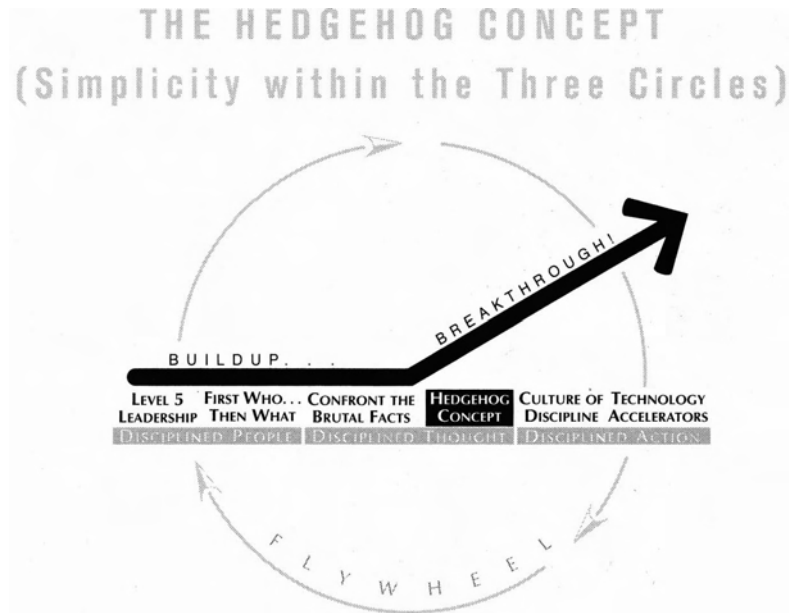




Know thyself.

— SCRIBES OF DELPHI,
via Plato¹

Are you a hedgehog or a fox?

In his famous essay "The Hedgehog and the Fox," Isaiah Berlin divided the world into hedgehogs and foxes, based upon an ancient Greek parable: "The fox knows many things, but the hedgehog knows one big thing."² The fox is a cunning creature, able to devise a myriad of complex strategies for sneak attacks upon the hedgehog. Day in and day out, the fox circles around the hedgehog's den, waiting for the perfect moment to pounce. Fast, sleek, beautiful, fleet of foot, and crafty—the fox looks like the sure winner. The hedgehog, on the other hand, is a dowdier creature, looking like a genetic mix-up between a porcupine and a small armadillo. He waddles along, going about his simple day, searching for lunch and taking care of his home.

The fox waits in cunning silence at the juncture in the trail. The hedgehog, minding his own business, wanders right into the path of the fox.

"Aha, I've got you now!" thinks the fox. He leaps out, bounding across the ground, lightning fast. The little hedgehog, sensing danger, looks up and thinks, "Here we go again. Will he ever learn?" Rolling up into a perfect little ball, the hedgehog becomes a sphere of sharp spikes, pointing outward in all directions. The fox, bounding toward his prey, sees the hedgehog defense and calls off the attack. Retreating back to the forest, the fox begins to calculate a new line of attack. Each day, some version of this battle between the hedgehog and the fox takes place, and despite the greater cunning of the fox, the hedgehog always wins.

Berlin extrapolated from this little parable to divide people into two basic groups: foxes and hedgehogs. Foxes pursue many ends at the same time and see the world in all its complexity. They are "scattered or diffused, moving on many levels," says Berlin, never integrating their thinking into one overall concept or unifying vision. Hedgehogs, on the other hand, simplify a complex world into a single organizing idea, a basic principle—or concept that unifies and guides everything. It doesn't matter how complex the world, a hedgehog reduces all challenges and dilemmas to simple—indeed almost simplistic—hedgehog ideas. For a hedgehog, anything that does not somehow relate to the hedgehog idea holds no relevance.

Princeton professor Marvin Bressler pointed out the power of the hedgehog during one of our long conversations: "You want to know what separates those who make the biggest impact from all the others who are just as smart? They're hedgehogs." Freud and the unconscious, Darwin and natural selection, Marx and class struggle, Einstein and relativity, Adam Smith and division of labor—they were all hedgehogs. They took a complex world and simplified it. "Those who leave the biggest footprints," said Bressler, "have thousands calling after them, 'Good idea, but you went too far!'"³

To be clear, hedgehogs are not stupid. Quite the contrary. They understand that the essence of profound insight is simplicity. What could be more simple than $e = mc^2$? What could be simpler than the idea of the unconscious, organized into an id, ego, and superego? What could be more elegant than Adam Smith's pin factory and "invisible hand"? No, the hedgehogs aren't simpletons; they have a piercing insight that allows them to see through complexity and discern underlying patterns. Hedgehogs see what is essential, and ignore the rest.

What does all this talk of hedgehogs and foxes have to do with good to great? Everything.

Those who built the good-to-great companies were, to one degree or another, hedgehogs. They used their hedgehog nature to drive toward what we came to call a Hedgehog Concept for their companies. Those who led the comparison companies tended to be foxes, never gaining the clarifying advantage of a Hedgehog Concept, being instead scattered, diffused, and inconsistent.

Consider the case of Walgreens versus Eckerd. Recall how Walgreens generated cumulative stock returns from the end of 1975 to 2000 that exceeded the market by over fifteen times, handily beating such great companies as GE, Merck, Coca-Cola, and Intel. It was a remarkable performance for such an anonymous—some might even say boring—company. When interviewing Cork Walgreen, I kept asking him to go deeper, to help us understand these extraordinary results. Finally, in exasperation, he said, "Look, it just wasn't that complicated! Once we understood the concept, we just moved straight ahead."⁴

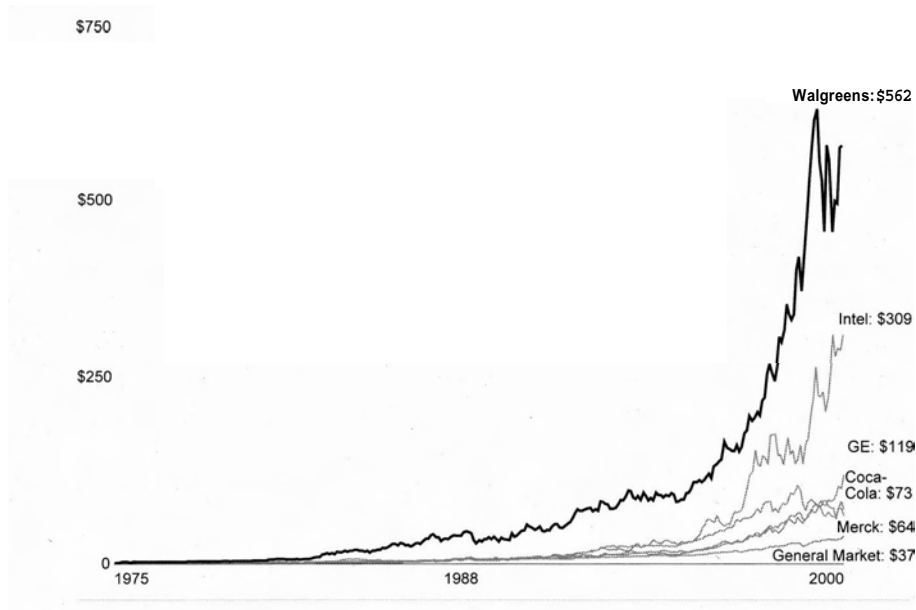
What was the concept? Simply this: the best, most convenient drugstores, with high profit per customer visit. That's it. That's the breakthrough strategy that Walgreens used to beat Intel, GE, Coca-Cola, and Merck.

