

Your Company is Killing Itself: Achieving success is difficult, maintaining it is even tougher.

By Eric Balinski & Mark Sauter

Organizations in their quest to continually differentiate themselves – a noble pursuit – build cost into their infrastructure that ultimately shrink profit margins and erode their competitiveness as their businesses mature. If not addressed, this insidious erosion will signal the demise of once proud and successful organizations.

Customers and the Bottom-Line

In 2001, 257 publicly held companies with \$258 billion in assets declared bankruptcy in the United States. This surpassed the previous worst year for bankruptcies, 2000, which saw 176 companies with \$95 billion in assets declare bankruptcy. In the 2001- 2002 bear market, 26 Fortune 100 companies lost at least two-thirds of their market value. In the first quarter of 2002, 67 companies went bankrupt. ¹

Much has been written explaining this disturbing phenomenon. These explanations include: loss of focus, loss of leadership, excessive spending, poor customer satisfaction, inefficient business processes, competitive pressures, declining market conditions, bad IT systems, employee issues, internal focus, executive arrogance, complacency, and so forth.

While all of these are contributing factors, the decline of business today often has a simpler and more profound explanation. Namely these companies lost sight of the value they provide customers and how to do it efficiently. While they focused on capturing growth, making profits, or managing costs, they failed to analyze the way they conducted business both in the front and back office operations. During periods of success, many companies exhibited attitudes and behaviors that

confidently propelled the company forward without realizing subtle implications around them.

We believe that these attitudes and behaviors actually mask what's really happening inside many companies, that is:

- 1) The growing disconnect with what is or could be important to customers,
- 2) The failure to recognize that the company's success depends on customers value, and
- 3) The people, processes and costs in the business are not aligned to what customers will really pay for.

In a world where capitalism has emerged as the dominant economic and customer model on which businesses are built, companies are likely to continue to struggle. The critical question then becomes, ***how can a business grow and sustain profitability and/or how can a business with poor performance revitalize itself?***

Revenue or Profit – You Decide

Any business, big or small succeeds because it brings something to the marketplace that people are willing to pay for. That is, the business has a value proposition that a segment of customers see value in and then buy. The better the value proposition is from the customer's perspective, the better chance the business has to attract and gain these customers.

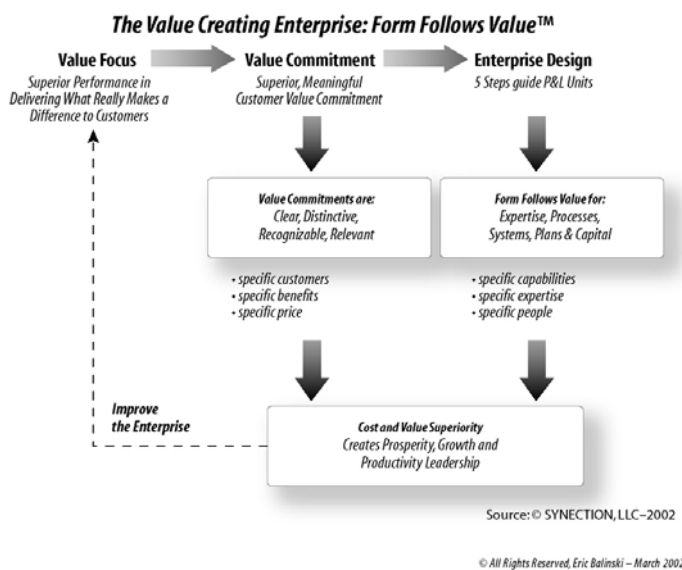
However, in today's haste to deliver "added value" organizations shouldn't lose sight of another basic principle of business – are you doing it profitably?

Form Follows Value™

Companies that create both superior customer value and profits are companies that focus their precious expertise, processes, resources and capital to deliver value for customers with a cost structure perfectly aligned to customer value. We call this systematic structuring of back office resources and operations to deliver the promise of the front office customer value: ***Form Follows Value™***. Any

company, in any situation, can implement Form Follows Value to achieve strong business performance and profitable customer relationships.

