

**EUROPARTNERSHIP WHITE PAPER**

**Using performance drivers  
in scenario based models**



**Helping you to chose a way forward in an  
uncertain environment**

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## SUMMARY

Scenarios allow teams to model the “unthinkable”. We have experience of teams making market exit decisions; of pricing and offer-enhancement moves that would have seemed too risky without the customer insight; and technology choices for future products. Team based scenario testing of strategic alternatives means people are able to convince themselves and others that “We have genuinely looked at all our options and that this is the play to which we commit ourselves.”

**Europartnership's “Performance Management Toolbox” Series examines approaches and tools that can be deployed when implementing change and improvement programmes. Our aim is to bring together leading practice from around the World in an easy to read set of articles.**

## Using performance drivers in scenario based models

What approaches are open to companies facing relentless pricing pressure and stagnant revenues? Traditional market research has limited value for identifying and exploiting new growth opportunities. We need an approach that integrates the technology and market insights with the microeconomics of both customer demand and company costs, enabling fully informed decision-making and leading to rapid implementation.

In the search for revenue growth, managers at many firms are finding that the classic combination of market research plus business case analysis falls short.

For instance, in the late 1990s a host of new high-growth businesses appeared on the scene offering a range of software applications hosting, management, and infrastructure services. These businesses, loosely lumped together under the Application Service Provider (ASP) label, were the darlings of investors. But even at the time, a discerning analyst could see that the initial value proposition for much of the industry—“lower cost enterprise applications through IP infrastructure”—was going to run out of steam quickly. Companies that were focused on large-scale, low-cost rental business models are finding that they lack differentiation and do not add compelling value to customers.

By contrast, other ASP players focused much more carefully on understanding customer needs beyond low cost:

- Creating new applications closely tailored to particular segments, not just renting knock-off versions of existing functionality, because buyers put more value on functionality than cost alone
- Enabling smaller, more incremental levels of service instead of a wholesale shift to applications rental, because buyers wanted to mitigate the risk of shifting to a new service delivery method
- Innovating the applications management business, because buyers had a large unmet need for guaranteed access to scarce skills, superior service levels, and leading methodologies

The companies that were willing to evolve their original value propositions by looking deeper into customer requirements are the ones that survived the crunch.

Trying to anticipate how demand is shifting is a tricky and risky proposition. Managers have to make big bets on new offer development, tactics to increase market share profitably, or efforts to differentiate from the low-cost competitor. They need better answers than garden variety market research can provide. And they need not just the right answer but also a more effective process to reach consensus, so as to execute the strategy quickly and successfully.

Fortunately, new customer science methodologies allow companies to integrate the insights and microeconomics of both customer demand and company costs, enabling fully informed decision-making with minimal risk. There are hands-on decision support tools that allow managers to test scenarios, get everyone on the team to see where the greatest value lies, and quickly redeploy resources to capture growth opportunities. These methodologies have allowed companies in numerous sectors to achieve significant growth in revenues, margins, sales close rates, and average deal size.