In classic hedgehog style, Walgreens took this simple concept and implemented it with fanatical consistency. It embarked on a systematic program to replace all inconvenient locations with more convenient ones, preferably corner lots where customers could easily enter and exit from multiple directions. If a great corner location would open up just half a block away from a profitable Walgreens store in a good location, the company would close the good store (even at a cost of \$1 million to get out of the lease) to open a great new store on the corner.⁵ Walgreens pioneered drive-through pharmacies, found customers liked the idea, and built hundreds of them. In urban areas, the company clustered its stores tightly together, on the precept that no one should have to walk more than a few blocks to reach a Walgreens.⁶ In downtown San Francisco, for example, Walgreens clustered nine stores within a one-mile radius. Nine stores!⁷ If you look closely, you will see Walgreens stores as densely packed in some cities as Starbucks coffee shops in Seattle.

Walgreens then linked its convenience concept to a simple economic idea, profit per customer visit. Tight clustering (nine stores per mile!) leads to local economies of scale, which provides the cash for more clustering, which in turn draws more customers. By adding high-margin ser-

WALGREENS VERSUS SELECTED GREAT COMPANIES

Cumulative Stock Returns of \$1 Invested,
December 31, 1975 – January 1, 2000



vices, like one-hour photo developing, Walgreens increased its profit per customer visit. More convenience led to more customer visits, which, when multiplied times increased profit per customer visit, threw cash back into the system to build even more convenient stores. Store by store, block by block, city by city, region by region, Walgreens became more and more of a hedgehog with this incredibly simple idea.

In a world overrun by management faddists, brilliant visionaries, ranting futurists, fearmongers, motivational gurus, and all the rest, it's refreshing to see a company succeed so brilliantly by taking one simple concept and just doing it with excellence and imagination. Becoming the best in the world at convenient drugstores, steadily increasing profit per customer visit—what could be more obvious and straightforward?

Yet, if it was so obvious and straightforward, why didn't Eckerd see it? While Walgreens stuck only to cities where it could implement the convenience/clustering concept, we found no evidence of a similarly coherent concept for growth at Eckerd. Deal makers to the core, Eckerd's executives compulsively leapt at opportunities to acquire clumps of stores—forty-two units here, thirty-six units there—in hodgepodge fashion, with no obvious unifying theme.

While Walgreens executives understood that profitable growth would come by pruning away all that did not fit with the Hedgehog Concept, Eckerd executives lurched after growth for growth's sake. In the early 1980s, just as Walgreens became religious about carrying out its convenient drugstore concept, Eckerd threw itself into the home video market with its purchase of American Home Video Corporation. Eckerd's CEO told *Forbes* magazine in 1981, "Some feel the purer we are the better we'll be. But I want growth, and the home video industry is only emerging—unlike, say, drugstore chains."⁸ Eckerd's home video foray produced \$31 million in losses before Eckerd sold it to Tandy, which crowed that it got the deal for \$72 million below book value.⁹

In the precise year of Eckerd's American Home Video acquisition, Walgreens and Eckerd had virtually identical revenues (\$1.7 billion). Ten years later, Walgreens had grown to over twice the revenues of Eckerd, accumulating net profits \$1 billion greater than Eckerd over the decade. Twenty years later, Walgreens was going strong, as one of the most sustained transformations in our study. Meanwhile, Eckerd ceased to exist as an independent company.¹⁰

THE THREE CIRCLES

The notion of a Hedgehog Concept originated in our research team meetings when we were trying to make sense of Walgreens' spectacular returns.

"Aren't we just talking about strategy?" I asked. "Convenient drugstores, profit per customer visit—isn't that just basic strategy? What's so interesting about that?"

"But Eckerd also had strategy," said Jenni Cooper, who analyzed the contrast between the two companies. "We can't say that it's just about having strategy. They both had strategy." Jenni was correct in her observation. Strategy per se did not distinguish the good-to-great companies from the comparison companies. Both sets of companies had strategic plans, and there is absolutely no evidence that the good-to-great companies invested more time and energy in strategy development and long-range planning.

"Okay, so are we just talking about good strategy versus bad strategy?"

The team sat there for a minute, thinking. Then Leigh Wilbanks observed, "But what I find so striking is their incredible simplicity. I mean, look at Kroger with the superstore concept, or Kimberly-Clark with the

move to paper-based consumer products, or Walgreens with convenient drugstores. These were simple, simple, simple ideas."

The research-team members all jumped into the fray, bantering about the companies they were studying. It soon became abundantly clear that all the good-to-great companies attained a very simple concept that they used as a frame of reference for all their decisions, and this understanding coincided with breakthrough results. Meanwhile, the comparison companies like Eckerd got all tripped up by their snazzy strategies for growth. "Okay," I pushed back, "but is simplicity enough? Just because it's simple doesn't mean it's right. The world is filled with failed companies that had simple but wrong ideas."

Then we decided to undertake a systematic look at the concepts that guided the good-to-great companies in contrast to the comparison companies. After a few months of sifting and sorting, considering possibilities and tossing them out, we finally came to see that the Hedgehog Concept in each good-to-great company wasn't just any random simple idea.

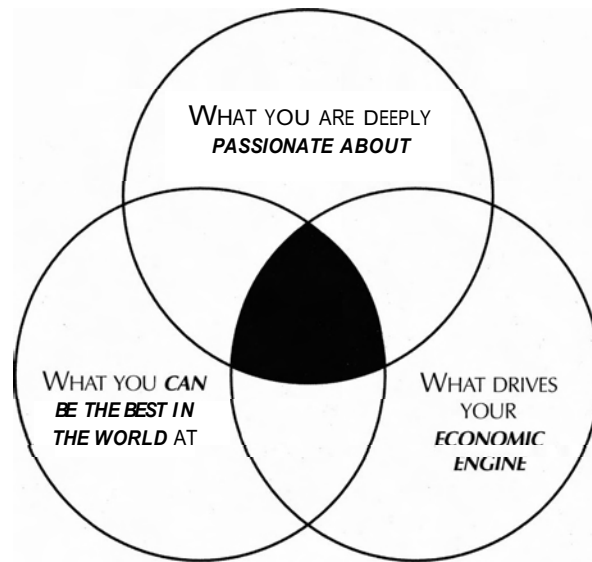
The essential strategic difference between the good-to-great and comparison companies lay in two fundamental distinctions. First, the good-to-great companies founded their strategies on deep understanding along three key dimensions—what we came to call the three circles. Second, the good-to-great companies translated that understanding into a simple, crystalline concept that guided all their efforts—hence the term *Hedgehog Concept*.

