THE CHINA CHALLENGE NOW...page 80 PROVING YOU'VE GOT THE CHOPS...page 92

Harvard Business Review

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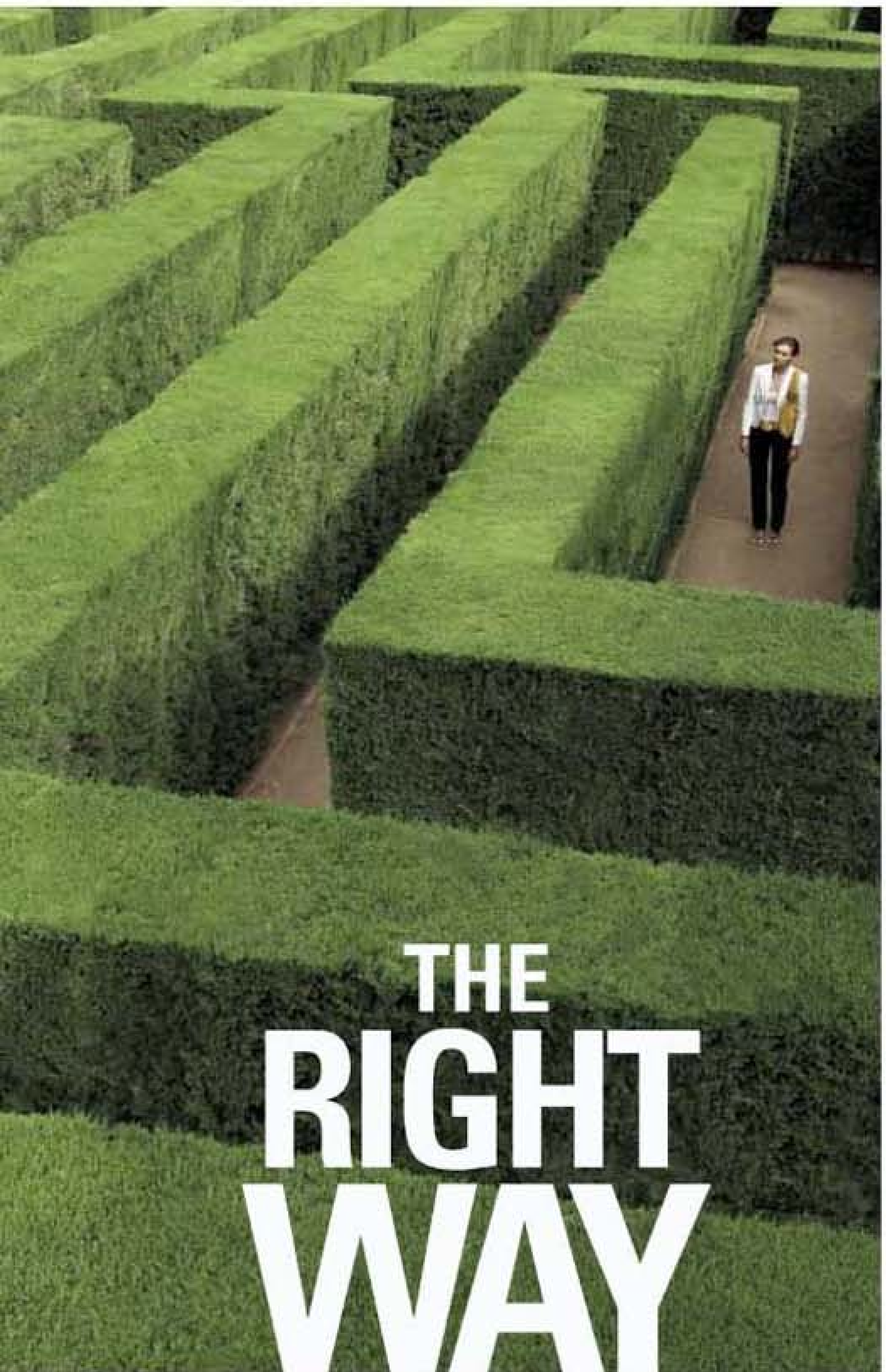

...page 62


Greg Norman drives:
A Gulfstream G550
A Bell 407 helicopter
A golf ball 320 yards
An earthmover
A one-man multinational
The Range Rover
Himself
RANGE ROVER
THE 2008 RANGE ROVER SUPERCHARGED DESIGNED FOR THE EXTRAORDINARY


LAND ROVER

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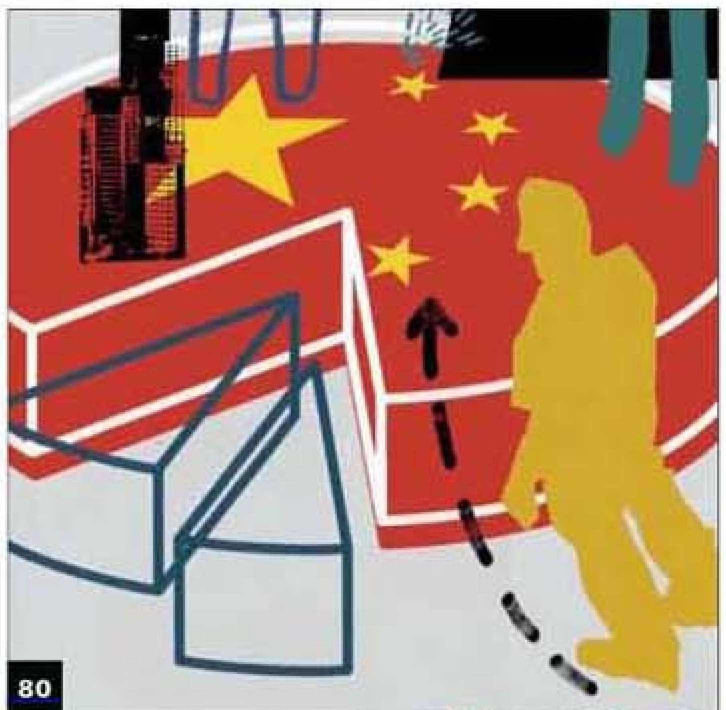
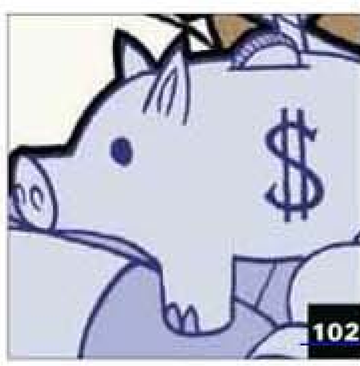
Features

continued on page 6





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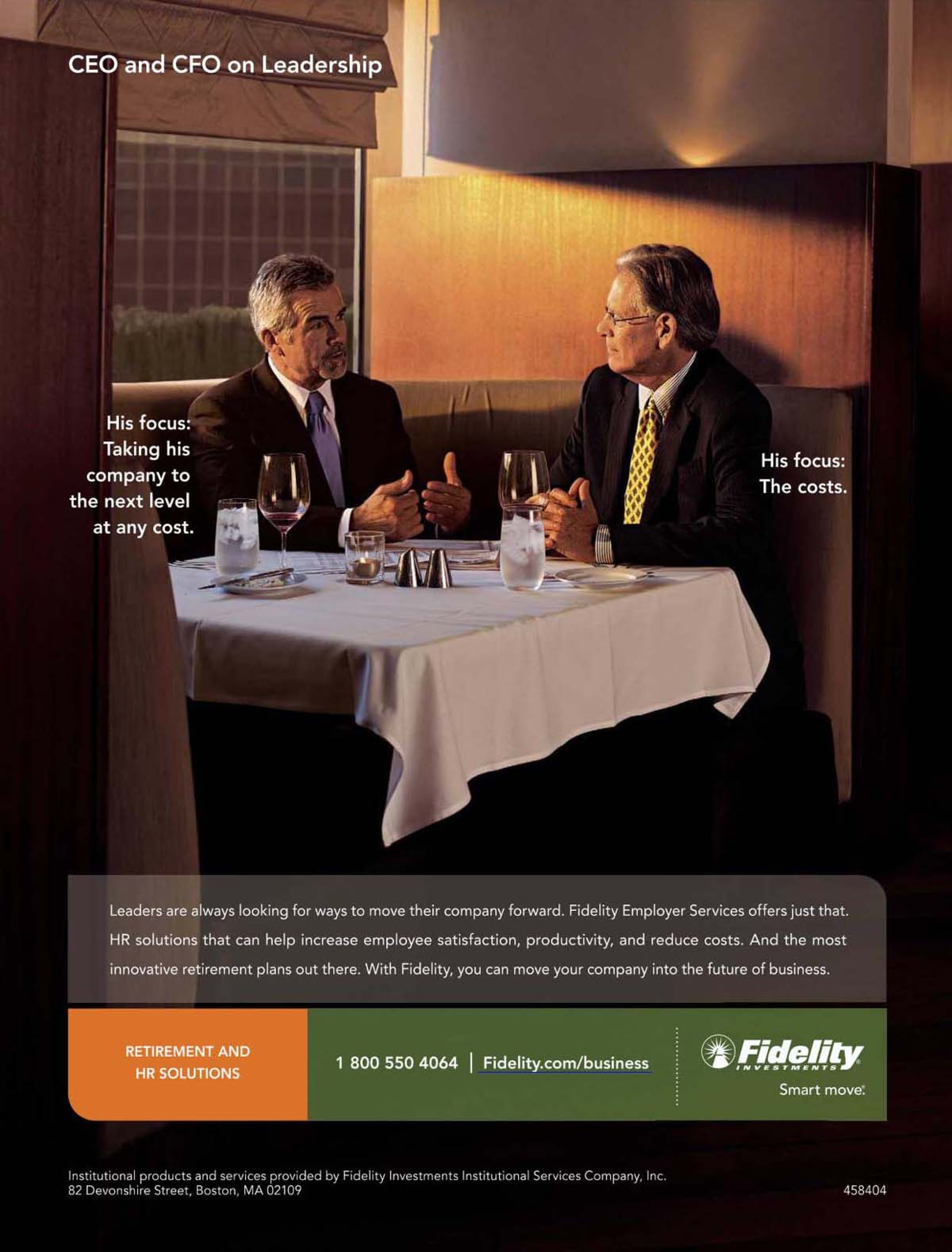
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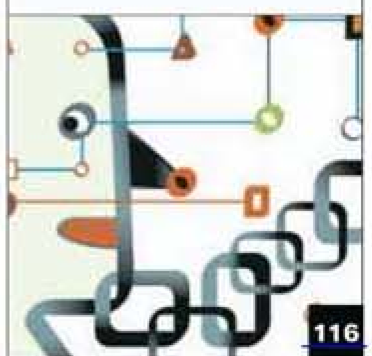

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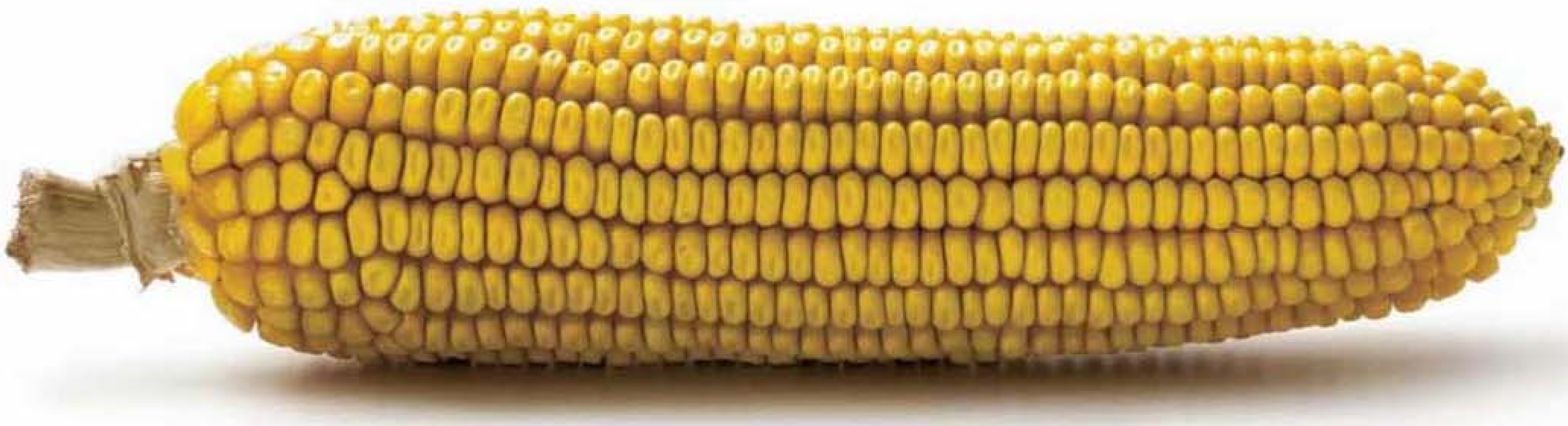

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The special Back to Business section highlights eight articles that HBR has published on evaluating individuals' work and on setting direction for an entire organization. During the month of September, readers can download the articles free by clicking on the "Back to Business" link on the home page.

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Through the Editors' Preview podcast, HBR editors share their thoughts on articles slated for publication in upcoming issues. To listen to the podcast, link to HBR's audio page from HBR.org.

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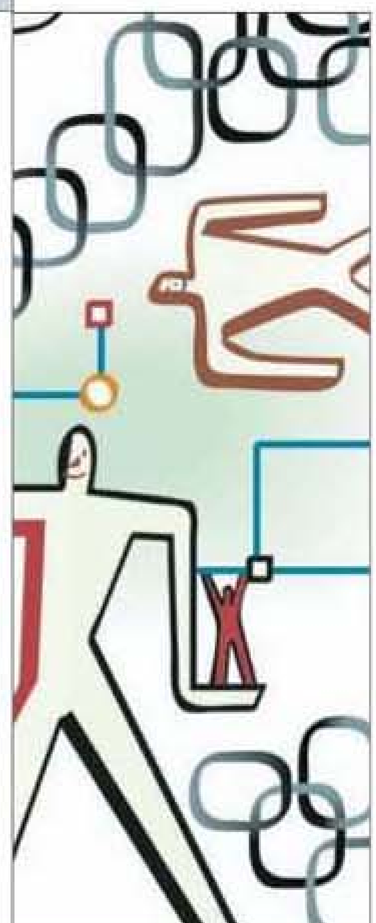
The Web version of the article "Are You the Weakest Link in Your Company's Supply Chain?" includes an interactive tool that will help you gauge how well you manage your own company's supply chain. Additionally, the authors will respond to selected queries at HBR.org on Wednesday, September 19. To submit a question, e-mail supplychain@hbsp.harvard.edu by Monday, September 10.



> Delve into Research on Women in Top Leadership

Readers wanting a more detailed look at the research behind "Women and the Labyrinth of Leadership" will find a full bibliography posted with the article online.

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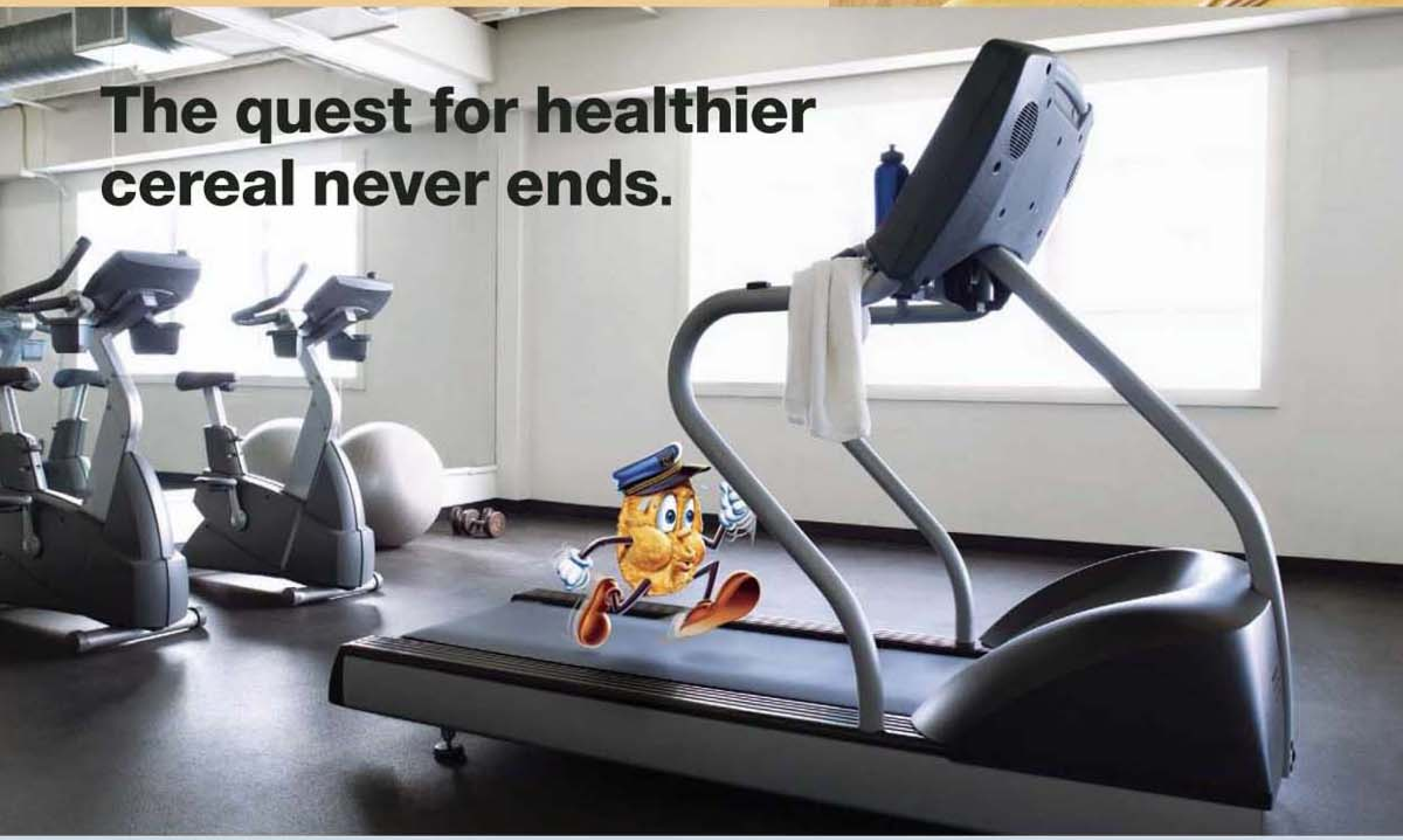
The editors of HBR have posted questions that managers ask about their biggest challenges, along with select articles that address each one. Readers can suggest questions or topics by clicking on "E-mail Us" on the HBR Answers page at HBR.org.



Organizations in this issue are indexed to the first page of each article in which they are mentioned. Subsidiaries are listed under their own names.

AUTHOR AFFILIATIONS

"How about here? This looks like a good spot to check our messages."

Carole Cable

Nose to the Grindstone, Eyes to the Stars

THE FRENCH HAVE A NAME for it: "la rentrée," the weekend when the autoroutes are clogged with families returning from their August vacations. It's "il retorno" for the Italians. In America, it's Labor Day weekend, the three-day holiday that marks the end of summer on the emotional calendar, if not the solar one.

It's back to business. In Manhattan, subways once again resemble sardine tins. In Europe, shutters are raised that had been pulled down a month before. Everywhere in the Northern Hemisphere, steps quicken. And, just as sailors can smell land long before it becomes visible, executives everywhere in the world sense the arrival of that entirely artificial but most important event, the end of the calendar year.

At HBR we don't normally track the progress of the calendar, but there's something about the September return that's worth marking. Maybe because it harks back to school days, September (not January) is the month when I'm most full of resolutions to improve myself, take on a big project, or finally dig in to work that has been sitting too long undone.

If you're like me, you'll find lots to fuel your resolve in this special back-to-business issue. To begin with, there's "Women and the Labyrinth of Leadership." In it, Alice Eagly and Linda Carli synthesize decades' worth of research about women in business and the experience of millions of women to show how the impediments to progress aren't one or two big bumps – a sidelining here, a glass ceiling there – but are, instead, a thousand small insults whose sum is unexpectedly large. Like the Colorado River, whose mighty waters are siphoned off for irrigation an acre-foot here, an acre-foot there, till nothing but a trickle reaches the Gulf of California, so is the stream of female talent diverted and discouraged. Read this – and resolve to change your and your company's efforts to recruit, retain, and promote talented women.

Read also Ivan Lansberg's "The Tests of a Prince." The title, of course, alludes to *The Prince,* Machiavelli's advice to a young leader. Lansberg, a consultant and expert on family business, has for a long time examined the process by which a son or daughter becomes seen as a legitimate successor. It's one thing to inherit daddy's company; it's another to be seen as worthy of the legacy. Lansberg found that heirs must pass four kinds of tests in the eyes of their peers and followers: qualifying tests of education or experience; self-imposed tests such as vision or team creation; circumstantial tests like those a crisis imposes; and political tests, for example, a rival's challenge to one's authority. These tests obviously apply to aspiring leaders in any kind of organization, yours included. Read about them – and resolve to meet your own next tests and to help your promising princes and princesses surmount theirs.

Read "Managing Global Accounts," by George Yip and Audrey Bink, for smart, tested advice and extremely useful frameworks about serving your biggest, most important customers. These are the ones that touch your company in many places, the customers for whom, in theory, a global-account-management program can create extra value for the customer and extra revenue and profit for you. In practice, however, global account management too often turns into a mechanism by which customers you can't afford to lose hammer your margins till you can't afford to keep them. Read this article – and find ways to get global accounts back on track.

And don't miss a back-to-business bonus. Beginning on page 112, we've created a special section summarizing classic HBR articles about two seasonal challenges: developing next year's strategic plans and preparing and delivering performance reviews. We've gone through the archive to select articles that will help you with these important tasks. This section of the magazine links to one on the Web, at hbr.org, where subscribers can read the full text of all the articles. Read them – and be a better leader.

Tom Stewart

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Harvard Business Review

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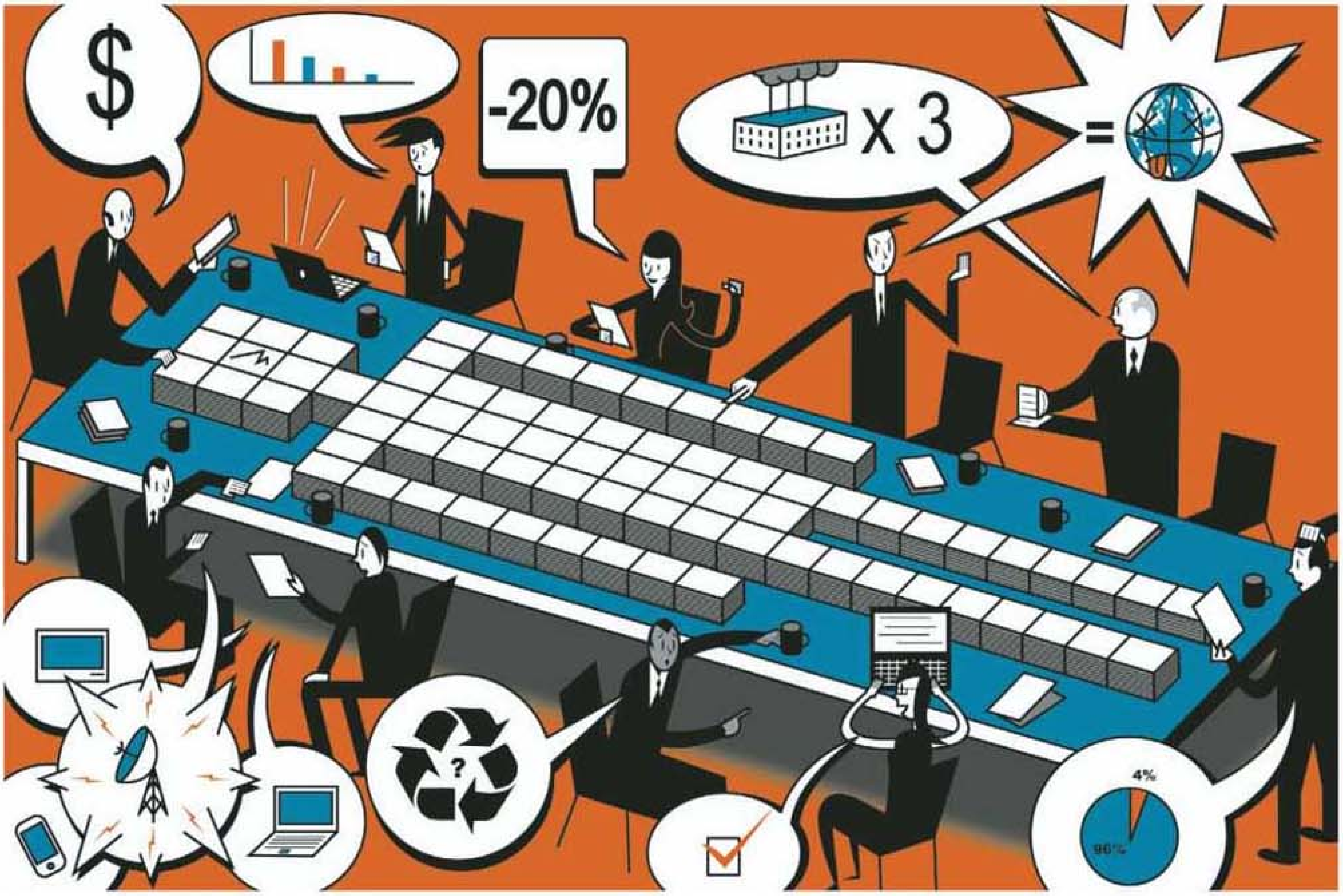
A survey of ideas, trends, people, and practices on the business horizon



Joel Castillo

GRIST

Performing a Project *Pre*mortem by Gary Klein

Projects fail at a spectacular rate. One reason is that too many people are reluctant to speak up about their reservations during the all-important planning phase. By making it safe for dissenters who are knowledgeable about the undertaking and worried about its weaknesses to speak up, you can improve a project's chances of success.

Research conducted in 1989 by Deborah J. Mitchell, of the Wharton School; Jay Russo, of Cornell; and Nancy Pennington, of the University of Colorado, found that prospective hindsight – imagining that an event has already occurred – increases the ability to correctly identify reasons for future outcomes by 30%. We have used prospective hindsight to devise a method called a *premortem,* which helps project teams identify risks at the outset.

A premortem is the hypothetical opposite of a postmortem. A postmortem in a medical setting allows health professionals and the family to learn what caused a patient's death. Everyone benefits except, of course, the patient. A premortem in a business setting comes at the beginning of a project rather than the end, so that the project can be improved rather than autopsied. Unlike a typical critiquing session, in which project team members are asked what *might* go wrong, the premortem operates on the assumption that the "patient" has died, and so asks what *did* go wrong. The team members' task is to generate plausible reasons for the project's failure.

A typical premortem begins after the team has been briefed on the plan. The leader starts the exercise by informing everyone that the project has failed spectacularly. Over the next few minutes those in the room independently write down every reason they can think of for the failure – especially the kinds of things they ordinarily wouldn't mention as potential problems, for fear of being impolitic. For example, in a session held at one *Fortune* 50–size company, an executive suggested that a billion-dollar environmental sustainability project had "failed" because interest waned when the CEO retired. Another pinned the failure on a dilution of the business case after a government agency revised its policies.

Next the leader asks each team member, starting with the project manager, to read one reason from his or her list; everyone states a different reason until all have been recorded. After the session is over, the project manager reviews the list, looking for ways to strengthen the plan.

In a session regarding a project to make state-of-the-art computer algorithms available to military air-campaign planners, a team member who had been silent during the previous lengthy kickoff meeting volunteered that one of the algorithms wouldn't easily fit on certain laptop computers being used in the field. Accordingly, the software would take hours to run when users needed quick results. Unless the team could find a workaround, he argued, the project was impractical. It turned out that the algorithm developers had already created a powerful shortcut, which they had been reluctant to mention. Their shortcut was substituted, and the project went on to be highly successful.

In a session assessing a research project in a different organization, a senior executive suggested that the project's "failure" occurred because there had been insufficient time to prepare a business case prior to an upcoming corporate review of product initiatives. During the entire 90-minute kickoff meeting, no one had even mentioned any time constraints. The project manager quickly revised the plan to take the corporate decision cycle into account.

Although many project teams engage in prelaunch risk analysis, the premortem's prospective hindsight approach offers benefits that other methods don't. Indeed, the premortem doesn't just help teams to identify potential problems early on. It also reduces the kind of damn-the-torpedoes attitude often assumed by people who are overinvested in a project. Moreover, in describing weaknesses that no one else has mentioned, team members feel valued for their intelligence and experience, and others learn from them. The exercise also sensitizes the team to pick up early signs of trouble once the project gets under way. In the end, a premortem may be the best way to circumvent any need for a painful postmortem.

Gary Klein (gary@decisionmaking.com) is the chief scientist of Klein Associates, a division of Applied Research Associates, in Fairborn, Ohio. He is the author of *Sources of Power: How People Make Decisions* (MIT Press, 1998) and *The Power of Intuition* (Doubleday, 2004).

Reprint F0709A

EMPLOYEE MORALE

How to Teach Pride in "Dirty Work"

Managers in occupations that the public considers repellent can use an array of techniques to help their employees cope with and, indeed, feel proud of their work, according to a study that drew on interviews with 54 managers in 18 stigmatized occupations, including exterminator, "exotic" entertainer, and prison guard.

Perhaps the most potent method is to develop an occupational ideology that confers a more positive image on the work by reframing it, according to Blake E. Ashforth, of Arizona State University, and three coauthors in the February 2007 *Academy of Management Journal*. A manager at a pest-control company, for instance, might emphasize the value of the knowledge that exterminators acquire. Managers can also help employees establish social buffers, in the form of professional associations or informal groups of coworkers and friends or family members who understand the work. As one manager of morticians said in an interview that was part of the study, "You go to...a national convention and you find out everybody's in the same boat."

A third tactic is to provide training on how and when to confront clients and the public to challenge their perceptions of the job. A fourth is to teach how and when to use defensive tactics, such as avoiding specifics during conversations with outsiders. The manager of an abortion clinic, for example, might advise staff members to say that they work "in women's health care."

The study also found that the organization as a whole can do things to protect employees, such as training them to deal with antagonistic members of the public; providing tours (if appropriate) to dispel suspicion about what goes on behind closed doors; rotating individuals out of particularly stigmatized tasks; and providing "backstage" areas, such as lunchrooms and lounges, where workers can step out of character and unwind. The authors note, however, that because some of these tactics are based on an us-versus-them view of outsiders, managers need to be careful not to decrease respect for clients and the public in the process of increasing workers' occupational self-esteem.

Most of the interviewees believed that society misunderstands their occupations and considered the stigma on their work to be unjust. In fact, when asked if they would recommend their occupations to their children, fewer than 20% said no. That suggests a refreshingly positive view of jobs that, as the authors put it, society often "necessitates but then sanctimoniously disavows."

Reprint F0709B

SOCIAL RESPONSIBILITY

Beware of Bad Microcredit

by Steve Beck and Tim Ogden

Companies are racing to add poverty-reducing microcredit initiatives to their corporate social responsibility (CSR) activities. Their hearts may be in the right place, but these well-intentioned efforts can backfire.

Don't misunderstand: Microcredit *can* raise borrowers' standard of living and help reduce poverty. In the past three years we've brokered investments in more than 150 carefully selected microcredit programs and have seen positive effects firsthand, including improved school enrollment, women's empowerment, better nutrition, and increases in household incomes.

Yet little evidence exists that microcredit borrowers, on average, commonly, directly, and quickly escape poverty, as many assume. Poverty, as always, is resistant to silver bullets, no matter how popular and appealing to donors they are. And if a company supports the wrong microcredit program, it may not only fail to reduce poverty but also tarnish its own good name.

Consider these facts: Many heads of microfinance programs now privately acknowledge what John Hatch, the founder of FINCA International (one of the largest microfinance institutions), has said publicly: 90% of microloans are used to finance current consumption rather than to fuel enterprise. Abhijit Banerjee and Esther Duflo, of MIT's Poverty Action Lab, recently evaluated dozens of rigorous studies on the economic lives of the poor, finding that regardless of country or continent, very little of each additional dollar of disposable income is spent on any form of investment, or even on food and shelter. In Bangladesh, where in 2001 approximately one out of four households had at least one microloan, microcredit seems to have had little impact on the country's relative development performance. In 1991, for example, Bangladesh ranked 136th on the UN Development Programme's Human Development Index (a measure of societal well-being); 15 years later it ranked 137th. And aside from the shortage of data showing benefits, there is evidence that some microcredit programs may actually be harmful, plunging the poor deeper into debt.

The root challenge for CSR leaders is that microcredit, like most other social programs developed in the charity sector, lacks standardized, readily available, outcome-based measures that would enable good funding decisions. Repayment rates and other commonly reported measures tell us nothing about the impact of a program on poverty. There are a number of promising trends in microcredit, including improvements in outcome measurement and reporting, the influx of capital with rigorous financial and social-benefit requirements, and the growth of commercial microfinance organizations with the scale and discipline required to drive down the costs of service delivery. These trends are nascent, however, and expert due diligence around investment in any program is therefore essential.

What are the dangers of a bad investment? From a humanitarian perspective, donating to ineffective microcredit programs slows the growth and threatens the sustainability of the best programs. From a corporate public relations perspective, companies that make low-value or even harmful microcredit investments risk being attacked for unsubstantiated claims about the impact of their CSR activities. Increasingly, companies are being exposed for "green washing" (touting environmental programs that have little or no benefit); now they may get bad press for "poverty washing."

How can a company avoid these undesirable outcomes? First, insist on a set of clearly defined measures of success – such as income growth, quality of housing, school enrollment, and nutrition – for microcredit programs you support, and be willing to pay for the measurement. Second, invest in improving the effectiveness of microcredit – for example, by supporting vocational training and financial literacy for borrowers, improving access to technology that lowers the cost of lending and borrowing, or lobbying for regulatory changes that make starting and growing businesses easier. Third, look for opportunities to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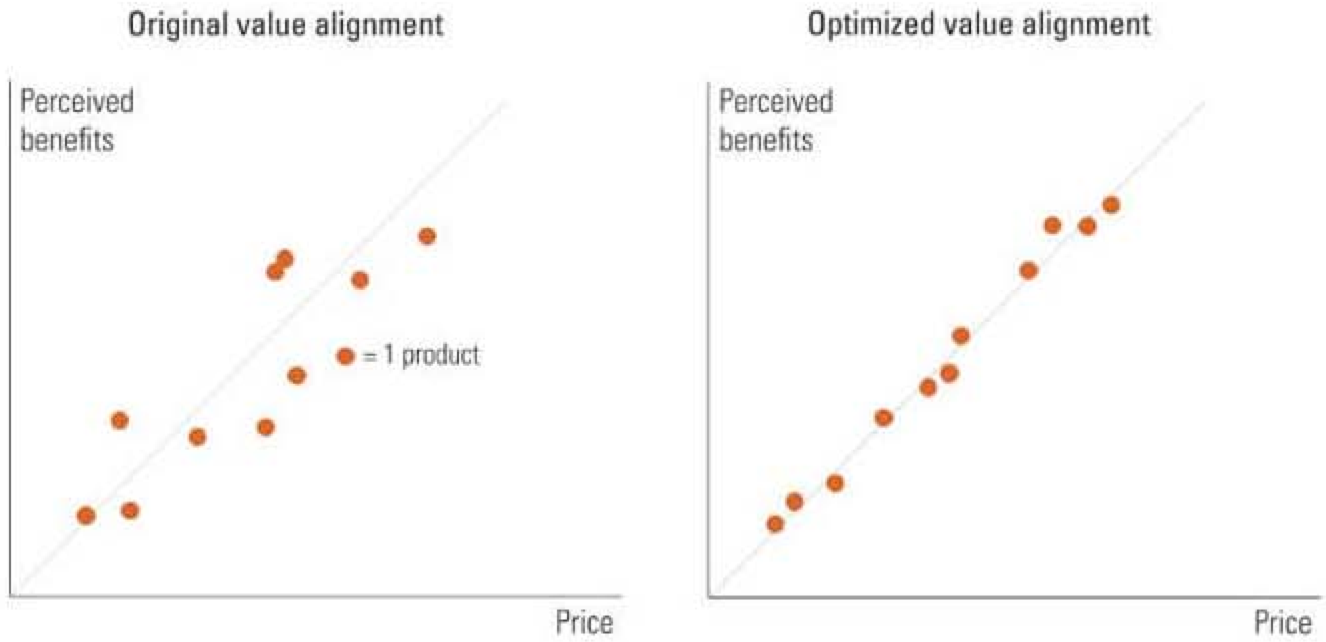
support the growth of small and medium-size companies in regions of poverty. Businesses that create stable, productive, nonexploitative jobs and vibrant local economies are the only sustainable program for mass poverty alleviation ever created.

Steve Beck (sbeck@genevaglobal.com) is the chief executive officer of Geneva Global, a philanthropy advisory firm with offices in London, Philadelphia, and Washington, DC. **Tim Ogden** (togden@genevaglobal.com) is Geneva Global's chief knowledge officer.

Reprint F0709C

Aligning Value

By charting perceived benefits relative to price across a product line, a company may discover significant misalignment (left chart). Aligning price with benefits (right chart) can result in increased sales and margins.



HOW THEY DID IT

Charge What Your Products Are Worth

by Venkatesh Bala and Jason Green

In a world with too many choices, aligning a product's price with its perceived benefits is critical – but many companies seem to miss this simple point. A good question for any company to ask itself is "What would Goldilocks think?" Instead of offering too few benefits – or too many – for a stated price, they must perfectly align benefits and price across the product category and the brand portfolio, finding the combination that is "just right."

To do this, companies must assess how customers accord value to products and brands within a category. From the customer's perspective, value has two components: the benefits received and the price paid. Value increases as benefits are added at the same price point or as price is reduced for the same benefits. After gauging customers' perceptions of value, managers can plot a simple chart that reveals any misalignment and use it to balance the benefit-price equation. This approach reaped huge dividends for Swingline, one of the most recognizable brands in office products. (See the exhibit "Aligning Value.")

Several years ago Swingline was growing only modestly and was on the verge of losing retail distribution for the category with the greatest growth opportunity: electric staplers. After extensive research, the company concluded that price and perceived benefits were poorly aligned across its products: Customers thought that some of its products were too expensive and others were too cheap.

Swingline's research identified a top segment of customers who were highly demanding and very much involved with paper tools. These "stapler aficionados" were willing, even eager, to pay a premium for a stapler that could handle constant heavy-duty use without ever breaking down. Yet until Swingline came to fully understand their perceptions of value, it failed to communicate why its electric staplers – priced up to ten times as high as a basic manual stapler – represented good value.

Working with similar insights along the entire product line, Swingline altered its strategy; it persuaded retailers, for example, to reorganize the layout and signage of stapler shelves to reflect customers' underlying value equation: product benefits by price tier. And the company shifted its communications to focus on the specific benefits – such as "no jamming" – that resonated most with each customer segment, rather than on basic product features that customers found less motivating. The cheapest staplers were promoted as delivering basic functionality at the lowest cost, mid-tier products as durable and reliable, and deluxe electrics as superior performers for "elite" users. Within months the sales of electric staplers had doubled, while premium manual staplers, whose sales had been flat, experienced strong double-digit growth. The new marketing model encouraged many customers to trade up, turning Swingline's own performance around by increasing sales and margins.

Venkatesh Bala (vbala@thecambridgegroup.com) is the director of the Economic Center at The Cambridge Group in Chicago. **Jason Green** (jgreen@thecambridgegroup.com) is a principal at The Cambridge Group.

Reprint F0709D

MARKETING

Sports Sponsorship to Rally the Home Team

by Francis J. Farrelly and Stephen A. Greyser

Companies often sponsor sports teams and events to promote their brands to the public. Increasingly, however, sponsorships are being used strategically inside companies to motivate employees or facilitate a major structural change, such as a merger.

This surprising finding emerged as part of a larger study – done in collaboration with our colleague Pascale Quester, of


There are 193 countries in the world.
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Global Oil Flows
The fact is, the vast majority of countries rely on the few energy-producing nations that won the geological lottery, blessing them with abundant hydrocarbons. And yet, even regions with plenty of raw resources import some form of energy. Saudi Arabia, for example, the world's largest oil exporter, imports refined petroleum products like gasoline.
So if energy independence is an unrealistic goal, how does everyone get the fuel they need, especially in a world of rising demand, supply disruptions, natural disasters, and unstable regimes?
True global energy security will be a result of cooperation and engagement, not isolationism. When investment and expertise are allowed to flow freely across borders, the engine of innovation is ignited, prosperity is fueled and the energy available to everyone increases. At the same time, balancing the needs of producers and consumers is as crucial as increasing supply and curbing demand. Only then will the world enjoy energy peace-of-mind.
Succeeding in securing energy for everyone doesn't have to come at the expense of anyone. Once we all start to think differently about energy, then we can truly make this promise a reality.
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. FIND MORE TRADITIONAL FUELS
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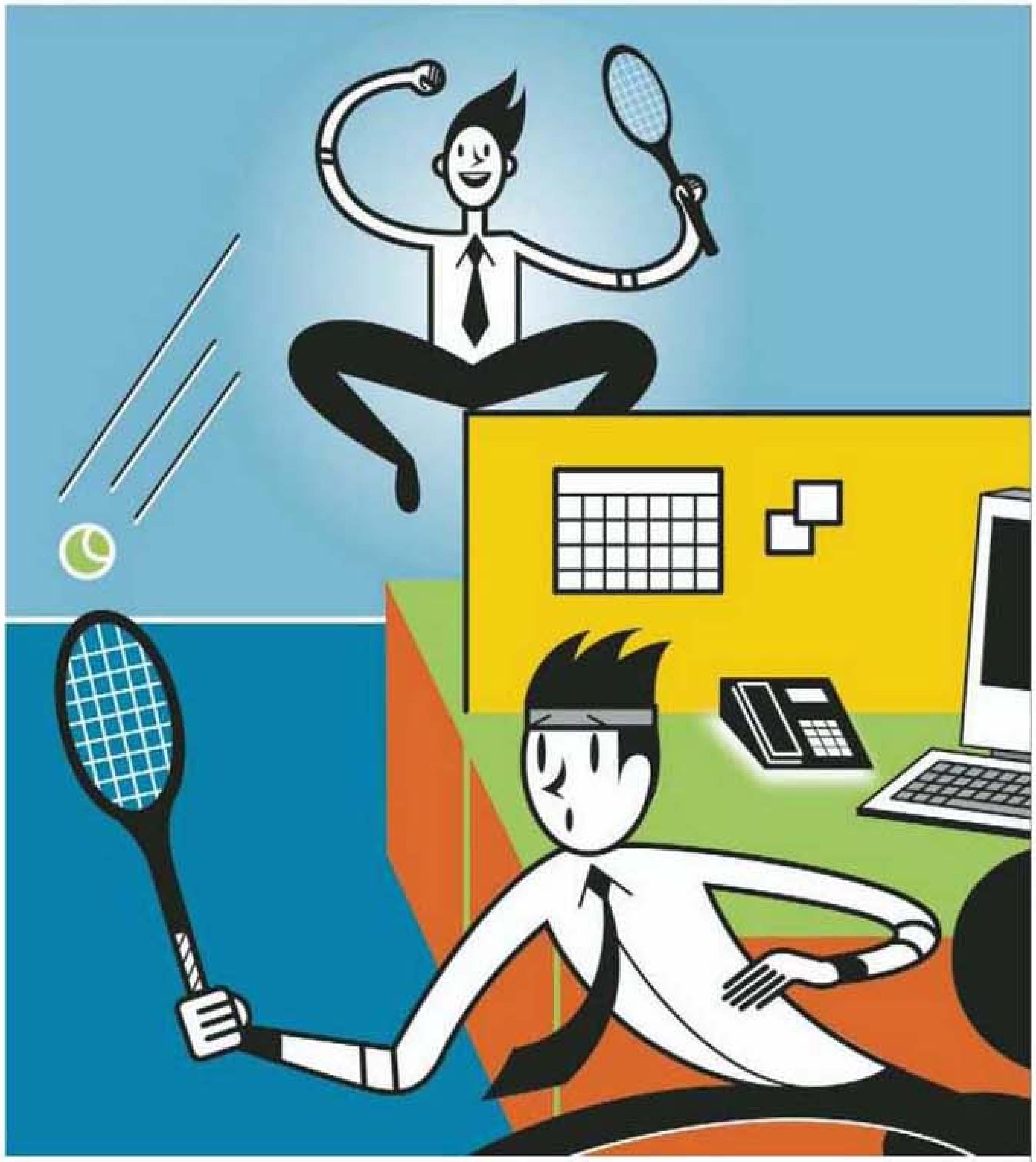

the University of Adelaide – that looked at sponsorship and brand-management practices in 20 global companies and sports organizations, including Nike, Visa, Crédit Lyonnais, the International Olympic Committee, and the International Federation of Association Football (FIFA).

Consider how Switzerland-based UBS, one of the world's leading financial firms, uses its sponsorship of Team Alinghi, the current title holder of the America's Cup yacht race, as an internal marketing vehicle. Values common to UBS and Team Alinghi, such as teamwork, responsibility, informed and rapid decision making, drive to succeed, and Swiss identity, are at the heart of communications designed to unite, motivate, and improve the output of the company's 67,000 employees scattered across the globe. UBS incorporates references to the sponsorship in internal memos and newsletters and in professional development programs (such as leadership education) where those common values reinforce corporate messages about the company's approach to employees and clients. UBS also integrates the sponsorship into various incentive programs, including one that rewards high-performing staff members by sending them to regattas around the world.

UBS created an intranet site known as the World of Alinghi, which offers information about the sponsorship's objectives and provides a toolbox of presentations, images, and display materials that employees can use to leverage the sponsorship in approaching clients. In addition to external marketing, an important function of the intranet site and toolbox is to build enthusiasm for the sponsorship. Across companies, the employee engagement stimulated by internal marketing of a sponsorship enhances the external effectiveness of the program; in the case of UBS, the sponsorship has been instrumental in motivating employees to help build the UBS brand.

In another case, the French banks BNP and Banque de Paris et des Pays-Bas (Paribas) used sponsorship of the French Tennis Federation as a unifying element in employee communications to promote acceptance of their post-merger identity and to describe the new company's future direction. Indeed, the logo and livery of the merged bank were launched primarily through the association with tennis; tennis merchandise and posters of tennis events were distributed widely through the combined network of branches. Moreover, rather than sponsoring just the French Open at Roland Garros, the new organization, operating as BNP Paribas, worked with the tennis federation to develop other events, including a masters competition, that would create further opportunities to engage with staff members around the sponsorship throughout the year. The resulting media exposure and the sponsorship's internal presence inspired many employees to embrace the new identity.

Management should weigh potential internal marketing value when contemplating any sponsorship program. Sports-related internal communication programs can create cohesion, elicit pride in the company, and enhance perceptions of it as a vibrant "winner" or leader in its industry. During a sponsorship, employee surveys can help in value assessment, and the very act of surveying can further engage employees in the program. Meanwhile, employees may find that their company's identification with a team or an event strengthens their relationships with customers.

Francis J. Farrelly (francis.farrelly@buseco.monash.edu.au) is an associate professor of marketing at Monash University in Victoria, Australia. **Stephen A. Greyser** (sgreyser@hbs.edu) is the Richard P. Chapman Professor of Business Administration (Marketing/Communications) Emeritus at Harvard Business School in Boston and a former HBR editorial board chairman.