This framework aligns the business **Form** (with Form referring to the resources, people, processes, and systems- the *back-office*), to the *front-office Value* that is most important to customers, *and* to what they **will pay for**. This is also a more advanced strategic use or view of cost-to-serve. That is, every cost is aligned within the company to those elements the targeted customers will derive value from. As such, any costs must be seen to have a strategic significance in the decisions, planning and operations of the company. How these costs either enable or detract from delivering customer value must be carefully considered.



Additionally, *Form Follows Value* leads to a prioritization of the benefits that a company offers rather than an ever increasing drive to delight customers in more costly ways. Prioritizing the components of customer value gives a business the ability to reallocate resources based upon those most critical to customers. Conversely, the lower priority activities and resources are realigned to areas that have the greatest impact for customers. This strategic approach to cost-to-serve customers provides a common-sense principle to also enhance

the implementation of any ABC-accounting, CRM or ERP systems.

Success in the Toughest Industry

If you picked the worst industry in which to compete over the past two decades, it would be the airlines industry. Of 48 major industries analyzed in the Fortune 500 issue of Fortune magazine, April 14, 2003, the airline industry ranked 48th in the 48 industries reviewed. The airline industry lost (8.3%) total return to shareholders from 1992 to 2002, the worst of any industry. And while 2001 and 2002 were rough years for every business, they are also years all major airlines but one, Southwest, lost money. Southwest made \$511 million and \$241 million in 2001 and 2002 profits, respectively.

While much has been written about the amazing success of Southwest Airlines, little points to what we believe are the two most critical drivers of their sustained success. First, they discovered what really made a difference (**Value**) to a specific group of business travelers. That is, they specifically defined customer value factors for short-distance business travelers that were important and measurable: fastest point to point transportation and cheapest. Secondly, Southwest then diligently built its business based upon this specific customer value dimensions. Thus, every process, person, system in their organization (**Form**) was structured and run to deliver this value to its customers. The *back-office* operations of Southwest delivered exactly what the front office had promised customers. Southwest has become the most profitable airline because every decision, ranging from what planes they fly to whom is hired are completely aligned to the value they bring short-distance business travelers.

In this age of total customer satisfaction, ironically Southwest did not/does not provide many things customers satisfaction surveys have historically said an airline needed. Southwest recognized pre-assigned seats, inter-airline ticketing, baggage handling and food service all raise costs.

When it compared these costs against the value they could deliver and had the strongest impact on customers, it decided not to provide them, even when customers asked for them.

Southwest has also achieved exceptional financial performance in an industry that long-term, typically makes no profit. It is the only major airline in the world that has made money consistently every year. Southwest's performance from 1990 to 2000 averaged a total return to investors of 34.8 percent. By 2000, Southwest had consistently become one of America's most admired companies, returning 37.7 percent from 1995 to 2000, with a whopping 108.2 percent in 2000. In comparison, GE delivered 28.6 percent from 1990 to 2000, a 34.0 percent return from 1995 to 2000, and a total return of (negative 6.1 percent) in 2000. And while 2002 was a tough year even for Southwest and its investors, it still made a profit. Its ten-year total return to shareholders (1992 – 2002) was 13.7%, the only positive return for any major carrier in this time period.

Conversely, Continental Airlines, which boasts the highest customer satisfaction within the industry, lost \$95 million in 2001 and \$451 million in 2002. Yet as of April 7, 2003 Business Week states, "Continental Airlines Inc. has weathered this storm better than others due in part to its lower costs. Yet the carrier continues to lose money and its unit-cost disadvantage to low-fare players is more than 60%."

Southwest Airlines CEO Herb Kelleher stated in *Money Magazine* in June 1999, "When we started out, the people of Texas weren't willing to settle for peanuts either. You have to establish a different value system."² His statement suggests that there is a proactive system approach (**Form**) for creating a better business. Southwest Airlines **first** discovered what the best **Value** was and **then** consistently made outstanding returns for investors after its initial start-up phase because its *back-office* operations were systematically structured to this customer value.

