

The Upside of Strategic Risk

How Coach learned
to know, not guess,
what customers want

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Have you ever been blindsided by changes in your customers? Have you ever felt that half or more of your marketing dollars are wasted?

Perhaps the most insidious strategic risk is decimation of your customer base by shifts in behavior, preferences, and demographics. Customers are people—unpredictable, irrational, emotional, curious, and highly prone to change. Their priorities change from quality to price to solutions to style to brand.

Every time customer priorities shift, your business design is at risk of losing a few customers, and eventually your most profitable customers. And a 1 percent loss of revenue turns into a 6 percent loss of profit.

The Genius of Knowing 5 Percent More

You can't force people to buy from you. But you can reduce the risk of losing customers by reducing the uncertainty that creates the risk in the first place. After all, that's what risk is about—not knowing what's going to happen, what your customers are thinking, what they want, what they will do, what they will respond to.

This is why the best countermeasure for defeating customer risk is creating and applying continuous

proprietary information about your customers. It's answering the question: What do we know about customers that others don't? And then using that knowledge to make and keep profitable customers for life.

The first step is to develop a healthy fear of ignorance, followed by steps to move your organization from guessing to knowing—shifting the frontier that separates what you know from what you don't know, and thereby reducing the area in which betting (and therefore risk) are unavoidable.

For the best players, proprietary information is the cornerstone of a system with several key components. These include:

- Persistently asking *the toughest and most probing questions* about customers, their needs and interests, and the ways in which the company's business processes can serve those customers better. Always asking: "What am I afraid to find out? And how can I find it out today?"
- Having *models or algorithms* that convert the flow of proprietary information into an "aha!" that the company can act on, especially pricing systems that align customer preferences and the company's economics so as to maximize the flow of value to customers along with profits to the company.
- Having programs that *organize the most important elements in the customer relationship* (such as customized product offerings, reward programs, and service interventions) so that satisfactory transactions evolve, little by little, into strong, lasting, low-beta, and highly profitable relationships.
- A *customer-centered culture*, inculcated and reinforced through training and incentives, that gives employees the skills and enthusiasm they need to keep doing the right things for the customer and the business.
- A *culture of experimentation*, in which it's customary to test product offers, prices, terms, and other conditions with an open mind, relishing counter-intuitive results and "failed" experiments just as much as obvious successes.

Reduce the risk of losing customers by creating and applying continuous proprietary information about what customers want and how they behave.

The ultimate outcome of building a business around proprietary customer information is the creation of knowledge intensity—a way of doing business by which the myriad unknowns that characterize every company have been systematically tracked, quantified, studied, analyzed, and codified so as to reduce uncertainty, enhance predictability, and enable managers to make more accurate decisions than ever before.

Outdancing Customer Risks in the Luxury Fashion Market

At Coach, the maker of luxury bags and accessories, managers have figured out how to develop and apply customer insights that enable them to track and profit from even the most unpredictable shifts and twists of the fashion business.

The world of fashion, driven by whims, fads, and frenzies, is characterized by significant customer risk. It's a rare company that can traverse this minefield successfully on a consistent basis. Even more rare is the long-established company that can update a set of classic styles and make them as hip and forward-looking as next month's Vogue—and stay ahead of the trends, year after year, without alienating its traditional customers.

Coach is such a company. Long famous for its classic women's handbags, Coach has become a \$2 billion fashion leader in its segments, trailing only Gucci and Louis Vuitton in the \$13 billion global market for high-end leather goods and accessories. This happened thanks to the knowledge-based strategy devised by CEO Lew Frankfort and team—a strategy that has enabled Coach to capture and retain one of the largest and most desirable niches in the fashion accessories business, keeping up

The more frequent the customer data, the faster you can make sharp turns when market attitudes shift.

with and even anticipating the constant shifts in customer tastes.

Coach was launched in 1941 in a loft in New York's Soho district by a leather craftsman named Miles Cahn, who created ladies' purses designed in elegantly understated black or brown and featuring simple brass turnlocks and little other decoration. The bags were expensive but so well made that they were considered an excellent value. For many women lawyers, financiers, and executives in the 1970s and 1980s, a classy Coach bag was an essential accessory. And Coach had a comfortable niche in a traditional market.

But in the mid-1990s, the landscape of Coach's marketplace began to change in ways that upset the company's equilibrium. The change was driven in part by changes in women's lifestyles. The initial feminist push into the workplace was giving way to a world in which women had leadership roles in more industries. As the pressure on women to prove they "belonged" diminished, women's business attire became less formulaic, less mimicking of men's suits, and more overtly feminine. Handbags became fashion accessories, ways to update a look and feel stylish without buying a new wardrobe.

