Translating Customer Experience Into a Durable Competitive Advantage

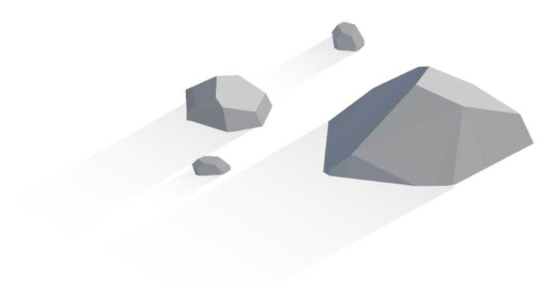
Technology is commoditizing experiences and increasing the risk of disruption. Sustainable value from customer experience can be achieved by accentuating strategic advantages.

BY RYAN PARKER

By 2022, First Republic Bank was a notable leader in customer experience and a prime example of the maxim "Take care of your customers, and they'll take care of you." In an industry where the average Net Promoter Score (NPS) is 31, First Republic hit a high of 80,[1] giving it more in common with customer-favorite companies like Apple rather than begrudging competitors like Bank of America. First Republic identified and prioritized customers (such as Silicon Valley-based investors), offered concierge levels of customer service to increase retention, and innovated on its tracking and management of CX-related metrics — all worthy CX tactics. Unfortunately, the CX successes were disconnected from the business at large. Its customer base became less diversified and reliant on high-net-worth depositors, it did not mitigate the risk of rising uninsured deposits as its investment products became more sensitive to changes in interest rates, and once rates did rise, its best-in-class experience could not retain customers as they fled to safe havens at other banks. In the end, it was the core products and the business model that dictated the longevity of the business. First Republic Bank was closed by the FDIC and sold to JPMorgan Chase on May 1, 2023.

Many customer experience initiatives championed today are not sufficient to deliver durable strategic advantages, and they won't be able to overcome radical disruption in the market. Programs such as customer insights or experience design are often optimized for top-line growth and will likely deliver some temporary value to the firm. However, CX initiatives that can ultimately be mimicked or quickly undone by market forces are not strategic, because they do not contribute to increasing long-term equilibrium profit margins or market share. Competitors can and will employ similar tactics or introduce disruptive experiences that diminish the lasting impact of experience-led growth initiatives, putting the emphasis back on core strategies related to product or pricing. This is compounded by modern technology solutions that nearly everyone has access to. Personalized offers are now common, and white-glove experiences are more scalable through the help of large language models and other AI solutions. Technology is both commoditizing experiences and increasing the risk of disruption — a good experience is not a sustainable differentiator on its own.

So, how should CX leaders think about creating lasting value via customer experience in an age where the bar is continually raised, risk can materialize suddenly without warning, and standing out is a challenge? Customer experiences can become *strategic* and *durable* if they align with and accentuate the core product/service offering strategies and business model — what I call ***Durable Customer Experience Strategies.*** Durable Customer Experience Strategies deliver competitive advantages because they are in harmony with a firm's strategic power and fail when they are independent of each other. Experiences should be optimized around one or some combination of counter-positioning core products and services against the market incumbent, driving the necessary demand for scale economies or network effects, and increasing the competitive moat (i.e., justifying high switching costs or capitalizing on a cornered resource). Doing so will deliver sustainable returns for the business through the increased value offered to customers and/or a more cost-effective cost structure.



CX Strategic Traps: Process Power, Branding, and First Mover Advantage

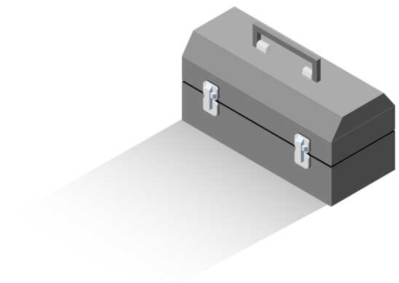
Hamilton Helmer, a noted strategist and former Stanford professor, described the "fundamental equation of strategy" as: value = market size x market growth x market share x differential margins.[2] A firm's primary strategic objective is to increase business value, so the imperative is to increase one or more of the value equation's four levers. To achieve superior performance, firms need to have better strategic positioning (make better choices than rivals to deliver greater business value) and operational effectiveness (executing better than rivals). The trap that customer experience leaders fall into is to focus CX initiatives solely in terms of operational effectiveness, rather than also considering strategic positioning. Optimizing CX initiatives for growth may sound strategic (increasing market share in the above equation), but the improvements stay in narrow lanes regarding effectiveness: target customers better, serve customers better, retain customers better, etc. Consider how similar this is to internal operational improvements: plan better, manage costs better, manage projects better, etc.

