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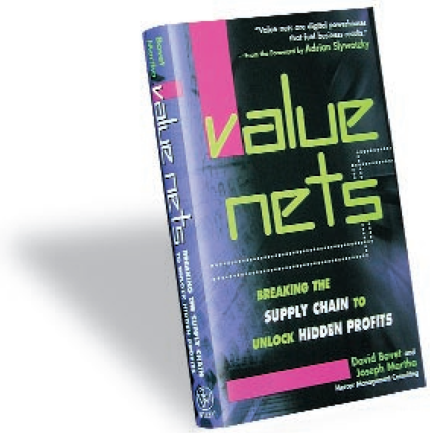
FILE: STRATEGIC MANAGEMENT



By David Bovet and
Joseph Martha

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Breaking the Supply Chain to Unlock Hidden Profits

VALUE NETS

THE SUMMARY IN BRIEF

If your company is like most, substantial profits are locked away where you would least expect to find them — in those activities commonly called the supply chain. Whether your company is a young dot-com company or a seasoned incumbent, enormous new value can be found and unlocked in the operating end of the business — how you handle orders, source components, build products and get them to customers.

The key, according to authors David Bovet and Joseph Martha of Mercer Management Consulting, is for your company to adopt an entirely new business design, the **value net**.

Value net design combines strategic thinking and recent advances in supply chain management, resulting in a flexible system that is driven by customer choice, not the company. This customer-driven system — with a mindset focused on *value creation*, not *supply* — replaces the traditional supply chain business design that fails to deliver the exceptional convenience, speed, reliability and customization that today's customers demand.

In this summary, you will learn how to use the business design methodology first introduced in *The Profit Zone* (written by a Mercer Management Consulting team of authors led by Adrian Slywotzky) to develop your company's value net business design.

Specifically, you will learn how to:

- choose among the different types of *value propositions* — service, convenience or customization — that you must offer customers;
- define the *scope* of the business design — which activities need to be performed, and by whom, to deliver the value proposition;
- capture *profit;*
- gain *strategic control* to keep those profits coming in; and
- *execute* the transformation from supply chain company to value net company.

But before you begin dealing with these five elements of the new business design, you will first learn in more detail how the value net improves on the old supply chain model — and why your company needs this new value net design today.

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VALUE NETS

by David Bovet and Joseph Martha

— THE *COMPLETE* SUMMARY

The Power of Value Nets

A new business model is emerging. If you've ordered a computer over the Internet, you have already been in contact with this model. It links increasingly stringent customer requirements to flexible and cost-effective manufacturing. It uses digital information to move products rapidly, bypassing costly distribution layers. It adapts to constant change. This new model, which is replacing the traditional supply chain business design, is the **value net.**

