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Tapping ecosystems to power performance

Forward-thinking companies are reaping the benefits of working across industry boundaries. Are you ready to do the same?

by Lang Davison, Tom Archer, and Wayne Borchardt

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Lang Davison
is managing director of global thought leadership in PwC Global Advisory.

Tom Archer
is global technology consulting and alliances leader. He is a partner with PwC US.

Wayne Borchardt
is director of management research insights and operations in PwC Global Advisory.

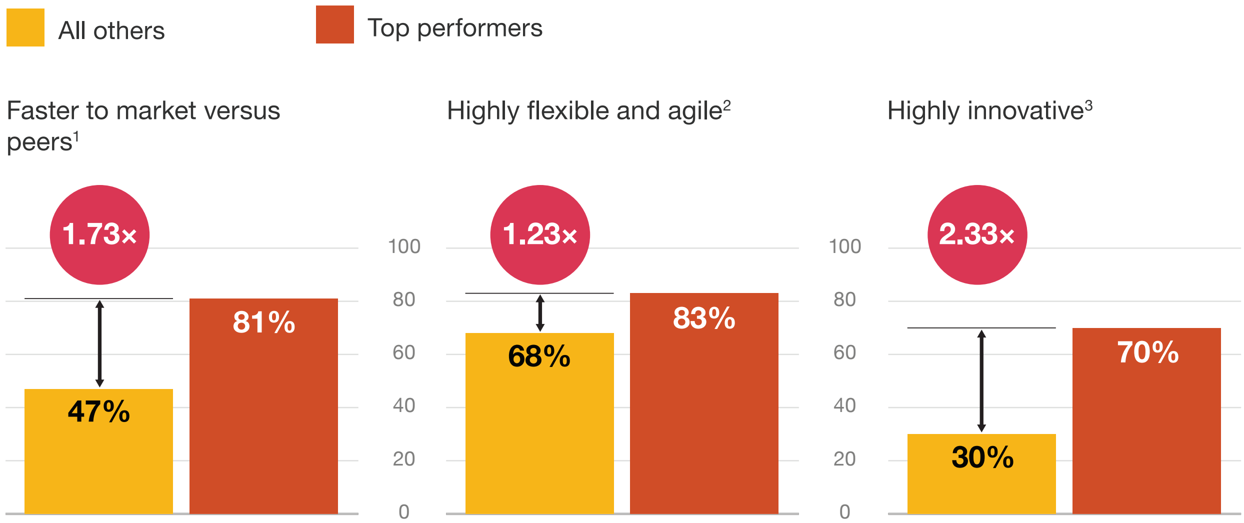
As companies transform traditional business models in the coming decade, economists and other experts predict ecosystems will drive seismic revenue shifts. And no wonder: by working across industry boundaries, companies can fulfill customer needs while creating value beyond what each could achieve alone. How much value? By 2030, for example, the US$3 trillion automotive industry could become part of a US$6.5 trillion mobility ecosystem, while the US healthcare industry could see a US$1 trillion revenue shift in the next five years as it transitions to a more ecosystem-driven structure. For companies that are able to evolve or create business models that enable scaling revenues in ecosystems, tremendous value is up for grabs.

For some, this strategy appears to be paying off already. New research from PwC examining differentiators that set apart top-performing companies finds that ecosystems are strongly associated with their success. These front-runners are more than twice as likely to generate greater than 60% of their revenues from ecosystems and expect that percentage to increase in the future. In other words, they recognize the potential for ecosystems to create value—and are poised to benefit by explicitly positioning themselves within these powerful cross-industry networks.

Consider, for instance, the Japanese construction company Komatsu, which has orchestrated an ecosystem that digitizes construction sites through open platforms, applications, and IOT devices—connecting customers with providers

Winning companies are performance-focused

The ecosystem advantage: Winning companies are 1.7 times more likely to be faster to market, 1.2 times more likely to be more flexible and agile, and 2.3 times more likely to have high levels of innovation.



