

Under the Buzz **NUGGETS**



Commentary on Business Strategy for Tech Company Executives & Professionals

Vol. 12, Number 5 – November 3, 2011

Under the Buzz is an email "viewsletter" published by Philip Lay, managing director at TCG Advisors, a Silicon Valley-based firm that helps executive teams in tech companies to deal with complex strategic, organizational, and operational challenges. Now in its twelfth year, this journal is published periodically and delivered free to subscribers via email on an opt-in basis. It is also posted on TCG Advisors' website, <http://www.tcg-advisors.com/Library/utb/utb.htm>, where back issues are also available.

1. Entertainment Weekly

How tech companies find different ways to keep us on the edge of our seats

The key focus of this article is to reflect on the contrasting fortunes of several significant companies in recent weeks, acknowledging their habit of upsetting the applecart when one least expects it – though some, such as HP, manage to surprise us on a regular basis.

Before discussing some of the colorful, controversial, and puzzling cases of recent times, it's worth citing Apple and IBM as two islands of relative predictability, stability, and sound management that make them the bellwethers they are. Specifically, the CEO successions that are taking place at each company teach us a lot about how to execute critical transitions effectively.

First, a suitably respectful note about Apple in the aftermath of Steve Jobs' passing on October 5, an emotionally charged occasion for millions of customers and tech professionals worldwide. Set aside for a moment Jobs' extraordinary contribution to the world – fulfilling the famous saying about Gates vs. Jobs that I might be mangling a bit here: "Bill Gates wants to rule the world, Steve Jobs wants to change the world" – and consider the amazing feat of handing the reins to his designated successor, Tim Cook, with virtually zero impact on investor sentiment, and thus on the company's stock price. A company whose CEO was, to my mind, rightly considered the most indispensable chief executive in the world, has managed to pull off a handover of power that two or three years ago looked absolutely daunting. What relatively few people understood was that Apple under Jobs, alongside its superlative achievements in product conception design, and marketing, became a world leader in operational excellence, exemplified by its ability to launch an unknown product, the iPad, and deliver a flawlessly working product to millions of customers

within its first ninety days, priced at a level that competitors still cannot match almost two years later. Consider the supply chain management implications of such an achievement – this is Tim Cook’s wheelhouse, and the principle reason that he is the company’s new chief executive, ahead of a world-class management team that Jobs assembled during the past decade or more of one product, marketing, and delivery triumph after another, from the revamped iMacs, to the iPod, the iPhone, and the iPad .

A second, more recent case of admirably conducted succession planning is that of IBM. Last week, Sam Palmisano, IBM’s chief executive for the past eleven years, announced that Virginia Rometty would become the company’s ninth CEO in its 100 years of operations. Talk about underplaying your hand. Who outside of IBM’s customer base had heard her name before? Within days, we became acquainted with a woman who had constructed an exemplary career in the company, in various assignments, and seemed to thoroughly deserve the job. These two exemplars of effective planning are precious to the tech industry, because there are plenty of cases of astoundingly poor decision-making by CEOs and executive teams in other visible, high-powered companies.

Take, for example, Groupon. In the October issue of this journal I referred to the new IPO “window” that LinkedIn, notably, helped to open earlier this year for young tech companies to plan their own public share offerings. Today, unless for some reason the company pulls its stock offering, Groupon will finally sell 5% or so of its shares to public-market investors. Zynga, Facebook, Box.Net, DropBox, Evernote, and a host of other young companies are in the IPO queue, waiting to see how Groupon’s big event will go and hoping to confirm the timing of their own offerings. Groupon’s investors and employees, having postponed their offering a couple of times in the past few months, must be hoping that their IPO will come out with a bang, so that the IPO window remains open for them.

Unfortunately, this is one company that to me looks quite scary from a potential investor’s point of view. To be clear, I do not profess to be a securities analyst or an expert stock-picker; my area of expertise is strategy. And there are six strategy-related factors that make Groupon appear to be an unacceptably high investment risk: 1) it raised \$950m in private money earlier this year and used \$810m of it to pay off investors and executives rather than use it to scale the business, 2) the obscure and misleading accounting metrics used in its original S1 (thankfully unearthed by the SEC prior to the IPO and since modified), 3) an apparent absence of sustainable competitive advantage, 4) an unproven and even suspect business model heavily dependent on marketing expenditures, 5) a recent slowdown in the company’s revenue growth, and 6) the short tenures of not one but two COOs in less than a year. The first two points speak to a problem of the founders’ and investors’ values, which although not strictly a question of strategy per se, relate directly to credibility and coherence. Problem #3 and #4 relate to strategy: for example, in a field of many daily deals sites, what exactly are Groupon’s undisputed crown jewels? Barriers to entry by competitors are low, switching costs are low for customers, repeat promotions by vendors are relatively few... so where’s the sustainability? Furthermore, the business model is unproven – the company cannot make money despite significant revenues due to staggeringly high marketing expenses, required because of very low vendor and customer loyalty to deals offered on the site.

The last point – the quick entry and exit of two COOs in succession, is puzzling, and if anything may point to the first issue - the (lack of) core values. What did these executives see when they entered the company that scared them away so quickly? In summary, it’s difficult to see how this

company can become a trusted brand. What seems likely to happen, in light of all these clues, is that most IPO investors will flip the stock as soon as they can for quick profits and the company will have an unstable stock price. Hopefully, I can be proven wrong, because this outcome would tend to cool the IPO market down and make other, possibly more promising, IPO candidates hesitate before taking the plunge.