**Don't just know who your customers are – get inside their heads**

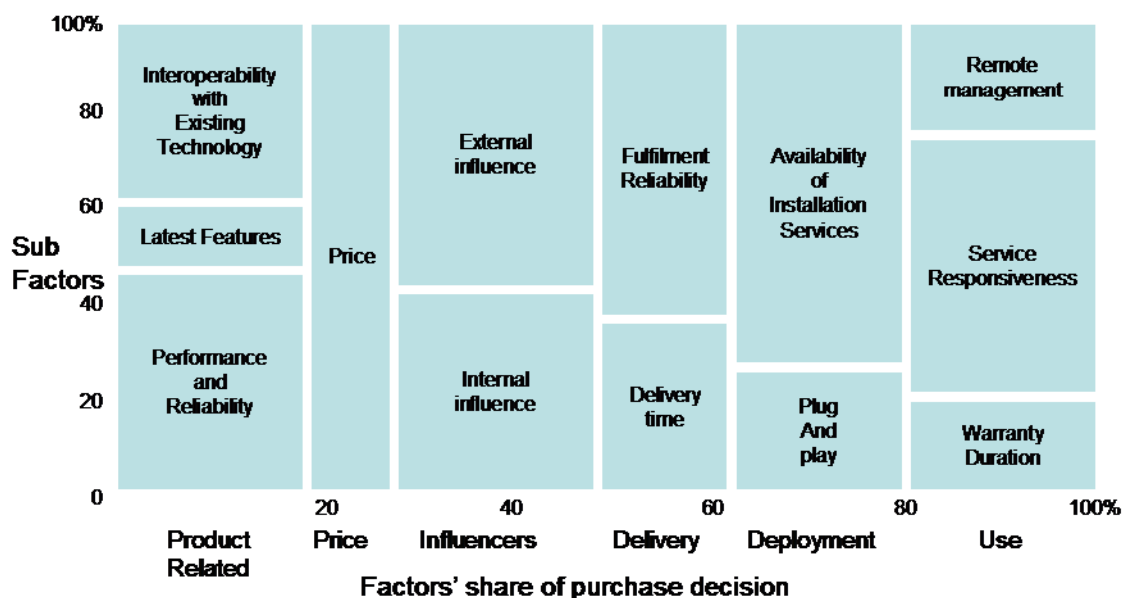
When sitting at the negotiating table, customers like to talk about two things: price and product features. Price and features always matter, of course. But if you can get inside the customer's head and understand how buying decisions are really made, you'll often find other important considerations.

For the manager at an insurance firm buying computer servers, these considerations might be reliability, ease of deployment, and maintenance and service arrangements. For a contractor buying cement or a printer buying paper, a key concern might be certainty of delivery date, which is worth even more than a shorter delivery cycle. For a consumer buying a new entertainment service, brand and neighbourhood word-of-mouth may trump price and promotion.

In choosing products and services, moreover, buyers often listen to the users inside their organization, to functional peers in their own and other industries, and to expert analysts at trade magazines and rating firms. Cumulatively, these influences may account for 70% to 80% of the purchase decision, as (illustrated below). Even knowing this, many companies still spend 80% of their effort on optimizing price and product features, they are missing the great majority of the drivers of their market's demand.

That's why there is gold to be mined by truly understanding the customer's world. For many companies, the traditional product-centred sources of revenue growth have run out of steam as product markets have become saturated and product innovations create only short-lived opportunities. Even in high-tech markets, the hot product is quickly copied by tenacious competitors or surpassed by the next wave of innovation within a couple of years.

But managers can find broader growth opportunities when they move into market spaces surrounding the core product, offering benefits such as improved operating efficiency or reduced risk. Addressing this rich lode of value downstream from the product typically opens up larger markets with higher margins. The trick is to cut through the day-to-day business of transactional negotiations and find out where these unspoken opportunities lie.



***Decision factors for a technology product go beyond features and price***

## How market research falls short

While market research and brand tracking studies are useful starting points, they're not sufficient to identify and exploit new growth opportunities. There are several limiting characteristics of market research:

- *Detached from the business economics.* Demand research rarely links directly to the economics of the business. For example, a won/loss analysis that surveys customers might arrive at the answer "Our company is difficult to do business with." Separate queries about the problem then go to the finance and marketing departments, and someone else cobbles together a possible fix. No one defines exactly what the customer means by "difficult to do business with," what the important processes to change are, what that would cost, how many new contracts the changes would yield to the top line, and, therefore, what they're worth in additional profits.
- *Descriptive, but not useful for action.* Marketing insights can be very descriptive about customer segments, but they're often not prescriptive about what the business should do differently in order to serve those segments more profitably.
- *Short-sighted.* Market-sensing resources within companies typically focus on customers' current needs and satisfaction levels with existing offers. Rarely do they systematically look at what's next in terms of customers' emerging priorities.
- *Arm's length.* Market research activity is too far removed from the day-to-day managers of a product or line of business. Like the parlour game of "telephone," by the time a problem gets divvied up into piece parts, handed off to internal marketing intelligence staff or external researchers, studied, and communicated back to the managers, the odds of receiving the right answer to nuanced questions are low.
- *Fragmentary, not transformative.* Multiple market research activities sponsored separately by sales, product development, corporate marketing, and other functions yield a fragmented and often contradictory mosaic of data. Naturally, any set of data can be challenged, so meetings devolve into arguments over the data, participants take away the fragmentary factoids that fit with their preconceptions while rejecting evidence to the contrary, and research findings gather dust on the shelf. The company never arrives at a transforming insight.

