
THE NEW SPACE ERA

Leadership on the Front Lines...page 112

Harvard Business Review

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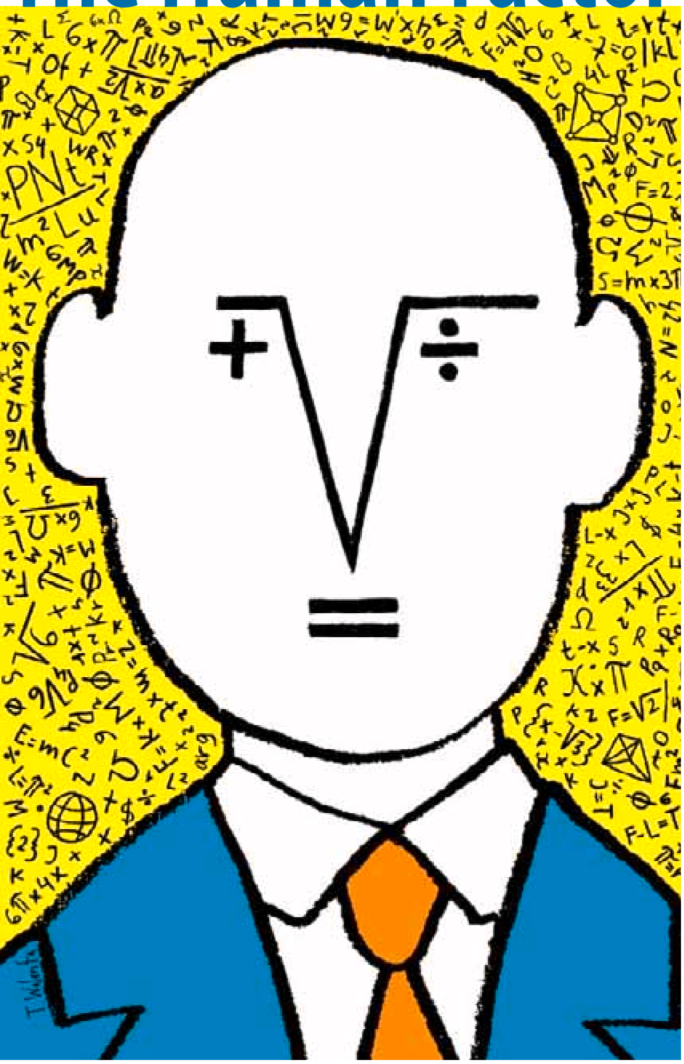
June 2005

The Human Factor



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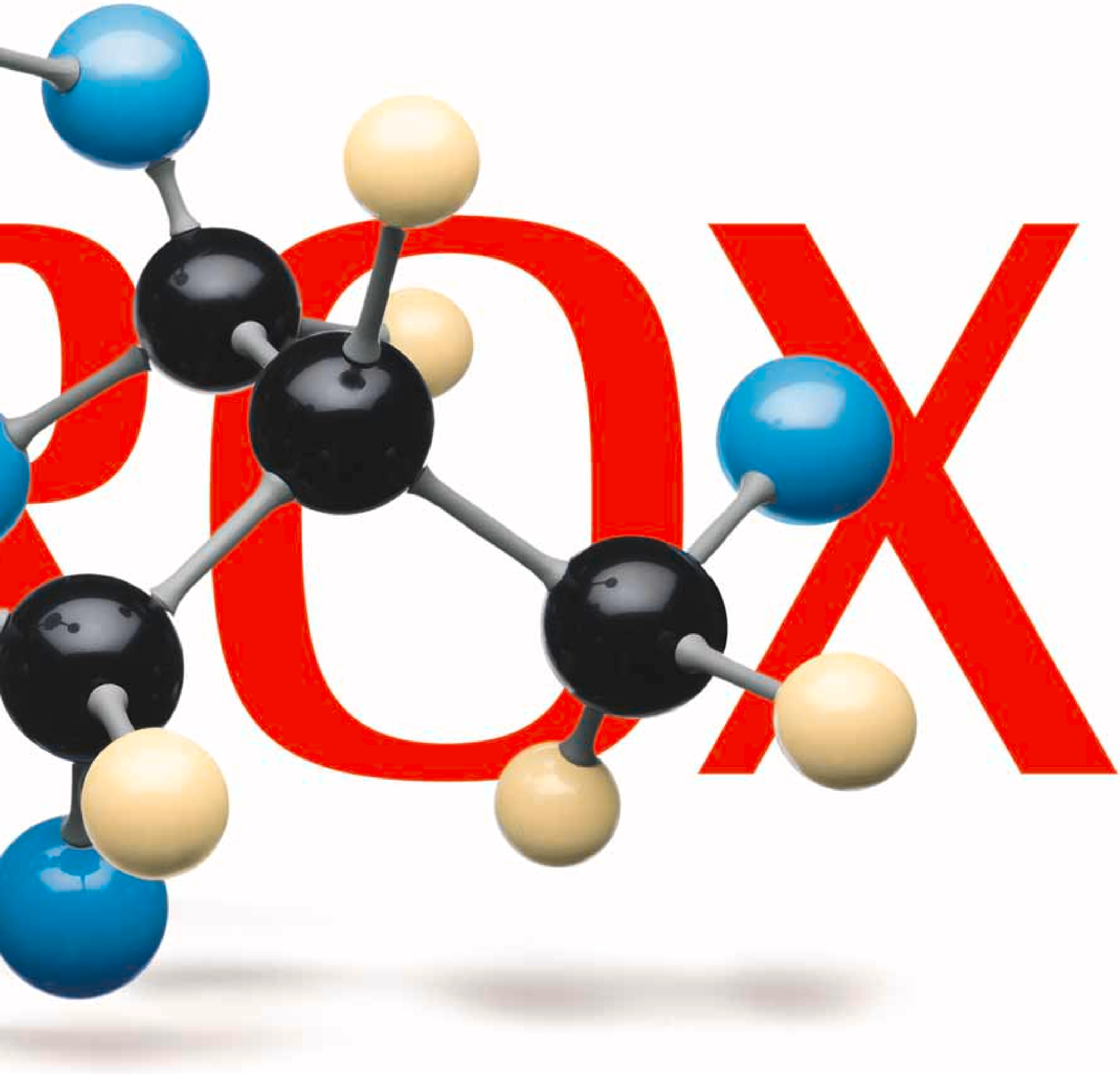

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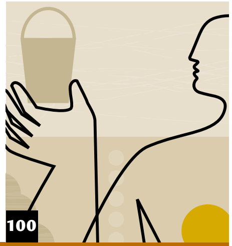
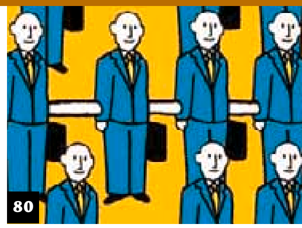
Features

June 2005





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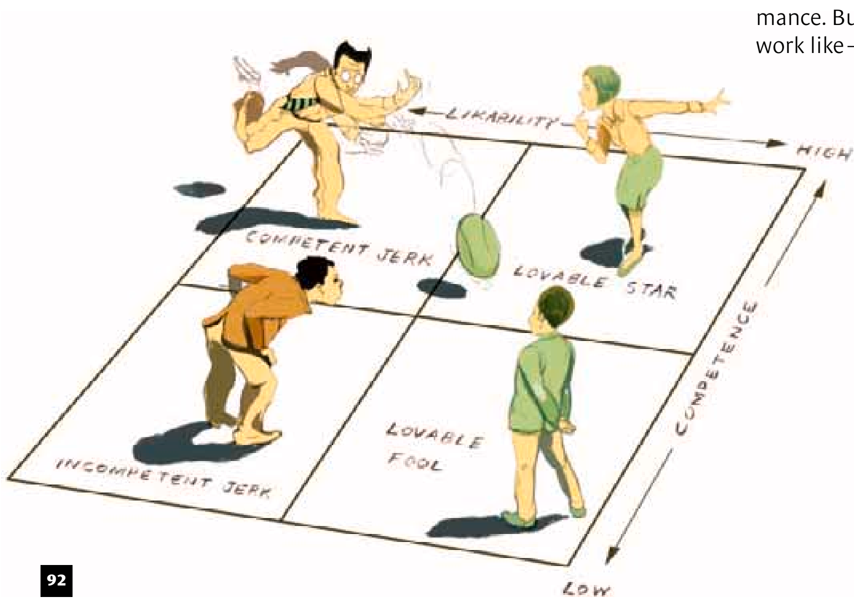

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DEPARTMENTS

June 2005

Risk and Reward in World Markets

HBR Spotlight

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Asking the Right Questions

Sometimes I find myself visualizing a business as though it were a big train. The engineer-CEO sits in the cab, wearing one of those hickory stripe railroad caps. The dials in front of him display the speed, pressure, temperature, and the like. At his hand are levers controlling the throttle, the brake, and so on, along with buzzers and phones to communicate with the crew. In a children's book, about which I remember everything except the title, there's a train that races from Kalamazoo to Timbuktu. Our family's favorite line, which we always chanted loudly whenever we came to it, was: "Slam! Bam! Grease the engine! Throw out the throttle and give it the gun!"

But – back to business – what if the engineer has the wrong set of instruments? What if the levers don't connect to anything? What if there's a steam pressure gauge, but the train has an electric motor? What if you have the skills and controls for a train but find yourself in the cockpit of an airplane?

Many managers partly and intuitively understand that the controls they have might not be right for their business. For example, they know it's not especially meaningful to measure the return on assets for a company like Microsoft, which has relatively few assets (apart from cash). They understand that economies of scale are a big deal in the automobile industry but that scale effects are markedly smaller in advertising, law, or hotel management. They know that some familiar levers seem irrelevant; they may complain, "The stock market doesn't understand us." They're less clear on why this is so and what they can do about it.

"The Surprising Economics of a 'People Business'" takes a revealing and useful look at this issue. Felix Barber and Rainer Strack, quantitatively minded partners at the Boston Consulting Group, have looked inside different kinds of firms to see which levers connect to which cams, gears, and other drivers. What they found is a whole (and very large) class of companies that look different on the outside but are very similar on the inside. These are *people businesses,* where capital costs are low compared to payroll and where there aren't a lot of activities aimed at creating value for the future, such as R&D. This might be true of an entire company or just one unit. IBM is a good example. The economics of its growing consulting and services business resemble those of an advertising agency like Omnicom or an oilfield services business like Schlumberger. IBM's hardware side, however, looks like Intel.

