



David Williams

Extreme competition

The forces of globalization, technology, and economic liberalization are combining to make life harder than ever for established companies.

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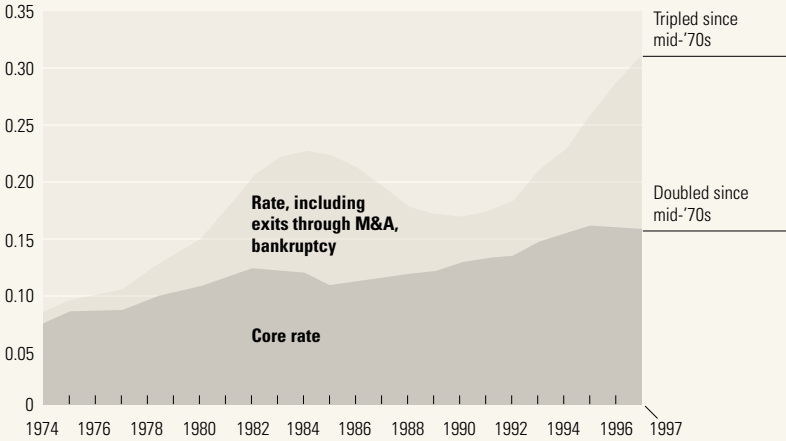
Jack Welch once said that the 1980s would be a “white-knuckle” decade of intensifying industrial competition—and that the 1990s would be tougher still. Despite history’s greatest bull market, rising incomes, and unprecedented prosperity throughout much of the world, the former GE chairman was proved right. The “topple rate,” at which companies lose their leadership positions, doubled in the 20 years to the mid-1990s (Exhibit 1, on the next page). New technologies eclipsed long-established industry champions, and nimbler competitors with sharper value propositions and lower costs emerged, seemingly from nowhere, to take their place.

In many ways, however, the 1990s were just the start of a massive reshaping of the global economy that will continue for the next 10 to 20 years. Three supply-side forces will combine to unleash innovation and to expand productivity and GDP on a scale never seen before: globalization, particularly the integration of large, low-cost economies into the world’s supply-and-demand base; technology, coupled with the exploitation of the networking and communications infrastructure created in the 1990s; and economic liberalization. The pie is still growing, and growing fast, but the increasingly uncomfortable reality is that the distribution of growth—and profits—is anything but uniform or predictable.

EXHIBIT I

Vulnerability at the top

Probability that a company in an industry's top revenue quintile will fall out of it within 5 years¹



¹Weighted 5-year rolling average of 35 industries; year shown is final year of rolling average (ie, 1997 includes data through 2002).

Welcome to the world of extreme competition, where supply-side trends that have been on the march for years are accelerating the pace of economic change and expanding its scope. Some industries are more exposed than others, but mature companies with seemingly dominant industry positions are particularly vulnerable: they face a double whammy of more intense competition and declining average industry performance. A comparatively gentle decline—like that of US automakers during the past 30 years as they lost market share to Japanese rivals with lower costs and better quality— isn’t likely.

Few incumbents are in a position to respond well to the challenge. Decision-making processes are often slow, backward looking, and incremental. Too many companies need nothing less than a new competitive approach built on speed, flexibility, and resilience—an approach that isn’t found in most strategy textbooks or, for that matter, in the experience of business leaders who won their spurs at a time of more incremental change.

