# Competing on Capabilities: The New Rules of Corporate Strategy

George Stalk, Philip Evans, and Lawrence E. Shulman

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In the 1980s, companies discovered time as a new source of competitive advantage. In the 1990s, they will learn that time is just one piece of a more far-reaching transformation in the logic of competition.

Companies that compete effectively on time—speeding new products to market, manufacturing just in time, or responding promptly to customer complaints—tend to be good at other things as well: for instance, the consistency of their product quality, the acuity of their insight into evolving customer needs, the ability to exploit emerging markets, enter new businesses, or generate new ideas and incorporate them in innovations. 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.

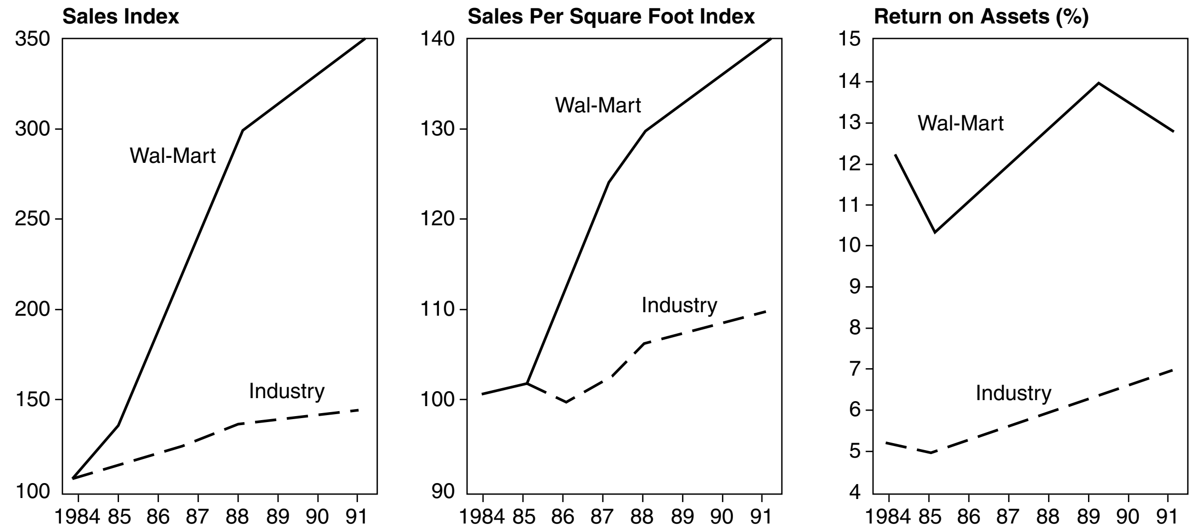
Today Wal-Mart is the largest and highest profit retailer in the world—a performance that has translated into a 32% return on equity and a market valuation more than ten times book value. What's more, Wal-Mart's growth has been concentrated in half the United States, leaving ample room for further expansion. 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

*George Stalk, Philip Evans, and Lawrence E. Shulman are vice presidents at the Boston Consulting Group. Stalk's first HBR article was "Time—The Next Source of Competitive Advantage" (July–August 1988). He is also the co-author, with Thomas Hout, of* Competing Against Time *(Free Press, 1990).*

**Capabilities Help Wal-Mart Outperform Its Industry**




Source: The Boston Consulting Group

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. Economists also point to Wal-Mart's big stores, which offer economies of scale and a wider choice of merchandise.

But such explanations only redefine the question. *Why* is Wal-Mart able to justify building bigger stores? Why does Wal-Mart alone have a cost structure low enough to accommodate everyday low prices and greeters? And what has enabled the company to continue to grow far beyond the direct reach of Sam Walton's magnetic personality? The real secret of Wal-Mart's success lies deeper, in a set of strategic business decisions that transformed the company into a capabilities-based competitor.

The starting point was a relentless focus on satisfying customer needs. Wal-Mart's goals were simple to define but hard to execute: to provide customers access to quality goods, to make these goods available when and where customers want them, to develop a cost structure that enables competitive pricing, and to build and maintain a reputation for absolute trustworthiness. The key to achieving these goals was to make the way the company replenished inventory the centerpiece of its competitive strategy.

