2025 Connective Leadership Summit

Pre-Reading Materials

27 - 30 May 2025 | The Trust Melbourne, VIC

HARVARD | BUSINESS | SCHOOL

Contents

Agenda

Tuesday 27 May 2025

From 3:00pm	Arrival, check-in and register
6:00pm	Meet in the foyer and walk to dinner
6:30 – 9:30pm	Welcome dinner – Pastuso

Wednesday 28 May 2025

6:30 – 8:00am	Breakfast at leisure
8:10am	Meet in the foyer and walk to The Trust
8:15am	Arrival tea and coffee
8:20am	Connective welcome and opening
8:30am	Harvard program – Innovate to Lead
9:45am	Morning tea
10:15am	Harvard program – Innovation as Shared Value
11:30am	Harvard program – Exercise—Value Maps
12:00pm	Lunch
1:00pm	Harvard program – Debrief—Value Maps
1:30pm	Harvard program – Design Thinking
2:45pm	Afternoon tea
3:00pm	Harvard program – AI-enabled Ideation
4:00pm	Harvard program concludes
6:00pm	Meet in the foyer and walk to dinner - Tonka
6:30 – 9:30pm	Dinner – Tonka

Agenda

Thursday 29 May 2025

6:30 – 8:00am	Breakfast at leisure
8:10am	Meet in the foyer and walk to The Trust
8:15am	Arrival tea and coffee
8:30am	Harvard program – Marshmallow Exercise
9:30am	Morning tea
10:00am	Harvard program – Hypothesis Testing
11:45am	Harvard program – Press Release Exercise
12:30pm	Lunch
1:30pm	Harvard program – Driving Innovation
3:00pm	Afternoon tea
3:15pm	Harvard program – Innovate to Lead—Parting Thoughts and Leadership Summit Wrap
4:00pm	Harvard program concludes
6:45pm	Meet in the foyer and walk to dinner - Vue de monde
7:00 – 11:00pm	Celebration dinner – Vue de monde

Friday 30 May 2025

6:30 – 8:00 am	Breakfast at leisure
8:45 am	Arrival tea and coffee – Stock Room – InterContinental Melbourne
9:00 am	Welcome and reflection
9:15 am	Lender Panel hosted by Mark Haron
10:15 am	Morning tea
10:45 am	Industry session
11:45 am	Close
12:00 pm	Lunch
1:00 pm	Return transfer to airport from The InterContinental Melbourne

2025 Connective Leadership Summit

Hey, Insta & YouTube, Are You Watching TikTok?

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FELIX OBERHOLZER-GEE

Hey, Insta & YouTube, Are You Watching TikTok?

"First come the innovators, who see opportunities that others don't… Then come the imitators, who copy what the innovators have done… Last come the idiots, whose avarice undermines the very innovations they are trying to exploit."

— Warren Buffet

Zhang Yiming, ByteDance's founder, his college classmate Liang Rubo, CEO of ByteDance, and TikTok CEO Chew Shou Zi pondered their response to a flurry of news that promised to remake the global social media landscape. YouTube had just announced that it would give away almost half of its advertising revenue to individuals who created TikTok-style short videos, extending its Partner Program that had been reserved for people who uploaded regular, long-form YouTube content. YouTube CEO Susan Wojcicki explained: "The YouTube Partner Program was revolutionary when we launched it back in 2007, and it's still revolutionary today. Over the past three years, YouTube has paid creators, artists and media companies more than $50 billion.… But we're not done yet. Today, we're doubling down." Chief Product Officer Neal Mohan added:

> YouTube's first-of-its-kind, industry-leading Partner Program changed the game for long-form video. And now, we're changing the game again, this time by opening it up to short-form creators…. This is the first time that revenue sharing is being offered for short-form video on any platform at scale.[1]

Perhaps an even bigger surprise for Zhang and his colleagues came from Mark Zuckerberg, CEO of Meta Platforms, who announced that Instagram would TikTokify its recommendation engine:

> One of the main transformations in our business right now is that social feeds are going from being driven primarily by the people and accounts you follow to increasingly being driven by Artificial Intelligence, recommending content that you'll find interesting…even if you don't follow those creators.[2]

Important questions loomed for Zhang, Liang and Chew. Had Zuckerberg really announced the end of social media? Did Wojcicki's move destroy TikTok's business model?

Professor Felix Oberholzer-Gee prepared this case. This case was developed from published sources. Funding for the development of this case was provided by Harvard Business School and not by the company. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

ByteDance

In early 2023, TikTok reached close to 1 billion users globally, placing the entertainment app 4th behind the leading social networks Facebook, YouTube and Instagram (see **Exhibit 1**). One in four social media users opened the app at least once a month. TikTok's scale was all the more impressive because it had taken the app only 5 years to reach the one-billion mark, faster than Instagram (7.7 years), YouTube (8.1) and Facebook (8.7).[3] In the United States, TikTok counted more than 100 million users, 45% of all people on social media.[4] The typical global user spent 1.5 hours on TikTok each day. For TikTokers in the U.S., it was close to an hour (see **Exhibit 2**).

Zhang Yiming 张一鸣

The Chinese entrepreneur Zhang Yiming founded ByteDance, the privately-held publisher of TikTok, in 2012. Zhang, who had studied microelectronics and software engineering at Nankai University in Tianjin, China, had worked at travel website Kuxun, Microsoft, and failed startup Fanfou prior to launching 99Fang, a real estate portal, as well as ByteDance. The company's first app was Neihan Duanzi ("subtle jokes," 内涵段子), a humor app that allowed users to share jokes, memes, and humorous videos.

Toutiao ("headline,"头条), a news app, was ByteDance's first broad success. Zhang had observed that it was challenging to find online news that matched the interests of Chinese readers. Toutiao employed machine learning and computer vision to classify news and serve its audience personalized content. Toutiao searched wide and far to discover suitable news reports. Most of the stories did not come from professional journalists, but from "new media creators," independent reporters and amateurs who were rewarded by the online traffic they attracted. In contrast to Facebook in the West, China's mainstream media was a minor source of content for Toutiao, less than 10% of its feed. By 2021, Toutiao reached 332 million monthly active users. Zhen Liu, senior vice president of ByteDance, explained its popularity and rapid growth:

> We have the first-mover advantage. By accumulating millions of users, Toutiao's computers have enough data to understand what users want. AI is like a child. It takes time to build up its intelligence level.[5]

Douyin 抖音

ByteDance launched the short-form video app Douyin in 2016. Douyin displayed many of the features that would eventually characterize TikTok:

- The app's user interface had no 'play' or 'pause' button. Instead, it opened to an endless stream of full-screen 15-second videos that were curated for each individual user.
- ByteDance did not produce any content. All videos on the platform were user generated.
- When looking for creators, ByteDance sidestepped celebrities. Instead, it courted unknown individuals with influencer potential, and it worked with agencies that specialized in promoting ordinary people to Internet stardom. For instance, Dai Gu La K (代古拉 K), a 22-year-old college student with an infectious smile, gained 10 million followers in just 30 days with her dancing clips. She was not an unusually talented dancer. Yang Cong, a top agency, had discovered her potential.[6]

- The Douyin team strategically employed hashtags to encourage users to produce closely-related content. The best videos received hundreds of millions of views; some even entered the national vocabulary. At hotpot chain Hai Di Lao, for instance, diners were able to order the "Douyin Dish," a tofu ball filled with raw egg and shrimp paste. User 113583939 had uploaded the dish after Douyin launched the hashtag "life hacks," unleashing a flood of quirky culinary preparations. Similarly, customers who ordered a "Douyin Milk Tea" at CoCo, a popular tea chain, received a caramel milk tea with barley pudding, zero sugar, and no ice. A Douyin influencer had promoted this tea as particularly delicious. Not surprisingly, restaurants soon encouraged their patrons to upload "life hack" creations.[7]

- Users saw Douyin videos and related comments at the same time, and many influencers interacted with their followers in the comment section, creating a lively back-and-forth that was often as entertaining as the videos themselves. "We collect data on how content creators and their followers interact," said Zhang. "Over time, this matching has become increasingly accurate, allowing influencers to increase their follower base."[8]

Zhang relied on China's top engineering talent to build Douyin's tech stack: "Our philosophy is to pay at the top of the market to get the best," he explained. "The company that wants to achieve the most, you need the best talent. Unlimited salary for unlimited talent." ByteDance's top employees made $1 million in annual salary, plus options.[9]

Zhang saw Douyin as a global opportunity:

> China is home to only one-fifth of Internet users globally. If we don't expand on a global scale, we are bound to lose to peers eyeing the four-fifths. Going global is a must.[10]

ByteDance launched the international version of Douyin, TikTok, in late 2017. It turbocharged the app by acquiring Musical.ly for $1 billion later that year. Shanghai-based Musical.ly, a music-oriented short-form video app that invited lip-synching, was founded by Alex Zhu and Louis Yang in 2014. The app had gone mainstream in Western markets and reached over 200 million users. Hans Tung, a board member, explained:

> [ByteDance's] Yiming and the Musical.ly co-founders have known one another for years. Yiming admired Musical.ly's product innovation and grasp of users' needs and tastes in the Western markets, while Musical.ly's Alex and Louis were impressed by ByteDance's efficient recommendation engine, monetization track record, and global vision.… In my opinion, ByteDance and Musical.ly are a natural fit.[11]

By 2021, Douyin reached 640 million users and hit an estimated $58 billion in revenue. It grew faster than any other major social network in China. TikTok had 690 million users and $4 billion in revenue. ByteDance's valuation rose to more than $350 billion in private transactions, making it the most valuable startup in the world, ahead of SpaceX. The company seemed poised for a blockbuster IPO.[12]

TikTok

ByteDance built a sophisticated recommendation engine to power TikTok.[13] The app opened to the "For You" page, an endless stream of short videos. Spending time on TikTok required little interaction: users did not have to search for or choose content as elsewhere on the web. The first video played automatically, and TikTokers progressed to the next by flicking away the one that was playing. Without any user interaction, the same video played in a continuous loop.

ByteDance's recommendation engine employed three types of data:

- *Content*—The company classified content using multiple tags for each video. The tags were hierarchically organized: "sport" linked to subtags such as "basketball," and the latter was associated with sub-sub tags such as "MLB" and "Japan." The company used creator-provided hashtags, computer vision and natural language processing to classify videos.
- *People*—User data included TikTokers' personal interests, demographic information and latent features that ByteDance inferred from customer clustering.
- *Time*—Scenario data captured elements that changed over time, for instance a user's location, the time spent watching a video, likes and shares.

TikTok's decision about what to show reflected correlations between these three types of data as well as global trends. Recommendations were updated in real time. When a TikToker ♥ a video, the app immediately adjusted the content the user saw next.[14]

The ByteDance team paid particular attention to newly created content. Each new video entered a cold start pool of about 200-300 randomly chosen users. Based on the video's performance—the number of views, likes, replays, shares and completion rates—as well as the creator's history of success, the top 10 percent were assigned an additional 10,000 to 100,000 exposures. Performance in this second pool determined whether TikTok then applied its user profile amplifier to the video, matching content, user preferences and scenario data for a third pool of content. Finally, the top 1 percent of videos entered a trending pool, content that was shown to users irrespective of their preferences (see **Exhibit 3**).[15]

TikTok mastered the art of keeping users interested for long periods of time. Elaine Moore, technology editor at the Financial Times, observed: "What keeps more than a billion users like me hooked is that TikTok drops in random videos now and again instead of boring users by showing the same sort of content."[16]

Collaborative filtering played a key role in creating the varied video feeds that might jump from a cooking video to a scientific explainer and on to a funny dance routine. The goal was to delight people with content they didn't know they wanted to see. Collaborative filtering classified two pieces of content as similar if many users showed an interest in both. Similarly, users were deemed similar if they shared characteristics. Unlike Facebook and Instagram that relied on users' social graphs and their connections with one another, TikTok's recommendations were primarily content based. It served videos that were similar to other content that similar users had liked.[17]

Creators with videos that reached the third pool, where TikTok applied its user profile amplifier, garnered enormous attention. These accounts attracted large numbers of followers and views. But attention of this kind was short-lived, by design. After about a week, TikTok's recommendation engine placed a lower value on fresh content from newly popular accounts.

While music-related videos and lip-synching had dominated TikTok in its early days, the diversity of content increased over time. Hashtags like #entertainment (535 billion views in 2022), #dance (181), #pranks (79), #fitness (57), #D.I.Y. (39) and #beauty (33) remained among the most popular categories even in 2023, but it was not difficult to find more specialized videos that still attracted large audiences.[18] For example, #blackhole, a hashtag that showcased videos about space and black holes, attracted more than one billion views. #romanhistory garnered 80 million. In a particularly noteworthy trend, TikTok grew to be a source of general news, in particular for younger audiences (see **Exhibit 4**).

Users

Generation Z (born between 1997 and 2012) made TikTok their own early on but the app attracted even younger and much older persons over time (see **Exhibits 5 & 6** for demographic information). Watching funny videos (60%), filling spare time (45%), finding new ideas (28%) and learning how to do new things (24%) were among the most important reasons why people spent time on TikTok. It was common for TikTokers to ♥ videos and follow creators they admired (see **Exhibit 7**).[19] Average engagement rates on TikTok hovered around 13% (see **Exhibit 8**).[a]

Creators

Creating videos was straightforward. Users uploaded clips they had shot on their phones as well as content they created in the app itself. CapCut, a ByteDance video editing app, made it easy to include a plethora of stickers, voice-overs, voice-changers and other special effects. Music was essential for many creators, and ByteDance provided a large music library of licensed tracks. It also encouraged creators to re-use music they had seen in other videos, often creating an avalanche of similar content. Meghan Trainor's hit song "Made You Look," for instance, encouraged creators to show themselves in luxury outfits (and fresh out of bed). The hashtag attracted billions of views, including a version by Thi Hồ, a TikToker who lived in Vietnam. Her creation garnered 26 million views, 3 million ♥ and thousands of comments.[20]

ByteDance gradually increased the maximum length of TikTok videos from originally 15 seconds to a minute in 2017, 3 minutes in 2021 and 10 minutes in 2022. Not everyone was pleased. "It's not because I don't have time," said one TikToker, "but because I can't concentrate. I can't concentrate [on long videos]."[21] TikTok's own research showed that half of its users experienced videos longer than one minute as stressful. One third watched longer videos at double speed. At the same time, longer videos provided the company with more attractive advertising opportunities. "If five-minute videos help TikTok push their average watch time up by even a few seconds, traditional advertisers may feel they have more freedom, and tech is always looking for as much revenue as possible," said Karyn Spencer, an industry expert.[22]

Among prominent TikTok creators, Senegalese-Italian comedian Khabane Lame who made fun of overly complicated life hacks led the ranks with 235 million followers. 19-year old American Charlie D'Amelio, famous for her dance routines, was followed by 212 million TikTokers. Lame and D'Amelio often collaborated with brands; they each earned about $100,000 per post, an implied CPM of nearly $8.[23] Analysts estimated that brands would have to spend an extra 35% to reach a similar-sized audience via paid social ads.[24] Not surprisingly, there was substantial variation in engagement rates across creators (see **Exhibit 9**).

TikTok introduced livestreaming in 2019. The feature allowed creators to interact with followers in real time. In turn, livestream participants were able to send their favorite creators virtual gifts, ranging from Pandas (5 TikTok coins, $0.012) to Drama Queens (5,000 coins, $60). The gifts were redeemable for cash. Justin Bieber was first to livestream a full-length performance on Valentine's Day 2021. The concert drew more than 4 million viewers.[25]

In 2021, TikTok set up a $200 million fund for creators in the U.S. and promised to grow the fund to $1 billion over the next three years. The fund rewarded creators with at least 10,000 followers and 100,000 views in the past 30 days for posting popular videos. While TikTok did not disclose its payout

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[a] Engagement rates were the total number of likes, comments, and shares divided by the total number of views.

formula, most creators could expect to earn between two and four cents per 1,000 views.[26] A year later, the company introduced Pulse, a program that allowed advertisers to display their brand alongside the most popular videos. After an intense debate, ByteDance decided to share a small fraction of Pulse revenue with a small group of creators.[27]

Business Model

Advertising was TikTok's principle source of revenue. Analysts expected the company to pull even with YouTube's ad revenue by 2024 (see **Exhibit 10**). Amazon and HBO were among TikTok's top clients (see **Exhibit 11**). The app offered a number of different ad formats. These included *In-Feed ads* that appeared as users scrolled through their feed; *Spark ads* that allowed brands to promote their own videos; as well as *Brand Takeover* and *TopView ads,* formats that TikTokers saw when they first opened their app.[28] Bloomberg's Zheping Huang explained: "TikTok is charging as much as $2.6 million for a one-day run of a TopView [ad]…, roughly four times what it charged a year ago. A 30-second Super Bowl ad runs about $6.5 million, but TikTok can charge that rate every day."[29] Across all its ad formats, TikTok charged advertisers an $8 CPM, considerably lower than YouTube ($13 CPM) and Instagram ($15 CPM).[30]

Predictably, TikToker's response to advertising was mixed. More than 50% said the ads were fun and engaging, 21% were annoyed.[31] To many users, *Branded Hashtag Challenges* were of particular interest. These ads dared users to create videos with a particular theme. Popular examples included #PlayWithPringles, which spawned 2 million videos that attracted close to 5 billion views, Colgate's #MakeMomSmile challenge (more than 5 billion views) as well as Kaiser Permanente's #OwnTheCurve campaign (8 billion views), which encouraged TikTokers to flatten the COVID-19 curve by doing something creative while observing public health guidelines.

By 2023, TikTok had become irresistible to many marketers. "TikTok is TV for Gen Z," said Jo Cronk, president of marketing firm Whalar. "If you want your brand, your product, your service to get attention with Gen Z, that's just a non-negotiable today."[32] Like others who had moved ad spend to TikTok, Richard Henne, co-founder of clothing store Ivory Ella, reduced spending on Facebook and Instagram: "[I am] trying to lower that number as much as possible, as soon as possible, because they're obviously losing their grip on the marketplace."[33] Across many industries, TikTok showed consistently higher brand engagement rates (6%) than Facebook (0.13%) and Instagram (0.83%).[34]

In 2020, TikTok called on businesses to "stop making ads." Katie Puris, managing director at the company, explained:

> Brands have found success…not because they had the glossiest ad or the biggest names in their campaign, but because of their ability to creatively engage and connect with users through feelings, actions and sounds. TikTok…is designed to inspire—with authentic…content…. Don't Make Ads, Make TikToks.[35]

The call to be more authentic did not resonate with everyone. Some ad agencies claimed that Instagram offered better products to drive sales or app installs. Fabian Ouwehand, head of social e-commerce at home shopping network HSE, described his experience:

> I'm in these calls with big companies and they say, 'yeah, but we want to create something like a TV commercial.' And then the TikTok team is always so frustrated because many don't get it, still, how to create a TikTok video.[36]

In addition to advertising, TikTok also explored e-commerce opportunities. Following Douyin's lead in China, where users spent more than $200 billion on products in 2022, TikTok rolled out an in-app marketplace in Great Britain, Indonesia and Thailand. It allowed users to jump from livestreams and videos to shopping portals. Bloomberg's Huang explained, "The idea is to create a closed loop where TikTok handles each and every step from a user discovering something to actually purchasing it."[37] "The journey to purchase something is very, very easy. It's like one click away," said Fauza Istighfareva, a Jakarta-based manager with digital agency, Leverate Media.[38] Gross merchandise volume on TikTok reached close to $5 billion in 2022.[39]

Political Headwinds

Throughout much of its history, ByteDance faced intense political pressure. In 2018, China's State Administration of Radio and Television shut down Neihan Duanzi, accusing the joke app of hosting "vulgar" and "improper" content."[40] For several weeks, the authorities also removed Toutiao from app stores. Zhang apologized:

> I sincerely apologize to regulators, our users and colleagues. I have been in a state of guilt and remorse since I received the notice from the regulatory authority yesterday…. We have placed too much emphasis on the role of technology, and failed to realize that socialist core values are the prerequisite to technology. We need to spread positive messages in line with the requirements of the times while respecting public order and good practice.[41]

While China's censors kept a close eye on "inappropriate" content on Toutiao and Douyin, central government agencies and local governments set up tens of thousands of accounts to reach citizens on Douyin. By 2020, more than 40% of the videos on the platform's trending page were affiliated with the government. Most videos imitated popular types of content and styles of presentation. Less than 30% represented propaganda. Human interest stories, news and entertainment dominated the government channels instead.[42]

Concerned about the growing power and influence of digital platforms in the economy, the Chinese government cracked down on the country's tech industry in 2020. Its enforcement actions focused on anti-competitive practices, fake ads, as well as violations of workers' rights.[43] Communist Party officials even unveiled a 30-point guide for regulating the algorithms of services like Douyin.[44] The tech purge led to the resignation of several prominent CEOs, and it wiped out more than $2 trillion from global equity markets.[45] Zhang stepped down as CEO of ByteDance, promising to work on longer-term initiatives: "The truth is, I lack some of the skills that make an ideal manager. [I prefer] solitary activities like being online, reading, listening to music, and daydreaming."[46] Under the leadership of Liang Rubo, ByteDance put off its long-awaited IPO. Investors struggled to offload ByteDance shares in the secondary market, even at asking prices that valued the company at $240 billion, 20% below the price at which it had recently bought back stock.[47]

TikTok Bans

Foreign political pressure mounted around the same time. Following military clashes between India and China along their border in 2020, India banned dozens of Chinese apps, including TikTok, to "ensure the safety and sovereignty of Indian cyberspace."[48] At the time, the app had 200 million users in India.

In the U.S., the Committee on Foreign Investment in the United States (CFIUS) reviewed the national security implications of ByteDance's acquisition of Shanghai-based Musical.ly, an investigation that prompted President Trump to order the sale of TikTok to U.S. investors in 2020. He also considered banning the app outright:

> [TikTok] is a big business. Look, what happened with China with this virus, what they've done to this country and to the entire world, is disgraceful.… We're gonna keep looking at TikTok…there's no question, what the Big Tech companies are doing is very bad.[49]

President Trump formally signed a TikTok ban a few weeks later:

> TikTok automatically captures vast swaths of information from its users, including… location data and browsing and search histories…potentially allowing China to track the locations of Federal employees and contractors, build dossiers of personal information for blackmail, and conduct corporate espionage.[50]

Pellaeon Lin, a privacy researcher at the University of Toronto, looked into TikTok's data sharing practices:

> TikTok and Facebook collect similar amounts of user data. Both apps collect device information and usage patterns.… Some of the information collected [by TikTok] is sent directly to TikTok servers while some is first sent to third parties such as Facebook and Google.[51]

In a comprehensive national security study, Milton L. Mueller and Karim Farhat, Georgia Institute of Technology, concluded:

> TikTok is a commercially-motivated enterprise, not a tool of the Chinese state.… Chinese government efforts to assert control over ByteDance's Chinese subsidiaries are targeting its domestic (Chinese) services, not its overseas operations. TikTok is not exporting censorship… its content policies are governed by market forces.[52]

TechCrunch editor Jonathan Shieber commented on the forced sale:

> The government…took a stab at "gangster capitalism" by trying to force the sale of TikTok to a group of buyers… [It] appeared willing to spend political capital to stymie the growth of a successful foreign business on its shores for the flimsiest of security reasons.

ByteDance successfully challenged both executive orders in court. In an attempt to address the data concerns, TikTok began to route all new traffic through Oracle, keeping U.S. user data on domestic shores. "We aim to remove any doubt about the security of U.S. user data," said Albert Calamug, who oversaw TikTok's U.S. policy team.[53]

ByteDance's trust-building efforts experienced a severe setback, however, when two of its employees in China, on the hunt for the source of leaked information, were discovered to have accessed the accounts of American journalists.[54] Seizing the moment to add additional pressure, Meta hired political consultants to run campaigns against TikTok. In one example, the firm paid by Meta spread rumors of a "Slap a Teacher TikTok challenge." No such challenge existed.[55]

New restrictions ensued. In December 2022, Congress banned TikTok on all devices owned by the federal government, following similar moves by more than two dozen states. Public universities implemented the bans by blocking TikTok on their Wi-Fi networks.[56] Lawmakers also introduced a bipartisan bill to ban TikTok from operating in the United States. Representative Mike Gallagher explained:

> For younger users, the concern isn't that they're using TikTok just to watch stupid videos. It's that they're relying on TikTok to get their news.[57]

Competition

As TikTok's global appeal became apparent, intense competition in the market for short-form videos ensued. "It's definitely a threat to Google and Facebook," said Pieter-Jan de Kroon, CEO of ad firm Entravision MediaDonuts. "TikTok is starting to command a percentage of the media budget that's more in line with its audience size."

YouTube

In 2023, YouTube was by far the largest platform devoted to video (see **Exhibit 1**). The service earned its parent, Alphabet, nearly $30 billion in ad revenue in 2022, about 10% of Alphabet's total revenue. As on TikTok, individual influencers attracted the lion share of video views (91%) on YouTube, followed by media companies (6%) and brands more generally (2%).[58] Creators were attracted to YouTube by its Partner Program under which the platform shared 55% of advertising revenue (for YouTube's cost structure, see **Exhibit 12**). Anyone with more than 1,000 subscribers and 4,000 watched hours in the last 12 months was eligible to become a partner.

To better compete with TikTok, YouTube created Shorts, a platform for 60-second videos, in September 2020. A dedicated tab in its main app, Shorts was essentially a clone of TikTok. It lacked its rival's rich set of filters, a Discovery tab that helped users find trending hashtags, and features such as Duet.[b] The overall user experience, however, was remarkably similar. YouTube kept the Shorts recommendation engine separate from its long-form service:

> When someone discovers a new channel via Shorts, we're not currently using that to inform what longer videos are recommended to them outside of the Shorts experience.… Every Short is given a chance to succeed no matter the channel or the number of videos on the channel. Performance of a Short is dictated by whether or not people are choosing to watch and not skip [it].[59]

In late 2022, Shorts had 1.5 billion monthly users who viewed 30 billion videos per day.

Instagram

Instagram contributed more than $40 billion in advertising revenue to its parent company, Meta Platform Inc., close to 40% of Meta's total. While Instagram remained the best-monetized social platform (see **Exhibit 13)**, the photo-sharing app faced numerous challenges. Revenue growth had dropped by more than 50% in the past three years; the app trailed TikTok and YouTube in user engagement; and the company's reputation was tarnished by research that showed how time spent on

[b] The Duet feature allowed TikTokers to post a video side-by-side with a video from another user. The two videos played at the same time in a split screen.

Instagram caused anxiety and depression in many young women. "We make body image issues worse for one in three teen girls.… [They] blame Instagram for increases in the rate of anxiety and depression," concluded the company's own researchers.[60]

In response to the shift from photo sharing to short-form video entertainment, Instagram introduced Reels in August 2020. A dedicated tab on its home screen and on each creator's account, Reels copied most of TikTok's features. The videos were featured heavily in users' feeds, often replacing photos. Instagram worked with individual creators and media companies to secure video content. In one such collaboration, it paid BuzzFeed millions of dollars to create videos.[61] BuzzFeed, a digital publisher, was best known for viral listicles and quizzes, as well as effective ad campaigns (see **Exhibit 14**). Instagram kept its ad load on Reels low, a marked contrast to YouTube's more aggressive monetization of Shorts.[62]

Following the introduction of Reels, many creators reposted their TikToks to Instagram. Maria Luisa Van Zwieten, a 29-year-old Dutch cosplayer who earned up to ten grand from brands enlisting her to make TikTok videos, welcomed the opportunity: "There's less work for me, but double the earnings, so I was like 'all good.'"[63]

Instagram had good success copying competitors in the past. For example, when social media company Snap introduced Stories, posts shared with friends that disappeared after 24 hours, Instagram copied the idea soon afterwards. Kevin Weil, Instagram's VP of product, explained:

> If we're being honest with ourselves, this is the way the tech industry works…. Good ideas start in one place, and they spread across the entire industry. Kudos to Snapchat for being first to Stories, but it's a format and it's going to be adopted widely across a lot of different platforms.[64]

Over time, Stories grew to be a favorite channel to share content with friends, partially displacing the Instagram feed as a way to exchange photos and videos.[c][65] Building on its success with Stories, Instagram also copied Snapchat filters and the rival's disappearing messages. More recently, the company added a feature, Dual, that allowed users to share more authentic and unfiltered photos using their smart phone's front and back cameras at the same time. Dual was a copy of BeReal, a buzzy social app that topped App Store downloads in 2022.[66]

A Fall Full of Surprises

A first surprise hit Zhang and his team when Zuckerberg announced a profound change in Instagram's algorithm in July 2022.[d] Moving away from showing photos of users they followed, the platform now wanted to promote popular videos irrespective of users' connections. Zuckerberg explained the new direction:

> Reels is one part of this trend that focuses on the growth of short-form video as a content format, but this overall AI trend is much broader and covers all types of content….

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[c] Posts shared to Stories were only visible to linked accounts if the user kept their account private. Posts shared to the Instagram feed were visible to everyone.

[d] The platform had last radically changed its recommendation engine in 2016 when it moved from listing the posts of friends chronologically to displaying them in the order of popularity.