Reprint F0709E

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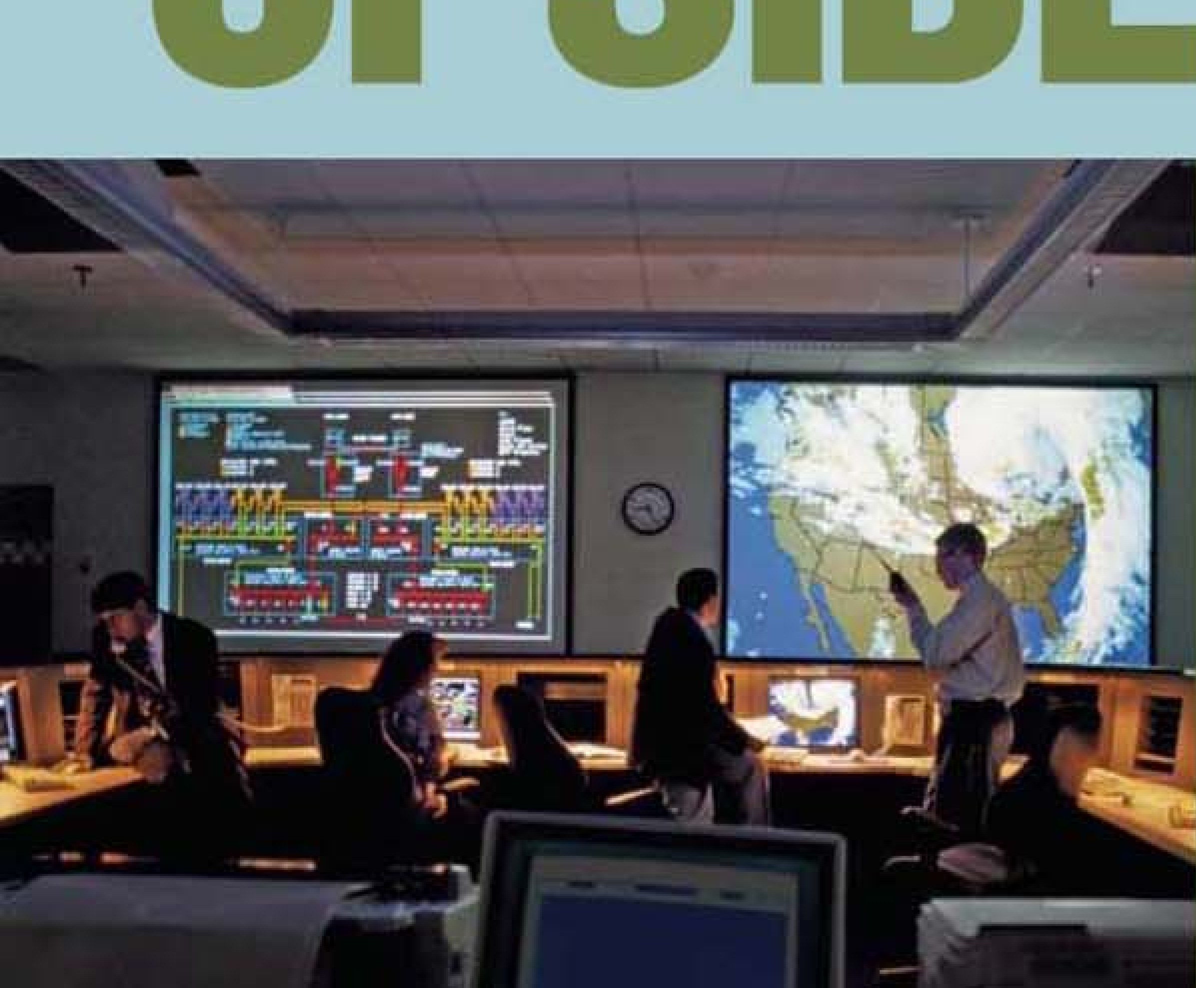
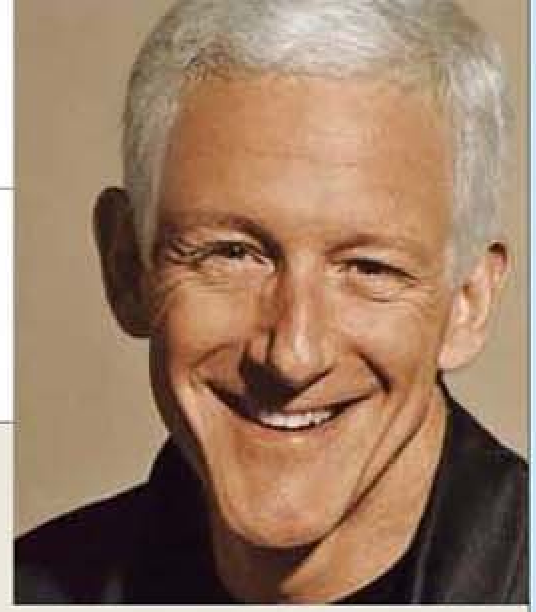


Conversation

Outdoor-apparel start-up CEO **Chris Van Dyke** on new ways to feed customers' passions



Nau, a fledgling U.S. retailer of high-performance outdoor apparel, does everything backward. It designed its Web site before building a single store; it encourages customers to buy less; and it markets by not talking about itself. Although it remains to be seen whether this experiment in retailing will succeed, Nau's CEO, Chris Van Dyke, offers some intriguing ideas about how to engage a generation of customers who are comfortable shopping online and know their way around an annual report.

Nau takes a contrarian approach to several aspects of retailing. For instance, your four stores – and the 20 planned for next year – are half the size of a typical apparel store. Why?

Most retailers start off with tangible stores and then try to mimic the in-store shopping experience on the Web. That's fine if you think of online shopping as just another marketing tool. But even though many of us at Nau come from decades of experience in big companies (I was at Nike and Patagonia), we designed our business from the opposite direction, aiming it at today's customers, who are completely at ease shopping online.

We created a Web experience, and then, because shoppers can't adequately appreciate the quality of clothing online, we created stores. Customers can come in and touch the fabric, try the garments on, and look at colors. But in many ways it's essentially an online experience. You go to a computer screen in the store and place an order, just as if you were sitting at home. And we give in-store shoppers a discount and free shipping to encourage them to have purchases sent to them. Customers can buy directly from the stores, but more than half elect to have their items shipped, even though, traditionally, immediate gratification is why people go into stores.

Is the ship-to-home approach meant mainly to save money on in-store inventory management?

Not at all. We believe our success will come from generating deep loyalty among customers, and we do that by appealing to them on many levels. We have great products that perform beautifully. But the products are embedded in an experience that reflects the way people like to shop nowadays – it has the convenience and choices that online shopping offers. And that experience is embedded within a corporate philosophy of personal responsibility toward society and the environment. Sustainability and social responsibility are important aspects of Nau. Our philosophy allows customers to be part of an active community and fulfills their desire to do the right thing for people and the planet.

Your company represents a high-risk bet on an unproven model. But could a mainstream retailer – Gap, for instance – learn anything from Nau?

Nau appeals to a somewhat rarefied demographic, but any company can benefit from authenticity. It provides a distinct brand-building advantage. Authenticity doesn't mean touting your donations to humanitarian causes. In our case, it means being aligned with personal responsibility on all levels. Many people in our customers' demographic – and more and more in all demographics – care about how a business operates and can figure out which business practices are only cosmetic.

Authenticity means that if a customer decides to peel back a layer and look at, say, an annual report or a news article, everything supports the company's stated philosophy. There are no hidden contradictions. For example, we recognize that sustainability is about reducing consumption, so our apparel is designed to be multiseason and multipurpose. We think we can offset each customer's reduced consumption by attracting more customers who are more loyal.

How does your marketing enhance a customer's experience of authenticity?

Months before we ever sold a T-shirt, we introduced ourselves in the blogosphere. We didn't talk about clothing. We created a dialogue around individual choice in living responsible lives. All of a sudden lots of people were coming to chat. The blog was just a manifestation of a bigger idea, the notion of a dialogue. The days of throwing one-way ads at customers to build brand relationships are over. That's true even if you're selling widgets or pipe fittings. In every business there are elements of design and engineering that customers have a passion for – and they want to express themselves in a dialogue with the company.

– Andrew O'Connell

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DECISION MAKING

The Wisdom of (Expert) Crowds

by Robert S. Duboff

A half-century-old divining method, the Delphi technique, is getting new attention from leading corporations, thanks to recent refinements and today's heightened connectivity. When properly framed and communicated, its broad predictions can be translated into highly useful strategic guidelines.

Named for the ancient oracle, the technique is a way of tapping the wisdom of experts. It involves recruiting 20 or so knowledgeable panelists and asking them to evaluate possible outcomes. Here's how the Delphi technique works: A company research team recruits a panel of experts in appropriate fields (the wider the range of relevant expertise, the better); asks them – by phone or e-mail or in person – about the future of, for example, an emerging innovation or a volatile market; and then requests that each panelist rate the likelihood of several predictions that have emerged from the panel's discussions or from company hypotheses. To ensure a free flow of ideas, the research team doesn't ask the experts to justify their predictions. The results are then tabulated for the panel, and the experts rate the predictions' likelihood again. Typically, at this point the team discusses the results with the experts. This process continues until consensus grows or ebbs. Some companies create and run the process themselves, but most use outside firms and remain anonymous, so that the panelists aren't biased by knowledge of a sponsor's identity. Companies that have tried the technique use it to guide decisions about major investments in, say, new technologies and about forays into immature or undefined markets.

Delphi panels were devised by the RAND Corporation to help the U.S. government imagine what might unfold in post–World War II Europe. They found early use in health care, education, and other nonprofit enterprises. Internet tools now enable panels to meet virtually, which makes it easier and less expensive for companies to recruit and schedule the experts, set up multiple panels to include a broad range of expertise, gather and distribute information, and conduct consensus building (though it is often helpful to bring the panelists together in person to mull over the findings). In addition, implementers have discovered that running multiple panels simultaneously can add great insight. In the case of an emerging technology, an additional panel of early adopters can be very helpful.

In the 1990s the Delphi technique helped a major television network predict that the advent of HDTV would be slower than widely expected. The network thus avoided making an unnecessary early investment to convert all of its equipment to digital. A global pharmaceutical company is using the technique to learn what trends or occurrences in the field of heart disease might induce consumers to take preventive actions such as changing their diets and starting medication when problems are first identified. A major financial services provider is beginning to use the technique, augmented by research among "lead users" (businesspeople and consumers deemed likely to be financially successful over time), to help determine which services to develop, which markets to target, and how best to earn customers' long-term trust and loyalty.

But Delphi results alone don't necessarily lead to great decisions any more than good market research does. The predictions are most useful if they are shaped into several possible scenarios that allow decision makers to understand the implications more fully. For instance, a panel's prediction that the incidence of Alzheimer's disease will increase would have much less value to a health care company than would a well-constructed scenario showing who might be affected – patients, families, health care facilities – and what the long-term consequences would be. Armed with detailed scenarios, a company can closely monitor the environment and act quickly in response to even faint indicators of which one is unfolding.

Robert S. Duboff (rob.duboff@hawkpartners.com) is a founder and the CEO of HawkPartners, a marketing consulting firm based in Cambridge, Massachusetts.

Reprint F0709G


You built this company from nothing.
Now you need capital to keep growing it.
But you're not about to cede control.
Not of the company you founded.
So, who are you going to turn to?
winningsolutions.ml.com
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ALIGNMENT

CEOs Misperceive Top Teams' Performance

by Richard M. Rosen and Fred Adair

New research suggests that CEOs have a rosier view of senior management's performance than other top team members do. In a global survey of 124 CEOs and 579 other senior executives at large and midsize firms from a range of industries, 52% of the non-CEOs said that their teams were doing poorly in critical areas such as thinking innovatively, cross-marketing, leading change, overseeing talent development, and building a company culture. Just 28% of the chief executives reported problems in these areas. Rating their teams' overall effectiveness on a seven-point scale (seven being the best), the CEOs gave an average score of 5.39, whereas the other executives gave an average score of only 4.02. (See the exhibit "Performance Scores Diverge.")

Statistically, these ratings are worlds apart, and it seems that CEOs are the executives who need a reality check. The research, conducted jointly by the Leadership Consulting practice of the executive search firm Heidrick & Struggles and the University of Southern California's Center for Effective Organizations, also included a survey of 60 top HR executives from *Fortune* 500 companies, only 6% of whom reported that "the executives in our C-suite are a well-integrated team."

To figure out if they and their teams are seeing performance the same way, CEOs could try turning to their colleagues for candid assessments. But without the anonymity of a large-scale survey, people may just tell the boss what he or she wants to hear. A simpler, more reliable test is for CEOs to ask themselves the following three questions. Those who answer no to any of them probably perceive team performance as better than other team members do – and, by extension, better than it actually is.

1. Does my team make decisions in meetings? Some CEOs prefer to weigh their options in private or to act on their own after having group discussions or one-on-one meetings with team members. Confident that such counsel has helped them make good choices, they may fail to see that their teams have been left out of a key part of the process: the final deliberation. Feeling powerless, the other executives understandably give themselves low marks for performance and for their ownership of team outcomes.

2. If we do make decisions in meetings, are they implemented shortly thereafter? The failure to move on an idea right away often indicates a team's lack of commitment to it. Since everyone has ostensibly signed off, the CEO assumes that the entire group is on board and that progress is imminent; meanwhile, silent dissenters let the idea wither through inaction.

3. Do meetings allow for lively conflict? Where there is no conflict, there is no passion. Avoiding disagreement means avoiding the really tough discussions, which almost inevitably require a higher level of engagement. In an always placid meeting room, a CEO may see consensus where a more objective observer would see conformity.

After reflecting on these questions, a chief executive will have a better sense of whether he and his team view their performance differently. If they do, management can get started on the hard work of true alignment; it will then become clear where performance really stands and what needs improvement.

Richard M. Rosen (rrosen@heidrick.com), who is based in New York, and **Fred Adair** (fadair@heidrick.com), who is based in Boston, are partners in the Leadership Consulting practice of Heidrick & Struggles.

Reprint F0709H

Performance Scores Diverge

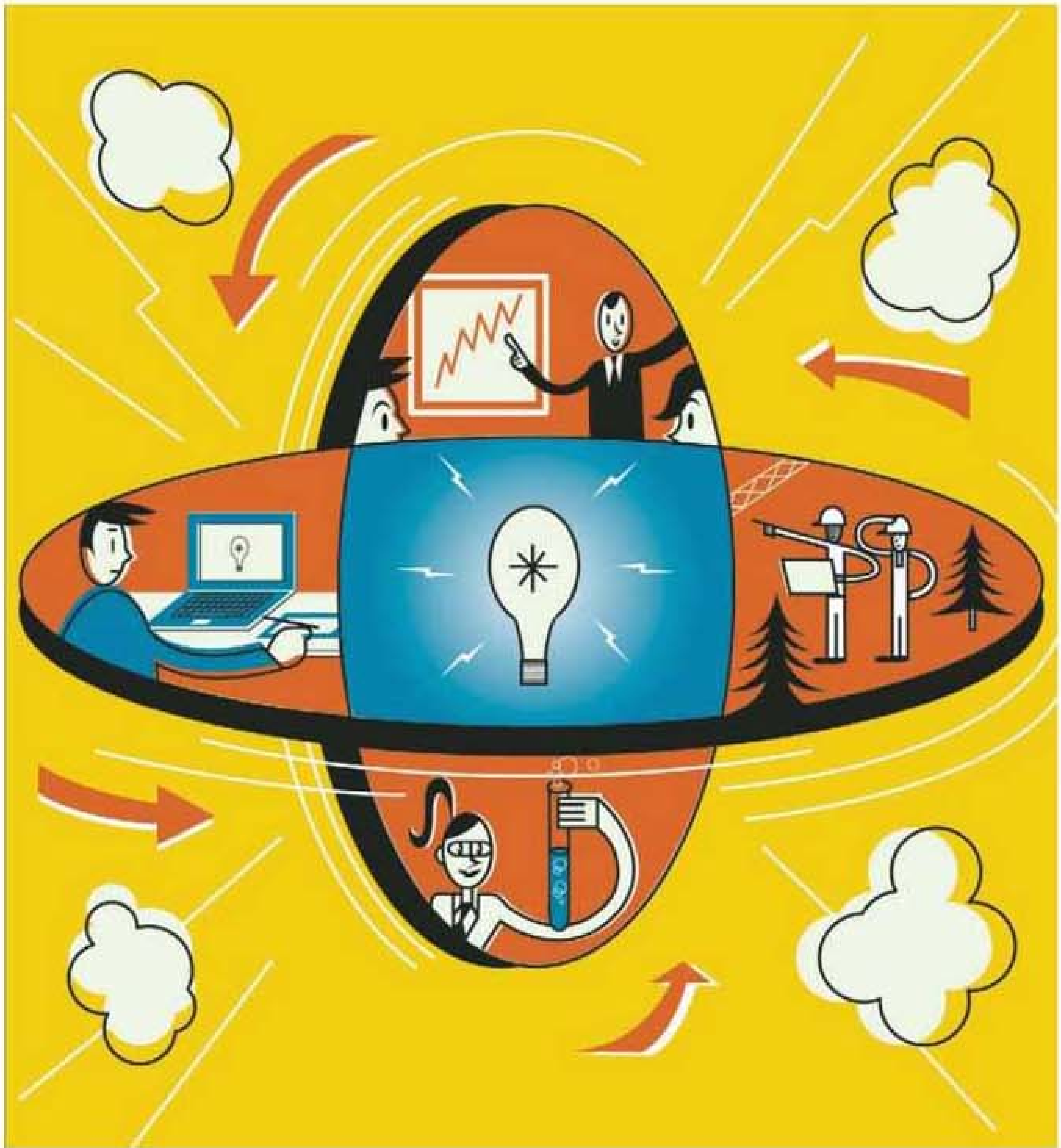
In a recent survey, 124 CEOs and 579 other senior executives rated several aspects of their top management teams' performance on a scale of one (lowest) to seven (highest). As the scores here show, the CEOs thought things were going better than the non-CEOs did.

INNOVATION

Innovate Faster by Melding Design and Strategy

by Ravi Chhatpar

If they're to do their job most effectively, designers should be brought into the innovation process at the very earliest stages. Too many companies still make the mistake of keeping business strategy and design activities separate. Typically, marketers conceptualize a new product based on company strategy; the project team gets input from various areas of the company and creates a business case; and senior executives make a final choice from among the possibilities they're given. Only then does the idea go to the designers.



That sequential method ensures that the product is aligned with strategy, allows the team to create buy-in and build consensus, and gives senior executives an array of options. But it takes a long time, so even if the original concept drew on real-world data about users, the company is inevitably unable to adapt to rapid, unforeseen changes in markets and user preferences.

The solution is to bring in designers at the very beginning of the process, because designers (if they do what they're supposed to) will put prototypes into circulation and share users' responses and attitudes with the project team, even as the business case is being developed. That enables the company to nimbly adjust to changes in market opportunities long before the product concept is set in stone.

From concept through development, designers should function in parallel with corporate decision makers, creating prototypes for a number of variations on a product and then testing them with users and, if appropriate, partners. Tracking how customers' ways of using a product evolve over time also makes it possible for designers to identify desirable new features and, in some cases, create new functionality in conjunction with users.

Planners should concurrently be considering the business implications, asking questions such as "How much would it cost to incorporate this new feature?" and "How should we respond to users' changing needs?" The team should continually feed new information from user research and prototype analysis into the evolving business strategy. Constraints that emerge, such as price or a decision to offer standard versus premium features, may be used to inform the next prototype, which can then be evaluated through more formal testing. And the cycle repeats.

Our firm's recent work with Alltel, the owner and operator of America's largest regional wireless network, provides an example of this fully integrated process. Alltel wanted to go beyond simply improving existing communications services; it wanted to change the industry, by making mobile devices more central in users' lives. We explored nearly 100 ideas, from basic to wild, and then used prototypes to investigate the most compelling. We tested these iteratively with users and with Alltel partners, to understand what users did with them and what the partners were interested in, and eventually focused on a new platform we called the Celltop, which brings the concept of "widgetization" – on-screen PC mini-applications – to the mobile environment. The findings from our prototypes informed the product road map and helped to develop a model for successful execution through collaboration with various industry players. Because Alltel's manufacturing partners were exposed to the Celltop concept early on, they were able to make needed adjustments quickly, and the new platform was brought to market in just 12 months.

The traditional method of formulating product strategy – in which the various phases (the options portfolio, the business case, the road map, the execution plan) are sequential and consensus is required for each step before the next begins – is inflexible and often leads to products that are based on outdated assumptions about customer behavior and company potential. This, in essence, is why the U.S. auto industry was late to recognize the market for hybrids and why Friendster lost its first-mover advantage to MySpace, which had better feature planning and scaling.

By contrast, involving designers at each stage of the strategy and development process can lead to better product decisions and improve a company's ability to seize new market opportunities.

Ravi Chhatpar (ravi.chhatpar@frogdesign.com) is the strategy director in the New York and Shanghai studios of Frog Design, a strategic-creative consulting firm headquartered in Palo Alto, California.

Reprint F0709J

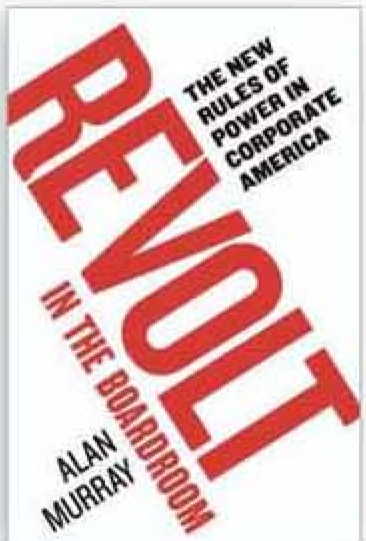
Reviews

Revolt in the Boardroom: The New Rules of Power in Corporate America

Alan Murray
(Collins, 2007)

If you're an American CEO, who's your boss? If you answer "The board – and it's breathing down my neck," you're in good company.

That's the premise behind a provocative book by *Wall Street Journal* reporter Alan Murray. Murray, a former Washington correspondent, analyzes current corporate governance and finds that it has much in common with the power struggles he wrote about on his previous beat.



Murray frames his engagingly written book as an update on the tensions laid out by Adolf Berle and Gardiner Means's 1932 classic *The Modern Corporation and Private Property*. Berle and Means explained that with the rise of mass stock ownership, investor oversight was too diffuse to keep managers accountable. They argued that managers, like anyone else with enormous power and few restraints, would inevitably abuse their positions.

As Murray tells the story, New Deal regulation and union power kept American executives in check for a few decades. But as those pressures waned in the 1980s and 1990s, and companies gained public prestige, executives flexed their muscles. Now, after a string of managerial abuses, governments have reasserted themselves and newly emboldened financial institutions have intervened.

Three recent forced resignations of CEOs set the stage for the book: Carly Fiorina at Hewlett-Packard, Harry Stonecipher at Boeing, and Hank Greenberg at American International Group. Murray argues persuasively that if their troubles had happened a decade ago, these executives would have kept their jobs. What changed, he says, is that personal liability, outside regulators, and aggressive investment funds have forced boards of directors to step in. Reluctantly, boards are now acting as real checks on managerial behavior.

The most interesting part of the book involves the identity of boards. Now able to meet without the CEO, having key oversight functions, and including fewer active CEOs in their midst, boards are taking on a life of their own. A good deal of evidence suggests that directors are showing no special loyalty to regular shareholders (they still pay CEOs as much as ever). And boards are hardly monolithic: A dramatic chapter on the infamous leak investigation at HP shows deep divisions among the company's independent directors. Clearly, directors must respect the growing outside pressures on corporations. But where do their own interests lie?

That question is all the more pertinent in light of the challenge thrown out by a number of departed CEOs whom Murray interviewed: At what point does board oversight become so active that it undermines managerial decisions and corporate flexibility?

– John T. Landry

Supercapitalism: The Transformation of Business, Democracy, and Everyday Life

Robert B. Reich
(Knopf, 2007)

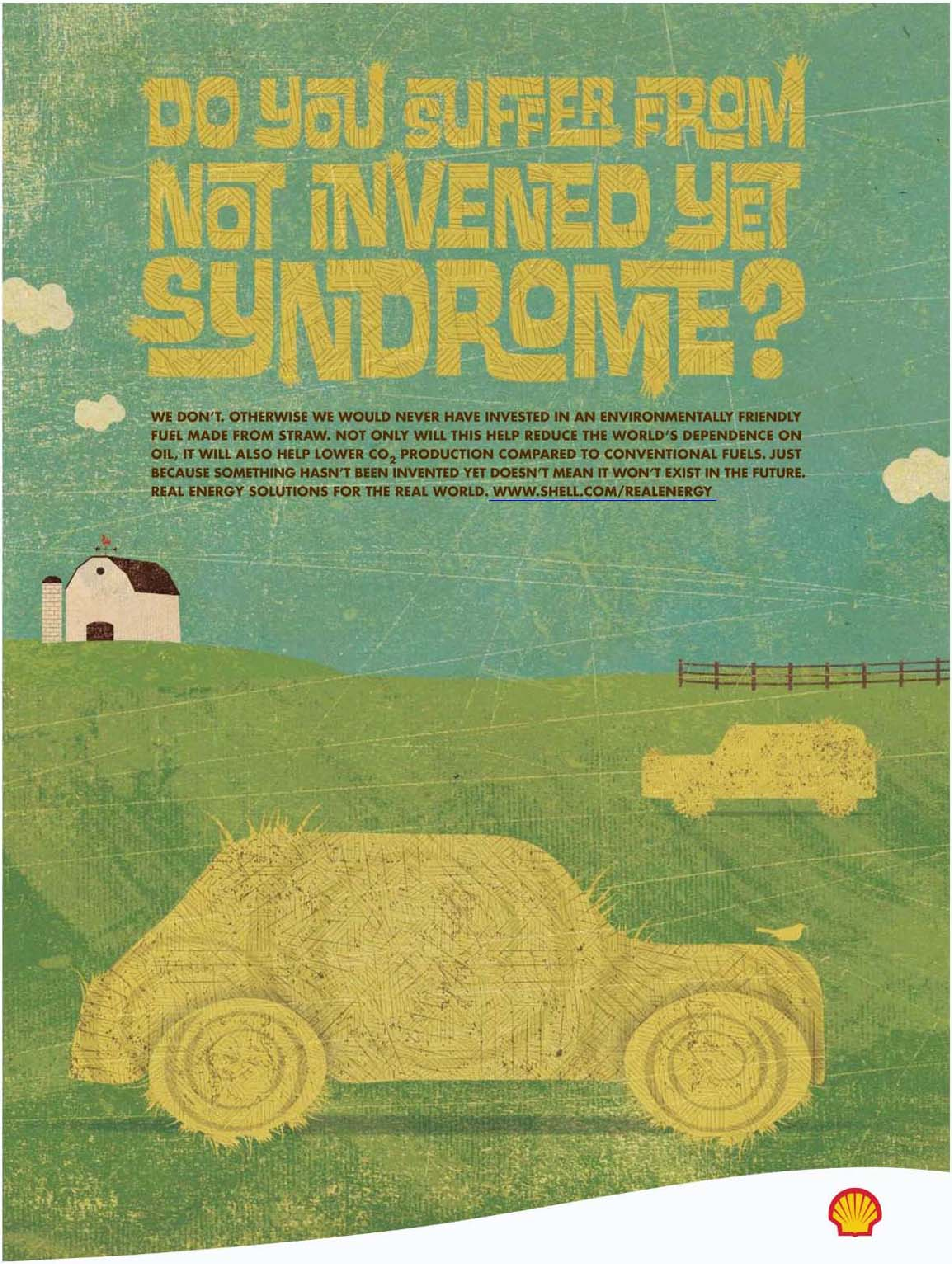
Just as corporate social responsibility is going mainstream, here's a powerful liberal argument that it is now, and can never be more than, a sham. Reich, a former U.S. labor secretary and now a professor of public policy at Berkeley, says that hypercompetition and the triumph of commercial values have made it practically impossible for companies to pursue social needs that don't pay off on the bottom line. Companies that go against marketplace forces (as Merck did in preventing river blindness) do so at best as an incidental add-on to their fundamental strategy of having profits drive the business (which led Merck to heavily market Vioxx). Soulless corporations, Reich says, should never be expected to address problems beyond their value chain – only citizens and governments can effectively address social challenges. The argument has some holes – if competition is so fierce, why are companies seeing record profits? – but it's an engaging and insightful account.

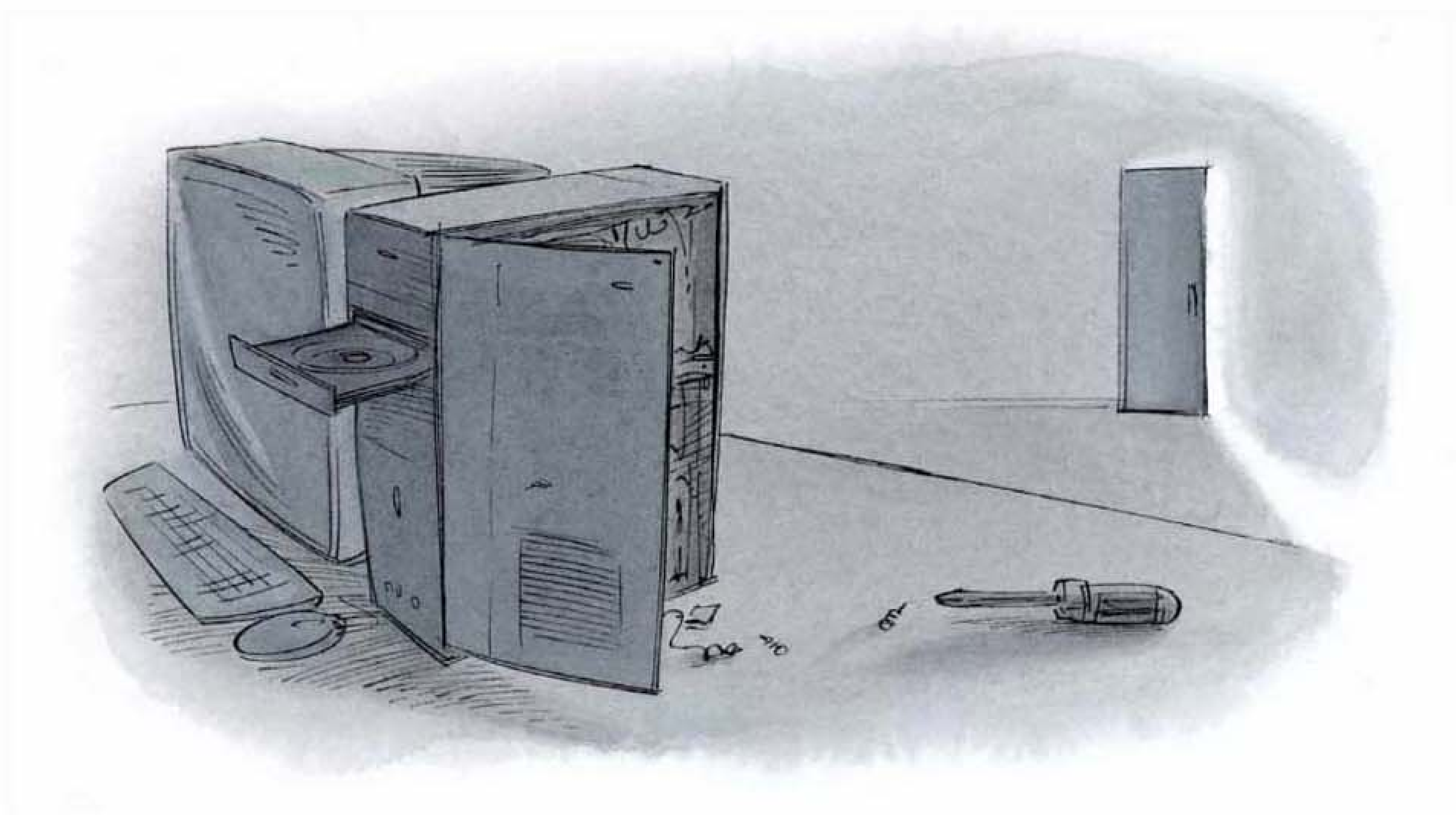
The Clean Tech Revolution: The Next Big Growth and Investment Opportunity

Ron Pernick and Clint Wilder
(Collins, 2007)

Technologies that minimize environmental harm are big business with a big question mark. How much of the current demand is due to social concerns – and therefore susceptible to the changing whims of governments and consumers – and how much to hard improvements that render these technologies competitive with existing practices? Everyone may accept the urgency of staving off global warming, for example, but the actual social and regulatory pressures to reduce carbon emissions will fluctuate, making business calculations difficult. Pernick and Wilder, researchers and publishers in this area, offer an accessible and detailed survey of the major technologies and players. Although technologies are improving quickly, the authors acknowledge that the social concerns are still an enormous factor in their acceptance; even wind power use varies heavily depending on tax credits. Yet they effectively argue that conventional fuel sources and consumption also benefit from a complex array of subsidies. Rather than being an external factor, social concerns are baked into the industry.

– John T. Landry


DO YOU SUFFER FROM NOT INVENTED YET SYNDROME?
WE DON'T. OTHERWISE WE WOULD NEVER HAVE INVESTED IN AN ENVIRONMENTALLY FRIENDLY FUEL MADE FROM STRAW. NOT ONLY WILL THIS HELP REDUCE THE WORLD'S DEPENDENCE ON OIL, IT WILL ALSO HELP LOWER CO_2 PRODUCTION COMPARED TO CONVENTIONAL FUELS. JUST BECAUSE SOMETHING HASN'T BEEN INVENTED YET DOESN'T MEAN IT WON'T EXIST IN THE FUTURE. REAL ENERGY SOLUTIONS FOR THE REAL WORLD. WWW.SHELL.COM/REALENERGY



Boss, I Think Someone Stole Our Customer Data

Flayton Electronics learns that the security of its customer data has been compromised – and faces tough decisions about what to do next.

by Eric McNulty

BRETT FLAYTON, CEO of Flayton Electronics, stared intently at a troubling memo on his desk from the firm's head of security. Running his hands through his full head of barely graying hair, he looked not unlike his father did when he established the first Flayton Cameras and Stereos 25 years ago.

The security situation had come to Brett's attention just before nine o'clock the previous evening. On his way home from a vendor meeting, he had been settling into an armchair in the airline lounge. He had barely opened *Electronics News* when his mobile phone rang. It was Laurie Benson, vice president for loss prevention.

"Brett, we have a problem. There might be a data breach." Laurie, a tough but polished former Chicago police detective, had been responsible for security at Flayton's for almost three years. She had an impressive record of reducing store thefts while

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

Daniel Vasconcellos

building productive relationships with local schools, community groups, and law enforcement.

"What kind of data breach?" Brett asked. His tone was calm, as always, yet he scanned the lounge to make sure that no one could overhear.

"I'm still not sure," Laurie admitted. "I was contacted by Union Century Bank. They regularly examine their fraudulent accounts for patterns, and we've shown up as a common point of purchase for an above-average number of bad cards. They're getting me more information, but I thought you'd want to know right away. It could be nothing – or it could be significant."

Brett recalled the newspaper stories he had read about stolen laptops with veterans' records stored on them and about hackers trying to penetrate eBay and other big online retailers. His firm was just a regional chain with 32 stores in six states and a modest online presence. Flayton's could hardly be a target for stealing lots of customer data. Or could it?

"Laurie, I'm not sure I understand. People were using stolen credit cards at our stores? Our clerks weren't checking cards correctly?"

"No," she replied earnestly. "It looks like we might be the leak."

New Territory

Back in his office the next morning, Brett surveyed the fruits of his own overnight Internet research. Data theft was apparently common, and companies could be breached in various ways. The thieves stole credit card information, social security numbers, bank account information, and even e-mail addresses. There seemed to be a black market for almost any kind of data. He learned that the criminals were becoming increasingly clever and that no one was immune. He took some comfort in his company's having recently spent considerable time and money becoming compliant with new payment card industry, or PCI, standards for data protection.

Laurie sat across from Brett in silence. She had anticipated this kind of theft would happen sometime, but actually coping with it was new territory for her. All of her related professional experience had involved the stealing of physical property. In this case, data had been obtained illegally by someone, somewhere – but with no clear-cut crime scene to sweep for clues.

A routine analysis by Union Century Bank of fraudulent credit card charges identified purchases at Flayton's on almost 15% of the cards in this particular batch of about 10,000 compromised accounts – so roughly 1,500 in all. It was a surprisingly high number for a routine check. Union Century had begun to notify other banks, as well as Visa and MasterCard, to see whether they had observed similar patterns.

"Wouldn't we have noticed that ourselves?" Brett asked. "We get regular reports from the banks."

"Not necessarily," Laurie replied. "We would have, if the purchases at Flayton's had been fraudulent. But that's not what seems to have happened. The purchases were legitimate, but the account information is being used elsewhere illegitimately. We could not have identified the problem, except through a random check like the one Union Century did. The 1,500 accounts could be just the tip of the iceberg."

"What's our potential exposure?" Brett inquired matter-of-factly. Quietly he wondered whether the firm's PCI compliance would provide sufficient protection.

"Not sure, I'm afraid. The credit card holders are protected by the bank, but what that means for us is tough to say."

"Why do we have to notify customers at all?" Brett asked, genuinely puzzled. "Haven't the banks already informed them that their accounts have been compromised?"

"It's not that simple," Laurie explained. "Some banks have sophisticated analysis tools to detect unusual patterns early on, but that method is imprecise. Often banks don't begin to recognize a problem until a bill goes unpaid or a credit card holder complains. They usually just monitor a situation until specific problems arise. If cardholders don't pay close attention to their bills, fraudulent debt could accumulate for months before it's caught. As I understand from the bank, alerting our customers that their data might have been stolen could be the best means of early detection."

"This business was built on trust. Our reputation for a square deal is a competitive advantage. I don't ever want to have to look a customer in the eye and defend not being straight with him."

Laurie had brought herself up to speed pretty quickly and had spent the early morning hours briefing key managers and flagging possible areas of vulnerability in the data chain. The chain itself was simple, but identifying its weakest points was not. At the cash register, a customer presented a payment card, which was swiped through a reader. The information from the card and the specifics of the purchase were transmitted to a bank for approval or rejection. It all happened in seconds. Transaction information was stored on company computers and showed up in a number of reports. Credit card numbers shouldn't have been stored in the firm's system, but Laurie still didn't grasp every step of the process. Could

Eric McNulty (emcnulty@hbsp.harvard.edu) is the managing director of the conferences division of Harvard Business School Publishing, which publishes HBR, in Boston. His weekly online column, "Heard in the Suite," appears on Thursdays at www.harvardbusinessonline.org.

the card readers have been hacked? Could the data lines between the stores and the bank have been tapped? Were the stored data secure? Might someone have inserted code into the company's software to divert certain information to a remote computer – or even a computer on the premises? Could it have been an inside job? Or perhaps the work of someone who had been fired?

"Any chance that this could just be someone's careless mistake?" Brett volunteered. "Maybe an employee tossed files into the dumpster."

"Well," Laurie shrugged, "it's possible." She paused, then shook her head. "But not likely."

"What about some kind of coincidence?" Brett was grasping at straws. "Perhaps 1,500 of our customers just had the same bad luck?"

Laurie inhaled deeply, then exhaled slowly. "Anything's possible at this point. I need to know more than I do now. The bank connected me with the Secret Service, which is handling the investigation because accounts in multiple states were affected. It will take a couple of days to have other banks try to corroborate Union Century's findings. For now, the Secret Service recommends that we run background checks on everyone who could possibly have access to data on the scale of the breach – even people we've run checks on before. We should also pull personnel files on anybody we've let go in the past year for cause. And we need to check, check, and triple-check every system in the house."

"I'm sure that Sergei already has that in the works," Brett replied. He knew that kind of thing would drive Sergei Klein, the CIO, nuts until he figured it out. Brett rose and paced around the perimeter of his office. He paused at the window to survey the more than 300 cars in the parking lot. He felt some responsibility toward every person with a vehicle in that lot and toward the hundreds more who worked in the stores.

"What else did the Secret Service say to do?" Brett had visions of black SUVs with tinted windows, full of earnest agents in wraparound sunglasses, descending on his headquarters and stores.

"First," Laurie explained, "they asked that we keep this under wraps until we get a full picture. Now that the banks know what's going on, they can shut off the cards quickly when fraud surfaces. But the feds want enough normal activity to allow them to do a proper investigation and, we all hope, initiate prosecution. Although the Secret Service is taking the lead, they expect to also involve some state and local fraud units.

"But what about the customers? We can't knowingly let them be defrauded!" Brett was uncharacteristically adamant. "This business was built on trust. Our reputation for a square deal is a competitive advantage. I don't ever want to have to look a customer in the eye and defend not being straight with him."

"It's a question of the greater good," Laurie offered. "The customers will not be responsible for the charges. They're fully covered. We have to nail the bastards who did this."

Limited Defenses

Brett couldn't bear to just wait for answers. He quickly ushered Laurie out of his office, canceled his next meeting, and made his way past a dozen gray cubicles toward Sergei's haunt. Listening to the sounds of fingers clicking on keyboards and file drawers opening and closing, he couldn't help but marvel at how much information was available to anyone in those cubicles at any time.

As Brett arrived at Sergei's door, the CIO was slamming down his phone in frustration. Brett's attention shifted from the receiver directly to Sergei's eyes. Sergei swallowed.

"Sergei, what do we know?"

"We're still trying to determine what happened," the CIO offered meekly.

"But we are *sure* that our PCI systems were working, right?" Brett pushed.

"Becoming PCI compliant is complicated," Sergei hedged, "especially when you're constantly improving your own technology." He ran through a laundry list of the complexities of recent improvements. At any given moment, Sergei had three or four high-priority tech projects in various stages of implementation. It was a constant juggling act.

Brett, in a rare display of anger, pounded his fist on Sergei's desk. "Are you saying, Sergei, that we're not actually PCI compliant?"

Sergei stiffened. "We meet about 75% or so of the PCI requirements. That's better than average for retailers of our size." The response was defensive but honest.

"How have we been able to get away with that?" Brett growled. He knew that PCI compliance, which was mandated by all the major credit card companies, required regular scans by an outside auditor to ensure that a company's systems were working – with stiff penalties for failure.

"They don't scan us every day," Sergei demurred. "Compliance really is up to us, to me, in the end."

Core Values at Risk

The wall across from Brett's office was covered with hundreds of photographs taken with cameras bought at Flayton's. Weddings, vacations, graduations, sunsets, and smiling infants – all sent in by customers. Similar displays brightened the walls of every Flayton Electronics store, to remind employees that customers are not just wallets who buy your products. One of the pictures closest to Brett's doorway was of his father handing over a poster-size check to a local charity.

As Brett contemplated the photos, he wondered whether he had pushed growth too quickly. After his dad retired, Brett ramped up his ambitions. He had sought private equity investment a few years ago, and he was constantly aware of his obligation to deliver the returns he'd promised. His strategy had been aggressive, but he was confident in it – until now. Had he been shortsighted about the infrastructure needed to run a much larger company? Had his company's needs outgrown the capabilities of his longtime staff? Had he left Flayton's vulnerable by underinvesting in systems? Had he pushed for too much, too fast?

Into the Breach

By day's end, Brett had assembled the top management team to review the crisis plan. Things seemed even more grim than they had in the morning.

Laurie informed the team that, with new information from additional banks, the number of accounts known to be compromised was increasing. The total was still not clear but certainly far more than the initial 1,500.

Sergei reported finding a hole – a disabled firewall that was supposed to be part of the wireless inventory-control system, which used real-time data from each transaction to trigger replenishment from the distribution center and automate reorders from suppliers. The system helped keep inventories low, shelves full, and costs and lost sales to a minimum. With the firewall disabled, however, supposedly internal company data were essentially being broadcast.

"All you'd need is the right equipment and the wrong motives," Sergei admitted. "But you'd have to be somewhere relatively close to the store because the broadcast range is limited." He paused to survey the expressions of

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his colleagues, ending with Brett. "We can get the firewall back up as soon as the cops give us the go-ahead." He knew his job was on the line.

"How did the firewall get *down* in the first place?" Laurie snapped.

"Impossible to say," said Sergei resolutely. "It could have been deliberate or accidental. The system is relatively new, so we've had things turned off and on at various times as we've worked out the bugs. It was crashing a lot for a while. Firewalls can often be problematic."

Brett looked at the human resources director, Ben Friedman, who had several personnel folders in front of him. "We've had five departures of people who were involved with that system in some way," Ben said, thumbing through the files one by one. "Two resignations, one to return to grad school, one termination for a failed drug test, and one termination for downloading inappropriate material using company computers." He placed the folders on the table, paused, and slid the two for the terminated employees over to Brett.

"Well," Brett sighed, "that gives us a couple of possible suspects." He turned to the communications director, Sally O'Connor. Earlier that day, she had handed Brett a memo outlining three communications options, which Brett had been contemplating ever since. Holding a press conference would get Flayton's out in front of the story – and it would, Brett thought, be the most forthright approach. He was troubled by Sally's second option – informing customers, by letter, that there had been a breach and that the situation was being addressed. He felt it might generate more customer anxiety than reassurance and could make Flayton's appear to be hiding something. The final option – do nothing until law enforcement was ready to go public – was the easiest in the short term because it put the decision in other hands.

Darrell Huntington, longtime outside counsel for Flayton's who had been briefed late the previous night, rose from his seat. "Let me say a couple of things. First, we still have no definitive proof here. All the evidence is circumstantial. And from my review of past cases, it's clear that whoever goes public first is the entity that gets sued."

"Who would be most likely to bring the suit?" asked CFO Frank Ardito. "No customer will suffer financial damage, right? The banks protect them."

"We could be sued on any number of grounds I won't go into here," said Darrell, "but other breaches have brought lawsuits from customers, banks, and even investors. Whether you win or lose, it costs you – and there's bound to be a lot of media coverage."

"Aren't we required to disclose this to our customers immediately?" Frank inquired.

"Three of the states in which you operate require immediate disclosure, and the other three do not," Darrell noted. "But from what I understand, you don't know what role, if any, Flayton's has in this possible crime. A bank has identified a pattern. There seems to be a correlation between cards with fraudulent activity and cards used to make purchases at Flayton's. That could be a coincidence. At this time, we have no actual evidence of a data breach at Flayton's. None."

"What are we supposed to do?" Brett pressed. "Doing nothing is not an option. Not for me."

"That is exactly what you *should* do," Darrell asserted. He turned to Sally. "Your communication strategy should be not to talk to anyone. If you do get a call from the media, simply confirm that Flayton's has been contacted by law enforcement authorities regarding an investigation about which you have been given no information and with which you are cooperating fully. Refer them to the Secret Service. They don't tell anybody anything."

"That may work for now," Brett acknowledged, "but, Sally, I want you to anticipate the next steps. However we communicate eventually, I want to offer straight talk, not spin." Darrell sat down.

Brett knew there were no easy answers. His online search last night had turned up a recent survey documenting that customers are reluctant to shop in stores known to have data breaches. Darrell was arguing that Flayton's could be vulnerable simply by trying to do the right thing and getting the news out quickly. Yet, the company's future depended on its reputation for fairness – one painstakingly earned over decades by Brett's father.

"Well, the decision may soon be out of our hands," said Sally. "I was reviewing the affected accounts, and one very interesting name cropped up: Dave Stevens, evening news anchor at KCDK-TV. Apparently, we installed a home theater for him." She turned to Brett. "Stories like this always leak somehow."

Brett shifted his jaw, pushed back his chair, and stood. "So if I understand this correctly, we have circumstantial but strong evidence that a breach has occurred, we have two former employees who might or might not be involved, some states that require we disclose, feds who want us to shut up, and a television personality among the victims. If we disclose, we'll probably get sued; if we don't, the story will eventually leak. The feds may get the perpetrators if we give them time, but there's no guarantee. No matter what, our reputation is on the line, and competitors will start running promotional specials to lure customers away first chance they get. And I am wondering if I can ever look a customer squarely in the eye again. Did I miss anything?"

Brett leaned forward and put both hands firmly on the table. His eyes met those of each member of his team. He knew – and trusted – them all. "The one thing I'm sure of is this: The Flayton name means something to me, to our employees, and to our customers. We're going to decide what to do. Today."

How should the Flayton Electronics team respond to the crisis? Four commentators offer expert advice on page 44.


Be nimble.
Given the pace of change these days, you'd better be ready to jump. That's why technology services giant EDS created the Agile Enterprise Platform–a flexible technology architecture that enables global corporations to not only survive change, but thrive on it. No wonder EDS chose Swansea, Wales as one of its global centers for developing Agile Enterprise applications. Because if anyone is embracing change, it's the Welsh. Indeed, we've transformed our small country into fertile ground for IT services. Just give us a call and watch us spring into action.
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James E. Lee (james.lee@choicepoint.com) is the senior vice president and chief public and consumer affairs officer at ChoicePoint, based in Alpharetta, Georgia.

HOW YOU react to news of a security breach at your company is, as a practical matter, much more important than what actually happened. Whether your business can survive the episode will depend on the corrective action you take and how you communicate about it to the various stakeholders. My firm's experience offers an excellent illustration.

ChoicePoint provides decision-making insight to businesses and government through the identification, retrieval, storage, analysis, and delivery of data about individuals and institutions. In 2005 our company was the victim of a fraud scheme in which criminals posed as customers to obtain the personal information of 145,000 people from our data systems. No technology breach occurred, but the media characterized the incident as if one had. We discovered the nefarious activities ourselves and reported them to the Los Angeles County Sheriff's Department, with whom we set up a sting operation that eventually led to the prosecution of a Nigerian crime ring.

Beyond fixing the firm's weaknesses in data security, the CEO must develop a brand-restoration strategy.

We agonized over choosing the right strategy for alerting consumers whose data may have been obtained fraudulently from ChoicePoint. In the end, we notified everyone believed to be at risk, regardless of their state of residence. We updated employees daily, and we had frequent conference calls with managers and officers. Our CEO and other senior executives visited key customers and investors to share the many new policies and procedures we were adopting to prevent a recurrence. All of these stakeholders were, we recognized, pivotal to our survival.

Some of our preventive steps were radical, including abandoning a line of business worth $20 million because of its potential to risk a future data breach. Changes in culture often were required. For example, every employee must now pass yearly privacy and security training courses as a condition of employment.

At ChoicePoint, we learned quickly that in situations like these, many factors are beyond your control. The media can be a huge distraction. But it's much worse than that. You face inquiries from many quarters, in our case from multiple state attorneys general, the Federal Trade Commission, and the U.S. Congress. You might be sued by banks; by others involved in the credit card transaction chain, such as processing companies and consumers; by shareholders; and even by employees and retirees.

For Flayton Electronics, moving swiftly in the face of crisis will be essential. Timing is a crucial factor in the inevitable lawsuits, which focus on what executives knew and how long they knew it before going public. Beyond fixing the firm's weaknesses in data security, CEO Brett Flayton must develop a brand-restoration strategy. The company should, as ChoicePoint did, notify the affected customers rapidly, set up toll-free information hotlines, and offer credit-monitoring services. Then they must exceed these basics with a broad range of extras to keep customers loyal: Offer discounts and sales, meet with critics of the company, and develop and promote new web pages that outline reforms in the firm's policies and practices.

Communiqués will also need to evolve to demonstrate responsiveness to developments, or else risk that the words of company executives will be perceived as just corporate lip service. Tone is very important. Public statements must be not only accurate, but sincere, contrite, and honest.

