Appendix B

A Little More Background on Outside-In

An outside-in perspective is one of the core principles underlying Customer Value Creation (CVC). Though the term "outside-in" can mean many things to many people, our shorthand definition indicates that too often companies do not spend enough time thinking about business decisions from a perspective other than their own. Instead, companies continue to make business decisions using an approach based on their internal knowledge and instincts: an inside-out approach. By continuing to operate with an inside-out approach, companies lose connection with their customers, struggle to offer enhanced value propositions, and frequently underperform against financial expectations.

The business world is familiar with the basic concept of outside-in. The idea that companies should align their businesses around their customers and make customers their top priority has been a popular area of emphasis for longer than we can remember. Yet despite everyone's acknowledgment of the importance of customer intimacy, few companies embrace what we consider to be a thorough customer focus, especially as it pertains to defining value. In our minds, companies that exhibit an outside-in perspective are those that employ a rigorous, fact-based approach to interacting with customers (yes, this means talking to them) to understand their perspectives, pain points, business drivers, growth objectives, and so forth. Several pioneering and market-leading companies have embraced this approach, but the majority of companies continue to struggle with viewing their customers through this lens. Thus, our first ingredient for achieving profitable growth is to establish an outside-in perspective.

How Did Outside-In Originate?

One of our primary objectives is to incorporate today's prevailing business ideas, as well as leading academic insights and discoveries, with our own personal experiences to provide practical, quantifiable, and tangible tools and processes that companies can leverage to drive growth. This objective has emerged over many years as we have studied what differentiates successful growth companies from the rest of the pack and developed tools to help others replicate that success. In our experience, we have repeatedly seen one common characteristic emerge with these companies: They understand their customers deeper and broader than anyone else. What explains this phenomenon? Better yet, how can we translate these companies' successful formulas into a language that others can understand and rapidly adopt to achieve similar success? To help answer this question, we must first understand what prevents most companies from developing this approach. By understanding these underlying hurdles and drawing the curtain back on the problem, we are in a better position to move forward to develop and implement well-targeted solutions. To that end, we have identified three dominant forces that can restrict companies in their quests to operate from an outside-in perspective.

1. *Human nature.* Significant scientific evidence and our own extensive experience suggest that despite most individuals' best intentions, their decisions largely reflect internal viewpoints and myopic perspectives on customers' needs
2. *Operational outlook.* The last decade of internal focus on cost improvement and enhanced efficiencies has had one unforeseen impact on the business world in that most organizations are too

focused on their own companies to peer outside and understand what customers want.

3. *Data availability*. Until recently, companies did not have access to the depth and breadth of reliable information available through tools such as Customer Relationship Management (CRM), Enterprise Resource Planning (ERP), and the Internet to quantify value drivers.

Human Nature

To explain the first element—that human nature can have a significant impact on the quality of decision making within our organizations—recall our previously mentioned objective to turn prevailing ideas and discoveries into useful tools for companies. In this case, we draw upon the lessons from the world of behavioral economics, an emerging academic field that marries the study of psychology, sociology, and economics.

Outside-In Is Based on Scientific Principles During the past several years, there have been significant advances in the field of behavioral economics that need to be incorporated into business. Many of these theories are being implemented in the capital markets but have not made their way into operating business practices. The most fundamental advancements in the behavioral economics field pertain directly to how we make decisions and the flaws inherent in many of those decisions.

Decision behavior has received increased recognition with the award of the Nobel Prize in Economics in 2002 to Dr. Daniel Kahneman. Dr. Kahneman, a professor at Princeton University, was the first behaviorist in history to win the award. Kahneman was cited "for having integrated insights from psychological research into economic science, especially concerning human judgment and decision making under uncertainty." Among other things, Kahneman's efforts have shown that we tend to be overconfident in our own ability and, as such, need to integrate an outside-in perspective to improve our business decisions. Kahneman's work has laid the foundation for a new field of research by discovering how human judgment may take shortcuts that systematically depart from basic principles of probability.

Relating the Outside-In Approach to Decision Making Why do so many people struggle with making decisions? To begin with, implications and outcomes result directly from being a decision maker. This responsibility can hinder an individual's ability to make rapid and confident decisions.

- *Consequences*. Sometimes decisions result in positive consequences, and sometimes the results are negative. Since most everyone desires a positive consequence, the possibility of a negative consequence causes many to stall decisions or never make them at all.
- *Accountability*. How many times have you heard "Whoever made this decision should be fired"? No one wants his or her name attached to a decision that may go wrong. Instead, people usually wait for a positive outcome and then work feverishly to take some part of the credit.
- *Choices*. We have too many choices. How do we know what choice should be chosen? In today's world, the number of choices seems to be growing without parallel growth in the number of right answers.

