BECOMING A CENTRE OF EXCELLENCE

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As an intellectual asset, operational excellence is a widely underrated tool for building value, says Juergen Graner in a book about how IP inspires hgh growth

Operational excellence is probably the most undervalued intellectual asset in business practice, when compared to technology and brand. Its role is integral to the holy grail of any venture: managing itself not just to establish an edge in the moment, but in a way that creates a competitive advantage that lasts.

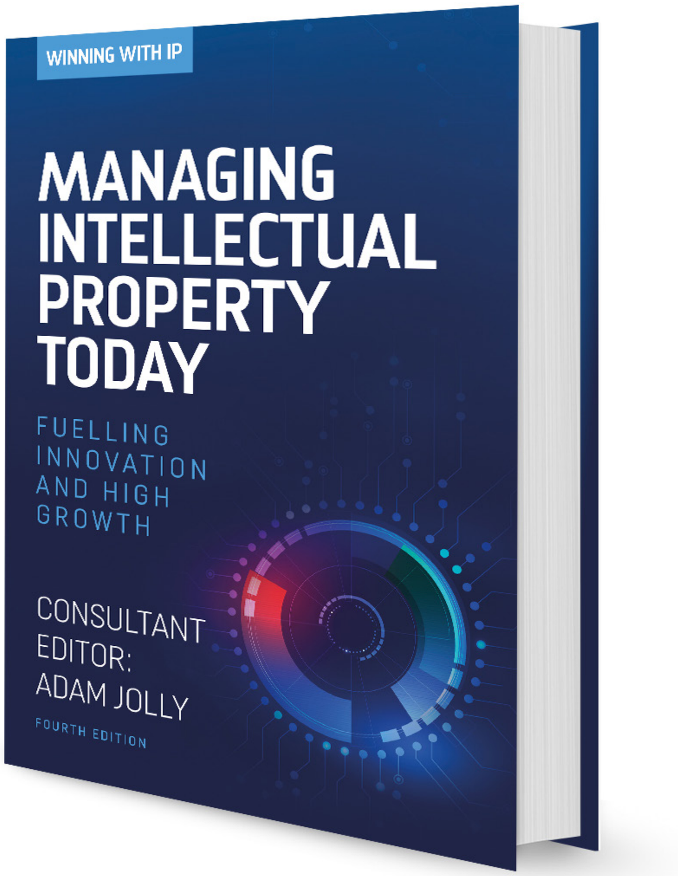
Amazon is a classic example of how to build a venture with the future in mind from the start and resist the pressure from investors for a swift return. It remains an exception. Incentives are usually geared towards the short term and operational excellence is assumed to be limited to standard operating procedures.

In fact, operational excellence rests on a foundation comprising three elements: overall strategy, business concept and operational systems. Performance then ascends in three levels: first, operational efficiency, then management independence and finally, establishing a centre of excellence, striving to become the number one in your chosen field.

As a model, it applies to companies differently depending on their priorities. For those on a build-to-sell pathway with a view to an exit in five to seven years, it pays to set a target of becoming a centre of excellence in a niche area of expertise. The strategy and the operational systems are then geared towards achieving this ambition.

For turnarounds, the focus is more on where operational efficiencies can have the most immediate effect. A centre of excellence will only become a priority, once a business has stabilised.

For companies that are pursuing build to grow, such as family businesses building a legacy, the emphasis is more



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on creating a strategy and operational system that supports diversification and the creation of the next tier of leaders.

Intellectual assets

IAs are what drive the value of a business, either as technology, as brands or as operational excellence. In each of these three forms, IAs always consist of an intellectual property component enabled by a human factor, although their intensity, durability and transferability vary in each case.

The IP component

The IP component of operational excellence is fundamentally different from that of technology or brand. A technology can be protected with patents, trade secrets and similar rights to deter violators. Similarly, a brand can be protected with trade marks.

However, the IP component of operational excellence is generally the operational systems that a company follows. Yes, it can and should protect itself through a policy of trade secrets, but there is no standardized registration mechanism and claims that operational systems have been copied by competitors are generally more difficult to defend.

	IP component	Human factor	Transferability
Technology	Patents and trade secrets	Team know-how	Medium
Brand	Trade marks	Customer mindshare	High
Operational excellence	Operational systems	Company culture	Low

Figure 1: Intellectual asset overview

The human factor

When it comes to the human factor that enables the IP component, operational excellence has some similarities with technology and brand. From a technology perspective, the similarity is that it is about the people within the organization and how they are managed. From a brand perspective, the similarity is that, while it is about gaining ownership of customer mindshare outside the organization, the people within have a massive impact on enhancing brand perception in the market. For both technology and brand, a company's culture has a strong influence.