Flayton's will also have to address the influence of blogs, viral videos, and other social media. Such user-generated content, unfiltered by traditional journalists and accessible by anyone using an online search engine, is often a mode of recruiting lawsuit plaintiffs and airing personal grievances.

Finally, Brett and his team will need patience in spades. The problem will not go away when the headlines do. Mitigating the effects on brand and reputation will take, I estimate, three to five years. Flayton's has a long road ahead.

Wendy Wray

Bill Boni (bill.boni@motorola.com) is the corporate information security officer for Motorola in Schaumburg, Illinois. He is also a vice president and board member of the Information Systems Audit and Control Association, a global organization based in Rolling Meadows, Illinois.

MOST SENIOR executives have the insight and the measurement tools to assess potential damage from tangible disasters such as floods and fires. That's not often the case when it comes to information security, including prevention of and planning for data theft. "Let the technical staff handle that" tends to be the default strategy, with responsibility relegated to nonsenior IT or corporate-security management. Businesses that are serious about protecting their data and preserving the data's value should have a high-level official, such as a director or a vice president of information protection, who serves not merely as a manager but as a senior champion in this area.

Seven years ago, I was appointed Motorola's first-ever corporate information security officer. As a data-protection leader, I am responsible for the firm's information and IT environment globally and for having a comprehensive strategy for risk management. One useful strategy component is to require every new initiative to identify, in the initial idea phase, the data that might be involved – and their value. This mandate builds appropriate safeguards right into the projects themselves. Also beneficial are policies, procedures, and training protocols that are customized for each company function, to reduce the likelihood that individuals will make wrong choices because they do not understand how the overall data standards apply to their specific roles.

You need people on hand with the digital expertise to match wits with tech-savvy cyber criminals.

Being fully PCI compliant is, of course, a vital first line of defense against data theft, and my best guess is that a third of companies meet that standard. However, increasingly capable cyber adversaries do not give up and offer their congratulations because you did what you were supposed to do. During my tenure in information security, hobbyist hacking has evolved to become a much more sophisticated, parasitic extraction of valuable data from targeted organizations. One common fallacy is that silver bullet technology can save the day. I've seen organizations spend hundreds of millions of dollars on security safeguards that were penetrated by a knowledgeable person with a handheld device. For example, Motorola proved to one of its customers, who had invested heavily in some of the best protection technology available, that we could access their core business systems using just a smartphone and the Internet.

To prevent and cope with data breaches, you need people on hand with the digital expertise to match wits with tech-savvy cyber criminals and to understand the systems they're targeting. Data protection isn't necessarily a core competency of either an IT or a traditional loss-prevention team. Also indispensable are knowledge of the applicable privacy statutes and regulations, and the ability to gather and preserve sources of relevant evidence. You can assemble an internal team of lawyers, accountants, and experienced digital-forensic investigators from law enforcement or defense agencies – or use external sources such as law firms, public accounting firms, and consultancies with digital specialization.

Armed with facts from experts, yet to be assembled, Flayton's should put law enforcement on notice that the company exists to serve customers and maintain its reputation. Flayton's can't afford to wait indefinitely to inform the public. The firm should, of course, work with the Secret Service to achieve prosecutions but must also make it a priority to maintain the public's trust while complying fully with data-protection and privacy laws in states that require breach disclosure.

Until Flayton's thoroughly understands its security status, it risks making poor choices. None of the managers or advisers appears to have enough experience or information to reach sound decisions about the risks they are confronting. For example, allowing the firewall to remain down may compromise even more customer accounts. An established model response plan, such as that from the American Institute of Certified Public Accountants, is one potential source of immediate help for this company in crisis.

John Philip Coghlan is a former president and CEO of Visa USA, headquartered in San Francisco.

A DATA BREACH can put an executive in an exceedingly complex situation, where he must negotiate the often divergent interests of multiple stakeholders. Witness the array of players you would encounter in a case like that of Flayton Electronics.

Banks that issue payment cards, such as the fictional Union Century, are often the first to spot possible fraud when their systems identify merchants who are common points of purchase for potentially compromised accounts. For the protection of their cardholders, they strongly support early identification of these merchants.

A bank that performs payment processing for a given merchant, called the acquiring bank, is protective of that business relationship and sensitive to the merchant's interests. However, that bank is responsible to payment networks such as Visa and MasterCard for certifying merchant compliance with payment card industry standards. Therefore, the acquiring bank's brand and reputation also are potentially threatened, and its interests are only partly aligned with those of the merchant.

Further complicating the situation is the role of law enforcement. The Secret Service has asked Flayton Electronics not to disclose the breach, believing that leaving the system vulnerability in place during surveillance provides the best chance to catch the thieves should they act again. Unfortunately, such requests can be open-ended, and with each passing day the opportunity for the company to lead in communications is frittered away. It is not illegal to refuse such appeals from law enforcement. On the contrary, many state laws require a breached entity to disclose specific information in a timely way.

Making data security a priority for the future – and communicating the specific policy changes that flow from that – may allow the company to become recognized as a leader in this area.

Beyond the institutional stakeholders just described, there are consumer groups, legislators, shareholders, and of course the employees and customers, whose interests we see Brett Flayton actively considering. Regarding customers, the CEO might wish to know that in a study by Javelin Strategy & Research, 78% of consumers said they'd be unlikely to continue shopping at a store once they had learned of a data breach there.

So our harried CEO has no better option than disclosure. If he doesn't speak out, he is not allowing his customers the best means of protecting themselves: by using a different, uncompromised payment card or by scrutinizing transactions on the compromised card. Even if he waits to learn more, Brett will eventually have to go public, still lacking complete information. In the meantime, he runs a rapidly escalating risk that another party will disclose the breach, at which point he will need to defend having violated his customers' trust. The electronics firm has built its reputation on honesty, a fact that Brett and his advisers should not let each other forget.

So Flayton Electronics must communicate – right now – with its customers. Among the potential avenues are to use contact information from the store's own database; to set up a special company web page; and to hold exclusive informational events, such as call-ins and webcasts – all reinforced with a customer support hotline.

Of course, Brett should make sure that Sergei addresses the known technological weakness immediately. Customers will want to know when the system is safe again. Making data security a priority for the future – and communicating the specific policy changes that flow from that – may allow the company to become recognized as a leader in this area.

Research from Bain & Company also offers some hope: Customers who receive adequate compensation after making a complaint are actually more loyal than are those without complaints. So, if Brett Flayton's company provides a timely, focused, and effective response, his compromised customers might just become the most loyal of all.

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Jay Foley (jfoley@idtheft center.org) is the executive director of the Identity Theft Resource Center in San Diego.

THE EXECUTIVES at Flayton Electronics are being misinformed by Darrell Huntington, their outside counsel. The companies that get sued are not those that are first to go public about a data breach but those that do so poorly. Right now, Flayton's has no chance of putting out good information, because it doesn't have any. Announcing inaccurate information and then having to correct it as the breach investigation evolves would encourage a feeding frenzy of plaintiffs' lawyers. For now, Flayton's should remain quiet, but for reasons different from Darrell's.

Another misconception of the management team at Flayton's is that they should consider notifying customers themselves. The credit card transactions belong to a bank that has protections in place for its cardholders. For Flayton's to mire itself in identifying private addresses for – and then contacting – potentially affected individuals would be to expose itself to liability. Someone else in the transaction chain, such as the credit card processing company, might very well be at fault, in which case it would be wise to wait for that party to come forward first. In fact, it is possible that the Secret Service investigation will show that the electronics retailer was not the source of the breach at all.

Not alerting customers right away is not the same as doing nothing.

Law enforcement officials have asked Flayton's to remain tight-lipped while they do their work, to give them a better chance of apprehending the criminals. If Flayton's rushes into a public announcement, the bad guys have the chance to disappear, only to resurface elsewhere. Nothing positive will have been achieved with that result.

Instead, CEO Brett Flayton should calmly think through his crisis response. Not alerting customers is not the same as doing nothing. The company's first action should be to reduce the risk for future thefts by closing any data-transaction loopholes that this incident has brought to light, provided that the Secret Service does not think it will interfere with their investigation. The executives at Flayton's should also reevaluate their internal policies and procedures, and should establish regular self-audits and strategic-planning assessments. Sergei, the CIO, really fell down on the job. There's no excuse for his sloppiness.

Sadly, though, Sergei's technological woes are not unique. In 2006 the Computer Security Institute in San Francisco conducted a survey of 616 large, U.S.-based companies and found that 52% had experienced some kind of unauthorized use of their computer systems. Almost half of that subset said they suffered a laptop or mobile device theft.

Unfortunately, the true scope of the data-theft problem is not known. Hard statistics on its long-term impact, whether for companies or individuals, are scarce. From the Computer Security Institute, we have the figure that only 15% of their surveyed companies suffered financial losses as a result of cyber security breaches. We also know that most victims of data theft do not then become victims of identity theft. Typically, a criminal is out to rack up a few quick purchases using stolen credit cards and then move on. In fact, it's likely that customers at Flayton's were victims of this type of fraud. Thieves might reasonably assume that people who have money to buy fancy electronics have enough disposable income not to notice extra charges on their accounts immediately.

Perhaps the most worrying indicator is that the criminal industry for information is growing. I can go to MacArthur Park in Los Angeles any day of the week and get $50 in exchange for a name, social security number, and date of birth. If I bring a longer list of names and details, I walk away a wealthy man. This gritty new reality illustrates how much the value of personal data is increasing and should encourage every company to take data protection very seriously.

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The Strategic Secret of Private Equity

Why "buying to sell" can generate a much higher return on investment than the public company practice of "buying to keep"

by Felix Barber and Michael Goold

John Ritter

PRIVATE EQUITY. The very term continues to evoke admiration, envy, and – in the hearts of many public company CEOs – fear. In recent years, private equity firms have pocketed huge – and controversial – sums, while stalking ever larger acquisition targets. Indeed, the global value of private equity buyouts bigger than $1 billion grew from $28 billion in 2000 to $502 billion in 2006, according to Dealogic, a firm that tracks acquisitions. Despite the private equity environment's becoming more challenging amid rising interest rates and greater government scrutiny, that figure reached $501 billion in just the first half of 2007.

Private equity firms' reputation for dramatically increasing the value of their investments has helped fuel this growth. Their ability to achieve high returns is typically attributed to a number of factors: high-powered incentives both for private equity portfolio managers and for the operating managers of businesses in the portfolio; the aggressive use of debt, which provides financing and tax advantages; a determined focus on cash flow and margin improvement; and freedom from restrictive public company regulations.

But the fundamental reason behind private equity's growth and high rates of return is something that has received little attention, perhaps because it's so obvious: the firms' standard practice of buying businesses and then, after steering them through a transition of rapid performance improvement, selling them. That strategy, which embodies a combination of business and investment-portfolio management, is at the core of private equity's success.

Public companies – which invariably acquire businesses with the intention of holding on to them and integrating them into their operations – can profitably learn or borrow from this buy-to-sell approach. To do so, they first need to understand just how private equity firms employ it so effectively.

The Private Equity Sweet Spot

Clearly, buying to sell can't be an all-purpose strategy for public companies to adopt. It doesn't make sense when an acquired business will benefit from important synergies with the buyer's existing portfolio of businesses. It certainly isn't the way for a company to profit from an acquisition whose main appeal is its prospects for long-term organic growth.

However, as private equity firms have shown, the strategy is ideally suited when, in order to realize a one-time, short- to medium-term value-creation opportunity, buyers must take outright ownership and control. Such an opportunity most often arises when a business hasn't been aggressively managed and so is underperforming. It can also be found with businesses that are undervalued because their potential isn't readily apparent. In those cases, once the changes necessary to achieve the uplift in value have been made – usually over a period of two to six years – it makes sense for the owner to sell the business and move on to new opportunities. (In fact, private equity firms are obligated to eventually dispose of the businesses; see the sidebar "How Private Equity Works: A Primer.")

Conglomerates that acquire unrelated businesses with potential for significant improvement have fallen out of fashion. As a result, private equity firms have faced few rivals in their sweet spot.

The benefits of buying to sell in such situations are plain – though, again, often overlooked. Consider an acquisition that quickly increases in value – generating an annual investor return of, say, 25% a year for the first three years – but subsequently earns a more modest if still healthy return of, say, 12% a year. A private equity firm that, following a buy-to-sell strategy, sells it after three years will garner a 25% annual return. A diversified public company that achieves identical operational performance with the acquired business – but, as is typical, has bought it as a long-term investment – will earn a return that gets closer to 12% the longer it owns the business. For the public company, holding on to the business once the value-creating changes have been made dilutes the final return.

In the early years of the current buyout boom, private equity firms prospered mainly by acquiring the noncore business units of large public companies. Under their previous owners, those businesses had often suffered from neglect, unsuitable performance targets, or other constraints. Even if well managed, such businesses may have lacked an independent track record because the parent company had integrated their operations with those of other units, making the businesses hard to value. Sales by public companies of unwanted business units were the most important category of large private equity buyouts until 2004, according to Dealogic, and the leading firms' widely admired history of high investment returns comes largely from acquisitions of this type.

More recently, private equity firms – aiming for greater growth – have shifted their attention to the acquisition of entire public companies. (See the exhibit "Private Equity's New Focus.") This has created new challenges for private equity firms. In public companies, easily realized improvements in performance often have already been achieved through better corporate governance or the activism of hedge funds. For example, a hedge fund with a significant stake in a public company can, without having to buy the company outright, pressure the board into making valuable changes such as selling unnecessary assets or spinning off a noncore unit. If a public company needs to be taken private to improve its performance, the necessary changes are likely to test a private equity firm's implementation skills far more than the acquisition of a business unit would. When KKR and GS Capital Partners, the private equity arm of Goldman Sachs, acquired the Wincor Nixdorf unit from Siemens in 1999, they were able to work with the incumbent management and follow

The authors are directors of the Ashridge Strategic Management Centre, in London. **Felix Barber** (felix.barber@ashridge.org.uk) is a coauthor of "The Surprising Economics of a 'People Business'" (HBR June 2005). **Michael Goold** (michael.goold@ashridge.org.uk) is a coauthor of "Do You Have a Well-Designed Organization?" (HBR March 2002).

How Private Equity Works: A Primer

To clarify how fundamental the buy-to-sell approach is to private equity's success, it's worth reviewing the basics of private equity ownership.

Private equity firms raise funds from institutions and wealthy individuals and then invest that money in buying and selling businesses. After raising a specified amount, a fund will close to new investors; each fund is liquidated, selling all its businesses, within a preset time frame, usually no more than ten years. A firm's track record on previous funds drives its ability to raise money for future funds.

Private equity firms accept some constraints on their use of investors' money. A fund management contract may limit, for example, the size of any single business investment. Once money is committed, however, investors – in contrast to shareholders in a public company – have almost no control over management. Although most firms have an investor advisory council, it has far fewer powers than a public company's board of directors.

The CEOs of the businesses in a private equity portfolio are not members of a private equity firm's management. Instead, private equity firms exercise control over portfolio companies through their representation on the companies' boards of directors. Typically, private equity firms ask the CEO and other top operating managers of a business in their portfolios to personally invest in it as a way to ensure their commitment and motivation. In return, the operating managers may receive large rewards linked to profits when the business is sold. In accordance with this model, operating managers in portfolio businesses usually have greater autonomy than unit managers in a public company. Although private equity firms are beginning to develop operating skills of their own and thus are now more likely to take an active role in the management of an acquired business, the traditional model in which private equity owners provide advice but don't intervene directly in day-to-day operations still prevails.

With large buyouts, private equity funds typically charge investors a fee of about 1.5% to 2% of assets under management, plus, subject to achieving a minimum rate of return for investors, 20% of all fund profits. Fund profits are mostly realized via capital gains on the sale of portfolio businesses.

Because financing acquisitions with high levels of debt improves returns and covers private equity firms' high management fees, buyout funds seek out acquisitions for which high debt makes sense. To ensure they can pay financing costs, they look for stable cash flows, limited capital investment requirements, at least modest future growth, and, above all, the opportunity to enhance performance in the short to medium term.

Private equity firms and the funds they manage are typically structured as private partnerships. In some countries – particularly the United States – that gives them important tax and regulatory advantages over public companies.

its plan to grow revenues and margins. In contrast, since taking Toys "R" Us private in 2005, KKR, Bain Capital, and Vornado Realty Trust have had to replace the entire top management team and develop a whole new strategy for the business.

Many also predict that financing large buyouts will become much more difficult, at least in the short term, if there is a cyclical rise in interest rates and cheap debt dries up. And it may become harder for firms to cash out of their investments by taking them public; given the current high volume of buyouts, the number of large IPOs could strain the stock markets' ability to absorb new issues in a few years.

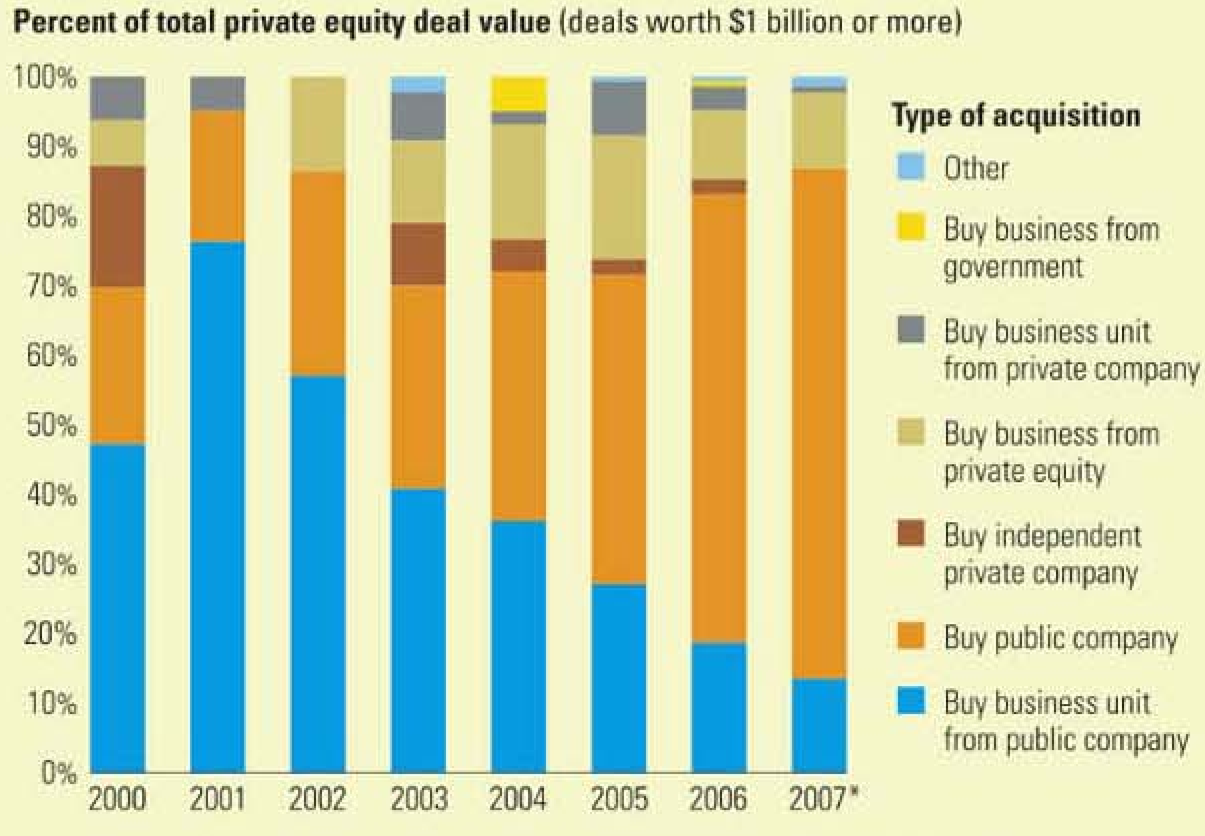
Even if the current private equity investment wave recedes, though, the distinct advantages of the buy-to-sell approach – and the lessons it offers public companies – will remain. For one thing, because all businesses in a private equity portfolio will soon be sold, they remain in the spotlight and under constant pressure to perform. In contrast, a business unit that has been part of a public company's portfolio for some time and has performed adequately, if not spectacularly, generally doesn't get priority attention from senior management. In addition, because every investment made by a private equity fund in a business must be liquidated within the life of the fund, it is possible to precisely measure cash returns on those investments. That makes it easy to create incentives for fund managers and for the executives running the businesses that are directly linked to the cash value received by fund investors. That is not the case with business unit managers or even for corporate managers in a public company.

Furthermore, because private equity firms buy only to sell, they are not seduced by the often alluring possibility of finding ways to share costs, capabilities, or customers among their businesses. Their management is lean and focused, and avoids the waste of time and money that corporate centers, when responsible for a number of loosely related businesses and wishing to justify their retention in the portfolio, often incur in a vain quest for synergy.

Finally, the relatively rapid turnover of businesses required by the limited life of a fund means that private equity firms gain know-how fast. Permira, one of the largest and most successful European private equity funds, made more than 30 substantial acquisitions and more than 20 disposals of independent businesses from 2001 to 2006. Few public companies develop this depth of experience in buying, transforming, and selling.

Private Equity's New Focus

Over time, private equity firms have shifted from buying business units of public companies to taking entire public companies private.



Source: Dealogic

*First half of year

What Public Companies Can Do

As private equity has gone from strength to strength, public companies have shifted their attention away from value-creation acquisitions of the sort private equity makes. They have concentrated instead on synergistic acquisitions. Conglomerates that buy unrelated businesses with potential for significant performance improvement, as ITT and Hanson did, have fallen out of fashion. As a result, private equity firms have faced few rivals for acquisitions in their sweet spot. Given the success of private equity, it is time for public companies to consider whether they might compete more directly in this space.

We see two options. The first is to adopt the buy-to-sell model. The second is to take a more flexible approach to the ownership of businesses, in which a willingness to hold on to an acquisition for the long term is balanced by a commitment to sell as soon as corporate management feels that it can no longer add further value.

Buy to sell. Companies wishing to try this approach in its pure form face some significant barriers. One is the challenge of overhauling a corporate culture that has a buy-to-keep strategy embedded in it. That requires a company not only to shed deeply held beliefs about the integrity of a corporate portfolio but also to develop new resources and perhaps even dramatically change its skills and structures.

In the United States a tax barrier also exists. Whereas private equity funds, organized as private partnerships, pay no corporate tax on capital gains from sales of businesses, public companies are taxed on such gains at the normal corporate rate. This corporate tax difference is not offset by lower personal taxes for public company investors. Higher taxes greatly reduce the attractiveness of public companies as a vehicle for buying businesses and selling them after increasing their value. Public companies in Europe once faced a similar tax barrier, but in roughly the past five years, it has been eliminated in most European countries. This much improves European public companies' tax position for buying to sell. (Note that two tax issues have been the subject of public scrutiny in the United States. The first – whether *publicly traded* private equity management firms should be treated like private partnerships or like public companies for tax purposes – is closely related to the issue we raise. The second – whether the share of profits that private equity firms' partners earn on selling businesses in funds under their management should be taxed at the low rate for personal capital gains or the higher rate for ordinary personal income – is quite distinct.)

Despite the hurdles, some public companies have in fact successfully developed a buy-to-sell business model. Indeed, two longtime players in mid-market buyouts (those valued between $30 million and $1 billion) are public companies: American Capital Strategies, which had a recent market capitalization of about $7 billion, and the UK-based 3i, whose market cap is about $10 billion. Both companies found ways to circumvent the corporate capital gains tax (the UK eliminated the tax only in 2002) by adopting unusual organizational structures – a "business development company" in the case of American Capital; an "investment trust" in the case of 3i. However, those structures place legal and regulatory restrictions on the firms' operations; for instance, there are limitations on business development companies' ability to acquire public companies and the amount of debt they may use. Those restrictions make such structures unattractive as vehicles for competing with private equity, at least for large buyouts in the United States.

With the removal of the tax disincentives across Europe, a few new publicly quoted buyout players have emerged. The largest are two French companies, Wendel and Eurazeo. Both have achieved strong returns on their buyout investments. Eurazeo, for example, has achieved an average internal rate of return of 53% on Terreal, Eutelsat, and Fraikin, its three large buyout exits over the past five years. (In the United States, where private companies can elect, like private partnerships, not to be subject to corporate tax, Platinum Equity has become one of the fastest-growing private companies in the country by competing to buy out subsidiaries of public companies.)

The emergence of public companies competing with private equity in the market to buy, transform, and sell businesses could benefit investors substantially. Private equity funds are illiquid and are risky because of their high use of debt; furthermore, once investors have turned their money over to the fund, they have no say in how it's managed. In compensation for these terms, investors should expect a high rate of return. However, though some private equity firms have achieved excellent returns for their investors, over the long term the average net return fund investors have made on U.S. buyouts is about the same as the overall return for the stock market.

Private equity fund managers, meanwhile, have earned extremely attractive rewards, with little up-front investment. As compensation for taking the initiative in raising money, managing investments, and marketing their benefits, they have structured agreements so that a large portion of the gross returns – around 30%, after adding management and other fees – flows to them. And that figure doesn't take into account any returns made on their personal investments in the funds they manage. Public companies pursuing a buy-to-sell strategy, which are traded daily on the stock market and answerable to stockholders, might provide a better deal for investors.

With the removal of the tax disincentives across Europe, a few new publicly quoted buyout players have emerged.

From where might a significant number of publicly traded competitors to private equity emerge? Even if they appreciate the attractions of the private equity strategy in principle, few of today's large public industrial or service companies are likely to adopt it. Their investors would be wary. Also, few corporate managers would slip easily into a more investment-management-oriented role. Private equity partners typically are former investment bankers and like to trade. Most top corporate managers are former business unit heads and like to manage.

Public financial firms, however, may find it easier to follow a buy-to-sell strategy. More investment companies may convert to a private equity management style, as Wendel and Eurazeo did. More private equity firms may decide, as U.S.-based Ripplewood did with the initial public offering of RHJ International on the Brussels stock exchange, to float an entire investment portfolio on the public markets. More experienced investment banks may follow the lead of Macquarie Bank, which created Macquarie Capital Alliance Group, a company traded on the Australian Securities Exchange that focuses on buy-to-sell opportunities. In addition, some experienced private equity managers may decide to raise public money for a buyout fund through an IPO. (These examples are to be distinguished from the private equity firm Blackstone's initial public offering of the *firm that manages* the Blackstone funds, but not the funds themselves.)

Flexible ownership. A strategy of flexible ownership could have wider appeal to large industrial and service companies than buying to sell. Under such an approach, a company holds on to businesses for as long as it can add significant value by improving their performance and fueling growth. The company is equally willing to dispose of those businesses once that is no longer clearly the case. A decision to sell or spin off a business is viewed as the culmination of a successful transformation, not the result of some previous strategic error. At the same time, the company is free to hold on to an acquired business, giving it a potential advantage over private equity firms, which sometimes must forgo rewards they'd realize by hanging on to investments over a longer period.

Flexible ownership can be expected to appeal the most to companies with a portfolio of businesses that don't share many customers or processes. Take General Electric. The company has demonstrated over the years that corporate management can indeed add value to a diversified set of businesses. GE's corporate center helps build general management skills (such as cost discipline and quality focus) across its businesses and ensures that broad trends (such as offshoring to India and the addition of service offerings in manufacturing businesses) are effectively exploited by them all. Despite occasional calls for GE to break itself up, the company's management oversight has been able to create and sustain high margins across its portfolio, which suggests that limiting itself to synergistic acquisitions would be a mistake.

Indeed, with its fabled management skills, GE is probably better equipped to correct operational underperformance than private equity firms are.

To realize the benefits of flexible ownership for its investors, though, GE would need to be vigilant about the risk of keeping businesses after corporate management could no longer contribute any substantial value. GE is famous for the concept of cutting the bottom 10% of managers every year. To ensure aggressive investment management, the company could, perhaps with less controversy, initiate a requirement to sell every year the 10% of businesses with the least potential to add value.

GE would of course have to pay corporate capital gains taxes on frequent business disposals. We would argue that the tax constraints that discriminate against U.S. public companies in favor of private equity funds and private companies should be eliminated. Nevertheless, even in the current U.S. tax environment, there are ways for public companies to lighten this burden. For example, spinoffs, in which the owners of the parent company receive equity stakes in a newly independent entity, are not subject to the same constraints; after a spinoff, individual shareholders can sell stock in the new enterprise with no corporate capital gains tax payable.

A decision to sell or spin off a business is viewed as the culmination of a successful transformation, not the result of a strategic error.

We have not found any large public companies in the industrial or service sector that explicitly pursue flexible ownership as a way to compete in the private equity sweet spot. Although many companies go through periods of actively selling businesses, the purpose is usually to make an overly diversified portfolio more focused and synergistic, not to realize value from successfully completed performance enhancements. Even the acquisitive conglomerates, such as ITT and Hanson, that successfully targeted performance improvement opportunities ultimately weren't willing enough to sell or spin off businesses once they could no longer increase their value – and thus found it difficult to sustain earnings growth. But given the success of private equity's model, companies need to rethink the traditional taboos about selling businesses.

Mapping Potential Portfolio Strategies

Both public companies and investment funds manage portfolios of equity investments, but they have very different approaches to deciding which businesses belong in them and why. Public companies can learn something from considering the broad array of common equity investment strategies available.

A portfolio manager can take one of three approaches to creating value: simply make smart investments; invest in businesses and then influence their managers to produce better results; or invest and influence while looking to build synergies among portfolio businesses. At the same time, the nature of a portfolio's holdings will be defined by whether the owner or investor acquires them with the intention of selling them in the short or medium term (the strategy of most investment funds) or keeping them for the long term (the strategy of most public companies).

The search for synergies that will enhance operating performance across portfolio businesses plays a critical role in many public companies' strategies, and in fact, often drives the acquisition agenda. Procter & Gamble is an example of a successful company that acquires businesses that have strong synergies and keeps them for the long term. It would not make sense for P&G to integrate an acquired business into its own process infrastructure – and then suddenly put it on the block for sale.

A few diversified public companies, such as Berkshire Hathaway, seek to create shareholder value merely by making smart investment decisions. Like P&G, Berkshire buys to keep. Unlike P&G, however, it doesn't have to, because its success doesn't depend on the long-term exploitation of synergies. Warren Buffett actually admits in the Berkshire Hathaway owner's manual that buying to keep hurts the company's financial performance. To be good investments, Berkshire's businesses have to beat the market not just for five or ten years but forever! Even if you are the Sage of Omaha, that is a tall order.

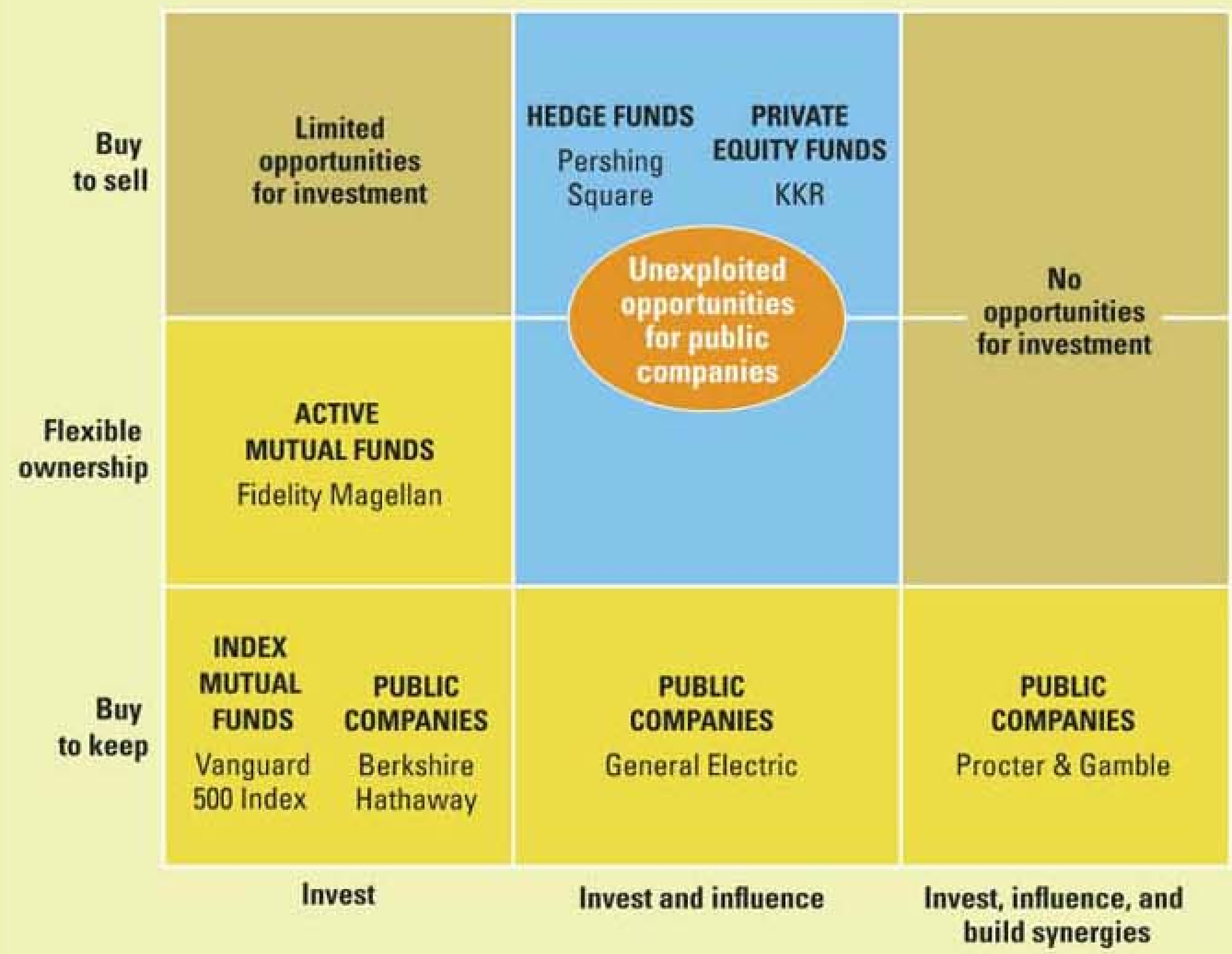
Compare Berkshire Hathaway's strategy with that of investment funds. Index mutual funds, such as the Vanguard 500 Index Fund, buy to keep, but they seek to match the market, not to beat it. Active mutual funds that do seek to beat the market, such as the Fidelity Magellan Fund, adopt a flexible ownership strategy.

Buying with a definite intention to sell is more typical for "event-driven" investors, such as Pershing Square and other hedge funds. They buy shares in companies in which they expect a particular event, such as a merger or a breakup, to create shareholder value, and plan to sell out and take their profits once it occurs. These investors are usually activists, pressuring the company's management to carry out the anticipated event, or are riding on the coattails of activists. After all, if profits depend on a merger or breakup, it's logical to use your influence to trigger it. Perhaps because it's hard to beat the market by investing without influence on management, activist investing is becoming more common.

Because they maintain liquidity for their investors, hedge funds and mutual funds cannot bid to take outright control of public companies or invest in private companies. This is where private equity funds, such as those managed by KKR, which are willing to sacrifice liquidity for investors, have an edge.

Some diversified public companies, like General Electric, focus, as do private equity funds, on making good acquisitions and exerting a positive influence on their management. The important difference is that where private equity funds buy with the intention to sell, diversified public companies typically buy with the intention to keep. If recent history is any indicator – private equity firms are growing while conglomerates have dwindled in number – the private equity funds may have the more successful strategy.

Public companies acquire for the long term but miss opportunities that investors with shorter horizons are seizing.



Choosing and Executing a Portfolio Strategy

As we have seen, competing with private equity offers public companies a substantial opportunity, but it isn't easy to capitalize on. Managers need skills in investing (both buying and selling) and in improving operating management. The challenge is similar to that of a corporate restructuring – except that it must be repeated again and again. There is no return to business as usual after the draining work of a transformation is completed.

Competing with private equity as a way to create shareholder value will make sense primarily for companies that own a portfolio of businesses that aren't closely linked. (For more on the range of investment approaches that funds and corporate buyers take, see the sidebar "Mapping Potential Portfolio Strategies.") In determining whether it's a good move for your company, you need to ask yourself some tough questions:

Can you spot and correctly value businesses with improvement opportunities? For every deal a private equity firm closes, it may proactively screen dozens of potential targets. Many firms devote more capacity to this than to anything else. Private equity managers come from investment banking or strategy consulting, and often have line business experience as well. They use their extensive networks of business and financial connections, including potential bidding partners, to find new deals. Their skill at predicting cash flows makes it possible for them to work with high leverage but acceptable risk. A public company adopting a buy-to-sell strategy in at least part of its business portfolio needs to assess its capabilities in these areas and, if they are lacking, determine whether they could be acquired or developed.

Do you have the skills and the experience to turn a poorly performing business into a star? Private equity firms typically excel at putting strong, highly motivated executive teams together. Sometimes that simply involves giving current managers better performance incentives and more autonomy than they have known under previous ownership. It may also entail hiring management talent from the competition. Or it may mean working with a stable of "serial entrepreneurs," who, although not on the firm's staff, have successfully worked more than once with the firm on buyout assignments.

Good private equity firms also excel at identifying the one or two critical strategic levers that drive improved performance. They are renowned for excellent financial controls and for a relentless focus on enhancing the performance basics: revenue, operating margins, and cash flow. Plus, a governance structure that cuts out a layer of management – private equity partners play the role of both corporate management and the corporate board of directors – allows them to make big decisions fast.

Over the course of many acquisitions, private equity firms build their experience with turnarounds and hone their techniques for improving revenues and margins. A public company needs to assess whether it has a similar track record and skills and, if so, whether key managers can be freed up to take on new transformation challenges.

Note, however, that whereas some private equity firms have operating partners who focus on business performance improvement, most do not have strength and depth in operating management. This could be a trump card for a public company adopting a buy-to-sell strategy and competing with the private equity players.

Can you manage a steady stream of both acquisitions and disposals? Private equity firms know how to build and manage an M&A pipeline. They have a strong grasp of how many targets they need to evaluate for every bid and the probability that a bid will succeed. They have disciplined processes that prevent them from raising bids just to achieve an annual goal for investing in deals.

At least as important, private equity firms are skilled at selling businesses, by finding buyers willing to pay a good price, for financial or strategic reasons, or by launching successful IPOs. In fact, private equity firms develop an exit strategy for each business during the acquisition process. Assumptions about exit price are probably the most important factor in their valuations of targets – and are continually monitored after deals close. A public company needs to assess not only its ability but also its willingness to become an expert at shedding healthy businesses.

If you can comfortably answer yes to those three questions, you next need to consider what kind of portfolio strategy to pursue.

Flexible ownership seems preferable to a strict buy-to-sell strategy in principle because it allows you to make decisions based on up-to-date assessments of what would create the most value. But a flexible ownership strategy always holds the risk of complacency and the temptation to keep businesses too long: A stable corporate portfolio, after all, requires less work. What is more, a strategy of flexible ownership is difficult to communicate with clarity to investors and even your own managers, and may leave them feeling unsure of what the company will do next.

Our expectation is that financial companies are likely to choose a buy-to-sell approach that, with faster churn of the portfolio businesses, depends more on financing and investment expertise than on operating skills. Industrial and service companies are more likely to favor flexible ownership. Companies with a strong anchor shareholder who controls a high percentage of the stock, we believe, may find it easier to communicate a flexible ownership strategy than companies with a broad shareholder base.

Joining the Fray

Private equity's phenomenal growth has given rise to intense public debate. Some complain that private equity essentially is about asset stripping and profiteering, with private equity investors, partners and managers taking unfair advantage of tax breaks and regulatory loopholes to make unseemly amounts of money from dubious commercial practices. Others defend private equity as a generally superior way of managing businesses.

Our own view is that the success of private equity firms is due primarily to their unique buy-to-sell strategy, which is ideally suited to rejuvenating undermanaged businesses that need a period of time in intensive care. Private equity *has* enjoyed an unfair tax advantage, but this has been primarily because of corporate capital gains taxes, not private equity firms' use of interest payments on debt financing to shield profits from tax. (Public companies, after all, can also finance acquisitions and other investments with borrowed money.) The high rewards enjoyed by private equity partners reflect the value they create – but also investors' somewhat surprising willingness to invest in private equity funds at average rates of return, which, in relation to risk, appear low.

We believe it's time for more public companies to overcome their traditional aversion to selling a business that's doing well and look for opportunities to compete in the private equity sweet spot. (Such a change would be hastened if the United States and other governments followed the lead of European nations in leveling the tax playing field.) Public companies could then benefit from the opportunities afforded by a buy-to-sell strategy. Investors would benefit, too, as the greater competition in this space would create a more efficient market – one in which private equity partners were no longer so strongly favored over the investors in their funds.

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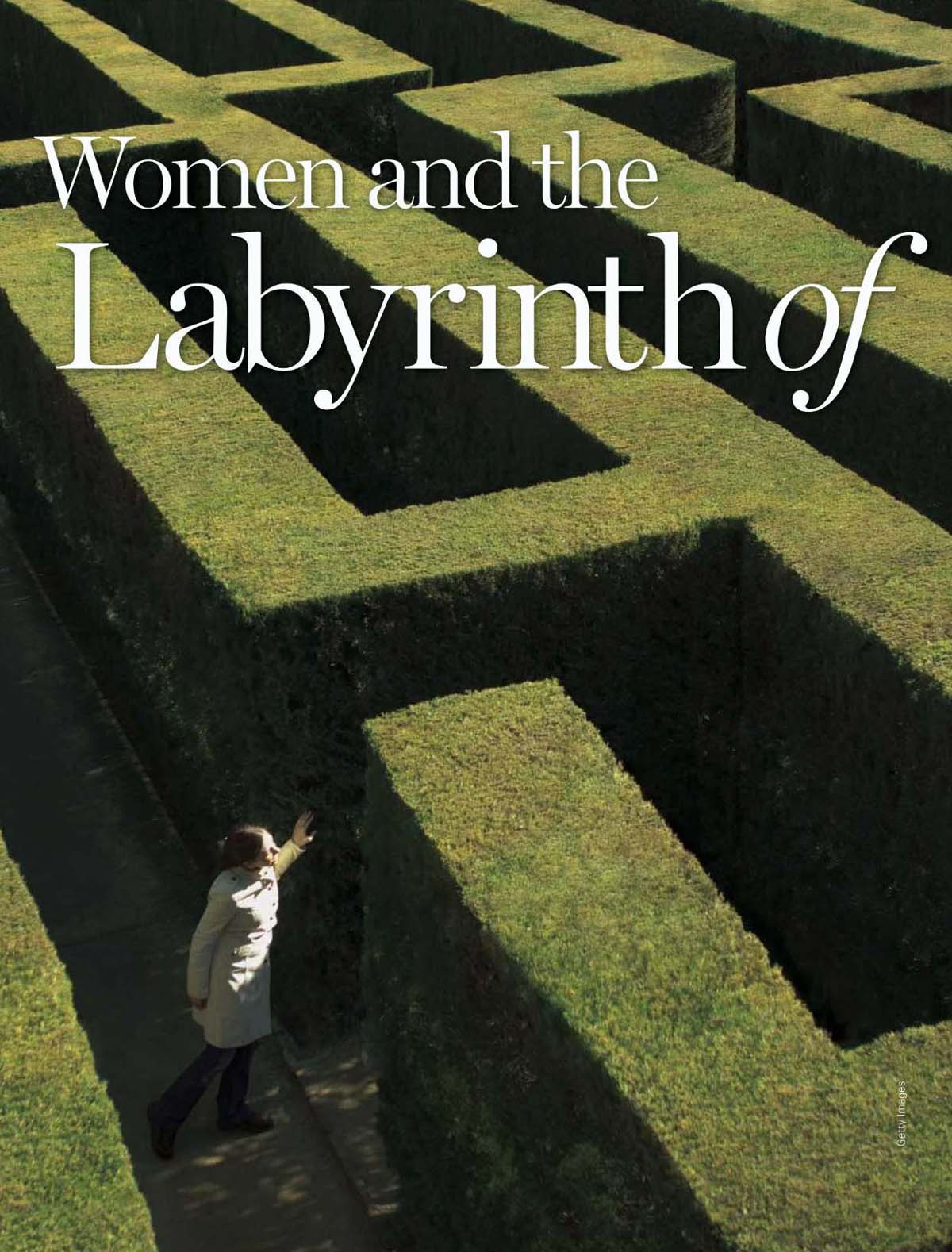
Women and the Labyrinth *of*



Getty Images

Leadership

When you put all the pieces together, a new picture emerges for why women don't make it into the C-suite.

It's not the glass ceiling, but the sum of many obstacles along the way.

BY ALICE H. EAGLY AND LINDA L. CARLI

If one has misdiagnosed a problem, then one is unlikely to prescribe an effective cure. This is the situation regarding the scarcity of women in top leadership. Because people with the best of intentions have misread the symptoms, the solutions that managers are investing in are not making enough of a difference.

That there is a problem is not in doubt. Despite years of progress by women in the workforce (they now occupy more than 40% of all managerial positions in the United States), within the C-suite they remain as rare as hens' teeth. Consider the most highly paid executives of *Fortune* 500 companies – those with titles such as chairman, president, chief executive officer, and chief operating officer. Of this group, only 6% are women. Most notably, only 2% of the CEOs are women, and only 15% of the seats on the boards of directors are held by women. The situation is not much different in other industrialized countries. In the 50 largest publicly traded corporations in each nation of the European Union, women make up, on average, 11% of the top executives and 4% of the CEOs and heads of boards. Just seven companies, or 1%, of *Fortune* magazine's Global 500 have female CEOs. What is to blame for the pronounced lack of women in positions of power and authority?

In 1986 the *Wall Street Journal*'s Carol Hymowitz and Timothy Schellhardt gave the world an answer: "Even those few women who rose steadily through the ranks eventually crashed into an invisible barrier. The executive suite seemed within their grasp, but they just couldn't break through the glass ceiling." The metaphor, driven home by the article's accompanying illustration, resonated; it captured the frustration of a goal within sight but somehow unattainable. To be sure, there was a time when the barriers were absolute. Even within the career spans of 1980s-era executives, access to top posts had been explicitly denied. Consider comments made by President Richard Nixon, recorded on White House audiotapes and made public through the Freedom of Information Act. When explaining why he would not appoint a woman to the U.S. Supreme Court, Nixon said, "I don't think a woman should be in any government job whatsoever…mainly because they are erratic. And emotional. Men are erratic and emotional, too, but the point is a woman is more likely to be." In a culture where such opinions were widely held, women had virtually no chance of attaining influential leadership roles.

Times have changed, however, and the glass ceiling metaphor is now more wrong than right. For one thing, it describes an absolute barrier at a specific high level in organizations. The fact that there have been female chief executives, university presidents, state governors, and presidents of nations gives the lie to that charge. At the same time, the metaphor implies that women and men have equal access to entry- and midlevel positions. They do not. The image of a transparent obstruction also suggests that women are being misled about their opportunities, because the impediment is not easy for them to see from a distance. But some impediments are not subtle. Worst of all, by depicting a single, unvarying obstacle, the glass ceiling fails to incorporate the complexity and variety of challenges that women can face in their leadership journeys. In truth, women are not turned away only as they reach the penultimate stage of a distinguished career. They disappear in various numbers at many points leading up to that stage.

Metaphors matter because they are part of the storytelling that can compel change. Believing in the existence of a glass ceiling, people emphasize certain kinds of interventions: top-to-top networking, mentoring to increase board memberships, requirements for diverse candidates in high-profile succession horse races, litigation aimed at punishing discrimination in the C-suite. None of these is counterproductive; all have a role to play. The danger arises when they draw attention and resources away from other kinds of interventions that might attack the problem more potently. If we want to make better progress, it's time to rename the challenge.

Walls All Around

A better metaphor for what confronts women in their professional endeavors is the labyrinth. It's an image with a long and varied history in ancient Greece, India, Nepal, native North and South America, medieval Europe, and elsewhere. As a contemporary symbol, it conveys the idea of a complex journey toward a goal worth striving for. Passage through a labyrinth is not simple or direct, but requires persistence, awareness of one's progress, and a careful analysis of the puzzles that lie ahead. It is this meaning that we intend to convey. For women who aspire to top leadership, routes exist but are full of twists and turns, both unexpected and expected. Because all labyrinths have a viable route to the center, it is understood that goals are attainable. The metaphor acknowledges obstacles but is not ultimately discouraging.

If we can understand the various barriers that make up this labyrinth, and how some women find their way around them, we can work more effectively to improve the situation. What are the obstructions that women run up against? Let's explore them in turn.