Herein lies the real reason why other airlines will continue to struggle. All major airlines, except Southwest (and now Jet Blue), fail to first determine who their target customers are and the value they bring to them. Unfortunately, airlines focus on only cutting costs in *back-office* operations to survive rather than working to deliver the best value through an organization structured to deliver it at the lowest cost. And while other major airlines call themselves "high value" carriers, they are really expensive carriers delivering inferior value to customers.

Though many in the airline industry look to the economy, terrorism and the recent war to explain their poor performance, as BusinessWeek points out, "the airlines deserve plenty of the blame for their current agony. During the boom of the 90's, they lost control of costs and then passed the burden along to high-paying business passengers by raising business fares 79% in five years."³ Oddly enough, **during the boom times, the industry also had a negative total return to shareholders.** This hints at the deeper issues killing companies in the industry.

Equally intriguing to Southwest's shareholder performance is its high customer satisfaction level and excellent safety record while maintaining the lowest cost structure in the industry. In addition, Southwest continues to have highly motivated and well-paid employees, and the airline is still aggressively sought by airport authorities to serve their cities.

The real demonstration of Southwest's greatness as an organization and as a company worthy of emulation came in the wake of the September 11th tragedy. Southwest did not solicit the government for bailouts or institute lay-offs, as did its industry peers. In fact, Southwest has **never in its 30 years laid-off a single employee.** How many people would love to work for a company like Southwest?

It is also a tempting over-simplification that better leadership or employee programs achieve better business performance. But these are not

likely to be sustainable if a company's value to customers is inferior. Our belief is that superior value for customers, with appropriately aligned business processes and organizational structure, creates the most successful business. This is what leadership needs to focus on and implement. In turn, this can ultimately foster progressive employee practices by providing a clearer sense of purpose and results. This is the secret that Southwest Airlines figured out. It is what they have practiced diligently for 30 years.

Good People – Wrong Things

Organizations are inherently made up of many good people – most with the best interests of their customers in mind. However, *people without vision perish*. Or in the case we're making, people without clear understanding of their customers' priorities may be working hard, however, on the wrong things.

As a company grows - the *front-office* sales and marketing operations are selling more *value* to more customers - powerful changes slowly begin to occur in the *back-office* operations of the business. More people, systems and resources are added to produce, sell and service the growing customer base and emerging customer requirements. With each new customer request comes an implication for another bit of expertise, service or feature to be added. Ultimately these grow into *back-office* departments, staffs and *front-office* value-added bundles that eventually become permanent parts of the cost structure of the company. The more diverse the customer base becomes the more complex and ambiguous the cost structure of both the front and back-offices become. The business now is providing a bigger bundle of "Value Adds" to its customers but finds its highly competent and full service organization is out of focus, too costly and losing customers and profits anyway.

On the one hand these changes appear logical and very natural for a growing business. Yet, for

most companies the growth and changes are the root cause of the business' own decline in profits. **What most people fail to understand and manage is how their front office success effects the back office operations, and vice versa.**

Dramatically Improving a Company

While the Southwest example provides compelling evidence of the benefits of *Form Follows Value*™ thinking, what's less obvious is the fact that Southwest has successfully inculcated this mindset into their culture from its inception. But what about the more common situation where this mindset may not be built into the culture?

It's important to compare Southwest's example with how *Form Follows Value*™ applies to organizations that face issues common to most companies today: undifferentiated brands, escalating non-product costs; eroding profit margins; increasing competitive inroads; and declining customer satisfaction.

Dow Corning Corporation is an organization that has faced challenges like these and even some bigger obstacles. With a long history of innovation and market success, it required significant transformation of mindsets and business approaches to meet these challenges head-on. The strategies that made Dow Corning a leader in its industry for 60 years were no longer right to deal with the dynamics of today's customers. And like many organizations facing similar challenges, it needed to realistically assess the very things in its organization and culture that had made it successful.

