

Newsletter Series

The Challenge of Digitalization

Part 2: Vertical and Horizontal Networking

by Dr. Rudolf Pritzl and Dr. Peter M. Ruppert

Vertical and Horizontal Networking

German companies have used digitalization as a **lever for increasing efficiency**, to improve cost positions, and to increase competitive advantages, as well as market share. Increases in productivity and profitability are primarily based on vertical networking.

In **vertical networks** suppliers, manufacturers, and distributors work closely together in closed systems. Each part of the network tries to improve the whole, the greatest possible number of achievable optimizations within the vertical network are addressed. A horizontal view outside of the own network is seldom considered necessary.

Horizontal networking includes a **change in the existing rules of the game and the process chains** themselves in order to improve customer benefit or to realize unused potential.

Four **“game changers”** have a direct effect on customer benefits, customer communication, and therefore also have a direct influence on the business:

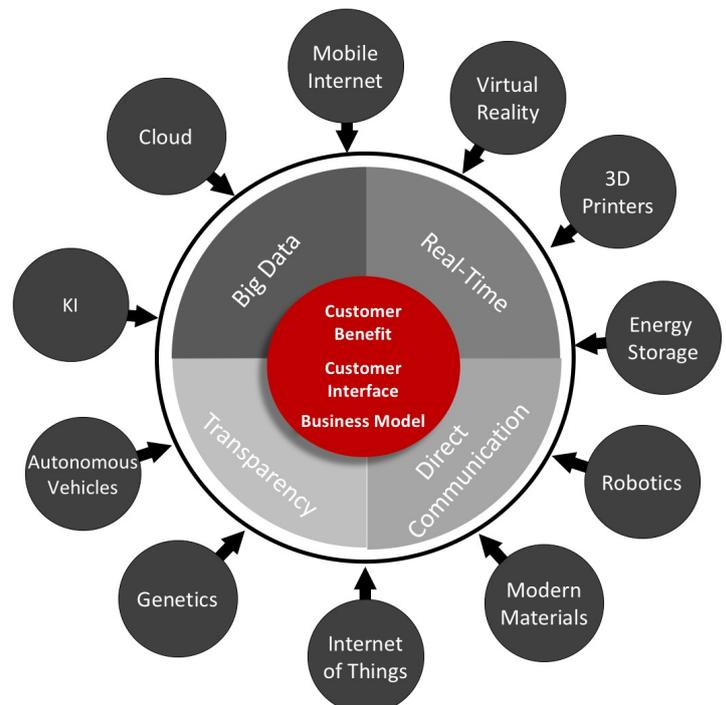
- **Big Data:** Enables consumption-based and targeted offers, focused on the usage behavior of customers
- **Real-time:** Targeted data usage, offers derived from analysis and direct communication with customers
- **Direct communication:** Enables disruption of existing customer interfaces and the direct recording of customer data
- **Transparency:** Business models based on a lack of transparency and insufficiencies are difficult to maintain and are increasingly threatened.

The game changers are strengthened by future opportunities for disruptive technologies and can break the existing value chains. Companies should find out and analyze the influence of customer benefit, customer interfaces, and business models within this context, to determine what opportunities and risks would result from horizontal networking.

Horizontal networks require the **abandoning of rigid value chains** and **thinking in connections beyond one's own vertical network and industry**.

Many German companies are hidden champions and have a top position in value creation. They will lose this position if new players from outside their industry use the „game changers“ in a targeted way in connection with disruptive technologies. With these innovative business models, they can take over significant parts of the value creation.

If companies allow other companies to take their place using their domination of customer interfaces and targeted data expertise, this will lead to significant drops in value creation and margin development.



This means that the traditional market leaders may be pushed to one side or even out of business if digital platforms monopolize client contact and increasingly dominate producers.

Digitalization creates completely new opportunities for increased efficiency and for growth. On the other hand, huge losses in gross value creation can result from this. According to a study by the BDI, by 2025 European industry may lose gross value creation of EUR 605 billion to international competitors if it does not take advantage of these opportunities itself.

