Getting on Board: Why 'Crossing the CASM' Is Key to Minimizing Risk

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Leadership

Business model risk is today's biggest strategic risk, and companies without boards that are digitally savvy could find themselves starved of investor capital, according to this opinion piece written by Deloitte & Touche partners William J. Ribaudo and Henry Ristuccia; Barry Libert, CEO of OpenMatters, and his associate Megan Beck Fenley.

Years ago, boards and management teams could be comfortable that a company's business model would endure for 30 years or more. Today, that is no longer true. Technology is disrupting business models every day, and boards should provide input and perspective on how management handles this strategic risk and the potential rewards available to those that keep pace.

In 2011, Internet pioneer Mark Andreessen wrote a widely read article in *The Wall Street Journal* called "Why Software Is Eating the World." And while he might have been biased due to his background as a software developer and venture capitalist, three years later it is clear that not just software, but the digital technologies and networks that software enables, are transforming the world and having a profound impact on how customers interact, employees engage and investors value businesses. In response to this digital revolution, companies in every industry are changing how they operate, create, communicate and sell. Or at least they should be.

Research conducted by OpenMatters with input from Deloitte — which included an analysis of 40 years of financial data for the S&P 500 — shows that businesses at the forefront of the digital revolution are already cashing in with consumers and investors. Yet, many traditional businesses are still struggling to “cross the CASM” and have yet to embrace the disruptive power of digital technologies such as Cloud, Analytics, Social and Mobile.

The good news is that according to our research, essentially every company — regardless of industry — has the potential to improve its shareholder value and long-term performance by capitalizing on digital technologies. However, achieving these benefits will require new network-driven business models — which in turn will likely require a mental shift for corporate leaders raised in a different era with different rules for business success.

Change is risky — but not as risky as standing still. We believe one of the greatest strategic risks faced by businesses today is not adapting quickly enough to the disruptive forces of the digital revolution. These forces are affecting almost every aspect of business. However, the kinds of fundamental changes required to address them need to start at the top, which is why our focus here is on what boards can do to oversee and work with management to mitigate risk in a digital world.

The digital revolution is particularly amazing when you consider its rapidity and pervasiveness. Just 10 years ago, the concept of social media was still being cooked up in a Harvard dorm room, the iPhone was just a design concept, big data wasn’t on anyone’s radar and “cloud” was a meteorological term most often used to describe impending storms. Things have certainly changed since then. Today, even traditional manufacturers are viewing digital as a new frontier of opportunity. For example, Nike has developed a software/hardware ecosystem with Nike+ and FuelBand SE at its core, while GE Capital has begun to develop apps for its industrial clients, creating a digital marketplace similar to an app store for consumers.

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For many companies, however, digital may be all talk with little action — especially in the boardroom and C-Suite. According to recent research, many boards and CEOs are dangerously behind the times when it comes to capitalizing on digital:

- **Fewer than 10% of S&P 500 companies have integrated digital into their business model.** Our research and analysis of S&P 500 data shows that companies that generate a high percentage of their revenues from software, analytics and codified intellectual property make up only about 7% of the index. And even when we include companies that are using those technical capabilities to build social networks and commercial networks (such as credit card payment networks), the figure only grows by 2% or 3%. These numbers are particularly surprising in light of our findings on how technological adaption drives value.
- **Only nine companies in the S&P 500 are “highly digital.”** A highly digital organization is one that “generates a high percentage of [its] revenues [and value] digitally; its leadership (both the CEO and the board) have deep digital experience; it does business significantly enabled by digital channels; and it’s recognized as transformational in its industry,” according to a blog post on the HBR Blog Network by Jeffrey F. Rayport and Tuck Rickards.

- **The United States faces a gap of 1.5 million leaders who are savvy enough to take advantage of big data.** A 2011 study by the McKinsey Global Institute found that there are enormous potential gains from big data and analytics once companies and their leaders learn how to use it — gains as high as a $300 billion value increase in health care, and a 60% increase in retailer operating margins.

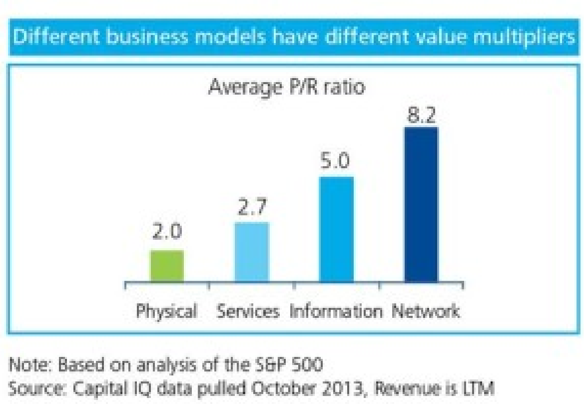
This lack of investment and preparedness on the technological front is particularly troubling given how the market is responding to and valuing technologically advanced firms.

According to our research, investors are rewarding companies that go digital, and leaving others behind (in terms of valuation and capital availability). In particular, we found the most effective companies are those reallocating their capital to make and deliver the digital products that consumers and businesses want (such as social and mobile networks) and to harness the power of big data and analytics. This holds true regardless of industry. Meanwhile, companies that make, market and sell physical products and traditional services are left with lower valuations. Companies that don't align their boards with the CASM world may be missing out on major opportunities to create value and satisfy the demands of customers and investors.

Our research indicates there are four distinct business models that today's companies use to create value, with each model featuring a different level of technological enablement.

