

Is your core competence A MIRAGE?

Managers now consider just about everything a potential competence

Are you measurably better, can you sustain the difference, and does it matter?

Building a core competence: three options

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CORE COMPETENCE – the idea that a company can succeed without a structural competitive advantage by becoming the best at a few key skills or in a few knowledge areas – has enjoyed enormous popularity over the past six years. The article that introduced the concept¹ has been one of the most requested reprints in the *Harvard Business Review*'s history. Executive management programs and MBA curricula routinely devote hours to the subject, and executives often refer to their own and competitors' core competences as key drivers of strategy.

¹ C. K. Prahalad and Gary Hamel, "The core competence of the corporation," *Harvard Business Review*, May–June 1990, pp. 79–91.

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But despite all the attention this concept has received, its tangible impact on corporate performance has been mixed at best, as these statements attest:

“Core competence has too often become a ‘feel good’ exercise that no one fails.”²

“True core competences are hard to define precisely and are often discovered retrospectively. That is, as you experiment, you define your competences by simply describing your successes and failures.”³

“We talked to [core competence experts] and asked them to help us identify our core competences. But after having them work with our senior management, leading them through some group exercises, we really had a mess on our hands. We could not define what was core as opposed to noncore, and what was a competence as opposed to some process or offering we just did well.”⁴

Our own observations bear out these views. Few managers we have talked to could claim to have utilized a core competence to achieve success in the marketplace, and even fewer to have built a core competence from scratch. Indeed, most were uncertain as to exactly what qualifies as a core competence.

We are left with a conundrum. Core competence is clearly an important concept, and some companies seem to be able to make it work. But for most, it is like a mirage: something that from a distance appears to offer hope in a hostile environment, but that turns to sand when approached.

Why do competences seem so elusive? One reason may be that there is no clear basis for identifying them, nor any established way of gauging progress toward them. To address the need for a more rigorous approach, we reviewed the literature, assessed individuals’ experience, and conducted case studies of

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² David J. Collis and Cynthia A. Montgomery, “Competing on resources: Strategy in the 1990s,” *Harvard Business Review*, July–August 1995, pp. 118–28.

³ Dan Simpson, Director of Strategy and Planning, The Clorox Company.

⁴ Paula Cholmondeley, Vice-President, Business Development and Global Sourcing, Owens-Corning Fiberglass.

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companies that had attempted (successfully or unsuccessfully) to develop a core competence. This research produced four important findings: “core competence” is an umbrella phrase covering two distinct bases of advantage; certain tests can help predict whether a competence-led strategy will be successful; there are three distinct paths to developing a competence, each with its own benefits and drawbacks; and sustaining a core competence requires just as much rigor as developing one in the first place.

What are core competences?

While most of the examples in Hamel and Prahalad’s article concerned knowledge of one or more technologies, executives have extended the idea of core competence to cover many types of skills and functions, including process engineering, production, new product idea generation, and even corporate identity. They treat everything as a potential competence. One executive asserted, “The way I determine core competences is that they are those few things that you do together with the customer that create value.”

In contrast, we believe a precise definition is essential. To mount a winning competence-based strategy, it is not enough to rely on broad generalizations like “marketing,” “product development,” or “service.” One consumer goods company with a reputation for marketing excellence assumed that it was superior in all aspects of marketing. Yet it is not particularly skilled at pricing, is only average at channel management, and has made some costly errors in a string of new product failures. Its true competence is much narrower: demand stimulation through image-based advertising. Companies must define their core competences with equal precision if they are to use the concept to its full advantage.

Most managers we talked to were uncertain as to exactly what qualifies as a core competence

The definition must also incorporate the applications and limits of the competence. A large regional bank believed that one of its core competences was its ability to process financial transactions with tremendous accuracy. It indeed excelled at cash management, check processing, and several similar lines. But it exited the mortgage servicing business after failing to master the transaction processing tasks involved.

We propose a simple definition:

“A core competence is a combination of complementary skills and knowledge bases embedded in a group or team that results in the ability to execute one or more critical processes to a world-class standard.”

