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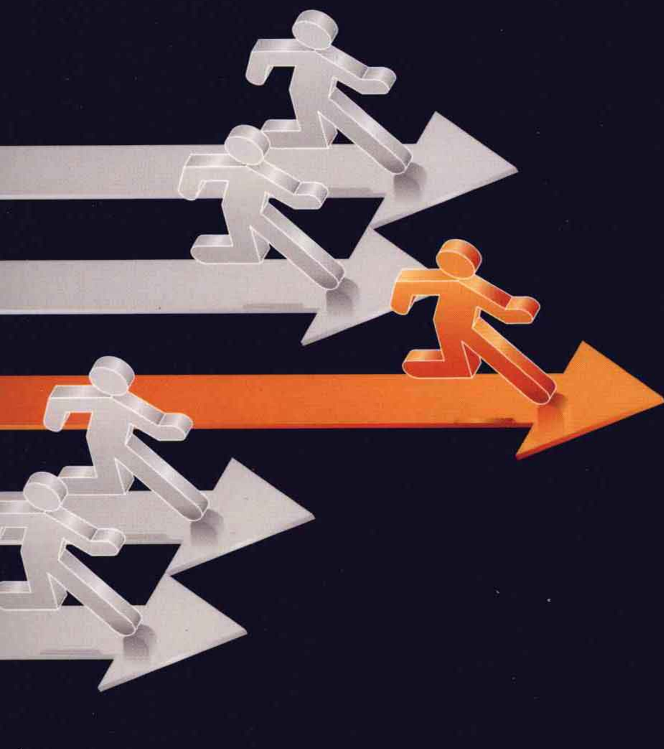

HOW TO WIN WITH A CAPABILITIES-DRIVE STRATEGY

PAUL LEINWAND • CESARE MAINARD

BOOZ & COMPANY

ACKNOWLEDGMENTS

To some extent, expressing appreciation to a few individuals who helped with this book misses the point: our perspective on value creation and strategy is derived from at least two generations of Booz & Company consultants who, over time, formed the fundamental ideas behind the capabilities-driven strategy. We especially thank our clients who collaborated with us to discover the essence of advantage. We admire them for their courage in embracing capabilities-driven strategies to boldly transform their companies.

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clarity of our ideas and helped us push further with their energy and enthusiasm.

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Chicago and Cleveland
July 13, 2010

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LIVING COHERENCE EVERY DAY

I

STRATEGIC COHERENCE

CHAPTER ONE

THE ESSENCE OF ADVANTAGE

It's 8 a.m. in the executive conference room of a large global manufacturing company. About twenty-five people, most of them heads of businesses or of major functions, are seated around the table. A dozen more leaders are attending by phone, calling in from their respective regions. The occasion is a quarterly review of new growth options, and the head of one of the major business units is making her pitch now. Raised in Delhi, Aadya is a poised, fast-talking, 41-year-old engineer-turned-executive; she has been with the company ten years. Currently based in California, she spent much of this past year in India and other Asian countries, because that's where she believes the best prospects are for growth in their industry.

At the head of the table is the CEO, Martin—who, as it happens, hired Aadya when he was head of the North American business. He has been CEO for only four years, and already these meetings, which he initiated, have become a signature event in the company. It's a sign of status to be invited, because everyone knows that this is where the company's overall strategy is really hammered out.

Aadya is presenting an audacious new idea: an extremely inexpensive adaptation of one of the company's flagship devices, to be sold in emerging markets. If it works out, it won't just be mildly successful; hundreds of millions of people will purchase it.

Martin leans forward and asks Aadya a simple question: "Do we have the right to win in this business?"

People in the room have heard him ask this question before. But the calm, direct tone of his voice still makes most of them sit up a little straighter. It means something very specific. What makes Aadya so sure that they can compete effectively with this product? Has she chosen the right game to play? Do they have the right capabilities to deliver?

Martin's manner is reminiscent of a coach talking to an athlete: "Do you feel ready for this game?" Or a teacher asking a student: "Do you think you can ace this test?" But the stakes are much higher. The company could end up investing millions before anyone finds out whether the venture will succeed. The market could turn out to be much smaller than the company expects. An upstart competitor could knock off the device and underprice the company.

"Yes," Aadya says simply. She then carefully presents a logical analysis of the consumer market; a view of the competitors from a variety of countries, including India, China, and South Africa; and, most importantly, a detailed, sober, and well-considered view of the company's capabilities. The company is already skilled at procuring the materials it will need, and it has advanced marketing and distribution capabilities for reaching emerging-market consumers. Its innovation capabilities, on the other hand, would need to be expanded, particularly for creating simpler, lower-cost versions of their devices. Aadya thus proposes a new R&D technical center in Asia, which would find and develop local talent capable of doing this. She also quickly sketches out an acquisition plan that would provide the company with better access to some promising markets where it doesn't currently have a position. In all of this, she doesn't come across as trying to sell her idea, but as simply explaining the stakes and what it will take to make the proposal succeed.

