SPECIAL HBS CENTENNIAL ISSUE

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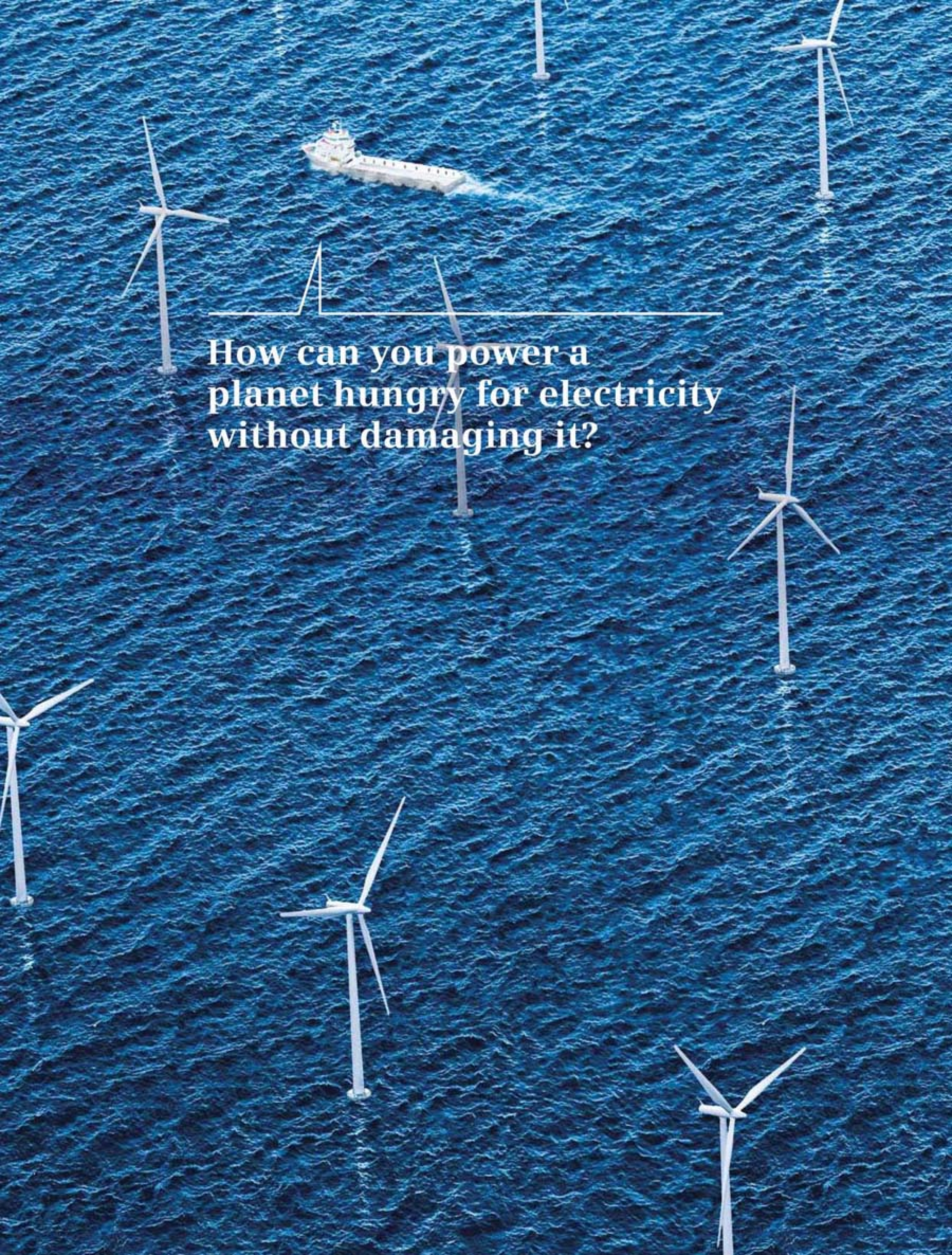
LEADERSHIP &STRATEGY

FOR THE TWENTY-FIRST CENTURY


How can you power a planet hungry for electricity without damaging it?

HBR JANUARY 2008

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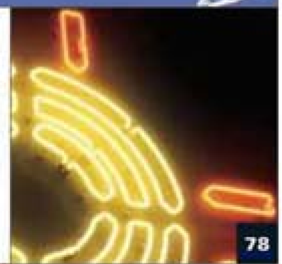

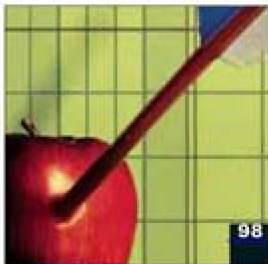

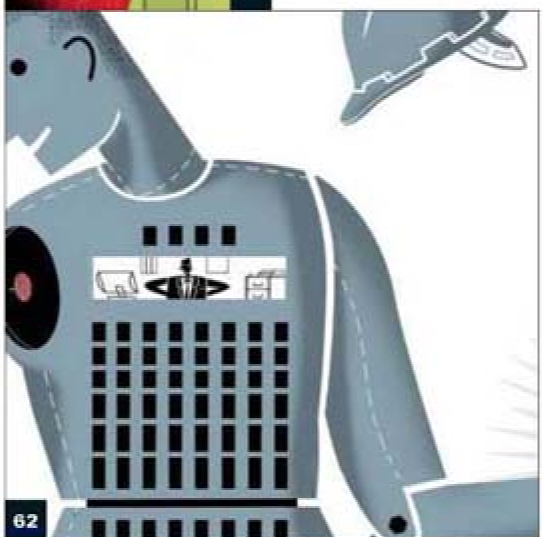

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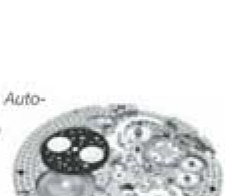

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"It's him – the one they call 'El Auditor.'"

Thomas Cheney

Great Enterprise

ON MARCH 30, 1908, the Corporation of Harvard University voted to establish the Graduate School of Business Administration, the university having concluded, in the words of its then-president Charles W. Eliot, that "business in its upper walks has become a highly intellectual calling" meriting "professional graduate instruction." The first dean of the school, Edwin F. Gay, built it on the principle that the men in his charge should learn not just the nuts and bolts of accounting, contracts, and marketing but something about how to be leaders: to possess courage, good judgment, and "a certain kindness of spirit which unites the other two elements, which purifies courage by removing its grosser belligerency and tempers judgement by the understanding heart."

This year the school – our owner – celebrates its centenary. From our offices three miles upriver from the HBS campus, watching the preparations has been rather like seeing a city appear in the middle of a prairie: a crane here, a road there, an accelerating chaos of ideas, and then, somehow, the emergence of a coherent and indisputably splendid celebration.

VE RI TAS
100 YEARS
1908-2008

At HBR we decided to mark the occasion in two ways: first by serving our mission with redoubled energy, to improve the practice of management by publishing the best work we can find, by whomever written, that helps women and men in the "upper walks" of business become better leaders, see the future first, solve their toughest problems, and learn what really works; and second by devoting both 2008 special issues exclusively to the work of current HBS faculty and alumni who are leaders of important enterprises.

The first of these issues is in your hands. It turns out that a project we launched to laud the school does a glorious job of honoring the mission. It also happens that we couldn't have done a better job of hitting Edwin Gay's target if we had fired point-blank at it. We decided from the start that this issue should focus on leadership and strategy, believing that they're inseparable. Unbeknownst to us, Cynthia A. Montgomery had been working on an article that makes that case with great eloquence and expertise. We decided the issue should acknowledge HBS's legacy of scholarship but focus on the future; lo and behold, Michael E. Porter told us that he was embarking on a profound and exciting revision, update, and reaffirmation of his classic "five forces" article, published 29 years ago. We wanted to dive into the connection between strategy, leadership, and change – that is, getting things done. Clayton M. Christensen, Stephen P. Kaufman, and Willy C. Shih responded with a devastating analysis of how management systems hobble innovation, while Robert S. Kaplan and David P. Norton gave us a magisterial article about how to build a management system that works. (Only half-joking, around the office we've called it the only management article you'll ever need.)

People come to us – HBR and HBS – to learn how to manage great enterprises in a global environment, and to become the kind of leaders who make a difference in the world. Put those two purposes together and you get Rosabeth Moss Kanter's article about global giants that are transforming themselves and the world by putting their values at the forefront of strategy. Look at those purposes from another angle and you're likely to conclude that twenty-first-century leaders will be different from those of the past. In an extraordinary conversation with HBR's senior editor Paul Hemp, Linda A. Hill tells us who these future leaders will be. Thomas J. DeLong, John J. Gabarro, and Robert J. Lees add an important dimension, describing the changing role of mentors, who hand-shape leaders; and Howard H. Stevenson contributes a case that brings alive the choices leaders face about making a difference. Senior editor Gardiner Morse and I spent several hours in the presence of one such leader, Lazard CEO (and HBS alumnus) Bruce Wasserstein, who has given more good advice to more CEOs than almost anyone alive and now shares some with you.

Editorial director Sarah Cliffe and senior editors Steve Prokesch and Anand Raman made this magnificent issue possible, with help from our colleagues downriver, including especially Debora Spar, senior associate dean for research when we put the issue together.

Thomas A. Stewart

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forethought

A survey of ideas, trends, people, and practices on the business horizon

Travis Foster

GRIST

Love and Fear and the Modern Boss

by Scott A. Snook

Five hundred years ago, Niccolò Machiavelli posed the question of whether it is better for a leader to be loved or feared, concluding that if you can't be both (and few people can), being feared is more effective. While the complexities of human nature resist definition in such stark terms – behaviors lie along a continuum – the question of fear versus love has been a fundamental one for leaders throughout history.

Until a generation or so ago, fear was the predominant model. In the 1950s and 1960s, corporal punishment was common even in public schools, and the workplace was a largely hierarchical and autocratic arena where leaders imposed rewards and punishments based on conformity with the rules. Today, teachers in most of the developed world would instantly lose their jobs for hitting a student, and in the office, too, acceptable models of leadership have shown their softer side. This shift in the predominant leadership model reflects the move from an industrial to an information economy. In factories, you need strict rules and you reward people based on very simple and clear productivity metrics. Knowledge workers don't respond well to such rigidity, and fearful service employees would have trouble putting on a good face for customers. In fields like advertising, tight controls stifle creativity and commitment.

But even in the developed world, plenty of leaders still rely on fear, and many people continue to put up with it. One reason is simply that people rationalize the fear model as "just the way things are done around here," as is the case with hazing, arguably a form of leadership among students. Another reason is that some people feel a sense of pride and accomplishment in toughing it out; they find satisfaction in meeting the standards of a very demanding boss. Others simply prefer an autocratic style over an empowering one; they don't want to decide how to do their work but would rather just know the rules and follow them. Still others actually believe that they will ultimately be more successful with a strong boss, one who will push them beyond the limits to which they'd stretch themselves.

It's just as well that we have people who can work under these bosses because some circumstances still call for a fear-based style of leadership – where you want to discourage risky behavior, such as in a nuclear power plant. With the stakes so high on safety, tight control – not improvising – is prudent. Employees tend to self-select into these companies. Leaders need to do the same – find roles that match their temperaments.

Indeed, if a leader is stern and autocratic – even rude and insulting – he can inspire great respect if he is also authentic, and if he genuinely cares about the people working for him. Two of the most successful coaches in the history of college basketball exemplify Machiavelli's two extremes – the feared Bobby Knight at Texas Tech and Mike Krzyzewski, Duke's beloved Coach K – and both have won devoted followings among players. Coach K, whose leadership style relies on open communication and caring support, wrote a book called *Leading with the Heart*. Knight, on the other hand, has had a career marked by controversies about his harshness, including allegations that he choked a player during practice. Despite his bullying, he inspires tremendous loyalty and even love. Texas Tech players know what they're getting into, and they know that Knight's temper is integral to his being – and that he truly cares about them.

That's why, five centuries after it was written, we can still take lessons from *The Prince*. Leading by force and intimidation has its downsides – the potential for the leader's derailment chief among them. Thanks to his violent behavior and inability or unwillingness to adapt his dominant style to changing societal norms, Knight was eventually fired from his job at Indiana University (though quickly snapped up by Texas Tech). But there are times when the softer approach to leadership is equally ineffective – or simply inauthentic – and rule by fear is the way to go. Successful leaders read the signals and adapt their styles accordingly, but they know their limits. A stretch assignment for a leader might be a developmental opportunity that brings out previously unrecognized strengths – but if the role requires a style beyond the leader's adaptability, the result is often disastrous.

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Reprint F0801A

PRODUCT TRANSITIONS

Beware of Old Technologies' Last Gasps

by Daniel C. Snow

When superior technologies emerge, old ones usually don't simply fade away. To the contrary, their performance often leaps suddenly, thereby extending their lives and slowing the adoption of the new technologies. This happened with sailing ships when steam-powered vessels were developed. More recent examples of what I call "last gasps" include manual versus computerized typesetting, CISC versus RISC architecture for computer processors, steel versus aluminum bicycle frames, automobile carburetors versus electronic fuel-injection systems, and coronary artery bypass graft surgery versus angioplasty.

For decades, the conventional explanation of this phenomenon was behavioral: When the old-technology companies faced extinction, they worked harder to find ways to stave it off. When I started conducting research on last gasps, however, I found something puzzling about this explanation. Most of the technologies that experienced a last gasp were being sold in markets that were intensely competitive before the new technology arrived. So the existing players already seemed to be doing everything they could to improve the old technology, calling into question the old assumptions. When I delved deeper, I found that two overlooked mechanisms were at work:

A retreat to defensible ground. In most instances, the transition to the new technology is gradual. The old technology is initially displaced from the segments of the market (or applications) to which it is relatively poorly suited, leaving it in those where it can better compete.

In some cases, the result is an improvement in performance that owes little to changes in the technology itself. Sailing ships quickly ceded short ferry routes to steam-powered ships but continued to ply the longer routes, which meant that, overall, sailing vessels were spending less time doing the things they were bad at (maneuvering around harbors with their confined spaces and variable wind conditions) and more doing what they were good at (moving across the open sea without having to carry fuel). As a result, their performance – as measured by average speed and cost per ton of cargo moved – jumped.

In other cases, the focus on a market segment does spur an improvement in the old technology. My research with Robert Huckman of Harvard Business School revealed that this happened with coronary artery bypass graft surgery after angioplasty was introduced as a treatment for relatively healthier patients with blockages. Even though surgeons who perform bypasses were left with sicker, higher-risk patients, outcomes after surgery actually improved for such patients. It turns out that the concentration of difficult cases gave the surgeons better opportunities to learn how to hone their techniques.

Use of the new to improve the old. Existing technologies often borrow components of the new technology. Carburetor manufacturers increased fuel efficiency by incorporating electronic controls in the products they developed for electronic fuel-injection systems (see the exhibit "The New Appears; the Old Improves"). Producers of CISC computer chips increased the performance of their products by adopting features of RISC chips, such as the latter's design for conducting some core processing operations.

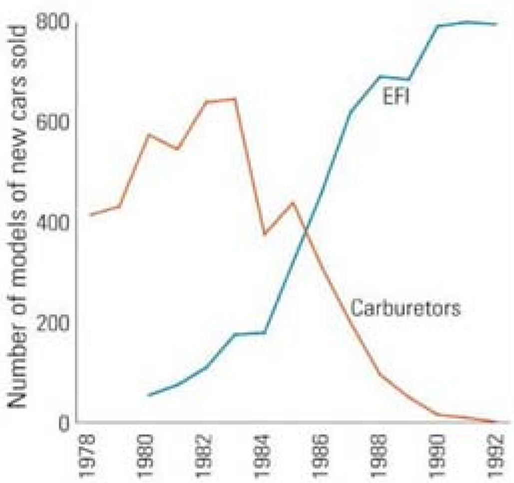
...

These insights into the causes of last gasps have major strategic implications for firms in industries where technology transitions are occurring. A danger for new-technology firms is underestimating how long the last gasp will delay them from becoming profitable. In a study of the semiconductor materials industry, I found that this miscalculation caused numerous tech start-ups to founder. For established players that have managed to breathe new life into old technologies, a danger is mistaking the last gasp for sustainable improvement. This can lead them to overestimate the prospects of their products, overinvest in trying to enhance them, and wait too long to switch to the new technology. Digital Equipment Corporation and two carburetor manufacturers, Holley and Carter, fell into this trap. From their experiences and those of others, it's clear that strategy can affect how transitions from old to new technologies occur and who wins and who loses. The path, pace, and outcome are not preordained.

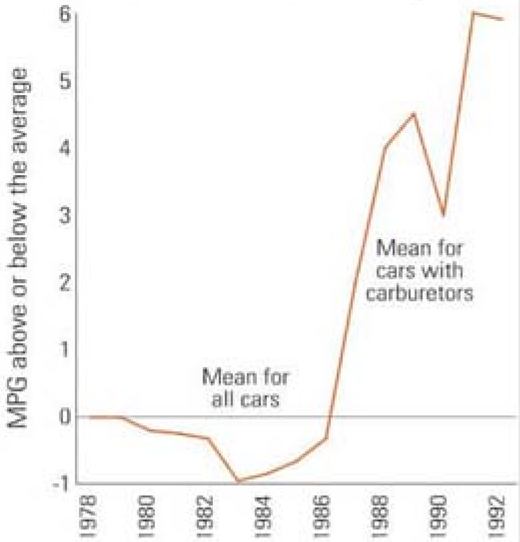
The New Appears; the Old Improves

When electronic fuel-injection (EFI) systems started to replace carburetors in the early 1980s, the miles-per-gallon (MPG) performance of carburetors spiked dramatically.

Car Models with EFI vs. Carburetors



Carburetor Fuel Economy



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Reprint F0801B

MARKETS

High Margins and the Quest for Aesthetic Coherence

by Robert D. Austin

Companies squeezed by low-cost competitors might be able to learn something from a Danish maker of upscale wastebaskets and soap dispensers.

As globalization further erodes profits in developed countries, brands whose labor is based in low-cost economies may eventually have an insurmountable advantage over those from the developed world. Consumer product firms in Europe, the United States, and Japan will need alternative business models. One that has had striking success is selling well-designed and well-crafted products at high margins – but that strategy is far from simple. Executing it correctly requires that a company and its products have what I call *aesthetic coherence.*

Consider Vipp, maker of a select few high-priced household items. Vipp is known throughout Europe for design, workmanship, and a resonant backstory about founders Holger and Marie Nielsen. The design of its trash bins, which sell for up to €500 each and are little changed from the original that Holger invented in 1939 for Marie's hairdressing salon, has been recognized by the Louvre as iconic. Its products are built by European craftspeople. Its "limited edition" toilet brush is python green, a color inspired by a satin ball gown Marie wore in 1957. Every detail fits into a compelling picture.

The result of that aesthetic coherence is product profit margins that a mass marketer would envy. Three hundred percent (my rough estimate) looks pretty good to companies that typically get single digits on items they produce for discount retailers.

To succeed in selling high-end products, a company needn't go to Vipp's extremes. But its story, products, partners, and even sales channels have to fit a coherent picture for customers. The Danish audio company Bang & Olufsen, much larger than Vipp, has had a distinctive Bauhaus-influenced style since the 1960s, sells state-of-the-art products, has developed a car stereo system with Audi, and retails through B&O-only stores in high-rent locations or in specially designed sections of larger stores.

A few companies have managed to use a design-intensive approach to get better-than-discount margins while still maintaining reasonable prices and high volume: Target, IKEA, and the utensil maker OXO International, for example, have developed an aesthetic coherence that blends a style focus with cost consciousness.

Wal-Mart, on the other hand, didn't have the aesthetic coherence it needed for credibility with upscale customers when it tried to market higher-end fashion lines. The company hadn't done its homework – it didn't have the necessary design and quality reputation. Wal-Mart soon retreated from the strategy, with chief executive H. Lee Scott, Jr., telling *BusinessWeek*, "We can't wake up one morning and say we're going to be something different...and not earn it."

My in-depth studies of Vipp, B&O, and other companies, and my observations of Wal-Mart's attempts to crack a high-margin market, suggest that as companies try to create aesthetic coherence, they should avoid three dangerous temptations:

Skipping the homework on design, workmanship, public relations, and story, thereby creating aesthetic incoherence.

Sacrificing margin potential for efficiency – don't go after potential cost savings that might reduce a product's attractiveness and thereby lower the price that customers are willing to pay. The price drop could even wipe out the entire benefit of the initial cost reduction.

Going after low-margin business, which makes the product less distinctive. Don't let short-term thinking driven by quarterly reporting push you too far down market in search of greater volume, or you'll wake up one morning to realize you're selling commodities again.

...

I've often wondered why some of the companies that best exemplify aesthetic coherence are Scandinavian, whether it's at least partly because their high labor costs limit their ability to compete on price. They've gotten very good at differentiation instead. In that sense, the Scandinavian design-centered players may represent the future for companies elsewhere in the developed world, where the high-margin approach may prove an extremely attractive – perhaps the only – alternative to competing on cost.

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Reprint F0801C

SOCIAL RESPONSIBILITY

Do Well by Doing Good? Don't Count on It

by Joshua D. Margolis and Hillary Anger Elfenbein

It's alluring and very much in vogue to connect social responsibility with profitability. If you can make a business case for positive social action, everybody wins – employees, shareholders, and society at large. But for decades researchers have labored to answer a nagging question: Is there, in fact, a link between corporate social performance and corporate financial performance? Not a strong one, according to an analysis of 167 such studies that were conducted over 35 years, a project we undertook with James P. Walsh from the University of Michigan's Ross School of Business.

While doing good doesn't appear to destroy shareholder value, we found only a very small correlation between corporate behavior and good financial results (the exception being public misdeeds, which had a discernible negative impact). Moreover, the minor correlation that does exist could well be explained by deep pockets – a history of strong financial performance may simply give a company the wherewithal to contribute to society. Indeed, of the various forms social responsibility can take, cash contributions to charities have shown a stronger correlation with success than have socially responsible corporate policies or community projects. Here is a slightly more detailed summary of our findings:

Corporate misdeeds are costly to companies – if people find out. Anecdotal evidence about recent scandals highlights just how grave the consequences of wrongdoing can be for companies and their executives, but it's difficult to estimate the likelihood of being found out.

Doing good is unlikely to cost shareholders. Perhaps the easiest way to communicate our findings is to say that only 2% of the studies we reviewed showed that managers who dedicate corporate resources to social performance – taking actions that consider the interests of society – impose a direct cost to shareholders. Companies can do good *and* do well, even if they don't do well *by* doing good.

Profitability should not be the primary rationale for corporate social responsibility. None of this is to suggest that companies should not engage in activities that generate social good. However, they should not expect to be handsomely rewarded. Socially responsible behavior may not cost you financially, but if the goal is return on investment, there are many other ways to spend money that can deliver a greater payoff.

An alternative, and perhaps more cynical, way to interpret the mild correlation is to suggest that it pays to be good, but not too good. It could be that companies that are demonstrating a payoff are doing enough not to run afoul of regulators and activists, but not so much that they offend analysts and investors.

In the end, if the promise of an economic payoff can persuade companies to clean up their questionable conduct or redress social ills, society would benefit. However, framing a societal investment in terms of shareholder interest may be misguided. Investments need to be judged solely on the merits, and leaders can and should explore their own motivations before buying into the hype. Doing good may be its own reward.

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Reprint F0801D

STRATEGY AND TECHNOLOGY

The Value of a Broader Product Portfolio

by Bharat N. Anand

With rapid technological change posing ever more intense competitive challenges, companies are often advised to scrutinize their portfolios and eliminate unprofitable products. Every product, the reasoning goes, must stand on its own bottom line. That, however, may be exactly the wrong mantra for these times. A broader portfolio of products – even if some are, for a time, unprofitable – often can help a company capture more value.

To understand why breadth matters, it helps to look at how today's strategic landscape is changing. New, less-expensive production technologies and ease of entry into some markets have led to a proliferation of products and services; at the same time, the cost of reproducing and distributing certain classes of products has dropped dramatically. The result is a heightening of two core strategic challenges facing businesses: getting noticed and getting paid.

How is a brand to get noticed when there are some 13,000 U.S. mutual funds to select from and, as Barry Schwartz notes in *The Paradox of Choice*, supermarkets can offer 175 varieties of tea bags and 285 kinds of cookies? In information industries, the problem is particularly acute: U.S. publishers produce more than twice as many books today as they did a decade ago, and the volume of information our society generates is far outstripping our ability to consume it all.

And how is, say, a music company to recover its investments when people can cheaply copy and distribute the products? Media organizations are currently having the most trouble getting paid – think of big metropolitan newspapers and the competition from free dailies and free online content such as blogs. Other types of businesses face similar problems – witness the challenge to Microsoft by Linux.

It's tempting for companies to try to meet the twin challenges of getting noticed and getting paid by shedding product lines, but successful firms have shown that the best approach is often the opposite one: to expand and extend the product portfolio. Expanding it increases not only the chances for a big win but also the number of other products that can benefit from a hit's popularity. The portfolio approach has been used for years in the traditional supermarket – that brawling arena of product proliferation – in such tactics as umbrella branding and loss-leader pricing.

Indeed, the technique is showing up in a range of industries. Apple's expansion of its portfolio to include the iPod has not only launched a whole economy of "i-" add-ons, including the iPhone, but also boosted sales of Apple's existing computers. The Indian network Star TV saw its prime-time viewer share increase from less than 5% to more than 80% in one year after a single hit show, *Kaun Banega Crorepati* (the Indian version of *Who Wants to Be a Millionaire*), helped all its productions become more popular. The benefits can even extend to other firms. Author Dan Brown had written three books with mediocre sales prior to his best seller *The Da Vinci Code*. When his former publishers then re-released the older works, they became best sellers as well.

The portfolio approach can also help a company tackle the getting-paid problem. When there's price pressure in a compa-

Conversation

Harvard Business School's **Sandra J. Sucher** on the value of a book club for executives

For 20 years, Harvard Business School's literature class The Moral Leader has tapped a rich canon of fiction and nonfiction to offer executives deep and powerful lessons about leadership. Senior lecturer of business administration Sandra J. Sucher, who teaches the course and has had a long career as a practicing manager, argues that bringing executives together to read and discuss literary works can be a potent leadership development tool.

Teaching literature in school may illuminate big ideas, but how do you justify spending executives' time reading and talking about books? Shouldn't those be off-duty pleasures?

Life as an executive is replete with decisions that have moral or ethical dimensions – and that usually catch you off guard. You see a colleague being mistreated by your boss – do you speak up? You don't agree with a decision that comes down from senior management – how do you explain it to your subordinates?

Most people, when asked how they would approach such decisions, say that they would rely on their moral code. But what does that really mean? Organizations provide few opportunities for executives to develop a nuanced understanding of moral challenges or to practice moral debate. The value of The Moral Leader isn't so much in what I or previous instructors have had to say during the course but in how the students reason through the moral challenges together and debate the perspectives that the literature evokes. Managers responsible for developing other leaders can use this type of literary debate to spark very revealing conversations.

Because the books we read are not about business, executives can distance themselves from their biases and only later, upon reflection, see how their own choices might mirror those in the narratives. For instance, we read Kazuo Ishiguro's novel, *The Remains of the Day,* about an English butler reflecting on a life given over to a single moral principle: loyalty to his boss. His sacrifices and their consequences for him and others paint a terrifying picture of a moral code taken to extremes, even though the protagonist can understand this in only a limited way. It's very hard not to read the novel at least in part as a cautionary tale about the limits of loyalty and the points at which we start to lose ourselves in our jobs.

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A book can be a cautionary tale whether or not we discuss it. Why make it more than assigned individual reading?

The Remains of the Day is a fine piece of literature no matter how you read it, but if you want to wrestle with your own moral code, reading it in isolation isn't so different from the butler's lonely musings. He gains some perspective into his actions and their consequences by reflecting on his life, but he doesn't have the full story. People need others' points of view.

I also have my students read an excerpt from *Personal History,* Katharine Graham's autobiography, which details her bold decisions about covering the Pentagon Papers and Watergate at the *Washington Post*; and Alfred Lansing's *Endurance,* the tale of Sir Ernest Shackleton's disastrous Antarctic excursion. The moral question concerns Shackleton's motives for saving his entire crew – he stood to gain financially by sparing everyone, even though supporting the weakest of them put the other crew members at risk.

What value does a book group offer individual leaders and, by extension, the firms that employ them?

It is in the exchange of ideas about these books that people come to understand how their own moral codes constrain them – and how they might approach decisions with a more nuanced understanding. Most of us believe that our moral views are self-evident. Hearing people present arguments you had never thought of is one way to strengthen your own moral reasoning skills. It also can create a powerful bond within a group. Firms might consider integrating discussions of texts into their leadership development programs or even creating a book club for senior leaders – or for any group that confronts moral decision making. Choose a few books, meet once a month or so, rotate discussion leaders, and see what happens; you might be surprised at the depth of insight that emerges.

– M. Ellen Peebles

Reprint F0801F

ny's core business, a product-oriented strategy would be to try to boost the return from each product by, for example, giving up price-sensitive customers and pursuing those who are willing to pay more. With a portfolio approach, a company doesn't have to do that – it can protect itself by expanding into sectors that make more money when prices of the company's core products fall. Recording studios were kicking themselves for not seeing the opportunity in products such as MP3 players that were adjacent to easily duplicated CDs. Many media firms, such as the Norwegian company Schibsted, have aggressively expanded into complementary businesses such as free newspapers and online classifieds.

With technology moving so quickly that virtually no manager, engineer, or technologist can predict next year's winning and losing products, a portfolio approach presents greater opportunities for creative solutions than does fighting with your competitors on a product-by-product level.

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Reprint F0801E

COMPETITIVE ADVANTAGE

Seek Strategy the Right Way at the Right Time

by Giovanni Gavetti and Jan W. Rivkin

Among managers who make strategy and researchers who study it, fierce battles have been fought over the right way to discover a strategy. In one corner stand advocates of analysis, deliberation, and planning: Managers should study the competitive forces in their environment, deduce a set of choices that helps the firm confront those forces, and then implement the choices. In the opposite corner are those who support what's termed an emergent approach: Managers should try things out, learn from experience, adjust, and gradually craft a strategy.

Our recent research, an in-depth, multiyear study of firms searching for strategies in the internet portal industry, suggests that both views are right – but incomplete. Deliberation *and* emergence work, just under different circumstances and at different times in an industry's development.

Early in the life of a typical industry, competitive conditions are extremely ill-defined. In the nascent portal industry of 1993 to 1995, for instance, fundamental features of the market (who the customers were, what they would pay for) were ambiguous. It would have been futile for companies in this industry to search for a strategy purely by deliberate application of economic logic. Firms such as Yahoo that thrived in those early days analyzed the environment to some degree but took a largely emergent, experiential approach. Later, as the industry's features solidified, it became effective for strategists to be more deliberate. By 1997, for example, managers at Lycos could see that economies of scale and switching costs were rising, which meant the company needed to be big and to lock in customers. The managers reasoned that the company had to grow quickly and that acquisition was the fastest way. Great strategists can, first, size up whether deliberate deduction is effective in an industry at a given point in time and, second, match how they search for a strategy to current conditions in their industry.

Both the deliberate and emergent views are incomplete in that they miss important other ways to search for a strategy, approaches that lie between deliberation and emergence. One way is analogical reasoning. After the period when industry conditions are wholly undefined but before economic cause and effect become sufficiently clear, an industry's environment offers clues that it is similar to other settings. Around 1996, for instance, the internet portal industry started to bear certain resemblances to traditional media. This enabled forward-thinking firms such as Yahoo, which saw the similarities early, to precede rivals in adopting effective practices from the established media business. Yahoo organized itself around "producers" developing online "properties" and invested deeply in its brand; some other portals focused on developing the fastest search technology. Great strategists not only rely on emergence and deliberation at the right moments, but they also know when and how to employ analogies with care.

All this sets up a tension that managers must confront. A new firm in a new industry is highly flexible – it has made few immobile commitments, and its managers aren't set in their ways. So if the management team could deduce a great strategy, the company would be adaptable enough to run with it. However, deduction rarely works in nascent industries. Over time, two things occur: Industry conditions clarify, making analogical reasoning and deliberate economic analysis effective. But the firm ossifies and commits itself to a particular way of doing business, and managers become inert in their thinking.

This raises a key question for managers: Can your firm remain supple and adaptable long enough to take advantage of analogy and deliberate analysis once they become useful tools? In the portal industry, Lycos accomplished this, shifting its strategy toward a media play late in the game and enjoying a few years of strong performance (well before, of course, Google rose to prominence). Meanwhile, some of Lycos's rivals in the late 1990s appeared to develop industry wisdom too late to act on it, after they had hardened in their ways.

The ideal is to couple the flexibility of youth with the wisdom of age. The sad reality is that many firms lose flexibility sooner than they gain wisdom.

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SHAREHOLDERS

When (Not) to Listen to Activist Investors

by Robin Greenwood and Michael Schor

Hedge funds are more likely than ever to demand that poorly performing managers change their company's strategic direction. However, executives shouldn't necessarily heed those demands. Our research shows that, on average, a company that alters strategy in response to activist shareholders won't see stock gains that outperform the market – that is, unless the company is taken over.

Hedge funds tend to target firms whose stock prices have lagged those of industry peers. The mere fact that a hedge fund has invested in a company is often enough to give the stock a boost, but more and more hedge funds see activism as a way to raise companies' share prices further. Whereas hedge funds were involved in a handful of activist events targeting small public firms during the mid-1990s, by 2006 they participated in more than 90% of activist interventions, often setting their sights on large, well-established companies. The number of firms targeted by hedge funds for poor performance grew as well – more than 10-fold from 1994 to 2006.

Hedge fund activism can range from asking for a stock repurchase or dividend increase to making more controversial requests, such as for seats on the company's board, a change in corporate strategy, or the spin-off of a division. Executives at target companies often resist, arguing that these actions will not increase shareholder value, while passive investors sit on the sidelines wondering who is right.

We collected data on every incident from 1994 to 2006 in which an activist investor became involved with a U.S. company. In the vast majority of these events, the investor was a hedge fund that had acquired more than 5% of the target company's shares and had presented the company with a set of complaints. According to our research, activism created value for shareholders only if it succeeded in getting the target firm acquired. When activists were able to prompt a takeover, investors collected hefty premiums, sometimes as much as 40%. In cases where hedge funds were unable to find a buyer for the firm, the company's 18-month stock market performance, on average, didn't beat the market; these cases included companies where the activists had been able to force strategic "improvements" or get seats on the board. (See the exhibit "It Pays to Get Acquired.")

Pirate Capital, for example, held 7.9% of James River Coal stock and in 2005 pushed the company into hiring an investment bank to explore "strategic alternatives" to increase shareholder value. James River's stock lost nearly 75% of its value before the activist reduced its position to below 5% at the end of 2006. All this occurred despite Pirate Capital's obtaining three seats on James River's board.

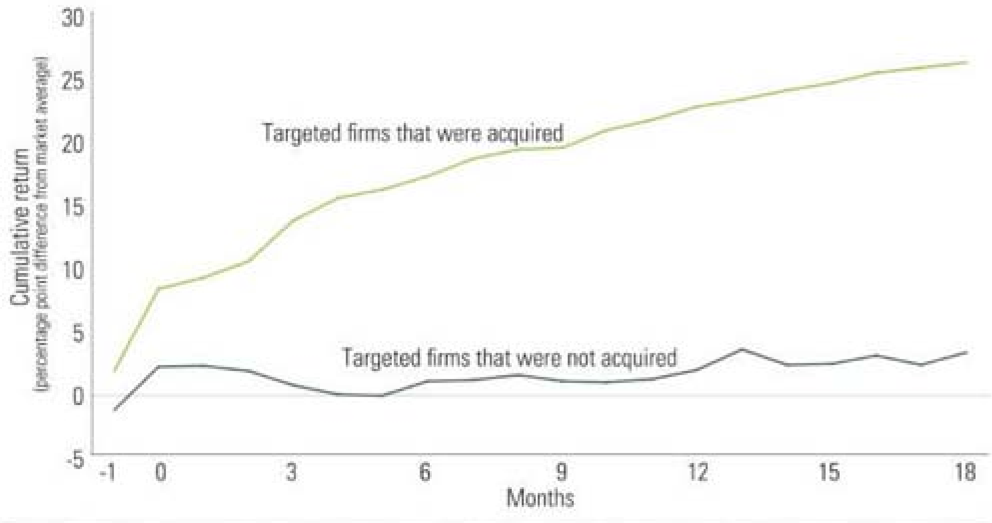
Our findings shouldn't be surprising. Activists are investors, not managers, and their real talent lies in identifying undervalued assets, not in determining the right steps to fix them. If a buyer doesn't step up to acquire a targeted company, the activist is stuck with a large position in a firm that it has no particular expertise in managing.

We're certainly not saying that activist hedge funds' strategic demands should be ignored out of hand. Managers targeted by activism face a difficult tradeoff between acceding to demands they may disagree with and engaging in a costly, distracting fight with the investor. Sometimes giving in on certain points may be the wisest choice.

In addition, managers should bear in mind that activist hedge funds come knocking when the stock is performing below expectations. If management cannot communicate to shareholders why the company has underperformed or why its stock is trading below fundamental

It Pays to Get Acquired

Hedge funds that become activist shareholders after investing in undervalued companies create shareholder value, on average, only when they succeed in getting the target company acquired. The chart shows the average returns, over 18 months, of all activist interventions in the U.S. from 1994 to 2006.



For more information, see: Robin Greenwood and Michael Schor, "Hedge Fund Investor Activism and Takeovers," Harvard Business School Working Paper (July 2007).

value, then a showdown with an activist – and, ultimately, a change in control at the company – may soon follow.

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INNOVATION

Learning the Fine Art of Global Collaboration

by Alan MacCormack and Theodore Forbath

Companies that excel in using partnerships to innovate are known for doing many things well. For example, they figure out how collaboration can improve the top line as well as the bottom line, and they organize themselves to work effectively with partners. What isn't widely appreciated is how much time and effort these companies put into getting better at collaborating.

Unlike the many companies that treat collaboration as a form of outsourcing, leading firms make significant investments to develop their collaborative capabilities – for instance, by experimenting to learn what processes and practices work best or by selecting a new partner in order to tap its broader experience of cooperating with others. These firms don't assume that their existing staff and processes are equipped to work with creative partners around the globe. In fact, they believe the opposite – that they must discover new skills and organizational arrangements to make collaboration work.

Our worldwide study of collaborative innovation reveals that this willingness to invest in improving partnering capabilities is one of the factors that help successful companies develop collaboration as a new and important source of competitive advantage. The study, encompassing a range of industries, from aerospace to software, included interviews with more than 100 managers in 20 firms that use collaboration extensively in their innovation efforts.

Our work revealed that leading firms make strategic investments in collaboration, drawing funds from outside the budgets of individual projects. These investments address four crucial areas:

People. Successful firms alter their recruitment, training, evaluation, and reward systems to focus on "soft" skills such as communication so that managers can better learn to motivate and coordinate team members who are outside the firm and, sometimes, in vastly different cultures. Many of these companies also help to train partners – for example, by inviting them to internal development programs so that future teams learn together what it takes to collaborate.

Processes. Leading firms use a learning-driven approach to designing collaborative processes. German electronics giant Siemens recruited several university teams around the globe to test different strategies for managing distributed teams. Among the lessons learned: Teams from different cultures have different strengths and working methods, which must be matched to their assigned tasks; and formal requirements are no substitute for frequent, high-bandwidth communications, which are critical for resolving unanticipated problems.

Platforms. It's important to create an infrastructure – a set of tools and standards for sharing data – that allows dispersed teams to work together seamlessly. Failure to do so puts a project at risk. In 2006, Airbus revealed that its flagship A380 aircraft would be delayed two years, at a cost of billions of dollars, because partners' use of different versions of design software resulted in 300 miles of wiring and 40,000 connectors that did not fit together.

Program. Successful firms manage collaboration as a coherent program, not a series of stand-alone efforts. Many companies achieve this by, in effect, designating a "chief collaboration officer," who oversees all partnered efforts and focuses on building the firm's overall collaborative capabilities.

Boeing's development of the 787 Dreamliner, scheduled for introduction later this year, highlights what can be achieved by addressing all four crucial areas. The incredibly complex project includes 50-plus partners from more than 130 locations that have worked together for more than four years. From the start, Boeing's aim was to leverage advanced capabilities from this network, not replicate partners' skills. For example, rather than trying to become the primary expert in the new composite materials that were being deployed, Boeing tapped

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the expertise of smaller firms that already possessed leading-edge capabilities in those materials.

Our observations suggest that Boeing's source of competitive advantage is shifting. While the firm possesses technical skills in hundreds of diverse disciplines, those skills no longer differentiate it from competitors. Instead, the company's success is increasingly tied to its ability to orchestrate and integrate the efforts of hundreds of global partners. Boeing is learning how to collaborate.

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FINANCIAL COMMUNICATION

How to Talk to Investors – Through the Press

by Gregory S. Miller

Managers in public companies frequently underestimate – at their peril – the function of the press in their financial communications. Wharton's Brian J. Bushee and I collected data on more than 200 firms traded on the Nasdaq or other over-the-counter markets, and found that most small and mid-cap companies have trouble obtaining coverage from analysts. However, getting media coverage is more feasible and cheaper than pursuing the attention of analysts. The problem is that many finance executives don't see the import of managing the press.

Like it or not, investors and analysts – and even the SEC – get a lot of their information from the media. In fact, in my study of the role of the press in uncovering accounting fraud, I found that more than one-quarter of the firms known to have engaged in questionable accounting practices were first identified by the media – before regulators were alerted and before the company made any announcements. Journalists are more sophisticated than ever when it comes to financial reporting.

Even if your focus is investor relations, the press is an audience you can't ignore. When you're just starting out and your visibility is low, the object is, of course, to get noticed – and that's just a matter of keeping in touch, getting to know reporters' interests, showing them you have something intelligent to say. Cultivating these fundamental relations with the press is often the first step in creating understanding and visibility among investors and analysts.

However, scandal sells, so small and midsize firms find they are more likely to get attention when there is a negative story. In such situations, managing the message is crucial. Hand-wringing and recriminations may be natural and justified, but they are useless when it comes to correcting public perceptions. The first thing to do is carefully examine your own assumptions – maybe the press is right and you're wrong. If you're certain the reports are inaccurate, don't go on the defensive – play offense instead. Ruthlessly review your messaging and reshape and retell your story as often as you have to. For example, French oil giant Total actively tracks everything that's reported about it. A few negative stories have dogged the company for years – the Erika oil spill, for instance – and its executives patiently and repeatedly explain why the press coverage has been misleading. By taking ownership of the story, the firm's executives assist the press and their many constituents in accurately understanding Total's activities. Total has even received industry accolades for its relations with the financial media.

Sometimes the news about a company simply is bad, and the stock price almost inevitably takes a hit in such cases. To mitigate the blow, smart managers cultivate press relationships in good times as well as bad. It's not about spin; dishonesty would poison the relationship. Instead, it's a matter of helping the media to understand you, of providing perspective. Then, when you have to explain, say, an oil spill or an unexpected change in management, you might see reporting that balances the bad news with your environmental efforts or the depth of your managerial bench.

Of course, reporters are not by any stretch a firm's only, or even its most important, audience. But if you're in need of investor attention, the press can be a convenient megaphone, and if you've got all the attention you need, the media can be an ally or an enemy – either way, you want to keep them close.

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How to Change the World

Alan Wilson has several career options but only one ambition – to make a difference.

by Howard H. Stevenson

ALAN WILSON PEERED past his Atomics at the skiers whizzing by 20 feet below the chairlift. The sky had darkened, and a light, wind-whipped snow was falling, but the changing conditions certainly hadn't deterred the diehards. He watched a young woman hurtle down the steep slope, poles and powder flying.

He carefully adjusted his goggles. He hadn't said much to his best friend, Karl, during their 10-minute ride together. Alan was feeling reflective. What was he going to do with his life now that some exciting new possibilities had opened up? People think it's miserable to have no options, he thought, but in a way, it's more stressful to have too many.

Three-quarters of the way up the mountain, the strengthening wind gently rocked the chair. Karl pulled out the trail map and pointed a gloved finger at one of the black-diamond runs. "The

HBR's cases, which are fictional, present common managerial dilemmas and offer concrete solutions from experts.

Daniel Vasconcellos

Couloir Noir is the one on the right," he said. "What do you think?"

