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Is your company disciplined enough to focus intensely on what it does best?

The Coherence Premium

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Is your company disciplined enough to focus intensely on what it does best? *by Paul Leinwand and Cesare Mainardi*

Sustainable, superior returns accrue to companies that focus on what they do best. The truth is that simple, and yet it's incredibly hard to internalize. It is the rare company indeed that focuses on "what we do better than anyone" in making every operating decision across every business unit and product line. Rarer still is the company that has aligned its differentiating internal capabilities with the right external market position. We call such companies "coherent."

Most companies don't pass the coherence test because they pay too much attention to external positioning and not enough to internal capabilities. They succumb to intense pressure for top-line growth and chase business in markets where they don't have the capabilities to sustain success. Their growth emanates not from the core but from the acquisition of apparent "adjacencies" that are often anything but and the exploration of "blue oceans" that turn out to be unswimmable. Even in contraction mode, when companies hunker down and try to wring more out of execution, most strategies fail to pay sufficient attention to capabilities. Cost-cutting, for example, is usually an across-the-board exercise, rather than a considered reallocation of resources. In fact, few strategies explicitly mention capabilities at all. Instead, strategy development follows the well-worn path from the market back to the boardroom.

We're not suggesting that companies disregard market signals; all strategy is set within that vital context. We are suggesting, however, that companies start from the opposite direction, figuring out what they're really good at and then developing those capabilities (three to six at most) until they're best-in-class and interlocking. From there, strategy becomes a matter of aligning that distinctive capabilities system with the right marketplace opportunities—and the market rewards them with outsize

ILLUSTRATION: TOMASZ WALENTA

returns. We call this the "coherence premium," and we've measured it.

Let's look at Wal-Mart to see how a capabilities-driven strategy works. Most attribute the chain's success to its impressive logistics operations or its ability to get vendors to fall in line. But having one or two superior capabilities is not enough. What really underlies Wal-Mart's competitive advantage is a system of mutually reinforcing capabilities that lowers total value chain cost in a differentiated way. The giant discount retailer achieves maximum efficiency by integrating four capabilities: aggressive vendor management, expert point-of-sale data analytics, superior logistics, and rigorous working-capital management. Every one of these capabilities reinforces the others and supports the company's strategic purpose to deliver "everyday low prices" to consumers. It's a capabilities system rooted in superior information. Because of its world-class point-of-sale analytics, Wal-Mart can continually tailor its product assortment to local consumption trends and feed vendors better information than they have themselves. That, in turn, increases the company's leverage with suppliers and allows it to move inventory and manage working capital with extraordinary efficiency. Every product and service it sells fits with its "way to play," or market approach, and capabilities system. Wal-Mart does not sell big-ticket items like furniture or large appliances, for which its capabilities would not create a cost advantage. And you won't find a Wal-Mart on Fifth Avenue or the Champs-Elysées.

It's textbook capabilities coherence.

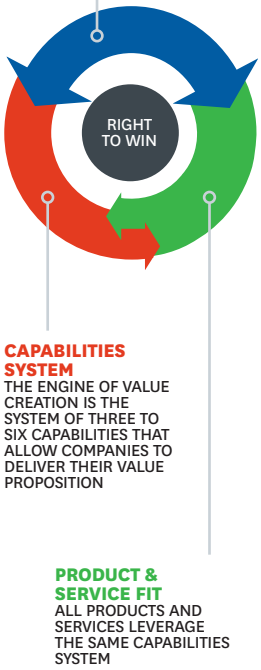
The Power of Coherence

A capability is something you do well that customers value and competitors can't beat. It's more than an activity or a function: It's the interconnection of people, knowledge, IT, tools, and processes that enable a company to outexecute rivals on some important measure. It might be the ability to secure shelf space in particular types of stores, or to use customer-data mining to develop new products, or to bundle products and services to meet customers' shifting needs over time.

