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Overcoming Competitive Pressures: "Making" vs. "Milking"

A fresh take on the classic theme of generic business strategies.

Business strategy is fundamentally about allocating scarce resources to create the greatest impact on organisational performance. As a strategist, you will often be confronted with two broad innovation strategies: "making" and "milking".

The making strategy involves enhancing value creation through an organisation's products and services by better meeting customers' needs. This value to customers, as measured by their willingness-to-pay minus the costs incurred by the firm to serve them, is critical for profitability as it enables the firm's offering to better compete with that of rivals. The milking strategy involves positioning an organisation to better capture the value it is already creating for customers by bargaining more effectively with them. In doing so, the organisation is able to more easily overcome competitive pressures from its customers.

The strategies of making and milking can be illustrated with the case of an online distribution platform for a media company, for which an important and scarce resource would be its team of software engineers and data scientists. In this context, the making strategy would have the team prioritise tasks such as developing new user experience features and algorithms to remove abusive or disturbing posts. By enhancing its value proposition through improved user experience, the platform could deepen engagement with existing customers to deter switching and potentially attract new customers from competing platforms.

In contrast, the milking strategy would see the technical team focusing on projects to drive monetisation such as pricing algorithms, which could bring each customer's subscription fee closer to their willingness-to-pay. Similarly, the tech team could also develop an automated call centre support tool to help upsell existing customers to capture more of their wallet.

The question then boils down to: Which innovation strategy do you choose? And under which circumstances?

How the strategies work

Our study on **value-based strategies**, published in *Strategic Management Journal,* explores the dynamics behind these choices. To identify key drivers for choosing the milking and making strategies, we analysed a setting where two rival firms compete across two customer segments. For example, these could be B2B firms selling IT or professional services to customers from distinct industry segments like finance and healthcare.

A firm's ability to capture value, in the form of profits, is impacted by two dimensions of competitive pressures. First, the firm faces competition, and with it the need to meet and beat the value created by its rival in a specific segment by creating more value. Second, the firm then faces buyer power (one of Michael Porter's **five forces**) as customers look to further reduce prices through aggressive counteroffers, threats to cancel services and other negotiation tactics. Direct competition with a rival limits the firm's potential value capture to its added value relative to the rival's offering, from which customers will try to shift more value from the firm to themselves.

By increasing a firm's value creation capabilities, the making strategy neutralises competition in two ways. First, for an existing customer segment, the firm has more added value relative to its rival and hence there is more value to negotiate over with its customers. Second, a sufficient increase in value creation enables the firm to neutralise an initial value creation disadvantage in a new segment, allowing it to win over customers from its rival and thereby opening new possibilities for value capture. On the other hand, by increasing a firm's bargaining capabilities, the milking strategy allows the firm to capture more of its existing added value for customers.

Interestingly, our findings show that the innovation strategy that you choose not only has direct impact on your organisation's performance, but also has wider implications for the competitive dynamics in your market.

Addressing your weaknesses may be your best bet

One of the oldest rules of thumb in strategy is to "build on your strengths". For example, in diversification strategy, firms often look for market opportunities that allow them to leverage core competencies (i.e. strengths). Does this intuitive approach also apply to the choice between milking and making? For instance, should a firm with a greater value creation capability double down on creating more value?

Our analysis shows that when choosing between these innovation strategies, there are clear benefits to addressing your weaknesses rather than just building on your strengths. The stronger a firm is in value creation, the more it can benefit from increasing its milking capabilities in order to capture more of its existing added value.

Conversely, the stronger a firm is in bargaining, the greater its returns from enhancing its value creation through a making strategy as the firm will capture a larger share of the value created. An important implication is that without sufficient bargaining capabilities to capture value, firms may experience a dearth of value-creating innovations, since those innovations will not generate sufficient returns to make a strong business case for investing in them.

For instance, a pharmaceutical firm with a strong portfolio of patented drugs might prioritise its pricing, lobbying and sales capabilities to enhance its ability to capture more of the value created by that portfolio. In contrast, a pharmaceutical firm with a weaker drug portfolio – perhaps hit by the expiry of patent protections – might focus more on building up its drug pipeline to ensure future value creation.

Follow your competitors?

Our analysis shows that firms tend to imitate each other's strategy choices. Why? This arises from the different impact of the two strategies on competitive dynamics.