Even in the steel industry, which up to now has worked in a traditional analog manner, completely new competitors are turning up via Amazon or Alibaba and are seizing the opportunity. Gisbert Rühl, Chairman of the Board of Klöckner & Co. therefore clearly says "I am cannibalizing my own business before somebody else does it."

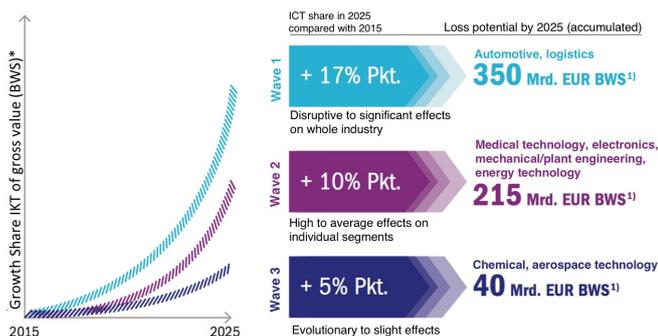
Klöckner is therefore focusing consistently on expanding digital trading platforms and Mr. Rühl forecasts that digital revenues will grow to over 50% of total revenue by 2019 (currently 10%). In many industries, there is still a tendency to concentrate on vertical networks, because this means keeping existing value chains and proven business models seem to remain stable. Opportunities resulting from horizontal networking are often neglected.

The high level of specialization and the predominant thinking in closed systems within German companies therefore results in digitalization being operated in a primarily vertical manner. Successes based on vertical networking that result in an increase in profitability often stop these companies from looking at new opportunities.

The focus is on doing the right things in the future and not simply optimizing what exists. It is about cannibalizing yourself before someone else does it.

In our newsletter series, we will give examples of how new competitors from other industries may arise as a result of horizontal networking. And how the rise of completely new markets is threatening existing markets. They can destroy existing market structures and entirely change existing business models.

**BY MISSING DIGITAL TRANSFORMATION,
EUROPE RISKS VALUE CREATION LOSSES OF EUR 605 BILLION**
Potential loss from change in the value creation share



* BWS: gross value, ICT: Information and communication technology
1) Loss of the gross value of EU-17 countries if the share of additional ICT is lost to international competitors

Similar opportunities also exist in other industries such as financial services and retail, as well as in the consumer goods industry. More than 10 years of e-commerce has dramatically changed traditional sales structures in some cases. Online sales go directly to the end customer. This makes it possible to offer significantly lower prices and on the customer's side there is increasingly less understanding of why trade receives a majority of the value creation. The German Furniture Industry Association, for example, states that customers have fundamentally changed their behavior. In the future, complicated processes, long delivery times and multi-level distributions will be less acceptable.

Sample Questions about Horizontal Networking

- Will our market change fundamentally as a result of the “game changers” and disruptive technologies? Will new markets be created that influence our existing market?
- Do the “game changers” and disruptive technologies have implications for our products, processes, structures, or our entire business model?
- Is our business model based on insufficiencies that will be rectified by the “game changers” in the sense of additional benefits for the customers?
- Does our business model offer additional potential if existing customers and product data are generated and used by partners in our industry or other industries?
- Do we have opportunities through strategic alliances or through changes in our business model to build up direct customer access?
- Who has customer or usage data that will influence our business model and the use of our products?
- Is there a threat of new platforms squeezing themselves between us and our existing business partners or customers, and is there a threat of new players taking over the customer interface?



We create clarity concerning strategy and operations

We reduce complexity and capture essentials

Our results are guidelines for profitable growth

We offer our clients exactly the support they need

We communicate open and directly

We work towards building a Long Term Partnership with our clients.

LONG TERM PARTNERS Deutschland

Südliche Münchner Straße 2, D-82031 Grünwald

T +49 89 6424 8380 **F** +49 89 6424 8381

E info@longtermpartners.de

LONG TERM PARTNERS Italien

Via Borgonuovo, 14/16, I-20121 Milano

T +39 02 7773 3105 **F** +39 02 7773 3100

E info@longtermpartners.it