Alan and Karl shared a passion for moguls. Alan had been a Division 1 skier in college, and Karl, who'd grown up in Kitzbühel, Austria, had once entertained Olympic dreams. They had never explored this particular resort on any of their New Year's trips to the slopes of the Rockies. Alan looked up at the steep, narrow run snaking off through the pine trees. He nodded toward another one – the Dragon Chute, which started as a drop over a cliff and then spread out into a powdery bowl. "I like the look of that one, too," he said.

They still hadn't decided which course to take when they raised their ski tips at the top of the lift. Sliding off the chair, they stopped to look again at the map. Alan pointed to the Dragon Chute, which appeared to be closer. They skied to the brink of the cliff. Bending his knees and pushing in his poles, Alan launched himself into the swirling snow with Karl following hard behind.

Moguls in the Making

A few hours earlier, over bread bowls of steaming, fragrant chili in the noisy lodge, Karl had asked Alan, a bit delicately, how things were going.

"You mean at work?" Alan said.

"Well, yes, at work. And everything. How's your dad doing?"

"A lot better now. It's hard to believe it's been five years since my mom died." He dug a spoon into the chili-soaked bread, fighting a lump in his throat. The memory of the hospital room – the slant of the afternoon light through the vertical blinds, the merciless hiss of the respirator, all that plastic tubing everywhere – was still searing. He thought how unfair his mother's death was when she'd given so much to others, not least by founding and running Help and Hope, now a well-established charity. He remembered the day they'd been told her cancer had spread; she had taken his hand, as if to comfort *him*. Her fingers were ice-cold. "Alan, darling, you are my gift to the world," she had said. "You will make a bigger difference in it than I."

At the time, he'd been working flat out for the strategy consulting firm he'd joined out of business school, in its pharmaceutical industry practice. And although he firmly believed that work was the best therapy for grief, he had also begun to regret the toll that traveling 20 days a month was taking on his personal life. Not long after the memorial service for his mother, a headhunter had called on behalf of Grepter, a New Jersey–based multinational pharmaceutical firm, and dangled a vice presidency. Alan had decided to make the move.

"Yeah, I miss your mom," Karl said. "I still have that crazy hat she brought me from Bangladesh." He grinned. "It always reminds me to send my check to Help and Hope. I figure if they're dedicating themselves to all those projects, the least I can do is supply some money."

"Tell me about it," Alan said ruefully. "There's a fund-raiser coming up that I should be putting a lot more time into." He took a sip of coffee. "But anyway, on the work front, I can't complain. Grepter has been very good to me. The people are great."

"I'm glad to hear it," Karl said. "Stock's doing well, too, which doesn't hurt. But it's so corporate, isn't it? You never struck me as a big-company guy. Are you really happy there? Challenged enough?"

Alan smiled. Good old Karl, ever the career counselor. He had gone a completely different route. Deciding to see how far his undergraduate degree in math could take him, he had chosen to forgo an MBA. Now he was making money hand over fist at a New York hedge fund, LSM Investments. Alan had a vague sense of what was coming.

"Well, the thing about M&A is that every deal is different, so I'm still learning a lot," he said. "I've been working on some big possibilities, including some international ones. If half of them come through, I guess I'll be on track for a promotion."

"You never struck me as a big-company guy. Are you really happy there? Challenged enough? And how about the money? Are they paying you what you're worth?"

"And how about the money?" Karl asked. "Are they paying you what you're worth?"

Alan wasn't sure what he was worth – or, for that matter, how inflated his friend's idea of a decent income might have become. He offered an exaggerated shrug. "How could they possibly?"

Karl laughed and then dropped his voice. "The reason I ask is this: There's an opportunity at LSM that has your name written all over it." He raised his hand slightly so that Alan would let him continue. "You know, in the first few years I was making close to half a million. With the fund size and performance on the rise, I'm now making – you won't believe this – almost 10."

Alan took a deep breath. The figure stunned him. "Jeez, Karl," he responded. "That's amazing. But that's you, and you're really good at it. You love the risk. You've always been a maverick."

"Don't kid me that you're afraid of risk," Karl replied. "I've watched you bomb down mountains for years." His eyes glinted. "I mean, sure there's risk, but it's mainly about being smarter than the average bear. You'd have no

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problem. And talk about Help and Hope – if you earn this kind of money, you'll be in a position to really make a difference. At some point down the line you could even cash in your chips, start the Jenny Wilson Memorial Foundation, and do that for the rest of your life."

Alan leaned back. Karl's proposal was certainly something to think about. But it was also complicating things. During a business trip to California the previous week, another friend had made Alan an offer, too.

A Parallel Turn

Shiori Masaki, resplendent in a crimson silk dress, had stood waiting for Alan near the host station of a 1940s-style restaurant in downtown San Francisco.

"It's been too long," she said breezily, kissing his cheek. "Thank you for making the time for me!"

They settled into the comfortable booth. He ordered a draft beer, she a glass of pinot grigio. Alan admired her long, pale hand as she ran a finger down the stem of her wineglass. Still no ring, he noticed.

It was good to catch up. They'd dated a little in business school, but after graduating at the top of her class, Shiori had moved to California. Very quickly she'd made a mint, first as the cofounder of a dot-com that sold out to a large software company, and then as a partner at a Silicon Valley–based venture capital firm that was moving toward biotechnology. Most recently she'd decided to become a social entrepreneur. She'd founded a company that focused on getting lifesaving medical care to patients in Third World countries. Every time Alan talked to her, she sounded more passionate about what her company was achieving.

"We've just lined up some new investors – which, let me tell you, is easier since the Gates Foundation came on board," Shiori said. "Now that we're so flush, we can finally get started on a couple of projects I've been dying to launch. I wanted to pick your brain about one in particular." She described a plan for partnering with big pharmaceutical companies to get medications for cancer, pain, and infectious diseases to people in Africa and Indonesia more quickly and cheaply. "It's really exciting stuff. But have we made it appealing enough for an industry partner? That's what I need you to tell me."

The waiter appeared to take their order. "Oysters Rockefeller for two," he said with a nod. "An excellent choice."

As Alan looked over some materials Shiori had brought, she chatted about

> **"We need a talented person with the right network to kick-start this thing – and you're the perfect fit."**

how much she enjoyed living on the peninsula. "You know, it's sunny most of the time – even in January," she said. "It seems like every time I've been in New Jersey, it's been freezing." She leaned toward him. "Do you remember when I took you to Half Moon Bay for surfing lessons? You were pretty good."

Alan laughed. "Oh, come on, Shiori," he said. "You forget. I managed to get up on the board, that's all."

"Well, you did a lot better than I did," she replied. "Anyway, you seem to like California. Have you ever thought about moving out here?"

Alan narrowed his eyes. "Why do you ask?"

"We need a talented person with the right network to kick-start this thing – and you're the perfect fit. That's what I really wanted to talk to you about."

This was a once-in-a-lifetime opportunity, Shiori said. Alan could get his entrepreneurial hands dirty. They would work directly together. "C'mon, don't you want to meet Bill and Melinda?" she said teasingly.

Alan laughed. "I can see me now, hobnobbing with them and Bono."

"In fact, that's a distinct possibility," Shiori said seriously. "But here's the real hard sell. You could help save a lot of people from dying of AIDS. Or cancer."

A View from the Top

"Okay, let's take a 10-minute break," said Gary Dreisinger, Grepter's longtime CEO, as the investment bankers, their work over for the day, gathered up their briefcases and slowly filed out of the boardroom. "We'll meet back here at 4:15."

Alan felt grateful for the respite, however slight. He was still a little sore from his ski trip, and it had been a long meeting. Now the whole thing was finally, mercifully, nearly over. He stood up, stretched, and ambled over to the west windows to lower the blinds against the setting sun.

Alone in the room, he had a chance to review his position. This merger with Schweitzer was the biggest deal he'd ever worked on, and the final decision would be made in just a few minutes. In his mind he ticked off all the requirements. The research stream had been thoroughly vetted. The team had carefully considered all the possible cost and revenue synergies. A thorough human resources map of both firms showed that Grepter and Schweitzer were highly complementary, so comparatively few people (primarily on the administrative side) would have to be let go. Independent analysts had asked the tough questions. The lawyers and bankers had done all their due diligence.

Alan felt exhausted. The deal had been a nail-biter, and he'd flown many times to and from Zurich, putting hundreds of hours into the negotiations. Schweitzer's board had rejected Grepter's initial offer of $39 a share, so Alan had negotiated an increase to $42. The plan was to invest simultaneously in Grepter's manufacturing capacity and Schweitzer's very promising drug R&D, in order to expand Grepter's pipeline. The acquisition would position

Grepter to take over the global vaccines market and compete toe-to-toe with a larger rival.

Soon Gary, carrying a fresh mug of coffee, re-entered the boardroom accompanied by the CFO and the head of strategic planning, Alan's boss. The moment of truth had arrived. "Gentlemen," Gary said, as the four of them took their seats, "it's decision time." He took a sip of coffee, setting the mug down on the polished table with a sharp click. "We all know this deal is about the R&D pipeline, and we agree that the financials look positive. I've read the reports."

He looked directly at Alan. "Alan, you've been in Zurich; you've seen what they're doing firsthand. Are you personally confident that everything is as good as they say it is?"

"Yes, I'm truly impressed," Alan said firmly. "It's exactly what the team said it would be. I think the pipeline is real. And the people are first-class."

"All right," Gary said. "We'll go for it. Let's get the paperwork ready."

The other two men left the room, but Gary stayed behind while Alan gathered up his notes. He shook Alan's hand, smiling broadly. "So, young man," he said with a twinkle in his eye, *"Sprechen Sie Deutsch?"*

"Not really," Alan replied.

"Well, you might want to learn some. What would you think about spending a little more time in Zurich?"

Alan stared at Gary. "What do you have in mind?"

"The first order of business will be to integrate Schweitzer," Gary said. "That would give you an opportunity to get some experience in operations. Besides," he said with a grin, "since you're a ski buff, I thought you might appreciate the surroundings."

"Ah...," Alan began, not quite knowing what to say.

"After that – I figure in six months or so – I'll consider promoting you to senior vice president in charge of global M&A, reporting directly to me. By then you'll be an exceptionally strong candidate. With a few years of global experience under your belt, you'll be as well positioned in the company as anyone could possibly be."

The Big Jump

Alan felt a little light-headed as he drove to the house of his favorite cousin, Beth, for dinner. He wasn't sure whether he was just hungry or reacting to the plethora of dizzying choices. As he pulled into the driveway, the front door opened. Eva and Kia, Beth's four-year-old twins, came tumbling down the steps to meet him, squealing with delight.

"Uncalan! Uncalan! Uncalan's here!" the girls cried, hugging his legs as he closed the car door. He grinned.

"Brr, it's cold out here!" he said cheerily. "Let's go inside. I brought presents."

Alan had trained his little cousins well. Beth had pleaded with him to stop spoiling them, but he enjoyed it when they behaved like Pavlovian puppies, jumping and yipping in expectation of the trinkets he always provided. His visits had a bittersweet side, though: He couldn't help wondering sometimes if he'd missed the chance to have his own family.

As the twins bounced into the house, Beth greeted him at the door, wiping her hands on a cloth. She kissed his cheek as her husband, Eric, offered to take his coat. Alan reached into the pockets and pulled out two brightly colored, silken-maned plastic horses for the girls.

"Girls, say thank you!" Beth shouted as they ran off with their prizes.

"Thankyuncalan!"

Over a dinner of roast chicken and mashed potatoes with gravy, Alan recounted the events of the afternoon to Beth and Eric.

"My goodness!" Beth said. "What an offer! What did you tell him?" As a schoolteacher, she had ambitions of a different kind, but she always seemed to be dazzled by the accomplishments of her cousin, who was as close to her as her own brother.

"I told him I'd be glad to think about it," Alan said.

"Think about it!" Beth cried. "What's to think about? I'm surprised you didn't just grab it right there and then."

"Hmmm, I get the feeling Alan's a little conflicted," Eric observed.

Alan told them about the offers from Karl and Shiori, and then started weighing his options aloud. "If I stay with Grepter, I not only have an opportunity to work directly with the CEO, but I can get both operational and global experience. And if I continue to advance – well, let's just say that anyone who gets to the top of a *Fortune* 100 company has a big platform for bringing about some positive changes in the world. But that's counting chickens. On the other hand, if I worked in the hedge fund, I'm sure I'd make more money in the short term – so I could probably start making a difference sooner."

"Because you could support the kind of work that Aunt Jenny did," Beth ventured.

Alan nodded. "And people like her probably do it better than I could anyway. That's my hesitation about the California opportunity. I'd be making a difference for some very unfortunate people right now, and that would be gratifying, but..."

"And does that Shiori still appeal to you?" Beth interrupted with a smile. "She sure did once, as I remember. She's cute. Smart, too."

Eric rescued him by saying, "It sounds like the real question is not about money but about where you think you can make the greatest impact on the world."

"You're right," Alan said. "That's what I wish I knew."

"Alan, you're such a superstar," Beth chimed in. "Just do what you love, and the impact will follow."

Which career should Alan choose to make the biggest difference?
Four commentators offer expert advice.

Laura Scher is a cofounder and the chair and CEO of Credo Mobile (formerly Working Assets), a San Francisco–based wireless phone service provider that has generated $56 million for nonprofit groups since 1985.

THOUGH ALAN is single, it's clear that family is important to him. A devoted son and cousin, he loves children and entertains thoughts of fatherhood. The best way to honor his mother's wishes would be to raise his future children – her grandchildren – with a good value system. Therefore, the overriding questions he should ask himself are these: Where do I see myself in 10 years, when I have a family of my own? How will I teach my kids about making a connection between values and work? From this perspective, it seems that any of his career options will work very well – as long as he brings his values into the workplace.

Alan should also weigh each of his job options on a five-point scale – money, fame, power, personal values, and quality of life. By this measure, working in Shiori's social enterprise organization might well score high on personal values and quality of life. Working as a senior manager at Grepter would score very high on power; would undoubtedly reward Alan with a fine salary, bonuses, and stock; and – if he persuaded his company to provide free medicine for the poor – would also score high on personal values. Furthermore, if he's thinking about his future family and quality of life, the chance to raise his children in Zurich – a safe, clean, cosmopolitan city where they could learn to speak multiple languages – might tempt him, too.

A person who puts a high premium on doing good in the world might think that joining Karl at LSM Investments would be the worst possible choice, because he or she might assume that making money is the only real driver. Certainly, if Alan were a hedge fund manager who flew around the world on a private jet and saw his kids two weeks a year, they would probably judge him negatively. But he could choose to use his position at LSM to support his personal values and his quality of life. If he lived modestly, tried to get the fund to invest in socially valuable projects, set an example of philanthropic priorities, and made sure to spend a lot of time with his children, they would judge him differently.

Having imagined himself in the future and considered the various positions according to this five-point scale, Alan can begin to weigh the benefits against the possible risks, both personally and professionally. For instance, living in California or Zurich might make him feel too distant from his beloved cousins: a negative for quality of life. As he weighs these considerations, however, he should rely not on hearsay and hunches but, rather, on a clearheaded, objective investigation of the facts. For example, is there a basis for believing that the CEO will really follow through on his promise? Or would Alan find himself too far away from the corporate epicenter if he worked in Zurich, and thus be passed over for a more advantageous position? To find out, he should look at the career paths of other managers at Grepter. And has the company demonstrated any interest in supporting or expanding his social agenda?

Alan should rely on a clearheaded, objective investigation of the facts. For example, is there a basis for believing that the CEO will really follow through on his promise?

As for the hedge fund, he should look at the makeup of the board. Does he share the vision of its members? What is the long-term plan? The same goes for Shiori's company.

Once Alan has evaluated his options this way, his choice will be clearer. But regardless of the choice he makes, he should remember that many paths lead to the same place. It's really a matter of approach – bringing your values to work.

Wendy Wray

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** Source: Air Force Materiel Command press release, 5/6/2006*

Daniel Vasella (office.vasella@group.novartis.com) is the chairman and CEO of Novartis in Basel, Switzerland.

THE WORLD certainly seems to be Alan's oyster, but his mother's ghost is interfering with his enjoyment of it. His confusion springs, in part, from the fact that he has not yet finished with the grieving process. As she was passing away, his mother burdened him with a heavy expectation. Her dying wish has put Alan in the unhappy position of living to fulfill her role for him rather than choosing his own direction. By hinging his future on the fulfillment of his mother's wishes, he may miss the opportunity to realize the full potential of his own life.

Alan must start by asking himself a few key questions: What is really driving me, professionally and privately? Am I living my own life, following my ideals, or am I acting from a heavy conscience? What are my core skills, and what satisfies me most?

Some of Alan's personal predilections already indicate a path. Consider the way he skis. He takes calculated risks. Instead of choosing the narrow track, where he might hit a tree, he goes for the wide-open run. By leaping before Karl, he shows that he's a leader, not a follower.

Alan's skill with people makes the opportunity in California more appropriate, but he needs to ask whether professional networking is really what he wants to do. Another question arises: Does it make sense to go into business with a friend? What will happen if Alan, a natural leader, reports to Shiori – or to Karl? If he competes with one of them or if something goes wrong, can the friendship survive?

Grepter, however, satisfies his need to work with people and offers excellent prospects. An international position abroad and responsibility for an integration project would indeed give Alan extremely valuable experience. The CEO has hinted that he might mentor him and has even intimated that Alan might be his successor. Alan should confide in Gary and openly and honestly discuss his options and concerns; he might say that he'd like to find a way to combine a career in big pharma with social entrepreneurship. Indeed, it might be strategically interesting for Grepter to grow a business based on providing affordable drugs to the world's poor. During this discussion Alan could learn a lot about Gary's interest in and intentions for him.

Does it make sense to go into business with a friend? What will happen if Alan, a natural leader, reports to Shiori – or to Karl?

Such hints suggest that working for a hedge fund might be the wrong choice. Instead of broadening his competency level through a wide variety of experiences, he would be narrowing it by spending his days studying the movements of stocks. Moreover, interpersonal relationships are important to him, but he probably wouldn't be interacting much with people at a hedge fund. And money doesn't seem to interest him as much as it does Karl – at least not for its own sake. I suspect that Alan knows that money has an addictive quality: The more you earn, the more you spend, and it doesn't necessarily make you happy.

In his role as a mentor, the CEO might also help Alan discover that being useful to society has to do not just with work but with all aspects of life – not just the charities to which he contributes but also the products and services he helps produce, the relationships he builds, even the taxes he pays. By being open with his mentor and paying attention to his own heart, Alan may discover that he can follow his true self and at the same time do more for the world than his mother ever dreamed of.

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WHEN A dying mother tells her son, "You are my gift to the world," those words echo forever in the core of his being. Alan will never be able to completely disregard the memory of his mother's voice, and it is bound to have an influence on his future behavior.

However, his cousin is right: If he does what he loves, the impact will follow. I would advise Alan not to worry that any decision he makes now might foreclose future opportunities. At this early stage in his career it probably won't. Instead he should sort through his thoughts by pulling out a yellow pad and writing things down. Specifically, he should make two lists. One should note the things he really loves to do: What turns him on? What sorts of work situations and personal activities does he find fun? The other should list the things he really doesn't like. Having done this, he should note the pros and cons of each job opportunity and then compare them with his likes and dislikes. His goal should be to discover which opportunity best matches what he loves doing.

If I were advising Alan, I would caution him against either joining the hedge fund or accepting a longer tenure at Grepter. He doesn't appear to be sufficiently driven by money to join Karl's team. The stress factor in that business might be high, and – even assuming the fund does well and Alan makes a lot of money – his satisfaction quotient might be low. Moreover, he wouldn't be able to make the social impact he wants to for several years. And although Grepter seems to be a fine place, and Alan has been happy in his career there so far, wading through a large corporate bureaucracy might not be the best thing for him, as his old friend has pointed out. Nor, again, would Alan be able to make an impact for quite a while, especially if he is working very hard as a senior manager.

There are several reasons why Alan should seriously consider joining Shiori's enterprise. First, the entrepreneurial adventure of building a company, although it can be risky, is energizing and fun – and Alan seems capable of tolerating the level of risk involved. Shiori has already shown that she knows how to make money, so her new company's chances of success may be better than average. And if Alan has an equity stake in the company and it goes public or is sold, he could make some money in the process. However, working with Shiori could be a pitfall if Alan isn't clear about his romantic feelings for her.

Second, the satisfaction that he derives from working on a meaningful social venture would be a wonderful balm for the emotional pain of losing the mother he loved and admired.

Third, he would gain experience in social policy. If he combined this with the high-level contacts that Shiori hints he could make, he might find himself in a position of greater influence later. For example, he might be drawn to the public sector. There are many jobs in government – in the United States and globally, in appointive or elective office – where he could have a very positive impact on society. Not many MBAs choose the public-service path: Public service is often tough, and you can't get rich doing it. But there is great satisfaction in making a contribution this way. It is worth considering if Alan really wants to become a force for large-scale change.

Alan might be drawn to the public sector. Public service is often tough, and you can't get rich doing it. But there is great satisfaction in making a contribution this way.

I CAN RELATE to Alan's situation. When I finished my MBA at Harvard Business School in 2004, my possibilities seemed limitless. I, too, wanted to do something meaningful but didn't know what. I had experienced a rewarding career in software, having started two companies and taken one public before landing at HBS; but I wanted to expand my horizons. So many other paths were now open to me. Would I go into venture capital or private equity, where I would be on the other side of building businesses? Would I join a *Fortune* 100 firm for best-of-class management training? Or would I make something of the business plan I'd written during the program? (In the end that's what I did.)

First I had to understand my own character. I realized that I enjoy taking risks and charting my own course. Alan is more conservative and analytical in his approach. He likes to evaluate things at a high level and develop strategies. Although his people skills seem good, it is not clear that he has the propensity to be a leader who gets out there and takes charge.

Consider his career choices thus far. His mother was a great role model, but Alan isn't necessarily cut from the same cloth. (Otherwise he might have chosen to work in the nonprofit world instead of in business.) She was a successful entrepreneur in her own right, but Alan doesn't seem to lean that way either. Going into consulting was a safe bet for him after business school; he didn't have to run anything or take a career risk. When he joined Grepter, he opted for a corporate role rather than a frontline job in sales or marketing.

In light of his innate caution and his desire to make a difference, the hedge fund is not a wise choice. Although it might let him make good use of his analytical skills, the only real draw appears to be money. If the fund fails, however, he may be left with neither wealth nor a persuasive career record. Likewise, working with Shiori does not make sense. Alan could indeed make a lasting impact, but the social enterprise is already *her* dream and vision. How could Alan develop and demonstrate his expertise independently? Moreover, it's never a good idea to mix personal and professional lives. If Alan's romantic interest in Shiori reawakens and things don't work out, it could be disastrous.

If Alan is motivated to build something with lasting impact, he cannot continue analyzing his career from the sidelines. He must cultivate his operational and management skills. Staying with Grepter and accepting the challenge of integrating the Zurich firm will give him the perfect opportunity to get his hands dirty and gain real operational experience under the CEO's tutelage. If Alan wants eventually to run a social enterprise or a smaller company, the best way to get there is to develop his capabilities and network at a leading firm until he is ready to make the leap. That will continue to move his career forward, rather than sideways, and build skills that will make him more valuable. Meanwhile, he will have time to discover what is meaningful to him and to develop a much firmer notion of what he wants to be and do. This will position him to make his next career decision on his own terms, rather than on the basis of a seductive temptation.

If Alan wants eventually to run a social enterprise or a smaller company, the best way to get there is to develop his capabilities and network at a leading firm.

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Delivering High Performance

Leveraging Talent Starts at the Top

It's late in the first decade of the 21st Century. Do you know what talent your organization has and what talent you need to be successful in the future? Many top executives don't. They are discovering that talent is harder to find and retain. They are also discovering that it is a challenge to deploy talent and multiply its value.

Executives who understand and are focused on these issues are typically at the helm of companies that outperform their peers. They know that the pressures of globalization, changes in workforce demographics and the knowledge-based economy have made talent their most important competitive asset.

TALENT DEVELOPMENT GAP

Although top managers say talent-related capabilities are important to achieving better performance, they acknowledge poor execution in developing those capabilities.

Source: Accenture High-Performance Workforce Study, 2006

"Most top executives have a keen appreciation of the critical value of talent," says Peter Cheese, global managing director of Accenture's Human Performance practice. "But when it comes to how best to manage and develop that talent, they're often frustrated by the lack of progress."

Accenture uses insights from its research and experiences to help clients achieve high performance. In its analysis, Accenture identified the critical links between effective talent management practices–a key driver of high performance–and organizational success. Accenture also found that executives who manage high-performance companies view their talent strategies as a top priority in sustaining the superior performance of their businesses.

Cheese and his colleagues recently published their findings and lessons learned in the book *The Talent Powered Organization: Strategies for Globalization, Talent Management and High Performance.* They conclude that although having the right talent both aligned and engaged is crucial to achieving strategic corporate objectives, fragmented talent management systems, processes and practices are still the norm at too many organizations. These companies have not sufficiently focused on building talent management capabilities across the organization. And as competition for talent increases, they are increasingly facing shortfalls in critical workforce segments.

For example, most of the 251 executives polled last year as part of Accenture's High-Performance Workforce Study noted that they considered three talent-related factors–attracting and retaining skilled staff, having a performance-oriented mindset in the workforce, and finding and developing talented leaders–to be very important in influencing high performance. Yet few respondents thought their companies were addressing any of these factors very well (see chart, "Talent Development Gap").

Indeed, relatively few senior executives were satisfied with their human resources and training functions. Knowledge capture and transfer, knowledge management, change management and aligning workforce skills to business priorities were particularly weak at most companies (see chart, "HR and Training Not Up to the Task").

HR AND TRAINING NOT UP TO THE TASK

Research shows that few senior executives believe their current human resources and training functions are highly effective (% of respondents indicating their organization was "highly effective" at each function).

Source: Accenture High-Performance Workforce Study, 2006

In contrast, Accenture found that truly talent-powered organizations are adept at defining talent needs, discovering diverse sources of talent, developing individual and collective talents, and deploying talent in ways that align people with strategic objectives.

"To create what we call a talent-powered organization, companies must be prepared to do more than just fill in gaps by adding people," Cheese says. "They have to be able to multiply their talent to generate superior levels of effort, imagination and creativity."

FOR MORE INFORMATION

The Research Report To learn more about the Accenture High-Performance Workforce Study, go to: http://accenture.com/workforcestudy

More on High Performance Business To see insights from Accenture's research and experience, including its study of over 500 high performers, go to: http://accenture.com/research

The Book To read a summary of *The Talent Powered Organization: Strategies for Globalization, Talent Management and High Performance*, go to: http://accenture.com/talentpowered


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Transforming Giants

What kind of company makes it its business to make the world a better place?

by Rosabeth Moss Kanter

WHAT ENABLES A BIG BUSINESS TO BE AGILE?

Not too long ago, most people would have called that question a contradiction in terms. The common perception was that profit-seeking behemoths were dysfunctional. They were written off as lumbering, inflexible, reactive, and inherently bureaucratic – as systems so closed they had lost the ability to see the problems in the world around them, let alone be part of the solutions. Yet talk to the leaders of some of the world's biggest companies today, and you hear a different story. They're claiming new abilities to shift organizational gears on a global basis and produce meaningful innovations quickly.

To discover the truth behind these claims, I assembled a research team and ventured deep inside a dozen such giants. After two years of visiting their operations – a process that comprised more than 350 interviews on five continents – I am convinced that the transformation these leaders describe is real. Companies such as IBM, Procter & Gamble, Omron, CEMEX, Cisco, and Banco Real are moving as rapidly and creatively as much smaller enterprises, even while taking on social and environmental challenges of a scale only large entities could attempt – and they are bringing small and midsize businesses with them on the journey.

The key, I've concluded, is that a decisive shift is occurring in what might be called the guidance systems of these global giants. Employees once acted mainly according to rules and decisions handed down to them, but they now draw heavily on their shared understanding of mission and on a set of tools available everywhere at once. They more readily think about the meaning of what they do in terms of the wider world and include external partners in the extended family. Authority is still exercised and activities are still coordinated – but thanks to common platforms, standardized processes, and, above all, widely shared values and standards, coherence now arises more spontaneously. This shift is often heralded, and in most of these companies it has been a long time coming. But now it is happening with dramatic effects.

In this article I will set forth the pillars of this new model of big business – what IBM CEO Sam Palmisano calls the "globally integrated enterprise." I will outline the benefits that accrue to the companies that have those pillars in place, which go beyond innovation to include a whole host of mutually reinforcing effects. I will identify the various mechanisms that have helped these giants establish and maintain high standards worldwide – and can help other companies do the same. Replicating the conditions that are emerging at the most progressive megacorporations will not be easy. But if others follow their lead, soon this new paradigm of capitalism could be viewed as not only a competitive necessity but also a benefit to society. When giants transform themselves from impersonal machines into human communities, they gain the ability to transform the world around them in very positive ways.

When giants transform themselves from impersonal machines into human communities, they can transform the world.

I recognize that it has become very fashionable in corporate circles to talk about values, and often there is little behind that talk. However, for the vanguard companies we studied, values truly are a primary consideration. They help the companies find business opportunities and motivate both employees and partners.

At IBM, even before the full rollout of grid computing to commercial customers, the company gave away the technology to scientists searching for cures for HIV-AIDS, heart disease, and cancer. Grid computing enables the aggregation of individual PCs' power through a network, providing the information processing necessary for big, ambitious research. As soon as IBM had perfected the technology, it created a nonprofit partnership, World Community Grid (WCG), through which any organization or individual can donate unused computing power to research projects and see what is being done with the donation in real time. Through WCG, IBM gains an inspiring showcase for its new technology, helps business partners connect with the company in a positive way, and gives individuals anywhere in the world the chance to contribute to something big. In São Paulo, Brazil, as I talked with an executive of IBM Latin America, he proudly pointed to the action on the ThinkPad behind his office desk, which was at that moment processing data for a WCG cancer research project.

Shared Values, Principles, and Platforms

To compete effectively, large corporations must respond quickly and creatively to opportunities wherever they arise, and yet have those dispersed activities add up to a unified purpose and accomplishment. The companies that meet this challenge rely in part on clear standards and disciplines, including, at the most basic level, standardized processes.

Consider the "CEMEX Way." Around 2000, the Mexico-headquartered global cement company CEMEX launched this companywide program to identify and disseminate best practices and standardize business processes globally using IT platforms. The point was to foster sameness in areas where sameness would make life easier. In every one of the company's plants, for example, pipes carrying natural gas were painted one color, and pipes containing air were painted another color. This made it simple for transferring employees or visiting managers not to waste

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time upon their arrival figuring out the setup. The same logic followed for other plant configuration systems, financial recording systems, requisition systems, and so forth.

Standardization does not mean that no enhancements can be made. People at CEMEX are encouraged to recommend improvements. If a change is piloted in one plant setting and proves effective, the new practice is immediately rolled out worldwide. Even when a change is not mandated, a novel approach can be disseminated thanks to web-based information sharing. An oft-cited example is how a successful initiative in the United States to substitute alternative fuels for petroleum coke was quickly adopted elsewhere.

Standardized management practices and technologies in companies are the equivalent of infrastructure in cities: They allow people to stop wasting energy on basic activities and instead focus on higher-order concerns. But providing a platform on which creative people can build is only half the battle. What's also required is a shared set of values to guide their choices and actions.

Values turn out to be the key ingredient in the most vibrant and successful of today's multinationals. I refer not to the printing of wallet cards but to the serious nurturing of values in hearts and minds. Once people agree on what they respect and aspire to, they can make decisions independently and not work at cross-purposes. When they team up on a project, they communicate and collaborate efficiently, even despite great differences in backgrounds and cultural traditions, because they have a strong sense of business purpose and company identity.

At Procter & Gamble, the values and standards captured in the company's statement of purpose, values, and principles (known as the PVP) enable managers in diverse locations to respond quickly and effectively to business opportunities or crises. P&G's purpose, the PVP says, is to "improve the lives of the world's consumers" with high-quality products that represent good value. The list of company values underscores the importance of leadership, ownership, integrity, passion for winning, and trust. The statement has eight principles describing how the company chooses to compete. In talking with P&G managers around the world about their operations, my research team and I heard the PVP invoked repeatedly. A developing-country manager said, "We all want the same thing: what will delight the customer and improve her or his life. To do that, we must treat our people as valued assets."

Likewise, at IBM, three simple sentences about customers, world-improving innovation, respect, and responsibility were repeated everywhere we visited and in meetings I had as a senior adviser to the company. Those values were credited with clarifying decisions and cutting through internal politics. Some of this potency may come from the participatory process by which the three sentences were crafted – a three-day chat session on the Web in 2003 called the Values Jam, in which all the employees could contribute thoughts. (See "Leading Change When Business Is Good," HBR December 2004.)

A strong backbone of shared values has always been a strength of some companies. IBM's twenty-first-century values are a reinvention of values laid down almost a hundred years ago;

Omron, a global electronics company headquartered in Japan, identified its core principles in the 1950s. But in the age of globalization, values and principles take on even greater importance, and the vanguard companies we studied have recently redoubled their efforts to bring them front and center.

Shortly after CEMEX's first series of acquisitions outside its home region, in the mid-1990s, the company's leaders articulated core values of collaboration, integrity, and leadership and added a set of standards for behavior that employees were required to sign. The company soon learned to appreciate the challenge of upholding those values in parts of the world with very different ethical standards and social norms. In 1999, for example, CEMEX bought a state-owned enterprise in Egypt and found that obtaining and renewing access to rock quarries there – a necessity for cement companies – traditionally involved offering gifts to the people in charge. That was in clear violation of CEMEX's standards, and local employees initially doubted that the company would succeed without compromising them. Indeed, it took a year and a half rather than the usual month, but eventually CEMEX obtained the approval. Today, the story is often retold in situations where there appears to be a conflict between the company's standards and business objectives.

Getting Close at a Distance

The payoff for companies that have embedded values and principles in their guidance systems comes in many forms. The first benefit is integration, which permits collaboration among diverse people. This has clearly occurred in a series of national cultural projects IBM has taken on in recent years, building on its work to digitize the treasures of the State Hermitage Museum in Saint Petersburg, Russia.

The company's Cairo Technology Development Center prides itself on having world-class engineers (all Egyptian, many of them women). It competes for business globally and wins its share: A recent project for Sony in Hollywood, for example, was handled from Cairo. Aware of their colleagues' work for the Hermitage Museum, and knowing that preserving Egypt's cultural heritage was a government priority, leaders at IBM Egypt proposed a project called Eternal Egypt. It would involve partnering with the Egyptian government's Center for Documentation of Cultural and Natural Heritage and the Ministry of Communications and Information Technology to digitize not only the contents of a museum but also ancient structures such as the pyramids, so that they could be viewed in detail, virtually.

Technological innovation was required. In particular, the project demanded new high-resolution scanning technology for three-dimensional objects, which called for an exchange of ideas with IBM engineers in the United States. For website design, the Cairo team got help from an IBM team in Chicago and experts at IBM's research labs in Haifa, Israel (despite political hostilities and religious differences between the countries). Eternal Egypt was launched to wide acclaim, particularly because of the importance of heritage-based tourism to Egypt's economic development. It also led to a commercial contract to digitize the contents of the Library of Alexandria. And most recently, it became a model for IBM China's Forbidden City project, which will go Eternal Egypt one better by including a virtual tour.

The Eternal Egypt model is an important example, because it demonstrates the true global integration of a company. Innovations do not simply emanate from the home country and radiate outward. They emanate from many places. Know-how is transferred to and from emerging and developed countries through a web of global connections.

Sometimes companies achieve collaboration by bringing people from diverse backgrounds together physically. CEMEX is especially adept at getting people to the problem and gaining speed in the process – for example, seconding large numbers of experienced people to newly acquired operations to work on postmerger integration teams for periods of a few months to a few years. This encourages every manager to train replacements, even if the replacement will be temporary. It ensures deep bench strength, as there are always people well schooled in the CEMEX Way ready to mentor others.

Common values and standards allow people at the front lines to make consistent decisions, even under pressure.

Empowerment in the Field

Common values and standards also allow people at the front lines to make consistent decisions, even under pressure and in the company's most culturally and geographically disparate locations. Among the leading-edge companies we examined, this was the most striking similarity, and sometimes the most difficult thing for outside observers to understand. A strong, broadly internalized guidance system obviates the need for controls that stress obedience and instead promotes autonomy.

Expressing values and standards in universal terms is not meant to inhibit differences. In fact, it helps people see how to meet particular customers' and communities' needs by adding localization to globalization. At P&G Brazil, leaders called this "tropicalizing." As a marketing executive told us: "The values and principles don't change, but we respect the local trade, the local consumer, the local organization."

That sentiment was echoed by the general manager of P&G's Near East unit, which has dual headquarters in Cairo and Beirut. "Whenever we're in a tough situation, we start looking at the principles of the company," he said, "because you will find in them the answer to the problem you're having." He faced just such a crisis when Lebanon was bombed in 2006. On the first day of the war, Near East executives conferred. "My team needed to make a decision: What do we need to do with the people in Beirut?" the manager told us. Together they drew from the PVP to agree on a principle of "people safety" first, followed by agility and determination to drive the business.

It may sound uncontroversial in retrospect and from afar, but consider that attending to people safety for employees and their families meant increasing the number of office locations in Lebanon from one to three (to reduce travel distance to work and incidentally conserve gas, which was scarce during the crisis). It also meant moving people who lived in the areas most affected to hotels. P&G offered all employees working in Lebanon (including Lebanese employees) evacuation to Egypt and housing there for their families and up to three extended family members. About half of the workforce moved. These decisions were made and action was taken before any official permission was requested from headquarters. As a result, P&G evacuated employee families faster than some countries moved diplomatic personnel. Although the evacuation cost a great deal, the decisions were supported by regional bosses in Switzerland and global headquarters in Cincinnati.

Innovating in Markets

Procter & Gamble is also responsive to the diverse needs of customers around the world. But if many top management teams would object to the kind of rogue action taken by P&G's Near East unit, just imagine how they would react to local ideas that present some

One Company's Return on Values

Imagine a developing country where workers like their beer and like it cheap – to the extent that alcohol use has become a serious public health problem. Now imagine you are the country manager there for a multinational corporation that profits by selling alcoholic beverages. Your goal is to gain more market share. Is this anywhere for values to hold sway?

Here's how the story played out in Kenya. UK-headquartered Diageo, the world's leading producer of premium alcoholic beverages, had entered the market with a large investment in East African Breweries but couldn't match the low price of its competition. That was because the competition was home brew, subject to no standards or inspections and sold out of garages. Illicit beer was downright dangerous in a country where water supplies are often contaminated – it was known to cause blindness as well as the intense hangovers and related illnesses that routinely lowered productivity in Kenya's labor-intensive industries. But it was popular because, with no government taxes added to its price, it offered the most sips for the shilling.

Diageo had the benefit of local talent with global thinking who could recognize the opportunity in the situation and seize it. (Over the years, the company encouraged members of the internationally educated African diaspora to return to Africa at expatriate pay rates.) Using Diageo's global resources, including a web-based innovation tool, the local team attacked the problem. Importantly, it put the focus on the best outcome for society and was therefore able to open lines of communication with the national government. The company proposed producing a low-cost beer and making it widely available, giving the buyers of illicit beer an alternative they would consider reasonable. The safer product would succeed, however, only if the government agreed to reduce the surtax on it, so the price would be truly comparable. The government, of course, had no interest in corporate charity, but it became clear that if more people bought legal beer, taxes would be collected on a greater proportion of the alcohol being consumed. A tax cut, therefore, was likely to yield higher tax revenue overall.

To make the new beer, now called Senator, widely available, Diageo needed to develop a new distribution channel: responsibly managed licensed pubs. The team talked to community leaders throughout Kenya to identify influential solid citizens, such as shopkeepers and sports club owners, who could set these pubs up. Diageo provided equipment and trained them in business operations, eventually establishing 3,000 new outlets.

The launch of Senator beer saw success on many fronts. Beyond the high market share it immediately claimed, Diageo received a prestigious award for contributing to reduced rates of blindness and increases in workplace productivity. Meanwhile, thousands of new small businesses flourished, and government policies started to change. The work was gratifying to Diageo managers both locally and internationally.

At the time of Diageo's formation in 1997 (by the merger of Guinness and Grand Metropolitan), its leaders had articulated the company's values and operating principles to emphasize both high global standards and local community responsibility. With that kind of guidance system in place, local decision makers – even in a "sin industry" – can have a transformative positive social impact.

Having It Both Ways

When do you know a paradigm is shifting? When long-standing contradictions begin to resolve. In the giants my research team and I studied, I was struck by the number of areas in which they achieved a balance between seemingly opposing goals.

- They both globalize and localize, deriving benefits from the intersections.
- They both standardize and innovate, endeavoring to prevent consistency from becoming stifling conformity.
- They foster a common universal culture but also respect for individual differences, seeking inclusion and diversity.
- They maintain control by letting go of it, trusting people educated in the shared values to do the right thing.
- They have a strong identity but also a strong reliance on partners, whom they collaborate with but do not control.
- They produce both business value and societal value.
- They bring together the "soft" areas (people, culture, and community responsibility) and the "hard" areas (technology and product innovation).
- They do not abandon values in a crisis; in fact, as leaders put them to the test, crises serve to strengthen commitment to values.

risk to the brand. This was the situation at P&G in the early 2000s, when it was struggling to grow its business in Brazil.

The company's Brazilian marketing group knew its consumers well; in fact, it had gained a deep understanding of local women by using the kinds of market research tools and processes P&G uses globally. Based on that knowledge, it claimed that the company's Always feminine hygiene product could not succeed at its current price point. A better offering, these marketers insisted, would be a stripped-down version, still employing the essential technology that made the product perform well, but without certain features that added cost beyond their value to lower-income consumers. Naturally, many skeptics at headquarters worried that selling "Always Básico" would dilute the brand's equity. But the experiment was allowed to go forward.

The manager who led the project in Brazil described for us the local energy that went into it. A small team of office staff, plant managers, R&D experts, and external advertising agency talent collaborated to bring Always Básico to market as rapidly as possible. Within the plant, a creative team found a way to adjust an existing line and reduce the cost of manufacturing. The manager told us about the day, a mere six months after her team began its work, that everyone stood holding hands and watching the first units come off the line.

Always Básico succeeded beyond the team's projections, and headquarters took note. It wasn't long before Pampers Básico was launched in Brazil. More broadly, the initiative became a model for products for low-income consumers around the world. Knowledge moved horizontally to other product lines and also vertically to other markets. As each similar effort improved on previous ones, the Brazilians took pride in having innovated on behalf of the world.

The story teaches two lessons. First, people versed in universal standards are often most innovative when they apply those standards to local situations. And second, it is critical that the standards be open-ended and aspirational, not constraining or restrictive. We saw the same kind of balance struck by CEMEX, which has managed to innovate continuously despite dealing in a product most people would consider the purest form of commodity. We heard how an idea for making concrete more resistant to salt water – a significant benefit in harbor and marine applications – originated in Egypt and made its way to the Philippines. Other recent innovations include antibacterial concrete for hospitals and farms, and road surfaces made of recycled tires in countries experiencing rapid growth in road construction.

People are even more inclined to be creative when their company's values stress innovation that helps the world. Banco Real, the Brazilian arm of a European bank, discovered this when it put social and environmental responsibility at the core of its search for differentiation. The result was a spate of new financial products, including consumer loans for green projects (such as converting autos or houses), microfinance for poor communities, and the first carbon credit trading in the region. Banco Real also chose suppliers with higher environmental and social standards and even helped them improve their practices. By 2007, it was enjoying the fruits of its values; it had more than doubled its profitability, grown in size to become the third-largest bank in Brazil, and been rated number one or number two in various surveys. CEO Fabio Barbosa had been elected president of the Brazilian Banking Federation, from which position he could spread Banco Real's model.

A Stronger Basis for Partnering

Companies that have established strong guidance systems find themselves more effective in selecting and working with external partners – increasingly a necessity for competitive success. A more outward- and forward-looking definition of purpose encourages exploration of partnership opportunities that extend well beyond the formal boundaries of the company. It causes people in the company to think about end-to-end responsibilities to the whole ecosystem, from suppliers' suppliers to customers' customers and beyond – to society itself. And it creates coherence across the entire network. "We have partnerships all over the place," P&G chief executive A.G. Lafley said, referring to a sweep from contract manufacturing to advertising and design. "What holds them together is one purpose, one set of values, one set of principles."