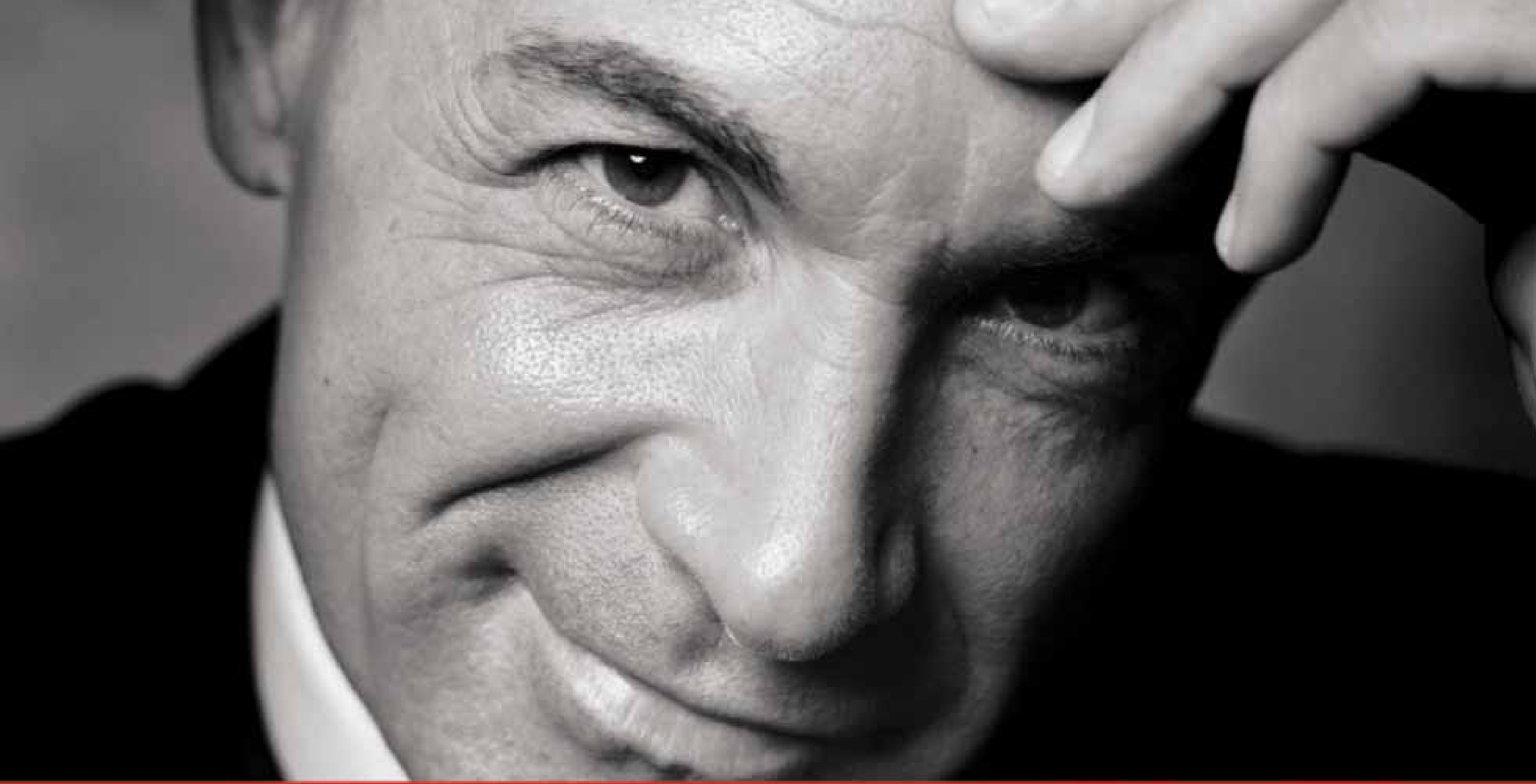
A rich stream of consequences flows from this insight and analysis. The most important have to do with making sure that a company's leaders are paying attention to the levers and gauges that are relevant to the business's performance. Take a gold standard measurement like Economic Value Added. EVA gives a picture of the true economic profit of a business by recognizing the cost of the capital employed in the business. EVA is the number that tells shareholders whether they're getting their money's worth. Executives should care about that and about something else: the steps they can take to increase EVA most effectively. Those steps are different for people-intensive shops than for capital-intensive ones.

I'm a little worried that I've made this all sound more technical than it is. In fact, Barber and Strack's article is full of implications for line managers, human resource executives, CFOs – and the engineer in the cab.

There's lots more in this issue, including a superb pair of articles that spotlight the strategic and operational risks of moving into new markets. I want to call your attention to one feature in particular: "Developing First-Level Leaders" by BP executive Andreas Priestland and Dialogos VP Robert Hanig. HBR devotes many pages to the issues senior managers face – how they develop, how they can lead more effectively, and so on. Research shows that first-level managers – those work-group supervisors on the front lines of the business – have an enormous effect on performance. "Developing First-Level Leaders" takes us inside a major company, BP, to show how it made big improvements in the training and performance of this important group. Make sure you read it.

Thomas A. Stewart

ROBERT MEGANCK



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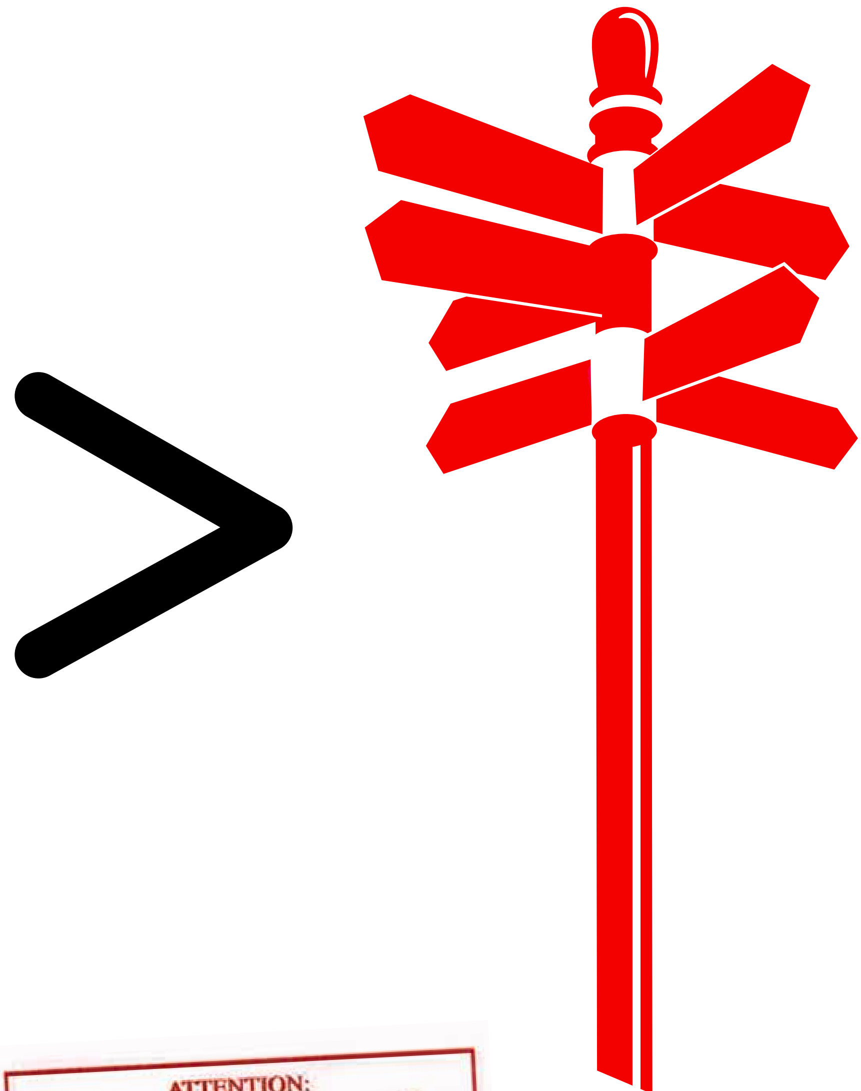

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A survey of ideas, trends, people, and practices on the business horizon.

SALLY WERN COMPORT

GRIST

The Eureka Myth

by HAROLD EVANS

Innovation, cast as the triumph of human imagination, may be the most romantic discipline in business. And the eureka moment, that epiphany of total clarity in which a breakthrough invention or discovery occurs, is the most romantic aspect of innovation. In fact, the eureka moment still looms so large in the folklore of business that it overshadows the historically far more important matter of how an invention reaches the marketplace as a practical innovation. As companies turn their sights anew to top-line growth, it is time to see the eureka moment – indeed the whole gestalt of "breakthrough thinking" – for what it is: largely a myth.

Admittedly, the eureka myth is seductive. Thomas Edison, who usually stressed that invention was the easy bit, forgot his own 1%-inspiration-to-99%-perspiration rule in describing to a newspaper reporter how the incandescent lightbulb came to him as a gift from the gods. The reporter wrote: "Sitting one night in his laboratory, Edison began abstractedly rolling between his fingers a piece of compressed lampblack mixed with tar for use in his telephone....His thoughts continued far away, his fingers meanwhile mechanically rolling over the little piece of tarred lampblack until it had become a slender filament." In fact, Edison's laboratory notebooks suggest that he had considered carbon early on but discarded it in favor of platinum because carbon burned up too quickly. It was a new prospect – evacuating most of the air from the bulb – that induced Edison to return to carbon.

The trouble with the eureka myth is that it causes managers and investors to overestimate the pace of invention and underestimate the fortitude required to move from the early stages of discovery to a marketable product. Thomas Watson, Jr., is one of the few who took – and took sustenance from – a more realistic view. In the 1950s, Watson struggled to move IBM from punched cards to computers, "something a hundred times faster that we didn't understand," he later wrote. What kept him going through this grueling process? He thought of the Wright brothers, moving doggedly from one problem to the next, "any one of which could have grounded them for good," as Watson told it. In the popular imagination, the Wright brothers' 1903 flight at Kitty Hawk kicked off the age of aviation. But as Watson, a wartime pilot, knew, it took four more years of hard, secretive labor before the Wrights were able to demonstrate flight that was sufficiently sustained to convince a skeptical world.

Some seemingly obvious innovations had much longer gestation periods. Malcolm McLean was a 24-year-old truck driver waiting for his cotton bales to be unloaded at a seaport when it occurred to him how much easier it would be just to drive the truck onto the ship. But it was 20 years before he transmuted the idea into container shipping. His *Ideal X* containership sailed from Port Newark, New Jersey, on April 26, 1956, effectively initiating globalization.

The eureka moment is a hugely attractive idea, full of drama. But the act of inventing and improving is far more often a long, hard slog. And the act of capitalizing on invention – of managing the transition from a brain wave to the bustle of the marketplace – is the really hard part.

So declare yourself an innovation company and celebrate creativity, by all means. Then treat your employees to a little seminar in business history that emphasizes real-life time frames and the numbing necessity of trial and error, trial and error, trial and error. The great business stories make wonderful fodder for such an education, but don't neglect your own archives. (How many of your employees know what labor went into producing and bringing to market your company's core products? Do you?) And if your innovators get discouraged, tell them about the inventor who tried 3,000 different materials – including cedar shavings, coconut hair, twine, fishing line,

HOW THEY DID IT

Outsourcing Integration *by* JANE C. LINDER

Postmerger integrations are tough. Generally, the acquirer puts the target's distinctive capabilities under its own management and then struggles to pull the two companies' operations together. Managers often end up plugging holes in dikes instead of focusing on the core business, and, when they finally emerge from this distraction, they often find that their customers have wandered off and competitors have moved in. It's no wonder that acquisitions so often destroy value.

If integration is so hard, why not outsource it? That's essentially what Hungary's MOL Group, a $7 billion energy company, did when it outsourced its finance and accounting, treasury, tax, and information technology processes in 2001. MOL plans to become a dominant player in consolidating the central European oil and gas industry. Outsourcing its support activities, says CFO Michel-Marc Delcommune, allows company managers to sidestep the distraction of aligning accounting systems and integrating staff during acquisitions and to stay focused on MOL's core operations and aggressive acquisition strategy. According to Delcommune, when MOL acquired full control of Slovnaft, a $2 billion Slovakian energy company, in 2004, the efficiency of the postmerger integration was palpable. Because the acquisition took place in two steps – MOL had bought 36% of Slovnaft and options for the rest in 2000 – the company had time to ready itself for the full merger on the horizon and deliberately delegate postmerger integration to its outsourcing provider.

This made all the difference, Delcommune says. To integrate Slovnaft, the management team assembled 26 task forces to address all the critical business processes, from how the company set wholesale prices to how it managed the supply chain. By contrast, MOL spent none of its management resources on integrating the back office.

It's hard to measure the value of efficient integration and undistracted management. But profits and revenues are easy to track. Between 2000 and 2003, MOL's sales doubled to $7.3 billion and its profits quintupled to $478 million; 2004 profits are expected to top $1 billion. Slovnaft turned its 2000 financial losses into a $400 million profit in 2004. That growth would have been hard to achieve, Delcommune says, if MOL had kept the back office in-house.

JANE C. LINDER *(jane.c.linder@accenture.com) is a director of research at the Accenture Institute for High Performance Business in Wellesley, Massachusetts. She is the author of* Outsourcing for Radical Change *(Amacom, 2004).* Reprint F0506B

bamboo, and cardboard – only two of which proved able to light the world: Thomas Edison.