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 truckloads 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 stockouts 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. Instead of the retailer pushing products into the system, customers "pull" products when and where they need them. 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 headquarters 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. The key to competitive advantage was *where* a company chose to compete. *How* it chose to compete was also important but secondary, a matter of execution.

Few managers need reminding of the changes that have made this traditional approach obsolete. As markets fragment and proliferate, "owning" any particular market segment becomes simultaneously more difficult and less valuable. As product life cycles accelerate, dominating existing product segments becomes less important than being able to create new products and exploit them quickly. Meanwhile, as globalization breaks down barriers between national and regional markets, competitors are multiplying and reducing the value of national market share.

In this more dynamic business environment, strategy has to become correspondingly more dynamic. Competition is now a "war of movement" in which success depends on anticipation of market trends and quick response to changing customer needs. Successful competitors move quickly in and out of products, markets, and sometimes even entire businesses—a process more akin to an interactive video game than to chess. In such an environment, the essence of strategy is *not* the structure of a company's products and markets but the dynamics of its behavior. And the goal is to identify and develop the hard-to-imitate organizational capabilities that distinguish a company from its competitors in the eyes of customers.

Companies like Wal-Mart, Honda, Canon, The Limited, or Banc One have learned this lesson. Their experience and that of other successful companies suggest four basic principles of capabilities-based competition:

1. The building blocks of corporate strategy are not products and markets but business processes.
2. Competitive success depends on transforming a company's key processes into strategic capabilities that consistently provide superior value to the customer.
3. Companies create these capabilities by making strategic investments in a support infrastructure that links together and transcends traditional SBUs and functions.
4. Because capabilities necessarily cross functions, the champion of a capabilities-based strategy is the CEO.

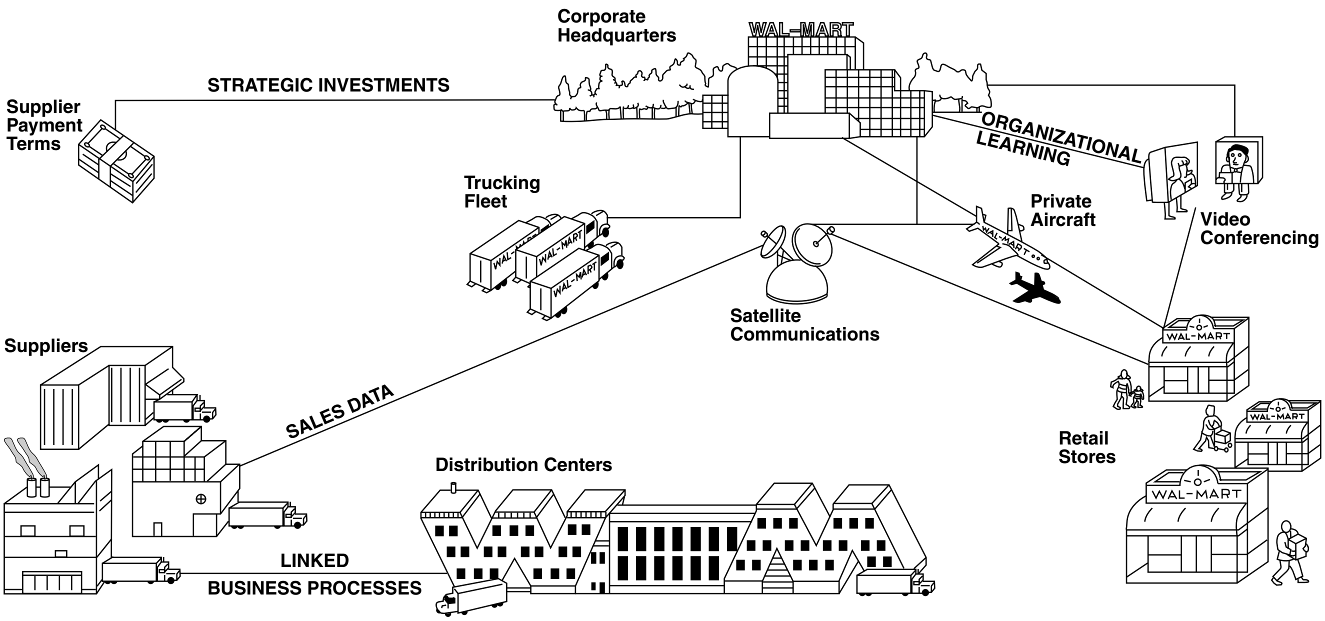
A capability is a set of business processes strategically understood. Every company has business processes that deliver value to the customer. But few think of them as the primary object of strategy. Capabilities-based competitors identify their key business processes, manage them centrally, and invest in them heavily, looking for a long-term payback.