More precisely, a Hedgehog Concept is a simple, crystalline concept that flows *from* deep understanding about the intersection of the following three circles:

1. What you can be the best in the world at (and, equally important, what you cannot be the best in the world at). This discerning standard goes far beyond core competence. Just because you possess a core competence doesn't necessarily mean you can be the best in the world at it. Conversely, what you can be the best at might not even be something in which you are currently engaged.
2. What drives your economic engine. All the good-to-great companies attained piercing insight into how to most effectively generate sustained

and robust cash flow and profitability. In particular, they discovered the single denominator — profit per x — that had the greatest impact on their economics. (It would be cash flow per x in the social sector.)

3. *What you are deeply passionate about.* The good-to-great companies focused on those activities that ignited their passion. The idea here is not to stimulate passion but to discover what makes you passionate.



THREE CIRCLES OF THE HEDGEHOG CONCEPT

To quickly grasp the three circles, consider the following personal analogy. Suppose you were able to construct a work life that meets the following three tests. First, you are doing work for which you have a genetic or God-given talent, and perhaps you could become one of the best in the world in applying that talent. ("I feel that I was just born to be doing this.") Second, you are well paid for what you do. ("I get paid to do this? Am I dreaming?") Third, you are doing work you are passionate about and absolutely love to do, enjoying the actual process for its own sake. ("I look forward to getting up and throwing myself into my daily work, and I really believe in what I'm doing.") If you could drive toward the intersection of these three circles and translate that intersection into a simple, crystalline concept that guided your life choices, then you'd have a Hedgehog Concept for yourself.

To have a fully developed Hedgehog Concept, you need all three circles. If you make a lot of money doing things at which you could never be the best, you'll only build a successful company, not a great one. If you become the best at something, you'll never remain on top if you don't have intrinsic passion for what you are doing. Finally, you can be passionate all you want, but if you can't be the best at it or it doesn't make economic sense, then you might have a lot of fun, but you won't produce great results.

**UNDERSTANDING WHAT YOU CAN
(AND CANNOT) BE THE BEST AT**

"They stick with what they understand and let their abilities, not their egos, determine what they attempt." So wrote Warren Buffett about his \$290 million investment in Wells Fargo despite his serious reservations about the banking industry.¹² Prior to clarifying its Hedgehog Concept, Wells Fargo had tried to be a global bank, operating like a mini-Citicorp, and a mediocre one at that. Then, at first under Dick Cooley and then under Carl Reichardt, Wells Fargo executives began to ask themselves a piercing set of questions: What can we potentially do better than any other company, and, equally important, what can we not do better than any other company? And if we can't be the best at it, then why are we doing it at all?

Putting aside their egos, the Wells Fargo team pulled the plug on the vast majority of its international operations, accepting the truth that it could not be better than Citicorp in global banking.¹³ Wells Fargo then turned its attention to what it could be the best in the world at: running a bank like a business, with a focus on the western United States. That's it. That was the essence of the Hedgehog Concept that turned Wells Fargo from a mediocre Citicorp wanna-be to one of the best-performing banks in the world.

Carl Reichardt, CEO of Wells Fargo at the time of transition, stands as a consummate hedgehog. While his counterparts at Bank of America went into a reaction-revolution panic mode in response to deregulation, hiring change gurus who used sophisticated models and time-consuming encounter groups, Reichardt stripped everything down to its essential simplicity.¹⁴ "It's not space science stuff," he told us in our interview. "What we did was so simple, and we kept it simple. It was so straightforward and obvious that it sounds almost ridiculous to talk about it. The average businessman coming from a highly competitive industry with no regulations would have jumped on this like a goose on a June bug."¹⁵

Reichardt kept people relentlessly focused on the simple hedgehog idea, continually reminding them that "there's more money to be made in Modesto than Tokyo."¹⁶ Those who worked with Reichardt marveled at his genius for simplicity. "If Carl were an Olympic diver," said one of his colleagues, "he would not do a five-flip twisting thing. He would do the best swan dive in the world, and do it perfectly over and over again.""

The Wells Fargo focus on its Hedgehog Concept was so intense that it became, in its executives' own words, "a mantra." Throughout our interviews, Wells Fargo people echoed the same basic theme— "It wasn't that complicated. We just took a hard-nosed look at what we were doing and decided to focus entirely on those few things we knew we could do better than anyone else, not getting distracted into arenas that would feed our egos and at which we could not be the best."

*This brings me to one of the most crucial points of this chapter: A Hedgehog Concept is not a goal to be the best, a strategy to be the best, an intention to be the best, a plan to be the best. It is an *understanding* of what you *can* be the best at. The distinction is absolutely crucial.*

Every company would like to be the best at something, but few actually understand— with piercing insight and egoless clarity— what they actually have the potential to be the best at and, just as important, what they cannot be the best at. And it is this distinction that stands as one of the primary contrasts between the good-to-great companies and the comparison companies.

Consider the contrast between Abbott Laboratories and Upjohn. In 1964, the two companies were almost identical in terms of revenues, profits, and product lines. Both companies had the bulk of their business in pharmaceuticals, principally antibiotics. Both companies had family management. Both companies lagged behind the rest of the pharmaceutical industry. But then, in 1974, Abbott had a breakthrough in performance, producing cumulative returns of 4.0 times the market and 5.5 times Upjohn over the next fifteen years. One crucial difference between the two companies is that Abbott developed a Hedgehog Concept based on what it could be the best at and Upjohn did not.

Abbott began by confronting the brutal facts. By 1964, Abbott had lost the opportunity to become the best pharmaceutical company. While

Abbott had drowsily lumbered along in the 1940s and 1950s, living off its cash cow, erythromycin, companies like Merck had built research engines that rivaled Harvard and Berkeley. By 1964, George Cain and his Abbott team realized that Merck and others had such a huge research lead that trying to be the best pharmaceutical company would be like a high school football team trying to take on the Dallas Cowboys.