When she's done, Martin leans back and laces his fingertips together thoughtfully. "I'm inclined to think we should do this," he says.

Aadya resumes breathing. She knows how few proposals ever get this far. But this is still not the full decision; it's an opening to a discussion.

A major question now needs to be answered by everyone: if the company makes this commitment, what will it take? What other capabilities—new and existing—will they need to support it? What investments would be required to bridge the gap? What savings will they need to find elsewhere to fund these investments? Around the table and on the phone, each person speaks in turn: regional leaders, functional directors, and the heads of other businesses, talking about the role they would have to play and the contribution they might make.

The conversation is relatively unforced and free of tension; this team has had many similar meetings, and everyone understands the types of growth ideas that will work and those that won't, given the company's capabilities profile. Two hours later, it is clear that the company is ready to stand behind Aadya's proposal. It will not be sent off to succeed or fail on its own; it will be an inherent part of the overall growth strategy, drawing on every major capability that the company has.

In a small but increasing number of companies, conversations like this are taking place today. They may not take this exact form, but the strategic relevance, the intensity, and the focused perspective on their business are the same. Companies like this are known to be consistently successful—to have an essential advantage that their competitors can't match. Sure, they make mistakes, sometimes huge ones. But more often than not, they learn from their errors and come back stronger. They focus their efforts on the products and services that succeed for them, and they continually and consciously reinvest in the capabilities that differentiate them the most. For all these reasons, their competitors have difficulty catching up.

These companies succeed, not because of what they own or how big they are or because they are positioned in the right industries. Their advantage lies in what they do and how everything fits together to create value. They succeed because they are coherent.

Why Coherence Matters

Coherence, to many people, means having your act together—acting with uniformity and coordination. In this book, coherence means something much more specific. For a company to be described as coherent, it must be resolutely focused and clear-minded about three critical elements: its market position (its chosen "way to play," if you will); its most distinctive capabilities, which work together as a system; and its product and service portfolio. In a coherent company, the right lineup of products and services naturally results from conscious choices about the capabilities needed for a deliberate way to play.

Achieving coherence with one, or even two, of these elements is not enough. Only when all three are in sync—with one another and with the right external markets—can a company truly claim the "right to win" in the contests that matter over time. This coherence generates the essential advantage that distinguishes leading companies. It is sustainable and almost impossible to copy—as opposed to being a transitory advantage that allows companies to thrive only for a while.

The essential advantage in business is coherence. Our core insight is that simple. To be sure, companies can enjoy other forms of business advantage—advantages based on products, brands, assets, or positions. But they are all transient. They are vulnerable to technological disruptions, upstart competition, and the shifting global economy. Patents and copyrights expire. Business processes prevail until more proficient competitors appear. Government protection erodes when policies change. Technological monopolies are threatened by new innovations.

At the same time, most organizations are "sticky": their identities, cultures, and relationships are by nature slow to adapt to changing conditions. You simply cannot adapt as rapidly and as often as the audience and technology around you. But by becoming more coherent, like a boat moving toward a lighthouse at night, you align your organization toward a clear, more visible, more constant goal. You are no longer as vulnerable to external events—or to your own internal fragmentation.

Consider your own struggles with incoherence. How many times have you followed a new strategic direction or pursued a new growth opportunity with an enormous investment of time and effort, but without creating much value? How many initiatives have you started that didn't fit with anything else in your company and that didn't achieve their desired results? How many conversations have you had, trying to balance the needs of multiple functions, businesses, and regions—each arrived-at solution reasonable in itself, but contradicting one another and overwhelming the budget and resources available to you?

"We're searching for the glue," lamented the CEO of one of the world's largest consumer products companies not long ago. He is not alone. Few senior executives spend enough time thinking about the enterprise as a whole. Incoherence has been a way of life in business for years. People are used to it. But it can no longer stand in today's business environment. Many companies are finding themselves forced to change.

To unlock the benefits of coherence, you need to take deliberate steps—to reconsider your current strategy, overcome the conventional separation between your outward-facing and inward-facing activities, and bring your organization into focus. In this book, we will show you how.

A Breakthrough Business in a Mature Market

To see what we mean by coherence, consider the story of the consumer health-care division of the pharmaceutical giant Pfizer, Inc. The division, which was big enough to be a *Fortune* 500 company in its own right, generated billions of dollars of value between 2002 and 2006. It did this by creating what some say is impossible: a breakthrough business in a largely mature market.

