INNOVATION

Capture More Value

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When Switzerland-based Vestergaard introduced its LifeStraw technology, it proved it could innovate. LifeStraws remove 99.99999% of bacteria and 99.9% of protozoan cysts from contaminated water. The product is a favorite of aid organizations: Over the past decade, LifeStraws have been distributed after almost every disaster.

But not every place with bad drinking water is a relief zone; 780 million people in the world lack access to clean water in their daily lives. So Vestergaard saw a much larger potential market than its NGO customer base—and proved that it could innovate in another way. The challenge was LifeStraw's cost, which is beyond the means of most households in developing countries. The company found a clever means for families to fund their purchases: with carbon offset credits. Thanks to the worldwide carbon emissions trade, any documented Co_2 savings can now be monetized—and using LifeStraws means not having to burn petrol or wood to boil dirty water. Vestergaard's Carbon For Water initiative has enabled hundreds of thousands of Kenyan families to pay for its product, growing its business substantially.

Both these kinds of innovation—one in value *creation,* the other in value *capture*—are important. But most companies focus only on the first. Sometimes a business can get away with failing to think about value capture if it sells plenty of its new offerings through existing approaches. But when value capture goes unexamined, money is usually left on the table—and sometimes the only thing that can save a business is finding a way to capture value. This is the situation in which many publishing companies find themselves, as more consumers than ever are accessing content while revenue streams to producers are drying up. It can also confront young, new-economy businesses—for example, Facebook. With 1.3 billion active monthly users, Facebook has an undisputed ability to create value for customers. But as the highly volatile share price testifies, it is not at all clear that the company will figure out how to capture enough value to justify its hefty market capitalization and price-earnings ratio.

To benefit from both kinds of innovation, companies need to think about value capture more imaginatively and as a matter of course. In this article I'll present 15 ways I've seen firms capture new value, clustered under five focal points of change. Such a framework is an important step toward developing a common language around value capture—a concept that, like "business model reinvention," is hard for many executives to get a handle on. It should help managers identify value-capture twists that could work for them. (See the sidebar "A Framework for Value-Capture Innovation.")

A Framework for Value-Capture Innovation

A comprehensive survey of strategic moves to capture more value suggests that innovations come in 15 distinct forms.

INNOVATION CATEGORY	INNOVATION STRATEGY	EXAMPLES
CHANGING THE PRICE-SETTING MECHANISM	VALUE-BASED PRICING	• BOSSARD'S ECOSYN-LUBRIC FASTENERS
	AUCTIONING	• GOOGLE ADWORDS • GOVERNMENT AUCTIONS OF VANITY LICENSE PLATES
	DEMAND-DRIVEN PRICING	• AIRLINES' YIELD-MANAGEMENT SYSTEMS • THE BERLINER REPUBLIK RESTAURANT'S BEER EXCHANGE
	NAME YOUR OWN PRICE	• PRICELINE
	PAY WHAT YOU WANT	• PANERA BREAD'S COMMUNITY CAFÉS
CHANGING THE PAYER	TWO-SIDED MARKET MODEL	• *20 MINUTEN* • CARDEA
	CHANGING THE PAYER IN THE VALUE CONSTELLATION	• CARBON FOR WATER • SUBSIDIZED TUTORING SERVICES
	INTERNAL BUDGETING	• IMD'S EXECUTIVE EDUCATION PROGRAMS
CHANGING THE PRICE CARRIER	CHANGING THE CARRIER	• NETFLIX • NESPRESSO
	BUNDLING AND UNBUNDLING	• TELECOMMUNICATIONS • AIRLINE INDUSTRY
	ALL-INCLUSIVE OFFERING	• CRUISES

The Innovation Blind Spot

In constant pursuit of the new, businesses maintain R&D labs, conduct pilots, crowdsource ideas, use open innovation—to top managers, it may seem that investment in innovation is enormous. Yet even avid innovators often have a blind spot when it comes to value capture. They may assume that if value is created, rewards will follow. Indeed, one reason value-capture innovation tends to be overlooked is that companies that do it well often simultaneously innovate in value creation, and the latter tends to take center stage. For example, when Netflix became a mortal threat to Blockbuster, it was easy to chalk up its victory to greater value creation. And it's true that Netflix deftly capitalized on new digital capabilities to offer personalized recommendations and could avoid presenting customers with shelves picked clean of current hits. But the death blow came from the value-capture side. The brick-and-mortar incumbent's revenue model relied heavily on late fees. Netflix introduced a subscription model that milked higher revenue from the same tendency to be tardy—without vilifying customers in the process.