Even though Abbott's entire history lay in pharmaceuticals, becoming the best pharmaceutical company was no longer a viable option. So, guided by a Level 5 leader and tapping into the faith side of the Stockdale Paradox (There must be a way for us to prevail as a great company, and we will find it!), the Abbott team sought to understand what it could be the best at. Around 1967, a key insight emerged: We've lost the chance to be the best pharmaceutical company, but we have an opportunity to excel at creating products that contribute to cost-effective health care. Abbott had experimented with hospital nutritional products, designed to help patients quickly regain their strength after surgery, and diagnostic devices (one of the primary ways to reduce health care costs is through proper diagnosis). Abbott eventually became the number one company in both of these arenas, which moved it far down the path of becoming the best company in the world at creating products that make health care more cost-effective.¹⁸

Upjohn never confronted the same brutal reality and continued to live with the delusion that it could beat Merck.¹⁹ Later, when it fell even further behind the pharmaceutical leaders, it diversified into arenas where it definitely could not be the best in the world, such as plastics and chemicals. As Upjohn fell even further behind, it returned to a focus on ethical drugs, yet never confronted the fact that it was just too small to win in the big-stakes pharmaceutical game.²⁰ Despite consistently spending nearly twice the percentage of sales on R&D as Abbott, Upjohn saw its profits dwindle to less than half those of Abbott before being acquired in 1995.²¹

The Abbott versus Upjohn case highlights the difference between a "core business" and a Hedgehog Concept. Just because something is your core business—just because you've been doing it for years or perhaps even decades—does not necessarily mean that you can be the best in the world at it. *And if you cannot be the best in the world at your core business, then your core business cannot form the basis of your Hedgehog Concept.*

Clearly, a Hedgehog Concept is not the same as a core competence. You can have competence at something but not necessarily have the potential to be the best in the world at it. To use an analogy, consider the young person who gets straight A's in high school calculus and scores high on the math part of the SAT, demonstrating a core competence at mathematics. Does that mean the person should become a mathematician? Not necessarily. Suppose now that this young person goes off to college, enrolls in math courses, and continues to earn A's, yet encounters people who are genetically encoded for math. As one such student said after this experience, "It would take me three hours to finish the final. Then there were those who finished the same final in thirty minutes and earned an A+. Their brains are just wired differently. I could be a very competent mathematician, but I soon realized I could never be one of the best." That young person might still get pressure from parents and friends to continue with math, saying, "But you're so good at it." Just like our young person, many people have been pulled or have fallen into careers where they can never attain complete mastery and fulfillment. Suffering from the curse of competence but lacking a clear Hedgehog Concept, they rarely become great at what they do.

The Hedgehog Concept requires a severe standard of excellence. It's not just about building on strength and competence, but about understanding what your organization truly has the potential to be the very best at and sticking to it. Like Upjohn, the comparison companies stuck to businesses at which they were "good" but could never be the best, or worse, launched off in pursuit of easy growth and profits in arenas where they had no hope of being the best. They made money but never became great.

To go from good to great requires transcending the curse of competence. It requires the discipline to say, "Just because we are good at it—just because we're making money and generating growth—doesn't necessarily mean we can become the best at it." The good-to-great companies understood that doing what you are good at will only make you good; focusing solely on what you can potentially do better than any other organization is the only path to greatness.

Every good-to-great company eventually gained deep understanding of this principle and pinned their futures on allocating resources to those

few arenas where they could potentially be the best. (See the table below.) The comparison companies rarely attained this understanding.

THE GOOD-TO-GREAT COMPANIES AND THE "BEST IN THE WORLD AT" CIRCLE OF THE HEDGEHOG CONCEPT

This table shows the understanding the good-to-great companies attained that formed the foundation of their shift from good to great. Note: This list does not show what the companies were already best in the world at when they began their transitions (most of these companies weren't the best at anything); rather, it shows what they came to understand they could become best in the world at.

Abbott Laboratories:
Could become the best at creating a product portfolio that lowers the cost of health care.

Notes: Abbott confronted the reality that it could not become the best pharmaceutical company in the world, despite the fact that pharmaceuticals at the time accounted for 99 percent of its revenues.²² It shifted its focus to creating a portfolio of products that contribute to lower-cost health care, principally hospital nutritionals, diagnostics, and hospital supplies.

Circuit City: Could become the best at implementing the "4-S" model (service, selection, savings, satisfaction) applied to big-ticket consumer sales.

Notes: Circuit City saw that it could become "the McDonald's" of big-ticket retailing, able to operate a geographically dispersed system by remote control. Its distinction lay not in the "4-s" model per se—but in the *consistent, superior execution* of the model.

Fannie Mae: Could become the best capital markets player in anything that pertains to mortgages.

Notes: The critical insight was to see (1) that it could be a full capital markets player as good as any on Wall Street and (2) that it could develop a unique capability to assess risk in mortgage-related securities.

Gillette: Could become the best at building premier global brands of daily necessities that require sophisticated manufacturing technology.

Notes: Gillette saw that it had an unusual combination of two very different skills: (1) the ability to manufacture billions of low-cost, super-high-tolerance products (e.g., razor blades) and (2) the ability to build global consumer brands—the "Coke" of blades or toothbrushes.

Kimberly-Clark: Could become the best in the world at paper-based consumer products.

Notes: Kimberly-Clark realized that it had a latent skill at creating "category-killer" brands—brands where the name of the product is synonymous with the name of the category (e.g., Kleenex)—in paper-based products.

Kroger: Could become the best at innovative super-combo stores.

Notes: Kroger always had a strength in grocery store innovation. It took this skill and applied it to the question of how to create a combination store with many innovative, high-margin "mini-stores" under one roof.

Nucor: Could become the best at harnessing culture and technology to produce low-cost steel.

Notes: Nucor came to see that it had tremendous skill in two activities: (1) creating a performance culture and (2) making farsighted bets on new manufacturing technologies. By combining these two, it was able to become the lowest-cost steel producer in the United States.

Philip Morris: Could become the best in the world at building brand loyalty in cigarettes and, later, other consumables.

Notes: Early in transition, Philip Morris saw that it could become simply the best tobacco company in the world. Later, it began to diversify into non-tobacco arenas (a step taken by all tobacco companies, as a defensive measure), but stayed close to its brand-building strengths in "sinful" products (beer, tobacco, chocolate, coffee) and food products.

Pitney Bowes: Could become the best in the world at messaging that requires sophisticated back-office equipment.

Notes: As Pitney wrestled with the question of how to evolve beyond postage meters, it had two key insights about its strengths: (1) that it was not a postage company, but could have a broader definition (messaging) and (2) that it had particular strength in supplying the back rooms with sophisticated machines.

Walgreens: Could become the best at convenient drug-stores.

Notes: Walgreens saw that it was not just a drugstore but also a convenience store. It began systematically seeking the best sites for convenience—clustering many stores within a small radius and pioneering drive-through pharmacies. It also made extensive investments in technology (including recent Web site developments), linking Walgreen stores worldwide to create one giant "corner pharmacy."

Wells Fargo: Could become the best at running a bank like a business, with a focus on the western United States.

Notes: Wells came to two essential insights. First, most banks thought of themselves as banks, acted like banks, and protected the banker culture. Wells saw itself as a business that happened to be in banking. "Run it like a business" and "Run it like you own it" became mantras. Second, Wells recognized that it could not be the best in the world as a superglobal bank, but that it could be the best in the western United States.

**INSIGHT INTO YOUR ECONOMIC ENGINE—
WHAT IS YOUR DENOMINATOR?**

The good-to-great companies frequently produced spectacular returns in very unspectacular industries. The banking industry ranked in the bottom quartile of industries (in total returns) during the same period that Wells Fargo beat the market by four times. Even more impressive, both Pitney Bowes and Nucor were in bottom 5 percent industries; yet both these companies beat the market by well over five times. Only one of the good-to-great companies had the benefit of being in a great industry (defined as a top 10 percent industry); five were in good industries; five were in bad to terrible industries. (See Appendix 5.A for a summary of industry analysis.)