1. Share of respondents who indicated "moderately faster" or "significantly faster"

2. Share of respondents who indicated "to a large extent" or "to a very large extent" with respect to flexibility in response to demand-side and supply-side variability

3. Share of respondents who indicated that at least 60% of this year's sales came from products or services that did not exist three years ago

Source: PwC analysis

of services and software solutions. In so doing, Komatsu has fundamentally transformed the way it creates value for customers.

For companies looking to up their ecosystem game, our examination of how high-performers view and participate in ecosystems reveals insights that could help close the gap.

Ecosystems fuel success

We surveyed more than 2,000 leaders at director level or higher, at companies with median revenues of US$650 million, to identify the differentiators that give top companies an edge. We then quantified the effect of 40 areas of management practice and company investment. During their latest fiscal year, we found that companies in the top quintile captured a "performance premium" (the combined effect of profit margin and revenue growth, in industry-adjusted terms) that was greater than 13 times that of their industry peers. These leading

What we did—and why

To better understand what's behind top performance we needed to define performance. For purposes of this research, we used two measures: profit margin and revenue growth. Using both measures allowed us to account for important differences in how companies grow profits. Consider, for example, how two companies with identical profit margins but different rates of revenue growth will have profits with very different growth trajectories.

Meanwhile, we also needed to account for the fact that some industries are growing faster than others. We did this by factoring into the analysis both the industry median profit margins and the industry median growth rates. This allowed us to level the playing field and make respondent-by-respondent (as a proxy for company-by-company) comparisons. In all cases, the time frame for our analysis was the respondents' last fiscal year.

The result was a so-called performance premium—or the combined effect of profit margin and revenue growth in industry-adjusted terms—which we calculated for each of the 2,006 respondents to our survey.

Next—and separately—we constructed an index from the survey results associated with the 40 areas of management practice and company investment that we'd set out to study: for instance,

(continues on next page)

companies are also faster to market, more agile, and more innovative (see chart on page 3 and "What we did—and why," above).

Ecosystems play a big role in outperformance. Leading companies were 1.6 times as likely as other companies to leverage ecosystems to gain competitive benefits that include access to new customers and markets; privileged insights leadership characteristics; investment in business and operating model transformation; the use of technology; and the use of service partnerships, or managed services. Dividing the index into quintiles showed us the degree to which the respondents' companies were following the 40 practices themselves.

Finally, we linked the respondents' position on the index to the performance premium we'd calculated earlier—essentially revealing the performance premium associated with various degrees of adherence to the management initiatives and practices.

The resulting shape of the distribution was decidedly nonlinear, which led us to name the performers in the top quintile "quadratic companies." What are the benefits of achieving this title? Quadratic companies earned an average performance premium of 44% in their last fiscal year. By contrast, the next-best performers (those in the fourth quintile) earned just 9%.