Omron's principles, for instance, form the basis for choosing partners and gaining trust. The knowledge that partners would share Omron's values and standards helped the Japanese company's R&D transform what one manager called a "not-invented-here, ivory tower" research approach into collaborative information sharing with partners. Omron leaders consider the company's principles a competitive advantage in securing preferred customers, even when its prices are higher, and winning preferred acquisitions, even when its bids are lower. Recent acquisitions, including some in the United States, rested on discussions of the importance Omron places on people and society. The integration process, leaders said, was "like the joining of two families." Indeed, the target companies largely performed the integration themselves, posting the Omron principles and wearing the Omron uniform at the first postintegration meetings. In most of Omron's offices, daily morning meetings start with the company's motto, "At work for a better life, a better world for all," recited by employees or broadcast by a manager.

The giants we studied gain allies in innovation, influence standards, and improve lives in the countries in which they operate through their partners as well as their direct activities. They work with established companies but also grow their own networks. Consider two different value chains anchored by CEMEX. The first is Patrimonio Hoy, which the company created in Mexico in 1998 to organize low-income consumers into self-financing cells and give them access to low-cost building materials, technical expertise, and services. Within six years, hundreds of thousands of families had been served, and this profitable business model was in operation in Mexico, Colombia, Venezuela, Nicaragua, and Costa Rica. The second is Construrama, a distribution program CEMEX started in 2001 to offer small hardware stores training, support, brand recognition, and easy access to products. CEMEX owns the Construrama brand and handles promotion but doesn't charge distributors, operate stores, or have decision-making authority, although service standards must be met. By 2005, this network in Mexico and Venezuela was the equivalent of the largest retail chain in Latin America, and it was expanding to other developing countries.

Construrama was created in response to competition from The Home Depot and Lowe's, both of which were then entering Latin America. CEMEX wanted its own distribution outlets and found common ground with the small and medium-sized enterprises that were threatened by the large international chains. In building the network, CEMEX hewed to the values and standards it had articulated, favoring partners of integrity who were trusted in their communities, and rejecting candidates whose business tactics didn't meet CEMEX's ethical standards (even if they boasted high growth or high margins). Partners are expected to share the company's values, including participation in community-building philanthropic endeavors – for example, contributing people and materials to expand an orphanage or improve a school.

When Banco Real put social and environmental responsibility at the core of its search for differentiation, the result was a spate of new financial products.

As companies tackle pieces of the public agenda, the partnerships they forge go beyond the commercial world – and commitment to shared values and standards becomes even more important. A good example is IBM's Reinventing Education (RE) work in the United States. In these initiatives, IBM targeted problems that K–12 school districts identified as their most significant. Researchers from the company's renowned Watson lab created prototypes of tools and tested them quickly, and then assembled the right set of commercial and noncommercial partners to help spread the use of the tools. Some RE solutions, like KidSmart workstations for preschool children, are also spreading worldwide through partnerships with government ministries and nonprofit organizations.

As projects like this become more commonplace, the ability to exercise diplomacy is becoming a job require-

ment for professionals far down in the organization. We were particularly struck by this at IBM India, where people could rattle off the priorities of government officials and explain how the company's activities are in sync. Lorenzo Zambrano, CEO of CEMEX, related a comment made by one of his country managers: "I was trained as an engineer, and now I have to be a politician." Zambrano's response? "Well, yes – welcome to top management!" The activity involved is not simply a trickled down version of lobbying. Managers bring knowledge to government officials about how rules such as product-testing protocols operate in other countries. (Of course, they have to do this gently and with the sensitivity of guests in a host country – even if they are nationals rather than expats.) They can also apply their diplomacy skills to broader matters. The chairman of IBM Greater China, a Chinese national who had worked his whole life in Asia, visited the White House to encourage U.S.-Chinese cooperation on the environment.

Fire in the Belly

If values and standards served no other purpose in a company, they would still serve as motivational tools. They offer people a basis for engagement with their work, a sense of membership, and an anchor of stability in the midst of constant change.

IBM's Palmisano told me that culture is perhaps the hardest area to influence but fundamental to long-term success. "Management is temporary; returns are cyclical. But if we use these values as connective tissue, that has longevity. If people can get emotionally connected and have pride in the entity's success, they will do what is important to IBM." CEMEX's Zambrano echoed this: "We know that high standards have to be applied everywhere. At first, we thought of our reputation conceptually, as something that we needed to keep improving. Now we know it affects our ability to attract the right people. After all, businesses are networks of people working toward the same end. And everyone has to be proud of what they're doing."

Values arouse aspirations to increase the company's positive impact on the world, and that is worth more to many people than increases in compensation, as a manager in India pointed out to me. This, he believed, was why his rapidly growing unit could attract the best talent without offering the highest pay scales. Centrality of values provides a rationale for longer-term investments where the immediate business case is mixed or unclear, and it permits compassionate decisions that show that people in the company really care, thus taking the edge off the natural cynicism that large companies evoke. In the aftermath of the Lebanon bombing, a P&G manager reflected on the impact of the decision to help employees evacuate. "This was a defining moment for the people," he said, "because they saw that a company that is always saying that people are very important, are the most important asset, was really acting on it. That is where you really believe in the principles and values of the company."

How the Fabric Is Woven

The global giants we studied are operating according to a model that differs from what most people might expect of a multinational corporation. It is not ironfisted hierarchy or some clever engineering of structure that provides coherence to their organizations; it is the effect of commonly held values translating into operations through clear standards and processes – values and standards that are embraced by individuals because they allow autonomy, flexibility, and self-expression. Not only does this approach enable a company to unify geographically and culturally diverse people and guide their daily decision making. It also inspires much higher levels of creativity, leading to more breakthrough innovations.

What about the companies still operating under the old paradigm? Is it possible for them to make the shift? Conversations we had with company leaders suggest the challenges involved. Some companies find it hard to transmit values and standards to portions of the workforce lacking education or international experience, such as unskilled workers in developing countries. Sometimes specific deep-rooted local realities present stumbling blocks; we heard complaints about the history of corruption in Russia, for example, and a generally poor work ethic in Latvia. Companies committed to upholding global standards often find that their demands go beyond local standards and can seem excessive to local managers. Any one of these issues can rear its head in the aftermath of an acquisition, and the desired alignment of standards and values will not come about overnight.

The key to success with the new model may seem counterintuitive to leaders facing such challenges. More than anything else, we heard in our interviews about a loosening of organizational structures in favor of fluid boundaries and flexible deployment of people. Managers and professionals generally appeared less concerned with where they worked and to whom they reported than with what projects they were able to join or initiate. Rather than focusing on the function or discipline that was their organizational base, they focused on the problem to be solved – and figuring out how to assemble the expertise relevant to it. Think of how IBM's cultural heritage projects, like Eternal Egypt and Forbidden City, draw on people across geographies and roles – some colocating, some working virtually, some committing to long-term assignments, some serving as short-term sources of expertise.

Many of these companies have a tradition of making mobility a part of career development, which ensures a degree of international mixing as well as the carrying of expertise from one place to another. This is one of the ways that P&G, for example, transmits its PVP and cultural norms. But using career structures to do this is relatively slow. On the rise, instead, is the practice of asking managers to wear multiple hats for multiple projects – taking on regional or global assignments from anywhere, while not changing their home address. The P&G Brazil marketing manager who worked on Always Básico next headed a global team looking at low-income consumers. IBM's corporate citizenship manager for Latin America previously headed Reinventing Education efforts worldwide out of her base in Rio de Janeiro, watching over work in Ireland, then South Africa and Vietnam. In fact, at IBM these days, about a third of professionals don't have a regular office to which they report; they work from whatever workstations – at customer sites, homes, or IBM offices – they are currently plugged into.

Working with extended networks of partners across inter- and extracompany boundaries requires large numbers of people to serve as connectors among activities – not as bosses but as brokers, network builders, and facilitators. For example, a director-level IBM executive working at IBM China's development labs is focused mainly on making sure that the most promising ideas pass from one stage of development to the next; he and his team serve primarily as technology-savvy bridges between two steps in the process handled by other teams. The IBM leader who envisioned and championed the World Community Grid spends a great deal of time listening to the priorities of executives in the business units and staying in touch with the research laboratories to understand their latest breakthroughs. He is particularly adept at finding ways that needs and opportunities can be connected, from any part of the value chain.

One last element that seems central to the success of the global giants we studied is that they have explicitly added mutual respect and inclusion to the values they live by. Diversity programs are no longer primarily a response to legal requirements; they are valued because they help people form relationships more quickly and overcome tensions between groups. At Cisco, global diversity is the centerpiece of CEO John Chambers's leadership development agenda.

Social contributions are no longer an afterthought – a luxury enjoyed only by those who are already profitable – but a starting point that helps companies find profitable growth.

I was struck by how far one company, Shinhan Financial Group, was willing to take this attitude in its acquisition of a major competitor. Well before any formal integration was permitted by the terms of the deal, the company was forging relationships of respect, achieving "emotional integration" through executive retreats, and asking joint working groups to create common practices voluntarily. Similarly, the values of respect and inclusion embedded in P&G's PVP were said by leaders to have helped make the Gillette integration smooth. A well-designed diversity program also encourages people to recognize their similarities – that they are guided by values sufficiently universal to allow for communication and collaboration despite great differences in their ethnic backgrounds or their local or professional cultures.

A Giant Change

Over the course of a career studying the organizations of huge corporations, I have learned how they typically direct activity in and maintain control over their far-flung operations. What I have seen in recent years is a model different from what has prevailed in the past. In the most influential corporations today, a foundation of values and standards provides a well-understood, widely communicated guidance system that ensures effective operations while enabling people to make decisions appropriate to local situations. This, rather than any traditional control system, is what enables IBM or CEMEX to operate as one enterprise in projects that span many countries and to share a culture that makes people inside and external partners connect as an extended family.

A first-order effect is that the new model helps large companies avoid the traps of bureaucracy that in the past made them seem like dinosaurs. More deeply, it yields a way of doing business that is more localized and humane. When large groups of people are subject to management by values, aspirations, and open boundaries instead of management by traditional controls, their energies and passions are engaged. Social contributions are no longer an afterthought – a luxury enjoyed only by those who are already profitable – but a starting point that helps companies find profitable growth. The interplay of corporate standards and local conditions puts companies in a position to influence the ecosystem around them (especially in emerging markets) and to generate innovation. If these vanguard companies lead others to adopt their way of working, then we will see a new, and I think more promising, kind of capitalism. And if it flourishes, not only will that be good for business, it will also be good for the world.

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A CEO must be the steward of a living strategy that defines what the firm is and what it will become.

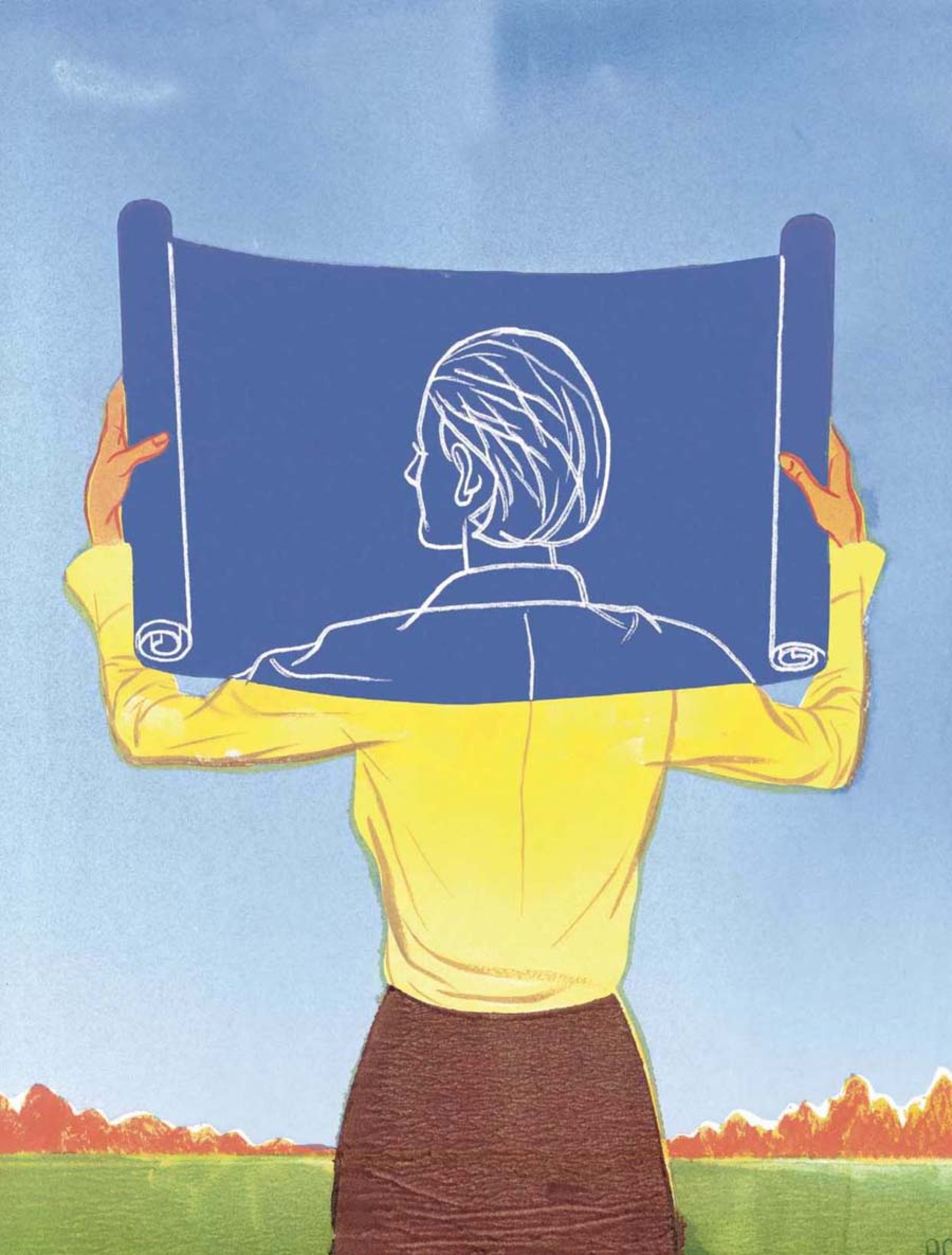
PUTTING LEADERSHIP BACK INTO STRATEGY

by Cynthia A. Montgomery

STRATEGY IS NOT WHAT IT USED TO BE – or what it could be. In the past 25 years it has been presented, and we have come to think of it, as an analytical problem to be solved, a left-brain exercise of sorts. This perception, combined with strategy's high stakes, has led to an era of specialists – legions of MBAs and strategy consultants – armed with frameworks and techniques, eager to help managers analyze their industries or position their firms for strategic advantage.

This way of thinking about strategy has generated substantial benefits. We now know far more than before about the role market forces play in industry profitability and the importance of differentiating a firm from its

Alex Nabaum



competitors. These gains have come in large part from the infusion of economics into the study of strategy. That merger added much-needed theory and empirical evidence to strategy's underpinnings, providing considerable rigor and substance. But the benefits have not come without costs. A host of unintended consequences have developed from what in its own right could be a very good thing. Most notably, strategy has been narrowed to a competitive game plan, divorcing it from a firm's larger sense of purpose; the CEO's unique role as arbiter and steward of strategy has been eclipsed; and the exaggerated emphasis on sustainable competitive advantage has drawn attention away from the fact that strategy must be a dynamic tool for guiding the development of a company over time.

To redress these issues, we need to think about strategy in a new way – one that recognizes the inherently fluid nature of competition and the attendant need for continuous, not periodic, leadership.

The Road to Here

Fifty years ago strategy was taught as part of the general management curriculum in business schools. In the academy as well as in practice, it was identified as the most important duty of the chief executive officer – the person with overarching responsibility for setting a company's course and seeing the journey through. This vital role encompassed both formulation and implementation: thinking and doing combined.

Although strategy had considerable breadth then, it didn't have much rigor. The ubiquitous SWOT model taught managers to assess a company's internal *strengths* and *weaknesses* and the *opportunities* and *threats* in its external environment, but the tools for doing so were pedestrian by any measure.

Advances over the next few decades not only refined the tools but spawned a new industry around strategy. Corporate-planning departments emerged and introduced formal systems and standards for strategic analysis. Consulting firms added their own frameworks, among them the Boston Consulting Group's influential growth-share matrix and McKinsey's 7-S framework. Academics weighed in, unleashing the power of economic analysis on problems of strategy and competition.

It has been a heady period, and the strategy tool kit is far richer because of it. That said, something has been lost along the way. While gaining depth, strategy has lost breadth and stature. It has become more about formulation than implementation, and more about getting the idea right at the outset than living with a strategy over time.

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The teaching of strategy has both led and followed suit. At many top business schools, general management departments have been replaced by strategy groups made up of experts who delve into the economics of competitive advantage but rarely acknowledge the unique role leaders play in the process of formulating and implementing strategy. When the head of the strategy group at one major business school was asked recently to describe the common denominator among faculty members in his department, he replied, "We are a group of economists with a lively interest in business." An honest man and a telling comment.

Pulled apart and set on its own in this way, strategy both gains and loses. In terms of analytical precision, it is a big plus; organizationally, it is not. What we have lost sight of is that strategy is not just a plan, not just an idea; it is a way of life for a company. Strategy doesn't just position a firm in its external landscape; it defines what a firm will be. Watching over strategy day in and day out is not only a CEO's greatest opportunity to outwit the competition; it is also his or her greatest opportunity to shape the firm itself.

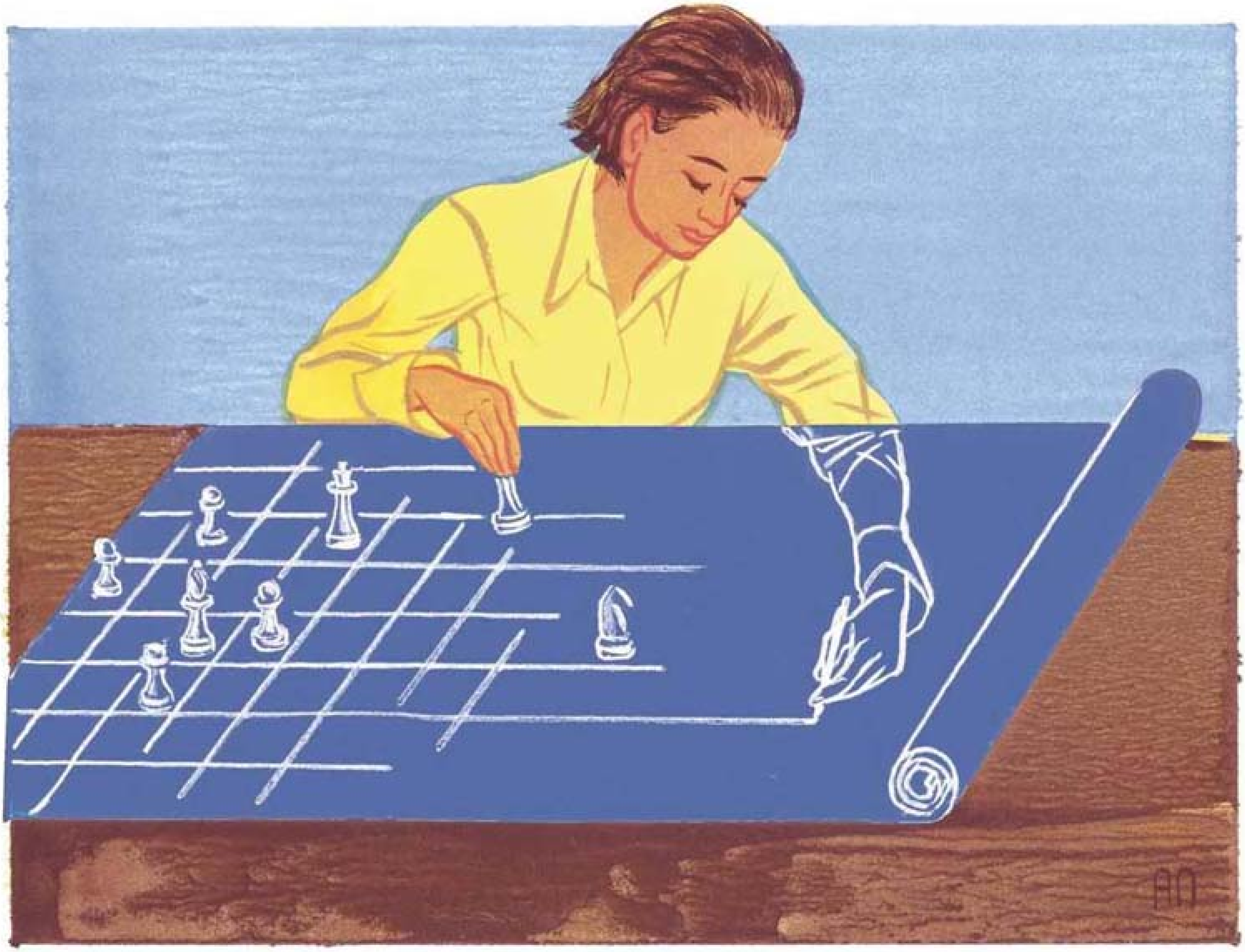
Strategy and Being

In "How to Evaluate Corporate Strategy," an article that appeared in this magazine in 1963, the Harvard Business School lecturer Seymour Tilles proposed that of all the questions a chief executive is required to answer, one predominates: What kind of company do you want yours to be? He elaborated:

> If you ask young men what they want to accomplish by the time they are 40, the answers you get fall into two distinct categories. There are those – the great majority – who will respond in terms of what they want to *have*. This is especially true of graduate students of business administration. There are some men, however, who will answer in terms of the kind of men they hope to *be*. These are the only ones who have a clear idea of where they are going.
>
> The same is true of companies. For far too many companies, what little thinking goes on about the future is done primarily in money terms. There is nothing wrong with financial planning. Most companies should do more of it. But there is a basic fallacy in confusing a financial plan with thinking about the kind of company you want yours to become. It is like saying, "When I'm 40, I'm going to be *rich*." It leaves too many basic questions unanswered. Rich in what way? Rich doing what?

As strategy has striven to become a science, we have allowed this fundamental point to slip away. We need to reinstate it.

In 1996 Adam Brandenburger and Barry Nalebuff got close to this idea in their book *Co-opetition,* which recognized that in order to *claim* value, firms must first *create*



value. This requires bringing something new to the world, something customers want that is different from or better than what others are providing.

To press their point, Brandenburger and Nalebuff urged managers to consider the world with their firm versus the world without it. The difference (if there is one) is the firm's unique added value – what would be lost to the world if the firm disappeared. Tilles might have described this as the firm's purpose, or its raison d'être. To say that a firm should have a clear sense of purpose may sound exceedingly philosophical. It is in fact exceedingly practical.

In the strategy portion of the Owner/President Management executive program at Harvard Business School, the notion of added value is core to everything we do. Early in the module, executives are asked to respond to the following questions:

- If your company were shuttered, to whom would it matter and why?
- Which of your customers would miss you the most and why?
- How long would it take for another firm to step into that void?

When the questions are presented, classrooms that minutes earlier were bursting with conversation fall silent – not because the questions are complex but because they are so basic and yet so difficult. Managers long accustomed to describing their companies by the industries they are in and the products they make often find themselves unable to say what is truly distinctive about their firms. For these leaders the challenge is a matter not of unearthing an existing purpose but of forging one.

The questions are as relevant to large multibusiness companies as they are to focused owner-led ones. As private equity firms proliferate and supply chains open up around the world, nothing is more important for complex corporate entities than a clear sense of purpose, a clear sense of why they matter. A board chairman at one such firm made the point bluntly when he asked, "What hot dish is this company bringing to the table?" He was issuing the same challenge.

Sam Palmisano, the CEO of IBM, is well aware of the importance of this sort of reflection. In 2003 he hosted a 72-hour online Values Jam in which he asked IBM's nearly 320,000 employees to weigh in on these questions: If our company disappeared tonight, how different would the world be tomorrow? Is there something about our company that makes a unique contribution to the world? (See "Leading Change When Business Is Good," HBR December 2004.)

In my experience, few leaders allow themselves to think about strategy at this level.

Purpose should be at the heart of strategy. It should give direction to every part of the firm – from the corporate office to the loading dock – and define the nature of the work that must be done. In "Unleashing the Power of Learning," a 1997 interview with HBR, John Browne, then the CEO of British Petroleum, put it this way: "A business has to have a clear purpose. If the purpose is not crystal clear, people in the business will not understand what kind of knowledge is critical and what they have to learn in order to improve performance....What do we mean by *purpose?* Our purpose is who we are and what makes us distinctive. It's what we as a company exist to achieve, and what we're willing and not willing to do to achieve it."

The most viable statements of purpose are easy to grasp and true to a company's distinctiveness. Pixar, one of the world's most innovative animation firms, says that it exists "to combine proprietary technology and world-class creative talent to develop computer-animated feature films with memorable characters and heartwarming stories that appeal to audiences of all ages." No films for mature audiences only. Lots of pushing the envelope. And who wouldn't recognize IKEA's intent to offer customers "a wide range of well-designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them"? Sitting at the hub of the strategy wheel, purpose aligns all the functional pieces and draws the company into a logically consistent whole. Well understood, it serves as both a constraint on activity and a guide to behavior. As Michael Porter has argued, an effective strategy says not only what a firm will do but also, implicitly, what it will not do.

Forging a compelling organizational purpose is a close corporate equivalent to soul-searching. It does require the kind of careful analysis and left-brain thinking that MBAs have honed for a generation. Equally important to the task, however, is the right-brain activity in which managers are almost universally less well schooled. Creativity and insight are key, as is the ability to make judgments about a host of issues that can't be resolved through analysis alone.

Articulating and tending to a purpose-driven strategy so that it fills this role is no easy task. It is a human endeavor in the deepest sense of the term. Keeping all the parts of a company in proper balance while moving the enterprise forward is extraordinarily difficult. Even when they have substantial talent and a deep appreciation for the job, some CEOs ultimately don't get it right. Their legacies serve as sobering reminders of the complexities and the responsibilities of stewardship. (Witness BP's recent travails – the deficiencies in investments and operating practices that compromised workers' safety, threatened the environment, and contributed to Browne's abrupt departure from the company in 2007.) On the other hand, it is exactly these challenges that make the triumphs so rewarding.

THE MISSING DIMENSION

Over the past few decades strategy has become a plan that positions a company in its external landscape. That's not enough. Strategy should also guide the development of the company – its identity and purpose – over time.

The Prevailing Approach: **Strategy as a Set Solution**		What Is Missing: **Strategy as a Dynamic Process**
A long-term sustainable competitive advantage	**Goal**	Creation of value
The CEO and strategy consultants	**Leadership**	CEO as chief strategist; the job cannot be outsourced
Unchanging plan that derives from an analytical, left-brain exercise	**Form**	Organic process that is adaptive, holistic, and open-ended
Intense period of formulation followed by prolonged period of implementation	**Time Frame**	Everyday, continuous, unending
Defending an established strategy through time	**Ongoing Activity**	Fostering competitive advantages and developing the company through time

Strategy and the Strategist

In most popular portrayals the strategist's job would seem to be finished once a carefully articulated strategy has been made ready for implementation. The idea has been formed, the next steps specified, the problem solved. But don't be fooled. The job of the strategist never ends. No matter how compelling a strategy is, or how clearly defined, it is unlikely to be a sufficient guide for a firm that aspires to a long and prosperous life.

Just as complete contracts are difficult to write with one's trading partners, so too complete strategies are difficult to specify in all their particulars. There will always be some choices that are not obvious. There will always be countless contingencies, good and bad, that cannot be fully anticipated. There will always be limits to communication and mutual understanding. As Oscar Wilde quipped, "Only the shallow know themselves." At heart, most strategies, like most people, involve some mystery.

Interpreting that mystery is an abiding responsibility of the chief strategist, the CEO. Sometimes this entails clarifying a point or helping an organization translate an idea into practice, such as what "best in class" will mean in that company and how it will be measured. Other times it entails much more: refashioning an element of the strategy, adding a previously missing piece, or reconsidering a commitment that no longer serves the company well. Whether you call this strategy implementation or strategy reformulation (the boundaries blur), it is arduous work and can't be separated from leadership of the firm.

Ryanair provides a case in point. During its early years the Irish airline entered the Dublin–London market with full service priced at less than half the fares of incumbents British Airways and Aer Lingus. Ryanair's leaders didn't anticipate the ferocity with which its competitors would respond. When the resulting fare war brought Ryanair to its knees, its leaders didn't simply urge the airline to try harder. They revamped the strategy and transformed the company into a no-frills player with a true low-cost business model. This involved changing the airline's fleet as well as its cost, fare, and route structures. "Yes, Aer Lingus attacked us," Michael O'Leary, Ryanair's CEO since 1994, has said, "but we exposed ourselves." Reborn, Ryanair went on to become a major airline and one of the world's most profitable.

When confronted with challenges, the CEO must recognize the strategic significance of issues being raised and opportunities being contemplated and see them through the lens of the whole, even as those with narrower responsibilities may be seeing the same issues parochially. While faithfully translating purpose into practice, the CEO must also remain open to the idea that the purpose itself may need to change. The judgments made at these moments of transition can make or break a leader or a firm.

At heart, most strategies, like most people, involve some mystery. Interpreting that mystery is an abiding responsibility of the chief strategist, the CEO.

Lou Gerstner, Palmisano's legendary predecessor, faced such a moment when he became CEO of a troubled IBM in 1993. To resurrect the company, he concluded, a radical shift in its mind-set was necessary. This required taking a fearless moral inventory of the business, realistically evaluating the firm's core capabilities, and shedding everything else. After making this assessment, Gerstner announced that IBM would no longer concern itself with the invention of technology but instead would focus on application. The company would move beyond its long history of creating computer hardware in order to provide integrated information technology services and solutions. "History," Gerstner has written, "shows that truly great and successful companies go through constant and sometimes difficult self-renewal of the base business."

The CEO is the one who chooses a company's identity, who has responsibility for declining certain opportunities and pursuing others. In this sense he or she serves as the guardian of organizational purpose, watching over the entity, guiding its course, bringing it back to the center time and time again, even as the center itself evolves.[1] This is why the job of the strategist cannot be outsourced. This is why the job of the strategist is never done, and why the vigil the CEO keeps must be a constant one.

Strategy and Becoming

What, after all, is the strategist trying to achieve? The conventional wisdom would say a sustainable long-term competitive advantage. I challenge this view. Although critically important, competitive advantage is not the ultimate goal. That way of thinking mistakes the means for the end and sends managers off on an unachievable quest.

Competitive advantage is essential to strategy. But it is only part of a bigger story, one frame in a motion picture. The very notion that there is a strategic holy grail – a strategy brilliantly conceived, carefully implemented, and valiantly defended through time – is dangerous. It is akin to the complete-contract view, in which all the thinking is done at the beginning and *the* key job of the strategist is to get that analysis right. If this were so, the role of the strategist would be limited and easy to separate from the leadership of a firm. If this were so, the strategist wouldn't have to be concerned with how the organization gets from here to there – the execution challenge writ large – or how it will capitalize on the learning it accumulates along the way.

But this is not so. Great firms – Toyota, Nike, and General Electric, to name a few – evolve and change. So do great strategies. This is not to say that continuity has no value. It is not to say that great resources and great advantages aren't built over the long term. It is, however, to acknowledge that the world, both inside and outside the firm, changes not only in big, discontinuous leaps but in frequent, smaller ones as well.

An ancient Greek legend provides a powerful metaphor for this process. According to the legend, the ship that the hero Theseus sailed back to Athens after slaying the Minotaur in Crete was rebuilt over time, plank by plank. As each plank decayed, it was replaced by another, until every plank in the ship had been changed. Was it then still the same ship? If not, at what point – with which plank – did the ship's identity shift?

This metaphor captures the evolution of most companies. Corporate identities are changed not only by cataclysmic restructurings and grand pronouncements but also by decision after decision, year after year, captain after captain. An organic conception of strategy recognizes that whatever constitutes strategic advantage will eventually change. It recognizes the difference between defending a firm's added value as established at any given moment and ensuring that a firm is adding value over time. Holding too strongly to one competitive advantage or one purpose may result in the firm's being controlled by a perception of value long after that value has diminished in significance. It encourages managers to see their strategies as set in concrete and, when spotting trouble ahead, to go into defensive mode, hunkering down and protecting the status quo.

Apple Computer was caught in this trap for most of the 1990s. The company stubbornly stuck to its original strategy of producing high-end differentiated personal computers, convinced that it was adding value even as the intensely competitive marketplace told it otherwise. By the summer of 1997 Apple's share price was at a 10-year low, its market share had plummeted to about 3%, and industry pundits were trumpeting the company's demise. The strategy had performed so poorly that there was little left to defend. Only after Steve Jobs returned as CEO, reclaimed the best of what Apple once was (a passionate design company that believed technology could change the world), and took the firm into new businesses (digital audio players, cell phones, and retailing) with distinctive products did the company attract a new mass of passionately loyal customers and generate handsome returns. Plank by plank the company changed its identity while remaining in many respects the same. Fittingly, in January 2007 it dropped "Computer" from its name and became simply Apple Inc.

The need to create and re-create reasons for a company's continued existence sets the strategist apart from every other individual in the company.

The need to create and re-create reasons for a company's continued existence sets the strategist apart from every other individual in the company. He or she must keep one eye on how the company is currently adding value and the other eye on changes, both inside and outside the company, that either threaten its position or present some new opportunity for adding value. Guiding this never-ending process, bringing perspective to the midst of action and purpose to the flow – not solving the strategy puzzle once – is the crowning responsibility of the CEO.

1. Kenneth R. Andrews, in *The Concept of Corporate Strategy* (Irwin, 1971), described one of the roles of the CEO as the "architect of organization purpose." I prefer the term "guardian of organizational purpose," because it encompasses both formulation and implementation, and because it implies a more ongoing responsibility.

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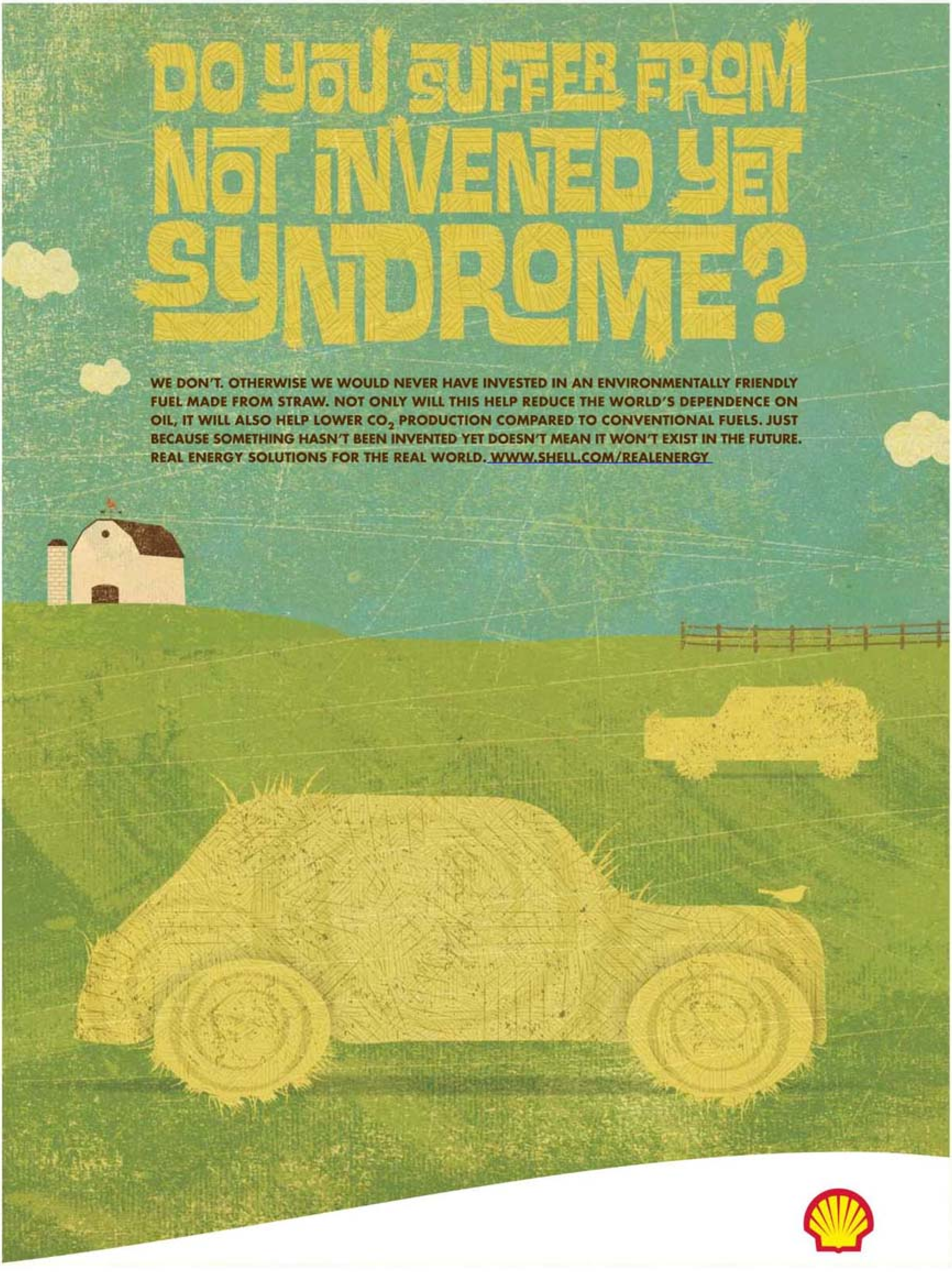
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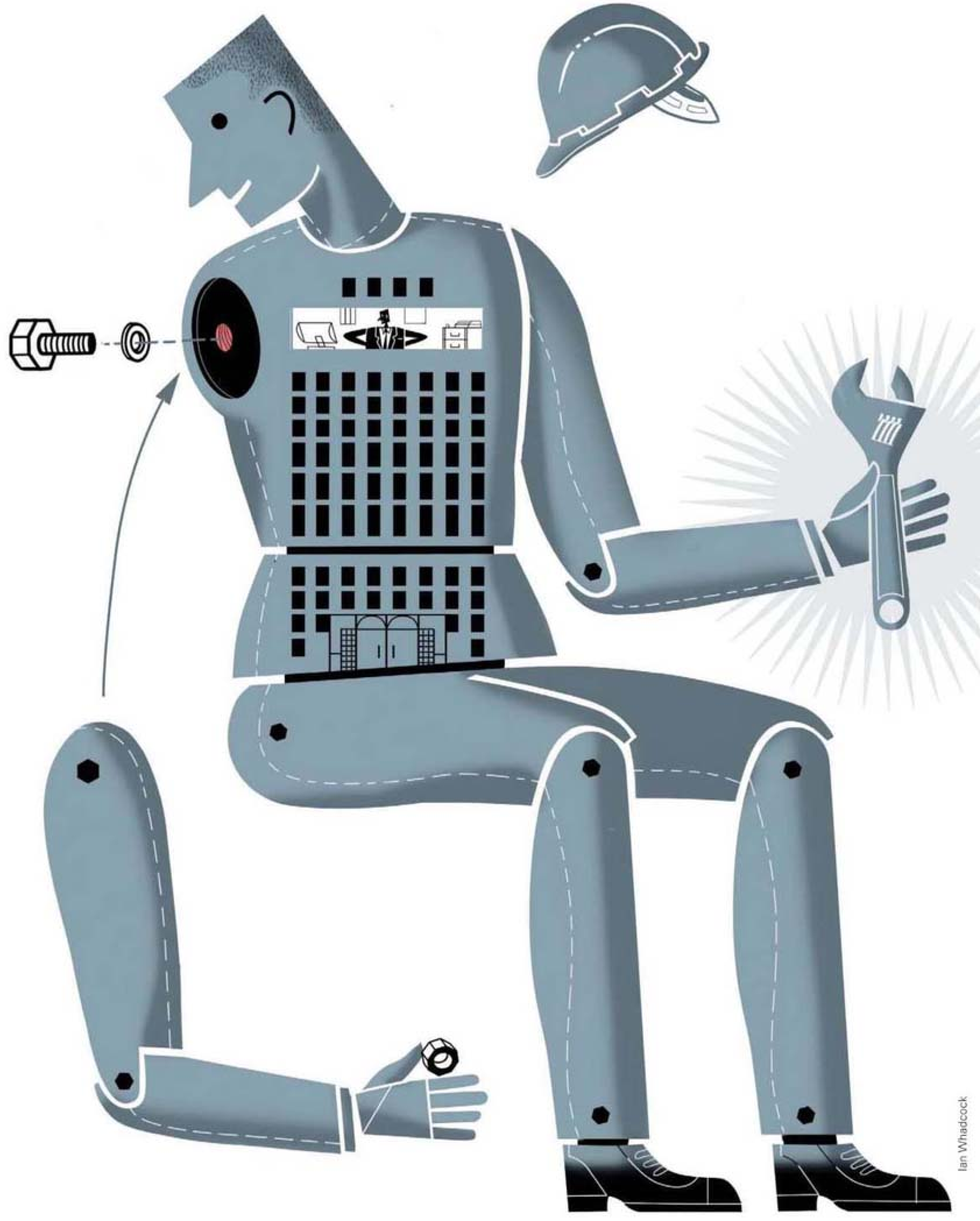

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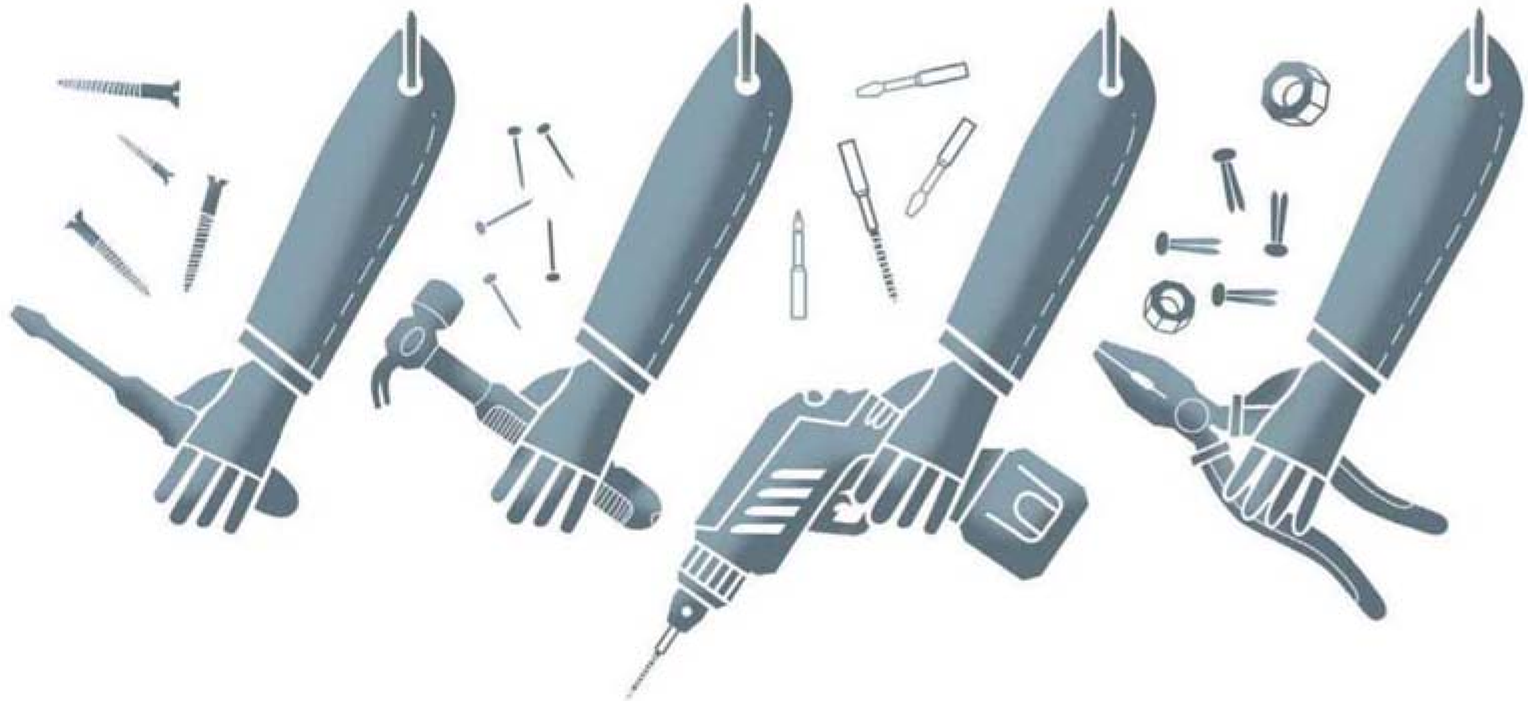

Successful strategy execution has two basic rules: understand the management cycle that links strategy and operations, and know what tools to apply at each stage of the cycle.

