Article

Due Diligence – Innovation

By L. Burke Files, CDDP, President, Financial Examinations & Evaluations, Inc (01/02/2013)

Michael Porter’s Monitor Group went bankrupt. You say who? Michael Porter is a PhD from Harvard who discovered that some companies possess the ability to generate excess and persistent profits because of barriers to competition. Those barriers could be legislative, access to capital, exclusivity such as with patents - but barriers none the less. For economists excess and persistent profits are a problem, for businessmen it is fiscal alchemy. Porter’s research seemed to imply that there was a short cut to fiscal alchemy.

The appeal of the short cut is simple. Forget all the garbage that was loaded into managers’ little pointed management heads in business school and countless seminars about innovation and building better products and offering better services as it is utter rubbish according to Porter’s observations. All a business needs for fiscal alchemy is a “barrier to entry”. Than lets call this discipline of management “barrier to entry”- aka throttling any hope of competition - “the discipline of strategy”. For any discipline one must also possess guiding points called strategies. Porter called the three Strategies; cost leadership, differentiation and focus. He added to the three Strategies the five Forces analysis: threat of new competition, threat of substitute products, bargaining power of customers, bargaining power of buyers and intensity of competition. To make use of the short cuts to fiscal alchemy provided by the three Strategies and the five Forces all you need is a Wizard. Those Wizards were made available, for a hefty fee, by Michael Porter’s Monitor Group.

Does it appear I do not like Michael Porter and his ideas? Quite the contrary, I read his books and papers, even if some of them are nearly indecipherable even in English. I read them and discuss them with only a few others that I know read and apply Porter’s wisdom. His insight has been, and continues to be, keen. However - and you know this was coming - his ideas have been taken to extremes, taken to extremes that are not only unhealthy for an economy but unhealthy for nations.

The readers of IFC are some of the smartest and most literate minds in management and finance in the world. We have seen and discussed issues at conferences, meetings, and on line about the volumes of regulation coming from all quarters of the world. Those volumes of regulations are those artificial barriers being erected allowing some companies to possess the ability to generate excess and persistent profits. An oligopoly of the regulated over the innovative has evolved seed by Porter’s ideas. Artificial barriers/regulations - have been understood now by generations of managers to be good for the bottom line. This has mutated in law makers’ brains that more regulations are good for the economy. The law makers do not understand that their bottom line consisting of corporate donations to their campaign coffers and opportunities for post elected office consultancies is not the same as the bottom line for industry.

But wait, did not the Wizards at the Monitor Group fail? Yes, they did and they failed on many fronts. The first small failure is they ran afoul of regulations. The Monitor Group failed under OFAC regulations when they did some work for Muammar Gaddafi - a real faced moment for the champions of artificial barriers to entry. The second failure was the continued failure to understand - as many of us do - the frighteningly rapid pace of innovation and change. The three Strategies and the five Forces look more like short term tactics, good, but still short term.

We see it all around us, companies that have relied on these barriers to entry for profits. Barriers such as regulation, capital, even patents are failing long term to generate those desired results. Look at the titans of business but a few years ago... Kodak, Swiss Air, Indymac Bank, Sharper Image, Polaroid, Bethlehem Steel, Commodore Computers - not frauds but companies that possessed the ability to generate excess and persistent profits

Mauritius
Netherlands
Nevis
New Zealand
Panama
Samoa
Seychelles
Singapore
St Vincent & The Grenadines
Switzerland
United Arab Emirates

frauds but companies that possessed the ability to generate excess and persistent profits because of barriers to competition. Monitor Group failed in the same way as these titans failed.

Innovation, commercialisation, and commodification on the way to obsolescence is the path goods, service and business naturally take. To stop this path for an organisation, part of the strategy (not tactics) must be to not only innovate but harness the innovation to gain and keep the competitive advantage. They must innovate in goods and services to be sure, but also in staffing, management, operations and finance. Reliance upon barriers to entry - even if they are regulatory in nature - in the end are futile.

The IFC community knows this as we make our bread and butter by being economically very disruptive. The IFC community are the ones who provided for opportunities for businesses, mostly smaller businesses, to grow and thrive away from their homeland regulator framework. To grow and thrive away from the domestic barriers crafted and erected by their domestic industry and law makers.

The Wizards of the Monitor Group failed as they and many other business and governments have been too dependant upon barriers for their economic health.

Investing in companies that are overly dependant on barriers is bit like a party dependant upon the punch bowl. One must possess sufficient discipline and insight to exist the investment at the right moment, just as one must have the discipline and insight to remove the punch before the party turns messy.

All barriers fail. The barriers either fail overnight through innovation or erode over time as workarounds are devised.

Sustainable competitive advantage can only be maintained by harnessing long term and continuous disruptive innovation!

It is a bit like lassoing a whirlwind... - it needs a special kind of rope.