We are hardly the first to write about the importance of capabilities to strategy. C.K. Prahalad and Gary Hamel's seminal article, "The Core Competence of the Corporation" (HBR May 1990), was the first in a long line of articles and books to explore this idea. But a capability in isolation is not enough to produce the coherence premium. We believe that

The Power of Coherence

A coherent company focuses on what it does best in making every decision across every business. It derives its "right to win" by aligning:



a capabilities system creates value in a differentiated way.

A company becomes coherent only when its capabilities system is consciously chosen and implemented to support a focused strategic purpose, or way to play, and is aligned with the right product and service portfolio. It can provide clear answers to these questions:

How are we going to face the market? Successful companies have a clear understanding of how they create value for customers. Ways to play are broad enough to allow flexibility and growth and narrow enough to focus strategy and decision making. They include being the innovator, the low-cost provider, the value chain optimizer, the customer service king, and so forth.

What capabilities do we need? The engine of value creation is a system of three to six capabilities that together allow a company to deliver its value proposition effectively. When firms cultivate a system of mutually reinforcing capabilities, their competitive advantage becomes that much more powerful.

What are we going to sell, and to whom? Coherent companies build their product and service portfolios so that every offering is aligned with the capabilities system and the way to play. Products that require different capabilities are surgically removed from the mix. The external market is continually scanned for new opportunities that leverage the capabilities system.

Coherent companies build deep, scalable expertise in just a few areas and align their strategy and day-to-day decision making to take advantage of them.

Pfizer: A Case Study

The consumer health care business of Pfizer is a good example of capabilities coherence. After its back-to-back acquisitions of Warner-Lambert and Pharmacia in the early 2000s, the pharmaceutical giant owned several leading consumer products: Listerine, Benadryl, Sudafed, Nicorette, and Rogaine. In 2002, Pfizer set the goal of becoming the leader in global consumer health care and applied a capabilities lens to the business.

Choosing the way to play. First Pfizer's leaders examined the market dynamics to determine how the company would compete. The market was highly fragmented (no player enjoyed more than a 5% share globally) and plagued by low overall growth. The so-called Rx-OTC switch—whereby prescription

Idea in Brief

The pressure to grow the top line is so intense that most companies pay too much attention to expansion and not enough to building differentiated capabilities.

A few companies start from the opposite direction: They figure out what they're really good at, then develop those capabilities (three to six at most) until they're best-in-class and interlocking.

For them, strategy becomes a matter of aligning what they do well with the right marketplace opportunities—and the market rewards them with sustained superior returns.

The engine of value creation is a system of three to six capabilities that together allow a company to compete in a differentiated way.

drugs become candidates for over-the-counter sale—was one key avenue of growth, but it was severely constrained by tight country-by-country regulation and mass retailers that had begun introducing private-label alternatives to brand-name drugs. Still, the market was expected to grow as a result of global demographic factors—aging populations, rising income levels, and faster-paced lifestyles—that increased consumers' tendency to self-medicate.

The breakthrough in determining the way to play was Pfizer's realization that demonstrable health benefits mattered more than category strength in driving sales. If you could make a defensible marketing claim that your product was better—"Benadryl is 54% more effective than the leading prescription allergy medicine" or "Listerine reduces plaque significantly more than brushing or flossing alone"—you had a license to thrive worldwide. In other words, consumer health care was more of a health care business than a consumer products business, making it a natural fit for Pfizer.

Evaluating the capabilities system. On the basis of this insight, Pfizer chose a distinctive approach: to focus on innovation that would lead to defensible therapeutic claims and the ability to scale up a few brands worldwide. To achieve success, Pfizer identified a core system of six interlocking capabilities:

- Science-based innovation around formulations
- Ability to influence regulatory management and government policy
- New-product development through the Rx-OTC switch as well as through licensing and acquisition
- Claims-based marketing featuring a demonstrable health benefit
- Channel management in both general trade stores and pharmacies (particularly product positioning, pricing, and promotion)
- Focused portfolio management of aggressive and moderate growth brands and geographies

Each of these capabilities was important to carrying out Pfizer's strategy, but it was the way they worked together that was competitively differentiating. If Pfizer was going to build an unbeatable franchise in claims-based marketing, it needed science-based innovation and robust Rx-OTC switching capabilities to ensure a supply of formulations about which to make those claims. It needed the ability to get the claims approved by regulators and translated into terms consumers around the world could understand when they made their purchase decisions. And it needed focused portfolio management of those few brands that promised blockbuster results.

