What Customers

One reason British Airways beats American: smart coddling of business fliers from New York to London.

Why does Dell Computer continually make money and gain market share selling commodity products that decline in price every day, while other companies in the same business struggle to earn a dime?

Why has Royal Bank of Canada increased revenues by $1 billion over the past three years while also cutting costs by $1 billion—its stock rising 100% while the market has tanked?

Why has BA for years beaten the daylights out of American Airlines in the highly lucrative business of flying customers between New York and London in first class—using the same kind of aircraft between the same airports?

Though these companies operate in very different industries and face widely diverse challenges, the major reason for their success is the same. They are putting their customers at the center of their business in ways most companies do poorly or not at all. They understand that success depends most fundamentally on the profits they earn from customers—and on management's ability to improve that profitability by creating competitively dominant customer experiences, or *value propositions.*

We learned this lesson by spending two years examining how companies can best meet the challenge of growing profitably. The patterns we've seen are remarkably consistent. It turns out that great value propositions produce sustained, superior returns much better than do hot products or strong geographic presence. A small but growing number of companies—including Dell, Royal Bank of Canada, and Fidelity Investments—have created and executed highly distinct, competitively dominant, profitable value propositions for different customer segments. By doing so, they improved performance significantly, sometimes spectacularly.

These companies calculate the amounts they earn or lose from customers using the measure that counts: economic profit (net operating profit after tax, minus a capital charge). They learn

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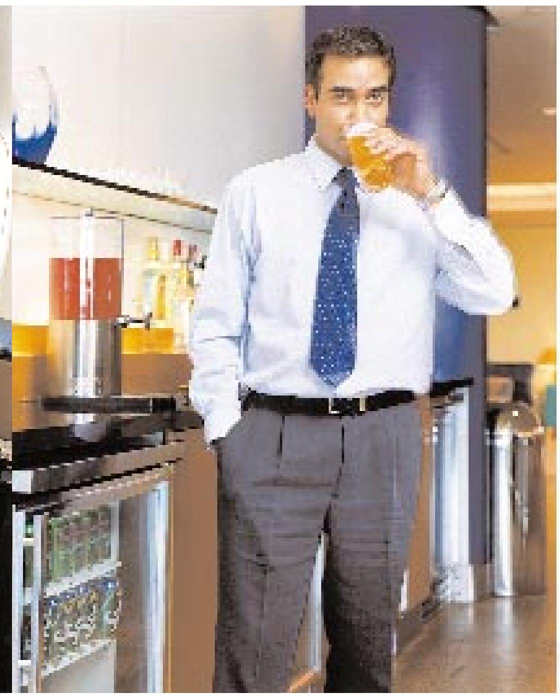
PHOTOGRAPHS BY RICK LEW



Want

Incredibly, most companies scarcely know. Here are six steps to boost your stock by getting it right. **by Larry Selden and Geoffrey Colvin**

new thinking
new products
smart moves

that the best 20% of customers often generate 150% of the company's total economic profit, while the worst 20% can lose 75% of the profits (see "Will This Customer Sink Your Stock?" on fortune.com). To increase overall profitability, they retain and grow their most profitable customers and acquire more of them. They fix, close, or sell their least profitable customers. And they organize in a nontraditional way, around customer segments.

Every company has value propositions. Most just aren't very good. Think of Kmart. At various times it tried to mimic Wal-Mart's everyday-low-prices value proposition or Target's hipness-on-a-shoestring, but it couldn't execute either one and couldn't create a superior value proposition of its own. Result: Chapter 11.

A winning value proposition is the one that best meets the full set of customer needs, including price. That is, certain critical elements of the experience deliver on the customers' most important needs better than the competition. This creates differentiation and the potential for superior customer profitability—a mutually beneficial value exchange. Your goal is to create mutually beneficial value exchanges with customer segments that offer the greatest economic profit potential.

Creating, communicating, and executing competitively dominant value propositions that earn exceptional customer profitability involves a six-step process we've identified at leading companies and dubbed value proposition management.

Step 1: Figure out the needs of your most profitable customers

Imagine a lawyer, investment banker, or senior executive who frequently needs to fly from New York after a full workday for meetings the next morning in London, then return to New York for an evening board meeting. The needs of any customer in this segment are quite specific and similar: saving time and getting rest. BA and American Airlines both offer value propositions—which consultant Michael J. Lanning has elegantly defined as complete experiences—for these customers. The experience starts when the customer realizes the need for the trip and comprises each interaction with the airline: making the reservation, arriving at the airport, checking in, clearing security, boarding, eating, sleeping, deplaning, and going through customs in London, with most of the process repeated on the return flight. The experience's final elements include posting the mileage to the customer's frequent-flier statement and charging the cost to his credit card.