Dow Corning, by focusing on customer value and *Form Follows Value*™ has begun to transform the company. It's a work-in-process example yet the strides made can provide a helpful perspective for other organizations who want to reach a higher level of business performance.

Since its formation in 1943, Dow Corning Corporation was a market innovator in the specialty chemical industry, more specifically with regard to silicone materials. It grew by innovating new products and applications with customers. Paralleling its success were customers who were innovating and growing their businesses using Dow Corning materials. Both Dow Corning and its 25,000 worldwide customers prospered together, but over time as the customer's business grew and its markets matured, customer value changed between Dow Corning and its customers. The reality was that they were collecting an ever larger collection of mature businesses. Although Dow Corning still intended to grow its innovation leadership position, it became clear that an increasing number of customers needed Dow Corning to offer a second customer value based on lower costs in its mature product lines so customers could remain competitive in their markets. Dow Corning's sales and profits now came from at least two distinctive customer groups, yet they were attempting to serve both using one business model.

More insidious was the gap between the prices its mature products could command in the marketplace and what had become a wide-spread belief in the Dow Corning culture -- their commitment to "innovation" was sufficient to continually command higher prices. Over time, Dow Corning's business model, including its systems, processes, management and rewards further evolved to strengthen its innovation focus with its customers, while overlooking the needs of maturing markets. Its sales efforts cost more and were directed toward selling value-added packages of innovation that weren't necessarily required by a significant portion of their customer base.

For a company with a history of success through innovation, this emerging customer group represented a contradictory message for Dow Corning's employees and business model with which to deal with. It had actually built a "*form follows value*" business model to effectively serve customers

who valued innovation. As such, the model did not serve well the customer value that emerged in mature markets. Additionally, it was becoming ever clearer that some competitors who weren't as vested in innovating with customers were willing to buy the maturing customer markets with a lower price offering than Dow Corning had. The critical strategic decision in front of Dow Corning now was to either, stay focused only with customers who valued innovation or find a way to serve the segment of maturing customer needs as well.

The changes in the company didn't start with a realization of this value-shift issue. Like many organizations they initially focused on internal cost optimization and re-engineering work processes to improve their operational efficiencies, which certainly helped, however, fell short. Also, consistent with their history, they focused on optimizing their material innovation processes, necessary, yet insufficient when considering the shifting needs of their maturing markets.

Their journey to change the company began in the late 90's when Dow Corning faced intense economic pressures. They have been in Chapter 11 bankruptcy protection since 1995 - brought on by lawsuits regarding the safety of breast implants. Significant competitive inroads had been made into its markets and customer base during the 90's, as Dow Corning's attention was focused on its legal issues.

As everyone worked harder to become more productive and competitive, its leaders gradually realized there was something missing. "***The real insight began when we applied value-based marketing principles to each of our global business units***" relates Scott Fuson, Global Executive Director Marketing and Sales. "*After applying a customer needs-based segmentation methodology, we began to realize that there was a significant sub-set of existing customers who buy for very different reasons than innovation. This led us to develop an enterprise-wide look at our customers, then we*

created distinct and compelling value propositions and business models (Forms) for each of the customer needs- based segments we identified.”

Thus, each customer value segment represented a commitment and potential change in the way Dow Corning's businesses approached their customers. It was the first time the company deviated from the assumption that all customers equally valued Dow Corning's innovation to determining what was valued by specific customers in each customer value segment.

In addition, this value-based work also provided direction to internal support operations as more precise decisions could be made on cost elimination, capacity investments, and structural and resource realignment. Significant reductions were made in non-product related costs, while at the same time improving the value offered to their customers.