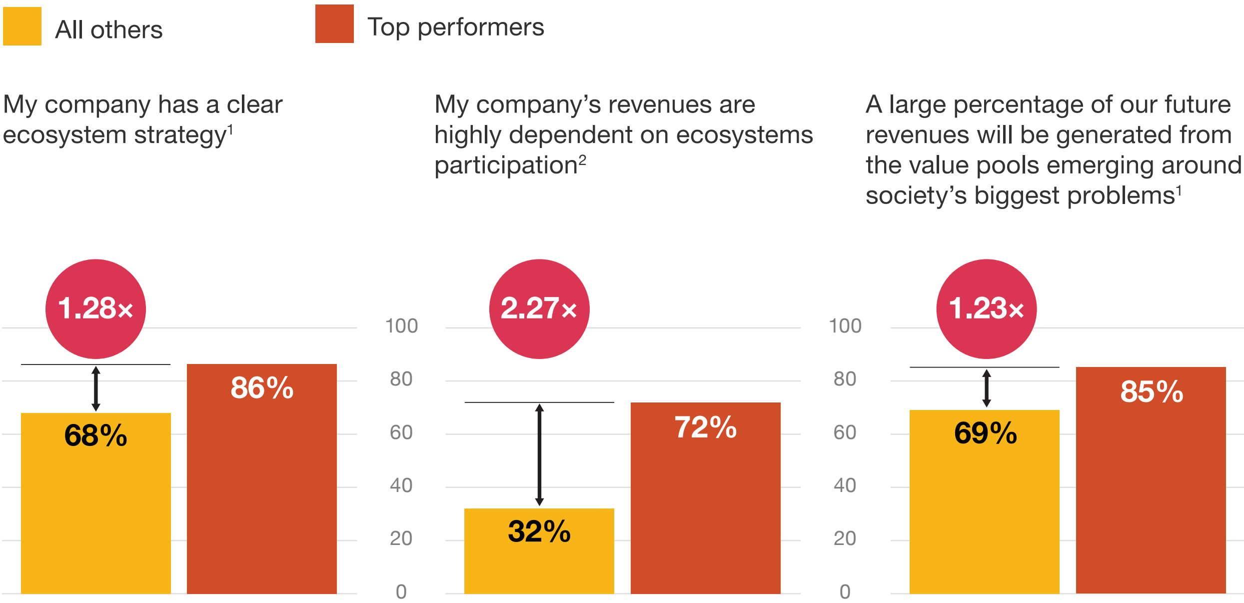
To put it another way, consider the performance of two hypothetical competitors. Both start with revenues of $100. After one year, the quadratic company would have $44 of profit over what would have been earned if the company had achieved the industry medians for profit margin and revenue growth. By contrast, the fourth-quintile company would have earned just $9 of profit over those industry medians.

such as data on customers' needs, desires, and experiences; and complementary skills and capabilities. In effect, these leaders participate in and contribute to a system of capabilities supporting a collective value proposition that is more compelling than any company could provide on its own.

The benefits to companies are valuable not just in isolation—they can have powerful "flywheel" effects on performance. Consider, for example, how privileged insights into what customers want can help companies identify

Top-performing companies harness ecosystems to seize the value upside

Ecosystem-driven: Top-performing companies are almost 1.3 times more likely than other companies to have a clear ecosystem strategy, and are nearly 2.3 times more likely to already generate more than 60% of their revenues from ecosystems—and plan to increase this in the future.



1. Share of respondents who indicated "to a large extent" or "to a very large extent"

2. Share of respondents who indicated that they earn at least 60% of their revenues from their ecosystem participation

Source: PwC analysis

capability gaps that, when addressed, support new or improved customer value propositions, which bring in more prospective customers that companies can tap for further insights. Network effects are in play here, too. When a travel website aggregates customer reviews of hotels and restaurants, for example, the more users that participate, the greater the incentive for others to do the same.

These are just some of the results of the big bets that top performers have already placed on ecosystems—bets they plan to increase going forward. The chart above shows three key characteristics that set winners apart: a clear business ecosystem strategy; a strong dependency on ecosystems for revenues (and strong results already); and plans to gain future revenues in the value pools emerging around society's biggest problems.

Senior executives need to start with a clear-eyed examination of where the company creates unique value and how it contributes this to the ecosystem.

Seize the value upside

Given the head start that top-performing companies are developing, others would be smart to revisit their own ecosystem plans with urgency. Our research identifies three actions to help teams begin grappling with how to seize the full potential of ecosystems.

1. Strategize and then focus. Just as companies have corporate and M&A strategies, they also need a clear ecosystem vision and strategy that address the classic where-to-play and how-to-win questions. Yet clear answers may seem elusive, as disruptive technologies blur industry boundaries and customer wants and needs shift. Senior executives need to start with a clear-eyed examination of where the company creates unique value and how it contributes this to the ecosystem. This latter point is crucial: companies that focus only on the value they create, and not the value they bring, will set themselves up for disappointment.