Looking across the population of customers, an airline would find that the most profitable 10% of customers are heavily populated by frequent first-class fliers on the New York-to-London route. This group is profitable because its members travel often and pay the full first-class fare. Further analysis would show that these customers frequently depart from New York in the evening and return late the following afternoon; often they don't even stay in a hotel. Demographic analysis would indicate that these travelers are senior business executives concentrated in a handful of industries. Interviews with customers would reveal common critical needs: saving time on departure and arrival, and maximizing restful sleep on the plane.

It's not enough to create the best experience; it must also be communicated superbly.

Step 2: Get creative

"Everything starts with hypotheses," says Gaétane Lefebvre, vice president of strategic marketing research and analytics at RBC Financial Group, parent of Royal Bank, one of the most sophisticated companies we know when it comes to creating effective value propositions based on deep understanding of customer needs and profitability. She means that managers must imagine new, competitively superior value propositions. Through creative hypothesizing, Royal Bank has developed many profit-boosting new products and services, such as first mortgages and estate settlement. Lefebvre, whose department collects and analyzes vast amounts of customer data for RBC, loves going through printouts of such data, sliced and diced in various ways, looking for insights.

In our airline example, understanding the needs and behavior of the New York-to-London senior executive might lead one to imagine a value proposition. There could be separate first-class express check-in and security clearance, a preflight express meal service in the first-class lounge so that the time-pressed senior executive could maximize sleep time on the plane with minimum noise from the serving of in-flight meals, seats that recline into perfectly flat beds to provide restful sleep, and a fast-track customs area in British airports to speed the executive on his way. Of course, these changes would involve costs—some minor, some major. For this value proposition to work for the airline as well as the customer, this segment would have to pay a higher fare, perhaps by losing its deep corporate discounts.

Hypothetically speaking: Royal Bank of Canada's Lefebvre

NADIA MOLINARI

Step 3: Test and verify your hypotheses

For testing through experimentation, hypotheses need to be specific and measurable. For example: The most popular flight times will be 100% sold out, with more than 90% of the customers coming from the target segment. Market share within the segment will exceed 80%. Churn among targeted customers will decline from 11% to 3%. Corporate discounts will decline from an average of $3,500 to $0. At least 85% of the senior executive segment will use the preflight meal service.

Against hypotheses like these, managers can find exactly what's working and what isn't. But they still won't make a wise decision on whether to roll out the value proposition in a big way unless they remember the real bottom line. It's vital to carry the analysis all the way to the initiative's effect on customer economic profit, on the company's share price, and on the P/E ratio. Only then can you make a sound judgment about the success of a value proposition.

Step 4: Tell customers how great your value propositions are

No value proposition will succeed in delivering exceptional economic profit to a company unless the target customer segment perceives the offer as meeting its needs best. So it's not enough to create the best experience and execute it well; it must also be communicated superbly. Everyone knows Wal-Mart has low prices every day. In truth it can't always offer the lowest price on every item, but so many millions of consumers know Wal-Mart's everyday-low-prices value proposition, and have experienced it, that the company brings in more revenue than any other company in the world.

Step 5: Apply the best value propositions on a large scale

Someone must be explicitly accountable for formulating customer-segment hypotheses and for implementing them to achieve results. This may seem self-evident. But many companies that think they're gung-ho users of customer knowledge in fact assign responsibility for it to the marketing department or the sales operation. That won't work because people in those areas can't be held accountable for the total customer, and they may not have access to the full trove of customer data the company may possess or be able to get. Only customer-segment chiefs who are fully accountable for total economic profit from specific customers or segments—that is, whose heads will be on the block—will cross departmental boundaries and make things happen.

Step 6: Begin anew

Even the most successful initiatives need to be revised or reinvented over time. Competitors improve their value propositions, consumer tastes change, the economy booms or busts, customers get older—these and many other shifts in the environment can turn a winning idea into a loser. By rewarding customer-segment chiefs for continually gathering data, analyzing it, forming hypotheses, testing them, and scaling the winners, a company is learning. That learning makes the next iteration of the cycle more effective—and helps the company produce an ever-increasing competitive advantage.

Where does this leave you? You can be among the first in your industry to create dominant, mutually beneficial value exchanges with customers, like Dell, Royal Bank, and Fidelity. Or you can get blindsided like Kmart. That's your choice.

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Scandal hits—now what?

Before Enron there was Waste Management. Here's how it came back from the brink.

BY JULIE CRESWELL ■ Remember Waste Management? In 1998—well before Enron, Tyco, and WorldCom provoked America's outrage—the nation's largest trash hauler was embroiled in one of the biggest accounting scandals ever. Regulators accused its top officers of engaging in massive fraud while pocketing almost $29 million in annual bonuses and gains from insider trading. The company, which restated over $1.7 billion in earnings over five years, went through five CEOs between 1996 and 1999, and its stock lost more than $25 billion in value. The turmoil allowed a smaller company, USA Waste Services, to take over the crippled giant in a merger that later failed miserably and resulted in more than $1.2 billion in charges.

