corporate-strategy Operations Strategy Competing on Capabilities: The New Rules of Corporate Strategy by ?The 100 most successful projects, known as the "Best of the Best," are documented and circulated among affiliates. Wachovia and Banc One both compete on capabilities. Both banks focus on key business processes and place critical decision-making authority with the people directly responsible for them. Both manage these processes through a support system that spans the traditional functional structure, and senior managers concentrate on managing this system rather than controlling decisions. Both are decentralized but focused, single- minded but flexible. But there the similarities end. Wachovia responds to individual customers en masse with personalization akin to that of a private banker. Banc One responds to local markets en masse with the flexibility and canniness of the traditional community bank. As a result, they focus on different business processes: Wachovia on the transfer of customer-specific information across numerous points of customer contact; Banc One on the transfer of best practices across affiliate banks. They also empower different levels in the organization: the personal banker at Wachovia, the affiliate president at Banc One. Most important, they grow differently. Because so much of Wachovia's capability is embedded in the training of the personal bankers, the bank has made few acquisitions and can integrate them only very slowly. Banc One's capabilities, by contrast, are especially easy to transfer to new acquisitions. All the company needs to do is install its corporate MIS and intensively train the acquired bank's senior officers, a process that can be done in a few months, as opposed to the much longer period it takes Wachovia to train a new cadre of frontline bankers. Banc One has therefore made acquisitions almost a separate line of business. If Banc One and Wachovia were to compete against each other, it is not clear who would win. Each would have strengths that the other could not match. Wachovia's capability to serve individual customers by cross-selling a wide range of banking products will in the long term probably allow the company to extract more profit per customer than Banc One. On the other hand, Wachovia cannot adapt its products, pricing, and promotion to local market conditions the way Banc One can. And Wachovia's growth rate is limited by the amount of time it takes to train new personal bankers. Moreover, these differences are deep-seated. They define each of the two companies in ways that are not easy to change. Capabilities are often mutually exclusive. Choosing the right ones is the essence of strategy. 1 See T. Michael Nevens, Gregory L. Summe, and Bro Uttal, "Commercializing Technology: What the Best Companies Do," HBR May-June 1990, p. 154.This strategic vision reached its fullest expression in a largely invisible logistics technique known as "cross-docking." In this system, goods are continuously delivered to Wal-Mart's warehouses, where they are selected, repacked, and then dispatched to stores, often without ever sitting in inventory. Instead of spending valuable time in the warehouse, goods just cross from one loading dock to another in 48 hours or less. Cross-docking enables Wal-Mart to achieve the economies that come with purchasing full truck-loads of goods while avoiding the usual inventory and handling costs. Wal-Mart runs a full 85% of its goods through its warehouse system--as opposed to only 50% for Kmart. This reduces Wal-Mart's costs of sales by 2% to 3% compared with the industry average. That cost difference makes possible the everyday low prices. But that's not all. Low prices in turn mean that Wal-Mart can save even more by eliminating the expense of frequent promotions. Stable prices also make sales more predictable, thus reducing stock-outs and excess inventory. Finally, everyday low prices bring in the customers, which translates into higher sales per retail square foot. These advantages in basic economics make the greeters and the profit sharing easy to afford. With such obvious benefits, why don't all retailers use cross-docking? The reason: it is extremely difficult to manage. To make cross-docking work, Wal-Mart has had to make strategic investments in a variety of interlocking support systems far beyond what could be justified by conventional ROI criteria. For example, cross-docking requires continuous contact among Wal-Mart's distribution centers, suppliers, and every point of sale in every store to ensure that orders can flow in and be consolidated and executed within a matter of hours. So Wal-Mart operates a private satellite-communication system that daily sends point-of-sale data directly to Wal-Mart's 4,000 vendors. Another key component of Wal-Mart's logistics infrastructure is the company's fast and responsive transportation system. The company's 19 distribution centers are serviced by nearly 2,000 company owned trucks. This dedicated truck fleet permits Wal-Mart to ship goods from warehouse to store in less than 48 hours and to replenish its store shelves twice a week on average. By contrast, the industry norm is once every two weeks. To gain the full benefits of cross-docking, Wal-Mart has also had to make fundamental changes in its approach to managerial control. Traditionally in the retail industry, decisions about merchandising, pricing, and promotions have been highly centralized and made at the corporate level. Cross-docking, however, turns this command-and-control logic on its head. This approach places a premium on frequent, informal cooperation among stores, distribution