> Building a recommendation system across all these types of content is something we're uniquely focused on.[67]

Zuckerberg estimated that more than a third of a user's feed would come from accounts they did not follow by 2023. The backlash was immediate. Mega-influencers Kylie Jenner and Kim Kardashian shared a meme that said "Make Instagram Instagram again." Model Chrissy Teigen protested that she no longer saw her friends' posts. More than 300,000 users signed a petition that asked Instagram to "stop trying to be TikTok!"[68]

Instagram's CEO Adam Mosseri was little impressed:

> It's not surprising to us that there's a lot of anxiety around changing Instagram. I think that's always been the case. One positive way of looking at this is if people are passionate enough to get spicy on Twitter, that means they care about Instagram. That's a good thing.[69]

At the same time, he acknowledged the risk of changing the platform's recommendation engine:

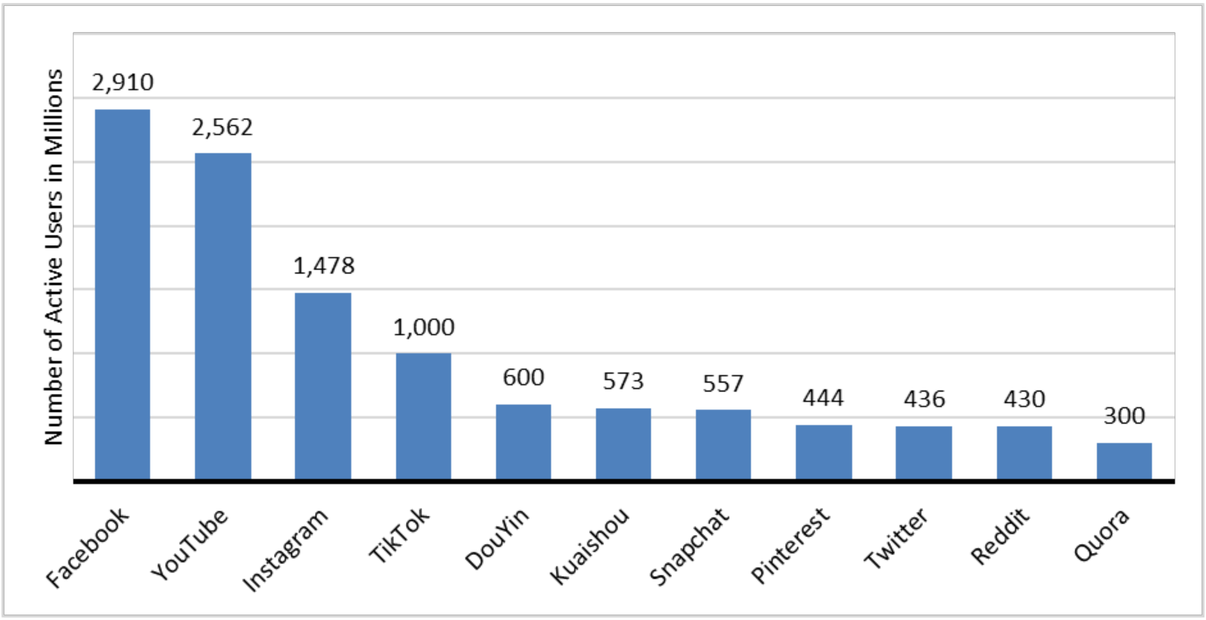
> I'm glad we took a risk—if we're not failing every once in a while, we're not thinking big enough or bold enough.… How people share with friends has changed. It has shifted to stories, and it has shifted to [direct messages]…. Which then begs the question, what's the future of feed?[70]

Two months after Instagram's announcement, YouTube said it would extend its Partner Program to Shorts. Creators with more than 1,000 subscribers and 10 million Shorts views over the past 90 days were eligible to participate. YouTube planned to share 45% of ad revenues (net of music licensing fees) with the creators of Shorts. Videos previously posted to other platforms would not qualify.[71]

YouTube's decision was all the more noteworthy because there appeared to be little competitive pressure to share revenue from Shorts. Instagram barely monetized Reels, and there was some evidence that the company had even scaled back its payments for short videos.[72] "I was personally resistant to monetizing our relationships with creators. It's a slippery slope," said Liz Perle, Instagram's first hire focused on teens and creators.[73] Similarly, TikTok's revenue sharing programs were limited in scope, and they rewarded only a small number of top creators.

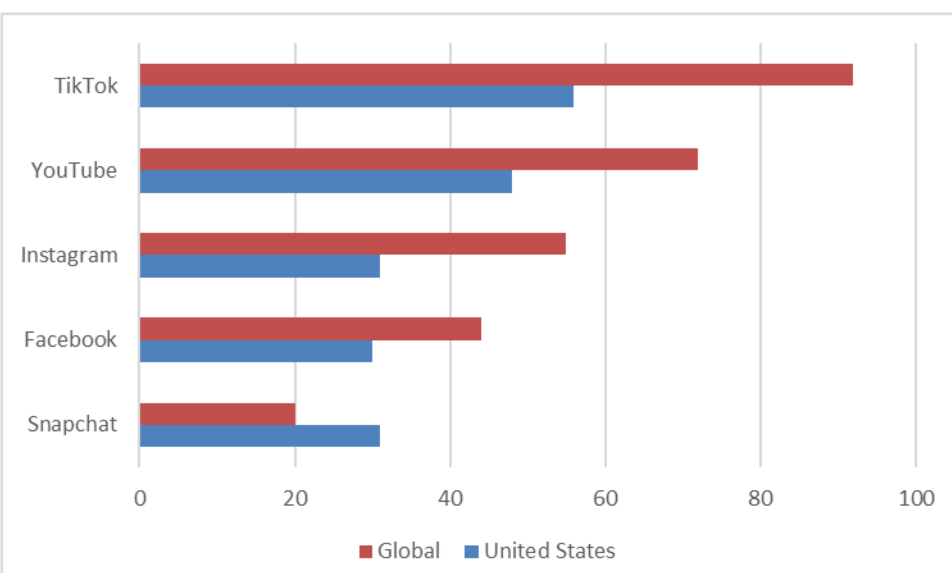
TikTok's Zhang, Liang and Chew had important decisions to make. Learning why Instagram and YouTube had changed direction seemed an important first step.

Exhibit 1 Global Social Networks, January 2022, Millions of Active Users



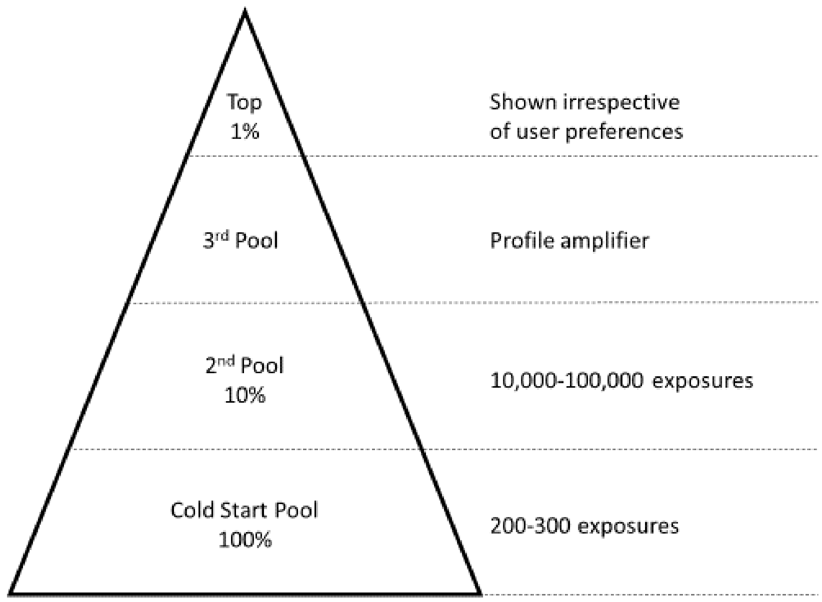
Source: Most popular social networks worldwide as of January 2022, ranked by number of monthly active users, via Statista, https://www-statista-com.ezp-prod1.hul.harvard.edu/statistics/272014/global-social-networks-ranked-by-number-of-users/.

Exhibit 2 Average Time Spent per Day on Selected Social Media Platforms, 2023 (Minutes)



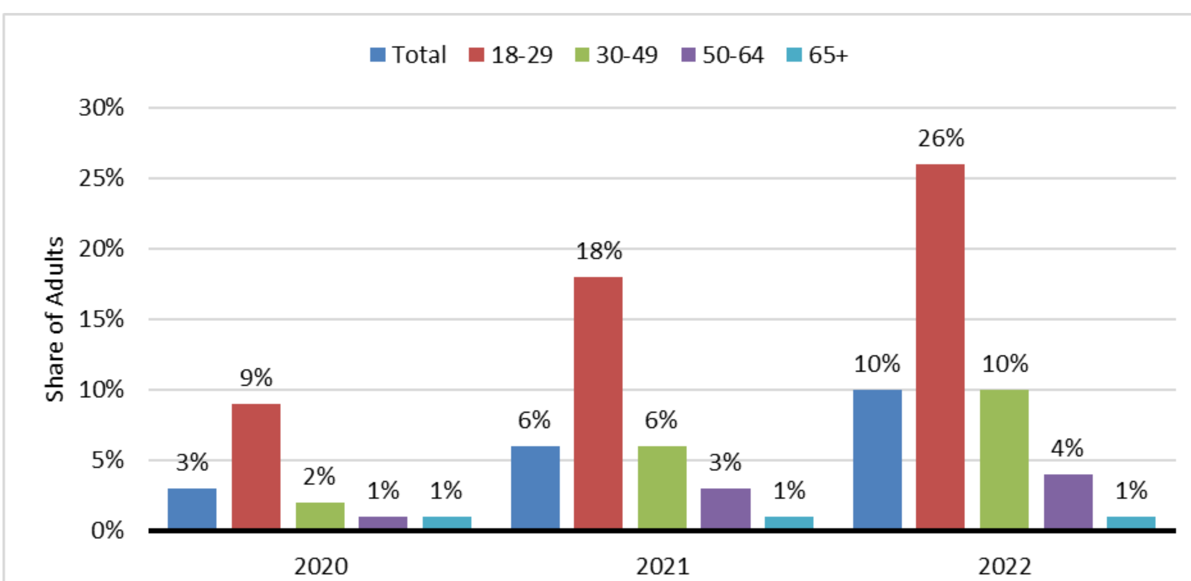
Source: Compiled from Justin Post and Joanna Zhao, "Alphabet: 2023 PM Level Outlook," Bank of America Global Research, January 10, 2023 and "Average Time Spent per Day by US Adult Users on Select Social Media Platforms, 2023 (minutes), eMarketer, January 1, 2023, https://chart-na1.emarketer.com/260920/average-time-spent-per-day-by-us-adult-users-on-select-social-media-platforms-2023-minutes.

Exhibit 3 Video Pools



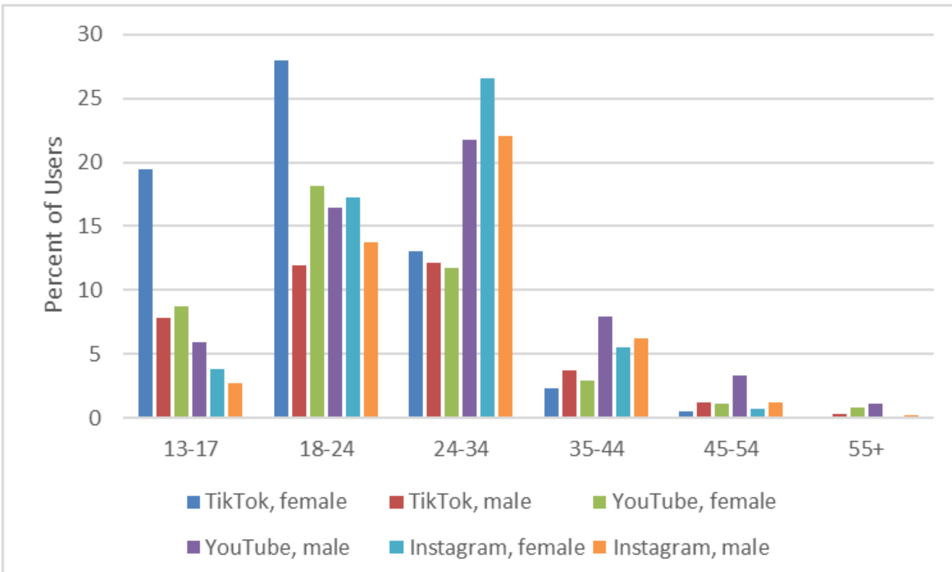
Source: Casewriter.

Exhibit 4 Share of Adults in the U.S. Who Regularly Get News from TikTok, by Age Group



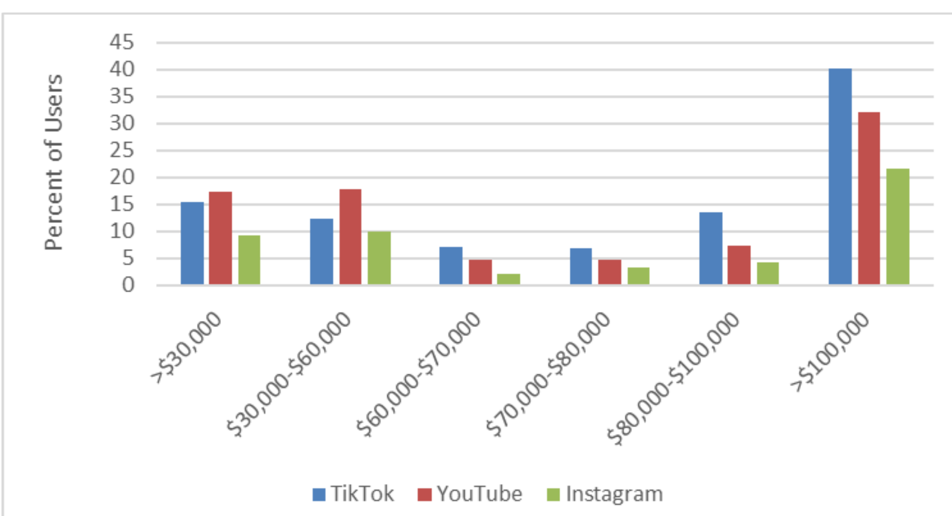
Source: Share of adults who regularly get news from TikTok in the United States from 2020 to 2022, by age group, via Statista, https://www.statista.com/statistics/1346500/share-adults-age-news-regular-tiktok-us/.

Exhibit 5 User Demographics—Age, by Gender



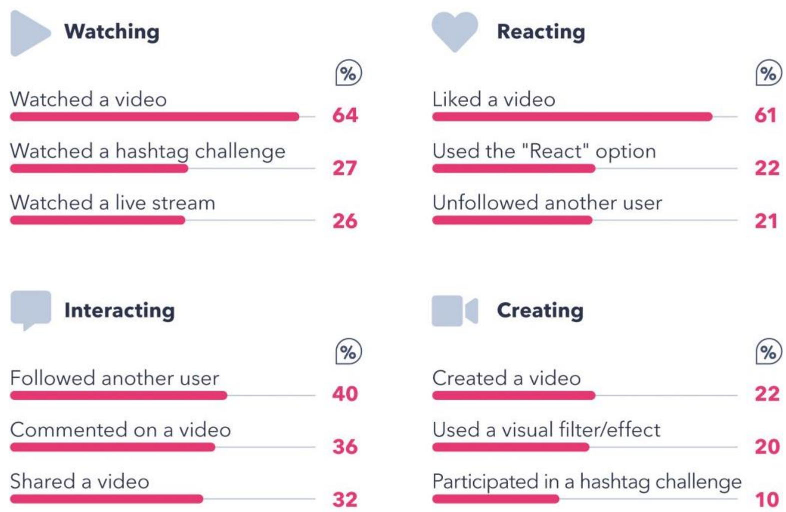
Source: Casewriter, based on data from Werner Geyser, "The State of Influencer Marketing 2023: Benchmark Reports," Influencer MarketingHub, February 7, 2023, https://influencermarketinghub.com/influencer-marketing-benchmark-report/.

Exhibit 6 User Demographics—Household Income



Source: Casewriter, based on data from "The 2022 Social Media Demographics Guide," Khoros, https://khoros.com/resources/social-media-demographics-guide#you-tube-demographics and PK, "Household Income Percentile Calculator for the United States," DQYDJ, https://khoros.com/resources/social-media-demographics-guide#you-tube-demographics.

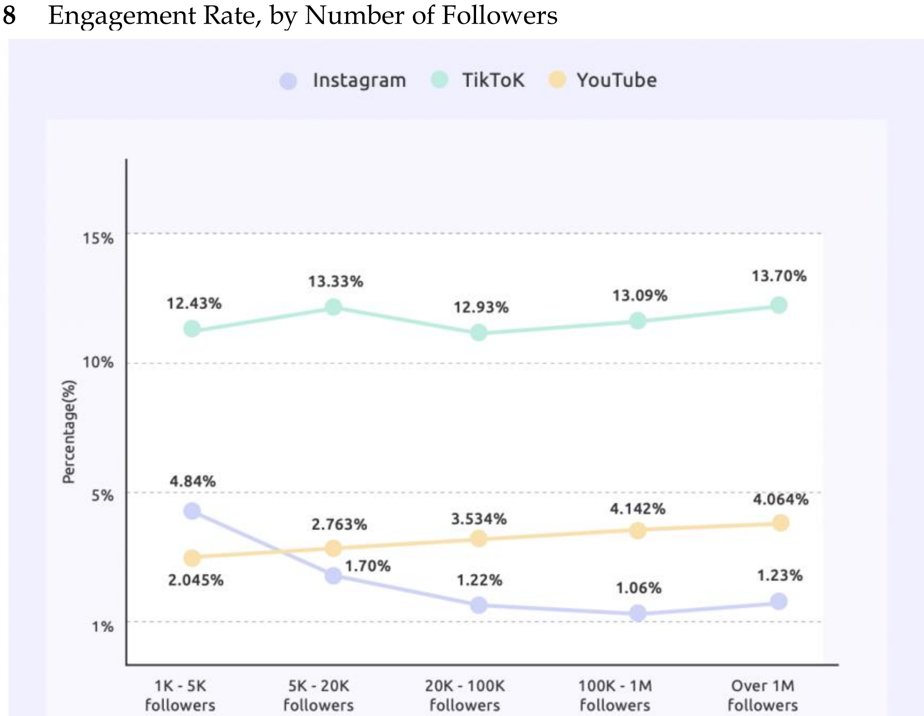
Exhibit 7 TikTok Forms of User Engagement, U.S. and U.K. Users, 2020



Note: Percent of U.S. TikTokers who engaged in this activity this past month.

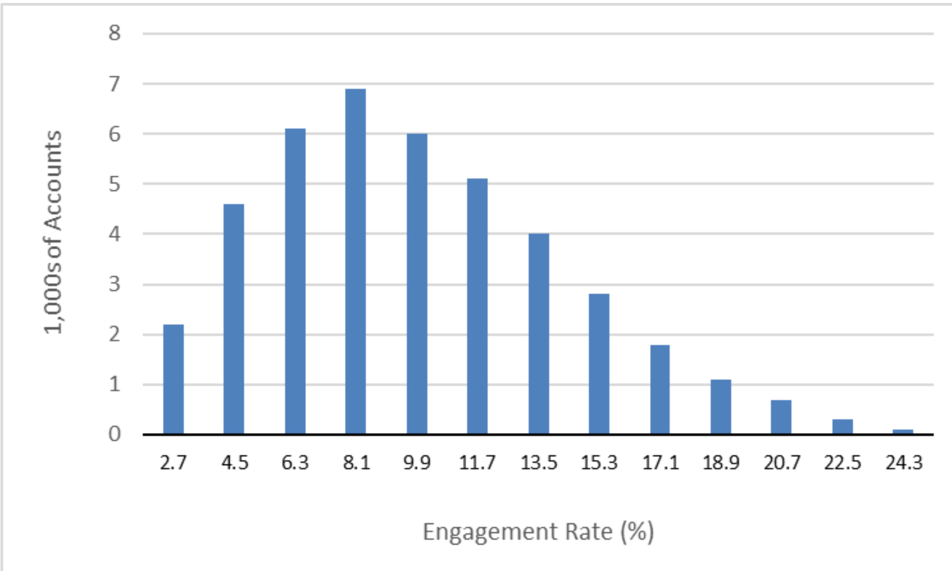
Source: Shauna Moran, "A byte-sized guide to TikTok and the new social media," GWI, September 2, 2020, https://blog.gwi.com/trends/tiktok-new-social-media/.

Exhibit 8 Engagement Rate, by Number of Followers



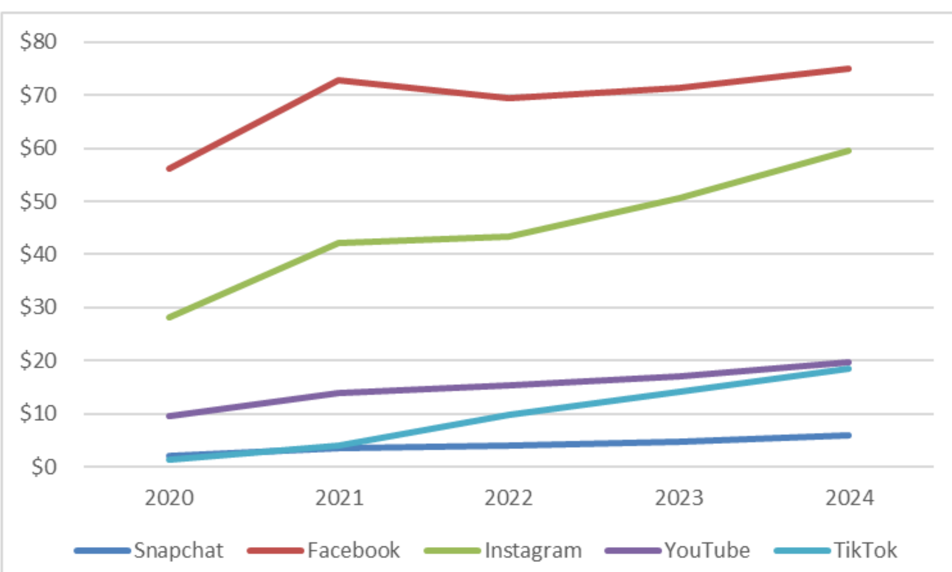
Source: Jacinda Santora, "Key Influencer Marketing Statistics to Drive Your Strategy in 2020," Influencer MarketingHub, January 11, 2023, https://influencermarketinghub.com/influencer-marketing-statistics/.

Exhibit 9 Distribution of Engagement in a Sample of TikTok Accounts, 2022



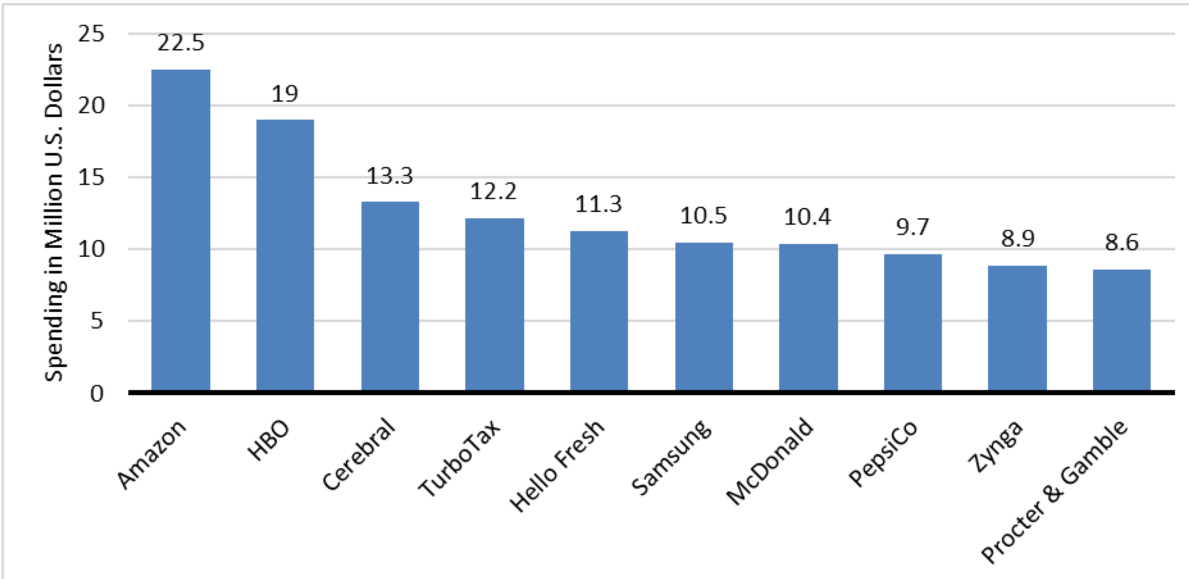
Source: Casewriter, based on data from HypeAuditor.

Exhibit 10 Global Advertising Revenue, Billions



Source: Casewriter, based on data from eMarketer.

Exhibit 11 Leading TikTok Advertisers in the U.S., 2022



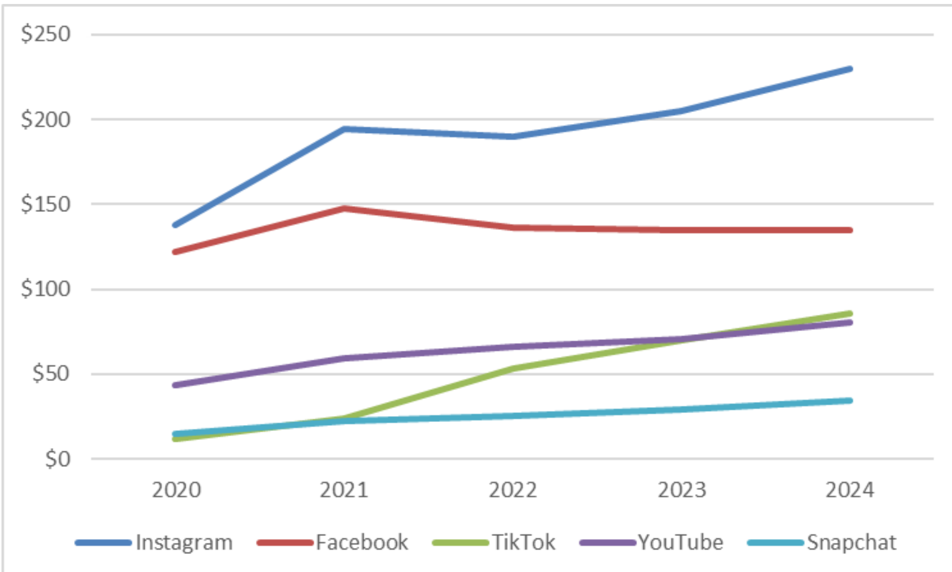
Source: Leading TikTok advertisers in the United States between January 1 and May 1, 2022, by spending, via Statista, https://www-statista-com.ezp-prod1.hul.harvard.edu/statistics/469106/tiktok-advertisers-usa/.

Exhibit 12 YouTube Revenue and Cost Structure, as % of Revenue in 2022

Revenue	100%
From advertising	85%
From Subscriptions	15%
Cost	
Content acquisition	47%
Data center, hosting	7%
SG&A	35%
Operating margin	**11%**

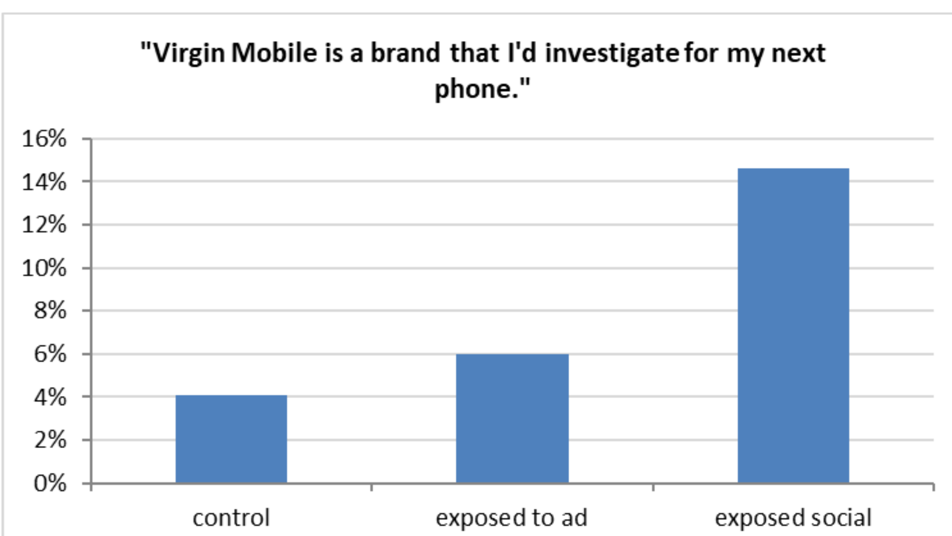
Source: Casewriter estimates based on Alphabet's 10K, Q4, December 31, 2022.

Exhibit 13 Average Revenue per U.S. User, 2020-2024



Source: Casewriter, based on data from Evelyn Mitchell, "Social Video Ad Spending Forecast 2023," eMarketer, January 24, 2023, https://content-na1.emarketer.com/social-video-ad-spending-forecast-2023.

Exhibit 14 Brand Lift of BuzzFeed's Virgin Mobile Campaign



Note: Persons in the control group did not see the ad. Those in the "exposed social" group received the ad from a person they follow via social media.

Source: Casewriter, based on information from BuzzFeed in "BuzzFeed—What Future for Native Advertising and Branded Content?" HBS No. 718-511, (Boston: Harvard Business School Publishing, 2018), p.21.

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Case Question

CASE: Hey, Insta & YouTube, Are You Watching TikTok?

In this opening session, we observe how ByteDance built Douyin and TikTok, two innovative social media companies that rely on data and artificial intelligence to outcompete the company's rivals. ByteDance's success is all the more remarkable because the legacy businesses benefit from strong network effects. We debate how TikTok in particular was able to attract over one billion monthly users.

1. What are the reasons for TikTok's success?
2. Who will win the short-form video competition—TikTok, Instagram, or YouTube?