MASTERING the Management System

by Robert S. Kaplan and David P. Norton

NOT LONG AFTER ITS SUCCESSFUL IPO, the Conner Corporation (not its real name) began to lose its way. The company's senior executives continued their practice of holding monthly one-day management meetings, but their focus drifted.

The meetings' agenda called for a discussion of operational issues in the morning and strategic issues in the afternoon. But with the company under pressure to meet quarterly targets, operational items had started to crowd strategy out of the agenda. Inevitably, the review of actual monthly and forecast quarterly financial performance revealed revenues to be lower, and expenses to be higher, than targeted. The worried managers spent hours discussing how to close the gap through pricing initiatives, capacity downsizing, SG&A staff cuts, and sales campaigns. One executive noted, "We have no time for strategy. If we miss our quarterly numbers, we might cease to exist. For us, the long term is the short term."

Like Conner, all too many companies – including some well-established public corporations – have learned how Gresham's Law applies to their management meetings: Discussions about bad operations inevitably drive out discussions about good strategy implementation. When companies fall into this trap, they soon find themselves limping along, making or closely missing their numbers each quarter but never examining how to modify their strategy to generate better growth opportunities or how to break the pattern of short-term financial shortfalls. Analysts, investors, and board members start to question the imagination and commitment of the companies' management.

In our experience, however, breakdowns in a company's management system, not managers' lack of ability or effort, are what cause a company's underperformance. By *management system,* we're referring to the integrated set of processes and tools that a company uses to develop its strategy, translate it into operational actions, and monitor and improve the effectiveness of both. The failure to balance the tensions between strategy and operations is pervasive: Various studies done in the past 25 years indicate that 60% to 80% of companies fall short of the success predicted from their new strategies.

By creating a closed-loop management system, companies can avoid such shortfalls. (See the exhibit "How the Closed-Loop Management System Links Strategy and Operations.") The loop comprises five stages, beginning with strategy development, which involves applying tools, processes, and concepts such as mission, vision, and value statements; SWOT analysis; shareholder value management; competitive positioning; and core competencies to formulate a strategy statement. That statement is then translated into specific objectives and initiatives, using other tools and processes, including strategy maps and balanced scorecards. Strategy implementation, in turn, links strategy to operations with a third set of tools and processes, including quality and process management, reengineering, process dashboards, rolling forecasts, activity-based costing, resource capacity planning, and dynamic budgeting. As implementation progresses, managers continually review internal operational data and external data on competitors and the business environment. Finally, managers periodically assess the strategy, updating it when they learn that the assumptions underlying it are obsolete or faulty, which starts another loop around the system.

A system such as this must be handled carefully. Often the breakdown occurs right at the beginning, with companies formulating grand strategies that they then fail to translate into goals and targets that their middle and lower managers understand and strive to achieve. Even when companies do formalize their strategic objectives, many still struggle because they do not link these objectives to tools that support the operational improvement processes that ultimately must deliver on the strategy's objectives. Or, like Conner, they decide to mix discussions of operations and strategy at the same meeting, causing a breakdown in the strategic-learning feedback loop.

In the following pages we draw upon our extensive research and experience advising companies, as well as nonprofit and public sector entities, to describe the design and implementation of a system for strategic planning, operational execution, and feedback and learning. We present a range of tools that managers can apply at the different stages, most developed by other management experts and some of our own design. (See "A Management System Tool Kit" on page 67 for further reading on the tools discussed.) We will show how these can all be integrated in a system that links the management of strategy and operations.

STAGE 1 Develop the Strategy

The management cycle begins with articulating the company's strategy. This usually takes place at an annual off-site meeting during which the management team either incrementally improves an existing strategy or, on occasion, introduces an entirely new one. (Our experience suggests that strategies generally have three to five years of useful life.) Developing an entirely new strategy may take two sets of meetings, each lasting two to three days. At the first, executives should reexamine the company's fundamental business assumptions and its competitive environment. After some homework and research, the executives will hold the second set of meetings and decide on the new strategy. Typically, the CEO, other corporate officers, heads of business and regional units, and senior functional staff attend these strategy sessions. The agenda should explore the following questions:

What business are we in and why? This question focuses managers on high-level strategy planning concepts. Before formulating a strategy, managers need to agree on their company's purpose *(mission),* its aspiration for future results *(vision),* and the internal compass that will guide its actions *(values).*

The *mission* is a brief statement, typically one or two sentences, that defines why the organization exists, especially what it offers to its customers and clients. The pharmaceutical firm Novartis presents a good example: "We want to discover, develop and successfully market innovative

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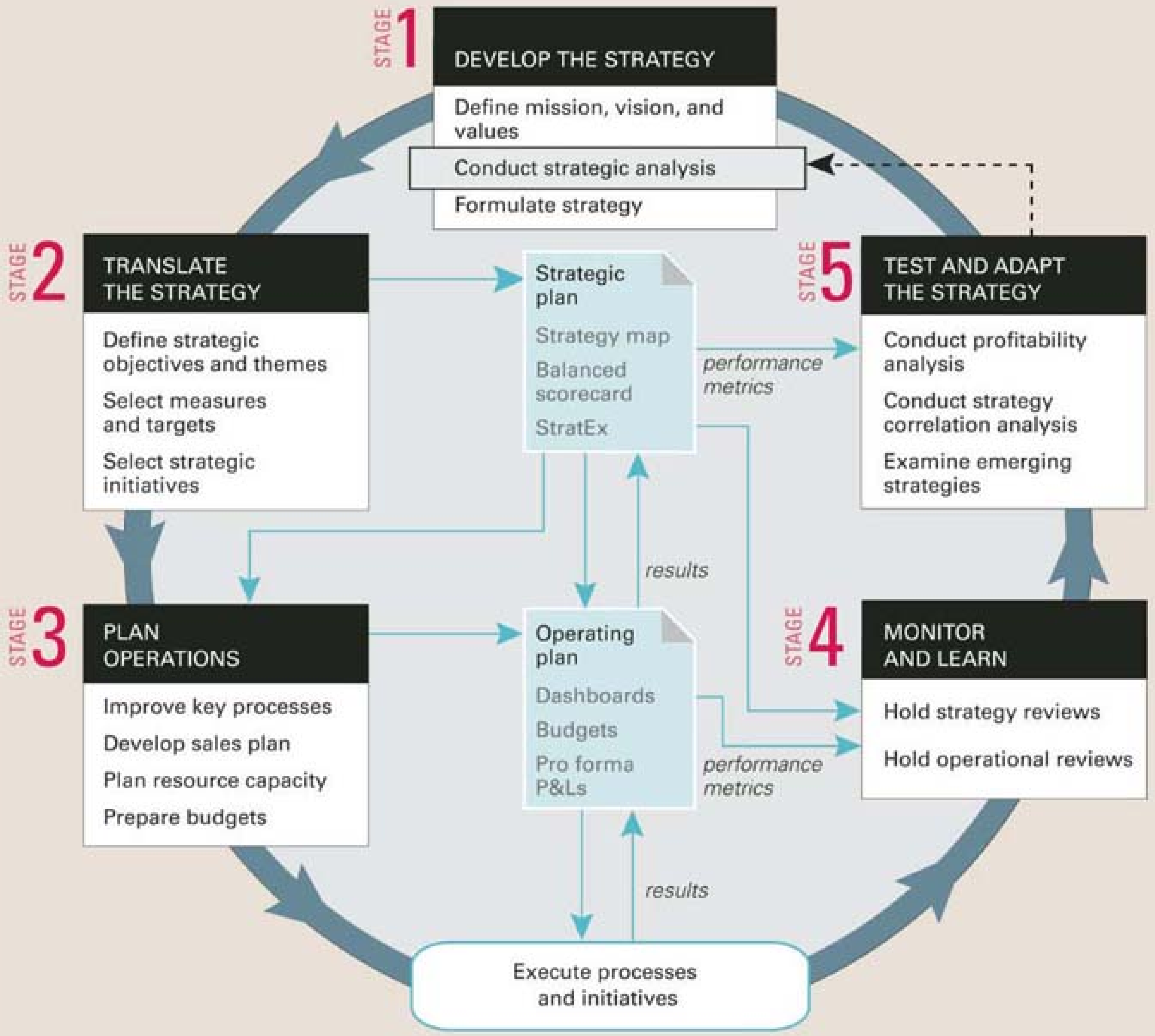
How the Closed-Loop Management System Links Strategy and Operations

Most companies' underperformance is due to breakdowns between strategy and operations. This diagram describes how to forge tight links between them in a five-stage system. A company begins by developing a strategy statement and then translates it into the specific objectives and initiatives of a strategic plan. Using the strategic plan as a guide, the company maps out the operational plans and resources needed to achieve its objectives. As managers execute the strategic and operational plans, they continually monitor and learn from internal results and external data on competitors and the business environment to see if the strategy is succeeding. Finally, they periodically reassess the strategy, updating it if they learn that the assumptions underlying it are out-of-date or faulty, starting another loop around the system.



products to prevent and cure diseases, to ease suffering and to enhance the quality of life. We also want to provide a shareholder return that reflects outstanding performance and to adequately reward those who invest ideas and work in our company."

The *vision* is a concise statement that defines the mid- to long-term (three- to 10-year) goals of the organization. Cigna Property and Casualty, an insurance company division we worked with in the 1990s, stated its goal this way: "to be a top-quartile specialist within 5 years." Though short, this vision statement contained three vital components:

- Stretch goal: "top quartile" in profitability (at the time, Cigna P&C was at the bottom of the fourth quartile).
- Definition of market focus: "a specialist," not a general-purpose underwriter, as it was at the time.
- A time line for execution: "5 years" (a heartbeat in the slow-moving insurance industry).

The stretch goal in the vision statement should truly be a difficult reach for the company in its present position. The CEO has to take the lead here; indeed, one of the principal roles of an effective leader, as Jim Collins and Jerry Porras noted in *Built to Last,* is to formulate a "big, hairy, audacious goal (BHAG)" that challenges even well-performing organizations to become much better. The classic example is Jack Welch's challenge for every GE business unit to become number one or two in its industry. In determining a stretch goal, it pays to look at the financial market's expectations as a benchmark, since the company's share price usually contains an implicit estimate of future profitable growth, which can be well beyond that achievable through incremental improvements to existing businesses. If a company is setting a new goal, rather than reaffirming an established goal, managers may need to undertake pre-offsite research and engage in extensive discussion at the meeting.

Finally, the *values* (often called core values) of a company prescribe the attitude, behavior, and character of an organization. Value statements, which are often lengthy, describe the desirable attitudes and behavior the company wants to promote as well as the forbidden conduct, such as bribery, harassment, and conflicts of interest, that employees should definitely avoid. These excerpts from the value statement of the internet service provider Earthlink illustrate the components of value statements:

- *We respect the individual, and believe that individuals who are treated with respect and given responsibility respond by giving their best.*
- *We are frugal. We guard and conserve the company's resources with at least the same vigilance that we would use to guard and conserve our own personal resources.*
- *We are believers in the Golden Rule. In all our dealings we will strive to be friendly and courteous, as well as fair and compassionate.*
- *We feel a sense of urgency on any matters related to our customers. We own problems and we are always responsive. We are customer-driven.*

The reaffirmation of mission, vision, and values puts executives in the right mind-set for considering the rest of the agenda and setting the company's fundamental guidelines.

What are the key issues we face in our business? With mission, vision, and values established, managers undertake a *strategic analysis* of the company's external and internal situation. The management team studies the industry's economics using frameworks such as Michael Porter's five forces model (bargaining power of buyers; bargaining power of suppliers; availability of substitutes; threat of new entrants; and industry rivalry). The team assesses the external macroeconomic environment of growth, interest rates, currency movements, input prices, regulations, and general expectations of the corporation's role in society. Often this is described as a PESTEL analysis, encompassing *political, economic, social, technological, environmental,* and *legal* factors. Managers can then dive into competitiveness data and consider the dynamics of the company's financial, technological, and market performance relative to its industry and competitors.

After the external analysis, managers should assess the company's internal capabilities and performance. One approach is to use Michael Porter's value chain model, categorizing capabilities used in the processes that create markets; develop, produce, and deliver products and services; and sell to customers. Or the internal analysis could identify the distinctive resources and capabilities that give the firm a competitive advantage. Finally, unless managers are introducing an entirely new strategy, they will want to assess the performance of the current strategy, a topic we discuss more later.

The next step is to summarize the conclusions from the external and internal analyses in a classic SWOT matrix, assessing the ability of internal attributes and external factors to help or hinder the company's achievement of its vision. The aim here is to ensure that the strategy leverages internal *strengths* to pursue external *opportunities,* while countering *weaknesses* and *threats* (internal and external factors that undermine successful strategy execution). This analysis will reveal a series of issues that the strategy must address: the best role for new products and services; whether new partners need to be acquired; what new market segments the company might enter; and which customer segments are contracting. These issues will become the focus of the strategy formulation process, which often takes place at a subsequent meeting.

How can we best compete? Finally, managers tackle the *strategy formulation* itself – the statement describing the strategy and how the company proposes to achieve it. In this step managers decide on a course of action that will create a sustainable competitive advantage by distinguishing the company's offering from competitors' and, ultimately, will

A Management System Tool Kit

Where to learn more about the concepts and frameworks described in this article

Develop the Strategy

Competitive Strategy

Michael E. Porter
Competitive Advantage: Creating and Sustaining Superior Performance
Free Press, 1985 (republished with a new introduction, 1998)

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Harvard Business Review
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Chris Zook and James Allen
Profit from the Core: Growth Strategy in an Era of Turbulence
Harvard Business School Press, 2001

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Jay B. Barney
Gaining and Sustaining Competitive Advantage – 3rd edition
Prentice-Hall, 2006

Jay B. Barney and Delwyn N. Clark
Resource-Based Theory: Creating and Sustaining Competitive Advantage
Oxford University Press, 2007

David J. Collis and Cynthia A. Montgomery
"Competing on Resources: Strategy in the 1990s"
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Gary Hamel and C.K. Prahalad
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Blue Ocean Strategy

W. Chan Kim and Renée Mauborgne
Blue Ocean Strategy: How to Create Uncontested Market Space and Make the Competition Irrelevant
Harvard Business School Press, 2005

Disruptive Strategy

Clayton M. Christensen and Michael E. Raynor
The Innovator's Solution: Creating and Sustaining Successful Growth
Harvard Business School Press, 2003

Emergent Strategy

Gary Hamel
"Strategy Innovation and the Quest for Value"
Sloan Management Review
Winter 1998

Henry Mintzberg
"Crafting Strategy"
Harvard Business Review
July–August 1987

Translate the Strategy

Robert S. Kaplan and David P. Norton
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Harvard Business School Press, 2000

Robert S. Kaplan and David P. Norton
Strategy Maps: Converting Intangible Assets into Tangible Outcomes
Harvard Business School Press, 2004

Robert S. Kaplan and David P. Norton
The Execution Premium: Linking Strategy to Operations for Competitive Advantage
Harvard Business School Press, 2008

Plan Operations

Process Improvement

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John Wiley & Sons, 2006

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Beyond Reengineering: How the Process-Centered Organization Is Changing Our Work and Our Lives
HarperBusiness, 1996

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McGraw-Hill, 2000

James P. Womack, Daniel T. Jones, and Daniel Roos
The Machine That Changed the World: The Story of Lean Production
Macmillan, 1990

Budgeting and Planning Resource Capacity

Jeremy Hope and Robin Fraser
Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap
Harvard Business School Press, 2003

Robert S. Kaplan and Steven R. Anderson
Time-Driven Activity-Based Costing: A Simpler and More Powerful Path to Higher Profits
Harvard Business School Press, 2007

Test and Adapt Strategy

Dennis Campbell, Srikant Datar, Susan L. Kulp, and V.G. Narayanan
"Testing Strategy Formulation and Implementation Using Strategically Linked Performance Measures"
HBS Working Paper, 2006

Thomas H. Davenport and Jeanne G. Harris
Competing on Analytics: The New Science of Winning
Harvard Business School Press, 2007

Anthony J. Rucci, Steven P. Kirn, and Richard T. Quinn
"The Employee-Customer-Profit Chain at Sears"
Harvard Business Review
January–February 1998

lead to superior financial performance. The strategy must respond, in some form, to the following questions:

- Which *customers* or *markets* will we target?
- What is the *value proposition* that distinguishes us?
- What *key processes* give us competitive advantage?
- What are the *human capital* capabilities required to excel at these key processes?
- What are the *technology enablers* of the strategy?
- What are the *organizational enablers* required for the strategy?

Managers can draw upon an abundance of models and frameworks as they formulate the strategy. Michael Porter's original competitive advantage framework, for example, presented the strategy decision as a choice between whether to provide generic low-cost products and services or more differentiated and customized ones for specific market and customer segments. The Blue Ocean approach, popularized by W. Chan Kim and Renée Mauborgne, helps companies search for new market positions by creating new value propositions for a large customer base. Resource-based strategists (including those in the core competencies school) emphasize critical processes – such as innovation or continual cost reduction – that the company does better than competitors and can leverage into multiple markets and segments. Clay Christensen has identified how new entrants can disrupt established markets by offering an initially less capable product or service at a much lower price to attract a large customer base not targeted by the market leaders.

We are agnostic with respect to these frameworks; we have seen each one we've described be highly successful. Which among them is the right choice probably depends on a company's circumstances and its competitive analysis. The Porter and resource-based frameworks help companies leverage existing competitive positions or internal capabilities, whereas the Blue Ocean and disruptive technology frameworks help them search for entirely new positions.

STAGE 2 Translate the Strategy

Once the strategy has been formulated, managers need to translate it into objectives and measures that can be clearly communicated to all units and employees. Our own work on developing strategy maps and balanced scorecards has contributed to this translation stage.

The strategy map provides a powerful tool for visualizing the strategy as a chain of cause-and-effect relationships among strategic objectives. The chain starts with the company's long-term financial objectives and then links down to objectives for customer loyalty and the company's value propositions. From there, it links to goals related to critical processes and, ultimately, to the people, the technology, and the organizational climate and culture required for successful strategy execution. Typically, a large corporation will create an overall corporate strategy map and then link it to strategy maps for each of its operating and functional units.

Even though a strategy map reduces a complex strategy statement to a single page, we have learned that many managers find the multiple objectives (typically, 15 to 25) on a map, along with their corresponding measures and targets, somewhat complex to understand and manage. Some of a map's objectives relate to short-term cost reduction and quality improvements while others reflect long-term innovation and relationship goals. Managers often find it challenging to balance these myriad objectives.

In our recent work, we've found that companies can simplify the structure and use of a strategy map by chunking it into three to five *strategic themes*. A strategic theme, typically a vertical slice within the map, consists of a distinct set of related strategic objectives. (For an example, see "Mapping Strategic Themes," a generic strategy map organized by three vertical strategic themes and a horizontal theme to cluster the learning and growth objectives.)

Strategic themes offer several advantages. At the business unit level, the theme structure allows unit managers to customize each theme to their local conditions and priorities, creating focus for their competitive situation while still keeping their objectives integrated with the overall strategy. Second, the vertical strategic themes typically deliver their benefits over different time periods, helping companies simultaneously manage short-, intermediate-, and long-term value-creating processes. Using themes, executives can plan and manage the key elements of the strategy separately but still have them operate coherently.

Once managers have developed the strategy map, they link it to another tool of our design: a balanced scorecard of performance metrics and targets for each strategic objective. We believe that if you don't measure progress toward an objective, you cannot manage and improve it. The balanced scorecard metrics allow executives to make better decisions about the strategy and quantitatively assess its execution.

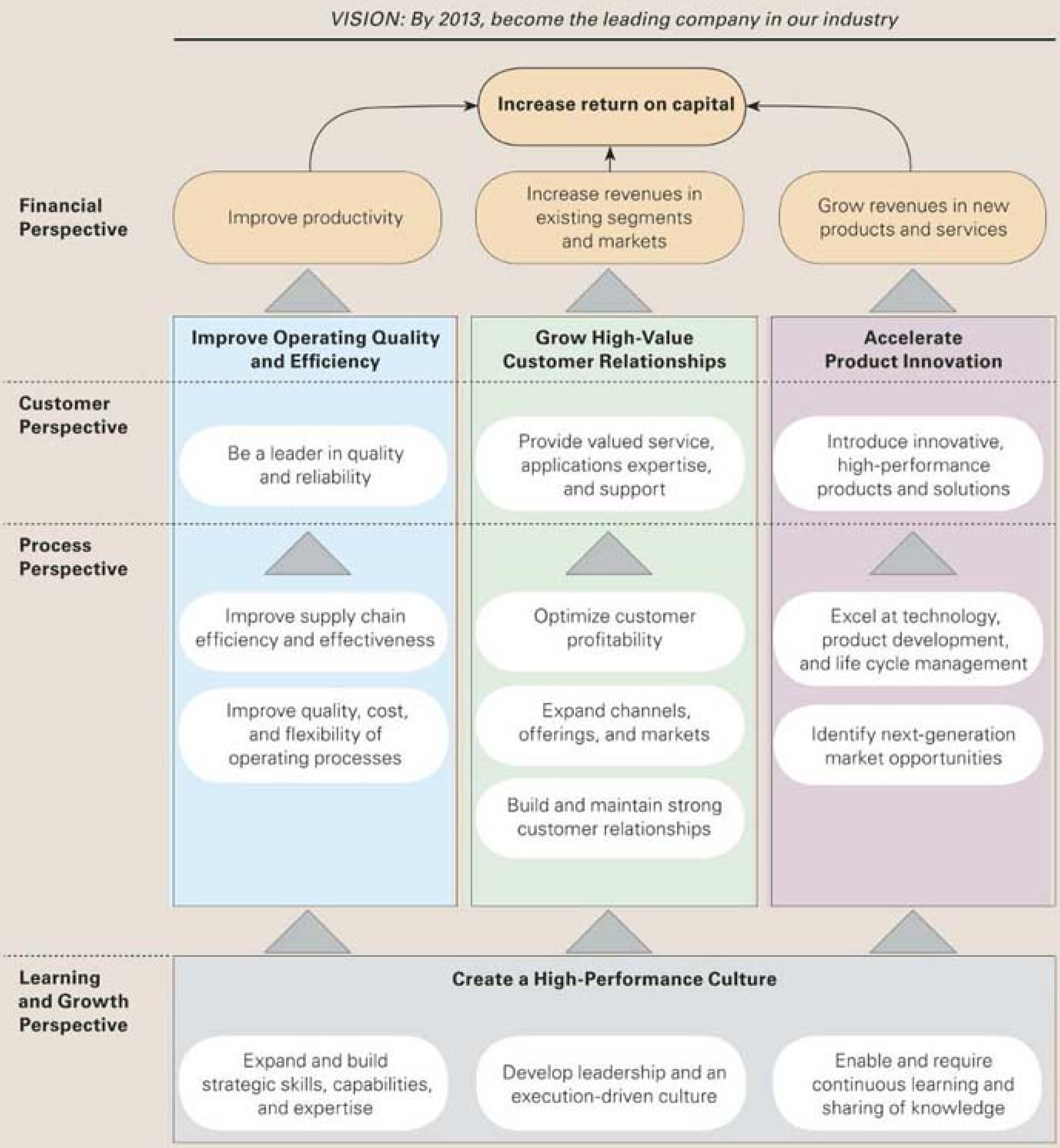
A third step at Stage 2 involves identifying, and authorizing resources for, a portfolio of strategic initiatives intended to help achieve the strategy's objectives. A strategic initiative is a discretionary project or program, of finite duration, designed to close a performance gap. It might focus on, say, developing a customer loyalty program or training all employees in Six Sigma quality management tools.

In our original conception of the strategy map and the balanced scorecard, we encouraged companies to select initiatives independently for each objective. We came to realize, however, that by doing so, companies would fail to benefit from the integrated and cumulative impact of multiple, related strategic initiatives. Achieving an objective in the customer or financial realm generally requires complementary initiatives from different parts of the organization, such as human resources, information technology, marketing,

Mapping Strategic Themes

This generic strategy map illustrates how a corporate strategy can be sliced into four themes, each with its own cause-and-effect relationships.

Real-life maps will be more complex but will still have the desirable property of making strategy much easier to understand and manage. The strategic themes provide a common structure that unit managers can use to develop their own maps within the big picture and a governance structure that assigns accountability for actions.



distribution, and operations. Also, stand-alone cross-unit initiatives often have no clear owner or home in the organization. Starved for resources and lacking clear accountability for execution, the strategic initiatives wither away, thwarting the strategy's execution.

Companies with theme-based strategy maps avoid these problems by assigning a senior executive to lead each strategic theme. In this way, the company gains an accountability and reporting structure even for cross-business and cross-functional-unit objectives. The executive assigned to own each theme assumes the responsibility for devising and executing an entire portfolio of initiatives selected to achieve the theme's performance targets. The executive team authorizes the resources required for the various portfolios; we call the designated funds strategic expenditures (or StratEx). Committing funds to StratEx is similar to budgeting for research and development: Both categories represent spending on near-term actions expected to deliver mid- to long-term performance, and both are separate from the operating and capital expenditures (OpEx and CapEx, described in the next stage) that support current operations.

STAGE 3 Plan Operations

With strategic metrics, targets, and initiative portfolios in place, the company next develops an operational plan that lays out the actions that will accomplish its strategic objectives. This stage starts with setting priorities for process improvement projects, followed by preparing a detailed sales plan, a resource capacity plan, and operating and capital budgets.

Process improvements. The strategic initiatives developed in Stage 2 consist of the short-term projects (lasting as long as 12 to 18 months) selected to help achieve the strategy map's objectives. However, to execute their strategies, companies generally must also enhance the performance of their ongoing processes – measured, for example, by their

What Resources Do You Need to Implement Your Strategy?

It's critical for companies to factor their strategic goals into their operational planning. Here's how one company broke its sales forecast down into figures for each of the activities required to achieve it and used those figures to estimate the personnel and computing resources it would need in the next period.

Breaking Down the Sales Target

Towerton Financial, a financial services company, broke down a monthly sales target of about $7.9 million into subtargets for its four product lines: stock trading, mutual fund trading, investment management, and financial planning. It then broke each line's forecast down into the volume and mix of transactions that the company's most expensive resources (people and computing) would be expected to handle each month. That information helped the company's managers calculate the resources needed to achieve their sales goals.

	Stock trading	Mutual fund trading	Investment management	Financial planning
Sales target	**$3,636,000**	**$2,031,000**	**$919,000**	**$1,323,000**
Number of transactions	275,000	49,000	5,500	6,300
Number of new accounts opened	750	400	130	100
Number of calls to customer service center	11,000	20,000	21,500	84,500
Number of meetings opening new accounts	750	400	130	100
Number of meetings servicing existing accounts	400	200	250	450
Computing MIPS utilized	419,690	56,212	60,835	11,457

responsiveness, speed, quality, and cost. Companies will get the biggest bang for their buck when they focus their business process management, total quality management, lean management, Six Sigma, and reengineering programs on processes directly related to the objectives on their strategy maps and scorecards. The goal is to align near-term process improvements with long-term strategic priorities.

Managers need to deconstruct each strategic process to identify the critical success factors and metrics that employees can focus on in their daily activities. Electronic and physical dashboards, displaying data on the key indicators of local process performance, will inform the actions of and provide feedback to employees attempting to achieve process performance targets. For example, one large pharmaceutical chain has a dashboard system that gives each store manager a customized, single page display of financial and operating metrics – those that a statistical analysis revealed have the highest correlation with aggregate store performance. The managers' dashboards also display monthly quartile rankings among comparable stores for six key metrics.

Sales plan. Managers also must identify the resources required to implement their strategic plan. Before they can do that, they need to deconstruct their overall sales target into the expected quantity, mix, and nature of individual sales orders, production runs, and transactions. (For an illustration, see the example of Towerton Financial in "Breaking Down the Sales Target." Towerton is a composite of various firms we've worked with.) Companies with well-functioning ERP systems will have a historical record of product and customer mix and transaction volumes they can draw upon to do this. A company can start by simply grossing up last period's distribution of order sizes by the desired percentage change in sales. Using this baseline, the company's planners can modify the distribution to reflect expected changes in sales and ordering patterns, such as an increase in minimum order sizes and the additional

Translating the Sales Plan into Resource Requirements

In this chart, Towerton Financial calculated the quantity of resources required to implement the sales plan at left, using a time-driven ABC model. The numbers under total hours show what Towerton would need from each kind of personnel or IT resource. (Note that the capacity of computing resources is measured by MIPS, not hours.) The next column indicates how many hours (or MIPS) are supplied monthly by one unit of each resource. The numbers for resource units required were obtained simply by dividing the total demand for each resource by the quantity supplied monthly by one unit of it. After examining the resource requirements under a range of assumptions, Towerton authorized the level of resource supply to be carried into the next period. In general, companies will want to supply somewhat more capacity than forecast, as shown in the column for resource units supplied; resource demands are not uniform throughout a period. As the final column shows, Towerton expects to operate at close to full capacity during the upcoming period. Knowing the cost of each resource unit, Towerton can quickly translate its operating plan into an overall profit plan and individual product line P&Ls.

Resource type	Total hours	Available hours/month per resource unit	Resource units required	Resource units supplied	Capacity utilization
Brokers	27,070	130	208.2	215	97%
Account managers	6,540	130	50.3	51	99%
Financial planners	7,300	130	56.2	59	95%
Principals	4,627	130	35.6	36	99%
Customer service representatives	14,654	140	104.7	110	95%
IT consultants	10,321	140	73.7	75	98%
Computing MIPS utilized	548,194	7,920	69.2	75	92%

sales from new lines of products or services or new markets. Finally, data-rich companies can easily embrace scenario planning to explore the sensitivity of their sales forecasts to alternative economic and competitive assumptions.

Resource capacity plan. Armed with data about productivity from process improvements and likely sales numbers, companies can now estimate what resources they will need in the year ahead to execute on their strategic goals. Our preferred tool for this step is time-driven activity-based costing (TDABC). Activity-based costing's original use was to measure the cost and profitability of processes, products, and customers (as we will describe in Stage 5). The time-driven version of ABC adds a new capability, the ability to easily translate future sales numbers into a forecast of required resource capacity. At the heart of the TDABC model is a set of equations, based on historical experience, that describe how various transactions and demands consume the capacity of resources such as people, equipment, and facilities. A company that has such a model in place can update these equations for any productivity gains that have occurred or are anticipated from process improvements (determined during the first step in this stage). Managers then feed the new detailed sales plans (from the second step) into the updated model, to produce estimates of the demand for resources implied by the sales forecast. (See "Translating the Sales Plan into Resource Requirements" for a simplified example.) The company, seeing the capacity required to deliver on its strategic plan, can then authorize the quantity of people, equipment, and other resources to be supplied, including any buffer capacity to handle fluctuations or short-term spikes in demand.

Dynamic operating and capital budgets. Once managers have determined the authorized level of resources for the future period, the financial implications become easy to calculate. In the Towerton Financial case used in the resource capacity exhibit, the company already knew the full monthly cost of each kind of personnel – brokers, account managers, financial planners, customer service representatives, and IT consultants – as well as the monthly cost for each server, the unit of computing capacity. To obtain the budget figures for each of the resources needed to meet the sales forecasts, Towerton's planners simply multiply the cost of each type of resource by the quantity it has decided to supply. Most of the resource capacity represents personnel costs and would be included in the OpEx budget. Increases in equipment resource capacity (such as Towerton's servers) would be reflected in the CapEx budget. The process quickly and analytically generates operating and capital budgets that grow logically and dynamically out of the sales and operating plans, rather than being imposed by fiat or through power negotiations. Since the company started with detailed revenue forecasts and now has the resource costs associated with delivering on them, simple subtraction will yield a detailed P&L for each product, customer, channel, and region. Companies that have shifted from an annual budgeting cycle to one with quarterly updates can use this process to obtain resource capacity plans for every period for which they have a sales forecast.

In a final budgeting step, the company authorizes the discretionary spending that does not have an immediate relationship with sales and operations, such as process improvement initiatives, advertising, promotion, research and development, training, and maintenance. The amount of such spending remains a judgment call for experienced executives and is not a decision that can yet be automated through an analytic model.

The company now has finished the integrated planning of strategy and operations, which encompasses the following steps: Formulate the strategy; translate it into linked objectives, measures, and targets; develop and fund the portfolio of strategic initiatives; identify the process improvement priorities; forecast sales consistent with the strategic plan; estimate the resource capacities required for those sales; authorize the spending on resources; and produce next period's pro forma income and detailed P&L statements. From here on, it is up to the managers to execute, learn, and adapt, moving the management cycle into its fourth stage.

STAGE 4 Monitor and Learn

As companies implement their strategic and operational plans, they need to hold three types of meetings to monitor and learn from their results. First, managers should convene meetings that review the performance of operating departments and business functions and address problems that have arisen or persist. They also should hold strategy management meetings that review balanced scorecard performance indicators and initiatives to assess progress and identify barriers to strategy execution. Those two meetings make up Stage 4 of the system. In Stage 5, managers meet to assess the performance of the strategy itself and adapt it if necessary. The three meetings have different subject matter, different frequencies, and, often, different sets of attendees. (See the exhibit "Management Meetings 101" for a comparison of the meetings.)

Operational review meetings. Management groups need to meet frequently – perhaps weekly, twice weekly, or even daily – to review their operating dashboards and reports on sales, bookings, and shipments, and to solve short-term issues that have recently arisen: complaints from important customers, late deliveries, defective production, mechanical breakdowns, the extended absence of a key employee, new sales opportunities. The speed at which new data are posted on operational dashboards is the central factor in determining meeting frequency: If the company has a short operations cycle, with new data posted hourly and daily, then a daily review promotes rapid learning and problem solving. But for a product development group, progress against milestones and stage gates may be better evaluated monthly.

The people attending an operational review typically come from within a single department, function, or process. A unit's salespeople, for example, will meet (often via conference calls and webcasts) to discuss the sales pipeline, recent sales closings, and new customer opportunities and problems. Operations people review production problems, including defects, yields, bottlenecks, maintenance and repair schedules, equipment breakdowns, downtime, scheduling, expediting, supplier concerns, and distribution. Finance personnel address short-term cash flow issues, including collections on receivables, late payments to suppliers, treasury operations, and banking relationships. The top management group may meet monthly to review overall financial performance.

Smaller companies, without functional departments, may have only a single monthly operating meeting, corresponding to the frequency with which they close their books. In general, however, we recommend gearing operating review

Management Meetings 101

It's important to distinguish clearly among the various kinds of meetings that form the feedback and learning component of the management system. They require different frequencies and have very different agendas and informational requirements. Companies that try to double up these meetings in order to accommodate the availability of senior staff run the risk of having discussions of operational crises drive out consideration of strategic issues.

MEETING TYPE	Operational review	Strategy review	Strategy testing and adapting
Information requirements	Dashboards for key performance indicators; weekly and monthly financial summaries	Strategy map and balanced scorecard reports	Strategy map, balanced scorecard, ABC profitability reports, analytic studies of strategy, external and competitive analyses
Frequency	Daily, twice weekly, weekly, or monthly, depending on business cycle	Monthly	Annually (perhaps quarterly for fast-moving industries)
Attendees	Departmental and functional personnel; senior management for financial reviews	Senior management team, strategic theme owners, strategy management officer	Senior management team, strategic theme owners, functional and planning specialists, business unit heads
Focus	Identify and solve operational problems (sales declines, late deliveries, equipment downtime, supplier problems)	Implement strategy	Test and adapt strategy based on causal analytics, product-line and channel profitability, changing external environment, emergent strategies, and new technology developments
Goal	Respond to short-term problems and promote continuous improvements	Fine-tune strategy; make midcourse adaptations	Incrementally improve or transform strategy; establish strategic and operational plans; set strategic targets; authorize spending for strategic initiatives and other major discretionary expenditures

meeting frequency to the operating cycle of the department and business, so management can respond to sales and operating data and to myriad other tactical issues in the most timely manner.

Ideally, operational meetings are short, highly focused, data driven, and action oriented. One company we've advised holds its operational reviews in a small room filled with whiteboards and flip charts but no chairs. Attendees post agenda topics and look over dashboards before the meeting, which lasts only as long as needed to discuss each issue, develop an action plan, and assign responsibility for carrying it out. Forcing everyone to stand signals that the meeting's purpose is not to spend time together, passively listening. It is to engage managers in active and brisk problem-solving discussions on the most pressing issues of the day.

Strategy review meetings. The leadership team of a business unit must meet periodically to review the progress of its strategy. Operational issues, unless they are particularly significant and cross-functional, should not be discussed at this meeting. Attendance at strategy reviews should be compulsory for the unit's CEO and all members of its executive committee.

There's no clear consensus around the optimal frequency for these meetings, though most companies hold a monthly two- to three-hour strategy review meeting, to ensure that strategy remains top of mind. That works well when a management team works in one central location. Some companies, especially those with dispersed teams, hold their strategy review meetings quarterly. Strategy is a long-term commitment, and strategic initiatives such as developing new workforce competencies, redefining the brand, innovating new products, building new customer relationships, and reengineering key business processes typically take more than a month to yield measurable results. Quarterly meetings will probably require at least an entire day for active discussion of all strategic objectives and themes.

Many company units hold their monthly operational financial review on the same day as the strategy review, since the same people attend both. If that's the situation, it's essential to set distinctly different agendas for the two meetings. Otherwise, as in our opening example of the Conner Corporation, short-term operational and tactical issues will drive out discussions of strategy implementation.

One company holds its operational reviews in a room with no chairs. Forcing everyone to stand signals that the meeting is not about passive listening; it's about active and brisk problem solving.

Like operational reviews, strategy management meetings should not be spent listening to report presentations. Managers should come to the meetings already familiar with the data to be discussed, thinking about the issues that the gaps in recent performance raise, and formulating solutions to problems. At the meetings themselves, executive committee members should discuss the issues, explore their implications, and propose action plans.

Executives have to make a trade-off between breadth and depth at these reviews. In the early years of balanced scorecard implementations, we encouraged a full discussion of BSC measures at each strategy management meeting. It soon became apparent that the normal time reserved for a monthly meeting did not permit a full discussion of all the objectives, measures, and initiatives on a strategy map and scorecard. The solution, we discovered, came from the practice of using strategic themes to organize strategy maps: devote most of the meeting to a deep dive into one or two of the strategic themes.

That is precisely what happens at HSBC Rail, an operating unit of the HSBC Group, which purchases, leases, and maintains the locomotives and cars for the UK and other nations' railroad systems. Its monthly two-and-a-half-hour meeting brings together its strategy council, consisting of the CEO, the head of Finance, the head of Customer Service–Operations, the head of Customer Relationship Management–Sales, the head of Learning and Development, and the strategy management officer, who coordinates the data on the strategic measures and initiatives for each strategic theme in advance of the meeting. The data go into a monthly report that has a section for each strategic theme. The section contains the theme's strategy map, objectives, targets, and initiatives, with each component color-coded green (if the objective's target has been achieved), yellow (progress is slower than expected but doesn't require immediate senior management attention), or red (progress is off track *and* requires management attention to resolve critical issues). Each theme's section also contains evaluations and commentary from the theme owner about any performance gaps and proposed actions for addressing them.

The monthly meeting focuses on one (or at most two) strategic themes in depth. The agenda also allots time for one operational or strategic "hot topic" to ensure that urgent issues that fall outside the theme under discussion will be addressed. The February 2007 strategy council meeting was a typical HSBC Rail strategy review. (See the exhibit "A Model Strategy Review Agenda.") The strategy management officer started with an update on the action items from the previous month, indicating which had been accomplished and which were still under way. The CEO followed with a quick review of the unit's color-coded strategy map and offered his perspective on the business. Then, the attendees gave in-depth consideration for about 60 minutes to the Customer Relationship Management strategic theme. For the remaining themes, the council spent about five minutes each on any issues that had to be resolved before the scheduled deep dive on that theme. The meeting participants, who were already familiar with the data and ready to discuss the implications and to propose action plans, built constructively on the ideas presented during the meeting. The CEO questioned and probed, kept the meeting focused on the key issues, encouraged dialogue and debate, and ensured that the meeting stayed on schedule. The strategy management officer recorded each approved action item and the designated manager who would be accountable for following up on it.

HSBC's meetings – like all excellent strategy reviews – focus on whether strategy execution is on track, where problems are occurring in the implementation, why they're happening, what actions will correct them, and who will have responsibility for achieving targets. These meetings take the strategy as a given. They are not used, except in unusual circumstances, to question or adapt the strategy. That is what takes place in the final stage.

STAGE 5 Test and Adapt the Strategy

From time to time managers will discover that some of the assumptions underlying their strategy are flawed or obsolete. When that happens, managers need to rigorously reexamine their strategy and adapt it, deciding whether incremental improvements will suffice or whether they need a new, transformational strategy. This process closes the loop of the management system. It generally occurs at the strategy

A Model Strategy Review Agenda

Time	Item	Detail	Duration	Responsibility
10:10	Action Log	Review Status	5 minutes	Paul (Strategy Management Officer)
10:15	Overview	Review Strategy Map Highlight Key Issues Review Initiatives Review Measures	10 minutes	Peter (CEO)
10:25	Theme Assessment	Customer Relationship Management	60 minutes	Bob (Head of CRM–Sales)
11:25	Break		5 minutes	
11:30	Theme Summary	Learning and Growth	5 minutes	Nick (Head of Learning and Development)
11:35	Theme Summary	Capital Efficiency	5 minutes	David (Head of Finance)
11:40	Theme Summary	Operational Excellence	5 minutes	Robert (Head of Customer Service–Operations)
11:45	Hot Topic	Resourcing Challenge	30 minutes	David (Head of Finance)
12:15	Meeting Review	Communication Summary	10 minutes	Peter (CEO)
12:25	Meeting Review	Feedback	5 minutes	
12:30	Action Log	Review of New Items	5 minutes	Peter (CEO)
12:35	Any Other Business and Meeting Close			Paul (Strategy Management Officer)
	Next Meeting	18/04/07 – Theme Assessment: Capital Efficiency		

development offsite described under Stage 1 but could occur during the year if the company experiences a major disruption or a new strategic opportunity. The strategy testing and adapting process introduces new inputs to the offsite: an analysis of the current economics of existing products and customers, statistical analyses of correlations among the strategy's performance measures, and consideration of new strategy options that have emerged since the previous strategy development meeting.

Cost and profitability reports. Anytime a company reviews its strategy, it should first understand the current economics of its existing strategy by examining activity-based costing reports that show the profit and loss of each product line, customer, market segment, channel, and region. Executives will then see where the existing strategy has succeeded and failed, and can formulate approaches to turning around loss operations and expanding the scope and scale of profitable operations.

Consider the experience of a large New York City bank with an overall profitable product line of demand and time deposits. Information from its aggregate profitability measurement system showed that all customers with balances greater than $25,000 were profitable, so the bank launched a major initiative to retain those clients. During the initiative, however, the bank conducted a more detailed ABC study to calculate the cost to serve and the profitability of all accounts. It learned that 35% of the households targeted for retention were unprofitable, with cumulative losses totaling more than $2 million. Unprofitable customers could be found in every balance tier up to $1 million, in fact. Managers at first could not believe that high-deposit individuals could be unprofitable. Further analysis revealed that unprofitable customers did a large number of transactions in the branches, the most expensive service channel, and kept most of their deposits in accounts that yielded low margins to the bank. Fortunately, the bank discovered this error in its strategy before it was too far along in its client retention initiative.

Unprofitability doesn't mean that a company should simply drop a customer or product, however. In our experience, companies find multiple ways – process improvements, repricing, and redefining relationships – to reduce or eliminate the losses from unprofitable products and customers, once a credible costing system has identified them.

Statistical analyses. Companies, especially those with large numbers of similar operating units, can use statistical analysis to estimate correlations among strategy performance numbers. Such analysis will usually validate and quantify links between investments in, for example, employee skills or IT support systems, and customer loyalty and financial performance. Occasionally, however, the analysis can reveal that assumed linkages are not occurring, which should cause the executive team to question or reject at least part of the existing strategy. Companies that consistently measure strategy performance through tools such as the strategy map and balanced scorecard have ready access to the data needed for strategy validation and testing.