- **Physical:** Companies use capital to make, market, distribute and sell physical things. Examples include automakers, big box retailers and delivery businesses.
- **Services:** Companies use capital to hire employees who produce billable hours. This model is similar to the physical model, but it substitutes an individual's output for a machine's output. Examples include consulting firms and financial institutions.
- **Information:** Companies use capital to develop and sell intellectual property, such as software, analytics and intellectual property. Once created, these assets can be sold multiple times. Examples include software and biotech companies.
- **Network:** Companies use capital to create a network of peers in which every participant makes and sells products or provides digital content to the many other members of the network. Examples include online marketplaces, social media businesses and credit card companies.

Understanding business models is crucial because business models drive shareholder value and strategic risks. According to our research and analysis, investors pay premiums for information and network firms, valuing them two to three times more than physical or services firms. The average multiplier (or P/R ratio) is roughly 2x, 3x, 5x and 8x respectively for physical, services, information and network businesses. The bottom line is that the most effective organizations are adapting their business models to serve today's empowered and digitally connected customers — and investors are rewarding their efforts.



But if business models drive value, then what drives business models? The answer is the "mental model" of a company's leadership team and board of directors.

In simple terms, a mental model is what an organization's leaders and board members value, measure and invest in. For manufacturing companies, leaders typically value making and selling things. For services firms, they care about hiring people and selling services. For information firms, the focus is on creating intellectual property, such as biotech solutions and software. For network firms, the top priority is building and operating social and commercial networks.

A good way to understand where a company is headed — and how likely it is to cross the CASM — is to look at senior management's mental model, skillsets and areas of expertise, as well as the composition of its board.

Two primary roles of a board are (1) advising on the company's strategic plan and related capital allocation, and (2) hiring the CEO. As such, a board's preferred mode of thinking may drive the company's focus. Board members whose primary expertise is in traditional business areas such as operational efficiency or people management might have limited insight on how CASM technology can create the most value for the business.

Predictably, the most CASM-savvy boards are generally found at network and information companies. Often, these companies have board members who are very skilled and experienced at operating and investing in information and digital network projects, and can align strategic objectives and asset investments (including cash and talent) with digital products and services that meet today's customer and shareholder needs. For these companies, digital technology is at the core of what they do.

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By contrast, if your company is in a physical or services business, at this point you are probably feeling like an uninvited guest at the digital party. The good news is that according to our research you, too, can win the hearts and minds of investors and customers. But to do so, you will need to work with your fellow board members to reallocate your organization's attention and capital to bridging the CASM — building its own social and commercial networks of customers, employees and partners, and mining data to unearth new business value. This will require taking active steps to create and nurture the right mental models.

Whether you oversee a publicly traded company, or just want to infuse a new digital mindset into your private equity backed organization, not-for-profit organization or private firm, we recommend making a conscious effort to help the board become more digitally savvy.

The issue of board composition and who is at the table to provide perspective, input, oversight and advice on strategy is at the heart of governance. Investors and stakeholders alike are focused on board composition and whether a board's combined skills and experiences align with its company's strategy and the goal of maximizing shareholder value.

While a small percentage of companies already have boards that are "digital-ready," so to speak, we believe others would be wise to start addressing this skill sooner rather than later.

How do you help your board become more digitally savvy at a time when digital expertise is in high demand and low supply? The first step is to assess your board's existing capabilities and expertise. Consider what skills and experience board members currently have by asking the following questions: Have existing board members been involved in building, managing and exiting business in the digital realm? Do they actively use today's technologies? (e.g., leveraging big data to inform their decisions, and using social media to communicate with peers and stakeholders). Are they advocating the reallocation of capital from traditional uses to digital networks because they have personal experience and knowledge of the benefits?

This initial assessment may reveal a critical gap in the board's knowledge and experience with regard to digital strategies and disruption. If so, we believe there are three ways to fill the gap: educate, seek advice or recruit.

1. **Educate the board (or individual board members) about digital technologies and digital disruption**: Our research shows that winning companies fully embrace the digital world and invest significant capital in this way of doing business. Provide existing board members with continuing education classes to help them become more knowledgeable in this area. This kind of education can provide a foundation that enables board members to contribute to the digital dialogue.
2. **Seek advice from an advisory board or outside experts:** Consult with advisors who have personally acquired digital skills and experience either as investors or executives of digital organizations. These advisors can challenge your business model and show your board and senior management team the ropes — helping to avoid costly pitfalls. Although they have no formal authority over your company, digital advisors can still have a significant impact on your strategy and operations — particularly in areas such as social media policies, mobile business strategies, big data and analytics opportunities, and cloud deployments.
3. **Consider recruiting a director with digital expertise**: In today's business environment of social, mobile, cloud and big data, we believe every company can benefit from real-world digital know-how. Leading companies across a wide range of traditional industries — from retail to entertainment to food & beverages — have already added top executives from social media and internet gaming companies to their boards. However, given the short supply of qualified candidates, finding the right person might require widening your view to consider younger digital executives who are not CEOs. In fact, many companies are finding prospective board members in small, venture-backed firms where there is a larger pool of digital talent. You can recruit the skills needed or consider using an executive recruiter that has a Digital Board Practice with clear expertise in this area.

The stakeholders you serve — including customers, employees and investors — are already reallocating their attention and capital to digital, and are excited by companies that are taking advantage of CASM technologies. Change is risky, but so is getting stuck on the wrong side of the CASM — especially in a business environment that is rapidly evolving. Business model risk is today's biggest strategic risk (and source of rewards), and companies without boards that are digitally savvy could find themselves starved of the investor capital and customer demand they need to innovate, thrive and grow.

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