Notes

Notes

2025 Connective Leadership Summit

Discovery Bank

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REV: DECEMBER 12, 2024

FELIX OBERHOLZER-GEE
PIPPA TUBMAN ARMERDING
NAMRATA ARORA

Discovery Bank

On a warm afternoon in May 2023, Hylton Kallner, CEO of Discovery Bank (the Bank), was in an Uber on the way to his office in Sandton, the business center of Johannesburg, South Africa. He studied two proposals that he planned to present to the board of Discovery Limited (Discovery), the bank's parent company. One was to link all of Discovery's apps and make the banking app the face of the entire suite of Discovery products. Kallner also hoped to convince the board to allow the bank to introduce new lending products. He had been with Discovery for 27 years, heading several of its businesses before becoming CEO of the Bank in 2021. In his time at Discovery, Kallner had seen the group grow from a modest health insurer to one of South Africa's leading insurance companies[a] and a thriving group of businesses that included, he believed, a successful bank. (See **Exhibit 1** for an organizational chart of Discovery and some of its subsidiaries and **Exhibit 2** for a timeline.) However, the group's future was tied to the bank's profitability, which in turn depended on the success of Kallner's proposals.

At the core of Discovery's success was its shared-value business model, which focused on generating profits while also creating value for customers. To achieve this goal, Discovery incentivized its members to engage in behaviors that enhanced their physical, mental, and financial well-being.[b] Discovery Vitality, a subsidiary created to drive this strategy, provided members with incentives that encouraged them to adopt a healthier lifestyle, drive more carefully and make improved financial decisions. (See **Exhibit 3** for an infographic of the shared-value model.)

While the bank was Discovery's fastest-growing business—in early 2023, it had nearly 660,000 customers and $650 million in deposits[c]—it operated at a loss and faced stiff competition from full-

[a] In South Africa, health insurance was commonly known as medical aid. For ease of reference, health insurance is used in this case.

[b] Discovery referred to its customers as members.

[c] All USD figures are approximations, based on a Rand/USD exchange rate (ZAR/USD) of 0.05 as of May 2023, Oanda, except where specified otherwise.

Professor Felix Oberholzer-Gee, Executive Director Pippa Tubman Armerding (Africa Research Center), and Senior Researcher Namrata Arora (Global Initiative) prepared this case. It was reviewed and approved before publication by a company designate. Funding for the development of this case was provided by Harvard Business School and not by the company. The citation review for this case has not yet been completed. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

service banks. As Kallner's Uber pulled up to Discovery's iconic headquarters building, he wondered if his proposals had the potential to secure the future of the bank and the group.

Discovery Health

Discovery Health was founded in 1992 by Adrian Gore, a South African actuary who began his professional career at Liberty Life, a prominent South African insurance company. In the early 1990s, the South African healthcare sector was characterized by an underfunded public healthcare system. Large sections of the population did not qualify for free care or discounted fees through the government. At the same time, they did not have the means to access private health insurance. Gore was dismayed by the situation. Driven by a desire to create health insurance products "that would appeal to everyone," Gore set out to disrupt the industry.[1] He raised US$0.9 million[d] from Rand Merchant Corporation (RMC) and convinced them to let him use their dormant insurance license. Barry Swartzberg, a former Liberty Life colleague, joined Gore as a co-founder of Discovery Health. Drawing on their collective experience, the duo decided to offer a medical savings account (MSA) plan. The plan covered nondiscretionary services in full but charged high deductibles for discretionary services. As a result of the substantial deductible component, Discovery's insurance premiums were much lower than the fees of traditional healthcare plans.

Discovery Health was an instant success. By the end of 1993, the company had enrolled thousands of customers.[2] The competition did not take long to notice, however. By the late 1990s, other insurers offered variations of Discovery Health's core product, encouraging Gore to look for new ways to differentiate the business. When a fitness chain contacted the two founders with a proposal to market its membership through Discovery, Gore saw this as the perfect opportunity to re-build the company's offerings with a focus on member wellbeing. This new direction matched his intuition that a healthier population would also experience reduced healthcare costs. Although the idea was not new—several insurers had tried to lower their costs by encouraging healthy lifestyles—Gore believed that they had not incorporated insights from behavioral economics and data analytics, resulting in their limited success.

Vitality Health

In late 1997, Gore and Swartzberg introduced a proprietary behavior change program, which they called Vitality. Francois Groepe, deputy CEO of Discovery Bank explained, "Our insurance business is about a joint partnership. We encourage you to adopt healthy behaviors in return for lower claims and reduced capital needs. We then split these gains with our clients in the form of incentives."

Vitality members earned points when they engaged in behaviors that supported their health. A health check in a clinic was worth 22,500 points, a mental health assessment 500, a round of golf 100 (see **Exhibit 4a** for a list of activities that earned points). Vitality tiered its members based on the number of points that they had earned (see **Exhibit 4b**). Although Vitality was offered separately from Discovery's health insurance plans, only Discovery members were able to join Vitality. Membership was priced at $16 a month. Customers were attracted to the program because the value of the rewards often exceeded the $16 monthly fee. Discovery offered generous discounts on fitness devices (50%), sports apparel (50%) and healthy groceries (25%). The Vitality rewards also included discounts on

[d] An exchange rate of 0.09 ZAR = $1 has been used here.

services that were not directly related to member health, including flights (up to 35%), movie tickets (50%) and dining (25%) (see **Exhibit 5** for other examples.)

Discovery structured many of its awards to boost program adherence. For example, the company offered members who set weekly and monthly exercise goals an Apple Watch on an installment basis. If they met their goal for the week, they received a small reward such as a free smoothie or coffee. If they met their goals for the month, they did not have to pay anything towards the Apple Watch. However, if members failed to meet their goals, they were charged an installment fee, which reflected the number of weekly goals they had met. Research showed that members who opted for this program were 34% more active than other Vitality members.[3]

Following the introduction of Vitality in 1997, Discovery Health grew to be the largest open enrollment[e] health insurance company in South Africa.[4] By 2023, 40% of Discovery Health insurance customers were also Vitality Health members. Those who joined Vitality experienced improved health, had higher life expectancy, and spent 28% less on healthcare.[5] The likelihood of members being hospitalized fell with increasing levels of activity; one additional exercise session per week resulted in a 7% reduction, while two additional sessions resulted in a 13% reduction.[6]

Policy changes contributed to Vitality's success. In early 2000, South Africa introduced community rating rules for health insurance. Insurance companies were no longer allowed to vary premiums within a geographic area based on factors such as age, gender and health status. The new law also guaranteed access to insurance; no applicant could be rejected.[7] Swartzberg said,

> We had a lot of success [early on] because we were good at individual risk rating. Moving forward toward an egalitarian system—with community rating and guaranteed access—meant that we needed to get people to lead healthier lives more than ever.

Kallner added,

> Attracting customers who are healthier than average keeps the entire system sustainable. But if they start thinking they're paying too much for health insurance, you can't retain them. They often let their insurance lapse because they know they can always come back. The sickly ones, on the other hand, always stay. The shared value model helps us retain healthy [customers].

Some criticized Vitality as a marketing ploy, "designed to attract healthy people to the company while leaving the sick for someone else to cover."[8] Emile Stipp, Chief Actuary at Discovery Health, pushed back,

> [This perspective] is a little bit too cynical. The selection effect is important, but there's another effect and that's the behavior change effect. And what we see when people interact with shared value is that there are actually very significant changes in behavior over time. And what's important to us is that those changes in behavior are more than what you'd find in a population without the incentives, and we see evidence of that every single day. If you have enough transactional data to derive what people's habits are, then you can build on those habits and make it better and share the value with them through incentives.

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[e] In South Africa, open enrollment meant that people could purchase insurance as needed throughout the year instead of being able to do so only during a specific annual period.

By 2023, Discovery Health had over 3.82 million customers and earned a normalized operating profit of $192.7 million.[9]

Diversification

While Discovery was building out its suite of healthcare products, the company also experimented with services in related markets. In 2001, Discovery launched a life insurance company, Discovery Life, which adjusted policy premiums based on the policyholder's Vitality engagement. Discovery Life offered premiums that were 15% lower than the prices charged by competitors. The life insurance product experienced lower lapse rates, and it produced higher profit margins.

In 2011, Discovery branched out into car, home, and business insurance, forming a new subsidiary, Discovery Insure. Insure introduced Vitality Drive, a program that encouraged safe driving. Policyholders installed a tracking device in their car. The device collected data on braking, acceleration, cornering, speed, distance and late-night driving. Each day, Vitality Drive members started out with 60 "driver intelligence points," for which they could get cashback on fuel, up to $75 each month. The company deducted points when drivers accelerated rapidly, braked suddenly, used their phone while driving, or exceeded the speed limit. By 2023, 82% of Discovery Insure's customers were Vitality Drive members.

Discovery Bank

Discovery's first banking product was a Visa credit card that it launched in partnership with South Africa's First National Bank (FNB) in 2004. The idea was that members would use their Discovery card to redeem rewards and earn cashback. The card met with significant success, leading Discovery to consider offering additional banking services. Since the banking customer base was much bigger than the insurance market, expanding into banking provided Discovery with an avenue for growth. Nic Salmon, head of product development and data science at Discovery Bank explained, "We weren't intending for it to be a profitable credit card, but when we saw how well it was doing, we decided to grow it into a banking proposition." (See **Exhibit 6** for the financials of the credit card business.)

Discovery built its bank based on the company's shared value ethos, using rewards to encourage good financial behavior. The team believed that people often failed to meet their financial obligations because of three risks, which were in turn linked to five controllable behaviors. The three risks—unsustainable amounts of debt, unplanned debt and not being protected in retirement— were a direct result of (1) spending more than what one earned, (2) not having insurance, (3) not saving for emergencies, (4) not saving for retirement and (5) managing secured debt poorly.[10] By encouraging customers to control these behaviors, the bank hoped to improve their financial health.

In October 2016, Discovery obtained an initial authorization from the South African Registrar of Banks to set up a banking subsidiary.[11] For the next several months, the team developed a provisional business plan with the aim of beginning operations by June 2018, achieving break even by 2020 and earning a projected profit of $25 million by 2023. (See **Exhibit 7** for key indicators from the initial business plan.) Recalling this 'build' phase, John Cruickshank, CFO, Discovery Bank, said, "People don't realize just how incredibly difficult it is to build a bank from scratch. It's easier just to buy another bank. We had an expensive headcount even before we got a license to open." Discovery envisaged the bank to be fully digital, offering a complete range of services. Salmon explained, "Our goal, was to become a full retail bank, not a skinny digital bank."

In an early setback, however, South Africa's Competition Commission nixed the company's plans to partner with FNB, citing competition concerns.[12] As a result, Discovery Bank had to fully acquire the card business from FNB. Kallner explained, "We ended up migrating customers in large batches. That meant we had to develop a full banking and credit card infrastructure, which wasn't part of our business plan." Cruickshank added,

> To acquire almost 4 billion rand in credit card balances, we had to buy bonds worth 4 billion rand. We had no money. You can imagine the sleepless nights. It was intense. What if people don't open savings accounts? What if people don't want to put in their money?

In November 2018, Discovery publicly announced its plan to establish the "world's first behavioral bank." And after five months of beta-testing, Discovery Bank finally launched. It offered a credit card as well as transaction, savings, and foreign currency accounts. All products were accessible through the bank's proprietary app. Discovery Bank did not, however, offer personal loans, mortgages, vehicle financing, investment banking, commercial banking, or wealth management—products offered by most full-service banks in South Africa. Sarisha Naidoo Singh, Discovery Bank's wealth relationship manager, said, "As a new bank, we are more geared to personal banking. We don't have all the glorious products that large, long-established banks offer, like trusts and structured lending, but that doesn't mean we won't have them in the future. For now, our customers go to other banks for those services."

Vitality Money

Discovery Bank's financial offerings were bundled with its trademark behavior change program, and offered as Vitality Money, which offered customers incentives for being smart in managing their finances. Kallner explained,

> The bank is an example of shared value in its purest form—the behavioral banking design leverages superior actuarial dynamics to address the important societal need of addressing poor financial behavior; clients benefit from immediate rewards, and the bank will benefit from an improved risk profile.

Vitality Money was a fixed component of Discovery's financial services. Rivonia Govender, strategy manager, explained, "You can't say I don't want Vitality money, you get it, whereas with health, Vitality Health is a separate behavioral program that doesn't have a product linked to it." Vitality Money was based on insights from studies that documented consumers' tendency to prioritize short-term gratification over long-term goals, leading to insufficient savings, excessive spending, and inadequate insurance coverage.[13]

When customers opened an account, the Vitality Money app assessed their financial health using the five measures of good financial behavior: sufficient savings (3x gross monthly income was considered ideal), limited short-term debt (debt repayments of less than 5% of income), insurance (having health, life and property insurance), retirement savings (being able to replace 75% of pre-retirement income), and property investments. The latter consisted of a person's home equity plus savings in excess of 3x their monthly income, evaluated against the average long-term assets of a person with the same level of income. Based on their score across all five metrics, customers were assigned a Vitality Money status—Blue, Bronze, Silver, Gold or Diamond. As they improved their financial health, they accumulated points, climbing from Blue (less than 40,000 points) towards Diamond (80,000 points).

Customers with higher point balances were rewarded with higher interest on their savings and lower rates on outstanding credit card balances. (See **Exhibit 8** for the interest rates.) David Leibowitz, Technical Marketing manager, emphasized the idea of financial health that underpinned the program: "Vitality Money is not about selling Discovery products. It doesn't matter where you keep your insurance or retirement funds. It isn't a loyalty program. We reward you as long as you have coverage that protects you against unforeseen events."

In addition to better financial terms, Vitality Money also rewarded responsible behavior with a broad array of rewards, not unlike Vitality Health. More affluent customers who signed up for a suite of higher-fee banking products received more generous discounts. The entry-level Gold Card (annual income up to US$17,500) discounted healthy foods up to 40%, depending on the customer's point balance. The higher-income Platinum and Black cards reimbursed healthy groceries up to 50%. These cards also carried a more ambitious weekly points maximum. (See **Exhibit 9** for an overview of Vitality Money.)

Discovery eventually linked the three Vitality programs—Vitality Health, Drive, and Money—so that points from all three were combined. Govender said, "There's a stacking effect. Let's say you're a purple-card or black-card customer. If you achieve the highest status in both Vitality Money and Vitality Health, you can receive a discount of up to 75% on healthy groceries every month. Vitality Money contributes two-thirds of the discount, and Vitality Health contributes one-third."

Discovery Bank offered some rewards directly through its banking app. Firoze Bhorat, chief marketing officer at Discovery, said, "In early 2022, we introduced Vitality Travel, a travel booking platform that aggregates flights from major airlines. It has become one of our most popular rewards." Using the app, customers were able to book discounted flights using their Vitality points. Discovery soon became one of the largest travel platforms in South Africa.

Incentive Design

It was not trivial to design incentives that encouraged responsible behavior and made financial sense to customers. For instance, customers earned points if they charged expenses to their Discovery cards. To help customers better control spending, Discovery replaced a monthly spending target with a weekly goal. Kallner explained:

> The weekly versus monthly spend goal is a lesson we learned in health. We've seen that people respond to a weekly goal much better than a monthly goal. It gets people really focused on exactly how they're behaving in each program. So, "Did I do my exercise for the week?" We're finding the same pattern in spending as well. "Have I managed my spending this week?" It's not that we want you to spend more, but ideally, you want it to be fairly uniform.

Under the new system, purple-card holders were encouraged to spend $500 each week to obtain the maximum number of points. However, the weekly goal was met with mixed reactions. Singh remarked:

> Some of the purple-card customers said, 'I don't have time to track whether I'm spending $500 every week on the app, but I might spend $2,500 all at once. If I do that, I won't achieve my spending goal because I didn't spend $500 every week.' Our customers understand the science behind being active and driving well, but they struggle to grasp the thinking behind some of the Bank's incentives.

Path to Profitability

As of April 2023, Discovery Bank had more than 600,000 customers and 1.5 million active accounts. Expenses, however, were at an all-time high of $79 million, and Discovery Bank operated at a loss. Thato Malakalaka, head of finance, explained, “We’re concentrating on finding ways to turn a profit. Personnel is our main cost. Because we are digital, we don’t need branch personnel like tellers, so that’s a plus. But we do need skilled professionals in areas like marketing, IT, data science, and customer relations. Our IT expenses are the second-largest budget item, followed by marketing. We spend $4.4 million on acquiring new customers. All our build costs, setting up the infrastructure and building systems for a full-fledged bank, have to be amortized one day and that’s coming through now.” (See **Exhibit 10a and 10b** for the income statements of Discovery Bank and Standard Bank, the largest South African bank by assets.)

Cruickshank pointed to quickly growing deposits:

> On the deposit side, we have done incredibly well. We launched a year before COVID. When the pandemic hit, people started saving because nobody knew what the future held for them. That savings culture contributed to the growth of deposits, but it’s not making us the margins we need.

Discovery Bank’s management expected to break even with one million customers. Cruickshank said, “It was half a million before, but we realized people were just trying us out, taking low end products – we’ve seen a lot of clients opening accounts, but they’ve got banking relationships elsewhere and so that changed our initial projections.”

Only 13% of Discovery Bank’s customers considered it their primary bank, and overall customer engagement tended to be low (see **Exhibit 11**). This was true across South African banks, in particular among low-income households. A 2021 survey found that 40% of these households left their accounts dormant. Another 19% withdrew all funds as soon as they were deposited.[14]

Switching banks was burdensome. Customers had to manually move their automatic debit orders, salary deposits, and mortgage details, all of which prevented even Discovery Health members from changing banks. Bhorat remarked, “You would think that most of our clients would be existing clients. However close to 50% are actually new to Discovery. This provides an opportunity for our other verticals to cross-sell.”

A strength of Discovery Bank was its low credit loss ratio of 2.2%, which compared favorably with the ratio at other large banks in South Africa, which averaged 5.1%.[15] In part, the sharply reduced losses reflected the Bank’s customer base. Bhorat explained, “Our marketing strategy tends to target higher-income customers. Many of them don’t let interest accrue on their credit card balances; they pay off their entire balance every month.” Customer behavior influenced losses as well. Malakalaka said, “What we realized with our credit loss ratios is that, as you get your customers to engage more with the products, they default less, and that’s how we then make money.”

To boost the active use of accounts and promote cross-selling, Discovery employed 1,400 financial advisors who helped customers with their health coverage and other insurance programs—but not with banking-related services. Most advisors worked on a commission basis.

Competition in Financial Services

South Africa had a large financial sector with an asset to GDP ratio of over 100%, well above that of most emerging markets. Banking was highly concentrated, with the largest institutions holding over 80% of the industry's deposits. South Africa's leading banks were well capitalized and profitable (see **Exhibit 12**).[16] "We're in a very competitive space," said Govender:

> Our competitors are strong and quick to act. When we launch something new, they quickly copy it or try to do it a little better. We always have to be looking over our shoulder… Our biggest competitive advantage is our proprietary Vitality money program.

The recent entry of digital banks—most notably TymeBank and Bank Zero—promised to make the market even more competitive. TymeBank, which had launched in 2019, operated exclusively through an app. The bank offered no-fee transaction accounts, savings accounts, and a credit card. By the end of 2022, TymeBank had attracted 6 million customers, 70% of whom were actively using their accounts.[17] Cruickshank was not concerned: "They're digital, but they're a skinny bank. I don't know how much profit they can make. It's a venture capital investment, so they probably aim to flip it and sell their millions of customers to one of the big banks. Where else could it be going?"

Bank Zero launched in August 2021 as a mutual bank, which meant that it was owned by its depositors. Exclusively digital, its accounts carried no fees. Bank Zero had no plans to offer credit, as it viewed the lending market as saturated.[18] The bank specifically targeted small and medium-sized businesses and aimed to break even at 100,000 customers and achieve profitability within three years.[19] Bhorat assessed the threat: "Bank Zero and TymeBank operate at the lower end of the market, where there is a large population of underbanked and unbanked people. So propositions like zero fees align with the needs of that market segment. They can acquire customers very quickly that way."

The Bank as the Face of Discovery?

The Bank's success in attracting new customers propelled Discovery to consider making the banking app the gateway to all Discovery businesses. Salmon said, "Purely from a number's perspective, our banking business has pretty much outperformed our health business in terms of volume. It's our fastest-growing business. What we are proposing is a very deliberate strategy for cross-selling and upselling ancillary Discovery products."

Making banking the face of all other services would involve integrating Discovery Health and Discovery Insure with the banking app and discontinuing the existing Discovery app that hosted these services. Bhorat said, "Customers will be able to access all their insurance plans from the banking app. They'll be able to see all our products in one place, which isn't possible now, because they are all separate entities on different apps."

Discovery Health and Discovery Insure already shared some data to better price and market their services. Emile Stipp, chief actuary of Discovery Health, gave an example: "Through our data analytics, we can see a strong link between how people drive and whether they have an annual dental checkup. People who go for dental checkups also tend to drive safely. That sort of insight helps us promote the right products to the right people."

If the existing apps were replaced with a single banking app that carried all products, customers would have to consent to having their private data shared across the Discovery subsidiaries. There were many potential benefits. Kallner shared an example:

> The bank has geo-located every single point of sale device in the country, and we also geo-locate when customers make payments. Typically, people make payments in two places, when they are at work and when they are at home. So we quickly form our view of where the person lives and where they work. This gives us a direct indication of how far they drive every day, and driving distance is the best metric of motor risk. If you have given us permission as a bank client to access your group data, we can offer you car insurance potentially at a much lower rate.

The possibilities seemed endless. Kallner offered another mechanism to let customers benefit: "If a Bank customer visits an obstetrician who specializes in infertility, we can flag that information. The next time they access the banking app, they might receive an offer for financing options related to infertility treatments not covered by their health insurance."

Integrating Discovery's services raised complex ethical considerations. Stipp recalled, "During the pandemic, we had to consider how our life insurance company should approach a situation where a customer decided not to get vaccinated." To resolve these kinds of tensions, the company established internal and external governance committees, and it instituted permission controls to ensure that a customer's data was not used in a way that disadvantaged them. Kallner described the company's policy: "It dictates that we use the data for the benefit of the customer. In car insurance, for example, we use telematics, but we won't use speeding data to decline a claim in the event of an accident—only to confirm that the customer was present—so that there's no question of fraud."

A related concern with the integration of all services was whether customers would be willing to open a bank account in order to access Discovery's other products. Stipp explained,

> Health insurance companies usually consider people without a bank account a liability. You can argue that it's best for people to interact with Discovery Bank via their health product first, particularly if they're undergoing treatment. However, you don't want to force them to go through a bank to get their medication.

Kallner's view was nuanced, "There may be certain benefits that you won't be able to access if you don't have the banking app. For instance, if we are providing bank loans for healthcare, you'd have to bank with us to get that."

The company's experience with its travel app—it had once been a free-standing app that was subsequently integrated into the banking app—added to the executive team's confidence. Govender recounted, "To make the Vitality Travel platform available to customers who didn't bank with us, we introduced a free bank account. Even though it was free, we still had initial pushback from insurance customers who felt they were being forced to become bank customers. But once they started using the app, most customers were okay with it. One Discovery customer explained how accessing the travel platform influenced his decision to switch to the bank: "I switched to Discovery for the travel benefit. I already had medical aid and Vitality Health. When Discovery integrated the travel platform into the bank app, I thought it best to just switch over to avoid transferring money from different banks when I had to book a flight."

Building a Loan Business?

The loan question

Personal loans were a $13.3 billion market, a potentially significant business opportunity for Discovery Bank. The company had found that its customers had $765 million in loan balances at other institutions. More than 80% of that balance was owed by customers who the Bank deemed creditworthy.[20]

With a substantial loan portfolio, Discovery Bank's business would depend more strongly on interest rates. Govendor said, "Prime rates are currently just under 11%. We were at about 6.5% three years ago, and there's talk now about the prime going up to 20%. By getting into unsecured lending, depending on how high interest rates rise, there's no guarantee that we'll be able to achieve our loan growth target, purely from an affordability perspective." Rising interest rates and the leading banks' more limited risk appetite had already curtailed the growth of all lending products (see **Exhibit 13**).

Discovery Bank's forecasts indicated that, if they decided to enter unsecured lending, pre-tax profits would be $1.7 million in the first year, $5.9 million in the second year, and $12.4 million in the third. (See **Exhibit 14** for the business case for unsecured loans.)

The mortgage question

Mortgages were a $56 billion market that had grown rapidly in 2021 and 2002, but lending activity fell back to 2019 levels as interest rates rose in 2023.[21] Discovery Bank estimated that its customers held $10.9 billion in mortgage balances at other banks. $9.6 billion of that total was held by customers with acceptable risk scores. Kallner was not entirely convinced that offering mortgages was a good idea: "The economics around mortgages are not good. They're a very capital-intensive product that is highly competitive and commoditized… We have a competitive disadvantage [in mortgages] because we don't have an enormous balance sheet, and it's not a profitable product to write."

At the same time, Kallner knew that mortgages would offer the Bank's financial advisors an attractive opportunity to generate income (see **Exhibit 15**). Kallner said, "Mortgages, bank accounts, mortgage insurance, and property insurance all pay commissions, so the motivation for our financial advisors is obvious."

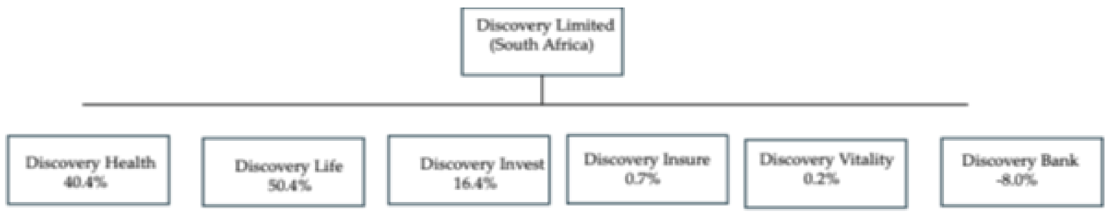
If it decided to offer mortgages, Discovery Bank intended to outsource the back-end operations to a specialized mortgage partner while keeping the mortgages on its balance sheet. Govender said, "For the moment, we are considering partnering with an existing mortgage provider. Through that partnership, much of the profit would have to be shared with that partner."

Discovery Bank predicted that a potential mortgage business would break even in year 4 of operations (s**ee Exhibit 16).**

Choices

As Kallner entered his office, he understood that him and his team had many reasons to be proud of Discovery Bank's progress. Since its launch in 2019, the Bank had rapidly grown its customer base, accumulated significant deposits, and developed a strong brand. Kallner decided to present all three proposals to Discovery's Board of Directors. Would he be able to convince the board to adopt all of them? Was this even in Discovery's best interest?

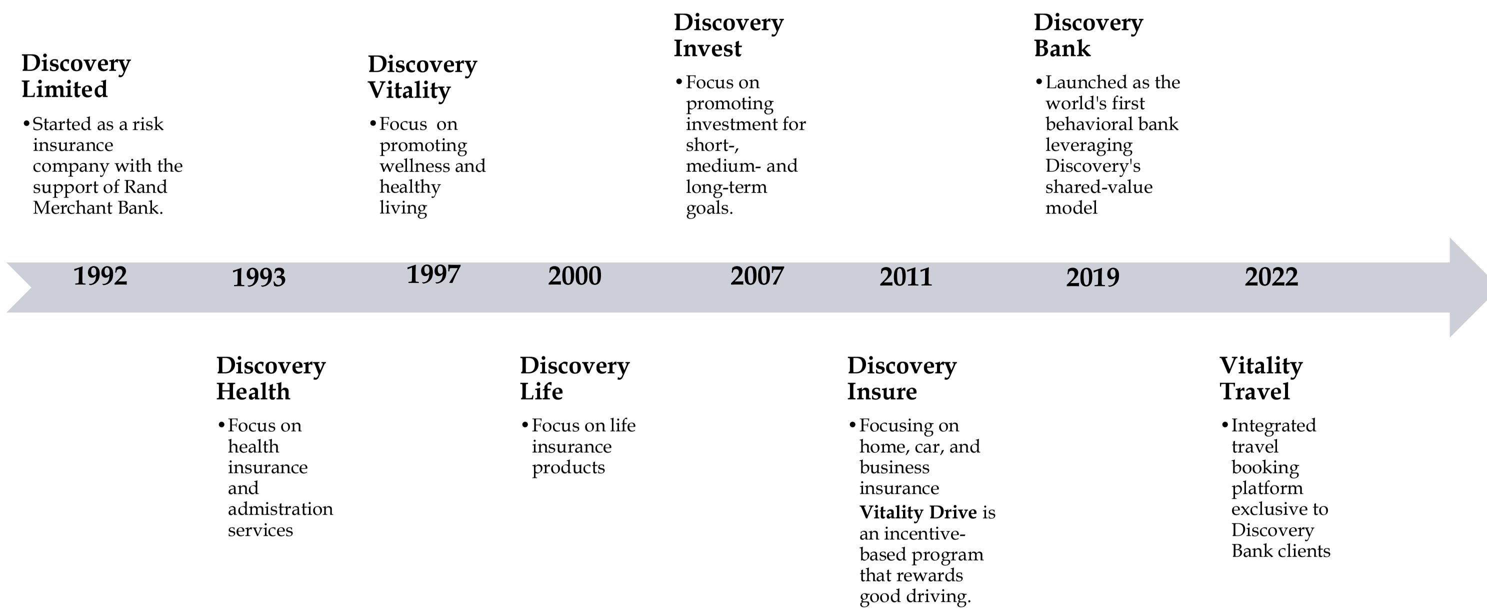
Exhibit 1 Discovery—Subsidiaries and Share of Operating Profit 2023



Source: Company documents.