Why Do We Tend to Look Inside-Out? Once individuals overcome the difficulties that prevent them from making decisions in the first place, how can we be certain that they make the proper decisions? Do they consider all factors and strive toward an objective, rationale decision? Dr. Kahneman's findings have shown unequivocally that they rarely do. There is good reason for this: Most of us think we are smarter than everybody else, and the answer we develop in our own conference rooms is right. Unfortunately, research has demonstrated that humans do not decide rationally and make predictable errors. We exhibit decision failures for a number of reasons: biases in perception; fallacies in reasoning; and problems of groupthink. As a result, it is more often the case that our answers and ensuing decisions do not deliver on the financial returns we promised.

To highlight the importance of outside-in, consider the following well-documented biases and heuristics that can sabotage decision making with an inside-out approach:

- **Overconfidence Bias**

  Our brains are programmed to make us feel overconfident. Behavioral economists often illustrate this point with simple quizzes: guess the weight of a fully laden jumbo jet or the length of the River Nile. Participants are asked to offer not a precise figure but rather a range in which they feel 90 percent confidence for example, the Nile is between 2,000 and 10,000 miles long. Time and again, participants walk into the same trap: Rather than playing safe with a wide range, they give a narrow one and miss the right answer. Most of us are unwilling and unable to reveal our ignorance by specifying a wide range. Most of us prefer to be precisely wrong rather than vaguely right.

So how does this relate to business? Most of us think we are smarter than the next guy. This overconfidence in our own abilities too often leads us into making fundamentally flawed decisions.

- **The Status Quo Bias**

  In one classic example (William Samuelson and Richard Zeckhauser, "Status quo bias in decision making," *Journal of Risk and Uncertainty*, March 1988), students were asked how they would invest a hypothetical inheritance. Some received several million dollars in low-risk, low-return bonds and typically chose to leave most of the money alone. The rest received higher-risk securities and left most of the money alone. What determined the students' allocations in this experiment was the initial allocation, not their risk preference. People would rather leave things as they are. One explanation for the status quo bias is aversion to loss: People are more concerned about the risk of loss than they are excited by the prospect of gain. The students' fears of switching into securities that might end up losing value prevented them from making the rational choice, which is rebalancing their portfolios.

- **Anchoring**

  One of the more peculiar wiring flaws in the brain is called anchoring. Present the brain with a number, ask it to make an estimate of something completely unrelated, and it will anchor its estimate on that first number. The classic example is the Genghis Khan date test. Ask a group of people to write down the last three digits of their phone numbers, and then ask them to estimate the date of Genghis Khan's death. The results show a correlation between the two numbers; people assume that he lived in the first millennium, when in fact he lived from 1162 to 1227.

Anchoring can be a powerful tool in negotiations. In negotiations, naming a high sale price for a business can help secure an attractive outcome for the seller because the buyer's offer will be anchored around that figure.

- **The Herding Instinct**

  The desire to conform to the behavior and opinions of others is a fundamental human trait and an accepted principle of psychology. Warren Buffett summarized this point when he wrote, "Failing conventionally is the route to go; as a group, lemmings may have a rotten image, but no individual lemming has ever received bad press." For most CEOs, the only thing worse than making a huge strategic mistake is being the only person in the industry to make it.

  We all felt the tug of the herd during the dot-com era. At times of mass enthusiasm for a strategic trend, pressure to follow the herd rather than rely on one's own information and analysis is irresistible. Yet the best strategies break away from the trend. Some actions may be necessary to match the competition; for example, imagine a bank without an ATM. But these are not unique sources of strategic advantage, and finding such sources is what defines strategy.

- **False Consensus**

  People tend to overestimate the extent to which others share their views, beliefs, and experiences, which is the false consensus effect. Research shows many causes:

  - *Confirmation bias.* The tendency to seek out opinions and facts that support our own beliefs and hypotheses.
  - *Selective recall.* The habit of remembering only facts and experiences that reinforce our assumptions.
  - *Biased evaluation.* The quick acceptance of evidence that supports our hypotheses, while contradictory evidence is being subjected to rigorous evaluation and almost certain rejection. We often, for example, impute hostile motives to critics or question their competence.
  - *Groupthink.* The pressure to agree with others in team-based cultures.

The tendency is to ask questions or seek information that confirms a favored hypothesis and to avoid asking questions or seeking information that might disconfirm a favored hypothesis.

