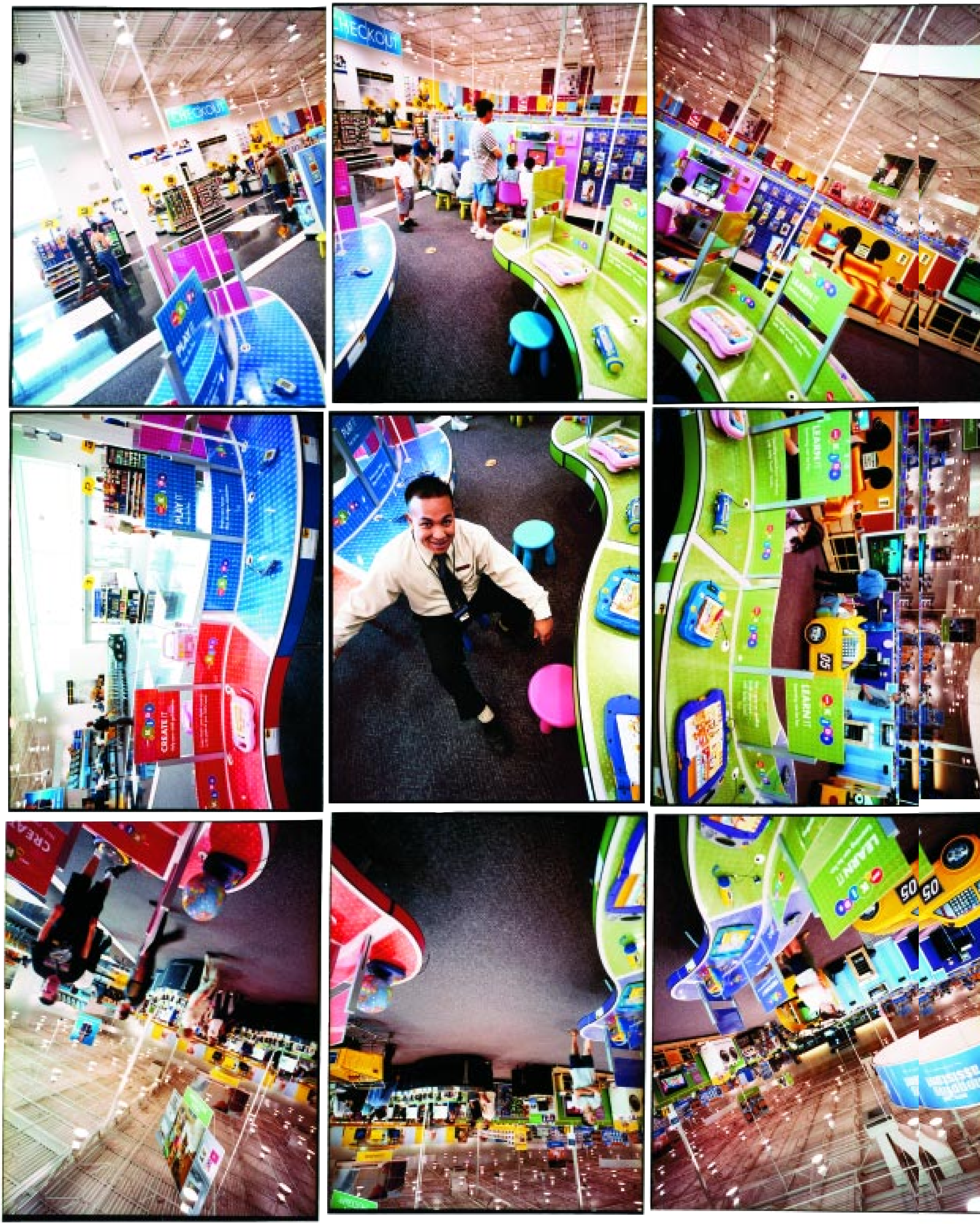

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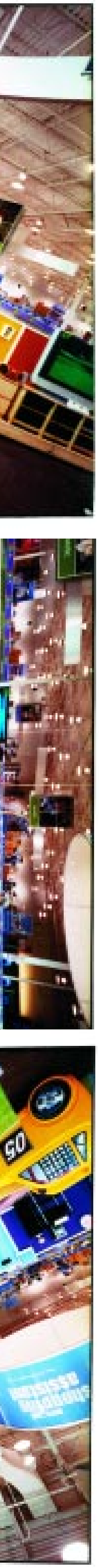


Sure, companies say they **put customers first.** But only a few do. They're the ones whose stock you want to own.