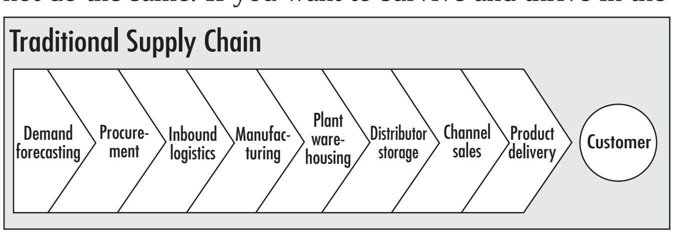
Value Net Defined

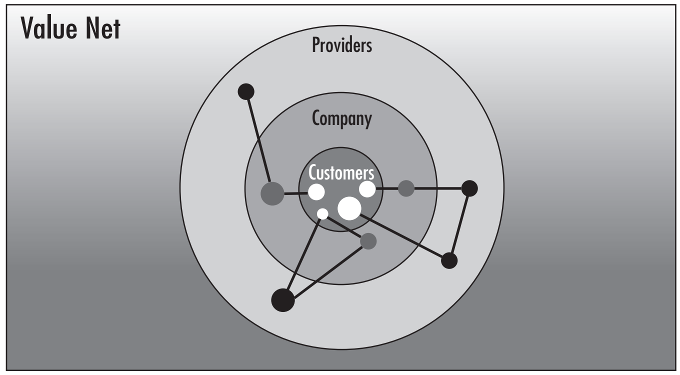
A value net is a fast, flexible system aligned and driven by customer choice. It is a dynamic, high performance network of customer and supplier partnerships and information flows. A value net begins with customers, and builds to satisfy actual demand. It is nothing like the old supply chain theory, which relied on manufacturing products and pushing them through distribution channels in the hope that someone would buy them. In fact, a value net is not about supply; it is about creating value for customers, the company and its suppliers. The value net replaces the sequential links of the supply chain (see figure below) with a network of two-way customer/supplier relationships.

Customers Choose

A value net views every customer as unique. It allows customers to choose the product or service they value most. Manufacturing, delivery and associated services are differentiated to meet the needs of each customer segment, profitably.

Companies like Dell Computer, Gateway, furniture maker Miller SQA, and delivery innovator Streamline.com are in the vanguard of creating value nets. These companies allow customers to configure their own orders, then build and deliver them to their doorsteps in a matter of days. No hassles. No mistakes. No excuses. And they are killing competitors who cannot do the same. If you want to survive and thrive in the new economy, you must learn to respond to customer demand the way these companies have. When you adopt the value net as your business model, you will.





A value net looks nothing like the old supply chains, which relied heavily on demand forecasting followed by manufacturing and delivering products or services to a customer who might or might not want the product. Instead, a value net places the customers at the center of the entire process, as shown in the figure above.

The choices of these customers are captured in real time and transmitted digitally to other value net participants. In the next concentric circle, surrounding the customer, is the company. It controls the customer contact points by accessing customer information, nurturing the relationship, and managing satisfaction through digitally integrated service and support.

At the outer circle of the value net are the providers who perform some or all of the sourcing, assembly and delivery activities.

Five Characteristics of Value Nets

There are five characteristics distinct to a value net business that give it an edge over a traditional business design that relies on supply chain thinking. Value nets are:

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The authors: David Bovet and Joseph Martha are vice presidents with Mercer Management Consulting's Supply Chain Strategy Team. Bovet is a well-known speaker on the subject of supply and value nets. Martha leads the Supply Chain Strategy Team, building Mercer's supply chain practice into a market leader.
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The Power of Value Nets

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Customer-aligned. Customer choices trigger sourcing, building and delivery. Customers command the value net.

Collaborative and systemic. Each activity is assigned to the partner best able to perform it, with many operational activities delegated to specialists.

Agile and scalable. Value nets are responsive to changes in demand, new product launches and rapid growth. Working capital shrinks and process time is collapsed.

Fast-flow. Order to delivery cycles are fast and compressed. Delivery is fast and convenient, at the customer's plant, office or home. Inventories are low.

Digital. E-commerce is a key enabler, and new digital information pathways link and coordinate the activities of the company, its customers and its providers.

Herman Miller's Value Net

You need look no further than office furniture maker Herman Miller for an example of value net design. A new unit, Miller SQA, makes office furniture with a twist. Its products and the entire furniture-buying experience are designed to be "simple, quick and affordable." Take, for example, the ordering experience. With the use of a digital interface, customers can configure a purchase to order. Once an order is placed, the information suppliers will need to build the furniture is instantly transmitted for just in time delivery. So fast and efficient is the operation that order to delivery time is measured in **days** not **months**. Orders are being shipped 99.6 percent on time and complete. It's no wonder sales are growing at 25 percent a year.

Time for a Value Net Design?

Take this test to see if your company or one of its units needs to migrate from supply chain to a value net design. Look for the following indicators and ask yourself the tough questions they raise:

✓ **Your business isn't meeting customer demand for speed, reliability and convenience.** A good product isn't good enough anymore. Today's customers want rapid fulfillment, on-time delivery and convenience in doing business with you, and won't settle for less.