This selection of human behavior is not intended to be exhaustive, and many organizations may have controls to combat these tendencies. Regardless, we hope readers will recognize this brief list, which highlights the varying ways human tendency can get in the way of sensible decision making within an organization. Without the proper processes to mitigate these inherent human traits, organizations will generally gravitate toward maintaining their traditional inside-out approach to business decision making.

Operational Outlook

The second factor impeding adoption of an outside-in perspective in companies today is the prevailing internal focus on cost savings, reengineering, and operational effectiveness during the past decade. Since we have discussed this point and most readers have experienced this process firsthand, we will not devote significant time to the history behind this evolution. Instead, consider the long-term impact of repeated emphasis on perfecting internal processes to deliver products or services efficiently. How has this lengthy focus on improving our own companies affected our ability to look objectively at our business, the value chains we participate in, and, most importantly, the end customers? We have seen the results of relying on this approach leading to a poor understanding of how the outside world values a company's products and services. Unfortunately, this inside-out approach is not a recipe for developing and sustaining competitive advantage in the marketplace. Cost reduction and operational improvements are an organizational imperative for many organizations, and ample evidence indicates that we can derive some value from these programs. But today's competitive imperative is to identify new growth sources. Continuous cost improvement and enhanced efficiencies are not the formula for long-term profitable growth. Companies must augment their internal initiatives with an outside-in perspective. Now is the time for companies to recognize how this deeply engrained emphasis on operational effectiveness can cloud an organization's outside view and to take measured action to institutionalize an outside-in philosophy.

Data Availability

The third major factor affecting the adoption of outside-in is the prevailing perception that it is too difficult to obtain the necessary data to understand value. This is an excuse that we hear from companies. Since this issue is raised so often, is it true that the information is unavailable, or is it more accurate that many companies do have the right data to define and quantify the exchange of value with customers? In the case of retailers, the answer may be yes. The proliferation of data summarizing consumer-buying patterns, customer preferences, and demographics has helped retail companies tailor their business offerings to customers' perceived values. Unfortunately, companies in the industrial world are less likely to grasp the concept of outside-in, partly because they have not had access to the same data to help them understand customers as retailers have learned to do. Industrial companies have also not likely adopted this perspective to the level of their retail counterparts because there has not been a competitive imperative to do so. In retail, you listen, market, and deliver value comparatively better than your competitor, or you cease to exist. This competition is partly enabled by third-party information providers that mine consumer data and make it available to all who are interested in competing for consumer share. In the business-to-business (B2B) industrial world, however, downstream customer information is not as readily available. This lack of common information across the competitive set creates a hurdle to understanding how customers value one offering versus another. This information gap exists for many reasons:

- Lack of easily available customer data, buying behaviors, tendencies, and so forth: For example, locating existing data that summarize the demographics and buying habits of industrial adhesive customers is probably difficult.
- Supply-oriented versus customer-oriented: Whereas retailers often have a primary focus on growing market share, industrial companies are often focused on managing supply chain and improving efficiencies.

- Focus on generating sales as opposed to creating value.
- Uncertainty regarding ownership of customers.
- Outdated attitudes that customers are for retailers.

Though this data gap has existed for a long time and the competitive imperative to adapt and pursue new perspectives has not been compelling, companies cannot continue to differentiate without repositioning themselves and their approach to understanding customer value. Companies need to acknowledge that the following developments can enhance their understanding of customer requirements and begin moving beyond the data availability excuse:

- *CRM (Internal).* Companies have made significant investments in technology infrastructure to capture and deliver better information about customers, cost drivers, and overall profitability. In many cases, firms are still refining their internal profitability calculations, but companies must recognize that they do not need to wait for precise data. They need to accept that what they have is a strong, quantifiable starting point to begin assessing customer value.
- *CRM (External).* Companies are not alone in the above step. With the widespread build-out of technology infrastructure, companies are not alone in possessing better customer data. Companies can take advantage of this opportunity to share and exchange data with other participants in their value chains.
- *Information sharing.* In the past, companies were cautious and protective of their internal customer data. Most organizations were reluctant to share information for fear of giving away competitive advantage. This perspective has been replaced with a competitive imperative to identify new sources of competitive advantage. In the global economy, information sharing and strategic alliances are a competitive necessity. Many companies have begun to embrace sharing information with delivery partners, and they can identify new opportunities to create incremental value for everyone. Most of the success thus far has been with a supply chain emphasis. Now is the time to take this same approach to the demand side of the equation. You have data. Your customers have data. By stepping outside your organization and meeting with your customers, you can gain access to the full range of data to understand value.

What Is Outside-In?

