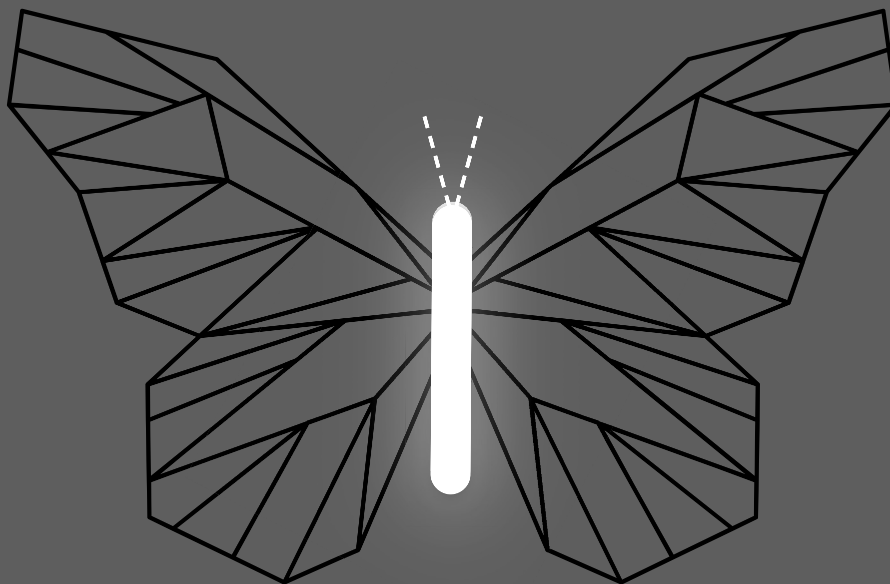
THE TRANSFORMATION PLAYBOOK

INSIGHTS, WISDOM AND BEST PRACTICES TO MAKE TRANSFORMATION REALITY



THE VERY BEST THINKING AND INSIGHTS IN THE FIELD OF STRATEGY AND BEYOND

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Insights, wisdom, and best practices to make transformation reality

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THALES TEIXEIRA, LEANDRO GUISSONI & FREDERICO TRAJANO

An unlikely case of successful digital transformation

> "Look around, anywhere in the world. Where can you find examples of incumbent companies that were able to successfully transform their traditional businesses into digital ones?"
> Frederico (Fred) Trajano, CEO of Magazine Luiza (Magalu)

Many executives of established companies are torn between two worlds. In one, they remain a traditional company and hold onto current profits but aren't prepared for the digital future. To be a member of the other world requires going through a major digital transformation, thereby competing with a swath of money-losing, venture-funded start-ups.

Fueled by venture capital, many of the fastest-growing tech and digital start-ups have adopted a new playbook. They spend vast amounts of money on growing as quickly as possible to achieve leadership positions. Among the most prominent adopters of this profit-losing growth strategy are Uber, Dropbox, Airbnb, Pinterest, Tesla, and WeWork. The latter recently filed for an IPO on $1.8 billion in revenue and $1.9 billion in losses in 2018. By contrast, Brookfield, a traditional real estate investment firm, had nearly $48 billion in revenue and $2.3 billion in profits that year, yet WeWork had a higher market value.

Established businesses in industries such as auto manufacturing, industrials, hospitality, media, real estate, and retailing are well aware that their customers are moving toward acquiring, paying for, using, and maintaining products and services over the internet. Therefore, some degree of transitioning to digital products, services and processes is critical to a traditional company's survival. The real dilemma faced by executives of established businesses is not if, but how, to move from a traditional profit-making business to a digital business positioned to maintain a profitable leadership position.

Since 2016, as CEO of Magazine Luiza (Magalu), one of Brazil's oldest and most traditional mass-market retailers, Frederico Trajano has faced this dilemma.

Magalu was founded by his aunt in 1957, and by 2019 had 24,000 employees across 1,000 stores scattered across Brazil, serving 18 million customers. Before his decision to transform the traditional retailer, Mr. Trajano had led the company's ecommerce since 2000. By 2015, less than 20 percent of its sales came from online channels. Four years later, this figure had more than doubled. But purely increasing the percentage of online sales was not Mr. Trajano's main goal. He wanted to modernize the company for continued leadership in the decades to come. His vision was to completely transform the brick-and-mortar retailer into a digital company subject to economic drivers and strategies akin to Amazon, Apple, and Google.

The question Mr. Trajano wrestled with was how to go about a full digital transformation of the $4.5 billion-revenue retailer.

Magalu at a crossroads: growth or profitability?