Once armed with clear ideas around value creation, leadership teams can tease out the implications for the company's ecosystem model, and choose a role that best fits their situation. That may be as an orchestrator—at the center of the ecosystem, enabling others to collaborate—but more likely as an ecosystem partner or participant. For example, in *Beyond Digital: How Great Leaders Transform their Organizations and Shape the Future*, PwC's Paul Leinwand and Mahadeva Matt Mani note that, in addition to the orchestrator, ecosystem roles include:

Anticipating—and filling—**capability gaps** is vital, and that's where there's an important lesson from top performers: **don't go it alone.**

- platform providers, such as Microsoft or the New York Stock Exchange
- solutions providers, such as Hitachi
- aggregators, such as Walmart, which provide the convenience and simplicity of one-stop shopping.

Finally, a word of caution. Don't fall into what strategy and entrepreneurship professor Ron Adner calls the "ego-system trap," which occurs when executives misjudge their starting point as well as the capabilities and investment involved to play the orchestrator role. The number of companies positioned to succeed as orchestrators is lower than you might guess.

2. Address capability gaps. It is one thing to articulate a sharp ecosystem value proposition but carrying out the related business model is another. As companies focus on the new business models necessary to participate in ecosystems, many of them will find capability gaps and blind spots relating to everything from people skills to technology. These shortfalls may present themselves in any or all of the organization's core functions and across a range of both differentiating and non-differentiating processes. They might involve more familiar areas, such as digital tools, but also less intuitive ones, such as governance and decision-making. What many of these gaps will have in common is the human factor. Success arises not just from having the right technology platform and tools for your sector, for example, but from how you and your people use them.

Anticipating—and filling—capability gaps is vital, and that's where there's an important lesson from top performers: don't go it alone. Leading companies are more than seven times as likely to use service partners to keep pace with technology changes and to close capability shortfalls in their operating models.

No matter the gap you're trying to close, though, you may need to address what author Cass Sunstein calls the "sludge" in your organization. Sludge manifests as high transaction costs, a defining characteristic of too many organizations. Unless checked, sludge is liable to hamstring a company's ecosystem plans. In contrast, our research found that top-performing companies are 1.2 times as likely to use a digital operating model to reduce transaction costs.

Why does sludge matter? Because getting things done in ecosystems requires being nimbler and more responsive to everything from customer needs to managing tricky relationships with partners that might otherwise be competitors. Sludge is the great enemy of nimble responsiveness. Among other things, it can impede decision-making and resource reallocation, making companies slower at closing capability gaps and reducing their speed-to-market. In addition to sluggish resource reallocation, warning signs of sludge within companies also include failures to move data cleanly and easily from one part of the company to another.

3. Look to the future. Many of the unresolved challenges the world faces, such as climate change or healthcare access, are so big and complex that no one company on its own can solve them. They can be addressed only by networks of companies and institutions working together toward a common purpose and making the most of new business models and technology. That's because no single company has the resources to develop the capabilities required, nor could it scale them as quickly as a dynamic world demands.

Even as society benefits, companies and customers benefit, too. Komatsu's construction ecosystem, for example, helps address serious labor shortages in Japan's construction industry by digitizing construction sites and enabling customers to use less labor than in the past. And as companies grapple with how to handle their environmental, social, and governance (ESG) risks, meanwhile, they're partnering in ecosystems to access the sustainability capabilities they need—and contributing to carbon reduction.

Similarly, in precision farming, companies have come together to combine remote sensing, IOT-enabled agricultural equipment, and other technologies to collectively help their customers use farmland more cost effectively and with less environmental impact. Here, as with all ecosystems, a winning customer value proposition requires a range of complementary services that no single company can provide or scale alone.

To be sure, competing in ecosystems won't come easily to top leadership teams that are used to static industry boundaries and traditional, zero-sum-game forms of competition. But they had better learn fast. As ecosystems become more of a differentiating factor that separates out high performance, companies that already have an edge will be well placed to extend it. To improve their odds, companies should clarify their ecosystem strategy, identify and develop the necessary capabilities, and start looking for opportunities through a long-term, societal lens—before others beat them to it.

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