Michael Porter, of Porter's Five Forces fame, frames the issue of operational effectiveness (and what I've included in that grouping as typical customer experience effectiveness) as "necessary, but not usually sufficient."[3] The first reason that operational effectiveness is not sufficient is that as competition creates more absolute improvements, it leads to relative improvements for no one; margins ultimately become compressed over time. The second reason is that things like benchmarking and competitive analysis reduce companies' similarity, making operations generic and leading to a war of attrition in the market that ultimately drives M&A activity. The remaining competitors are often those who just outlasted the others, not the ones with a real advantage.

The traps that lead to the market compression that Porter describes can be framed in three areas for CX leaders: process power, branding, and first-mover advantage. Process power is a real, but extremely complex, power to wield in the market. It is often based on a core cultural component of a company built over a long period of time – think of Toyota's process of continuous improvement called kaizen. Many automakers and other manufacturing enterprises sought to imitate Toyota's processes but, in the end, it was such an engrained cultural component of Toyota the company that it proved impossible to truly implement elsewhere. Similarly, Ryanair's position as a leading low-cost airline was enabled by a dedicated culture of cost control down to locking up office supplies, a culture borne out of restructuring in 1990. These examples demonstrate that the biggest factors in process power are time (in the order of decades) and culture. Regardless, both Toyota and Ryanair continually combat the same kind of margin compression that Porter described. CX leaders who believe their CX-related processes are better than competitors' should heed Porter's warning and examine whether they have the requisite time and culture needed to create a strategic and durable advantage.

Branding is often the way that CX leaders describe the strategic value of CX initiatives, but it is a power susceptible to the kind of imitation that makes everything generic that Porter warned of. Branding is the ability of a firm to deliver a higher perceived value to customers for identical offerings of competitors based on historical information about the firm. This is where CX leaders often misuse the branding term; customer perception of value is misidentified, like-for-like offerings aren't being compared versus competitors, or there is less historical information about the firm available in the market than CX leaders realize. These failures of branding attribution are what make branding seem so fickle. Branding requires an honest evaluation of the competitive landscape and a deep understanding not just of what customers will pay for an offering but also how they value it. This was First Republic's fatal flaw. It misunderstood its branding power and how its customers valued its offerings. Once the interest rate environment changed, its customer value deteriorated rapidly, and its branding power evaporated overnight. Thirty-eight years of customer-centric operations were not enough to give customers confidence that their money would be safe.

It is worth talking briefly about first-mover advantages. Business value *can* be derived from being the first firm in a market to make a CX-related change. However, if that first-mover action is not parlayed into a different strategic power, it too is a trap because it is susceptible to competitive action. Often, if a firm is first to market with a CX innovation, the question shifts to how a competitive barrier can be created or how being first can be parlayed into long-term positioning. Therefore, I consider the first-mover advantage to be strategic, but ultimately not durable. What's important is for CX initiatives to align with the more sustainable strategic powers that I cover in the following paragraphs to create a durable advantage.



CX Enabling Counter-Positioning

Firms that are not the incumbent market leader have access to a potent strategic power called "Counter-Positioning." Counter-positioning is what happens when a newcomer adopts a different and superior business model that the incumbent can't or won't adopt because of potential damage to its business. A classic example of counter-positioning is Netflix versus Blockbuster. Netflix introduced DVD-by-mail with no late fees in 1997, a new and radically different model from Blockbuster's tenured retail strategy. Blockbuster got pilloried for not imitating Netflix's model quickly. However, what often gets overlooked is that Blockbuster had the means and capability to also offer DVD-by-mail, but that would have done substantial damage to its business. By 2000, Blockbuster was making 16 percent of its revenue from late fees ($800 million) and was committed to the in-store experience as a core tenet of its strategy.[4] Switching its model to Netflix's would've been value destructive for years; it was not a choice it could make (but it ultimately tried anyway in 2004, losing $2 for every DVD returned in the process).[5] This illustrates why market leaders don't have access to counter-positioning power.