Assessing product fit. Having made considered choices about how Pfizer would compete and with what capabilities, executives recognized that some products no longer fit the strategy. Thanks largely to the Warner-Lambert acquisition, the consumer health care portfolio had migrated away from OTC drugs and into personal care (Schick razors and shaving cream) and confectionary (Chiclets, Trident, and Bubblicious gums)—categories that leveraged distinctly different capability sets. Personal care requires specific innovation in skin technologies, keeping up with fashion trends, and the ability to design attractive packaging. Confectionary requires rapid-

The Coherence Test

How do you capture the coherence premium? The first step is to determine just how incoherent you are. You may be sitting in a company that holds a range of market positions and maintains disparate capabilities systems, wondering where to begin. This simple diagnostic will help you determine the areas where coherence is embedded in your organization—and where you may be going off the rails.

CAN WE STATE IT?	DO WE LIVE IT?
WAY TO PLAY	
Are we clear about how we choose to create value in the marketplace?	Are we investing in the capabilities that really matter to our way to play?
CAPABILITIES SYSTEM	
Can we articulate the three to six capabilities that describe what we do uniquely better than anyone else? Have we defined how they work together in a system?	Do all our businesses draw on this superior capabilities system? Do our organizational structure and operating model support and exploit it? Does our performance management system reinforce it?
PRODUCT & SERVICE FIT	
Have we specified our product and service "sweet spot"? Do we understand how to leverage the capabilities system in new or unexpected areas?	Do most of the products and services we sell fit with our capabilities system? Are new products and acquisitions evaluated on the basis of their fit with the way to play and capabilities system?

cycle flavor innovation and the ability to command space at the front of the store near the cash register. If Pfizer no longer was going to invest in those capabilities, it needed to divest those products, or risk strategic incoherence.

In 2003, Pfizer sold the confectionary products business to Cadbury Schweppes and the Schick–Wilkinson Sword wet-shave business to Energizer Holdings. These divestitures enabled Pfizer to focus even more attention and resources on growing its global health care brands (Listerine, Zyrtec, and Nicorette) at above-market rates and acquiring new brands that could be differentiated based on claims, such as Purell ("Purell kills 99.99% of disease-causing germs within seconds").

By 2006, Pfizer Consumer Healthcare had grown its business to nearly $4 billion in annual sales and was a premier company in its category, delivering a rate of growth double the industry average. That year Pfizer redeemed the value built by PCH by selling the business to Johnson & Johnson for an unprecedented $16.6 billion, or 20.6 times EBITDA (compared with average multiples of 15 at the time).

The Payoff

So, do coherent companies have superior financial performance? We examined a number of industries and mapped the level of capabilities coherence of the major players against their operating margins over the past five years. (See the exhibit "Coherence and Profitability in the Consumer Packaged Goods Industry"). The data show that coherence in capabilities correlates strongly with greater profitability (as measured by EBIT margin, or earnings before interest and taxes divided by net revenue, over a five-year period). This is particularly true in mature, post-consolidation markets.

The winners. In the consumer packaged goods industry, Coca-Cola—the most profitable company—stands out because of its focus on beverage creation, brand proposition, and global consumer insight. This very simple but powerful capabilities system enables it to exert tremendous strength in beverage segments around the world. With the exception of certain ill-fated forays (Columbia Pictures, for instance), Coke has been ruthless in its focus on beverages that benefit from this capabilities system. Its ability to tap into consumer preferences allows it to create an unrivaled emotional brand connection with customers everywhere.