Our study clearly shows that a company does not need to be in a great industry to become a great company. Each good-to-great company built a fabulous economic engine, regardless of the industry. They were able to do this because they attained profound insights into their economics.

This is not a book on microeconomics. Each company and each industry had its own economic realities, and I'm not going to belabor them all here. The central point is that each good-to-great company attained a deep understanding of the key drivers in its economic engine and built its system in accordance with this understanding.

That said, however, we did notice one particularly provocative form of economic insight that every good-to-great company attained, the notion of a single "economic denominator." Think about it in terms of the following question: *If you could pick one and only one ratio—profit per x (or, in the social sector, cash flow per x)—to systematically increase over time, what x would have the greatest and most sustainable impact on your economic engine?* We learned that this single question leads to profound insight into the inner workings of an organization's economics.

Recall how Walgreens switched its focus from profit per store to profit per customer visit. Convenient locations are expensive, but by increasing profit per customer visit, Walgreens was able to increase convenience (nine stores in a mile!) and simultaneously increase profitability across its

entire system. The standard metric of profit per store would have run contrary to the convenience concept. (The quickest way to increase profit per store is to decrease the number of stores and put them in less expensive locations. This would have destroyed the convenience concept.)

Or consider Wells Fargo. When the Wells team confronted the brutal fact that deregulation would transform banking into a commodity, they realized that standard banker metrics, like profit per loan and profit per deposit, would no longer be the key drivers. Instead, they grasped a new denominator: profit per employee. Following this logic, Wells Fargo became one of the first banks to change its distribution system to rely primarily on stripped-down branches and ATMs.

The denominator can be quite subtle, sometimes even unobvious. The key is to use the question of the denominator to gain understanding and insight into your economic model.

For example, Fannie Mae grasped the subtle denominator of profit per mortgage risk level, not per mortgage (which would be the "obvious" choice). It's a brilliant insight. The real driver in Fannie Mae's economics is the ability to understand risk of default in a package of mortgages better than anyone else. Then it makes money selling insurance and managing the spread on that risk. Simple, insightful, unobvious—and right.

Nucor, for example, made its mark in the ferociously price competitive steel industry with the denominator profit per ton of finished steel. At first glance, you might think that per employee or per fixed cost might be the proper denominator. But the Nucor people understood that the driving force in its economic engine was a combination of a strong-work-ethic culture and the application of advanced manufacturing technology. Profit per employee or per fixed cost would not capture this duality as well as profit per ton of finished steel.

Do you need to have a single denominator? No, but pushing for a single denominator tends to produce better insight than letting yourself off the hook with three or four denominators. The denominator question serves as a mechanism to force deeper understanding of the key drivers in your economic engine. As the denominator question emerged from the research, we tested the question on a number of executive teams. We found that the question always stimulated intense dialogue and debate.

Furthermore, even in cases where the team failed (or refused) to identify a single denominator, the challenge of the question drove them to deeper insight. And that is, after all, the point— to have a denominator not for the sake of having a denominator, but for the sake of gaining insight that ultimately leads to more robust and sustainable economics.

ECONOMIC DENOMINATOR

This table shows the economic denominator insight attained by the good-to-great companies during the pivotal transition years.

Abbott: per employee

Key insight: Shift from profit per product line to profit per employee fit with the idea of contributing to cost-effective health care.

Circuit City: per geographic region

Key insight: Shift from profit per single store to profit per region reflected local economies of scale. While per-store performance remained vital, regional grouping was a key insight that drove Circuit City's economics beyond Silo's.

Fannie Mae: per mortgage risk level

Key insight: Shift from profit per mortgage to profit per mortgage risk level reflected the fundamental insight that managing interest risk reduces dependence on the direction of interest rates.

Gillette: per customer

Key insight: Shift from profit per division to profit per customer reflected the economic power of repeatable purchases (e.g., razor cartridges) times high profit per purchase (e.g., Mach3, not disposable razors).

Kimberly-Clark: per consumer brand

Key insight: Shift from profit per fixed asset (the mills) to profit per consumer brand; would be less cyclical and more profitable in good times and bad.

Kroger: per local population	Key insight: Shift from profit per store to profit per local population reflected the insight that local market share drove grocery economics. If you can't attain number one or number two in local share, you should not play.
Nucor: per ton of finished steel	Key insight: Shift from profit per division to profit per ton of finished steel reflected Nucor's unique blend of high-productivity culture mixed with mini-mill technology, rather than just focusing on volume.
Philip Morris: <i>per global brand category</i>	Key insight: Shift from profit per sales region to profit per global brand category reflected the understanding that the real key to greatness lay in brands that could have global power, like Coke.
Pitney Bowes: per customer	Key insight: Shift from profit per postage meter to profit per customer reflected the idea that Pitney Bowes could use its postage meters as a jumping-off point to bring a range of sophisticated products into the back offices of customers.
Walgreens: per customer visit	Key insight: Shift from profit per store to profit per customer visit reflected a symbiotic relationship between convenient (and expensive) store sites and sustainable economics.
Wells Fargo: <i>per employee</i>	Key insight: Shift from profit per loan to profit per employee reflected understanding of the brutal fact of deregulation: Banking is a commodity.

All the good-to-great companies discovered a key economic denominator (see the table on page 106), while the comparison companies usually did not. In fact, we found only one comparison case that attained a profound insight into its economics. Hasbro built its upswing on the insight that a portfolio of classic toys and games, such as G.I. Joe and Monopoly, produces more sustainable cash flow than big onetime hits.²³ In fact, Hasbro is the one comparison company that understood all three circles of the Hedgehog Concept. It became the best in the world at acquiring and renewing tried-and-true toys, reintroducing and recycling them at just the right time to increase profit per classic brand. And its people had great passion for the business. Systematically building from all three circles, Hasbro became the best-performing comparison in our study, lending further credence to the power of the Hedgehog Concept.

Hasbro became an unsustained transition in part because it lost the discipline to stay within the three circles, after the unexpected death of CEO Stephen Hassenfeld. The Hasbro case reinforces a vital lesson. *If* you successfully apply these ideas, but then stop doing them, you will slide backward, from great to good, or worse. The only way to remain great is to keep applying the *fundamental* principles that made you great.

