Chapter 1

Face Off: Skating to Where the Puck Will Be

Wayne Gretzky had it right: ''I skate to where the puck is going to be, not where it is.'' He was talking about playing hockey, but sports have always provided good metaphors for discussing business strategies.

Anticipating the future is *the single most important thing* that a management team needs to do to succeed. Would your business life not improve dramatically if you could peek at tomorrow's *Wall Street Journal* today? Who could not make more money if they knew what the future had in store?

Seeing tomorrow's *Wall Street Journal* even a day in advance would make you brilliant at picking stocks. But sadly no one knows for sure what is going to happen, and that uncertainty can lead to a business advantage for those with better insight into the future. The better you can anticipate the future the greater your advantage.

In our work we regularly get to see how well people anticipate the future. As industry analysts we straddle both sides of business innovation: the sellers' side—bright people inventing, developing, and marketing leading-edge products and services—and the demand side—customers who gain business value through the early use of innovative products. Fortunately for us, unlike doctors and lawyers, there are no minimum requirements necessary to become an industry analyst, other than to have a reasonably professional looking business card. Vendors explain their view of the future to us daily in the strange ritual called an ''analyst briefing,'' where companies trot out their senior executives to bedazzle us with their latest offerings and visions so that we, as known experts and pundits, in turn, will somehow ''bless'' them, thereby substantiating their view for less expert individuals, all the time hoping

that the press will pick up on the enthusiasm and start writing glowing articles. In turn, this is expected to provide meaningful comfort and hope to those who might buy their product or service. Analyst briefings are to the innovation community what movie critic preview junkets are for the entertainment business—an important part of creating ''buzz'' around a product—except, unfortunately, we do not get the food, wine, travel, luxurious hotel suites, free massages, and gift bags that movie critics do. We are fascinated by the frequency with which companies show us plans that have only one chance in millions of succeeding. This is like having a young boy show us the drawing of the Pokemon robot that he wants so badly to build and that must have special powers, remote control, and work perfectly under water—a compelling vision but one that we, as adults, know will never happen. These companies have all the creativity and enthusiasm of seven-year-olds, and unfortunately this often blinds them to their business plan's shortcomings.

When a company's executive team comes to tell us about the exciting business they are building, there are just three things that we really want to know from them (and that we think they should want to know as well): (1) How big is the market (and how fast is it growing)? (2) How different are they from their competition, and how long do they expect any key differences to last? and (3) How does their business model capitalize on this market opportunity?

There is a condition that we call ''no-fault marketing'' that has been raging through our industry like an out-of-control fire. It happens when marketers take it for granted that a market exists for any new product their company develops or *why would we have built it in the first place*? No-fault marketers do not let facts like market size and growth get in their way. They burn money and resources without plan or purpose. And since they have not taken a position on what it takes to succeed in the first place, when things fail it is no fault of their own. They are never wrong. We have learned not to take anything we are told at face value and have grown somewhat cynical in the process. We have found that the best thing to do is to remain skeptical, find out what the underlying market facts are, and then interpret these on our own.

By the time a company briefs us they are about to culminate lots of work and introduce their offering with great fanfare and hoopla. They have spent millions of dollars on development, the products are in early adopters' hands, and the big launch at a gala affair is just a few weeks away. But when we ask them the most basic and fundamental questions—who is going to buy it and why, how big the market is and in what segments, how are they different, how does their business

model work to their advantage, how they intend to win against their equally bright, energetic and well-funded competitors—the discussion degenerates quickly. The company tells us about the handful of eager early customers they have found, and how pleased they are. We in turn, recall for them the old TV ads for an over-the-counter drug that told us that ''three New York doctors recommend Miracle Medicine!'' The impact of the drug claim fades rapidly if and when consumers realize that you can find three New York doctors to recommend just about anything. In the same way, we believe that an innovative idea can garner a handful of interested customers—say three chief executive officers (CEOs), whose companies are all too often funded by the same investors as the new product's inventor, rather than three New York doctors. But with a multimillion-dollar investment it is not OK to just get a handful of customers. You have to tap into a rich vein of customer demand that can lead to big market opportunities, growth, profit, and, ultimately, a handsome return to investors. A few eager customers are no substitute for evidence that a substantial market is just around the corner.

Sometimes we can be sympathetic because the executives are dazed survivors of the dot-com investment boom, where you did not have to create a real business. You were given tens of millions of investment dollars just to create buzz and momentum that led quickly to a public stock offering with huge gains for the both employees and investors. But that Camelot has long since faded, and we're back to the ''good old days'' when real revenue and profits matter—you have to build companies the old-fashioned way, by finding customers and getting them to buy product. There are still a few of the surviving-but-not-public companies from the dot-com fantasy era around, now in a hopeless position, having taken down an obscene amount of investment when the money was easy, that have the proverbial chance of a snowball in Hell of ever producing a commensurate return. They might as well owe a bookie $50,000 and try to pay him off by working at McDonalds flipping burgers.