✓ **Your customers are defecting.** Your most profitable customers don't necessarily fit the "average" mold. Don't let the customers who want customized offerings shift their spending to the competition.

✓ **You worry about being "Amazoned."** You need to meet the Internet challenge and view e-commerce as an opportunity, not a threat.

Supply Chain vs. Value Net

Supply chains and value nets differ in five key ways.

Old Supply Chain	New Value Net
One size fits all	Customer-aligned
Arms length and sequential	Collaborative and systemic
Rigid and inflexible	Agile and scalable
Slow and static	Fast-flow
Analog	Digital

✓ **Profits are migrating elsewhere.** If your revenues per customer are stagnating, you need to change your business design to compete with all players, including the incumbents and the dot–coms.

✓ **You equate "customer-centric" with a good marketing department.** Nothing could be further from the truth today. Superb service doesn't happen when it's designed after the product and service mix decisions have been made.

✓ **Your managers view suppliers as enemies.** Think partnership rather than playing one off against the other. Collaborative initiatives define value nets.

✓ **Senior executives view the supply chain as an operational issue**. It must be much more if your business is going to be reshaped into a value net. ■

Value Nets and Business Design

There are profound changes occurring in the marketplace. The change drivers include:

Demanding customers. Consumers and business customers today want it all. They want speed, service and customization, all at a low price. Overnight and even instant delivery is becoming the norm for a growing spectrum of goods and services. Books, clothing and computers arrive at a consumer's doorstep in a few days. Today, with leisure time scarce, customers want and will pay for time-saving convenience, delivery, support and maintenance, and ultimate disposal of a wide range of products.

Digitization of the economy. The digitization of the economy is revolutionizing the way companies do business. The Internet is the most visible manifestation of

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Value Nets and Business Design

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digitization, and the catalyst for thousands of new businesses. But many of these new businesses have been better at designing fancy web pages than fulfilling their potential as value nets. The key to success is speedy e-fulfillment rather than a slick order page. Meanwhile, whole industries are being transformed by the power of the Internet. Postage stamps and music can now be delivered digitally.

Digital technology is impacting every aspect of business. Software can connect customer orders directly to shop floor activities, algorithms optimize production automatically, wireless global positioning systems guide deliveries, and remote sensors control machine maintenance.

High competition. Competitive pressures are emerging from unexpected quarters. Obscure entrepreneurs can launch new ventures that suddenly threaten established businesses. Venture capitalists are major players.

Globalization. Finally, globalization is providing new markets and new supply sources as never before. Low-cost, low-skilled labor is located in one nation, state-of-the-art contract assembly plants in another, and a pool of technically specialized workers can be tapped in yet another country.

Value Migration

The four change drivers just described cause value migration. Value migration is the flow of profits and value away from outmoded business designs toward others that are better designed to maximize utility for customers and profits for companies. A perfect example is the computer industry, which has shifted from traditional manufacturing and distribution to a build-to-order model. Dell Computer and Gateway together benefitted from this shift to the tune of $134 billion in added market value from 1990 to 1999. During the same time, more traditional computer manufacturers Digital Equipment and Compaq created only $22 billion in market value. Migration patterns like these are signals that business redesign is needed.

Business Redesign

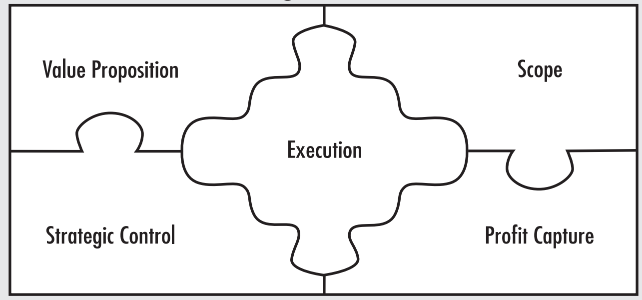
There are three essential factors that determine market value. These are the growth rate of profits, capital efficiency and the ability to sustain profitable growth.