## The Customer Value Engineering approach

So how can companies move beyond these limitations? Firstly, by using knowledge about their customers and applying the drivers of business economics. Secondly, by building consensus through pooling the entire management team's knowledge – challenging the folklore about the customers' behaviour and the dynamics of the market.

One pioneering approach, Customer Value Engineering, has helped managers and corporate strategists capitalize on proprietary insight about the next major sources of value for customers and for shareholders. Customer Value Engineering goes beyond market research to uncover what customers will value and actually pay for, links these insights with the economics of the business, and creates a process for building consensus and driving rapid implementation.

A Customer Value Engineering approach combines the insights and microeconomics of both customer demand and company cost as follows.

### **1. *Uncover the drivers of demand.***

Add in a tool such as Strategic Choice Analysis® (SCA). This can help get inside the customer's world to uncover which considerations actually drive demand. SCA asks customers to make informed choices by employing rich multimedia simulations that bring to life realistic decision-making scenarios customers are likely to face, complete with alternative products, services, performance levels, and influencers. This allows companies to derive what is truly valued by customers based on the choices and decisions that they make, in stark contrast to garden-variety market research techniques that ask customers to merely *state* what is important to them by ranking their needs, often without considering the decision-making context.

Ultimately, this approach can quantify the importance of brand, outside influencers, downstream services, or other considerations. The key is to identify the right questions (so outcomes can be acted upon), the right way to ask those questions (so customers reveal what makes them tick), and to have the interpretive skills to derive what customers truly value.

To illustrate this methodology, consider a study conducted in the Internet access market in 1996 (just about the time that America Online (AOL) had acquired its one millionth customer). The study focused on consumer selection of Internet Service Providers (ISPs). Specifically, the aim was to understand what customers value when they select their ISP and how company offerings might be more attractive. 2,000 U.S. consumers were asked to make choices in a variety of market scenarios where competitive alternatives are arrayed with various combinations of prices, monthly fees, and hours included.

Econometric model were used to undertake various strategic analyses. It was possible to model the effect of changing price plans (unlimited or fixed usage) and price levels. This supported predictions about which competitors gain or lose share as each company changes price. The allowed simulation to look at the results of attack and counterattack.

This work proved remarkably prescient in predicting the evolution of the Internet access market during the few years after 1996. The study showed that even by 1996, AOL had built a powerful brand, measured not just in awareness but also in its ability to influence customer choice. It appealed to ordinary rather than sophisticated users of the Web. Perhaps most important, our research showed the popularity of unlimited-usage pricing plans, even prior to the existence of such plans. In late 1996, AOL moved to a \$19.95 unlimited plan, creating such demand that it swamped AOL's networks with eager Internet users—exactly what the SCA predicted.

### **2. *Segment in a smarter way.***

In some consumer industries, companies have become adept at highly segmented customer acquisition and retention—for example, in financial services (American Express, Citigroup, CapitalOne) and packaged goods (Coke, Pepsi, Proctor & Gamble). Whilst firms in many other industries, especially the business-to-business sector, are content with basic segmentations based on revenue, number of employees, or industry category.

While segments like “small banks” or “businesses with more than 1,000 employees” may be easy to locate in the market, they reveal nothing about the different evaluation criteria, channel preferences, and price sensitivities of buyers within those groups. In our experience, descriptive factors such as size do matter, but buyer behaviours and priorities matter much more. Being smart about segmentation means looking at customers. Do this using value-based analysis, including customers' current profitability to the business; differences in

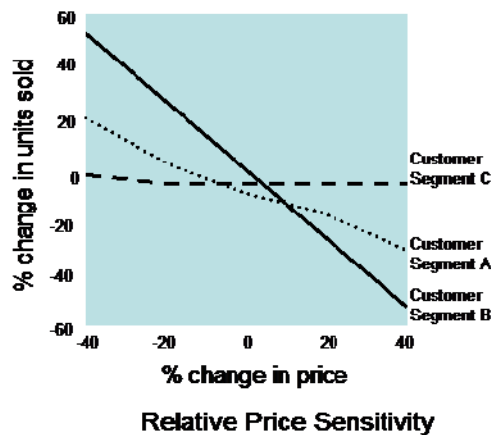
elasticity of their demand with respect to all offer elements; and their prospects for future growth.