That was the smelly mess facing A. Maurice "Maury" Myers when he took over Waste Management in November 1999. Myers, now 63, had succeeded in turning around two other troubled companies: trucking firm Yellow Corp. and America West Airlines (he left in 1996 after having tripled the stock price in two years). Today, after nearly four years of steady effort, Waste Management's odor is decidedly sweeter. Myers has managed to reduce the company's debt by nearly a third, to $8.3 billion; the stock has soared 85% from its March 2000 low. Meanwhile, net income rose 9% last year; free cash flow is expected to jump 30% this year, to nearly $1 billion. This past spring came a huge milestone: Rating agencies upgraded Waste Management's debt from junk to investment grade. Perhaps most important, Waste Management is no longer a pariah. "There has been a complete change in this company, with new talent, new direction, new focus, and new priorities," says Roman Szuper, a debt analyst at Standard & Poor's Ratings Services. "Investors like what they've seen so far."

ANDREW HETHERINGTON

CEO Myers's first step: Regain the trust of employees like these.

What did Myers do, exactly, to scrub the taint of scandal from the garbage hauler and get it performing again? His first task, he told FORTUNE while touring the sparkling-clean company facilities in Rochester, N.Y., where

MISTY KEASLER

Waste Management's high-tech Houston data center plots efficient truck routes.

he comfortably cracked jokes with office workers and truck drivers, was to regain the trust of his employees. "In a crisis like this," says Myers, "you don't want to risk losing valuable people" who are critical to driving the recovery.

He was just one week into the job when he realized how dire the situation was. About 10,000 of the 55,000 company paychecks had been sent out incorrect, shortchanging the workers. Myers immediately began visiting Waste Management workers around the country. Employees were upset not only with the paycheck problem, they told him, but also with the company's benefits plan. Within a few weeks he had begun updating the payroll system and offering enhanced benefit options. "We quickly fixed the things we could fix," says Myers, "which showed the employees that we really did care about them."

To get ahead of the hyperdrive rumor mill, Myers also launched a weekly company newspaper. This isn't the typical company mouthpiece trumpeting the firm's baseball team scores or employees' anniversaries. It talks about real company issues, like customers the firm lost and why it lost them.

To show that the new Waste Management valued doing the right thing, Myers created an anonymous hotline for employees to call to report improper behavior. It has logged more than 4,600 calls since early 2001, resulting in the termination of 60 employees (all duly noted in the company newspaper) and disciplinary actions for many more. Myers also reestablished the position of ethics officer—who trains not only the workforce but the board of directors as well.

The CEO was also rushing to clear up any lingering controversy as quickly as possible. The accounting scandal and failed merger had resulted in over 30 shareholder lawsuits against Waste Management. In July 1999 they were consolidated into a class-action suit. Even before Myers agreed to take the job, he met with Waste Management's lawyers to gauge whether the suit could be settled. "As long as there are lawsuits outstanding, you'll have more and more people making claims against you," says Myers. "Furthermore, Wall Street hates uncertainty. They worried the settlement would start with a 'b'—as in billions." (In late 2001, Waste Management agreed to pay $457 million to settle the suit.)

> "We quickly fixed the things we could fix, which showed employees that we cared."

It wasn't until he'd spent three months on the job that Myers finally met with analysts. He didn't promise a quick fix. He told them it would take as long as three years to get the company stabilized and five years to really get it rolling. He explained to the *Houston Chronicle* in 2000, "We will convince investors and other skeptics by underpromising and overdelivering."

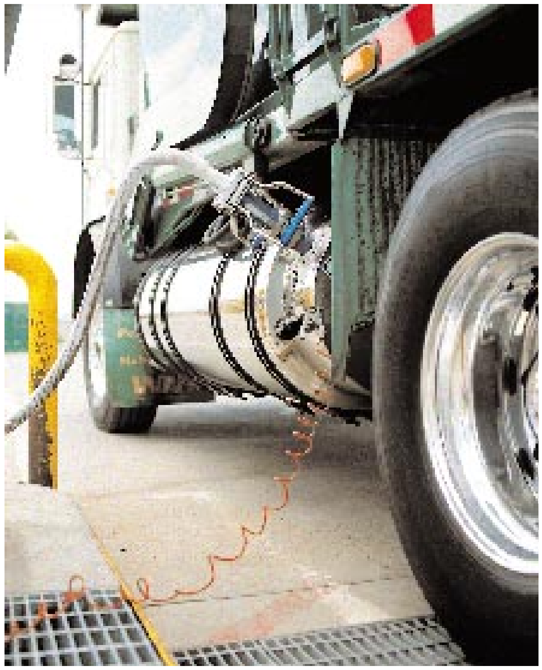
As months went by, it became clear to Myers that Waste Management had another big problem. It didn't know enough about its business. The company had never fully integrated the thousands of mom-and-pop garbage operations it snapped up during the 1980s and '90s. When Myers started, Waste Management didn't know how many landfills it owned and didn't keep safety records. That kept insurance costs and workers' compensation costs high.