UNDERSTANDING YOUR PASSION

When interviewing the Philip Morris executives, we encountered an intensity and passion that surprised us. Recall from chapter 3 how George Weissman described working at the company as the great love affair of his life, second only to his marriage. Even with a most sinful collection of consumer products (Marlboro cigarettes, Miller beer, 67 percent fat-filled Velveeta, Maxwell House coffee for caffeine addicts, Toblerone for chockoholics, and so forth), we found tremendous passion for the business. Most of the top executives at Philip Morris were passionate consumers of their own products. In 1979, Ross Millhiser, then vice chairman of Philip Morris and a dedicated smoker, said, "I love cigarettes. It's one of the things that makes life really worth living."²⁴

The Philip Morris people clearly loved their company and had passion for what they were doing. It's as if they viewed themselves as the lone, fiercely independent cowboy depicted in the Marlboro billboards. "We have a right to smoke, and we will protect that right!" A board member told me during my research for a previous project, "I really love being on

the board of Philip Morris. It's like being part of something really special." She said this as she proudly puffed away.²⁵

Now, you might say, "But that is just the defensiveness of the tobacco industry. Of course they'd feel that way. Otherwise, how could they sleep at night?" But keep in mind that R. J. Reynolds was *also* in the tobacco business and under siege from society. Yet, unlike Philip Morris, R. J. Reynolds executives began to diversify away from tobacco into any arena where it could get growth, regardless of whether they had passion for those acquisitions or whether the company could be the best in the world at them. The Philip Morris people stuck much closer to the tobacco business, in large part because they loved that business. In contrast, the R. J. Reynolds people saw tobacco as just a way to make money. As vividly portrayed in the book *Barbarians at the Gate*, R. J. Reynolds executives eventually lost passion for anything except making themselves rich through a leveraged buyout.²⁶

It may seem odd to talk about something as soft and fuzzy as "passion" as an integral part of a strategic framework. But throughout the good-to-great companies, passion became a key part of the Hedgehog Concept. You can't manufacture passion or "motivate" people to feel passionate. You can only *discover* what ignites your passion and the passions of those around you.

The good-to-great companies did not say, "Okay, folks, let's get passionate about what we do." Sensibly, they went the other way entirely: *We should only do those things that we can get passionate about.* Kimberly-Clark executives made the shift to paper-based consumer products in large part because they could get more passionate about them. As one executive put it, the traditional paper products are okay, "but they just don't have the charisma of a diaper."²⁷

When Gillette executives made the choice to build sophisticated, relatively expensive shaving systems rather than fight a low-margin battle with disposables, they did so in large part because they just couldn't get excited about cheap disposable razors. "Zeien talks about shaving systems with the sort of technical gusto one expects from a Boeing or Hughes engineer," wrote one journalist about Gillette's CEO in 1996.²⁸ Gillette has always been at its best when it sticks to businesses that fit its Hedgehog

Concept. "People who aren't passionate about Gillette need not apply," wrote a Wall Street Journal reporter, who went on to describe how a top business school graduate wasn't hired because she didn't show enough passion for deodorant.²⁹

Perhaps you, too, can't get passionate about deodorant. Perhaps you might find it hard to imagine being passionate about pharmacies, grocery stores, tobacco, or postage meters. You might wonder about what type of person gets all jazzed up about making a bank as efficient as McDonald's, or who considers a diaper charismatic. In the end, it doesn't really matter. The point is that they felt passionate about what they were doing and the passion was deep and genuine.

This doesn't mean, however, that you have to be passionate about the mechanics of the business *per se* (although you might be). The passion circle can be focused equally on what the company stands for. For example, the Fannie Mae people were not passionate about the mechanical process of packaging mortgages into market securities. But they were terrifically motivated by the whole idea of helping people of all classes, backgrounds, and races realize the American dream of owning their home. Linda Knight, who joined Fannie Mae in 1983, just as the company faced its darkest days, told us: "This wasn't just any old company getting into trouble; this was a company at the core of making home ownership a reality for thousands of Americans. It's a role that is far more important than just making money, and that's why we felt such depth of commitment to preserve, protect, and enhance the company."³⁰ As another Fannie Mae executive summed up, "I see us as a key mechanism for strengthening the whole social fabric of America. Whenever I drive through difficult neighborhoods that are coming back because more families own their homes, I return to work reenergized."

THE TRIUMPH OF UNDERSTANDING OVER BRAVADO

On the research team, we frequently found ourselves talking about the difference between "prehedgehog" and "posthedgehog" states. In the pre-hedgehog state, it's like groping through the fog. You're making progress on a long march, but you can't see all that well. At each juncture in the trail, you can only see a little bit ahead and must move at a deliberate, slow crawl. Then, with the Hedgehog Concept, you break into a clearing,

the fog lifts, and you can see for miles. From then on, each juncture requires less deliberation, and you can shift from crawl to walk, and from walk to run. In the posthedgehog state, miles of trail move swiftly beneath your feet, forks in the road fly past as you quickly make decisions that you could not have seen so clearly in the fog.

What's so striking about the comparison companies is that—for all their change programs, frantic gesticulations, and charismatic leaders—they rarely emerged from the fog. They would try to run, making bad decisions at forks in the road, and then have to reverse course later. Or they would veer off the trail entirely, banging into trees and tumbling down ravines. (Oh, but they were sure doing it with speed and panache!)

For the comparison companies, the exact same world that had become so simple and clear to the good-to-great companies remained complex and shrouded in mist. Why? For two reasons. First, the comparison companies never asked the right questions, the questions prompted by the three circles. Second, they set their goals and strategies *more from bravado than from understanding*.

Nowhere is this more evident than in the comparison companies' mindless pursuit of growth: Over two thirds of the comparison companies displayed an obsession with growth without the benefit of a Hedgehog Concept.³¹ Statements such as "We've been a growth at any price company" and "Betting that size equals success" pepper the materials on the comparison companies. In contrast, not one of the good-to-great companies focused obsessively on growth. Yet they created sustained, profitable growth far greater than the comparison companies that made growth their mantra.

Consider the case of Great Western and Fannie Mae. "Great Western is a mite unwieldy," wrote the *Wall Street Transcript*. "It wants to grow everyway it can."³² The company found itself in finance, leasing, insurance, and manufactured houses, continually acquiring companies in an expansion binge.³³ Bigger! More! In 1985, Great Western's CEO told a gathering of analysts, "Don't worry about what you call us—a bank, an S&L, or a Zebra."³⁴

Quite a contrast to Fannie Mae, which had a simple, crystalline understanding that it could be the best capital markets player in anything

related to mortgages, better even than Goldman Sachs or Salomon Brothers in opening up the full capital markets to the mortgage process. It built a powerful economic machine by reframing its business model on risk management, rather than mortgage selling. And it drove the machine with great passion, the Fannie Mae people inspired by its vital role in democratizing home ownership.

Until 1984, the stock charts tracked each other like mirror images. Then in 1984, one year after it clarified its Hedgehog Concept, Fannie Mae exploded upward, while Great Western kept lollygagging along until just before its acquisition in 1997. By focusing on its simple, elegant conception—and not just focusing on "growth"—Fannie Mae grew revenues nearly threefold from its transition year in 1984 through 1996. Great Western, for all of its gobbling of growth steroids, grew revenues and earnings only 25 percent over the same period, then lost its independence in 1997.

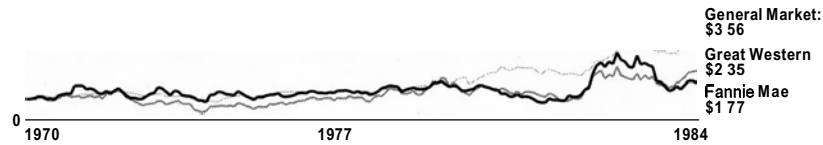
The Fannie Mae versus Great Western case highlights an essential point: *"Growth!" is not a Hedgehog Concept*. Rather, if you have the right Hedgehog Concept and make decisions relentlessly consistent with it, you will create such momentum that your main problem will not be how to grow, but how not to grow too fast.