Unfortunately it is not just the dot-com survivors that present impossible plans. Many come from newly funded companies and sometimes from innovative teams at larger companies—groups that should be able to answer our simple questions. All too often, they do not have any answers. They seem unable—or unwilling—to anticipate market changes.

Are the days of producing significant ROI on investments in innovative products and services gone forever? Should innovators just give up on trying to build important and exciting new businesses? Nothing

could be further from the truth. Just follow the money. You need only to look at the magnitude of current venture investment to see that plenty of capital remains to support innovative ideas. But we certainly do believe that too few of these ventures make an effort to anticipate markets far enough in advance. To take advantage of the extremely profitable opportunities that inevitably appear in every era, innovative companies must look ahead. They must anticipate.

THE RETURN FROM GETTING IT RIGHT THE FIRST TIME

Anticipating demand is the best way to make certain an innovative company (whether it is a start-up or an established company with the will to reinvent itself) can achieve breakthrough success. To take full advantage of the rewards of anticipating a market, the trick is to *get it right the first time.* Too many companies only get it right by the expensive and painful process of trial-and-error. They finish the product and *then* take a year to learn about their markets by exploratory marketing and selling. After those experiments, they focus their resources on what worked. What if they did more anticipation of the future while the product was being developed and as a result found the high yield markets twelve months earlier? What kind of a difference would that make? Here's what we think:

1. First of all, it is really expensive to do learning when you are all staffed up with sales and marketing. When a product is launched, the company is burning cash at the greatest rate by far in the company's young life. That additional year will cost a lot of cash, often half again as much as what they have spent up to that point. If the company has to go back to its venture backers during that period for more money, it will cost the proverbial pound of flesh and could easily dilute the employees' equity position by a third.
2. When the product is announced, the competition will understand what the company is doing and, during that year, have time to make their moves in the space, thereby diminishing the market available to our company. This can cause another one-third erosion of the downstream valuation due to lower sales volume caused by competitive erosion and competitive pressures on price.

3. And then there is the opportunity cost. The twelve months spent searching for the right solution might have been used for other company efforts such as planning for and prototyping the next product. This might cause it to miss a chance to add perhaps another one-third to the valuation.
4. Bringing the company to success a year earlier not only means a greater return but also an earlier return, therefore, faster liquidity. Given the time value of money, that is really important to the investors.

So according to our crude, back-of-the-envelope estimate, the company that gets it right the first time can yield as much as a 400 percent return on the original investment; the company that takes a year to find its way will yield only a 66 percent return. The actual result probably will be that the return to investors is even higher for the company that gets it right while the returns to the other investors are probably lower.

How well does this work in the real world? Here is one particularly vivid example. A small U.S./U.K.-based software company named Striva got it right the first time. Founded in 1999, Striva provided enterprise software for change data capture (CDC) and real-time and bulk data movement from mainframe systems. Although all the ''action'' had moved away from mainframes, Striva's management team recognized that more than 90 percent of large enterprises still used mainframes as part of their mission-critical information flow. Further, Striva saw that for enterprises to get a real-time view of business health via their operational information warehouses, they would need to upgrade their systems using the types of technologies that Striva was building so they could extract data quickly from mainframe systems (rather than using the traditional overnight extraction batch processes).

Despite the recession and the conventional wisdom, Striva built out its mainframe software products and marketed them as important additions to corporate information warehouses, mostly using joint marketing agreements with the industry leaders to keep down their marketing and sales expenses. In 2003, the information warehouse leader Informatica was being threatened as Oracle started to build out its data warehousing capabilities. As part of its plan to stay ahead of the competition, Informatica gobbled up Striva for $62 million. Not a bad outcome for a four-year-old software company with less than one hundred employees.

Striva produced one of the best venture capital (VC) returns in 2003 in terms of both the amount of money returned to investors and the speed with which it was returned. The second round investors saw their return in less than a year! And all because Striva got it right the first time.