Take the example of cross-docking at Wal-Mart. Cross-docking is not the cheapest or the easiest way to run a warehouse. But seen in the broader context of Wal-Mart's inventory-replenishment capability, it is an essential part of the overall process of keeping retail shelves filled while also minimizing inventory and purchasing in truckload quantities.

What transforms a set of indvidual business processes like cross-docking into a strategic capability? The key is to connect them to real customer needs. A capability is strategic only when it begins and ends with the customer.

[1]See T. Michael Nevens, Gregory L. Summe, and Bro Uttal, "Commercializing Technology: What the Best Companies Do," HBR May–June 1990, p. 154.

**Mapping Capabilities: Inventory Replenishment at Wal-Mart**




*At Wal-Mart, building capabilities begins with strategic investments: good payment terms to suppliers, a dedicated trucking fleet, satellite communications, company-owned aircraft, and videoconferencing. These investments enable suppliers to respond quickly to sales data beamed directly from stores, distribution centers to deliver new orders in less than 48 hours, and store managers to share best practice. The result: linked business processes that give Wal-Mart its competitive edge.

Of course, just about every company these days claims to be "close to the customer." But there is a qualitative difference in the customer focus of capabilities-driven competitors. These companies conceive of the organization as a giant feedback loop that begins with identifying the needs of the customer and ends with satisfying them.

As managers have grasped the importance of time-based competition, for example, they have increasingly focused on the speed of new product development. But as a unit of analysis, new product *development* is too narrow. It is only part of what is necessary to satisfy a customer and, therefore, to build an organizational capability. Better to think in terms of new product *realization,* a capability that includes the way a product is not only developed but also marketed and serviced. The longer and more complex the string of business processes, the harder it is to transform them into a capability—but the greater the value of that capability once built because competitors have more difficulty imitating it.

Weaving business processes together into organizational capabilities in this way also mandates a new logic of vertical integration. At a time when cost pressures are pushing many companies to outsource more and more activities, capabilities-based competitors are integrating vertically to ensure that they, not a supplier or distributor, control the performance of key business processes. Remember Wal-Mart's decision to own its transportation fleet in contrast to Kmart's decision to subcontract.

Even when a company doesn't actually own every link of the capability chain, the capabilities-based competitor works to tie these parts into its own business systems. Consider Wal-Mart's relationships with its suppliers. In order for Wal-Mart's inventory-replenishment capability to work, vendors have to change their own business processes to be more responsive to the Wal-Mart system. In exchange, they get far better payment terms from Wal-Mart than they do from other discount retailers. At Wal-Mart, the average "days payable," the time between the receipt of an invoice from a supplier and its payment, is 29 days. At Kmart, it is 45.

Another attribute of capabilities is that they are collective and cross-functional—a small part of many people's jobs, not a large part of a few. This helps explain why most companies underexploit capabilities-based competition. 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. The company also provided the necessary training so that employees could understand how their new roles would help achieve new business goals. Finally, Medequip created systems to support employees in their new roles. For example, one information system uses CD-ROMs to give field-service personnel quick access to information about Medequip's product line as well as those of competitors.