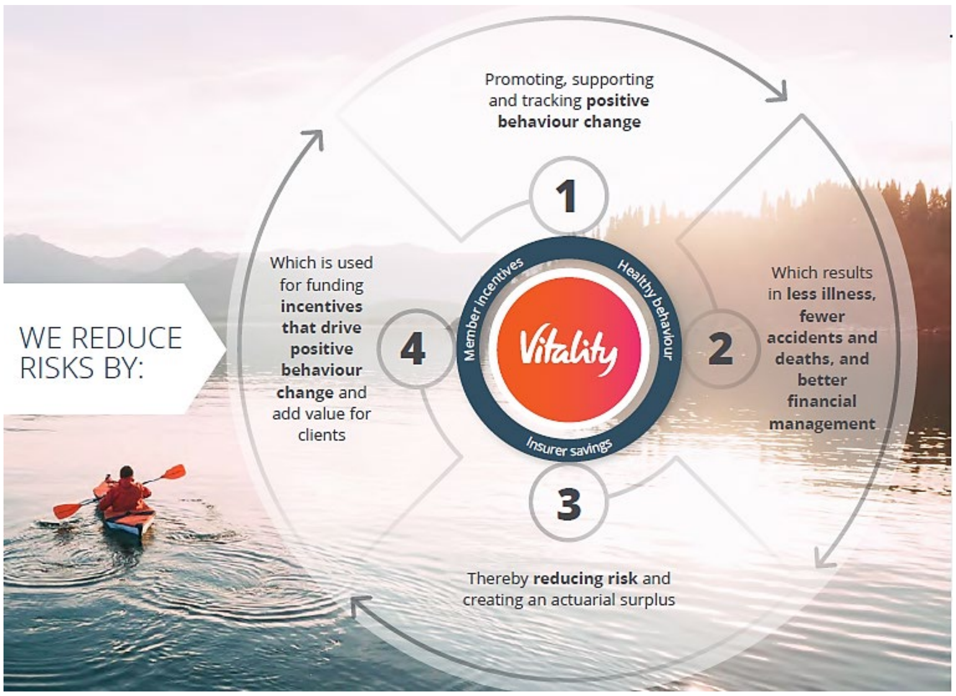
Note: This chart shows only key South African subsidiaries of Discovery mentioned in the case.

Exhibit 2 Timeline of Discovery's Expansion



Source: Company documents.

Exhibit 3 Discovery's Shared-Value Model



Source: Company documents.

Exhibit 4a Points Earned for Health-promoting Activities

Activity Type	Activity	Points Earned
Online Assessments	Find out your Vitality Age	1500
	Mental wellbeing assessment (twice a year)	500 per assessment
Vitality Health Check	Blood pressure, Blood Glucose, Cholesterol, Weight Management, Non-smokers Declaration	22500
Vitality Fitness Assessment	Basic Assessment	2500
	Additional Points Based on fitness level	Up to 5000
	High-performance fitness assessment	Up to 15000
Exercise	Exercise at Gym or Approved Facility	Up to 100 per day
	Track exercise on your smartphone or fitness device	Up to 300 per day
	Vitality-accredited partner online workout	Up to 50 per day
	Complete a free parkrun	Up to 300 per event
	Participate in a Vitality virtual event	Up to 300 per event
	Participate in a Vitality-timed race event	Up to 3000 per event
	Play a round of golf	100 per event
Nutrition	Buy HealthyFood items at Pick n Pay or Woolworths	Up to 12000
	Visit a dietitian	1000
	Pap smear	2500
	Mammogram	2500
	Colonoscopy	2500
	Dental health check	1000
	Flu vaccine	1000
	Initial HIV test	7500
	Chronic condition registration	2500
	Glaucoma screening	2500

Source: Compiled from company documents.

Exhibit 4b Vitality Health: Points Required for Each Level

Vitality Health Level	Required Points (depending on # of covered adults)		
	1 adult	**2 adults**	**Additional dependents**
Blue	None	none	none
Bronze	7,500	15,000	3,750
Silver	25,000	50,000	12,500
Gold	40,000	80,000	20,000
Diamond	50,000	100,000	25,000

Source: Company documents.

Exhibit 5 Sample Rewards for Vitality Health

Source: Company documents.

Exhibit 6 Statistics on Discovery's Credit Card Business 2016-2020 (in $ millions)

	FY2016	FY2017	FY2018	FY2019	FY2020
Revenue	40.01	43.40	46.60	45.75	30.72
Interest income	17.58	19.29	20.18	20.07	15.85
Bad debt charge	(2.84)	(3.70)	(3.55)	(5.02)	(5.92)
Non-interest income	25.26	27.82	29.97	30.71	20.79
Expenses	(24.71)	(25.68)	(25.92)	(27.83)	(20.35)
Reward funding to Vitality	(8.18)	(9.08)	(9.79)	(10.08)	(6.96)
FNB direct costs	(6.11)	(6.11)	(5.55)	(6.54)	(5.14)
Discovery expenditure	(5.11)	(5.09)	(5.36)	(5.50)	(3.71)
Support costs	(3.30)	(3.27)	(2.94)	(3.23)	(2.75)
VAT	(2.00)	(2.12)	(2.26)	(2.48)	(1.79)
Profit/ (loss) for the period	15.29	17.73	20.68	17.92	10.38
Active accounts per month	241,788	243,408	246,794	235,446	63,459
Gross advances	3,986,123,286	4,202,949,697	4,349,377,677	4,270,991,428	1,756,407,264
Number of non-performing loans	93,519,042	112,866,372	131,828,269	141,336,451	144,363,969

Source: Casewriter, based on company documents.

Exhibit 7 Key Indicators from the Initial Business Plan for the Bank 2018-2027

Profit and loss ($ Millions)	30-Jun-18	30-Jun-19	30-Jun-20	30-Jun-21	30-Jun-22	30-Jun-23	30-Jun-24	30-Jun-25	30-Jun-26	30-Jun-27
Net interest income	14.12	29.06	36.88	43.19	50.00	58.91	68.51	79.93	94.68	111.35
Net non-interest revenue	11.75	31.04	43.72	53.05	63.05	79.05	89.54	103.28	126.52	143.79
Provisions and impairment charges	(3.31)	(7.04)	(7.59)	(8.76)	(10.04)	(11.90)	(13.62)	(16.31)	(19.32)	(22.12)
Operating income	22.56	53.06	73.01	87.48	103.01	126.06	144.43	166.90	201.88	233.02
Personnel expenses	(16.36)	(24.59)	(24.21)	(26.28)	(28.58)	(31.06)	(33.66)	(36.54)	(39.37)	(42.43)
Depreciation & amortization	(4.59)	(8.23)	(8.23)	(8.23)	(8.23)	(8.23)	(8.23)	(8.23)	(8.23)	(8.23)
Other operating expenses	(19.41)	(33.81)	(34.85)	(38.26)	(41.80)	(49.03)	(51.09)	(56.01)	(65.22)	(60.68)
Profit before taxes	(17.80)	(13.57)	5.72	14.71	24.41	37.74	51.44	66.11	89.06	121.69
Taxes	3.69	1.78	(3.56)	(6.11)	(8.86)	(12.64)	(16.51)	(20.68)	(27.17)	(36.32)
Profit after taxes	(14.11)	(11.79)	2.16	8.60	15.55	25.10	34.93	45.43	61.89	85.37

Number of accounts (Units)	30-Jun-18	30-Jun-19	30-Jun-20	30-Jun-21	30-Jun-22	30-Jun-23	30-Jun-24	30-Jun-25	30-Jun-26	30-Jun-27
Credit card - current book	78,480	264,356	272,216	284,360	301,280	323,672	352,544	391,832	435,488	474,284
Credit card - new book	7,386	30,394	43,440	55,436	65,809	79,825	88,371	98,846	112,332	127,462
Transactional accounts	18,697	115,031	149,420	184,684	214,575	243,570	267,336	298,028	334,763	371,909
Savings accounts	9,241	56,851	73,847	91,275	106,048	120,377	132,123	147,292	165,447	183,805
Total	113,804	466,632	538,923	615,755	687,712	767,444	840,374	935,997	1,048,031	1,157,460

Number of customers (Units)	30-Jun-18	30-Jun-19	30-Jun-20	30-Jun-21	30-Jun-22	30-Jun-23	30-Jun-24	30-Jun-25	30-Jun-26	30-Jun-27
Number of unique customers	89,037	307,790	334,297	363,588	395,337	437,762	478,851	533,113	596,041	656,462
Additional customers on credit card accounts	31,392	105,742	108,886	113,744	120,512	129,469	141,018	156,733	174,195	189,714

Source: Developed by casewriter, based on company documents.

Note: The business plan is for illustrative purposes and does not constitute a forecast.

Exhibit 8 Dynamic Interest Rates, 2023

Source: Company documents.

Exhibit 9 Vitality Money Rewards by Level

<table>
<tr><th>Card Level</th><th>Annual Income Required and Fees</th><th>Weekly Points Goal (Max)</th><th>Behaviors and Maximum Points earned</th><th>Discovery Bank Savings Required for Diamond Status</th><th>Rewards</th></tr>
<tr><td>Gold</td><td>$5,000 – $17,500

$5 per month</td><td>250</td><td>• Saving: 30,000
• Managing Debt: 30,000
• Having Insurance: 25,000
• Investing for Retirement: 10,000
• Managing Property Investments: 5,000</td><td>$1,000</td><td>• Up to 40% back on healthy groceries
• Up to 10% back on fuel purchases and Uber rides
• Up to 2.5% back on Discovery Life plans
• Up to 40% off local flights and 35% off international flights</td></tr>
<tr><td>Platinum</td><td>$17,500 – $42,500

$7.75 per month</td><td>500</td><td rowspan="2">• Saving: 25,000
• Managing Debt: 25,000
• Having Insurance: 25,000
• Investing for Retirement: 10,000
• Managing Property Investments: 15,000</td><td>$2,250</td><td>• Up to 50% back on healthy groceries and personal care items
• Up to 15% back on fuel purchases and Uber rides
• Up to 3.5% back on Discovery Life plans
• Up to 50% off local flights and 35% off international flights</td></tr>
<tr><td>Black</td><td>$42,500 – $125,000

$11.75 per month</td><td>750</td><td>$5,000</td><td>• Up to 50% back on healthy groceries and personal care items
• Up to 15% back on fuel purchases and Uber rides
• Up to 5% back on Discovery Life plans
• Up to 60% off local flights and 50% off international flights</td></tr>
</table>

Source: Compiled by casewriter from *Discovery Vitality 2023. Live life with Vitality,* Discovery corporate brochure (Sandton, South Africa, July 2023), p. 5 – 7; and Discovery Bank, "Being smart with your money has never been more rewarding!" Discovery company website, https://www.discovery.co.za/bank/vitality-money-rewards, accessed June 2023.

Exhibit 10a Discovery Bank Income Statement (2020-2023)

Units: $ million	FY 2020	FY 2021	FY 2022	FY 2023
Fee income from administration businesses	6.85	0.10	0.00	0.00
Vitality income	6.05	1.05	0.00	0.00
Net banking fee and commission income	7.50	23.20	31.65	47.15
Banking fee and commission income	9.10	31.65	42.65	64.60
Banking fee and commission expenses	(1.60)	(8.45)	(11.00)	(17.45)
Net bank interest and similar income	3.15	10.70	15.90	28.70
Bank interest and similar income using the effective interest rate	8.10	31.35	40.55	65.90
Bank interest and similar expenses using the effective interest rate	(4.95)	(20.65)	(24.65)	(37.20)
Net fair value gains/(losses) on financial assets at fair value through profit or loss	4.60	4.15	0.00	0.00
Other income	6.05	15.60	0.00	0.00
Net income	34.20	54.80	47.55	75.85
Depreciation and amortization	(11.80)	(12.30)	(13.85)	(15.70)
Other expenses	(71.90)	(83.65)	(79.85)	(91.55)
Expected credit losses	(9.05)	(13.55)	(3.35)	(6.95)
Normalized profit/(loss) from operations	(58.55)	(54.70)	(49.50)	(38.35)
Income tax expense	13.50	16.70	10.90	11.30
Profit/(loss) for the period	(45.05)	(38.00)	(38.60)	(27.05)

Source: Casewriter, based on data from Discovery, Annual financial statements for the year ended 30 June 2023, pp 25-26, https://www.discovery.co.za/assets/discoverycoza/corporate/investor-relations/2023/discovery-annual-financial-statements-2023-v2.pdf, and Discovery Annual financial statements for the year ended 30 June 2022, pp. 32–33, https://www.discovery.co.za/assets/discoverycoza/corporate/investor-relations/2022/discovery-annual-financial-statements-fy-2022.pdf, and Discovery, Annual financial statements for the year ended 30 June 2020, p. 30, https://www.discovery.co.za/assets/discoverycoza/corporate/investor-relations/2020/new-discovery-annual-financial-statements-2020.pdf, accessed June 2023.

Note: Exchange rate of R1=$0.05 has been used.

Exhibit 11 Discovery Bank Customer Engagement (2021-2023)

	FY 2021	FY 2022	FY 2023 (Year to Date)
Proportion of customers with dormant accounts	14%	21%	29%
Proportion of customers with low engagement	51%	43%	36%
Proportion of customers with moderate engagement	16%	14%	13%
Proportion of customers with high engagement	11%	10%	9%
Proportion of customers with primary account usage	8%	11%	13%

Source: Compiled by casewriter, based on company documents.

Exhibit 12 Top Banks in South Africa by Assets, Loans, Deposits, Equity, and Profits, 2023

Institution	Total assets** ($ mil)	Loans & advances** ($ mil)	Deposits** ($ mil)	Total Equity** ($ mil)	Profits** ($ mil)	Number of customers* (millions)
Standard Bank	169,858	80,442	100,082	13,846	2,320	10.20
FirstRand Bank	93,365	51,704	98,914	10,363	1,578	9.06
Absa Bank	87,134	63,568	66,977	8,220	908	9.60
Nedbank	73,800	44,581	54,400	5,844	718	6.48
Investec Bank	32,203	36,361	49,484	2,739	554	0.90
Capitec Bank	11,565	4,891	7,203	1,896	378	19.00

Source: Casewriter, based on data from Natalie Cowling, Leading banks in South Africa 2023, by assets, Statista, October 19, 2023, https://www.statista.com/statistics/1346961/leading-banks-in-south-africa-by-assets/ , accessed November 2024, Natalie Cowling, Leading banks in South Africa 2023, by profit, October 19, 2023, https://proxy.parisjc.edu:8293/statistics/1346966/leading-banks-in-south-africa-by-profit/ , accessed November 2024, , Standard Bank, Analysis of financial results for the year ended 31 December 2023, p. 8, https://www.standardbank.com/static_file/Investor%20Relations/Documents/Financial-results/Annual-Results/SBG%202023%20Annual%20Results%20Booklet%20double%20page.pdf, accessed November 2024, FirstRand, Analysis of financial results for the six months ended 31 December 2023, p.78 and p.168, https://www.firstrand.co.za/media/investors/reports/fsr-analysis-of-financial-results-booklet-dec-2023.pdf, accessed November 2024, Absa Group Ltd., Annual consolidated and separate financial statements for the year ended 31 December 2023, p.23, https://www.absa.africa/wp-content/uploads/2024/03/Absa-Group-Annual-Consolidated-and-Separate-Financial-Statements.pdf, accessed November 2024, Nedbank Group, Annual results for the year ended 31 December 2023, p.16, p.90 and p.110, https://www.nedbank.co.za/content/dam/nedbank/site-assets/AboutUs/Information%20Hub/Integrated%20Report/2024/2023%20Nedbank%20Group%20Annual%20Results%20Booklet%20(double%20page).pdf, accessed November 2024, Investec, Investec Annual Report 2024, p.45, https://www.investec.com/content/dam/investor-relations/financial-information/group-financial-results/2024/Investec-Annual-financial-statements-Online-2024.pdf, accessed November 2024, Capitec Bank

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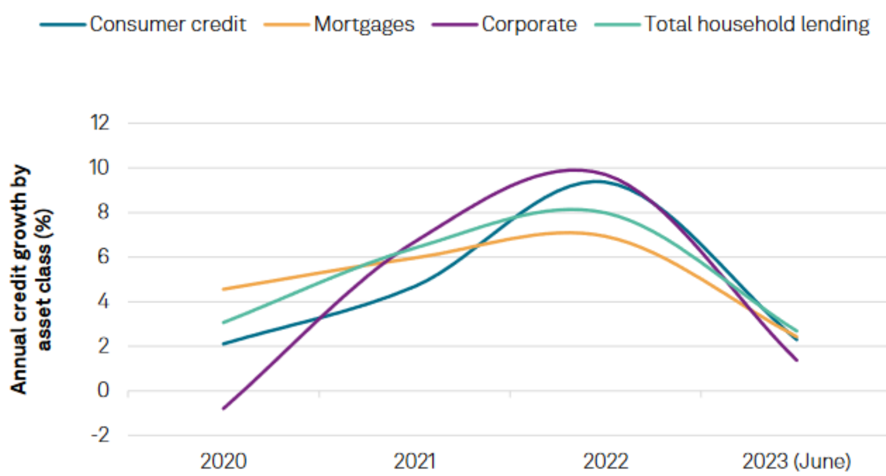
Note: Exchange rate of R1=$0.05 has been used, *Customer numbers as of 2022 and **As of end of 2023.

Exhibit 13 Credit Growth 2020-2023



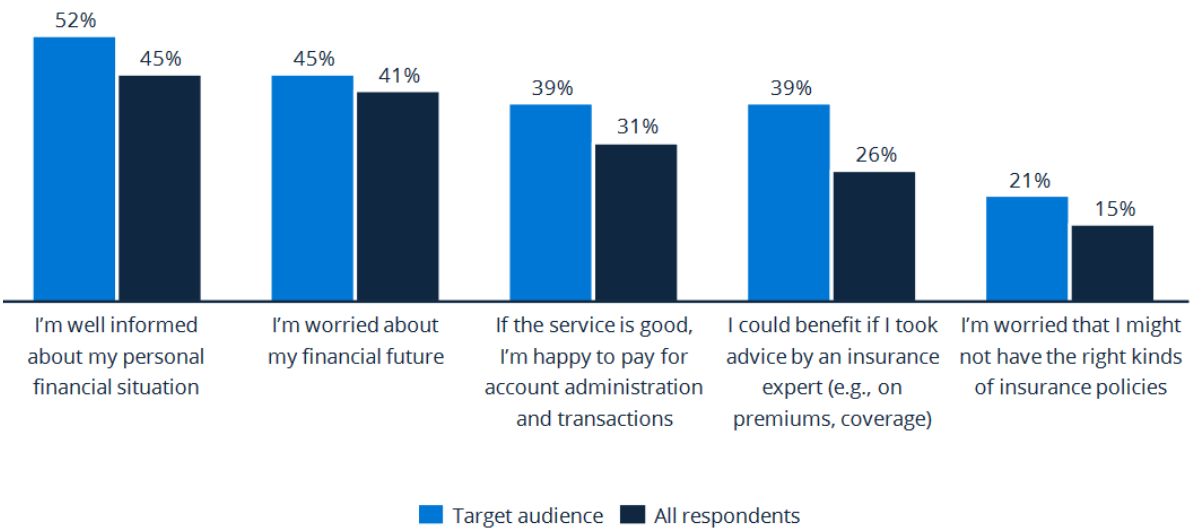
Source: Samira Mensah, "South African Banking Outlook 2024." S&P Global, January 18, 2024, https://www.spglobal.com/_assets/documents/ratings/research/101592098.pdf

Exhibit 14 Business Case for Unsecured Lending Products, 2023

Figures	Year 1	Year 2	Year 3
Total volume (thousands)	11.4	33.8	68.6
Sales (thousands)	11.9	21.9	34.8
Year-end balances on loans ($ millions)	35	85	160
Regulatory capital ($ millions)	5	10	20
Profit before tax, after capital costs ($ million)	1.65	5.9	12.4

Source: Casewriter, based on company documents.

Exhibit 15 Attitudes of Mortgage Holders in South Africa



Source: "Target audience: Mortgage holders in South Africa." Statista Consumer Insights, June 2024, https://www-statista-com.ezp-prod1.hul.harvard.edu/study/169735/target-audience-mortgage-holders-in-south-africa/

Note: The data report the share of mortgage holders, the target audience, and the general population who agree with the statement.

Exhibit 16 Business Case for Mortgages, 2023

Figures	Year 1	Year 2	Year 3	Year 4	Year 5
Total volume (thousands)	1.9	6.1	11	16.6	22.5
Sales (thousands)	1.9	4.5	5.6	6.6	7.4
Year-end balances on loans ($ million)	100	310	560	830	1,085
Regulatory capital ($ million)	5.6	17.95	32.8	25.25	32.85
Profit after tax, before capital costs ($ thousands)	-250	500	1,500	2,500	3,750
Profit after tax, after capital costs ($ thousands)	-250	-1,000	-1,500	0	250

Source: Casewriter, based on company document.

Endnotes

[1] "Discovery Limited," HBS No. 715-423 (Boston: Harvard Business School Publishing, 2021), p. 4, http://hbsp.harvard.edu, accessed May 2023.

[2] "Discovery Limited," HBS No. 715-423 (Boston: Harvard Business School Publishing, 2021), p. 3, http://hbsp.harvard.edu, accessed May 2023.

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[13] Discovery, "Banking for a stronger South Africa," November 2018, p. 3, https://www.discovery.co.za/assets/discoverycoza/bank/banking-for-a-stronger-south-africa.pdf, accessed June 2023.

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[15] See, Economist Intelligence Unit, Financial services: South Africa, March 31, 2023, Banks | Financial Services Report | EIU (harvard.edu), accessed October 2023; and Discovery Audited Results for the year ended June 2022, p. 25, AUDITED RESULTS (discovery.co.za), accessed October 2023.

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Case Question

CASE: Discovery Bank

We explore the business model of Discovery Group, a South-African insurance company that creates shared value. Discovery believes their model is applicable to many industries, including banking and real estate. We ask if shared value can serve as a foundation for customer discovery and innovation.

1. What is Discovery's value-based business model? In your view, is it different from how other companies create and share value?
2. Was it a good idea for Discovery to build a bank? Does the value-based business model lend itself to banking?
3. Do you recommend that Discovery make the banking app the face of all Discovery businesses?
4. Are you in favor of launching a loan product? A mortgage product?

Notes

Notes

2025 Connective Leadership Summit

"Storrowed": A Generative AI Exercise

Harvard Business School

9-824-188
MARCH 11, 2024

MITCHELL WEISS

"Storrowed": A Generative AI Exercise

A problem vexed Boston, Massachusetts, and its drivers. Trucks got stuck under the bridges on the city's Storrow Drive so often that this predicament even had a name, "Storrowing"[1] or getting "Storrowed". Though even many long-time residents who'd seen trucks lose their roofs to the collisions didn't quite know how often vehicles got wedged or nearly wedged on the roads that ran along Boston's Charles River. When queried by a reporter, "How many times would you think that happened over…the month of August?", one nearby pedestrian guessed, "Seven." The actual answer: "Thirty-four."[2] Some days featured so much "Storrowing" that on social media one observer took to calling it a "hat trick" when "an over-height truck has had to back out of Storrow before hitting a bridge THREE times today."[3] Efforts to date, including signage, social media campaigns, and fines, among other measures, had not put an end to Storrowing.[4] One driver – dismayed and delayed on the way to work behind one such run-in – wondered, "What would AI have to say about why this keeps happening?"

Exhibit 1 A Truck Gets "Storrowed"

Source: David L. Ryan, The Boston Globe, September 8, 2023. "A truck 'Storrowed' Friday morning — though not on Storrow Drive," https://www.bostonglobe.com/2023/09/08/metro/truck-storrows-on-soldiers-field-road, accessed March 2024.

Professor Mitchell Weiss prepared this exercise as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Endnotes

[1] Travis Anderson, "A truck 'Storrowed' Friday Morning – though not on Storrow Drive." *The Boston Globe,* September 8, 2023. https://www.bostonglobe.com/2023/09/08/metro/truck-storrows-on-soldiers-field-road/, accessed March 2024.

[2] Katie Thompson, Boston Averaged More than 1 'Storrowing' a Day Last Month. *WCVB Channel 5,* September 6, 2021. https://www.youtube.com/watch?v=ftU2_32R_ag&t=17s, accessed March 2024.

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Case Question

CASE: “Storrowed”: A Generative AI Exercise

In this session, we apply AI tools to a common problem in Boston, trucks getting stuck under bridges. We develop best practices for the use of these tools. In the second half of the session, the participants refine their solution to an innovation challenge in their own organization, applying these practices.

1. In your experience, how effective is Generative AI at helping you understand problems?
2. How good are these tools at ideation?

Notes

Notes

2025 Connective Leadership Summit

Rent the Runway

HARVARD | BUSINESS | SCHOOL

9-812-077
REV: DECEMBER 17, 2012

THOMAS R. EISENMANN
LAURA WINIG

Rent the Runway

Every woman should have access to this Cinderella experience for the special occasions in her life. Rent the Runway sells the self-confidence that comes when a woman wears brands she never dreamed she would be able to afford. Whether a woman is 15 or 55, she wants to feel beautiful. Rent the Runway makes refreshing your wardrobe a magical, convenient experience.

— Jenn Hyman, co-founder and CEO, Rent the Runway

We're trying to get women to step out of their comfort zones. This business is about the anti-little-black-dress. You have a black dress in your closet. Try a hot pink one-shoulder sequined dress—a stunner you normally wouldn't buy because you'd only wear it once.

— Jenny Fleiss, co-founder and president, Rent the Runway

In January 2010, Jennifer (Jenn) Hyman and Jennifer (Jenny) Fleiss, co-founders of Manhattan-based Rent the Runway (RTR), were debating their next moves. RTR was a website that rented designer dresses, charging 10% to 15% of a dress's retail purchase price and encouraging its members to "Try new brands, new trends and feel beautiful every night." Just two months after its launch, RTR had demonstrated strong demand for this value proposition by attracting more than 150,000 members.

With their November launch and the holiday crunch behind them, the co-founders faced a big decision: Should RTR raise another funding round, well ahead of schedule? They had originally assumed that their $1.75 million seed round of venture capital would last through the spring of 2011. Fleiss and Hyman had planned to grow RTR at a measured pace during 2010 while pursuing operational improvements that would move the company toward cash flow breakeven. After demonstrating proof of concept, RTR would then be well positioned to raise additional funds in early 2011. RTR would have ample funds available to cover budgeted inventory and head-count growth through 2010 if it followed that plan.

Based on feedback from early customers, however, the co-founders realized that RTR was delivering more than just great value and convenience through dress rentals. The company was fulfilling women's dreams by making them feel confident and beautiful. Consistent with this new vision, Hyman and Fleiss saw opportunities to serve a broader range of age groups and social occasions by increasing inventory more rapidly and by extending their product range, for example,

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Professor Thomas R. Eisenmann and Senior Researcher Laura Winig, Global Research Group, prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

adding accessories and maternity wear. Also, with website upgrades, customers could interact in ways that made the service more sticky, sharing stories and advice on what to wear to upcoming occasions. But pursuing these opportunities would put heavy demands on RTR's small management team, which was still scrambling to get operations under control. It also would require raising more capital, and doing so sooner than originally planned. Was the upside revenue potential in their new vision for RTR great enough to offset the additional dilution the co-founders would suffer if they raised additional equity now? Had they shown enough progress to significantly increase their valuation in a new round? Or should they stick with their original plan, which would deliver positive cash flow sooner—and a bigger equity stake of what might be a smaller company?

Background

Hyman and Fleiss met in the Harvard Business School (HBS) MBA Program. Prior to attending HBS, Fleiss was an internal strategy consultant at Lehman Brothers and Morgan Stanley, and also founded an essay editing service for college applicants. Hyman had worked in sales and marketing at Starwood Hotels and later became an in-house entrepreneur there, launching Starwood's wedding business. She then led WeddingChannel.com's ad sales team and was director of new media for the sports talent agency, IMG. (See **Exhibit 1** for biographies.)

The inspiration for RTR came to Hyman in November 2008, during her second year at business school. She recalled:

> My younger sister Becky desperately wanted to buy a $1,500 Marchesa dress to wear to a wedding. She felt compelled to buy a new dress—despite already having a closet full of designer dresses—because she knew photos would soon appear on Facebook and she didn't want to be seen twice in the same outfit. She was earning $55,000 a year as an accessories buyer at Bloomingdale's, so I thought it was crazy for her to spend that much. At the same time, I realized that designer brands *should* strive to acquire Becky as a customer. She loves fashion and she'll spend heavily on apparel for the rest of her life. The system was flawed: young women couldn't afford the brands they truly desired and designers couldn't access young women to build brand loyalty.

Hyman shared her idea for a dress rental business with her friend Fleiss. Hyman commented, "I knew I needed a partner whose skills would complement mine. I'm great at the strategic and marketing vision—coming up with ideas and selling them, but executing on the details is not my strength. Jenny is very task-oriented and I knew she would keep us on track. She's also more risk averse than I am, and I knew I could count on her to challenge ideas that were not fully thought through." Neither co-founder had experience in the designer apparel business, which had generated $149 billion in 2008 retail sales to women in the U.S.—$80 billion from dresses alone. "In some ways, our lack of fashion industry experience has been an asset. We approached the industry with a fresh perspective on how to change it," said Hyman.

Getting Started

In December 2008, two weeks after RTR was conceived, the women cold-called Diane von Furstenberg, an influential fashion designer who also was president of the Council of Fashion Designers of America, and secured a meeting with her. Von Furstenberg was intrigued with their idea and agreed to meet again to consider a formal proposal.

Fleiss and Hyman devised a plan for a turnkey service that would allow DVF (Von Furstenberg's company) and other designers to rent their dresses through the designers' own websites. The designers would bear the costs of website upgrades, supplying dresses to rent, and acquiring customers, while RTR would manage warehouse and customer service operations in exchange for a transaction fee. Hyman commented: "From the outset, we saw an opportunity to build our own site, but this white-label approach could be an interim step that required much less capital. This was important because we both had traditional job offers, and Jenny had resolved to make her career choice by June. Raising a lot of capital in that time frame would be difficult."