Consider a business product manufacturer. Its managers had a long-held belief that their products, while integral to their customers’ operations, were essentially a commodity. That is, all buyers used the products in the same way, and they all comparison-shopped based on price and functionality. There was some slight variation in requirements by company size and industry, but that was it. The challenge was to identify the right amount of functionality to add to the next release of this product in order to maintain market share and minimize price declines.

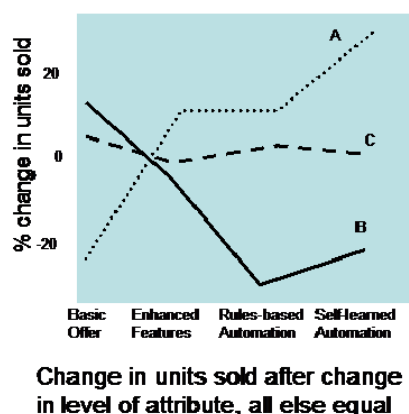
In reality, the market, which managers saw as a homogeneous mass, was in fact sharply divided along almost every important dimension. A more detailed picture emerged by using a quantitative survey of buyer needs, attitudes, and economic trade-offs. The company was able to identify groups of customers with very different price sensitivities - and realised their “one size fits all” pricing model was leaving money on the table with some customers and losing them share among other customers. Certain features were highly valued by some customers and not at all by others. It was possible to tweak marketing and sales operations to get the right offer to the right segment. Finally, different groups of customers had different preferences among the channels they wanted to use to learn about the company’s products, buy them, and then maintain their post-sale relationship.

	<b>Segment A</b>	<b>Segment B</b>	<b>Segment C</b>
<b>Preferred channel to learn about products</b>	Self reliant. Heavy use of web	Reliant on peer references and retailer/channel recommendation	On-line product comparison sites
<b>Preferred channel to buy</b>	On-line purchase. Self install	Visit retail outlet. Live sale. “Do it for me” installation	Direct sales representative
<b>Preferred channel to maintain relationship</b>	Dedicated free call number. Self help from supplier’s website	Low touch. Moderate customer service level required	Multiple Channels: Web; free phone; direct sales rep calls.

**Customers have different channel preferences...**



*...and very different price sensitivities...*



*...along with marked differences in their responses to the package on offer*

By combining these insights about channel preferences, price sensitivity and offer requirements, managers are able to understand the current and potential profitability of their customers and prospects with a far greater degree of precision than their competitors - and to develop superior value propositions for each key segment. As a result, this line of business has moved from commodity margins to a more profitable model.

Linking the information about each demand driver directly to the variable costs of the business answers questions such as: If the brand matters most, where should we invest to improve brand equity and what will it cost? If external influencers matter, should we shift the marketing mix away from golf tournaments and toward better relations with trade journalists? If customer acquisition cost determines most of the lifetime value of that customer, how do we adjust our channel mix to ensure a profitable relationship? If customer service matters, what exactly merits investment—a shorter wait on the phone, the knowledge of call centre representatives, or the speed of technician response? If the customer is asking for next day delivery, what are the economic implications?

### **3. Create a dynamic, robust strategy model.**

In order to answer the “what if” questions, the key value drivers and business economics data need to be built into a representation of the company’s business. Simple “models” can be constructed using spreadsheet software. More sophisticated models are found in proprietary tools such as Interactive Strategy Model™, or ISM.