*Make progress visible and bring measurements and reward into alignment.* Medequip also made sure that the company's measurement and reward systems reflected the new competitive strategy. Like most companies, the company had never known the profitability of individual customers. Traditionally, field-service employees were measured on overall service profitability. With the shift to the new approach, however, the company had to develop a whole new set of measures—for example, Medequip's "share-by-customer-by-product," the amount of money the company invested in servicing a particular customer, and the customer's current and estimated lifetime profitability. Team members' compensation was calculated according to these new measures.

*Do not delegate the leadership of the transformation.* Becoming a capabilities-based competitor requires an enormous amount of change. For that reason, it is a process extremely difficult to delegate. Because capabilities are cross-functional, the change process can't be left to middle managers. It requires the hands-on guidance of the CEO and the active involvement of top line managers. At Medequip, the heads of sales, service, and order entry led the subteams that made the actual recommendations, but it was the CEO who oversaw the change process, evaluated their proposals, and made the final decision. His leading role ensured senior management's commitment to the recommended changes.

This top-down change process has the paradoxical result of driving business decision making down to those directly participating in key processes—for example, Medequip's sales and service staff. This leads to a high measure of operational flexibility and an almost reflex-like responsiveness to external change.

## A New Logic of Growth: The Capabilities Predator

Once managers reshape the company in terms of its underlying capabilities, they can use these capabilities to define a growth path for the corporation. At the center of capabilities-based competition is a new logic of growth.

In the 1960s, most managers assumed that when growth in a company's basic business slowed, the company should turn to diversification. This was the age of the multibusiness conglomerate. In the 1970s and 1980s, however, it became clear that growth through diversification was difficult. And so, the pendulum of management thinking swung once again. Companies were urged to "stick to their knitting"—that is, to focus on their core business, identify where the profit was, and get rid of everything else. The idea of the corporation became increasingly narrow.

Competing on capabilities provides a way for companies to gain the benefits of both focus and diversification. Put another way, a company that focuses on its strategic capabilities can compete in a remarkable diversity of regions, products, and businesses and do it far more coherently than the typical conglomerate can. Such a company is a "capabilities predator"—able to come out of nowhere and move rapidly from nonparticipant to major player and even to industry leader.

Capabilities-based companies grow by transferring their essential business processes—first to new geographic areas and then to new businesses. Wal-Mart CEO David Glass alludes to this method of growth when he characterizes Wal-Mart as "always pushing from the inside out; we never jump and backfill."

Strategic advantages built on capabilities are easier to transfer geographically than more traditional competitive advantages. Honda, for example, has become a manufacturer in Europe and the United States with relatively few problems. The quality of its cars made in the United States is so good that the company is exporting some of them back to Japan.

In many respects, Wal-Mart's move from small towns in the South to large, urban, northern cities spans as great a cultural gap as Honda's move beyond Japan. And yet, Wal-Mart has done it with barely a hiccup. While the stores are much bigger and the product lines different, the capabilities are exactly the same. Wal-Mart simply replicates its system as soon as the required people are trained. The company estimates that it can train enough new employees to grow about 25% a year.

But the big payoff for capabilities-led growth comes not through geographical expansion but through rapid entry into whole new businesses. Capabilities-based companies do this in at least two ways. The first is by "cloning" their key business processes. Again, Honda is a typical example.

Most people attribute Honda's success to the innovative design of its products or the way the company manufactures them. These factors are certainly important. But the company's growth has been spearheaded by less visible capabilities.

For example, a big part of Honda's original success in motorcycles was due to the company's distinctive capability in "dealer management," which departed from the traditional relationship between motorcycle manufacturers and dealers. Typically, local dealers were motorcycle enthusiasts who were more concerned with finding a way to support their hobby than with building a strong business. They were not particularly interested in marketing, parts-inventory management, or other business systems.

Honda, by contrast, managed its dealers to ensure that they would become successful businesspeople. The company provided operating procedures and policies for merchandising, selling, floor planning, and service management. It trained all its dealers and their entire staffs in these new management systems and supported them with a computerized dealer-management information system. The part-time dealers of competitors were no match for the better prepared and better financed Honda dealers.