An important insight from the work conducted was the realization that one or more of the customer value segments cut across the traditional industry segments around which Dow Corning had organized its business and the corporation. The identification of each customer value segment enabled management to define needed resources in terms of people, infrastructure and financing. Its new emerging form would now follow and be aligned to the distinctive value it identified in each customer segment. This included the creation of an entirely new business **Form** for customers in mature markets who required a low price and reliable global supply but who didn't require technical service. This new brand positioning became the company's Xiameter™ brand (launched in the spring of 2002) which provided a web-enabled, lower cost, global supply option to customers. These efforts have enabled Dow Corning to proactively respond to the additional customer value expectations occurring in the marketplace without the innovation and technical service costs being passed on these customers that traditionally came with all Dow Corning products. Providing this option to this

group of customers also did not penalize Dow Corning's own profitability, because both groups of customers were now being managed by the offering that was most important to them.

As stated by Gary Anderson, Dow Corning Chairman and Chief Executive Officer, *“Our goal is to provide exactly what customers want, so that they pay only for the products and services they need. We anticipate these changes will provide a key point of differentiation for Dow Corning.”*

The Dow Corning changes were guided by the recognition that there was other real value that their customers sought. Recognizing this was a critical first step, however, their leaders' ability and courage to orchestrate the necessary enterprise transformation was essential.

As Dow Corning President, Stephanie Burns concludes, *“We've spent the past 5 years transforming Dow Corning from a product-focused supplier into a customer-directed company.”* Dow Corning invested more than \$100 million in a global information technology platform, expanding our e-commerce services, and redesigning business processes to be in synch with specific customer value it would provide.

Their commitment to this approach over time will be critical; otherwise any improvements would likely revert back into one business structure again. This tends to be one of the main follies of most restructuring and cost cutting efforts which force an either or choice between building a stronger company financially or improving customer value. In the case of Dow Corning, implementing **Form Follows Value**™ is a systematic dedication to continuously improving the company by aligning completely to customer value to improve all measures of performance, including financials. It can be tough, slow work, but work that over time produces a very cost efficient, productive and value generating company.

By following the principle of *Form Follows Value*, any organization, can both change and improve its culture to obtain a higher level of business performance. The dedication to such an effort enabled Dow Corning, in the spring of 2002, to formally introduce its redesigned market approach, both with the re-positioning of the corporate innovation brand and the launch of the web-enabled Xiameter™ brand. While it's still premature to claim total victory; however, first quarter 2003 performance indicates they are outperforming current industry and economic conditions. Q1 sales increased 13% to \$658.7 million over 2002 Q1 and net income increased 57% to \$35.8 million over 2002 Q1. In addition, Dow Corning's 2002 full year revenue of \$2.61 reflected a 7% increase over 2001 revenue at a time when many companies in the industry were stagnating or losing money.

Dow Corning's revitalization illustrates how a company can transform itself and become a more effective organization. They accomplished this by educating, aligning and focusing their people and processes around customer value, re-engineering their decision making processes and creating a culture focused on providing value in each customer segment they identified. The re-tooling of the organization is allowing Dow Corning to reclaim its leadership position in the marketplace by providing the value their customers require, and doing it in a profitable and sustainable manner to the benefit of all stakeholders (customers, employees, and shareholders). The example of Dow Corning, as with Southwest, proves the notion of *those who serve, prosper* which, in today's difficult times, serves as a framework for sustainable success.

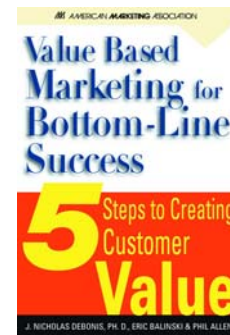
***“Value is in the eyes of the beholder ...
And in the wallet of the one who has to pay.”***

- 1- “Why Companies Fail.” *Fortune Magazine*. Cover Story- May 27, 2002 Charan, Ram and Useem, Jerry.
 - 2- “How Herb Keeps Southwest Hopping. Investing – CEO Speaks”, *Money Magazine*- June 1999
 - 3- “Can Anything Fix the Airlines?”, *BusinessWeek*, April 7, 2003, by Wendy Zellner & Michael Arndt.
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About Authors:

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