For operational excellence, the real value lies in this culture, which is complex and difficult, if not impossible, to copy. True operational excellence is really difficult to achieve, since company culture is the enabling human factor.

Every company has a culture. The only question is if the culture just happens or if it is managed pro-actively and systematically. A culture usually is built from the top down: either willingly or unwillingly, it is shaped by symbols and examples from leaders.

There are two levels to company culture. First, one that cuts across all departments and functions. Second, the sub-cultures that form to a greater or lesser degree as a company grows. In science and engineering companies, research and production typically have a different culture than marketing and sales. Sometimes, there are different cultures that cut across departments. As long as those are brought together in a productive way under an overall culture, they can all co-exist.

Unfortunately, many chief executives do not pay enough attention to actively managing their overall culture and sub-cultures. Moreover, a culture will evolve and change as a company grows, which is often overlooked.

Transferability

There is a significant difference when it comes to transferability between technology, brands and operational excellence as assets, which matters when it comes to strategic transactions, such as alliances, licences, spin-offs, acquisitions and divestments.

Brand IAs are generally the easiest to transfer. While there are exceptions, in most circumstances customers do not really care who provides them with a product or service, as long as it continues to fulfil or exceed their expectations.

Technology IAs can be transferred easily as long as it's solely the registered component (eg, the patent). However, it gets more difficult with trade secrets and team know-how, which are usually part of a technology IA. Therefore the ease of transferring of technology IAs is medium.

Operational excellence IAs are by a distance the most difficult to transfer. Some would argue they are impossible to transfer completely. Almost everything that a company does can be copied by someone else except culture. It's a challenge not just between companies, but also for locations within companies. The upside of this difference is that operational excellence has a natural protection mechanism in the company culture to some degree.

Foundation of operational excellence

Overall strategy

It makes a difference if a company is built as a generational business (build to grow) or if it is built towards an exit (build to sell). Most high-growth technology businesses will follow a build-to-sell strategy, since they often have risk capital (from business angels and/or venture capital) to fund their growth, which requires an exit. Therefore the business has to be ready to work within a much larger organization at some point in time. A company strategy is about more than just the overall direction and should be adjusted annually or when events arise that require a change in direction.

It is actually mind-boggling to interview individuals in the vast majority of companies about their strategy, especially within smaller enterprises. Those in different parts of a company often either have a completely different view of what it is or don't know about some of the main elements. However, growth only happens quickly and efficiently if everyone is aligned and moves into the same direction. Nevertheless, the strategy is usually not communicated well or is only present in the minds of the leadership team. A well-defined strategy fits on one page, has some graphic elements to enhance the message and everyone follows it.

Business concept

Many companies establish a clear vision, mission and value statement, but they fall short of defining how they make money. The business concept does exactly that. It defines what a company does and how it operates.

For example, Red Bull does not manufacture its products in its own facilities, but outsources them to long-term partners. At Amazon, the business concept is that it owns and operates its own warehouses within a proprietary system to manage the flow of goods.

Different from vision, mission and values, the business concept is usually only shared internally and with potential investors as a simple way to understand how a business operates. It has significant implications for operational excellence. For example, if many elements of the value chain are outsourced, then they are beyond the scope of direct management and more difficult to influence.

Operational systems

Almost any company, if prompted, will claim to have some form of operational system. It's usually written down in standard operating procedures to ensure consistent management of all its day-to-day activities from ideas for product and services to their delivery to the customer. Such SOPs represent the core IP component of operational excellence.

Ventures in their early years may have basic systems that use simple spreadsheets. Others use a sophisticated ISO 9000, six sigma, and/or total quality management (TQM), which is supported by a fully-fledged enterprise resource planning (ERP). Ideally, these systems will evolve with the growth of a business, always having the next two iterations of growth in mind. Re-engineering an operational system has the potential to limit growth for one to two years.

Levels of operational excellence

Operational efficiency

Operational efficiency is the first level of operational excellence; for most managers it is the only level. Especially smaller companies will have to define their priorities, as it is unrealistic to have the highest possible operational efficiency through the whole value chain of a company.

For those building to sell, operational efficiency can have a high impact on the valuation of a business. For acquirers, the three financial drivers for valuations are high growth rate (top line), high gross margin and high earnings (EBITDA on the bottom line), probably in that order. Different functions have an impact on each of them:

- High operational efficiency in marketing and sales generally provides a high growth rate.
- High operational efficiency in manufacturing generally provides a high gross margin.
- High operational efficiency throughout the company generally provides a high EBITDA.