centers, and suppliers--with far less centralized control. The job of senior management at Wal-Mart, then, is not to tell individual store managers what to do but to create an environment where they can learn from the market--and from each other. The company's information systems, for example, provide store managers with detailed information about customer behavior, while a fleet of airplanes regularly ferries store managers to Bentonville, Arkansas head-quarters for meetings on market trends and merchandising. As the company has grown and its stores have multiplied, even Wal-Mart's own private air force hasn't been enough to maintain the necessary contacts among store managers. So Wal-Mart has installed a video link connecting all its stores to corporate headquarters and to each other. Store managers frequently hold videoconferences to exchange information on what's happening in the field, like which products are selling and which ones aren't, which promotions work and which don't. The final piece of this capabilities mosaic is Wal-Mart's human resources system. The company realizes that its frontline employees play a significant role in satisfying customer needs. So it set out to enhance its organizational capability with programs like stock ownership and profit sharing geared toward making its personnel more responsive to customers. Even the way Wal-Mart stores are organized contributes to this goal. Where Kmart has 5 separate merchandise departments in each store, Wal-Mart has 36. This means that training can be more focused and more effective, and employees can be more attuned to customers. Kmart did not see its business this way. While Wal-Mart was fine-tuning its business processes and organizational practices, Kmart was following the classic textbook approach that had accounted for its original success. Kmart managed its business by focusing on a few product-centered strategic business units, each a profit center under strong centralized line management. Each SBU made strategy--selecting merchandise, setting prices, and deciding which products to promote. Senior management spent most of its time and resources making line decisions rather than investing in a support infrastructure. Similarly, Kmart evaluated its competitive advantage at each stage along a value chain and subcontracted activities that managers concluded others could do better. While Wal- Mart was building its ground transportation fleet, Kmart was moving out of trucking because a subcontracted fleet was cheaper. While Wal-Mart was building close relationships with its suppliers, Kmart was constantly switching suppliers in search of price improvements. While Wal-Mart was controlling all the departments in its stores, Kmart was leasing out many of its departments to other companies on the theory that it could make more per square foot in rent than through its own efforts. This is not to say that Kmart managers do not care about their business processes. After all, they have quality programs too. Nor is it that Wal-Mart managers ignore the structural dimension of strategy: they focus on the same consumer segments as Kmart and still have to make traditional strategic decisions like where to open new stores. The difference is that Wal-Mart emphasizes behavior--the organizational practices and business processes in which capabilities are rooted--as the primary object of strategy and therefore focuses its managerial attention on the infrastructure that supports capabilities. This subtle distinction has made all the difference between exceptional and average performance. Four Principles of Capabilities-Based Competition The story of Kmart and Wal-Mart illustrates the new paradigm of competition in the 1990s. In industry after industry, established competitors are being outmaneuvered and overtaken by more dynamic rivals. ? In the years after World War II, Honda was a modest manufacturer of a 50 cc. engine designed to be attached to a bicycle. Today it is challenging General Motors and Ford for dominance of the global automobile industry. ? Xerox invented xerography and the office copier market. But between 1976 and 1982, Canon introduced more than 90 new models, cutting Xerox's share of the mid-range copier market in half. 1 Today Canon is a key competitor not only in mid-range copiers but also in high-end color copiers. ? The greatest challenge to department store giants like Macy's comes neither from other large department stores nor from small boutiques but from The Limited, a $5.25 billion design, procurement, delivery, and retailing machine that exploits dozens of consumer segments with the agility of many small boutiques. ? Citicorp may still be the largest U.S. bank in terms of assets, but Banc One has consistently enjoyed the highest return on assets in the U.S. banking industry and now enjoys a market capitalization greater than Citicorp's. These examples represent more than just the triumph of individual companies. They signal a fundamental shift in the logic of competition, a shift that is revolutionizing corporate strategy. When the economy was relatively static, strategy could afford to be static. In a world characterized by durable products, stable customer needs, well-defined national and regional markets, and clearly identified competitors, competition was a "war of position" in which companies occupied competitive space like squares on a chessboard, building and defending market share in clearly defined product or market segments.Because a capability is "everywhere and nowhere," no one executive controls it entirely. Moreover, leveraging capabilities requires a panoply