When the pair presented their plan in February 2009, Von Furstenberg said she would only come on board if Hyman and Fleiss could convince other designers to participate. "From this conversation, it became clear we'd have to buy dresses directly from designers and develop our own rental site. Designers would not be willing to bear the costs and risks of building a rental business themselves," said Fleiss, adding, "While this model would be more challenging and capital intensive, we realized that it gave us more control over the business and offered the potential for greater profitability over time." Hyman said, "It also became clear that it would be imperative to build a customer experience and a brand that would encourage women to try this new behavior of renting dresses."

Surveying the Competition

To prepare to meet with more designers, Fleiss and Hyman studied other fashion rental websites. They found only two services in the U.S. that might pose a near-term competitive threat. Wear Today, Gone Tomorrow (WTGT), launched in March 2009 by a former women's lifestyle magazine editor, rented dresses, tops, jackets, and skirts. WTGT's customers paid about 90% off an item's retail purchase price for weekly rentals and 70% off for monthly rentals. Fleiss and Hyman were not impressed with the quality of WTGT's website or its inventory, but the site was new and could improve.

Avelle, launched in 2004 as "Bag Borrow or Steal," focused on renting handbags, sunglasses, and jewelry. The online service had raised $15 million in venture capital in 2007 and gained popularity after being mentioned in the 2008 movie, *Sex and the City*. Fleiss said, "Avelle launched with a good selection of top brands, but rather than buying directly from designers, they initially purchased through sample sales [retail events that offered designer goods at low prices] and other discount retailers." She added, "This created ill will among designers. It also meant that Avelle paid retail prices for their inventory and bought stale goods at the end of the fashion season. We wanted access to designers' best new products at wholesale prices, so we couldn't afford to alienate designers. Everyone knows each other in fashion, so if you build trust with one brand, others will follow."

Hyman commented on the prospect of competition:

> There have always been brick-and-mortar boutiques that rent to wealthy women before red carpet events. And there are a few websites that rent dresses, mostly with assortments built from one woman's closet. But if Rent the Runway turns out to be a great business, we'll see serious copycats. We might negotiate designer exclusivity for some period, but if rental becomes a major new channel, competitors will eventually get access to product. Consequently, we need to differentiate our customer experience. We need to create a brand that women love; one that absolutely, positively will get them the right dress, on time, with flawless, "feels-like-new" presentation; and with superb service that treats the customer with the utmost respect.

Another factor would distinguish RTR: no existing competitor catered to women's needs to rent a dress for a specific occasion by allowing for reservations. Through a hotel-like reservation system, RTR would enable women to place orders for dresses up to six months in advance.

Selling the Concept to Designers

During February and March 2009, Hyman and Fleiss met with 20 designers and got a lukewarm reception from most of them. "We were lucky to get encouragement at the outset from Diane. Her belief in us gave us the fuel we needed to get through many early meetings at which people rejected our idea," said Hyman, adding, "We were going to designers as two young women who'd never worked in fashion, asking to buy their inventory so we could rent it at the same time it's available in Saks Fifth Avenue and Neiman Marcus for 10% of their retail price. In the first five meetings, their response was basically, 'over my dead body.'"

Hyman and Fleiss steadily refined their pitch. Instead of selling the RTR concept, they asked for designers' advice and listened carefully to concerns about retail market cannibalization and brand dilution. Hyman recalled, "Our goal in every conversation was to listen to designers' and retailers' objections so that we could create a service that was synergistic with their needs. We also were focused on using meetings to get more introductions. We never turned down a meeting that someone suggested, even if we couldn't initially figure out its purpose. We were often surprised by what emerged from building relationships across the industry."

By the end of March, they had formulated a response. "Initially, we had focused on the superior price that RTR could offer consumers. We could have targeted older women who have money to spend on black-tie events with a value play. But after learning about designers' concerns about retail cannibalization, we positioned RTR as a new customer acquisition channel that exposes younger women to designers' brands, giving these women an aspirational experience," said Fleiss.

Hyman and Fleiss pointed out to designers that women had long found ways to experiment with brands, but the designers rarely benefited from these interactions. Hyman commented:

> Some women try things on in a store's dressing room. Many others buy dresses, wear them once, and return them for full credit, deodorant stains and all. Returns rates in department stores for designer dresses are often over 50%. Another segment of young women are intimidated by the experience of shopping for designer apparel. They shop for moderately priced dresses on the fifth floor of Bergdorf's, afraid to venture down to the fourth floor to try on the expensive dresses they dream of wearing.
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> We said to designers: "This is a way to put that girl in your dress, and give her a powerful emotional experience. She gets compliments from the most important people in her life. Those compliments make her intensely loyal to your brand: she wants to own it. And maybe it doesn't hurt your brand to show it off on a 25-year-old rather than a 45-year-old. Rent the Runway is the gateway drug to designer fashion."

The new positioning was greeted more warmly; by July, the RTR team had supply agreements with 15 top dress designers. Derek Guillemette, an experienced Bloomingdale's fashion buyer who joined RTR as head merchant in May 2009, said the company had avoided pushing too hard to sign reluctant designers. He said, "We still haven't signed Marc Jacobs and Michael Kors, two of the most important U.S. designers, but we meet with them regularly. We feel strongly that designers should only come on board when they are 100% committed to our concept. It would be a disaster if a high-profile brand came for a while, then left. That would be worse than not having them in the first place!"

Market Trials

To gauge customer demand for dress rentals, the co-founders invited 140 women to two market trials during the spring of 2009, and 125 attended. The first trial was held at Harvard College in April. Fleiss and Hyman borrowed or purchased 130 dresses from 15 designers with retail prices ranging from $50 to $1,500; mid-tier designer dresses were typically priced in the middle of this range. They held a "styling session" in a dormitory common room to assess the appeal of different price points, styles, and sizes. "We also wanted to see who would rent more, true fashionistas or aspirational girls, and whether styling advice had an impact," said Fleiss. Women were encouraged to try on the dresses, which were priced between $35 to $75, plus a mandatory $4 insurance charge.

During the first trial, 34% of the Harvard College women rented dresses. "We also wanted to see to what extent the rental experience is inherently social," said Hyman, "so we invited women in groups, targeting two high-profile undergrad final clubs [sororities] as well as groups like the dance team." She recalled, "A junior tried on a silver-sequined Tory Burch mini-dress. When she put it on, the expression on her face changed. She twirled in front of the mirror, threw back her shoulders, turned to her friends, and said, 'I look hot!' And I said to Jenny, '*That's* our business.' It was the first time we saw the self-confidence and the powerful emotional experience that Rent the Runway can deliver."

At the second trial, held at Yale College, women could view the dresses, but they were not allowed to try them on. Fleiss and Hyman also adjusted their dress assortment to focus on trendy styles and aspirational classics that had been popular at the Harvard trial. At Yale, 75% of the women rented.

In both trials, renters were given pre-addressed return envelopes to mail back the dresses. "We needed to know if the women would return the dresses promptly and if the U.S. Postal Service was a viable option for return shipping," said Hyman. "We received 85% of the dresses back within 24 hours and the rest within two days, and 51 of the 53 were returned in perfect condition. The other two had minor stains that were easily removed by the dry cleaner."

The team was encouraged by these results, but they had not yet demonstrated that women would rent dresses online. To address this uncertainty, they conducted a third trial in September 2009 with a random sample of 1,000 women who had asked to be contacted when RTR launched. These women were e-mailed PDFs with pictures of dresses that they could rent by telephone. During the trial, 5% of the women rented. As expected, this was lower than rental rates for the earlier trials, but above the target rate required for a profitable service.

Preparing to Launch

In February 2009, Hyman and Fleiss sought legal advice on incorporating RTR. They met John Chory, a senior partner at Wilmer Hale, one of the Boston venture community's most seasoned attorneys. "Despite our lack of experience, John was impressed with our passion and our progress, so he decided to work with us," explained Fleiss. Chory introduced the team to several venture capital (VC) firms, including Bain Capital Ventures, which pursued RTR vigorously. Bain had missed an opportunity to invest in Gilt Groupe, an invitation-only luxury shopping website, and saw in RTR a chance to capitalize on the rapid growth in online fashion.

"A Bain partner, Scott Friend, liked the way we were learning through trials and networking. He saw that we had a bias for action, not business planning," said Fleiss, adding, "We debated whether to get initial funding from angels instead, because we'd heard so many bad stories about VCs. But we knew that if we were successful, we'd need a lot of capital for inventory—more than angels could provide. We also knew what we *didn't* know and recognized the value of a VC's connections." Hyman said, "We were immediately comfortable with Scott; we didn't feel like we had to be on guard with him. We'd labored over our financial projections, but he barely looked at them in our first meeting. From the questions Scott asked, it was clear that he wanted to work together to figure out if we'd found a good opportunity. Because he shared our commitment to learning-by-doing, it was okay with Scott that we didn't have all the answers right away. How could we? After all, we weren't experts about fashion, technology, or operations." Bain led a $1.75 million seed round that included some angels.

Fleiss and Hyman also recruited a board of advisers during spring 2009 that included Carley Roney, CEO and founder of The Knot, a wedding planning website; Alexandra Wilkis-Wilson, co-founder of Gilt Groupe; Matt Diamond, co-founder of Alloy Media and creator of the hit television series, *Gossip Girl*; and Catherine Levine, COO of DailyCandy, a style and fashion news site. Fran Hauser, president of *People* magazine's *InStyle* online edition, and Jim Gold, president and CEO of high-end department store Bergdorf Goodman, also offered extensive advice during RTR's early stages.

Merchandising and Operations

With designers on board and initial funding in hand, RTR began to buy dress inventory. Hyman and Fleiss had considered trying to borrow dresses from designers through a profit-sharing arrangement, but they determined that designers would prefer a straightforward purchase by RTR. "E-commerce was a fairly new concept within the fashion industry, so we had to be careful about pacing our interactions with designers in a way that made them comfortable," said Fleiss.

Most dresses were purchased from designers at wholesale prices—which averaged about 40% to 50% of retail prices—at the same time that high-end department stores bought their seasonal inventory. At Gold's suggestion, RTR initially gave department stores an exclusive selling window of several weeks before offering a new style for rent. After launch, however, RTR collected data that proved that opportunities for incremental retail sales through broader exposure far outweighed cannibalization risks: 98% of RTR's customers rented brands they had never owned, and 90% reported after their rental that they either had purchased or had high intent to purchase that brand. Based on this data, only a small fraction of designers subsequently requested an exclusive selling window for department stores.

Fleiss and Hyman considered outsourcing warehouse operations but decided that they should keep this function in-house. They inventoried and shipped dresses from a warehouse in lower Manhattan, and sent the dresses to a nearby high-end dry cleaner. "In every part of the process we knew there was so much to learn. If we'd outsourced, we wouldn't get insights about fit issues, how to work with our dry cleaner to reduce wear and tear on the dresses, or how to make smart substitutions when a reserved dress is not in stock because its return was delayed," said Fleiss.

Designing and Building the Website

In February 2009, the team hired a designer to develop the "look and feel" of RTR's website, marketing materials, and packaging concepts. The designer, whom Hyman had worked with before attending business school, was the former creative director of a marketing agency and had extensive luxury-brand experience. "Unfortunately, the look he created was all wrong," said Fleiss. "The imagery was orange and pink: too young, teenybopper, girly." (See **Exhibit 2a** for an image of the initial design and **Exhibit 2b** for an image of the launch design.) Hyman and Fleiss tried to work with the designer to overhaul the design because they were under pressure to hand it off to a website development firm. "It was hard, but we had to fire him," said Hyman. "He had 20 years of experience and he thought his designs were perfect. Our philosophy is to iterate, make mistakes, learn, and change. He was never going to be someone who had the flexibility to make changes that way," she said. After securing VC funding, RTR shifted design work to New York City–based Hard Candy Shell, which previously had worked with Hulu, an online video service, and with Gilt Groupe.

To find a firm to build their site, Fleiss and Hyman relied on an HBS classmate. The classmate, who had a computer science background and had worked as a project manager in two technology companies, referred RTR to a nine-person firm in Canada, which purported to have extensive experience in website development, retail content management, and inventory control/logistics systems. RTR hired the firm and paid $45,000 to initiate the project, but by August, just three months before the site's scheduled launch date, Fleiss discovered that the firm had made little progress. "Because we lacked technical backgrounds, we'd assumed that there'd be little value in visiting the firm and requesting interim code reviews," said Fleiss. "We figured we wouldn't understand what they were doing because we couldn't read the code. But we could have gotten a sense for the personality and quality of the developers and seen if they were doing *something*. Once we visited, we realized that we were way behind schedule. With only two developers actually doing any work, it would be impossible to meet our targeted launch date. At that point we decided to pull the project from the Canadian team and start anew," she said. "The lesson I learned from trusting this classmate was to always check your peers' references," added Hyman.

RTR shifted development work to a firm located in India, based on an investor's referral. At the same time, RTR hired an engineer through a Craigslist posting, but the fit proved to be poor, so they fired him in October. With the launch looming in just two weeks, RTR hired Abhishek Sachdeva, a developer found through a recruiter, as director of technology. Sachdeva scrambled to integrate the software developed in India. He recalled:

> When I arrived, I quickly saw that 1,000 things were wrong with the code. The firm in India did a solid job building the consumer-facing website, but they lacked deep expertise with back-end server software for booking reservations and tracking orders. Our reservation system is like an airline's. It's much more complex than a standard off-the-shelf e-commerce engine. So, we received a very wobbly set of back-end systems. But we had to launch with what we had. If something was 20% okay, we kept it; otherwise, we wrote new code as fast as possible and made daily fixes.

How to Rent the Runway

RTR was an "invitation only" website; women received an invitation—an e-mail with a link that allowed them to register for free membership—through a referral by a current member or after adding their name to a waiting list via RTR's registration web page. Only members (who provided their e-mail address upon registration) could shop for dresses. To do so, a member entered the date for her rental, the shipping zip code, and her dress size (0 to 12). She could further filter results by rental fee, dress color, type of occasion (e.g., wedding, cocktail party), dress style, and designer. The member could select any dress, read a detailed description, see additional images, and review stylist notes and fit guidelines. Fees ranged from $50 to $300 for a four-day rental—about 10% to 15% of designers' suggested retail price, which was displayed alongside the rental fee. For a premium, members could rent a dress for eight days. Late fees were charged to members who did not return dresses on time.

After reserving a dress, the checkout process began. To improve the odds that the dress would fit, RTR shipped members the same style in a second size, free of charge. Members were also given the option to order a second, less expensive style for an additional $25. Members were required to pay shipping charges of $12.95 (which covered return shipping as well) and a $5 insurance fee that covered reasonable "wear and tear," including spills and stains, broken zippers, and similar minor damage.

RTR orders were shipped via UPS in custom-designed garment bags bearing the RTR logo. "The dresses look and feel new when they arrive," said Fleiss. RTR asked members to return dresses by dropping them in a mailbox, using an RTR-supplied package with prepaid postage. When the dresses were returned to RTR's warehouse, they were inspected and, if necessary, repaired and then sent to a nearby, high-end, professional dry cleaner that used gentle chemicals to prolong the life of the dresses.

Launch: November 9, 2009

To build buzz before the launch, RTR's co-founders shared their plans with industry insiders and influential fashion blogs such as Refinery 29. Hyman said, "Our strategy was to rely principally on word of mouth. We spent a few thousand dollars on a public relations agency to do some prelaunch work, but we got much more impact from our own networking efforts and from our advisory board members." RTR launched a beta version of its service on November 2, 2009, with about 5,000 invited members, one week prior to its full public launch on November 9. The beta test gave the team a sense of the strong level of demand for dress rentals and the importance of having a waiting list to control inventory availability. The team also saw from the beta test that women had many questions about how RTR worked and had a strong need for styling guidance. The co-founders scrambled to staff up and train their customer service team accordingly.

RTR's team had anticipated launching with a splashy story in *Vogue* magazine, but news of RTR's beta test was "scooped" by Fashionista.com, a fashion industry news website, and was subsequently reblogged extensively. Having lost its exclusive angle, *Vogue* decided not to print the story. "We were devastated," recalled Fleiss. As luck would have it, a business reporter from the *New York Times* had been an RTR beta user and approached them about writing a story. "The story ran on the front page of the business section, with a photo of us in our warehouse posed on ladders in flashy dresses. We got a lot of attention as young female entrepreneurs in online fashion," Hyman said. The story, "Haute Couture, Available Through Netflix Model" (see **Exhibit 3**) was the newspaper's third-most e-mailed story on November 9, and eventually brought 60,000 new members to the site.

When RTR launched, the company had 30,000 names in its e-mail database and 800 dresses in 160 styles from 30 designers at the ready. "We followed the minimum viable product approach," said Fleiss. "At the outset, we just wanted to provide the capability to rent dresses. Nothing fancy. But in a sense, we were also forced to use this approach by our limited engineering capabilities."

Initial demand proved almost overwhelming. "We got vastly more orders in our first month than we had expected," said Sachdeva, adding, "Our warehouse processing system was essentially manual. We scrambled to write a simple system to generate pick tickets and labels from reservations."

Due to unexpectedly strong demand, RTR faced an inventory shortage during the crucial holiday party season; 75% of inventory was reserved for New Year's Eve. "We maintained a waiting list to avoid disappointing new members who would otherwise find nothing to rent. But the list led to dissatisfaction, too, because people had heard about this great service and they wanted to use it right away," said Fleiss. In December, the waiting list reached 50,000, but by mid-January, as dress inventory grew to 1,000 units and holiday demand subsided, the team had reduced the list to 5,000 names and a one-week wait. By then, RTR had received 2,000 orders and had registered more than 150,000 members. Although the site had only been live for just two months, already 12.5% of customers had ordered more than once. On average during the period, 60% of RTR's dress inventory was out for rental. (See **Exhibit 4** for estimates of unit economics made in July 2009, prior to launch.)

It seemed clear that lack of inventory availability was holding down RTR's conversion rate—the rate at which new members became renting customers. In response, Fleiss and Hyman decided they needed to boost dress inventory to 5,000 by April. "We were confident that we could get the conversion rate up," recalled Fleiss, adding, "Also, with real data about what was renting, we were taking a lot less risk when we bought inventory."

Likewise, the co-founders saw opportunities to boost conversion rates by improving their welcome pages and checkout process. "Just like Netflix, we are asking women to engage in a very new mode of behavior, so the challenge is to get members to try it for the first time," said Hyman. They had learned from site usability tests and focus groups that their pages for orienting first-time visitors were not working well. Fleiss said, "Visitors have a serious misunderstanding of how things work, like the availability of insurance to cover minor damage." She added, "There also seems to be customer confusion about the checkout process, resulting in a high rate of shopping cart abandonment [i.e., orders initiated but not completed]. We'll get to work soon on redesigning our welcome pages and checkout process."

Building the Business

Marketing

RTR's co-founders determined that about 60% of new members had been acquired directly through publicity efforts during their two months after launch, and 40% came through word-of-mouth referrals. About half of those referrals came via a member-get-member offer, which provided members with a $20 account credit for each friend they referred, after the friend's first rental shipped. The co-founders planned to start experimenting with online advertising in the spring to determine the cost of customer acquisition with pay-per-click search engine marketing (SEM) and Facebook ads. "So far, we've directed all of our energies into PR, social media, and marketing partnerships; we still need to hire someone to lead SEM/SEO [search engine optimization] efforts," noted Fleiss.

RTR was planning to sign up "brand ambassadors"—fashionable sorority women on college campuses—to recruit new members in exchange for free rentals. Likewise, RTR expected to enter marketing partnerships with media outlets that were relevant to RTR members. Hyman said, "We've had several requests from fashion magazines, television shows, and e-commerce companies. Partnerships could be a big source of customer acquisition."

"Our service is event-based, so we see lots of virality," she added. "Conversion from member to renter is higher amongst those who had been referred by a friend. With a new behavior like renting, women are more receptive when they hear about it from a trusted source, particularly someone who has actually tried the service successfully." Fleiss said, "We thought it might be a hush-hush thing with people not wanting others to know that they were renting. But instead, our Facebook fan page has thousands of very active followers. They love posting photos of themselves in the dresses and talking about their experiences." (See **Exhibit 5** for RTR's Facebook page.)

RTR's early customers were more demographically diverse than the team had expected, as were the variety of occasions for which they rented. Hyman said, "We knew we'd appeal to women age 15 to 30, but we've also seen heavy demand from women in their thirties and older, even though our inventory wasn't selected with the tastes of more sophisticated customers in mind—so far, we've offered a lot of short, bright dresses. And we have women renting not only for weddings and sorority parties, but also baby showers and anniversary dinners."

The team was planning to retain a fashion-focused public relations firm to build industry credibility and to get media coverage in industry periodicals that would influence key designers, such as *Women's Wear Daily*. "Brand is incredibly important, not just to members but also designers," noted vice president of brand marketing Lara Crystal, who had joined RTR in July 2009.

The Customer Insights Team

One of RTR's biggest marketing challenges was getting women comfortable with the idea of renting dresses they could not try on. "An insight we got from our early trials is that every woman thinks her body is unique. She thinks that she's the one that dresses don't fit, that she uniquely needs to spend tons of time in dressing rooms trying things on," said Hyman.

In addition to sending dresses in two sizes (with the second size shipped free of charge) and offering another style for an additional $25, RTR had built a customer insights team that offered styling advice and guidance about fit. Hyman said, "Women contact the stylists by phone or via online chat and say, 'I'm 5'8" and weigh 140 pounds and I don't like showing off my hips. Will this dress fit me in a size 6? What other styles might work?' Most importantly, our stylists give women the confidence to try something new." Brooke Hartmann, head of the customer insights team, who had joined RTR in August 2009, said, "Our stylists are experts who've personally tried on all our styles, so they understand fit."

Beyond advising on fit, stylists informed product innovation by listening to customers' complaints, suggestions, and questions. "The stylists are our most important source of feedback about the service. They are crucial to our ability to experiment and iterate," explained Hyman. "For example, right after launch, the team heard over and over that customers wanted the ability to filter dresses according to availability for a particular date. We added that feature as quickly as we could," she said. Hartmann added, "We don't view this as an operations function and a cost to be minimized. The stylists represent the voice of the customer." Stylists were encouraged to build relationships with customers. "We urge customers to chat with our stylists. It's part of the Cinderella experience, making customers feel special. You're in the hands of an expert who's attentive to your needs," said Hyman, who noted that RTR did not time customer service calls.

Stylists also explained to members how RTR worked, and they handled order troubleshooting. Hartmann explained: "A small fraction of reserved dresses can't be shipped due to late returns or the need for damage repair. When that happens, we offer members any dress on the site instead, regardless of the rental price. Our credo is never leave a member with nothing to wear, talk to them like a girlfriend, and have personal familiarity with fit."

Building the Team

With the launch behind them, the co-founders turned more of their attention to building the organization. In January 2010, the company had just eight full-time team members: Hyman, Fleiss, Crystal, Guillemette, Hartmann, Sachdeva, and two warehouse managers, along with about a dozen unpaid interns and some contract workers.

For the time being, the co-founders had determined that they would not need a chief marketing officer, since Hyman was playing that role, although RTR planned to hire managers to work on SEM/SEO and on marketing partnerships. Similarly, Fleiss took on all finance functions, obviating the need to hire a CFO. She commented:

> Having Jenn serve as CMO and me as CFO is typical of our fluid approach to allocating responsibilities. With things moving so fast, we need managers who can wear different hats. When it gets busy here, everyone has to be willing to answer the phones. We learned about the value of all-around athletes when Lara joined on an unpaid, trial basis almost a year ago to help with our college market tests. Although she'd had years of experience at Coach, she wasn't afraid to move dress racks. Brooke, our director of customer insights, has had several different roles, but she's never worried about her title. She and other senior team members are very proactive about just jumping into areas where they can have the biggest impact. In a startup, resources are slim, and you need people who are scrappy and committed to getting things done. We now make heavy use of unpaid internships to test whether prospective employees have the same hungry, jack-of-all-trades attitude.
>
> Above all, we look for passion. When we brought Derek on board as head merchant, we knew we needed his fashion knowledge and buying skills. But we also needed *selling* skills—something his job at Bloomingdale's didn't really call for. At the outset, our head merchant would spend most of his time pitching RTR to skeptical designers. We asked Derek to show us how he'd do that, and we were dazzled by his passion and conviction.

Early on, Hyman and Fleiss had shared the product manager role for RTR's website, despite their non-technical backgrounds. "We did everything from wireframes to requirements documents. We didn't even know the meaning of those terms on day one," said Fleiss. Sachdeva noted, "Every project does have an owner, but lots of people have a say, which results in some churn in project priorities." Hyman added, "We have been handicapped in many ways by not having a CTO. While we were able to define needs around the product and customer experience, we had no real way of telling whether our developers were doing a great job, and what skills we might need to add on the engineering team."

RTR's co-founders saw a need to significantly expand their engineering staff, since Sachdeva found it difficult to keep pace with demand for new features. Hyman said, "We see technology, including personalization, at the core of the amazing consumer experience we want to deliver. This will require a new class of information technology hires. We're missing some staff, including system administrators and Java programmers, and we need a CTO to guide hiring decisions." RTR had recently retained an executive search firm to conduct a national search for a CTO. Hyman reflected, "We figured we were going to be stereotyped as two young women who lack technical experience, so we needed help from a strong search firm. It will probably be a difficult search. Candidates need to grasp that we want to revolutionize the way that women shop, and that there's a huge role for technology in that vision."

Issues in January 2010

With the whirlwind of the November launch and the peak holiday season behind them, Hyman and Fleiss paused to consider their next moves. One decision loomed large: should they raise a new funding round, well ahead of schedule? The co-founders had originally projected that their $1.75 million seed round would last until spring 2011, and would be used to establish proof of concept. "We had assumed that we'd grow at a measured pace as we fine-tuned operations. We knew we couldn't achieve cash flow breakeven this year, but we could get close, and we wanted to show that we were on the path to profitability. With a proven model, we figured that we'd be well positioned to raise more money early next year," said Fleiss. She added, "Fund-raising can be very time consuming. We'd hoped to avoid that distraction this year, so we could focus our energy on operational effectiveness."

"But after our strong launch, our lead investor, Scott Friend from Bain Capital Ventures, has been encouraging us to consider scaling up faster," said Hyman. She continued:

> As we've learned more, we've been rethinking what Rent the Runway is all about. At the very beginning, we described our company as "Netflix for fashion." Like Netflix, we'd be all about delivering great value and convenience—a smarter wardrobe. Our slogan still reflects that: "Love. Wear. Return." We do offer value and convenience, of course, but we've come to realize that we are providing much more. We're giving women the best nights of their lives—empowering them to feel confident and beautiful. Back in November, our customer insights team surveyed our first customers to find out about their experiences. They heard over and over, "I've never felt so special." We see the same thing in members' comments on our Facebook page. We've learned that a woman gets an average of 2 compliments per night with her own wardrobe, and 12 when she rents from us. And on the flip side, our insights team has heard the anger and frustration that women feel when we can't make the perfect dress available for a big occasion.
>
> I should have seen this 14 months ago, when I was standing in front of my sister's closet. I had no clue then that we'd be building anything beyond a rational business. But what we're learning is that this business is all about the way that Becky felt about herself when she went out.
>
> So, if your mission is delivering women's dreams, not just value and convenience, how do you think about accelerating expansion and funding? You probably want a lot more inventory to serve a broader set of age groups and social occasions. You add accessories so a member can complete her look. Maybe you do maternity wear, too. And you upgrade your website with engaging editorial and community elements that create stickiness. We want our exuberant customers to share their stories with each other. The site needs to be about more than the dresses we rent—it needs to be about how we make our members feel.

Fleiss said, "Reframing our mission this way could really change our plans. With our original focus on value, we had assumed that during 2010 we would emphasize operational improvements, to ensure that we can deliver value *profitably*." She added, "There are dozens and dozens of ways we can boost efficiency. We need to redesign our website to increase conversion rates from visitor to renter. We need to analyze rental patterns and reservation data to optimize our dress-buying decisions and increase inventory turns. Our warehouse is often chaotic, and a logistics expert could surely find ways to reduce picking and packing costs and error rates."

Did the team have the capacity to pursue these improvement opportunities while also expanding in new directions? Adding accessories could be one way to test this. The co-founders had originally planned to offer accessories rental one year after launch, but based on feedback collected by the customer insights team, it was clear that demand for accessories—including bracelets, necklaces, and earrings—was very strong. Also, based on Avelle's rental prices, it was evident that margins on accessories would be high. But did it make sense to burden the team with a new product line so soon after launch? Adding accessories would require considerable effort in every function, including merchandising, website design, and warehouse operations. Order and inventory tracking systems would have to be modified, and the customer insights team would have to be trained to coach members on accessories options.

The prospect of accelerated expansion also raised questions about the appropriate allocation of responsibilities between the co-founders. They had originally agreed on a division of duties that made Hyman responsible for revenue-related activities—everything that members experienced directly, including merchandise procurement, website design, marketing, and customer service. Fleiss was responsible for cost-related activities including warehouse operations, finance, administration, and information technology infrastructure. Although Hyman was CEO, Fleiss, as president, did not report to her. Hyman said:

> If we expand more rapidly, it might make sense to have Jenny take the lead on new initiatives. She is great at moving a project from idea to inception. We've always known that I excel at sales and marketing, but we've come to realize that I love the people side of running the business, too: inspiring employees, motivating them, giving and getting feedback, and making sure the culture of the company is incredible. So we're considering a new division of roles in which Jenny gets to implement new business ideas. I'd take responsibility for all operations related to the core business. I'd rather spend my day talking to people, and she'd rather power through a long list of tasks. With the new structure, we'd both get to do what we're good at and what we love doing.

