



THE DEATH OF BUSINESS AS USUAL AND THE UNRAVELING OF THE VERTICAL INDUSTRY STRUCTURE: THE EMERGING THREAT FROM CHINESE GIANTS

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Over several decades, western companies have relinquished manufacturing capabilities to low cost, mass production facilities in the far east. Today, the Chinese juggernaut is poised to take control of the services industries as well, through a carefully planned, well-crafted strategy of owning the consumer mindshare. Companies that do not wake up to this impending threat and act, are destined to be the dinosaurs of tomorrow.

EXECUTIVE SUMMARY

A tsunami of industry disruption is on the horizon and most western companies have yet to wake up to the threat. This highly disruptive revolution, while starting in Asia, will soon impact Western economies forcing service companies out of their vertical industry orientation and into horizontal, experience-oriented business models.

Traditionally, companies bundle similar products and services within well-established industry verticals. Whether it is a bank, insurer, healthcare provider, retailer, telecommunications provider or media company, you will find them offering similar services across individuals, small enterprises and large enterprise customers. The fact that the service provider such as a bank, serves a large enterprise is of little value to the individual who needs banking services. Nimblier, experience-oriented service providers are turning this business model, which has dominated the past 100 years of economic expansion, on its head. These new competitors, instead of building within one industry, are selecting and stringing together a series of products and services from a range of adjacent industries that enable them to own and monetize all facets of a consumer's life.



A millennial lifestyle enablement approach will force incumbent market leaders to reevaluate their strategies and competencies.

Two Chinese service providers, Alibaba and Tencent, are specifically leading the charge. Instead of creating offerings and expecting Millennial consumers to seek them out, these firms seek to understand Millennial lifestyles and behavior and provide services that effortlessly fit into their lives. Meeting Millennials where they live and providing services conveniently at the point of need, regardless of industry or product, allows them to monetize every possible interaction, and create a digital stickiness that is markedly different from traditional brand loyalty. This has fueled their success and has resulted in Tencent & Alibaba dominating markets as varied as banking, gaming, social, search and retail. As the opportunity for growth slows within China, these firms have begun to look overseas for expansion.

Based on the success of Tencent and Alibaba, a few Indian giants are following a similar playbook. Given the potential for large US tech. giants to adopt this Millennial lifestyle enablement approach, we believe this shift toward horizontal, cross-industry, experience-oriented service is secular and will become the dominant business model globally. This will especially be true in the retail and small enterprise sectors within traditional services industries. This changing industry dynamic will force incumbent market leaders to reevaluate their strategies and competencies. Several of these strategies are headlined in this paper.

Upending the industry structure

In Western economies, the service industry consists primarily of vertically built companies. We are used to the concept of specialist businesses that have grouped similar capabilities together to get economies of scale. We, as consumers, have been trained to have relationships with these specialist companies. We have banks to meet our banking needs, insurance companies to meet our insurance needs, retailers to meet our shopping needs, etc. While these companies occasionally stray into each other's markets, for the most, they tend to stick to their core. A bank, for example, might look to provide their customers with a world class banking experience in Payments or Lending. This banking centric view, where businesses view the world through a banking lens, has led to historic success for many financial institutions. It is also at the heart of why they are now at risk of being disrupted. The new players see Payments or Lending as a means to achieving a commerce transaction. They don't focus on providing the best payments product, but rather on being the most convenient service or on offering the features most valued by Millennials. It also means they may be providing this payments product alongside a chat service, a search engine and an ecommerce site. A financial institution on the other hand will often be bundling their product with other banking products such as a checking account and may even hesitate to include social aspects of payments much valued by Millennials.

Alibaba and Tencent are at the forefront of upending this way of thinking. Leveraging the fact that Millennials have shown less loyalty to brands than previous generations, Alibaba and Tencent have taught customers not to worry about who's providing the service, but rather how and when the service is being offered. Why not let a messaging platform provide you payment capabilities if it's easy and accessible? By reframing the discussion they've taken away the specialist businesses brand advantage.

To a large extent, these Chinese titans have put a new spin on a traditional Asian business model, the Japanese Keiretsu and the Korean Chaebol, being the most famous, and adapted this for the digital world. In the process they have achieved staggering financial returns in a very short span of time at the expense of incumbents (Exhibit 1).