SIR HAROLD EVANS *(harold371@aol.com) is the author of* They Made America: From the Steam Engine to the Search Engine: Two Centuries of Innovators *(Little, Brown, 2005) with researchers Gail Buckland and David Lefer.*

Reprint F0506A

ADVERTISING

New Laws of the Jingle

by LEIGH BUCHANAN

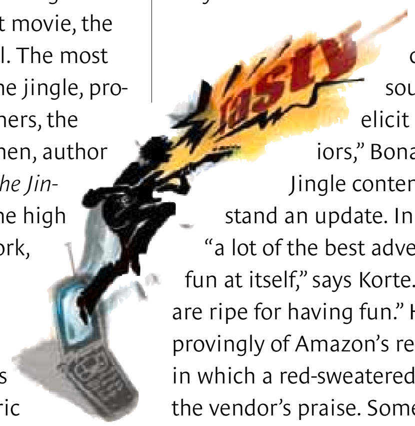
Cultural critics mourn the passing of any art form – be it the silent movie, the pinup, or the penny dreadful. The most recent subject of eulogy is the jingle, pronounced dead by, among others, the *Boston Globe* and Steve Karmen, author of the new book *Who Killed the Jingle?* Guilty parties include the high cost of recording original work, music companies eager to license popular songs, and a jaded public. "For most corporate advertisers, jingles are no longer viable," says Eric Korte, vice president and musical director of the advertising giant Saatchi & Saatchi. "Creatively, it's not on the cutting edge. It's considered old-fashioned."

Still, effective jingles perform a unique service: marrying the name of a product or company with a melody that clings to the mind like a burr. Marketers love the borrowed equity they get from popular songs – think Cadillac and Led Zeppelin, Microsoft and the Rolling Stones – but the connection isn't organic. The day will come when Lenny Kravitz sings about that little lady and consumers won't picture her in Gap jeans. And there's nothing stopping more than one company from licensing a single song. "I've heard 'Ain't No Mountain High Enough' used by three different advertisers at the same time," says Korte.

So is there life left in the jingle – or in the jingle reimagined for a new age?

The Internet is one obvious home for jingles: on a Web site or accompanying pop-up ads. A visitor to Duracell's site is greeted by the battery maker's signature three notes. Could other marketers achieve similar effects with slightly less minimalist ditties? "The best part of wakin' up," reads the message on Folgers' home page. Consumers mentally supply the tune, but the coffee company could do it for them.

Cell phones might also host jinglelike snippets, suggests Eric Bonabeau, chief scientific officer at Icosystem, a technology and strategy company. "Cell phones are ideal because simple stimuli are more acceptable there than on television, and jingles are relatively simple." And while piggybacking on popular tunes breeds positive associations, "marketers may be able to use new auditory display techniques to create specific sounds designed to elicit specific behaviors," Bonabeau says.



Jingle content, too, could stand an update. In the age of irony, "a lot of the best advertising pokes fun at itself," says Korte. "Jingle parodies are ripe for having fun." He speaks approvingly of Amazon's retro TV spots in which a red-sweatered chorus sings the vendor's praise. Some folks adored (though others hated) last year's Quiznos campaign featuring two bizarre koala-like creatures crooning, "We love the subs." Seth Stevenson, a writer for *Slate* who deconstructs advertising, praised the spot (and by extension the song) for educating consumers about the brand. "We're told that Quiznos subs are tasty, crunchy, warm, and toasted," Stevenson says. "We're introduced to the concept of the pepper bar."

"The spots that we remember through the years are the ones that sang to us about a product, or danced for us about the product, or entertained us musically about the product for 30 seconds," writes Steve Karmen. "Ask anyone over 30 what's in a Big Mac, and they will tell you…because it was sung."

So there may still be a role for jingles in marketing. Don't underestimate the appeal of simplicity in a complicated age.

LEIGH BUCHANAN *(lbuchanan@hbsp.harvard.edu) is a senior editor at HBR.*

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GOVERNANCE

Shareholder Votes for Sale

by LUH LUH LAN AND LOIZOS HERACLEOUS

Whatever you think of Carly Fiorina's management style, she is a shrewd tactician. In the acrimonious proxy battle surrounding the 2002 Hewlett-Packard–Compaq merger, the promerger group, headed by the former HP CEO, squeaked by the antimerger dissidents with less than a 1% margin. But before Fiorina's side could claim victory, the dissidents brought suit, accusing Fiorina's group of, among other things, buying votes to push the merger through.

Buying votes? It may be illegal in politics, but in the corporate arena, it is a legitimate, if controversial, strategic tool. In essence, to achieve a corporate goal, management can give cash, loans, or business opportunities to shareholders in exchange for the voting rights attached to their shares. Indeed, the promerger side in the HP-Compaq affair secured its hair-thin lead with the help of 17 million Deutsche Bank votes that HP management had allegedly bought from the bank. In a decision on the case, the judge addressed HP's vote buying, finding that it did not violate Delaware law governing corporate fiduciary duty. The judge also laid down guidelines that have important implications for managers and directors contemplating vote buying.

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Some background: The law states that stockholders have proprietary interests in the stock they have purchased, and neither the corporation nor anyone else can interfere with the exercise of those interests. The interests include the right to vote on mergers and acquisitions, sales of assets, and governance matters such as director elections. In the absence of fraud, shareholders can legally choose to separate their ownership and control over the shares so that they can continue to enjoy the economic benefits of owning the shares while relinquishing the voting rights attached to them.

This all makes legal sense, but, not surprisingly, vote buying is controversial because management can use it to push through unpopular transactions that a stockholder majority could otherwise thwart. Perhaps inevitably, vote-buying agreements can attract charges of unfair diversion of corporate assets, self-dealing, and board entrenchment, especially in takeovers, so they are frequently challenged in court.

To make effective and legitimate use of vote buying, and to head off lawsuits, managers would do well to follow a few basic principles:

First, managers should scrupulously act with the company's best interests in mind, even though vote buying is protected by the "business judgment rule," which says managers are presumed to have acted in good faith unless a claimant is able to prove that there was illegal behavior or a conflict of interest.

Second, management should ensure that the transaction does not defraud or disenfranchise any group of shareholders. Even though stockholders' voting rights are proprietary, courts will closely scrutinize vote buying in cases where a sale appears to violate the interests of shareholders.

Finally, management should build into the transaction protective measures to safeguard against the abuse of shareholders' rights. These measures would include, for example, forming a special committee with independent counsel to advise on the vote-buying agreement and related deals, and putting the agreements before a full board. In addition,

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Opinion

by LAURENCE PRUSAK

The Madness of Individuals

The popular success of Malcolm Gladwell's book *Blink* has refocused attention on the perennial issue of intuition versus reason. Rational decision making has been the dominant model since at least World War II, when the military's need for fast, accurate calculations gave rise to new tools for scientific decision making and fueled the rapid expansion of computing.

The spread of computing from government to the workplace led to the metaphor of the human brain as computer and the notion that the best decisions were driven by brute rationality. (Indeed, as a 12-year-old devotee of *Popular Electronics* in the 1950s, I built a "decision machine" with vacuum tubes that promised to enhance any decision.) Out of the coupling of society's emphasis on rationality and its growing interest in leadership emerged the image of the heroic leader making lonely decisions at the top, neither asking for nor receiving any help, with rationality as his guide (back then it was always "his").

This model, articulated or tacit, remains strong even today. But there have always been dissenters who challenged the idea that any one person can know enough to make optimal, or even reasonable, complex organizational decisions. The twentieth-century economist Friedrich von Hayek wrote several stinging critiques along these lines and advised that we depend on markets for smart decisions instead. In recent years, we have seen numerous examples of how the many, when informed, make better decisions than the individual – a concept celebrated by James Surowiecki in his book *The Wisdom of Crowds.* Consider the success of "whisper numbers," which often predict companies' future earnings better than individual analysts do. And does anyone doubt that Hewlett-Packard would be better off if a group of its senior executives had made a collective decision about whether to merge with Compaq? Cumbersome as that process might have been, the decision probably would have been better than the one reached by a single person.

If collective decisions are often demonstrably better than individual ones, why do we embrace the single-person, rational-actor model? I think the answer lies in evolutionary psychology. An instinctive faith in the reliability of hierarchical leadership is baked into our genes. A hundred thousand years ago, it surely made sense for a single leader to make command decisions for the group (put another way, cavemen who sought consensus as the wolves bore down probably got eaten). Back then, consuming lots of fat to stock up for a famine also made sense, as did the tendency to band together in tribes and stigmatize, if not kill, outsiders. Yet no one would say these measures are sound today, even if they're instinctive.

What worked for our Stone Age forebears doesn't work in the corporation today. It's time to acknowledge that it's impossible for any individual to make fully informed decisions about running vast entities like large firms and nations. Leaders do, of course, have a role to play – inspiring the troops, building teams, representing the organization. But when it comes to organizational decision making, maybe America's national motto, *E pluribus unum,* can be used to new effect: From many voices, one better decision.

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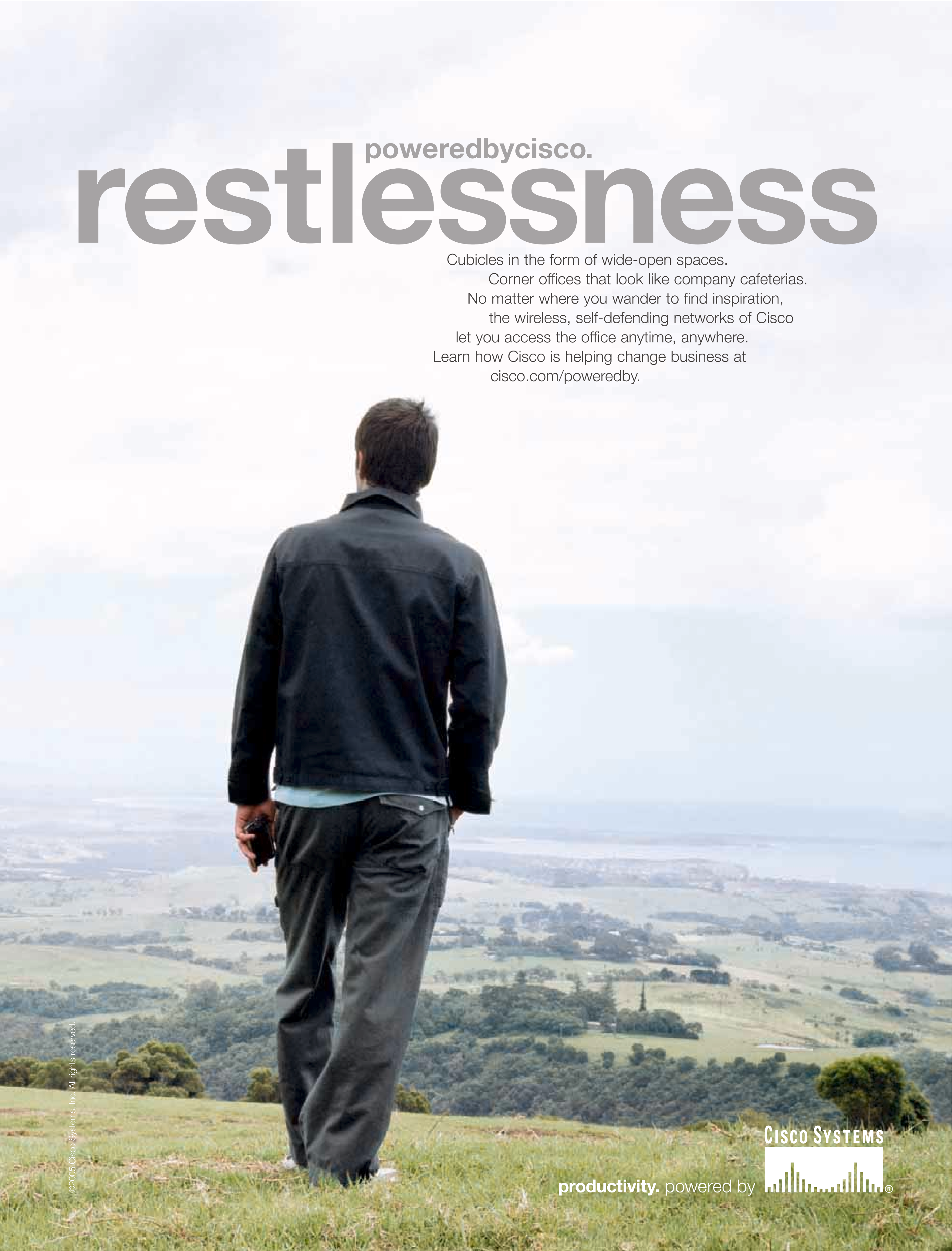
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the vote-buying proposal should be separately voted on by the shareholders before it is entered into by the board on behalf of the corporation. As a condition for passing the proposal, a majority of outstanding shares (as well as a majority of the shares neither participating in the agreement nor owned by directors and officers of the corporation) have to be voted in favor of the proposal.