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Such a definition excludes many skills or properties often cited by organizations as core competences. Patents, brands, products, and technologies do not qualify; neither do broad management capabilities such as strategic planning, flexibility, and teamwork; nor do high-level corporate themes like quality, productivity, and customer satisfaction.

Core competences so defined can be grouped into two categories:

Insight/foresight competences. These enable a company to discover or learn facts or patterns that create first-mover advantages. Such insights might derive from:

- ◆ Technical or scientific knowledge that produces a string of inventions, as with Canon's optics knowledge and miniaturization ability
- ◆ Proprietary data, such as the behavioral and credit-scoring knowledge used by Citibank to build the United States' leading credit-card business in the 1980s
- ◆ Information derived from having the largest share of leading-edge transactions in the deal flow, such as is now being exploited by Enron in the gas business
- ◆ Pure creative flair in inventing successful products, such as is displayed by the Walt Disney Company's animated film business and by 3M
- ◆ Superior analysis and inference, as evidenced by the outstanding financial returns realized by Berkshire Hathaway and the Fidelity Magellan Fund under Peter Lynch using the same data available to other stock analysts.

What distinguishes this kind of competence is that value ultimately derives from the insight itself. A company may have to go to great lengths to exploit it, but others could do so just as effectively if they had access to it.

Frontline execution competences arise in cases where the quality of an end product or service can vary appreciably according to the activities of frontline personnel. They can be defined as a unique ability to deliver products and services that are consistently nearly equal in quality to what the best craftsman would have produced under ideal circumstances. (Obviously, there is no opportunity for a frontline execution competence strategy when almost *anyone* can attain such quality, since there is no scope for differentiation.)

In commercial lines insurance, for example, an individual underwriter decides whether the company will accept a policy, and prices that policy in line with his/her personal assessment of the risk. Although the underwriter refers to guidelines, he/she also enjoys great personal latitude. Studies have shown that when the "best" (rather than an average) underwriter handles a book

of policies, the insurer's return on equity on that book can rise by more than 15 percent.

In retailing, Nordstrom's ability to satisfy customers is an example of a frontline competence. Its stores achieve an unsurpassed level of service thanks to the actions and decisions of hundreds of members of its salesforce. These salespeople are embedded in a corporate culture that provides socialization, incentives, and a supportive environment for the Nordstrom way of doing business.

Instead of commissioning research, companies tend to infer their superiority from general usage and attitude surveys

Insight/foresight and frontline execution competences can coexist in the same company, but each will require its own managerial focus. McDonald's, for instance, uses its frontline execution competence to engineer the food delivery system at individual restaurants and its insight/foresight to identify winning sites for its outlets.

Evaluating core competences

Successful core competences are rarer than many imagine. Most companies that claim a competence-led strategy are deluding themselves. So how can an executive in serious pursuit of such a strategy determine whether it is likely to prove worthwhile?

The first step is to define the competence as precisely as possible, as described above. With definition in hand, the executive should ask four key questions:

1. Are our skills truly superior?

It is obvious, but usually overlooked, that any competence-led strategy requires that a company be the best (or at the very least, nearly the best) at its chosen competence. Many companies wrongly assume they can base their strategy on competence merely because a particular skill is important to their business or attractive to their customers. If a core competence is to form the basis of its strategy, a company must be demonstrably better at it than all or most of its actual and potential competitors.

The most direct check is simply to ask, "Would independent tests show that we are better at this skill than leading competitors in technical terms or customer opinion (or both)?" and then commission research to find out. Surprisingly, this is rarely done. Companies tend instead to infer their superiority from more general usage and attitude surveys.

Frontline execution competences offer output benchmarks that can help a company ascertain its relative capability. In banking, North Carolina-based

Wachovia Bank has long been recognized for its credit skills. This superiority can be empirically tested by examining its history of credit write-offs and comparing it with the experiences of similar banks. From 1980 to 1995, Wachovia forfeited 0.6 percent of loans to credit losses compared with over 1.1 percent at the average regional bank, which translates into a 6 to 8 point advantage in return on equity for Wachovia.