Take Store 24, one of New England's largest convenience store chains (now owned by Tedeschi Food Shops), which in 1998 implemented a new customer strategy called "Ban Boredom." Store 24's CEO believed that providing an entertaining shopping atmosphere, including frequent themes and promotions, would differentiate the shopping experience at the chain from its competitors'. The company created a strategy map and balanced scorecard to communicate and help implement the new strategy. Within two years, however, Store 24's executive team learned that the strategy was not working. Feedback from individual customers and focus groups led the chain to abandon the Ban Boredom strategy and replace it with an updated version of its previous strategy, which featured fast and efficient service.

A Harvard Business School faculty team (Dennis Campbell, Srikant Datar, Susan Kulp, and V.G. Narayanan) gained access to quarterly data from Store 24's 85 retail outlets and performed statistical analysis to see whether the company's executives could have recognized the flaws in the Ban

UNPROFITABILITY DOESN'T MEAN that a company should simply drop a customer or product. Companies can find multiple ways to reduce or eliminate losses, once a credible costing system has identified them.

Boredom strategy earlier. Looking at data from the first year of the strategy, the study found that better implementation of the Ban Boredom program was indeed negatively correlated with store performance, exactly the opposite of what the strategy had intended. The data also showed that differences in profits were best explained by variables not related to the strategy, including store managers' skills, local population, and local competition. By uncovering those (and several other) simple correlations, Store 24 management could have learned one year earlier than it actually did that the new strategy was not working. The managers would also have seen that the strategy would be successful only if all stores raised their crew skills to high levels, something that wasn't feasible given the 200% annual employee turnover rate typical of retail stores.

Emergent strategies. The strategy offsite, beyond examining the performance of existing strategy, provides executives with a great opportunity to consider new strategy proposals that managers and employees throughout the enterprise may have suggested. Henry Mintzberg and Gary Hamel, in fact, argue against top-down strategy implementation, contending that the most innovative strategies emerge from within the organization. Not all such strategies are worth pursuing, however, and even if several seem promising, the executive team still needs to decide which, if any, to adopt.

If the executive team decides, based on analyses of the internal data, the competitive environment, and emerging strategy ideas, to alter the existing strategy, it should follow up by modifying the organization's strategy map and scorecard. That will launch another cycle of strategy translation and operational execution, with new targets, new initiatives, a new sales and operating plan, revised process improvement priorities, changed resource capacity requirements, and an updated financial plan. The new strategic and operational plans set the stage and establish the information requirements for next period's schedule of operational reviews, strategy reviews, and strategy testing and adaptation meetings.

...

Managers have always found it hard to balance near-term operational concerns with long-term strategic priorities. But such a balancing act comes with the job; it is an inherent tension that managers cannot avoid and must continually address. As a senior strategic planner at a *Fortune* 20 company told us, "You can have the best processes in the world, but if your governance processes don't provide the direction and course correction required to achieve your goals, success is a matter of luck." At the same time, a company can have the best strategy in the world, but it will get nowhere if managers cannot translate that strategy into operational plans and then execute the plans and achieve the performance targets.

Managers that carefully follow the recommendations we have laid out in this article will have a complete management system that helps them set clear strategic goals, allocate resources consistent with those goals, set priorities for operational action, quickly recognize the operational and strategic impact of those decisions, and, if necessary, update their strategic goals. The closed-loop management system enables executives to manage both strategy and operations, and to balance the tensions between them.

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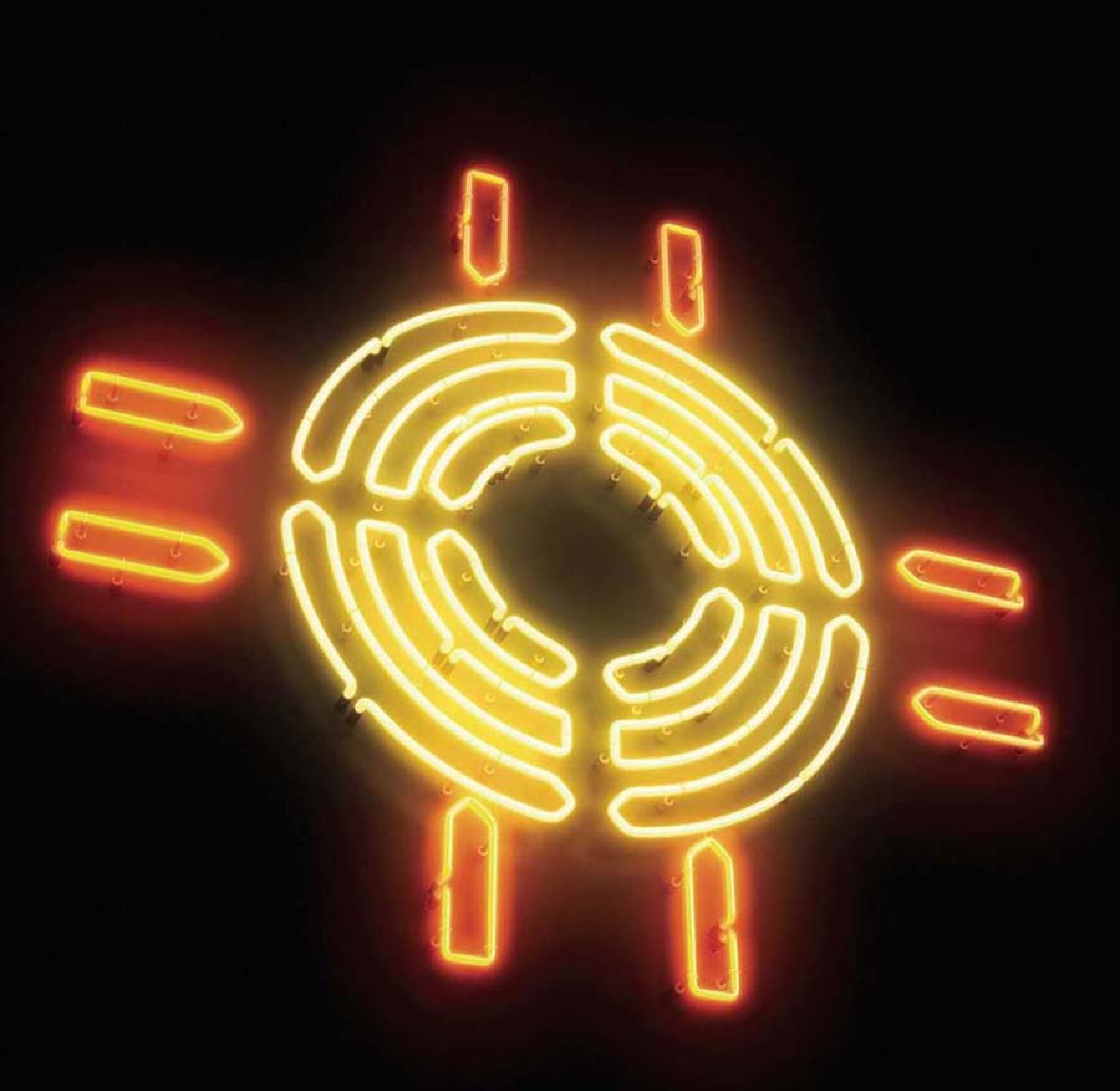
Mike Lynch



Awareness of the five forces can help a company understand the structure of its industry and stake out a position that is more profitable and less vulnerable to attack.

THE FIVE COMPETITIVE FORCES THAT SHAPE STRATEGY

by Michael E. Porter

Editor's Note: In 1979, *Harvard Business Review* published "How Competitive Forces Shape Strategy" by a young economist and associate professor, Michael E. Porter. It was his first HBR article, and it started a revolution in the strategy field. In subsequent decades, Porter has brought his signature economic rigor to the study of competitive strategy for corporations, regions, nations, and, more recently, health care and philanthropy. "Porter's five forces" have shaped a generation of academic research and business practice. With prodding and assistance from Harvard Business School Professor Jan Rivkin and longtime colleague Joan Magretta, Porter here reaffirms, updates, and extends the classic work. He also addresses common misunderstandings, provides practical guidance for users of the framework, and offers a deeper view of its implications for strategy today.

Peter Crowther

IN ESSENCE, the job of the strategist is to understand and cope with competition. Often, however, managers define competition too narrowly, as if it occurred only among today's direct competitors. Yet competition for profits goes beyond established industry rivals to include four other competitive forces as well: customers, suppliers, potential entrants, and substitute products. The extended rivalry that results from all five forces defines an industry's structure and shapes the nature of competitive interaction within an industry.

As different from one another as industries might appear on the surface, the underlying drivers of profitability are the same. The global auto industry, for instance, appears to have nothing in common with the worldwide market for art masterpieces or the heavily regulated health-care delivery industry in Europe. But to understand industry competition and profitability in each of those three cases, one must analyze the industry's underlying structure in terms of the five forces. (See the exhibit "The Five Forces That Shape Industry Competition.")

If the forces are intense, as they are in such industries as airlines, textiles, and hotels, almost no company earns attractive returns on investment. If the forces are benign, as they are in industries such as software, soft drinks, and toiletries, many companies are profitable. Industry structure drives competition and profitability, not whether an industry produces a product or service, is emerging or mature, high tech or low tech, regulated or unregulated. While a myriad of factors can affect industry profitability in the short run – including the weather and the business cycle – industry structure, manifested in the competitive forces, sets industry profitability in the medium and long run. (See the exhibit "Differences in Industry Profitability.")

The Five Forces That Shape Industry Competition

Understanding the competitive forces, and their underlying causes, reveals the roots of an industry's current profitability while providing a framework for anticipating and influencing competition (and profitability) over time. A healthy industry structure should be as much a competitive concern to strategists as their company's own position. Understanding industry structure is also essential to effective strategic positioning. As we will see, defending against the competitive forces and shaping them in a company's favor are crucial to strategy.

Forces That Shape Competition

The configuration of the five forces differs by industry. In the market for commercial aircraft, fierce rivalry between dominant producers Airbus and Boeing and the bargaining power of the airlines that place huge orders for aircraft are strong, while the threat of entry, the threat of substitutes, and the power of suppliers are more benign. In the movie theater industry, the proliferation of substitute forms of entertainment and the power of the movie producers and distributors who supply movies, the critical input, are important.

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The strongest competitive force or forces determine the profitability of an industry and become the most important to strategy formulation. The most salient force, however, is not always obvious.

For example, even though rivalry is often fierce in commodity industries, it may not be the factor limiting profitability. Low returns in the photographic film industry, for instance, are the result of a superior substitute product – as Kodak and Fuji, the world's leading producers of photographic film, learned with the advent of digital photography. In such a situation, coping with the substitute product becomes the number one strategic priority.

Industry structure grows out of a set of economic and technical characteristics that determine the strength of each competitive force. We will examine these drivers in the pages that follow, taking the perspective of an incumbent, or a company already present in the industry. The analysis can be readily extended to understand the challenges facing a potential entrant.

THREAT OF ENTRY. New entrants to an industry bring new capacity and a desire to gain market share that puts pressure on prices, costs, and the rate of investment necessary to compete. Particularly when new entrants are diversifying from other markets, they can leverage existing capabilities and cash flows to shake up competition, as Pepsi did when it entered the bottled water industry, Microsoft did when it began to offer internet browsers, and Apple did when it entered the music distribution business.

The threat of entry, therefore, puts a cap on the profit potential of an industry. When the threat is high, incumbents must hold down their prices or boost investment to deter new competitors. In specialty coffee retailing, for example, relatively low entry barriers mean that Starbucks must invest aggressively in modernizing stores and menus.

The threat of entry in an industry depends on the height of entry barriers that are present and on the reaction entrants can expect from incumbents. If entry barriers are low and newcomers expect little retaliation from the entrenched competitors, the threat of entry is high and industry profitability is moderated. It is the *threat* of entry, not whether entry actually occurs, that holds down profitability.

Barriers to entry. Entry barriers are advantages that incumbents have relative to new entrants. There are seven major sources:

1. *Supply-side economies of scale.* These economies arise when firms that produce at larger volumes enjoy lower costs per unit because they can spread fixed costs over more units, employ more efficient technology, or command better terms from suppliers. Supply-side scale economies deter entry by forcing the aspiring entrant either to come into the industry on a large scale, which requires dislodging entrenched competitors, or to accept a cost disadvantage.

Scale economies can be found in virtually every activity in the value chain; which ones are most important varies by industry.[1] In microprocessors, incumbents such as Intel are protected by scale economies in research, chip fabrication, and consumer marketing. For lawn care companies like Scotts Miracle-Gro, the most important scale economies are found in the supply chain and media advertising. In small-package delivery, economies of scale arise in national logistical systems and information technology.

2. *Demand-side benefits of scale.* These benefits, also known as network effects, arise in industries where a buyer's willingness to pay for a company's product increases with the number of other buyers who also patronize the company. Buyers may trust larger companies more for a crucial product: Recall the old adage that no one ever got fired for buying from IBM (when it was the dominant computer maker). Buyers may also value being in a "network" with a larger number of fellow customers. For instance, online auction participants are attracted to eBay because it offers the most potential trading partners. Demand-side benefits of scale discourage entry by limiting the willingness of customers to buy from a newcomer and by reducing the price the newcomer can command until it builds up a large base of customers.

3. *Customer switching costs.* Switching costs are fixed costs that buyers face when they change suppliers. Such costs may arise because a buyer who switches vendors must, for example, alter product specifications, retrain employees to use a new product, or modify processes or information systems. The larger the switching costs, the harder it will be for an entrant to gain customers. Enterprise resource planning (ERP) software is an example of a product with very high switching costs. Once a company has installed SAP's ERP system, for example, the costs of moving to a new vendor are astronomical because of embedded data, the fact that internal processes have been adapted to SAP, major retraining needs, and the mission-critical nature of the applications.

4. *Capital requirements.* The need to invest large financial resources in order to compete can deter new entrants. Capital may be necessary not only for fixed facilities but also to extend customer credit, build inventories, and fund start-up losses. The barrier is particularly great if the capital is required for unrecoverable and therefore harder-to-finance expenditures, such as up-front advertising or research and development. While major corporations have the financial resources to invade almost any industry, the huge capital requirements in certain fields limit the pool of likely entrants. Conversely, in such fields as tax preparation services or short-haul trucking, capital requirements are minimal and potential entrants plentiful.

It is important not to overstate the degree to which capital requirements alone deter entry. If industry returns are attractive and are expected to remain so, and if capital markets are efficient, investors will provide entrants with the funds they need. For aspiring air carriers, for instance, financing is available to purchase expensive aircraft because of their high resale value, one reason why there have been numerous new airlines in almost every region.

5. *Incumbency advantages independent of size.* No matter what their size, incumbents may have cost or quality advantages not available to potential rivals. These advantages can stem from such sources as proprietary technology, preferential access to the best raw material sources, preemption of the most favorable geographic locations, established brand identities, or cumulative experience that has allowed incum-

Industry structure drives competition and profitability, not whether an industry is emerging or mature, high tech or low tech, regulated or unregulated.

bents to learn how to produce more efficiently. Entrants try to bypass such advantages. Upstart discounters such as Target and Wal-Mart, for example, have located stores in freestanding sites rather than regional shopping centers where established department stores were well entrenched.

6. *Unequal access to distribution channels.* The new entrant must, of course, secure distribution of its product or service. A new food item, for example, must displace others from the supermarket shelf via price breaks, promotions, intense selling efforts, or some other means. The more limited the wholesale or retail channels are and the more that existing competitors have tied them up, the tougher entry into an industry will be. Sometimes access to distribution is so high a barrier that new entrants must bypass distribution channels altogether or create their own. Thus, upstart low-cost airlines have avoided distribution through travel agents (who tend to favor established higher-fare carriers) and have encouraged passengers to book their own flights on the internet.

7. *Restrictive government policy.* Government policy can hinder or aid new entry directly, as well as amplify (or nullify) the other entry barriers. Government directly limits or even forecloses entry into industries through, for instance, licensing requirements and restrictions on foreign investment. Regulated industries like liquor retailing, taxi services, and airlines are visible examples. Government policy can heighten other entry barriers through such means as expansive patenting rules that protect proprietary technology from imitation or environmental or safety regulations that raise scale economies facing newcomers. Of course, government policies may also make entry easier – directly through subsidies, for instance, or indirectly by funding basic research and making it available to all firms, new and old, reducing scale economies.

Entry barriers should be assessed relative to the capabilities of potential entrants, which may be start-ups, foreign firms, or companies in related industries. And, as some of our examples illustrate, the strategist must be mindful of the creative ways newcomers might find to circumvent apparent barriers.

Expected retaliation. How potential entrants believe incumbents may react will also influence their decision to enter or stay out of an industry. If reaction is vigorous and protracted enough, the profit potential of participating in the industry can fall below the cost of capital. Incumbents often use public statements and responses to one entrant to send a message to other prospective entrants about their commitment to defending market share.

Newcomers are likely to fear expected retaliation if:

- Incumbents have previously responded vigorously to new entrants.
- Incumbents possess substantial resources to fight back, including excess cash and unused borrowing power, available productive capacity, or clout with distribution channels and customers.
- Incumbents seem likely to cut prices because they are committed to retaining market share at all costs or because the industry has high fixed costs, which create a strong motivation to drop prices to fill excess capacity.
- Industry growth is slow so newcomers can gain volume only by taking it from incumbents.

An analysis of barriers to entry and expected retaliation is obviously crucial for any company contemplating entry into a new industry. The challenge is to find ways to surmount the entry barriers without nullifying, through heavy investment, the profitability of participating in the industry.

THE POWER OF SUPPLIERS. Powerful suppliers capture more of the value for themselves by charging higher prices, limiting quality or services, or shifting costs to industry participants. Powerful suppliers, including suppliers of labor, can squeeze profitability out of an industry that is unable to pass on cost increases in its own prices. Microsoft, for instance, has contributed to the erosion of profitability among personal computer makers by raising prices on operating systems. PC makers, competing fiercely for customers who can easily switch among them, have limited freedom to raise their prices accordingly.

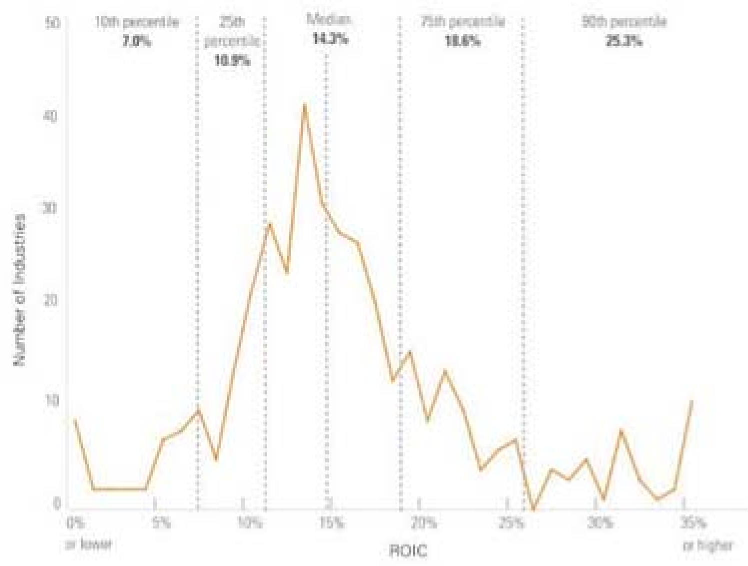
Companies depend on a wide range of different supplier groups for inputs. A supplier group is powerful if:

- It is more concentrated than the industry it sells to. Microsoft's near monopoly in operating systems, coupled with the fragmentation of PC assemblers, exemplifies this situation.
- The supplier group does not depend heavily on the industry for its revenues. Suppliers serving many industries will not hesitate to extract maximum profits from each one. If a particular industry accounts for a large portion of a supplier group's volume or profit, however, suppliers will want to protect the industry through reasonable pricing and assist in activities such as R&D and lobbying.
- Industry participants face switching costs in changing suppliers. For example, shifting suppliers is difficult if companies have invested heavily in specialized ancillary equip-

Differences in Industry Profitability

The average return on invested capital varies markedly from industry to industry. Between 1992 and 2006, for example, average return on invested capital in U.S. industries ranged as low as zero or even negative to more than 50%. At the high end are industries like soft drinks and prepackaged software, which have been almost six times more profitable than the airline industry over the period.

Average Return on Invested Capital in U.S. Industries, 1992–2006

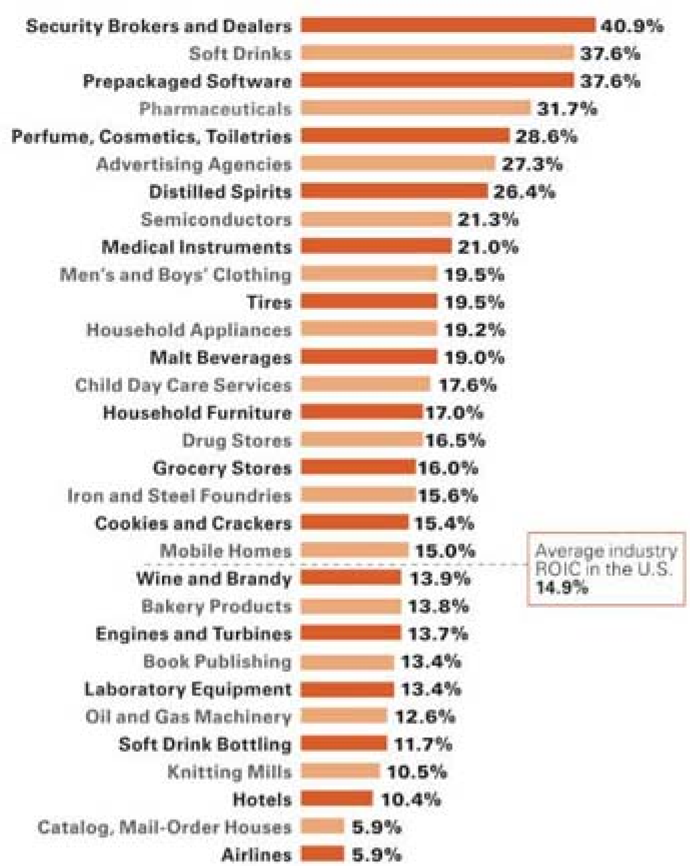


Return on invested capital (ROIC) is the appropriate measure of profitability for strategy formulation, not to mention for equity investors. Return on sales or the growth rate of profits fail to account for the capital required to compete in the industry. Here, we utilize earnings before interest and taxes divided by average invested capital less excess cash as the measure of ROIC. This measure controls for idiosyncratic differences in capital structure and tax rates across companies and industries.

Source: Standard & Poor's, Compustat, and author's calculations

Profitability of Selected U.S. Industries

Average ROIC, 1992–2006



ment or in learning how to operate a supplier's equipment (as with Bloomberg terminals used by financial professionals). Or firms may have located their production lines adjacent to a supplier's manufacturing facilities (as in the case of some beverage companies and container manufacturers). When switching costs are high, industry participants find it hard to play suppliers off against one another. (Note that suppliers may have switching costs as well. This limits their power.)

- Suppliers offer products that are differentiated. Pharmaceutical companies that offer patented drugs with distinctive medical benefits have more power over hospitals, health maintenance organizations, and other drug buyers, for example, than drug companies offering me-too or generic products.

- There is no substitute for what the supplier group provides. Pilots' unions, for example, exercise considerable supplier power over airlines partly because there is no good alternative to a well-trained pilot in the cockpit.

- The supplier group can credibly threaten to integrate forward into the industry. In that case, if industry participants make too much money relative to suppliers, they will induce suppliers to enter the market.

THE POWER OF BUYERS. Powerful customers – the flip side of powerful suppliers – can capture more value by forcing down prices, demanding better quality or more service (thereby driving up costs), and generally playing industry participants off against one another, all at the expense of industry profitability. Buyers are powerful if they have negotiating leverage relative to industry participants, especially if they are price sensitive, using their clout primarily to pressure price reductions.

As with suppliers, there may be distinct groups of customers who differ in bargaining power. A customer group has negotiating leverage if:

- There are few buyers, or each one purchases in volumes that are large relative to the size of a single vendor. Large-volume buyers are particularly powerful in industries with high fixed costs, such as telecommunications equipment, offshore drilling, and bulk chemicals. High fixed costs and low marginal costs amplify the pressure on rivals to keep capacity filled through discounting.

- The industry's products are standardized or undifferentiated. If buyers believe they can always find an equivalent product, they tend to play one vendor against another.

- Buyers face few switching costs in changing vendors.

• Buyers can credibly threaten to integrate backward and produce the industry's product themselves if vendors are too profitable. Producers of soft drinks and beer have long controlled the power of packaging manufacturers by threatening to make, and at times actually making, packaging materials themselves.

A buyer group is price sensitive if:

• The product it purchases from the industry represents a significant fraction of its cost structure or procurement budget. Here buyers are likely to shop around and bargain hard, as consumers do for home mortgages. Where the product sold by an industry is a small fraction of buyers' costs or expenditures, buyers are usually less price sensitive.

• The buyer group earns low profits, is strapped for cash, or is otherwise under pressure to trim its purchasing costs. Highly profitable or cash-rich customers, in contrast, are generally less price sensitive (that is, of course, if the item does not represent a large fraction of their costs).

• The quality of buyers' products or services is little affected by the industry's product. Where quality is very much affected by the industry's product, buyers are generally less price sensitive. When purchasing or renting production quality cameras, for instance, makers of major motion pictures opt for highly reliable equipment with the latest features. They pay limited attention to price.

• The industry's product has little effect on the buyer's other costs. Here, buyers focus on price. Conversely, where an industry's product or service can pay for itself many times over by improving performance or reducing labor, material, or other costs, buyers are usually more interested in quality than in price. Examples include products and services like tax accounting or well logging (which measures below-ground conditions of oil wells) that can save or even make the buyer money. Similarly, buyers tend not to be price sensitive in services such as investment banking, where poor performance can be costly and embarrassing.

Most sources of buyer power apply equally to consumers and to business-to-business customers. Like industrial customers, consumers tend to be more price sensitive if they are purchasing products that are undifferentiated, expensive relative to their incomes, and of a sort where product performance has limited consequences. The major difference with consumers is that their needs can be more intangible and harder to quantify.

Intermediate customers, or customers who purchase the product but are not the end user (such as assemblers or distribution channels), can be analyzed the same way as other buyers, with one important addition. Intermediate customers gain significant bargaining power when they can influence the purchasing decisions of customers downstream. Consumer electronics retailers, jewelry retailers, and agricultural-equipment distributors are examples of distribution channels that exert a strong influence on end customers.

Producers often attempt to diminish channel clout through exclusive arrangements with particular distributors or retailers or by marketing directly to end users. Component manufacturers seek to develop power over assemblers by creating preferences for their components with downstream customers. Such is the case with bicycle parts and with sweeteners. DuPont has created enormous clout by advertising its Stainmaster brand of carpet fibers not only to the carpet manufacturers that actually buy them but also to downstream consumers. Many consumers request Stainmaster carpet even though DuPont is not a carpet manufacturer.

THE THREAT OF SUBSTITUTES. A substitute performs the same or a similar function as an industry's product by a different means. Videoconferencing is a substitute for travel. Plastic is a substitute for aluminum. E-mail is a substitute for express mail. Sometimes, the threat of substitution is downstream or indirect, when a substitute replaces a buyer industry's product. For example, lawn-care products and services are threatened when multifamily homes in urban areas substitute for single-family homes in the suburbs. Software sold to agents is threatened when airline and travel websites substitute for travel agents.

Substitutes are always present, but they are easy to overlook because they may appear to be very different from the industry's product: To someone searching for a Father's Day gift, neckties and power tools may be substitutes. It is a substitute to do without, to purchase a used product rather than a new one, or to do it yourself (bring the service or product in-house).

When the threat of substitutes is high, industry profitability suffers. Substitute products or services limit an industry's profit potential by placing a ceiling on prices. If an industry does not distance itself from substitutes through product performance, marketing, or other means, it will suffer in terms of profitability – and often growth potential.

Substitutes not only limit profits in normal times, they also reduce the bonanza an industry can reap in good times. In emerging economies, for example, the surge in demand for wired telephone lines has been capped as many consumers opt to make a mobile telephone their first and only phone line.

The threat of a substitute is high if:

• It offers an attractive price-performance trade-off to the industry's product. The better the relative value of the substitute, the tighter is the lid on an industry's profit potential. For example, conventional providers of long-distance telephone service have suffered from the advent of inexpensive internet-based phone services such as Vonage and Skype. Similarly, video rental outlets are struggling with the emergence of cable and satellite video-on-demand services, online video rental services such as Netflix, and the rise of internet video sites like Google's YouTube.

• The buyer's cost of switching to the substitute is low. Switching from a proprietary, branded drug to a generic drug usually involves minimal costs, for example, which is why the shift to generics (and the fall in prices) is so substantial and rapid.

Strategists should be particularly alert to changes in other industries that may make them attractive substitutes when they were not before. Improvements in plastic materials, for example, allowed them to substitute for steel in many automobile components. In this way, technological changes or competitive discontinuities in seemingly unrelated businesses can have major impacts on industry profitability. Of course the substitution threat can also shift in favor of an industry, which bodes well for its future profitability and growth potential.

RIVALRY AMONG EXISTING COMPETITORS. Rivalry among existing competitors takes many familiar forms, including price discounting, new product introductions, advertising campaigns, and service improvements. High rivalry limits the profitability of an industry. The degree to which rivalry drives down an industry's profit potential depends, first, on the *intensity* with which companies compete and, second, on the *basis* on which they compete.

The intensity of rivalry is greatest if:

• Competitors are numerous or are roughly equal in size and power. In such situations, rivals find it hard to avoid poaching business. Without an industry leader, practices desirable for the industry as a whole go unenforced.

• Industry growth is slow. Slow growth precipitates fights for market share.

• Exit barriers are high. Exit barriers, the flip side of entry barriers, arise because of such things as highly specialized assets or management's devotion to a particular business. These barriers keep companies in the market even though they may be earning low or negative returns. Excess capacity remains in use, and the profitability of healthy competitors suffers as the sick ones hang on.

• Rivals are highly committed to the business and have aspirations for leadership, especially if they have goals that go beyond economic performance in the particular industry. High commitment to a business arises for a variety of reasons. For example, state-owned competitors may have goals that include employment or prestige. Units of larger companies may participate in an industry for image reasons or to offer a full line. Clashes of personality and ego have sometimes exaggerated rivalry to the detriment of profitability in fields such as the media and high technology.

• Firms cannot read each other's signals well because of lack of familiarity with one another, diverse approaches to competing, or differing goals.

The strength of rivalry reflects not just the intensity of competition but also the basis of competition. The *dimensions* on which competition takes place, and whether rivals converge to compete on the *same dimensions*, have a major influence on profitability.

Rivalry is especially destructive to profitability if it gravitates solely to price because price competition transfers profits directly from an industry to its customers.

Rivalry is especially destructive to profitability if it gravitates solely to price because price competition transfers profits directly from an industry to its customers. Price cuts are usually easy for competitors to see and match, making successive rounds of retaliation likely. Sustained price competition also trains customers to pay less attention to product features and service.

Price competition is most liable to occur if:

• Products or services of rivals are nearly identical and there are few switching costs for buyers. This encourages competitors to cut prices to win new customers. Years of airline price wars reflect these circumstances in that industry.

• Fixed costs are high and marginal costs are low. This creates intense pressure for competitors to cut prices below their average costs, even close to their marginal costs, to steal incremental customers while still making some contribution to covering fixed costs. Many basic-materials businesses, such as paper and aluminum, suffer from this problem, especially if demand is not growing. So do delivery companies with fixed networks of routes that must be served regardless of volume.

• Capacity must be expanded in large increments to be efficient. The need for large capacity expansions, as in the polyvinyl chloride business, disrupts the industry's supply-demand balance and often leads to long and recurring periods of overcapacity and price cutting.

• The product is perishable. Perishability creates a strong temptation to cut prices and sell a product while it still has value. More products and services are perishable than is commonly thought. Just as tomatoes are perishable because they rot, models of computers are perishable because they soon become obsolete, and information may be perishable if it diffuses rapidly or becomes outdated, thereby losing its value. Services such as hotel accommodations are perishable in the sense that unused capacity can never be recovered.

Competition on dimensions other than price – on product features, support services, delivery time, or brand image, for instance – is less likely to erode profitability because it improves customer value and can support higher prices. Also, rivalry focused on such dimensions can improve value relative to substitutes or raise the barriers facing new entrants. While nonprice rivalry sometimes escalates to levels that undermine industry profitability, this is less likely to occur than it is with price rivalry.

As important as the dimensions of rivalry is whether rivals compete on the *same* dimensions. When all or many competitors aim to meet the same needs or compete on the same attributes, the result is zero-sum competition. Here, one firm's gain is often another's loss, driving down profitability. While price competition runs a stronger risk than nonprice competition of becoming zero sum, this may not happen if companies take care to segment their markets, targeting their low-price offerings to different customers.

Rivalry can be positive sum, or actually increase the average profitability of an industry, when each competitor aims to serve the needs of different customer segments, with different mixes of price, products, services, features, or brand identities. Such competition can not only support higher average profitability but also expand the industry, as the needs of more customer groups are better met. The opportunity for positive-sum competition will be greater in industries serving diverse customer groups. With a clear understanding of the structural underpinnings of rivalry, strategists can sometimes take steps to shift the nature of competition in a more positive direction.

Factors, Not Forces

Industry structure, as manifested in the strength of the five competitive forces, determines the industry's long-run profit potential because it determines how the economic value created by the industry is divided – how much is retained by companies in the industry versus bargained away by customers and suppliers, limited by substitutes, or constrained by potential new entrants. By considering all five forces, a strategist keeps overall structure in mind instead of gravitating to any one element. In addition, the strategist's attention remains focused on structural conditions rather than on fleeting factors.

It is especially important to avoid the common pitfall of mistaking certain visible attributes of an industry for its underlying structure. Consider the following:

Industry growth rate. A common mistake is to assume that fast-growing industries are always attractive. Growth does tend to mute rivalry, because an expanding pie offers opportunities for all competitors. But fast growth can put suppliers in a powerful position, and high growth with low entry barriers will draw in entrants. Even without new entrants, a high growth rate will not guarantee profitability if customers are powerful or substitutes are attractive. Indeed, some fast-growth businesses, such as personal computers, have been among the least profitable industries in recent years. A narrow focus on growth is one of the major causes of bad strategy decisions.

Technology and innovation. Advanced technology or innovations are not by themselves enough to make an industry structurally attractive (or unattractive). Mundane, low-technology industries with price-insensitive buyers, high switching costs, or high entry barriers arising from scale economies are often far more profitable than sexy industries, such as software and internet technologies, that attract competitors.[2]

Government. Government is not best understood as a sixth force because government involvement is neither inherently good nor bad for industry profitability. The best way to understand the influence of government on competition is to analyze how specific government policies affect the five competitive forces. For instance, patents raise barriers to entry, boosting industry profit potential. Conversely, government policies favoring unions may raise supplier power and diminish profit potential. Bankruptcy rules that allow failing companies to reorganize rather than exit can lead to excess capacity and intense rivalry. Government operates at multiple levels and through many different policies, each of which will affect structure in different ways.

Complementary products and services. Complements are products or services used together with an industry's product. Complements arise when the customer benefit of two products combined is greater than the sum of each product's value in isolation. Computer hardware and software, for instance, are valuable together and worthless when separated.

In recent years, strategy researchers have highlighted the role of complements, especially in high-technology industries where they are most obvious.[3] By no means, however, do complements appear only there. The value of a car, for example, is greater when the driver also has access to gasoline stations, roadside assistance, and auto insurance.

Complements can be important when they affect the overall demand for an industry's product. However, like government policy, complements are not a sixth force determining industry profitability since the presence of strong complements is not necessarily bad (or good) for industry profitability. Complements affect profitability through the way they influence the five forces.

The strategist must trace the positive or negative influence of complements on all five forces to ascertain their impact on profitability. The presence of complements can raise or lower

Industry Analysis in Practice

Good industry analysis looks rigorously at the structural underpinnings of profitability. A first step is to understand the appropriate time horizon. One of the essential tasks in industry analysis is to distinguish temporary or cyclical changes from structural changes. A good guideline for the appropriate time horizon is the full business cycle for the particular industry. For most industries, a three-to-five-year horizon is appropriate, although in some industries with long lead times, such as mining, the appropriate horizon might be a decade or more. It is average profitability over this period, not profitability in any particular year, that should be the focus of analysis.

The point of industry analysis is not to declare the industry attractive or unattractive but to understand the underpinnings of competition and the root causes of profitability. As much as possible, analysts should look at industry structure quantitatively, rather than be satisfied with lists of qualitative factors. Many elements of the five forces can be quantified: the percentage of the buyer's total cost accounted for by the industry's product (to understand buyer price sensitivity); the percentage of industry sales required to fill a plant or operate a logistical network of efficient scale (to help assess barriers to entry); the buyer's switching cost (determining the inducement an entrant or rival must offer customers).

The strength of the competitive forces affects prices, costs, and the investment required to compete; thus the forces are directly tied to the income statements and balance sheets of industry participants. Industry structure defines the gap between revenues and costs. For example, intense rivalry drives down prices or elevates the costs of marketing, R&D, or customer service, reducing margins. How much? Strong suppliers drive up input costs. How much? Buyer power lowers prices or elevates the costs of meeting buyers' demands, such as the requirement to hold more inventory or provide financing. How much? Low barriers to entry or close substitutes limit the level of sustainable prices. How much? It is these economic relationships that sharpen the strategist's understanding of industry competition.

Finally, good industry analysis does not just list pluses and minuses but sees an industry in overall, systemic terms. Which forces are underpinning (or constraining) today's profitability? How might shifts in one competitive force trigger reactions in others? Answering such questions is often the source of true strategic insights.

barriers to entry. In application software, for example, barriers to entry were lowered when producers of complementary operating system software, notably Microsoft, provided tool sets making it easier to write applications. Conversely, the need to attract producers of complements can raise barriers to entry, as it does in video game hardware.

The presence of complements can also affect the threat of substitutes. For instance, the need for appropriate fueling stations makes it difficult for cars using alternative fuels to substitute for conventional vehicles. But complements can also make substitution easier. For example, Apple's iTunes hastened the substitution from CDs to digital music.

Complements can factor into industry rivalry either positively (as when they raise switching costs) or negatively (as when they neutralize product differentiation). Similar analyses can be done for buyer and supplier power. Sometimes companies compete by altering conditions in complementary industries in their favor, such as when videocassette-recorder producer JVC persuaded movie studios to favor its standard in issuing prerecorded tapes even though rival Sony's standard was probably superior from a technical standpoint.

Identifying complements is part of the analyst's work. As with government policies or important technologies, the strategic significance of complements will be best understood through the lens of the five forces.

Changes in Industry Structure

So far, we have discussed the competitive forces at a single point in time. Industry structure proves to be relatively stable, and industry profitability differences are remarkably persistent over time in practice. However, industry structure is constantly undergoing modest adjustment – and occasionally it can change abruptly.

Shifts in structure may emanate from outside an industry or from within. They can boost the industry's profit potential or reduce it. They may be caused by changes in technology, changes in customer needs, or other events. The five competitive forces provide a framework for identifying the most important industry developments and for anticipating their impact on industry attractiveness.

Shifting threat of new entry. Changes to any of the seven barriers described above can raise or lower the threat of new entry. The expiration of a patent, for instance, may unleash new entrants. On the day that Merck's patents for the cholesterol reducer Zocor expired, three pharmaceutical makers entered the market for the drug. Conversely, the proliferation of products in the ice cream industry has gradually filled up the limited freezer space in grocery stores, making it harder for new ice cream makers to gain access to distribution in North America and Europe.

Strategic decisions of leading competitors often have a major impact on the threat of entry. Starting in the 1970s, for example, retailers such as Wal-Mart, Kmart, and Toys "R" Us began to adopt new procurement, distribution, and inventory control technologies with large fixed costs, including automated distribution centers, bar coding, and point-of-sale terminals. These investments increased the economies of scale and made it more difficult for small retailers to enter the business (and for existing small players to survive).

Changing supplier or buyer power. As the factors underlying the power of suppliers and buyers change with time, their clout rises or declines. In the global appliance industry, for instance, competitors including Electrolux, General Electric, and Whirlpool have been squeezed by the consolidation of retail channels (the decline of appliance specialty stores, for instance, and the rise of big-box retailers like Best Buy and Home Depot in the United States). Another example is travel agents, who depend on airlines as a key supplier. When the internet allowed airlines to sell tickets directly to customers, this significantly increased their power to bargain down agents' commissions.

Shifting threat of substitution. The most common reason substitutes become more or less threatening over time is that advances in technology create new substitutes or shift price-performance comparisons in one direction or the other. The earliest microwave ovens, for example, were large and priced above $2,000, making them poor substitutes for conventional ovens. With technological advances, they became serious substitutes. Flash computer memory has improved enough recently to become a meaningful substitute for low-capacity hard-disk drives. Trends in the availability or performance of complementary producers also shift the threat of substitutes.

New bases of rivalry. Rivalry often intensifies naturally over time. As an industry matures, growth slows. Competitors become more alike as industry conventions emerge, technology diffuses, and consumer tastes converge. Industry profitability falls, and weaker competitors are driven from the business. This story has played out in industry after industry; televisions, snowmobiles, and telecommunications equipment are just a few examples.

A trend toward intensifying price competition and other forms of rivalry, however, is by no means inevitable. For example, there has been enormous competitive activity in the U.S. casino industry in recent decades, but most of it has been positive-sum competition directed toward new niches and geographic segments (such as riverboats, trophy properties, Native American reservations, international expansion, and novel customer groups like families). Head-to-head rivalry that lowers prices or boosts the payouts to winners has been limited.

The nature of rivalry in an industry is altered by mergers and acquisitions that introduce new capabilities and ways of competing. Or, technological innovation can reshape rivalry. In the retail brokerage industry, the advent of the internet lowered marginal costs and reduced differentiation, triggering far more intense competition on commissions and fees than in the past.

In some industries, companies turn to mergers and consolidation not to improve cost and quality but to attempt to stop intense competition. Eliminating rivals is a risky strategy, however. The five competitive forces tell us that a profit windfall from removing today's competitors often attracts new competitors and backlash from customers and suppliers. In New York banking, for example, the 1980s and 1990s saw escalating consolidations of commercial and savings banks, including Manufacturers Hanover, Chemical, Chase, and Dime Savings. But today the retail-banking landscape of Manhattan is as diverse as ever, as new entrants such as Wachovia, Bank of America, and Washington Mutual have entered the market.

Implications for Strategy

Understanding the forces that shape industry competition is the starting point for developing strategy. Every company should already know what the average profitability of its industry is and how that has been changing over time. The five forces reveal *why* industry profitability is what it is. Only then can a company incorporate industry conditions into strategy.

The forces reveal the most significant aspects of the competitive environment. They also provide a baseline for sizing up a company's strengths and weaknesses: Where does the company stand versus buyers, suppliers, entrants, rivals, and substitutes? Most importantly, an understanding of industry structure guides managers toward fruitful possibilities for strategic action, which may include any or all of the following: positioning the company to better cope with the current competitive forces; anticipating and exploiting shifts in the forces; and shaping the balance of forces to create a new in-

Eliminating rivals is a risky strategy. A profit windfall from removing today's competitors often attracts new competitors and backlash from customers and suppliers.

Using the five forces framework, creative strategists may be able to spot an industry with a good future before this good future is reflected in the prices of acquisition candidates.

dustry structure that is more favorable to the company. The best strategies exploit more than one of these possibilities.

Positioning the company. Strategy can be viewed as building defenses against the competitive forces or finding a position in the industry where the forces are weakest. Consider, for instance, the position of Paccar in the market for heavy trucks. The heavy-truck industry is structurally challenging. Many buyers operate large fleets or are large leasing companies, with both the leverage and the motivation to drive down the price of one of their largest purchases. Most trucks are built to regulated standards and offer similar features, so price competition is rampant. Capital intensity causes rivalry to be fierce, especially during the recurring cyclical downturns. Unions exercise considerable supplier power. Though there are few direct substitutes for an 18-wheeler, truck buyers face important substitutes for their services, such as cargo delivery by rail.

In this setting, Paccar, a Bellevue, Washington–based company with about 20% of the North American heavy-truck market, has chosen to focus on one group of customers: owner-operators – drivers who own their trucks and contract directly with shippers or serve as subcontractors to larger trucking companies. Such small operators have limited clout as truck buyers. They are also less price sensitive because of their strong emotional ties to and economic dependence on the product. They take great pride in their trucks, in which they spend most of their time.

