What Has To Happen

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Newsweek magazine recently ran a story about online music stores.* The article described intense competition among Apple's iTunes Store, Microsoft, Musicmatch (purchased a couple of weeks ago by Yahoo for $160 million), and Real Networks. It focused on Real's price cut to 49 cents per song from the industry standard of roughly 99 cents per song. Despite the cut, Real continues to pay the full royalty fee to the labels who license the songs, which is almost 70 cents a song.

That's right. Real voluntarily went from making 29 cents per song sold to losing 21 cents per song sold. Meanwhile, Real sold six times as much music at the lower price.

Let's run some numbers. Imagine Real sold a million songs a month at the old price (that's an assumption, not a real number; the analysis below is the same whatever sales number you use). Here's what we get:

	Old price	**New price**
Price per song ($)	0.99	0.49
Unit sales	1,000,000	6,000,000
Dollar sales ($)	990,000	2,940,000
Royalty costs ($)	700,000	4,200,000
Gross profit ($)	290,000	-1,260,000
Profit / sales	29%	-43%

So, they're not making it up on the volume. In fact, it would appear that volume is their enemy: the more they sell, the more they lose.

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* "Forecast: Song Costs May Fall Like Rain," by Steven Levy, *Newsweek*, September 27, 2004.

Presumably, management at Real Networks knows that a) revenue of 49 cents per song doesn't cover costs of 70 cents a song, and b) volume doesn't make that better. What were they thinking that led them to decide it was a good move?

At one level, it seems obvious: they made a conscious decision to trade profit (presumably in the short term) for sales and new customers (which they got). However, that just begs the question again. What were they thinking to decide that's a good trade? After all, there are plenty of risks, such as reprisals. Real could certainly expect their competitors to care.

- It's an important profit and growth source for Apple.
- Microsoft wants growth and has pockets deep enough to compete as long as it takes.
- Yahoo isn't about to write off a fresh $160 million investment.

Real might have ignited a price war that will defer profits indefinitely. So, why did Real do it?

At ACS we talk about *what has to happen* (WHTH) for a strategy to work. That's a critical question for strategists to ponder.

- *Before* adopting a strategy, pondering WHTH can surface key assumptions on which the success of the strategy depends. You can then decide whether you believe those assumptions will come true, and thus whether you want to adopt the strategy.
- *After* adopting a strategy, pondering WHTH can focus competitive intelligence and market research so you know if your implementation is on track and so you can get early warning if anything is going awry.

Note that WHTH assumptions may be explicit, and they may be implicit. They may even be unconscious.

- An *explicit* WHTH assumption might concern market growth: hitting our sales-growth target depends on the market growing as fast as we've forecast (and on other things, of course).

- An *implicit* WHTH assumption might concern price sensitivity: cutting our price will bring more customers to us.
- An *unconscious* WHTH assumption might concern competitive response: our competitors will not match our price cut.

The distinction between implicit and unconscious WHTH assumptions is subtle, yet it is important. You can generally tell the difference by people's reactions. A strategist's reaction to hearing someone articulate an implicit WHTH assumption will be to say, "yeah, of course." A strategist's reaction to hearing someone articulate an unconscious WHTH assumption will probably be more like shock ("oops") or denial ("it's not an assumption, it's a fact").

Your author wasn't privy to the strategy deliberations leading to the price cuts at Real Networks. However, he is willing to speculate. Here are some speculative WHTH assumptions, speculatively categorized, that they might have made. It is not necessary for all of the assumptions to come true for Real's strategy to work.

Explicit	■ New customers will enter the market if prices go down ■ Existing customers will shift to low-priced suppliers ■ We can negotiate with record labels to reduce royalty fees
Implicit	■ Customers will find out that our prices are lower ■ Once we gain a customer, he or she is likely to be loyal to us ■ Customers will continue to buy music over time
Unconscious	■ Competitors' reactions (if any) won't make us regret our cuts ■ Competitive forces won't prevent us from raising prices later ■ Customers will stay with us even if we raise prices later

The point is, the success of the strategy depends as much on WHTH assumptions that may not be clearly recognized as it depends on the on-the-surface WHTH assumptions.

Your author's observations of competitive intelligence and market research suggest that much (not all) intelligence and research focuses on validating or quantifying explicit WHTH factors. For instance:

- How big is the potential market?
- How elastic is demand as prices change?
- Who has the most customers now?
- How many of them can we get?

The implicit or unconscious factors get less attention, perhaps because they're harder to measure, and perhaps precisely because they're implicit or unconscious. Yet when strategies fail, it is more often because something implicit or unconscious didn't work as expected rather than because of a surprise in something carefully articulated and measured.

What do you have to do about what has to happen? Here are some suggestions.

First, generate multiple strategy options. If you only generate one option, then it's sort of pointless to be clear about WHTH for it to succeed, since there aren't any others available for you to select. Fortunately, the process of getting clear about WHTH can in itself inspire new options.

Second, talk about WHTH as part of evaluating the strategy options you've generated. Use brainstorming techniques to help expose implicit or unconscious assumptions. Remember that articulating WHTH isn't about judging whether it will happen. For instance, you can recognize that a given strategy's success may depend on competitive forces allowing you to raise prices later, without judging whether that assumption is warranted.

Third, evaluate the WHTH factors for your strategy options. Have your team rate each factor on a 0-10 scale for its odds of coming true and on another 0-10 scale for how critical they are to the strategy option's success. If you find critical WHTH factors where the odds are poor, consider that a signal that success is against the odds.

Fourth, do appropriate research or analysis if you find that attractive strategy options are vulnerable to WHTH assumptions. Do the research to find out just how price sensitive the market is, for instance. Run a business war game to find out what would happen to your performance if competitors reacted to your moves in different ways. Build or buy a quantitative model of your business if the math gets complicated or if people argue about what (they believe) the results of a move will be.

Finally, close the loop. Now that you're clear on what has to happen, track what actually does happen. You get two benefits: you hone your ability to understand WHTH and its impact on strategy decision-making, and you get early warning of your assumptions being validated or refuted.

About the author

Mark Chussil is Founder and CEO of Advanced Competitive Strategies, Inc. (**www.whatifyourstrategy.com**), and lead creator of the award-winning ValueWar® strategy simulator. He and his colleagues at ACS have implemented business war games for dozens of Fortune 500 companies around the world. He has published extensively and spoken at numerous conferences. Mark is also a Founder of Crisis Simulations International, LLC (**www.crisissimulations.com**). Prior to founding ACS, Mark worked at The Strategic Planning Institute (The PIMS Program) and Sequent Computer Systems. He earned his B.A. from Yale and his M.B.A. from Harvard.

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