Similarly, publicly available data show that the best property and casualty insurance companies have an underwriting loss ratio that is nearly ten points below the industry average. The difference accounts for an improvement in return on equity of between 10 and 20 points. Where comparative data are not published, companies can usually obtain useful benchmarks through trade associations, “best practice” visits, vendors, and other sources.

Measuring superiority in insight competence tends to be harder. Crude measures may exist: the number of patents granted in recent years, technical reviews in trade magazines, movements in market share, or changes in the profitability of insight-dependent transactions such as trading. Often, however, companies have to rely on input rather than output benchmarks. Here they have to assume a direct link between the amount and type of resources they dedicate to the task of finding new insights and their ability to develop superior insights or to be first with new ones.

R&D personnel assessments represent a potentially valuable gauge of product development skills, for instance. Relevant measures might include the number of researchers, their academic qualifications, and their ability to influence product offerings. Although this method is less reliable than output measures, it may indicate whether a claim of superiority is justified. A firm that has difficulty hiring and retaining the best graduates should surely doubt its superiority in insight competence. By contrast, Microsoft is able to select from a huge pool of potential employees. “Not everybody has the luxury we have of getting MIT’s best and Stanford’s best,” admits the company’s Mike Maples.

2. How sustainable is the superiority?

A good start to answering this question is to ask how quickly your best-positioned rival could imitate your competence, assuming it knew how. Ease of imitation is a function of how rare a competence is, how long it takes to develop, and how difficult it is to understand its source. Sustainability can be assessed by investigating each of these in turn.

Rareness is evaluated by comparing your competence to those of other firms in various industries (not just your own). The fewer examples you can find of similar competences, the more likely it is that you possess something rare.

The time it takes to develop a competence is a function of its type and complexity. Even if a firm could pinpoint the source of a competitor competence and set out to copy it, the advantage would not be eroded immediately. With insight/foresight, the imitator must develop supporting mechanisms such as databases or personnel hiring, and it may be necessary to do this sequentially rather than in parallel. With frontline competences, it can take months or years to train personnel, revise policies, unlearn current practices, and make the multitude of other changes necessary to create and sustain a competence. A competence that is supported by diverse functions within an organization, rests on deeply held cultural norms, and draws on employees' tacit knowledge of tasks and processes will be more time consuming and difficult to replicate.

When a core competence relies on the subtle alignment of myriad elements, even employees may not know what is special about what they do

Whether the **source** of your competence can be understood by outsiders often depends on its nature. The inspiration that drives insight/foresight competences is intrinsically difficult to understand. In frontline execution strategies, skills may be deeply embedded in a company's culture. Attempts by competitors to hire underwriters from the best insurance firms, for instance, seldom produce the desired results. An individual underwriter may not be able to transfer an ability that is rooted in an entire culture.

The number of organizational elements in a competence contributes to its sustainability and defensibility. A core competence comprising only a few elements is much easier to understand and imitate than one that relies on the subtle alignment of myriad elements. Indeed, in the latter case, even a company's employees may not know what is special about what they do.

3. How much value can the competence generate in comparison to other economic levers?

A common error is to assume that being the best at a particular skill offsets other disadvantages. The fact that a company has chosen to emphasize one or two skills does not erase a scale or scope disadvantage, or compensate for inferiority in other areas. For a competence-led strategy to win, that competence must be more powerful than other strategic levers relevant to the industry, such as structural advantage or access to cheap resources.

Most companies shy away from quantifying the potential value of competences, but it can be done. One consumer goods company set out to create \$1 billion in value through a combination of superior marketing, new product development, and realigning the industry value chain. To test this plan, the strategy team looked back at where the company had created value in the past. They identified six core competences in the business and used a

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combination of quantitative analysis and management workshops to see how much value these competences had created. They then repeated the exercise looking forward.

To their alarm, they found that some of the very competences they were relying on to create future value had actually *destroyed* value historically. Moreover, all but one of them would have to be rebuilt from a position of relative weakness. Needless to say, they decided to revise their strategy.

Analyzing the economic value of frontline competences is relatively straightforward. One can estimate the value of best-in-class performance over industry average for a particular competence, and compare this with the value created by a similar level of superiority in other skills, by scale advantages, or by input cost differentials. Evaluating superior insight is more complex; it is difficult to know in advance just how superior a new insight will prove to be. That said, a broad picture can be obtained by assessing how much of the total value in the industry chain is added by the company and by estimating how much further technical improvement new insights might be capable of contributing.