Honda's move into new businesses, including lawn mowers, outboard motors, and automobiles, has depended on re-creating this same dealer-management capability in each new sector. Even in segments like luxury cars, where local dealers are generally more service-oriented than those in the motorcycle business, Honda's skill at managing its dealers is transforming service standards. Honda dealers consistently receive the highest ratings for customer satisfaction among auto companies selling in the United States. One reason is that Honda gives its dealers far more autonomy to decide on the spot whether a needed repair is covered by warranty. (See the sidebar, "How Capabilities Differ from Core Competencies: The Case of Honda.")

But the ultimate form of growth in the capabilities-based company may not be cloning business processes so much as creating processes so flexible and robust that the same set can serve many different businesses. This is the case with Wal-Mart. The company uses the same inventory-replenishment system

## How Capabilities Differ from Core Competencies: The Case of Honda

In their influential 1990 HBR article, "The Core Competence of the Corporation," Gary Hamel and C.K. Prahalad mount an attack on traditional notions of strategy that is not so dissimilar from what we are arguing here. For Hamel and Prahalad, however, the central building block of corporate strategy is "core competence." How is a competence different from a capability, and how do the two concepts relate to each other?

Hamel and Prahalad define core competence as the combination of individual technologies and production skills that underlie a company's myriad product lines. Sony's core competence in miniaturization, for example, allows the company to make everything from the Sony Walkman to videocameras to notebook computers. Canon's core competencies in optics, imaging, and microprocessor controls have enabled it to enter markets as seemingly diverse as copiers, laser printers, cameras, and image scanners.

As the above examples suggest, Hamel and Prahalad use core competence to explain the ease with which successful competitors are able to enter new and seemingly unrelated businesses. But a closer look reveals that competencies are not the whole story.

Consider Honda's move from motorcycles into other businesses, including lawn mowers, outboard motors, and automobiles. Hamel and Prahalad attribute Honda's success to its underlying competence in engines and power trains. While Honda's engine competence is certainly important, it alone cannot explain the speed with which the company has successfully moved into a wide range of businesses over the past 20 years. After all, General Motors (to take just one example) is also an accomplished designer and manufacturer of engines. What distinguishes Honda from its competitors is its focus on capabilities.

One important but largely invisible capability is Honda's expertise in "dealer management"—its ability to train and support its dealer network with operating procedures and policies for merchandising, selling, floor planning, and service management. First developed for its motorcycle business, this set of business processes has since been replicated in each new business the company has entered.

Another capability central to Honda's success has been its skill at "product realization." Traditional product development separates planning, proving, and executing into three sequential activities: assessing the market's needs and whether existing products are meeting those needs; testing the proposed product; then building a prototype. The end result of this process is a new factory or organization to introduce the new product. This traditional approach takes a long time—and with time goes money.

Honda has arranged these activities differently. First, planning and proving go on continuously and in parallel. Second, these activities are clearly separated from execution. At Honda, the highly disciplined execution cycle schedules major product revisions every four years and minor revisions every two years. The 1990 Honda Accord, for example, which is the first major redesign of that model since 1986, incorporates a power train developed two years earlier and first used in the 1988 Accord. Finally, when a new product is ready, it is released to *existing* factories and organizations, which dramatically shortens the amount of time needed to launch it. As time is reduced, so are cost and risk.

Consider the following comparison between Honda and GM. In 1984, Honda launched its Acura division; one year later, GM created Saturn. Honda chose to integrate Acura into its existing organization and facilities. In Europe, for example, the Acura Legend is sold through the same sales force as the Honda Legend. The Acura division now makes three models—the Legend, Integra, and Vigor—and is turning out 300,000 cars a year. At the end of 1991, seven years after it was launched, the division had produced a total of 800,000 vehicles. More important, it had already introduced eight variations of its product line.

By contrast, GM created a separate organization and a separate facility for Saturn. Production began in late 1990, and 1991 will be its first full model year. If GM is lucky, it will be producing 240,000 vehicles in the next year or two and will have two models out.