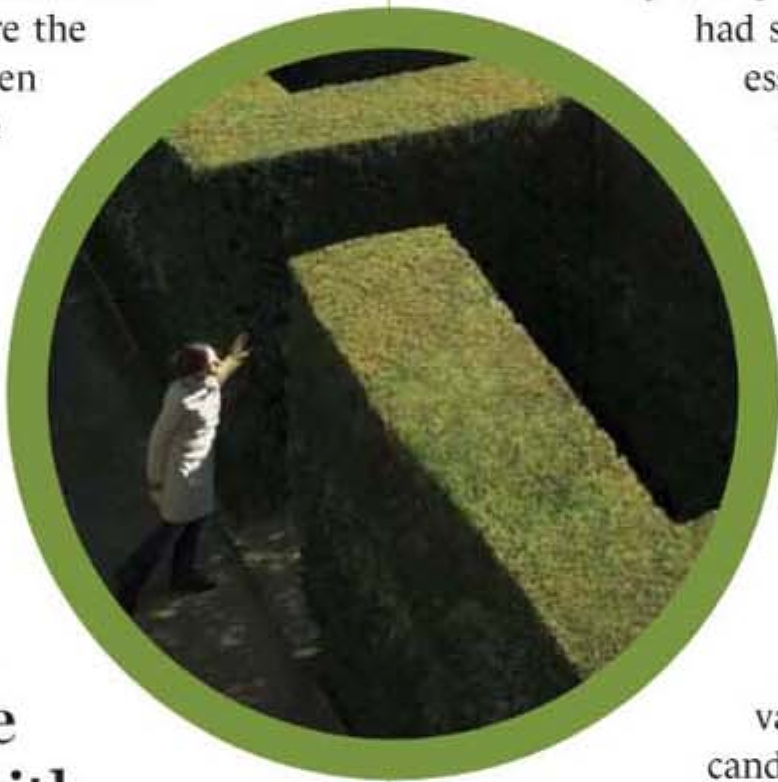
Vestiges of prejudice. It is a well-established fact that men as a group still have the benefit of higher wages and faster promotions. In the United States in 2005, for example, women employed full-time earned 81 cents for every dollar that men earned. Is this true because of discrimination or simply because, with fewer family demands placed on them and longer careers on average, men are able to gain superior qualifications? Literally hundreds of correlational studies by economists and sociologists have attempted to find the answer.

One of the most comprehensive of these studies was conducted by the U.S. Government Accountability Office. The study was based on survey data from 1983 through 2000 from a representative sample of Americans. Because the same people responded to the survey repeatedly over the years, the study provided accurate estimates of past work experience, which is important for explaining later wages.

Alice H. Eagly (eagly@northwestern.edu) is a professor of psychology and holds the James Padilla Chair of Arts and Sciences at Northwestern University, in Evanston, Illinois; she is also a faculty fellow at Northwestern's Institute for Policy Research. Linda L. Carli (lcarli@wellesley.edu) is an associate professor of psychology at Wellesley College, in Massachusetts; her current research focus is on gender discrimination and other challenges faced by professional women. The two are coauthors of *Through the Labyrinth: The Truth About How Women Become Leaders* (Harvard Business School Press, forthcoming in October), from which this article is adapted.

The GAO researchers tested whether individuals' total wages could be predicted by sex and other characteristics. They included part-time and full-time employees in the surveys and took into account all the factors that they could estimate and that might affect earnings, such as education and work experience. Without controls for these variables, the data showed that women earned about 44% less than men, averaged over the entire period from 1983 to 2000. With these controls in place, the gap was only about half as large, but still substantial. The control factors that reduced the wage gap most were the different employment patterns of men and women: Men undertook more hours of paid labor per year than women and had more years of job experience.

Although most variables affected the wages of men and women similarly, there were exceptions. Marriage and parenthood, for instance, were associated with higher wages for men but not for women. In contrast, other characteristics, especially years of education, had a more positive effect on women's wages than on men's. Even after adjusting wages for all of the ways men and women differ, the GAO study, like similar studies, showed that women's wages remained lower than men's. The unexplained gender gap is consistent with the presence of wage discrimination.



Marriage and parenthood are associated with higher wages for men but not for women.

Similar methods have been applied to the question of whether discrimination affects promotions. Evidently it does. Promotions come more slowly for women than for men with equivalent qualifications. One illustrative national study followed workers from 1980 to 1992 and found that white men were more likely to attain managerial positions than white women, black men, and black women. Controlling for other characteristics, such as education and hours worked per year, the study showed that white men were ahead of the other groups when entering the labor market and that their advantage in attaining managerial positions grew throughout their careers. Other research has underscored these findings. Even in culturally feminine settings such as nursing, librarianship, elementary education, and social work (all specifically studied by sociologist Christine Williams), men ascend to supervisory and administrative positions more quickly than women.

The findings of correlational studies are supported by experimental research, in which subjects are asked to evaluate hypothetical individuals as managers or job candidates, and all characteristics of these individuals are held constant except for their sex. Such efforts continue the tradition of the Goldberg paradigm, named for a 1968 experiment by Philip Goldberg. His simple, elegant study had student participants evaluate written essays that were identical except for the attached male or female name. The students were unaware that other students had received identical material ascribed to a writer of the other sex. This initial experiment demonstrated an overall gender bias: Women received lower evaluations unless the essay was on a feminine topic. Some 40 years later, unfortunately, experiments continue to reveal the same kind of bias in work settings. Men are advantaged over equivalent women as candidates for jobs traditionally held by men as well as for more gender-integrated jobs. Similarly, male leaders receive somewhat more favorable evaluations than equivalent female leaders, especially in roles usually occupied by men.

Interestingly, however, there is little evidence from either the correlational or the experimental studies that the odds are stacked higher against women with each step up the ladder – that is, that women's promotions become progressively less likely than men's at higher levels within organizations. Instead, a general bias against women appears to operate with approximately equal strength at all levels. The scarcity of female corporate officers is the sum of discrimination that has operated at all ranks, not evidence of a particular obstacle to advancement as women approach the top. The problem, in other words, is not a glass ceiling.

Resistance to women's leadership. What's behind the discrimination we've been describing? Essentially, a set of widely shared conscious and unconscious mental associations about women, men, and leaders. Study after study has affirmed that people associate women and men with different traits and link men with more of the traits that connote leadership. Kim Campbell, who briefly served as the prime minister of Canada in 1993, described the tension that results:

> I don't have a traditionally female way of speaking.... I'm quite assertive. If I didn't speak the way I do, I wouldn't have been seen as a leader. But my way

> of speaking may have grated on people who were not used to hearing it from a woman. It was the right way for a leader to speak, but it wasn't the right way for a woman to speak. It goes against type.

In the language of psychologists, the clash is between two sets of associations: communal and agentic. Women are associated with communal qualities, which convey a concern for the compassionate treatment of others. They include being especially affectionate, helpful, friendly, kind, and sympathetic, as well as interpersonally sensitive, gentle, and soft-spoken. In contrast, men are associated with agentic qualities, which convey assertion and control. They include being especially aggressive, ambitious, dominant, self-confident, and forceful, as well as self-reliant and individualistic. The agentic traits are also associated in most people's minds with effective leadership – perhaps because a long history of male domination of leadership roles has made it difficult to separate the leader associations from the male associations.

As a result, women leaders find themselves in a double bind. If they are highly communal, they may be criticized for not being agentic enough. But if they are highly agentic, they may be criticized for lacking communion. Either way, they may leave the impression that they don't have "the right stuff" for powerful jobs.

Verbally intimidating others can undermine a woman's influence, and assertive behavior can reduce her chances of getting a job or advancing in her career.

Given this double bind, it is hardly surprising that people are more resistant to women's influence than to men's. For example, in meetings at a global retail company, people responded more favorably to men's overt attempts at influence than to women's. In the words of one of this company's female executives, "People often had to speak up to defend their turf, but when women did so, they were vilified. They were labeled 'control freaks'; men acting the same way were called 'passionate.'"

Studies have gauged reactions to men and women engaging in various types of dominant behavior. The findings are quite consistent. Nonverbal dominance, such as staring at others while speaking to them or pointing at people, is a more damaging behavior for women than for men. Verbally intimidating others can undermine a woman's influence, and assertive behavior can reduce her chances of getting a job or advancing in her career. Simply disagreeing can sometimes get women into trouble. Men who disagree or otherwise act dominant get away with it more often than women do.

Self-promotion is similarly risky for women. Although it can convey status and competence, it is not at all communal. So while men can use bluster to get themselves noticed, modesty is expected even of highly accomplished women. Linguistics professor Deborah Tannen tells a story from her experience: "This [need for modesty] was evident, for example, at a faculty meeting devoted to promotions, at which a woman professor's success was described: She was extremely well published and well known in the field. A man commented with approval, 'She wears it well.' In other words, she was praised for not acting as successful as she was."

Another way the double bind penalizes women is by denying them the full benefits of being warm and considerate. Because people expect it of women, nice behavior that seems noteworthy in men seems unimpressive in women. For example, in one study, helpful men reaped a lot of approval, but helpful women did not. Likewise, men got away with being unhelpful, but women did not. A different study found that male employees received more promotions when they reported higher levels of helpfulness to coworkers. But female employees' promotions were not related to such altruism.

While one might suppose that men would have a double bind of their own, they in fact have more freedom. Several experiments and organizational studies have assessed reactions to behavior that is warm and friendly versus dominant and assertive. The findings show that men can communicate in a warm or a dominant manner, with no penalty either way. People like men equally well and are equally influenced by them regardless of their warmth.

It all amounts to a clash of assumptions when the average person confronts a woman in management. Perhaps this is why respondents in one study characterized the group "successful female managers" as more deceitful, pushy, selfish, and abrasive than "successful male managers." In the absence of any evidence to the contrary, people suspect that such highly effective women must not be very likable or nice.

Issues of leadership style. In response to the challenges presented by the double bind, female leaders often struggle to cultivate an appropriate and effective leadership style – one that reconciles the communal qualities people prefer in women with the agentic qualities people think leaders need to succeed. Here, for instance, is how Marietta Nien-hwa Cheng described her transition to the role of symphony conductor:

Is It Only a Question of Time?

IT IS A COMMON PERCEPTION that women will steadily gain greater access to leadership roles, including elite positions. For example, university students who are queried about the future power of men and women say that women's power will increase. Polls have shown that most Americans expect a woman to be elected president or vice president within their lifetimes. Both groups are extrapolating women's recent gains into the future, as if our society were on a continuous march toward gender equality.

But social change does not proceed without struggle and conflict. As women gain greater equality, a portion of people react against it. They long for traditional roles. In fact, signs of a pause in progress toward gender equality have appeared on many fronts. A review of longitudinal studies reveals several areas in which a sharp upward trend in the 1970s and 1980s has been followed by a slowing and flattening in recent years (for instance, in the percentage of managers who are women). The pause is also evident in some attitudinal data – like the percentage of people who approve of female bosses and who believe that women are at least as well suited as men for politics.

Social scientists have proposed various theories to explain this pause. Some, such as social psychologist Cecilia Ridgeway, believe that social change is activating "people's deep seated interests in maintaining clear cultural understandings of gender difference." Others believe progress has reached its limit given the continuing organization of family life by gender, coupled with employer policies that favor those who are not hampered by primary responsibility for child rearing.

It may simply be that women are collectively catching their breath before pressing for more change. In the past century, feminist activism arose when women came to view themselves as collectively subjected to illegitimate and unfair treatment. But recent polls show less conviction about the presence of discrimination, and feminism does not have the cultural relevance it once had. The lessening of activism on behalf of all women puts pressure on each woman to find her own way.

> I used to speak more softly, with a higher pitch. Sometimes my vocal cadences went up instead of down. I realized that these mannerisms lack the sense of authority. I strengthened my voice. The pitch has dropped....I have stopped trying to be everyone's friend. Leadership is not synonymous with socializing.

It's difficult to pull off such a transformation while maintaining a sense of authenticity as a leader. Sometimes the whole effort can backfire. In the words of another female leader, "I think that there is a real penalty for a woman who behaves like a man. The men don't like her and the women don't either." Women leaders worry a lot about these things, complicating the labyrinth that they negotiate. For example, Catalyst's study of *Fortune* 1000 female executives found that 96% of them rated as critical or fairly important that they develop "a style with which male managers are comfortable."

Does a distinct "female" leadership style exist? There seems to be a popular consensus that it does. Consider, for example, journalist Michael Sokolove's profile of Mike Krzyzewski, head coach of the highly successful Duke University men's basketball team. As Sokolove put it, "So what is the secret to Krzyzewski's success? For starters, he coaches the way a woman would. Really." Sokolove proceeded to describe Krzyzewski's mentoring, interpersonally sensitive, and highly effective coaching style.

More scientifically, a recent meta-analysis integrated the results of 45 studies addressing the question. To compare leadership skills, the researchers adopted a framework introduced by leadership scholar James MacGregor Burns that distinguishes between transformational leadership and transactional leadership. Transformational leaders establish themselves as role models by gaining followers' trust and confidence. They state future goals, develop plans to achieve those goals, and innovate, even when their organizations are generally successful. Such leaders mentor and empower followers, encouraging them to develop their full potential and thus to contribute more effectively to their organizations. By contrast, transactional leaders establish give-and-take relationships that appeal to subordinates' self-interest. Such leaders manage in the conventional manner of clarifying subordinates' responsibilities, rewarding them for meeting objectives, and correcting them for failing to meet objectives. Although transformational and transactional leadership styles are different, most leaders adopt at least some behaviors of both types. The researchers also allowed for a third category, called the laissez-faire style – a sort of nonleadership that concerns itself with none of the above, despite rank authority.

The meta-analysis found that, in general, female leaders were somewhat more transformational than male leaders, especially when it came to giving support and encouragement to subordinates. They also engaged in more of the rewarding behaviors that are one aspect of transactional leadership. Meanwhile, men exceeded women on the aspects of transactional leadership involving corrective and disciplinary actions that are either active (timely) or passive (belated). Men were also more likely than women to be laissez-faire leaders, who take little responsibility for managing. These findings add up to a startling conclusion, given that most leadership research has found the transformational style (along with the rewards and positive incentives associated with the transactional style) to be more suited to leading the modern organization. The research tells us not only that men and women do have somewhat different leadership styles, but also that women's approaches are the more generally effective – while men's often are only somewhat effective or actually hinder effectiveness.

Another part of this picture, based on a separate meta-analysis, is that women adopt a more participative and collaborative style than men typically favor. The reason for this difference is unlikely to be genetic. Rather, it may be that collaboration can get results without seeming particularly masculine. As women navigate their way through the double bind, they seek ways to project authority without relying on the autocratic behaviors that people find so jarring in women. A viable path is to bring others into decision making and to lead as an encouraging teacher and positive role model. (However, if there is not a critical mass of other women to affirm the legitimacy of a participative style, female leaders usually conform to whatever style is typical of the men – and that is sometimes autocratic.)

Demands of family life. For many women, the most fateful turns in the labyrinth are the ones taken under pressure of family responsibilities. Women continue to be the ones who interrupt their careers, take more days off, and work part-time. As a result, they have fewer years of job experience and fewer hours of employment per year, which slows their career progress and reduces their earnings.

In one study of Chicago lawyers, researchers sought to understand why women were much less likely than men to hold the leadership positions in large law firms – the positions that are most highly paid and that confer (arguably) the highest prestige. They found that women were no less likely than men to begin their careers at such firms but were more likely to leave them for positions in the public sector or corporate positions. The reasons for their departures were concentrated in work/family trade-offs. Among the relatively few women who did become partner in a firm, 60% had no children, and the minority who had children generally had delayed childbearing until attaining partner status.

There is no question that, while men increasingly share housework and child rearing, the bulk of domestic work still falls on women's shoulders. We know this from time-diary studies, in which people record what they are doing during each hour of a 24-hour day. So, for example, in the United States married women devoted 19 hours per week on average to housework in 2005, while married men contributed 11 hours. That's a huge improvement over 1965 numbers, when women spent a whopping 34 hours per week to men's five, but it is still a major inequity. And the situation looks worse when child care hours are added.

Mothers provide more child care hours than they did in earlier generations – despite the fact that fathers are putting in a lot more time than in the past.

Although it is common knowledge that mothers provide more child care than fathers, few people realize that mothers provide more than they did in earlier generations – despite the fact that fathers are putting in a lot more time than in the past. National studies have compared mothers and fathers on the amount of their primary child care, which consists of close interaction not combined with housekeeping or other activities. Married mothers increased their hours per week from 10.6 in 1965 to 12.9 in 2000, and married fathers increased theirs from 2.6 to 6.5. Thus, though husbands have taken on more domestic work, the work/family conflict has not eased for women; the gain has been offset by escalating pressures for intensive parenting and the increasing time demands of most high-level careers.

Even women who have found a way to relieve pressures from the home front by sharing child care with husbands, other family members, or paid workers may not enjoy the full workplace benefit of having done so. Decision makers often assume that mothers have domestic responsibilities that make it inappropriate to promote them to demanding positions. As one participant in a study of the federal workforce explained, "I mean, there were 2 or 3 names [of women] in the hat, and they said, 'I don't want to talk about her because she has children who are still home in these [evening] hours.' Now they don't pose that thing about men on the list, many of whom also have children in that age group."

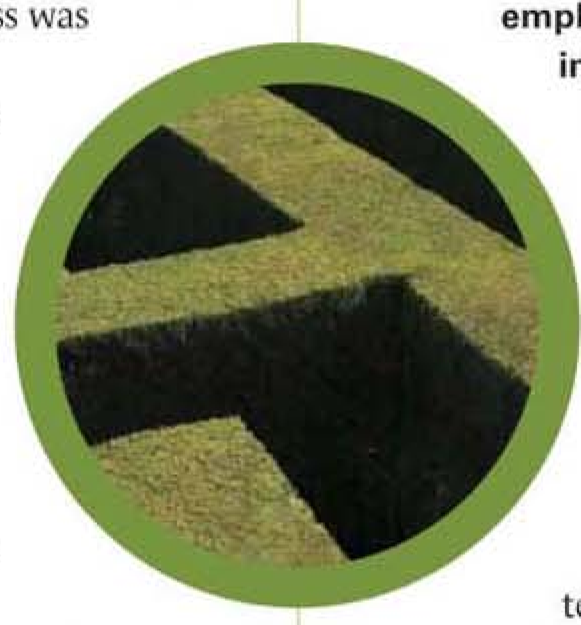
Underinvestment in social capital. Perhaps the most destructive result of the work/family balancing act so many women must perform is that it leaves very little time for socializing with colleagues and building professional networks. The social capital that accrues from such "nonessential" parts of work turns out to be quite essential indeed. One study yielded the following description of managers who advanced rapidly in hierarchies: Fast-track managers "spent relatively more time and effort socializing, politicking, and interacting with outsiders than did their less successful counterparts…[and] did not give much time or attention to the traditional management activities of planning, decision making, and controlling or to the human resource management activities of motivating/reinforcing, staffing, training/developing, and managing conflict." This suggests that social capital is even more necessary to managers' advancement than skillful performance of traditional managerial tasks.

Even given sufficient time, women can find it difficult to engage in and benefit from informal networking if they are a small minority. In such settings, the influential networks are composed entirely or almost entirely of men. Breaking into those male networks can be hard, especially when men center their networks on masculine activities. The recent gender discrimination lawsuit against Wal-Mart provides examples of this. For instance, an executive retreat took the form of a quail-hunting expedition at Sam Walton's ranch in Texas. Middle managers' meetings included visits to strip clubs and Hooters restaurants, and a sales conference attended by thousands of store managers featured a football theme. One executive received feedback that she probably would not advance in the company because she didn't hunt or fish.

Management Interventions That Work

Taking the measure of the labyrinth that confronts women leaders, we see that it begins with prejudices that benefit men and penalize women, continues with particular resistance to women's leadership, includes questions of leadership style and authenticity, and – most dramatically for many women – features the challenge of balancing work and family responsibilities. It becomes clear that a woman's situation as she reaches her peak career years is the result of many turns at many challenging junctures. Only a few individual women have made the right combination of moves to land at the center of power – but as for the rest, there is usually no single turning point where their progress was diverted and the prize was lost.

What's to be done in the face of such a multifaceted problem? A solution that is often proposed is for governments to implement and enforce antidiscrimination legislation and thereby require organizations to eliminate inequitable practices. However, analysis of discrimination cases that have gone to court has shown that legal remedies can be elusive when gender inequality results from norms embedded in organizational structure and culture. The more effective approach is for organizations to appreciate the subtlety and complexity of the problem and to attack its many roots simultaneously. More specifically, if a company wants to see more women arrive in its executive suite, it should do the following:



One study suggests that social capital is even more necessary to managers' advancement than skillful performance of traditional managerial tasks.

Increase people's awareness of the psychological drivers of prejudice toward female leaders, and work to dispel those perceptions. Raising awareness of ingrained bias has been the aim of many diversity-training initiatives, and no doubt they have been more helpful than harmful. There is the danger they will be undermined, however, if their lessons are not underscored by what managers say and do in the course of day-to-day work.

Change the long-hours norm. Especially in the context of knowledge work, it can be hard to assess individuals' relative contributions, and managers may resort to "hours spent at work" as the prime indicator of someone's worth to the organization. To the extent an organization can shift the focus to objective measures of productivity, women with family demands on their time but highly productive work habits will receive the rewards and encouragement they deserve.

Reduce the subjectivity of performance evaluation. Greater objectivity in evaluations also combats the effects of lingering prejudice in both hiring and promotion. To ensure fairness, criteria should be explicit and evaluation processes designed to limit the influence of decision makers' conscious and unconscious biases.

Use open-recruitment tools, such as advertising and employment agencies, rather than relying on informal social networks and referrals to fill positions. Recruitment from within organizations also should be transparent, with postings of open positions in appropriate venues. Research has shown that such personnel practices increase the numbers of women in managerial roles.

Ensure a critical mass of women in executive positions – not just one or two women – to head off the problems that come with tokenism. Token women tend to be pegged into narrow stereotypical roles such as "seductress," "mother," "pet," or "iron maiden." (Or more colorfully, as one woman banker put it, "When you start out in banking, you are a slut or a geisha.") Pigeonholing like this limits women's options and makes it difficult for them to rise to positions of responsibility. When women are not a small minority, their identities as women become less salient, and colleagues are more likely to react to them in terms of their individual competencies.

Avoid having a sole female member of any team. Top management tends to divide its small population of women managers among many projects in the interests of introducing diversity to them all. But several studies have found that, so outnumbered, the women tend to be ignored by the men. A female vice president of a manufacturing company described how, when she or another woman ventures an idea in a meeting, it tends to be overlooked: "It immediately gets lost in the conversation. Then two minutes later, a man makes the same suggestion, and it's 'Wow! What a great idea!' And you sit there and think, 'What just happened?'" As women reach positions of higher power and authority, they increasingly find themselves in gender-imbalanced groups – and some find themselves, for the first time, seriously marginalized. This is part of the reason that the glass ceiling metaphor resonates with so many. But in fact, the problem can be present at any level.

Help shore up social capital. As we've discussed, the call of family responsibilities is mainly to blame for women's underinvestment in networking. When time is scarce, this social activity is the first thing to go by the wayside. Organizations can help women appreciate why it deserves more attention. In particular, women gain from strong and supportive mentoring relationships and connections with powerful networks. When a well-placed individual who possesses greater legitimacy (often a man) takes an interest in a woman's career, her efforts to build social capital can proceed far more efficiently.

Prepare women for line management with appropriately demanding assignments. Women, like men, must have the benefit of developmental job experiences if they are to qualify for promotions. But, as one woman executive wrote, "Women have been shunted off into support areas for the last 30 years, rather than being in the business of doing business, so the pool of women trained to assume leadership positions in any large company is very small." Her point was that women should be taught in business school to insist on line jobs when they enter the workforce. One company that has taken up the challenge has been Procter & Gamble. According to a report by Claudia Deutsch in the *New York Times*, the company was experiencing an executive attrition rate that was twice as high for women as for men. Some of the women reported having to change companies to land jobs that provided challenging work. P&G's subsequent efforts to bring more women into line management both improved its overall retention of women and increased the number of women in senior management.

Establish family-friendly human resources practices. These may include flextime, job sharing, telecommuting, elder care provisions, adoption benefits, dependent child care options, and employee-sponsored on-site child care. Such support can allow women to stay in their jobs during the most demanding years of child rearing, build social capital, keep up to date in their fields, and eventually compete for higher positions. A study of 72 large U.S. firms showed (controlling for other variables) that family-friendly HR practices in place in 1994 increased the proportion of women in senior management over the subsequent five years.

Allow employees who have significant parental responsibility more time to prove themselves worthy of promotion. This recommendation is particularly directed to organizations, many of them professional services firms, that have established "up or out" career progressions. People not ready for promotion at the same time as the top performers in their cohort aren't simply left in place – they're asked to leave. But many parents (most often mothers), while fully capable of reaching that level of achievement, need extra time – perhaps a year or two – to get there. Forcing them off the promotion path not only reduces the number of women reaching top management positions, but also constitutes a failure by the firm to capitalize on its early investment in them.

When the eye can take in the whole of the puzzle – the starting position, the goal, and the maze of walls – solutions begin to suggest themselves.

Welcome women back. It makes sense to give high-performing women who step away from the workforce an opportunity to return to responsible positions when their circumstances change. Some companies have established "alumni" programs, often because they see former employees as potential sources of new business. A few companies have gone further to activate these networks for other purposes, as well. (Procter & Gamble taps alumni for innovation purposes; Booz Allen sees its alumni ranks as a source of subcontractors.) Keeping lines of communication open can convey the message that a return may be possible.

Encourage male participation in family-friendly benefits. Dangers lurk in family-friendly benefits that are used only by women. Exercising options such as generous parental leave and part-time work slows down women's careers. More profoundly, having many more women than men take such benefits can harm the careers of women in general because of the expectation that they may well exercise those options. Any effort toward greater family friendliness should actively recruit male participation to avoid inadvertently making it harder for women to gain access to essential managerial roles.

Managers can be forgiven if they find the foregoing list a tall order. It's a wide-ranging set of interventions and still far from exhaustive. The point, however, is just that: Organizations will succeed in filling half their top management slots with women – and women who are the true performance equals of their male counterparts – only by attacking all the reasons they are absent today. Glass ceiling–inspired programs and projects can do just so much if the leakage of talented women is happening on every lower floor of the building. Individually, each of these interventions has been shown to make a difference. Collectively, we believe, they can make all the difference.

The View from Above

Imagine visiting a formal garden and finding within it a high hedgerow. At a point along its vertical face, you spot a rectangle – a neatly pruned and inviting doorway. Are you aware as you step through that you are entering a labyrinth? And, three doorways later, as the reality of the puzzle settles in, do you have any idea how to proceed? This is the situation in which many women find themselves in their career endeavors. Ground-level perplexity and frustration make every move uncertain.

Labyrinths become infinitely more tractable when seen from above. When the eye can take in the whole of the puzzle – the starting position, the goal, and the maze of walls – solutions begin to suggest themselves. This has been the goal of our research. Our hope is that women, equipped with a map of the barriers they will confront on their path to professional achievement, will make more informed choices. We hope that managers, too, will understand where their efforts can facilitate the progress of women. If women are to achieve equality, women and men will have to share leadership equally. With a greater understanding of what stands in the way of gender-balanced leadership, we draw nearer to attaining it in our time.

For a list of the sources the authors consulted, view the article at www.hbr.org.

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P.C. Vey

"You've blurred the boundary between working from home and being unemployed."

INVESTIGATIVE

THE BEST WAY TO GET WHAT YOU'RE AFTER IN A NEGOTIATION – SOMETIMES THE ONLY WAY – IS TO APPROACH THE SITUATION THE WAY A DETECTIVE APPROACHES A CRIME SCENE.

NEGOTIATION

by Deepak Malhotra and
Max H. Bazerman

CHRIS, A *FORTUNE* 500 EXECUTIVE, is known in his firm as a gifted negotiator who can break impossible deadlocks. Consider his performance in the following deal.

A few years ago, Chris's company entered into negotiations with a small European firm to buy an ingredient for a new health care product. (Some details have been changed to protect the companies involved.) The two sides settled on a price of $18 a pound for a million pounds of the substance annually. However, a disagreement developed over terms. The European supplier refused to sell the ingredient exclusively to the U.S.

Michael Meister

firm, and the U.S. firm was unwilling to invest in a product that was based on an ingredient its competitors could easily acquire. With considerable hesitation, the U.S. negotiators sweetened the deal, offering guaranteed minimum orders and a higher price. To their shock, the supplier still balked at providing exclusivity – even though it had no chance of selling anything close to a million pounds a year to anyone else. The negotiation seemed to be at a dead end, with the U.S. negotiators out of ideas for pushing through a deal. Even worse, the relationship had deteriorated so much that neither side trusted the other to continue bargaining in good faith.

At that point the stymied U.S. team brought in Chris to help improve relations. He did more than that. After listening to the facts, he asked the Europeans a simple question: Why? *Why* wouldn't they provide exclusivity to his corporation, which would buy as much of the ingredient as they could produce? The response surprised the Americans. Exclusivity would require the supplier's owner to violate an agreement with his cousin, who bought 250 pounds of the ingredient each year to make a locally sold product. Armed with this new knowledge, Chris proposed a solution that allowed the two firms to quickly wrap up a deal. The European firm would provide exclusivity with the exception of a few hundred pounds annually for the supplier's cousin.

In retrospect, that solution seems obvious. But as we've seen in real-world negotiations, as well as in classroom simulations with seasoned deal makers, this type of problem solving is exceedingly rare. That's because most negotiators wrongly assume that they understand the other side's motivations and, therefore, don't explore them further. The U.S. team members initially failed because they thought they knew why the supplier was being difficult: Clearly, they assumed, the Europeans were holding out for a higher price or didn't want to lose out on future deals with other customers.

Would you have made the same mistake? We have presented this case to hundreds of experienced executives in negotiation courses at Harvard Business School. When we asked them to strategize on behalf of Chris's team about how to break the impasse, roughly 90% of their answers sounded like these: "Consent to a larger minimum purchase agreement." "Ask for a shorter exclusivity period." "Buy out the supplier." "Increase your offer price." "Threaten to walk away." All those suggestions share the same flaw: They are solutions to a problem that has not been diagnosed. Moreover, even if one of them had been effective in securing exclusivity, it would have been more costly than Chris's solution.

Deepak Malhotra (dmalhotra@hbs.edu) is an associate professor of business administration at Harvard Business School in Boston. **Max H. Bazerman** (mbazerman@hbs.edu) is the Jesse Isidor Straus professor of business administration at Harvard Business School. This article is adapted from their forthcoming book, *Negotiation Genius* (Bantam, 2007).

Chris succeeded because he challenged assumptions and gathered critical information regarding the other party's perspective – the first step in what we call "investigative negotiation." This approach, introduced in our new book, *Negotiation Genius,* entails both a mind-set and a methodology. It encourages negotiators to enter talks the same way a detective enters a crime scene: by learning as much as possible about the situation and the people involved.

Though the solution to every negotiation may not be as straightforward as Chris's, his approach can help in even the most complex deals. In this article, we delineate five principles underlying investigative negotiation and show how they apply in myriad situations.

PRINCIPLE 1 Don't just discuss *what* your counterparts want – find out *why* they want it.

This principle works in fairly straightforward negotiations, like Chris's, and can be applied fruitfully to complex multiparty negotiations as well. Consider the dilemma facing Richard Holbrooke in late 2000, when he was the U.S. ambassador to the United Nations. At the time, the United States was more than $1 billion in arrears to the UN but was unwilling to pay it unless the UN agreed to a variety of reforms. As a result, U.S. representatives were being sidelined in UN committee meetings, and the country faced losing its vote in the General Assembly. Meanwhile, U.S. senators were calling for a withdrawal from the organization.

Why the turmoil? For decades the United States had paid 25% of the regular UN budget. Believing that was too large a share, Congress decided to hold the $1 billion hostage until the UN agreed to, among other changes, reduce the U.S. assessment from 25% to 22% of the budget. The other UN member states saw this as a nefarious tactic.

Ambassador Holbrooke faced a tough challenge. According to UN regulations, a change in the allocation of dues needed the approval of all 189 members. What's more, a hard deadline was fast approaching. The Helms-Biden bill, which had appropriated close to $1 billion to cover much of what the United States owed, stipulated that if a deal was not struck by January 1, 2001, the money would disappear from the federal budget.

Holbrooke's team had hoped that Japan and some European countries would absorb most of the U.S. reductions. Unfortunately, the Japanese (who were already the second-highest contributors) rejected that idea outright. The Europeans also balked. How could Holbrooke break the impasse?

With the clock ticking, he and his team decided to concentrate less on persuading member states of the need for change and more on better understanding their perspectives. Whenever a member resisted an increase, Holbrooke, instead of arguing, would push further to discover precisely why it could not (or would not) pay more. Soon, one entirely unanticipated reason became salient: Many countries that might otherwise agree to increase their contributions did not have room to do so in their 2001 budgets, because they had already been finalized. The January 1 deadline was making the deal unworkable.

This new understanding of the problem gave rise to a possible solution. Holbrooke's proposal was to immediately reduce U.S. assessments from 25% to 22% to meet Congress's deadline but delay the increase in contributions from other nations until 2002. (The 2001 shortfall was covered by CNN founder and philanthropist Ted Turner, who agreed to make a onetime personal contribution of $34 million to the UN.) The key to resolving the conflict, however, was discovering that the dispute entailed not one issue but two: the timing of assessments as well as their size. Once the negotiators broadened their focus to include the issue of the timing, they could strike a deal that allowed each side to get what it wanted on the issue it cared about most.

PRINCIPLE 2 Seek to understand and mitigate the other side's constraints.

Outside forces can limit our ability to negotiate effectively. We may be constrained by advice from lawyers, by corporate policies that prohibit making concessions, by fear of setting a dangerous precedent, by obligations to other parties, by time pressure, and so on. Similarly, the other side has constraints that can lead it to act in ways that don't seem rational – and that can destroy value for both sides – but unfortunately, the constraints of the other side are often hidden from (or ignored by) us.

Smart negotiators attempt to discover the other party's constraints – and to help overcome them – rather than dismiss the other side as unreasonable or the deal as unworkable. Above all, investigative negotiators never view the other side's constraints as simply "*their* problem."

The experience of a company we'll call HomeStuff demonstrates why. At HomeStuff, a producer of household appliances, the CEO was negotiating the purchase of mechanical parts from a supplier we'll call Kogs. The two key issues were price and delivery date. HomeStuff wanted to pay a low price and get immediate delivery; Kogs sought a high price and more time to deliver the goods.

Eventually, the parties agreed on a price of $17 million and delivery within three months. "Meeting that deadline will be difficult for me," said the supplier, "but I'll manage." The CEO of HomeStuff was tempted to let the discussion end there – the deal was already done and meeting the deadline was now the supplier's problem – but she decided to explore matters further. Aware that a delivery after three months would cost her company close to $1 million, she offered to accept a delay if Kogs would drop the price by that amount. "I appreciate the offer," the supplier responded, "but I can't accommodate such a large price cut."

Curious, the CEO pressed on. "I'm surprised that a three-month delivery would be so costly to you," she said to the supplier. "Tell me more about your production process so that I can understand why you can't cheaply manufacture the parts in that time frame." "Ah! But that's not the problem," the supplier explained. "We can easily manufacture the products in three months. But we have no way of cheaply shipping the order so it would arrive on time."

When the HomeStuff CEO heard this, she was thrilled. Because her firm often had to transport products quickly, it had arranged favorable terms with a shipping company. Using that service, HomeStuff could have the parts delivered in *less than* three months for a small fraction of what the supplier would have paid.

The CEO made the following offer, which the supplier immediately accepted: HomeStuff would arrange for its own shipper to deliver the parts in two and a half months, the supplier would pay the shipping costs, and the price would drop from $17 million to $16.5 million.

As this story illustrates, the other side's problem can quickly become your own. This is true not only when the other party is quietly accepting its constraints but also when it's being disagreeable. Often, when the other side refuses to meet demands, its intransigence is interpreted as a sure sign it's acting in self-interest, but in fact its hands may be tied. Through investigation, negotiators may find that they can help mitigate the other side's constraints to their own advantage.

PRINCIPLE 3 Interpret demands as opportunities.

The CEO of a successful construction company was negotiating a deal to build a number of midsize office buildings. After months of talks – but just before the contract was signed – the developer approached the CEO with an entirely new and potentially costly demand: a clause that would require the builder to pay large penalties if the project fell more than one month behind schedule. The CEO, understandably, was irritated by this last-minute attempt to squeeze more concessions from him.

The builder weighed his options. He could accept the new clause and seal the deal, he could reject it and hope the deal would survive, or he could try to negotiate lower penalties. As he thought more deeply, he began to focus less on possible responses and more on what the demand revealed. At the very least, it showed that the developer had a strong interest in timely project completion. But might it also suggest that the developer valued *early* completion? With that in mind, the CEO approached the developer with a new proposal: He would pay even higher penalties than the developer wanted if the project was delayed. If the project was completed earlier than scheduled, however, the developer would give the construction company a bonus. Both sides agreed to that clause and were happier with the new terms. The builder was confident that his company would finish ahead of schedule and receive the bonus, and the developer minimized his downside risk.

Typically, when the other side makes seemingly unreasonable demands, negotiators adopt a defensive mind-set: "How can I avoid having to accept this?" In contrast, investigative negotiators confront difficult demands the same way they confront any statement from the other party: "What can I learn from the other side's insistence on this issue?

What does this demand tell me about this party's needs and interests? How can I use this information to create and capture value?" The construction company CEO's breakthrough came from his ability to shift his efforts away from fighting the other side's demand and toward investigating the opportunities hidden beneath it.

PRINCIPLE 4 Create common ground with adversaries.

Negotiation professors often engage their students in a complex simulation called "The Commodity Purchase," written by Leonard Greenhalgh of Dartmouth's Tuck School of Business. In it, one student plays the role of the seller of 100,000 pheasant eggs, and five other students play potential egg buyers. The buyers have different motives (for example, some want chemicals in the eggs to manufacture health products) and need a variety of quantities, encouraging the formation of coalitions among them. The alliance that will create the most value, however, involves two competing pharmaceutical firms that, by cooperating,

have the potential to outbid the other three buyers. The problem is that one of the firms needs at least 80,000 eggs, the other needs at least 70,000, and it is not obvious how both can get what they want, given that there are only 100,000 eggs. In fact, only about 5% of MBA students and executives that participate in this simulation manage to discover the solution.

To find it the company reps must first realize that the needs of their respective pharmaceutical firms are complementary, not competitive. Specifically, one firm needs the whites of the eggs, and the other needs the yolks. Once they know this, the two firms can split the cost of the eggs and each take what they need from the acquired product. However, few come to this conclusion, because to develop it the parties must adopt an investigative negotiation approach, overcome their reluctance to seek common ground with someone who is considered the enemy, and attempt to understand their competitor's perspective. The naive assumption that other firms in the same industry are strictly competitors typically prevents negotiators from taking an investigative approach.

As professors Adam Brandenburger of New York University and Barry Nalebuff of Yale University demonstrate in their book *Co-opetition,* it is often possible to simultaneously cooperate and compete with others. Investigative negotiators understand this. Those who view their relationship with the other side as one-dimensional – "He is

GETTING INFORMATION FROM DISTRUSTFUL NEGOTIATORS

NEGOTIATION ENTAILS RISK. If you share private information with the people on the other side, they might use it to their advantage. Guess what? The other side feels the same way. When other parties seem to be hiding information and evading your questions, you are likely to see them as deceptive or conniving rather than simply nervous and afraid. Try giving them the benefit of the doubt, recognizing that most people are reluctant to open up in negotiations because they don't know whether you can be trusted. The following three tactics can help you elicit information when trust is in short supply.

Share information and encourage reciprocity. If you are up against a reticent negotiator, be the first to share information, making it clear that you expect reciprocity. For example, you might say: "I know that there are many things we need to discuss. If you prefer, I can get the ball rolling by describing some of my key interests, concerns, and constraints. Then you can do the same. Does that sound like a reasonable way to proceed?" Such an approach helps reduce the other side's anxiety, because the other party knows that both sides will be vulnerable.

Keep in mind two things. First, you want to explicitly state the ground rules up front: I will start, and then you will follow suit. Make sure that the other side commits to reciprocating. Second, if the parties don't have full confidence in each other, share information incrementally, taking turns with the other side. That minimizes your own risks. If the other party fails to be forthcoming, you can hold back.

Negotiate multiple issues simultaneously. In most complex negotiations, issues are discussed one at a time. You might start by discussing what's presumed to be the most important (for example, price). When you have reached some agreement on price, you turn your attention to another concern (such as contract length), and then another (such as exclusivity). However, when there is only one issue on the table at any given moment, both sides behave as if it is the most important issue to them. When you move to the second concern, that concern appears to be the most critical. And so you continue to clash on each issue and never learn what the other party truly values or needs most.

Often, it's better to negotiate multiple issues simultaneously. That is, identify all the issues up front and put everything on the table at the same time. Then, go back and forth between the issues as you make offers and counteroffers. Doing so allows you to get information regarding the other side's true interests and priorities.

To determine what is really most important to the other side, look at the following signs:

- Which issue does the other party want to return to constantly?
- Which issue makes him or her the most emotional, tense, or stressed?
- Which issues are most likely to lead your counterpart to try to control the conversation, rather than listen?
- What is the other side most obstinate about when you ask for a concession or compromise?

Make multiple offers at the same time. Not only is it useful to negotiate multiple issues simultaneously, but it is also useful to make multiple *offers* at once. The next time you are preparing to make an offer to the other side, stop. Instead, make two offers at the same time that are equally valuable to you but differ on the details of one pair of issues.

Consider the case of a business owner who was negotiating with an ex-employee. The ex-employee was threatening to sue for having been fired without cause. The business owner preferred to settle out of court and soon discovered that the ex-employee was offering to settle for $15,000 in cash plus six months of temporary employer-paid health insurance. The business owner felt this amount was unjustified but was willing to negotiate. He started by asking whether the ex-employee cared more about the cash or about the health coverage. The ex-employee refused to offer this information. The business owner, having first calculated that the cost of providing the insurance would be approximately $2,500 for three months, decided to propose two options.

Offer X: $7,500 plus three months of health insurance.

Offer Y: $5,000 plus six months of health insurance.

The ex-employee was unwilling to accept either of the offers outright but voiced a preference for something closer to Y than X. This revealed that health insurance was more valuable to him than the cash. Offering him two options had prompted him to divulge his relative preferences. The final arrangement, then, could be made more attractive to the ex-employee and less costly to the business owner if further concessions were more heavily weighted toward insurance than toward cash.

Making multiple offers simultaneously is a great tactic for other reasons as well. It allows you to discover the interests of reticent negotiators, and it also makes you appear flexible and empathetic. It signals to the people on the other side that you are willing to be accommodating and interested in understanding their needs.

my competitor" – forgo opportunities for value creation, whereas those who appreciate the complexity of relationships and explore areas of mutual interest are able to find common ground.

PRINCIPLE 5 Continue to investigate even after the deal appears to be lost.

How many times have you tried to close a deal only to have your final offer rejected? If you are like most people, once someone has said no to your best offer, you presume there is nothing left to do. Often, this is the case. Sometimes, however, you are wrong – and you lose the deal not because there was no viable agreement but because you did not negotiate effectively.

A few years ago the chief executive of a specialty-gift-item manufacturer learned that a *Fortune* 500 company she had courted for months had decided to purchase from her competitor. Though she had no further plans for winning the deal, the CEO placed one final call to the prospect's vice president, asking why her offer was rejected and

explaining that an answer could help her improve future offerings.

To the CEO's surprise, the VP explained that the competitor, despite charging more, had beaten her offer by including product features that his company valued. Under the false assumption that the prospect cared mostly about price, the CEO had made a final offer that reduced the prospect's cost as much as possible. The CEO thanked the VP for his explanation and added that she had misunderstood his position earlier. "Knowing what I know now," she told him, "I'm confident that I could have beaten their offer. Would you consider a revised offer?" The answer was yes. One week later the CEO won over the prospect – and signed the deal.

After being rejected, an investigative negotiator should immediately ask, "What would it have taken for us to reach agreement?" Though it may appear costly to continue negotiating when a "no deal" response appears certain, if you're confused about the *reason* your deal fell through in the first place, it could be even more costly to abandon the discussion.

Even if you find that you cannot win the deal, you may still acquire important information that will help in future negotiations. By staying at the table, you can learn about this customer's future needs, the interests and concerns of similar customers, or the strategies of other players in the industry. Keep in mind that it is often easier to get candid information from the other side when you are not in selling mode and there is little reason to distrust your motives. Next time you've lost the deal and been asked to leave the room, see if you can stick around and investigate further. You may be surprised by what you find out.

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As these five principles demonstrate, successful investigative negotiation requires challenging some time-honored negotiation approaches. Chief among these is the reflex to "sell" your position.

Imagine that you're observing a salesperson at work. What is he doing? Most people picture a smooth talker with a briefcase making a pitch – arguing his case and trying to persuade a potential target to buy what he has to offer. Now imagine that you're observing a negotiator at work. What is he doing? If, once again, you picture a smooth talker with a briefcase making a pitch, you are missing a crucial distinction between selling and negotiating.

Selling involves telling people about the virtues of your products or services, focusing on the strengths of your case, and trying to induce agreement or compliance. While effective negotiating requires some of those activities, as the previous cases demonstrate, it also requires a strong focus on the other side's interests, priorities, and constraints. Investigative negotiators – like truly effective salespeople – keep this focus top of mind. They also understand that constructing a value-maximizing deal often hinges not on their ability to persuade but on their ability to listen.

In the end, negotiation is an information game. Those who know how to obtain information perform better than those who stick with what they know. In the situations described here, the decision to challenge assumptions, probe below the surface, and avoid taking no for an answer helped negotiators improve their options and strike better deals. More generally, the investigative negotiation approach can help you transform competitive negotiations into ones with potential for building trust and cooperation, creating value, and engendering mutual satisfaction.

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Multinationals and local firms for the first time are squaring off in China's rapidly growing middle market – a critical staging ground for global expansion and the segment from which world-beating companies will emerge.

THE BATTLE FOR CHINA'S GOOD-ENOUGH MARKET

by Orit Gadiesh, Philip Leung, and Till Vestring

CATERPILLAR, the world leader in construction equipment, is having trouble making deeper tracks in China. The U.S.-based manufacturer of tractors, backhoes, road graders, and other devices began selling equipment in China in 1975, a year before the death of Chairman Mao. As the Chinese government invested massively in infrastructure, Caterpillar helped pave the way, literally, for economic growth and modernization in the world's fastest-growing market for construction equipment.

Like many foreign players in any number of industries, Caterpillar got its start in China by selling goods to the Chinese government – the only possible customer before the era of economic reform – and then began selling high-quality equipment to the private sector as a premium segment of the market emerged. But it never broadened its focus to include other segments, and by the early 2000s, Komatsu, Hitachi, Daewoo, and other competitors from

Gary Sawyer

Japan and Korea were in the middle market with tools and equipment that cost less but were still reliable. Meanwhile, a tranche of local manufacturers that had previously been focused only on the low end of the market were burrowing up to battle the established players, designing and releasing their own products targeted squarely at middle-market consumers.

As the experiences of Caterpillar and other multinationals suggest, a critical new battleground is emerging for companies seeking to establish, sustain, or expand their presence in China: It's the "good-enough" market segment, home of reliable-enough products at low-enough prices to attract the cream of China's fast-growing cohort of midlevel consumers.

Harvard professor Clay Christensen, author of *The Innovator's Dilemma,* has used the phrase "good enough" to suggest that start-up companies developing and releasing new products and services don't necessarily need to aim for perfection to make inroads against established players. The phrase can be similarly applied to middle-market players in China that have been able to steal a march on incumbents by developing and releasing good-enough products that are displacing premium ones.

These forward-thinking companies (multinational and domestic firms alike) are doing more than just seizing share of wallet and share of mind in China's rapidly expanding middle market – in and of itself a major achievement. They are conditioning themselves for worldwide competition tomorrow: They're building the scale, expertise, and business capabilities they'll need to export their China offerings to other large emerging markets (India and Brazil, for instance) and, ultimately, to the developed markets. Given China's share of global market growth (Goldman Sachs estimates that China will account for 36% of the world's incremental GDP between 2000 and 2030) and the country's role in preparing companies to pursue opportunities in other developing regions, it's becoming clear that businesses wanting to succeed globally will need to win in China first.

In the following pages, we'll explore the importance of China as a lead market. We'll describe the surge of activity in China's middle market; when (and whether) multinationals and Chinese companies should enter this vibrant arena for growth; and, most important, how they can compete effectively in the good-enough segment. As Caterpillar and other foreign players have learned, achieving leadership in China's middle market isn't easy.

Orit Gadiesh (orit.gadiesh@bain.com) is the chairman of Bain & Company in Boston. **Philip Leung** (philip.leung@bain.com), a Bain partner in Shanghai, leads the firm's Greater China health care practice. **Till Vestring** (till.vestring@bain.com), a Bain partner based in Singapore, leads the firm's Asia-Pacific industrial practice.

An Evolving Opportunity

Historically, there has been a simple structure to China's markets: at the top, a small premium segment served by foreign companies realizing solid margins and rapid growth; at the bottom, a large low-end segment served by local companies offering low-quality, undifferentiated products (typically 40% to 90% cheaper than premium ones) that often lose money – when producers do their accounting right. Between the two is the rapidly expanding good-enough segment. (For an example of how one market sector breaks out, see the exhibit "The Structure of China's Market for Televisions.")

The good-enough space in China is growing for many reasons, not the least of which are recent shifts in consumer buying patterns and preferences. These shifts are coming from two directions: Consumers with rising incomes are trading up from the low-end products they previously purchased. At the same time, higher-income consumers are moving away from pricey foreign brands and accepting less expensive, locally produced alternatives of reasonable quality. The same holds true on the B2B front.

Consequently, China's middle market is growing faster than both the premium and low-end segments. In some categories, the good-enough space already accounts for nearly half of all revenues. Eight out of every ten washing machines and televisions now sold in China are good-enough brands. It should come as no surprise, then, that China – and, in particular, its opportunity-rich middle market – is increasingly capturing multinational executives' resources and attention. As Mark Bernhard, chief financial officer of General Motors' Shanghai-based GM China Group, recently told the *Detroit News:* "For GM to remain a global industry leader, we must also be a leader in China."