Mr. Trajano saw two avenues. One was to emulate Silicon Valley: get venture capital funding and grow as fast as possible. That would require investing in top talent, building a digital platform and offering digital services. This playbook also meant advertising heavily to acquire customers and drastically lower prices to beat the competition. Amazon, Flipkart, Rakuten, and Brazil's ecommerce leader, B2W, had all taken this route at one time. Investing in new technologies, new hires, and new partnerships meant that maintaining the historical profitability level would not be realistic. But over time, the thinking went, as scale economies and network effects kicked in, large upfront investments and price aggressiveness would lead the way to profitability.

The alternative to this "Silicon Valley Way" was to keep investing in technology, new hires, and partnerships but not abdicating margins. However, this avenue would certainly reduce the speed of online customer acquisition, dampening growth.

Choosing between Silicon Valley's growth-focused model and a traditional profit-focused model was a mutually exclusive decision at the time. But investors pointed out to Mr. Trajano that if he separated the businesses into a traditional brick-and-mortar retailer (to focus on profits) and an ecommerce player (to focus on growth), he could have the best of both worlds. Such a separation would also allow each business to cater to different investor profiles.

Still, Mr. Trajano resisted the temptation to separate. In his view, it was in the best interest of the customer to have a seamless shopping experience across all channels. An integrated frontend user experience online and in stores would

generate customer-side synergies, whereas backend logistics and inventory management would generate firm-side synergies. This decision, however, would carry a significant toll as investors might not see the long-term benefits but rather focus on the short-term downsides.

Indeed, amid a sluggish economy in Brazil, investors were sceptical and with cause. Such a monumental digital transformation of an established player had never been done before and certainly not in the retailing industry where many retailers worldwide were shrinking or going bankrupt. As a result of lack of investor confidence, Magalu's stock price lost 86 percent of its value, reaching one Brazilian Real (0.33 US dollars) in December 2015.

Phase 1 – Technology innovation

Given the all-time low stock price, raising new funds in the equity markets was not advantageous at the time. Mr. Trajano would have to fund a sizable investment in technology from the company's operations. The company hired and housed 55 software engineers and programmers, which eventually grew to 850, in a secluded corner at the company's headquarters. They were instructed to build digital tools for both the online and offline businesses and to do so from the ground up, quickly and with total focus on the end user experience. In the following years, free cash flow was pumped into building new technologies in-house, such as a consumer-friendly app, an integrated on-demand delivery system, and a store employee point-of-sale support tool. Shoppers, suppliers, salespeople, and employees became digitally connected.

By September 2017, ecommerce sales represented 30 percent of total sales and, except for one year, the company was profitable throughout the transformation. As the economy improved, the stock price increased by 7,900 percent to 80 Brazilian reals and it became favourable for the company to issue a follow-on round of stocks, which raised funds for the second phase of digital transformation.

Phase 2 – Business model innovation

Having instilled a customer-first digital culture at the company, Mr. Trajano saw an opportunity to greatly increase product assortment without having to invest in inventory, by building an online marketplace.

In less than three years, Magalu carefully curated a list of 5,000 suppliers who carried more than five million new SKUs to offer in its new marketplace. Similar to other two-sided platforms such as Uber and Airbnb, network effects

drove more suppliers and customers, which fed into each other to build momentum and growth. This time, giving up some profitability for growth was warranted, in preparation for Amazon's impending entry into Brazil with its own national operations.

By mid-2019, Magalu was one of the largest retailers in Brazil and, at +32 percent, growing revenues at near-start-up rates. After two critical phases of digital transformation, it was in the midst of completely changing itself from a traditional retailer into a tech company with physical locations. For a country with only 5 percent of retail sales coming from online channels, Magalu stood well above its competitors with 41 percent of its sales done online. The financial markets blessed the transformation and the company's stock price reached 180 Brazilian reals. In 2018, Magalu was recognized by *Fast Company* as one of the top ten most innovative companies in Latin America, the only one on the list that was not a start-up.

For phase 3, Mr. Trajano's goal is to spread the benefits of the digital economy to all Brazilians, not just the affluent, just as his aunt had done half a century ago by popularizing electric home appliances for lower class Brazilians.

Lessons for other incumbents

In our collective experience, there is a mismatch between what people say about digital transformation and what successful companies actually do. Digital transformation is not about buying tech start-ups and forcing their employees to collaborate with the old guard. While you can purchase many things on the Internet, you can't buy yourself into a digital world. Four lessons we have learned are noteworthy.