Taking into consideration these three factors, Mercer Management Consulting developed a business design model based on five key elements:

✓ **Value proposition —** what the company will offer to potentially profitable customers.

✓ **Scope** — which activities need to be performed and by whom.

Elements of business design



✓ **Profit capture** — how the company aims to earn a compelling return on shareholder capital.

✓ **Strategic control** — the ability to protect the profit stream over time through sustainable advantages.

✓ **Execution** — the human capabilities and digital technology that hold all the elements together.

The first and third elements represent the company's ability to grow profitably. The second element represents the efficiency with which the capital is employed. The last two elements determine a company's ability to sustain profitable growth over time. These five elements are the keys that will help you create a value net company. ■

Value Proposition: Crafting the Offer

The first piece of the business puzzle is understanding customer needs and serving them with unique products and services that respond to each segment's most relevant priorities. It is no simple matter. The value proposition is the utility-creating product or service that a company offers to customers. In many cases, product and service are tightly bound together. Purchase decisions are determined by the service and information attributes that enhance tangible products; a pleasing store ambiance, next day delivery, expert assistance and after sale service. These are the *service wrap*.

Three Powerful Value Propositions

The innovators who have capitalized on the demographic and social trends that are emerging offer three powerful value propositions. These are:

✓ **Super service** — including speedy and reliable delivery;

✓ **Convenient solutions** — delivering complete and targeted services addressing a broad set of customer needs; and

✓ **Customization** — providing customized products and services, bundled together in unique ways.

To take advantage of these value propositions, you must target them at the right customers: those who

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Value Proposition: Crafting the Offer

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place a high value on the offer and are profitable to serve. The key is to stay focused on the needs of specific profitable customer segments, develop a proposition they value highly, and design a value net capable of profitably delivering on the proposition.

Super Service in Action

Super service is a quantum leap. Super service delights the customer and differentiates the provider. It may be product availability, quality service or easy returns, or it may be rapid, reliable product delivery. There are two key aspects of super service: speed and reliability.

Consider what happened when the nation's fifth largest auto insurer, Progressive, changed its delivery design to make settlements happen fast. Until the 1990s Progressive took days or weeks to settle a claim. The company had banker's hours. Every Monday started with taking loss reports. The rest of the week was spent catching up, as claims agents were dispatched into the field. Then the CEO redesigned the organization to respond immediately when the customer called. Before long, the company had an on-the-spot system for settling claims. An Immediate Response® fleet of 1500 Ford Explorers equipped with cell phones, laptops and wireless modems made it possible for claims adjusters to access the company's databases immediately and settle claims on the spot.

Shrinking Leisure Time = Demand for Service and Convenience

Shrinking leisure time and larger household incomes have boosted the demand for all types of services, from house cleaning to personal chefs. They have also spurred demand for time-saving conveniences like home shopping and delivery. Busy people don't like spending their scarce leisure time doing routine errands or milling around malls. At the same time, the public appetite for fast and reliable service has mushroomed. E-mail and fax provides fast communication, as do cell phones, pagers, ATMs, one-hour photos, 10-minute loan approvals, downloadable software and drive-through liquor stores. You now have a culture in which people expect that anything can and should be available anytime, anywhere.

Reliability at Cemex

Cemex has almost made reliability its trademark. The company is the world's third largest cement producer, and sells cement, ready-mix concrete, aggregates and clinker primarily to the construction industry. It has operations in 10 countries and sells in 60.

Reliability is an important virtue in the ready-mix business since delivery delays can wreak havoc with construction schedules. Yet reliability is difficult to achieve since many customers, unable to control their own schedules, frequently cancel or reschedule orders. For years, delivery was chaotic. Then the CEO began to rethink the entire operation with an eye toward reliability.