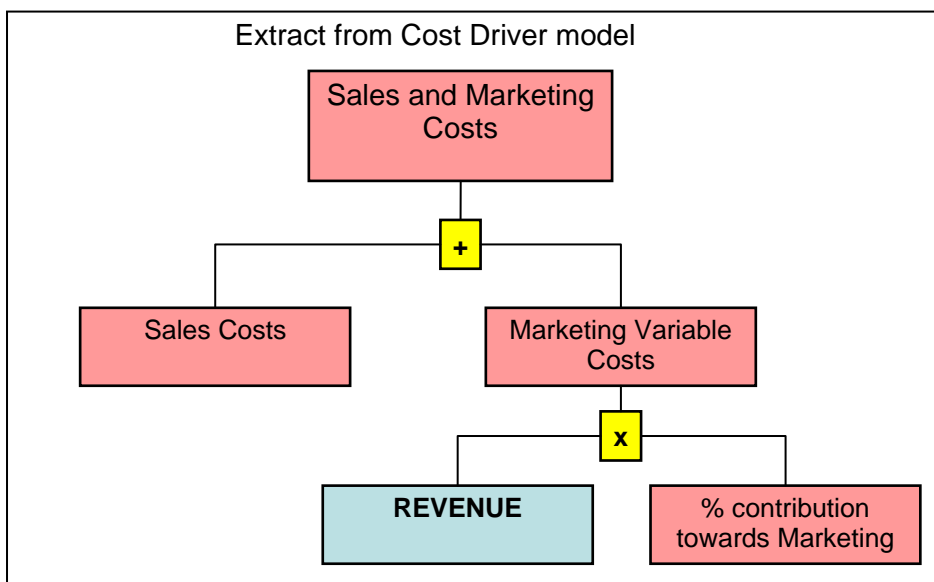
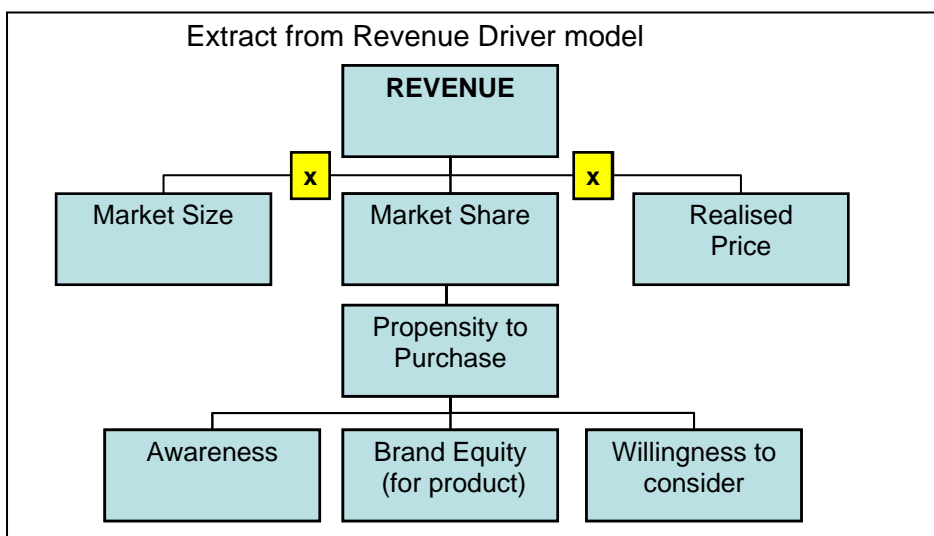
Managers can use the models to evaluate the impact of possible initiatives or actions on various financial metrics. Further, how countermoves by competitors will affect any given strategy.

This allows stakeholders to understand the relative value drivers, evaluate “what if” scenarios, and rapidly turn strategy into action with a minimum actual risk to the business. The technique equally supports decisions of a long-strategic nature, or specific short term issues such as pricing and product offering.

We can illustrate how a model is really the only way to support “what if” or “scenario” discussion. Taking a very small extract from a business model that has been configured work interactively, we can vary the performance drivers to follow, say, three scenarios – ‘retrenching’, ‘prudent’ and ‘aggressive’. The details are determined by the team responsible for managing the business and their assumptions about each are recorded as part of the

process. Note in the illustration, the impact that the assumptions have on REVENUE. Yet, because in this business, marketing costs are determined as a % of revenue, the cost implications are directly updated. Sophisticated models run to literally dozens of interacting drivers.

Performance Driver	Retrenching	Prudent	Aggressive
Market Size	12m	12m	12m
Market Share	10%	12%	15%
Realised Price	10	11	12
REVENUE	12,000,000	15,840,000	21,600,000



The illustration above assumes that the organisation can both increase market share and realised price at the same time...there may be some question about this combination of assumptions - and perhaps some other scenarios to be explored! What we can see is that the discussion on how market share will evolve will be informed by discussion of the how the

drivers evolve. Further, once the revenue from a scenario is established, the impact on costs e.g. contributions based on % revenue, are calculated through the model.

Two real life examples illustrate how the approach helps to grow a business through long-term strategies as well as short-term moves.