The automaker's strategy in China embodies that belief. GM had traditionally been an underperformer in the market for small cars. However, its acquisition of Korea's ailing Daewoo Motor in 2002 enabled it to compete and ultimately take a leadership position in China. The deal allowed GM to develop new models for half what it would cost the company to develop them in the West. Daewoo-designed cars now make up more than 50% of GM's sales in China, currently its second biggest market. What's more, GM is using these vehicles to compete against Asian automakers and sell small cars in more than 150 markets around the world, from India to the United States.

Colgate-Palmolive made similar moves in China. It entered into a joint venture in the early 1990s with one of China's largest toothpaste producers, and it acquired China's market leader for toothbrushes a decade later, allowing it to scale up and then leverage its production processes to compete in other parts of the world. As a result, Colgate more than doubled its oral hygiene revenues in China between 1998 and 2005, and it now exports its China products to 70 countries.

The Structure of China's Market for Televisions

Premium (Narrow)

Definition: High-end products purchased by discerning customers with significant purchasing power.

Leading Vendors: Panasonic, Philips, Sony

Product Features: LCD and plasma screens, many state-of-the art user features, priced according to their status as international brands.

Share of Market in 2005: 13%

Good-Enough (Rapidly Expanding)

Definition: Products of good quality, produced by local companies for a rapidly expanding group of value-seeking consumers with midlevel incomes.

Leading Vendors: Hisense, Skyworth, TCL

Product Features: LCD, plasma, and large cathode-ray tube screens, with limited user features, priced to undercut foreign brands.

Share of Market in 2005: 62%

Low-End (Evolving Base)

Definition: Products of lower quality, meeting basic needs, produced by local firms for a large group of consumers with low incomes.

Leading Vendor: Konka

Product Features: Cathode-ray tube screens with basic standard user features and low-cost components, priced to sell.

Share of Market in 2005: 25%

Local Chinese competitors pose the biggest challenge to multinationals seeking to capitalize on their business ventures in China and beyond. In the auto industry, for instance, domestic carmakers like Geely and Chery have eaten away at Western companies' market share in China by introducing good-enough cars for local consumption. Several of these automakers have started exhibiting vehicles at car shows in the United States and Europe, buying available Western brands, and exporting vehicles to other emerging markets. True, these players face enormous challenges in meeting safety and emissions standards and in building up the required distribution networks to compete in Europe and North America. But no Western company should underestimate the determination of Chinese firms to figure out how to meet international quality standards and make their global mark.

European and North American companies producing major appliances, microwaves, and televisions know this all too well. They abdicated China to low-cost local competitors in the 1990s and now find themselves struggling to compete globally against those same Chinese companies. Haier, which started making refrigerators in 1984, went on to become one of China's best-known brands and then used its hard-won scale advantages and manufacturing skills to crack, and then dominate, foreign markets. Today, it is one of the largest refrigerator companies in the world, controlling 8.3% of the highly fragmented global market. The company sells products in more than 100 markets, including the United States, Africa, and Pakistan.

Obviously, the stakes in China have changed. Local companies are using booming domestic markets to hone their strategies at home before taking on the world. Multinationals, therefore, need to defend their positions in China not only to profit from the economic growth in that country but also to prevent local competitors from becoming global threats. The good-enough space is where multinationals and Chinese firms are going head-to-head – and it's the market segment from which the world's leading companies will emerge.

Making an Entrance

It's one thing to recognize the importance of China's middle market; it's another thing entirely to turn that awareness into action. The first step in winning the battle for China's good-enough market is determining when – or when not – to enter the fray. That will depend on the attractiveness of the premium segment: Is it still growing? Are companies still achieving high returns or are returns eroding? Another consideration is your company's market position: Are you a leader or a niche player? (See the exhibit "Should You Enter the Middle Market?")

Foreign companies grappling with the good-enough decision in China will need to consider these factors and perform thorough market and competitor analyses, along with careful customer segmentation and needs analyses – classic strategy tools, of course, but applied in the context of a rapidly changing economy that may lack historical data on market share, prices, and the like. Senior managers will need to establish the factors that are key to success in everything from branding to pricing to distribution. This knowledge will inform important decisions about whether companies should expand organically into the middle market, acquire an existing player in that space, or find a good-enough partner.

Generally speaking, competing in the good-enough space is neither necessary nor wise for multinationals operating in stable premium segments. These companies should instead focus on lowering their costs and innovating to maintain their premium or niche positions and to sustain their margins. We studied one large manufacturer of automation equipment, for example, that wisely decided to stand pat in the premium segment. Market research suggested that its customers were still willing to pay more for reliability, even with a variety of lower-cost choices out there. The company continued to invest in R&D, hoping to further differentiate its products from those of local players; it expanded its distribution and service networks to improve its responsiveness to customers; and it cut costs by taking advantage of local production resources.

Few multinationals find themselves in such a fortunate position, however. If growth in the premium segment is slowing and returns are eroding, multinational corporations will need to enter the good-enough space. Even those companies that because of their strong competitive position initially abstain from entering the middle market should revisit their decision frequently to guard against emerging competitive threats. For their part, Chinese companies will need to move upmarket as the lower-end segment becomes increasingly competitive.

Our research and experience indicate that companies contemplating a move into the good-enough space go about it in one of three basic ways: Leading multinationals in the premium segment *attack from above.* The goal for these organizations is to lower their manufacturing costs, introduce simplified products or services, and broaden their distribution networks while maintaining reasonable quality. Meanwhile, Chinese challengers in the low-end segment tend to *burrow up from below.* These companies aim to take the legs out from under established players by providing new offerings that ratchet up quality but cost consumers much less than the premium products do. And, finally, multinationals that can't reduce their costs fast enough, and domestic players looking for more skills, technology, and talent, *buy their way in.*

Each of these moves comes with its own set of traps. The challenge, then, for companies eyeing the middle market is to understand why those that went before them failed in this space – and how to sidestep the pitfalls they encountered. Let's take a closer look at these three approaches.

Multinationals will need to tear apart the cost structure of their good-enough competitors to understand how they make money while charging such low prices.

Attacking from Above

Whether they're selling toothpaste or power transmission equipment, multinational companies dominate China's small but high-margin premium segment – the only one in which foreign players have traditionally been able to compete successfully. So a move toward the middle certainly holds a fair amount of risk for those already thriving in the premium space. A chief concern is cannibalization. After all, selling to consumers in less-than-premium segments could negatively affect sales of high-end products. These companies also run the risk of fueling gray markets for their wares. If, say, a business sells a T-shirt for $10 in China but $20 in the United States, there's a good chance an enterprising distributor will find a way to buy that T-shirt in China and export it to the United States for sale there.

Multinational managers, therefore, need to conduct careful market analyses to understand the differences between China's premium and good-enough segments. There may be, for instance, strong geographic distinctions a company can capitalize on. Consider the strategy GE Healthcare employed to expand sales of its MRI equipment in China. The company created a line of simplified machines targeted at hospitals in China's remote and financially constrained second- and third-tier cities – places like Hefei and Lanzhou, where other multinationals rarely ventured. That good-enough territory had all the right conditions: It was a fast-growing market whose customers' purchasing criteria weren't likely to change soon. GE's cost structure allowed it to compete with other middle-market players in the industry. And there was little risk that the company would cannibalize its premium line of diagnostic machines; large city hospitals were not keen on downgrading their MRI equipment.

Markets are dynamic, and there's no place on the planet where they are shifting as quickly or as dramatically as in China. So multinational executives also need to think about the degree to which the premium and good-enough segments will converge over time. Managers can use traditional forecasting methods (scenario planning, war gaming, consultations with leading-edge customers, and so on) to pick up on emerging threats and impending opportunities. Which brings us back to GE Healthcare's MRI expansion plans: The company's long-held commitment to health care development in China meshed perfectly with Chinese leaders' publicly stated desire to improve health services in less-privileged areas of the country. Given the government's aims, GE Healthcare understood there would eventually be some overlap of the premium, middle, and low-end markets – and profitable opportunities in the good-enough space.

After weighing the risks that cannibalization and dynamic markets pose to their company's premium positioning, managers in multinationals need to consider their possible opportunities in the good-enough space: Can they take advantage of their lower purchasing costs, greater manufacturing scale, and distribution synergies? Then they have to determine which capabilities they may need to develop: How adept is their organization at designing products, services, brands, and sales approaches that will attract customers in the middle market without diminishing their company's position in the premium space? They may need to convene teams dedicated solely to studying the opportunities and resources required in the good-enough segment, as GE Healthcare did. (See the sidebar, "Penetrating the Good-Enough Market, One County Hospital at a Time.") They may also want to recruit local management talent – individuals with experience competing in the middle space – or purchase local companies to gain new technologies or expertise.

Those multinationals that decide to enter the middle market tend to employ an "offensive-defense" strategy – aggressively staking claims in the good-enough space to box out emerging local players and established global competitors seeking to gain their own scale advantages. By entering the good-enough space ahead of the pack, for instance, GE Healthcare was able to defend its position against local upstarts, including Mindray, Wandong, and Anke. The company is still trying to develop the optimal product portfolio and is addressing such issues as how best to service the equipment. Even so, GE captured 52% of the $238 million market in 2004, generating roughly $120 million in sales. Having honed its approach to the good-enough space, GE is replicating the strategy in new markets in several developing countries, including India.

Multinationals are bound to find it tough to jump in from above. Apart from the risks of cannibalization and all the challenges always associated with going down-market, companies will need to adapt fast, as customers' preferences change and competitors react. And they will probably need to tear apart the cost structure of their good-enough competitors to understand how those firms make money while charging such low prices. Just switching to local sourcing, for instance, may not be sufficient for large multinationals to match the lower production costs of their domestic competitors.

Should You Enter the Middle Market?

Multinationals deciding whether to move into China's middle market need to first consider the attractiveness of the premium segment and their current market position. If conditions warrant, they can attack aggressively from above. Chinese firms can burrow up from below. Both can acquire their way into the good-enough space.

STATE OF THE PREMIUM MARKET SEGMENT

COMPANIES' COMPETITIVE POSITION	STRONG	WEAK OR ERODING
STRONG	**Maintain strong premium status** Hold off on entering the good-enough segment of the market – for now. Drop prices as required to remain competitive; lower costs and innovate to defend premium status and sustain margin. Regularly reevaluate the decision not to enter.	**Attack from above or buy your way in** Premium players employ an offensive-defense approach to enter the middle market. That is, they enter the good-enough segment in order to defend against the rise of local competitors and the erosion of the premium segment.
WEAK OR ERODING	**Innovate to maintain current premium status** Hold off on entering the good-enough segment of the market – for now. Increase innovation efforts to capture a niche position in the premium segment. Regularly reevaluate the decision not to enter.	**Burrow up from below or buy your way in** Value players enter the good-enough segment using a breakthrough approach – with a merger, for instance, or by developing China-specific products or business models – to steal share from incumbents and attain market leadership.

Burrowing Up from Below

Multinationals for years underestimated the ability and desire of local players in the low end of the market to move up and compete – a miscalculation that may now be coming home to roost. Recent developments have strengthened local competition in China and facilitated Chinese companies' moves upmarket and beyond.

Let's start with consolidation. For years, there were often hundreds of companies in a single industry catering primarily to customers in the low end of the market and typically focusing on regional needs. Many of those companies operated unprofitably – think of Red Star Appliances or Wuhan Xi Dao Industrial Stock. Because of China's free-market reforms, however, the weakest of those competitors are folding, and industries are experiencing waves of consolidation. Red Star, Wuhan Xi Dao, and 16 other money-losing concerns shifted and reshifted throughout the 1990s to form appliance maker Haier. A competent player or two, like Haier, have risen in each industry, often benefiting from national support. China's booming economy has enabled these survivors to build scale and develop market capabilities such as R&D and branding. As we have seen, over time, several of these emerging domestic champions have become direct challengers to global companies in a variety of industries.

Next, look at the rapidly expanding customer base in the middle space. Chinese customers – whether individual consumers, businesses, or government agencies – are becoming less willing to shell out 70% to 100% premiums for international products. At most, they may pay 20% to 30% more for world-class brands. The Italian dairy giant Parmalat discovered exactly that when it tried selling fruit-flavored yogurt for the equivalent of 24 cents a cup. Instead, consumers went with local brands at half the price. It seemed that brand, innovation, and quality – the hallmarks of multinationals in China – were no longer critical points of differentiation in customers' minds. This price sensitivity is opening up new ground for ambitious Chinese companies traditionally focused on the low end. These firms are designing and releasing good-enough products that overcome buyers' skepticism about quality at much lower prices, which generate higher margins than their low-end products. The often brutal competitive dynamics in the low-end segment also serve as a huge incentive for the better-managed local companies to move up. Until consumer demand began to explode in China, however, there really wasn't anywhere for these firms to go. Now there is.

The journey from low end to good-enough to global usually takes a decade and then some – but more and more Chinese companies are embarking on it. For instance, Lenovo, founded in 1984, entered the good-enough segment via a joint venture, flourished in the middle market, and then went on to establish its international brand with the purchase of IBM's PC division in 2005 for $1.75 billion. It is currently the world's third-largest PC maker. Similarly, Huawei

Penetrating the Good-Enough Market, One County Hospital at a Time

GE HEALTHCARE already had a successful business selling high-end medical equipment in China when the Chinese government set a goal for the next decade of improving the health care available in less-privileged locales. To support the government's efforts and also to break out of the high end of the market, GE developed a business case for manufacturing and selling medical devices for China's good-enough market. CEO Jeff Immelt's visits and conversations with Chinese leaders motivated the company to pursue the opportunity. In the end, GE's research and analysis identified a substantial demand from thousands of midtier and low-end Chinese hospitals in less affluent provinces that were not served by multinationals. GE knew that it could design new products and business models to serve this market. GE also knew that by using techniques like Six Sigma to eliminate manufacturing waste, it could make its costs competitive.

A team was charged with observing operations in the target hospitals and meeting with the hospital administrators and physicians to help determine what sort of medical equipment customers wanted, the specific features they needed, possible price points, and the kinds of distribution and services that would be required. Armed with this information, the fact-finding team considered stripping out some of the expensive equipment features and adding others that these target customers valued more. For instance, doctors in China's high-end hospitals preferred to program the medical equipment themselves, whereas physicians in the midlevel and low-end hospitals, who considered themselves less computer savvy, preferred preprogrammed machines.

The team worked with staffers in GE's R&D and manufacturing groups to build the right products at the right price points for the good-enough market. Because GE's existing sales, distribution, and service systems were not geared to the target customers, the company also had to reconfigure its networks of existing representatives and recruit new ones. This middle-market initiative is still a work in progress, but GE Healthcare has taken an enormous first step in establishing itself – and defending itself against rivals – in the good-enough segment.

Chinese customers are becoming less willing to shell out 70% to 100% premiums for international products. At most they may pay 20% to 30% more for world-class brands.

Technologies has grown since 1988 to the point where 31 of the first 50 firms on Standard & Poor's ranking of the world's top telecom companies are clients of the Chinese maker of mobile and fixed telecommunications networks.

Just as foreign players approaching the market from above come face-to-face with their shortcomings – high costs, limited distribution capabilities, and the possibility of cannibalizing their own products – local companies moving up encounter their own limitations. Foremost is the shortage of managerial talent, especially for international businesses. Growing numbers of Chinese students are pursuing MBAs and studying abroad. They are slowly distinguishing themselves from the large cohort of current Chinese managers, whose command-and-control leadership style dominates local manufacturing houses. But catching up remains difficult, as China's surging economic growth outpaces the country's ability to educate and apprentice twenty-first-century managers.

Another obstacle for Chinese companies is their inability to compete with global players through innovation or by establishing a strong brand because of their limited size and their lack of management tools and experience. A question like "How much should we spend on advertising?" can stymie local managers looking at expansion. Long used to competing solely on price, they have little experience in understanding and addressing segment-specific needs, linking those needs to R&D and brand-building efforts, and creating the required infrastructure in sales and distribution.

Consider the early successes enjoyed by Chinese handset manufacturer Ningbo Bird. It was among a group of small, local companies that took 20% to 30% of the telecom market between 2000 and 2002 from the likes of Nokia and Motorola. Ningbo Bird prevailed by competing on price. But its success was short-lived, its march toward global expansion thwarted. The company just didn't have the expertise and resources the foreign corporations had in customer segmentation, R&D, innovation, and distribution.

By contrast, Huawei has been able to successfully navigate such roadblocks. Initially established as a network equipment distributor, Huawei has built and acquired the technical and managerial capabilities it needed to rise up from the low end of the market. From its inception, Huawei invested 10% of its sales in R&D. It developed its own products to penetrate new segments in China and forged technical alliances to further broaden its product mix. With government support, Huawei prompted consolidation in the domestic market, gaining massive scale in the process. The company now controls 14% of the local market for telecom networks. Firmly established in the good-enough space at home, Huawei built brands to meet the requirements of global customers. It established 12 R&D centers around the world, pioneering next-generation technologies (customized communication networks and voice access systems) and partnering with global brands such as 3Com to build customer awareness of its own brands.

Huawei has broadened its reach in stages over 14 years. The company first focused on establishing itself in developing regions of China, where multinationals had less incentive to compete. It then penetrated countries with emerging economies, such as Russia and Brazil. Finally, it attacked the developed countries. It has expanded internationally through aggressive sales and marketing, by taking advantage of low-cost China-based R&D, and by leveraging its ability to outsource some of its manufacturing processes to other players in China. A little more than a decade ago, Huawei was a regional company in a local market that few multinationals considered important. With 2005 revenues of $8.2 billion, it is now second only to Cisco, according to InfoTech Trends' ranking of the networking hardware industry. It could never have ascended the way it has without using China's good-enough segment as a springboard for growth.

Buying Your Way In

For multinational companies that can't alter their costs or processes quickly enough to compete with local players, and for Chinese firms that lack the production scale, R&D mechanisms, and customer-facing capabilities to compete with foreign players, there is still a breakthrough option for entering the middle market – mergers and acquisitions.

China's entry into the World Trade Organization in 2001 fueled a surge in M&A activity. Now, however, foreign acquirers are facing tougher approval processes. China's public commitment to open markets remains strong, but several high-profile deals have gotten stuck at the provincial or ministerial level, owing to increasing public concerns about selling out to foreign firms. For instance, in its bid to buy Xugong Group Construction Machinery, China's largest construction machinery manufacturer and distributor, the U.S. private equity firm Carlyle Group met with unexpected resistance from the government and ended up twice reducing its stake, ultimately to 45%. In rejecting successive Carlyle bids, officials in Beijing insisted the nation's construction equipment industry should be controlled by "domestic hands."

As the Carlyle Group learned, gaining regulatory and political approval for M&As in China is a major undertaking. Foreign companies seeking such approval may need to draft (and redraft) a compelling business case for the acquisition, one that cites up front the benefits for local companies and authorities. Like Carlyle, they must be willing to adjust (and readjust) the structure, terms, and conditions of a deal to gain government support. They may also need to engage in heavy-duty relationship building, investing the time and resources required to woo critical players in the deal.

As is always the case with M&As the world over, it's all about fit: There should be cost and distribution synergies between the multinational and its target and little chance that the local company's products will cannibalize the multinational's premium brands. Successful acquirers in China – multinationals and Chinese firms alike – use a clear strategic rationale to select the right target. They overinvest in the due diligence process. They take a systematic approach to postmerger integration.

That was the game plan behind Gillette's 2003 acquisition of Nanfu, then China's leading battery manufacturer. Gillette's Duracell division throughout the 1990s was losing market share in China to lower-priced competitors. By 2002, Duracell's share of the Chinese domestic battery market was 6.5%. By contrast, Nanfu controlled more than half the market. After careful analysis, Gillette's management team recognized that its Duracell unit was at a cost disadvantage compared with its rivals and concluded it would be difficult to broaden the brand's market penetration. Facing such odds, Gillette decided to buy into the good-enough market, acquiring a majority stake in Nanfu. But Gillette was extremely careful to protect both Duracell's and Nanfu's brands in their respective segments. Gillette continues to sell premium batteries in China under the Duracell brand and has maintained Nanfu as the leading national brand for the mass market. The dual branding, cost synergies, sales growth, broadened product portfolio, economies of scale, and distribution to more than 3 million retail outlets in China have paid off for Gillette, which has seen significant increases in its operating margins in China.

Buying into the good-enough segment also worked for consumer-goods giants Danone, L'Oréal, and Anheuser-Busch – companies that saw the vast potential in China but couldn't get their costs low enough to compete. For instance, in 2004, Anheuser-Busch outbid its competitor SABMiller to acquire Harbin, the fourth-largest brewer in China. That acquisition allowed Anheuser-Busch to reach the masses while preventing Harbin from swimming upstream. The next year, it increased its stake in Tsingtao Brewery, from 9.9% to 27%. Both moves enabled the global brewer to rapidly increase its share among China's drinkers of less-than-premium beer.

Chinese companies are also wrapping their arms around acquisition strategies, attempting to establish their presence in the middle market by purchasing brands, talent, and other resources from target companies in Europe and North America. To date, they've met with mixed results. On the one hand, Lenovo's acquisition of IBM's PC division turned the Chinese computer maker into the world's third-largest PC company. On the other hand, the acquisition experiences of TCL, a major Chinese consumer electronics manufacturer, have been less successful.

Many Chinese companies believe they must forge ahead and buy established Western brands and distribution systems whether or not they have the experience and management tools to handle them.

TCL built a strong position in the Chinese market by producing and distributing basic cathode-ray tube TVs at astonishingly low prices. It also engaged in contract and private-label manufacturing for the U.S. and European markets. But TCL realized it would need a strong brand to rise up from the low end of the China market and that growing organically in a mature industry like TV manufacturing would be prohibitively expensive. So TCL acquired French firm Thomson, which owned a number of well-known brands, including RCA. Unfortunately, Thomson also owned some high-cost and unproductive manufacturing facilities in France. TCL has struggled since acquiring Thomson, as the market for TVs has shifted from cathode-ray to plasma and LCD technologies. In 2006, the company lost $351 million from operations. Many Chinese companies believe that in order to play in the global arena, they must simply forge ahead, buying established Western brands and distribution systems – whether or not they have the experience and management tools to handle such acquisitions. But, as TCL's story suggests, executing such a plan is hardly cut-and-dried.

...

In the 1960s and 1970s, the mantra for many organizations was "Capture U.S. market share, capture the world." Today, China – and its middle market in particular – has become the object of multinationals' ardent pursuit. The enormous market potential of the country's population, the formidable growth of the economy, and China's established position in low-cost sourcing and manufacturing are providing competitive advantages for many companies – benefits these organizations are then leveraging both inside and outside the nation.

Local Chinese companies know their futures depend on entering the good-enough space and attacking global leaders (and their premium positioning) by offering low-cost products of reasonable quality that they can eventually take to the world. Multinationals are beginning to recognize that ceding the middle space to Chinese firms may breed competitors that will ultimately challenge them on a global scale. Ironically, Chinese companies that have already gone global are on the defensive as well. A recent *Forbes Asia* article reported that as Haier has attacked international markets and won share abroad, both local companies and multinationals have been nibbling away at its share of China's middle market – which fell from 29% in 2004 to 25% last year.

The stakes are high. All the more reason, then, for companies that have stumbled in China in the past to redouble their efforts. Danone's high product costs thwarted its early attempts to sell dairy products in China's middle market. But that obstacle was removed when the firm reengaged in the fight, lowering its costs by buying a local dairy.

Likewise, Caterpillar hasn't diverted its focus away from China and the importance of the good-enough space. The company plans to triple its sales by 2010, opening more manufacturing plants and dealerships and forming more joint ventures with local companies. "Operational and sales success in China is critical for the company's long-term growth and profitability," said Rich Lavin, vice president of Caterpillar's Asia Pacific Operations Division, in November 2006. Shortly thereafter, the company moved its divisional headquarters – from Tokyo to Beijing.

Reprint R0709E
To order, see page 151.

John Caldwell

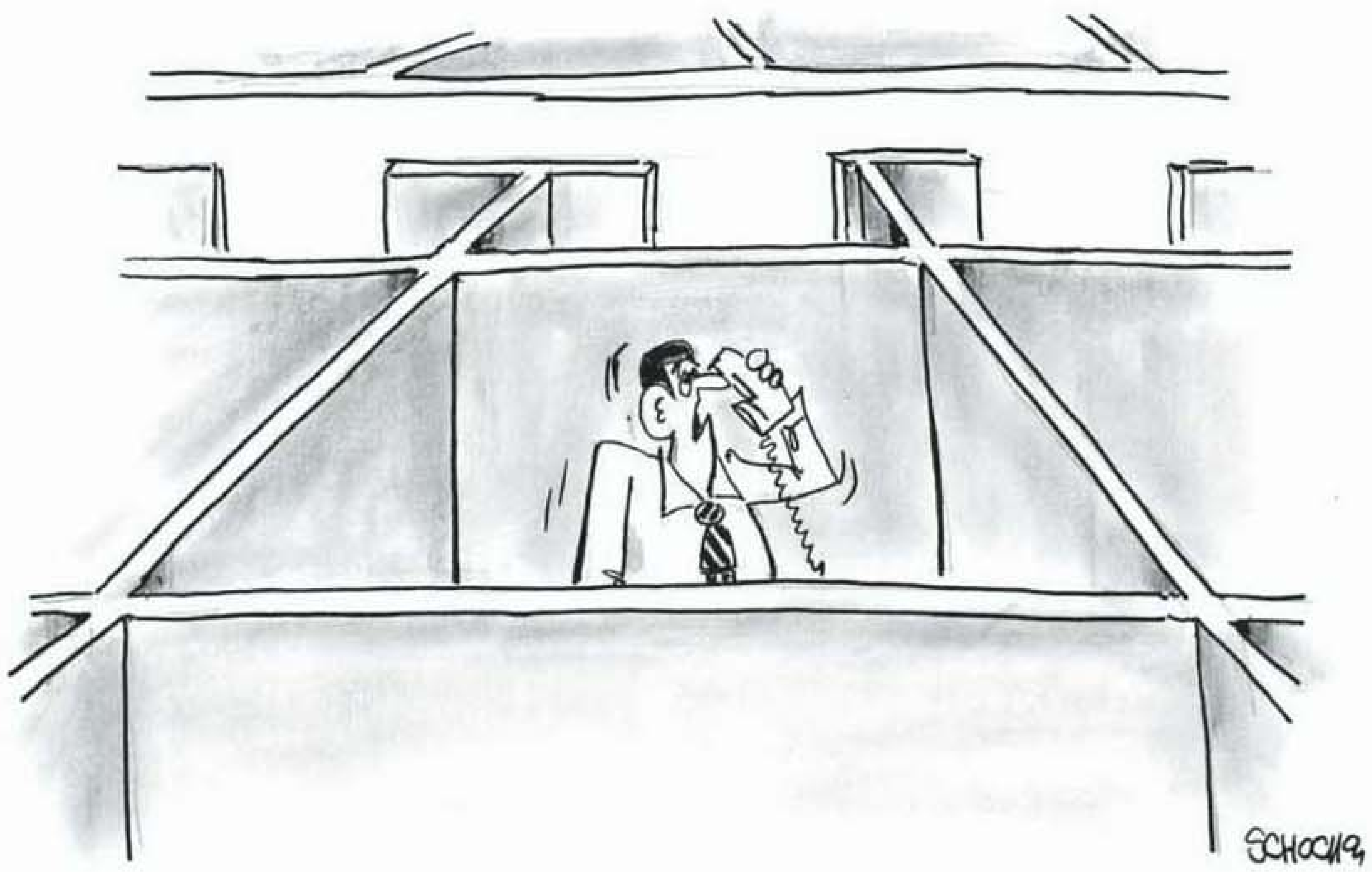
"I'm sorry, but Mr. Fenniman has stepped away from his desk.
Would you like to listen to his podcast?"

Space Case

"Because people are accustomed to equating status with an office of a certain location and size, they cling to this equation even when it is no longer suitable."

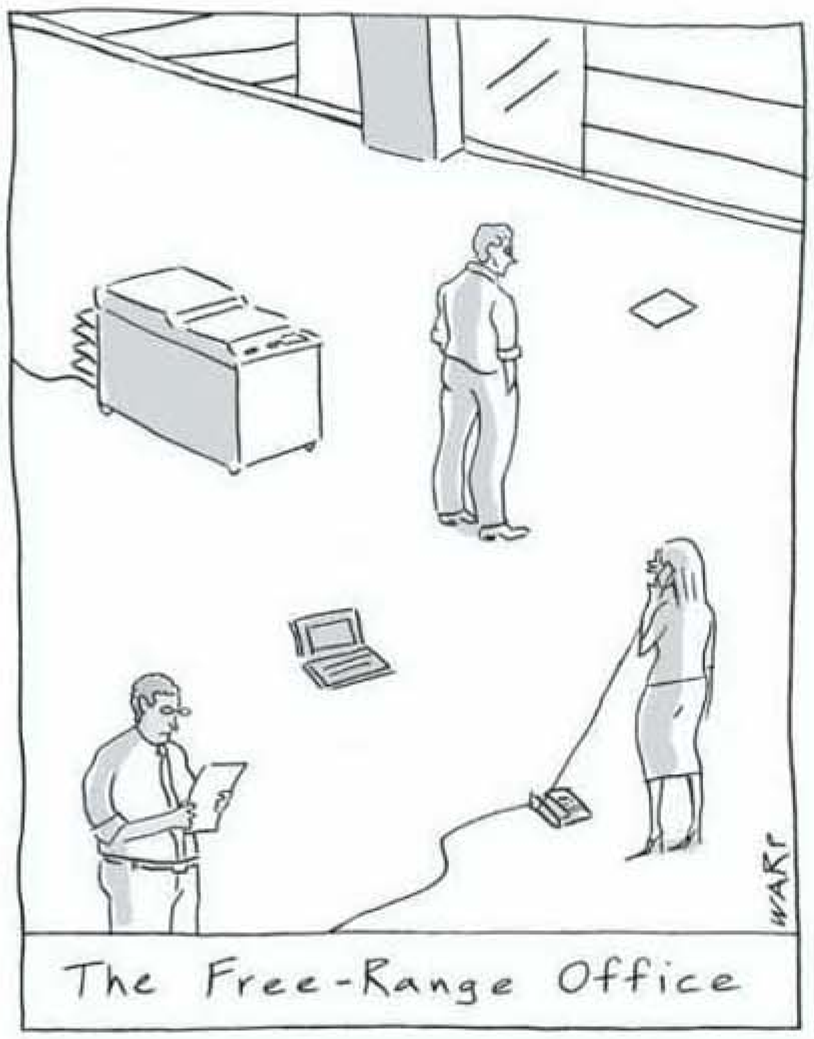
Philip J. Stone and Robert Luchetti
"Your Office Is Where You Are"
Harvard Business Review
March–April 1985

"We're a little short on space at this time, Mr. Benson. This will have to do for now."



"HELP!"

Mike Lynch, Bob Schochet, P.C. Vey, Kim Warp, and Robert Zasadny



"Oh, vowels are so 2006!"

"I've always kept it as a reminder of where I came from."

The Tests of a Prince

Future leaders, particularly in family businesses, must jump through four kinds of hoops to earn the respect – and then the support – of stakeholders.

by Ivan Lansberg

PEOPLE HAVE BEEN SIZING UP BRIAN ROBERTS, the CEO of the $25 billion American telecommunications giant Comcast, since he was a child. Employees in the company's Philadelphia head office remember him as a kid, hanging onto the coattails of his father, Ralph Roberts, one of Comcast's founders. Brian Roberts may have been interested in the cable industry even as a boy; according to a 2001 *Fortune* article, he helped punch the coupon books that Comcast mailed to customers! As Brian grew older, anecdotes suggest, Ralph Roberts taught his son the skills he would need to manage the family business. When Brian was still in high school, he regularly accompanied his father to meetings with Comcast's bankers and lawyers. At 15, on the first day of his first summer job, he got a taste of how the company's employees regarded him. As he told *Wharton Alumni Magazine* in spring 2000, when he showed up for work in a tie and a jacket, his supervisor warned him: "I don't give a goddamn whose son you are. You come to work for me, you're going to work."

Jacob Thomas


THOMAS

When Brian Roberts graduated with a finance degree from the University of Pennsylvania in 1981, he wanted to join Comcast. However, his father was keen that he work for some other company. The younger Roberts refused; he kept turning down offers until his father reluctantly gave him a job. The finance whiz assumed he would join Comcast's corporate finance group, but Ralph Roberts assigned him to a project in Trenton, New Jersey. Roberts joined Comcast as a trainee, doing everything from stringing cables atop poles to selling cable services door-to-door. But in 1986, when Comcast helped bail out Turner Broadcasting System, Ralph Roberts catapulted his son into the senior management ranks by nominating him to TBS's board. Four years later, Ralph Roberts appointed himself Comcast's chairperson and made his 31-year-old son the company's president. Since then, Brian Roberts has earned a reputation for being an aggressive deal maker. In 2002, when Comcast acquired AT&T Broadband, investors criticized him for taking on $25 billion in debt in a weak economy. When the two companies finished integrating their operations, however, Comcast's profit margins rose, and, in 2003, *Institutional Investor* magazine declared Roberts one of America's best CEOs. The next year, an abortive bid to take over the Walt Disney Company rekindled perceptions that he was overreaching himself. Although Roberts redeemed himself in 2005 by allying with Sony to take over MGM Studios, in some ways the jury is still out on the "young" Mr. Roberts.

Like celebrity children, would-be leaders of family enterprises are in the public eye literally from the time they are born. As a scion moves to center stage, stakeholders dissect his or her intellectual, physical, and emotional capacity at every turn. Anxious to know whether the next-generation leader will help them fulfill their aspirations and protect them from trouble, stakeholders try to form opinions about the individual's capabilities and trustworthiness as he or she rises to the top. They analyze issues such as the person's values, vision, competence, and interpersonal skills, and at the same time, each constituency tries to learn how the possible successor will respond to its specific needs. Stakeholders often influence the choice of CEO, and in return for their support, they expect the new leader to meet their demands.

Yet my research suggests that corporate scions usually ignore or greatly underestimate stakeholders. They don't realize that, particularly after they are formally anointed as CEOs, they must establish their credibility with and authority over these spheres of influence. Most successors of family businesses, having grown up in fishbowls, take stakeholders for granted – and are shocked if some turn against them. When that happens, leaders often have to step down prematurely. For example, according to media reports, Krister Ahlstrom, former chairperson of Finland's Ahlstrom Corporation, and Thomas Pritzker, chairperson of Global Hyatt Corporation, ran into trouble because they misread their families. Others – such as Motorola's Christopher B. Galvin, Seagram's Edgar Bronfman, Jr., and Ford's William Clay Ford, Jr. – had to step down as CEOs because they were unable to meet shareholders' expectations.

New leaders of family businesses influence stakeholders not because they've earned that right but because they or their families possess large equity stakes, enjoy the support of incumbent CEOs, or control organizational resources and rewards. However, they can't sustain their leadership through raw power; stakeholders must also accept that leaders have the right to influence them. Followers grant leaders the authority to lead – which the latter tend to forget. The idea that leaders' authority emanates from their followers isn't new; sociologists such as Max Weber and Georg Simmel pointed that out in the last century.

Thus, the greatest challenge any newly anointed CEO faces is turning stakeholders into followers. For the inheritor of a family business, the challenge is particularly thorny. He or she must cope with family members, especially siblings and cousins whose support may be vital to control the enterprise, as well as manage several other constituencies – such as directors and senior executives; bankers and suppliers;

Heirs to family businesses can't sustain their leadership through raw power; stakeholders must grant them the authority to lead.

Ivan Lansberg (lansberg@lgassoc.com) is a senior partner at Lansberg, Gersick & Associates, a New Haven, Connecticut–based research and consulting company specializing in family enterprise. He is the author of several books, including *Succeeding Generations: Realizing the Dream of Families in Business* (Harvard Business School Press, 1999).

and, from time to time, stock analysts, regulatory agencies, institutional investors, and trade unions – that may not be convinced that the successor has earned the right to lead the company. These stakeholder groups have different, even contradictory priorities, and they usually make their judgments in silos. Still, the fate of a CEO depends on how all of them answer the same question: Are we in good hands?

Different stakeholders find answers to that question in remarkably similar ways. For 25 years, I have worked with business families during times of transition. I have observed the manner in which families anoint successors and how these inheritors take charge. In many cases, as a consultant, I have helped stabilize new regimes. My experience suggests that stakeholders form opinions about leaders through an inquiry process I call iterative testing. Through this process, stakeholders gather data, analyze information, and form conclusions about potential leaders long before it is clear that they will ascend to the top job.

The success of a CEO depends on his or her ability to understand, accept, and manage the iterative testing process. All too often, anointed leaders are surprised and hurt by stakeholders' need to keep questioning whether they are fit for the top job and to test their vision, values, motivations, and skills. After working hard to climb the corporate hierarchy, successors are shocked that they have to learn a new set of skills for winning the hearts and minds of a wide array of stakeholders. The more entitled successors feel – the more they look upon their positions as theirs by right – the more humiliated they are by stakeholders' doubts. Smart successors, in contrast, understand stakeholders' need to know them better, and they engage proactively with the process. For, as Machiavelli wrote in *The Prince,* those who become "princes by good fortune do so with little exertion on their own part, but subsequently, they maintain their position only through considerable exertion" while those "who become rulers by prowess acquire their principalities with difficulty but hold them with ease."

What Is Iterative Testing?

From a psychological standpoint, iterative testing is the way followers "write" a leader's story in their minds. As leadership expert Howard Gardner wrote in his 1995 book, *Leading Minds: An Anatomy of Leadership,* such narratives are how followers gather, arrange, and store information about their leaders. The stories partly determine the degree to which stakeholders are willing to subordinate themselves to a leader's influence. The testing process is not a neatly organized sequence of objective challenges, like the Twelve Labors of Hercules, that aspirants can tackle to establish their credibility. Stakeholders' perceptions influence the process, so it is subject to the psychological biases and political dynamics that characterize all human systems. I use the word "tests" because that's how stakeholders conceive of the trials that

Running the Gauntlet in Nonfamily Companies

Organizations that aren't controlled by families spend large amounts of time and money creating processes to select and train would-be leaders. In these companies, executives are supposed to move up the ladder only if they display the capabilities, experience, and determination to lead. However, merit usually lies in the eye of the beholder. Nepotism and favoritism aren't limited to family businesses; many CEOs have used their social networks to rise through the hierarchy. Circumstances thrust others into power; for instance, corporate restructurings sometimes propel people who happen to be at the right place and time into leadership roles. Organizations often appoint outsiders, whom stakeholders know little about, as CEOs. Stakeholders in nonfamily organizations therefore put their leaders through the iterative testing process, and those leaders' responses determine their fates.

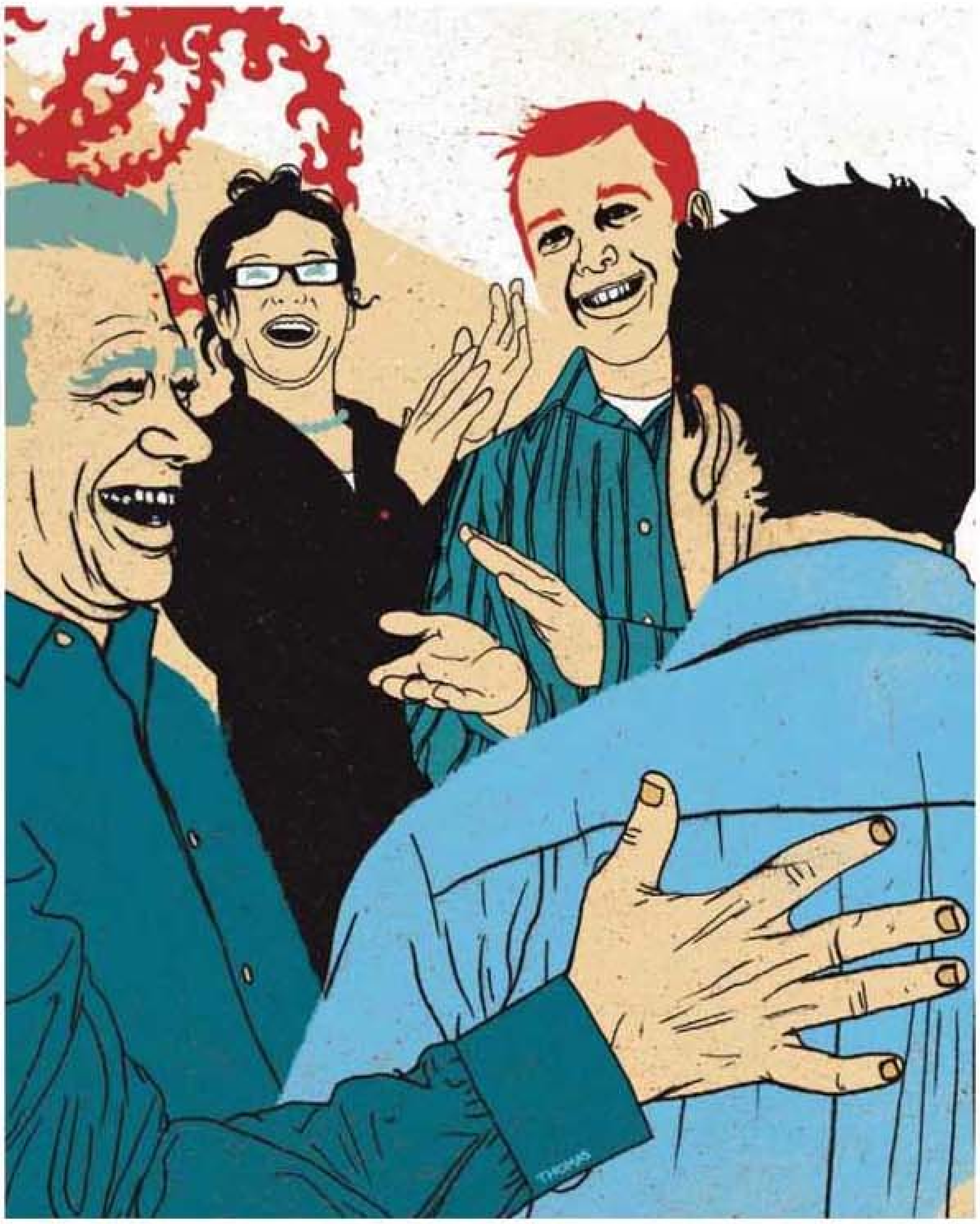
Still, there are differences in the way the tests play out in family and nonfamily organizations. First, stakeholders in nonfamily enterprises tend to pay less attention to qualifying tests; they assume that CEOs wouldn't have gotten that far if they didn't have the right education, skills, and experience. Nonfamily organizations test those who aspire to top roles with mechanisms such as formal interviews by boards of directors; career paths with regular performance assessments; and market-determined compensation monitored by the board of directors. By contrast, being a member of the family is a handicap for successors in family businesses, since the assumption is that they got to where they are because of family connections. In these companies, stakeholders place a premium on qualifying tests.

Second, family successors often feel personally affronted at the first sign of stakeholder testing. By contrast, in nonfamily enterprises, leaders have been tested several times before they get to the top and, therefore, are likely to have developed the skills and ego to effectively handle iterative testing.

Finally, in family enterprises, leaders may be harder to remove because they own or represent those with equity stakes. Where the exit barrier is higher, people are more likely to rationalize the presence of an inadequate leader. In a nonfamily business, the higher likelihood that stakeholders can remove the leader and install someone new increases possible resistance to the successor. If iterative testing reveals a lot of discontent with the successor, stakeholders will band together to remove him or her. In a family business, stakeholders' choices often boil down to shutting up or shifting out.

leaders must go through to earn their trust and respect.

My research has focused on family businesses, but stakeholders of nonfamily enterprises put their leaders through the same tests. The testing process is particularly rigorous in those companies when the board makes a surprising choice, when someone is brought in from outside the company, or when stakeholders are unable to form a consensus about the new leader. Exactly when the testing process starts and how much emphasis stakeholders place on the tests are different in family and nonfamily enterprises (see the sidebar "Running the Gauntlet in Nonfamily Companies"), but iterative testing characterizes the formative period of every leader's rule. It serves to reassure people that their leaders have the physical, intellectual, and emotional abilities to withstand the pressures of office. Stakeholders light fires under an aspiring leader to forge his or her mettle.



The intensity of iterative testing isn't constant. Leaders would hardly be able to function if they were under relentless scrutiny by stakeholders all the time. Iterative testing operates in cycles that start early in a would-be leader's career, and it comes to a peak once the honeymoon period is over. From there on, the intensity of the process depends on the leader's perceived effectiveness and on circumstances. For example, if the conditions under which the leader took office change radically, stakeholders, feeling the need to reassess whether they are in good hands, will set off a fresh wave of evaluation.

Iterative testing also allows stakeholders to explore whether there is a fit between what they need from the leader and his or her capabilities. No single leadership style fits all circumstances. Autocratic leaders, ideal for managing crises, may be disastrous when conditions call for shared decision making. Followers usually have a good sense of what they need from a leader. Of course, circumstances color the lenses through which they conduct the assessment. For instance, during a crisis, stakeholders will be all too willing to suspend their doubts about the leader; it is hard to question the captain's skills when the ship is sinking and you're busy trying to survive. In stable times, stakeholders will be emboldened to ask if the leader is meeting their needs such as financial security and self-actualization.

The less information stakeholders have about a successor, the more intense the iterative testing process will be. Some business families promote young inheritors to positions of influence without notice or lengthy apprenticeships; these heirs have, as William Shakespeare wrote in *Twelfth Night*, "greatness thrust upon them." The inheritor often has to go about establishing credibility in the long shadow of an incumbent to whom everyone attributes heroic stature. Moreover, the incumbent typically maintains an active presence in the company even as the unfortunate successor tries to take charge. This leads to considerable uncertainty and fuels iterative testing by stakeholders desperate to learn about the new boss.

The Four Kinds of Tests

The process of iterative testing may be messy and driven by circumstance, but it isn't random. Over the years, I've been able to discern four distinct kinds of tests.

Qualifying tests are assessments based on the formal criteria that society in general, and companies in particular, use to judge executives' capabilities. The criteria include formal education, work experience, military and community service, and awards that executives can cite as evidence of professional development. Equally important are on-the-job achievements such as excellent performance in demanding positions, successful completion of challenging projects, and international and board experience. By gaining the professional accolades that the business world values, successors show that they have earned the approval of impartial judges. Indeed, a good record in an organization where the family name doesn't matter can allay worries about a successor's suitability for the job.

Self-imposed tests are expectations that leaders themselves set and against which they expect stakeholders to measure their performance. For example, when inheritors present their organizational vision, strategic direction, or business plan, they define the parameters on which they expect stakeholders to evaluate their effectiveness. Stakeholders' perceptions about the leader's ability to deliver contribute to establishing the leader's credibility. Similarly, when CEOs draw up norms about punctuality, what constitutes harassment, and how conflicts of interest should be handled, stakeholders judge their sincerity by checking whether leaders are walking the talk.

Circumstantial tests are unplanned challenges that leaders must face. In such situations, stakeholders can observe the leader as he or she copes with the unexpected. A circumstantial test might be negotiating a labor dispute, resolving a crisis brought on by the head of the family's sudden death, or tackling a snowballing business challenge. For instance, the credibility of August A. Busch IV, Anheuser-Busch's CEO since September 2006, rides on whether he'll be able to rebuild the flagship Budweiser brand, whose loss of market share is fast turning into a crisis. Crises often propel aspiring leaders to center stage, presenting them with opportunities to demonstrate their abilities.

Political tests are challenges from rivals who want to enhance their own influence, often by undermining the leader. Blocking the implementation of the leader's plans, creating a coalition to counter his or her power base, spreading a malicious rumor – all these serve, in stakeholders' eyes, to test the leader's capacity to navigate the realpolitik of organizational and family life. For instance, News Corp's chairperson, Rupert Murdoch, appointed his son James Murdoch as CEO of BSkyB, the group's satellite television operations, in 2003 over the objections of institutional investors. James Murdoch faces a stiff political challenge; stakeholders are waiting to see if he is as good a corporate warrior as his father. If they aren't convinced, they may well thwart his rise to the top.

The judgment of all the stakeholders, across these four categories of tests, forms the basis for a leader's authority. Opinions will vary because people and groups will have different types of information. Some, such as family members and close colleagues, will have witnessed firsthand the successor's abilities and follies. Those who are more distant must rely on formal appearances and secondhand information, including hearsay and gossip, which distorts their judgment.

Managing Iterative Testing

Successors who provide the evidence that stakeholders need to make judgments about their fitness for office stand a better chance of getting to the top and staying there. Sure, by engaging with the testing process, they increase the risk of failing, but there is no other way they can win followers. Unfortunately, incumbents in family businesses often try to shelter heirs, sometimes by giving them ambiguous positions such as "assistant to the CEO." This erodes young leaders' attempts to earn credibility and robs them of the opportunity to demonstrate what they have to offer the enterprise. Incumbents would do better to work with anointed heirs to tackle the four types of tests systematically.

Unfortunately, incumbents in family businesses often try to shelter heirs, sometimes by giving them ambiguous positions such as "assistant to the CEO."

Tackling qualifying tests. Stakeholders rely on qualifying tests to shape their expectations of a new leader before they have had much direct contact with him or her. How the leader stacks up provides a context in which company directors, senior executives, and family members can gauge the leader's capacity during the first days in office. Stakeholders will be more forgiving of a leader's early on-the-job blunders if he or she has a good business education, a track record of excellence, experience working outside the family business, and a history of doing well in demanding jobs. They will attribute the leader's mistakes to the circumstances he or she faced when taking charge; they will ascribe successes to the leader.