Using state-of-the-art communications and information systems, Cemex now boasts "Quality cement available anywhere, anytime." The delivery of cement product is now tracked from plant to customer via wire, satellite and the Internet. The company now boasts a 98 percent on-time performance using a 20-minute delivery window.

The end result for Progressive has been increased customer retention, increased referrals, reduced fraudulent activity, reduced car rental costs and rising insurance premium revenues. While the rest of the auto insurance industry grew at an annual rate of about five percent, Progressive has grown at a rate of 25 percent.

Reliability is the other component of super service. Reliability means predictable, on-time delivery of "perfect orders," as expected by the customer. A perfect order is one that is shipped on time and complete and received at the customer's desired location within a precise time window, in excellent condition, and ready-to-use. It includes the flexibility to respond to last minute changes requested by the customer.

Convenient Solutions

Convenient solutions is another powerful value proposition. Customers today are looking for solutions. To offer this, you must do two things well: pinpoint the convenience needs of the customer, and deliver the solution without a slip. Value nets pinpoint needs by capturing critical customer information at "touch-points" during the ordering and selection process, while tracking order status, and during delivery and maintenance.

Streamline.com for example is one of the new breed of companies providing convenient Internet-enabled home delivery of goods and services. Streamline was created as a service enterprise, offering scheduled delivery of

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Value Proposition: Crafting the Offer

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groceries, personal care products and dry cleaning. Streamline's aim is to simplify the lives of busy families by eliminating the need for trips to the supermarket, the dry cleaners, the florist, and so on.

Streamline Delivers

Streamline's targeted customer segment is the busy suburban family with children, high income and homes close to its distribution facility. The set of products and services include food and non-food items that ordinarily would require trips to many stores. Customers place orders via the Internet directly into the company's order entry system. These are then routed to the warehouse management system. The warehouse is supplied by dry grocer vendors, a local bakery, a top of the line meat supplier, a UPS package service, Blockbuster Video, and dozens of others.

Each customer is on a fixed weekly schedule, and selects items for the week at least one day before delivery. There is a "Don't Run Out" list, along with a selection that the customer can change. Delivery is to the customer's special refrigerated "Box" in an accessible part of the house such as a garage. Customers pay $30 monthly for the service, plus the price of goods purchased. The company has identified a consumer problem and provided a convenient way to solve it. Streamline has created a value net. ■

A Virtual Company

SOHO Inc. is a virtual company with an expansive mission, a narrowly-defined scope and brilliantly-executed value net operations. The California startup makes ergonomic computer desks and sold $8 million dollars worth of them in 1999. Initial capitalization was a mere $100,000. SOHO used 14 suppliers and six retail partners from around the U.S. Those partners do everything except marketing, order entry and customer service. The company now operates on $400,000 working capital and fixed costs per year and does no advertising. Instead, SOHO relies on offering retail partners promotional discounts in return for premium shelf or catalog space.

Scope: Deciding Where and How to Play

Every business must define the critical activities it will perform in creating value for customers, maintaining strategic control of the customer interface, and capturing the profits it needs to prosper. These activities represent the scope of the business designs. Scope decisions determine what activities must be performed to deliver on the company's value proposition and who will perform them — the company or outside partners. Three categories of scope must be incorporated in the value net design: customer choice, production and delivery.

Choiceboards

The choiceboard is a new phenomenon made possible by the Internet. Companies now can enjoy real-time two-way interaction with customers. When you configure a personal computer at Dell or Gateway, you are using a choiceboard. Choiceboards have four key elements. First, choiceboards involve a fast two-way conversation between the company and its customers. Second, a choiceboard captures real demand by linking their desires to its operational design. A choiceboard allows companies to determine real choice instead of guessing it from customers' purchases. Companies can observe buyer reactions and gain accurate insights into exact customer preference. Third, a choiceboard allows choice management by the company as it makes available limited choices. For example, Gateway is using choiceboards to manage demand by steering customers to components that are in better stock positions, resulting in lower inventory and superior profits. Finally, a choice board allows product definition as each customer configures a product or service to his requirements.