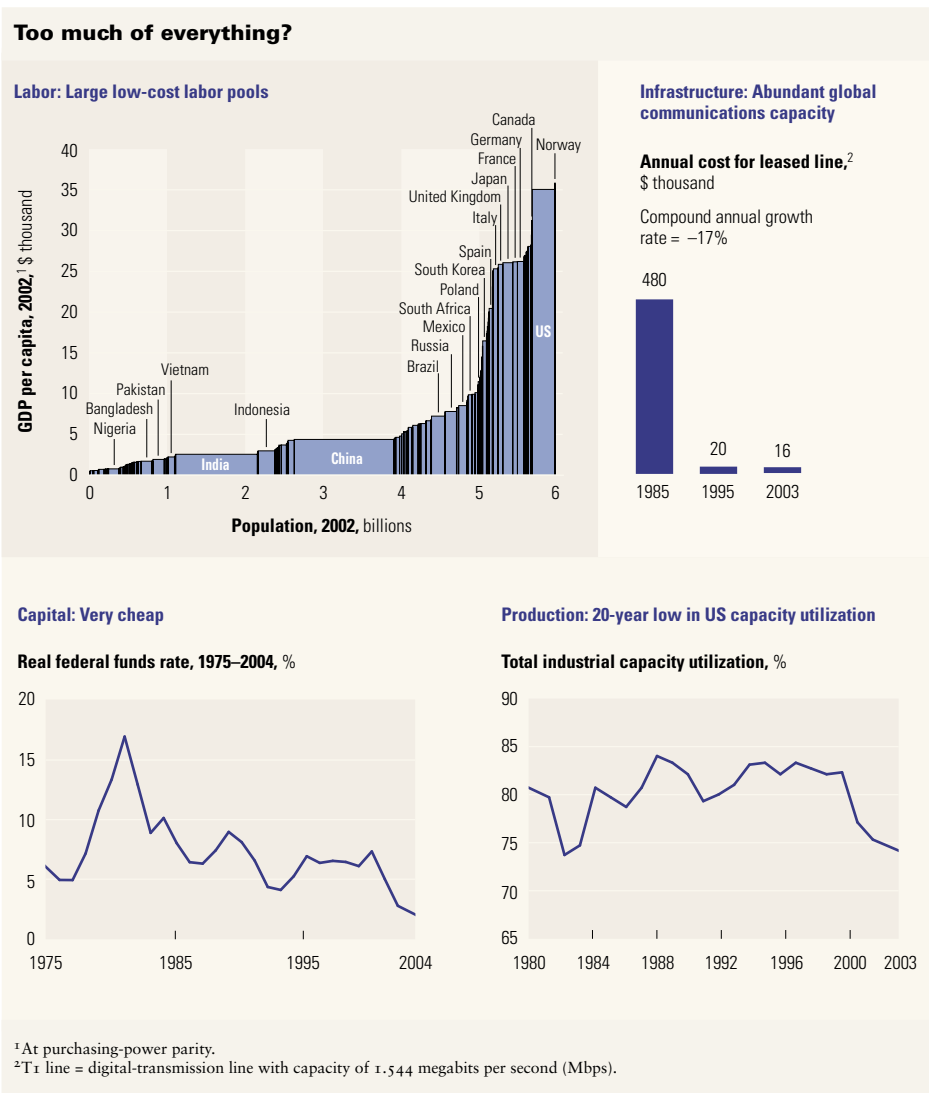
Everything in oversupply

Let’s take a closer look at the dynamics of supply-side growth—a term familiar to politicians and economists but used less often in managerial contexts. Every corporation requires, to varying degrees, labor, raw materials, a communications infrastructure, production facilities, and

capital. Over time, these factors of production and the way they combine in business systems have changed dramatically (Exhibit 2).

Take labor, for example. More than one-third of the world's six billion inhabitants live in China or India, but 25 years ago their population pools were out of reach for the developed world's companies. Technology, in the form of vastly more efficient communications and computing power, has now made large numbers of people in these countries available for an astonishing array of physical and knowledge work. The buildup of North American industrial capacity in the second half of the 1990s was equally unprecedented. Finally, capital is both cheap and mobile. The federal funds rate, 15 percent in real terms in 1980, is close to zero today.

EXHIBIT 2



Three industry effects

Plentiful, cheap, and global labor, capital, capacity, infrastructure, and information have affected industries profoundly. In microeconomic terms, this growth in supply has had three broad consequences: the aggregation of formerly distinct markets, enhanced market clearing and efficiency, and greater specialization, particularly in supply chains.