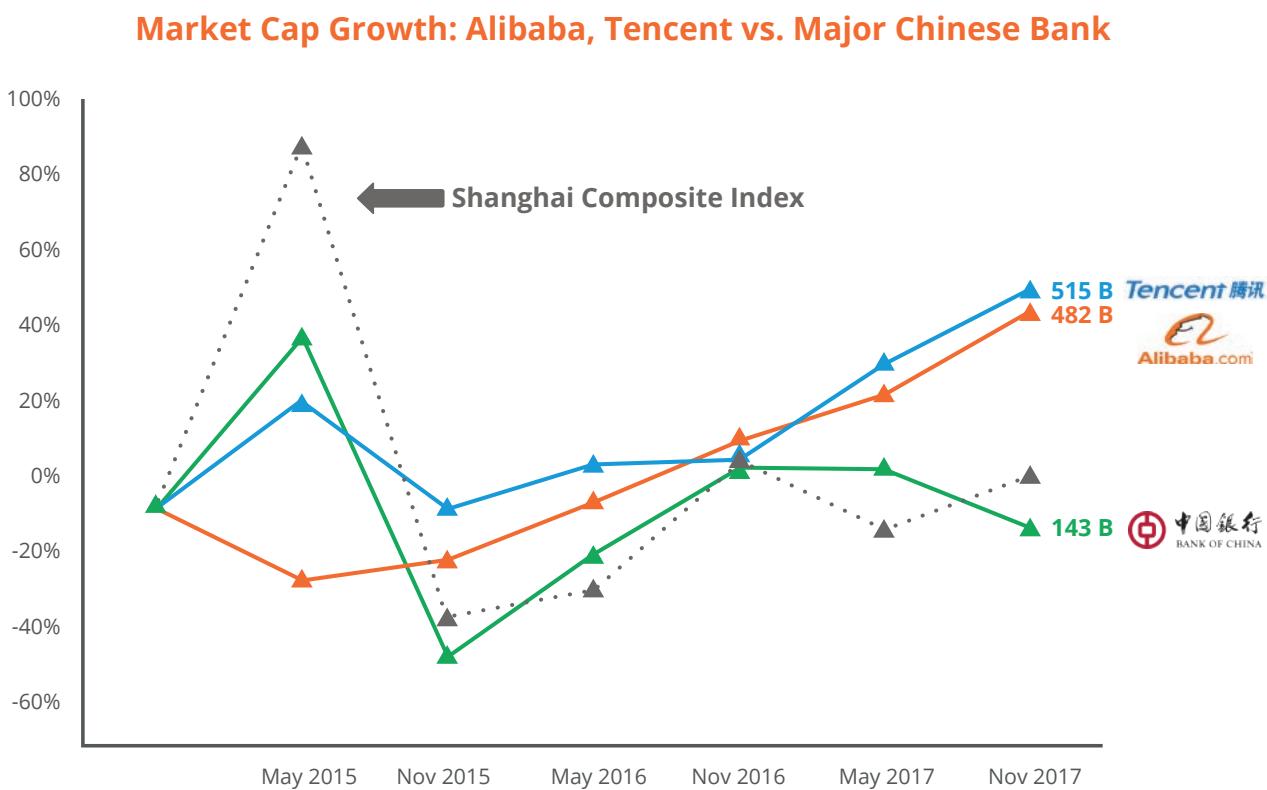


Exhibit 1

They're nimble and can launch new businesses quickly

One way in which Alibaba and Tencent are different than their forbearers is the speed at which they enter new markets. Whereas it took Samsung decades to develop its portfolio, Alibaba has moved into a variety of industries in a matter of years. They can do this because barriers to entry are lowering dramatically in three synergistic ways:

1. Fintechs, Insurtechs and others are creating the disruptive digital technology attractive to Millennials.
2. Access to cheap capital enables incumbents to buy the technology they need to provide the service.
3. Extreme digital automation drastically reduces the labor required to move into adjacent businesses.

They enter adjacent industries based on the customers' lifestyles

Alibaba and Tencent have changed the traditional Asian approach to the horizontal business model by changing the way they select which adjacent industries to enter. Traditionally, different industries within these adjacent businesses complemented one another — the Keiretsu use their banks to finance the activities of their other entities. Alibaba and Tencent flipped this equation. They are not focused on how the industries synergize with each other, but rather how they help their customers meet a need. In addition, rather than launch the new business as a standalone entity, they combine them in a simple, intuitive, integrated model that embeds the firm in the customer's day-to-day activities and services over 80% of their daily online needs. Exhibit 2 below illustrates how a horizontal experience-oriented service provider is able to find monetization opportunities throughout a consumer's day.