Take the case of Peter (I have used pseudonyms in these examples), whose father built one of the largest construction companies in the UK. When Peter graduated from engineering school in the 1990s, his father called in his chief engineer and asked him where the company's most difficult project was. The chief told him about a pipeline the firm was laying across the Saudi desert; that sounded to the father like the right entry job for his son. Soon, Peter was on his way to Saudi Arabia, where he worked as a junior engineer for two years. Switching climates, he next worked on a pipeline project in northern Alberta, Canada, for a year. His father then insisted that if Peter wanted to join the company's executive ranks, he would have to get a postgraduate degree from a top American university. Peter enrolled at MIT's Sloan School, where he completed a dual engineering and management master's degree in three years.

When Peter returned home, his father asked him to lead the construction of an underground mass-transit system in a major European city. Peter served as the project engineer, responsible for overseeing every aspect of the effort, including negotiating with government officials, hiring crews, and ensuring that the project was completed on time and on budget. By the time his father decided to retire, stakeholders were well aware of Peter's capabilities. An external director told me: "Even if he hadn't been his father's son, the board would be nuts not to consider Peter for the top job." Some of Peter's shortcomings – he lacked the charisma and interpersonal skills of his father – were brushed aside. Peter took over as CEO, and a few years later, he took the company public, which would have been impossible had he not enjoyed the support of his stakeholders.

It's necessary to underline the importance of qualifying tests because business families differ in the value they assign to formal education as a path for leadership. Some families have a tradition of educational achievement and place considerable pressure on children to excel at school. Others have developed cultures of self-reliance; they see on-the-job apprenticeships as a more effective road to success. In my experience, scions' willingness to undertake a rigorous education has always been a powerful antidote to stakeholders' concerns about privilege and patronage.

If successors enter the family business upon leaving college, though, they usually don't receive the kind of impartial feedback they would get elsewhere. It becomes difficult for them to see when they need to take corrective action, and they are set up to confirm everyone's worst fears. Over time, they can become impervious to the consequences of their behavior and isolated from the organizations they lead. Choosing an external path conveys to stakeholders that the successor isn't afraid of being held accountable to objective standards. It also signals that the young inheritor has career options, making the decision to join the family business a choice rather than a necessity.

Recognizing the importance of qualifying tests, some family businesses have created career-planning committees that comprise the CEO, the human resource head, an independent director, an external career coach, and, occasionally, a professional from an executive search firm. In coordination with the board of directors, the family council, and the executive team, such committees develop policies that regulate family members' entry into and exit from the organization. Through the committee, key stakeholders can manage and support each family member's career development and protect both the family's aspirations and the integrity of the CEO-selection process.

Doing well on qualifying tests is neither necessary nor sufficient for success. Several legendary scions, such as IBM's Thomas Watson, Jr., who needed six years and three schools to get through high school, emerged as great corporate leaders despite less-than-stellar educational records. And, many CEOs have done brilliantly at school before plunging the family business into bankruptcy. So why should successors bother with the qualifying tests if they offer no guarantees? Because when there is no reliable evidence of a leader's prowess, there is more uncertainty about his or her fitness for office. This triggers intensive scrutiny from stakeholders and makes the successor's early tenure more trying – even unbearable.

Delivering on self-imposed tests. Stakeholders constantly monitor whether a new leader's behavior corresponds to the messages and signals he or she is sending out. It's tempting for new leaders, eager to demonstrate they have the right stuff, to promise more than they can achieve. Successors must therefore learn to walk the line between the inspiring and the deliverable. Almost all failed successions I've studied

Successors, eager to demonstrate they have the right stuff, often promise more than they can achieve. They must learn to walk the line between the inspiring and the deliverable.

involved an ambitious new leader laying out a lofty plan without considering the viability of his or her promises or the risks to the enterprise.

Smart successors realize that predictability is essential for earning stakeholders' trust, and initially they search for growth strategies that will deliver results without being too risky. They underpromise but overdeliver, gradually earning the confidence and respect of key constituencies. The riskier the strategy a successor pursues, the more important it becomes to recruit stakeholders' support. Inexperienced successors often work hard at selling the upside of their initiatives without conveying the risks they may pose. The moment they start underperforming, they lose stakeholders' confidence. At one Latin American company I studied in early 2000, the founder's eldest son took charge of the $500 million enterprise just when the country's economy was falling apart. Instead of battening down the hatches, the successor pursued growth, promising quick results to the board, the family, and executives. After just two disastrous years, the family replaced him with his younger sister.

In accepting her nomination, the new leader quoted Churchill to the board and the family: "I have nothing to offer but blood, toil, tears, and sweat." She was quick to announce a freeze in salaries, starting with her own, and scrapped her brother's plans to build a lavish headquarters building. She set modest but achievable objectives and gained stakeholders' trust by consistently delivering the results she promised. Six years into her tenure, the company has almost doubled in size, and she has called on her hard-earned credibility to get stakeholders to back her as she takes on new challenges. That's important too; if successors don't create an inspiring agenda, stakeholders will reject them as complacent caretakers, incapable of lifting the family enterprise to new heights.

One of the first self-created hurdles leaders face is assembling their top teams. Successors who are insecure about their capabilities shy away from executives with talent superior to their own. They put together a cadre of adulating subordinates and relatives, who feed them information they want to hear. Smart leaders pick seasoned collaborators who challenge their thinking and complement their deficiencies. They choose executives who are unafraid to tell them the truth – however painful it may be. This discipline is particularly important for heirs to family businesses, as they are less likely than other leaders to hear unvarnished facts from those around them. What's more, effective successors openly acknowledge the need for control mechanisms to measure their performance. For example, they seek the development of effective boards. They recruit top-notch independent directors, establish rigorous selection criteria for family directors, professionalize the board's processes, and encourage transparency in reporting. They also keep shareholders informed and treat dividends as a reward that shareholders have the right to expect for the risks they bear.

How Stakeholders Respond to Flawed Leaders

The process of iterative testing will eventually expose every new leader's flaws. When the successor's deficiencies become evident to stakeholders, they take one of the following actions. Successors should be aware of the warning signals.

- **Protect and coach** the new leader. Loyal stakeholders may be willing to throw their lot in with the new leader – whatever the consequences. This is a particularly difficult undertaking for nonfamily executives who must bet their reputations to buttress a successor in trouble. The problem is, if the successor's performance doesn't improve, this is tantamount to putting personal loyalty above the interests of the enterprise.
- **Blow the whistle** to make the successor's deficiencies obvious to those with the power to take corrective action. If the successor is a family member, this is a risky strategy. However, courageous shareholders, directors, and senior executives who acknowledge that a leader must go have saved many an enterprise.
- **Hide and wait** for the leader to fall on his or her own. Stakeholders can ride the waves, hoping that the organizational immune system – through directors' and shareholders' intolerance of poor leadership – will correct the problem. The downside is that if the leader doesn't go quickly, the business might fold first.
- **Exit** the company. When executives feel they cannot change a failing leader, they may have to seek employment elsewhere. For family shareholders, getting out is often complicated, particularly when their shares are held in trusts or when shareholder agreements restrict their sale. The family will regard even the announcement of an intention to sell as disloyalty. Nonetheless, legal battles often result because family members are unwilling to submit to poor leadership.

Responding to circumstantial tests. An effective performance under the stress of a crisis can get stakeholders to think that the new leader, rather than contextual factors, turned things around; this is how followers "write" narratives about leaders. Tackling the unexpected requires a willingness to take risks and to take charge. Instead of projecting a sense of responsibility and control during a crisis, however, successors often hide behind seasoned executives, who then reap all the credit. When an enterprise is under fire, the successor must move to center stage. Stakeholders need to hear the leader's diagnosis and plans for getting out of trouble. They evaluate the inheritor's capacity to inspire hope without denying the challenges facing the organization. A crisis can also reveal whether the new leader can rally others to

How Fit Are You to Lead?

This self-diagnostic will help successors, particularly in family businesses, assess their suitability for the top job. By answering yes or no to the following questions, they can spot their strong points and weaknesses in stakeholders' eyes, and take corrective action where necessary. If you find yourself saying mostly nay and don't want to do anything about it, you would be wise to abandon your pursuit of the top job.

Qualifying Criteria	Yes	No
Is there a good fit between what I studied and the leadership role?		
Have I worked outside the family business and shown that I can succeed?		
Have I taken on jobs and projects whose results can be objectively measured?		
Am I aware of the deficiencies in my training and what I should do about them?		
Do my behavior and demeanor serve to defuse concerns about nepotism?		

Self-Imposed Standards		
Are the expectations I'm setting achievable?		
Have I taken personal responsibility for the gaps between what I promised and delivered?		
Have I picked a talented top management team?		
Have I treated family members and friends impartially?		
Have I assembled a first-rate board of directors?		

Circumstantial Measures		
Am I willing to take on difficult challenges and crises to demonstrate my ability?		
Have I thought through my strategy for success? Do I have the resources? Can I deliver results in the available time?		
Do I know how to motivate others to collaborate with me?		
Am I willing to take responsibility for what goes badly and share the glory for what goes well?		
Am I willing to invest the extra effort necessary to succeed?		

Political Parameters		
Can I identify everyone who is threatened by my appointment and my leadership choices?		
Am I aware of what my rivals for the job say and do to undermine me?		
Do I ensure that information flowing to stakeholders is not distorted?		
Would stakeholders regard the way I allocate rewards and punishments as fair?		
Am I willing to place the company's interests above everything else, even if that means disappointing my family?		

combat the problem. The history of every family company that survived for generations tells us of heroic feats at decisive moments that consolidated the authority of untested successors – be it Katharine Graham's taking charge of the *Washington Post* when her husband died in 1963 or Arthur Ochs "Punch" Sulzberger's publishing the Pentagon Papers in the *New York Times* in 1971.

I'm not arguing for recklessness. The stakes that surround circumstantial tests are high; if successors fail, regaining credibility is almost impossible. Insofar as they have a choice, successors should pick their battles carefully. Consider the case of three cousins who aspired to lead a well-known Canadian manufacturing company their grandfather had set up. The board decided to create an Office of the President and make them copresidents, because all three were well qualified and had complementary talents. Privately, the directors also worried that choosing one over the others would set off a destructive conflict among the three branches of the family. David, 35, the youngest copresident, had joined the company after completing his MBA at Harvard Business School and had worked in a number of staff positions before being named to the top team. Although they liked David, directors and executives thought he was green. "David is very smart and capable. I just wish he would stop offering theoretical solutions," one senior executive told me.

Shortly after the cousins took charge, the company's troubled European division took a turn for the worse. The task of turning it around was shunned by his cousins, but David, sensing the board's equivocal feelings about his abilities, offered to handle the crisis. He moved his young family to Frankfurt and spent the next four years restructuring the European business. He brought costs under control by streamlining the manufacturing process, downsizing the organization through negotiations with trade unions, and renegotiating debt payments. By this time, the board was beginning to realize that the cousin consortium wasn't working. Communication had broken down, decision making was slow, and despite the European division's turnaround, the company's performance was faltering. The board eliminated "the Office" and named David the company's CEO. He had provided ample evidence of his leadership capabilities, prompting one of his cousins to say: "There's no doubt that he has earned our respect." It's unlikely David would have gotten the nod if he hadn't taken the risk of moving to Europe.

Circumstantial tests often make stakeholders aware of leaders' magnanimity. Inheritors can win their approval by taking responsibility for what has gone badly and sharing the glory for what has worked. Interestingly, young CEOs tend to recognize the contributions of senior executives, but they find it harder to thank family shareholders, particularly those who aren't involved in management. These shareholders are often the company's biggest investors and so bear the greatest risks. If leaders acknowledge the backing of family shareholders, they will earn this critical constituency's loyalty.

Meeting political tests. It is impossible for anyone to exercise leadership without at some stage disappointing, frustrating, and angering certain stakeholder groups. Many successors are naive about the potential for backlash. The nature of political processes – the wheeling and dealing of influence as individuals and groups compete for control of organizational resources – often escapes them. Many have had a privileged upbringing, which leads them to overly trust close relatives, colleagues, and advisers. When the first act of defiance or disloyalty takes place, it catches inexperienced successors off guard. They want everyone to like them, but they will lose respect in stakeholders' eyes if they don't confront those who break norms or disregard the direction they have set.

For example, a few months after James took over as the CEO of a *Fortune* 1,000 company, a faulty product required a costly and highly publicized recall. The crisis had been long in the making. Lax oversight by the COO and the divisional head, despite repeated warnings from line managers, had resulted in a product that put customers' lives at risk. Under pressure from his family, the board, and investors, James fired the COO – a person he considered his friend and mentor. It was an agonizing decision. However, after the COO left, James learned that his colleague had repeatedly tried to undermine his promotion. Asked about James during an interview, for instance, the COO had responded: "I like Jim but, I got to tell you, he wouldn't be CEO if he hadn't been a family member. I met with the head of the nominating committee to tell him that Jim was the wrong choice for this business..." A number of directors and family members regarded the fact that James learned about this only after the COO left as naïveté. "This is a wake-up call about the authority issues every leader faces. Let's hope Jim learns some street smarts from this," the company's chairperson told me.

To neutralize challenges to their authority, effective successors develop a vision for the enterprise and find ways to connect it to stakeholders' wants and needs. They, in effect, become the weavers of a shared dream that represents a synthesis of stakeholders' aspirations. They also manage to imbue enough of their own identity into the dream to claim it as their own. Given the contradictory demands made on leaders, their vision must be clear and engaging so that it provides meaningful direction; it must also be broad enough to offer hope to stakeholders that they will realize their diverse and contradictory aspirations. Along the way, leaders must learn to negotiate the system, picking their battles with care and using their political capital to serve the interests of stakeholders and the company.

To neutralize challenges to their authority, effective successors develop a vision and find ways to connect it to stakeholders' needs.

Does this sound like an impossible job? In some respects, it is. Yet many successors succeed at these tests and lead their companies to great heights. They often do so by selecting a team of trusted advisers who question their priorities, initiatives, and strategies in private but support them when they become lightning rods for stakeholders' frustrations. The "kitchen cabinet" helps young leaders grow into their roles, and as they do so, stakeholders stop testing them intensely.

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The response of successors to the iterative testing process plays a large role in determining if stakeholders will throw support behind them. By acknowledging they have weaknesses, heirs to the family business demonstrate maturity and a willingness to learn. Those who deny their deficiencies further undermine their credibility. In fact, many inheritors fail to win stakeholders' respect because they compensate for their inadequacies with arrogance and opulence. New leaders would do well to remember that, as the fairy tale of the emperor's new clothes tells us, followers' perceptions are the subjective basis on which their credibility rests.

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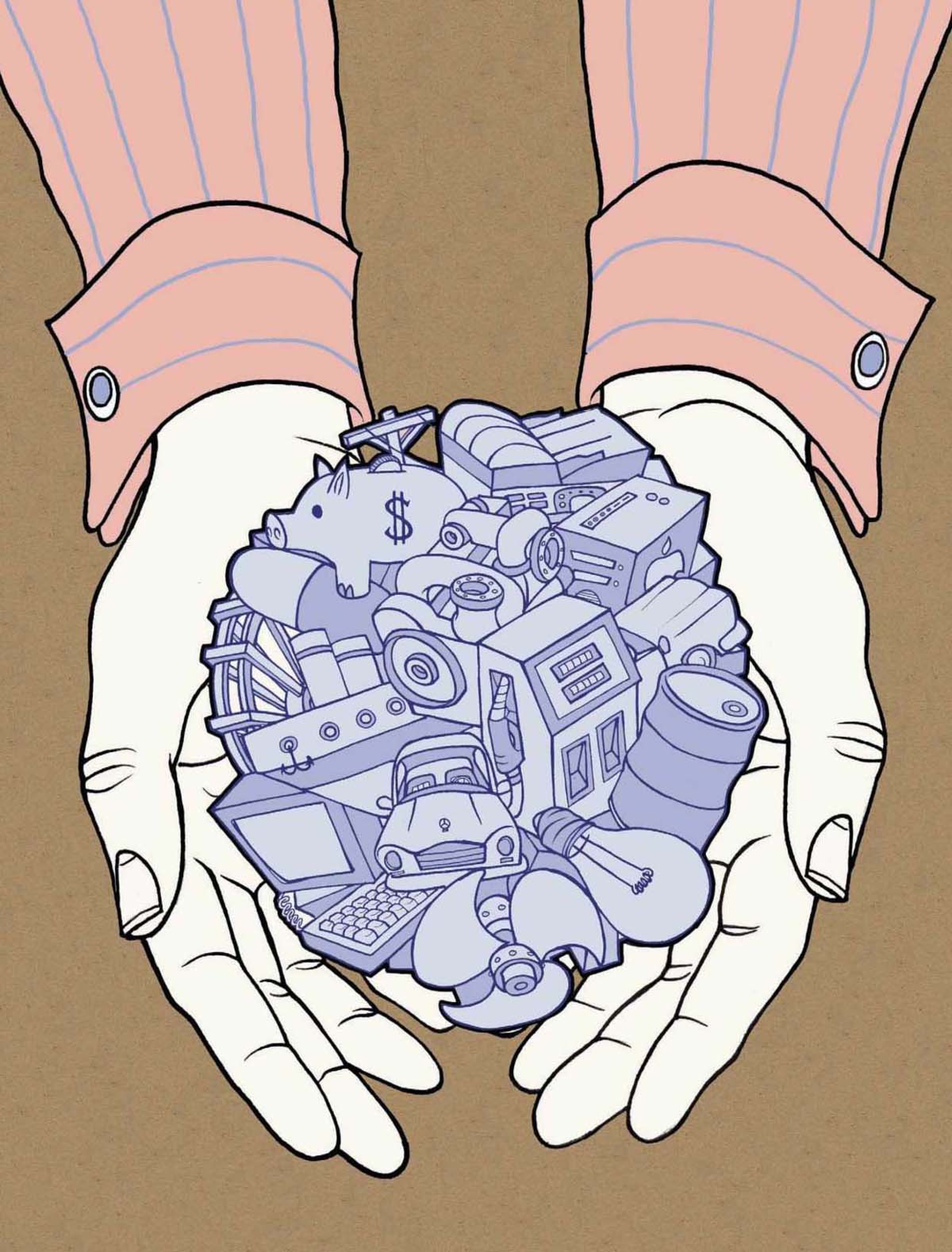

Designing programs to serve global accounts has been a painful and often unprofitable art. You can turn it into a science that benefits both you and your customer.

MANAGING GLOBAL ACCOUNTS

by George S. Yip and Audrey J.M. Bink

JUST MENTION THE TERM "global account management" to executives at suppliers of multinational companies, and more often than not, they will groan. In the past decade GAM programs – which treat a customer's operations worldwide as one integrated account, with coherent terms for pricing, product specifications, and service – have proliferated. Our research suggests that only about a third of the hundreds of suppliers that have adopted GAM are happy they did so, and that even for them success came hard.[1] The pioneers that introduced their programs in the late

Jason Greenberg

1980s through the mid-1990s constitute the vast majority of this satisfied bunch – and it took them ten years of trial and error, on average, to get to the point where their gains (a bigger share of the customer's business and a richer sales mix) outweighed their pains (lower prices and a higher cost to serve).

Contrary to the prevailing view, however, global account management can be good for suppliers. That's the conclusion we've drawn from a study of 165 major suppliers that one of us helped conduct, from our consulting work, and from journal articles on individual companies' experiences. Our findings: Within a few years of their introduction, these programs can improve customer satisfaction by 20% or more and raise both profits and revenues by 15% or more. Mature programs – those at least five years old – can generate increases twice as large or more.[2]

Much of the pain associated with GAM arises from confusion about when and how suppliers should offer it to customers. Such confusion has caused companies either to offer GAM to the wrong customers (yes, on occasion you can and should say no) or to offer the wrong form of GAM to the right customers. This article provides a framework that will help suppliers to avoid these mistakes.

The Spread of Global Account Management

Global account management is the natural extension of national account management. Its initial adopters were primarily technology giants like Hewlett-Packard, IBM, and Xerox, whose customers – especially large multinationals in the automotive, financial services, and petrochemical industries – were demanding that the IT products and services provided to all of their locations be compatible and supported to the same standard. GAM has since been adopted by medium-size suppliers, too, and is now used in nearly every sector.

Not surprisingly, multinational customers have been and continue to be the driving force behind the spread of GAM. These companies recognize that when purchasing is centralized and far-flung units can no longer negotiate their own deals, prices become much more transparent. In addition, by consolidating orders a buyer can demand bigger volume discounts and manage product specifications and service more effectively. This often means a substantial loss in pricing power for suppliers – and that's not the only negative. All too often a customer's national operations resist abiding by a global contract that requires them to give all their business to a single supplier and, instead, try to continue to pick their own suppliers and dictate their own terms. Even worse, the new organization and processes required to serve global accounts can easily cause costs to soar – especially if customers demand customization. We have found that the cost of GAM per customer adds from $100,000 to more than $1 million to what a supplier had been spending in individual countries for sales and support. Given that a supplier may have scores or even hundreds of global accounts, the total cost of GAM can be enormous.

Suppliers hope, of course, that these negatives will be outweighed by the promised positives: a bigger share of existing business and, in many cases, strategic-partner status that will lead to new, higher-value-added business. The problem is that an account may take a long time to become lucrative, if it ever does. For example, HP had 26 global accounts in 1993; over the next three years it expanded that number to 250 and then slashed it to 95 in 1997, when it realized that costs were exceeding returns. Today 200 of HP's nearly 20,000 corporate clients have global account status and are highly profitable, because HP has mastered the science of selecting and structuring global accounts.

If companies understand how to answer three fundamental questions – whether GAM is appropriate at all, which customers are suitable candidates, and what form or forms GAM should take – they, too, can reach the Promised Land, and sooner rather than later.

Should You Even Consider Adopting It?

You can determine if GAM is appropriate for your company by using four criteria: whether your products or services need global coordination and are profitable enough to justify it, whether your multinational customers want GAM, whether your multinational customers are important to your business, and whether you can gain competitive advantage from GAM.

Products and services. The nature of its own offerings – not a customer's desire for volume discounts or global contracts – should be the first factor a supplier considers when contemplating GAM. Prime candidates are complex products and services such as computers, process controls, and global fueling contracts, or value-added commodities such as specialty chemicals, food ingredients, and corporate banking. Offerings must command a high margin, must be globally consistent or compatible, must meet complex specifications across borders, or must be supplied to an integrated transnational operation in a carefully coordinated fashion.

George S. Yip (george.yip@capgemini.com) is a vice president and director of research and innovation at Capgemini, based in London, and a professor at London Business School. Audrey J.M. Bink (abink@uxbridgecollege.ac.uk) is the head of marketing communications at Uxbridge College in London and previously was a manager at DMV International in the Netherlands. Yip and Bink are the authors of *Managing Global Customers: An Integrated Approach,* to be published in September 2007 by Oxford University Press. Several British organizations – the Leverhulme Trust, the Advanced Institute of Management Research, the Economic and Social Research Council, and the Engineering and Physical Sciences Research Council – have supported their work.

Some illustrations:

• Honeywell provides GAM to multinational customers that want to specify centrally what sorts of process-control equipment are installed in their factories worldwide in order to ensure common quality standards and to minimize variations in operating and training procedures.

• Most of the top 20 global advertising chains have instituted some form of GAM for key clients that need to centrally manage how their international brands are positioned in various countries.

• The fueling service of BP's Castrol division offers GAM to key multinational customers in the transportation industries for obvious reasons: Because international routes and their activity on those routes are constantly changing, global coordination is essential to ensure that their planes and ships don't run dry.

• DMV International, a Dutch supplier of nutritional ingredients, needs GAM to serve multinational customers that buy complex products such as lactoferrin, a milk protein with antimicrobial and antiviral properties that is used in, for example, infant formula, health supplements, cosmetics, and animal feed. Incorporating such ingredients requires extensive R&D assistance. DMV's GAM program ensures that a customer's production operations in different countries receive the same level of support.

Not coincidentally, all of these businesses have comfortable profit margins. Because a GAM program (with its staff) is layered on top of existing national sales organizations, it always entails higher costs. So the products and services in a GAM program must have margins sufficient to cover those additional costs. This means that key customers for low-margin products and services should offer higher volume, service payments, or some other sweetener before a supplier agrees to provide them with GAM. If a customer buys both high- and low-margin products, a supplier might want to include all those products in the GAM program – provided that the economics are favorable – in order to build the global relationship.

Customers' wants. If your offerings are appropriate, the next step is to consider whether your customers want GAM. It is no secret that the vast majority of multinationals have by now instituted global purchasing or supply-chain programs to buy the kinds of offerings suitable for GAM – particularly those that could generate sizable volume discounts. Many of these customers expect their suppliers to provide a single point of contact; coordinated resources for serving them; globally uniform or at least consistent prices; uniform terms of trade for volume discounts, transportation charges, overhead, special charges, and the like; globally standardized products and services; globally consistent service quality and performance; and service in any country in which the customer operates. If such customers are important to your business, you had better heed their demands.

We have discovered that suppliers often resist requests for GAM out of fear that the only result will be lower prices. Such fears are overblown. A study one of us conducted found that globally consistent service performance was

more important than lower prices to customers seeking global account status, and that many other features of the program were nearly as important as lower prices. So adopters of GAM can build relationships with customers that go far beyond discounts. And, obviously, if one supplier of GAM-suitable offerings doesn't comply with a customer's legitimate demand for a program, another one will.

Importance of multinational customers. How can you decide whether your customers are sufficiently important to merit GAM? There are several crude measures: If, say, one global customer accounts for 5% or more of your business; if more than 10% of your revenues come from multinational customers that coordinate their purchasing globally or regionally; if more than 25% of your revenues come from multinational customers, regardless of how they do their purchasing; if large multinational customers are your most profitable accounts. In all these cases you should seriously consider offering GAM to protect your franchise.

Competitive advantages. You may be able to win business in global or regional bidding situations more easily than in national ones. That's because there are almost always many more competitors that can make national offers than can make global or regional ones. Conversely, if some of your key competitors provide GAM to the same customers you serve or seek, you need to play catch-up. The features of a GAM program are increasingly important criteria to global customers when they are selecting suppliers.

Which Customers Are Candidates?

Not every worldwide customer that buys GAM-suitable offerings and is important to your business should be a global account. When it comes to global accounts, more is not always better – and there's no ideal number. Unilever, for instance, has only four or five global accounts, whereas IBM and Xerox have more than 100 apiece. Rather than striving for a particular number, managers should focus on identifying those accounts that will accrue significant value from a GAM relationship – in terms of growth potential, increased share of the customer's business, margin improvement, and opportunities to learn about each other's business. Here are six criteria for selecting global accounts:

Size and revenue potential. The size of an existing account is critical in assessing whether the customer should be offered GAM. That said, the biggest mistake a company can make is to select global accounts solely on the basis of its current sales to those customers. Some big customers may want only a global discount rather than a global relationship that would benefit both the supplier and themselves. Marriott International once rescinded the global account status of its largest customer (worth $100 million in revenues) for that reason.

In general, new sales opportunities are more important than current revenues in selecting global accounts. The immediate gains will come from the national operations that were using other suppliers and now have to use you. Longer-term sales gains will come from the jointly developed programs that a close global relationship can spawn.

Geographic spread. If a customer has large businesses in several countries, it may be a candidate for GAM. However, if its business is concentrated in one market (for example, it has only a few minor operations outside its home country), serving that customer with some form of national account management would be better.

Integration capabilities. A customer should not be offered global account status unless it has the structure, processes, and information systems it needs to integrate, or centrally coordinate, global purchases. A global contract won't mean much in the absence of such organization: The supplier will still have to sell country by country, negotiating quantity, price, and other terms with each operation. And despite this extra effort, the customer will still expect a global volume discount.

A company's integration capabilities are *low* if its strategies (business model, products, brands, value chain) are developed mostly at the country level; each national unit has its own P&L; country heads are responsible for nearly all activities in the country; most processes are national variations of the corporate approach; critical information (sales, profits, and market share by business unit, product line, and customer) is collected at the national level only; global teams manage or coordinate at most only one or two primary activities (R&D, product design, production, marketing, sales, service); only data-based operating information (revenues, profits, capacity utilization) is shared outside the country; and there is no common corporate culture.

A company's integration capabilities are *moderate* if its strategies are developed at the country, regional, and global levels; some businesses have global P&Ls; country heads are fully responsible for less strategic activities (field service, facilities) but share authority with global executives over key areas (production, marketing); a handful of global processes exist (strategic planning, production planning); some but not all critical information is collected at the global level; global teams manage or coordinate about half of primary activities; along with operating data, the most important information (about innovations, key customers, and competitors, for example) is widely shared globally; and senior executives worldwide have a common culture while lower-level employees retain separate national cultures.

A company's integration capabilities are *high* if its strategies are developed mostly at the global level; most businesses

THE BIGGEST MISTAKE a company can make is to select global accounts solely on the basis of its current sales to those customers.

have global P&Ls; country heads' responsibilities are largely limited to servicing the activities of global business lines, functions, and customers; most processes span countries and regions; nearly all critical information is collected at the global, regional, and national levels; global teams manage or coordinate most primary activities; vital information from any part of the company is systematically captured and shared globally in real time; and a truly global culture permeates the organization.

Strategic importance. A supplier cannot afford to lose a customer that buys 10% of its total production or 60% of the production of a crucial product line. In addition, suppliers need to pay more attention to customers that may be critical to their strategic goals. For example, Xerox cares less about customers that simply buy its photocopiers than about those that buy its complex office solutions (machines plus consulting services, such as assessments of a customer's document-processing needs or advice about improving office workers' productivity and satisfaction) or its document-management services (production, storage, and transmission). Finally, a customer may be deemed strategically important if its high profile will influence others to buy from the supplier.

Strategic, cultural, and geographic fit. It helps if the customer's strategies fit the supplier's. For example, similar strategies for expanding sales in India led Royal Dutch Shell and Wärtsilä, a Finnish producer of marine engines, to create joint marketing agreements to sell Shell's oils and lubricants and Wärtsilä's engines as a package (or at least to promote each other's products to customers). Given the scope of the interactions that a global account relationship entails, cultural fit, or at least cultural empathy, also matters. (The likelihood that a supplier with performance-oriented values and methodical processes is going to be able to forge a trusting working relationship with a customer that has creative values and flexible ways of operating is remote.) Finally, a supplier must be able to serve global customers in most of their key locations, either by having service operations in those countries or by arranging for reliable local partners to provide the service.

A close and trusting relationship. When a supplier and a customer truly trust and value each other, the relationship can take off. For example, when the French company Schneider Electric, a world leader in electric power and control equipment and services, invested in special equipment to design and manufacture a line of products for a favored global customer, the customer rewarded Schneider by making it the sole supplier of that line. In deciding whether to make a customer a global account, a supplier should consider whether it might be able to forge a trusting relationship with the customer if it doesn't already have one.

Three of these criteria – size and revenue potential, geography, and integration capabilities – are quantifiable to some extent. The other three – strategic importance; strategic, cultural, and geographic fit; and relationship – are softer, and assessing them depends to some degree on gut feelings. The exhibit "A Scorecard for Selecting Global Accounts" can help suppliers think about which customers might be serious candidates for global account management.

Which Form Is Best?

After choosing the best customer candidates for global account status, suppliers need to figure out which form or forms of GAM to offer. Companies have found both to be challenging endeavors. We have discovered that in designing their programs, they often get two major issues wrong: (1) how much responsibility and power to give the central GAM group and how much to give the national sales organizations, and (2) the trade-off between tailoring GAM programs for individual customers and minimizing the resources that each program consumes. Suppliers also need to make choices about the role of global account managers, the composition and size of their supporting teams, how to engage national sales managers, how to use high-level executives as account support, and what sort of global customer information system to set up.

Although GAM can take a multitude of forms, they are all variations on three basic approaches, each of which strikes a different balance between global integration and local (or national) autonomy. We call these *coordination GAM, control GAM,* and *separate GAM.*

Coordination GAM. In this approach the GAM unit is weak and the national sales organizations retain a great deal of power. Global account managers are added to the company's existing structure; their main task is to coordinate the sales and support activities of the national operations serving a customer that has negotiated global terms. The national operations continue to take the lead in sales, but any deals struck have to abide by the global terms for discounts, product specifications, and the like. Although the global account managers have little or no authority over local operations and must get their consent for any new global activity in deals, initiatives, or terms, they are expected to take the lead in expanding accounts into new product lines or regions where the supplier has no business. Coordination GAM is most appropriate when local relationships are extremely important and the need to standardize services across borders is relatively slight, which explains why many banks use this approach. It's also the best choice for suppliers that lack the integration capabilities required to centrally manage multinational customers.

A superb example of a firm that uses coordination GAM for all the right reasons is Unilever. For most of its long history the consumer-products company has operated as a collection of largely autonomous national units. Although over the past decade it has significantly centralized management of back-end activities such as R&D,

A Scorecard for Selecting Global Accounts

When a company has determined that its business could benefit from global account management, the next step is to select specific multinational customers for the program. This diagnostic tool allows you to identify candidates by scoring them anywhere from zero to ten on a number of characteristics and then using the key to evaluate the customers' total scores.

Customer Characteristics	Scoring Guidelines	Score (0–10)
Current account size (minimum about $5M in revenue)	10 = your largest account 5 = half that size 1 = one tenth that size	
Revenue potential	10 = can grow 100% or more in the next 3 years 5 = can grow 50% 0 = no growth potential	
Profitability (minimum about $1M in gross margins)	10 = the highest margins among all your customers 5 = half that 0 = no profits	
Geography	10 = operates in countries that account for 100% of your market 5 = operates in countries that account for 50% 1 = operates in countries that account for 10%	
Integration capabilities	10 = all the capabilities required for global integration and coordination 5 = moderate capabilities 0 = no capabilities	
Strategic importance	10 = absolutely vital to your business 5 = moderately important 0 = of no strategic importance	
Strategic fit	10 = many joint strategies 5 = some joint strategies 0 = no joint strategies	
Cultural fit	10 = complete fit (might happen if customer is in the same industry, from the same country, and of similar size and age) 5 = partial fit 0 = no fit	
Geographic fit	10 = you operate in all the countries in which the customer operates 5 = you operate in half of them 0 = you operate in none of them	
Relationship	10 = a very close and trusting relationship, in which vital information is shared 5 = moderate sharing 0 = no sharing	
	TOTAL SCORE	

Total score	The customer is
0 – 25	not a good prospect for GAM
26 – 50	worth considering
51 – 75	a very promising prospect
76 – 100	should be one of your key global accounts

product development, and manufacturing in order to cut costs and leverage expertise, Unilever has seen little reason to follow suit with its customer-facing functions. Most of its multinational customers – including such giants as Wal-Mart, Carrefour, and Tesco – still allow their local units to make decisions on prices, new-product introductions, and the size of orders. Since these megacustomers want a central point of contact only for dealing with a handful of issues, such as global discounts and private-label arrangements, coordination GAM has sufficed.

One advantage of coordination GAM over the other two forms is that it's relatively easy to implement, because it doesn't disturb any existing organizational structures. Another is that it is much less costly, because it requires fewer additional people: Often a single global account manager handles one or more accounts with no support team. The drawback is that this approach leaves lots of room for disagreement – between the global account manager and the national operations, and also among the national operations – which can make negotiating and implementing a global contract difficult.

Control GAM. This approach, the most common form of GAM, divides responsibility for global customers between the GAM group and the national operations but gives the upper hand to the former. The GAM group has ultimate responsibility for the account; global account managers have the authority to enforce actions worldwide and the final say when disputes with national managers arise.

Control GAM is structured as a matrix organization: Employees serving a global account at the local level report to both their manager in the national or regional organization and the global account manager. The global account manager reports to the senior corporate executive responsible for the whole GAM program and, if the customer is a major player in a strategic country or region, to a regional manager as well. In the early days of a GAM program, local account managers typically have a solid-line relationship with the national or regional manager and a dotted-line relationship with the global account manager. As the program becomes better established, the global account manager's authority over local account managers typically grows; in many cases they ultimately become direct reports.

Control GAM usually includes a support team that identifies opportunities, makes plans for the global account, manages information and communication, and strengthens the relationship network. Some local account managers, along with representatives of key functions such as R&D and service, are typically members of the support team.

Because of its dedicated staff, control GAM costs notably more than coordination GAM. Other disadvantages are the need to change the company's organizational structure and the friction that may arise between the GAM group and the national operations as a result of the inevitable ambiguity about authority in matrix organizations. However, control GAM's many benefits – aligning the organization behind one customer focal point (the GAM team), achieving a better balance between global integration and local autonomy than coordination GAM provides, and engaging many parts of the company at multiple levels and across countries in serving the customer – outweigh the disadvantages.

Control GAM is most suitable when the product and customer attributes point to a strong need for GAM, but compelling reasons exist to anchor the account in the national operations. For example, an account may not be big enough (a gross margin of $10 million is generally the minimum) to justify the considerable expense of a dedicated global sales and support team. In addition, the supplier must be at least moderately capable of integrating its global sales, delivery, and service. It helps if the customer, too, has some integration capabilities.

For all these reasons, it makes sense that Royal Dutch Shell uses control GAM. The company is only moderately capable of serving customers on an integrated basis. One reason, no doubt, is its long-standing practice of granting exploration operations considerable freedom to deal with the different, often difficult local conditions they encounter around the world. Another is the nature of its global accounts, primarily very large multinationals that buy fuel and lubricants from Shell: Most are in industries where regional and corporatewide interests must be balanced, such as automotive manufacturing, automotive components, gas and power utilities, food, and mining. As a result, these customers tend to centralize the management of functions that can be shared globally (R&D, for example) and delegate to the regions power over issues

A SUPERB EXAMPLE of a firm that uses coordination GAM for all the right reasons is Unilever. Its megacustomers want a central point of contact only for dealing with a handful of issues.

GLOBAL ACCOUNT MANAGEMENT must be addressed in the context of a company's overall strategy and structure; if one of them changes, the GAM approach may need to change, too.

or functions that vary locally (production, sales, and service, for example). Accordingly, Shell's GAM employs both regional and global account teams; the former deal with issues such as prices, margins, and quantities sold, whereas the latter are in charge of the overall value proposition (how Shell adjusts its offer to help a particular customer), global service-level agreements, and global discount terms.

Separate GAM. In this approach a supplier creates a separate business unit with total responsibility for global accounts. All the frontline employees serving a global account belong to the GAM organization, which also operates its own technical support and sales services. Separate GAM is not totally autonomous, however, because it doesn't contain or control back-end functions such as R&D and manufacturing. But it does have functional specialists with the expertise and authority to call on the company resources needed to serve the global account.

The main advantages of separate GAM are those that derive from having unified rather than shared control of the customer relationship: No friction exists between global and local operations; account information is easier to manage; and customers often receive better service, because the employees assigned to them by the supplier are not also serving local accounts.

Only a tiny minority of companies have adopted this approach, however, for three reasons: Creating such an autonomous group is tantamount to a major reorganization. The group's autonomy results in less sharing of best practices with other parts of the company. And this solution is very expensive.

Separate GAM is most suitable when all the drivers for GAM are strong and the supplier has customers whose business is big enough and profitable enough to support the extra costs. The supplier and its customers must also, obviously, have the advanced capabilities required to centrally coordinate their transactions and other activities.

IBM belongs to the handful of suppliers for which separate GAM is an option. The company and 100 or so of its global customers have global leaders for each major function with the authority to set or at least coordinate strategy and resource allocation in their areas companywide; global teams that coordinate primary activities such as R&D, product design, production, marketing, sales, and service; and information systems that make it easy to report purchases and sales on a global basis. These customers together provide more than $10 billion worth of business – enough to support the high costs of operating separate GAM.

Customization and Evolution

Because relationships with individual customers differ, as do those customers' needs and capabilities, a supplier would ideally offer different forms of GAM to different customers. But that is both hard and expensive, and only a few very large companies can do it. (For example, IBM uses control or coordination GAM for accounts other than its 100 or so largest ones.) The best solution for the vast majority of suppliers is to customize one form of GAM. This can be done in multiple ways: The global agreement can cover more or fewer items – for example, all items sold by the supplier in some cases but just a few key items in others. The agreement can be stricter or looser about the terms and conditions that apply to the individual national operations of a given customer. The level of service can vary across customers, particularly in terms of the number of employees assigned to support a given account. The involvement of the supplier's national operations can vary, depending on each customer's desire or need for local interaction.

A common error is to start with a form of GAM too ambitious for either the supplier's or the customer's organization to handle. In such cases the program's prospects are blighted by high costs, political resistance, and failure to deliver the desired benefits. Because of the expense and the resistance that comes with any shift in power resulting from organizational change, suppliers should generally start with the least challenging form of global account management: coordination GAM. As a supplier gains experience, as its capabilities increase, and as the global relationship deepens and becomes more important, it might decide to adopt separate GAM. But again, the customer's integration capabilities must be taken into account before making this leap.

Hewlett-Packard – its initial problems in offering GAM to too many customers aside – is a model in terms of the way it chose a GAM approach and how its program evolved. In 1991 the company started a pilot program in its largest division, the computer systems organization, which involved providing six accounts with coordination GAM. Over the next few years HP added more elements to the program (such as support managers based at corporate headquarters to help global account managers in the field access corporate resources) and steadily increased the global account managers' power. As HP and its customers gained experience in dealing with each other globally, the program evolved into control GAM for the larger accounts with strong global integration capabilities, but HP retained a form of coordination GAM for other accounts. In the late 1990s HP moved to separate GAM: Its top 100 accounts were taken away from the national operations and put into one centrally managed program. Separate GAM worked well in terms of revenue growth, profit gains, and customer satisfaction. However, HP moved those accounts back into a control GAM program in 2001, when it decided to radically restructure the entire company in a bid to become much better at serving customers' total needs on an integrated basis. It replaced its vertical product divisions with units focused on customer segments and a separate R&D and production organization. HP's national operations became integral parts of the customer-focused units, so it was no longer necessary to use separate GAM. This raises a critical point: Global account management must be addressed in the context of a company's overall strategy and structure; if one of them changes, the GAM approach may need to change, too.

...

Suppliers that are either struggling with global account management or doing their best to avoid it must understand that GAM is not inherently bad for them. It can be extremely rewarding for multinational customers and suppliers alike if it is designed in accordance with the guidelines we've described. Suppliers unhappy with their existing GAM should revisit both the form they have adopted and the customers to which they provide it to see what adjustments may be needed. Suppliers that are still resisting pressure from customers to implement GAM should realize that although dangers exist, substantial gains can result. A resistant supplier may miss out on opportunities to maximize its business with important customers and, even worse, risk losing those customers to competitors that have seen the light.

If the conditions are appropriate for global account management, instituting such a program is not a choice for suppliers – it's a necessity.

1. See George S. Yip, G. Tomas M. Hult, and Audrey J.M. Bink, "Static Triangular Simulation as a Methodology for International Strategic Management Research," in *Research Methodology in International Strategy and Management*, vol. 4, ed. David J. Ketchen and Donald D. Bergh (Elsevier JAI, forthcoming 2007).

2. David B. Montgomery and George S. Yip, "The Challenge of Global Customer Management," *Marketing Management* 9, no. 4 (Winter 2000): 22–29.

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Mike Lynch

"It's a great place to work – but the ergonomics are lousy."

HBR BACK TO BUSINESS

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STAYING ON TARGET

1 PERFORMANCE REVIEWS

Fear of Feedback

The Set-Up-to-Fail Syndrome

Saving Your Rookie Managers from Themselves

A New Game Plan for C Players

2 PLANNING

Turning Great Strategy into Great Performance

Building Your Company's Vision

Discovery-Driven Planning

Off-Sites That Work

LEARN MORE ON PAGE 114

1 PERFORMANCE REVIEWS

Fear of Feedback

JAY M. JACKMAN AND MYRA H. STROBER

Originally published April 2003

Nobody likes performance reviews. Subordinates are nervous they'll hear nothing but criticism, and bosses are nervous their direct reports will respond defensively. So people generally keep their mouths shut.

That's unfortunate, because most employees need help figuring out how to improve their performance and advance their careers. Also, it can be detrimental to the company if a lack of clear feedback leads to behaviors such as procrastination, denial, and brooding.

There's a way to avoid this problem. Managers can help employees learn adaptive techniques – like acknowledging negative emotions and reframing fears and criticisms constructively – to prevent destructive responses. Once people are comfortable asking for feedback, they'll begin to see how they are doing relative to management's priorities, and their work will become better aligned with organizational goals. What's more, transforming a feedback-averse environment into a more honest and open one will improve performance throughout the company.

The Set-Up-to-Fail Syndrome

JEAN-FRANÇOIS MANZONI AND JEAN-LOUIS BARSOUX

Originally published March–April 1998

If you have an employee whose performance keeps deteriorating – despite your close monitoring – you may have unknowingly triggered the set-up-to-fail syndrome. According to the authors' research, which included surveys of hundreds of executives, the scenario plays out as follows: You and the employee start with a positive relationship. Then something – a missed deadline, a lost client – makes you question his performance. You begin micromanaging, but rather than improve the situation, the increased supervision has the reverse effect. Suspecting your reduced confidence, he withdraws from his work and from you.

To get things back on track, you must accept the possibility that your own behavior could be contributing to the problem. Then you must have one or several candid conversations with the employee to untangle the unhealthy dynamics in the relationship. An intervention like this is never easy, but the time and energy invested will usually yield a high payback.

Saving Your Rookie Managers from Themselves

CAROL A. WALKER

Originally published April 2002

You've promoted a top performer into management. Six months later, this rising star has fallen hard. He's overwhelmed, fearful, and not respected by his staff. Why?

Many rookie managers fail to grasp how their roles have changed – that their jobs are no longer about personal achievement but about enabling others to achieve. Even the best employees have trouble adjusting to this new reality, and that trouble can be exacerbated by the normal insecurities that prevent rookie managers from asking for help. Instead, they may internalize their stress, become self-focused, and as a result lose the confidence and trust of their staff members.

How to save your erstwhile star? Understand that employees promoted for their technical competence are not always naturally attuned to the basics of management, such as delegating, getting support from senior staffers, projecting confidence, thinking strategically, and giving feedback. Also, recognize that as the boss of a rookie manager, you have a responsibility to anticipate and address this challenge.

A New Game Plan for C Players

BETH AXELROD, HELEN HANDFIELD-JONES, AND ED MICHAELS

Originally published January 2002

It's a big driver of business success, but one that executives are loath to talk about: upgrading the management talent pool by weeding out "C" players. These aren't the incompetent or unethical managers whom organizations dismiss without a backward glance. C performers deliver results that are acceptable – barely – but they fail to inspire the people they lead.

In fact, the mediocre performance of C players pulls down a company's performance by calling their bosses' judgment into question, blocking talented employees' advancement or otherwise repelling valuable people, and encouraging a C-player mentality in others.

Confronting these individuals is painful, but to strengthen your firm's talent pool, you must do it. The authors' approach isn't about being tough on people; it's about being relentlessly focused on performance. And since letting C players languish in jobs where they're not respected only hurts them, moving them out may even help them.

Getty Images

Turning Great Strategy into Great Performance

MICHAEL C. MANKINS AND RICHARD STEELE

Originally published July–August 2005

Leaders press for better execution when they really need a sounder strategy. Or they craft a new strategy when they really need to improve execution. Their misplaced energy has consequences. According to the authors' research, companies on average deliver only 63% of the financial performance their strategies promise.

To avoid this kind of shortfall, leaders need to view strategic planning and execution as inextricably linked – and then raise the bar for both simultaneously. This article presents seven basic rules for setting and delivering strategy, such as keeping it simple and concrete, making resource-allocation decisions early, and continually monitoring performance as strategic plans are rolled out.

As high-performance companies like Cisco Systems and Dow Chemical have discovered, following these rules can dramatically boost financial results and narrow the strategy-to-performance gap.

Building Your Company's Vision

JAMES C. COLLINS AND JERRY I. PORRAS

Originally published September–October 1996

Some companies have visions that are built to last (think 3M and Sony). The secret to their success has two main components, the authors say – an envisioned future and a core ideology.

A company envisions its future by identifying bold stretch goals and vividly describing what it will take to achieve them. Henry Ford set the goal of democratizing the automobile and then told the world, "When I'm through...everyone will have one. The horse will have disappeared from our highways." Core ideology, which combines an organization's values and purpose, holds the company together through growth and change.

Taken together, core ideology and an envisioned future foster the dynamic that motivates truly visionary companies: preserving the core while stimulating progress.

Discovery-Driven Planning

RITA GUNTHER MCGRATH AND IAN C. MACMILLAN

Originally published July–August 1995

It's no wonder that companies often incur huge losses when they enter unknown territory – witness Disney's early troubles setting up a theme park in Europe and Polaroid's foray into instant movies. New ventures inevitably deviate from their original targets. Conventional planning (which involves extrapolating future results from past experience) doesn't allow for that degree of uncertainty. Discovery-driven planning is a better approach for new businesses.

Rather than forcing start-ups into the methodologies used for existing, well-understood businesses, discovery-driven planning acknowledges that, in the beginning, little is known. It highlights potentially dangerous assumptions and converts them into knowledge as a venture unfolds and new information comes to light. Managers should start by establishing required profits and then figure out how much revenue is needed and how much cost can be allowed. That will force them to identify and address – before agreeing to major resource commitments – the unknowns that can make or break new ventures.