Meanwhile, Coach stuck to its classic styles, shapes, and colors, and gradually became less relevant to changing customer tastes.

Lew Frankfort had gone to work for Coach in 1979. When Sara Lee bought Coach in 1985, it made Frankfort president, and then chairman and CEO in 1995. Frankfort had already introduced major changes at Coach. He'd created a multichannel distribution system for the company, including freestanding Coach stores and a catalog business.

He had also begun building a powerful database of customer information, based on a continuous stream of data and a multi-angled vision of customer behavior. This database would play a crucial role in Coach's risk turnaround.

In 1996, the year after Frankfort became CEO, he hired Reed Krakoff, a young designer at Tommy Hilfiger, to bring a new fashion sense to Coach. The two men quickly developed a strong rapport. They also quickly faced a moment of maximum risk.

The Database Revelation

In 1996, Coach's continuous customer tracking system was sending some disturbing signals to Frankfort, Krakoff, and the Coach team. The company's sales growth rate in Japan dropped abruptly, from more than 30 percent down to single digits. This was one of those moments where the speed and effectiveness of response make all the difference.

"Fortunately, our continuous tracking and our multiple views of the customer provided us with a way to attack this problem," Frankfort says. "We found out why new customers were down, and as to lapsed customers, we found out exactly why they left and what competitors they had moved to."

It was clear that the Coach model had to evolve quickly. Frankfort and Krakoff had to find a way to refresh the product line, make it more relevant to modern women, and give the company a new, more fashion-forward image—while still maintaining the company's enviable reputation for high quality. It also had to avoid alienating the loyal customers who knew and loved the "old" Coach.

Krakoff and Frankfort tackled the problem in stages. They started coming out with small changes, then quickly went on to make bigger moves. In 1998, they came out with the Neo handbag, a new version of a classic Coach design that was lighter, slimmer, and outfitted with more interior pockets. Customers liked it.

The Hamptons line, introduced in 2000, was a real turning point for the brand, not only because of its

fabrication—canvas twill with contrasting leather trim—but because it was the company’s first true lifestyle collection. Coach was able to present the brand from head to toe, including products from hats and outerwear to handbags and accessories.

Their next major innovation was the Signature collection, made of leather and fabric emblazoned with the letter C. The bags were a huge success, confirming that customers were willing to buy a new look from Coach. Krakoff and Frankfort had permission to push their experiments a little further.



They followed the Signature line with new products in innovative sizes and shapes. One major breakthrough was the “wristlet,” a zippered rectangular bag just 4 by 6 inches. This new product grew out of Coach’s research into how women were using their purses.

Coach had noticed that sales of cosmetic cases were rising steadily—faster than they thought made sense. They began asking about it. What were women doing with all those cosmetic cases? The women they interviewed told them that they wanted a small bag (that could fit inside their larger handbags) in which the most vital items could be kept—a lipstick, a credit card, keys, a driver’s license, and a cell phone. The cosmetic cases worked all right for this role, but women were ready for a purpose-designed accessory. Krakoff listened hard, went to his drawing table, and within a few months the wristlet was born. Introduced in 2001, the accessory was an immediate hit. During its first ten months, it morphed into 25 varieties and generated over \$4 million in sales. Today, Coach sells over \$40 million worth of wristlets in 30 different styles.

The traditional Coach store, like the product line, exuded understated, classic elegance.

Fast Experiments with Colors and Variation

In the years since these first successes, more new Coach products have been created in an expanding range of styles, shapes, colors, and materials. Coach stores sell not just bags and wallets and luggage but also gloves, shoes, scarves, sunglasses, even jewelry and watches.

Species evolution often operates by spinning out a startling array of variations to find out which ones will work. Under Frankfort, Coach has been using variation as a discovery tool. Some of its new products may fade after a few months on the shelves. But Coach will have learned which products its customer base responds to. Those designs will become the stars of the company’s next-generation product lineup and the inspiration for still more new ideas in the next round of variation, experimentation, and winnowing.

Coach stores have changed as well. Dark, clubby wood paneling has given way to bright, high-ceilinged stores with wide-open front doors and sample bags displayed on open shelves rather than



Lew Frankfort, left, and Reed Krakoff have transformed Coach from a classic brand into a hot, young fashion house.