4. Is the competence integral to our value proposition?

If you are to capture the value of your core competence and generate better returns for shareholders, your investment in superior skills must be tied to actions that will be rewarded by the marketplace. In the case of frontline competences, the link will be direct. A company should not invest in becoming superior in service, for example, if it does not intend to position itself with the customer as the best service provider.

Where insight competence is concerned, that competence must be capable of generating future value propositions. Customers do not buy insights, they buy products; an insight must translate into a valuable product. Many companies have had wonderful insights that they were not able to commercialize: for instance, it was Xerox that invented the graphical user interface that revolutionized the personal computer industry, not Apple or Microsoft.

Creating core competences

If the tests above reveal that your company does not actually possess a core competence, you might well ask, “Can we create one in a reasonable period?” Research suggests that it is possible, but not easy. Companies that have managed to do so appear to adhere to a couple of fundamental principles.

First, a world-class competence must **steer the power structure** in a company. The keeper of the skill drives all the company’s major decisions,

even in unrelated functions. At Procter & Gamble, for instance, the core consumer marketing skill resides in the advertising department (the company's name for brand management). Brand managers exert a dominant influence on all decisions throughout the company. And at Wachovia Bank, even relatively new credit officers routinely block loans proposed by experienced senior line officers.

One telecommunications organization is currently being reorganized so that all functions will eventually be funded via the marketing department. The aim is to ensure that the “factories” – the telephone network and information systems that control the installation of switches and wires – focus improvements to the physical plant on areas where there is demonstrable customer demand. This clear emphasis on a chosen competence will eventually enable market-driven factory development to steer the entire organization.

The company's power structure cannot be driven by several functions at once

Second, a core competence strategy must be **chosen by the CEO**, not by department heads acting independently. Many companies get this wrong: “Some think everything they do is a core competency. This is especially true at successful companies; whatever department you talk to, the head of that department will say, ‘My area is a core competency of the corporation.’”⁵ This does not work; a company's power structure cannot be driven by several functions at once. The CEO must select only one, or at most two, competences to develop at a time.

There seem to be three distinct routes to developing a core competence: **evolution**, where a company attempts to build a skill at the same time as the individuals involved perform their usual jobs; **incubation**, where a separate group is formed to focus exclusively on the chosen competence; and **acquisition**, where one company purchases another to obtain the skills it seeks.

Evolution

An evolutionary approach to developing a core competence poses the same challenges as any large-scale change program, plus a few of its own. Evolutionary programs that produce real benefits involve implementing and coordinating dozens of organizational efforts. Companies that have attempted to build core competences via one-off programs almost always fail. One firm recently installed a new incentives system, but saw no change in behavior. Another revamped its training system, to no avail. The inertia of the remaining organizational elements was simply too strong.

⁵ Dan Simpson, Director of Strategy and Planning, The Clorox Company.

Success in competence building comes from tackling many capabilities and practices simultaneously. One commercial lines property casualty insurer seeking to improve its core underwriting skills initiated over 60 programs. It changed its hiring criteria, used different managers to conduct interviews, and modified entry-level pay scales. It adjusted promotion paths for underwriters and revamped its training programs. To improve information, it introduced new underwriting guidelines and new information systems to provide more accurate historical and industry data.

In addition, the insurer changed its measures and incentives to reward underwriting quality rather than volume. It revised its organizational structure, creating an underwriting manager in each office to break the link with branch managers, who were always under pressure. At headquarters, it made changes in the actuarial and underwriting policy departments, set up an underwriting audit team, and improved links with the claims department. Within three years, the insurer had improved its underwriting relative to the industry by the equivalent of an extra 15 percent return on equity.

Any business initiative requires managers to quantify the projected benefits of investment, but this is especially important for evolutionary programs, which invariably turn out to be more difficult than expected. Mounting

Companies that succeed with the evolutionary approach demand payoffs from their programs along the way

expenses and setbacks may tempt companies to cut these programs to protect short-term earnings. If they have not calculated the economic benefits they expect to see, they may find it hard to justify continued investment. The precision of such a calculation matters less than the conviction it generates.