of strategic investments across SBUs and functions far beyond what traditional cost-benefit metrics can justify. Traditional internal accounting and control systems often miss the strategic nature of such investments. For these reasons, building strategic capabilities cannot be treated as an operating matter and left to operating managers, to corporate staff, or still less to SBU heads. It is the primary agenda of the CEO. Only the CEO can focus the entire company's attention on creating capabilities that serve customers. Only the CEO can identify and authorize the infrastructure investments on which strategic capabilities depend. Only the CEO can insulate individual managers from any short-term penalties to the P&Ls of their operating units that such investments might bring about. Indeed, a CEO's success in building and managing capabilities will be the chief test of management skill in the 1990s. The prize will be companies that combine scale and flexibility to outperform the competition along five dimensions: ? Speed. The ability to respond quickly to customer or market demands and to incorporate new ideas and technologies quickly into products. ? Consistency. The ability to produce a product that unfailingly satisfies customers' expectations. ? Acuity. The ability to see the competitive environment clearly and thus to anticipate and respond to customers' evolving needs and wants. ? Agility. The ability to adapt simultaneously to many different business environments. ? Innovativeness. The ability to generate new ideas and to combine existing elements to create new sources of value. Becoming a Capabilities-Based Competitor Few companies are fortunate enough to begin as capabilities-based competitors. For most, the challenge is to become one. The starting point is for senior managers to undergo the fundamental shift in perception that allows them to see their business in terms of strategic capabilities. Then they can begin to identify and link together essential business processes to serve customer needs. Finally, they can reshape the organization--including managerial roles and responsiblities--to encourage the new kind of behavior necessary to make capabilities- based competition work. The experience of a medical-equipment company we'll call Medequip illustrates this change process. An established competitor, Medequip recently found itself struggling to regain market share it had lost to a new competitor. The rival had introduced a lower priced, lower performance version of the company's most popular product. Medequip had developed a similar product in response, but senior managers were hesitant to launch it. Their reasoning made perfect sense according to the traditional competitive logic. As managers saw it, the company faced a classic no-win situation. The new product was lower priced but also lower profit. If the company promoted it aggressively to regain market share, overall profitability would suffer. But when Medequip managers began to investigate their competitive situation more carefully, they stopped defining the problem in terms of static products and markets. Increasingly, they saw it in terms of the organization's business processes. Traditionally, the company's functions had operated autonomously. Manufacturing was separate from sales, which was separate from field service. What's more, the company managed field service the way most companies do--as a classic profit center whose resources were deployed to reduce costs and maximize profitability. For instance, Medequip assigned full-time service personnel only to those customers who bought enough equipment to justify the additional cost. However, a closer look at the company's experience with these steady customers led to a fresh insight: at accounts where Medequip had placed one or more full-time service representatives on-site, the company renewed its highly profitable service contracts at three times the rate of its other accounts. When these accounts needed new equipment, they chose Medequip twice as often as other accounts did and tended to buy the broadest mix of Medequip products as well. The reason was simple. Medequip's on-site service representatives had become expert in the operations of their customers. They knew what equipment mix best suited the customer and what additional equipment the customer needed. So they had teamed up informally with Medequip's salespeople to become part of the selling process. Because the service reps were on-site full-time, they were also able to respond quickly to equipment problems. And of course, whenever a competitor's equipment broke down, the Medequip reps were on hand to point out the product's shortcomings. This new knowledge about the dynamics of service delivery inspired top managers to rethink how their company should compete. Specifically, they redefined field service from a stand-alone function to one part of an integrated sales and service capability. They crystallized this new approach in three key business decisions. First, Medequip decided to use its service personnel not to keep costs low but to maximize the life-cycle profitability of a set of targeted accounts. This decision took the form of a dramatic commitment to place at least one service rep on-site with selected customers-- no matter how little business each account currently represented. The decision to guarantee on-site service was expensive, so choosing which customers to target was crucial; there had to be potential for considerable additional business. The company divided its accounts into three categories: those it dominated, those where a single competitor