Wrigley, now part of Mars, is also highly profitable relative to the industry. It, too, hews to what it does best—constant flavor innovation and securing shelf space at the checkout counter. In fact, Mars's acquisition of Wrigley is an example of how, when managed well, capabilities not only drive value for a portfolio but also define its composition. Mars's decision to leave Wrigley intact as a business indicates that this acquisition was not motivated by scale alone—in fact, Mars has transferred its nonchocolate brands, Starburst and Skittles, to Wrigley's portfolio to further consolidate and leverage these differentiating capabilities. Mars knows chocolate. Wrigley knows gums and candy.

The losers. ConAgra Foods, at the other end of the spectrum, created incoherence through an unfocused acquisition binge in the 1990s. In the mid-2000s, its portfolio spanned three segments that drew on distinctly different capability sets: Prepared foods, which required superior merchandising and supply chain capabilities; snacks, which relied on strong product innovation; and staples such as flour and processed meat, which depended on efficient sourcing and production. Not surprisingly, ConAgra struggled with subpar performance in the years we studied: 2002 to 2007. It has since shed some noncore brands in a move toward coherence and has been rewarded with more robust financial performance in the past year.

Sara Lee's operations were similarly unfocused. Its diverse product portfolio as recently as five years ago encompassed products ranging from bakery goods to Hanes underwear to Kiwi shoe polish. As the exhibit shows, its financial performance was at the bottom of the pack. Sara Lee has undertaken three major restructurings in the past 10 years and has begun to tap into the coherence premium, having divested many noncore brands.

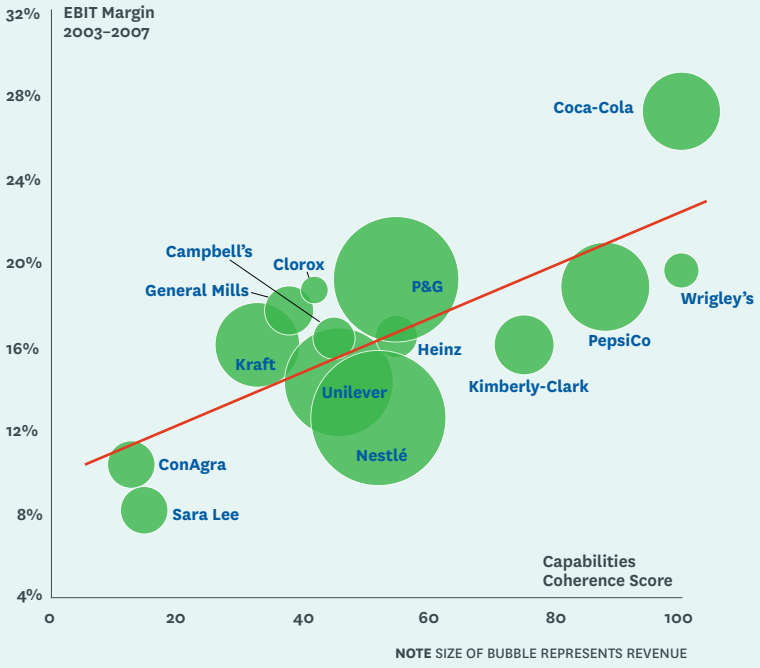
The coherence we've measured creates value in four ways. First, it strengthens a company's competitive advantage. Companies that focus on their capabilities, day in and day out, continually improve them. Employees become more skilled and systems grow more adept, enabling companies to consistently outexecute their rivals and capture the top-line growth in their industries.

Second, coherence focuses strategic investment on what matters. Companies make better organic growth decisions and pursue acquisitions that are in keeping with their capabilities. It also reduces waste. Coherent companies direct capital, time, and talent to those activities, products, and businesses that will extend their lead. They don't invest in making accounts payable world-class. They don't fund R&D projects that won't enhance their position. And they don't overspend on marketing campaigns that won't move the needle on sales.

Third, coherence produces efficiencies of scale. Companies can spend more wisely and grow more easily when they deploy the same capabilities across a larger array of products and services—in fact, these companies can apply the capabilities to businesses that would not normally be able to afford them.