### **Illustration: Exit or reinvent?**

In the first case, a global technology provider had been eking out a 1% profit margin in a line of business that had become relatively commoditized. Widely viewed as the high-cost player, the firm was losing profits faster than it was gaining market share. Managers were at the point of deciding whether to exit or remake the business.

Customer Value Engineering was applied to the problem. The first step was to engage 1,100 buyers of the products in question with a simulated decision exercise. From that data, we built a customer segmentation scheme, quantified the incremental cost required to drive incremental demand in each segment, and tested various strategy scenarios. Critical to the project's success was leading senior management through a series of competitive scenarios, gaming out moves and counter-moves to develop a dynamic strategy for sustainable growth.

Based on the analysis and scenario modelling, the firm shifted resources away from product features and toward post-sale services such as remote monitoring and fault detection. The additional value discerned by customers justified an increase in price and led to an incremental \$500 million in potential revenue, plus an additional 4 percentage points of margin during the first year.

### **Illustration: Gaining visibility to end users**

In another recent case, a multinational networking product and service company was looking to grow its share among small- and medium-size businesses. In this highly competitive market, the firm was bracketed by low-cost, down-market established players and higher-end, strongly branded newcomers. Being heavily reliant on third-party distribution channels, the management team had limited insight into buyer needs and preferences.

Based on anecdotal evidence, managers believed that their offerings were overpriced relative to the market.

In fact, examination of the customer value proposition revealed multiple customer segments that had distinctly different price sensitivities and offering requirements. This allowed development of separate scenarios for each customer segment and then engage the management team in depth, sharing our findings in detail and exploring scenarios and sensitivity analyses as a group. These working sessions produced a series of offensive and defensive moves that could be relatively quickly implemented.

The company has lowered prices in some segments, while in others it has focused on adding features and service assurance that make the product more valuable to customers rather than on dropping price.

As these experiences suggest, understanding the customer value propositions offers three important benefits beyond a better understanding of demand:

- *It provides a deeper understanding about what drives revenue growth.* Focussed surveys help generate detailed insight into how much customers value different elements of an offering. Managers can test both direct offer elements, such as price

- *It integrates demand and cost into an interactive profitability model.* To be truly useful, the drivers of demand must link directly to the variable cost drivers required to generate that demand. Businesses can build these links across the full spectrum of key internal stakeholders, marketing initiatives, channel requirements, and variable cost of goods sold. The resulting data can be model a range of moves that will grow value, from short term pricing tactics to longer-term moves, such as becoming the leader in ease of use.
- *It builds consensus rapidly.* The process is inclusive and cross-functional from the outset. The sales force, marketing, corporate strategy, product management, product development, and other teams should be engaged early on to ensure that the firm is testing the full range of relevant questions. This helps avoid the classic trap at the end of the process in which a customer study commissioned by one group gets rejected by others because it didn't ask the right questions.

An iterative, workshop approach allows even a large group to work through analyses and build recommendations. All participants must have ongoing access to the assumptions, sensitivities, and exploration of alternatives so that they can challenge findings that run contrary to their expectations whilst actually running the model. In other words, no black boxes, no data hoarding, and less reliance on static research read-outs.

The inclusive and transparent nature of working as a team on the customer value proposition helps to get everyone in the organisation to channel their energies in a single direction. This approach lowers the risk of taking a new approach by raising the odds of getting an answer where value is migrating and of having a successful implementation.

Scenarios allow teams to model the “unthinkable”. We have experience of teams making market exit decisions; of pricing and offer-enhancement moves that would have seemed too risky without the customer insight; and technology choices for future products. Team based scenario testing of strategic alternatives means people are able to convince themselves and others that “We have genuinely looked at all our options and that this is the play to which we commit ourselves.”

## ABOUT EUROPARTNERHIP



Europartnership is a management consultancy that offers high quality services to clients designed to improve organisational performance.

This includes the provision of consulting services; software; facilitation; and training in performance management and strategy development.

Europartnership's skilled staff and consultants deliver ethical consulting services and work in partnership with clients to deliver continuous improvement programmes.

Our unique proposition and added value is that we work with organisations and, in so doing, transfer our knowledge and skills. Our aim is always:

**“to equip organisations to improve performance”**

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