiting list longer than many, if not all, mainstream brand cars.

> Small, fast-growing, **FOCUSED COMPANIES ARE NOT AT RISK.** Those in danger are established **FIRMS THAT CLING TO OLD ASSUMPTIONS.**

Can the big automakers serve this low-cost need simply by stripping goodies from their cars and providing as little service as possible? The short answer is no. It is impossible merely by tinkering to compete against a setup that is not only entirely specialized but also has huge (and appropriate) scale just for the low-cost market. This is an example of why specialization poses such a potential risk to leading companies in industries everywhere. The big firms may lead in overall market share, but that doesn't mean they're able to compete in multiple specialized theaters.

Modularization: specialty mineral waters and nonalcoholic beverages. Modular value chains are a big factor in specialization. They help smaller companies overcome their size disadvantage by tapping into parts of the value chains of other companies.

Take the fast-moving consumer goods (FMCG) market. Here we see many new and highly differentiated premium products being brought to market—not by giants such as Unilever, Coca-Cola, Henkel or Procter & Gamble, but by relatively small, specialty companies. The high-concept mineral waters and nonalcoholic beverages such as Fuji, POM and vitaminwater are good examples. The companies behind these products have taken advantage of modular value chains to reduce their size disadvantage as they bring their products into today's consolidated retail market.

Innovation based on this sort of modular partnership isn't easy for the market leaders to duplicate, so they often buy competitors in attractive markets—consider Coca-Cola's $4 billion purchase of Glacéau, a leader in the enhanced water and energy drinks categories, in the spring of 2007. Coke thinks water (vitamin water, smart water and fruit water) will comprise a large portion of the beverage industry's growth in North America.

FIGURE 2

Characteristics of hybrid and specialized value chains

Hybrid value chains	Specialized value chains
Focus on serving customer segments	Focus on serving specific customer needs
Cover broad scope	Cover single specialization
Leverage loading from fully serving customer segment	Leverage performance from fit with specific customer needs
Have specialization potential	Have potential to increase production significantly

Source: A.T. Kearney

Hybrid versus Specialized Value Chains

Before we dive into what to do next, let's first define the two different value chain models that are key to our argument: the old notion of a single, do-it-all value chain, which we call a hybrid, versus the multiple specialized value chains we propose as the better approach. Figure 2 shows the salient characteristics of each.

How do you know when your hybrid value chain is no longer sufficiently nimble, cost effective or powerful enough to compete against focused competitors? How do you know when there is enough potential to warrant creating a specialized chain? Here are some signs to pay attention to:

- It is difficult to find growth opportunities, yet focused competitors are gaining ground
- Internal complexity is rising, but customer satisfaction isn't
- The potential for horizontal synergies among units can no longer be ignored
- The need to find external partners is increasing, but there seem to be more obstacles than opportunities
- Channel conflicts and price cannibalization are on the rise
- Customers are being cherry-picked, their loyalty is eroding, and competitive RFP and tender situations are on the rise

Companies exhibiting such symptoms may nonetheless be tempted to stay with their hybrid chain rather than take on the seemingly high-risk exercise of developing specialized chains. Such a radical shift would require building a new, nontraditional organization and governance structure, questioning the scale versus scope argument, pursuing new customers for the newly specialized chains, and managing many more interfaces. Yet customer expectations are likely to diverge further, and once specialized competitors are allowed to reach scale, they will be hard to compete against with an existing hybrid chain.

It may likewise be tempting to believe that the symptoms of an overstretched hybrid chain can be resolved simply by getting bigger—as if mergers, acquisitions and organic growth alone could somehow compensate for the lack of specialization. It's true that increased scale can help in certain ways, such as by reducing fixed costs. Yet the real benefit is that it can help make the transition to specialization easier, so long as it's done with that goal in mind. In other words, the company is growing parts of the chain specifically because it plans to specialize there later on.

This phenomenon can be witnessed in the packaging segment of the pulp and paper products industry. Fragmented a decade ago, it has since experienced considerable consolidation, which has allowed the leading firms to specialize their paper-making machines and corrugators for better efficiency, even as they expand their combined offerings to customers.

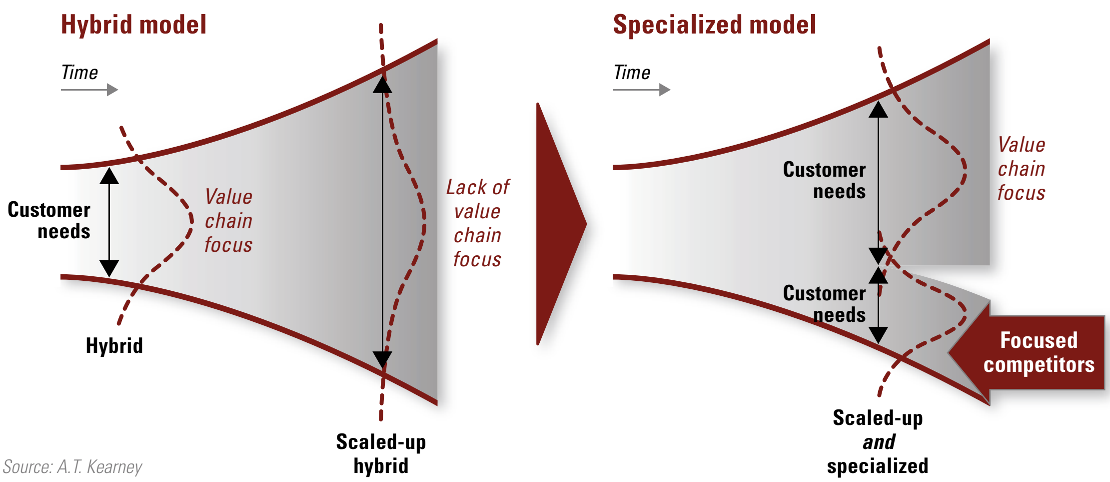
Redefining Customer Centricity, Orchestrating Cannibalization

Central to our strategic plan is understanding two aspects of specialization that pose particular challenges, especially for established companies with a long history of success.