> Even avid innovators often have a blind spot when it comes to value capture, assuming that if value is created, rewards will follow.

Even managers who know they should worry about value capture often reduce the subject to pricing. Pricing is important, of course, and there is a rich literature devoted to managing it well. But changing a tag from $9.50 to $9.99 or running a "buy one, get one free" promotion does not constitute innovation. Value capture involves more-fundamental considerations, with greater strategic implications.

Therefore, the first step toward innovating in value capture is simply to make people conscious of it. Open managers' eyes to novel approaches like Vestergaard's and Netflix's, and the blind spots disappear. Go a step further and contemplate multiple examples, such as the ones below, and patterns emerge.

Changing the price-setting mechanism.

The first group of innovations involve the mechanism or rationale by which prices are established. The most familiar of them is *value-based pricing.* This occurs when a company stops setting prices by simply marking up production costs or calibrating against competitors' prices and instead charges according to the offering's worth to the customer.

A good example involves ecosyn-lubric, a product sold by Bossard, which supplies fasteners to John Deere and other manufacturers (full disclosure: I am a member of Bossard's board). Bossard discovered that its customers' workers were spending more time manually lubricating screws than putting machines together—with messy and uneven results. So it teamed up with a chemical company to find a way to deliver fasteners with lubricant already uniformly applied. Bossard does not disclose profit margins for individual items; however, its operating margin is about twice the industry average. It's safe to say that the substantially higher price of its lubricated screws is not based on their production cost. More likely, Bossard priced ecosyn-lubric to capture a fair share of the savings its customers experience.

The other innovations in this group begin with the assumption that value-based pricing is superior and focus on two challenges: discovering customers' value perceptions (especially tricky when perceptions vary from customer to customer) and creating a structure in which different customers are charged different prices depending on their willingness to pay.

Auctioning works well for Google. The company's revenue stream comes largely from advertisers' payments to appear on search-result pages. Rather than set prices, Google has advertisers bid for the keywords with which they want to be associated. The term "mortgage," for example, is valued to different degrees depending on banks' and brokers' priorities and budgets. An auction can quickly surface its highest acceptable price (probably upwards of $5 per click—far more than the average cost of 35 cents), and Google rewards the top bidder with maximum prominence in search results.

The downside of auctioning, as many an eBay seller has learned, is that it can result in prices that don't please the seller but must be honored nonetheless. However, auctioning can also yield prices the seller would never have had the audacity to name. Imagine charging one customer 6,000 times as much as others for the same thing—and leaving him happy about the transaction. That is what a Swiss canton did when issuing license tags for cars. Although drivers in the United States can pay a set fee for vanity plates of their own devising, the same isn't true in Switzerland, where plates are issued with consecutive numbers. However, the numbers of returned plates are reused, and occasionally the authorities get back a set so special that it seems a pity to simply hand it to the next person in line. An internet-based auction was held for the plate SG 1—the lowest number in the canton of St. Gallen—with the winner paying an astounding 135,000 francs (about $150,000). In a similar auction in Abu Dhabi, Sheikh Saeed al-Khouri paid 52 million dirhams (about $14 million) for the license tag bearing just the number 1.

> One value-capture innovation, auctioning, can yield prices the seller would never have had the audacity to name.

Demand-driven pricing lets fluctuations in aggregate demand drive changes in price. Consider the yield-management practices of airlines, hotels, and rental car agencies. Using forecasting models based on past reservation patterns, these asset-utilization-obsessed businesses can predict peaks and valleys in demand and adjust prices to maximize profitability during both. An entertaining application of the strategy can be experienced through the Bierbörse ("beer exchange") in Germany's Berliner Republik restaurant. The fact that the price of a beer changes dynamically over the course of an evening is largely a novelty—watching the monitors update in real time gives customers something fun to talk about. But it also smooths demand and averts the slow service that often comes during peak hours.