The potential benefits of the underwriting program were never estimated any more precisely than \$40 to \$50 million per year, but this was enough to create the conviction to proceed.

Companies that succeed with the evolutionary approach to building a core competence demand payoffs from their programs along the way. As one manager put it, “We don’t want any Grand Canyon strategies.” When asked what he meant, he replied, “What would happen to a motorcyclist who was 90 percent successful at jumping over the Grand Canyon? We want to have programs that make us money even if they are only partially successful.”

Incubation

In this approach, an in-house team is isolated from the rest of the organization and charged with developing a competence over a two- to three-year period. The advantage of incubation is that it allows a competence to grow in a nurturing environment. Once it has become strong enough to drive value

within the incubator, the competence can begin to be transferred to other parts of the organization.

Two companies that have recently followed this approach are Southwestern Bell, one of the seven large regional US telephone companies, and Brown & Root, an engineering services firm. Southwestern Bell developed a new competence in cellular telephony marketing, Brown & Root in logistics management. Both are reaping the benefits. Brown & Root is a global leader in logistics and emergency response management, with contracts with US and foreign governments and annual revenues approaching \$500 million. Southwestern Bell has built a leadership position in the US cellular telephony market, with 3.2 million customers and \$2.3 billion in revenues in 1995.

Both companies created protected and stimulating environments in which the new competences were able to flourish. These environments were bounded not by fire walls, but by one-way membranes that allowed the incubator to beg, borrow, or steal people and practices from the main business, while not being bound by its rules. Brown & Root leveraged its existing project engineering competence in its new logistics business, but broke house rules within the incubator in a way that would not have been tolerated in the main organization. It used aggressive performance-based management approaches and freely adapted and cannibalized parent systems.

As in the evolutionary approach, companies using incubation will rely on outsiders. While in the former case the imperative is to hire in sufficient numbers to counteract organizational inertia, in the latter it is to garner the needed skills as quickly and efficiently as possible. When Southwestern Bell's cellular division needed long-distance expertise, it hired not from the "big three" companies, but from the competitive long-distance resellers with "streetfighter" commercial skills.

The advantage of incubation is that it allows a competence to grow in a nurturing environment

Both Southwestern Bell and Brown & Root focused on specific new business opportunities, not on building competence in the abstract. Their incubators were managed not by "competence stewards" or "knowledge leaders," but by business executives looking for bottom-line results. They employed simple performance metrics that measured the strength of their competences against external benchmarks, and concentrated pragmatically on delivering business results in a challenging new environment. Brown & Root set up its logistics operation at a time when the main business, hit by the oil price slump, was losing close to \$1 million per day. Arthur Stephens, CEO of the new venture, confessed, "All of our futures were on the line. It was made very clear to us that we needed to build a successful business out of this concept."

Acquisition

Managers often resort to acquisition out of frustration with the time and effort involved in evolution or incubation: witness the number of acquisitions performed in recent years for the primary purpose of obtaining skills. In reality, however, acquisition is more likely to fail than either of the other approaches. To improve their chances of success, managers must understand how the type of competence they seek affects their acquisition strategy, and be aware of the structural factors that will influence the outcome.

In general, a strategy to acquire frontline execution skills is a safer bet than one concerned with insight/foresight. In the former, a raft of complementary organizational systems (for instance, incentive and knowledge systems) supports and promotes the competence behavior. Even if some people leave after the acquisition, these systems will tend to replicate the competence behavior in new hires. In the case of insight/foresight, however, key individuals who leave the company take their skills with them, and are extremely difficult to replace.

Past successes with major change programs will favor evolution; a track record of skunkworks, incubation

Structurally, competence-driven acquisitions are more often successful when the acquired company is not fully integrated into the acquirer, but retains some autonomy. With

frontline execution, it is vital to retain all the organizational systems that underpin the competence behavior, at least until the drivers of the competence are understood. Full integration may disrupt or even demolish these systems. In the case of insight/foresight competences, it is important to bear in mind that the acquired company's existing organizational arrangements may have persuaded talented individuals to join it. Rapid changes could make them leave. One professional services firm found that over 90 percent of the managers of the company it acquired left within two years of full integration.