Value-Enhancing Delivery

A value net does not see delivery as an afterthought. Instead, delivery is an important opportunity to enhance the value of the offer, delight the customer and make money. But delivery is more than getting the product from the company to the customer. It includes physical delivery, installation and training, ongoing support, product returns and end-of-life retrieval.

Outsourcing

Value net companies face a major question, "Which activities should we outsource to others?" They place a high value on delivering performance through whomever has the ability to execute with superior efficiency and added value. You should control customer touch-points like ordering, customer service and delivery, and outsource other functions as needed.

Outsourcing provides flexibility and scalability, all ideal characteristics for a young start-up company. If you are an entrepreneur with a vision for a new product or service, you can take that concept to market faster and with less cash by outsourcing production, distribution and

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Scope: Deciding Where and How to Play

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other functions, creating an almost virtual company.

Every company needs to understand that the best place to play in the interconnected world of customers and suppliers is not constant. Outsourcing is about collaborative business cultures and support for the spread of technology. Outsourcing is no longer a trade-off between lower cost or better service. Both are possible. ■

Profit Capture: Casting the Net

A company can grow if it has a powerful and appealing value proposition. But growth only benefits a company when it can capture profit from the value it creates for its customers. A value net uses elements of its operating design to generate and capture superior profits.

Profitable revenue generation is driven by the ability to provide super service and convenient solutions. On the cost and asset side, value net designs drive profits through magnitude reductions in inventory, extremely efficient operations processes and the ability to grow rapidly with limited cash for working capital or fixed asset investments.

Profits from Super Service

Companies that provide superior service are often able to charge a premium for that "customer wrap." Companies can also increase profits by increasing profitable volume rather than raising margins.

Consider an example from the fashion industry. Rapid and reliable delivery plays a critical role since customer tastes can change in the blink of an eye. Fashion retailers know what's hot today may be on the clearance rack tomorrow.

Rapid and reliable delivery plays a critical role [in the fashion industry] since customer tastes can change in the blink of an eye.

The key in the fashion industry is to make products available when and where they are hottest. The Limited has designed a supply chain delivering $10 billion worth of goods through the company's ten main brands. Getting the trendy new products into stores quickly is a must. To maximize profits, the company has developed an operating design that prioritizes time, service and cost of delivery in that order.

How do they do it? They meet every Monday night for an "information scrub." By 10 p.m. the conference room walls are lined with data on what's selling where. Product redeployment plans are developed, and products are shifted. The Limited can get the right products to the right stores and change the floor layout of every store within 72 hours.

Money in Solutions

There is money to be made by value net companies that provide a more complete solution for customer needs. Nowhere is this more true than in the business-to-business world. GE Medical is an example of a company that realized the value of providing a complete solution to a customer problem. Broken medical equipment costs the medical profession plenty in lost time. So GE began servicing not just its own equipment, but other makers' equipment also. By 1998, services represented almost half of GE Medical's revenues.

Cost and Assets

By adopting a value net system to replace an older system, companies can dramatically cut costs and optimize asset usage. Companies do this by melting inventory stockpiles, achieving operations effectiveness through digitization, and growing without cash.

An important factor in shrinking inventory levels is reduced product complexity. Remember that about 90 percent of customer demand is satisfied with about 10 percent of a product line. Don't complicate matters with too many choices. Concentrate instead on mass customization rather than a large inventory of every possible combination. One powerful technique is to use standard components to reduce inventory. You must also manage supply reliability by building supplier relationships rather than stockpiling components for a rainy day.