The people within the organization that have the capabilities to build and support operational efficiency are a key factor for its success. Those capabilities are highly impacted by experience in combination with creativity. When it comes to fine-tuning the operational systems to the highest level of efficiency, experience matters. Such people aren't cheap and an audit of capabilities often reveals that the required level of experience might not be available within the team that has been built to date. New talent can be found, however it is harder to also evaluate the creative potential of new candidates. Often hires from larger corporations do not do well in smaller high-growth settings. They have great experience in managing a component within a well-established system. At a smaller company cross-functional training and creative thinking is a must.

Questions about cultural fit are worth asking too during recruitment, particularly for a high-growth business. Is someone ready to fit the current culture and how will they deal with likely cultural shifts as the company moves through its growth stages? It is worth spending time on cultural fit evaluations in hiring and managing growth, since culture drives behaviour and behaviour impacts performance, positive and negative.

Management independence

There are two levels of management independence: independence from the founders and independence from key functions or know-how carriers. Anyone who can't take a three-month holiday without the company being seriously affected falls into that latter category. Similar to operational efficiency the success of this second level of operational excellence is highly dependent on people and company culture.

Successful ventures are usually founded by entrepreneurially minded individuals or small teams who are able to create the excitement for others to join them, often combined with some deep subject matter know-how. These are major assets during formation and the initial growth phase of a company. However, they can become a liability as the business grows due to the dependence of the business on individuals.

To make matters worse some entrepreneurs tend to associate their personal brand with the company's, making the two synonymous. Founder dependence is so common that the vast majority of potential purchasers of a business would generally require the founders to stay on board several years after an exit (often up to three years).

Besides the founders, there are many other functions run by hard-to-replace individuals. While this dependence can be mitigated through delegation, this is often not practiced by many key employees.

Clearly, a business benefits from having great leaders, managers and know-how carriers. From the founders' perspective, however, the difficulty arises when they transfer the business to someone else, either through an exit or passing it on to the next generation. A well-established professional management team as the company grows that is able to run the company without the owner is key for any succession planning. Ideally the founder's function becomes more visionary, including building operational systems and a culture that can handle losing those with critical know-how.

Culturally, the personalities of the founders often dominate. However, if they can encourage a more professionally managed culture, perhaps by taking a step back, it encourages key individuals to stay and perform, mitigating the risk of them leaving, or even worse, joining a competitor.

Centre of excellence

A centre of excellence is at the third and highest level on the spectrum of operational excellence. A position in one niche or function is established, where a company can perform better than most of the competition: in the best case, striving to be best in the world. It is missing the point to think that the business as a whole consists of centres of excellence. It is about focus and dominating one segment.

Even large companies show how far one centre of excellence can go. For example, while Amazon is probably good at many things, its true centre of excellence is its capability to get the right products to the right customers in the shortest period of time. It's not something Amazon came up with recently. In the late 1990s, when all other competitors where producing beautiful websites, Amazon built extensive distribution centers across the United States supported by efficient operational systems. It quickly established itself as the most reliable company in the e-commerce space, which continues to give it a competitive edge.

As with operational efficiency and management independence, people and culture are important factors for the success for a centre of excellence. However, the two other IAs, technology and brands, also play an important role.

Technology IAs become an early target for building a centre of excellence. Technology advancement and patent protection are expensive activities, so the budget prioritises the segment that a venture seeks to dominate. If a product or service requires several technologies, it makes sense to focus on one technology area that the company can own. Such strength can be a bargaining chip to access other technologies. It is always better to be best in one segment and adequate in all others, than having a bit of everything.

From a brand IA perspective, a company should let the market know that it is a leader in its field. Constant communications inside and outside of the desired leadership position has the potential to create a self-fulfilling prophecy. Obviously, some strength is first required to make any claims. If a brand is seen as world-class in one area, there is a secondary marketing effect that it is assumed to be world class in other related segments. As long as products and services can satisfy customers, it's a powerful association to have. At the same time, care has to be taken about making claims that cannot be substantiated. In today's hyper-connected world, the word about under-performance spreads fast and a brand is easier ruined than built.

To have one true centre of excellence for a company that is on a build-to-sell pathway has one additional advantage. It also secures the future of the employees. Many founders are not only looking at a great financial return, but also want to secure their employees' future once the business is sold. A centre of excellence can provide the best of both worlds: it basically is an employee insurance policy that also makes money.

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