Two forms of innovation in this group let customers set prices themselves. *Name your own price* is probably best known from Priceline, whose customers stipulate what they are willing to pay to travel from point A to point B, or for lodgings in a particular locale, within a given time frame; sellers can take or leave the deal. The arrangement is akin to an auction, but with an important distinction: The amount is not disclosed to anyone outside the transaction, so airlines and hotels can hold prices generally even as they discount for incremental sales. Taking this idea to an extreme, some companies have *pay what you want* arrangements, whereby the seller must take whatever the customer offers. Given the potential for free-rider abuse, few businesses contemplate this innovation. However, the fast-casual restaurant chain Panera Bread has shown that the model can capture value. Having implemented it in five nonprofit "community cafés" over three years, Panera reports that although 20% of customers pay less than the suggested donation (and sometimes nothing), another 20% pay more.

Changing the payer.

In a straightforward world, those who consume offerings would pay for the value they receive, but in reality other arrangements often better serve consumers and producers alike. Perhaps the most familiar examples are in media businesses where content is expensive to produce and consumption is subsidized by advertisers—an arrangement known as a *two-sided market model.* Many types of businesses have relationships with consumers whom others would like to reach; they could probably succeed as two-sided markets selling access to the valuable networks they have assembled.

Any two-sided market forces a decision about how much each side pays—and the solution may be surprising. For example, the Swiss paper *20 Minuten* reaches 2 million readers—33% of the country's population between the ages of 14 and 70. Its secret? It is handed out free, mainly on public transportation. The newspaper innovated by making advertisers the sole payers. The key to the model's success is the public-transportation distribution: Advertisers are comfortable footing the bill because they know that commuters tend to be young and employed, with higher-than-average disposable incomes.

A similar innovation came from Cardea, a "meta-consultancy" that helps companies find the best consulting firms for their various managerial challenges (recommending one for, say, a cost-reduction analysis and another for a merger). The firm found that many companies resisted what they saw as a surcharge on already expensive services. Its fortunes improved when it changed its value-capture model and charged referrals to the consultants instead of their clients. Consultants accept the arrangement because Cardea's referrals reduce the acquisition costs they normally incur to gain new business.

Sometimes markets have more than two sides. In these cases it may be possible to *change the payer in the value constellation.* The U.S. market for tutoring is a case in point. With the 2001 passage of the federal No Child Left Behind Act, parents of underachieving children gained access to private tutoring services paid for by the government. Other players with a stake in student outcomes include state and local education departments, future employers, schools, teachers, and students themselves. With multiple diverse players, tutoring services can move among and combine several revenue streams.

A special case of changing the payer is possible in B2B settings where *internal budgeting* creates multiple (and shifting) reservoirs of cash to be tapped. When my business school, IMD, got word that a company for which it provided executive education programs was terminating its contract, it was mystified; the client had always registered very high satisfaction. The explanation soon came: Drastic cuts had been made to the firm's executive-development budget. A colleague devised a value-capture innovation that saved the account. He approached a group of the company's global functional managers and persuaded them to cover half the costs for their functions' participants out of their division budgets. When the original buyer, a human resources leader, was then offered a price cut of 50% (in terms of his own budget), he was able to say yes.

Changing the price carrier.

What is the “price carrier” in your offering? In simple terms, it’s the part of the experience you hang the price tag on. Someone might patronize a McDonald’s restaurant because he needs a Wi-Fi connection or wants to bring the kids to a PlayPlace on a rainy day. But McDonald’s doesn’t charge for either of those things. The price for a visit, regardless of what one values about the experience, is carried by the food and beverage order. A strategic question many companies should ask: Is the price tag affixed to the right part of the package, and what would happen—to profits and to other players in the market—if it were moved?

Let’s return to Netflix, a prime example of *changing the carrier.* The film-renting public was accustomed to discrete transactions in which customers selected DVDs and paid for each one. Many people benefited from clerks who came to know their tastes and made useful recommendations, but that service carried no price tag. Netflix changed that, moving to a membership subscription model and making personalized recommendations an explicit part of its value proposition. With customers viewing anywhere from a handful to hundreds of selections a year, the per-rental price was no longer the point; the price carrier was now the subscription service.