BY LARRY SELDEN AND GEOFFREY COLVIN

5 Rules for Finding the Next Dell

DELL, BEST BUY, and Royal Bank of Canada are stocks you wish you'd bought years ago. They've all been knockout performers for shareholders for the same reason: Each has truly put customers at the center of its business. And we mean truly—not in the golly-aren't-customers-great way that most companies have hyped for years but rather in a way that transforms the entire business. If you'd like to spot more such stocks, consider this vignette about electronics retailer Best Buy, related by UBS retail analyst Gary Balter:

Balter walked into one of the company's stores in Pasadena in May and met an employee named Matt. What was most remarkable about Matt wasn't his helpful demeanor or plentiful pleases and thank-yous but rather what he knew about his customers—including one key group of them. Best Buy even has a pet name for them. After carefully studying the area around its Pasadena store, the company concluded that one highly promising bunch were upper-income soccer moms, which the company singularized as "Jill." And it wasn't just the store manager who knew about Jill and her shopping ways, but sales people right down the line. Matt, for instance, took the time to explain to the visiting analyst that small appliances hadn't been selling well, even though they'd been chosen with Jill in mind. So, based on interactions with customers, hourly workers moved the items from high shelves above major appliances to low racks along the main walkway. Small appliances are an impulse buy for Jill, and this way, if she needed a kitchen mixer, she wouldn't have to go over to the stoves but could find it along an aisle she frequents. Small-appliance sales soon rocketed.

But that's not the best part of the story. More surprising was that employees understood how reconfiguring the sales floor would improve the Jill segment's sales and return on invested capital, a measure that drives Best Buy's stock price. In this case they knew that selling more small appliances would not only raise profits but also do so without increasing invested capital, since the store just turns the appliance inventory faster. At most companies, employees haven't a clue what their firm's return on invested capital is, let alone the returns on specific customer segments—and even if they knew, they'd be powerless to do anything

WELCOME, MOMS Best Buy's Pasadena store, aimed at "soccer moms," includes a shopping assistant (center).

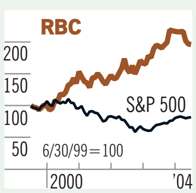
BEST OF THE BUNCH

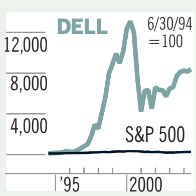
30%

Fourth-quarter sales growth at Best Buy's seven customer-centric stores, vs. 9% for the chain overall.

REWARD FOR GOOD SERVICE

Each of these stocks has beaten the market since the company took a customer-centric approach.





about it. But at that Best Buy store in Pasadena—one of 32 pilot stores testing an initiative called "customer-centricity"—they did. Customers loved the results. While Best Buy's same-store sales grew 9% overall in the company's fiscal fourth quarter, sales at its seven customer-centric stores in the Los Angeles area, including Matt's Pasadena outlet, grew 30%. Balter believes the company is now "in a league with Wal-Mart at its zenith and Home Depot under Bernie and Arthur [co-founders Bernard Marcus and Arthur Blank]." In retailing, praise doesn't get higher than that.

"Customer-centricity" means shareholders as well as customers win, because the customer-centric approach can juice a company's stock with a powerful double boost: rising earnings, plus a higher P/E multiple applied to those earnings. That phenomenon, which we call rerating the P/E, is critical to making stocks rise in this torpid investment environment. The effect is magical: If a stock is trading at a P/E of 20, which is about the market average, and earnings rise 20%, then the stock will also rise 20% as long as the P/E remains unchanged. But if Wall Street decides that the company can sustain that profit growth for years into the future and thus deserves a new P/E of 40, then that 20% gain in earnings sparks a one-time jump of 140% in the stock, after which earnings increases get multiplied by 40. Rerating the P/E has been key to Dell's performance as the best stock of the past decade and to Best Buy's doubling over the past year. We believe putting customers in the hands of educated employees like Matt may be the best way for a company to get its P/E rerated.

Let's be clear up-front that we're blowing our own horn. A book we've written (*Angel Customers & Demon Customers: Discover Which Is Which and Turbocharge Your Stock*) is all about how companies can become genuinely customer-centric. One of us, Larry Selden, is an emeritus professor at Columbia University's business school and has a consulting firm that's teaching many companies (including Best Buy and Royal Bank of Canada) in retail, financial services, telecom, technology, and other industries how to apply those concepts. Companies that embrace this core philosophy, we believe, are benefiting, as are their shareholders and customers. Which leads to the obvious question: How can investors spot the next customer-focused winners—and do it before the stocks take off?

A customer-centric approach can juice a company's stock with a powerful double boost: rising earnings, plus a higher P/E.

