We all know that sustained superior performance is no accident. How do the best companies keep their value high? Peter Cohan believes it’s all tied to managing a cycle.
Federal Express, Airborne Express (now part of DHL), and Genentech are three powerhouse corporations, each successful in its own way. However, it can be shown that, whether consciously or not, they employ a Value Cycle to spur their success. As with many management models that elucidate complex processes, some initial defining of terms will help you to use the concept in your own business. The Value Cycle articulates a broadly applicable management process for achieving and sustaining superior performance; specifically, it ties together:

**Value**, which refers to an organization’s ability to exceed the specific needs of its customers. The concept of a customer can be more complex than it appears. For a consumer products company, for example, a firm may have two sets of customers – the retailers who purchase its products directly – and the consumers who buy the firm’s products from the retailers’ shelves. To create value for these two sets of customers, the firm must understand each set’s distinct needs. For example, while the retailer might list its top three requirements as high profit margins, rapid shelf stocking and generous cooperative advertising budgets, the consumer’s top needs might be the product’s excellent taste, low price, and recommendation from family members. To create superior customer value, a firm would need to exceed its competitors’ performance on each of these attributes.

**Cycle**, which refers to an important notion that in most industries, firms are continually investing to upgrade the value they create for customers. Moreover, new entrants backed with innovative technology may seek to upend the firm’s basis for creating customer value. Furthermore, over time, the needs of customers and/or the relative importance of their needs may evolve. Thus, while a firm may provide superior customer value at a given point in time, the goal of the Value Cycle concept is to help firms sustain that leadership. Moreover, a firm’s initial success may lock it into ways of thinking about value creation that impede its ability to adapt to change. And the concept of the cycle helps managers focus on the need to clear away maladaptive mental habits.

**Performance**, which is deliberately vague at this point in order to enable managers of both for-profit and non-profit organizations to use the Value Cycle. Superior performance for shareholders of public companies is measured by long-term return on equity and shareholder value creation. By contrast, while they must take in more cash than they spend in order to survive, non-profit organizations measure performance in non-financial terms based on how well they achieve their stated missions. As illustrated here, the Value Cycle consists of three nodes: customer needs, firm activities and relative profitability – and three connecting processes: value creation, value capture and value renewal.

The Value Cycle’s ambition is to articulate a broadly applicable management process for achieving and sustaining superior performance.
their unmet needs the satisfaction of which could provide the firm with a chance to enhance its competitive position.

**Firm activities**, the ways the firm performs business functions - such as hiring, purchasing, research, inbound and outbound logistics, manufacturing, sales and service. Managers can benefit in choosing how the firm should perform these activities by understanding how competitors perform them. Such understanding can yield insights such as ways to improve how the firm operates and its areas of competitive weakness, the bolstering of which can help the firm improve its long-term performance.

**Relative profitability**, which compares the firm’s profitability for a typical product with that of a competitor’s. This relative profitability analysis should identify how much of the product’s costs are consumed by performing each of the activities detailed above. The analysis should further compare the firm and the competitor’s product prices and profit margins. Managers can use this relative profitability analysis to pinpoint specific competitive advantages and vulnerabilities in its approach to setting prices and managing the factors that drive its relative cost position. These insights can help managers make pricing and cost management choices that will improve the firm’s long-term performance.

The nodes of the Value Cycle are useful starting points for creating, capturing and sustaining value. However, in order to sustain superior performance, managers must create connecting processes that link the nodes through repeated rounds of competition:

- **Value creation** is how the firm configures its activities to deliver superior value to customers. In general, firms can configure their activities to create value through two generic strategies, low cost and differentiation. A low-cost strategy is particularly useful for customers who place a high priority on purchasing an adequate product or service at the lowest possible price. By contrast, a differentiation strategy is effective for customers who are willing to pay a price premium to buy a product with other attributes, such as the highest quality and the best after-sales service. For such firms, value creation requires managers to configure activities, (such as product design, purchasing, manufacturing, marketing and service) in order to deliver the best quality and service in the industry.

- **Value capture** is the way the firm sets its prices and costs to earn a profit given the way it chooses to perform activities. The generic strategies are similarly useful for understanding value capture. For low-cost strategy adherents, value capture requires managers to manufacture and distribute the firm’s product at the lowest unit cost in the industry so that the firm can set the lowest price and still earn a profit. And for firms pursuing a differentiation strategy, value capture generally leads a firm not only to incur higher relative costs but also to charge customers a far higher price, thus enabling the firm to earn attractive profits.

- **Value renewal** is how the firm invests its profits and learns to create customer value as customer needs change, new competitors emerge and innovative technology hits the market. When a company can renew its market value, it usually draws on one or more of four sources of advantage: entrepreneurial leadership, open technology, boundaryless product development or disciplined resource allocation.