The Hedgehog Concept is a turning point in the journey from good to great. In most cases, the transition date follows within a few years of the Hedgehog Concept. Furthermore, everything from here on out in the book hinges upon having the Hedgehog Concept. As will become abundantly clear in the following chapters, disciplined action—the third big chunk in the framework after disciplined people and disciplined thought—only makes sense in the context of the Hedgehog Concept.

Despite its vital importance (or, rather, because of its vital importance), it would be a terrible mistake to thoughtlessly attempt to jump right to a Hedgehog Concept. You can't just go off-site for two days, pull out a bunch of flip charts, do breakout discussions, and come up with a deep understanding. Well, you can do that, but you probably won't get it right. It would be like Einstein saying, "I think it's time to become a great scientist, so I'm going to go off to the Four Seasons this weekend, pull out the flip charts, and unlock the secrets of the universe." Insight just doesn't

FANNIE MAE, GREAT WESTERN, AND THE GENERAL MARKET Cumulative Value of \$1 Invested, 1970 – 1984

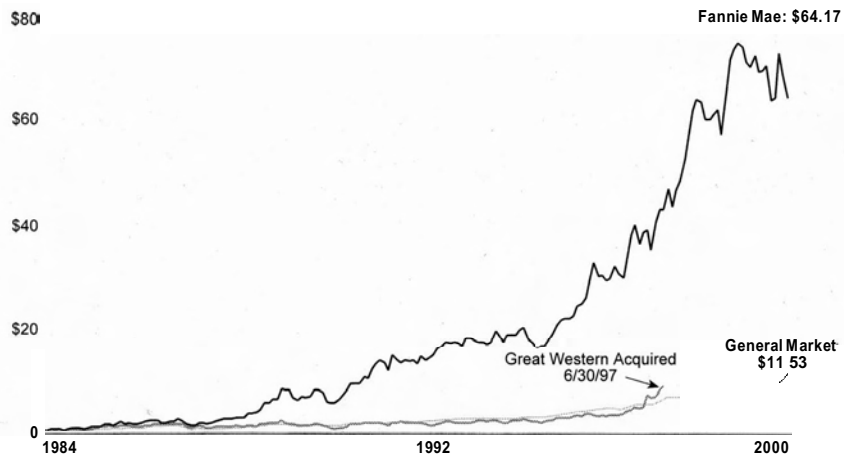
\$10



Notes:

1. Shows cumulative value of \$1 invested December 31, 1970 –January 1, 1984
2. Dividends reinvested.

FANNIE MAE, GREAT WESTERN, AND THE GENERAL MARKET Cumulative Value of \$1 Invested, 1984 – 2000



Notes:

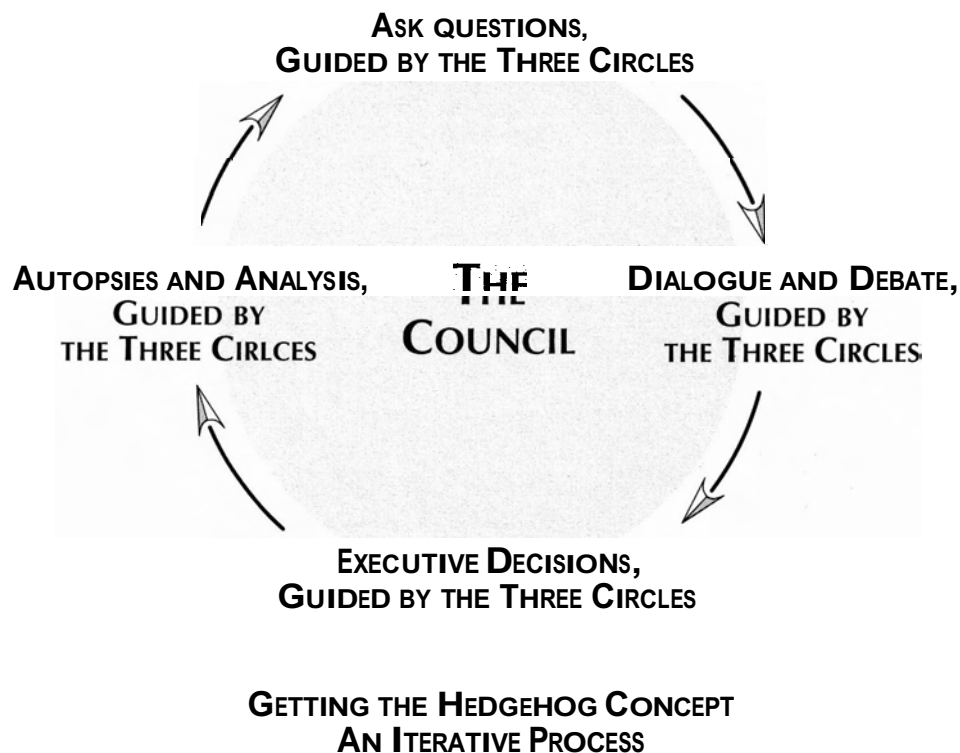
1. Fannie Mae transition point occurred in 1984.
2. Cumulative value of \$1 invested December 31, 1984 –January 1, 2000
3. Dividends reinvested.

happen that way. It took Einstein ten years of groping through the fog to get the theory of special relativity, and he was a bright guy.³⁵

It took about four years on average for the good-to-great companies to clarify their Hedgehog Concepts. Like scientific insight, a Hedgehog Concept simplifies a complex world and makes decisions much easier. But while it has crystalline clarity and elegant simplicity once you have it, getting the concept can be devilishly difficult and takes time. Recognize that getting a Hedgehog Concept is an inherently iterative process, not an event.

The essence of the process is to get the right people engaged in vigorous dialogue and debate, infused with the brutal facts and guided by questions formed by the three circles. Do we really understand what we can be the best in the world at, as distinct from what we can just be successful at? Do we really understand the drivers in our economic engine, including our economic denominator? Do we really understand what best ignites our passion?

One particularly useful mechanism for moving the process along is a



device that we came to call the Council. The Council consists of a group of the right people who participate in dialogue and debate guided by the three circles, iteratively and over time, about vital issues and decisions facing the organization. (See "Characteristics of the Council," below.)

In response to the question, "How should we go about getting our Hedgehog Concept?" I would point to the diagram on page 114 and say: "Build the Council, and use that as a model. Ask the right questions, engage in vigorous debate, make decisions, autopsy the results, and learn—all guided within the context of the three circles. Just keep going through that cycle of understanding."

When asked, "How do we accelerate the process of getting a Hedgehog Concept?" I would respond: "Increase the number of times you go around that full cycle in a given period of time." If you go through this cycle enough times, guided resolutely by the three circles, you will eventually gain the depth of understanding required for a Hedgehog Concept. It will not happen overnight, but it will eventually happen.