The co-founders saw many opportunities for growth. "I have visions of RTR guiding women through the stages of their lives: prom, sorority, graduation, dating, marriage, maternity, black-tie events, and so forth," said Hyman. Besides broadening the merchandise mix to include accessories and maternity apparel, shoe rentals were an option. The team also saw opportunities to sell "consumables." Fleiss said, "We could sell stockings, for example, or cosmetics to increase our average order price and make us a one-stop shop for a woman's big night out."

While these avenues for growth seemed promising, with so much work to do in the core business, did it make sense for Fleiss to focus full-time on expansion opportunities at this early stage? If the team stuck with its original plan to focus on operational improvements during 2010, RTR had ample funds available to cover budgeted inventory and personnel additions through early 2011. The co-founders felt that it only made sense to raise more capital now if they had a clear plan for how to spend it, and if they had already significantly boosted their valuation by resolving key uncertainties. Demand for their service was clearly strong. But had they truly achieved proof of concept—months ahead of schedule?

Exhibit 1 Rent the Runway Leadership Team Biographies

Jenn Hyman, CEO. Hyman is an entrepreneur at heart. She started her career at Starwood Hotels working on strategy and quickly saw an opportunity for Starwood to expand their business. She spent over three years developing and leading a wedding business for Starwood, including the first honeymoon registry in the country. The program was recognized on the *Oprah Winfrey Show* and in the *Wall Street Journal* for its innovation, and quickly became a $30-million-per-year profit center. A natural leader, she then moved on to WeddingChannel.com where she directed an advertising sales team, followed by a stint at IMG working in business development at the intersection of media and fashion. Additionally, Hyman created a college consulting business, which she ran for seven years. She graduated from Harvard Business School (MBA 2009) and Harvard College (BA 2002, *cum laude*).

Jenny Fleiss, President. Fleiss came by way of Wall Street. She started her career at Morgan Stanley in the Strategic Planning Group crafting long-term company strategy. She then moved to Lehman Brothers' Asset Management Group where she was responsible for analyzing business growth opportunities through acquisitions, international expansion, and new product strategies. A natural entrepreneur, Fleiss founded an essay editing and coaching service for college applicants, and built the company into an online tutoring service. She graduated from Harvard Business School (MBA 2009) and Yale College (BA 2005, *cum laude*).

Lara Crystal, Vice President of Brand Marketing. Crystal has played an integral role in all aspects of marketing strategy as a founding member of the RTR team. Crystal started her career in fashion at Coach where she worked for three years on the merchandise strategy for U.S. retail stores. Crystal graduated *cum laude* from Cornell with a BS in Applied Economic Management and received an MBA from The Wharton School with a focus on marketing and finance. Crystal joined RTR in July 2009.

Derek Guillemette, Head Merchant. As RTR's first hire in May 2009, Guillemette leveraged his existing relationships to introduce the concept of Rent the Runway to women's fashion designers. He began his career in retail at Bloomingdale's as an Assistant Buyer in Women's Designers and was quickly promoted to Buyer in 2007, with responsibility for about 50 American and European designer brands, including Herve Leger, Alberta Ferretti, and Yigal Azrouel. Guillemette graduated cum laude from Boston University with a BA in economics.

Brooke Hartmann, Director of Consumer Insights. Hartmann joined the RTR team in August 2009 and plays an integral role in delivering superior member experiences. Hartmann started her career at Reebok as Global Product Marketing Manager of the women's fashion footwear category and was instrumental in launching Reebok's innovative Easy Tone technology in spring 2009. Hartmann graduated *magna cum laude* from Boston College in 2005 with a BS in management.

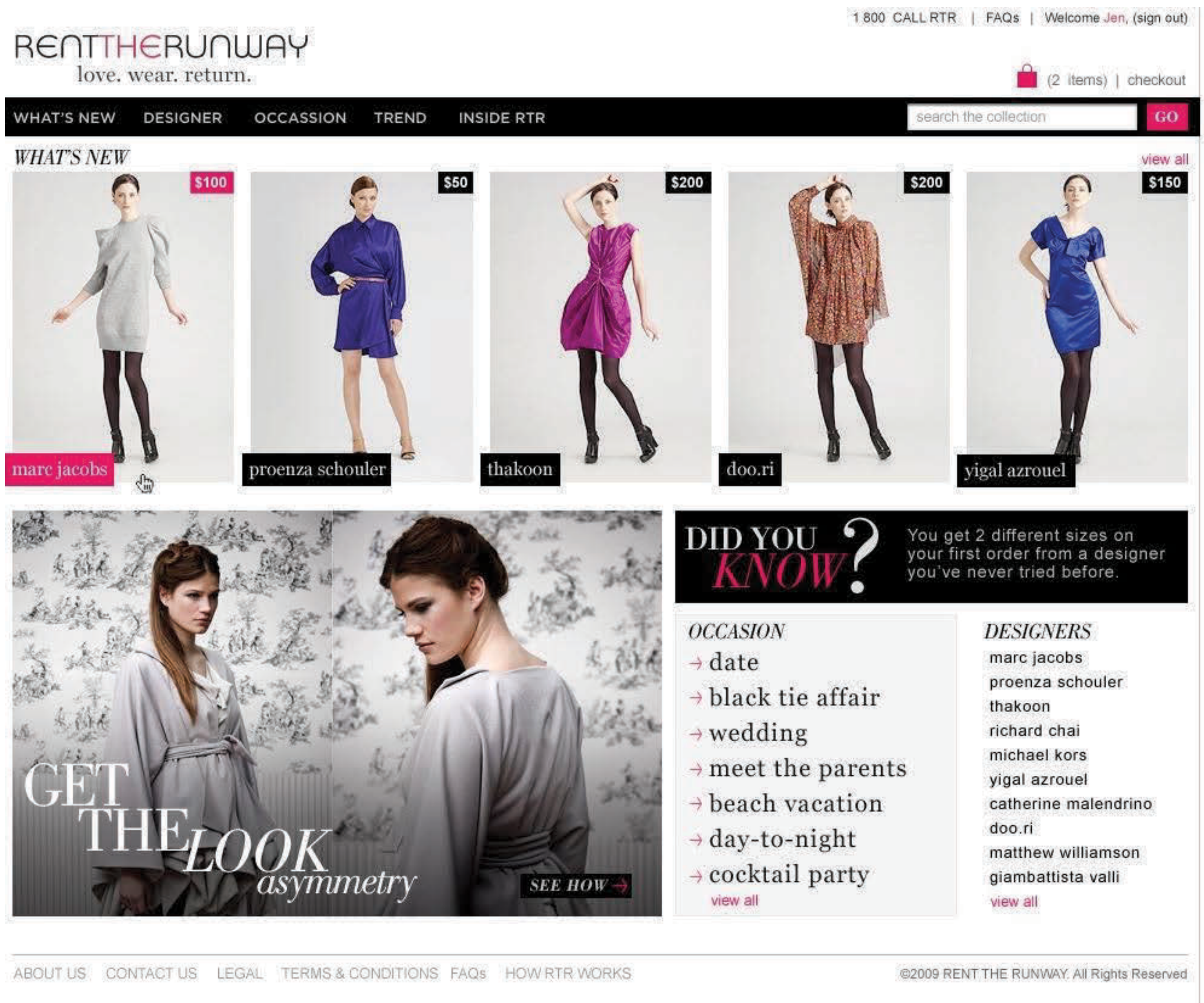
Abhishek Sachdeva, Director of Technology. Prior to joining RTR in October 2009, Sachdeva worked for Ketchum Interactive and other software development firms as a LAMP stack specialist serving many clients, including AOL, Monster.com, and Federal Express. He started his career in Poland working with scientists on medical software, where he discovered his love for Linux. Sachdeva graduated in 2000 with computer science degree from Guru Nanak Dev University, India.

Source: Company documents.

Exhibit 2a Image of Original Rent the Runway Home Page Design

Source: Company documents.

Exhibit 2b Rent the Runway Home Page at Launch



Source: Company documents.

Exhibit 3 *New York Times* Article Published on Day of Rent the Runway Launch

Haute Couture, Available Through the Netflix Model

By JENNA WORTHAM

For many women, a $1,000 dress is something they admire in the pages of a glossy magazine or see draped on the frame of a celebrity — not an item hanging in their closet.

But a nascent Web site called Rent the Runway is hoping to make high-end fashions much more accessible and almost as easy as renting a movie from Netflix.

The mail-order service, which finishes the testing phase on Monday, allows women to rent dresses from notable fashion designers like Diane Von Furstenberg, Hervé Léger and Proenza Schouler for roughly one-tenth of what they would cost to buy in a retail store.

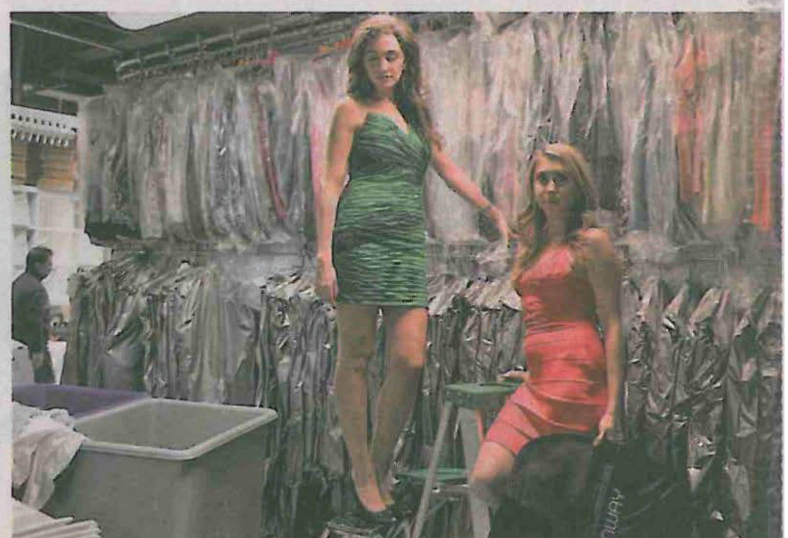
The rentals run $50 to $200 for a four-night loan and are shipped directly to the customer's doorstep. After wearing the dress, she puts it into a prepaid envelope and drops it in the mail. Dry cleaning is included in the price, but damage insurance costs $5, and in the case of outright destruction of the dress, the renter is responsible for the full retail price.

Rent the Runway is a recession-era twist on the Internet rent-by-mail model, which has been used for things like textbooks and video games in addition to movies. Unlike those utilitarian items, however, the dresses offer a touch of Cinderella — on a budget.

Julia Harris, a 27-year-old graduate student living in New York, turned to Rent the Runway when she needed something chic for a fall wedding. For $50, she got a fuchsia Catherine Malandrino number with an elaborately ruffled bust that would have cost $495 to buy.

"It was so easy. You just wear it and drop it back in the mail to them," Ms. Harris said. "I don't spend $2,000 on a dress regularly, so it's nice to be able to wear some of the more expensive brands I wouldn't be able to buy otherwise. And instead of just buying one or two dresses for this season, I

Continued on Page 2



TODD HEISLER/THE NEW YORK TIMES

Jennifer Hyman, left, and Jennifer Carter Fleiss at Rent the Runway headquarters.

Exhibit 3 (continued) *New York Times* Article Published on Day of Rent the Runway Launch

Haute Couture via the Netflix Model

From First Business Page

can still have a lot of things to wear."

Rent the Runway was founded by two recent Harvard Business School graduates, Jennifer Hyman and Jennifer Carter Fleiss. Ms. Hyman said she got the idea for the service last year after watching her younger sister agonize over whether to buy an expensive new outfit to wear to a wedding.

"Here was this young girl who loves fashion and was willing to spend a good portion of her salary on a dress that she's only going to wear once or twice, and I thought, there has to be a solution for this," said Ms. Hyman.

The founders say that more than 20,000 women have signed up for the service, which has been shipping dresses for only a week. Bain Capital Ventures provided seed financing, which the company used to build its inventory of 160 styles.

Rent the Runway declined to discuss its business strategy, but it is clear the company faces several risks. Unlike DVDs, fashion changes quickly, and there is no guarantee that the company will be able to rent each dress enough times to cover its costs.

In addition, retail stores in major cities have offered dresses for rent for years. Rent the Runway is betting that its shop-by-Web convenience and the appeal of its top-quality fashions will persuade women across the country to rent a dress for a special occasion without trying it on beforehand.

The company has also chosen to make the service invitation-only, which gives it an air of exclusivity but may limit its audience.

Jeff Roster, an analyst with Gartner, said that execution would be critical. "If my movie doesn't come on time, I might be mad, but life goes on," he said. "But if my fancy dress for a big important event doesn't arrive, that's a customer service problem like you've never had before."

Ms. Hyman and Ms. Carter Fleiss said they had taken several steps to guard against service fiascos. For starters, they use a reservation system to ensure that a customer can get a specific dress for the night she needs it.

To assist with fitting, they have on-call stylists who can advise customers on how certain materials feel and how a particular dress might hang on various body types. In addition, the site offers returns within 24 hours for any reason and will include an extra size of a first dress at no additional cost.

Customers who want to be extra-safe can choose a second style as a backup, for an additional $25. And all dresses come with a custom garment bag and a "fit kit," which includes double-sided tape, bra strap adjusters and deodorant stain removers.

For fashion designers, the service is a creative marketing strategy and a way to reach a new generation of customers, said Ms. Hyman. "If someone wears a dress and absolutely loves it, she will go out and buy it," she said.

Although most designers are selling their dresses directly to the service, some are providing exclusive runway pieces that are not commercially sold in exchange for a cut of the revenue.

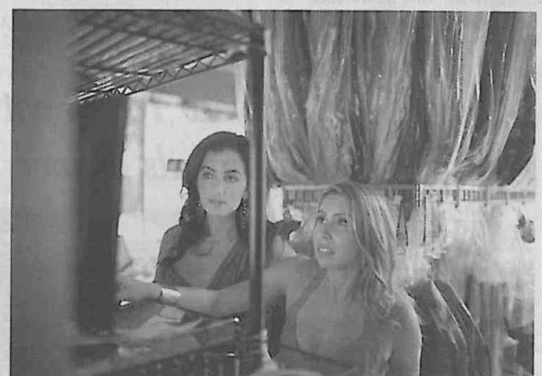
Christian Siriano, a New York designer who was the winner in the fourth season of the "Project Runway" reality TV show, said Rent the Runway was a way to introduce his collection to a broader audience.

"Even though most people probably know who I am, they don't know the brand yet," he said. At a boutique, Mr. Siriano's pieces can cost as much as $3,000. On Rent the Runway, his styles are offered for $150 to $200.

Those prices are especially appealing in a tough economy, said Karen Scheck, president of Lela Rose, a label whose fans include celebrities like Anne Hathaway.

"In challenging economic times, it's important for brands to reach a larger audience and age demographic that you wouldn't normally because of the price," she said. "This is a great way to do it without jeopardizing the brand."

The real test of the service will be the quality of its collection, said Samantha Durbin, editor of FabSugar.com, a fashion blog. "The key is to have really great products that are on trend," she said. "No one wants to rent last season's dress."



PHOTOGRAPHS BY TODD HEISLER/ THE NEW YORK TIMES

Through the mail-order service from Jennifer Hyman, above left, and Jennifer Carter Fleiss, a four-night dress rental costs $50 to $200.

Source: Jenna Wortham, "Haute Couture, Available Through the Netflix Model," *New York Times*, November 9, 2009, Section B, p. 1.

Exhibit 4 Economics for a Mid-Tier Dress, Estimated Pre-Launch in July 2009

Middle-Tier Dress	
Retail price of dress	$750
Wholesale cost of dress	$323
Cost of dress to RTR	$226
Revenue per rental	$90
Variable cost per rental	$31

Source: Company documents.

Note: Revenue per rental includes charges for insurance and shipping. Variable cost includes shipping, dry cleaning, credit card processing, and packaging

Exhibit 5 Facebook Page

Source: Company documents.

Case Question

CASE: Rent the Runway

For innovative managers, new ideas are hypotheses to be tested. In Rent the Runway, we see how the founding team ran a battery of tests to find out if their idea can prove successful.

1. Examine the cofounders' decisions and actions: the sequencing and substance of their discussions with designers; the design and learnings from the multiple trunk shows; and launching the service in 2009 to take advantage of the holiday season.
2. Do you agree with the founders' approach to validate their business idea? Is there anything you would have done differently or is something critical missing?
3. Which variable is the most important driver of the business model? What additional tests would you recommend to validate the hypothesis of the founders?

Notes

Notes

2025 Connective Leadership Summit

Deloitte's Pixel (A): Consulting with Open Talent

9-420-003
REV: MARCH 19, 2024

MICHAEL L. TUSHMAN
JOHN WINSOR
KERRY HERMAN

Deloitte's Pixel (A): Consulting with Open Talent

It was fall 2018, and Principal Matt David, head of Deloitte Consulting LLP's (Deloitte)[1,1] Strategy & Analytics portfolio offering, sat with his colleagues, Peter Giorgio, principal and head of Deloitte's Hybrid Solutions and Incubation team (HS+I), and Balaji Bondili, general manager and head of Deloitte Pixel (Pixel). They looked over the latest budget for Pixel. Launched in 2014 as one of several innovation initiatives, Pixel enabled Deloitte's teams and their clients to leverage open (or on-demand) talent and crowdsourcing for client engagements, to access specific, difficult-to-find expertise, collaborate to develop new products and/or insights, and to design, build, and test new digital assets.[2] While some professionals were very enthusiastic, growth of Pixel's use was slow going. David, Giorgio, and Bondili were grappling with whether and how to push Pixel's adoption across Deloitte.

Just a few months earlier, in June 2018, Bondili and the Pixel team had moved from Deloitte's Office of Innovation to sit under David's Strategy & Analytics group. Pixel was one of several innovation initiatives housed in Giorgio's HS+I team, including experiments across multiple digital, artificial intelligence (AI), and cognitive domains. In May, Deloitte Chairman and CEO Janet Foutty had led a Massachusetts Institute of Technology (MIT) conference on Emerging Technologies. Her keynote address focused on the convergence of new technology, changing demographics, and society's shifting dynamics, and the ways businesses might lead the redesign of work, the workforce, and the workplace for themselves, as well as how leadership, talent, skills, and technology might keep pace with the exponential change in the way people worked.[3] Pixel offered Deloitte one lens into these questions.

In parallel, Giorgio, David and Bondili had been monitoring Pixel's uptake across Deloitte's leadership and client engagements. As David noted, "Things had stalled." Indeed, at times they

[1] Deloitte Touche Tohmatsu Limited, also referred to as "Deloitte Global" or "DTTL," is a U.K. private company that includes a network of member firms and their related entities, each of which are legally separate and independent entities. Deloitte provides audit, consulting, tax and advisory services, however DTTL does not provide services to clients and certain services may not be available to attest clients under the rules and regulations of public accounting. For the purposes of this case, unless otherwise indicated, Deloitte refers to Deloitte Consulting LLP, a subsidiary of the U.S. member firm Deloitte LLP. As used here, "Deloitte" means Deloitte Consulting LLP, a subsidiary of Deloitte LLP. See www.deloitte.com/us/about for a detailed description of Deloitte's legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Professor Michael L. Tushman, Executive-in-Residence John Winsor (Harvard Business School's Laboratory for Innovation Science at Harvard) and Director Kerry Herman (Case Research & Writing Group) prepared this case. It was reviewed and approved before publication by a company designate. Funding for the development of this case was provided by Harvard Business School and not by the company. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

wondered, should they shut down this initiative? As Bondili observed, "Perhaps it was time to go big or go home."

While Pixel had experienced pockets of success with several professionals, many others rejected the approach. Bondili and the team found substantial resistance to applying open talent and tools to client engagements. There were several concerns. One was the perceived conflict inherent in integrating contributions of open talent into a consulting practice that had traditionally staffed highly trained, well-mentored Deloitte professionals to work in close contact with clients. Another centered on Deloitte's focus on confidentiality and protection of client information when seeking external contributions to solutions and talent, especially for a consulting organization with audit capabilities. Finally, a third was that open talent utilization could drive questions about the value of Deloitte professionals with deep client experience and relationships. One partner acknowledged, "There's a concern. They think, 'Well, if a crowd can do it, then what's our value proposition?'"

Nonetheless, early successes showed that relying on open talent could be substantially faster in delivering some client solutions, and an order of magnitude less expensive for the firm than its traditional staffing model, with the same client satisfaction and service quality. Principal Richard Walker, a Pixel advocate, said, "You sacrifice nothing on the deliverable quality. It's outstanding."

Now that Bondili and his team had moved into David's Strategy and Analytics portfolio, Pixel was given expectations and goals to accelerate the pace of its uptake and contribute to sales. It had its own notional profit and loss (P&L) statement. This was Bondili's first budget meeting with David and Giorgio, and he had yet to get a sense of David's and Giorgio's enthusiasm for Pixel. Their meeting had focused on ways to encourage more professionals to pull Pixel into their client projects as part of Pixel's financial targets. "We have to make the business earn its own keep," said Bondili. Was relying on evangelizing leaders like Walker the right approach? Or, should Deloitte's senior management mandate utilization targets for Pixel into client engagements? In the later 2000s, a similar mandate had helped drive adoption of Deloitte's then-new India capability, USI. Walker recalled, "At first it was hard to get people to change their work processes to use the new talent source. Today it's a natural extension of the ways they deliver solutions and products to clients."

As he headed out of David's meeting room at Deloitte University, Bondili wondered if Pixel would ever take hold. It had already been several long years. Getting traction was challenging; a bottom-up approach worked to establish proof points and identify "hero" leaders that continued to use it, but broad-based adoption was not getting traction. Bondili's long-time Pixel colleague, Manager Adam Sandlin, had left Pixel to join TopCoder, one of Pixel's open talent providers. Bondili wondered whether he should he invest his energies in something else. On good days, he felt one option was to keep doing what he was doing, and continue to drive steady, if slow, growth. If he could gauge David's enthusiasm for Pixel, he felt there was a chance for a top-down commitment to drive deeper integration of Pixel use cases into client engagements. Bondili had the numbers to prove that the model was worthwhile and that it would help change consulting, but the move could be risky. "Matt and Pete oversee a lot of innovative initiatives," Bondili noted. "If Matt's not excited about Pixel, I could really be shooting myself in the foot." On bad days, Bondili thought his best option would be to quit and work on something else. As a successful senior manager doing traditional consulting work before he started Pixel, Bondili wondered, "Should I go back to doing something I feel is truly valued by the firm?"

David watched Giorgio and Bondili head down the hall. Their meeting had laid out several options to push the team's growth. He summarized:

> Balaji and his team have done an amazing amount of work. They've built relationships with different crowd platforms, thinking through the logistical/legal challenges of

crowdsourcing. Thinking through data privacy concerns. They have clearly tapped into peoples' desire to work in the gig economy. But, when we think about that business—How are we making money on this? Is this something that's really about transforming our internal delivery mechanism? Transforming ourselves? Is it a standalone business, where we go out and advise our clients who have similar issues attracting talent, and have questions on how to navigate and provide services around the crowd? Or, is this something we focus on internally? These are important but distinct paths. Which one should Pixel pursue, or should we pursue both?

Open Talent for Consulting?

By 2018, a set of online/digital marketplaces had emerged that brought talent and potential engagers of that talent together. These marketplaces included online staffing platforms, online work services, and crowdsourcing, or open (on-demand) talent (see **Exhibit 1**). Several providers operated across more than one of these approaches.[4] In 2018, analysts pegged the annual spend on this "human cloud" at about $82 billion, growing 65% in 2017; as a portion of consulting services, one analyst reported crowdsourcing vendor fees in 2017 at about $244 million (see **Exhibit 2**).[5] Online work services typically involved the delivery of specialized services, such as translations, customer service, or taxi rides, performed by online workers managed by a platform provider. In 2017, analysts reported that online work service firms processed $76.5 billion worldwide in estimated spend, with the largest ride share companies in the U.S. and China as the dominant contributors.[6] Online staffing platforms—such as Upwork, Freelancer.com, Fiverr, and Upcounsel—brought specific workers and specific hirers together in work arrangements, typically virtually, from anywhere in the world. While graphic design, research and web design dominated the early usage of freelancers, companies such as Toptal (developers, engineers, product managers), Experfy (data scientists and AI professionals), Clora (Life Sciences professionals), BTG (middle- to senior-management executives) were focused on high quality talent and serving talent shortage needs for large companies. These online staffing services could include freelancer management systems, which helped hirers manage the process of finding and hiring talent, or just-in-time staffing, which provided hiring or staffing services for specific sectors (i.e., trade or blue-collar work).[7] In 2017, online staffing generated about $5.2 billion in spend.[8]

Crowdsourcing relied on an online platform that facilitated connecting a problem, project, task or work request between an individual requesting a task and a widespread group of individuals. Workers typically performed the task for pay or another form of compensation but had no direct connection to the task requestor. Two models dominated. In one, the distributed micro-task model, the online platform acted as collector, project disaggregator (if necessary), collector of completed tasks, and (re)integrator of project pieces for a final deliverable. The other model, contest-based, saw the platform accept challenges from the problem supplier, present the problem to the crowd to solve, run the challenge for a set time, accept submissions from solvers (the crowd), and facilitate the hirer's selection of winners from the pool of submitted solutions. Typically, contest-model winners received cash awards. Both financial and reputational awards played a prominent role in the contest-based model. In 2017, analysts reported that crowdsourcing companies generated about $800 million, globally.[9]

While clearly relevant for routine tasks, could open talent be relevant for non-routine consulting assignments? Open talent enabled organizations like Deloitte to gain access to supplemental specialty skills and capabilities, including software and application design; software and product testing; data analysis; predictive modeling; expert insights and interviews; and benchmarking and marketing analysis. Could access to these additional capabilities be of value to Deloitte's consulting practice? As workforce trends indicated a greater move towards freelancing and open talent models, Bondili felt that consulting firms could not afford to remain on the sidelines. (**Appendix A** provides one view of the space in the market between staffing and consulting.)

Deloitte

Deloitte's roots traced back to the 1840s, when the U.K.-based Great Western Railway enlisted accountant William Welch Deloitte to perform an audit after its stock price dropped.[10] Over the following decades, the organization continued to grow through several mergers, including with competitor Touche Ross in 1989, forming Deloitte & Touche.[2,11] In 2018, as one of the "Big Four" accounting firms (Deloitte & Touche, Ernst & Young, KPMG, and PriceWaterhouse Coopers), the firm provided consulting, accounting, advisory and tax services, and was the largest professional services network in the world by revenue and employees. The organization's various local firms were organized beneath the U.K.-based parent company, Deloitte Touche Tohmatsu Limited (Deloitte Global).[12] As members of the organization's global network, local firms were required to follow certain global policies, standards, and strategies.[13] Otherwise, local firms operated as separate legal entities, typically with independent ownership, and had significant freedom to tailor their operations to local markets.[14]

In the early 2000s, the accounting industry had undergone convulsive change. The Enron scandal in 2001[3] forced Arthur Andersen and other major industry players to reevaluate their current practices. A review of the U.S. accounting industry found that the level of concentration in the industry was potentially troubling.[15] The U.S. government passed the Sarbanes-Oxley Act, placing limits on non-audit services (e.g., consulting) that audit firms could provide to clients.[16]

Subsequently, several of the large players agreed to separate their consulting and auditing services.[4] By 2005, the Big Four collectively audited 97% of large U.S. companies.[17] Over the next decade, the Big Four expanded their strategy consulting capabilities, and as one example, Deloitte acquired strategy consulting firm Monitor.[18]

In 2018, Deloitte consisted of four subsidiaries: Deloitte & Touche LLP, Deloitte (Consulting LLP), Deloitte Financial Advisory Services LLP, and Deloitte Tax LLP.[19] Each subsidiary provided its own services, was managed separately, and was divided into various divisions.[20] Fiscal 2017 revenues totaled $18.6 billion, up from $17.5 billion in fiscal 2016.[21] Of total 2017 revenues, 48.5% was driven by consulting, while the remainder was driven by audit and enterprise risk services (29.5%), tax (17.4%), and financial advisory services (4.6%).[22] Deloitte U.S.'s operations consisted of 115 offices in 97 cities, with 84,890 employees.[23]

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[2] The Deloitte and Touche Ross global networks had typically operated independently, with some member firms of the Touche Ross network rejecting the merger with Deloitte, and some members of the Deloitte network likewise rejecting mergers over time. These independent entities joined other networks to form entities Coopers Lybrand and PriceWaterhouse, and eventually PwC. Given these independent articulations, "Deloitte" and "Touche Ross" were not exclusive brands. In 1993, the firm settled on the name Deloitte Touche Tohmatsu Limited.

[3] In 2001, the accounting and consulting landscape underwent a shift after the energy company Enron revealed that it had misstated crucial financial figures, leading to the company's collapse. Enron had used audit firm Arthur Andersen, which at best had failed to notice the red flags that led to Enron's collapse.

[4] In 2002, Deloitte Global separated its consulting and audit services, and by 2004 had reorganized into four subsidiaries—Deloitte & Touche LLP, Deloitte Consulting LLP, Deloitte Financial Advisory Services LLP, and Deloitte Tax LLP.

The Office of Innovation

In 2012, Deloitte's senior leadership created the Office of Innovation to fund and run initiatives that explored innovative approaches to consulting. The organization named Andrew Vaz as chief innovation officer. Vaz had previously overseen Deloitte's Life Sciences and Health Care business; Bondili noted, "Andrew had the clout to pull this together." Vaz focused the Office on energizing the organization around exponential technology trend areas like AI, blockchain, 3D printing, Internet of Things (IoT), and organizational enabler areas such as crowdfunding and crowdsourcing. In an interview, Deloitte's then-CEO Jim Moffatt elaborated on the firm's interest in crowdsourcing:

> When we took a strategic look at our business [. . .] we made the decision that open talent models and crowdsourcing was really going to be a big part of our future. And it is and will continue to be. We started exploring crowdsourcing [. . .] and we came at it more from an angle of thinking about our talent model and saw the potential disruption and wanted to understand it more.[24]

Bondili, who had been in strategy in Deloitte's New York office, with a focus on digital health, medical devices, and more broadly on digital challenges in the life sciences space, moved over to the Office of Innovation. He said, "I realized I was doing projects over and over again. It was not fulfilling to my soul. I wanted to build something. At the time, I thought seriously about quitting the firm to go do that."