Before getting into specific examples of how the Value Cycle actually works, it is important to emphasize the critical importance of clear linkages between the nodes:

In order to sustain superior performance, managers must create connecting processes that link the nodes through repeated rounds of competition.

To illustrate how companies use the Value Cycle, let’s examine the three companies I mentioned earlier; for each company demonstrates an effective use of one of the three linkages just outlined.

**Value creation at FedEx**

In 1993, the express mail industry in the US featured three leading competitors: Federal Express, UPS and Airborne Express. These firms positioned
themselves differently within the industry. While Federal Express offered a higher-priced service based on its heavy advertising and timely delivery, Airborne Express tailored its service to the specific needs of business customers who outsourced their logistics to the company, such as low price and reliable delivery.

To create value for these different groups of customers, Airborne Express and Federal Express performed their activities very differently. Generally, Federal Express spent heavily on advertising, information technology and newer airplanes in order to set and satisfy high customer expectations for quick delivery and to justify a price premium. By contrast, Airborne Express set itself up as a low-cost operator with its own airport, used planes, a mix of airplane and truck delivery, no national advertising and selective technology investment. As a result, Airborne Express was able to sell its service profitably while charging 20 per cent less than Federal Express did.

Value capture at Airborne Express

These different approaches to value creation produced very different cost structures for each package the two competitors delivered. Business strategists must be able to describe specifically how their choices about activities translate into prices and costs at the activity level for each unit of product or service. This ability is important because it is an effective way to identify a firm’s competitive position and to take action to defend strengths and bolster weaknesses. It’s helpful to see graphically how each company translated its strategy into prices and costs (see figure 1).

The table below summarizes how Airborne Express’s $1.67 per-package cost advantage over Federal Express results from the differences in the way the two firms performed the activities mentioned above.

<table>
<thead>
<tr>
<th>Activity</th>
<th>Airborne Per-Package Cost Advantage/(Disadvantage)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Package Pick Up</td>
<td>$0.30</td>
</tr>
<tr>
<td>Long-Haul Transport</td>
<td>$0.56</td>
</tr>
<tr>
<td>Delivery</td>
<td>$0.29</td>
</tr>
<tr>
<td>Advertising</td>
<td>$0.22</td>
</tr>
<tr>
<td>Sales</td>
<td>($0.09)</td>
</tr>
<tr>
<td>Overhead</td>
<td>$0.39</td>
</tr>
<tr>
<td><strong>Airborne Total Cost Advantage Per Package</strong></td>
<td><strong>$1.67</strong></td>
</tr>
</tbody>
</table>

Here’s how Airborne Express achieved the difference; it saved:

- $0.30 due to more efficient package pickup procedures. Since Airborne used lower-paid contract labour for 65 per cent of its packages, it paid 10 per cent less than Federal Express for its pickup labour. Furthermore, Airborne Express enjoyed a 20 per cent labour-cost advantage, since it picked up more packages at each stop than did Federal Express.
- $0.56 due to more efficient long-haul transport processes. Since it shipped 15 per cent more of its package volume by lower-cost truck, rather than airplane, Airborne Express enjoyed a 67 per cent cost advantage over Federal
Express in its long-haul transport. Moreover, Airborne Express gained other cost advantages due to its airplanes being 80 per cent full (versus 65 per cent for Federal Express) and its freedom from paying landing fees, since Airborne owned its own airport.

- $0.29 due to more efficient delivery. Airborne Express enjoyed a cost advantage in delivery for the same reasons as noted above in the pickup analysis.
- $0.22 due to lack of advertising. Since it did very little advertising, Airborne Express enjoyed a 22-cent per-package cost advantage over Federal Express, which advertised extensively. This advertising contributed to Federal Express’s ability to charge 20 per cent more to deliver a package than Airborne Express.
- ($0.09) resulting from its larger sales force in proportion to its package volume. In sales, Airborne Express had a cost disadvantage relative to Federal Express because it wanted to establish personal connections with its corporate clients.
- $0.39 due to lower overhead. Airborne Express disdained waste and as a result it kept its overhead at a relatively low 8% of revenue.

These details illustrate that management can make choices about how to perform activities that contribute both to how a firm creates value for its customers and how it captures that value in the form of price, cost and profit margin advantages vis-à-vis its competitors.

Value renewal at Genentech

Genentech, the biotechnology company, excels at value renewal. Perhaps no statistic testified more eloquently to this than Genentech’s June 2005 $83 billion stock market value, which exceeded Merck’s by $12 billion – a company with five times Genentech’s revenues. At 18 times revenues, Genentech was valued more highly than any leading publicly traded health care company in the eight sectors analyzed in this study. For the decade ending that month, Genentech’s stock was up 11-fold; in the five years ending that month, its revenues had climbed an annual average of 21 per cent and in the 12 months ending in June 2005, Genentech earned a 21 per cent net profit margin on $4.2 billion in revenues.