CX can and should play a big role in counter-positioning strategies. This is the opportunity for CX to be disruptive, and it requires an intimate understanding of the new business model and the customer experience in the old model offered by competitors. In the Netflix example, there is a world of possibilities for how DVD-by-mail could have been implemented from a CX standpoint. It could've charged fees like Blockbuster did (and eventually abandoned in response to Netflix's strategy) or moved to a kiosk model like Redbox (founded in 2002) to better standardize inventory offerings and be "closer to the customer." However, Netflix understood the core frustration of customers regarding late fees. It also understood that a DVD being unavailable to rent on Netflix.com was already the same experience customers got in-store at Blockbuster, and offering the ability to reserve a copy in the future and set an ordered list of next rentals was a value-add feature to customers. Blockbuster could not reasonably stand up an e-commerce experience and offer a comparable experience to customers fast enough, and Netflix's counter-positioning depressed Blockbuster's revenue enough that it was overcome by its debt obligations (driven primarily by its real estate strategy!).

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CX's Turning the Wheel for Scale Economies and Network Effects

aCX is an important function to achieve value for firms that develop scale economies (proportional savings in cost for incremental production increases) or network effects (proportional increases in value to the customer for incremental increases in the number of users). Both powers involve flywheels where growth in demand leads to growth in value in another part of the business. CX is important in this context for driving the first and subsequent turns of the flywheel sustainably. Independent of CX, these flywheels do not turn, and value is not delivered. Conversely, if CX initiatives are championed independently of these strategies, margins will erode, or market share will stall.

Scale economy businesses rely on CX to grow the demand that justifies production increases, thereby increasing cost savings and expanding margins. Supermarkets are the easiest example to point to as they buy products in enormous quantities, receive price breaks from suppliers, and lower their cost per unit as they incrementally increase their order sizes. The CX side of supermarkets is evident. Those per unit savings are passed on to consumers in terms of lower prices, coupons, and discounts are used to incentivize consumers to buy more products or higher quantities, and strategies that are employed to increase the number of consumers shopping in-store to continually churn the scale economy flywheel. Stores such as Aldi use loss leader strategies, offering deep discounts on premium items such as TVs to encourage more consumers in the store to shop for groceries. Trader Joe's offers a distinctive product set and a unique customer engagement model (store layouts and overly friendly staff) to entice consumers. CX independent of the scale economy flywheel would be disastrous. Grocery stores could not stay in business offering these types of experiences (and incurring their associated costs) without the benefit of scale economies. Calling back to the value equation, market share would have grown from these CX initiatives, but margins would have decreased and value would not have been created without being intimately tied to the business' scale economy strategy.

Network economy businesses are reliant on CX as well to drive user growth and adoption. Social media networks are a prime example where CX is critically important. Users not only need a good enough experience to join a social network, but they also need valuable experience to stay on a social network, which is also partly a function of the number of other users on the platform. Slack, the business communications platform, employed an interesting strategy to drive user growth that required a deep understanding of the core user experience. Slack works through nodes on its network called workspaces. Users that join Slack enter by being added to a workspace, whereas other users in that workspace are joining as well. Slack's business model is based around a per-user model, so it was incumbent on Slack to prove the value to the user justified that cost and that was primarily a function of the number of users on the platform at the workspace level. Slack identified the critical mass of users needed to sustain a workspace, and how to grow workspace users and engagement once that critical mass was achieved. Creating a great platform with interesting features through a CX lens would not have been enough for Slack. It had to fundamentally understand how CX tied to the platform's network effects, which meant understanding how to get multiple users engaged at the same time to overcome the initial inertia at a workspace level, rather than focusing on overall user numbers. The platform's business model has low variable costs, meaning the potential for high margins. But market share would have stalled if the customer experience was not aligned with the core network effect strategy instead of basic user growth.

CX and the Delicate Act of Building a Moat

Two powers can deliver business value that seems at odds with customer experience: switching costs and cornered resources. Both powers involve an advantage that can lead to suboptimal outcomes for consumers. High switching costs mean customers may not be able to seek value elsewhere in the market because they can't or won't incur the cost to move, and cornered resources may mean customers simply have few to no other options. Customers deal with high switching costs because of several factors: convenience (such as proximity to the supplier), emotional connections from relationships built over time, time-based considerations to make a change, and pure economics through things such as exit fees. Businesses always desire to create barriers to competitors to poach customers, and switching costs is a natural way to build those barriers. A business that has a cornered resource as preferential access to a coveted resource that independently enhances value, such as talent, property, patents, or rare physical materials.