And consider Nespresso, which manufactures single-cup coffee makers and the capsules used in brewing. Yes, the launch of such a handy appliance is an exercise in value creation. But any innovation that allows a company to sell $19 worth of a commodity (the typical retail price for a kilo of coffee beans) for up to $137 must also be celebrated for its value capture. Nespresso accomplished this by changing the price carrier from the bag of beans to the perfectly brewed beverage.

When managers talk about *bundling and unbundling* a company’s offerings, they are referring to the most common way of changing the price carrier. We see this in telecommunications, where a customer’s solution typically consists of several elements, each of which could be priced separately. Bundling elements into a package with one overall price allows sellers to assemble varying solutions that appeal to different customer segments; it also staves off price wars by making comparisons between vendors more difficult. When it comes to unbundling, the best current examples are in the airline industry. Under the International Air Transport Association’s old regime, the price of a ticket included a full range of services. As the market was deregulated and price wars intensified, new carriers such as Southwest Airlines, EasyJet, and Ryanair offered lower prices and fewer services. Established carriers had a hard time competing because their offerings were inherently bundled, forcing them to charge higher ticket prices. They have recently started unbundling, charging separate fees for checked bags, seat reservations, food, and extra legroom. (Ironically, the low-cost pioneer Southwest is now known for carrying bags at no added charge.)

An *all-inclusive offering* is a variant on bundling—think of it as an "ultrabundle." A bundle offers a combined price for the sake of convenience or to induce customers to buy more elements. An all-inclusive offering combines elements that customers might not normally regard as components of one solution but that they are obliged to buy because of the time frame or setting. Cruise ships, for instance, offer all-inclusive deals that cover meals, entertainment, and sleeping quarters—purchases that are not ordinarily linked but that in the course of a cruise can hardly be made elsewhere. Another example involves the company Châteauform', whose name itself bundles parts of the French words for "castle" and "training." Châteauform' offers executive seminars in European resorts. It captures maximum value by handling room reservations and dining, subsumed under a single, fixed fee. (After a long workshop, many a manager is happy that wine and beer are included.)

Changing the timing.

The preceding innovations all assume a fairly simultaneous exchange of value. But some famous cases of "desynchronized" exchange also suggest ways to innovate.

Installed base pricing is probably best known as the razor-and-blades model. Gillette's customers, for instance, initially buy a razor and blades together for a low price, probably receiving much more value in that transaction than they pay for. But the company effectively charges for the razor in every subsequent purchase of blades. Ink-jet printers use a similar model: The printer is cheap, but the replacement cartridges are expensive. Elevator companies apply the same logic. Schindler can install elevators at a very competitive price because the installation comes with a profitable 10-year service contract. As these examples indicate, changing the timing is usually tied to a price-carrier change; indeed, the model might be seen as a special instance of a price-carrier innovation. Certainly it requires the company to secure its future revenue stream: If printer customers started buying ink-jet cartridges from third-party suppliers, the business would not be sustainable.

A second approach to changing the timing, *futures contracting,* offers an even purer form of desynchronizing the value exchange. About 150 years ago farmers in the U.S. Midwest began selling their harvests in advance. They received cash immediately, while buyers secured a certain amount of wheat or corn for a preset price. Selling futures on commodities is now a high-volume practice. The innovation opportunity is for other sellers to adopt the approach when future needs can be anticipated. For example, a hotel chain might presell to a corporation the number of rooms it knows the firm will need; a chemical company might contract in advance for the delivery of a certain quantity of materials at a given price.

Changing the segment.

The first four categories of innovation capture value within the existing customer base. The fifth captures it from customers new to the firm or the market. This path starts with two steps: Identifying customers who are unwilling or unable to pay current prices but display a need for a given offering, and then determining how to create a profitable offering for them.