Aggregation takes place when competitors in one geography can compete in another because of falling shipping costs, lower search costs for consumers (as a result of the ability to find sellers on the Internet, for example), or both. Technology or deregulation can also bring about convergence, a different kind of aggregation: like the geographic variety, it can quickly create substitutes and new competitors. Technology-driven convergence is common in consumer electronics—cell phones, for instance, are now cameras and Web browsers too—and will become even more so as communications, computing, and storage technologies continue their forward march. Deregulation, as well, drives convergence: with the stroke of a pen, and some subsequent litigation on both sides, US long-distance and local telecom providers could invade each other's markets.

Enhanced market clearing means that buyers can make more efficient purchasing decisions. While sophisticated purchasing practices and the scale of the buyers have long driven corporate purchasing power, widespread information and the presence of new supply alternatives with radically different economics now take the traditional “supplier squeeze” to a new level. These forces promise to reshape the economics of many industries as the products and services of competitors with dramatically different cost structures become acceptable substitutes for dominant offerings.

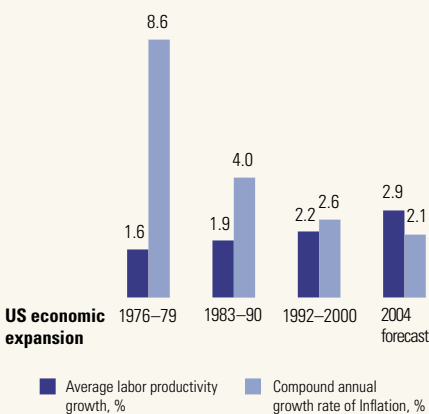
The combination of aggregating markets and enhanced market clearing creates the third effect: increased specialization in the supply chain. As transportation, communication, and coordination costs fall, suppliers can more easily spread production across facilities and geographies, and companies learn to optimize production by taking greater advantage of scale, proximity to end consumers, and differing costs of labor, capital, and raw materials.

Perhaps the clearest glimpse into the way these forces shape industries and the companies that compete in them comes from the personal-computer industry. In the early 1990s, it had three leaders—IBM, Compaq, and Apple Computer—and dozens of other assemblers. During the past ten years, the market aggregated dramatically. Geographically, demand for PCs became global; functionally, major players clearly came to recognize the trend

toward digital convergence across PDAs, music players, and other devices and the threats and opportunities it will pose. The increasing sophistication of the buyers, low-cost sources of supply, and the widespread information access facilitated by the relatively transparent component architecture of the product itself have made PC manufacturing one of the world's most competitive businesses. Finally, open standards for the PC platform, coupled with rapid innovation and short product life cycles, have fueled the expansion of geographically distributed, highly specialized supply chains.

This transition to extreme competition was hard for many companies—just look at Apple's near-death experiences as personal computing coalesced around the Windows-Intel platform, Compaq's acquisition by Hewlett Packard, and IBM's pending exit from the business. Yet the industry's dynamism masked some of the harshness of the shift. For more mature industries with legacy production capabilities and investments, a sudden supply-led transition can be brutal. Consider the case of a US-based white-goods manufacturer whose story will resonate with many midsize manufacturers. In the late 1990s, the company, building on momentum established through improved operational effectiveness, was posting record results. By 2001, however, its principal customers were demanding major price concessions in view of credible Chinese alternatives. In that year, the company's margins fell by 40 percent because of pricing concessions and cost-to-serve increases.

EXHIBIT 3

A fundamental shift

Its response—major cost reductions through increased Asian sourcing and painful cuts to overhead—seemed appropriately dramatic. But even that wasn't enough. The company's Chinese competitors made products of comparable quality for 15 to 20 percent less, leaving it with a stark and fundamental choice: to move closer to their cost structure, to find and exploit innovations they couldn't copy immediately, or to exit the industry.

A broader trend

US macroeconomic data suggest that such anecdotes are part of a broader trend. Exhibit 3 shows that as productivity increased, inflation fell steadily during each period of economic expansion during the past 30 years. The effect of these trends has been most dramatic in manufacturing, where globalization

and technology have also had their greatest direct impact. In the 1990s, however, the productivity gains spread to the services sector.