Like the Coach product line, the Coach retail stores have been redesigned with colorful displays that send an inviting message to a new generation of customers.

in glass cases, so that customers feel invited to handle and admire the products.

Cost-conscious customers appreciate Coach's combination of an accessible price point with high quality and a fashion-forward look. It's a new focus for Coach and a promising one that actually enables the company to mitigate its risk level by diversifying its product platform and broadening its customer base. It involves a richer product collection, more frequent introductions, and managing a higher level of complexity.

For a risk shaper such as Frankfort, it's not enough to guess what will work for Coach's unique target market. Frankfort and his team have to know. Hence he works hard to transmit this passion for numbers to everyone around him.

Coach's top 30 managers are greeted at the office each morning by a voice-mail message reciting sales figures from the day before. Coach's database doesn't include only sales figures; those are simply outcomes. It also includes a steady stream of customer input measurements, as the company constantly looks for the drivers of consumer choice. Today, Coach spends over \$5 million per year on marketplace testing of new products,

using many lenses to read the market, including more than 40,000 one-on-one customer interviews, telephone surveys that reach 500 customers at a clip, numerous market experiments, competitive analyses, prototype studies, and in-store product tests. Coach's customer database has grown to include over 9.7 million households. Frankfort himself visits Coach stores and department stores a few times each week, eager to supplement the bird's-eye view provided by survey data with ground-level impressions straight from the mouths of customers.

Coach constantly looks at its customer base from many different angles, studying metrics such as customer satisfaction, competitive rating, positive buying intent (cross-checked against actual buying behavior), new customers, lapsed customers, price response, response to new varieties of product, and response to variations at the micro level (demand for crimson versus vermilion or blue versus aquamarine). The combination of all these partial views helps Coach construct an incredibly precise moving picture of the customer.

Based on advance reactions to proposed products, Coach frequently alters designs and expands plans for styles that prove surprisingly appealing.

(Recently, a new product tested wildly popular relative to baseline numbers. Production plans were doubled.) Frankfort is especially fond of what he calls quick-and-dirty research—last-minute, small-scale surveys that provide on-the-spot confirmation of a strategy or highlight the need to make a change.

In some cases, the results drop directly to the bottom line. One pre-launch survey disclosed that the new Hamptons Flap Satchel could command a

price of \$328, a full \$30 more than the amount that company insiders had predicted would be the limit of customer spending on the item. Tags and signs were quickly reprinted, and sales proved brisk.

Coach's in-depth knowledge allows managers to tailor merchandise presentation to fit the customer demographics at particular store locations. For example, in conservative Midwestern U.S. towns, the most trendy products might be kept toward

A Hazardous Environment

At most companies, risk management focuses on three categories of risk that are widely understood: hazard risks (fire, flood, earthquake), financial risks (bad loans, currency and interest rate swings), and operating risks (the computer system goes down, the supply chain gets interrupted, an employee steals).

These kinds of risks are important. But even more dangerous are the strategic risks your business faces. Strategic risk targets one or more of the crucial elements in the design of your business model. In some cases, it shatters the bond between you and your customers. In other cases, it undermines the unique value proposition that is the basis of your revenue stream. In still other cases, it siphons away the profits you depend on. And sometimes it destroys the strategic control that helps your company fend off competition. In the worst case, a major strategic risk can threaten all these pillars of your business.

There's a host of striking statistical evidence for the expansion of risk in recent years. Standard & Poor (S&P) ranks over 4,000 publicly-traded companies each year. In the mid-1980s, more than 30 percent of S&P stocks were rated "A", meaning the ability to achieve long-term, stable earnings growth. By the mid-2000s, that figure had fallen to 12 percent. During the same period, stocks rated "C" had risen from 12 percent of the total to 30 percent.

Expansion of strategic risk has also led to an increasing number of market value collapses. From 1993 to 1998, one in ten Fortune 1000 companies lost 25 percent of their market value in one month. From 1998 to 2003, one in ten dropped 55 percent in one month. And

during the past 12 years, 170 of the Fortune 500 lost half or more of their value over a 12-month period. Furthermore, it is now taking longer for companies that experience significant value declines to recover their lost value than it did just a decade ago.

Such trends account for why a growing number of business leaders have identified strategic risk management as the crucial discipline for the first decade of the twenty-first century. Not all businesses face every form of strategic risk, but every business faces some. There are seven major kinds of strategic risk to prepare for:

- Project risk
- Customer risk
- Transition risk
- Unique competitor risk
- Brand risk
- Industry risk
- Stagnation risk

While your company no doubt faces other risks, such as regulatory or geopolitical risks, these seven cover the gamut of risks that threaten most companies' business designs.