The textbook marketing approach suggests conducting a market analysis to define objectives before defining strategy. It requires segmentation, targeting, and positioning to arrive at a marketing plan, including product, price, place, and promotion decisions. In contrast, *target costing* uses market analysis to gain customer insights and then determines the price at which a certain segment of the market will buy a certain product. With that price in mind, the company designs the product at a cost that ensures a sufficient margin. A prime B2B example is Xiameter. In the course of a customer-insight project, Dow Corning, one of the largest producers of industrial silicone, identified four needs-based segments of the market. Among customers seeking innovative solutions, proven solutions, or cost-effective solutions, it was well positioned. It was much less competitive among those in the fourth segment, price seekers—customers uninterested in features and services and focused solely on obtaining the lowest price. To address that segment without weakening its value proposition to the others, Dow Corning created not just a new offering but a new brand, one with a substantially different business model. Xiameter is an internet-based platform that offers silicone without also providing consulting and other related services, thus permitting a very different pricing approach.

A second means of innovation through segmentation involves self-segmentation. Segmenting according to willingness to pay may be illegal; at the least, it is perceived as unfair. Charging different prices for similar products may lead customers who once bought a premium brand to switch to a low-cost version. Further, it is not easy to identify and group customers according to their willingness to pay. The solution, which I call *self-segmented fencing,* has two parts: First, customers self-segment by choosing either a high- or a low-priced offer. Next, the firm creates a fence in order to prohibit arbitrage, such that customers with a high willingness to pay are prevented from buying the low-priced product. Coupons are an almost perfect example of a fence. Instead of selling groceries at low prices to everyone, retailers offer coupons that discount specific products for specific periods of time. The hassle of finding a coupon, checking its validity, searching for the exact item offered, and presenting the coupon at checkout fences off customers who prioritize saving from those who are more interested in convenience.

Focusing Managers on Value Capture

The innovation pathways I've described are not mutually exclusive; often approaches can be combined. Nor are all of them applicable to every market. The point of this categorization, developed through simple pattern recognition, is to help executives innovate in value capture by suggesting new possibilities.

The process begins with top management's communicating a concern to the organization: Are our innovation efforts fairly balanced between value creation and value capture? Senior leaders must stress that fresh thinking about value capture should be integral to every strategy and innovation exercise in the firm.

A core team might then be assigned to rethink how to capture value and challenge the status quo. Having a dedicated team creates a sense of urgency and lets members develop a common language for discussing ideas. Such a team should be cross-functional, because value-capture innovations are likely to traverse lines between R&D, strategic planning, market research, IT, legal, and more. Beyond the core team, anyone in the company responsible for defining and executing strategy should be invited to join a network that is kept apprised of the team's work and routinely asked to offer ideas and feedback.

In the course of a year, the core team should devote at least one full day to envisioning value-capture innovations, perhaps using the framework presented here as a basis for brainstorming. When a large European airline staged such a workshop for its managers, the group quickly surfaced new possibilities. One participant wondered, "What if we sold contracts based not on tickets but on miles, so that a large client might buy a million miles for a fixed amount regardless of the routes?" Another idea sounded wild but provided a logical solution to a backhaul problem: "Should certain routes be offered free on certain days?" Not every idea proved to be compliant with regulations or profitable enough to pursue, but one result alone—a new approach for a specific customer segment, small and medium-sized enterprises—made the entire exercise worthwhile.

In a workshop for a services firm with more than 250,000 employees worldwide, the CEO challenged his top team to imagine how the operating margin, which had dropped to 5.5%, could be expanded—not just to 5.7%, say, but to 9.5%. Over two days the group discussed 24 value-capture innovations. The cases were presented in six batches, each followed by a two-hour exploration of how the firm might make similar changes. Several concrete follow-up actions emerged. Although none gave the firm a margin of 9.5%, the margin's decline was slightly reversed.

My work with more than 50 companies in dozens of countries has confirmed for me that businesses have spent far more time, money, and effort on value-creating innovations than on value-capturing ones—and that much can be gained by correcting the imbalance. When a driver eagerly pays 135,000 francs for a special license plate, it suggests that many sellers may not be capturing nearly as much value as they have already produced. When a coffee lover happily spends $137 for a kilo of coffee, it reminds us that new value can be created—and captured—when customers' needs are better understood. What opportunities to capture value are you missing?

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