First, customer centricity has to be redefined. Instead of trying to figure out how to serve existing customers better along the same lines, the focus shifts: Now it becomes a hunt to uncover a specific and previously unserved need *within* the large population of existing and potential customers *(see figure 3)*. Take the airlines again. Ryanair, easyJet and Southwest didn't look for customers around specific hubs. Instead, they targeted attractive routes and thus customers who might have an interest in

FIGURE 3

Specialized model targets specific customer needs



Source: A.T. Kearney

flying these routes with no frills. For a network carrier, such a switch would represent a radical departure from the decades of building customer bases around hubs and improving connections and services in line with the strategy.

This brings us to the second challenge. If a network airline decides to set up a low-cost operation, it must inevitably cannibalize its existing network operations to make the new operation a success. Mergers and acquisitions can help provide the scale needed for specialization, as illustrated by the merger that created Air France-KLM a few years ago. In the past year, Air France-KLM grew its revenues by almost 8 percent and its operating income increased almost 33 percent, according to its 2006-2007 annual report.

Planning for Specialization

Given the importance of value chain specialization, the need is obvious for a plan detailing where and when parts of the value chain will have to be specialized, and how business improvements will fit in along the way. The following outlines a plan for specializing a company's value chain.

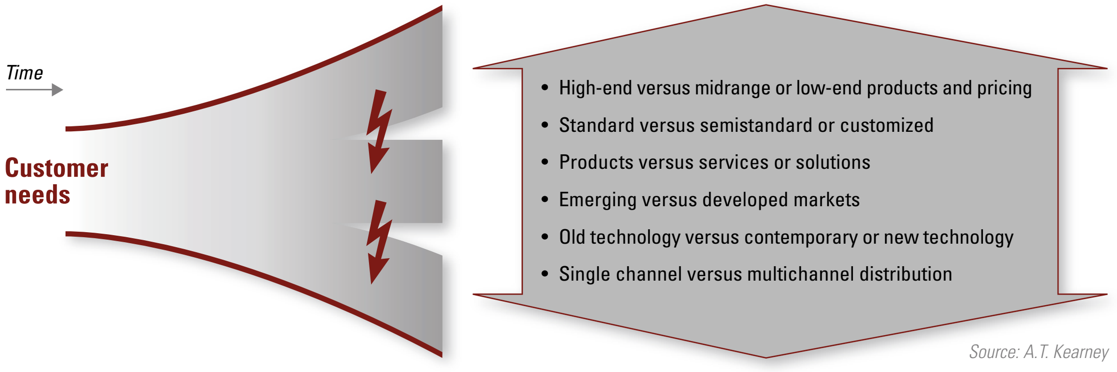
Explore customer segments by customer needs. The first step is to determine the different customer segments that would potentially benefit from increased value chain specialization. A pragmatic approach is to explore definitions of customer needs along any of several axes, asking in each case how an idealized value chain might differ from today's hybrid chain. Figure 4 illustrates some typical dimensions to consider.

Another approach is to assess the competitive playing field, looking for focused competitors gaining market share. They are likely doing something right, and most likely through a less-compromised value chain. Also, search for emerging needs that are not yet major forces. It may be that there isn't yet a specialized value chain to cater to them effectively.

Develop stand-alone business plans. Once you've identified customer needs that can be served substantially better via specialization, the next step is to define what optimal, stand-alone businesses might look like if built around such specializations. Where could potential customers be found? What sort of processes would be required? Where should the center of gravity for governance be? What would be the optimal

FIGURE 4

Customer needs diverge along several dimensions



Source: A.T. Kearney

scale requirements? This sounds difficult, but needn't be if the customer-need segments are well chosen. In fact, relevant competencies and performance requirements can be quite obvious. In many cases, a great deal can be learned from studying setups that have been successful in other industries.

Determine the company's position. With the ideals defined, we must look again at the starting point, comparing the company's current position with the potential specialized businesses. Several aspects will influence the outcome of this comparison. For example:

To what extent are customer needs targeted by the specialized businesses already present in the existing customer franchise? More overlap provides a good starting point, but implies more cannibalization. It also represents a risk that other competitors may move in on your customers through similar specialization.

Is the company positioned to drive the specialized business? Does it have the resources, culture and skills to do so? What partnerships will allow for access to the required skills and resources?

How will the likely competitive dynamics play out? Which companies are likely to target the specialization potential? Will they be able to create significant competitive advantage quickly?

Plot an actual course of action. Reslicing and resizing a company based on differentiated customer needs is clearly a major transformation. It entails communicating clearly about the newly diverging products or services, and tactfully resolving the differences in culture and resources among various business units. Remember, too, that the depth of value generation may vary substantially from one specialization to another. For example, managing the value generated by third parties might lie side by side with deep vertical integration, and they all depend on market and company life cycles, and available resources and competencies.

Saying Goodbye to the Village Store

Reconsidering the alignment between segments of current or future customer needs and the company's degree of value chain specialization can represent an important source of growth and value for established firms and new entrants alike.

We are not alone in arguing this. The most significant voice is that of customers, who have learned to value new experiences nearly as fast as companies can invent them, and who seem unlikely to revert any time soon to older, simpler ways. To return to the metaphor we began with, if our customers have said goodbye to the village store, then so must we.

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