Supply-side growth and its accompanying turbulence will continue and even accelerate over the next 10 to 20 years. After all, the world economy is nowhere near the end of the line in the search for new disruptive technologies and for low-cost, high-talent labor to generate new products, higher productivity, or both. China now accounts for a relatively small part of the global supply base. Our analysis of the country's role in ten significant industrial segments indicates that Chinese exports represent about 5 percent of total global production. While these share positions may not seem significant, the trajectory is: more than half of this share has been won during the past five years. Consider too the still unexploited opportunities for outsourcing to the developing world and the impact their eventual exploitation will have on costs and productivity. The transition to the new regime is reflected, to some extent, in the rising price of inputs such as steel as China's economy grows.

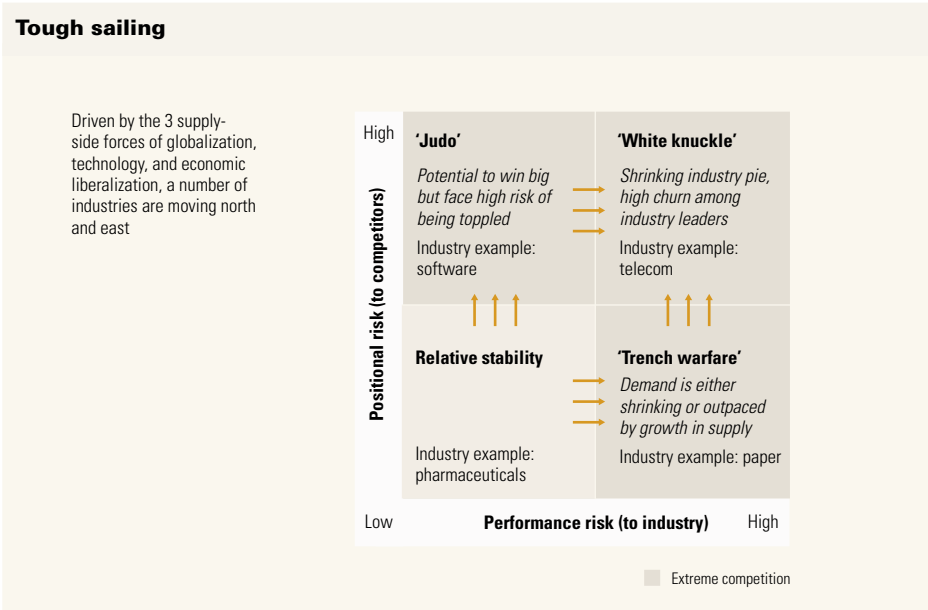
Zones of extreme competition

Extreme competition comes in three flavors (Exhibit 4). The first is traditional “trench warfare,” common in mature, undifferentiated industries when demand is shrinking or can't keep pace with rapid growth in supply. Either way, the result is shrinking profits caused by intensifying competition but few changes among the market leaders.

The second flavor—“judo competition”—is just the opposite: the overall industry pie grows, but the scoreboard is constantly changing. Companies on top often win big but face the perpetual risk that smaller or more nimble attackers will topple them using product innovation or new business models that compensate for a lack of scale or scope. Many newer industries, such as software, fall in this category. So do older trend-based industries, like restaurants and branded apparel.

Finally, “white-knuckle competition” combines the worst of both worlds: a shrinking industry pie and high churn on the industry scoreboard. Our analysis of industry leaders and rising topple rates suggests that many industries are migrating north along the vertical axis of the matrix of Exhibit 4. There is also an “eastward” pull toward the white-knuckle quadrant as a result of several supply-side forces, notably major innovations that spill over and disrupt adjacent industries. The telecom industry is a good example. The growth of wireless telephony, the rise of broadband, and the advent of VoIP (Voice over Internet Protocol) are forcing companies to rethink their business boundaries. As telecom service providers know all too well, their traditional wireline businesses can only shrink

EXHIBIT 4



as competitive offers gain ground. Growth calls for a broader set of offers, including wireless, broadband, and even entertainment. Such a redefinition brings with it major investments, new competitors—and considerable uncertainty. Risks to the industry’s performance and to the market positions of specific competitors rise alarmingly.