We consider companies that have embraced an outside-in perspective as those that employ a rigorous, fact-based approach to interacting with and understanding customers' perspectives, business drivers, and growth objectives. Only by understanding these quantitative fundamentals can companies be in a position to establish an appropriate value perspective. Some examples of company activities that reflect an outside-in perspective include:

- Developing a quantitative assessment of customer value.
- Assessing products or services from the customer perspective and quantifying your offering in terms of customer value as opposed to measuring from a cost perspective.
- Defining the system economics or the sources and exchange of profit for each participant in a value chain as opposed to considering the producing company's economics or viewing the flow of goods only in terms of cost.
- Thinking in terms of understanding and addressing customer problems as opposed to developing and selling new product offerings not aligned with customer requirements.
- Focusing on establishing stronger relationships/partnerships with your customers so you understand their business in greater detail.
- Mapping the exchange of goods and services from the customer back through the change as opposed to mapping with a supply chain emphasis that originates with suppliers.

Why Now?

Ask industrial company executives if they understand better than their competitors how these value trade-off decisions are made and they will likely suggest they do. Unfortunately, the competitive dynamics are as strong in the industrial world as retail. But all of the biases and heuristics discussed here are playing tricks on their business judgment. Companies must understand these inherent challenges and develop specific strategies to position themselves for growth:

- Behavioral economics describes how the lack of formal decision-making processes can allow human biases and myopic views to obstruct important business decisions.
- The competitive imperative is on us. Though savings opportunities from internal projects exist, profitable growth cannot be achieved from inside. Companies must learn to leverage their Six Sigma–focused efforts and turn them outside toward new value-creating opportunities.
- The data do exist. Over the past decade, we have spent billions of dollars on technology infrastructure. Countless companies have implemented CRM, ERP, Activity-Based Costing (ABC), and so forth. Now is the time to leverage these massive investments to drive new growth.

By understanding these biases and taking an aggressive outside-in approach, there is an opportunity to create competitive advantage and drive profitable growth.

Summarizing Outside-In

Taking an Outside-In approach is one of the fundamental concepts of achieving profitable growth under the CVC management philosophy. Companies that continue to focus on creating value by having meetings among themselves in their conference rooms have little chance of creating differential value in the eyes of their customers. Dr. Kahneman's research has shown that we do not know as much about our businesses as we think, and we are often afraid to ask too many questions lest we discover our own ignorance. Likewise, the years of internal focus on improving operations have had the unanticipated effect of helping companies forget about their customers. By systemically taking an outside-in approach, the risk of perpetuating an ill-conceived overconfidence in our ability to create and capture value in our exchanges with customers and suppliers can be reduced.

In conjunction with adopting an outside-in perspective, companies must learn to think about their products and services within the context of how they deliver and capture value. By employing tools such as Customer Value Creation, companies can apply the same rigor and discipline (traditionally reserved for operations) to their market-facing business processes. Leveraging these perspectives and tools to define and quantify how value is exchanged with customers is the critical bridge to translating outside-in into profitable growth.

Case Study: Pepsi versus Coke

To highlight the importance of an outside-in approach, consider the classic example of Pepsi's attempts to challenge the dominant position of Coke during the 1970s. Though these events are more than 30 years old, they continue to provide timeless lessons of how to think about your customers. Furthermore, though most retailers have applied the lessons from Pepsi's experience competing with Coca-Cola, industrial companies have not grasped the power of these case studies and their ability to transform their ability to deliver value to customers.

At the time, Pepsi executives were certain that Coca-Cola's distinctive, hourglass-shaped bottle was Coke's most important competitive advantage. Trying to compete with Coke's bottle, Pepsi spent millions of dollars and many years studying new bottle designs, but the company's efforts never achieved the recognition of the Coke bottle.

In dealing with this problem, John Sculley, better known as the former chairman of Apple Computer and Pepsi's vice president of marketing at the time, decided to take a different approach by asking what the customer wanted. Sculley realized the company did not know enough about the consumers to identify what they wanted and, therefore, could not conduct its marketing decision process properly. So, before he tried to assign the bottle question to a new task force, Sculley launched a test to study how families consumed Pepsi and other soft drinks in their homes.

As a result of the study, Pepsi discovered what all marketers now recognize as a key fact about snack foods: However much you can persuade people to buy, there is much to be learned by studying how much they will consume. This helped Sculley determine that Pepsi needed to design packages that made it easier for people to get more soft drinks into the home. Pepsi began a new intelligence-gathering stage, decided to launch a new group of larger packages, and established new systems to learn from store feedback to refine the packaging strategy further.

The results of Pepsi's changes were dramatic: Coca-Cola could not convert its famed hourglass silhouette bottle into a larger container. Pepsi's market share expanded dramatically and drove the long unassailable Coke bottle into extinction in the U.S. market.