dominated, and those where several competitors were present. Medequip protected the accounts it dominated by maintaining the already high level of service and by offering attractive terms for renewing service contracts. The company ignored those customers dominated by a single competitor--unless the competitor was having serious problems. All the remaining resources were focused on those accounts where no single competitor had the upper hand. Next Medequip combined its sales, service, and order-entry organizations into cross-functional teams that concentrated almost exclusively on the needs of the targeted accounts. The company trained service reps in sales techniques so they could take full responsibility for generating new sales leads. This freed up the sales staff to focus on the more strategic role of understanding the long-term needs of the customer's business. Finally, to emphasize Medequip's new commitment to total service, the company even taught its service reps how to fix competitors' equipment. Once this new organizational structure was in place, Medequip finally introduced its new low-price product. The result: the company has not only stopped its decline in market share but also increased share by almost 50%. The addition of the lower priced product has reduced profit margins, but the overall mix still includes many higher priced products. And absolute profits are much higher than before. This story suggests four steps by which any company can transform itself into a capabilities-based competitor: Shift the strategic framework to achieve aggressive goals. At Medequip, managers transformed what looked like a no-win situation--either lose share or lose profits--into an opportunity for a major competitive victory. They did so by abandoning the company's traditional function, cost, and profit-center orientation and by identifying and managing the capabilities that link customer need to customer satisfaction. The chief expression of this new capabilities-based strategy was the decision to provide on-site service reps to targeted accounts and to create cross-functional sales and service teams. Organize around the chosen capability and make sure employees have the necessary skills and resources to achieve it. Having set this ambitious competitive goal, Medequip managers next set about reshaping the company in terms of it. Rather than retaining the existing functional structure and trying to encourage coordination through some kind of matrix, they created a brand new organization--Customer Sales and Service--and divided it into "cells" with overall responsibility for specific customers.But all these qualities are mere reflections of a more fundamental characteristic: a new conception of corporate strategy that we call "capabilities-based competition." For a glimpse of the new world of capabilities-based competition, consider the astonishing reversal of fortunes represented by Kmart and Wal-Mart. In 1979, Kmart was king of the discount retailing industry, an industry it had virtually created. With 1,891 stores and average revenues per store of $7.25 million, Kmart enjoyed enormous size advantages. This allowed economies of scale in purchasing, distribution, and marketing that, according to just about any management textbook, are crucial to competitive success in a mature and low-growth industry. By contrast, Wal-Mart was a small niche retailer in the South with only 229 stores and average revenues about half of those of Kmart stores--hardly a serious competitor. And yet, only ten years later, Wal-Mart had transformed itself and the discount retailing industry. Growing nearly 25% a year, the company achieved the highest sales per square foot, inventory turns, and operating profit of any discount retailer. Its 1989 pretax return on sales was 8%, nearly double that of Kmart. Today Wal-Mart is the largest and highest profit retailer in the world--a performance that has translated into a 32% return on equity and a market valuation more than ten times book value. What's more, Wal-Mart's growth has been concentrated in half the United States, leaving ample room for further expansion. If Wal-Mart continues to gain market share at just one-half its historical rate, by 1995 the company will have eliminated all competitors from discount retailing with the exception of Kmart and Target. The Secret of Wal-Mart's Success What accounts for Wal-Mart's remarkable success? Most explanations focus on a few familiar and highly visible factors: the genius of founder Sam Walton, who inspires his employees and has molded a culture of service excellence; the "greeters" who welcome customers at the door; the motivational power of allowing employees to own part of the business; the strategy of "everyday low prices" that offers the customer a better deal and saves on merchandising and advertising costs.For example, Wal-Mart has recently begun to supplement its growth "from the inside out" by acquiring companies--for example, other small warehouse clubs and a retail and grocery distributor--whose operations can be folded into the Wal-Mart system. It is interesting to speculate where Wal-Mart will strike next. The company's inventory-replenishment capability could prove to be a strong competitive advantage in a wide variety of retail businesses. In the past decade, Wal-Mart came out of nowhere to challenge Kmart. In the next decade, companies such as Toys "R" Us (Wal-Mart already controls as much as 10% of the $13 billion toy market) and Circuit City (consumer electronics) may find themselves in the sights of this capabilities .predator.Take the example of cross-docking at Wal-Mart.2.3.4