Diamond in the rough
Too many companies are slow to respond when growth hits a wall. Chris Zook and James Allen believe you can renew your core business by tapping into hidden assets.
Few products conjure up such a range of experience and emotion as diamonds. Often associated with bleak, poor regions, diamonds are symbols of enduring love. For all the emotions involved, the business world of diamonds was for decades much like a diamond itself: colourless and highly stable. At the top of the industry was De Beers Group, the market leader for decades. Yet, this powerful market-leading company learned that sometimes your core business alone won’t carry you into the future.

In fact, by 1999, De Beers’ dominance seemed to have ended. New mines were opening and new competitors emerging. De Beers’ share of global production had declined, its market value was shrinking, and its profits were vanishing. As new chairman, Nicky Oppenheimer, with new group managing director, Gary Ralfe, discussed the situation with shareholders, board members, analysts and senior managers, they found no shortage of opinions. Some felt things would turn around; De Beers just needed to cut costs and stay the course. Others thought the company should acquire competitors, invest in new mines or both. A few mavericks suggested that De Beers should diversify. A bone of particular contention was what to do with De Beers’ $5 billion stockpile of rough diamonds, once used to stabilize prices: Maintain it? Expand it? Sell it off?

Oppenheimer and Ralfe came to believe that they could not reverse the situation with a strategy anything like the one De Beers had pursued in the past. Somehow, some way, they would need to redefine De Beers’ core.

Redefinition and the cycle of growth

Redefine the core. Change where you compete, how you compete, or what you compete over. It’s a major event in a company’s life.

Redefinition today is more than an option: it’s essential. The issue for executives is what to do. Some will decide to man the fort and defend the status quo. Others will try to transform their companies all at once through a big merger or a leap into a hot new market. All such strategies, it turns out, are inordinately risky. But a number of companies have found a far less risky alternative. They search out and uncover hidden assets – those that have been overlooked, undervalued or underutilized – and redefine their company around them.

Two well-publicized examples of this kind of redefinition: A few years ago, a struggling Apple
realized that its talent for software, appealing product design and imaginative marketing could be applied to more than just computers, and in particular to a little device for listening to music. Today, iPod-based music accounts for nearly 50 per cent of Apple's revenues and 40 per cent of profits – a new core. A second example: IBM's Global Services Group was once a tiny services and network operations unit, not even a stand-alone business within IBM. By 2001, it was larger than all of IBM's hardware business and accounted for roughly two-thirds of the company's market value.

How could valuable assets go unrecognized instead of being put to work or disposed of? The sheer size and complexity of many companies mean that they invariably acquire more skills, capabilities and business platforms than they can focus on at any one time. Some of these assets won't be exploited to their full potential – and once that has been the case for awhile, the people at the top often continue to discount their value. But somewhere down the road, market conditions change or the company acquires new capabilities that complement its underutilized ones. At that point, the value of overlooked assets can emerge in a new light.

Three ways to win

Most hidden assets seem to fall into three categories: undervalued business platforms, untapped customer insights and underexploited capabilities. Each can provide the foundation on which a company can redefine its core.

Undervalued business platforms GUS, the big British retailer that recently "de-merged" into three separate companies, took this notion farther than most. Originally a collection of about 80 specialty retailers, along with its signature catalogue operation, GUS found itself under attack in the mid-1990s from discounters and other competitors. But the company had one small business platform that was doing well, an information services unit known as CCN. In 1996, it acquired a larger information services company, Experian, and merged the two under the Experian name. Two years later, it acquired a general merchandise retailer called Argos. GUS then sold off many of its existing businesses, including the catalogue operation, to focus on building up these two business platforms and one other, the Burberry luxury brand. Experian soon became a global information solutions company with significant business in the credit rating markets. Argos, fuelled by the 2002 acquisition of Britain's second-largest home improvement and do-it-yourself retailer, grew into one of the nation's pre-eminent retail chains. GUS invested heavily in building up Argos's Internet channel, adding $2 billion in sales and turning Argos into one of the top three Internet retailers in the UK. GUS's stock price rose 130 per cent between 2000 and 2005 even though the FTSE 100 London stock index was down 30 per cent. Then GUS took the final steps: it spun off Burberry, then separated its information services and its retail operations into two separate companies: Experian and Home Retail Group. All three have increased in market value since the de-merger.