Legal history shows that courts have been tolerant toward management. Business history shows, in addition, that there can be legitimate, strategic reasons for management to buy control of voting rights of certain shareholders. However, managers who engage in vote buying still face a high threat of litigation. It should go without saying, but the management team that pays vigilant attention to the interests of shareholders and keeps its dealings transparent is most likely to avoid legal entanglements and help the corporation benefit strategically from vote buying.

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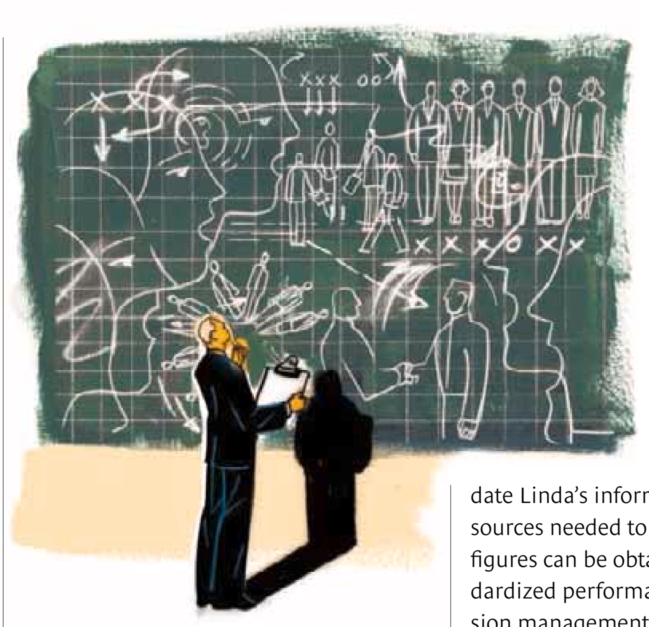
Reprint F0506D

DECISION MAKING

Little Decisions Add Up

by FRANK ROHDE

We judge leaders by how well they make big, strategic decisions. But corporate success also depends on how well rank-and-file employees make thousands of small decisions. Do I give this client a special price? How do I handle this customer's complaint? Should I offer a seat upgrade to this passenger? By themselves, such daily calls – increasingly made with the help of enterprise decision-management technology – have little impact on business performance. Taken together, they influence everything from profitability to reputation.



Companies need a system for measuring and managing the decision yield of customer-related decisions – that is, the impact of an individual decision on business results. Consider an insurance company that is acquiring a new customer through a call-center interaction. Terry, the service representative, gathers information from Linda, the potential customer, provides a premium quote, perhaps changes that quote on the basis of Linda's feedback, and finally issues a policy. Traditionally, the insurance company measures this interaction as a tiny fraction of its year-end or quarterly underwriting results. No one evaluates the quality of Terry's specific decisions.

A decision yield approach would evaluate this interaction along five dimensions: precision, cost, speed, agility, and consistency. That information can be collected and calculations can be performed by the decision management systems that companies increasingly use to guide employee responses or execute fully automated decisions.

Precision. Did Linda receive the profit-optimal price and package, given the information Terry gathered? Did the underwriting system correctly classify her, and did the company's statistical models accurately predict the likelihood of her filing a claim or renewing the policy, as well as her lifetime value to the company? Depending on the decision, precision is best assessed by metrics such as acquisition cost, loss ratio, and retention and by comparison of those metrics against expected performance, industry average, or best-in-class peers.

Cost. What was the total cost of the decision process, based on the time Terry spent talking to Linda, additional data required to validate Linda's information, and system resources needed to issue a policy? Those figures can be obtained through standardized performance reports of decision management systems or through activity-based costing.

Speed. How long did Linda have to stay on the phone with Terry? This customer-centric aspect of decision making – distinct from the cost of labor – influences satisfaction and loyalty. Speed of decision making is measured by most call center software and other decision management applications.

Agility. Was Terry able to change the product configuration in real time and respond to Linda's requests? Agility in customer interactions is measured by comparing the variety of a company's decisions with an established baseline. In essence, agility describes a company's ability to change business rules quickly in response to market and competitive changes.

Consistency. Would Linda have received the same quality of interaction and the same quote had she called a different customer service representative on a different day? Consistency is probably the most difficult aspect of decision making to measure. Corporations with enterprise decision-management systems can assess consistency by running simulations on batches of hypothetical customers. Other organizations can deploy mystery shoppers to continually test and evaluate frontline employees.

The decision yield is calculated by weighting these metrics according to how they affect customer satisfaction, competitive differentiation, and financial

Conversation

HERB GREENBERG ON INTERVIEWING

Knowing What to Listen For

LEIGH PHOTO AND IMAGING

Herb Greenberg founded Caliper, a human-resource consulting firm, in 1961; since then, the company has evaluated more than 2 million job candidates and employees for its clients. Caliper also advises companies on how to make job interviews more meaningful, a task to which Greenberg brings a distinct perspective. Blind since age ten because of a virus, the CEO emphasizes character above presentation. And his experience assessing athletes for professional sports teams, such as the 2004 NBA Champion Detroit Pistons, has shaped his definition of a "winner." HBR senior editor Leigh Buchanan asked Greenberg how managers can be led – or misled – by appearances.

Do managers overemphasize or misread visual cues when evaluating people for jobs or promotions?

Most people depend too much on their sight. How does someone look? Do they fit the part? Some of those visual cues can be as superficial and as inaccurate as "She seems to carry herself as a leader" or "He looks like he would fit in with the rest of our department." That first impression then becomes the context for the rest of the information they gather about an individual. They may hear the person's responses differently because they like what they see. Or because that person is smiling convincingly at them. That's one of the reasons why, during the Freudian interview, an individual is on the couch, facing away from the therapist, who just listens.

A hiring interview is a very unnatural way to meet someone. Applicants can impress you with the homework they've done on you and your company. And it's not hard to convey an enormous amount of enthusiasm for just an hour. So you have to delve below the surface. Try to get a sense of their character as well as what they've learned from their accomplishments *and* their failures. Try to get at what is genuine. The key to hiring and managing people is to find out what drives them. One of the most important questions to ask is "Why?"

What sorts of nonvisual cues do you notice?

The proverb says, "The eyes are the window to the soul," but I think it's the voice. People can work on their smile. There's so much plastic surgery these days that someone can actually buy a certain look. But voices are genuine. You can tell if the person is comfortable with you, not putting up barriers. Or you can tell if there's no reaching out in their voice. When someone's voice is flat or quiet, you don't have any idea what they are feeling or thinking. That can be a warning flag.

I pay very close attention to someone's voice. Is there warmth? Genuine enthusiasm? Sincerity? A way of expressing themselves that is real? Or are they trying too hard? Uncomfortable with themselves? Not really interested? Thinking about something else?

It might be interesting for someone who is sighted to concentrate more on voices. Try it for a day. Can you describe the voice of someone you really care about? Someone you don't?

What has your experience evaluating professional athletes taught you about evaluating people in the corporate world?

It's taught me that psychology is more important than talent when it comes to winning. In professional sports, talent is clearly the dominant factor. But you can have all the talent in the world and not be able to make use of those strengths if you lack the character and determination and enthusiasm.

The questions that keep coaches up all night are the same ones that should be keeping managers up all night. Does this person have the inner fire to drive him to the next level of performance? Can he work with the rest of the team? How coachable is he?

Winning athletes start with three qualities: self-discipline, competitiveness, and a positive sense of self. There's a reason sports is often used as an analogy for succeeding in business. It's the same road map.

To beat your competition and the odds in either arena, enormous talent has to be matched by a consuming inner motivation. Reprint F0506G results. (The weights assigned to the metrics represent organizational priorities.) Those numbers are then combined to create an overall decision yield that measures the performance of the company's customer interactions.

An organization can use a decision yield scorecard to improve its enterprise decision management, evaluate investment opportunities, and establish a direct link between the results of individual interactions and overall business performance. As technology increases the number of rules-based decisions employees make, companies need tools to ensure that those decisions are the best ones possible. Decision yield is one such tool, and it should become a performance indicator on the executive dashboard.

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Reprint F0506F

SOCIAL RESPONSIBILITY

The Low Value of Virtue

by DAVID VOGEL

The business case for corporate virtue, namely that firms can do well by doing good, underlies much of the enthusiasm among corporations for social responsibility. Echoed endlessly in books and articles, that argument appeals to the business community because it suggests that managers need not make trade-offs between decisions that benefit society and those that benefit shareholders.

Unfortunately, there's not much basis for the claim that corporate social responsibility (CSR) systematically "pays." Most consumers are unaware of and indifferent to where, how, and by whom the vast majority of products they consume are made. The most prominent "ethical" label in the United States – Fair Trade coffee – has a market share of less than 1%, and boycotts and protests have not measurably affected sales or share prices of other brands. While the assets of ethical mutual funds have grown substantially, they still make up only 2% of mutual fund assets in the United States.

For all the ink spilled about CSR's importance to long-term business success, few reports by security analysts of corporate financial performance mention social or environmental practices. Some business risks and benefits are associated with CSR, but they are typically marginal when compared with the risks and opportunities of more mainstream practices and strategies.

In fact, the financial performance of many firms with relatively positive CSR reputations such as Marks & Spencer, Sainsbury, Merck, Levi Strauss, Hewlett-Packard, Chiquita, Shell, Ben & Jerry's Homemade, and the Body Shop has recently been poorer than that of their less responsible competitors. These companies did not perform more poorly because they were more responsible. Rather, as is true for almost all firms, CSR was largely irrelevant to their profitability.

There is a market for virtue, but it is a niche market. CSR is best understood as a business strategy that, like any business strategy, makes sense for a subset of companies under specific circumstances. In particular, companies with highly visible brands whose reputations have been threatened by activists may want to make investments in CSR. For other firms, CSR may be a component of their branding. But a public embrace of corporate virtue is not without risks. The more a corporation trumpets its social or environmental commitment, the more vulnerable it is to challenges by activists when its behavior fails to meet their expectations.

One reason CSR often *seems* to pay is that relatively few companies devote substantial resources to it. Were they to do so, the limits of the business case would rapidly become apparent. Business self-regulation can do and has done much to improve some aspects of social and environmental performance, and under some circumstances it also benefits shareholders. But there are limits to how responsibly companies can behave when behaving responsibly raises their costs and consumers are unwilling to pay higher prices. The most important constraint on the pursuit of virtue is the market.

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Reprint F0506H

MARKETING

Don't Blame the Metrics

by KEVIN J. CLANCY AND RANDY L. STONE

Companies are understandably obsessed with measuring marketing performance. They want some "accountability," and all eyes are on the CMO to produce a return on investment. With their budgets, brands, and jobs on the line, CMOs are in hot pursuit of metrics that show that their programs work. A few years ago, such measurements were difficult to implement and inexact, but new data sources, technologies, and tools have made it possible to link marketing investments directly to market share, sales, and profits.

You'd think marketers would be delighted (and indeed a few are). Strangely, though, a recent CMO Council survey of senior marketing executives found that more than 80% were dissatisfied with their ability to measure marketing ROI, and fewer than 20% of the respondents said their companies employed meaningful metrics. Just as marketing measurement becomes more exact and accessible, marketing executives are becoming less and less happy. This doesn't make sense – unless something else is going on.