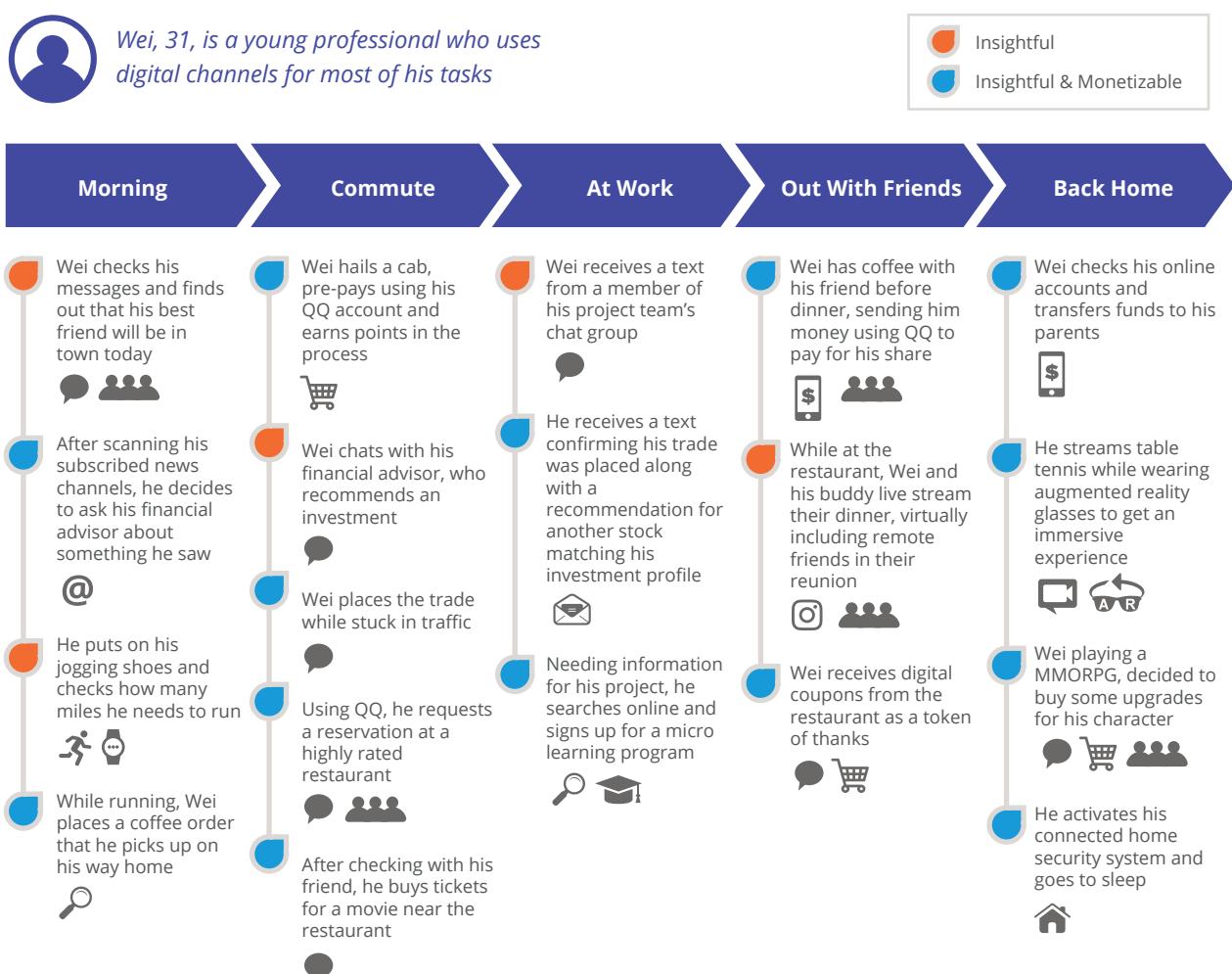


Exhibit 2

Masters at understanding their customers' digital persona and facilitating their daily lives

These companies initially built strong customer bases through digital businesses like social, search, chat, content and ecommerce which are at the core of defining a person's digital persona. Based on the insight mined from the digital personas, these companies are now systematically monetizing a wide range of activities that would have traditionally been seen as outside of their industry vertical. They have realized that their core competency is not the ability to deliver a specific product, but rather the ability to rapidly identify and launch businesses that fit seamlessly into their customer's lifestyle. This creates a network effect as more people join for one service and start using adjacent services while bringing their friends on to the platform.

Rapidly identify and launch businesses that fit seamlessly into their customer's lifestyle.



Global ambitions

While Alibaba and Tencent may be leading the horizontal business model revolution, they are not alone. Other Asian firms, such as Reliance and PayTM in India, are adopting similar models. These companies, have fully embraced this new competency model, and are beginning to build out large customer bases with the intent of providing multiple adjacent services. Alibaba and its affiliates are rapidly expanding throughout Asia and are beginning to enter the U.S. market. Alibaba for example has already acquired or invested in multiple US entities replicating their playbook across four core components of the digital persona (Exhibit 3).