As the Honda example suggests, competencies and capabilities represent two different but complementary dimensions of an emerging paradigm for corporate strategy. Both concepts emphasize "behavioral" aspects of strategy in contrast to the traditional structural model. But whereas core competence emphasizes technological and production expertise at specific points along the value chain, capabilities are more broadly based, encompassing the entire value chain. In this respect, capabilities are visible to the customer in a way that core competencies rarely are.

Like the "grand unified theory" that modern-day physicists are searching for to explain physical behavior at both the subatomic level and that of the entire cosmos, the combination of core competence and capabilities may define the universal model for corporate strategy in the 1990s and beyond.

that makes its discount stores so successful to propel itself into new and traditionally distinct retail sectors.

Take the example of warehouse clubs, no-frills stores that sell products in bulk at a deep discount. In 1983, Wal-Mart created Sam's Club to compete with industry founder Price Club and Kmart's own PACE Membership Warehouse. Within four years, Sam's Club sales had passed those of both Price and PACE, making it the largest wholesale club in the country. Sam's 1990 sales were $5.3 billion, compared with $4.9 billion for Price and $1.6 billion for PACE. What's more, Wal-Mart has repeated this rapid penetration strategy in other retail sectors, including pharmacies, European-style hypermarkets, and large, no-frills grocery stores known as superstores.

While Wal-Mart has been growing by quickly entering these new businesses, Kmart has tried to grow by acquisition, with mixed success. In the past decade, Kmart has bought and sold a number of companies in unrelated businesses such as restaurants and insurance—an indication the company has had difficulty adding value.

This is not to suggest that growth by acquisition is necessarily doomed to failure. Indeed, the company that is focused on its capabilities is often better able to target sensible acquisitions and then integrate them successfully. 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.

## The Future of Capabilities-Based Competition

For the moment, capabilities-based companies have the advantage of competing against rivals still locked into the old way of seeing the competitive environment. But such a situation won't last forever. As more and more companies make the transition to capabilities-based competition, the simple fact of competing on capabilities will become less important than the specific capabilities a company has chosen to build. Given the necessary long-term investments, the strategic choices managers make will end up determining a company's fate.

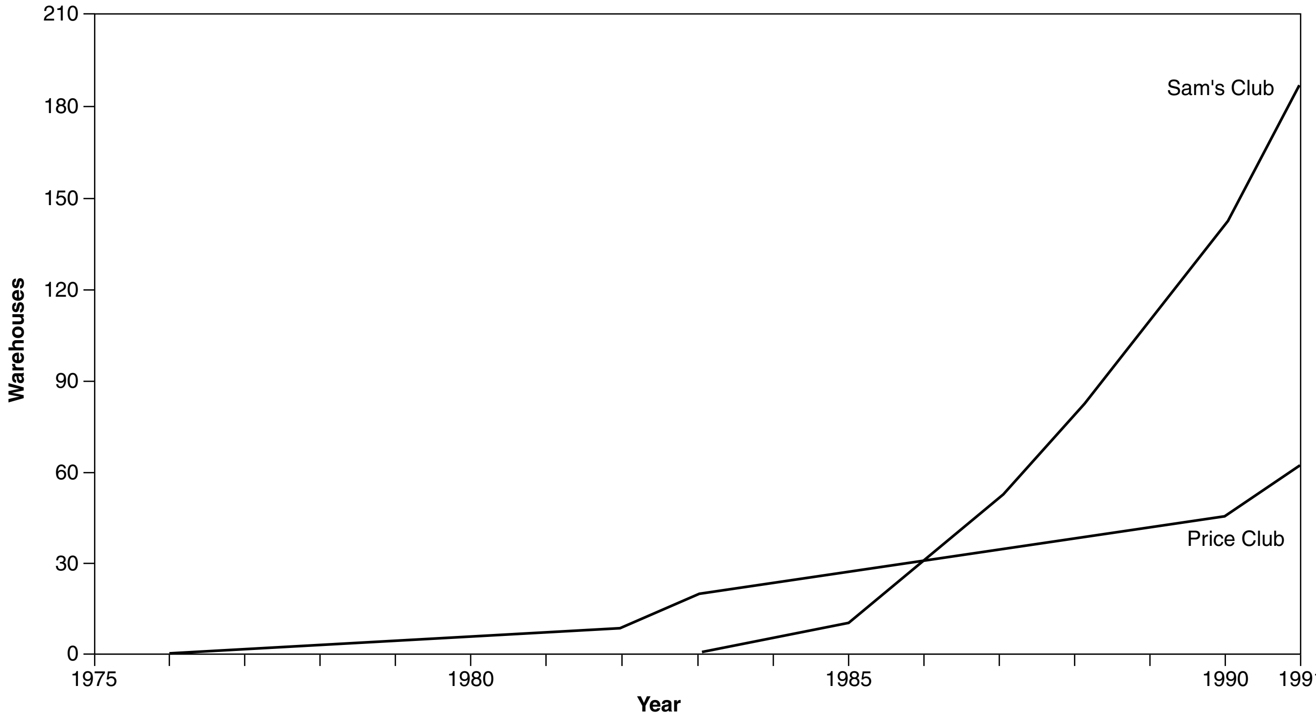
If Wal-Mart and Kmart are a good example of the present state of capabilities-based competition, the story of two fast-growing regional banks suggests its future. Wachovia Corporation, with dual headquarters in Winston-Salem, North Carolina and Atlanta, Georgia, has superior returns and growing market share throughout its core markets in both states. Banc One, based in Columbus, Ohio, has consistently enjoyed the highest return on assets in the U.S. banking industry. Both banks compete on capabilities, but they do it in very different ways.