Paccar has invested heavily to develop an array of features with owner-operators in mind: luxurious sleeper cabins, plush leather seats, noise-insulated cabins, sleek exterior styling, and so on. At the company's extensive network of dealers, prospective buyers use software to select among thousands of options to put their personal signature on their trucks. These customized trucks are built to order, not to stock, and delivered in six to eight weeks. Paccar's trucks also have aerodynamic designs that reduce fuel consumption, and they maintain their resale value better than other trucks. Paccar's roadside assistance program and IT-supported system for distributing spare parts reduce the time a truck is out of service. All these are crucial considerations for an owner-operator. Customers pay Paccar a 10% premium, and its Kenworth and Peterbilt brands are considered status symbols at truck stops.

Paccar illustrates the principles of positioning a company within a given industry structure. The firm has found a portion of its industry where the competitive forces are weaker – where it can avoid buyer power and price-based rivalry. And it has tailored every single part of the value chain to cope well with the forces in its segment. As a result, Paccar has been profitable for 68 years straight and has earned a long-run return on equity above 20%.

In addition to revealing positioning opportunities within an existing industry, the five forces framework allows companies to rigorously analyze entry and exit. Both depend on answering the difficult question: "What is the potential of this business?" Exit is indicated when industry structure is poor or declining and the company has no prospect of a superior positioning. In considering entry into a new industry, creative strategists can use the framework to spot an industry with a good future before this good future is reflected in the prices of acquisition candidates. Five forces analysis may also reveal industries that are not necessarily attractive for the average entrant but in which a company has good reason to believe it can surmount entry barriers at lower cost than most firms or has a unique ability to cope with the industry's competitive forces.

Exploiting industry change. Industry changes bring the opportunity to spot and claim promising new strategic positions if the strategist has a sophisticated understanding of the competitive forces and their underpinnings. Consider, for instance, the evolution of the music industry during the past decade. With the advent of the internet and the digital distribution of music, some analysts predicted the birth of thousands of music labels (that is, record companies that develop artists and bring their music to market). This, the analysts argued, would break a pattern that had held since Edison invented the phonograph: Between three and six major record companies had always dominated the industry. The internet would, they predicted, remove distribution as a barrier to entry, unleashing a flood of new players into the music industry.

A careful analysis, however, would have revealed that physical distribution was not the crucial barrier to entry. Rather, entry was barred by other benefits that large music labels enjoyed. Large labels could pool the risks of developing new artists over many bets, cushioning the impact of inevitable failures. Even more important, they had advantages in breaking through the clutter and getting their new artists heard. To do so, they could promise radio stations and record stores access to well-known artists in exchange for promotion of new artists. New labels would find this nearly impossible to match. The major labels stayed the course, and new music labels have been rare.

This is not to say that the music industry is structurally unchanged by digital distribution. Unauthorized downloading created an illegal but potent substitute. The labels tried for years to develop technical platforms for digital distribution themselves, but major companies hesitated to sell their music through a platform owned by a rival. Into this vacuum stepped Apple with its iTunes music store, launched in 2003 to support its iPod music player. By permitting the creation of a powerful new gatekeeper, the major labels allowed industry structure to shift against them. The number of major record companies has actually declined – from six in 1997 to four today – as companies struggled to cope with the digital phenomenon.

When industry structure is in flux, new and promising competitive positions may appear. Structural changes open up new needs and new ways to serve existing needs. Established leaders may overlook these or be constrained by past strategies from pursuing them. Smaller competitors in the industry can capitalize on such changes, or the void may well be filled by new entrants.

Shaping industry structure. When a company exploits structural change, it is recognizing, and reacting to, the inevitable. However, companies also have the ability to shape industry structure. A firm can lead its industry toward new ways of competing that alter the five forces for the better. In reshaping structure, a company wants its competitors to follow so that the entire industry will be transformed. While many industry participants may benefit in the process, the innovator can benefit most if it can shift competition in directions where it can excel.

An industry's structure can be reshaped in two ways: by redividing profitability in favor of incumbents or by expanding the overall profit pool. Redividing the industry pie aims to increase the share of profits to industry competitors instead of to suppliers, buyers, substitutes, and keeping out potential entrants. Expanding the profit pool involves increasing the overall pool of economic value generated by the industry in which rivals, buyers, and suppliers can all share.

Redividing profitability. To capture more profits for industry rivals, the starting point is to determine which force or forces are currently constraining industry profitability and address them. A company can potentially influence all of the competitive forces. The strategist's goal here is to reduce the share of profits that leak to suppliers, buyers, and substitutes or are sacrificed to deter entrants.

To neutralize supplier power, for example, a firm can standardize specifications for parts to make it easier to switch among suppliers. It can cultivate additional vendors, or alter technology to avoid a powerful supplier group altogether. To counter customer power, companies may expand services that raise buyers' switching costs or find alternative means of reaching customers to neutralize powerful channels. To temper profit-eroding price rivalry, companies can invest more heavily in unique products, as pharmaceutical firms have done, or expand support services to customers. To scare off entrants, incumbents can elevate the fixed cost of competing – for instance, by escalating their R&D or marketing expenditures. To limit the threat of substitutes, companies can offer better value through new features or wider product accessibility. When soft-drink producers introduced vending machines and convenience store channels, for example, they dramatically improved the availability of soft drinks relative to other beverages.

Sysco, the largest food-service distributor in North America, offers a revealing example of how an industry leader can change the structure of an industry for the better. Food-service distributors purchase food and related items from farmers and food processors. They then warehouse and deliver these items to restaurants, hospitals, employer cafeterias, schools, and other food-service institutions. Given low barriers to entry, the food-service distribution industry has historically been highly fragmented, with numerous local competitors. While rivals try to cultivate customer relationships, buyers are price sensitive because food represents a large share of their costs. Buyers can also choose the substitute approaches of purchasing directly from manufacturers or using retail sources, avoiding distributors altogether. Suppliers wield bargaining power: They are often large companies with strong brand names that food preparers and consumers recognize. Average profitability in the industry has been modest.

Sysco recognized that, given its size and national reach, it might change this state of affairs. It led the move to introduce private-label distributor brands with specifications tailored to the food-service market, moderating supplier power. Sysco emphasized value-added services to buyers such as

Faced with pressures to gain market share or enamored with innovation for its own sake, managers can spark new kinds of competition that no incumbent can win.

credit, menu planning, and inventory management to shift the basis of competition away from just price. These moves, together with stepped-up investments in information technology and regional distribution centers, substantially raised the bar for new entrants while making the substitutes less attractive. Not surprisingly, the industry has been consolidating, and industry profitability appears to be rising.

Industry leaders have a special responsibility for improving industry structure. Doing so often requires resources that only large players possess. Moreover, an improved industry structure is a public good because it benefits every firm in the industry, not just the company that initiated the improvement. Often, it is more in the interests of an industry leader than any other participant to invest for the common good because leaders will usually benefit the most. Indeed, improving the industry may be a leader's most profitable strategic opportunity, in part because attempts to gain further market share can trigger strong reactions from rivals, customers, and even suppliers.

There is a dark side to shaping industry structure that is equally important to understand. Ill-advised changes in competitive positioning and operating practices can *undermine* industry structure. Faced with pressures to gain market share or enamored with innovation for its own sake, managers may

Defining the Relevant Industry

Defining the industry in which competition actually takes place is important for good industry analysis, not to mention for developing strategy and setting business unit boundaries. Many strategy errors emanate from mistaking the relevant industry, defining it too broadly or too narrowly. Defining the industry too broadly obscures differences among products, customers, or geographic regions that are important to competition, strategic positioning, and profitability. Defining the industry too narrowly overlooks commonalities and linkages across related products or geographic markets that are crucial to competitive advantage. Also, strategists must be sensitive to the possibility that industry boundaries can shift.

The boundaries of an industry consist of two primary dimensions. First is the *scope of products or services*. For example, is motor oil used in cars part of the same industry as motor oil used in heavy trucks and stationary engines, or are these different industries? The second dimension is *geographic scope*. Most industries are present in many parts of the world. However, is competition contained within each state, or is it national? Does competition take place within regions such as Europe or North America, or is there a single global industry?

The five forces are the basic tool to resolve these questions. If industry structure for two products is the same or very similar (that is, if they have the same buyers, suppliers, barriers to entry, and so forth), then the products are best treated as being part of the same industry. If industry structure differs markedly, however, the two products may be best understood as separate industries.

In lubricants, the oil used in cars is similar or even identical to the oil used in trucks, but the similarity largely ends there. Automotive motor oil is sold to fragmented, generally unsophisticated customers through numerous and often powerful channels, using extensive advertising. Products are packaged in small containers and logistical costs are high, necessitating local production. Truck and power generation lubricants are sold to entirely different buyers in entirely different ways using a separate supply chain. Industry structure (buyer power, barriers to entry, and so forth) is substantially different. Automotive oil is thus a distinct industry from oil for truck and stationary engine uses. Industry profitability will differ in these two cases, and a lubricant company will need a separate strategy for competing in each area.

Differences in the five competitive forces also reveal the geographic scope of competition. If an industry has a similar structure in every country (rivals, buyers, and so on), the presumption is that competition is global, and the five forces analyzed from a global perspective will set average profitability. A single global strategy is needed. If an industry has quite different structures in different geographic regions, however, each region may well be a distinct industry. Otherwise, competition would have leveled the differences. The five forces analyzed for each region will set profitability there.

The extent of differences in the five forces for related products or across geographic areas is a matter of degree, making industry definition often a matter of judgment. A rule of thumb is that where the differences in any one force are large, and where the differences involve more than one force, distinct industries may well be present.

Fortunately, however, even if industry boundaries are drawn incorrectly, careful five forces analysis should reveal important competitive threats. A closely related product omitted from the industry definition will show up as a substitute, for example, or competitors overlooked as rivals will be recognized as potential entrants. At the same time, the five forces analysis should reveal major differences within overly broad industries that will indicate the need to adjust industry boundaries or strategies.

trigger new kinds of competition that no incumbent can win. When taking actions to improve their own company's competitive advantage, then, strategists should ask whether they are setting in motion dynamics that will undermine industry structure in the long run. In the early days of the personal computer industry, for instance, IBM tried to make up for its late entry by offering an open architecture that would set industry standards and attract complementary makers of application software and peripherals. In the process, it ceded ownership of the critical components of the PC – the operating system and the microprocessor – to Microsoft and Intel. By standardizing PCs, it encouraged price-based rivalry and shifted power to suppliers. Consequently, IBM became the temporarily dominant firm in an industry with an enduringly unattractive structure.

Expanding the profit pool. When overall demand grows, the industry's quality level rises, intrinsic costs are reduced, or waste is eliminated, the pie expands. The total pool of value available to competitors, suppliers, and buyers grows. The total profit pool expands, for example, when channels become more competitive or when an industry discovers latent buyers for its product that are not currently being served. When soft-drink producers rationalized their independent bottler networks to make them more efficient and effective, both the soft-drink companies and the bottlers benefited. Overall value can also expand when firms work collaboratively with suppliers to improve coordination and limit unnecessary costs incurred in the supply chain. This lowers the inherent cost structure of the industry, allowing higher profit, greater demand through lower prices, or both. Or, agreeing on quality standards can bring up industrywide quality and service levels, and hence prices, benefiting rivals, suppliers, and customers.

Expanding the overall profit pool creates win-win opportunities for multiple industry participants. It can also reduce the risk of destructive rivalry that arises when incumbents attempt to shift bargaining power or capture more market share. However, expanding the pie does not reduce the importance of industry structure. How the expanded pie is divided will ultimately be determined by the five forces. The most successful companies are those that expand the industry profit pool in ways that allow them to share disproportionately in the benefits.

Defining the industry. The five competitive forces also hold the key to defining the relevant industry (or industries) in which a company competes. Drawing industry boundaries correctly, around the arena in which competition actually takes place, will clarify the causes of profitability and the appropriate unit for setting strategy. A company needs a separate strategy for each distinct industry. Mistakes in industry definition made by competitors present opportunities for staking out superior strategic positions. (See the sidebar "Defining the Relevant Industry.")

Typical Steps in Industry Analysis

Define the relevant industry:

- What products are in it? Which ones are part of another distinct industry?
- What is the geographic scope of competition?

Identify the participants and segment them into groups, if appropriate:

Who are

- the buyers and buyer groups?
- the suppliers and supplier groups?
- the competitors?
- the substitutes?
- the potential entrants?

Assess the underlying drivers of each competitive force to determine which forces are strong and which are weak and why.

Determine overall industry structure, and test the analysis for consistency:

- *Why* is the level of profitability what it is?
- Which are the *controlling* forces for profitability?
- Is the industry analysis consistent with actual long-run profitability?
- Are more-profitable players better positioned in relation to the five forces?

Analyze recent and likely future changes in each force, both positive and negative.

Identify aspects of industry structure that might be influenced by competitors, by new entrants, or by your company.

Common Pitfalls

In conducting the analysis avoid the following common mistakes:

- Defining the industry too broadly or too narrowly.
- Making lists instead of engaging in rigorous analysis.
- Paying equal attention to all of the forces rather than digging deeply into the most important ones.
- Confusing effect (price sensitivity) with cause (buyer economics).
- Using static analysis that ignores industry trends.
- Confusing cyclical or transient changes with true structural changes.
- Using the framework to declare an industry attractive or unattractive rather than using it to guide strategic choices.

Competition and Value

The competitive forces reveal the drivers of industry competition. A company strategist who understands that competition extends well beyond existing rivals will detect wider competitive threats and be better equipped to address them. At the same time, thinking comprehensively about an industry's structure can uncover opportunities: differences in customers, suppliers, substitutes, potential entrants, and rivals that can become the basis for distinct strategies yielding superior performance. In a world of more open competition and relentless change, it is more important than ever to think structurally about competition.

Understanding industry structure is equally important for investors as for managers. The five competitive forces reveal whether an industry is truly attractive, and they help investors anticipate positive or negative shifts in industry structure before they are obvious. The five forces distinguish short-term blips from structural changes and allow investors to take advantage of undue pessimism or optimism. Those companies whose strategies have industry-transforming potential become far clearer. This deeper thinking about competition is a more powerful way to achieve genuine investment success than the financial projections and trend extrapolation that dominate today's investment analysis.

If both executives and investors looked at competition this way, capital markets would be a far more effective force for company success and economic prosperity. Executives and investors would both be focused on the same fundamentals that drive sustained profitability. The conversation between investors and executives would focus on the structural, not the transient. Imagine the improvement in company performance – and in the economy as a whole – if all the energy expended in "pleasing the Street" were redirected toward the factors that create true economic value.

1. For a discussion of the value chain framework, see Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (The Free Press, 1998).

2. For a discussion of how internet technology improves the attractiveness of some industries while eroding the profitability of others, see Michael E. Porter, "Strategy and the Internet" (HBR, March 2001).

3. See, for instance, Adam M. Brandenburger and Barry J. Nalebuff, *Co-opetition* (Currency Doubleday, 1996).

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To order, see page 139.

"Do you have to barge into my office every day and talk about work?"

P.C. Vey

What Really Works

> "The whole purpose of systems and structures is to help normal people who behave in normal ways to complete routine jobs successfully, day after day. It's not exciting or glamorous. But that's management."

John P. Kotter
"What Leaders Really Do"
Harvard Business Review
May–June 1990

"My management secret? I never let on when the cat's away."

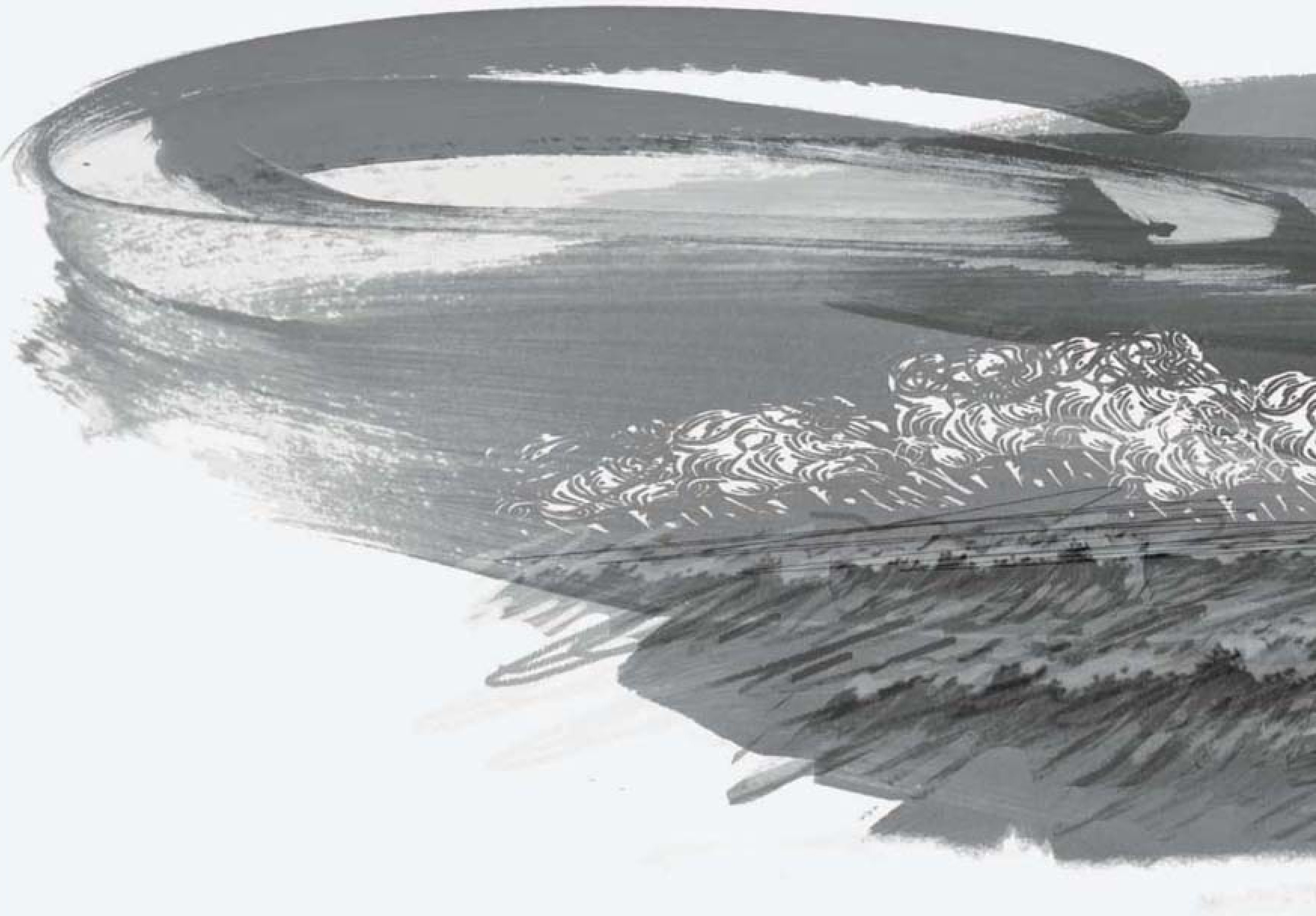
"If the negotiations start going sour, give them the cake."

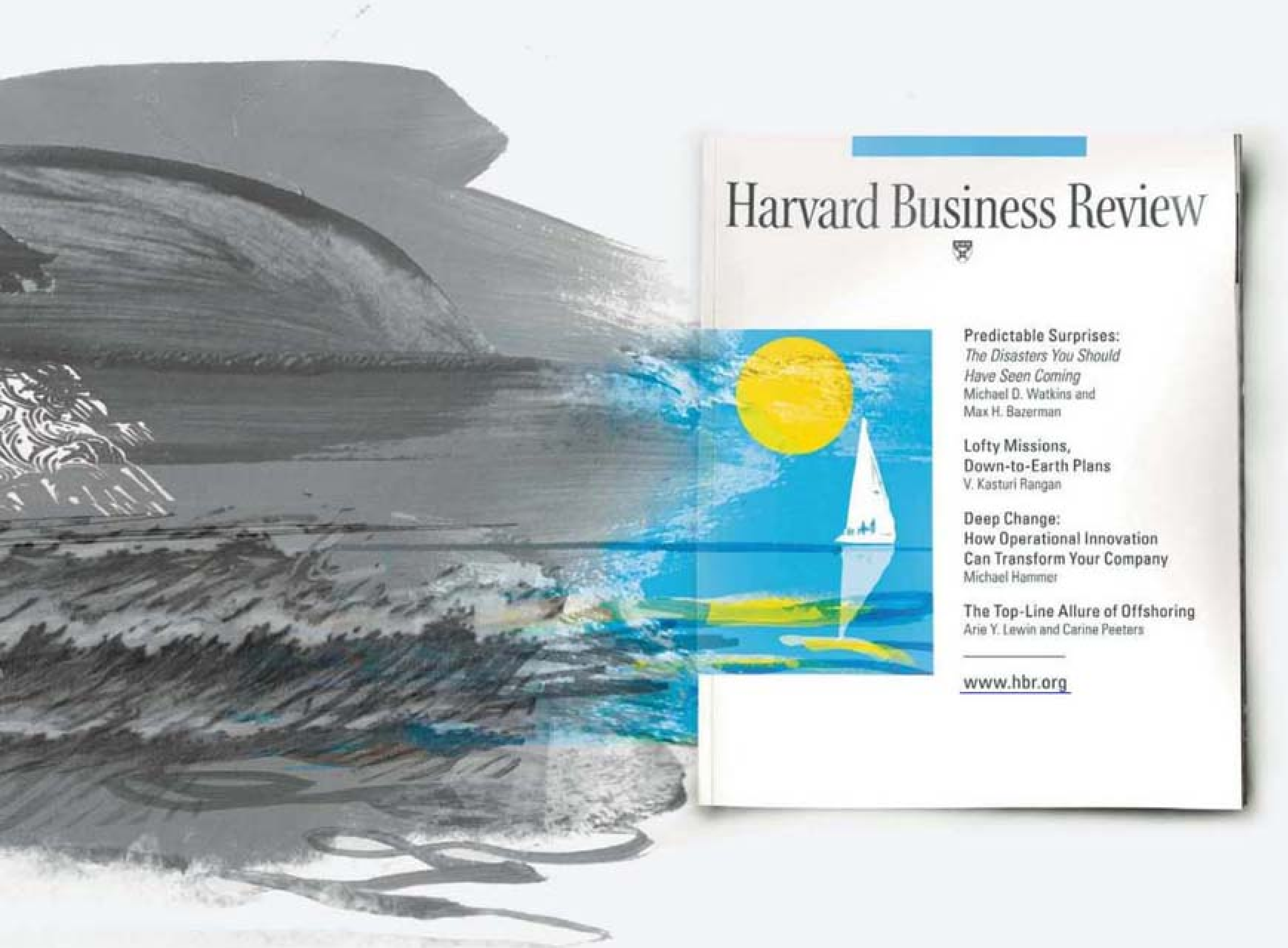
John Caldwell, Patrick Hardin, Scott Arthur Masear, and P.C. Vey

When CEOs dream

"To be honest, we're looking for a CEO with more gravitas."

"What is it you'd like to know about incentives, my son?"





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Innovation Killers

How Financial Tools Destroy Your Capacity to Do New Things

by Clayton M. Christensen, Stephen P. Kaufman, and Willy C. Shih

FOR YEARS WE'VE BEEN PUZZLING about why so many smart, hardworking managers in well-run companies find it impossible to innovate successfully. Our investigations have uncovered a number of culprits, which we've discussed in earlier books and articles. These include paying too much attention to the company's most profitable customers (thereby leaving less-demanding customers at risk) and creating new products that don't help customers do the jobs they want to do. Now we'd like to name the misguided application of three financial-analysis

Stephen Webster

tools as an accomplice in the conspiracy against successful innovation. We allege crimes against these suspects:

- The use of discounted cash flow (DCF) and net present value (NPV) to evaluate investment opportunities causes managers to underestimate the real returns and benefits of proceeding with investments in innovation.
- The way that fixed and sunk costs are considered when evaluating future investments confers an unfair advantage on challengers and shackles incumbent firms that attempt to respond to an attack.
- The emphasis on earnings per share as the primary driver of share price and hence of shareholder value creation, to the exclusion of almost everything else, diverts resources away from investments whose payoff lies beyond the immediate horizon.

These are not bad tools and concepts, we hasten to add. But the way they are commonly wielded in evaluating investments creates a systematic bias against innovation. We will recommend alternative methods that, in our experience, can help managers innovate with a much more astute eye for future value. Our primary aim, though, is simply to bring these concerns to light in the hope that others with deeper expertise may be inspired to examine and resolve them.

Misapplying Discounted Cash Flow and Net Present Value

The first of the misleading and misapplied tools of financial analysis is the method of discounting cash flow to calculate the net present value of an initiative. Discounting a future stream of cash flows into a "present value" assumes that a rational investor would be indifferent to having a dollar today or to receiving some years from now a dollar plus the interest or return that could be earned by investing that dollar for those years. With that as an operating principle, it makes perfect sense to assess investments by dividing the money to be received in future years by $(1 + r)^n$, where r is the discount rate – the annual return from investing that money – and n is the number of years during which the investment could be earning that return.

While the mathematics of discounting is logically impeccable, analysts commonly commit two errors that create an anti-innovation bias. The first error is to assume that the base case of not investing in the innovation – the do-nothing scenario against which cash flows from the innovation are compared – is that the present health of the company will persist indefinitely into the future if the investment is not made. As shown in the exhibit "The DCF Trap," the mathematics considers the investment in isolation and compares the present value of the innovation's cash stream less project costs with the cash stream in the absence of the investment, which is assumed to be unchanging. In most situations, however, competitors' sustaining and disruptive investments over time result in price and margin pressure, technology changes, market share losses, sales volume decreases, and a declining stock price. As Eileen Rudden at Boston Consulting Group pointed out, the most likely stream of cash for the company in the do-nothing scenario is not a continuation of the status quo. It is a nonlinear decline in performance.

It's tempting but wrong to assess the value of a proposed investment by measuring whether it will make us better off than we are now. It's wrong because, if things are deteriorating on their own, we might be worse off than we are now after we make the proposed investment but better off than we would have been without it. Philip Bobbitt calls this logic Parmenides' Fallacy, after the ancient Greek logician who claimed to have proved that conditions in the real world must necessarily be unchanging. Analysts who attempt to distill the value of an innovation into one simple number that they can compare with other simple numbers are generally trapped by Parmenides' Fallacy.

The projected value of an innovation must be assessed against a range of scenarios, the most realistic of which is often a deteriorating competitive and financial future.

It's hard to accurately forecast the stream of cash from an investment in innovation. It is even more difficult to forecast the extent to which a firm's financial performance may deteriorate in the absence of the investment. But this analysis must be done. Remember the response that good economists are taught to offer to the question "How are you?" It is "Relative to what?" This is a crucial question. Answering it entails assessing the projected value of the innovation against a range of scenarios, the most realistic of which is often a deteriorating competitive and financial future.

The second set of problems with discounted cash flow calculations relates to errors of estimation. Future cash

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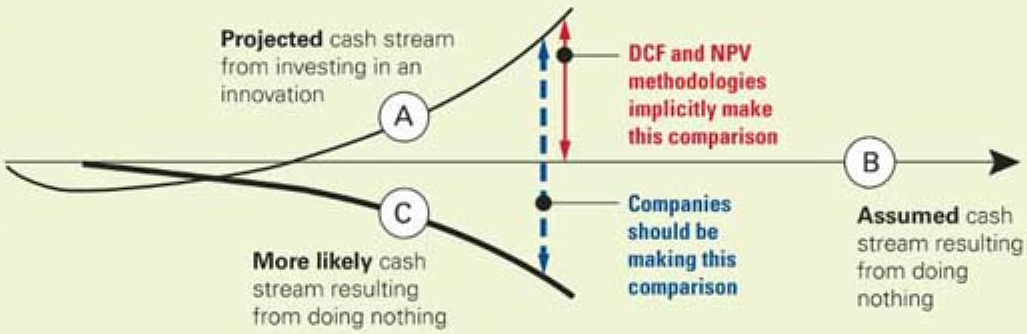
The DCF Trap

Most executives compare the cash flows from innovation against the default scenario of doing nothing, assuming – incorrectly – that the present health of the company will persist indefinitely if the investment is not made. For a better assessment of the innovation's value, the comparison should be between its projected discounted cash flow and the more likely scenario of a decline in performance in the absence of innovation investment.



flows, especially those generated by disruptive investments, are difficult to predict. Numbers for the "out years" can be a complete shot in the dark. To cope with what cannot be known, analysts often project a year-by-year stream of numbers for three to five years and then "punt" by calculating a terminal value to account for everything thereafter. The logic, of course, is that the year-to-year estimates for distant years are so imprecise as to be no more accurate than a terminal value. To calculate a terminal value, analysts divide the cash to be generated in the last year for which they've done a specific estimate by $(r - g)$, the discount rate minus the projected growth rate in cash flows from that time on. They then discount that single number back to the present. In our experience, assumed terminal values often account for more than half of a project's total NPV.

Terminal value numbers, based as they are on estimates for preceding years, tend to amplify errors contained in early-year assumptions. More worrisome still, terminal value doesn't allow for the scenario testing that we described above – contrasting the result of this investment with the deterioration in performance that is the most likely result of doing nothing. And yet, because of market inertia, competitors' development cycles, and the typical pace of disruption, it is often in the fifth year or beyond – the point at which terminal value factors in – that the decline of the enterprise in the do-nothing scenario begins to accelerate.

Arguably, a root cause of companies' persistent underinvestment in the innovations required to sustain long-term success is the indiscriminate and oversimplified use of NPV as an analytical tool. Still, we understand the desire to quantify streams of cash that defy quantification and then to distill those streams into a single number that can be compared with other single numbers: It is an attempt to translate cacophonous articulations of the future into a language – numbers – that everyone can read and compare. We hope to show that numbers are not the only language into which the value of future investments can be translated – and that there are, in fact, other, better languages that all members of a management team can understand.

Using Fixed and Sunk Costs Unwisely

The second widely misapplied paradigm of financial decision making relates to fixed and sunk costs. When evaluating a future course of action, the argument goes, managers should consider only the future or marginal cash outlays (either capital or expense) that are required for an innovation investment, subtract those outlays from the marginal cash that is likely to flow in, and discount the resulting net flow to the present. As with the paradigm of DCF and NPV, there is nothing wrong with the mathematics of this principle – as long as the capabilities required for yesterday's success are adequate for tomorrow's as well. When new capabilities are required for future success, however, this margining on fixed and sunk costs biases managers toward leveraging assets and capabilities that are likely to become obsolete.

For the purposes of this discussion we'll define fixed costs as those whose level is independent of the level of output. Typical fixed costs include general and administrative costs: salaries and benefits, insurance, taxes, and so on. (Variable costs include things like raw materials, commissions, and pay to temporary workers.) Sunk costs are those portions of fixed costs that are irrevocably committed, typically including investments in buildings and capital equipment and R&D costs.

An example from the steel industry illustrates how fixed and sunk costs make it difficult for companies that can and should invest in new capabilities actually to do so. In the late 1960s, steel minimills such as Nucor and Chaparral began disrupting integrated steelmakers such as U.S. Steel (USX), picking off customers in the least-demanding product tiers of each market and then moving relentlessly upmarket, using their 20% cost advantage to capture first the rebar market and then the bar and rod, angle iron, and structural beam markets. By 1988 the minimills had driven the higher-cost integrated mills out of lower-tier products, and Nucor had begun building its first minimill to roll sheet steel in Crawfordsville, Indiana. Nucor estimated that for an investment of $260 million it could sell 800,000 tons of steel annually at a price of $350 per ton. The cash cost to produce a ton of sheet steel in the Crawfordsville mill would be $270. When the timing of cash flows was taken into account, the internal rate of return to Nucor on this investment was over 20% – substantially higher than Nucor's weighted average cost of capital.

Incumbent USX recognized that the minimills constituted a grave threat. Using a new technology called continuous strip production, Nucor had now entered the sheet steel market, albeit with an inferior-quality product, at a significantly lower cost per ton. And Nucor's track record of vigilant improvement meant that the quality of its sheet steel would improve with production experience. Despite this understanding, USX engineers did not even consider building a greenfield minimill like the one Nucor built. The reason? It seemed more profitable to leverage the old technology than to create the new. USX's existing mills, which used traditional technology, had 30% excess capacity, and the marginal cash cost of producing an extra ton of steel by leveraging that excess capacity was less than $50 per ton. When USX's financial analysts contrasted the marginal cash flow of $300 ($350 revenue minus the $50 marginal cost) with the average cash flow of $80 per ton in a greenfield mill, investment in a new low-cost minimill made no sense. What's more, USX's plants were depreciated, so the marginal cash flow of $300 on a low asset base looked very attractive.

And therein lies the rub. Nucor, the attacker, had no fixed or sunk cost investments on which to do a marginal cost calculation. To Nucor, the full cost was the marginal cost. Crawfordsville was the only choice on its menu – and because the IRR was attractive, the decision was simple. USX, in contrast, had two choices on its menu: It could build a greenfield plant like Nucor's with a lower average cost per ton or it could utilize more fully its existing facility.

So what happened? Nucor has continued to improve its process, move upmarket, and gain market share with more efficient continuous strip production capabilities, while USX has relied on the capabilities that had been built to succeed in the past. USX's strategy to maximize marginal profit, in other words, caused the company not to minimize long-term average costs. As a result, the company is locked into an escalating cycle of commitment to a failing strategy.

The attractiveness of any investment can be completely assessed only when it is compared with the attractiveness of the right alternatives on a menu of investments. When a company is looking at adding capacity that is identical to existing capacity, it makes sense to compare the marginal cost of leveraging the old with the full cost of creating the new. But when new technologies or capabilities are required for future competitiveness, margining on the past will send you down the wrong path. The argument that investment decisions should be based on marginal costs is always correct. But when creating new capabilities is the issue, the relevant marginal cost is actually the full cost of creating the new.

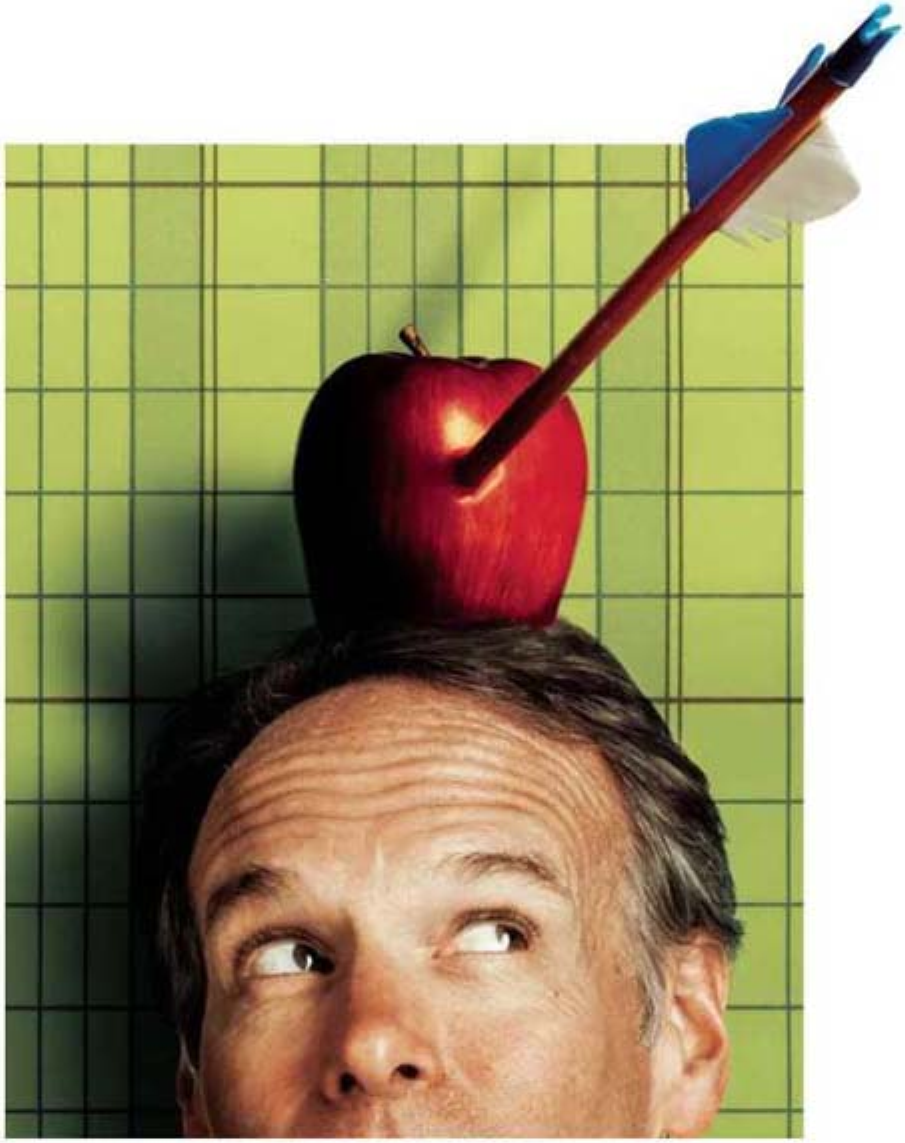
Knowing that the equity markets will punish them for a write-off of obsolete assets, managers may stall in adopting new technology.

When we look at fixed and sunk costs from this perspective, several anomalies we have observed in our studies of innovation are explained. Executives in established companies bemoan how expensive it is to build new brands and develop new sales and distribution channels – so they seek instead to leverage their existing brands and structures. Entrants, in contrast, simply create new ones. The problem for the incumbent isn't that the challenger can outspend it; it's that the challenger is spared the dilemma of having to choose between full-cost and marginal-cost options. We have repeatedly observed leading, established companies misapply fixed-and-sunk-cost doctrine and rely on assets and capabilities that were forged in the past to succeed in the future. In doing so, they fail to make the same investments that entrants and attackers find to be profitable.

A related misused financial practice that biases managers against investment in needed future capabilities is that of using a capital asset's estimated *usable* lifetime as the period over which it should be depreciated. This causes problems when the asset's usable lifetime is longer than its *competitive* lifetime. Managers who depreciate assets according to the more gradual schedule of usable life often face massive write-offs when those assets become competitively obsolete and need to be replaced with newer-technology assets. This was the situation confronting the integrated steelmakers. When building new capabilities entails writing off the old, incumbents face a hit to quarterly earnings that disruptive entrants to the industry do not. Knowing that the equity markets will punish them for a write-off, managers may stall in adopting new technology.

This may be part of the reason for the dramatic increase in private equity buyouts over the past decade and the recent surge of interest in technology-oriented industries. As disruptions continue to shorten the competitive lifetime of major investments made only three to five years ago, more companies find themselves needing to take asset write-downs or to significantly restructure their business models. These are wrenching changes that are often made more easily and comfortably outside the glare of the public markets.

What's the solution to this dilemma? Michael Mauboussin at Legg Mason Capital Management suggests it is to value *strategies,* not projects. When an attacker is gaining ground, executives at the incumbent companies need to do their investment analyses in the same way the attackers do – by focusing on the strategies that will ensure long-term competitiveness. This is the only way they can see the world as the attackers see it and the only way they can predict the consequences of not investing.



No manager would consciously decide to destroy a company by leveraging the competencies of the past while ignoring those required for the future. Yet this is precisely what many of them do. They do it because strategy and finance were taught as separate topics in business school. Their professors of financial modeling alluded to the importance of strategy, and their strategy professors occasionally referred to value creation, but little time was spent on a thoughtful integration of the two. This bifurcation persists in most companies, where responsibilities for strategy and finance reside in the realms of different vice presidents. Because a firm's actual strategy is defined by the stream of projects in which it does or doesn't invest, finance and strategy need to be studied and practiced in an integrated way.

Focusing Myopically on Earnings per Share

A third financial paradigm that leads established companies to underinvest in innovation is the emphasis on earnings per share as the primary driver of share price and hence of shareholder value creation. Managers are under so much pressure, from various directions, to focus on short-term stock performance that they pay less attention to the company's long-term health than they might – to the point where they're reluctant to invest in innovations that don't pay off immediately.

Where's the pressure coming from? To answer that question, we need to look briefly at the principal-agent theory – the doctrine that the interests of shareholders (principals) aren't aligned with those of managers (agents). Without powerful financial incentives to focus the interests of principals and agents on maximizing shareholder value, the thinking goes, agents will pursue other agendas – and in the process, may neglect to pay enough attention to efficiencies or squander capital investments on pet projects – at the expense of profits that ought to accrue to the principals.

That conflict of incentives has been taught so aggressively that the compensation of most senior executives in publicly traded companies is now heavily weighted away from salaries and toward packages that reward improvements in share price. That in turn has led to an almost singular focus on earnings per share and EPS growth as *the* metric for corporate performance. While we all recognize the importance of other indicators such as market position, brands, intellectual capital, and long-term competitiveness, the bias is toward using a simple quantitative indicator that is easily compared period to period and across companies. And because EPS growth is an important driver of near-term share price improvement, managers are biased against investments that will compromise near-term EPS. Many decide instead to use the excess cash on the balance sheet to buy back the company's stock under the guise of "returning money to shareholders." But although contracting the number of shares pumps up earnings per share, sometimes quite dramatically, it does nothing to enhance the underlying value of the enterprise and may even damage it by restricting the flow of cash available for investment in potentially disruptive products and business models. Indeed, some have fingered share-price-based incentive compensation packages as a key driver of the share price manipulation that captured so many business headlines in the early 2000s.

The myopic focus on EPS is not just about the money. CEOs and corporate managers who are more concerned with their reputations than with amassing more wealth also focus on stock price and short-term performance measures such as quarterly earnings. They know that, to a large extent, others' perception of their success is tied up in those numbers, leading to a self-reinforcing cycle of obsession. This behavior cycle is amplified when there is an "earnings surprise." Equity prices over the short term respond positively to upside earnings surprises (and negatively to downside surprises), so investors have no incentive to look at rational measures of long-term performance. To the contrary, they are rewarded for going with the market's short-term model.

The active leveraged buyout market has further reinforced the focus on EPS. Companies that are viewed as having failed to maximize value, as evidenced by a lagging share price, are vulnerable to overtures from outsiders, including corporate raiders or hedge funds that seek to increase their near-term stock price by putting a company into play or by replacing the CEO. Thus, while the past two decades have witnessed a dramatic increase in the proportion of CEO compensation tied to stock price – and a breathtaking increase in CEO compensation overall – they have witnessed a concomitant decrease in the average tenure of CEOs. Whether you believe that CEOs are most motivated by the carrot (major increases in compensation and wealth) or the stick (the threat of the company being sold or of being replaced), you should not be surprised to find so many CEOs focused on current earnings per share as the best predictor of stock price, sometimes to the exclusion of anything else. One study even showed that senior executives were routinely willing to sacrifice long-term shareholder value to meet earnings expectations or to smooth reported earnings.

We suspect that the principal-agent theory is misapplied. Most traditional principals – by which we mean shareholders – don't themselves have incentives to watch out for the long-term health of a company. Over 90% of the shares of publicly traded companies in the United States are held in the portfolios of mutual funds, pension funds, and hedge funds. The average holding period for stocks in these portfolios is less than 10 months – leading us to prefer the term "share owner" as a more accurate description than "shareholder." As for agents, we believe that most executives work tirelessly, throwing their hearts and minds into their jobs, not because they are paid an incentive to do so but because they love what they do. Tying executive compensation to stock prices, therefore, does not affect the intensity or energy or intelligence with which executives perform. But it does direct their efforts toward activities whose impact can be felt within the holding horizon of the typical share owner and within the measurement horizon of the incentive – both of which are less than one year.

Ironically, most so-called principals today are themselves agents – agents of other people's mutual funds, investment portfolios, endowments, and retirement programs. For these agents, the enterprise in which they are investing has no inherent interest or value beyond providing a platform for improving the short-term financial metric by which their fund's performance is measured and their own compensation is determined. And, in a final grand but sad irony, the real principals (the people who put their money into mutual funds and pension plans, sometimes through yet another layer of agents) are frequently the very individuals whose long-term employment is jeopardized when the focus on short-term EPS acts to restrict investments in innovative growth opportunities. We suggest that the principal-agent theory is obsolete in this context. What we really have is an *agent-agent* problem, where the desires and goals of the agent for the share owners compete with the desires and goals of the agents running the company. The incentives are still misaligned, but managers should not capitulate on the basis of an obsolete paradigm.