Digital technology forms the backbone of a value net. By digitizing the manufacturing of custom doors, for example, Weyerhauser has turned "a dead dog" plant into a profitable center. Gone are hand-written notes stapled to doors as they move through the production line. Door design instructions are now delivered via computer. ■

Iomega Slashes Inventory Stockpiles

Iomega, a $1.7 billion manufacturer of data storage systems, demonstrates the benefits to be gained when companies create direct information links in the supply chain. The company creates several i2 Technology software packages. These packages, including the Demand Planner, the Factory Planner and the Supply Chain Planner, enable an efficient information flow through the company's value net. With the software deployed, the company has slashed inventory by 50 percent.

Strategic Control: Staying in the Game

After companies begin making money through profit capture, they must turn to strategic control to protect those profits over time. Value net companies achieve strategic control through mechanisms like a **brand** that provides differentiation in the eyes of the customer, through a **hook** that holds customers, through a solid provider **relationship** with supply partners, through **innovative design** that puts your service ahead of others', and through a **low price** that competitors find hard to match. The more your value net focuses on brand and hooks, the less likely competition will move in and deprive you of long term profitability. The more it focuses on design innovation or low price, the more likely you will face significant competition in the future.

Value net companies hook customers with superior service and convenience. Consider Ritz Carlton Hotels. The chain keeps a database that lets a returning customer skip the usual check-in questions, no matter in which hotel the original information was gathered. ■

Value Net Brands

Product brand can account for as much as 100 percent of sustained profitability. Consider examples like Coke, Tide, Advil and Sony. Over time, brand holders can spend less on customer acquisition, experience fewer defections, and charge a premium for the name. Brands are more than names for products, however. Value net companies like Gateway don't have a distinct product. Instead, the brand is comprised primarily of the value associated with customization and rapid delivery.

Designing for Execution: Realizing the Net

Execution is the fifth element of value net business design. It translates business design into fast, reliable and flexible value-creating activities. Execution links all other design decisions. Nothing else you have done to create a value net will work unless you can execute. Mess up execution and you are out.

You will have to create a breakthrough culture with leadership vision, an entrepreneurial team, simple and clear goals, and new skills. Visionary leadership requires commitment from the top; it does not percolate from the bottom. Once the visionary leadership is in place, the next big challenge is to get people on board who can carry through that vision. A team-oriented culture is essential. Everyone must be on board, including the rank and file.

Value net companies must also take full advantage of digital technology to communicate with customers and suppliers. ■

Lessons from the Innovators

The companies who are successful value net operations can offer valuable lessons for any company that wants to reinvent itself as a value net company.

Customer Focus

First, clarify the offer. Successful value nets don't try to be all things to all people. Instead, these companies identify and target market segments and offer value propositions with powerful appeal to those segments. Value nets then deliver to that segment.

Second, use a choiceboard as your customer interface. A choiceboard's ability to accurately gather customer preferences and feed them digitally to supply partners lays the groundwork essential for customer knowledge and rapid turnaround.

Third, compress the order-to-delivery cycle so that customers get the speed they want. And finally, provide convenient delivery no matter what your product or service is.

Operating Effectiveness

Customer focus must be complemented with effective systems for production and distribution. Operational "innards" must be digitized to make good on the promise made to customers. Learn to build to order. Design your net to be fast, to provide customization, and to respond to actual orders, not guesses about what customers want.

Next, select strategic supply partners, including outsourcing partners, who can offer flexibility and scalability.

Digitizing the Value Net

Design the information flow first. Decide which partners need and should have access to information, taking into account that suppliers may also work for competitors. Then automate communications across the value net, especially communications from customers. Use software to harness bits to power decision-making. Automate processes where you can.

Management Techniques

Adopt simple and clear goals to drive successful performance. To make the transition from supply chain to value net company, don't create a formal organizational structure. Instead, use a small, strong, entrepreneurial team that sees the company vision, identifies the goal, and works across functions to build the value net. ■