Wachovia competes on its ability to understand and serve the needs of individual customers, a skill that manifests itself in probably the highest "cross-sell ratio"—the average number of products per customer—of any bank in the country. The linchpin of this capability is the company's roughly 600 "personal bankers," frontline employees who provide Wachovia's mass-market customers with a degree of personalized service approaching what has traditionally been available only to private banking clients. The company's specialized support systems allow each personal banker to serve about 1,200 customers. Among those systems: an integrated customer-information file, simplified work processes that allow the bank to respond to almost all customer requests by the end of business that day, and a five-year personal banker training program.

Where Wachovia focuses on meeting the needs of individual customers, Banc One's distinctive ability is to understand and respond to the needs of entire *communities.* To do community banking effectively, a bank has to have deep roots in the local community. But traditionally, local banks have not been able to muster the professional expertise, state-of-the-art products, and highly competitive cost structure of large national banks like Citicorp. Banc One competes by offering its customers the best of both these worlds. Or in the words of one company slogan, Banc One "out-locals the national banks and out-nationals the local banks."

Striking this balance depends on two factors. One is local autonomy. The central organizational role in the Banc One business system is played not by frontline employees but by the presidents of the 51 affiliate banks in the Banc One network. Affiliate presidents have exceptional power within their own region. They select products, establish prices and marketing strategy, make credit decisions, and set internal management policies. They can even overrule the activities of Banc One's centralized direct-marketing businesses. But while Banc One's affiliate

**Portrait of a Capabilities Predator**




Source: The Boston Consulting Group
By applying capabilities developed in its core business, Wal-Mart was able to penetrate the wholesale club market quickly. Its unit, Sam's Club, overtook industry leader Price Club in a mere four years.

system is highly decentralized, its success also depends on an elaborate, and highly centralized, process of continuous organizational learning. Affiliate presidents have the authority to mold bank products and services to local conditions, but they are also expected to learn from best practice throughout the Banc One system and to adapt it to their own operations.

Banc One collects an extraordinary amount of detailed and current information on each affiliate bank's internal and external performance. For example, the bank regularly publishes "league tables" on numerous measures of operating performance, with the worst performers listed first. This encourages collaboration to improve the weakest affiliates rather than competition to be the best. The bank also continously engages in workflow re-engineering and process simplification. 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.