Perspectives

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The Deconstruction of Value Chains

The end of the last century saw the construction of the vertically integrated value chains that came to define modern business. The end of this century is witnessing their deconstruction. Markets are intruding on the web of proprietary arrangements that have held these chains together. As they do so, the boundaries defining businesses, companies, and industries are coming under attack–radically transforming the nature of competition. New concepts of strategy and organization are required in order to cope.

The Logic of Value Chains–Undermined

Integrated value chains have served business well. They enabled the sophisticated coordination that growing technical complexity required. They organized the dedicated assets, both human and physical, necessary for achieving economies of scale and scope. Expensive to create, they were a formidable barrier to competition once established. The vertically integrated value chain has been a potent competitive machine.

Not anymore. Powerful forces are undermining the logic and practice of traditional vertical integration. Eroding trade barriers and the resulting globalization of markets give businesses worldwide access to world-class capabilities. Modern manufacturing and distribution technologies make global sourcing and selling increasingly low cost. Deregulation and increasingly sophisticated capital markets allow the laws of economics to prevail at every step of the value chain.

But the most powerful force subverting conventional value chains–partly because it acts as a catalyst and accelerator for all the others–is a revolution in the economics of information. Information has always been the glue that held value chains together. The cost of getting sufficiently rich information to suppliers, channels, and customers made proprietary information systems and dedicated assets a necessity, and gave vertical integration its leverage.

That glue is now melting. Universal connectivity and common communications standards are enabling the open and virtually cost-free exchange of information of all kinds. Companies share product designs, CAD/CAM parameters, logistics information, and financial data with equal ease both inside and outside the corporation. New intermediaries are emerging to support interconnection, facilitate comparison, guarantee performance, and make markets. Searching and switching are vastly simpler and cheaper than they used to be.

These trends have two simultaneous effects. On the one hand, proprietary links give way to markets. Witness the outsourcing trend: companies can now make use of key activities in the value chain without owning them. On the other hand, opportunities for rich communication and collaboration between customers and suppliers are greater than ever. Both these developments undermine vertical integration, replacing it with a highly flexible mix of new coordination mechanisms, ranging from the ruthlessness of the spot market at one extreme to the most strategic of partnerships at the other.

Patterns of Deconstruction

As traditional value chains deconstruct, fundamentally new business models begin to appear. In some cases, a start-up mounts a direct attack on the established business model by splitting information flows from physical flows. This is the essence of Amazon.com's challenge to conventional book selling.

A more common pattern begins when a vertically integrated incumbent recognizes the opportunity to outsource nonstrategic or particularly capital-intensive parts of the value chain–even as it continues to dominate the whole. In these cases, integration gives way to *orchestration*. Successful orchestrators possess powerful brands and use them to retain control of the lion's share of an industry's value added while minimizing their own assets. This is what Nike, Hewlett-Packard, and Sara Lee are trying to do.

But maintaining control of the value chain is not easy. The orchestrated–those who focus on a specific value-added step, or *layer*–have every incentive to drive for scale and scope themselves. If they succeed, they wrest control of the value chain from the orchestrator, as Intel and Microsoft did from IBM. The business then deconstructs entirely. Each layer becomes a distinct business with its own economics. Some of these layer businesses are highly scale sensitive; dominating them can be extraordinarily profitable. Others are naturally fragmented; after deconstruction, profits are hard to come by. The onset of fragmentation can, however, create opportunities for a new sort of player–*navigators* that help participants cope with the complexity of doing business in a deconstructed world.

The Implications of Deconstruction

The competitive implications of deconstruction are profound and wide ranging:

- The traditional definition of businesses and industries–and, therefore, the reference set of competitors, suppliers, and customers–becomes obsolete.

- Competitive advantage is de-averaged. Businesses in which the economics of one activity are compromised for the sake of the whole will be especially vulnerable.

- Advantage across the entire value chain no longer matters; it's advantage in each layer that counts. As a result, the new unit of strategic analysis is the layer.

- Horizontal strategies–those that leverage layer capabilities across previously distinct businesses–become serious alternatives to traditional strategies of vertical integration and customer franchise in a single industry.

- Managing resource allocation at the layer level requires new ways to evaluate investments and gives birth to a whole new concept of the portfolio. The finer parsing of risk permits imaginative new financial strategies.

- The boundaries of the corporation become fluid and permeable. Ownership is no longer a condition for effective co-ordination or control.

- Customers are empowered; brands become vulnerable. Traditional asymmetries of information are challenged by the rise of navigators that search and switch on the customer's behalf.

- Intermediaries that extract value from controlling a chokepoint in the flow of information are vulnerable to disintermediation.

In a competitive environment characterized by deconstruction, commitment to existing business models, however rational they may appear, becomes a liability. The attacker has the advantage. Incumbents are under threat from increasingly unfamiliar intruders–but they also have unprecedented opportunities to leverage their capabilities in new ways. In subsequent Perspectives, we will explore the new principles of strategy and organization that deconstruction requires.

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