Processes That Support (or Sabotage) Innovation

As we have seen, managers in established corporations use analytical methods that make innovation investments extremely difficult to justify. As it happens, the most common system for green-lighting investment projects only reinforces the flaws inherent in the tools and dogmas discussed earlier.

Stage-gate innovation. Most established companies start by considering a broad range of possible innovations; they winnow out the less viable ideas, step by step, until only the most promising ones remain. Most such processes include three stages: feasibility, development, and launch. The stages are separated by stage gates: review meetings at which project teams report to senior managers what they've accomplished. On the basis of this progress and the project's potential, the gatekeepers approve the passage of the initiative into the next phase, return it to the previous stage for more work, or kill it.

Many marketers and engineers regard the stage-gate development process with disdain. Why? Because the key decision criteria at each gate are the size of projected revenues and profits from the product and the associated risks. Revenues from products that incrementally improve upon those the company is currently selling can be credibly quantified. But proposals to create growth by exploiting potentially disruptive technologies, products, or business models can't be bolstered by hard numbers. Their markets are initially small, and substantial revenues generally don't materialize for several years. When these projects are pitted against incremental sustaining innovations in the battle for funding, the incremental ones sail through while the seemingly riskier ones get delayed or die.

The process itself has two serious drawbacks. First, project teams generally know how good the projections (such as NPV) need to look in order to win funding, and it takes only nanoseconds to tweak an assumption and run another full scenario to get a faltering project over the hurdle rate. If, as is often the case, there are eight to 10 assumptions underpinning the financial model, changing only a few of them by a mere 2% or 3% each may do the trick. It is then difficult for the senior managers who sit as gatekeepers to even discern which are the salient assumptions, let alone judge whether they are realistic.

The second drawback is that the stage-gate system assumes that the proposed strategy is the right strategy. Once an innovation has been approved, developed, and launched, all that remains is skillful execution. If, after launch, a product falls seriously short of the projections (and 75% of them do), it is canceled. The problem is that, except in the case of incremental innovations, the right strategy – especially which job the customer wants done – cannot be completely known in advance. It must emerge and then be refined.

The stage-gate system is not suited to the task of assessing innovations whose purpose is to build new growth businesses, but most companies continue to follow it simply because they see no alternative.

Discovery-driven planning. Happily, though, there are alternative systems specifically designed to support intelligent investments in future growth. One such process, which Rita Gunther McGrath and Ian MacMillan call *discovery-driven planning,* has the potential to greatly improve the success rate. Discovery-driven planning essentially reverses the sequence of some of the steps in the stage-gate process. Its logic is elegantly simple. If the project teams all know how good the numbers need to look in order to win funding, why go through the charade of making and revising assumptions in order to fabricate an acceptable set of numbers? Why not just put the minimally acceptable revenue, income, and cash flow statement as the standard first page of the gate documents? The second page can then raise the critical issues: "Okay. So we all know this is how good the numbers need to look. What set of assumptions must prove true in order for these numbers to materialize?" The project team creates from that analysis an assumptions checklist – a list of things that need to prove true for the project to succeed. The items on the checklist are rank-ordered, with the deal killers and the assumptions that can be tested with little expense toward the top. McGrath and MacMillan call this a "reverse income statement."

When a project enters a new stage, the assumptions checklist is used as the basis of the project plan for that stage. This is not a plan to execute, however. It is a plan to *learn* – to test as quickly and at as low a cost as possible whether the assumptions upon which success is predicated are actually valid. If a critical assumption proves not to be valid, the project team must revise its strategy until the assumptions upon which it is built are all plausible. If no set of plausible assumptions will support the case for success, the project is killed.

More often than not, failure in innovation is rooted in not having asked an important question, rather than in having arrived at an incorrect answer.

Traditional stage-gate planning obfuscates the assumptions and shines the light on the financial projections. But there is no need to focus the analytical spotlight on the numbers, because the desirability of attractive numbers has never been the question. Discovery-driven planning shines a spotlight on the place where senior management needs illumination – the assumptions that constitute the key uncertainties. More often than not, failure in innovation is rooted in not having asked an important question, rather than in having arrived at an incorrect answer.

Today, processes like discovery-driven planning are more commonly used in entrepreneurial settings than in the large corporations that desperately need them. We hope that by recounting the strengths of one such system we'll persuade established corporations to reassess how they make decisions about investment projects.

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We keep rediscovering that the root reason for established companies' failure to innovate is that managers don't have good tools to help them understand markets, build brands, find customers, select employees, organize teams, and develop strategy. Some of the tools typically used for financial analysis, and decision making about investments, distort the value, importance, and likelihood of success of investments in innovation. There's a better way for management teams to grow their companies. But they will need the courage to challenge some of the paradigms of financial analysis and the willingness to develop alternative methodologies.

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To order, see page 139.

GIVING GREAT ADVICE

Interview by Thomas A. Stewart and Gardiner Morse

Few deal makers have been at it as long, and at such a high level, as Lazard's CEO. Here's how he unlocks value in people, companies, and industries.

LAST SPRING, Bruce Wasserstein received Harvard Law School's 2007 Great Negotiator Award, joining a select group that includes Sadako Ogata, a former United Nations high commissioner for refugees, and George Mitchell, the former U.S. senator who led the peace talks in Northern Ireland. In presenting the award, Harvard Business School professor James Sebenius cited in particular the masterful deal making that went into Wasserstein's 2005 coup at Lazard, in which he famously disassembled a century and a half of family ownership and took the fractious M&A and financial advisory firm public. By many accounts, Lazard's IPO is among the most complex transactions Wasserstein has navigated – and indeed he keeps the nine bound volumes detailing the deal prominently displayed in his spacious New York office.

Andrew Kist

But Lazard's IPO is just one of a multitude of big deals that Wasserstein has crafted over the decades. A graduate of Harvard's business and law schools and Cambridge University, he's been a major figure in negotiation and mergers and acquisitions for over 30 years. He has helped broker more than a thousand deals, worth hundreds of billions of dollars, as an attorney at Cravath, Swaine & Moore; as cohead of First Boston's M&A practice in the late 1970s and most of the 1980s; as CEO of the investment-banking firm Wasserstein Perella Group in the late 1980s and the 1990s; and currently as chairman and CEO of Lazard. In 2006, the most recent calendar year for which complete data are available, Lazard's closed deals had a total value of more than $300 billion.

That's a lot of money. But, more to the point, it represents a lot of value. HBR's editor, Thomas A. Stewart, and senior editor Gardiner Morse spent many hours at Lazard and interviewed Wasserstein, setting out to understand how he creates value as a manager, as a deal maker, and as a counselor to CEOs. How does he attract and manage talent, build and sustain knowledge businesses, size up companies and industries, and craft advice? Partly, the answers lie in his sheer and subtle brainpower; those who've worked closely with him will tell you that he's among the smartest people – or perhaps the smartest person – they know. But it's also how he combines intellect with an idiosyncratic creativity and doggedness (Wasserstein once said to a colleague, "I thought about this last night while I was sleeping") that allows him to disassemble the most complex problems and devise novel solutions. With characteristic economy, Wasserstein describes his approach as discovering whether a deal or strategy "makes sense." Such sensemaking seems to underlie every move he makes, and it has paid off handsomely. Following is an edited presentation of HBR's conversations with Wasserstein.

You've always seen deal making as a kind of problem-solving game. Where did this approach come from, and how did it influence your early thinking about structuring an M&A advice business?

After I finished at Harvard, I studied at Cambridge University and wrote a thesis on British merger policy. When I joined Cravath, a New York law firm, I was therefore asked to focus on merger law. I worked on a lot of Wall Street deals, mostly asset acquisitions. These deals were very complicated and paper intensive. Not many people wanted to do them, because at the time public-offering work was more glamorous. But I liked doing them. I found them much more intellectually and creatively challenging.

> Your working assumption in a takeover, and in many mergers, is that **the top layer of management will be gone within a year.**

One of my clients was First Boston, which didn't have much of a merger business then – only a small group of generalists (who gave overall investment-banking advice to their corporate clients) that was supported by four young professionals. First Boston hired me to bring some technical depth and practical experience to the group. Its M&A business was generally slow, the deals were small, and the technology was primitive. The firm did only one or two deals a year at that time. So the questions were "How do we market the business?" and "What are we marketing?" and "How can we possibly compete with larger M&A businesses?" We decided first to execute deals really well and then to market that track record. Our competitors often delegated deal implementation to lawyers, which we felt was a mistake. We realized that understanding the nuances of deal terms and structure could have a tremendous financial impact.

Things were pretty dry for a while, but soon we had some breakthroughs, including a successful hostile offer. Since we had a small team, we gang-tackled problems. It was exhilarating. We gradually expanded the team and prioritized marketing targets. At first we simply approached the clients of other firms and said, "What you need is more attention and superior execution skills."

That was a good start, because the odds were that a percentage of those people were unhappy with the advice they'd been getting. But we had to think about the long-term strategy for our business. We decided to separate the M&A advice, which was a CEO business, from the financing advice, which was a treasurer or CFO business, and appeal directly to the CEOs in our marketing. That was a very different approach at the time.

We had to have some distinctive expertise to market, so we built up industry areas within M&A and set up local offices around the country. We also developed a "creative department." Its job was to think about the dynamics of industries and what changes within them would take place over the next five years. So when companies looked at their future, it was in the context of positioning themselves within a changing landscape rather than buying or selling a company by tomorrow. We also helped companies identify and focus on their hidden core strengths. For example, an international oil company might have potential in financial services because of its expertise in currencies and hedging.

Imitation is a form of both flattery and competition. Over the past decade, many investment-banking leaders have come out of that First Boston group, including my former partner, Joe Perella – and the diaspora of people who'd experienced this structure brought what they'd learned to wherever they landed.

Have you replicated or adapted this tripartite structure of industry expertise, creative capacity, and technical skills at Lazard?

The trend in investment banking now is toward industry specialization. There are very few people who divide their time between different industries and are generalists. What's good about specialization is that the advisers know their industries well. What's not so good is that in many firms the creative side has suffered, and it's harder for them to have a broad perspective and make conceptual connections between the dynamics in one industry and those in another. Also, implementation skills often apply across industries, but the specialists lack the breadth of deal skills you learn from working in different industries.

As the world gets more complicated, the ability of one small team or one person to do a deal is disappearing. So, what we try to do at Lazard is blend the two models, bringing together creative generalists and industry and regional specialists. Let's say we're advising a French company on buying a computer services firm in India. We'll bring in people with technology expertise, a local French banker, and someone with M&A experience in India.

At the same time, we're careful to preserve the broad perspective, to prevent thinking that's too compartmentalized. Our pharma people, for instance, were inspired by the advantages of scale that became apparent in the oil industry and drove its consolidation. Or if we're looking at, say, the roll-up of the cable television business, we're going to ask, "Is there an analogy with another industry, where the dynamics are similar?" If so, that industry is probably going to roll up as well. In that case, we should analyze what went right, what went wrong, and who did it well in cable, and figure out how to transport those lessons and advise firms in the other industry.

You have a reputation for thinking carefully about management structures. What's your approach at Lazard?

The key to running Lazard is recognizing that we have a clear brand personality: global, trustworthy, creative, smart, agile, focused on advice. It is the quintessential intellectual capital business. I spend a lot of time and thought on management, but I try to find people who are more gifted than I am to actually do the administering. We plan the structure of management to make sure it's consistent with our objectives. That's a central skill set of managing a business where the people are the product.

When I came to Lazard, it had a variety of counterproductive structures. One was what I called the cell-theory structure: You hire a banker. He or she has three assistants. They keep all their information to themselves, and they fight for revenue with other cells. Another was our fee-splitting system, which was well intentioned but caused undesirable behavior. If you were in Madrid and you worked with a banker in New York on a deal, you'd split the fees. Fair enough. But that led the bankers in Madrid to do the deals on their own. That system might have worked in the past, but it generally doesn't work now. Why? Because the world is so complex and interrelated that you lose your competitive advantage with that structure. It prevents the conceptual leaps I'm talking about. Lazard's competitive advantage is working on difficult, complex assignments, so having a very deep, global

When we do deals, I always ask, "Are the premises sound? Is the risk exposure worth it for this particular company, and have I protected my client's back?"

team is a necessity, especially in light of the impact that globalization has had on industries.

You've created extraordinary collections of highly talented people a number of times. How do you attract, motivate, and keep them?

You attract the people your system invites. If you create a bureaucratic system and have meetings every day at 8:00 AM and send a report card in at the end of the day, you may think, intuitively, that's good management. That works for some companies. But if I did that, I'd lose my best people – the people I want. We sacrifice some degree of efficiency by deliberately having a somewhat less centrally managed culture.

We've been very fortunate. Since I've been here, we have had a very low turnover rate. Our culture retains people who like the atmosphere – it's fun here. There's a lot of trust. Individuality and creativity are valued. People have a great deal of independence. And they get satisfaction from the visibility of their work, particularly people who came from major banks where they didn't have the same platform. While there's satisfaction, of course, in being paid well for your work, there's also satisfaction in finding elegant solutions that create value.

We're thought of principally as an M&A advice business, but what we do runs broader than that – and that breadth is another thing that helps us retain talented people. We advised on the restructuring of Eurotunnel. We're advising the UAW. We advise many of the governments in Europe and in a lot of other places around the world. We have a deliberate policy of working with finance ministries and other governmental and nongovernmental organizations to increase our knowledge and sophistication – but we also do it because our employees are happier when they're doing a good thing. For example, if you're in Belgium, and you're giving economic policy advice to the government, the firm is not getting paid much for that. But if you asked the people involved, they'd say Lazard's an asset for Belgium, which makes them proud of the company and happy with their jobs.

People also stay, I think, because we invest an enormous amount in developing the younger staff. Everyone gets a lot out of that. At the other end of the spectrum, if you look at our most senior people, many of us have worked together, on and off, for 10 to 30 years. That's pretty rare in this business, and it creates continuity.

How do you develop individual talent?

We have and want to attract a network of stars – people who communicate and cooperate but are entrepreneurial and stand out as quality individuals, who are not the cogs in a corporate machine. Quality people must be managed with customized approaches. The idea is to create a hothouse where young talent is nourished by our culture and people are encouraged to think creatively, think deeply, think about the long-term client relationship – but above all, think. I want them to reflect on what they are doing and why, and then wonder, "Can we do better?"

Management's role is to help them. It's an iterative process. Create an atmosphere where we can all teach one another and stimulate the imagination. Ideas are not hierarchical – they come from all levels – so allowing the talent of younger people to bubble up is our imperative. Our model also requires that senior managers lead by example – they are all "doers."

We've taken a similar approach in our asset-management business. As with our advisory business, we had to make Lazard a welcoming home for creative talent. The products were somewhat outdated, marketing needed more structure and focus, and generally we had underinvested. So we brought in some new leadership but also gave the veterans more freedom and responsibility. In particular, we promoted a new generation of talent and added depth to the investing function.

Soft language in a supposedly no-outs contract

In both investment banking and asset management, we think we have an advantage in creativity by understanding industry trends, global investment themes, and emerging markets. It's the same management philosophy.

Talk about the advice business. What are CEOs looking for as you're helping them understand the landscape? What do they need that you've got?

The point of advice is to create value. The first thing in that effort is not to assume the banker knows more than the client. The second thing is to remind the CEO that corporations have to change in order to prosper and that inaction isn't prudent – it's radical. What we can do is help the CEO think through an array of options, partly by asking the necessary questions, but also by inserting some very practical observations about the effects of specific decisions.

Good advice is at least as qualitative as it is quantitative. A firm may have people churning out reams of statistics, providing a detailed analysis showing margins of this company versus that company. But are they asking, "What's the point?"

In most cases, you start out with a personal question: What's the CEO's objective? A new CEO may have a very different objective than a CEO who wants a valedictory. If he wants a valedictory, why does he want it? Does he want to prove something? Does he want to show that he's created a platform for the future? How does he measure success? And how should he? Is he looking for an impact on his company, or an effect on his stock price? In the short term or in the longer term? How much time does he have? And, ultimately, you have to ask, how will pursuing his objectives benefit the company and its shareholders?

will live to haunt a deal.

A good banker can ask the right questions, marshal the arguments, highlight the risks, and detail the options from the financial market and practical implementation perspectives. On the one hand, the financing structure for any deal must give the CEO the flexibility to run the company in periods of difficulty. And part of that means you've got to help him look at his financing structure and ask, "What if things don't go well? What do I do, and will I be okay?"

On the other hand, there's the more qualitative part of the advice. This strikes me as being an underdeveloped side of most investment-banking relationships. Knowing the characteristics of the industry and possible consequences of a deal comes from having seen what's happened in many companies and industries over time. So, for example, you might say, "Look, you need a very different mentality to manage this type of business than your other businesses. You have a process-oriented mentality, but you need a more market-oriented approach. Are you confident that you're going to be able to keep the number-two guy in the company you're acquiring? Because the number-one guy will probably leave." Your working assumption in a takeover, and in many mergers, is that the top layer of management will be gone within a year. Implementation after a deal can be more important to its success than initial pricing.

You've talked about letting young talent bubble up. But when it comes to advising CEOs, what's the value of seniority?

Much of the ability to have these conversations with CEOs comes from the perspective you get from simply doing this for many years. You have experience observing and participating in the strategies of companies, and trying to relate that to what's happening in the capital markets, and you can bring it to bear on a particular CEO's problem.

You also realize, having been around the block, that there are lots of people in a company, all arguing for their own political interests or constituencies. Other advisers may be more interested in pushing the use of their proprietary Double Backflip bond than in the long-term interests of the client. And boards may have different tolerances for risk than chief executives do. Experience is useful when you're trying to help the CEO make sense of these sometimes conflicting interests.

Is the plan doable? Who else is going to be interested in it? What's the most efficient approach? What will the fallout of that be? Answering these questions depends on the ability to anticipate what's likely to happen and not happen. Often that insight comes from having seen this movie before. The actors may be a little different, but the odds are that the deal is going to play out a certain way. Ultimately, this is about making deals that make sense.

Deals that make sense. Can you elaborate on that?

Law school taught me to focus on dissecting premises. Anyone who's a good logician can build an argument on just about any premises. The argument may be taut, but the premises may be faulty. When we do deals, I always ask, "Are the premises sound? Is the risk exposure worth it for this particular company, and have I protected my client's back?" We proceed by identifying and evaluating qualitatively and quantitatively the key elements of risk in the transaction – overall economy risk, strategic risk, operating business risk, financing risk, people risk. Similarly, you need to fully understand the upsides. What are the opportunities in cost cuts, synergies, internal development, additional investments, or revenue enhancement? It's useful to apply all the paraphernalia of mathematical science in an analysis, but focusing on the sense of things is a much better use of time.

Part of determining the sense of a deal involves understanding the macroclimate, the broader context, which I think gets too little attention. Where is the industry going? What external factors will affect it? If you're looking at a plastics company: What's going to happen to the price of oil? If you're a cement company: How will the outcome of government elections affect things? That road bill is going to get passed if one candidate wins, but not if the other does. Recently we had conversations with a CEO who was looking at buying a company that makes doorknobs. It may have been a great company. But it didn't occur to him that many knobs are bought as replacements. Well, if people can't get mortgages, they can't do home improvements, and that affects the knob business.

Whether a deal makes sense relates directly to the question of the CEO's objectives, of course. Having an appreciation of the personality of your client, both the corporate personality and the individual personality, is key. In the case of the knob company, you'd ask the CEO, "If you acquired this company, what would you do with it?" You can't advise on the sense of this deal unless you really know what the plan would be. If Ace Hardware bought the knob company, it would do something completely different than Martha Stewart would.

Look at a deal through a prism, and you see one set of causes and effects. Turn the prism, and you get a different view. By repeatedly turning the prism and viewing the deal from all possible interrelating angles, you can determine if its premises are sound, what the risk exposure is, how to hedge risk, and what the opportunities are. It may make sense in one view but not another.

When you're examining a potential deal, how do you gauge general business conditions?

Well, that's the snake-in-the-tunnel problem.

The snake in the tunnel?

It's a metaphor people use when talking about monetary policy; it refers to currencies pegged to trading between two "bands" – a high price and a low price. If you draw the bands on a chart (one above the currency price, one below it), the chart looks like a snake going through a tunnel. I use the expression, misapplying the metaphor, because deals work the same way. There's an upper band and a lower band between which a deal makes sense. They are defined by factors like the state of the economy, the state of the industry, the region, the stage of the business cycle, the trajectory of interest rates, and the evolution of technology or regulations. You've got to understand where the bands are and what sets them there, and where the deal – the snake – lies between them. If someone wants to do a deal for 12 times EBITDA in a business where similar companies sell at, say, six to eight times, that person's probably making a mistake. But then again, context will affect where you set the bands. A deal worth six times EBITDA in the United States might be worth 10 times EBITDA in India.

Many people think of deals as a macho, one-on-one, zero-sum game. But they are multidimensional, because of the many constituencies involved.

How do you look at an industry and see what is coming two or three or four years out?

Some things are easy to see. Financial services will, over the next five years, become much more global. There will be more regional consolidation in Europe. It's almost inevitable there will be more consolidation of U.S. banks. If you're a financial services firm in Italy or Spain, you have a choice about whether you're going to be a major competitor or be squeezed by those that are. And the mission of many insurance companies will change as they vacillate between being primarily investors and being insurers. Some will end up doing one thing or the other.

It used to be that the place you went to insure against a hurricane was an insurance company. Now you might turn to hedge funds. A number of institutional investors are either buying catastrophe bonds or trading weather derivatives. Derivatives have now been created to help move all kinds of risk all around. So we're seeing a number of financial institutions redefining what their role is in the marketplace.

Technology is obviously transforming the news industry, where there's been a degree of consolidation already. We spend a lot of time on biotech here. And one thing that's clear is, the old big pharma business is evolving into a biotech-based product business, so the form of these companies will continue to change.

You'll see industries in India, Brazil, China, and the Middle East – and the regions themselves – taking more prominent positions in the world marketplace. The trend toward globalization is inevitable, so you have to ask, "What are the manifestations of that? What are the implications?" If you're a maker of railroad ties in the United States, your growth may become more linked to U.S. trade with China. Why are Chinese companies affecting the use of railroad ties? Because rail shipping volume's going up in the United States as trade increases with China.

You said that implementing deals, not just setting them up, is part of your competitive advantage. What's your execution process for a complex deal?

As the world becomes more integrated and more regulated, the implementation side of a deal requires more finesse. Some of this is counterintuitive. At an art auction with 10 bidders, holders three through eight feel wise because they've arrived at a general consensus. The two top bidders look like giddy high rollers, and the bottom two seem to lack a practical market feel. But, of course, only the top bidder buys the painting, and his judgment may turn out to have been right.

Similarly, in the deal business, to be a buyer you should have a conviction that is stronger than consensus. Good advice for one company may not be appropriate for another. When we say Lazard has a custom-tailored approach, we mean that we think about opportunities, including pricing, from the client's unique perspective. An asset price that's attractive to one buyer may not be a good opportunity for a company with different characteristics.

This idea is also reflected on the sale side. When we're presenting on a client's behalf to potential buyers, we tailor our presentations to suit each prospect. One may want to focus on cost synergies, another on opportunities in China.

We think of each deal in terms of a flow chart with a series of black boxes. Each box represents a facet of the deal – for example, valuation, financing structure, approach to the other party, negotiating tactics and deal process, taxes, legal structure, contracts, market reaction, and regulatory hurdles. Then we try to optimize within the boxes and weave the results into a cohesive recommendation. But each box affects the others: Soft language in a supposedly no-outs contract, for instance, will live to haunt a deal. So you have to keep going back to make adjustments.

Many people think of deals as a macho, one-on-one, zero-sum game. But deals are in fact multidimensional, because of the many constituencies – managers, boards, employees, shareholders, regulators, communities, and customers. Winning may not be about paying $1 more or less but about creating opportunities for the future, managing the target well after the closing, and not being unduly pressured by an inappropriate financing structure. And sometimes winning is not doing the deal at all.

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To order, see page 139.

"I get my best ideas in the shower."

Thomas Cheney

Michael Miller

Why Mentoring Matters in a Hypercompetitive World

Today's professional service firms are so busy making money that they've lost the art of making talent.

by Thomas J. DeLong, John J. Gabarro, and Robert J. Lees

AFTER 10 YEARS of rapid growth, Freedman-Miller, a midsize Seattle-based consulting firm, is in trouble. Junior and senior associate turnover is rising, and the firm is struggling to retain enough professionals to service existing clients, let alone acquire new ones. The loyal, cooperative culture that it enjoyed just five years ago has all but evaporated: Young professionals, seeing themselves as free agents, stay only until a choicer offer comes along. Others – women *and* men – are leaving to maintain work-life balance. Associates routinely complain that the partners don't invest time in helping them grow and develop. For their part, the partners wonder why they should spend so much energy teaching associates who will probably leave the firm anyway.

Freedman-Miller (not the firm's real name) is not alone. Over the past seven years, we have studied more than 30 professional service firms (PSFs) in depth: large, global, multifunction organizations, as well as small firms with fewer than 20 professionals. We found that many formerly modest-size outfits – including law firms, consulting firms, accounting firms, investment banks, marketing agencies, hospitals, money management firms, and universities – are becoming "corporatized" as they grow rapidly in size and complexity. Professionals are beginning to think they are merely cogs in a wheel. An onslaught of top-down imperatives for standard protocols, revenue and leverage targets, and compliance requirements is making partners feel overwhelmed, disenfranchised, and alienated. As one partner put it, "Once I no longer knew those associates we were making partners, I quit trying to create a climate of inclusion."

Article at a Glance

As professional service firms feel the burden of increasing competition, mentoring for junior professionals has fallen by the wayside, despite its promise for keeping attrition under control.

Successful leaders of PSFs build mentoring programs that are tailored not just for A players but also for B players, the solid citizens who make up 70% of PSFs. High fliers, like world-class athletes, need constant and constructive feedback. Solid citizens, who need less attention but still want to be included, thrive on cross-functional teams with A players.

Since mentors are in short supply, associates should learn from partners how to attract mentors, not just expect to be assigned one. In a world where partners sometimes mentor 20 or more associates, co-mentoring among juniors can play a critical role.

What can firms like Freedman-Miller do to reverse this damaging trend? We argue in these pages that, in order to survive, PSFs must revive mentoring, an institution that has been the chief casualty of hypercompetitiveness and rapid growth in these types of firms. Drawing on our research, we outline the principal issues PSFs will face as they develop mentoring strategies, and we show how some leading-edge firms have been coping.

Let's be clear: Reinventing the traditional mentoring model won't be easy. For starters, mentoring at PSFs doesn't lend itself to a systematized, corporate approach, because young professionals don't like systems and want personal treatment (see the sidebar "What Makes a Mentor"). Moreover, personal mentoring can't just be about the top 20% of your young hires: All the professionals in your firm need mentoring, customized to their individual needs, especially when assignment-based learning opportunities are limited. Last but not least, leaders of PSFs need to recognize that mentoring is a two-way street: Not only must partners mentor associates, but associates need to mentor one another.

Mentoring: A Casualty of Competition

The starkest reality of surviving in the professional service industry is that competition is fierce. In a world of eroding trade barriers in which companies compete on both scale and scope, corporations expect their professional service providers to make the journey with them. Many regional firms must now be global to adequately service major accounts, which has triggered relentless industry consolidation.

Witness the auditing profession, which over the last 10 years has become dominated by four large, global firms: PricewaterhouseCoopers, KPMG, Deloitte, and Ernst & Young. As these organizations grew, their portfolios of services and their client bases became increasingly similar. With fewer differentiators, competition starts to hinge on price and, to a certain degree, on flexibility in the face of client demands – with potentially disastrous effects. In addition, crises at Enron, WorldCom, and other firms have led to greater regulation in the form of the Sarbanes-Oxley Act of 2002, further increasing professional workloads and risks.

Not just in the accounting sector have keen competition and regulatory requirements placed huge demands on partners' time. Virtually every partner at an investment bank, law firm, or PR consulting firm is expected to be accountable for her time and her company's resources. That means doing more administrative work under greater scrutiny, which doesn't help morale. And because of globalization, partners are being asked to guide projects across many sites and functions simultaneously, with professionals who have never worked together before.

In the face of such pressure, something has had to give at PSFs, and it's been the mentoring process. Junior professionals joining a firm 20 years ago could count on the partners' treating them like protégés. There was an implicit agreement that a partner would teach a junior professional the ropes and guide her development within the organization. Today, partners in some PSFs are assigned as many as 20 associates to mentor, and relationships once based on covenants have become contractual. It's impossible for even the most people-oriented partners to develop a cadre of close associates while continuing to execute the business, manage projects, perform administrative functions, and sometimes run a special project for the managing partner.

The evidence of discontent in PSFs is both anecdotal and statistical. Everyone we spoke with over age 40 could name a mentor in his or her professional life, but younger people often could not. One young investment banker reflected, "Not only do I work out of a pool of associates with no real supervisor, but after all those months not one partner initiated something as small as a lunch. I know I'm responsible for my career, but the partners I see are obsessed with themselves and with hitting their numbers." It's no wonder, then, that the cumulative rate of law-firm attrition for the three-year period from 2004 through 2006 was 19%, the highest rate since the National Association for Law Placement (NALP) began conducting surveys about this a decade ago. The size of the firms is clearly an issue. NALP survey data show that attrition rates at law firms with fewer than 100 professionals are typically 50% lower than at firms with more than 500 professionals. Even the definition of a "small" law firm has changed: It was fewer than 50 professional employees in surveys conducted 10 years ago; now it's fewer than 100.

PSFs in most sectors cannot afford to endure such a high level of employee turnover. For one thing, every departing associate represents a real cost of finding a replacement and bringing her up to speed. Deloitte alone predicts that it needs to hire 50,000 professionals in the next five years just to keep up with normal demand and attrition. More important, though, professional services are people businesses: Competitive advantage depends less on the scale and scope of your services (given that your rivals are all large and diversified as well) than on the abilities and networks of your firm's professionals. PSFs that lack the collegiality and sense of genuine partnership they had in their early days will struggle to recruit – let alone retain – the talent they need to survive. Young professionals are still looking for mentors who can give them advice, encouragement, and space to grow.

Mentoring at professional service firms doesn't lend itself to a systematized, corporate approach, because young professionals want personal treatment.

The need for mentoring young professionals sounds obvious, even banal. Indeed, much of a PSF's attraction used to be its guild model of mentor and apprentice. However, as PSFs grew in size, mentors had to become managers – a role that's not a natural fit for most people who join PSFs. Companies like GE and Procter & Gamble tend to attract aspiring managers; professionals in PSFs, on the other hand, often disdain the duties of management. Therefore, leaders of PSFs are in a bind: If they promote a great producer to a leadership position, often she isn't very good at, or interested in, managing people; if they select an "also-ran" performer, she won't have the credibility to command authority. As a result, people problems fester, mentoring languishes, and PSF leaders turn to outsiders for help. The top 20 U.S. law firms, for example, are hiring

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What Makes a Mentor

To guage your mentoring skills, jot down some of the characteristics of your own best mentor. Our interviews with successful professionals have made clear that a good mentoring relationship is not just about career advancement. Again and again, our interviewees said that a good mentor...

- is someone absolutely credible whose integrity transcends the message, be it positive or negative
- tells you things you may not want to hear but leaves you feeling you have been heard
- interacts with you in a way that makes you want to become better
- makes you feel secure enough to take risks
- gives you the confidence to rise above your inner doubts and fears
- supports your attempts to set stretch goals for yourself
- presents opportunities and highlights challenges you might not have seen on your own

more HR leadership-development specialists (up from just 60 professionals seven years ago to over 300 today) to teach human relations, mentoring, and other skills. One such specialist told us, "I would have very little to do if partners would only pay attention to their people. I spend the majority of my time picking up after partners who have caused interpersonal problems or who have simply ignored some of their most basic responsibilities."

Now let's examine what it takes to build the basics of mentoring among your professional staff. We discuss four principles to use as guideposts in the brave new competitive world of professional services.

PRINCIPLE 1

Mentoring Is Personal

The notion that a standardized mentoring system will solve your problems is an illusion. Rewarding partners for engaging in prescribed interactions with subordinates simply doesn't work. When we discussed formalized mentoring with a partner at one PSF, he rolled his eyes and said, "Please, not another Mickey Mouse mentoring system. Do I really have to waste my time taking subordinates from some other department out to lunch? You have to be kidding." This kind of attitude surfaces when the mentoring process becomes a stylized charade devoid of any real learning.

The highly independent, achievement-driven personalities who become associates at PSFs distrust anything that feels like bureaucracy. They won't tolerate packaged mentorship; instead they want concrete, hands-on feedback from a senior professional who takes a personal interest in their careers. New associates demand some degree of predictability, but they are willing to work very hard. Like world-class athletes, professionals have an almost insatiable need to know how they are doing: the more able they are, the keener their need. One highly regarded mentor in a law firm reflected, "For some of my best performers, I have to tell them how well they are doing on Monday and again on Thursday. No amount of feedback is enough."

Leaders at PSFs need to pay attention not just to the quantity of feedback but also to how it's delivered. Experience has shown us that associates in PSFs are almost hardwired to smell the faintest trace of negative feedback. People drawn to PSFs are extraordinarily competitive. When these driven achievers join a firm, they track their own progress *and* that of the other associates. They notice who is assigned to whom, who gets the sexy projects, and who seems to be advancing. They are also constantly vigilant for indicators of how well they are doing, sometimes imagining signs that are not really there and seeing them as larger than life. Associates interpret any recognition, even a hello from a senior partner, as evidence of their status within the firm. Getting attention from a mentor becomes a vital way to compete.

Given how invested associates can be in even fleeting acknowledgments, more-substantive small gestures can go quite far. Sam, a practice group leader at Milbank, Tweed, Hadley & McCloy, took the time to acknowledge a third-year associate who, he did not realize, was ready to walk out the door. Sam casually tapped him on the shoulder to compliment the great work he heard the associate had done on a project. "Associates like you inspire me to be a better leader here," Sam told him. Later, the associate confided that the interaction left him "walking three feet off the ground for the rest of the day" and "glowing for a month." That little act, which took all of one minute, kept a frustrated high flier in the firm.

Partners must listen, inquire, and show interest. Ask an associate what kind of work she wants to do, where her passions lie, what skills she wants to develop. Don't leave this important job to human resources.

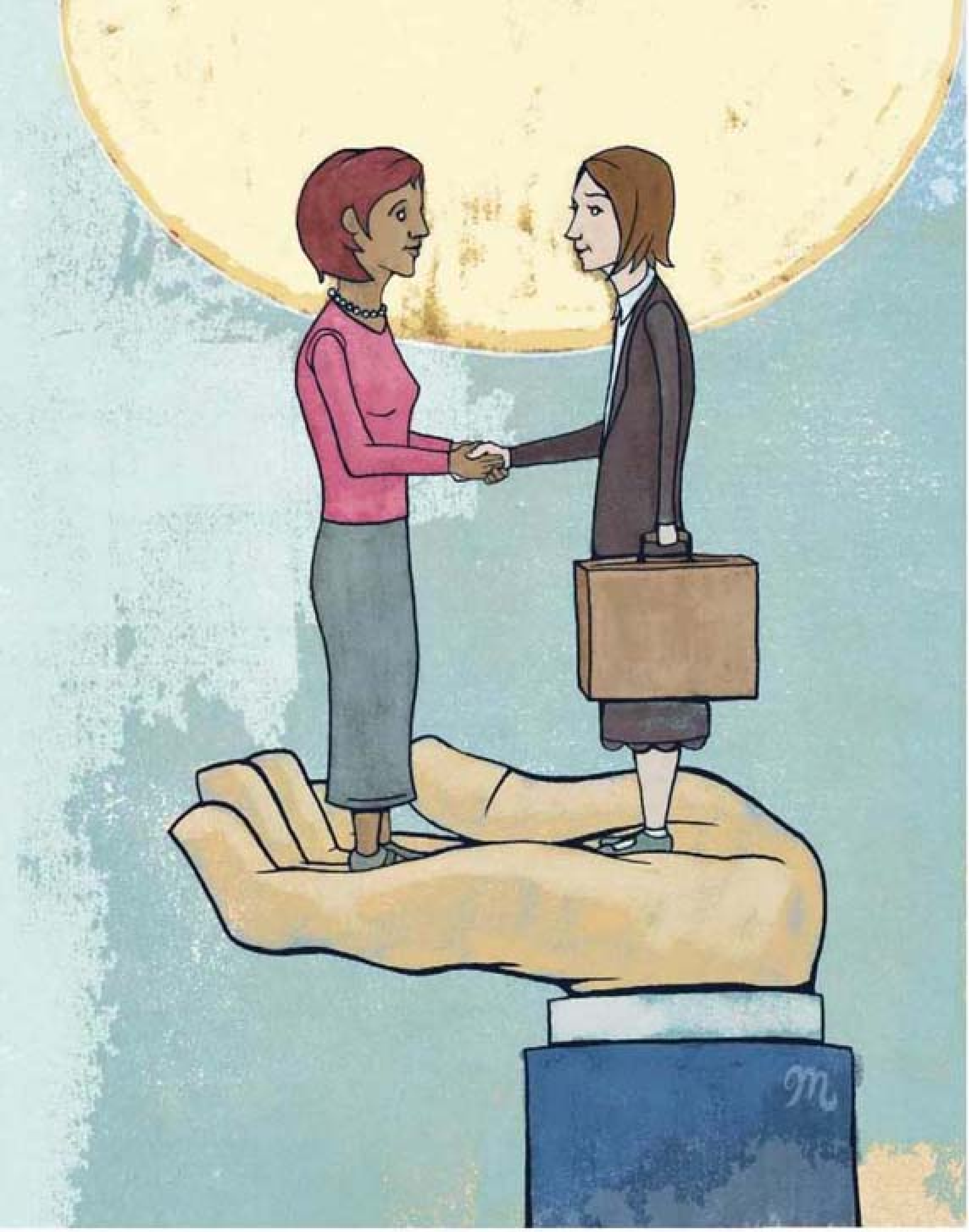
Unfortunately, partners who themselves needed praise and attention on the way up seldom take the time to provide it to juniors. It doesn't have to be that way. Partners already use their interpersonal skills with clients; they just need to extend those efforts to junior professionals. However, extra attention must be doled out judiciously, and not with the aim of manipulating people. This is especially true at top-tier PSFs, such as Merrill Lynch or HSBC, where most associates were at the head of their classes in school. Among such high achievers, insecurity can be prevalent, so a mentor must bestow attention fairly and meritoriously or she will have a revolution on her hands.

Ask an associate what kind of work she wants to do, where her passions lie, what skills she wants to develop. Don't leave this important job to human resources.

PRINCIPLE 2

Not Everyone Is an A Player

Although nearly everyone at a PSF thinks he is an A player, no PSF has only professionals of this type – nor, we would argue, should it. Indeed, in the typical modern PSF, A players constitute only 20% of the professional staff and C players another 10%. Therefore, B players make up the remaining 70% – a large group we call the "solid citizens." Even at top-tier firms, B players are the heart and soul of the organization. If they are mediocre, the firm will be mediocre; if they are high performers, the firm will follow suit. A players, relatively small in number, will never make up for the solid citizens, regardless of how good the A players are.



sibilities, and regardless of firm size or location. We have also found this among participants in Harvard's Leading Professional Service Firms program, which draws participants from the gamut of professional services, from architecture to money management to advertising. Certainly, then, many of the professionals who have an extreme need to achieve also happen to be B players. Amazingly, though, our research identified only a couple of PSFs with explicit strategies for rewarding and recognizing B players, on whom so much of a firm's long-term success depends.

Instead, partners at PSFs tend to focus on mentoring the A players. For instance, a senior managing director and head of the investment banking division at Morgan Stanley in the early 2000s learned that some of his more than 20 direct reports resented that others were receiving the lion's share of his attention. Realizing that he had no idea who was getting the most feedback, the division head began tracking his interactions with bankers. A clear pattern quickly emerged: Six high-performing A players were taking up to 50% of his time with various capital and human resource requests, inquiries about promotions decisions, and the like – in short, the high fliers demanded constant attention. At least half the direct reports, though, never initiated contact with the division head. He subsequently used his practice of tracking interactions to ensure that his schedule included regular meetings and dinners with all his direct reports. The level of discord among them dropped dramatically.

It's not hard to see why partners focus so much on A players. First, most partners are themselves A players and therefore tend to identify with them. One partner even attributed a solid citizen's lack of ambition to be a leader at the firm to his "inferior" law school training. Second, given the pressure on their time, partners often decide to focus their mentoring on the people who will deliver the highest return. However, as professional managers ought

Solid citizens differ from stars in that they usually stay on staff longer and thus build up institutional knowledge, which makes them invaluable when firms merge, downsize, or open new offices. These B players take a longer-term perspective because they have been through organizational cycles and understand their ebbs and flows. Solid citizens tend to pursue organizational goals over personal ones because they value stability both for themselves and for the firm. Indeed, they exhibit such extraordinary patience with career development that managers often overlook them.

For all these reasons, the presence of solid citizens in a PSF serves to ground the charismatic A players (who can sometimes destabilize the organization by their need for high maintenance) and to shore up C players (who might otherwise founder). In our experience, B players are also more likely than the individualistic high fliers to be natural team players.

Nevertheless, our research reveals that 67% to 85% of all the professionals in PSFs have an extreme need to achieve. The results hold for midlevel associates, new partners, and senior partners with major leadership responto know, the yield from investment in a few high-margin products or services is not necessarily greater than that from lots of lower-margin ones.

What's more, B players don't need much watering. As with A players, an e-mail or nod of appreciation goes a long way. However, because solid citizens tend to be very grateful for a little bit of attention, there are many other things you can do to include and challenge them. For example, assign them to firmwide, cross-functional committees where they will have the opportunity both to interact with high fliers and to demonstrate their capabilities. Whatever else you do, devise a system for monitoring who has been recognized and who has not. Good PSFs track interactions with their stars and with their solid citizens. (The sidebar "A Hidden Star" shows the value of transferring just a little of the time spent on A players to B players.)

PRINCIPLE 3
Choice Assignments Are in Short Supply

Clearly, staff assignments need to be made with the client in mind. However, you must also consider the career development of junior professionals. Katzenbach Partners, a New York–based consulting firm, tracks the development of its associates by keeping a running record of their different growth needs and of the content of their assignments. Management makes every attempt to balance the firm's needs with associates' wishes. That kind of dedication to associates pays off. For example, when Katzenbach associates tell their superiors why they're staying with the firm, they tend to cite the professional development climate, specifically the firm's genuine interest in giving everyone stretch assignments. Katzenbach, however, is a small firm of only about 150 professionals. The challenge at bigger organizations is not to let their professionals fall through the cracks.

That's easier said than done. David H. Maister, one of the first researchers to study PSFs and whose 1993 book *Managing the Professional Service Firm* remains the seminal text on PSFs, warned that one of the biggest problems in these firms is the underutilization of talent. It was true in 1993 and is even more so today. It can be very hard nowadays to promise associates the stretch assignments they need to learn. The competition for market share is so brutal that there are simply fewer plum assignments to go around, except at the very top-tier firms. When plums are not available, the junior professionals grow frustrated that the partnership group is not really interested in their career development. They also don't believe that HR will represent their best interests. That's where the mentor comes in.

One useful tactic, especially in times when the firm has few good assignments, is to let your junior professional shadow someone senior. This is particularly important for juniors who are very high fliers. As soon as possible after an associate joins the organization, a partner should take him on an assignment to a client and flood him with insight

A Hidden Star

A man we'll call Alex Parker was an experienced partner at a large, multinational financial services firm. In his late forties, he had been with the firm for 20 years and was very competent at executing the business. He was not, however, good at acquiring new clients. As a result, other professionals saw him as a solid performer but not a star. Associates didn't want to work with him because he couldn't get them promoted.

Not surprisingly, when a new department was created, Alex was passed over for the leadership role in favor of a high flier. The new department head didn't know what to do with Alex. She couldn't relate to him not only because he was older but also because he didn't have the star power she did. So she neglected him and focused on developing new clients.

Then the work flooded in. The associates were drowning in it. A couple of them quit. Another became sick. The department head worked harder than ever and resented Alex for not being like her. A year passed with nothing resolved. More associates left the firm. Resentments festered.

An insightful senior partner went to the new department head to report that some junior professionals wanted to transfer out of her area. Alex's boss had no choice but to leverage resources better. Reluctantly, she set up a number of key meetings with Alex, during which she realized he had a lot to offer. The more time, attention, and good assignments she gave to him, the more associates began to gravitate toward him. They came to see that Alex was good at his job, even though he didn't draw attention to himself.