THE ROLE OF DISRUPTION

Anticipating the future is a major problem for innovative companies because traditional methods of market research are not effective at predicting the disruptive changes that high-tech innovation brings. In his best-selling book, *The Innovator's Dilemma,* Clayton Christensen cites this as Principal #3 of disruptive technology: Markets that do not exist cannot be analyzed. That is a very important statement, because what he is telling innovators is that the most important thing they should be looking for is a *disruptive* opportunity and then turning around to note, by the way, that you cannot analyze its impact because the market does not yet exist. Although we completely concur about the potential importance of disruptive change, we differ in that we believe those future markets can be analyzed. Christensen is absolutely right that you cannot analyze markets that do not exist—*using traditional methods of market research and analysis.* But that is because traditional tools—focus groups, quantitative studies, surveys, and the like—were all developed to study markets that do exist. If you are running a research business, there is much more money in researching things that do exist than things that do not, so not surprisingly that is where the research tool and methodology efforts have gone first. Our point is simple—you can indeed understand markets that do not yet exist *if* you are willing to use some new methods and are willing to go patiently through the process of looking ''under the radar'' for evidence of the elements needed to ignite a market.

To be fair, high technology market strategy was never a very well-developed art. In earlier high-tech years, strategy was not so important. Markets were small, and products were exceedingly innovative. There were fewer competitors. Time was less of a factor. The technology spoke for itself and it was often all right to bring an innovative product out and discover the market after the fact. Companies such as Oracle, Cisco Systems, Network Appliance, and EMC have similar stories of evangelizing their technologies for years before they were adopted by mainstream buyers.

During the dot-com boom, whatever market anticipation practices had existed previously quickly disappeared. What is the point of trying to understand market growth and competition when your mission in life is to go public in a frenzy of irrational enthusiasm? Another nail in the marketing strategy coffin was that during the dot-com rage purchasing was remarkably ''horizontal.'' Everyone was getting the same Internet stuff—GM was no different from GE or from Pfizer. It did not make much difference what business you were in, everyone needed to move frantically to the Web so they did not get ''Amazoned'' by a newly funded competitor. If everyone is buying the same stuff, it is a waste of time to worry about what their business is or how the technology contributes to their success. Who needs strategic marketing?

Whether it is because the principals never really believed in strategic marketing or stopped doing it during the dot-com boom, most of the companies that we see tell us (in other words) that they did not do any real market anticipation. They have done nothing much to characterize future demand for their ideas, instead preferring to pick what seems to be the best market approach and to run it up the flagpole and to see who salutes. As one CEO proudly told us, ''I'm a believer in jumping into the pool and *then* learning how to swim.'' This type of thinking—market strategy development via sequential experiment—is unfortunately the norm for high-tech companies who would never do something so crude as part of their technical product development. The simplest reason that few people make the effort to better understand the future is simply that they have never seen it done and something they are not going to figure out how to do by themselves. If trial-by-fire strategy development was good enough for companies they worked for previously, why change it now? If you want a competitive advantage—better still, an *unfair* advantage—then it is time to turn on your market headlights to get better idea of what is coming down the road. This book will show you how.

People who have never done market anticipation do not know where to start or where to go. If you do not know what you are looking for, predicting the future is indeed a daunting task because the future gets big quickly. It is impossible to figure out the future of everything going on in business, but it is very possible to figure out the immediate future of what is happening in the areas that matter most to you. That is our secret!

MARKETROCITY

It does not take subtlety to show where a little anticipation would have made a big difference. We spoke earlier of business plans with no hope of success. There have even been entire industries that suffered dearly for their collective refusal to rationally consider the future. Our favorite is probably optical data networking.

During the great optical networking boom of the late 1990s, there were over 700 independent companies funded, each requiring at least $50 million to bring a product to market and grab a chunk of the new optical networking landscape. In retrospect, this was a completely hopeless overinvesting, but during the heyday, these companies would come by to brief us on what they were doing. Invariably they would share with us wonderful forecasts in which they got a small chunk of a huge and rapidly growing optical data communications market. If they could just grab a modest share of this new, exploding market, their future would be assured, and they and their backers would become fabulously wealthy.

These presentations came off the track when we asked our nasty little questions about the market—where's the beef? Understanding data communications is in a sense no more difficult than understanding the economy. The key insight that you have to gain about the economy is that it all builds on the needs and purchases of individuals. Just as an economy is built from the bottom up, one person at a time based on what they consume, so is data communications. Somehow the huge data volumes that were required to fuel these forecasts had to derive directly from what individuals were going to do. Please explain to us, we asked, where all this data will come from. Where will the demand for so much data traffic come from and how does it grow? And if you do not mind, start with scenarios about real people like you and me.