On the dip of profits: Companies that are transitioning from established businesses to digital ones need to realize that during this transition (see phase 1 in Figure 1) investments may cause their profitability to fall into negative territory. The reason this occurs is because during the transition from a 100 percent traditional business (phase 0) to a predominantly digital business (phase 2), you are operating two inefficient businesses with two sets of cost structures at the same time. As an example, in The New York Times' multiyear transition from a physical-only to a digital-only newspaper, its CEO, Mark Thompson, had to both invest in new digital assets such as servers, software development, and social media savvy reporters, while at the same time maintaining old-school reporters, printing presses, and trucks to deliver print newspapers. Unfortunately, he could not flip a switch and instantly divest away all the traditional assets. He needed

some of them to keep catering to print newspaper buyers. New customers of digital subscriptions take time to come on board. The idea is that if you manage the speed of transition, you get to keep and convert the "old" customers at the same time that you acquire the "new" digital subscribers. Go too slow, and you stay in the loss territory for too long. That is the alpha risk. But go too fast, and when you emerge from the transition you risk losing customers to competitors and your business becoming smaller than it was originally. That is the beta risk. Different classes of businesses in different industries possess inherently different combinations of alpha and beta risks that need to be managed. As in any investment decision, the upside is not necessarily achieved by minimizing both types of risk.

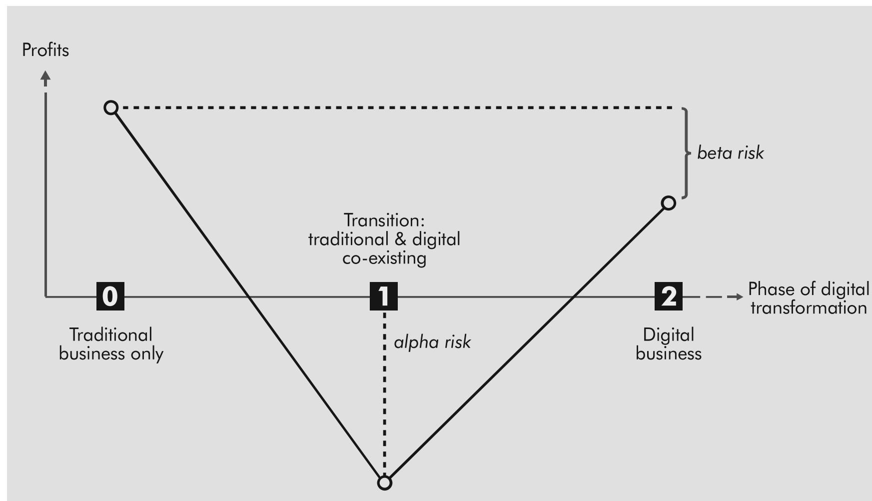

Figure 1.

On controlling the narrative: If you expect profits to decline in the transition, don't wait for it to happen before telling your employees, customers, and investors. Predicted outcomes should be preempted. Say to them, "Guys, this is going to happen, and this is why." Don't be overly optimistic either. As the CEO of a top US retailer told one of us, "We knew annual profits would go down in the transition. But it went down by twice what we had expected, and the transition took two times as long as we intended." Therefore, the financial impact of a digital transformation to the bottom line, even a successful one, can be 4X worse than what senior management predicts.

On integration versus separation: While the technology development unit

eventually has to be front and center in a digital business, the reality is that it starts small and powerless. If left to fend for itself inside the larger organization, it will get rejected. It needs to first be separated and incubated by the CEO, who should give it opportunities to get initial credibility through small wins that do not require much integration with the rest of the company. As these small wins accumulate and a digital culture permeates the rest of the company, the tech unit can start to work on projects that require and benefit the rest of the organization. Integrating should occur the moment tech has shown itself as the enabler of growth for the rest of the organization.

On alternatives to the Silicon Valley Way: The start-ups and tech giants have shown how customer-centric digital innovation should be built. Organizational tools and processes such as squads, lean methods, A-B testing, and agile development can, and should, be used by larger organizations. What Silicon Valley has not yet convincingly shown is whether the private capital funding model that fuels fast growth at the expense of profits in search of a leadership position should be applied to established companies. Losing great sums of money to achieve fast growth does not need to be the only game in town, at least not when it comes to the digital transformation of incumbents.

About the authors

Thales Teixeira is an Associate Professor at the Harvard Business School and author of the book "Unlocking the Customer Value Chain." He regularly consults for established companies on responding to digital disruption and transformation. His website is www.decoupling.co.

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Frederico (Fred) Trajano is the CEO of Magazine Luiza (Magalu). He joined the company in 1999 to lead its first ecommerce business. In 2016, he became only the fourth CEO in the retailer's 62 years of existence. One year later, he was awarded the Entrepreneur of The Year by audit firm EY, Brazil.

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