Coherence and Profitability in the Consumer Packaged Goods Industry

Companies that align a way to play, an integrated capabilities system, and the right products and services create superior value, and we've measured this "coherence premium" in a range of industries.



NOTE SIZE OF BUBBLE REPRESENTS REVENUE

Our approach to scoring coherence is similar across industries and can be distilled into three essential steps. First, we define the segments each company serves. Next, we identify the capabilities that drive value for the company in each segment. Finally, we determine the number of common capabilities across all the segments the company serves. This score is mapped against EBIT margin to determine the coherence premium.

Case Study
When Expansion Is the Enemy of Coherence

When companies focus on growth to the exclusion of everything else, they unavoidably end up competing in territory where they don't have the capabilities to win.

Consider this cautionary tale of a company lured by the siren song of adjacency. Back in 1979, executives at Anheuser-Busch reasoned that beer and salty snacks go together—they're purchased and consumed at the same time, they both use yeast, and they both rely on strong marketing and distribution. The company launched Eagle Snacks that year. Then, in the late 1980s, executives decided to expand beyond pretzels and peanuts in planes and bars and started selling chips as well to grocery and convenience stores. Snack foods were an attractive adjacent market valued at $11 billion, and Anheuser-Busch was rolling in cash.

But although the categories of beer and snack foods appeared to draw on similar capabilities, there were important differences that Anheuser did not anticipate. In particular, the categories required very different distribution capabilities. Alcohol is heavily regulated; snack foods are not. Snacks and beer are stocked in different parts of the store, they enter the store through different doors, and they're ordered by different buyers. Anheuser was not used to buying shelf or display space for beer, but it had to for snacks. Further increasing complexity, snacks and beer have fundamentally different weight and volume characteristics. For these reasons, snack distribution proved far more complicated and costly than executives had imagined.

Making matters worse, the beer maker had picked the wrong market to play in as an amateur. It was going up against the formidable Frito-Lay, the King Kong of snack foods. When Eagle Snacks started making incursions into Frito-Lay's stronghold in stores, the hammer came down. Frito-Lay mobilized its world-class capabilities system in flavor innovation, retail coverage, and IT-enhanced merchandising, launching an array of new products and slashing prices.

Eagle Snacks could not compete. Its share of market never topped 6%, whereas Frito-Lay's increased from 40% to 50%.

Finally, coherence creates alignment between strategic intent and day-to-day decision making. In a messy, confusing world, coherent companies execute better and faster because everyone in the organization understands what's important.

The Journey to Coherence

Given the natural tendency of organizations to devolve into incoherence, it takes extraordinary leadership to pursue a capabilities-driven strategy. Focusing on one way to compete and a system of differentiating, mutually reinforcing capabilities often requires hard choices, including divesting businesses, streamlining nonessential functions, and paring product and service lines. It means resisting the temptation to leap into a hot new market where your capabilities system can't help you or to pursue (especially in boom times) easy profits at the expense of strategic focus.

We've seen such leadership in many company situations. After P&G stumbled badly in the late 1990s, for example, the board gave A.G. Lafley license to transform the sprawling consumer goods giant. He accomplished that largely by recasting the company's way to play around open innovation and by divesting assets that did not draw on P&G's distinctive capabilities system.

When the bottom dropped out of the tobacco business in the wake of the U.S. government's 1998 Tobacco Master Settlement Agreement, R.J. Reynolds's leadership team responded by applying a capabilities-driven focus to the company's retail merchandising, removing $1 billion from its operating costs.

Most frequently, companies establish pockets of coherence, as Pfizer did. A division can often be sheltered from external pressures and scrutiny; a divisional leader may find it easier to stay focused on a single way to compete.

Coherence around capabilities not only shapes the leadership agenda; it enables leadership. It aligns the organization at every level and gives employees the tools to make the right decisions every day. The clean and uncluttered ideal we describe—the company with an aligned strategy, capabilities system, and product and service portfolio—may seem like an impossibly remote destination. But there is value in the journey. Every transaction, every R&D decision, every management choice is an opportunity to take a step forward rather than a step back.

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