Unfortunately, except in the best-managed firms, professionals like Alex often are not presented with meaningful opportunities for development. Instead, management tends to simply throw these B players into jobs at all levels and then tell them to adapt. Then they appear to be floundering or to lack star potential. In fact, they are often struggling with the limitations of their work, not their capabilities.

and expertise. The partner should tell her protégé what she thinks two hours before a meeting begins and again 30 minutes prior to it, with a follow-up after it's over.

Another way that PSFs can make up for a lack of choice assignments is to give individuals projects that are not client related. Research projects, for example, provide an opportunity for an associate to delve more deeply into a field of interest. One senior associate at a consulting firm was asked to research the connection between branding and new drugs being developed by a pharmaceutical client. Soon this associate developed a reputation throughout the firm as a branding expert. Extracurricular work need not even be germane to the business. Heller Ehrman, a top-tier law firm, allows valued associates to spend time on worthy, high-profile pro bono work during downtime. That not only gives the firm good PR but also keeps a strong associate stimulated and allows her to feel like a partner. In one case, a Heller Ehrman associate worked on documents to help the judicial process for detainees at Guantánamo Bay.

In today's professional service firms, associates can no longer just expect to be assigned a mentor; they also have to learn how to attract one.

PRINCIPLE 4

Mentoring Is a Two-Way Street

Not all the responsibility for mentoring rests with partners. Too many associates at PSFs give up quickly and look for greener pastures rather than learn how to thrive by catching the attention of mentors and partners. The truth is that in today's PSFs, with their limited resources, associates can no longer just expect to be assigned a mentor; they also have to learn how to attract one.

One particularly interesting approach developed at McKinsey & Company is to encourage associates to "build [their] own McKinsey." Although the process is very informal, members of the firm are counseled to seek out the subordinates, peers, and partners toward whom they naturally gravitate because of mutual chemistry, interests, and goals. The message is clear: This isn't just about promotion – it's much more about developing your potential as a professional and as a human being. If you want a mentor, start acting like you do and you will eventually find yourself connected with a core group of partners and associates who are invested in your personal development. In effect, these colleagues become part of your personal advisory board. One midlevel professional at a midsize advertising agency told us, "There are two specific partners and five other colleagues that I seek out for career advice, for counsel on how to manage my projects and how to manage my associates. These colleagues are the glue that keeps me at the firm."

Co-mentoring encourages young professionals to take some responsibility for their own careers. Partners should keep an eye out for professionals at all levels who are particularly gifted at being mentors. Reciprocal mentoring is not only advantageous to their careers, but it also builds up fundamental team skills among professionals, many of whom are not natural team players.

Consider a partner who was asked to develop a new asset-management arm of an investment bank. He reached out to a handful of junior partners and vice presidents to help develop the new business. Team members, leery of one another, sought to stake out positions based on old relationships or old functions. The meetings of the new group were less than effective, and they struggled to devise a competitive strategy the entire group could support.

A wise leader told the group that only by supporting one another could they be competitive. He created team metrics that encouraged them to work together not against one another. In effect, they became co-mentors as they began to work more collaboratively in anticipation of competing in the marketplace and being rewarded economically as a group. Despite their inclination to work individually and compete with one another, these professionals functioned effectively as a team when they were motivated to do so.

...

More than any other type of organization, PSFs live and die by their intellectual capital. If you fail to nurture this talent, you will lose the heart and soul of your firm, as well as the very people you recruited to give you an edge in a hypercompetitive world.

Unfortunately, as these types of firms bitterly compete for market share, their achievement-driven partners give priority to their clients over their colleagues – and the more success they have with the clients, the more they focus on them. That dynamic is simply unsustainable; partners in PSFs must take active steps to correct it. They will need to build time into their schedules to nurture *all* their associates, not just the ones most like themselves. They will have to involve juniors frequently and substantively in important client work and, if such opportunities are lacking, offer them other challenges. For their part, associates must learn to take charge of their own careers and seek out mentoring opportunities with one another as well as from their bosses. The partners and associates at the best firms recognize these challenges. If your firm is to compete with them, it will have to as well.

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Where Will We Find Tomorrow's Leaders?

A Conversation with Linda A. Hill

We might not recognize the leaders we really need because of who they are, where they're from, or how they behave.

FOR THE PAST half century, there has been consensus about the kinds of places effective business leaders are formed: companies like General Electric and Procter & Gamble, high-powered consulting firms like McKinsey, elite business schools like Harvard and Wharton, the military.

But it's a different world now. Markets and workforces are increasingly global and diverse. Change is so rapid that one leader can't hope to keep abreast of all developments, much less be responsible for the innovation needed to keep ahead of them. Decision making is broadly distributed across an organization, and collaboration is required with numerous parties outside it.

Leah Fasten

So it's worth reexamining our image of the ideal business leader and how and where a person will acquire the attributes needed to become one. We may find that it's through experiences unfamiliar to many of us and in places far from Cambridge or Crotonville.

Linda Hill, the Wallace Brett Donham Professor of Business Administration at Harvard Business School, has looked at leadership from many perspectives. In the early 1990s, she led the development of Harvard's required MBA course on leadership. Her research into the challenges faced by first-time managers resulted in the book *Becoming a Manager: How New Managers Master the Challenges of Leadership* (Harvard Business School Press, second edition, 2003). Her studies have also taken her around the globe to pursue a long-standing interest in emerging economies, from Argentina to South Africa to India to the United Arab Emirates. She is currently the faculty chair of the business school's High Potential Leadership Program and of the Leadership Initiative, a research program aimed at bridging the gap between leadership theory and practice.

In this edited conversation – based on several interviews with HBR senior editor Paul Hemp – Hill offers some predictions about the nature of leadership in the next half century, which she says will be defined in part by two notions: *leading from behind* and *leadership as collective genius.*

Are we looking for leaders in all the wrong places?

No, but we definitely need to broaden our search. Most companies understand that in a global economy much of their future growth will be in emerging markets. And because talent isn't as portable as we once thought – there is growing evidence that an executive who's successful in one context may not be in another – companies need leaders who know and are from those markets.

But emerging economies, by definition, do not yet have cadres of globally savvy executives. In places like China and Eastern Europe, capitalism is new. In South Africa, the majority of the population was for decades systematically shut out of the business arena. Elsewhere, lack of education has prevented the emergence of a knowledgeable business class. The war for talent in these countries is fierce, so the name of the game is finding individuals with leadership potential, sometimes in unconventional places, and preparing them for senior positions.

In South Africa, for example, many black business leaders got their start in the antiapartheid movement – they're former union leaders or leaders from the African National Congress. As one black executive explained to me, "You don't launch a revolution without leadership and organization." In fact, the ANC had its own rigorous leadership-development program, even for its youngest members. In Dubai, the government recognizes that achieving its ambitious growth targets is a marathon, not a sprint. Both the heart and the legs must be strong. Companies there will need increasing numbers of homegrown leaders augmented by expatriate talent.

I've gotten to know an executive named Adel Al Shirawi, who acquired his leadership skills working in the Dubai government. He's now the CEO of Tamweel, an innovative Islamic finance company with a value proposition that has turned out to be appealing to both Muslims and non-Muslims, who now account for 75% of the company's customers. Since its inception in 2004, the company has seen triple-digit growth in profits. Adel has realized that Tamweel could become a major player in the global market, so he's focusing on young managers inside the company, preparing them to lead not just local or regional operations but a global enterprise. He calls his aggressive mentoring program "CEO training, not management training."

As we look at leadership potential in emerging economies, we risk assuming that leadership models developed in the United States or Western Europe will work elsewhere. Leadership is about making emotional connections to motivate and inspire people, and our effectiveness at doing this has strong cultural overtones. We know from research that people's expectations of how leaders should behave vary across countries. But we need more research on what is universal about leadership and what is culturally specific.

As we look for those universal leadership principles, let's consider what we might find in emerging markets. For about 10 years, I've been following the careers of nonwhite business leaders in postapartheid South Africa. A number of these people have suggested to me that there is an African leadership style, captured in the notion of *ubuntu,* which is often summed up by the saying "I am because we are." If such a style does exist, the mind-set implied by ubuntu may turn out to be well suited to the increasingly important ability, no matter where you operate, to build partnerships within and between companies.

What other leadership approaches have you seen in emerging economies?

I've been especially interested in what I've seen at HCL Technologies, an Indian information technology company, which has been described as having the world's most modern management. The first tenet of HCL's change strategy is called, somewhat provocatively, Employee First, Customer Second. The aim is to attract the very best talent – a tall order in the competitive Indian labor market but crucial for the company's growth – and empower employees to take the lead in coming up with innovative ways to create value for customers. This distributed leadership model is based on communities of interest: tight-knit groups that pull together people from various functions and locations. Each community comes up with new ideas and then competes with the other groups for funding in HCL's internal market. According to HCL president Vineet Nayar, the strategy – which is supported by the savvy use of social-networking technology – will have succeeded when it "destroys the office of the president." That is, as the communities of interest evolve, the leaders of the groups will begin to share leadership of the company with Vineet.

In another move, Vineet – to emphasize the importance of leadership transparency – put his own 360-degree feedback up on the company intranet and encouraged his senior team and thousands of managers to do the same. Such radical tactics appear to be working. When Vineet took over HCL, employee morale was low and the company was trailing behind its competitors. Today, employees are rejuvenated and the company is one of the fastest growing in its industry.

We really haven't spent enough time studying leadership in emerging markets. Since necessity is often the mother of invention, I suspect some of the more disruptive leadership practices will come from those parts of the world. And I don't doubt that over time, more top executives will as well. Right now, though, I fear that some of the most-promising global leaders remain largely invisible to us, just as many have long been invisible in their own countries.

I suspect some of the more disruptive leadership practices will come from emerging markets.

Invisible? In what way?

For one reason or another, many talented people in all parts of the world haven't been viewed as potential business leaders. Often, this has been because of explicit limitations – lack of political rights in South Africa, say, or the absence of outlets for entrepreneurial flair in Central Europe. As you study leadership in both emerging and developed markets, though, you begin to realize that although potential leaders in an economy like the United States may not face explicit limitations, they may face implicit ones that prevent them from growing into leadership roles. Such limitations shut off a rich source of talent in our organizations.

Who are these invisible people in our organizations?

First, they are the well-known "demographic invisibles." These are people who, because of their gender, ethnicity, nationality, or even age, don't have access to the tools – the social networks, the fast-track training courses, the stretch assignments – that can prepare them for positions of authority and influence.

Second, and more subtle, are the "stylistic invisibles." These are people who just don't fit our conventional image of a leader. Because they don't exhibit the take-charge, direction-setting behavior we often think of as inherent in leadership, they are overlooked when an organization selects the people it believes have leadership potential.

But isn't a leader supposed to set a course and inspire people to follow it?

Traditionally, yes, that's what you hear. In the future, though, a person who conforms to that stereotype may not be the best choice to lead a team or run a business, wherever in the world it's located. We know that the increasing diversity within business organizations and the growing interdependence of players – from business partners to

NGOs – within a business ecosystem mean that leaders need to adopt a more inclusive, collaborative style. It's also becoming clear that today's complex environment often demands a team approach to problem solving. This requires a leader who, among other things, is comfortable sharing power and generous in doing so, is able to see extraordinary potential in ordinary people, and can make decisions with a balance of idealism and pragmatism. There's a term I use to describe this leadership model: leading from behind.

"Leading from behind?" That sounds like a contradiction in terms.

Well, it does send a bit of a mixed message. But I think it captures the type of leader I'm talking about. I got the idea from reading Nelson Mandela. Several years ago – jet-lagged in my hotel room in Cape Town, overlooking Robben Island, where Mandela had been imprisoned – I was reading his autobiography, *Long Walk to Freedom*. At the time, I was working on an article about leadership in the twenty-first century, and I came across a passage in which Mandela recalls how a leader of his tribe talked about leadership:

"A leader, he said, is like a shepherd. He stays behind the flock, letting the most nimble go out ahead, whereupon the others follow, not realizing that all along they are being directed from behind."

To me, this take on the shepherd image embodies the kind of leader we increasingly need: someone who understands how to create a context or culture in which other people are willing and able to lead. This image of the shepherd behind his flock is an acknowledgment that leadership is a collective activity in which different people at different times – depending on their strengths, or "nimbleness" – come forward to move the group in the direction it needs to go. The metaphor also hints at the agility of a group that doesn't have to wait for and then respond to a command from the front. That kind of agility is more likely to be developed by a group when a leader conceives of her role as creating the opportunity for collective leadership, as opposed to merely setting direction.

I probably should emphasize that leading from behind is not about abrogating responsibility. After all, the shepherd makes sure that the flock stays together. He uses his staff to nudge and prod if the flock strays too far off the track or into danger. In fact, leading from behind is hard work and involves some crucial responsibilities and judgment calls: deciding who's in (and, just as important, who's not in) the group; articulating the values that will inform the group; developing the talents of members so that they can flourish in their roles; setting boundaries for the group's activities; and managing the tensions inherent in group life – deciding, for example, when to be supportive and when to be confrontational, when to improvise and when to impose a structure.

Could you say that the shepherd knows the ultimate destination but leaves it to individuals in the flock to determine how to get there?

That's one way to put it. But keep in mind that leading from behind doesn't imply that everyone in the organization has equal talent or the right to lead at a given time. Talent – or nimbleness, if you will – is actually a function of context, which means that different individuals will come to the fore in different situations.

It's also crucial to understand that leading from behind isn't a style reserved for the uninspiring or the indecisive. Many people who lead from behind are perfectly capable of leading from the front. Certainly, Nelson Mandela, a charismatic leader in the classic sense, who chose to lead from behind, also led from the front when he deemed it appropriate. During the final years of his imprisonment, for instance, while cut off from his ANC colleagues, he made the bold decision to launch a dialogue with the South African government.

The choice to lead from behind must be based on the circumstances – and circumstances in the business world increasingly demand just this type of leadership. That's why it's a shame that leaders who take this approach are so often overlooked – invisible, if you will. If you think about what an organization looks for when it's trying to identify people for a high-potential leadership program, "generous in the sharing of power" isn't likely to be high on the list. Consequently, we're overlooking a tremendous amount of leadership potential in our organizations.

How do we know that people who don't behave in leaderlike ways can in fact lead successfully?

Let me tell you about two people I have watched lead from behind. One very exceptional leader was formed as an activist in South Africa – evidence that we can learn about different leadership styles by looking in unexpected places. The other comes from a very traditional setting: IBM.

Iqbal Survé – a South African medical doctor and social activist, who founded Sekunjalo Investments, a black-controlled investment holding company – is proof that it's not just the shy and retiring wallflowers who lead from behind. Iqbal learned how to lead through his experiences with the ANC, where, as a teenager, he was one of the rotating leaders of an 81,000-strong grassroots student organization.

When apartheid ended, Iqbal was disillusioned to see that political equality did not close the nation's enormous economic gap and decided that pursuing a business career was the best way he could contribute to his country's transformation. Although as a member of the ANC he'd been exposed to the tradition of leading from behind, he found himself moving toward a lead-from-the-front style as Sekunjalo grew. During a difficult financial period, however, Iqbal returned to his roots. When it came time to select a new head for one of the company's troubled divisions, he asked the employees of that division to nominate a slate of candidates, outline a formal selection process, and then choose the next division leader. Iqbal had to persuade some of the board members to go along. But the candidate selected by the employees received management's unwavering support, which proved crucial as the company worked through its difficulties.

Do you have to look as far afield as the African National Congress to find such a leader?
Not at all. Consider a project at IBM called the World Development Initiative, which is being led by Steve Kloeblen, a vice president for business development and a lifelong IBM employee. Steve's primary job is overseeing the acquisition of companies and their integration into IBM. But in 2006, he had the idea that there might be business opportunities for IBM in meeting the needs of people at the base of the socioeconomic pyramid, which would further one of IBM's corporate values: focusing on innovation that matters for the world. Using some of IBM's social-networking tools – an important enabler of any effort to lead from behind – he put out the word, basically saying, "I'm going to try to learn about this. Anybody interested?"

Steve got dozens of replies from people all over IBM – from different disciplines and different locations – who were willing to work on the project in addition to their regular jobs. He ended up with about 100 volunteers, primarily in their twenties and thirties, and a project that took on a life of its own. The group drafted detailed one-year, five-year, and 10-year plans, with aggressive targets for revenue and profit as well as for reducing the number of people living in poverty. Members have agreed to carry this additional leadership responsibility from job to job as they advance in their careers at IBM.

So far the group has built extensive external networks and traveled to places such as India, China, and Kenya to see firsthand what sort of business opportunities exist. It has also drafted business plans and presented them to senior IBM management to raise awareness of and get support for the project across IBM. The program is part of a broader set of initiatives IBM has adopted to help employees enhance the skills and expertise they need to become global leaders, which IBM's CEO dubbed the IBM Global Citizenship Portfolio.

And Steve? He has let the team define the project's mission. He doesn't inspire the group with stirring speeches. He's pretty unassuming, actually, keeping a low profile at meetings, often qualifying his comments with "we could do this" or "we could do that." What he has done is create a context in which people in the group can take the lead – while persistently nudging them with gentle admonitions. In other words, he leads from behind.

Here's another wrinkle: What started out as a business development initiative has, informally at least, also become a leadership development initiative, one that can help identify and develop new kinds of leaders at IBM who are globally aware, who can link the company's value and culture with its strategy, and who can collaborate with others throughout the organization.

Will leading from behind become the dominant leadership style?
Clearly, many situations require leadership from the front. In crises, for example, an organization needs to react quickly, but if the people in it have not been prepared to do so collectively, a leader needs to step forward and tell them where they are going and how to get there.

What we need is a shift in emphasis. Today, things are changing so fast that often it isn't clear exactly where an organization needs to go. And the complexity of the business environment makes the notion of the leader as expert irrelevant – no one can be an expert in every area that requires expertise. The more you want to get the best out of a group by letting people use their own judgment and take risks, the more you want to lead from behind.

Besides, we already have a lot of people who are able to lead from the front. We need to develop people who can lead in a different way.

Little things – taking the lead in a presentation, appearing to know more than you do – are still seen as markers of leadership potential, when in fact they may represent traits that are the opposite of what we need in a leader today.

There's one area in particular that calls for leading from behind, and that's innovation. By definition, you don't know exactly where you want to go. And innovation is almost always a collective process, the harnessing of the creative talents of a diverse group. Making such a process work is something I call leadership as collective genius. For the past few years, I've been doing research for a book with Greg Brandeau, the senior vice president of technology at Pixar, and my research associate, Emily Stecker, trying to understand how the leaders of teams with a sustained record of innovation manage to both unleash *and* harness team members' creativity. We've studied a number of leaders, at various levels in their organizations, in a variety of industries and countries, and have developed some theories about how this works.

What's the relationship between leadership as collective genius and leading from behind?

Well, you won't be able to get one without the other. The people on the teams we've studied are often stars in their own right, and if you try to lead them from the front, they simply won't follow. You have to create an environment in which they are engaged and in which the collective talent of team members is tapped by having everyone take the lead at some point. That is, you have to lead from behind – although the shepherd metaphor may not work here, because sheep aren't usually thought of as the smartest animals in the world.

Maybe *they've* simply been invisible, their talents and potential unappreciated.

Perhaps! Greg talks about the diverse talents of people in such a group as "slices of genius." At Pixar, for example, a group with a broad array of both artistic and technological expertise is involved in making a film. The process begins with the director's vision for the film, which he inspires the group to bring to life on the screen. Along the way, individuals from throughout the company collectively shape the director's vision. Someone might have a great idea for, say, the story or the animation or how to do some special effects. These suggestions are critiqued by the team. Over the course of the project, a network of ideas emerges that wasn't available to the director when he started out. For instance, some of those ideas involve cutting-edge technology that can be developed only in real time as the project progresses. The final product is the result of team members' collective genius.

What else are you learning about how collective genius can be leveraged to foster innovation?

I should say that we're still in the middle of our research and don't have definitive answers. But as one Pixar executive puts it, "You have to create a world in which people want to belong." One key is getting the stars you've brought together to realize that their collective output can be more than the sum of their individually impressive parts.

Take Pentagram, the award-winning multidisciplinary international design firm. The partners are rock stars in a variety of disciplines. Normally, you don't think of stars playing well together. In fact, there are very few global partnerships in any industry that have had the sustained success Pentagram has had. But Pentagram has taken great care in designing its partnership so that stars can learn together and raise the quality of their individual and collective work. The Pentagram partners have built a culture of equality – in one profile of the company, the author writes about its "socialist ethos." But believe me, they are capitalists. They just understand that the kind of interaction necessary for exceptional work – what my colleague Dorothy Leonard calls "creative abrasion" – requires a culture of mutual respect and trust. And they realize that working with people from other disciplines will allow them to get better at their own game, in their own area of expertise. One of the partners, graphic designer Kit Hinrichs, calls the work environment "postgraduate education."

What can companies do to create the kinds of leaders we'll need in the future?

The first step, of course, is not to let preconceptions about the way a leader looks and acts blind us to people with leadership potential. I once wrote about a woman named Taran Swan, who worked for Nickelodeon Latin America. During presentations to senior management, she would include members of her team, who, after a brief overview from Taran, each presented information while she sat on the side. She spoke only to offer support or clarification.

She got pulled aside by a supervisor and told, "You're making a career mistake. You're not going to get ahead if you do this. It would be better if you came by yourself and made the presentations." And she said, basically, "But it's not my work – it's our collective work. So I'm bringing the key people together here who actually did the work. It's motivating to them and important to their development. They deserve to get credit for it. And in certain instances, they can answer your questions better than I can." His reply was, "Okay, but you're paying a price." In his eyes, Taran wasn't behaving like a leader. Under her direction, however, her team built a strong presence for the channel in Latin America and met its overall budget in an extremely volatile market.

All too often, little things – taking the lead in a presentation, appearing to know more than you do – are still seen as markers of leadership potential, when in fact they may represent traits that are the opposite of what we need in a leader today. If we're trying to identify people who can lead from behind, we must be on the lookout for other indicators – for example, the extent to which individuals on a leader's team are taking risks or the willingness of leaders to ask for help from the people on their team.

Let me emphasize something here: I'm not saying that if you simply go out and find the right people, your leadership problems will be solved. It's not just about selection; it's about development. Leaders of the future must be nurtured by *their* leaders, who need to make space and provide opportunities for their team members to grow and lead.

Will leadership development, like leaders themselves, need to be different in the future?

In some ways, yes. For example, people will benefit from programs that require them to deal with challenging situations – say, struggling to accomplish tasks in unfamiliar cultures – that are quite different from traditional leadership crucibles. Two people on Steve Kloeblen's team at IBM came back from a trip chastened by how difficult it was to develop cost-effective ways to implement in an Indian village the business plan they had devised in New York, given logistical, language, and other barriers.

People may also acquire lead-from-behind skills working in volunteer settings. The experience of the people on the IBM team – learning to get work done with a diverse group of peers who are volunteering their time for a team that has no designated boss – will be different from the early career experience of working on a project team at, say, McKinsey. Experiences where people work with others who are different from themselves, and in settings that are unfamiliar, can be truly powerful opportunities for learning.

IBM's project hints at the potential of ad hoc, flexible approaches to leadership development. Most leadership-development programs follow a planned trajectory: People are selected to participate at particular stages in their careers as they move up the organizational ladder. Steve's program was "come one, come all."

Perhaps the voluntary nature of the program is its most significant characteristic. Not only do people get the experience of working and leading in a collaborative setting, one in which common and deeply held values hold the group together, but also they self-select as potential leaders.

And this may be one of the best ways to identify tomorrow's leaders: Let people who might otherwise be invisible to the organization because they lack conventional leadership traits make themselves visible. If IBM managers had selected people for the program from their pool of identified high-potential employees, would the makeup of the team have been the same? Maybe, but I am not sure. One thing is certain: The people on this team are inspired by its ultimate mission and aspire to get where they need to go, whatever the path they collectively end up taking.

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In honor of Harvard Business School's centennial, we've assembled a list of particularly influential *Harvard Business Review* articles authored by the school's faculty over the years. These articles include annual McKinsey Award winners, reprint best sellers, and republished classics. All articles had at least one author affiliated with the school at the time of publication.

–The Editors

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Gordon Donaldson
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Theodore Levitt
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John Fielden
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Executive Summaries

JANUARY 2008

"The very notion that there is a strategic holy grail – a strategy brilliantly conceived, carefully implemented, and valiantly defended through time – is dangerous."
–page 54

STRATEGY & COMPETITION

54 | Putting Leadership Back into Strategy

Cynthia A. Montgomery

In recent decades an infusion of economics has lent the study of strategy much needed theory and empirical evidence. Strategy consultants, armed with frameworks and techniques, have stepped forward to help managers analyze their industries and position their companies for strategic advantage. Strategy has come to be seen as an analytical problem to be solved.

But, says Montgomery, the Timken Professor of Business Administration at Harvard Business School, the benefits of this rigorous approach have attendant costs: Strategy has become a competitive game plan, separate from the company's larger sense of purpose. The CEO's unique role as arbiter and steward of strategy has been eclipsed. And an overemphasis on sustainable competitive advantage has obscured the importance of making strategy a dynamic tool for guiding the company's development over time.

For any company, intelligent guidance requires a clear sense of purpose, of what makes the organization truly distinctive. Purpose, Montgomery says, serves as both a constraint on activity and a guide to behavior. Creativity and insight are key to forging a compelling organizational purpose; analysis alone will never suffice.

As the CEO – properly a company's chief strategist – translates purpose into practice, he or she must remain open to the possibility that the purpose itself may need to change. Lou Gerstner did this in the 1990s, when he decided that IBM would evolve to focus on applying technology rather than on inventing it. So did Steve Jobs, when he rescued Apple from a poorly performing strategy and expanded the company into attractive new businesses.

Watching over strategy day in and day out is the CEO's greatest opportunity to shape the firm as well as outwit the competition.

Reprint R0801C

FORETHOUGHT

16 Love and Fear and the Modern Boss

Scott A. Snook

Should a leader be loved or feared? That age-old question still has no simple answer. It depends on who the leader is and whom she's leading. Successful executives adapt their styles when they need to; they also know their limits. **Reprint F0801A**

Beware of Old Technologies' Last Gasps

Daniel C. Snow

When a new technology appears, the old one experiences a sudden leap in performance. Whether you are an old- or a new-technology company, understanding how that phenomenon works can help you win during this critical transition period. **Reprint F0801B**

High Margins and the Quest for Aesthetic Coherence

Robert D. Austin

The key to selling well-designed, well-crafted products at high margins is the *aesthetic coherence* of the company and its goods. Embodying that ideal isn't easy, but it's possible if you avoid three temptations. **Reprint F0801C**

Do Well by Doing Good? Don't Count on It

Joshua D. Margolis and Hillary Anger Elfenbein

Research over 35 years shows only a weak link between socially responsible corporate behavior and good financial performance. However, there's no evidence of risk in doing good, only in being exposed for misdeeds. **Reprint F0801D**

The Value of a Broader Product Portfolio

Bharat N. Anand

The mantra "Every product must stand on its own bottom line" may no longer be the one to chant. Nowadays, broadening your portfolio can increase both your chances of a big win and the benefit your other products can get from a hit's popularity. **Reprint F0801E**

A Conversation with Sandra J. Sucher

When executives meet together to grapple with moral and ethical questions in literature, they end up applying their insights in practice. This Harvard Business School professor endorses book clubs as part of leadership development. **Reprint F0801F**

Seek Strategy the Right Way at the Right Time

Giovanni Gavetti and Jan W. Rivkin

Deliberate, emergent, and analogical approaches to finding the best strategy all have their advantages, depending on where an industry is in its life cycle. Be open to the best option at each juncture and wise enough to make the right call. **Reprint F0801G**

When (Not) to Listen to Activist Investors

Robin Greenwood and Michael Schor

Poorly performing managers shouldn't necessarily heed the demands of hedge funds that call for change in a company's strategic direction. Giving in does not, on average, yield stock gains that outperform the market – that is, unless the firm gets acquired. **Reprint F0801H**

Learning the Fine Art of Global Collaboration

Alan MacCormack and Theodore Forbath

Companies that excel in managing partnerships for innovation put a great deal of effort into improving their ability to collaborate. Their plans address four critical areas. **Reprint F0801J**

How to Talk to Investors – Through the Press

Gregory S. Miller

If you're seeking attention from investors and analysts, the press can be a convenient megaphone. Cultivating relationships with the media takes patience, but the payoffs in both good times and bad are priceless. **Reprint F0801K**

SELF-MANAGEMENT

HBR CASE STUDY

29 How to Change the World

Howard H. Stevenson

Alan Wilson has a decision to make. The CEO of his company, Grepter, wants him to relocate to Zurich, where he can gain valuable experience for a rise to the top. Karl, his best friend, hopes to lure him to a hedge fund that promises big money fast. Shiori, an enticing former girlfriend, wants him to join her in delivering medical care to patients in developing countries. Alan knows for sure only that he wants to make an impact. Four experts comment on this fictional case study.

Laura Scher, the CEO of Credo Mobile, advises Alan to consider what each option will deliver in terms of money, power, quality of life, and – most important – personal values. As long as he brings his values into the workplace, any of the three could be the right choice.

Daniel Vasella, the CEO of Novartis, cautions Alan to examine what truly drives him, personally and professionally. All things considered – not least the potential hazards of working with a friend – his future looks most promising at Grepter.

Barbara H. Franklin, the CEO of an international trade consulting and investment firm, thinks Alan would do well to join Shiori's enterprise. The experience with social policy might draw him to public service, where his impact on society could be significant.

Christina C. Jones, the CEO of Extend Fertility, has also faced a variety of choices combined with an urge to do meaningful work. She believes that Alan should cultivate his skills at Grepter while developing a firmer notion of what he wants to be and do.

Reprint R0801A
Reprint Case only R0801X
Reprint Commentary only R0801Z

STRATEGY & COMPETITION

43 Transforming Giants

Rosabeth Moss Kanter

Large corporations have long been seen as lumbering, inflexible, bureaucratic – and clueless about global developments. But recently some multinationals seem to be transforming themselves: They're engaging employees, moving quickly, and introducing innovations that show true connection with the world.

Harvard Business School's Kanter ventured with a research team inside a dozen global giants – including IBM, Procter & Gamble, Omron, CEMEX, Cisco, and Banco Real – to discover what has been driving the change. After conducting more than 350 interviews on five continents, she and her colleagues came away with a strong sense that we are witnessing the dawn of a new model of corporate power: The coordination of actions and decisions on the front lines now appears to stem from widely shared values and a sturdy platform of common processes and technology, not from top-down decrees. In particular, the values that engage the passions of far-flung workforces stress openness, inclusion, and making the world a better place. Through this shift in what might be called their guidance systems, the companies have become as creative and nimble as much smaller ones, even while taking on social and environmental challenges of a scale that only large enterprises could attempt.

IBM, for instance, has created a nonprofit partnership, World Community Grid, through which any organization or individual can donate unused computing power to research projects and see what is being done with the donation in real time. IBM has gained an inspiring showcase for its new technology, helped business partners connect with the company in a positive way, and offered individuals all over the globe the chance to contribute to something big.

Reprint R0801B

STRATEGY & COMPETITION

62 Mastering the Management System

Robert S. Kaplan and David P. Norton

Companies have always found it hard to balance pressing operational concerns with long-term strategic priorities. The tension is critical: World-class processes won't lead to success without the right strategic direction, and the best strategy in the world will get nowhere without strong operations to execute it. In this article, Kaplan, of Harvard Business School, and Norton, founder and director of the Palladium Group, explain how to effectively manage both strategy and operations by linking them tightly in a *closed-loop management system.*

The system comprises five stages, beginning with strategy development, which springs from a company's mission, vision, and value statements, and from an analysis of its strengths, weaknesses, and competitive environment. In the next stage, managers translate the strategy into objectives and initiatives with strategy maps, which organize objectives by themes, and balanced scorecards, which link objectives to performance metrics. Stage three involves creating an operational plan to accomplish the objectives and initiatives; it includes targeting process improvements and preparing sales, resource, and capacity plans and dynamic budgets. Managers then put plans into action, monitoring their effectiveness in stage four. They review operational, environmental, and competitive data; assess progress; and identify barriers to execution. In the final stage, they test the strategy, analyzing cost, profitability, and correlations between strategy and performance. If their underlying assumptions appear faulty, they update the strategy, beginning another loop.

The authors present not only a comprehensive blueprint for successful strategy execution but also a managerial tool kit, illustrated with examples from HSBC Rail, Cigna Property and Casualty, and Store 24. The kit incorporates leading management experts' frameworks, outlining where they fit into the management cycle.

Reprint R0801D

STRATEGY & COMPETITION

78 The Five Competitive Forces That Shape Strategy

Michael E. Porter

In 1979, a young associate professor at Harvard Business School published his first article for HBR, "How Competitive Forces Shape Strategy." In the years that followed, Michael Porter's explication of the five forces that determine the long-run profitability of any industry has shaped a generation of academic research and business practice. In this article, Porter undertakes a thorough reaffirmation and extension of his classic work of strategy formulation, which includes substantial new sections showing how to put the five forces analysis into practice.

The five forces govern the profit structure of an industry by determining how the economic value it creates is apportioned. That value may be drained away through the *rivalry among existing competitors*, of course, but it can also be bargained away through the *power of suppliers* or the *power of customers* or be constrained by the *threat of new entrants* or the *threat of substitutes*. Strategy can be viewed as building defenses against the competitive forces or as finding a position in an industry where the forces are weaker. Changes in the strength of the forces signal changes in the competitive landscape critical to ongoing strategy formulation.

In exploring the implications of the five forces framework, Porter explains why a fast-growing industry is not always a profitable one, how eliminating today's competitors through mergers and acquisitions can reduce an industry's profit potential, how government policies play a role by changing the relative strength of the forces, and how to use the forces to understand complements. He then shows how a company can influence the key forces in its industry to create a more favorable structure for itself or to expand the pie altogether. The five forces reveal *why* industry profitability is what it is. Only by understanding them can a company incorporate industry conditions into strategy.

Reprint R0801E

STRATEGY & COMPETITION

98 Innovation Killers: How Financial Tools Destroy Your Capacity to Do New Things

Clayton M. Christensen, Stephen P. Kaufman, and Willy C. Shih

Most companies aren't half as innovative as their senior executives want them to be (or as their marketing claims suggest they are). What's stifling innovation? There are plenty of usual suspects, but the authors finger three financial tools as key accomplices.

Discounted cash flow and net present value, as commonly used, underestimate the real returns and benefits of proceeding with an investment. Most executives compare the cash flows from innovation against the default scenario of doing nothing, assuming – incorrectly – that the present health of the company will persist indefinitely if the investment is not made. In most situations, however, competitors' sustaining and disruptive investments over time result in deterioration of financial performance.

Fixed- and sunk-cost conventional wisdom confers an unfair advantage on challengers and shackles incumbent firms that attempt to respond to an attack. Executives in established companies, bemoaning the expense of building new brands and developing new sales and distribution channels, seek instead to leverage their existing brands and structures. Entrants, in contrast, simply create new ones. The problem for the incumbent isn't that the challenger can spend more; it's that the challenger is spared the dilemma of having to choose between full-cost and marginal-cost options.

The emphasis on short-term earnings per share as the primary driver of share price, and hence shareholder value creation, acts to restrict investments in innovative long-term growth opportunities.

These are not bad tools and concepts in and of themselves, but the way they are used to evaluate investments creates a systematic bias against successful innovation. The authors recommend alternative methods that can help managers innovate with a much more astute eye for future value.

Reprint R0801F

NEGOTIATION

THE HBR INTERVIEW

106 Giving Great Advice

Bruce Wasserstein

Interview by Thomas A. Stewart and Gardiner Morse

Few deal makers have been at it as long, and at such a high level, as Bruce Wasserstein, the chairman and CEO of the financial advisory and asset-management firm Lazard. In this edited interview, two HBR editors explore how he creates value as a manager, as a deal maker, and as a counselor to CEOs. Wasserstein, who has been a major figure in mergers and acquisitions for more than 30 years, talks about attracting and managing talent, building and sustaining a knowledge business, sizing up industries and companies, and crafting advice to help CEOs unlock value. At the heart of his approach is a singular ability to dissect a strategy's underlying premises in order to figure out whether a plan or deal "makes sense." Part of that determination involves understanding the broader context: Where is the industry going? What external factors will affect it?

Such sensemaking informs every move Wasserstein makes, and it has paid off handsomely. In his career, he has helped broker more than a thousand deals, worth hundreds of billions of dollars. His intellect, creativity, and doggedness are what allow him to pick apart the most complex problems and devise novel solutions. In an age of specialization, he recognizes the importance of connecting the dots; he draws on the knowledge and skills of creative generalists as well as industry and regional specialists when setting up and executing deals.

Wasserstein studied at Harvard University's business and law schools and at Cambridge University, helped lead First Boston's M&A practice, cofounded the investment-banking firm Wasserstein Perella Group, and then joined Lazard, which he famously took public in 2005 after disassembling a century and a half of family ownership. He is the 2007 recipient of Harvard Law School's Great Negotiator Award.

Reprint R0801G

LEADERSHIP

115 Why Mentoring Matters in a Hypercompetitive World

Thomas J. DeLong, John J. Gabarro, and Robert J. Lees

Professional service firms (PSFs), like so many other companies, are juggling the modern challenges of global competition, increased regulation, and rapid employee turnover. In a people-oriented industry, attrition has special import. DeLong and Gabarro, of Harvard Business School, along with former Morgan Stanley and Ernst & Young executive Lees, argue that a PSF can gain a much-needed competitive edge by renewing its focus on mentoring. The authors' in-depth interviews with professionals from more than 30 PSFs have yielded four principles for firms to heed as they rediscover this lost art.

First, mentoring is personal. Rather than relying on standardized programs, mentors must frequently – and fairly – provide authentic advice and nurturing. Partners at PSFs know how to use their ample people skills effectively with clients; the benefits of using them with junior colleagues are even greater.

Second, not everyone is an A player. A small dose of attention given to a B player goes at least as far as a large one offered to an A player. Since B players constitute about 70% of PSF staff, that's time well spent.

Third, choice assignments are in short supply, which limits the number of learning opportunities available for associates. Good alternatives include shadowing senior professionals on assignments and taking on research or other projects that are not client-related but that nonetheless build expertise.

Finally, mentoring is a two-way street. Protégés should not only learn from their senior counterparts, but also be taught to attract mentors – and to co-mentor one another.

Reprint R0801H

LEADERSHIP

123 Where Will We Find Tomorrow's Leaders?

A Conversation with Linda A. Hill

Unless we challenge long-held assumptions about how business leaders are supposed to act and where they're supposed to come from, many people who could become effective global leaders will remain invisible, warns Harvard Business School professor Hill. Instead of assuming that leaders must exhibit take-charge behavior, broaden the definition of leadership to include creating a context in which *other* people are willing and able to guide the organization. And instead of looking for the next generation of global leaders in huge Western corporations and elite business schools, expand the search to developing countries.

In this conversation with HBR senior editor Paul Hemp, Hill describes the changing nature of leadership and what we can learn from parts of the world where people have not, until recently, had opportunities to become globally savvy executives. In South Africa, for instance, the African National Congress has provided rigorous leadership preparation for many black executives. Hill has also observed two approaches – in developed and developing economies alike – that she believes will be necessary in an increasingly complex business environment. The first, *leading from behind,* involves letting people hand off the reins to one another, depending on their strengths, as situations change. The second, *leadership as collective genius,* calls for both unleashing and harnessing individuals' collective talents, particularly to spur innovation.

Through her descriptions of these approaches in such companies as Sekunjalo Investments, HCL Technologies, and IBM, Hill highlights the challenges of finding and preparing people who can lead by stepping back and letting others come forward to make their own judgments and take risks.

Reprint R0801J

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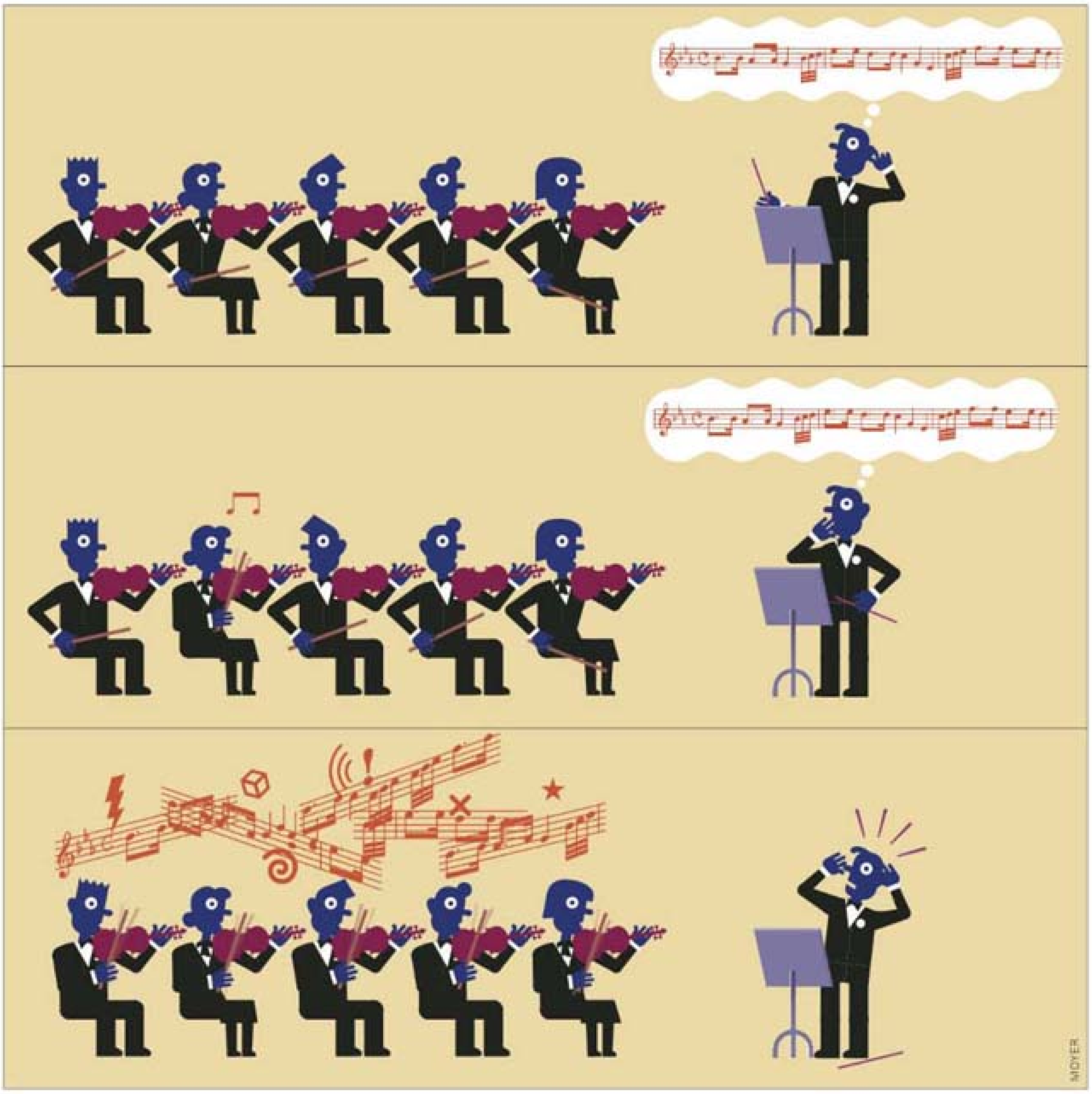

Pandemonium Inc.

WHEN LEADERS fail to share their thoughts, it can lead to turmoil among the troops. In "The Five Messages Leaders Must Manage" (HBR May 2006), John Hamm explains why: "In the absence of clear communication that satisfies the urgent desire to know what the boss is really thinking, people imagine all kinds of motives. The result is often sloppy behavior and misalignment that can cost a company dearly." So why don't leaders spell things out? Hamm's surprising answer: "They don't want to feel that they are talking down to people by providing what seems like unnecessary detail or context."

A leader who communicates a good strategy clearly stands a much better chance of success than one who communicates a brilliant strategy poorly. But a leader who can clearly convey what he is thinking *and* feeling stands the best chance of all. "Passion, emotion, and conviction are essential parts of the vivid description" that move people to action, Jim Collins and Jerry Porras write in "Building Your Company's Vision" (HBR September–October 1996). Those things transform a leader's message from everyday to extraordinary – just as they can turn a run-of-the-mill concert into a bravura performance.

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