Although I have no reason to believe that Genentech has ever heard of them, it appears that the company nonetheless uses the four sources of advantage I mentioned earlier:

First, it excels at entrepreneurial leadership by:
- Hiring top scientists Genentech’s CEO, Arthur Levinson, studied with Nobel Prize-winning scientists and could have had a successful academic career. Levinson created a university-like environment that attracted other top scientists.
- Driving scientific initiative through self-selected projects Genentech encourages its researchers to spend 25 per cent of their time on projects of their choosing (compared to an industry average of 10 per cent). In 1988, a Genentech scientist, Napoleone Ferrara, became interested in anti-angiogenesis, a process for choking off the blood supply to cancer tumours. His research led to Avastin, which was approved as a colorectal cancer treatment in 2004 and is expected to reach $3 billion in peak sales.
- Using peer recognition to motivate innovation Levinson believes peer recognition is a key motivator for researchers, and he gives them the opportunity to build a reputation for themselves. Genentech, unlike pharmaceutical companies, encourages employees to publish in-house research work in scientific journals. Pharmaceutical companies don’t want any of their findings to get out until they’ve got a patent. According to Levinson, by that time, the work is no longer ground-breaking; no one cares about it any more.

Second, it utilizes open technology by:
- Partnering to obtain technologies that its customers want Genentech has forged over 100 partnerships in which it licenses technologies that form the basis of significant revenue-generating products. For example, Genentech worked with Idec Pharmaceuticals, before that company merged with Biogen in 2003, to develop Rituxan, a blockbuster that generated $1.6 billion in 2004 sales.

Third, it employs boundaryless product development by:
- Using genomics to re-engineer drug discovery Genentech created the Secreted Protein Discovery Initiative that generated five exciting product
leads, including a surprising antiviral molecule, and could spawn as many as 20 more within two years. The project (called Speedy by company insiders) re-engineered Genentech's traditional approach to research, in which scientists worked alone or in tiny teams. Under the assembly-line-like Speedy process, 80 scientists, a quarter of the Genentech's research staff, search enormous gene-data warehouses. Traditionally, scientists chased drug leads, known proteins like insulin and growth hormone, by synthesizing them into marketable products. Today, drug prospects are more likely to lie within the human genome and are found with the help of computers. With Speedy, Genentech simplified the task by focusing on the 10 per cent of all proteins that travel outside the cell, blocking or spreading disease. Those 10,000 proteins are identified by using high-tech screens called signal sequence traps (SSTs), and then run through tests to determine their therapeutic benefits.

Lastly, Genentech manages disciplined resource allocation by:

- **Focusing on areas of therapeutic expertise**
  Levinson analyzed the drug industry and concluded that companies with a therapeutic focus earned higher shareholder returns than less focused competitors. After Levinson became CEO in 1995, he concluded that Genentech could best profit from this insight by focusing primarily on cancer treatment.

- **Setting tight deadlines and beating them**
  In early 2005, Genentech was in a race against Novartis to complete Phase III trials for using Avastin to treat a specific lung cancer. Genentech worked so quickly that Avastin achieved its goals for the Phase III trials by March 2005, effectively eliminating competition from Novartis, which had moved much more slowly and ultimately found that its product was no more effective than chemotherapy. Genentech is not above using financial incentives to encourage workers to meet deadlines. In 1998, Levinson promised employees "Genenchecks" of $3,000 or more if they beat an FDA marketing application deadline for Herceptin, a breast cancer drug.

- **Killing development projects which lack tight scientific justification**
  Levinson can be brutal in killing projects he thinks are going nowhere. His presence at Genentech's weekly science meetings is as much feared as appreciated because the CEO takes pleasure in asking tough questions. Genentech will not move compounds into clinical trials (which cost between $30 million and $100 million) until scientific arguments for pursuing the drug are able to withstand Levinson's intense scrutiny. And, unlike some competitors, Genentech routinely designs drug trials to prove that its therapies extend the lives of patients, an exacting standard that is arduous and time-consuming but which tends to convince even sceptics when the results are positive.

The Value Cycle is a powerful way to articulate an organization's ability to create and sustain benefits for its constituents while generating sufficient surplus to survive. Few organizations have thought through all the managerial choices required to create an effective Value Cycle. However, the examples presented here and the methodologies described are intended to illustrate the benefits of the Value Cycle and the means of capturing those benefits.

**Resources**


Strategy Lecture by Babson College Professor U. Srinivasa Rangan.

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