When your rival focuses on making, it increases the threat of competition, as your added value to your existing customers is at risk of being eroded. This reduction in your added value reduces the returns from the milking strategy, pushing you to focus on value creation through making as well. Conversely, when your rival focuses on milking, your market position is more secure, which increases the attractiveness of enhancing your bargaining power by focusing on milking as well.

This mutually reinforcing nature of firms' strategy choices can lead to two very different competitive outcomes in a market. One possibility is a making-making outcome where the two rivals get locked into a value creation race where they seek to drive growth at the other's expense. Equally possible would be a milking-milking outcome where both firms focus on capturing value from their own segments (a classic coordination game for those familiar with game theory). What are the implications of these competitive dynamics for firm performance?

When the two rival firms coordinate on the milking strategy, their profits are higher due to the reduction in the competitive pressures they impose on each other. Since firms are not mutually eroding each other's value created, there is both less rivalry and more scope to reduce the buyer power of customers. This is a form of tacit industry collusion. In contrast, customers are better off when firms focus on making. This happens not only because more value is being created, but also because the increased competition pushes a higher share of that created value to the customers when firms are not enhancing their bargaining power.

While there is a tendency for firms to align their strategy choices, other forces can lead to divergence. For example, if firms have wildly different customer segment sizes, the firm with the larger segment will choose to focus on milking its customer base, while the firm with a smaller segment will be drawn to making to grow its customer base. Similarly, if firms start with very different levels of value creation or bargaining capabilities, the pressure for each to address its weaknesses can also lead to diverging strategy choices.

Disrupting the market with radical innovations

In this golden age of entrepreneurship, where advancements in digital technologies have enabled ground-breaking innovations, what can our model tell us?

For making strategies, there is a crisp distinction between radical and incremental innovations. Incremental innovations correspond to enhancements to a firm's value creation – such as small improvements in user interface or delivery times – that increase willingness-to-pay for its home-segment buyers but are not large enough to allow the firm to break into new market segments.

In contrast, successful radical innovations deliver a significant leap in value creation that allows a firm to displace its rivals and break into new market segments. Prominent examples of such market disruptions include Apple's extension of the iOS from the iPhone to the iPad to win over the tablet computer segment, and Salesforce enhancing its CRM platform to include marketing automation and e-commerce capabilities. How does the increased importance of radical innovations influence risk-taking among rivals?

In our model, we allow firms to choose the risk profile of their value-creating innovations based on the classic risk-return trade-off principle – a lower probability of innovation success is compensated with a greater increase in value created. We see more risk-seeking behaviour when firms have access to radical innovations, due to the fixed cost of entering new market segments. A firm is better off going for a risky strategy that has a bigger upside when successful but incurs a fixed cost of entry less often, which translates to lower expected entry costs.

Interestingly, the pull towards riskier strategies can be good not just for an individual firm's performance but also for overall industry profitability. We have seen that the making strategy, when successful, results in a negative externality on the rival by eroding its added value. The riskier the making strategy, the less likely this negative externality is to occur. Hence, as long as one firm focuses on making, a shift to riskier value-creating innovations raises the profitability of both. Our results reinforce the importance of culture change in organisations to increase their risk tolerance.

An updated approach to generic strategies

In his classic strategy texts from the 1980s, Michael Porter promoted the idea of generic strategies that apply across industry settings. He highlighted a choice between a "differentiation" strategy, whereby firms focus primarily on enhancing the willingness-to-pay of customers, and a "cost leadership" strategy, whereby firms focus primarily on reducing costs. However, this once popular approach to generic strategies is arguably losing some of its appeal. Today, with the advent of modern value-based analysis, the focus of competitive strategy is on increasing the gap between willingness-to-pay and costs of a firm's offering, which contrasts with the Porterian emphasis on either dimension.

Our research highlights a novel and robust approach to generic strategies. Strategy choices should be shaped by an assessment of the competitive pressures that pose the greatest threat to firm performance. If the answer is rivalry, the making strategy of enhanced value creation takes centre stage. Once a firm has sufficient value creation to secure its customer base, then buyer power looms large as the key threat to a firm's value capture, and hence the milking strategy comes to the fore.

In the domain of innovation strategy, there is a tendency for strategists to focus almost exclusively on value creation. Such a narrow focus may be detrimental to firm returns, as it may lock rival firms into a needless lose-lose race for value creation. Our research suggests that a greater consideration of the potential of milking strategies – both in terms of their direct impact on value capture and of their implications for competitive dynamics between rivals – can pave the way for enhanced firm performance and overall industry profitability.

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