Untapped customer insights Most large companies gather considerable amounts of data about the people and businesses that buy their wares. But it's not always clear how much they actually know about those customers. In a recent series of business seminars, fewer than 25 per cent of participants agreed with the simple statement, "We understand our customers". In a 2004 Bain survey, we asked respondents to identify the most important capabilities they could add to their business to trigger a new wave of growth. "Capabilities to understand our core customers more deeply" was at the top of the list.

Companies and their customers often have dramatically different views of the customer experience. A year ago, we asked executives of 362 companies if they believed they delivered a "superior experience" to their customers, and 80 per cent replied that they did. When we asked customers a similar question about the companies they bought from, they gave superior marks to only 8 per cent of companies.

For just this reason, customer insights and relationships are often hidden assets. A company might discover that one neglected segment holds the key to far more growth than in the past. It might find that it is in a position of influence over its customers, perhaps because of the trust and reputation that it enjoys, and that it has not fully developed this position. Or it may find that it has proprietary data that can be used to alter, deepen or broaden its customer relationships. It is somewhat unusual, of course, to find an untapped segment of customers that is poised for such rapid growth. But it isn't at all unusual for a company to find that it has deeper relationships with customers than it

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De Beers’ experience shows how a variety of insights about consumers and interactions with them can completely transform even the most traditional business. De Beers had long-standing relationships throughout the diamond industry. Its very name stood for the finest diamond gemstones. That, decided Nicky Oppenheimer and Gary Ralfe, would be the basis for redefinition. The company liquidated 80 per cent of its inventory and created a new business model. It built up its brand through advertising. It developed new product ideas for distributors and jewellers and sponsored new ad campaigns. Suddenly couples were buying three-stone rings to celebrate the past, present and future of relationships or the birth of a child. Men were buying rings designed with a male flair. Women were buying “right hand” rings as symbols of independence. Demand grew, and by 2001, the company’s diamond business was valued at $9.3 billion, up from roughly $1 billion just two years earlier.

Underexploited capabilities If there were a business equivalent of Mendeleev’s Periodic Table (which lists the building blocks of all matter), capabilities would populate the cells of that table. Given resources and time, you can combine capabilities to create new properties and powers. As with inert elements, some capabilities are irrelevant to each other; but others can be combined, having multiplier effects and creating enormous commercial power for change or renewal. Capabilities are the third, and the most hidden, of the underexploited assets in our study. Tapping into them is critical to the strategic renewal of many businesses, as well as for strategic incursions on less capable rivals.

Sometimes the best way to obtain a set of missing capabilities is to acquire them, especially if they are extensive, complex, difficult to build from scratch and if your industry is evolving rapidly. That was the situation for Swiss pharmaceutical company Roche, whose risky biotechnology acquisitions have served as catalysts to transform the company. Through a series of biotech acquisitions, Roche found new capabilities from which to draw (or add) science and ideas. And Roche gained a heightened awareness of the growing convergence of diagnostics and pharmaceutical science based on molecular biology. Understanding this, in 1997 Roche decided to build up its diagnostics business by purchasing Boehringer Mannheim, thereby becoming the world leader in diagnostics systems and products. The acquisition also gave Roche a foothold in the fastest-growing and most promising segment of diagnostics: pharmacogenomics, the field of genetic testing and molecular diagnostics. Now Roche dominates that emerging market – a case, so far, in which the separate acquisitions of capabilities in diagnostics and biotechnology were combined to create a new and highly promising core.