Off-Sites That Work

BOB FRISCH AND LOGAN CHANDLER

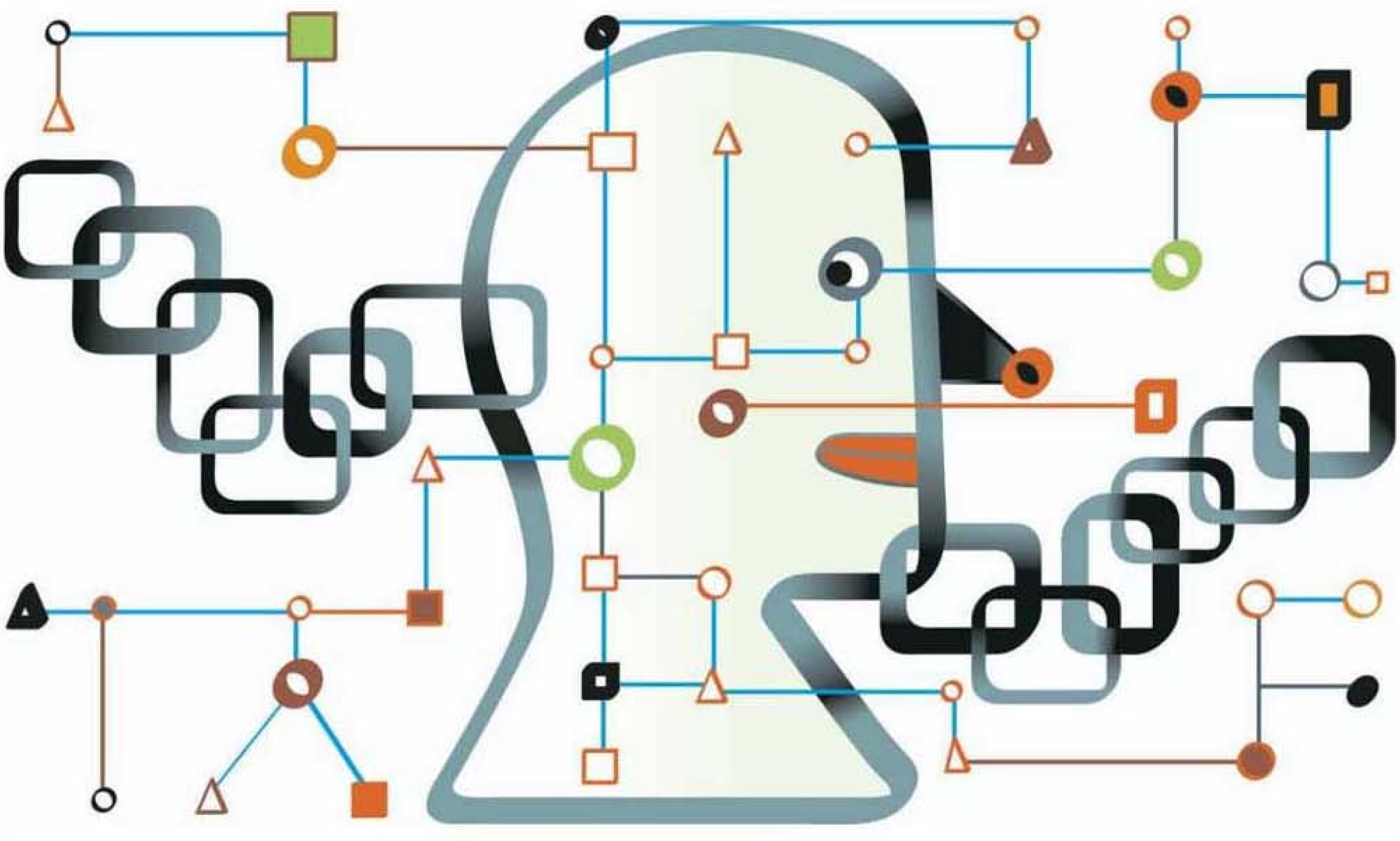
Originally published June 2006

If your management team is like most, you spend up to a week each year at an off-site strategy meeting. Collectively, such meetings cost U.S. businesses hundreds of millions of dollars annually in salaries alone. Yet despite the high price tag, most off-sites don't accomplish their primary goal, which is to determine a clear plan for the future of the business.

That's because many executives don't plan the right kind of event. If you and your team spend four days a year rafting down rivers together, you'll eventually get good at rafting down rivers. But spend four days a year having well-designed strategy conversations, and you will transform your annual off-site from a meaningless junket into a genuine turning point for your business.

From their two decades of experience designing and facilitating strategy off-sites for small and large companies, the authors have distilled a set of best practices that businesses can use to make the most of this annual opportunity.

2 PLANNING



Are You the Weakest Link in Your Company's Supply Chain?

If you're disengaged from supply chain management, you run the risk of sabotaging partner strategy and customer relations – and leaving money on the table now and for the long term.

by Reuben E. Slone, John T. Mentzer, and J. Paul Dittmann

A SUPPLY CHAIN EXECUTIVE walked the long hallway to his CEO's office one afternoon, quickly marshaling the arguments he would use to advocate for a global sales and operations planning, or S&OP, process. The goal: Convince the CEO that S&OP is indispensable to creating a world-class global supply chain, which in turn would become a major competitive advantage for the company. It seemed like a straightforward exercise, and the supply chain executive was prepared for any questions or challenges the CEO might throw at him. But as he neared the boss's office, questions of his own leaped to mind: "Why do I have to sell this plan? Why is the CEO not demanding it from me? I ought to be explaining why we're not moving faster rather than justifying S&OP in the first place!"

Federico Jordán

The answer to the supply chain executive's question is a surprisingly common one: He was not being pushed to move faster because his CEO didn't appreciate the business-critical nature of the supply chain operation. This lack of awareness was almost incomprehensible to the executive – yet there it was. (Perhaps, he thought, it was a failing of his own skills as a leader and advocate.) He knew, of course, that many worthy priorities compete for the CEO's attention and that not all of them manage to gain it. Still, in an industry where supply chain excellence is decisively important for operational efficiency, working-capital management, and ultimately the bottom line, a CEO ought to be fully engaged in this part of the business. Naturally, in some industries, supply chain excellence doesn't matter nearly as much. "But this isn't one of them," the executive thought.

Every conversation with the boss has the potential to be a turning point, to produce a long-awaited eureka moment. So, armed with the rich and persuasive vocabulary of business opportunity, the supply chain executive proceeded into the CEO's office, ready to make his case.

We have a case to make as well. In this article, we advise CEOs not to become unwitting weak links in their companies' own supply chain strategies. The costs of neglecting important matters of supply chain management are damaging to any type of business for which SCM is potentially a competitive differentiator (most notably, manufacturing, retail, and distribution). CEOs should get involved.

We have divided the supply chain domain into seven key areas where CEOs can exert either a positive or a negative influence. Each area is illuminated with real-world examples, taken largely from our confidential conversations with CEOs, supply chain executives, and other business leaders. We also illustrate the increase in return on assets that a CEO-led reform of the supply chain activity can yield (see the exhibit "The Supply Chain Value Chain"). Finally, we present a self-evaluation tool, encompassing the seven key areas, that CEOs can use to assess their level of engagement in and understanding of SCM issues.

Picking the Right Leaders

A CEO would never appoint a person with little or no manufacturing background to become the senior leader responsible for manufacturing. Nor would on-the-job training ever be appropriate for the head of sales or finance. Yet, we know of several large companies where the senior supply chain person came into that role with no supply chain background whatsoever.

We conducted an informal poll of 27 supply chain executives working at large manufacturers and retailers, and found that five had majored in supply chain management as undergraduates, four others had earned MBAs in the field, and five more had taken SCM executive development courses. The other 13 supply chain executives had no training or experience in the discipline before they took on their assignments.

What explains this misguided trend? We believe that many CEOs fail to realize that supply chain has become such a complicated set of activities – touching many business functions and processes, reaching beyond the enterprise, powered by fast-changing technologies, and presenting a range of strategic opportunities – that it can't be competently managed by the uninitiated, no matter how generally capable they might be. Senior supply chain executives need to have a background in SCM: formal education, significant prior experience, or both.

Consider the following unexceptional illustration of the risks when CEOs don't recognize this need. At a major durable goods company, one of the very talented rising stars moved from marketing to lead the supply chain function. He was being groomed for a much larger role in the corporation, and this assignment was deemed to suit his background well. Unfortunately, shortly after he took over, an abrupt swing in demand, coupled with a major problem in introducing a few new products, triggered a crisis that put the supply of an entire product line at risk. An experienced supply chain person would have seen the problem immediately and reacted aggressively. In this case, however, no appropriate action was taken for nearly two months – far too long to avert a major disruption in supply for the firm's customers. The impact on performance was severe, and the new leader of the function found himself climbing a near-vertical learning curve in the midst of a major crisis – clearly a prescription for disaster. Within a year the rising star, now tarnished, was moved to another area. The CEO learned from this experience and brought in a seasoned SCM expert

Article at a Glance

Supply chain management has become a complex, technology-driven discipline that reaches across functions, business processes, and corporate boundaries. Nevertheless, some CEOs pay little attention to SCM as a strategic concern and thereby squander its potential to improve overall performance.

Executed well by experienced supply chain professionals, SCM can deliver significant, tangible benefits in the form of reduced working-capital investment, faster inventory turns, lower fixed costs, and greater return on assets.

Broad application of SCM principles can minimize cross-functional conflicts, which so often exemplify the law of unintended consequences. Therefore, SCM strategy should inform business planning, performance metrics, and incentive and commission structures.

SCM merits direct CEO involvement, particularly in companies that compete in supply chain–intensive industries. CEOs should evaluate their own level of supply chain leadership, and this article provides a tool with which to do that.

from outside the company to set matters right. Within another year's time, the supply chain area had been turned around.

Only a CEO who is up to date on supply chain practices and trends can properly evaluate a supply chain executive's performance. We know of CEOs who, lacking this insight, have retained executives whose knowledge is years out of date. As long as SCM remains a black box to the CEO, so too will a supply chain leader's possible deficiencies.

Enlightened CEOs should insist that only the best supply chain professionals be hired – and should review new hires, not just at senior levels but possibly at lower ranks, where top-notch supply chain talent is also needed. Companies that understand this reality benefit from it. For example, when I was at Whirlpool, we had the opportunity to hire 13 new people for its supply chain organization. I set out to recruit the brightest supply chain MBAs from leading schools such as the University of Tennessee and Michigan State (read the details in "Leading a Supply Chain Turnaround," HBR October 2004). Leaders at Whirlpool viewed this cohort as its supply chain future – a true renaissance of talent.

The CEO of one textile manufacturer extends this best-and-brightest principle down to entry-level hiring: "Supply chain management philosophy so permeates our organization that…if we can just get quality supply chain management MBAs to join our company, they'll move quickly through the decision-making hierarchy and never be tempted to leave us." This company regularly recruits at major supply chain management schools – most productively during recessions, when other companies cut back on hiring and top talent can be recruited more easily.

Initiating Benchmarking and Devising Metrics

The most effective supply chains achieve the greatest possible availability of goods at optimal levels of inventory, transportation, and warehousing dollars. Specifying goals for improvement in these areas requires knowing where you stand now. A CEO ought to be able to list and explain the factors affecting availability, working capital, and cost; she should push the organization to do supply chain benchmarking and best-practice analysis – and should review the results personally.

As long as supply chain management remains a black box to the CEO, so too will a supply chain leader's possible deficiencies.

However, many firms fail to conduct external best-practice benchmarking. For example, a large pharmaceutical company was comfortable with inventory turns of about 2.0 – even though its competitors were doing much better, freeing hundreds of millions of dollars in cash by aggressively managing inventory and overall working capital. Other firms develop and report unrevealing, internally focused supply chain metrics that may actually conceal problems by neglecting crucial information. For instance, one construction materials manufacturer reported "good availability" if inventory to fulfill a new order was simply somewhere in the system, whether or not the order was actually delivered to the customer on time. OfficeMax used to report in-stocks at an SKU, or company-wide, level – not at the store level. When I arrived as the new supply chain executive, we gradually instituted a process of measuring and reporting store in-stocks the way the customer experiences them: daily and by specific store location.

Many firms measure only what they can assess easily. Few of those we work with know the total system cost of the SKUs they carry or take the trouble to measure the true cost of obsolete inventory. Likewise, we know of few companies that put inventory carrying cost on internal sales financial statements. Even those that include this measure typically count only interest cost, ignoring the other inventory costs of obsolescence, of warehousing, and – most serious of all – of draining investment capital away from other, more profitable projects.

When metrics are accurate and functionally aligned, magic can happen. Whirlpool, for example, put in place a set of metrics to track the effectiveness of SCM in reducing working capital. As a result, the company dramatically reduced working-capital DSO (days sales outstanding) and now is a leader in the appliance industry on this metric.

How should a CEO get involved in a program of metrics? First, ensure that any tool purporting to evaluate customer service assesses the company's performance from the customer's viewpoint. Then, make sure the metric's effectiveness is confirmed directly with several of the company's best customers. True cost to serve, determined on an activity basis, should be part of the CEO's metrics dashboard. Total assets employed, including both physical and

Reuben E. Slone (reubenslone@officemax.com) is the executive vice president of supply chain at OfficeMax in Naperville, Illinois. He was previously the vice president of global supply chain at Whirlpool in Benton Harbor, Michigan. **John T. Mentzer** (jmentzer@utk.edu) is the Harry J. and Vivienne R. Bruce Chair of Excellence in Business in the Department of Marketing and Logistics at the University of Tennessee in Knoxville. **J. Paul Dittmann** (jdittman@utk.edu) is the director of corporate partnerships and the managing director of demand and supply integration forums at the University of Tennessee in Knoxville.

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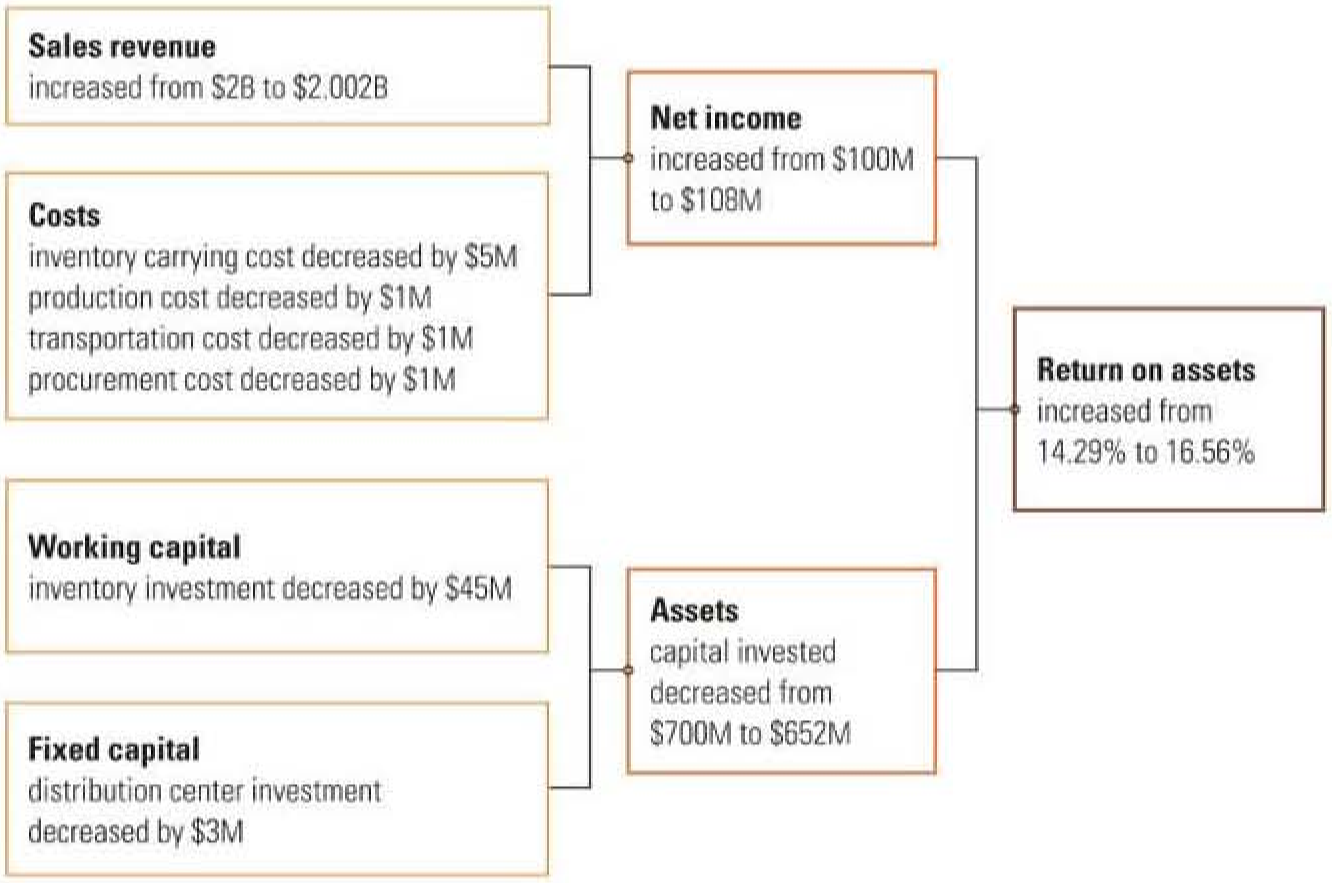
The Supply Chain Value Chain

One measurable benefit of improving supply chain management is an increase in return on assets. A major global chemical company substantially increased its ROA by aligning functional activities with supply chain strategy. Here are the hard numbers associated with the firm's function-related improvements in SCM.



Return on assets was calculated as follows: $100M / $700M = 14.29%; $108M / $652M = 16.56%.

working capital, should be measured and analyzed in relation to supply chain performance. Furthermore, the CEO should see evidence that goals are based on benchmarks of best practices and that they are shared cross-functionally.

Setting Incentives for Supportive Behavior

Armed with the confidence that best-practice benchmarks have been used to set appropriate goals and to effectively measure the progress toward them, CEOs should also establish reward and incentive programs to encourage employees to behave in ways that benefit the overall firm, not just their own functions. At one retail business whose supply chain executive spoke with us, the purchasing, logistics, and merchandising managers work in cross-functional teams and are measured – and rewarded – according to supply chain metrics that assess purchasing costs, logistics costs of getting the product to the store (also called "landed costs"), and the selling price in the store. Not surprisingly, these cross-functional teams drive supply chain performance to earn their bonuses.

The CEO, and sole owner, of a grocery products manufacturer saw even more dramatic results when he led the organization through an extensive analysis of its supply chain processes. The result was an ambitious strategic plan to take advantage of SCM throughout the firm and also with its partners. The overall goal – to save the company an estimated $3 million a year – directly targeted the bottom line. The only challenges to the strategic plan were requirements for significant collaboration with six key suppliers and three key retailers, and for major changes in how the manufacturer managed various aspects of its internal operations. The strategic-planning process culminated when the CEO met with the executive team to review the plan's rollout over a two-year horizon. In the middle of this meeting, he paused to observe, "You're talking about putting $3 million a year in my pocket, and it's just occurred to me that I'm the only one in the room excited about it." On the spot, he pledged to create a special annual million-dollar bonus pool above and beyond the company's normal bonus system. Any employee who could demonstrate having played a significant role in the success of the supply chain plan would get a portion of the pool. The CEO defined success as achieving the $3 million bottom-line improvement.

"Any year in which that happens, the special bonus pool exists," he said. He then instructed his three direct reports to devise a metric-and-compensation system (which he would review) for measuring individuals' contributions to the success of the plan and to determine how bonuses should be paid out. Suddenly, everyone in the company became an SCM enthusiast.

The owner of this company was a very clever man. How do you make certain you can clear a $3 million hurdle? You aim far above it. In the first year of implementing the supply chain reform plan and its special bonus, the bottom line improved not by $3 million – but $3.75 million. Employees were so intent on achieving the $3 million goal that they actually overachieved, in effect paying for three-fourths of their own bonuses.

As for those six key suppliers, the CEO of the grocery products manufacturer met personally with the CEOs of each, explained the strategy thoroughly, and pledged that for any year in which a supplier fully cooperated and the improvement goal was achieved, the company would not press the supplier for price cuts. Moreover, any savings to the firm directly attributable to the supplier's efforts would be shared 50/50. In essence, the suppliers were now being paid to help the company make its supply chain strategy work. Similar arrangements were made with the retailers. As a result, the manufacturer now

had a supply chain whose six key suppliers and three key retailers all worked in concert – and were rewarded for doing so – to make the strategic plan succeed. Not surprisingly, it did.

Keeping Up with Supply Chain Technologies and Trends

Many of the most-promising supply chain opportunities are made possible by sophisticated technologies that a CEO should take the time to understand. Supply chains today are often densely complex. They entail cross-functional participation (and deliver cross-functional benefits), and they therefore deeply permeate the firm. As we have just seen, supply chains are most successful when they inspire the cooperation of external partners. Major new software advances have enabled companies to optimize distribution and production planning, inventory management, warehousing, and transportation systems. Assorted new technologies – RFID (radio frequency identification) chips and systems, used in ever-more innovative ways; advanced bar codes; and other machine-readable coding schemes – have emerged to make SCM more sophisticated. Moreover, powerful process tools such as Lean and Six Sigma are now being applied to the entire supply chain. Nonetheless, the warehouses of many large companies still operate with 20-year-old technology, producing incomplete and unintegrated information flows and resulting in higher costs, higher inventory, impaired supplier relations, and declining customer service. All of this puts a company in jeopardy.

A CEO who understands new technologies can play the important devil's advocate role by challenging the business case for technology adoption. Most firms that have bought leading-edge supply chain systems acknowledge that they use only a fraction of the software's functionality and an even smaller fraction of the promised capability. An attentive CEO can lend authority to the change-management process, helping to foster user buy-in and making certain that proper vendor support, adequate training, and other resources are in place.

Moreover, CEOs who fully appreciate the challenges of deploying complex and costly systems can help their companies avoid classic missteps. The CEO of an industrial equipment manufacturer admitted that her company had fallen into one such classic trap: "We spent $18 million getting an ERP package up and running in our company, and all we did was bring more modern technology to bear on supply chain processes that are 40 years out of date. I expected this technology to bring supply chain costs down dramatically, and nothing has changed. My mistake was expecting technology to solve a process challenge." She is now leading the company through a major effort to understand existing processes, identify opportunities to improve them, and adapt the new system to support the reengineered supply chain processes.

CEOs, if fully engaged, demand that relevant business planning and negotiations anticipate and explicitly address important supply chain ramifications.

A large global chemical company uses its S&OP software as a communications hub for everyone in the business and for selected supply chain partners. The system allows for real-time access to demand plans, inventory levels, and the transportation status of various different deliveries – information that in turn can be coordinated with demands from supply chain customers and inbound materials from supply chain providers. Anyone in the supply chain can have read-only access to these real-time data, but only selected individuals have the rights to make changes to forecasts, plans, and deliveries. This system, which sits atop the supply chain processes developed jointly by the company and its supply chain partners, is fully exploited as a competitive tool to deliver product faster and cheaper than rivals' supply chains do. In essence, sharing information with supply chain partners creates breakthrough improvements in performance.

For the company to excel in the technology area, the CEO should be briefed regularly about and have high-level knowledge of supply chain technologies. She should also demonstrate a thorough understanding of how the firm is applying these technologies and be capable of asking challenging questions – and getting the right answers – before any new technology is specified, purchased, and rolled out.

Eliminating Cross-Functional Crossed Wires

Can you explain the role of each of your company's functions in driving results in cross-functional areas? At a large manufacturer of consumer durables, the CEO tasked the VP of marketing with reducing SKUs by 20%. However, the VP believed that other objectives – growing market share, for example – were more important than the SKU goal, so he made no progress toward achieving it. As he put it, "The CEO was not really serious when he said that. If I keep growing market share, he won't bother me about SKU count." Even though the CEO believed strongly in SKU reduction (it had paid big dividends at his former company), he did not know how to make it an equally urgent objective for the VP of marketing. In part, this was because the CEO didn't understand supply chain operations well enough to know *why* it had paid off for his former company. That deficit compromised his ability to persuade the marketing VP of his seriousness.

Harvard Business Review
Seven Transformations of Leadership
David Rooke and William R. Torbet
Creating the Living Brand
Neeli Bendapudi and Venkat Bendapudi
What Makes Global Firms Resilient?
Daniel Yergin
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Inventory is another cross-functional sinkhole. We have seen many cases where the sales unit will not use markdowns to move obsolete inventory because the CEO has allowed sales metrics to exclude the costs of carrying that inventory. The firm then pays the carrying costs and – sometimes years later – the cost of the inevitable markdown.

To avoid such needless inefficiencies, the CEO should be personally involved in developing a mature S&OP process. SKU complexity should be tracked and decreasing, as should obsolete inventory. The operations and supply chain function should be held equally accountable with the sales and marketing function for customer service and inventory. The CEO should also thoroughly understand – so that he can help to harmonize – the interplay of cross-functional and supply chain priorities.

Adding Supply Chain Insight to Business Planning

The old saying that the loss of a horseshoe nail can lead ultimately to the loss of a kingdom applies to business initiatives when key information is missing from the planning stage. Supply chain considerations (and expertise) should be core components of business planning, including sales and marketing promotions, and of contract negotiations with customers and partners. That's because unforeseen disjunctions can undermine the best strategic intentions.

A major North American railroad is currently struggling with this concept. Although the CEO has clearly articulated who the railroad's most profitable customers are, this directive isn't reflected operationally by individual terminal managers, who are measured on how many railcars they move with the available locomotives. This performance metric motivates terminal managers to assign priority status to longer trains, even though that might leave the shipments of the high-value customers languishing for days in the terminal. The terminal managers aren't thinking about where the high-value orders are. If they happen to be on shorter trains, they sit; if not, they move – simple. In one case, goods shipped by a $100 million customer regularly missed delivery deadlines because locomotives were consistently diverted to longer trains loaded with marginally profitable goods that didn't require expedited shipment but got it nonetheless.

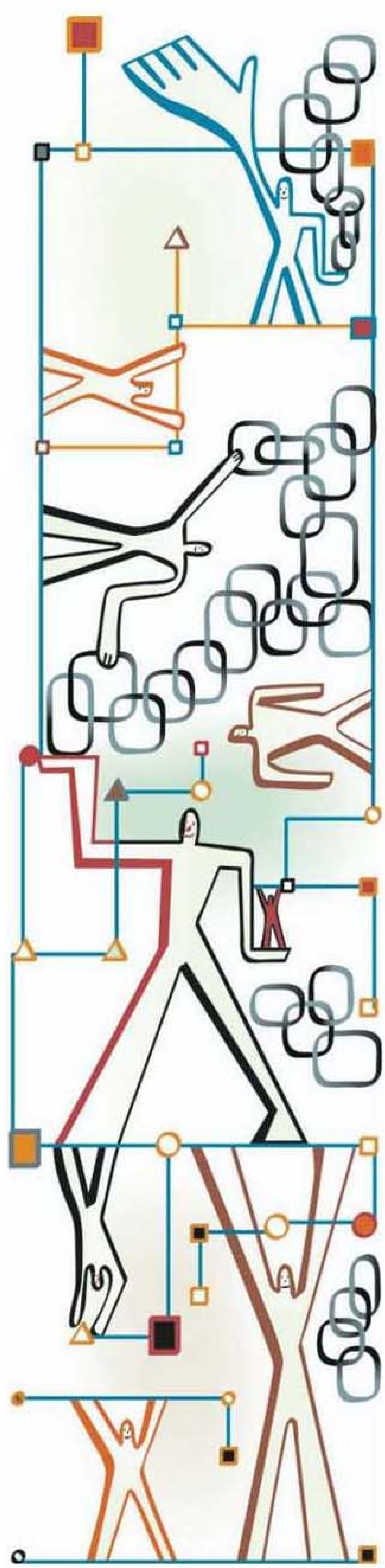
Another company's marketing organization ran a big promotion while its own factory was in the midst of a major, complex tooling changeover and couldn't provide the needed volume of product. At a third company, during pricing negotiations, a large customer was promised that all of its product would be served through the regional warehouse network rather than directly from the factory. This added a $15-per-unit cost for the company with no concession won from the customer in return. Why? The negotiators, coming from the sales function, didn't understand the added supply chain costs of the agreement.

The takeaway message: CEOs, if fully engaged, demand that relevant business planning and negotiations anticipate and explicitly address important supply chain ramifications.

Resisting the Tyranny of Short-Term Thinking

Sometimes a near-term focus leads to tactical decisions that conflict with one another, creating unintended – and sometimes costly – consequences in the supply chain. CEOs should guard, in particular, against allowing quarterly pressures to dictate unprofitable long-term trends.

Consider how unnecessary quarterly variability disrupts the flow of goods to the marketplace. In some cases, sluggish sales for most of a quarter are capped by an end-of-quarter surge. In others, goods move briskly for most of the quarter only to slacken in the final month. Both phenomena are caused by sales tactics that are misaligned with supply chain–planning objectives.



Evaluate Your Level of Supply Chain Leadership

Answer the seven questions in the left-hand column. For each question, assign yourself a score from 1 to 9, according to your current level of supply chain leadership (9 is the best). The statements within each column will help you decide where you fall on the leadership spectrum. If you score 3 or lower on a question, a remediation effort is in order – your firm may be in jeopardy in the low-scoring area. Conversely, a score of 7 to 9 on a question suggests you have a world-class opportunity to leverage. If your total score is 56 to 63, you are poised to drive your supply chain to a true competitive advantage. A score of 21 or lower should be a red flag, especially to a manufacturing, distribution, or retail CEO – your lack of supply chain focus may damage your company's interests. An interactive, multiple-choice version of this tool is available at www.hbr.org.

Question	Scoring Spectrum 1 2 3	4 5 6	7 8 9	Your Score
Is supply chain leadership a valued career path in your company?	• You do not get involved in career planning for supply chain personnel. • You do not understand why your supply chain leader must have a supply chain background.	• You are establishing a plan to develop or enhance supply chain talent in your company. • You see the major impact of the supply chain on your firm's success.	• You have chosen an experienced supply chain professional to lead the supply chain organization. • You are involved in the hiring of key supply chain personnel.	
Do you have a program of customer-focused metrics and best-practice benchmarking that drives cross-functional alignment?	• No benchmarking of best practices is done. • Customer-focused metrics are not in place. • Metrics are not shared across functions.	• Some metrics are shared across silos. • Customer-satisfaction metrics for fulfillment exist. • You understand how each function affects fulfillment and shares accountability for it.	• You consistently push for benchmarks of best practices and for sharing customer-fulfillment metrics across functions. • Customer service is the primary metric; activity-based costs and total assets are also measured.	
Do employee and customer behavior reflect your supply chain strategies? Are the strategies clearly articulated? Are strong reward and incentive plans in place?	• You are not involved in function leaders' formulation of incentives and goals. • You do not know whether supply chain partners have been enlisted to support your supply chain goals.	• You have some understanding of how compensation, bonus, and commission programs might inadvertently harm supply chain and profit performance.	• You actively support efforts to reward employees, suppliers, and customers who contribute to your supply chain efficiency.	
Do you understand important supply chain technologies and IT-powered trends?	• You have little interest in new supply chain technologies and leave that to the experts.	• You periodically become aware of – and are curious about – advances in supply chain technology.	• You have a good knowledge of supply chain technologies, can ask challenging questions about them, and have plans to apply them in your firm.	
Do you play a constructive role in resolving cross-functional disjunctions, including those that influence the ability to sell inventory at market price?	• Your company has no sales and operations planning process. • Product complexity is increasing or unknown. • Obsolete inventory is increasing or unknown.	• An S&OP process exists and is maturing. • Product complexity and obsolete inventory are tracked and periodically addressed.	• You are personally involved in the S&OP process. • You hold operations/supply chain and sales/marketing equally accountable for customer service and inventory. • Product complexity is decreasing, as is obsolete inventory.	
Do you demand that supply chain expertise be factored into business initiatives and planning, promotional programs, and customer-contract discussions?	• Customers and vendors all are treated equally. • Negotiation with partners focuses on price and product, not supply chain issues. • Internal groups routinely formulate plans without seeking input from supply chain managers.	• Supply chain collaboration with suppliers and customers sometimes occurs. • Some cross-functional planning takes into account supply chain requirements.	• Supply chain collaboration involves both customers and suppliers and is cross-functionally aligned. • You stress that all negotiations with partners should include supply chain issues.	
Do you ensure that short-term thinking doesn't sabotage supply chain management strategies and opportunities?	• If it takes an end-of-period surge to make quarterly and monthly EPS goals, you do it regardless of the costs. • You have not requested an analysis of the effects of this practice.	• You have a plan to reduce or eliminate end-of-period spikes. • You are gaining a good appreciation of the negative effects of such spikes.	• You have eliminated end-of-period spikes and now clearly see the resulting financial and operational benefits.	

Sometimes the unintended beneficiary is a wholesaler or large retail customer; one retailer confessed, "I'm building two new warehouses to take advantage of my supplier's end-of-quarter push."

Take the case of a large manufacturer of consumer products whose quarterly demand from many retailers followed a three-month sales pattern of low, low, high. In a meeting with the CEO, the head of supply chain pointed out the extreme costs and supply disruptions created by a quarterly cycle consisting of overcapacity and inventory buildup for two months, followed by rush production and delivery in the third month.

The CEO doubted that anything could be done about it – after all, wasn't that the natural demand pattern? Well, not exactly. The CEO learned that the product in question was disposable diapers, and the fluctuations were caused entirely by his pushing the company toward the "urge to surge." By accepting and managing to the quarterly sales numbers, the CEO was subtly signaling to retailers that when the company was falling short of its quarterly target, it would offer deep price discounts to make the numbers. Thus, retail customers regularly bought a three-month supply in the third month of each quarter, triggering low sales in the first two months of the next quarter, which would cause another discount surge.

As the CEO put it, "This was a real revelation for me. Babies pee at a constant rate, but our demand was fluctuating wildly. We had trained our retail 'partners' to take advantage of us and order only in the third month of each quarter, when we were trying to make our numbers." The CEO subsequently drove the supply chain to offer consistent price and delivery terms each month, saving tens of millions of dollars in supply chain costs. (These costs had consisted of the combined impact of overtime during the surge, downtime and wasted labor during the slow sales months, and higher inventory costs in anticipation of the coming surge.) The company shared its savings in supply chain costs with the retail partners, effectively netting them better prices than they had enjoyed under the old high-cost, urge-to-surge supply chain game.

Another manufacturer of consumer products illustrates a variation on the urge to surge: the urge to hold back. Demand from retail customers followed a quarterly pattern of high, high, low. This triggered greater production capacity and expenses in the first two months, then inventory buildup during the third. Predictably, it also created operational disruptions for the company's suppliers. The CEO was at a loss to explain this quarterly seasonal pattern, which seemed to affect all of the company's products. Like diapers, the products were staple items in grocery stores, and there was no logical explanation for the strange pattern in consumer purchasing behavior. In fact, analysis showed that annual demand at the consumer level was fairly stable month to month.

In this case, customers were being forced into ordering illogically by the company's sales force, whose compensation program was structured to pay a commission that included a bonus for forecasting accuracy. The sales force realized that their sales forecasts were used to set quotas. The CEO, whose background was in sales, wanted to motivate "rigor" in arriving at these de facto quotas. Motivation came in the form of commissions that were cut in half for any sales that exceeded the quarterly forecast. As the CEO saw it, this would train salespeople to forecast accurately. If they set the forecast too high, they'd lose the bonus offered for forecasting accuracy; too low, and their commissions on higher sales would be halved.

Human nature being what it is, the salespeople were motivated to aim low and then stop selling once they'd hit their cautious marks. Company lore had it that the salespeople were great forecasters. No doubt they appeared to be! The first two months of each quarter, they sold diligently until they hit their quotas, after which they refused to take any further orders from retailers. Why take orders that would earn them only half the usual commission and cause them to lose their bonuses?

The perverse incentives also had an impact on customer service and supply chain costs. Customer surveys revealed that retailers' major complaint about the company was the difficulty (if not the impossibility) of obtaining its products at the end of a quarter. Consumers cited the inexplicably cyclical lack of product availability. The CEO was, in effect, paying his sales force to disrupt the company's own supply chain and dissatisfy its customers – and all to achieve the illusion of forecasting excellence.

...

Now it's time to look in the mirror. We have developed a self-evaluation tool to help you measure the quality and depth of your involvement in supply chain strategy by assessing the programs you have – and haven't – put in place (see the exhibit "Evaluate Your Level of Supply Chain Leadership").

What should you do if you don't score well on the evaluation?

- Start by hiring the best supply chain professionals available.
- Get personally involved in cross-functional issues like S&OP, complexity management, and working-capital management.
- Lead the company away from quarter-end disruptions.
- Reward supply chain behavior that benefits the entire company.
- Invest personal time in learning about recent advances, including new technologies, in the supply chain field.
- Use benchmarking and get advice from outside experts.

If you scored well, don't waste time gloating. Build aggressively on your company's supply chain strengths, and dedicate yourself to increasing your advantage over the competition.

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To order, see page 151.

Rules to Acquire By

After buying 70 companies in six years, Pitney Bowes has learned a few things about how to make acquisitions successful.

by Bruce Nolop

COMPANIES THAT PURSUE growth through acquisitions take a lot of heat these days. Study after study proclaims the same kind of thing – that the impulse to buy other businesses is a sign of weakness, that corporate cultures don't mix, that the majority of acquisitions simply fail. After reading all that, it's hard to believe any company in its right mind would attempt one.

Yet a close look at the world's most successful companies reveals that, in general, they rely heavily on acquisitions to achieve their strategic goals. Despite the challenges, their managers affirm, acquisitions are faster, cheaper, and less risky than organic expansion. It's a seeming paradox, until you realize what's going on: Some acquirers have figured out how to do it right. Many have not.

Brett Ryder

When we at Pitney Bowes embarked on our acquisition program six years ago, we were one of the companies that had not yet figured it out. But we had one good idea going for us: We believed that we should develop a disciplined approach to making acquisitions and learning from them as an organization. We did not subscribe to the school of thought that says shrewd deals come from a smart CEO's instincts and sheer force of will. For us, buying other companies couldn't be a seat-of-the-pants adventure; it had to be treated as a business process.

More than 70 acquisitions later, we have that process firmly in place and have achieved enough success to believe in it. I certainly would not claim that we've made no mistakes. To some degree, they're inevitable – and are even valuable if they inspire process improvements. What matters is the net sum of what we've accomplished. In aggregate, these acquisitions have allowed us to meet our strategic goal of shifting our business portfolio from a hardware orientation to a focus on software and service offerings that have greater potential for growth and profitability. Our acquisitions have increased the company's revenue by more than 25%, substantially accelerated our organic revenue growth rate, and made a significantly positive contribution to our net income and cash flow.

What's behind the program's success? Like any good process owner, I could address that question in great detail. Our due diligence checklist, for example, now covers 93 separate points of concern. But as we've gained experience, I have been struck by the continued importance of a few key guidelines. I've also come to believe that this set of basic rules, stated in general terms, may apply just as well to other companies' acquisition efforts. I would have benefited from knowing these five principles at the outset of our acquisition program. Perhaps you can benefit from them now.

For us, buying other companies couldn't be a seat-of-the-pants adventure; it had to be treated as a business process.

Article at a Glance

The CFO of Pitney Bowes offers advice based on that company's acquisition experience:

Adjacent moves yield better results than broad diversification because they capitalize on the company's tacit strengths and are brand consistent in the eyes of customers.

Rather than focusing on big, game-changing deals, it's better to make many smaller acquisitions. This approach poses less risk and produces more predictable financial results over time.

Having a business sponsor for every acquisition ensures that the right deals are made and then kept on track.

Recognizing the difference between "bolt-on" and "platform" acquisitions leads to appropriate metrics for evaluating and managing them.

Safeguards can keep a management team from "shopping when it's hungry."

Rule 1 > **Stick to Adjacent Spaces**

Every American sports fan knows the one major embarrassment of Michael Jordan's otherwise amazing career: when he retired from basketball and decided to try his hand at major league baseball. We may all shake our heads at the folly of that move, yet it's not much different from the decisions routinely made by corporate strategists. Companies' acquisitions often take them just as far afield.

Plenty of evidence suggests that a better approach is to pursue what are called adjacencies – logical extensions of a company's current business mix, which can be taken on incrementally. Procter & Gamble, for example, uses acquisitions to expand its product lines and grows the acquired brands through its powerful marketing and distribution capabilities. It typically starts with a core acquisition (think Charmin or Clairol), followed by aggressive expansion deeper into the product category (think tissue or hair care). The wisdom of this approach was borne out by a 2001 McKinsey study that found that adjacent acquisitions correlate with increased shareholder value, whereas diversification into nonrelated areas actually reduces shareholder value. Another research project, by *Profit from the Core* author Chris Zook, looked for patterns in 2,000 companies' growth initiatives and concluded that adjacent moves were the most successful.

Our own experience has taught us why adjacencies prove so valuable. First, they take advantage of the tacit strengths of an organization – management know-how, customer insights, and cultural orientation – that are often ignored by strategists. With an adjacent acquisition, these organizational attributes go a long way toward making the integration work and allowing the acquirer to capitalize on what it has bought. But when an acquisition takes a company into remote territory, these strengths are neutralized – and can even be liabilities.

Adjacencies also have the advantage of being brand consistent. For a business to succeed, it must not only be well managed, it must also be trusted by the marketplace. In a sense, customers must grant a company permission to enter a new space. At Pitney Bowes we test our acquisition ideas by gauging the likely reaction of our existing customers. In many cases, this involves actively soliciting their input. Perhaps our customer base is particularly open to sharing opinions (we are an on-site presence at many sophisticated companies, including more than 120 of the *Fortune* 500), but I suspect that most companies' customers would offer use-

Which Comes First – the Strategy or the Attractive Deal?

When it comes to linking acquisitions to strategy, our fundamental approach has been unlike that of many other companies. In the traditional model, a company identifies – either on its own or with a consultant's help – a new business strategy or a new space and then buys something. By contrast, we work with our board of directors to develop a general sense of our strategic direction and then refine our strategy along the way through the process of acquisitions.

We're constantly using our acquisition campaign to force the question "What is the right strategy?" In this way, we operate much like the American system of jurisprudence. Certain basic concepts and principles are in place, certainly – but only by proceeding case by case does the meaning of the law in real life emerge. Likewise, Pitney Bowes management might make a general declaration that we would want to go in a certain direction – say, into the direct mail space. But until we look at actual opportunities, we don't have the specificity required for that strategy to be meaningful. For example, we originally set the strategic goal of being a market leader in mail and document management, but as we ventured further into the broad area of document management, we realized the goal would quickly take us outside our comfort zone. So we redefined our strategy in terms of the mail stream – the flow of information, mail, documents, and packages into and out of a business.

In general, we believe that looking at acquisitions is an excellent way to develop knowledge about our priorities. We purposely consider more acquisition proposals than we can possibly act on. Forcing ourselves to choose among many options is a method of prioritization that informs other managerial decisions. This approach also stresses the importance of looking at opportunities in a very disciplined manner, using consistent criteria and a highly standardized process.

ful feedback. In fact, a few of our most successful acquisitions have grown out of unsolicited customer suggestions. Our move into litigation support is an example: It would never have occurred if we hadn't been serving law firms with on-site photocopying centers. A few of them encouraged us to take on a specialized set of document management activities required by corporate trial lawyers. Two acquisitions grew out of that notion, and we are now a leader in a fast-growing segment. We received equally good guidance from a few of our larger mailing-machine customers that were using mailing efficiency software to lower their postage costs; they told us how convenient it would be to have those two things bundled into one offering. We moved into that space aggressively with the purchase of Group 1 Software, the market leader in that niche.

We test for adjacency at Pitney Bowes by asking ourselves: Can we really add more value to the target company than any other acquirer can? If we're convinced that no one is better suited than we are to make the deal, that's an important indication that we're on the right track. The same consideration works for us on the other side of the deal. We like it when the acquired company's management believes that we bring something unique to the table – when it's focusing not just on the money but on the chance to grow faster and better. From our standpoint, the ideal situation is one in which we are the only logical acquirer. Naturally, this avoids a competitive bidding situation in which we might overpay; it also reaffirms the clarity and distinctiveness of our strategy.

For all these reasons, adjacent acquisitions make for a much more compelling growth strategy than diversification does. There is also this: Communications about an acquisition have to bring a lot of people – including customers, employees, and financial analysts – around to its logic. When a deal doesn't require a stretch of the imagination, the story simply holds together better. That turns out to be crucially important, given that all of these people have to believe in an acquisition's potential for it to succeed.

Rule 2 > **Bet on Portfolio Performance**

My second rule is to manage acquisitions as you would a portfolio of investments. That is, rather than making one or two big bets and hoping for the best, a sound approach is to make multiple smaller acquisitions. The notion that smaller is better is backed by research. One study by Bain & Company looked at deals conducted by some 1,700 firms over a 15-year period and concluded that the probability of success in an acquisition was strongly influenced by the size of the target relative to the market capitalization of the acquirer. The economic returns were greatest from acquisitions that represented 5% or less of the acquirer's market capitalization. In Pitney Bowes's case, the sweet spot for success is a company in the $100 million to $500 million range.

A portfolio approach means that acquisitions will not only be of a manageable size but will also be of sufficient number to hedge the risk that any

Bruce Nolop is an executive vice president of Pitney Bowes in Stamford, Connecticut, and the company's chief financial officer.

one will go awry. No one has a perfect record – not even the savviest private equity firms, which arguably are the consummate deal makers operating today (and which, it should be noted, typically diversify each of their investment funds across multiple transactions). We try not to get discouraged by the few deals that haven't panned out. Rather, we see them as proof that a diversified approach is critical and try to learn from them.

The classic benefit of a portfolio strategy, whether for acquisitions or any other type of investment, is that it produces more-predictable financial results over time. This is especially helpful for companies that, like Pitney Bowes, attract investors by being consistent performers in a broad range of macroeconomic environments. Diversification also helps us meet the investment requirements of businesses that are in varying stages of development. For example, when we purchased PSI Group (a company that helps large mailers earn postal discounts), we knew that we would be investing in its national infrastructure. And now that those investments are completed, we are enjoying their benefits as we find additional adjacent businesses to bring into the fold. This cycle of "buy, invest, profit" develops its own rhythm, which helps to keep our financial results both predictable and improving.

It's amazing how quickly an acquisition loses its glamorous overtones and starts being real work.

Given all these benefits, why would anyone favor a single large acquisition over a set of smaller ones? In some cases, I suppose, egos are involved: Megadeals garner headlines that tend to hail the conquering hero. But the usual, and more compelling, logic is that, because small deals are just as hard to execute as larger ones, it's a better use of time to focus on a truly game-changing transaction. I would respond to that argument, however, by noting that a company can also learn as much from smaller deals as from larger ones, and this learning curve experience is itself a valuable asset. Indeed, various studies indicate that frequent acquirers have better acquisition track records than companies that pursue larger, less frequent transactions.

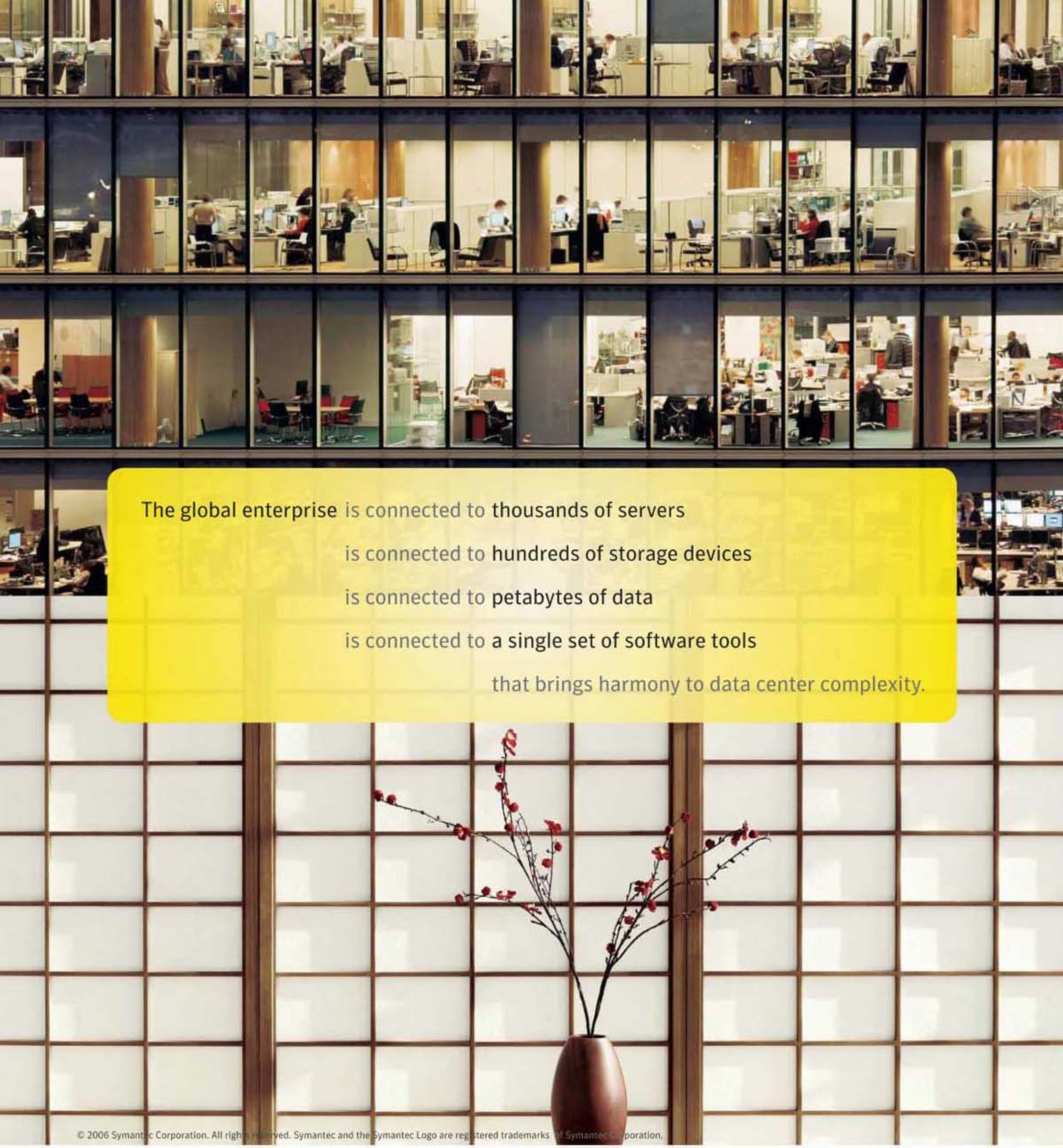
Rule 3 > **Get a Business Sponsor – No Exceptions**

I've mentioned that Pitney Bowes planned from the outset to manage acquisitions as a disciplined process. In line with that thinking, we created a corporate development group early on, and it has matured into a capable and sophisticated function. If other companies plan to create the same (and I recommend they do so), then I strongly suggest that they follow another rule we've learned the hard way: Never let that staff department *drive* the acquisitions. The leaders of business units are in the best position to gauge a potential acquisition's strategic and cultural fit, identify potential business synergies, and establish the road map for delivering expected outcomes. They need to be the sources and owners of acquisition proposals. The corporate development group's role should be to facilitate and execute the details of the transaction.