Of course, there's no way to eliminate strategic risk altogether. But understanding and anticipating it, shaping it, and implementing the specific countermeasures that have proven to be effective can enable a company to dramatically improve its odds for surviving and even thriving in today's risk-rich environment—and to discover the upside potential concealed by the frightening mask of downside risk.

the back of the store, while the same items might be front and center in Miami or Los Angeles.

Coach also uses its knowledge of customer habits to guide its product introduction strategies. For example, research shows that the best Coach customers visit the store every four to five weeks. This dictates the rhythm at which Coach rolls out its own products and floor-set changes.

The Virtues of Data Frequency

One of the keys to effective use of proprietary information is data frequency—having continuous data through constant probes into the marketplace, as opposed to sporadic or periodic snapshots of the moving market, from which the size and direction of customer shifts can only be inferred.

Coach understands these principles of data frequency. Constant communication with customers helps the company turn sharply when market attitudes shift. When preppy styles came back into fashion in spring 2004, Coach had anticipated the trend and was ready with pink-and-green bags and accessories. When Coach management noticed that its new Ergo bag had sold out just a few days after its launch in Japan (where the company's most fashion-forward items first appear), they quickly ramped up production, having recognized sooner than most companies would have that they had a hit on their hands.

Coach has taken the greatest risk in its business—customer shifts—reversed it, and created a growth breakthrough. As a result of its direct, continuous, and unfiltered customer connections, Coach has steadily grown in sales, margins, and market share since 1999, significantly outperforming its rivals Gucci and LVMH and steadily gaining on them in terms of worldwide popularity. Since 2001, Coach's sales have grown by an annual rate of 23 percent, while earnings have grown by an annual rate of 40 percent. In just two years (2003–2005), Coach's market share has increased from 18 percent to 23 percent.

Shareholder value has followed suit. In 2000–2001, Sara Lee, in a two-step transaction, spun off Coach as a freestanding company. Since then, Coach's

Exhibit 1 Coach's de-risking moves

- Create continuous customer information.
- Use multiple customer touchpoints to improve demand forecasting.
- Monitor early warning signals of customer change through detailed sales data.
- Reduce fixed costs (moving from 75% insourced in the mid-90s to 100% outsourced in 2002).
- Shorten new-product cycle time (releases every four to five weeks, up from twice a year).
- Learn through multiple new-product variations (12 to 28 per release, up from two to three).
- Shorten concept-to-shelf lead time (11 months, improved from 15 months).

stock has risen 20-fold. By contrast, the stock of LVMH, Louis Vuitton's parent company, increased by 96 percent over the same period, while Gucci's has declined by 6 percent.

The new Coach demographic is a key element in the company's reshaped risk profile. "Our current business model is much less risky than before," Frankfort says "because we have a broader price spectrum, a broader range of items, and goods appropriate for a broader list of occasions."

But the shift in style wouldn't be working for Coach if it hadn't been accompanied by a thoughtful realignment of the entire business design. To see how the pieces fit together, consider Exhibit 2, which compares the business designs of two types of makers and marketers of luxury fashion accessories, the design-driven model (such as Gucci or LVMH) and the information-driven model practiced by Coach.

As it evolved its business design, Coach significantly de-risked its business. It cut fixed costs by careful outsourcing; it cut development cycle time by 30 percent; it reduced inventory levels to one-third the level of rivals. It has developed a broader spectrum of products, purchase occasions, and price points; it can shadow the constant shifts in the market, contracting and expanding product lines as needed.

Exhibit 2 Comparing luxury fashion accessory business designs

	Design-driven	Information-driven (Coach)
Customer selection	Top income	Middle to top income
Unique value proposition	Fashion, brand prestige	Hitting the target of customer needs, monthly refresh of product line
Profit model	Enormous margins	Frequency, growing suite of products, share of customer wallet
Strategic control	Brand	Patents, chip manufacturing capabilities, lower cost position, "green" and "high-tech" brand

Most important of all, however, it created a continuous, multi-angled, highly accurate flow of customer information. This flow allows it to see threats early, to craft the right products in response, and to adjust production volumes with extraordinary accuracy.

Coach will no doubt face many new risks in the future. It has designed a business that will help it see those risks sooner, react faster, and craft a response that is uncannily accurate relative to what customers want and will pay for. ❖



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