When Roche sold its original over-the-counter drug business (which dated back to 1896) and its market-leading vitamin business, the transformation of the core was complete. The structural changes have allowed Roche to double its profit margins to 23 per cent. They reflect the power of investing preemptively in capabilities, of combining capabilities to create new possibilities in the core and of shedding businesses and capabilities that no longer fit the new equation. During the full 16-year span of this example, Roche has increased its market value by a factor of 13, compared with a fourfold increase for the S&P index of pharmaceutical companies and only threefold for the overall S&P 500 index.

The holy grail of capability development is to create a unique set of capabilities – no longer hidden – that can build one growth platform after another, giving a company repeated competitive advantage in multiple markets.
why so many companies are already in crisis when they begin their redefinition. It may also explain why 153 of the companies on the 1994 Fortune 500 wound up acquired or in bankruptcy court. If your ship’s radar focuses only on the next fifty feet of travel, you won’t see distant obstacles (or tidal waves) in time.

The first step in taking a longer view is to look hard at five important areas. First, define and assess your core customers. They are your most profitable and most loyal and are central to the way in which your business creates value. This definition and assessment can be difficult, but strategy simply doesn’t work unless it begins with the customer. Second, you must figure out your company’s key sources of differentiation, whether they are strengthening or eroding, and why. Third, focus on your industry’s profit pool, a variable that is often ignored in companies’ relentless concentration on growth and market share. You must determine where profits can be earned. Who earns them now? How is this likely to change? Fourth, assess your company’s capabilities. Finally, probe your organization’s culture and ask yourself whether that culture is ready for change. By looking at these areas with clarity, you can begin to contemplate whether and how to redefine your core.

Yet, the essential starting point for redefinition should be your core customer. It’s never enough to search only for a hot market, a big strategic idea or a promising new technology. The redefinitions that work are grounded in detailed behavioural patterns and economics of specific, identifiable customers. The Danish company Novozymes, for instance, knew precisely who would buy the bioengineered enzymes that their scientists could develop. And the company made sure that the scientists worked hand in glove with those core customers so that the end product was exactly what they needed.

And keep in mind that, although the subject at hand is strategy rather than organization, management technique and implementation planning are equally important. Finding hidden platforms for growth may also require new lines of sight – new ways of looking at your business and the environment it competes in. These assets are hidden from view, after all, not because they are somehow invisible, but because nobody appreciates their potential. Managers ignore or overlook them because the assets weren’t fully exploited in the past and probably because everybody else is ignoring or overlooking them as well. It is no accident that so many redefinitions were begun by new CEOs during their first 100 days on the job. But there are other paths to new perceptions. Try asking front-line employees for their perspective; they deal with customers every day yet are rarely consulted for strategic insights. And look beyond your four walls for ideas. Some of the most successful corporate rejuvenations of recent years have been fuelled by what we and our colleagues have termed open-market innovation, meaning innovation pioneered in one context – be it another business unit, vendor, customer or even competitor – and then adapted for use in another.

Successful strategic renewals using hidden assets must satisfy four criteria: (1) clear and measurable competitive differentiation, (2) tangible value added for the customer, (3) a robust (and often new) profit pool and (4) the ability to obtain the needed capabilities for implementation. Like the four essentials of a good golf swing, each of the four essentials of strategic renewal sounds doable on its own and not daunting. The difficulty comes in doing all of them at one time and then repeating them over and over. Apple’s iPod-based redefinition succeeded precisely because the company could meet each of these requirements. Missing any one of them would have torpedoed the entire effort.

Today’s world serves up a never-ending array of temptations, distractions, uncertainties and sources of doubt. Management teams can bounce like ping-pong balls from one issue to another; they may never really understand what their core is, let alone whether and how to redefine it. Those that do understand their core and who begin to redefine it face a challenging task even if they are able to find hidden assets to help them. For most, however, it is the only available path to sustained growth.

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