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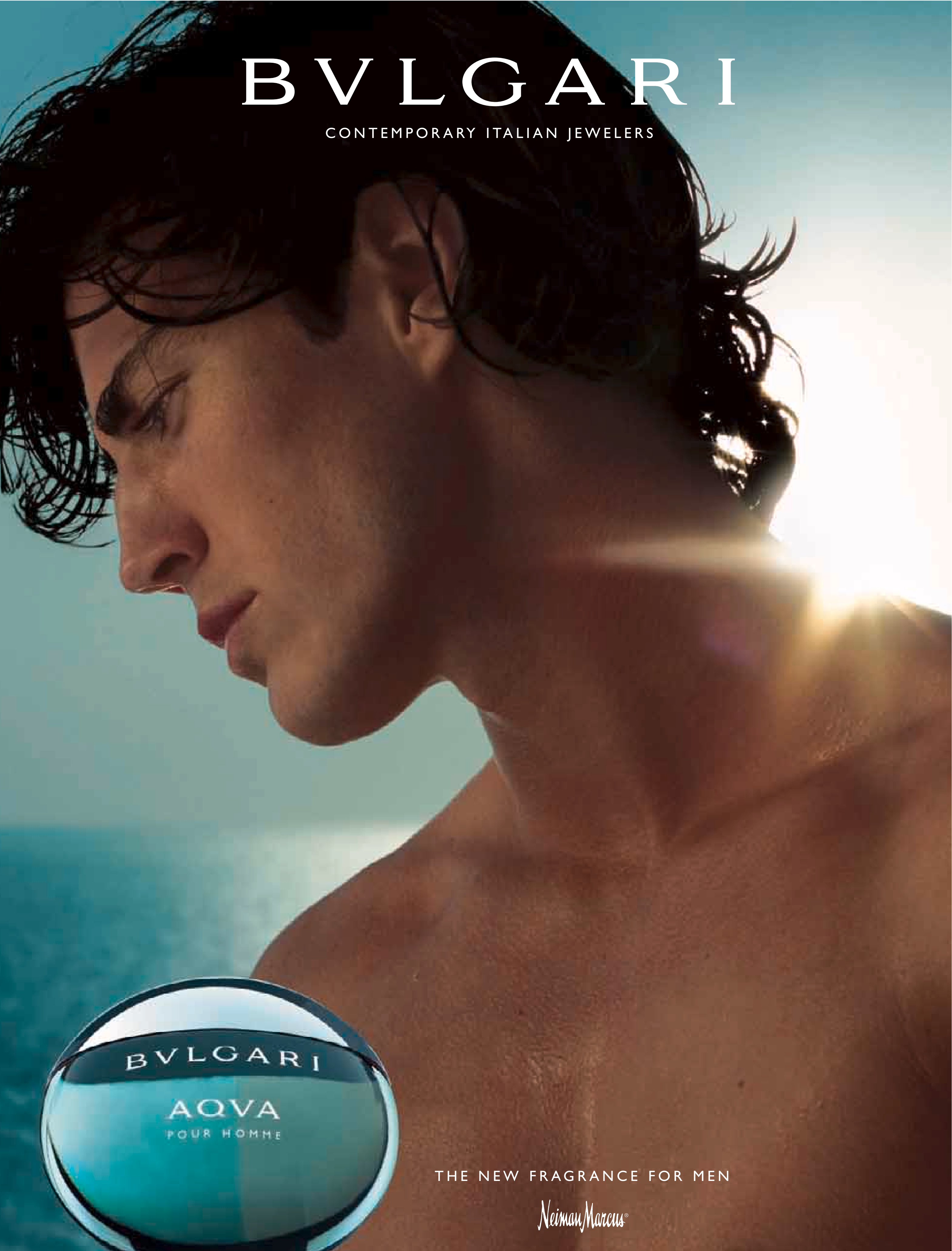
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Here's the real reason marketers are so gloomy: The effectiveness of marketing is disappointing and getting worse. For over a decade, Copernicus Marketing Consulting has collected performance data on more than 500 marketing programs for consumer and B2B products and services. The firm has found that 84% of these programs are decidedly second-rate, resulting in declining brand equity and market share. Customer satisfaction averages just 74%; most acquisition efforts fail to reach breakeven; no more than 10% of new products succeed; most sales promotions are unprofitable; and advertising ROI is below 4%.

Copernicus is not the only firm that has discovered such disappointing performance. Marketing Management Analytics, a marketing ROI measurement company, has found that in the short term, consumer packaged-goods advertising returns only 54 cents for every dollar invested (other product categories return 87 cents – better, but still a losing proposition). A recent ACNielsen BASES and Ernst & Young study put the failure rate of new U.S. consumer products at 95%. A 2004 Deutsche Bank study of packaged-goods brands found that just 18% of television advertising campaigns generated a positive ROI in the short term. And according to Dominique Hanssens of UCLA's Anderson School of Management, doubling advertising expenditures for established products increases sales just 1% to 2%.

Marketers aren't unhappy because they can't measure marketing performance. They're unhappy because they now can – and they don't like what they see. They need to go beyond metrics and take a hard look at why the numbers are so bad: Their marketing strategies are often flawed and their spending is inefficient. With increasing precision, they're measuring the impact of ill-defined targeting, weak positioning, mediocre advertising, pedestrian products and services, giveaway promotions, and poorly allocated spending.

Measuring marketing ROI won't improve performance. Fixing broken strategy and optimizing the marketing budget will. Take care of that and you'll be surprised at how good the metrics start to look.

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Reprint F0506J

MISBEHAVIOR

Hidden Harassment

by GARDINER MORSE

Sexual harassment is so destructive that most companies have zero-tolerance policies. Yet other types of antisocial behavior go largely unchecked, even though they can be equally harmful, new research shows.

Over the course of eight years, Christine Pearson, an associate professor at Thunderbird, the Garvin School of International Management, and Christine Porath, an assistant professor at USC's Marshall School of Business, along with colleagues, studied the "uncivil experiences" of more than 2,400 workers, managers, and executives in the United States and Canada. Though incivility sounds like a trivial problem, it can be as costly, in terms of lost productivity and turnover, as sexual harassment, and, the researchers say, should be treated as aggressively.

What is incivility? Essentially, it's any disrespectful behavior: a boss chewing out a subordinate in front of colleagues, an assistant refusing to lend a hand in a crisis, an employee spreading rumors about a coworker. Though it's sometimes visible and isolated, it's often covert, retaliatory, and repetitive, which makes it all the more harmful and difficult to manage.

Whatever its form, incivility is more prevalent and destructive than most managers think. It corrodes people's productivity, performance, motivation, creativity, and helpfulness. Half of those on the receiving end will lose work time worrying about future interactions with the instigator, Pearson and Porath found, and one quarter will consciously reduce their work effort. Half will contemplate changing jobs, and one in eight will actually quit in order to avoid the uncivil situation. With fully loaded costs of turnover estimated to average $50,000 per employee across all U.S. jobs and industries, the dollar impact of incivility is clear. The intangible costs are harder to measure but certainly huge.

What makes incivility particularly insidious is that, unlike sexual harassment, there are no laws – and, usually, no clear organizational norms – covering it. An employee who is sexually harassed is encouraged to speak out and is legally protected, but an employee who complains about incivility risks escalating the problem and forcing it underground. And because incivility is often invisible and unchecked in organizations, Pearson and Porath say, it tends to spread. What's more, because it's often retaliatory, it can feed on itself.

What to do? In a report in the February 2005 *Academy of Management Executive,* Pearson and Porath suggest nine best practices for containing incivility, based on what worked in the companies they studied: Have zero tolerance; take an honest

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look in the mirror (executives should use peer feedback and other methods to gauge their own civility); weed out trouble before it enters the organization (ask how job candidates behaved in previous jobs); keep your ear to the ground; interview former employees to find out why they quit; heed warning signals; don't make excuses for high-ranking instigators; teach civility; and, finally, crush incivility when it occurs.

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FRONTIERS

Coal Cleans Up Its Act

by AMY SALZHAUER

Are the energy markets shifting back toward coal? In some ways, they never left – coal generates more than 50% of U.S. electricity, for example. Yet since the 1950s, coal's share of that market has declined against natural gas and other fuels, largely because emissions from coal-fired plants have hurt the environment and stirred up not-in-my-backyard sentiments.

Now, new technologies are helping coal clean up its act – and not a moment too soon. As demand for energy skyrockets in such countries as India and China, cleaning up coal emissions is an effective short-term strategy for helping safeguard our planet's climate and air quality. Environmentalists point toward a future of renewable energy sources, but in the meantime, more coal-fired plants are being planned than at any other time in decades. And with significant coal deposits still available around the world, clean coal is piquing the interest of private investors and subsidy-wielding government officials.

Tech Talk: The new technologies range from simple pollution-control devices, such as advanced flue scrubbers, to gasification systems that use coal to create synthetic gas. The most common such system is called integrated gasification combined cycle (IGCC). IGCC plants cost about 20% more to build than their traditional counterparts but can generally produce much more power with significantly lower emissions.

The most efficient of the new clean-coal technologies will likely be solid oxide fuel cells. Fuel cell plants convert the chemical energy of coal into electrical energy through chemical reactions, without burning the coal. "We think we can make coal plants substantially more efficient than they are today, while at the same time eliminating all carbon dioxide emissions and all other emissions to the atmosphere," says Hans Ziock of Los Alamos National Laboratory. Still, considerable R&D is required, particularly in the area of absorbing or storing carbon dioxide created in power generation so that it does not pollute the atmosphere.

Why It Matters: "For the first time, there is major worldwide competition for fossil fuel supplies," explains Tony Lent, a partner at Los Angeles–based investment fund U.S. Renewables Group. As occurs in all energy markets, demand for coal in any given area is largely driven by costs, including those imposed by regulation. The costs of oil, natural gas, geothermal energy, and renewable energy sources like solar and wind power make clean coal look "pretty attractive as an investment," says Lent.

Clean coal is also important to national security. An estimated 200-plus years of coal reserves are in the ground worldwide. "The U.S. is the Saudi Arabia of coal, with Russia, China, India, and Australia next on the list," says Aaron Mandell, CTO of a Cambridge, Massachusetts-based clean-coal company that is still in stealth mode. Governments concerned with the geopolitical power of oil-rich Middle Eastern countries are willing to bet big on coal. The U.S. government is investing more than $2 billion in clean-coal technologies, and China is thought to be the top user of coal gasification.

In the Game: Energy companies around the world are investing in clean-coal technologies. The leaders include General Electric, which recently purchased ChevronTexaco's IGCC business, ConocoPhilips, and Houston-based Global Energy. Important research is being done in government and academic laboratories in Canada, the United States, China, and India. Lawrence Livermore and Los Alamos national laboratories, the University of North Dakota, Pennsylvania State University, and the University of Kentucky are among the top centers in North America.

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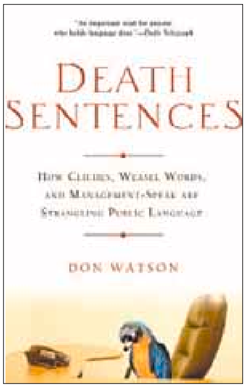
Reviews

Death Sentences
How Clichés, Weasel Words, and Management-Speak Are Strangling Public Language

Don Watson
(Gotham Books, 2005)

Don Watson takes an aversion-therapy approach to curing readers of business-speak. This rant in social commentary's clothing is so crammed with corporations' offenses against clarity that after a while you start skipping over them. Which is actually one of the book's points: Overuse of words – particularly lifeless words – renders language invisible. Managers who, out of habit, riddle their prose with "key," "enhance," "flexible," and "value" may be inadvertently occluding readers' comprehension. So lesson number one is: Don't do that.



There are actually many lessons and insights in this book, although they get a little lost amid the hyperventilating. Watson is an Australian speechwriter and satirist who worries that the language of business – which we all know has been drained of meaning – is spreading to other spheres of discourse, leeching meaning from those in turn. So there's a message here about responsibility. In a world where every organization, from the government to your local library, styles itself a business with "customers" and "bottom lines," conventional companies endanger all public language when they debase their own.

On a more practical level, *Death Sentences* describes the damage corporate-speak does to employee, customer, and community relationships. By relying on a common, largely abstract vocabulary, companies miss the chance to differentiate themselves. By omitting empathy and directness from their marketing, they fail to bond with customers. By avoiding the concrete and the specific, they raise suspicions at a time of pervasive mistrust. And by condoning sludgy writing, they succumb to sludgy thinking. (After all, if you don't have to say what you mean, you don't have to *know* what you mean.) Such language is a disability, preventing corporations from conducting intelligent, nuanced conversations with employees and customers. "This language is not capable of serious deliberation," writes Watson. "It could no more carry a complex argument than it could describe the sound of a nightingale."

More intriguingly, the author suggests that returning not just clarity but also color and emotion to corporate language could actually become a competitive advantage. Companies that communicate with "variety and possibility" gain character in the public eye; they are more congenial and trusted companions. Well-spokenness becomes, in effect, part of the brand.