The problem was that those companies (and the industry as a whole) could not come close to doing that. We got dead silence. How could we have our heads buried so deeply in the sand not to understand the potentiality of optical data networking? So we would next point out that it seemed to us that there is a limit to how much communications infrastructure an individual (and therefore a population) could consume. We reasoned that a private digital high-definition (HD) TV channel for each man, woman, and child in country—the pets had to share—was a reasoned maximum consumption (in technical terms that is around 20 million bits of data per second). From our experience, an individual with a compelling, personalized video channel is unlikely to

do anything else; their senses will be fully engaged. So what happened, we asked, if that was all there was? Unfortunately for those 700 optical data companies, the total data needs of even this market just did not add up to what was required to make all the companies operating in this market wealthy. It was not that fiber optics was bad technology, rather it was too good. When you can send hundreds of billions of bits per second over a single optical fiber, you just do not need many fibers—or lasers or high-speed routers—to make it all work. The technology and the basic ideas were fabulous, but the market anticipation was fatally weak. Too bad for all of those 700 companies and their backers.

It turns out that none of those companies (even the big networking companies like Nortel or Juniper), had ever asked those simple questions, and needless to say, they really did not like our simplistic, back-of-the-envelope calculations. One of the visiting CEOs literally started to explain that we had left out the communications required for the refrigerator to talk to the grocery store, prompting us to ask whether they were exchanging ''need more milk'' requests—which requires very little data to be communicated—or home movies of refrigerator construction in the factory—which produced meaningful amounts of data but obviously did not make sense. One CEO became visibly upset when he realized, a little too late, that these are completely reasonable questions and that someone should have asked them a long time before. Since the era of those rather entertaining briefings, the optical data communications market crashed just as hard as or harder than anything in the dot-com space did. We do not claim that the lack of demand was the only failing (there were many), but it is a sufficient line of questioning to have predicted accurately the collective disaster by itself.

The point of this story is simple—these companies were not being driven by demand but instead were operating in a false economy, one fueled by irrational exuberance and overinvestment, just as the dot com bubble was. The investment rate in these companies surged without regard to demand. Demand for networking capacity shot up slightly because of the arrival of the Internet boom, but it certainly was not surging to the levels necessary to support all of the optical networking companies that were forming. And because these products were so much better and had many orders of magnitude more capacity than what they replaced, ultimately demand was more than satisfied with a tiny amount of the new stuff. The world was much better off for the introduction of all the new optical data technology. And in the

end, the consumer got the benefit more quickly because of the foolish investments that were made without sufficient market forecasting! But it did not change the world in the way the emerging optical networking companies had hoped for and needed in order to justify the investments. Most of these companies were put out of their misery as soon as the financial markets realized how much these companies had overbuilt capacity.

WHAT'S THE ALTERNATIVE?

If you are seeking high gain and leveraging some form of disruption there is no excuse whatsoever for evading the task of understanding your market and the demand it will reasonably create. Whether or not you have ever done this kind of market anticipation, we are here to tell you that you really can do it. Our methodology is ultimately based on a skill that we can safely predict almost all readers of this book have: the ability to have a meaningful discussion with a subject matter expert in an area of high mutual importance—to use our terms, to hold an ''Expert Interview.'' No matter what you are trying to do, if it is going to be anything like the next big thing, then there are important precursors well under way now, and there are hundreds of smart people engaged in those activities in all sorts of roles. If you can be clear about what you need to know (your little piece of the future), you can find scores of those individuals who will be more than happy to discuss their passion with you, and those discussions will tell you more about your future than you can imagine possible today.

Expert Interviews are as straightforward as they sound—interviews with people who know much more than you do about a particular subject. For some reason, researchers often turn up their collective noses when it comes to chatting it up with experts. We have been brought up in the business world to believe that there is a certain mystique to the research process and that the only good research must have statistical blessings and high price tags. Expert Interviews break away from traditional research by putting you at the scene of potentially disruptive industry events, which is exactly where we think you should be. We often use the time-honored detective series *Colombo* to help illustrate what we try to accomplish with Expert Interviews. As soon as Colombo arrived at a crime scene, he would begin looking for clues. He considered everything important—cigarette butts, shoelaces, how knots were tied. Colombo would collect all of the evidence that he

could and then start to form an opinion of how the crime occurred and who the perpetrator was. Similarly, Expert Interviews provide the clues that can help you see what is likely to happen.

We will show you how to combine Expert Interviews with a decision-oriented methodology that lets you anticipate what customers will be doing in the near-term future. Then you can use this information to help you sell more of your product or service by identifying top customers and key market segments in advance of entering the market, strategically positioning your company in the eyes of its prospective adopters and catching the developing disruptive trends that are about to surprise your competitors. As you will learn, accurately anticipating the future is not that difficult to do. By doing this, you will make better decisions and you will avoid the completely off-the-mark assumptions that permeate and ultimately destroy whole industries—as the optical communications industry was destroyed. By using the right strategy and the right tactics, you have a good chance of *getting it right the first time*.