For the general good of the tech industry as one that benefits customers and society, I subscribe to the same theory that Steve Jobs espoused, i.e., that entrepreneurs should set out to build a great company rather than pursue an exit strategy at the earliest opportunity. As Jobs also observed, building a growing, sustainable company over the long haul is the hardest work anyone can do in business. I guess this can be seen as a quaint, old-fashioned view. But even if one accepts the notion that not every company can or should be built for the long haul, and that being acquired by a bigger player is not an outcome to be sneezed at, the overall Groupon "package" gives off a suspect aura - particularly if you compare it to other past and present poster-children during the past decade such as Google, Salesforce, Zappos, LinkedIn, Facebook, or Zynga. In every case, despite their idiosyncracies, these companies have focused on building a real business based on genuine, sustainable competitive advantage before going public.

On to two other companies that are experiencing serious scrutiny these days: RIM and Netflix. These are two quite different cases, the main similarity being a precipitous fall from grace during the past year or so. RIM is a case of a company that built an envious position in a very specific but compelling niche, mobile email for enterprise customers, then email + phone in the first generation of smart-phones when they expanded their target market to include consumers for the same functions. For three plus years now, since the introduction of the iPhone and its incursion into the enterprise, RIM's market share has been in decline, with an accelerated decline taking place in the past twelve months or so (from 24% to 9%, or thereabouts) as iPhones and Android devices have gained adoption. The strategic issue here is having your category effectively invaded by aliens and co-opted by a new super-smartphone category.

The response should have been much faster. For example, the company could have added features that would keep Blackberry users satisfied and defend against the jazzier touch-screen super-smart phones, and also worked to create a developer ecosystem, possibly by opening its architecture and providing APIs sooner, to enable business-focused application developers to provide apps that would compare favorably against the Apple and Google Android ecosystems even if with a smaller more targeted range of applications. Still on the issue of strategy, in light of the various disruptive innovations that were buffeting its business, it is questionable whether RIM should have developed its own tablet, the Playbook, rather than remain focused on enhancing the Blackberry's competitiveness against other super-smartphones. Thus, the execution issue for RIM, has been a loss of focus, dispersion of resources, mis-steps, and tardy product launches. This is one reason for analysts hectoring the company to do away with its dual-CEO structure, which is associated with a number of stop-go, this-way/that-way decisions in recent years. The result today is here for all to see, a stock price that values the company today at just below its book value.

Having scaled considerable heights earlier this year, with a stock price above \$300 and a market cap of \$15bn or so, Netflix suffered a surprisingly sudden decline in its fortunes in a matter of months, owing to two poor strategic decisions which have been pored over by the business press: 1) the decision to raise prices to viewers by 60% in one go following the highly successful

introduction of online movie streaming, and 2) the decision to split the established DVD-based service from the still-emerging streaming service, which would cause customers to visit two separate sites and deal with two different bills. The impact of these two decisions resulted in the loss of 800,000 subscribers during the third quarter and, even more negatively, a 75% decline in the company's stock price. In strategic terms, you have to ask whether CEO Reed Hastings and his team suddenly lost sight of their core value proposition – which, as I understand it, is to deliver movie and TV entertainment to customers quickly and inexpensively through a user-friendly web experience. The fact that they started several years ago by delivering the products on DVDs via snail-mail, and then in 2010 launched the wildly successful online streaming service, doesn't mean that the essential value proposition changed, just the delivery mechanism. But this is the Achilles heel of many tech entrepreneurs – confusing the delivery mechanism with the core business value proposition. Look how long it took for SaaS vendors to understand that the disruption they were bringing to the market was more about the new business model – subscriptions or pay-as-you-go fees vs. license and maintenance/upgrade fees – than about new intrinsic value in terms of functionality or the delivery model (plug into the cloud vs. download and install software).

Back to Netflix. Perhaps as harmful as the decisions themselves, the manner in which they were communicated was surprisingly ham-fisted for a company and CEO who were admired for previously effective conduct of the business. To compound this problem, it has taken Hastings and his team way too long to understand the furor they caused, and to figure out how to extricate themselves from the mess. This probably speaks to an imbalance between IQ and EQ. In other words, a reliance on internally focused decisions based on the heavy cost of mailing DVDs and the far-higher cost of obtaining streaming rights from movie studios and TV networks (hence the high price increases and also the desire to split the two services), outweighed any empathy for their customers, or appreciation of the emotional connection that the company's customers have formed with Netflix service – not to mention their price-consciousness during an ongoing economic downturn.

Although they have their similarities – and both companies are seen today as likely takeover bait - the Netflix and RIM cases have quite different characteristics as far as their future prospects are concerned. Netflix's stock price is showing signs of recovering in recent days, and assuming the company corrects its prior mis-steps and starts taking better care of its customers, one would imagine that it could recover some of its momentum. However, competition in online streaming will only intensify, and it is a very expensive business to set up because studios and networks see live streaming as cannibalizing their other distribution channels more significantly than the DVD service does. In the case of RIM, it is beginning to look as if the company's founding CEOs have reached the limits of their ability to stem the tide against them and reinvent the business, which is what it might take. Thus, an acquisition by a player such as Microsoft, IBM, or Google might turn out to be the best outcome, although the landscape of potential acquirers – if not a P/E firm - is far from obvious.

We haven't said much about HP here. Our hope is that new CEO Meg Whitman can provide clear direction to the company so that recent gaffes and false-starts by the board and others can be forgotten. Making a clear decision to keep the PC business – announced days ago - is a start, although it will undoubtedly be a challenge to grow this business against the ongoing commoditization of PCs and the advance of tablets, super-smartphones, and even the iMac. One

way or another, the marketplace probably still needs a healthy functioning HP to provide an alternative to IBM and Oracle/Sun.

This article was authored by Philip Lay, managing director at TCG Advisors.

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