Most people know the division through its widely successful over-the-counter (OTC) pharmaceutical products: Listerine antiseptic mouthwashes, Benadryl and Zyrtec allergy medicines, Zantac heartburn relief aids, Sudafed cold remedies, Nicorette smoking cessation products, and Rogaine hair regrowth medications among them. These products came together under the Pfizer corporate roof through a series of acquisitions—chief among them the 2000 purchase of Warner-Lambert, a company that made a wide variety of medicines, candies, mints, and gums. Pfizer's main objective in the deal was attaining Lipitor, a prescription medicine for reducing cholesterol. Then, in 2002, Pfizer merged with another loosely configured company, Pharmacia, seeking its anti-arthritis medicine Celebrex and gaining other attractive pharmaceuticals as well.

When the dust cleared, Pfizer had a much greater presence and visibility in over-the-counter products than it had ever had before.

Because of these acquisitions, the company's annual OTC revenue leaped from $560 million to nearly $3 billion, and by merging and streamlining operations, the consumer health-care division successfully cut about $300 million in annual costs. But the leaders of this business faced a major challenge: they were not in the larger company's mainstream. They needed to convince the rest of Pfizer that nonprescription mouthwashes, pills, and ointments could represent a viable business with robust top-line growth.

Pfizer is a relatively decentralized company; its divisions operate with fairly high autonomy. The parent company has a tough, science-oriented culture, reflecting the medical background of its staff and leadership. Within this culture, Pfizer's consumer health-care division was a bit of an oddball. Though the head of business development, Tom Booth, had come from the pharmaceutical parent, most of the division's leaders, including its president, Marc Robinson, had spent their careers in Warner-Lambert, at the rough-and-tumble front lines of consumer product marketing. They all fit in well with the rest of Pfizer in one respect: they were ambitious. By 2002, they had renamed the division Pfizer Consumer Healthcare (PCH) and set out to build a comprehensive strategy for global growth, with the aim of seizing the number one position in consumer health care worldwide.

Robinson, Booth, and the rest of the top management team began by looking closely at the market dynamics in their over-the-counter business. At the time, this was a highly fragmented sector with low overall growth. No player enjoyed more than 5 percent share globally. One key avenue for expansion was the so-called Rx-to-OTC switch: converting prescription drugs (Rx) into less concentrated versions for sale without a prescription on a pharmacy or grocery shelf. But this process would require the ability to manage tight country-by-country health-care regulation. The changing worldwide demographics—aging populations, growing income levels, and faster-paced urban lifestyles—offered another opportunity and meant larger markets for self-medication. But it also meant more competition: mass retailers were gaining clout and introducing more private-label ("drugstore brand") versions of brand-name products.

Next, the PCH management team looked at what many conventional strategy experts would suggest: high-potential, unfulfilled, "adjacent" categories. Weight-loss products, for instance, had a huge potential market and no dominant over-the-counter offerings. But PCH had no offering, either, and there were many potential entrants with experience in marketing products related to behavioral change. Even if PCH invested heavily in R&D, there was no assurance that the division would find the solution (or that regulators would approve it). The division would have to grow by marketing its existing products more effectively.

The team members compared the growth rates in Pfizer's over-the-counter products with those of its competitors. To their surprise, in every category, one or two brands stood out from the pack. These included some of their competitors' products, such as Tylenol analgesics, Bayer aspirin, and Centrum vitamins, as well as Pfizer's own Listerine and Nicorette. The standouts were invariably the products that based their marketing on demonstrable health benefits. If a company had a better product that made consumers healthier and could make a claim about it—"Benadryl is 54 percent more effective than the leading prescription allergy medicine" or "Zantac works fast, right when you need it, even at night, when heartburn is worst"—it could build a thriving worldwide business even in historically low-growth categories (since the claim itself could attract new customers). The PCH team members thus realized something important: their proposition was less about retail marketing and more about health care than they had realized.

It took some courage to abandon a premise that had been ingrained in their thinking since the Warner-Lambert days: the old belief that in consumer health care, like foods and toiletries, winning the battle for category leadership (otherwise known as the battle for shelf space) determined success. But the president, Marc Robinson, had worked with claims-based advertising at Warner-Lambert; he understood the power of health-related marketing. Tom Booth, the head of business development, kept emphasizing the importance of a single strategy and disciplined choices. The team also had the example of Listerine, which had been sold as a cold and sore throat remedy in the United States until 1976, when the Federal Trade Commission had ruled against the claim. Sales had slackened thereafter until the late 1990s, when Listerine had introduced another claim: "Listerine reduces significantly more plaque than brushing or flossing alone." With this new claim, sales had rebounded. With the benefit of preventing gingivitis (and, later, of whitening teeth), Listerine didn't need line extensions like toothbrushes and toothpaste; PCH didn't need to try to dominate the whole oral-care shelf.