Watson, not surprisingly, also criticizes the reductionism of mission statements and PowerPoint presentations. But he could use some of their discipline: *Death Sentences* is shapeless, meandering, and repetitive. And because this is a screed about dull writing, the author predictably overwrites. Still, when he calls consultants "the plague rats of the language virus," it's hard to suppress a chuckle.

– LEIGH BUCHANAN

Career Imprints: Creating Leaders Across an Industry

Monica C. Higgins
(Wiley, 2005)

Executive development is like agriculture: You reap what you sow. Baxter Healthcare in the 1970s, for example, "imprinted" an entrepreneurial ethos on its nascent leaders by giving them P&L responsibility, explains Higgins, a professor. That produced fast growth at the time but eventually also an exodus of talent for top jobs in emerging biotech companies. By contrast, Abbott pushed sales experience, Merck focused on scientific expertise, and Johnson & Johnson emphasized broad knowledge of corporate processes. And, yes, as a result, Baxter's competitors were less entrepreneurial, suggests Higgins. But they also kept more of their people down on the farm.

Make Your Own Luck: 12 Practical Steps to Taking Smarter Risks in Business

Eileen C. Shapiro and Howard H. Stevenson
(Portfolio, 2005)

When it comes to betting, the gut isn't everything. This consultant-and-professor team explains how to divide business risks into a series of decisions that narrow options and minimize uncertainty. They urge bettors to keep their eyes on the endgame and put most of their chips on dull but highly likely outcomes. Although this book doesn't make the promised case for something as grand as "predictive intelligence," it's full of good advice for those whose guts have let them down.

Made in China: What Western Managers Can Learn from Trailblazing Chinese Entrepreneurs

Donald N. Sull with Yong Wang
(Harvard Business School Press, 2005)

It's nice, for a change, to read something about Chinese business that doesn't use the term "low-cost producer" on every page. Professor Sull tells how eight companies, including Lenovo (PCs), Haier (appliances), and Hangzhou Wahaha (beverages), overcame regulatory, operational, and competitive uncertainty to reach the heights of Chinese industry. The lessons for managers: Anticipate emerging trends, set priorities, act decisively, and remain flexible. All of which are fine, but not nearly as novel as the title suggests.

– JOHN T. LANDRY

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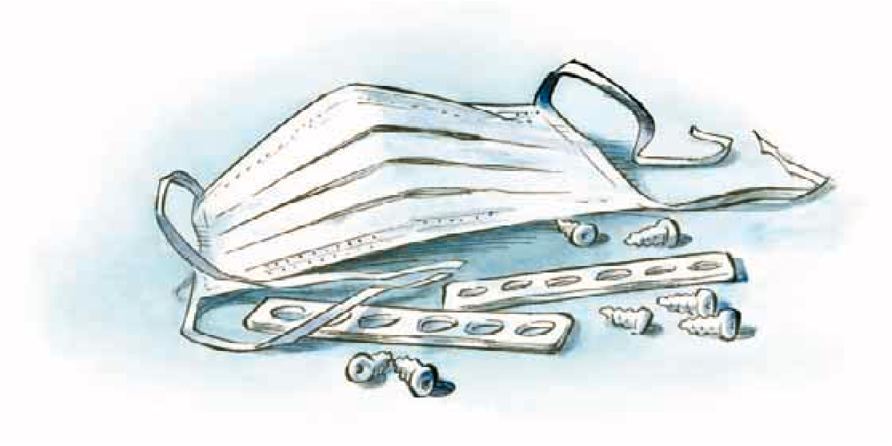

Crescordia's products are respected the world over. Now, rivals have launched a radical – albeit still buggy – new technology. Can the company afford to sit out the revolution?

Holding Fast

by John T. Gourville

"NOW REMEMBER, with every blow of the hammer, you've got to feel the femoral nail advancing through the bone. If you don't, then for heaven's sake, stop. It might be impinging on the cortex or it might be too large for the canal. Keep whacking, and you'll fracture the cortex." The trainer's calm, authoritative voice boomed out across the room as a dozen orthopedic surgeons toiled away on the cadaver limbs laid out before them. Pausing to observe the technique of one of the surgeons, he glanced up to see his boss, CEO Peter Walsh, crack open the door and squeeze through, trying his best to be unobtrusive. The trainer glanced at the clock. "Okay, let's save some of this fun for the afternoon," he called out. "We'll meet in the lobby in ten minutes and walk over to lunch."

In addition to making a range of products from artificial hips to scalpels, Crescordia was one of a handful of major companies that developed, manufactured, and sold the steel and titanium plates, nails, and screws – known as fixation devices – that surgeons used to repair broken bones. At least twice a month, Crescordia hosted training sessions like this one for orthopedic surgeons who used the company's products. Walsh joined the group for lunch as often as possible. It was a great opportunity to connect with the physicians and hear firsthand what they liked and didn't like about Crescordia's products. Besides, he just plain enjoyed their company. Trauma surgeons tended to be brilliant but down to earth. With their hammers, saws, and drills, they were as much carpenters as they were doctors. Maybe because so many of the cases they saw were the result of bad luck, they had a certain perspective on the world. They tended to joke a lot when they got together, and if you could tolerate some morbid humor you found yourself laughing along.

After the air-conditioned chill and formaldehyde odor of the lab, the heat of the summer day was a welcome change. Strolling along the paved path

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

DANIEL VASCONCELLOS

to the cafeteria, one of the surgeons launched into an account of a difficult case he'd seen that week. "Get this: The guy's a conductor – you know, with a symphony orchestra – so he really needs that wrist action." The surgeon flicked an imaginary baton upward by way of illustration. "So, of course, what does he manage to break his very first time on Rollerblades?" Walsh winced in sympathy. "On top of that, it's the same wrist he fractured five years ago, falling off his podium – and it was fixed that time with a distal radius plate." The rest of the group made sympathetic noises; no one liked having to remove old plates to implant new ones. "But wait – it gets worse. He's from Europe, just came here last year. And his surgeon must have fancied himself on the leading edge, because that plate was resorbable. Or, shall we say, it was *supposed* to be."

Now a great groan went up from the group, to the clear satisfaction of the surgeon. Everyone had a mental image of what he must have encountered, and it wasn't pretty. The idea behind resorbable hardware was a good one. Like dissolving sutures, resorbable plates and screws were made of biodegradable polymers that held up long enough to do their job – to support a healing bone – then gradually disintegrated harmlessly into the patient's body. The first and second generations of the technology were far from perfect, though, as the surgeon's case and many like it made clear. After five years, there should have been nothing left of the plate in the conductor's wrist – the key words being "should have."

"Let me guess," another doctor chimed in. "It looked like the hull of the *Titanic* in there." He sighed and shook his head. "And who knows if the resorbables on the market today are any better?" Walsh stiffened slightly and cleared his throat, anticipating what would come next.

Sure enough, someone posed the question right away. "So, when is Crescordia going to make a resorbable fixation system? You guys would do it right. Finally, I'd have the confidence to use the darn things on a regular basis."

Everyone looked at Walsh, but his response was as noncommittal as ever. "I wish we could give it to you today. But believe me, the science just isn't there yet. There's a reason those products are so buggy. And we wouldn't waste your time selling them to you. Our reputation – and yours – means too much to us."

Walsh then adroitly shifted the topic to what Crescordia would introduce next, and the conversation moved on. He relaxed again when they arrived at the bustling cafeteria and he could play host, offering pointers on what the various stations had to offer. As the trainees reconvened at the dining tables, Walsh sized up his seating options. Taking care not to spill his soup, he squeezed past a table with a group debating World Series prospects and joined a couple of surgeons who were obviously talking shop. One of them was using his turkey rollup to describe a femur fracture he'd recently fixed. "So right here's where the blade plate had to go in," he was saying as he pressed a plastic knife through the pita. The fellow beside him interrupted. "And we're in a lateral position, right?"

"Believe me, there's a reason those products are so buggy. And we wouldn't waste your time selling them to you. Our reputation – and yours – means too much to us."

"Yeah, yeah. Need to get the posterior exposure for this one." The surgeon guided the blunt plastic point expertly past a layer of Havarti and flicked at some shredded lettuce. "And the question is, Are these fragments here going to take to lag-screw fixation? Because, if so, that'll save me a lot of work." He studied his subject intently for a moment, then shoved it into his mouth.

Walsh laughed. "So much for that case!" he said. He wished he could eat with these guys every day.

Fixated on Quality

Later, in his office, Walsh returned to the challenge of resorbables. There was no question they would be great if they were reliable – and indeed Crescordia, along with many of its competitors, had been working on that problem for years. But were they ready for prime time? During internal trials, they still tended to fail about 8% of the time – sometimes disintegrating before the bone had fully healed and sometimes not fully disintegrating at all. Not exactly Six Sigma.

Unfortunately, not every company was so fussy. Walsh remembered the day back in the 1990s when he was stunned to find out that Innostat, an upstart competitor, was ready to launch a line of resorbable plates and screws. Walsh was confident he had the best scientists and R&D facilities in the business; could some geniuses have beaten them to the punch? Soon enough, the truth became clear, though it was only a partial relief: The product was even worse than what Crescordia could have put on the market at the time. Walsh made a strategic decision not to enter the fray and instead channeled resources into developing next-generation steel and titanium hardware. As the resorbables failed to deliver on their promise, Crescordia's market share and reputation grew.

But orthopedic surgeons, who'd been hearing for years that resorbables were right around the corner, were eager to use them. Some especially looked forward to using resorbables on children, so the kids wouldn't have to undergo a second operation for removal of the hardware after the bones healed, a com-

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mon procedure in pediatrics. In patients of all ages, old plates and screws could sometimes shift or come loose, causing painful protrusions. Just enough of the current generation of resorbables worked, it seemed, to keep Innostat in business and everyone else in the industry continuing their research. Even Walsh had to admit that, were he a surgeon, he might occasionally take the risk of using a resorbable.

But Walsh wasn't a surgeon. He was the CEO of a company whose products were respected throughout the industry. Thanks to decades of refusing to compromise on quality, there were orthopedic surgeons out there who used nothing but Crescordia hardware. The company simply could not afford to do something and not do it right.

Under Stress

Walsh arrived at his office the next morning to a typical flurry of meetings, conference calls, and paperwork. It was ten o'clock before he found a chance to pop down to see Gary Miskimen, his head of R&D. Miskimen was in the testing lab at the moment, his assistant told Walsh. She offered to page him.

"No, no," Walsh said. "I'm heading that way anyway." Soon after, he found Miskimen and one of his managers, both in pristine lab coats, looking on as a technician operated one of the company's servohydraulic fatigue testing machines. The technician clamped a long, slender, metal screw into place, picked up her strain gauge and started the test.

Miskimen filled Walsh in, murmuring, "The new cannulated screw versus the standard cortex screw." They stood staring, scarcely breathing, as the tension built and built more. Finally, the screw snapped. Miskimen's eyebrows rose. "Not bad," he said. The technician grinned.

Miskimen turned to Walsh and gave him a proper greeting. "And what brings you down to the lab on this fine day?"

"Actually, I was just curious to know if there was any news on the resorbables front," Walsh answered. "I know we're not due for a status update, but the subject came up yesterday."

Miskimen looked to the manager beside him. "We just finished some trials on the latest prototypes, didn't we?" The manager hurried off to get the data.

"Don't get your hopes up," Miskimen said, as he and Walsh followed at a more measured pace. "It's not perfection." They walked along in silence for a few moments. Then Walsh spoke up.

"I think it may be time to step up our efforts. Let's say we delay those new compression plates and put Wilkins on the case and maybe Sid Stratton…" Walsh glanced at Miskimen for a reaction.

Miskimen rubbed his close-cropped beard, then shook his head. "Peter, the truth is we've done as much as we can with resorbables in the lab. I know you don't want to hear this, but we're not going to know what we need to know to make the product better until we get it out in the field. We need to get it into the surgeons' hands."

"And into the patients' bodies," Walsh said with a sigh. Miskimen was right; it wasn't what Walsh wanted to hear. But Walsh knew enough about the science to know Miskimen wasn't just making excuses. Metal plates were relatively straightforward to test. They were inert, nonreactive with body tissue, so what you saw in the lab was what you'd get in the human body. The whole point of resorbables, on the other hand, was to be reactive – to interact with the body and dissolve over time. But every body was different and it wasn't possible to replicate every individual's physiology in the lab.