Alibaba & Ant Financial US Investments¹

The aggressive expansion strategies being deployed by the Chinese payment leaders will require financial institutions to develop a strategic response

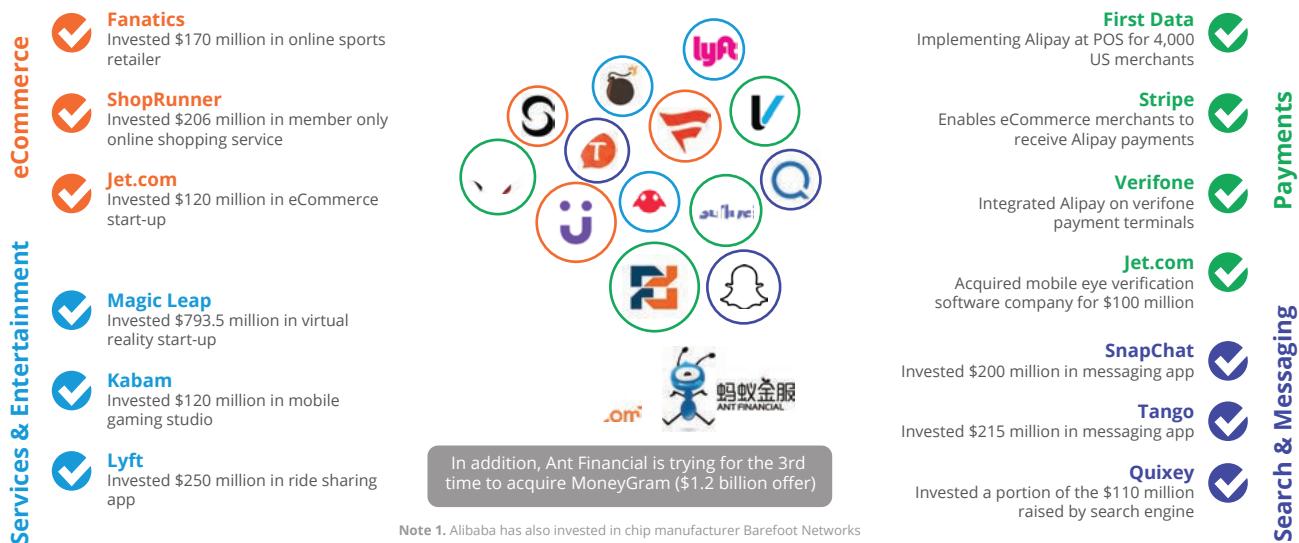


Exhibit 3

Within the U.S., tech. giants like Facebook, Google, Amazon, Apple and Paypal have yet to adopt this consumer lifestyle centric approach with the speed and laser sharp focus exhibited by their Asian peers. While these companies are well positioned to remain on top in the new industry landscape by copying the Chinese at their own game, they need to move rapidly to retain their advantage.

Future industry structure will collapse into customer experience based models

In the future, incumbent firms with huge customer bases and access to cash will embed themselves in all aspects of a consumer's life. Vertical business structures will collapse and re-form as horizontal models. How this plays out will vary by market. In growing markets like Asia, there may be an opportunity for new horizontal players to rapidly emerge alongside the established vertical players. In Europe and the U.S., where the market place is mature, these structural changes may develop more slowly, but will result in a Red Ocean. Horizontal, experience-based service providers will expand by taking market share from vertical competitors. The implications of these changes are profound. Large service providers of the future will no longer be capability focused. They will be experiential and socially focused, unbundling and re-bundling capabilities as needed to deliver an experience. The incumbent, product-oriented providers that make the shift will not only survive but thrive in the new environment. Those that don't will find themselves displaced by nimbler, experience-oriented innovators.

Options for today's service providers

This changing industry dynamic will force incumbent market leaders to reevaluate their strategies and competencies. Some incumbents will seek to compete directly. Retaining their customer base, and growth, will require them to develop comparable skillsets, develop an exceptional understanding of their customers' digital persona and the ability to provide a range of services seamlessly. While parts of this expanded customer experience may be through organic in-house development, most firms will require acquisitions and partnerships to provide the majority of these services. Other incumbents, not wanting to enter disparate businesses may pursue other strategic options. One option would be to become a platform provider and own the customer experience and source products from others to provide the end-to-end experience. Others may simply choose to provide services to the platform players mentioned above.

FOLLOW UP TOPICS

In future papers, we will explore various topics around this theme:

1. Which markets are showing signs of early disruption
2. How active are the Chinese titans in the US and other Western geographies
3. What are the different horizontal experience models and how will they evolve
4. What strategies are companies using to create a network effect
5. What's at the core of a digital persona and how does one build a digital persona
6. How is the strategy adopted by the American Tech giants different than the Chinese
7. Who among the tech giants is best positioned to copy the Chinese model
8. Is partnership across adjacent industries as a competitive response likely to succeed

Note – this paper was amended on January 10, 2019 to include that the Alibaba/Tencent integrated business model can serve over 80% of a customer's daily online needs.

ABOUT THE AUTHORS

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