Six ways to win

Executives who develop responses to extreme competition should bear in mind the breadth of the threats as well as the personalities of the new competitors—mostly young, fit, and flexible. The strategic patterns they are weaving are new, and their behavior is fresh and uninhibited. Mature companies in the firing line—experience and pedigree notwithstanding—must therefore learn their businesses anew to be ready for the seemingly rash moves of competitors with no regard for traditional pricing behavior.

Speed, flexibility, resilience, and energy are all attributes of youth. They will be needed to make the transition to extreme competition and must be built into the strategic and operational thinking of all vulnerable companies. The ability to cut through a world of information overload and uncertainty—in other words, foresight—will be among the most important requirements for the tasks ahead.

The list of companies that have failed in this respect may be longer than that of the successes, but executives can still take heart. Although the challenges are formidable and the pressures more intense than they were ten

years ago, the freedom to act and the scope for new approaches are greater than ever. Let's consider what companies need to do differently and why they must move quickly.

Retool strategy and restore its importance

Competitive strategy has taken a backseat at many companies during the past five years: first came e-commerce and then the downturn—neither conducive to longer-term planning. Now, however, the growing uncertainties created by converging supply-side pressures, together with the aggregation of industries and the shifting boundaries between them, demand a much more explicit and high-level strategic response.

In many companies, strategy means nothing more than a plan based largely on today's markets, today's product set, and today's competitors and emphasizing the financial forecast. Such a strategy may successfully identify opportunities to capture the upside of the current business over the next few years but can rarely anticipate extreme competition, much less show how to reposition a business to face it. Effective strategy should steer companies toward where an industry is heading, not where it is today.



Corporate leaders should therefore challenge business units to move quickly and flexibly in new directions by creating a portfolio of response options rather than building incrementally on existing ones. Chief executives should intervene more regularly in conversations within business units and stretch the imagination and urgency of their leadership teams. A readiness to contemplate and execute extreme solutions must start with the CEO and the top team and then be integrated across all layers of the company.

Manage transition economics

The economics of the shift to extreme competition must focus on cost positions, productivity, and the relationship between prices and margins as well as how they should all change over time. The significance of transition economics derives from both the aggregation of markets and the increasing efficiency of market-clearing mechanisms; the pace and scope of industry change drive the timing.

At the heart of this managerial challenge is the age-old trade-off between margins and market share. When does it make sense to hold prices steady in the face of new competition or to reduce them in the interest of holding the customer base? Will reducing them now provide a more secure long-term

competitive position? The answers, we believe, vary even within different product segments of the same company. A leading telco, for example, has followed distinct pricing strategies in different segments of its core business—“margin maximizing” in some, “share maximizing” in others. These pricing decisions are always carefully thought through in the context of broader industry transitions. By striking a careful balance between near-term profitability and longer-term strategic positioning, this company has enjoyed strong performance in both profitability and share prices.

Costs too are an important factor in transition economics. Building lower-cost positions earlier and more radically than seems necessary almost always pays off. Moreover, a healthy cost structure provides the headroom needed to cut prices or to invest in innovative products and business models should the market require them. When an incumbent transforms its cost structure, a deep understanding of the attacker’s business model should inform the way it does so. Take, for example, the attacker Southwest Airlines: the enhanced productivity that comes from eight takeoffs and landings per aircraft daily (as opposed to the usual four or five) enables the airline to generate up to 40 percent more revenue per aircraft a day than a traditional carrier does. Had major US airlines recognized the significance of this productivity advantage a decade ago—and of course hindsight is always 20-20—would they have been quicker to rethink their business models?

No part of the cost structure should escape scrutiny; radically cheaper alternatives are often possible for “below-the-line” expenses such as R&D and selling, general, and administrative costs. Software engineering and the development of pharmaceuticals are but two of the knowledge-intensive undertakings to which Western companies have successfully brought the power of Indian talent—and its lower costs.

Fight aggregation with disaggregation

As powerful forces of aggregation and integration reshape entire industries and create a raft of unlikely new competitors, supply chains—for physical as well as knowledge work—are fragmenting and specialized new players are forming around each link. Every incumbent should reexamine its product portfolios, customer segments, and geographies in this light and treat them less homogeneously by looking for the sharp edges where its value proposition is more attractive or the competition less intense.