The Governing Body

A week later, as Walsh approached the boardroom door for the executive committee meeting, the atmosphere seemed charged. Everyone had a strong opinion on the main topic the committee would be discussing today.

Probably most excited to see resorbables back on the agenda was Jane LaMott, vice president of sales. Walsh noted how antsy she seemed during Miskimen's R&D update and, as soon as Miskimen finished, gave her the nod to lead off the discussion.

"In the past few months, three of our top-tier accounts have placed substantial orders with Innostat," she said ominously. "And here's the kicker: They weren't just for resorbables. They included metal devices directly equivalent to ones that we sell." She went on to offer her analysis. These were surgeons who were doing some experimentation with resorbables, which they couldn't procure from Crescordia. "And once they turned to Innostat for resorbables – well, the camel's nose was under the tent."

Walsh leaned forward in his chair. "That's an important point, Jane. Having a resorbables option, even if limited, might prevent market share erosion in other areas."

Chief marketer Diane Robinson took her cue. "I couldn't disagree more," she said. "Our market share is a function of our reputation for quality. If we put out a product that isn't up to our standards, will people trust us with the rest of the product line?" She gave LaMott a conciliatory look. "Perhaps if we could move into this new technology in a very limited way – "

"Can't do it," Rob Bond piped up. As chief operating officer, he was acutely aware of the complexity of a new platform launch. "If we enter the market at all, we'll need to do it with the full set of implants – plates and screws in all relevant sizes – plus the hand and power tools to attach these implants." He nodded in LaMott's direction. "And you'll need an education offering to support them. And none of it has a chance of profitability if we can't scale production." That sent the group into a discussion of the retooling and inventory levels required, which quickly devolved into side debates.

"If there is one thing surgeons hate to do, it's to go back in on a kid to remove an implant. They get no credit if it goes right and a huge headache if it goes wrong."

"One conversation, folks," Walsh reminded them, then noticed that Miskimen was waiting patiently for the floor. He invited him to speak his mind.

"What about targeting just the pediatric market for a start?" Miskimen suggested. "It's a smaller range of sizes, and, from my perspective, it offers the greatest potential benefit to doctors and patients."

LaMott looked at Miskimen gratefully. "Not to mention the biggest source of demand," she said. "If there is one thing surgeons hate to do, it's to go back in on a kid to remove an implant. They get no credit if it goes right and a huge headache if it goes wrong. That's a terrific idea."

Up to this point, legal counsel Sam Maddox had hung back, observing the back-and-forth with an air of detachment. Now he made a face as though he were smelling sulfur. "Let me get this straight," he drawled. "We have a product that is probably substandard. We're expecting it to get better based on what we learn in the field. And our human guinea pigs are…children? Sounds like a field day for tort lawyers. Can't we try it out on old people or something?" He frowned thoughtfully. "Then again, I'm not sure I want my mother suing us, either."

What's In It for Us?

Walsh was glad he'd put the item on the agenda, even though the discussion was far from conclusive. The group tabled the resorbables debate until the next meeting, with various people promising to scare up relevant data.

The next day, however, Walsh had a morning of work scheduled with CFO Calvin Westbrook, and it struck him that Westbrook hadn't weighed in.

"I don't know, Peter," Westbrook admitted. "I'm no expert, but at this point I question the whole resorbables idea. Scientists have been promising us results for 20 years, and what do we have to show for it? It reminds me of that joke about Brazil: It's the country of the future – and always will be."

Walsh smiled. "But I think we're getting close. What if the market does materialize? It will be very fertile for whoever gets it right. I want Crescordia to be the one to make that happen."

"Well, there again, I'm not so sure," Westbrook said. "I was thinking about this last night. Let's assume the very best scenario – that we are the ones to get it right. Our resorbable implants succeed in the field and become the product of choice. Then, everyone responds and we see a gradual shift to the new technology. As I see it, we may be no better off."

"How's that?" Walsh asked.

"The margins will be only slightly better. But the retooling needed to make resorbables will be a huge capital expense." He sat for a few moments silently, letting Walsh ponder the point.

Walsh raised his head finally and stared at his colleague intently. "I get what you're saying," he said. "With the rest of the industry making no headway, why be in a hurry?"

"Exactly," said Westbrook. "Why usher out a golden era?"

Should Crescordia launch a resorbables offering? • Four commentators offer expert advice beginning on page 40.

The best companies balance perspectives from both sides of the brain when making decisions.

***Robert A. Lutz** is General Motors' vice chairman of global product development.*

Certain aspects of Crescordia's dilemma feel all too familiar for those of us in the auto industry. First, there's the advice from legal counsel predicting "a field day for tort lawyers," words that cause senior executives everywhere to tremble. America's litigious culture has created a society in which a child's Batman cape carries a label that reads, "Warning: This does not enable the user to fly," and nobody seems surprised.

I'll put it as gently as I can: Contingency fee lawsuits and sky's-the-limit punitive damage awards are cancers eating away at society. Until there is considerable and meaningful tort reform in this country, true risk-taking innovation – the kind that moves a society forward in giant leaps – will suffer. The auto industry knows that as well as anybody else.

Another familiar enemy of innovation comes up at the very end: the all-powerful Voice of Finance. The CFO deftly pleads his case: Why make the huge capital expenditure necessary to innovate when we're already on top and the competition isn't making any headway?

That's a classic example of left-brained thinking shooting its pencil-sharp arrows straight into the heart of right-brained creativity. When all is said and done, more good ideas are snuffed out in the name of the bottom line than there are dollars saved in doing so. The best companies balance perspectives from both sides of the brain when making decisions. That way, the CEO has the greatest possible input before deciding whether to play it safe or leap into the fray. The creation of the Dodge Viper when I was at Chrysler is a good example.

The Viper wasn't new technology by any stretch. It was good, old-fashioned, American V-10 power. But it was a radical idea and certainly disruptive. There were those at Chrysler who, quite rationally, thought the budget could be spent more prudently. Let's face it: We weren't exactly printing money at that time. But those of us who looked at the idea from an emotional, right-brained perspective saw what the car could do for the company. Sure, we could've spent another $100 million on a glitzy ad campaign or on refurbishing our plants, but how would that set us apart from any other automaker? In the end, we decided to take the risk.

If I'd had any lingering doubts that we'd done the right thing (and I didn't), a Wall Street institutional-investor analyst put them to rest. In 1991, two years into the Viper program, he asked what we'd cut if things started going south, and I soberly replied, "Viper." "My God," he said. "You can't do that! This car's changing everyone's perception of the company. It's reestablishing confidence. It's the last thing you should cut!" And he was absolutely right.

Automotive hybrids are another good example of the need for careful balance. You have to weigh the questionable business case that hybrids present versus the reputational benefit of connecting emotionally with consumers and breaking new technological ground. The same applies to the fuel cell issue. Once a company like GM commits itself to hydrogen fuel cells as the future of automotive transportation, it will have to go at it the way we're doing it – full throttle, no excuses, large investment. We know exactly how Peter Walsh feels when he says the market "will be very fertile for whoever gets it right. I want Crescordia to be the one to make that happen."

Now, I'm not saying that all decisions should be based on right-brained thought. Risks need to be carefully calculated, not foolishly hazarded. But it takes instinct, common sense, creativity, and a risk-taking mindset to know when to take the plunge – any plunge. The problems occur when the left-brainers wield too much power in senior management.

WENDY WRAY

Resorbable implants are a textbook example of a *disruptive technology* – my term for products that promise to render current technology obsolete but that aren't yet good enough to be used in mainstream applications. Therefore, Crescordia stands at the fork in the road that all established companies face when a disruption emerges in their industry. One possible direction to take is to commercialize the disruption as a sustaining technology that helps the company's mainstream customers do what they're already doing, only better. The other is to commercialize it as a disruption.

The sustaining direction entails keeping the technology in the lab and spending large amounts on R&D until the new product is better than the existing technology. This is the direction Walsh favors when he suggests that it's "time to step up our efforts" on the R&D front. He knows that his current customers – the ones looking for high quality and reliability–won't buy resorbables unless they are at least as good as metal implants on traditional metrics of performance and better on new metrics. Of course, as CFO Calvin Westbrook anticipates, the rewards and drawbacks for going down that path are mixed. Crescordia could spend millions to perfect the technology, only to watch it cannibalize the current product line and provide little growth beyond that. In many ways, then, this is a defensive strategy. The motivation is: "If the technology ever becomes good enough to start displacing our permanent implant technology, then, by gosh, we're going to be there."

Pursuing a disruptive strategy is harder. It requires competing against nonconsumption – finding applications where implants historically haven't been possible because of the complexity, cost, or unfavorable characteristics of permanent implants. From my reading of the case, it appears that the pediatric market may offer just such applications. If, as the vice president of sales notes, "one thing surgeons hate to do [is] to go back in on a kid to remove an implant," then it's probably true that many orthopedists opt not to use implants at all on young bones. The beauty of using resorbables in pediatrics is that, although they don't attain the same level of perfection as established offerings, surgeons will embrace them because they are much better than nothing. And the howling packs of tort lawyers will be held at bay for the same reasons.

If history is any guide, the technology will take root in these applications. And if Innostat or some other upstart seizes that turf first, it will be in position to make the products better and better and, ultimately, to invade Crescordia's original market–a very attractive endgame for the company.

So the question for Crescordia isn't *whether* it should follow a disruptive strategy. The question is *how.* Overwhelmingly, the evidence shows that the only way to address such a market is to create or acquire an autonomous business unit, including a new sales force that can target the new applications. This is what IBM did, with great success, when it entered the minicomputer and PC markets. Johnson & Johnson, similarly, has transformed itself repeatedly over the past few decades, always by setting up or acquiring new disruptive business units.

If Crescordia does not set up a resorbables business that is autonomous, the technology will be killed by a corporate sales force that is not motivated to seek new (and therefore small) applications. Instead, salespeople will try to sell that technology to existing customers in existing applications, because they think that's their path of least resistance. From Crescordia's perspective, that would constitute cramming a disruption down a sustaining path. And that amounts to a death march.

The question for Crescordia isn't *whether* it should follow a disruptive strategy. The question is *how.*

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Medical devices companies often wait too long to put an emerging technology on the market. Clinical, intellectual-property, and industry trade-secret requirements often constrain them for years, and then they are forced to make a rushed, possibly irrational, decision on how to proceed.

In Crescordia's case, at least two considerations should be persuading Walsh to move sooner rather than later into the resorbables business. First, even though most of Crescordia's customers aren't ready to embrace the technology, it is capturing the interest of an influential subset made up of more experimental physicians. Second, Crescordia's investors assuredly expect the company to hedge its bets. In the face of a potentially disruptive competing technology, it must at least position itself to eventually capitalize on the opportunity.

Interestingly, we don't see Crescordia's management team contemplating one of the most common moves in this kind of situation–simply acquiring Innostat. Acquisitions are, of course, the most expensive way to finance R&D. If you buy early, it's often unclear what you're paying for, and if you wait for the technology to mature, you've waited too long and will pay a significant premium. But the reality of the industry is that smaller private companies do have innovation advantages – such as more focused management and a better talent pool attracted to the potential rewards (cashing out at the IPO) – that typically can't be matched by larger, established companies. In this case, an acquisition would give Crescordia a jump-start into the business of resorbables, with the added bonus of eliminating a competitor. It's worth considering.