In November 2013, several senior leaders, along with Vaz, then-Principal David Martin, and Bondili, had an early conversation about crowdsourcing. Conversations continued into 2014. That year, Gartner predicted that by 2018, 75% of high-performing enterprises would use crowdsourcing in some form.[25] Managing and sourcing talent raised additional concerns. Even Deloitte struggled with growth and talent resource challenges. In 2014, the firm was growing at a double-digit top line growth rate. Walker noted, "We're running at very high utilization, and we've been hiring thousands of people each period for the last 18 months. Even with aggressive and large-scale hiring of people—we just can't catch up. That's untenable. There's not enough talent to meet the demand." Attracting digital natives and data scientists was even harder given the competition for this type of talent. "We heard things like, 'We're not interested in working on one thing full-time.'" Deloitte's clients faced similar challenges.

Bondili said, "We recognized that in the new digital world, crowdsourcing and open talent would become a big capability." They lacked a current method in place to effectively acquire these capabilities. Bondili proposed to Vaz that he help lead Deloitte's efforts to build crowdsourcing capabilities for Deloitte's strategy practice. In 2014, Pixel was one of about 30 to 40 initiatives sponsored by the Office of Innovation.

Pixel

Every time a leader asks when we acquired Pixel, we see it as a moment of success for us.

— Balaji Bondili

In late 2014, Sandlin joined Bondili to set up a small team to run crowdsourcing challenges. The team continued to sit under Vaz. Pixel needed to establish some wins. Bondili and his team had already put together research and insights from the market. They projected the crowdsourcing market at $927 million, with annual growth of 30%.[26] Many of Deloitte's clients already relied on crowdsourcing to solve the same business challenges they engaged Deloitte teams to solve. Select crowdsourcing vendors—and even some direct Deloitte competitors—offered similar skills and specialized profiles that Deloitte teams relied on in their client engagements (see **Exhibit 3**, refer to **Exhibit 1**). Multiple other member firms were already trying crowdsourcing. In 2015, Bondili's research suggested that of Deloitte's top clients by revenue, more than 30% had engaged in significant crowdsourcing efforts, and 76 of their top clients had publicly announced their use of crowdsourcing. Many companies had turned to crowdsourced talent for technology and digital outcomes.[5] But, could open talent add value for consulting work specifically, and consulting firms more generally?

The Pixel team focused on proving their concept, identifying a few internal opportunities that could highlight the speed and cost-effectiveness of crowdsourcing as applied to consulting engagements. They went back to leaders with whom they had relationships and asked if they could run redundant projects using open talent. Bondili explained, "So there was limited client risk; we just need problems to run our method against. We were able to go back and explain when Pixel was able to do a project at equivalent or better quality in addition to being cheaper and faster. We launched trench warfare." Sandlin added, "We could show other teams that this was not a theory but what a team actually experienced."

By 2016, the Pixel team had replicated a few client projects in parallel to actual client engagements. Bondili recalled, "Essentially, yes, this meant we executed the exact same project, but just behind the scenes. We had confidence in the approach, but this helped build confidence beyond our team, and allowed us to explore what processes and procedures would work." In an interview, Moffatt noted, "We [. . .] experiment[ed] with different types of projects and different types of crowds. Some are better fits for different elements of a project."[27]

Being part of the Office of Innovation gave Pixel the freedom to build credibility without concern about revenues or profit. By the end of 2016, the team had run 85 real world (non-redundant) projects delivering millions of dollars of value. According to Moffatt, about 80% to 90% of Pixel projects used multiple crowd players.[28] Moffatt added, "As we looked at this, what jumped out at us was the need for that platform. How do we actually pull together a program that leverages some of our core stuff but at the same time takes full advantage of the crowd, or different elements of crowds, for different aspects of the projects?"[29] Pixel built up an ecosystem of 16 vendors, out of a 150+ vendors evaluated. Their client list included players from a range of industries, including financial services, healthcare, medical device manufacturers, telecommunications and retail.

Pixelating Client Engagements

Pixel's methodology for crowdsourcing involved breaking—or pixelating—large problems into smaller pieces—i.e., pixels—and opening those pieces up to external audiences to address. The team relied on the ecosystem of possible crowdsourcing platforms vetted by the Pixel team (refer to **Exhibit 8** and **Appendix A**).[30] Deloitte consultants could then curate and integrate those crowdsourced solutions on their client engagements.

Pixel's early experiments helped identify advocates within certain consulting practices. Walker, whose clients were largely dealing with digital transformation, was eager to try Pixel. In contrast to the solution or product "answers" for which traditional crowdsourcing challenges aimed, Deloitte's client challenges presented problems of vision and strategy planning. This made pixelating projects more complicated.

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[5] Organizations used crowdsourcing across their global businesses for data management and testing, i.e., product classification across multiple markets, quality evaluation and product data collection, and testing of their digital capabilities.

Walker's experimentation helped Pixel refine its methodology and illustrate what it could offer. In one example, Walker and his team worked with a large company on an integrated regulatory program. The client engaged Deloitte to develop a vision of what meeting the regulator's requirements would mean. Walker explained, "You've got 35 operational playbooks. You've got multiple geographies. And what do you do to demonstrate your capabilities to regulators?" Once Walker's team outlined what the client needed to consider, the client looked for ways to harvest existing assets in order to meet the needs they were still trying to understand. Walker explained, "It's almost like going to a garage sale and picking out bits and pieces that you think would look good, but when you bring it all together, it's not designed." Walker worked with the client to develop a clearer vision of their desired process and suggested bringing in Pixel to help further develop that vision. Bondili and his team met with the client executive team, crafted a simple problem statement and put the challenge to the crowd. Walker added, "The vision for the output would be basically a prototype to show what does a dashboard and a set of functionalities that meet the needs of the company in a resolution event look like?"

Rather than reveal the name of client for whom the challenge was performed, the Pixel team structured the problem to get ideas on workflow and real-time information from multiple data sources. The team launched the challenge within a week and ran it for two weeks; 30 participants signed up to compete. The client reviewed the competitors' preliminary submissions over a weekend, and with Walker's team, selected finalists. The finalists competed through the second week, and the team picked a winner. They awarded the winner $5,000; the runner-up received $2,500 and third place won $1,000. Awarding prize money, Walker explained, meant that the client owned the intellectual property (IP) for all three solutions.

The Pixel team then took the results and structured a new challenge that launched immediately and ran again for two weeks. The challenge was to create a high-quality prototype to enhance the client's regulatory responsiveness. First place won $8,000. Walker said:

> From the first time we met with the client, to five weeks later, we delivered a click-through prototype that we can use with the executive team to help them understand what they needed to have, what kind of capabilities and what the experience would enable the enterprise resolution recovery office. The cost of the project at five weeks was $35,000. That was for our time and for the crowd prizes—all in delivered. Without Pixel, the client would likely have paid a lot more than that.

Another experiment involved a client seeking a redesigned printer for a specific market segment. The Deloitte team approached the project in its traditional way. The client and the strategy team worked on a set of ideas, but the ideas they delivered were adjacencies to the client's existing products. Bondili said, "Our traditional consulting approach delivered immediately implementable ideas, but the client was looking for ideas that were transformatively different. We proposed crowdsourcing as a way to source completely new solutions."

The Pixel team defined the printer design challenge and opened it to a resource of thousands of industrial designers through a hardware-design crowdsourcing marketplace. The challenge ran in two phases. The first phase saw 15 submissions of printer designs, which they narrowed to three (see **Exhibit 4** for an example). These three then came back with detailed CAD designs with thoroughness down to details on how to change ink, use a voice assistant interface, and how the product would look. They did it in two to three weeks, paying the vendor $15,000. The winning submission won $4,000. "Once we took it out of the environment of designers, seeing the same products over and over again, we were able to build something fresh," Bondili recalled. A Deloitte insider noted, "Something that would traditionally have been a multi-year process, from concept to prototype, we'd gotten down to six months."

Walker had become a convert. He said:

> At this point, for everything we do, for every project, I challenge my team—there's 15 to 18 leaders on my team serving a company globally—I said, 'Any time we do a proposal, I want the Pixel team to look at the proposal and see what they can add that will bring a disproportionate value proposition.' So, shortened cycle time, enhanced economics, etc. I don't want any proposal now to go to a client without Pixel looking at it to figure out what they can do, what they can add.

He explained the value-add of the crowd:

> They've brought capacity, further insight and objectivity. And to support our capacity, they perform tasks that allow our strategy consultants to focus on the higher-value work. Pixel creates capacity for consultants to do other big thinking. By having the crowd do research, modeling insights, even creating diagrams, models, visuals, creating infographics, that's a very compelling value proposition. Because then our consultants can do something with the flashes of insight that come from the infographic and apply that in the context of the client. Our people should always be doing work in the context of client value. If there's any work that can be done outside of context, then it's a candidate for Pixel.

Despite these wins for Walker and several other leaders, Bondili continued to struggle to sell Pixel more broadly across the organization. Some felt Pixel threatened the traditional management consulting ways of working. Bondili and his team had to address these issues. Giorgio explained:

> Within our consulting practice, a third of our leaders want to figure this out; another third would love to try it but they are too busy; and the last third resist it outright. They resist because the existing business model works, there's no need to shift what is tried and true. We live in a risk-averse culture, and they feel there is not enough data to prove its value, they have a 'show-me' mentality. They might think, "Pixel is generic and not sophisticated. We're too sophisticated for this." Sometimes you need a different personality, a different way to take risks to embrace some of these ideas—that are sometimes met with resistance. We try to stay low; it has impacted our ability to scale, but it has allowed us to survive.

Pixel's small team continued to refine processes, learn from successes and failures, expand its scope of experiments and drive selective adoption. Even as they gained incremental traction with some professionals, many were either indifferent or skeptical of Pixel's value-add. Pixel represented a culture change and a mind shift for Deloitte professionals. Pixel's executive sponsors continued to give the team cover. Moffatt added, "A lot of people think of crowdsourcing as simply having access to a temporary talent pool. We view it from a strategic standpoint: We want to aggregate and incorporate it into everything we do. It's incentive based, it's competitive and it's entirely based on outcomes."[31] David said, "We need to experiment with clients to figure this out ahead of our competitors. We are moving increasingly towards a range of hybrid/technology-enabled solutions."

Moving Closer to the Core

In 2018, Deloitte provided specialization in a variety of areas, including strategy and analytics, mergers and acquisitions (M&A), operations, technology, and human capital (see **Exhibit 5**), and offered three main lines of business: management consulting; human capital business (HR); and technology. In 2019, Janet Foutty, who was CEO of Deloitte and Chair of the Board, moved many of the organization's innovation efforts out of the Office of Innovation and closer to the core consulting businesses. David explained, "We were doing a variety of science experiments in a lot of different areas. Janet wanted to bring them closer to the core. She looked at where some of these different things were and how they could be better utilized." Pixel moved into David's portfolio, at that time called Strategy and Operations Services, where the team joined several other hybrid solution approaches that augmented Deloitte's traditional consulting work.

At the same time, Deloitte's Innovation initiative, now led by Chief Innovation Officer Nishita Henry, had evolved to focus on collaborating with early-stage startups, academics, and other non-traditional resources. Deloitte also made select acquisitions. According to David, Henry was reconstituting the next generation of innovation, including paying closer attention to AI and machine learning and the businesses that could come out of those efforts. David noted, "We were getting more laser-focused on what our innovation strategy should be. It's now tied to clear innovation, incubation, the academic community, and startups. And scanning for emerging things that we could see having potential commercial viability."

Foutty emphasized a more decentralized approach to innovation and experimentation, pushing it out to P&L leaders like David. Each P&L leader had an Asset Council, comprised of the group head's direct reports (including finance), that incubated experiments for their lines of business. These experiments might include offerings that combined knowledge, IP, methods and technological assets. They enabled Deloitte to consider new business models, new products and services, and to hear from the client in different ways. The experiments went through stages, with the aim to "graduate" them beyond the council in order to scale or terminate the experiment. A range of criteria might signal graduation; David explained, "These could include market acceptance, competitive products, competitive differentiation, client response. Or if the business model can scale, can it go to multiple clients, can it be reused? And, does it meet audit, legal independence criteria?" Each council coordinated and shared with their peers, under Deputy CEO of Deloitte Amy Feirn's purview.

A subsequent reorganization folded Deloitte's consulting analytics and big data capabilities into a newly configured Strategy and Analytics portfolio, still under David. Giorgio incubated several such efforts, including Pixel, and in June 2018, the organization set up the HS&I group in David's group (see **Exhibit 6**). The team oversaw 30 or so experiments at any one time; these included initiatives exploring opportunities with third-party customer data and analytics, pharmaceutical safety, and insurance business innovations. David noted:

> Some of our innovation efforts didn't have a champion and were drifting a bit. As any large company, Deloitte has lots of these small things and it has the antibodies to crush small things that don't make sense to them. Revenue is what makes you survive. Pixel and some of the other initiatives had suffered a bit from benign neglect. That weighed down on the businesses and prompted a bit of a bunker/survivor mentality in them. They needed a champion, someone who believed in them.

The reorganizations overall aimed to unleash and accelerate Deloitte's strategy and analytics capabilities. Giorgio noted, "We saw we needed a separate group to identify these opportunities." David added, "Hybrid Solutions is coupling advisory with technological assets. We experiment—incubate—and then decide which experiments go to scale. We need successful failures."

There were risks in moving many of the experiments closer to the core; Giorgio noted, "My job is to make it okay to do things that are not categorizable, to incubate and protect these 'seedlings.' Balaji survived by being patient and persistent and by linking Pixel's experiments to Deloitte Consulting's overall strategy. But it is a constant sales job." David outlined Giorgio's fit for this delicate role:

> He is entrepreneurial, creative and believes in the art of the possible. He has strong operational delivery skills. He is able to motivate and inspire Deloitte talent that is inherently innovative with a shared purpose and values. He creates a collective whole out of very disparate parts. This role requires social capital, credibility and networks throughout the organization to effectively sell experiments to skeptical leaders in a conservative culture. Pete has these capabilities; he built Deloitte's sports practice, he has experience across Deloitte. Above all, he is an inclusive leader.

Giorgio tasked Bondili with developing a vision for Pixel that he and other Deloitte evangelists could sell, a business plan that outlined how Pixel would grow in this next phase, and gave the team structured revenue targets, tying the team to a P&L. Under Giorgio, Bondili continued to make the case for Pixel, and built a broader portfolio of use cases. Some of these proved Pixel's ability to deliver speed, or difficult-to-source insights; others met difficult-to-fill staffing needs, all maintaining the highest quality service to clients. Giorgio explained, "Those are clients who ask, 'I need to get insight tomorrow. I need to talk to 47 people that know this esoteric thing.' Not just one specialist, but 30. Pixel could deliver that. Or, if someone needed a person with special skills for eight weeks. Pixel could provide that. And these engagements got our people to think differently." Some clients had also begun to ask, "How do I create my own Pixel?" Giorgio also pushed Bondili to foster deeper internal use of Pixel. "We—the HS&I group—need to eat our own dog food, and use our innovative solutions on our projects," he added.

The opportunities HS&I's experiments fostered surpassed pure technology-enabled solutions, allowing Deloitte's leadership to explore and understand transforming talent models. David noted:

> We cannot continue to rely on a traditional "up or out" model. We also need to experiment with talent models, not just hire MBAs from the best schools. We need technology-savvy consultants *as well as* data scientists and data architects—who typically don't want to work in consulting. We need to have a talent pool that is off our balance sheet; this means freelance, gig or crowd talent. This is all counter to what many people are used to doing—and many continue to want to do: work with people and resources they know and trust.

The experimentation Pixel and other efforts the HS&I team pursued helped Deloitte consider new ways of thinking about these challenges. Giorgio noted, "This is often where we hear the voice of the client in regards to the nature of consulting." But as they looked ahead, David and Giorgio wondered, had Pixel and Deloitte's other HS&I experiments been bold enough? Giorgio noted, "They've been fine with being a small business, without maybe thinking enough about how to be a big business."

Challenges

Nonetheless, the small Pixel team continued to face lack of awareness of crowdsourcing and other digital initiatives, and in some cases, faced continued pointed resistance to the "freelance" approach. Bondili said, "In certain services, crowdsourcing was still not on the list of initiatives to be considered. Given the early nature of the trend, it was difficult for them to imagine crowdsourcing as a way to deliver mainstream work." Despite these challenges, Pixel's trajectory remained on a steady climb (see **Exhibit 7**).

With respect to getting others to build Pixel's services into their operating model, David and other senior leaders had taken an "If you build it, they will come" approach. Bondili, the Pixel team, and other supportive leaders identified and curated a variety of relationships with different types of vendors (see **Exhibit 8**). They conducted roadshows with leaders across Deloitte. David explained, "They did not curate skillsets that tied directly into specific parts of our organization, but instead they had a menu of 'We can do all this stuff for you.' It was a very broad approach. Then you have to find a leader who's willing to come in and experiment with Balaji and his team." With digital transformation activities crowding out much of the consulting practices' business, the process of finding professionals willing to experiment needed rethinking. David said, "We need to take a different approach. We need to curate the crowd platform for specific businesses."

Internal resistance continued to be a factor. A large part of the organization continued to resist using Pixel or considering an open talent model for client engagements. Giorgio noted, "They resist because the existing business model already works, they don't see a need to shift from what is tried and true. Some feel there is not enough data yet to convince them of the need for things like Pixel." David summarized the general skepticism:

> Many of these leaders don't have the experience of working with fractional staffing of resources. Their capabilities are rooted in building Deloitte teams with Deloitte professionals working as teams. There is a strong history of pride in apprenticeship, developing talent inside, and many had not even considered using freelancers or gig resources. The identity of many leaders is rooted in their pride in people development—in both what we do (i.e., consulting services) and how we do it (i.e., full-time, up-or-out professional talent).

Consideration was given to whether there should be a requirement to mandate Pixel's use. A handful of Deloitte leaders like Walker brought a Pixel team member to each of their account meetings, but very few others integrated Pixel into their client engagements. In parallel, Deloitte aspired to be a leader in Future of Workforce thinking. Foutty noted, "Society demands more of organizations than ever before, asking for business leaders to take an even larger, more influential role in shaping our connected and mutually dependent ecosystem. [. . .] The pace of demographic, technological and social change is forcing organizations to reimagine how work gets done and what types of skills are needed in order to adapt and have greater success of sustaining long-term growth."[32] In a public interview, Deloitte U.K.'s lead partner for crowdsourcing noted, "Crowdsourcing is not just for start-ups. The crowd can offer enterprises an innovative way to find new solutions to traditional problems while creating opportunities for individuals to change the way they work and learn new skills."[33] Deloitte aimed to build a "crowd of crowds," he added, "allowing us, where appropriate, to take a crowdsourced approach to solving our clients' problems.[34]

Walker said, "I look at every project and say, 'What can we use Pixel for?' Does it allow us to have those people go do other, higher-value things?" The appeal of a "better, faster, cheaper" way to solve client pain points was persuasive for some. Walker elaborated, "I've gone in with a thesis that we have a 36-month backlog of work, and we're adding three to six months of backlog every year. There's so much latent demand for the things we do. We can't continue to do things the same way. This is the way to get more done faster while maintaining the same quality. It's an accelerator to get more done." Other leaders were harder to convince. David said, "We have lots of parts of our business that don't necessarily lend themselves to what the crowd is good for." He added, "But we need both talent models—in-house, traditional professional consultants—and access to the expertise available in the open talent model to meet specific needs, when we need it. But similar to any large company, there remains some not-invented-here syndrome that hinders the broader adoption of open talent for now. Many have an emotional attachment to our existing, very successful way of doing business."

At the same time, David and senior leaders recognized the opportunity Pixel offered for Deloitte to continue driving adoption and growth in their own analytics and cognitive business. David explained, "We're trying to gain some of the skills of AI architects and engineers, and many of the people who possess those skills are unicorns. They don't fit within our traditional business models. They don't want to work at consulting firms. They say, 'It's too stuffy for me. The interesting work is elsewhere, and by the way, I get paid very well being a gig worker.' Those two things combined are accelerating this."

A New Approach to Consulting?

By summer 2018, many at Deloitte, and across the management consulting industry more broadly, saw dramatic changes impacting their traditional models. At one meeting, Pixel team member Janine Leger talked about how her peers freelanced and lived comfortable and highly fulfilling lives. Indeed, many of these highly skilled millennial workers did not consider full-time employment an option. From a business perspective, several related factors were emerging. First, consulting itself had become more specialized and more data intensive. Bondili noted, "We had to invest in a set of products and service businesses that were data intensive. But as a professional services organization we didn't really come to any project with assets or data. We came to a client with people." David said:

> The traditional consulting fee-for-service model, with an hourly rate, is rapidly dying. As is the model where you rapidly train people with skillsets, whether they're doing strategy or technology work. The game was always add people, keep them utilized, keep costs down through different delivery centers around the world. We've kind of reached the end of that model. The scale of our practices and the number of people we have makes it difficult to keep feeding that engine. And some skills that clients are asking about are often from people who typically don't want to work in a traditional consulting environment.

This could mean a potential realignment of Deloitte's current business model. Bondili added, "We have to change the way we think about how to serve our clients, because what was more successful in the past will not necessarily be successful in the future. And when it comes to Pixel, there's a lot more recognition that we cannot sustain the growth with just one model in place that relies on full-time practitioners. Many people don't want to be full-time employees anymore. They want to be freelancers. They want agency over their time and choice of the problems they want to work on."

Second, this shift in the business pushed professional service organizations like Deloitte into a different talent arena, where it competed with companies like Google, Amazon Web Services (AWS), and the larger financial service firms, for data scientists and other specialized talent. Competition for these skillsets was intense; IBM, for example, projected that by 2020, demand for data scientists would increase by 28%.[35]

Third, although it had developed a number of tools and platforms for its clients, for the most part, Deloitte had resisted a move away from its traditional services—advisory and implementation businesses—towards what David termed the "operate" business (i.e., operating technical solutions or services for clients). Deloitte's focus was on advisory and implementation services (split about 35% to 65%), and this had historically been a nearly 100% people (labor)-based business. "Today, that's at about 90%," David explained, "but we're seeing a steady move towards the 'operate' model." This initial shift of about 10% first split out between an increased reliance on more off-balance-sheet labor, either through the crowd or other contractor models, and reseller fees split with the organization's technology vendors.

Many at Deloitte expected that the operate portion would continue to grow, and soon hit as much as 30% to 40% of revenues, as clients relied increasingly on AI and other technologies. David said, "Consulting services in that environment will look very different from how they look today. So how do we innovate in what our business looks like?" Bondili added, "The brand that Deloitte is moving towards is a brand of asset-enabled businesses, where we come in with predefined solutions, products, algorithms, so that we can use assets to help accelerate the client's solution." However, it was challenging to hire talent that could meet these needs.

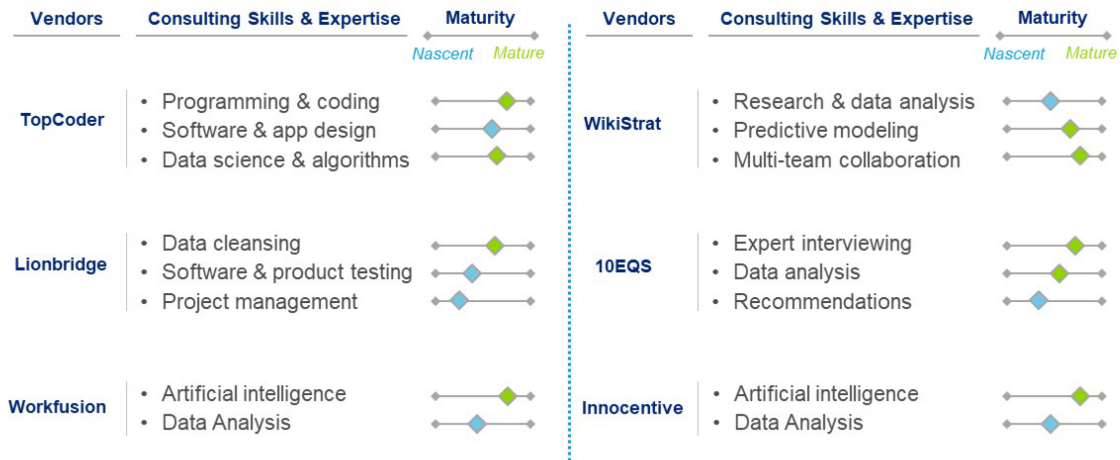
In parallel, David acknowledged, he was seeing a growing halo effect with clients when they learned Deloitte had capabilities such as those of Pixel. Many clients were moving from their internal technology approach to the cloud, prompting them to change their talent model from a project management/outsourced technical development model to an engineer-based model. Conversations like these focused on how to increase the technical diversity of the clients' business; David often introduced open talent as a possible solution. He said, "When we talk to our clients about the experimentation we're doing with Pixel, that we're trying to solve the same problem, they're more willing to say, 'Deloitte is an innovative company.' Even if the conversation doesn't lead to a project, it creates a haloeffect."

Even as this outside/in approach to innovation gained traction, internal resistance and skepticism remained. David observed that the issue of talent control coupled with the potential threat to people's professional identities and associated definition of management consulting made for an "uphill battle" for innovations like Pixel. Even with limited success, Bondili noted, "Pixel was significantly ahead of any of our consulting competitors, making it difficult to prove the case that competitors were forging ahead and we weren't. It also meant there was no playbook for how to scale a crowdsourcing/open talent-based business anywhere—not at competitors or clients."

Next Steps?

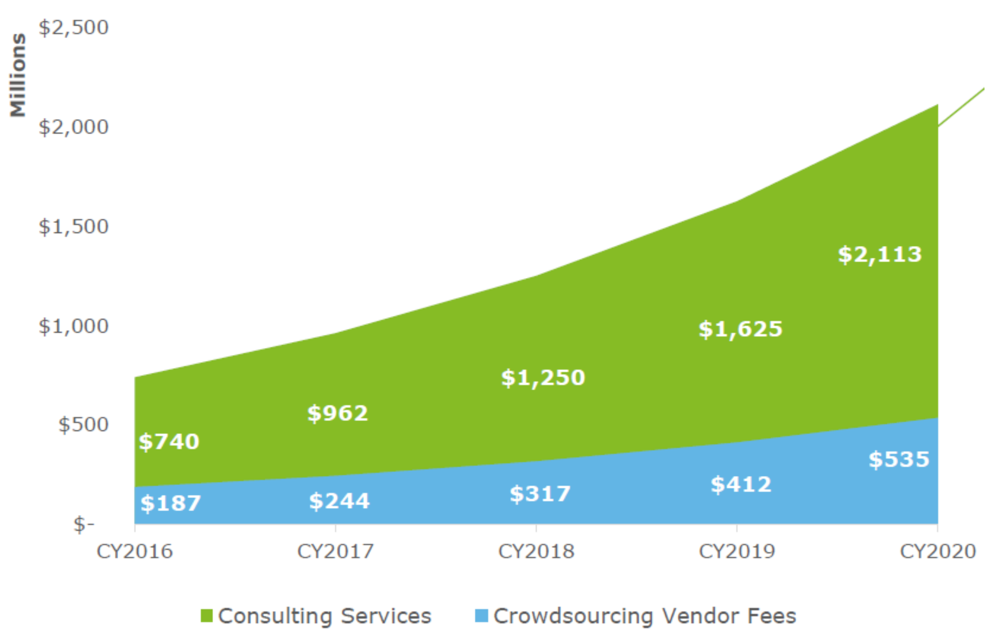
As they ended their budget meeting, David, Bondili and Giorgio debated options for Pixel. They identified three approaches aimed at embedding Pixel more effectively across Deloitte. One was to continue to push for incremental adoption across leadership. Another was to integrate Pixel more tightly with Deloitte's offerings, and mandate using open talent and crowds to transform business delivery across Deloitte. The third option was to hive Pixel off as a stand-alone business, freeing it to grow independent from internal resistance and antibodies. The final option was to call the experiment a failure and terminate it. David noted, "You can see the pull for open talent is coming—the rate and speed with which it will come is up for debate, but it will accelerate. The market is demanding that kind of delivery model. They need data science, AI, Cloud and Analytics talent at an economical price point. So, we have to solve for how we can do that while we manage internal resistance to change. As we evolve into a more AI driven, open talent supported business, we need to support entrepreneurial leaders able to build the next generation of Deloitte."

Exhibit 1 Skills and Expertise Profiles of Selected Crowdsourcing Vendors (2015)



Source: Deloitte documents.

Exhibit 2 U.S. Enterprise Crowdsourcing Market (2016)



Source: Adapted from company documents; IBISWorld, "Crowdsourcing Service Providers in the U.S. 2016," Deloitte analysis.