What's more, the company was paying little attention to a group it desperately needed to impress: its customers. The claims that Waste Management had been making for years—that it was the best in the industry and that it completely satisfied its customers—were just wishful thinking. The company had no way to measure its performance and had never bothered to ask customers what they wanted.

So the company began tracking numerous data—how long it took to answer a customer's call, how many customers reported billing problems, how many garbage pickups the company missed, how many accidents company workers had. Executives were stunned by what they discovered. For instance, 68% of the company's accidents were being caused by 12% of its drivers. Those drivers had typically worked at Waste Management for less than a year and usually were repeat offenders. The answer was simple: The company revved up training and dumped bad drivers. As a result, in the past two years the driver accident rate has fallen 48%.

Another surprise came when the company asked its commercial and industrial customers what was most important to them. It wasn't low prices, as it had expected. Bigger concerns were incorrect billing and missed garbage pickups. So the company upgraded its billing program last year. Since then, accounts receivable have fallen from 71 days to 47 days. "Every day of improvement is worth $30 million to us," says chief information officer Tom Smith, who also worked with Myers at Yellow and America West. "That translated into a lot of free cash flow."

The company knew that missed pickups were often a result of cars blocking garbage bins. So Waste Management launched a program called Haul or Call. Now if a driver sees something blocking the container, he calls the local Waste Management office. The office then calls the customer and asks when it can reschedule a pickup, typically within 24 hours. "Our customers were shocked—literally shocked—when we started to call them, asking when we could reschedule," says Myers, laughing. As a result, the company's customer churn rate has fallen from 12% to 8.6% in the past year.



DAVE LAURIDSEN

To capture efficiencies, the company converts gases from landfills to truck fuel.

Analysts say that Waste Management's hefty investment in technology will help boost profits further next year and beyond. For example, for years garbage routes were configured using maps and pushpins. Now, borrowing from FedEx and UPS, Waste Management is using global positioning system (GPS) technology in combination with route-optimization software to create the most efficient pickup schedules. "The company's goal is to reduce its 1,500 routes by 10% over the next two years," says Trip Rodgers, a research analyst at UBS. "That should result in savings of about $180 million, or 20 cents a share. That's significant."

Next up: Waste Management is giving drivers digital cameras they can use to take pictures of customer bins overflowing with garbage. Those pictures are e-mailed to customers with the suggestion that they consider getting a bigger container. "It's fun for the drivers, and almost always we end up with an upgrade in container size for the customer," says Myers. "This is a very simple way to use technology to drive revenues."

The company has also begun to capture gases released from landfills it owns and convert them into fuel for its trucks. Though the savings are small, the company hopes that the practice will help it win eco-sensitive customers.

Waste Management now is casting for two commercials—its first ever—to show how much it has changed. One thing that hasn't changed, of course, is the name. Did Myers ever consider altering it as a way to distance Waste Management from its past? Yes, he concedes—especially after the 2001 Enron scandal once again pushed Waste Management into the limelight (the firms had the same auditor, Arthur Andersen). But "you're not fooling anyone with a name change," says Myers. "In fact, it's almost insulting to investors."

The CEO—who plans to retire from the garbage business at the end of next year—knows that while consistently strong results may diminish scandal, it will never completely go away. "People have long memories," he says with a shrug. It just means that Waste Management has to keep trying harder. Late last year the company missed earnings because, Myers says, it overestimated the strength of the economy. "That was a mistake. We should have been more conservative," he says. "With these types of companies [that are dealing with scandal], everybody is watching you. You just can't mess up." F

FEEDBACK *jcreswell@fortunemail.com*

Maury Myers's Five Steps to a Turnaround

Regain trust and credibility.
Address employees' concerns before those of Wall Street. If they're not onboard, your turnaround will fail.

Clear up remaining controversy.
Settle lawsuits as quickly as possible and clean up financials, if necessary.

The past will haunt you. Deal with it!
Investors have long memories, and no quick-fix name change will alter that. But steady results may.

What are we?
Figure out what assets you own and what your competitive advantage is. (If you don't know, ask your customers.)

Technology, technology, technology.
Improve efficiencies by investing in technology that's better than what your competitors have.