It would be understandable to say CX is less important in the context of these powers. After all, these powers reduce competition and enable the business to extract value (for example, via higher prices). However, CX is what makes these powers durable over the long term. Industries with limited competition and poor customer experiences are ripe for disruption, like a large billboard advertising a prime opportunity for a newcomer to counter-position the incumbent. Companies that wield these powers should thoughtfully implement CX strategies to maintain a high level of perceived customer value. Customers can stomach higher prices if they perceive good value from the offerings and the experience.

Apple's ecosystem is an example of high switching costs and cornered resources paired with good customer experience. Apple products work in an ecosystem that "just works." Apple emphasizes beautiful design, curates hardware and software products around users having an exceptional experience, and ensures their products integrate seamlessly. However, there are switching costs between the Apple ecosystem and other platforms such as Android or Windows. Things don't integrate as seamlessly, and the value of both Apple products and non-Apple products is diminished as users attempt to move between the two. Customers understand this, and they recognize the high switching costs involved with Apple products. However, they buy into the Apple ecosystem and the high switching costs anyway *because* of the customer experience offered.

Apple also enjoys a cornered resource with executive and operational leadership within the company. This talent advantage enables it to deliver at exceptional levels and wield power in the market, leading it to its $1T+ valuation. This talent has not been arbitraged out because they want to stay at Apple. Because Apple has focused on delivering exceptional customer experiences, and because it also intentionally cultivates good employee experiences relative to competitive firms, it does just as well at retaining talent as it does retaining customers.

Lead
Supporting
Not directly impacting

FIRM STRATEGY	IMPACT ON LONG-TERM BUSINESS VALUE			
	MARKET		FIRM	
	MARKET SIZE	MARKET GROWTH	MARKET SHARE	DIFFERENTIAL MARGINS
COUNTER POSITIONING	(If first mover) Brings innovation to market	(If first mover) Brings innovation to market	Brings superior deliverable to market	Ensures lower cost through approach
SCALE ECONOMICS		Brings lower prices to market	Brings lower prices to market	Ensures lower cost through approach
NETWORK EFFECTS	(If first mover) Brings innovation to market	Expands network beyond existing market	Ensures greater value from incremental share	
SWITCHING COSTS			Defends share from disruption	
CORNERED RESOURCES	(If first mover) Brings innovation to market	(If first mover) Brings innovation to market	Defends share from disruption	Justifies and maintains advantage
PROCESS POWER			Brings value of culture & experience to market	
BRANDING			Maintains perception of value in market	

A Framework for Building a Durable Customer Experience Strategy

If CX initiatives are often necessary for driving business value, but not sufficient alone, then how should executives think about prioritizing CX-related opportunities or investing in customer-centric programs? To build a Durable Customer Experience Strategy, firms ought to approach CX through the lens of the strategic powers and impact on long-term business value (see table above for framework).

In the table above, the strategic powers are listed on the left and juxtaposed against the levers of the strategic value equation along the top. The boxes in the framework are color-coded to align CX's role in executing the strategy to achieve equilibrium value: red for a leading role, dark gray for a supporting role, and light gray color for no direct impact. Within each colored box, CX's type of function within the strategic context is given. For example, CX should play a leading role in growing market share for a counter-positioning strategy, serving the key function of bringing the superior offering to the market and driving share capture.

Using this framework can be distilled into four high-level steps:

Step One:
Establish the firm strategy, and specifically name the power(s) that the strategy is based on.

Step Two:
Confirm the desired and expected business value outcomes in terms of market size, market growth, market share, and differential margins.

Step Three:
Assess, plan, and design customer experiences that enable the delivery of the expected business value, aligning with the role and function of CX within the strategic context using the framework

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Step Four:
Execute the strategy and implement leading/supporting CX initiatives to drive business impact.

This framework will help align CX initiatives with firm strategy and assess what kind of function or role CX should play in executing the strategy, ensuring durability. Competitive threats and market forces will continue to be a factor in determining ultimate business value. Having CX operate within the context of the firm's market power and strategy will ensure that the CX initiatives are not easily mimicked and will be sustainable in the face of external threats and will be accretive long-term as a true Durable Customer Experience Strategy.

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