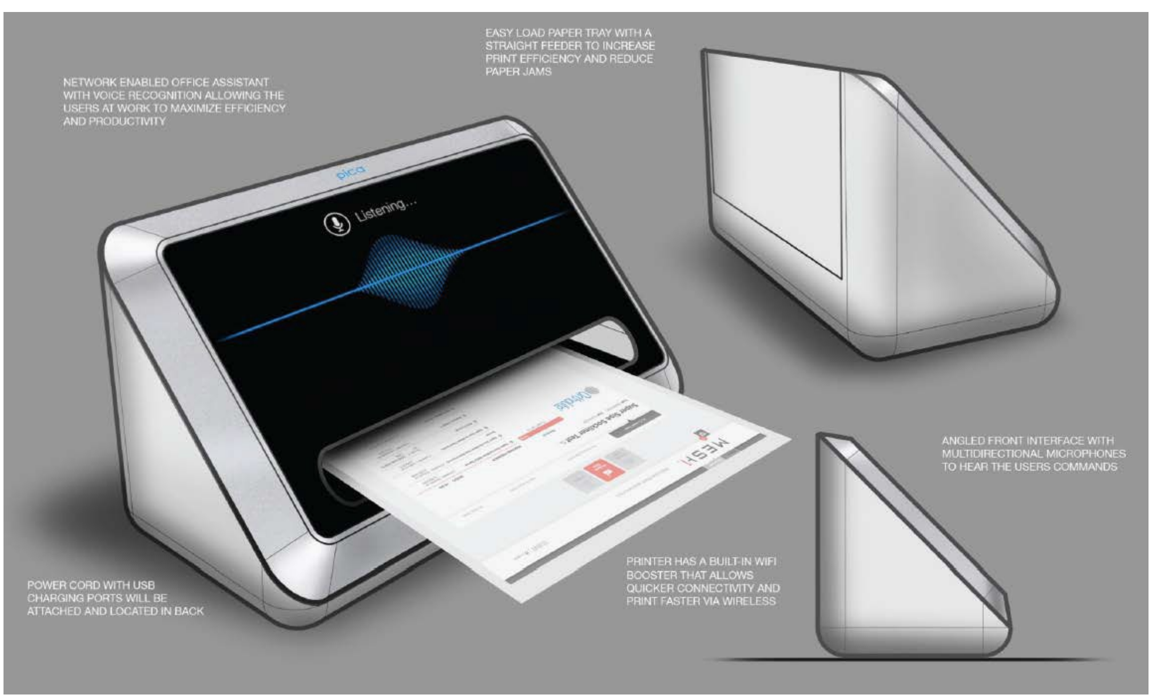
Note: The consulting services market size included fees from advising, curating and executing projects entirely or partially driven by crowdsourcing.

Exhibit 3 Competitor Offerings (2018)

Exploring (Uses crowdsourcing and publishes eminence)	**Engaged (Delivers some crowdsourcing services)**
IBM: Strategic partner to Topcoder, uses crowdsourcing internally, has collaboration platform and is developing an internal task matching platform	Booz | Allen | Hamilton: Delivers federal work with Topcoder, Kaggle, Innocentive, and is deepening crowdsourcing capabilities
BCG: Eminence on crowdsourcing innovation, millennial work trends; invested in Zapnito	Accenture: $25 million strategic investment in Applause
pwc: Built tax platform to connect as tax professionals at PWC and small businesses for tax rebates	EY: Acquired leading ideation crowdsourcing company and has engaged Wikistrat and Topcoder
KPMG: Leases employees to companies if they are not being utilized	

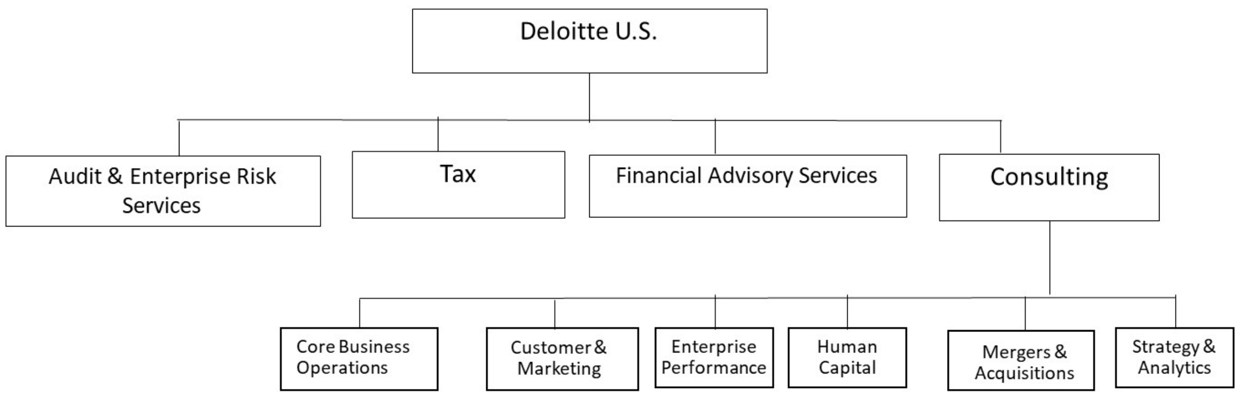
Source: Adapted from casewriter research and company documents.

Exhibit 4 Pixel Client Solution: Printer, Scanner, Virtual Personal Assistant Concept



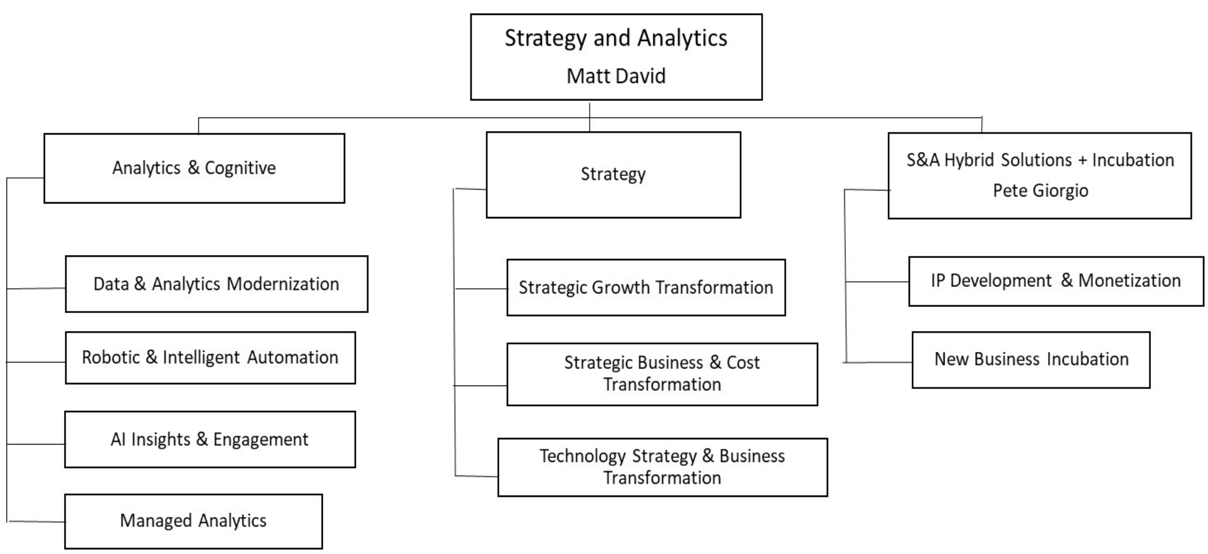
Source: Company documents.

Exhibit 5 Overview of Deloitte's Overall Organization, and Consulting's Lines of Business 2018



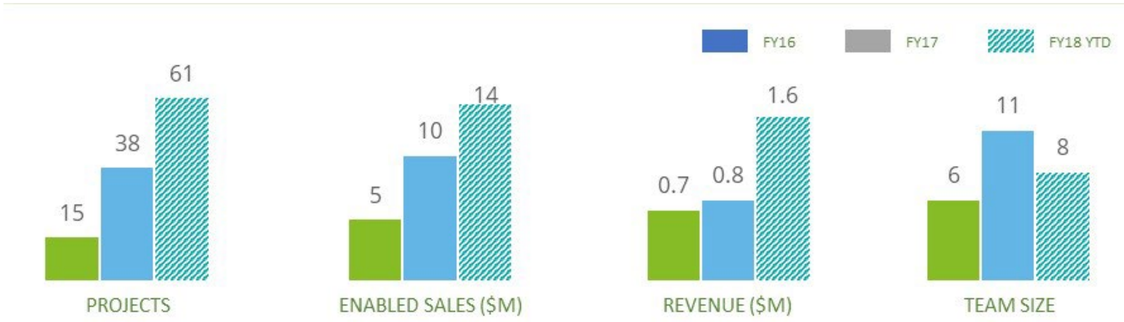
Source: Adapted from company website.

Exhibit 6 Strategy and Analytics Group, Deloitte Consulting (2018)



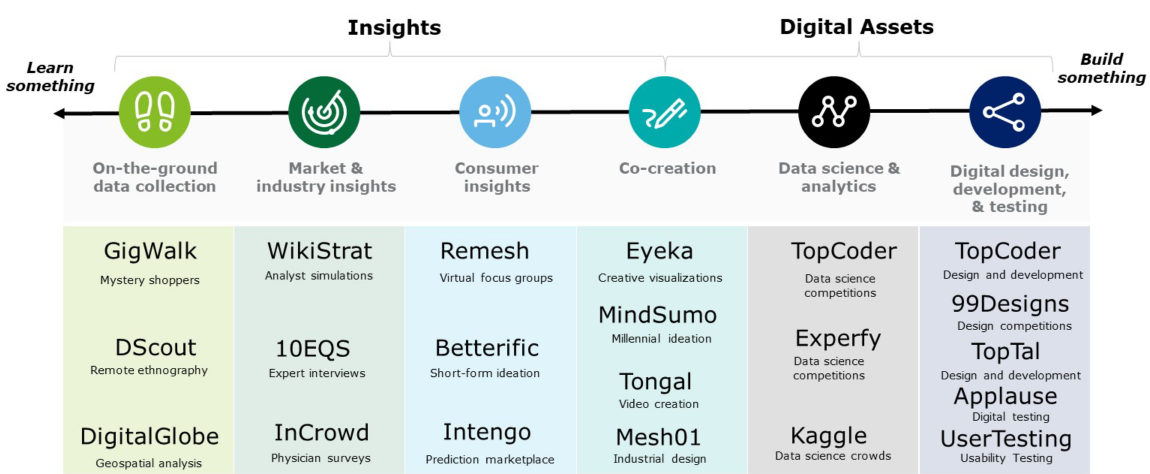
Source: Adapted from company website.

Exhibit 7 Pixel (2016-2018), % year over year



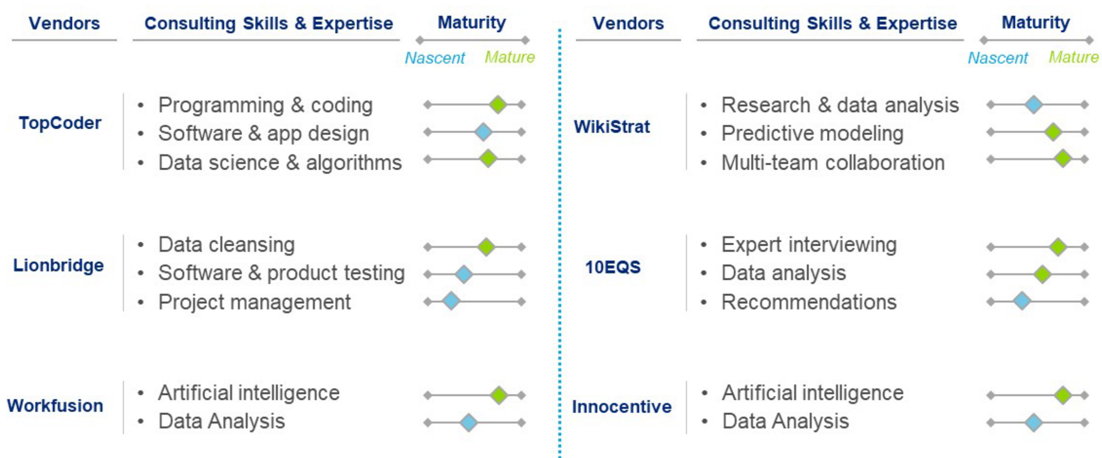
Source: Adapted from company documents.

Exhibit 8 Pixel's Offerings; Aggregating a Variety of Vendors for Client Needs

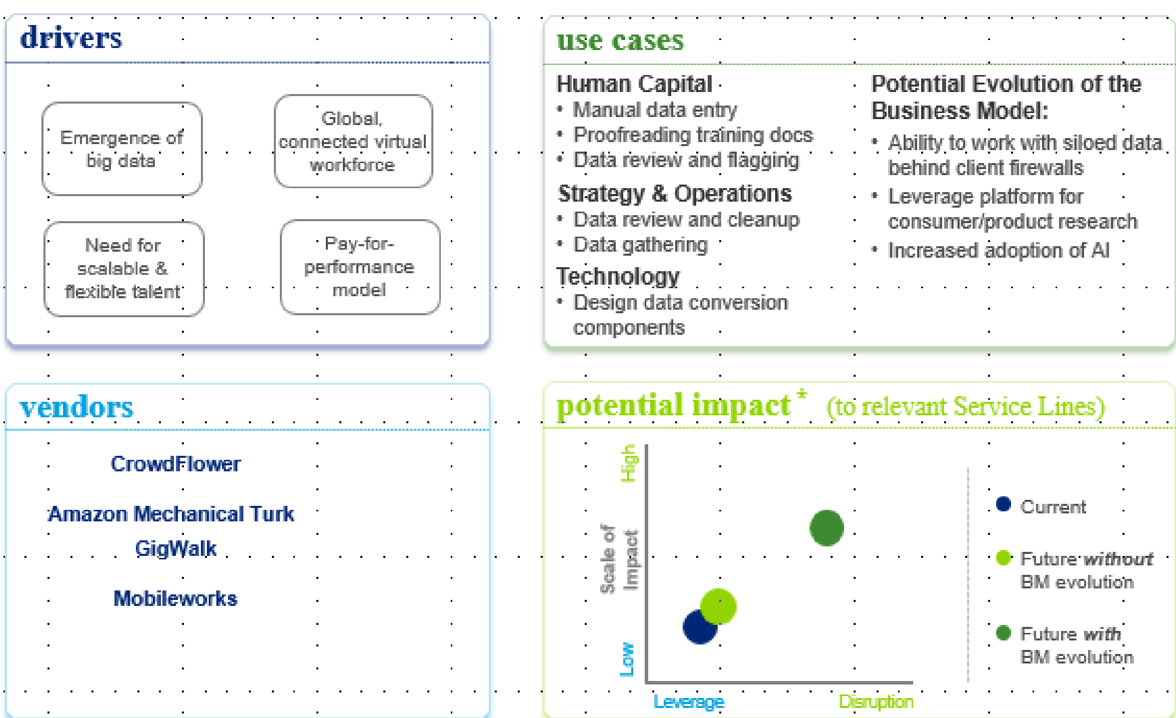


Source: Adapted from company documents.

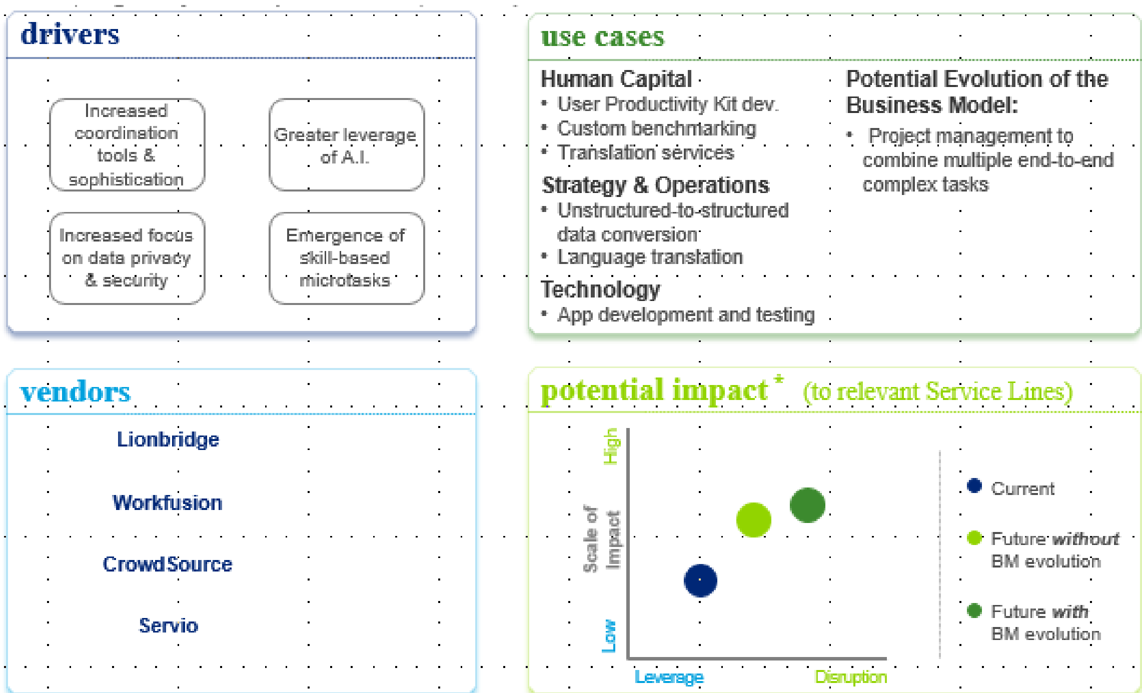
Appendix A Select Examples of Open Talent (Crowdsourcing) (2017)



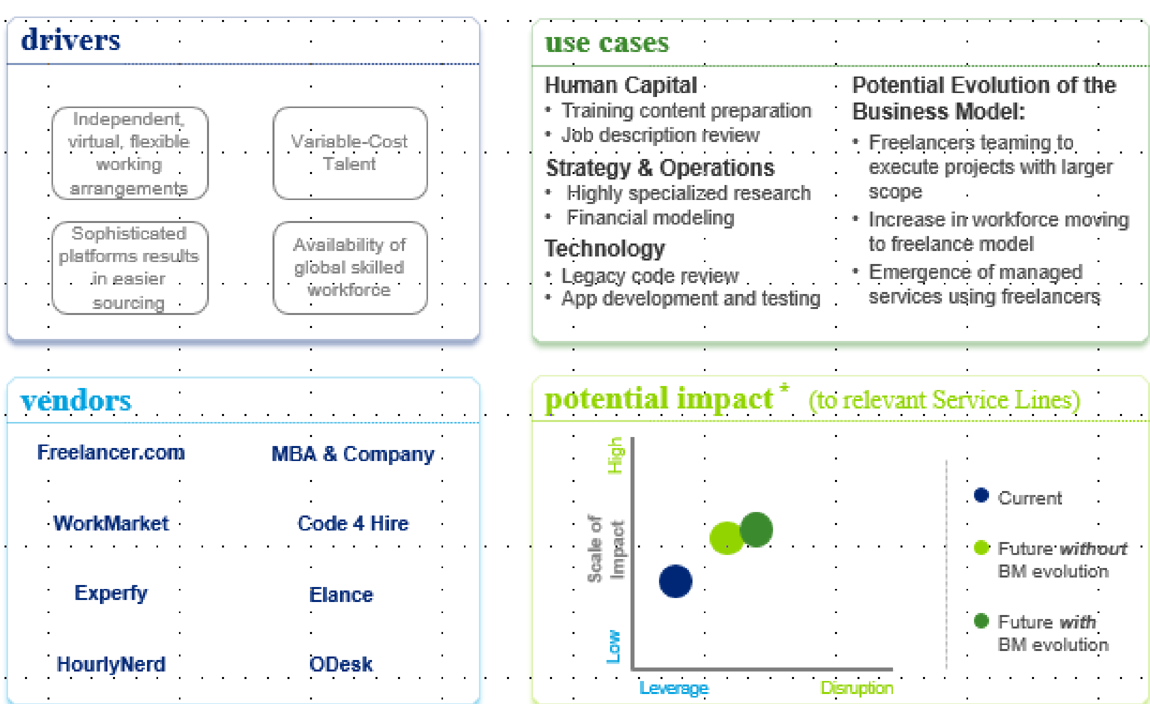
Micro-task example: A large group of people completing a high volume of very discreet activities, e.g., 10,000 virtual workers de-duplicating and cleansing one million records for a system transformation initiative.



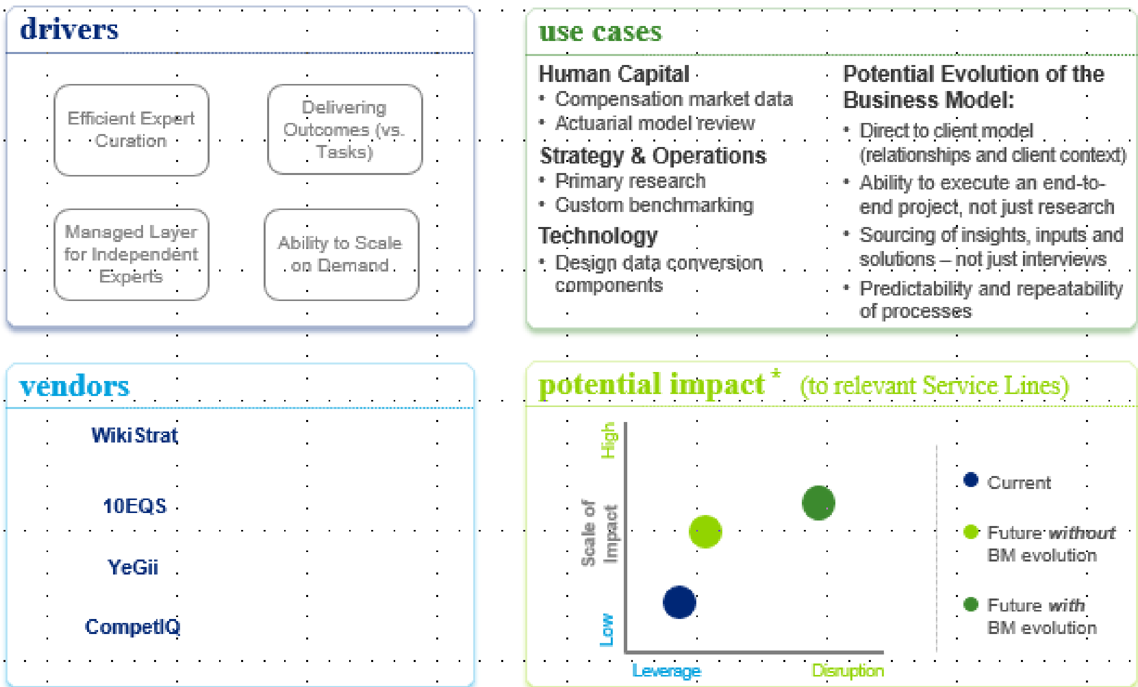
Complex task example Multi-disciplinary approach to crowdsourcing driving greater value for enterprise, e.g., job profile rationalization and standardization (from 6,000 profiles to 2,000 profiles) based on job requirements, and creation of written, long-form job descriptions for the 2,000 new profiles.



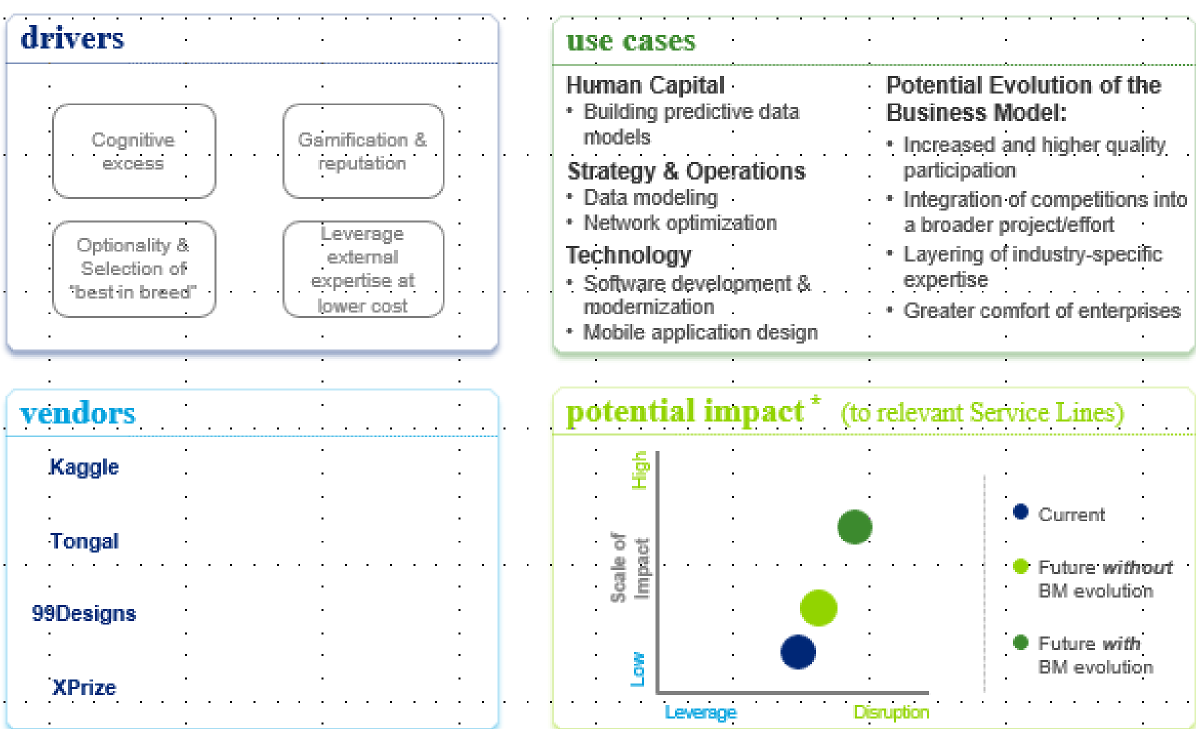
Freelance services example Independent contractors with specific skills hired to work on a specific short-term project; a project team requires 10 Cobol[a] programmers for an application modernization projects; e.g., the programmers work virtually for three weeks to augment in-house practitioners.



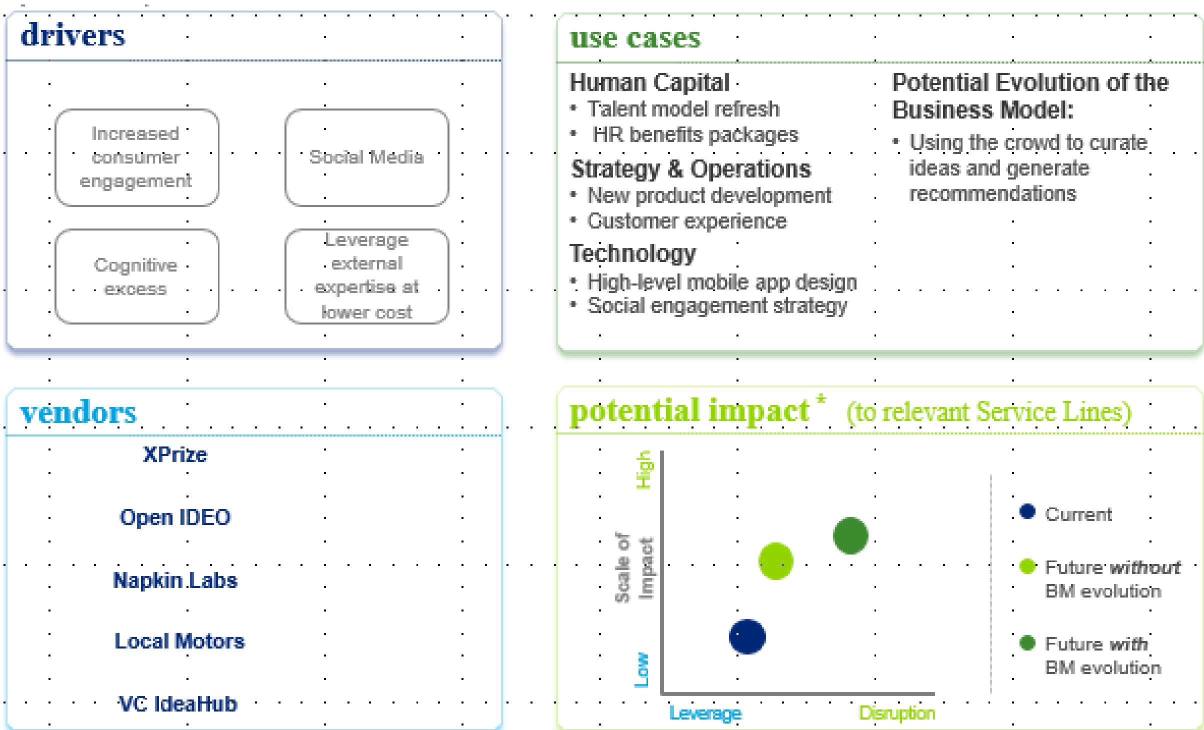
Expert insight and knowledge example Obtaining insight from external experts with a specific background and for a specific problem: e.g., locate, interview, and synthesize results from 40 doctors, regulators, and pharmaceutical companies to inform a new drug market entry strategy across 15 countries.



Competitions example Skills-based competitions: e.g., deliver an ASP.NET solution that allows retail customers to locate and learn about their pharmacy location options as well as to renew prescriptions online in a user-friendly, intuitive manner.



Competitions example Idea generation/challenges and co-creation: e.g., generate and prioritize recommendations directly from customers about how the company can improve its billing systems and processes.



Source: Adapted from company documents.

Notes: * Future potential impact placement included expectations for vendors to implement the business model evolutions described on these slides.

a. Cobol was an older, rarely used software language.

Endnotes

[1] As used here, "Deloitte" means Deloitte Consulting LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of Deloitte's legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting. This case study contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

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Case Question

CASE: Deloitte's Pixel (A): Consulting with Open Talent

Innovation initiatives cannot succeed if they are not supported by the organization. In this session, we observe Deloitte introducing a bold idea that meets stiff organizational resistance. We ask how managers can best gain acceptance for innovative endeavors.

1. What should David and Giorgio do regarding Pixel?
2. How should David and Giorgio manage internal skepticism regarding Pixel?
3. How strategic is Pixel to Deloitte?

Notes

Notes

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