It's amazing how quickly an acquisition loses its glamorous overtones and starts being real work. In my time as an investment banker, I never saw this; my involvement ended right after those few days of glory, and I never saw what it took to pull these things off. Some clearly defined leader has to be personally focused on executing the business plan for the acquisition: achieving revenue targets, engineering cost synergies, and delivering the expected return on investment (or more). At the same time, the business sponsor (who invariably appoints an integration manager) must drive all the behind-the-scenes infrastructure projects that are essential to operational success, including the integration of IT systems, HR policies, financial controls, management reporting, and talent retention. It's hard to imagine anyone who didn't have a real passion for the acquisition from the start putting a shoulder to all these tasks.

Sponsorship by business leaders is especially important to talent retention. It is imperative that our people establish and maintain strong working relationships with the new management teams to smooth their entry into our culture and their adoption of our operating procedures. This process begins during the courtship of a potential acquisition, when it's up to our business sponsor to develop a personal bond with the target company's leadership. It intensifies after the new company is aboard. We know by now that the bureaucratic processes of a *Fortune* 500 company can be a significant turnoff to talented executives from a smaller firm. Our business sponsors have to explain why it's all necessary while ensuring that corporate functions, however well-meaning, don't overwhelm the newly acquired team with requests for time and information beyond what is really needed.

All this should make it clear why, during my tenure at Pitney Bowes, there has never been a transaction without a business sponsor personally responsible for its success. Sponsors are held accountable through regular status reports to our CEO and board of directors on the integration of acquisitions. Over time, we've come to be very disciplined about these reviews. We impose a standard format on the reports, which forces us to compare actual performance against the business plan that was drawn up at the time the deal was proposed. This may seem obvious, but in practice it's easy to lose this rigor. Some regrettable misfires in our first couple of years drove home the need for regular follow-up and consistent measurements. It's an efficient



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and inexpensive way to reinforce good practices – and essential for even the smallest deals.

Rule 4 > **Be Clear on How the Acquisition Should Be Judged**

When business sponsors report on the progress of acquisitions, what, exactly, are we looking for in terms of growth potential, market leadership, management teams, and financial objectives? How much near-term synergy and what degree of integration do we expect? We realized early in our efforts that not all acquisitions could be held to the same yardstick, and yet it was important to approach such questions consistently.

It was tremendously helpful when we recognized a fundamental difference in the types of acquisitions we were undertaking. One type, the *bolt-on,* fits neatly into a business or market we are already in; the other, the *platform,* takes our company into a new (though adjacent) business space or activity. If a bolt-on acquisition is the equivalent of a swan dive, a platform is a reverse two-and-a-half somersault with a half twist. The higher degree of difficulty entails more risk (but a potentially higher reward) and less frequency; platforms represent less than a sixth of our transactions (although about two-thirds of our total investment) to date.

Making this distinction between bolt-ons and platforms is of critical importance because it leads to different criteria for evaluating potential deals. When the acquisition under consideration is a platform, near-term revenue opportunities and cost savings fade in importance. Instead, strategic questions become paramount: Is this a business we want to be in? Is it sufficiently adjacent to our current offerings that we understand the market? Do we have "brand permission" from our customers to offer the new products or services? Does the new space promise faster growth than our legacy businesses do? Is the target company culturally compatible with Pitney Bowes? We think hard about each of these questions and have established formal criteria that our board of directors has endorsed as prerequisite considerations before approving any platform deal. (See the sidebar "What Constitutes a Platform for Growth?")

With a bolt-on acquisition, such considerations are bypassed because the strategic question "Do we want to be in this business?" has already been answered. Instead, our focus is on probable business synergies and how they will show up in revenues and expenses. We target companies that can help us cross-sell products and services. We look for opportunities to combine facilities or staff with our existing businesses. We seek complementary technology or intellectual property that can help us gain a competitive advantage and that would be more expensive to develop on our own. And, particularly with acquisitions of independent dealers or distributors, we seek opportunities to strengthen our presence in attractive markets.

In terms of financial returns, our requirements for bolt-on acquisitions are decidedly more short-term than the ones we set for platform acquisitions. We typically expect bolt-ons to be at least neutral to earnings from the outset and accretive shortly thereafter. And we expect them to generate an unlevered return on capital of at least 10% within three years. Criteria like these keep us highly price conscious at transaction time.

Certainly we also run every platform acquisition through a series of financial screens to ensure that we are paying a fair price. These screens include a discounted cash flow analysis, a comparison of similar transaction multiples, an economic value-added analysis, and

Making this distinction between bolt-ons and platforms is of critical importance because it leads to different criteria for evaluating potential deals.

What Constitutes a Platform for Growth?

When the purchase of an existing business allows our company to establish a beachhead in a new market space, it is a *platform acquisition.* The way we think about platforms – from what we're willing to pay to how we measure success – is different from the way we think about other acquisitions. We know we are looking at good platform potential when we see:

- ✓ A market space that is adjacent to our existing businesses and is growing at a double-digit rate.
- ✓ The likelihood that Pitney Bowes can become a market leader and grow even faster than the market.
- ✓ An opportunity to generate significant revenue within five years (through either organic expansion or subsequent bolt-on acquisitions).
- ✓ Brand attributes that are compatible with and enhance our own.
- ✓ Little potential to do significant harm to our existing customer relationships.
- ✓ A low probability of competitor reaction that could change the underlying attractiveness of the new market.
- ✓ A strong management team that is committed to staying with the business and capable of leading a growth strategy.

There are various ways of ministering to a faltering business, but buying another business usually isn't one of them.

a review of the accounting impact (profit margin, earnings per share, return on capital, and so on) of the transaction. But our criteria for platform acquisitions put far less emphasis on standard financial metrics. We even allow platform acquisitions to be slightly dilutive to earnings in the first year; our goal is for them to be neutral to accretive within two years. (However, the newly acquired company should be accretive to cash earnings from the outset, meaning that the company would add to our earnings if we did not have to amortize the intangible assets created by acquisition accounting rules.) More important to us is the likelihood that profitability will improve every year to the point that the target company eventually would earn at least a 10% unlevered return on investment. The focus on nonfinancial criteria to evaluate platform acquisitions reflects their fundamentally different purpose in our corporate strategy. With platform acquisitions, we are much more concerned with the long-term growth projections for the business than we are with the short-term opportunities to increase revenue or reduce costs.

Rule 5 > **Don't Shop When You're Hungry**

The final rule comes courtesy of one of our directors: He told us, "Don't shop when you're hungry." We understood the reference to grocery buying. It's an all-too-human tendency to purchase more than is needed – and to be less price sensitive about it – when shopping on an empty stomach. Over time, we've realized how apt the analogy is and thought about how it should guide us.

First, on a strategic level, "hungry" can mean that the business is missing an element that management feels it urgently needs. That doesn't have to translate into impulsive purchasing, however. If managers can define the strategic possibilities broadly, they'll have alternative paths to consider. When a management team gets mentally locked into a particular path, and an investment banker keeps stressing the "scarcity value" of a transaction, the acquiring company's shareholders are probably due for some indigestion.

Just as problematic are acquisitions made to compensate for poor performance in a company's existing operations. There are various ways of ministering to a faltering business, but buying another business usually isn't one of them. Perhaps this explains why there was so much resistance to Hewlett-Packard's acquisition of Compaq. It clearly violated this rule. Another way to express this point is to say that you should expand from your strength, not your weakness.

Hunger can also warp the individual executive's judgment. That's why at Pitney Bowes we don't include potential acquisitions in any of our internal budgets or external financial commitments to Wall Street. Likewise, we generally don't include the execution of new acquisitions in our bonus incentives. We often set objectives to "consider" or "pursue" strategic transactions to keep our growth goals at the forefront of executives' minds. But we think that going further would make our "shoppers" hungry for revenue to an unhealthy degree.

The classic result of shopping while hungry is buyer's remorse, and avoiding it requires both analytical and emotional discipline. The first of these, implementing the right analytical tools and ensuring their correct use, is relatively straightforward. Less so is avoiding "deal fever" – a dangerous frame of mind that can infect an executive team when it has set its sights on a specific transaction. As a last line of defense, we subject acquisitions to two steps of review by people who were not personally involved in the earlier stages. Even

Doing Due Diligence

Every company in the midst of an acquisition performs a due diligence review to identify and eliminate major sources of potential risk before the transaction is closed. At the beginning of Pitney Bowes's acquisition program six years ago, this was yet another area about which we had much to learn. The good news is that the more you do, the more you know – and we have come far along the learning curve.

There is no shortcut for companies that are new to acquisitions. Nevertheless, I can offer some general advice.

First, start small, keep doing deals, and learn as much and as fast as you can.

Second, do not expect to get by with off-the-shelf checklists. There are plenty available, and having one provides a good starting point – but you must begin honing it immediately to fit your particular business profile and issues.

Third, use a consistent team to perform due diligence. Our team includes specific representatives from each of the corporate staff departments who work closely with our core corporate development people and the business unit sponsor. Over time, this team has developed and deployed an extensive checklist of queries to put to a target company (a sample section is shown here) and has become quite skilled at ensuring that we receive complete and accurate information in response.

Fourth, use what you discover in due diligence to guide the integration effort that follows the acquisition. When Pitney Bowes acquires a company, the completed checklist becomes the foundation of the integration plan. It highlights areas where the acquired company's way of doing things is different from ours or where weaknesses exist, allowing us to see what needs to be managed especially carefully.

Every Acquirer Needs Its Own Checklist

Pitney Bowes's homegrown checklist ensures that we collect needed information in 13 areas:

- Financial Information
- Corporate Data
- Products, R&D, and Manufacturing
- IT Infrastructure
- Distribution and Marketing
- Customers, Competition, and Markets
- Strategy
- Legal Information
- Environmental Matters
- Acquisition/Disposition
- Tax Matters
- Governmental Regulations and Certain Filings
- Other Information

The small excerpt below suggests the level of detail pursued in each area.

	Description	Date requested	Target comment
Done	**VI. CUSTOMERS, COMPETITION, AND MARKETS**		
	1. Key customers' relationship with company		
	a. As percentage of sales		
	b. By product area		
	c. By geographical area (if appropriate)		
	d. Contract terms		
	2. Listing of existing rental and service contracts showing revenue, costs, and profitability for all individual contracts		
	3. Copies of all significant customer-pricing amendments or correspondence		
	4. Overview of customer behavior (including anticipated shift in customer segments)		
	5. Main competitors		
	a. By product area		
	b. By geographical area		
	c. Estimated present and future market shares		
	d. Advantages/disadvantages by main competitor		
	6. Basis of competition (price, performance, service, quality, others)		
	7. Perceived future competitive threats		
	8. Detailed market overview, including:		
	a. Key success factors in the industry		
	b. Barriers to entry		
	c. Regulatory conditions		
	9. Perceived current industry trends and outlook		

if others have lost sight of the fact, our top executives and board of directors know we have the flexibility to say "no."

Living by the Rules

The five rules I've outlined have been critical to Pitney Bowes given that our approach resembles that used by private equity and venture capital firms. That is, we consider many more deals than we ever expect to complete. Winnowing down the possibilities to the best ones requires a solid framework. We could not succeed with our bottom-up approach, where acquisition proposals emanate from the business units, if we did not also have disciplined thinking – and consistent governance procedures – to ensure balance in our overall portfolio and progress toward the company's long-term goals.

Governance over acquisitions is closely managed and begins almost as soon as a business leader has an idea for a deal. The first step is for that executive to bring the idea to a committee that is led by our corporate development officer and made up of a small number of senior executives. Our role is analogous to a venture capital review committee's. At this early stage, the business sponsor does not distribute a lot of material. Instead, we get the "elevator speech" – the few statements that would answer an investor's first line of inquiry: Why are we doing this deal? What do we hope to get out of it? And why is Pitney Bowes the logical acquirer? Brevity is required because in a two-hour meeting, our executive committee may review as many as ten candidates. Some will get a green light for further pursuit. Most will not.

It may seem like a mistake to have such an informal screen so early in the process play such a crucial role in determining which opportunities enter our pipeline. But these rapid-fire reviews have strong benefits. Because the initial screen doesn't involve hundreds of staff hours of preparation, business unit leaders are encouraged to think broadly about possible deals. And the nature of the pitch gives the executive committee a reliable sense of whether the business unit leader is truly passionate about the opportunity.

The candidates that we choose to pursue further are subjected to more rigorous governance mechanisms as the stakes increase. What had been summarized in a few words is soon expanded to a handful of PowerPoint slides that offer more detail about the business rationale for and probable financial returns of an opportunity. The business unit sponsor then continues to update the group frequently at key stages, such as making formal contact with the target company, signing a nondisclosure agreement, performing due diligence, and preparing an offer.

Once a deal reaches the stage where we are ready to consider terms, we require preparation of a "decision memorandum." The format is consistent, with the major exception that different checklists are included for bolt-on than for platform acquisitions. Each memorandum covers the history of the transaction, its rationale and the synergy being sought, the integration plan, the implications for branding, and other important considerations. It also includes financial analyses that serve two major goals: to ensure that we know our point of indifference (the price beyond which we will walk away from the deal) and to show that the acquisition will create value for shareholders. After the finance committee of our board of directors reviews the memorandum, it is distributed to the full board.

It would be hard to overstate how important this memorandum is to our process. Far from being a perfunctory exercise, it is essential to disciplining our decision making. I've been amazed at how many elements of a deal that seemed clear in PowerPoint can fall apart when they're subjected to prose. In bullet-point format, the rationale for a deal might be summed up in a phrase, such as "cross-selling." But a memorandum demands clarity about exactly who is cross-selling what to whom – and how and why. What specific sales force are we talking about? Which customers would this apply to? Why would a customer want us to cross-sell?

Our thinking is never "How do we ram this through the board?"

It's important to note that directors are given ample time to read and reflect on this narrative document. Our thinking is never "How do we ram this through the board?" Quite the contrary: Many of our board members are very experienced in acquisitions, and we regard their thinking as one of our best process checks. I understand the other viewpoint – that opportunities often materialize that need quick decisions. But our view is that if fast action is required, the deal is probably not right for us. Flexibility to act fast can be seen as a virtue. But if it means less discipline, it's a vice.

The Process Continues

Whether or not the particular rules and procedures in this article are a perfect fit for other companies, the general lesson applies to all businesses: acquisitions should be managed as a process. That means mapping the complex chain of actions typically involved in an acquisition, paying attention to what can go right or wrong at different stages, standardizing effective approaches and tools, and continually improving on those approaches through closely observed tinkering. Like all business processes, this one can be documented, practiced, improved, and mastered.

Particularly for a serial buyer like Pitney Bowes, a process-based approach is vital. It has made us a smarter and more efficient buyer, encouraged our business unit leaders to be more disciplined about which companies get into our acquisition pipeline, and helped us walk away from deals that seemed tempting at the time but ultimately would have been disappointing. It has ensured that the transactions we end up completing are far more likely (although not guaranteed) to make strategic, business, and financial sense.

Business researchers will continue to debate whether organic growth is preferable to acquisition-fueled growth – and they will probably continue to come down on the side of the former. But perhaps that debate has been framed incorrectly. Our experience growing Pitney Bowes shows that the two approaches can be effective and complementary means for meeting strategic objectives. What makes a growth program successful is not strict adherence to one form or the other but mindful and superior execution of both. ⛉

Reprint R0709J
To order, see page 151.

Letters to the Editor

Scorched Earth: Will Environmental Risks in China Overwhelm Its Opportunities?

The dire descriptions of China's environmental health in Elizabeth Economy and Kenneth Lieberthal's article, "Scorched Earth: Will Environmental Risks in China Overwhelm Its Opportunities?" (June 2007), warrant further discussion. I've been acquainted with China for many decades and have logged several thousand miles of travel around North China over the past year. In my opinion, the authors are far from being some kind of "envirobashers" who malign China's "economic miracle." In fact, their observations and assessment strike me as moderate, if anything. The country's skies remain occluded with dense smog for weeks on end; there is widespread contamination of food with pesticides, chemical fertilizers, and other toxic substances; and many rivers, lakes, and estuaries have become so polluted that virtually nothing can live in them. Much of China certainly does seem to be headed toward near-unprecedented biological self-extinction.


Scorched Earth

Will Environmental Risks in China Overwhelm Its Opportunities?

by Elizabeth Economy and Kenneth Lieberthal

It is difficult to sound the environmental alarm, however, without appearing shrill, intemperate, extreme, and even anti-Chinese. Those who do so, therefore, often try to balance their pessimistic assessments with optimism, usually touting the many mitigation strategies now under way as signs of improvement. The problem is that, for every increment of mitigation, several more increments of industrial development occur as well – so despite all its efforts, China is constantly falling further behind.

Nevertheless, China does have a certain advantage. In the United States, municipal and state officials are more environmentally enlightened and activist than national leaders. In China, the situation is reversed: National leaders are far more enlightened than the provincial, county, and municipal authorities, who, as the authors point out, gain career advancement not on the basis of their environmental records but on their contributions to the nation's GDP. So, China may yet find the kind of top-down leadership necessary to bring about the environmental cleanup required to move the country forward.

Moreover, if leaders in Washington, DC, were to organize the United States' enormous entrepreneurial energy, muster its considerable technological

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know-how, put up substantial funds, and contribute technical and managerial skills for a major collaborative project with China, there is a good prospect that those efforts would be well received in Beijing.

Not only would such a move increase the chances of overcoming problems like global climate change, but Sino-U.S. relations might also end up on much friendlier and firmer footing – a beguiling dream of a rare win-win collaboration. In the meanwhile, all businesses should wake up to the fact that in a world that is falling in love with being "green," brand association with China has increasing downside risk.

Orville Schell
Arthur Ross Director
Center on U.S.-China Relations
Asia Society
New York

Yes, China has a pollution problem. Economy and Lieberthal join a long line of experts who lay out the facts of China's daunting and increasingly urgent challenge to strike a better balance between economic growth, reforms, and environmental degradation. The stakes are obviously huge – not only for China but for everyone on the planet.

Missing in their analysis is why. Why has China pursued such a pollution-intensive growth path? I suspect the answer to that question will have direct implications for determining what steps China must now take to realign its growth priorities with environmental imperatives.

An important part of that answer undoubtedly lies in the extremely unbalanced character of Chinese economic growth. Exports and fixed investment now collectively make up more than 80% of China's GDP. Economically, this concentration is unsustainable because it threatens the twin possibilities of a deflationary overhang of excess capacity and a protectionist backlash to open-ended exports. And it is unsustainable environmentally because it entails a growth model dominated by industrial production, which has a natural bias toward excess energy consumption and outsize levels of pollution.

The latest data put China's industrial sector at around 52% of its GDP, well in excess of the 32% average of developed economies and considerably higher than the 37% average of the developing world's low- and middle-income countries. Given the energy and carbon intensity of industrial activity, this underscores the existence of a structural pollution problem that is an important outgrowth of the seemingly chronic imbalances in the Chinese economy.

Coal is an added complication, one whose adverse environmental implications are well known. According to the *Stern Review,* the CO_2 emissions of coal per unit of energy generation are twice as much as those associated with natural gas and about 50% more than those generated by oil-burning technologies. China is in a league of its own in this respect: Coal-driven power accounted for fully 79% of total Chinese electricity generated in 2003, eight percentage points higher than in 1990 and essentially double the 40% share of coal-powered electricity for the world as a whole.

China has a rare and important opportunity to kill two birds with one stone. Successfully rebalancing the Chinese economy by moving away from excess reliance on investment and exports and embracing more of a proconsumption growth model would be a huge plus in dealing with both economic and environmental issues – though it should not be seen as a substitute for major environmental policy initiatives. The latest statements from official Beijing are encouraging. Premier Wen Jiabao's March 2007 government work report to the National People's Congress strongly endorsed a strategy of macro rebalancing, energy conservation, and environmental remediation.

I agree with Economy and Lieberthal that the time for action is at hand. Macro rebalancing could go a long way as a remedy for China's structural pollution problem.

Stephen S. Roach
Chief Economist
Morgan Stanley
New York

Economy and Lieberthal paint a bleak, but fundamentally accurate, picture of the environmental situation in China. While they provide a very useful set of recommendations for what corporations can do to mitigate environmental risk in China, they do not give much attention to a key strategy that would allow multinationals to substantially reduce costs, earn goodwill with the Chinese government, help decrease the massive amounts of pollution that choke China's cities and villages, and diminish the risks posed by climate change: pursuing energy efficiency.

Energy efficiency is not a new idea, and it remains the cheapest, fastest, and cleanest energy resource around, bar none. The savings are substantial. In California, for example, energy efficiency programs have helped achieve stable per capita electricity use over the past 30 years, even as the state's economy has grown by 40%. At, say, a midsize Chinese steel mill, energy efficiency could save the equivalent of tens of millions of U.S. dollars in electricity bills alone each year.

These are the kinds of numbers that Chinese officials are eager to achieve. China recently instituted an ambitious five-year target to reduce its energy intensity by 20% before 2010. Most Chinese jurisdictions missed their interim targets for 2006, so multinationals that bring in the technology and know-how to maximize energy efficiency will earn substantial goodwill from Chinese officials working to achieve future benchmarks. What's more, if a multinational required all its suppliers in China to employ state-of-the-art energy efficient technologies as well, it could negotiate more-favorable pricing, enhance its own profits, and burnish its reputation as an environmentally friendly company – all while suppliers save on energy costs.

A variety of new programs are now essentially putting free money on the table for implementing energy efficiency upgrades. Premier Wen Jiabao recently cited as a national model a pilot project (coordinated by the National Resources Defense Council with Jiangsu province) for providing financial incentives for energy efficiency upgrades in China, and the government is now preparing to make these financial incentives available nationwide. Other programs, such as the United States and China's Pollution Prevention and Energy Efficiency (P2E2) program, based in Hong Kong, essentially allow companies to make energy efficient improvements for free. Third-party environmental and energy service companies pay for all the up-front retrofitting costs by taking out bank loans that are partially guaranteed under the program. Loan payments are then made from the subsequent energy savings.

To top it all off, the environmental benefits would be substantial. A nationwide California-style incentive system for energy efficiency in China, coupled with the implementation of existing building and equipment standards, could avoid the construction of 530 to 730 coal-fired power plants over the next decade, reducing sulfur dioxide emissions by up to 150 million metric tons; nitrogen oxide emissions by up to 5 million metric tons; and, perhaps most important in these increasingly carbon-constrained times, carbon dioxide emissions by up to 11 billion metric tons.

Alex L. Wang
Attorney
Natural Resources Defense Council
Beijing

A Buyer's Guide to the Innovation Bazaar

In "A Buyer's Guide to the Innovation Bazaar" (June 2007), Satish Nambisan and Mohanbir Sawhney describe very well how companies can take a middle-of-the-road, strategic approach to innovation that focuses on the innovation capitalist as intermediary. They also offer a good framework to adopt in the process. ICs require a sophisticated understanding of the target companies' needs and capabilities, along with expertise in the management and reasonable allocation of intellectual property rights. Companies considering this approach need to focus on the ICs, building and nurturing long-term, trusting relationships with selected firms.

Given this, it's important to understand more about how the relationship between an IC and a company would be structured and how it would work. Can an IC maintain sustainable relationships with two or more competing companies? If yes, then how? If no, would this not reduce the number of target companies that the IC can hope to do business with, especially if it is concentrating on a specific industry? On the other hand, would a company feel comfortable working with an IC that has similar relationships with its competitors? What should be the nature of the contracts in such a case, and what should companies keep in mind while drafting those contracts? The authors have offered some tactical ways of managing the relationship, but, strategically speaking, what linkage mechanisms should companies and ICs adopt?

The article also suggests that consumer product companies looking for more options and flexibility move to the middle of the continuum. Would that type of a business model be feasible and widely accepted, especially in highly competitive industries? And do the current patent and IP laws support it?

Lokin Chemburkar
Solutions Architect, Manufacturing Domain
Patni Computer Systems
Mumbai

Nambisan and Sawhney respond: It is possible and desirable for innovation capitalists to maintain an "open architecture" approach with multiple clients.

Even clients that are competitors may have differing gaps in their portfolios and hence differing needs and priorities for acquiring new products or technologies. Therefore, it is natural for IC firms to shop around promising concepts to several potential buyers. That said, prudent IC firms will limit the number of relationships so they can acquire deep knowledge about their clients and gain their trust. In some cases, IC firms may offer a few marquee clients a right of first refusal, a weaker form of exclusivity that guarantees those clients will get first crack at a concept but also allows the firms to propose the concept to other prospects.

To achieve this delicate balance, IC firms should emphasize mechanisms that promote openness and trust. Contracts and formal agreements can foster transparency and commitment to sharing information. Because external innovation-sourcing contexts are rather unpredictable, however, mechanisms that facilitate trusting relationships between IC firms and clients – such as the "reverse flow" model we described in our article – are even more important.

We do believe that a move to the middle is desirable for most consumer product companies. Whether such a shift is feasible will depend on the number and the quality of innovation intermediaries. Since more and more IC firms are developing successful track records, we hope that companies will find balancing their innovation-sourcing portfolios easier and easier.

Finding Your Next Core Business

For many years we have heard calls for firms to focus on core competencies and, consequently, to divest or outsource everything not distinctive to their organizations.

In "Finding Your Next Core Business" (April 2007), Chris Zook suggests that the future of an organization is likely to be found in noncore businesses, unrecognized segments, noncore capabilities, and their kin.

I would agree but feel somewhat dismayed for those who have divested and outsourced in order to maximize short- and mid-term profits and so have little or no cushion when their core business begins to fail. Having some fat in the organization would seem a prerequisite for survival.

Dan McAran
Product Manager
Do Process Software
Toronto

Zook responds: I agree with Dan McAran that many companies run the risk of hollowing themselves out by outsourcing important, though noncore, capabilities that prove in later years to be critical for success or for accessing new pools of profit. Imagine if IBM had outsourced its services capability,

GE had outsourced the leasing business that became GE Capital, or Apple had outsourced software applications development.

On the other hand (as my recent book, *Unstoppable,* attests), I do not advise collecting and retaining weak or noncore assets. Rather, I note how often capabilities and assets that were created by a strong core business – but that were not absolutely central to the past strategy – become the linchpin or inspiration for the next-generation business model and a new wave of profitable growth.

I am sure that many companies outsourcing important functions too hastily today will find that they have accidentally sold tomorrow's crown jewels at a discount.

Inner Work Life: Understanding the Subtext of Business Performance

Crossing the ideas in Teresa M. Amabile and Steven J. Kramer's article, "Inner Work Life: Understanding the Subtext of Business Performance" (May 2007), with the work on happiness by Harvard University's Tal Ben-Shahar produces some useful ways to think about how to manage with a human touch. The core premise is that happiness is good and that people find happiness at work in some combination of doing good for others, doing good for themselves, and doing things they are good at.

Many who seek meaning in their work want to make an impact on others and do things that match their personal values. They try to protect this meaning by helping to shape the destinies of their organizations – not so much by making all the decisions but by being able to influence them and by staying informed.

Most people derive happiness from near-term pleasure, which comes from doing activities that are enjoyable in their own right and that fit with their life interests. Compensation, whether monetary or nonmonetary (such as recognition and respect), can also contribute to their satisfaction.

Finally, everyone finds it easier to do work they are good at – that is, work activities that successfully match their strengths and resources. Over the longer term, people value employability created by learning, development, and delivering results that build their résumés. Understanding these motivators makes it easier for leaders to enable others both to do good work and to derive happiness from that work.

George Bradt
Managing Director
PrimeGenesis
Stamford, Connecticut

Executive Summaries

SEPTEMBER 2007

> Times have changed... and the glass ceiling metaphor is now more wrong than right.
> –page 62

HUMAN RESOURCES

62 | Women and the Labyrinth of Leadership

Alice H. Eagly and Linda L. Carli

Two decades ago, people began using the "glass ceiling" catchphrase to describe organizations' failure to promote women into top leadership roles. Eagly and Carli, of Northwestern University and Wellesley College, argue in this article (based on a forthcoming book from Harvard Business School Press) that the metaphor has outlived its usefulness. In fact, it leads managers to overlook interventions that would attack the problem at its roots, wherever it occurs. A labyrinth is a more fitting image to help organizations understand and address the obstacles to women's progress.

Rather than depicting just one absolute barrier at the penultimate stage of a distinguished career, a labyrinth conveys the complexity and variety of challenges that can appear along the way. Passage through a labyrinth requires persistence, awareness of one's progress, and a careful analysis of the puzzles that lie ahead. Routes to the center exist but are full of twists and turns, both expected and unexpected.

Vestiges of prejudice against women, issues of leadership style and authenticity, and family responsibilities are just a few of the challenges. For instance, married mothers now devote even more time to primary child care per week than they did in earlier generations (12.9 hours of close interaction versus 10.6), despite the fact that fathers, too, put in a lot more hours than they used to (6.5 versus 2.6). Pressures for intensive parenting and the increasing demands of most high-level careers have left women with very little time to socialize with colleagues and build professional networks – that is, to accumulate the social capital that is essential to managers who want to move up.

The remedies proposed – such as changing the long-hours culture, using open-recruitment tools, and preparing women for line management with appropriately demanding assignments – are wide ranging, but together they have a chance of achieving leadership equity in our time.

Reprint R0709C; HBR Article Collection "Required Reading for Executive Women – and the Companies Who Need Them, 2nd Edition" 2489

FORETHOUGHT

18 | Performing a Project *Pre*mortem

Gary Klein

In a premortem, team members assume that the project they are planning has just failed – as so many do – and then generate plausible reasons for its demise. Those with reservations may speak freely at the outset, so that the project can be improved rather than autopsied. **Reprint F0709A**

How to Teach Pride in "Dirty Work"

Employees in stigmatized occupations can be helped with an array of techniques to cope with or even feel proud of their jobs, including developing an occupational ideology to confer a more positive image on the work; creating social buffers such as professional associations; and avoiding specifics in conversation with outsiders. **Reprint F0709B**

Beware of Bad Microcredit

Steve Beck and Tim Ogden

Failing to reduce poverty by supporting the wrong microcredit program can tarnish a company's good name. Executives in charge of corporate social responsibility should insist on clearly defined measures of success, invest in improving microcredit's effectiveness, and support the growth of small companies in regions of poverty. **Reprint F0709C**

Charge What Your Products Are Worth

Venkatesh Bala and Jason Green

For customers, value has two components: benefits received and price paid. After gauging their customers' perceptions of value, managers can plot a simple chart that reveals any misalignment and use it to balance the benefit-price equation. **Reprint F0709D**

Sports Sponsorship to Rally the Home Team

Francis J. Farrelly and Stephen A. Greyser

Companies are beginning to use their brand-enhancing sponsorship of teams and events internally, to motivate employees or facilitate major structural change. Sports-related communications and incentives can create cohesion and foster pride in the company. **Reprint F0709E**

Conversation

Chris Van Dyke, the CEO of the outdoor apparel start-up Nau, offers some intriguing ideas about how to engage a generation of customers who are comfortable shopping online and eager to enter into a dialogue with the companies they buy from. **Reprint F0709F**

The Wisdom of (Expert) Crowds

Robert S. Duboff

The Delphi technique involves recruiting panels of experts from a variety of fields and asking them to iteratively evaluate predictions about the future of, say, an emerging innovation until they reach consensus. Shaping the strongest predictions into several possible scenarios prepares managers to act quickly when one begins to unfold. **Reprint F0709G**

CEOs Misperceive Top Teams' Performance

Richard M. Rosen and Fred Adair

CEOs tend to have a rosier view of senior management's performance than other top team members do, according to new research – and it looks like the former need a reality check. The authors offer three simple questions that can provide one. **Reprint F0709H**

Innovate Faster by Melding Design and Strategy

Ravi Chhatpar

If designers are brought into the innovation process at the very beginning, they can test prototypes and share users' responses even as the business case is being developed, enabling companies to nimbly adjust to changes in market opportunities. **Reprint F0709J**

Reviews

Featuring *Revolt in the Boardroom: The New Rules of Power in Corporate America*, by Alan Murray.

HBR CASE STUDY

37 | Boss, I Think Someone Stole Our Customer Data

Eric McNulty

Flayton Electronics is showing up as a common point of purchase for a large number of fraudulent credit card transactions. It's not clear how responsible the company and its less than airtight systems are for the apparent data breach. Law enforcement wants Flayton's to stay mute for now, but customers have come to respect this firm for its straight talk and square deals. A hard-earned reputation is at stake, and the path to preserving it is difficult to see. Four experts comment on this fictional case study.

James E. Lee, of ChoicePoint, offers lessons from his firm's experience with a large-scale fraud scheme. He advises early and frank external and internal communications, elimination of security weaknesses, and development of a brand-restoration strategy.

Bill Boni, of Motorola, stresses prevention: comprehensive risk management for data, full compliance with payment card industry standards, and putting digital experts on staff. For the inadequately prepared Flayton's, he suggests consulting an established model response plan and making preservation of the firm's reputation its top priority.

John Philip Coghlan, formerly of Visa USA, discusses the often-divergent positions of data-breach stakeholders and puts customers' interests first. Swift disclosure by Flayton's, he argues, would empower consumers to protect themselves against further fraud and might even enhance the company's reputation for honesty.

Jay Foley, of the Identity Theft Resource Center, recommends that Flayton's emphasize quality of communication over speed of delivery. More broadly, he advocates cautious management to prevent data thefts, which are proliferating and could have long-term consequences.

Reprint R0709A
Reprint Case only R0709X
Reprint Commentary only R0709Z

PERFORMANCE MEASUREMENT

53 | The Strategic Secret of Private Equity

Felix Barber and Michael Goold

The huge sums that private equity firms make on their investments evoke admiration and envy. Typically, these returns are attributed to the firms' aggressive use of debt, concentration on cash flow and margins, freedom from public company regulations, and hefty incentives for operating managers. But the fundamental reason for private equity's success is the strategy of buying to sell – one rarely employed by public companies, which, in pursuit of synergies, usually buy to keep.

The chief advantage of buying to sell is simple but often overlooked, explain Barber and Goold, directors of the Ashridge Strategic Management Centre. Private equity's sweet spot is acquisitions that have been undermanaged or undervalued, where there's a onetime opportunity to increase a business's value. Once that gain has been realized, private equity firms sell for a maximum return. A corporate acquirer, in contrast, will dilute its return by hanging on to the business after the growth in value tapers off.

Public companies that compete in this space can offer investors better returns than private equity firms do. (After all, a public company wouldn't deduct the 30% that funds take out of gross profits.) Corporations have two options: (1) to copy private equity's model, as investment companies Wendel and Eurazeo have done with dramatic success, or (2) to take a flexible approach, holding businesses for as long as they can add value as owners. The latter would give companies an advantage over funds, which must liquidate within a preset time – potentially leaving money on the table.

Both options present public companies with challenges, including U.S. capital-gains taxes and a dearth of investment management skills. But the greatest barrier may be public companies' aversion to exiting a healthy business and their inability to see it the way private equity firms do – as the culmination of a successful transformation, not a strategic error.

Reprint R0709B

NEGOTIATION

72 | Investigative Negotiation

Deepak Malhotra and Max H. Bazerman

Negotiators often fail to achieve results because they channel too much effort into selling their own position and too little into understanding the other party's perspective. To get the best deal – or, sometimes, any deal at all – negotiators need to think like detectives, digging for information about *why* the other side wants what it does. This investigative approach entails a mind-set and a methodology, say Harvard Business School professors Malhotra and Bazerman.

Inaccurate assumptions about the other side's motivations can lead negotiators to propose solutions to the wrong problems, needlessly give away value, or derail deals altogether. Consider, for example, the pharmaceutical company that deadlocked with a supplier over the issue of exclusivity in an ingredient purchase. Believing it was a ploy to raise the price, the drugmaker upped its offer – unsuccessfully. In fact, the supplier was balking because a relative's company needed a small amount of the ingredient to make a local product. Once the real motivation surfaced, a compromise quickly followed.

Understanding the other side's motives and goals is the first principle of investigative negotiation. The second is to figure out what constraints the other party faces. Often when your counterpart's behavior appears unreasonable, his hands are tied somehow, and you can reach agreement by helping overcome those limitations. The third is to view onerous demands as a window into what the other party prizes most – and use that information to create opportunities. The fourth is to look for common ground; even fierce competitors may have complementary interests that lead to creative agreements. Finally, if a deal appears lost, stay at the table and keep trying to learn more. Even if you don't win, you can gain insights into a customer's future needs, the interests of similar customers, or the strategies of competitors.

Reprint R0709D; HBR Article Collection "Nuts and Bolts Negotiation" 2486

STRATEGY & COMPETITION

80 | The Battle for China's Good-Enough Market

Orit Gadiesh, Philip Leung, and Till Vestring

A critical new battleground is emerging in China: It's the "good-enough" market segment – home of reliable-enough products at low-enough prices to attract the cream of the country's fast-growing cohort of midlevel consumers.

Traditionally, foreign multinationals have dominated China's premium segment, while a plethora of domestic companies have served the low end, often unprofitably. But as middle-class buying power increases, and the tolerance for high markups at the top end wanes, the middle market is growing quickly.

Thriving in a market so big is clearly important in itself. But, argue Bain chairman Gadiesh and Bain partners Leung and Vestring, competition in this particular arena has more far-reaching implications. Companies that flourish in China's middle market today are learning valuable lessons they need to compete worldwide: Multinationals are discovering how to focus products downscale to break out of the premium tier, and domestic firms are building scale and marketing expertise to move up. Both are positioning themselves to export their China offerings to other large emerging markets such as India and Brazil – and, after that, to the developed markets. Ultimately, the authors warn, the good-enough space, where multinationals and Chinese firms are going head-to-head, is the one from which the world's leading companies will emerge.

The authors describe three strategies for entering and prevailing in this strategically vital space. Multinationals can attack domestic players from above, Chinese firms operating in the low end can burrow up from below, and both can acquire their way into it. The experiences of such players as Colgate-Palmolive, GM, GE, Huawei Technologies, Haier, and Ningbo Bird show how challenging it is to gain a foothold in the middle market but also how much potential there is to use it as a springboard for global expansion.

Reprint R0709E; HBR Article Collection "Doing Business in China" 2487

LEADERSHIP

92 | The Tests of a Prince

Ivan Lansberg

When a CEO takes office, stakeholders dissect his or her intellectual, physical, and emotional capacities as they try to gauge whether the new leader will help them fulfill their aspirations and protect them from trouble. For the heir to a family business, the challenge of turning stakeholders into followers is particularly thorny: He or she must manage many constituencies – family members, directors, senior executives, investors, trade unions – that may not be convinced the successor has earned the right to hold the top spot. Making matters worse, says Lansberg, a family business expert, corporate scions usually ignore or greatly underestimate stakeholders. They don't realize that, particularly after they are formally anointed as CEOs, they must establish their credibility with and authority over these spheres of influence.

Smart CEOs understand that their success depends on how well they respond to the *iterative testing process* that stakeholders use to make judgments about would-be leaders. This article offers a road map for managing the four kinds of tests that constitute iterative testing: *Qualifying* tests are assessments based on criteria – such as formal education, work experience, and professional awards – that executives can cite as evidence of suitability for the top job. *Self-imposed* tests are expectations that leaders themselves set and against which they assume stakeholders will measure their performance. *Circumstantial* tests are unplanned challenges or crises, during which stakeholders can observe the leader coping with the unexpected. And *political* tests are challenges from rivals who want to enhance their own influence, often by undermining the leader.

Reprint R0709F

| SALES |

102 | Managing Global Accounts

George S. Yip and Audrey J.M. Bink

Global account management – which treats a multinational customer's operations as one integrated account, with coherent terms for pricing, product specifications, and service – has proliferated over the past decade. Yet according to the authors' research, only about a third of the suppliers that have offered GAM are pleased with the results.

The unhappy majority may be suffering from confusion about when, how, and to whom to provide it. Yip, the director of research and innovation at Capgemini, and Bink, the head of marketing communications at Uxbridge College, have found that GAM can improve customer satisfaction by 20% or more and can raise both profits and revenues by at least 15% within just a few years of its introduction. They provide guidelines to help companies achieve similar results.

The first steps are determining whether your products or services are appropriate for GAM, whether your customers want such a program, whether those customers are crucial to your strategy, and how GAM might affect your competitive advantage.

If moving forward makes sense, the authors' exhibit, "A Scorecard for Selecting Global Accounts," can help you target the right customers. The final step is deciding which of three basic forms to offer: *coordination GAM* (in which national operations remain relatively strong), *control GAM* (in which the global operation and the national operations are fairly balanced), and *separate GAM* (in which a new business unit has total responsibility for global accounts). Given the difficulty and expense of providing multiple varieties, the vast majority of companies should initially customize just one – and they should be careful not to start with a choice that is too ambitious for either themselves or their customers to handle.

Reprint R0709G

| OPERATIONS |

116 | Are You the Weakest Link in Your Company's Supply Chain?

Reuben E. Slone, John T. Mentzer, and J. Paul Dittmann

Supply chain management is a competitive differentiator for many types of businesses, and CEOs who neglect it may be putting their firms in jeopardy. So say Slone, the executive vice president of supply chain at OfficeMax, and two of his colleagues at the University of Tennessee. The authors identify key areas where CEOs can influence their supply chains and show them how to assess the influence they currently exert.

Good SCM starts with finding the right people to lead a company's supply chain operation, from the most senior on down the ranks. CEOs need to participate in hiring a top-notch supply team that will use customer-focused metrics and best-practice benchmarking to bring about cross-functional alignment and achieve efficiencies, which the CEOs should personally review. Articulating the strategies to reach those goals – including effective use of supply chain technologies – and rewarding the employees, suppliers, and customers who make positive contributions are part and parcel of SCM success.

Sales and operations planning is an essential component of SCM. A well-devised S&OP process can eliminate cross-functional disconnects and thereby reduce product complexity and obsolete inventory – two serious threats to the supply chain. This approach should also extend to business planning, promotional programs, and customer-contract negotiations, with their inherent supply chain ramifications.

Even the best supply chain planning can be undermined, however, if its scope is only short-term. For example, sales strategies that don't align monthly and quarterly goals with long-term SCM objectives can lead to end-of-period surges, with potentially costly consequences for your company and its suppliers, partners, and customers. Attention to the supply chain requires attention to the long haul.

Reprint R0709H

| MERGERS & ACQUISITIONS |

129 | Rules to Acquire By

Bruce Nolop

When Bruce Nolop was an investment banker, he saw only the glamorous side of acquisitions. Since becoming executive vice president and chief financial officer of Pitney Bowes, however, he's learned how hard it is to pull them off. In this article, he shares the lessons his organization has learned throughout its successful six-year acquisition campaign, which comprised more than 70 deals: Stick to adjacent spaces, take a portfolio approach, have a business sponsor, know how to judge an acquisition, and don't shop when you're hungry.

Pitney Bowes's management and board of directors now use these five basic rules to chart the company's growth course. For example, when evaluating a potential acquisition, Pitney Bowes distinguishes between "platform" and "bolt-on" acquisitions to set expectations and guide integration efforts; the company applies different criteria, depending on the type.

According to Nolop, any company can improve its acquisition track record if it is able to learn from experience, and he suspects that Pitney Bowes's rules apply just as well to other organizations. Buying a company should be treated like any other business process, he maintains. It should be approached deliberately and reviewed and improved constantly. That means mapping a complex chain of actions; paying attention to what can go right or wrong at different stages; and using standard, constantly honed, approaches and tools.

Reprint R0709J

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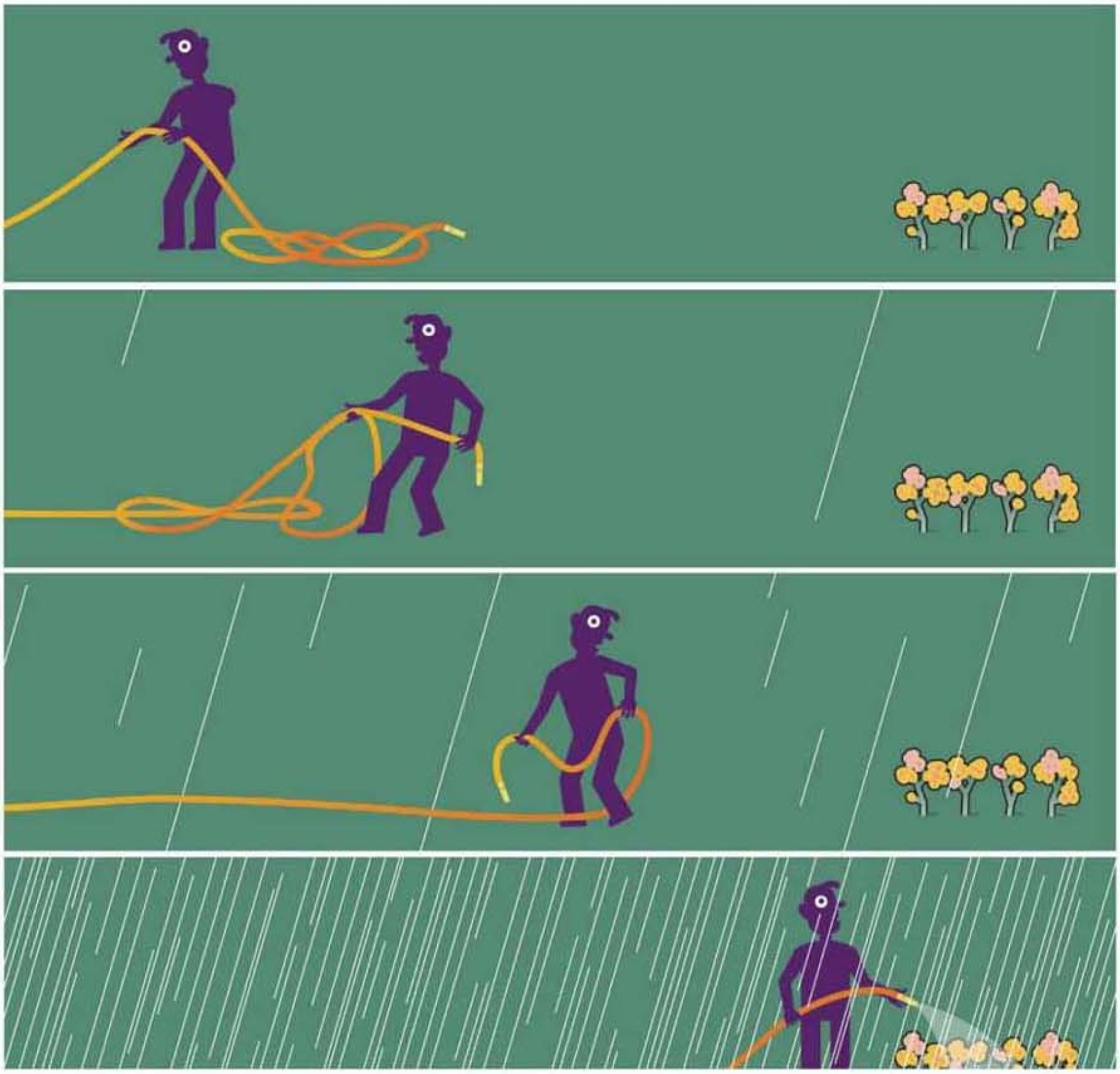

Worth Doing

PETER DRUCKER once warned that there's "surely nothing quite so useless as doing with great efficiency what should not be done at all." Just because you *can* improve your operations, he argued in "Managing for Business Effectiveness" (HBR May–June 1963), doesn't mean that you should.

In *The Process Edge*, Peter Keen writes about the very real dangers of improving the wrong processes. He warns that in many cases "even dramatic levels of process improvement don't translate into better business performance." Keen stresses the importance of improving processes so that they produce new value someone will want to pay for.

To distinguish worthwhile initiatives from those that waste time and money, look for projects that are visible to customers, affect core capabilities, or differentiate you from competitors. Limit your investments in processes that are mandated and avoid altogether refining processes that simply perpetuate traditions. Above all, pay attention. Innovation can suddenly either make vital processes pointless or transform today's routine operation into tomorrow's customer-pleasing, profit-driving one.

Don Moyer can be reached at dmoyer@thoughtformdesign.com.