This realization gave the PCH executives confidence. Instead of competing through merchandising, they would bet on a few highly favored brands that provided a therapeutic benefit for consumers. PCH would make claims about them, have local regulatory authorities approve those claims, and take position accordingly. The products would solve simple health-related problems for people around the world.

The executives knew this strategy could be profitable, particularly since no other major consumer health-care producer conceived of its business in quite that way. But as they thought it through, they realized that to make their strategy actually work, PCH would have to become proficient—even world-class—in six capabilities. Three of them were existing core competencies for the Warner-Lambert side of the division:

- The launching and commercialization of new over-the-counter products, through Rx-to-OTC switches
- Claims-based marketing featuring a demonstrable health benefit (Warner-Lambert had already demonstrated this with Listerine, Sudafed, and other products)
- Effective retail execution (e.g., product positioning, claims communication, pricing, and promotion) in both general trade stores and pharmacies

Pfizer's people were already well versed in the other three capabilities:

- The ability to influence regulatory management and government policy (so that claims could stand in many countries and jurisdictions)
- Focused portfolio management of selected brands, to bring them to global scale
- The pharmaceutical-like innovation of new "forms and formulations" (as pharmacologists call their products), so that the company could raise the value of the products' health benefits

While each of these capabilities was important to fulfilling Pfizer's strategy, the way they fit together would be what differentiated the company competitively. To build an unbeatable franchise in claims-based marketing, Pfizer needed to ensure a steady stream of formulations about which to make those claims—hence the need for science-based innovation and robust Rx-to-OTC switching capabilities. The company needed the ability to get the claims approved by regulators and to translate this approval into terms that consumers worldwide could understand. It needed focused portfolio management of those few brands that promised blockbuster results, and focused retail execution, to ensure that anyone seeking a PCH remedy would feel assured that they could find it easily.

Having settled on this way to play and system of capabilities, the management team now looked at its portfolio of products. Some no longer fit. For example, personal care products (such as lotions and shaving cream) tend to sell according to fashion and personal preference. Success in this category has little to do with clinical evidence: a claim that a particular perfume or aftershave will help people smell "42 percent better," even if somehow provable, won't help the product's sales. Another broad category was confectionaries, such as Chiclets, Trident, and Bubblicious chewing gums. These products sell to impulse buyers; success requires rapid-cycle flavor innovation and the ability to command space in the front of the store near the cash register.

Though many of these brands were successful, Pfizer sold them. In 2003, Cadbury Schweppes bought its confectionary line and Energizer Holdings bought its Schick/Wilkinson Sword shaving products. The company focused its attention and resources on growing its handful of global "golden" brands (such as Listerine, Zyrtec, and Nicorette) while acquiring new brands such as Purell, which could also be differentiated based on claims: "Purell kills 99.99 percent of disease-causing germs within seconds."

During the next few years, PCH built a world-beating franchise in its blockbuster products in particular, making sure that the operational teams supporting its six capabilities worked seamlessly together in every market. (Chapter 11 describes some of the steps they took to accomplish this.) Very few other companies could have assembled this exact lineup of capabilities. Together, the Warner-Lambert and Pfizer legacy leaders created a strategy—as well as the proficiency and product line to back it up. For leaders and employees alike, one of the most rewarding aspects was the experience of being part of an enterprise where everything fit together and where they had earned a right to win in their chosen market.

By 2006, Pfizer Consumer Healthcare had grown its business to nearly $4 billion in annual sales. It was a premier business in its category, delivering a rate of growth that was double that of the industry.[1] The value of the division became even more evident in 2006, when Pfizer sold it to Johnson & Johnson for a price of $16.6 billion. This represented 20.6 times earnings (specifically, earnings before interest, taxes, depreciation, and amortization, or EBITDA), compared with average multiples of 15 at the time. Most of that remarkable purchase price represented the value created by the profitable growth engine that PCH had created.

The Three Elements of Coherence

The critical factor in PCH's success was clearly not the value of any particular brand or asset. Nor was it the division's continuously improving execution: strategist Michael Porter correctly dismisses what he calls "operational excellence" as insufficient in itself for success.[2] Nor was it, strictly speaking, the competitive position that PCH held. All of these were important, but the most significant factor was the division's ability to put it all together, to craft the pieces of strategy and execution into a workable and coherent system.

Pfizer did this by developing a trio of strategic elements that were interrelated. If you are a company seeking coherence, then you will get there by thinking through the same three elements for your own business (see figure 1-1).

1. A Way to Play: "How are we going to capture value in our market?"

Your company's *way to play* is your considered approach for creating and capturing value in a particular market, in a way that differentiates you from all other companies. A well-defined way to play is broad