Scale advantages may push some companies in the other direction, toward the further aggregation of markets, but we believe that most will benefit by creating more differentiated value propositions to serve microsegments. Production processes may often be uniform, but markets rarely are. Disaggregation helps to expose value propositions that are stuck in the

middle—dangerous territory when most markets are clustering around either high excitement (Apple computers, Porsche cars) or high value and productivity (Dell computers, Toyota cars).

Seek out new demand and new growth

One upside to the new environment of extreme competition will be new sources of demand creating many opportunities for flexible and alert companies. Think of the one billion fledgling consumers in China alone and the scale of the opportunity as demand becomes universal. Executives must identify novel customer segments and geographies, help form their consumer trends, and spot emerging competitors (and partners) early. Although the economics of this new demand may well be unusual, lower prices and potentially lower margins shouldn't be an automatic excuse to stay out. For leaders of business units, the challenge will be to create new, less expensive business models and to make new trade-offs between capital and labor.

Extreme competition isn't a signal to bury the old tool kit. Tried and trusted techniques for moving quickly into position—acquisitions, alliances, and licensing, for example—are more important than ever, since in many industries purely organic business building will be a day late and a dollar short.

Expanding the scope of a business through diversification is another way to tap new demand and an important strategic consideration as product life cycles become ever more compressed. Research suggests that moderately diversified companies not only outperform more diversified ones but also perform at least as well as—if not better than—more focused companies.¹

Use the portfolio of initiatives to increase speed and flexibility

At least implicitly, every corporation owns a portfolio comprising initiatives to launch new products, enter new segments, or reduce the cost of supply chain processes as well as corporate-wide efforts to improve pricing, bolster account management, or build a presence in emerging geographies. Collectively, these initiatives represent where, how, and when the corporation will create value.

A realigned and actively managed portfolio of initiatives is central to a corporation's response to extreme competition. By "realigned," we mean the decisive responses already discussed, together with a rich set of initiatives to hedge major uncertainties; "actively managed" means more frequent senior-executive reviews of the portfolio and its initiatives. Both the speed and the depth of the challenge to established ideas and assumptions must increase: this

¹ Neil W. C. Harper and S. Patrick Viguerie, "Are you *too* focused?" *The McKinsey Quarterly*, 2002 special edition: Risk and resilience, pp. 28–37 (www.mckinseyquarterly.com/links/15837).

is no annual planning process but rather a dynamic approach that challenges leaders to reallocate scarce talent and money across business units and puts the spotlight on innovation and developing the next business model, not just on new products, processes, and services within the company's existing approach. These wider reviews should include as broad a range of leadership experience as possible: increasingly, familiarity with specific businesses is less important than the ability to develop more and creative responses.

By helping the leadership team cut through layers of management, bypass formal reviews, and force a wider and more urgent discussion of uncertainty and the available options, the portfolio-of-initiatives approach can speed up and increase the flexibility of a company's response to the pressures of extreme competition.

Count on strategic risk

Extreme competition means more volatile earnings—something that worries equity markets obsessed by predictable earnings per share. Most businesses monitor and control operational risks but pay too little attention to the more complex range of strategic ones. Four in particular merit attention: the value proposition risk (will a cheaper product knock the company out of the water?), the cost curve risk (will a low-cost competitor steal the company's market share?), the bad-conduct risk (will a price war destroy the company's profitability?), and the bad-bet risk (will the company's assumptions prove too optimistic?). Companies should assess the source, extent, and timing of all these risks, communicate them appropriately to investors, and define the activities that will help mitigate them. Two things are fundamental to making such an assessment: a dispassionate view of businesses whose trajectory indicates that they will never generate satisfactory returns and a willingness to close or divest them.

Powerful supply-side forces—globalization, technology, and liberalization—are increasing the pace and altering the shape of competition across the world. Traditional players will be toppled if they don't respond by embracing the spirit of youth, by adopting a forward-looking perspective, and by implementing radical solutions rapidly. Those that make the transition will find a world of bright new opportunities. **Q**

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