Choosing the approach

While the availability of suitable companies to buy is often the deciding factor in the acquisition approach, choosing between evolution and incubation is a more subtle affair. Usually, though, the decision hinges on a tradeoff. Under the evolutionary approach, it may be harder to create a superior competence, but success will automatically affect the core of the company. On the other hand, the chances of building a new competence are probably better with the incubator approach, but bringing that skill into the rest of the company may pose great difficulty.

The nature of the firm and the competence will bear on this tradeoff. Past successes with major change programs will favor evolution; a track record of skunk works, incubation. Frontline execution competences may be best

suited to evolutionary development, since their success depends on the efforts of many people across an organization. Conversely, insight/foresight competences may thrive in an incubator setup that can exploit the advantages of smaller groups and less formal processes.

Sustaining and enhancing core competences

Companies that already possess a superior competence can turn their attention to ensuring its sustainability and enhancing its value. At the most basic level, this means making sure it does not degrade over time through inattention. There are two common causes for such a problem.

First, skilled staff can gradually drift away. While this is usually obvious when it happens to an insight/foresight competence, it can be equally devastating with a frontline execution competence. Losses may go unnoticed until they reach epidemic proportions. One division of a company with a frontline execution competence had a reputation for developing the firm's best managers. It had always supplied talent to other divisions, but at one point the transfers increased substantially. At the same time, competitors launched a raid. By the time the combined effects were noticed, the division had lost over 25 percent of its most promising future managers.

Second, a competence can decline when many staff and line managers have the power to change separate organizational elements (for instance, recruiting practices, compensation, and promotion). If senior management

Companies must stop proclaiming that they have a competence and get serious about defining, testing, and developing one

does not monitor these individual changes for consistency with the broader program, they can cumulatively erode the competence. The property casualty insurer mentioned earlier had been a strong underwriter a decade before, but the elements of its organization had become detached

and conflicting. As the competence was rebuilt, the CEO's primary roles were to articulate a common vision of it and to restrain any of his subordinates who wanted to solve their portion of the puzzle in a way that was not consistent with the whole.

For those few companies whose dominance is so strong that other players do not challenge their competence, simply to prevent it degrading may ensure sustainability. But for most companies, maintenance is not enough. Formidable competitors are actively trying to displace them. Sustainability means having to make continuous improvements simply to stay where they are. And they must measure these improvements not just in absolute terms, but also in relation to competitors' efforts.

Consider a cautionary example. The president of a specialty subsidiary of a diversified company declared in late 1994 that he would base his strategy on a set of marketing competences. A year later, he had hired a new top marketing executive, replaced several of his direct reports, hired five or six marketing analysts, and introduced a sophisticated computer modeling technique. Getting budget approvals and sidestepping personnel restrictions had called for enormous efforts, and he felt he had made tremendous progress. Unfortunately for him, leading competitors in the same period employed 15 to 20 analysts, enjoyed continuity of management, gained substantial experience with the modeling technique, and devoted much bigger budgets to marketing experiments. In short, the president had made vast strides *and* fallen further behind.



A small number of firms already have a core competence. These fortunate few can devote their energies to sustaining and enhancing it. For most, however, the task is different. They must stop proclaiming that they have a competence, get serious about defining it, test to see if it would be valuable, and then set about developing it. If they do not, they will continue to see mirages and perish in the sand. **Q**

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BRINGING DISCIPLINE TO STRATEGY

“Strategy is the handful of decisions that:

- ◆ *drive or shape most of a company’s subsequent actions,*
- ◆ *are not easily changed once made, and*
- ◆ *have the greatest impact on whether the company’s strategic objectives are met.*

The handful of decisions are:

- ◆ *selecting the company’s strategic posture*
- ◆ *identifying the source(s) of competitive advantage*
- ◆ *developing the business concept*
- ◆ *constructing tailored value delivery systems.”*

Kevin P. Coyne and Somu Subramaniam, *The McKinsey Quarterly*, 1996 Number 4