Characteristics of the Council

1. The council exists as a device to gain understanding about important issues facing the organization.
2. The Council is assembled and used by the leading executive and usually consists of five to twelve people.
3. Each Council member has the ability to argue and debate in search of understanding, not from the egoistic need to win a point or protect a parochial interest.
4. Each Council member retains the respect of every other Council member, *without exception*.
5. Council members come from a range of perspectives, but each member has deep knowledge about some aspect of the organization and/or the environment in which it operates.
6. The Council includes key members of the management team but is not limited to members of the management team, nor is every executive automatically a member.
7. The Council is a standing body, not an ad hoc committee assembled for a specific project.
8. The Council meets periodically, as much as once a week or as infrequently as once per quarter.

9. The Council does not seek consensus, recognizing that consensus decisions are often at odds with intelligent decisions. The responsibility for the final decision remains with the leading executive.
10. The Council is an informal body, not listed on any formal organization chart or in any formal documents.
11. The Council can have a range of possible names, usually quite innocuous. In the good-to-great companies, they had benign names like Long-Range Profit Improvement Committee, Corporate Products Committee, Strategic Thinking Group, and Executive Council.

Does every organization have a Hedgehog Concept to discover? What if you wake up, look around with brutal honesty, and conclude: "We're not the best at anything, and we never have been." Therein lies one of the most exciting aspects of the entire study. In the majority of cases, the good-to-great companies were not the best in the world at anything and showed no prospects of becoming so. Infused with the Stockdale Paradox ("There must be something we can become the best at, and we will find it! We must also confront the brutal facts of what we cannot be the best at, and we will not delude ourselves!"), every good-to-great company, no matter how awful at the start of the process, prevailed in its search for a Hedgehog Concept.

As you search for your own concept, keep in mind that when the good-to-great companies finally grasped their Hedgehog Concept, it had none of the tiresome, irritating blasts of mindless bravado typical of the comparison companies. "Yep, we could be the best at that" was stated as the recognition of a fact, no more startling than observing that the sky is blue or the grass is green. When you get your Hedgehog Concept right, it has the quiet ping of truth, like a single, clear, perfectly struck note hanging in the air in the hushed silence of a full auditorium at the end of a quiet movement of a Mozart piano concerto. There is no need to say much of anything; the quiet truth speaks for itself.

I'm reminded of a personal experience in my own family that illustrates the vital difference between bravado and understanding. My wife, Joanne, began racing marathons and triathlons in the early 1980s. As she accumulated experience—track times, swim splits, race results—she began to feel

the momentum of success. One day, she entered a race with many of the best woman triathletes in the world, and—despite a weak swim where she came out of the water hundreds of places behind the top swimmers and having to push a heavy, nonaerodynamic bike up a long hill—she managed to cross the finish line in the top ten.

Then, a few weeks later while sitting at breakfast, Joanne looked up from her morning newspaper and calmly, quietly said, "I think I could win the Ironman."

The Ironman, the world championship of triathlons, involves 2.4 miles of ocean swimming and 112 miles of cycling, capped off with a 26.2-mile marathon footrace on the hot, lava-baked Kona coast of Hawaii.

"Of course, I'd have to quit my job, turn down my offers to graduate school (she had been admitted to graduate business school at a number of the top schools), and commit to full-time training. But . . ."

Her words had no bravado in them, no hype, no agitation, no pleading. She didn't try to convince me. She simply observed what she had come to understand was a fact, a truth no more shocking than stating that the walls were painted white. She had the passion. She had the genetics. And if she won races, she'd have the economics. The goal to win the Ironman flowed from early understanding of her Hedgehog Concept.

And, so, she decided to go for it. She quit her job. She turned down graduate schools. She sold the mills! (But she did keep me on her bus.) And three years later, on a hot October day in 1985, she crossed the finish line at the Hawaii Ironman in first place, world champion. When Joanne set out to win the Ironman, she did not know if she would become the world's best triathlete. But she understood that she could, that it was in the realm of possibility, that she was not living in a delusion. And that distinction makes all the difference. It is a distinction that those who want to go from good to great must grasp, and one that those who fail to become great so often never do.



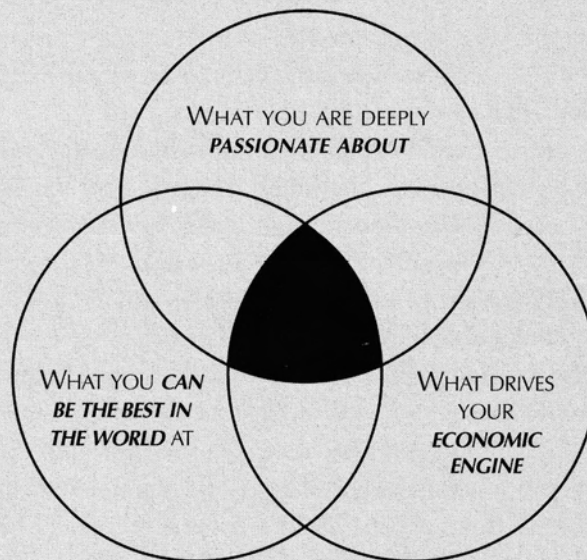
CHAPTER SUMMARY

HEDGEHOG CONCEPT

(SIMPLICITY WITHIN THE THREE CIRCLES)

KEY POINTS

- To go from good to great requires a deep understanding of three intersecting circles translated into a simple, crystalline concept (the Hedgehog Concept):



THREE CIRCLES OF THE HEDGEHOG CONCEPT

- The key is to understand what your organization *can* be the best in the world at, and equally important what it *cannot* be the best at—not what it “wants” to be the best at. The Hedgehog Concept is not a goal, strategy, or intention; it is an *understanding*.
- If you cannot be the best in the world at your core business, then your core business cannot form the basis of your Hedgehog Concept.
- The “best in the world” understanding is a much more severe standard than a core competence. You might have a competence but not necessarily have the capacity to be truly the best in the world at

that competence. Conversely, there may be activities at which you could become the best in the world, but at which you have no current competence.

- To get insight into the drivers of your economic engine, search for the one denominator (profit per x or, in the social sector, cash flow per x) that has the single greatest impact.
- Good-to-great companies set their goals and strategies based on understanding; comparison companies set their goals and strategies based on bravado.
- Getting the Hedgehog Concept is an iterative process. The Council can be a useful device.

UNEXPECTED FINDINGS

- The good-to-great companies are more like hedgehogs—simple, dowdy creatures that know “one big thing” and stick to it. The comparison companies are more like foxes—crafty, cunning creatures that know many things yet lack consistency.
- It took four years on average for the good-to-great companies to get a Hedgehog Concept.
- Strategy per se did not separate the good-to-great companies from the comparison companies. Both sets had strategies, and there is no evidence that the good-to-great companies spent more time on strategic planning than the comparison companies.
- You absolutely do not need to be in a great industry to produce sustained great results. No matter how bad the industry, every good-to-great company figured out how to produce truly superior economic returns.