Happily, it's easier than you may think. You don't need access to top management or internal company documents. Your own experience as a customer, in fact, can help you sort the true performers from the pretenders. Here are five questions to ask the best consumer expert around: Yourself.

1 Is the company offering you the best complete experience for you?

Only a few companies identify customer needs first, then create complete experiences to meet them. The vast majority just try to make you buy the products and services they already offer. Those companies are product-centric, no matter what they claim.

Here's an example of the difference. Royal Bank of Canada identified an important segment of its customers: snowbirds, Canadians who spend winters in Florida or Arizona. It is obviously a valuable segment, since its members tend to be quite affluent. They want the preferential treatment they get from RBC at home. They want to borrow in the U.S. for condos or houses. They want a U.S. credit rating that reflects their Canadian track record. Through it all, they want to be served by employees who know Canada as well as the U.S. and who can speak French if necessary.

To meet all those needs, RBC opened a branch in Hollywood, Fla., through its U.S. subsidiary, RBC Centura. The results have been exceptional: Customers are signing up in droves, and the new branch will have moved to profitability in months rather than the typical years. Opening new branches aimed at specific customer segments (rather than spending lots to buy branches) represents a tremendous growth opportunity for RBC's shareowners. They've already seen RBC stock grow 18% a year on average over the past 4½ years, thanks in large part to the bank's pioneering customer-centricity efforts.

2 Does the company know its customers well enough to differentiate between them?

Differentiating between customers seems like common sense, and most companies claim to do it. But it's not as simple as, say, offering volume discounts or other special deals to big customers. Real differentiation means knowing who your various customer segments are, what each group wants most, where the groups are shopping, and how to serve the customers individually. Take Best Buy, which configures some stores to serve Jill, as we said, but also knows how to court "Barry"(an aptly named segment of affluent entertainment lovers) with stores that have such amenities as a home-theater demo room. Still other stores are configured for budget-conscious family men ("Ray") or for young, early adopters of new technologies ("Buzz"), for small business customers, or for combinations of those segments.

3 Is someone accountable for you as a customer?

At most companies various departments own pieces, but no one owns any specific customer segment. Not so at Dell or RBC. Nor at Best Buy, which has an individual fully accountable for Jills across multiple stores using the same financial measures and oper-

HOME SWEET STORE Presenting goods in settings customers can relate to helps sales at Best Buy.

You don't need inside information about a company. Your role as a customer can be one of the best investing tools.

ational metrics as Matt in the Pasadena store.

To see if a company operates this way, ask someone at the company: "Is someone here fully accountable for my relationship with you?" The answer—and the way it's answered—can tell you a lot. (If the rep on the other end of the phone has no idea what you're talking about, that's a clue.) Another way is to check with a part of the business you haven't used before. If you have only a checking account with a bank, call the mortgage people and see if they've ever heard of you.

4 Is the company managed for shareholder value?

If it is, then everyone there knows that the game is about earning a return on invested capital that exceeds the cost of capital, plus investing increasing amounts of capital at that positive spread and maintaining that spread for as long as possible. At the end of the day, those are the only factors that drive the share price. Customer-centric companies apply those criteria to customer segments. They know how much capital they've invested in a segment and how much return they earn on it. They maintain the positive spread by creating and reinventing enduring customer relationships. Thus, when an RBC segment manager created a program to attract first-time mortgage borrowers, she knew those customers were more interested in guidance through the scary home-buying experience than in getting rock-bottom rates (good return on capital for the bank) and were likely to become long-term customers (longer duration of positive spread). Such companies can and do link their success with customers directly to the price of their stock.

Customer-centricity means that all employees understand how their actions affect the share price. Talk to employees. If they speak the language of shareholder value, you may have a winner.

5 Is the company testing new customer offers and learning from the results?

Seven-Eleven Japan—consistently one of Japan's most profitable companies—does just that. (Like America's 7-Eleven, it's a subsidiary of Ito-Yokado.) Every week employees from all over Japan meet to discuss specific hypotheses tested and verified in the stores. It can be as obvious as changing the noodle order for the next day's lunch based on the weather forecast. (A cold day? Serve warm noodles!) Relentless learning about what customers want and a formal process for sharing it are critical to customer-centricity.

You'd think all companies would adhere to all five rules, but few do. Customer-centricity is hard. For investors, that's an attraction: Companies that achieve it hold an advantage that can lead to a jump in share price. They are companies investors should focus on now. Our test can help you tell the real deals from the rapidly proliferating fakes. F

FEEDBACK *gcolvin@fortunemail.com*