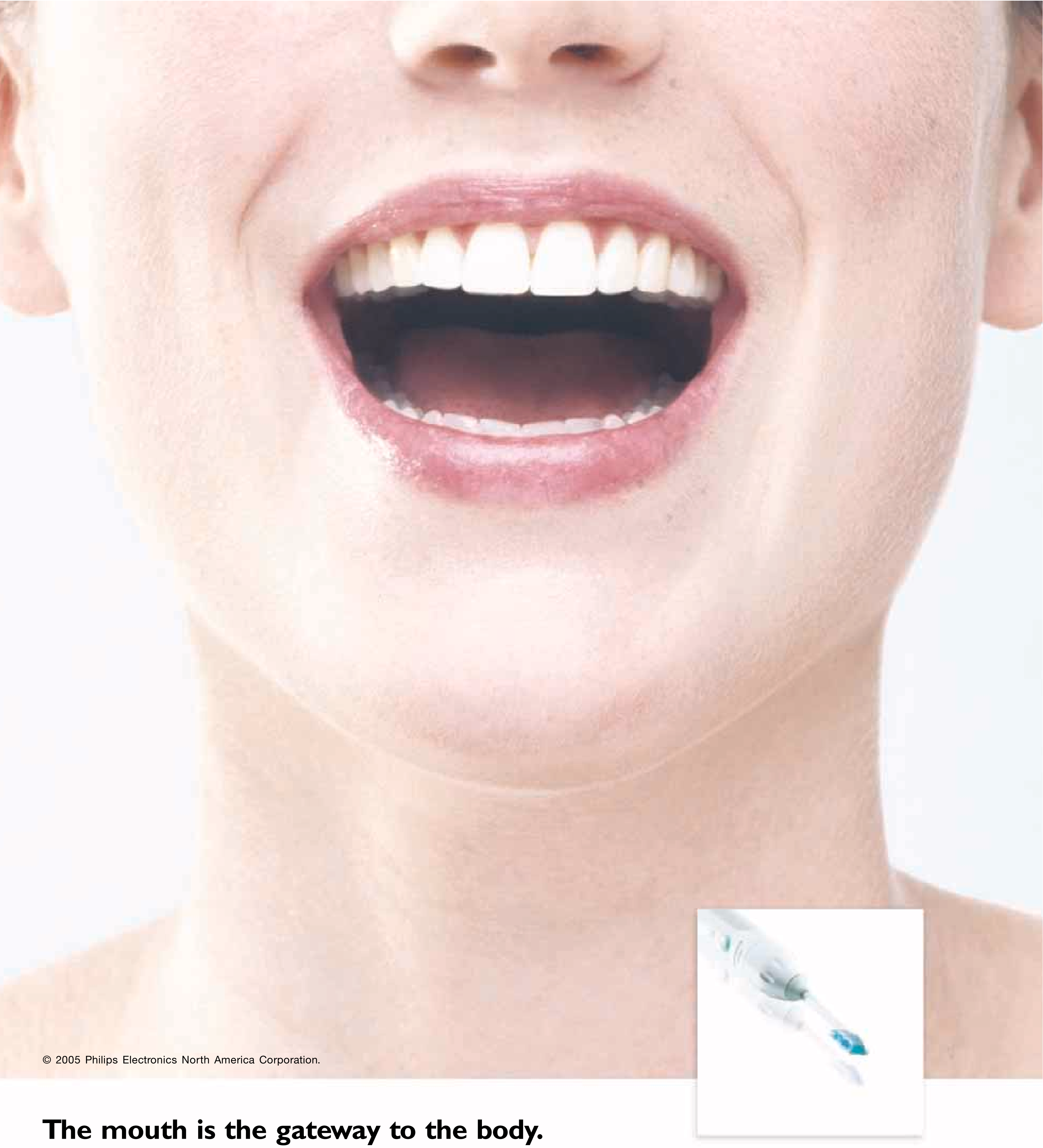
An acquisition would give Crescordia a jump-start into the business of resorbables, with the added bonus of eliminating a competitor.

Unfortunately, whether it buys or builds the new venture, Crescordia will have to worry about Wall Street breathing down its neck. Publicly financed ventures are the worst settings for nascent disruptive technologies because the investment horizons are so short. In medical devices, the adoption curve for new technologies typically extends from three to five years. But investors aren't that patient. They want to see measurable revenue generation on investment within two years. Given the inherent risks, it would be naive to expect public investors to pay or wait for investments beyond this horizon – especially when the profitability outlook is not significantly better than in Crescordia's current markets.

The result of this conflict is that the successful, larger companies in the industry have become very good at sales and marketing and at product iterations in established markets where turnover is quick. But their track records in developing new, disruptive markets with slower turnover have proven abysmal.

The best solution for Crescordia is to shelter its investment in resorbables from Wall Street expectations. It can do this through a passive (less than 50%) investment in a new venture. That would give the venture itself significant autonomy–a benefit in attracting managerial and research talent – while still allowing Crescordia a measure of control. And Walsh can maintain Crescordia's focus on serving its core group of physicians instead of alienating them with experimental, possibly buggy, products. Meanwhile, the new entity can appropriately develop resorbable technologies and serve the more experimental physicians.

Ultimately, this new business could begin to significantly encroach on Crescordia's traditional business, but that is not a development to be feared. In fact, that is precisely when Crescordia should choose to exercise its option. Everyone would be well served at that point by bringing the resorbables venture into Crescordia's organization, because the technology would be ready for prime time. The company would then need to shift its focus from development to selling into an established market, bringing Crescordia's core competencies to the fore.



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What's missing in this case is a clear sense of whether the resorbable products' shortcomings are only a question of efficacy or also of safety. If the product is safe in clinical trials, and if the efficacy potential is there but not fully proven, then I would take the risk of launching it. That's a fairly common approach in the pharmaceutical and biotech industries, given that (as it's phrased in the case) every body is different, and it isn't possible to replicate every individual's physiology in the lab. On the other hand, I would certainly *not* take the risk if the product threatened to lead to safety problems. If things went wrong on that front, it would be very tough to recover.

Consider the challenge that the entire gene therapy sector has faced for the past six years. Gene therapy is a disruptive technology that promises to revolutionize the practice of medicine. With this treatment, a patient would no longer take drugs to control symptoms of a genetic disorder; instead, the therapy would control the expression of the therapeutic gene in the patient's defective cells. But the several dozen companies pursuing that promise were dealt a stunning blow by the death of just one patient – a young man participating in a trial at the University of Pennsylvania in 1999. It seems that less-than-optimal clinical planning was to blame, but investors became extremely skeptical of the whole sector. Only now do we see the ill perceptions beginning to dissipate and some venture capitalists making contrarian bets.

I would certainly *not* take the risk if the product threatened to lead to safety problems.

Let's assume, however, that Crescordia's qualms are not fundamentally about safety and that the resorbables already on the market have produced no disastrous outcomes (beyond wasting surgeons' time). In that case, the company is proceeding too cautiously. I am reminded of the sad story of a Cambridge, Massachusetts–based company called Genesis Pharmaceuticals. In the early 1990s, Genesis was a pioneer in the brand-new field of combinatorial chemistry. At the time, this was another disruptive technology; instead of the conventional drug-discovery method of focusing on one molecule at a time, the technology introduced the now common procedure of creating many, many molecules in parallel and rapidly screening them for desirable properties. The potential for accelerating drug discovery made every big pharmaceutical company sit up and take notice. Genesis's missteps in bringing this new capability to market, however, cost its investors dearly. They netted less than $30 million when the company was ultimately acquired by Sphinx Pharmaceuticals (itself later acquired by Eli Lilly). The fact that Affymax – a Palo Alto, California, company that came up with the same concept a year later – was sold in 1995 to Glaxo Wellcome for more than $500 million gives a sense of the lost opportunity.

Today, of course, the big story in health care is genomics. Thanks to the study of the human genome, we now have a better understanding of human biology as an integrated system rather than a set of individual drug targets – and that is a profoundly disruptive shift. Surely companies that stand on the sidelines too long will suffer. They will see their business models overturned by the likes of Millennium Pharmaceuticals, probably the most aggressive player in the field. Since 1993, Millennium has completed large transactions with pharmaceutical companies and raised more than $2 billion to explore genomics. It has used the created value to buy companies like ChemGenics, LeukoSite, and COR Therapeutics and to accelerate its transition from a technology company to a product company. The strategy is paying off: In a business where it takes 12 to 14 years to go from concept to launch, Millennium already has two products on the market. It's a great example of how upstarts can turn into major players in a hurry. Walsh should take note.

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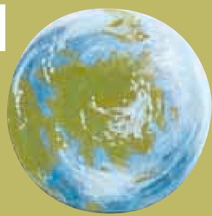
HBR Spotlight

RISK AND REWARD IN WORLD MARKETS



Business investment is pouring into the economies of the developing world. Altogether, these nations have taken in more than $2.5 trillion of foreign capital. The flood will continue; according to a 2004 survey by A.T. Kearney, chief executive officers of large companies rate China, the United States, and India as the world's three most attractive investment destinations – in that order. Already Brazil, Russia, India, and China (or BRIC) account for about 11% of the world's economic output. Brazil grows more soybeans than the United States. Russia produces as much oil as Saudi Arabia. India has become "the world's back office" and China "first factory to the world." Their people, already great producers, are becoming great consumers – they constitute the largest markets for mobile phones, motorcycles, refrigerators, and personal computers, as well as for raw materials like steel.

No wonder that business leaders have focused on emerging markets in a way not seen since before the Industrial Revolution. While other nations – notably in Africa – remain tragically out of the picture, the BRIC quartet, like Asia's Tigers a generation ago, have captured the imaginations of the world's companies and kindled the ambitions of indigenous entrepreneurs.

Yet something is missing from this picture: profits. In a great paradox, businesses in the developing world encounter both higher-than-usual risk and lower-than-usual rewards. The equation is not supposed to work that way – it cannot work that way for long.

The two articles that follow will help companies lower the risks and raise the rewards. The first, Ian Bremmer's "Managing Risk in an Unstable World," offers a sophisticated set of tools for understanding political risk. Companies can't change the odds that a country's government will alter tax or investment policies, expropriate property, or even collapse. (In the long run, a vibrant business community is both a sign and guarantor of political stability.) But informed risks are lower risks; and by evaluating different degrees and kinds of political risk, companies can develop thoughtful strategies that take into account countries' different risk profiles.

The second article probes a question that has frustrated CEOs and country managers for decades: Why is the gap between strategy and execution so much wider in emerging markets than in developed ones? The usual explanations – such as capricious governments and unreliable infrastructures – aren't sufficient. They aren't helpful, either, since managers can do little about them. In "Strategies That Fit Emerging Markets," Tarun Khanna, Krishna G. Palepu, and Jayant Sinha put forth a remarkable new explanation, tested by extensive research. Most companies' strategies, they argue, take for granted the existence of rank upon rank of specialized intermediary firms, ranging from bankers and advertising agencies to warehousemen and HVAC services. Indeed, those strategies unwittingly *depend* on intermediaries that cannot be counted upon to exist in emerging markets. Managers who understand this can cut the fabric of their plans to fit the bodies of the markets they wish to cover – or they can decide to stay away from markets that simply cannot provide the intermediaries they need.

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LEIGH WELLS

Managing Risk in an Unstable World

As emerging markets generate greater shares of global supply and demand, companies need better methods to weigh political risk against financial reward.

by Ian Bremmer

Countries in turmoil elbow one another off the front page at a dizzying pace: Lebanon follows Ukraine follows Sudan follows Argentina. Companies, meanwhile, fear unpredictable change, even as they seek profit from the opportunities change creates – a freshly privatized industry in Turkey, recently tendered oil blocks in Libya, a new pro-Western government in the former Soviet republic of Ukraine. To help weigh dangers against opportunities, corporations mulling foreign ventures routinely consult economic risk analysts. But basing global investment decisions on economic data without understanding the political context is like basing nutrition decisions on calorie counts without examining the list of ingredients.

Reassuring data on countries' per capita income, growth, and inflation – the bread and butter of economic risk analysis – often obscures potential threats from other sources. Iran's parliament, for example, last year passed legislation that complicates foreign companies' abilities to plant stakes in that country's telecom sector. The 2003 revolution in Georgia altered the strategic calculus for investment in Caspian Sea energy development. The Kremlin's politically motivated prosecution of business tycoon Mikhail Khodorkovsky sent a chill through Russia's oil market. And Brazil's government is pressing both its agencies and its citizens to adopt open-source software, a policy that could inflict some nasty wounds on Microsoft and other technology companies.

These are examples of *political risk,* broadly defined as the impact of politics on markets. Political risk is influenced by the passage of laws, the foibles of leaders, and the rise of popular movements – in short, all the factors that might politically stabilize or destabilize a country. The significance of any given risk, of course, depends upon the context of the investment decision. A hedge fund manager worries about developments that could move markets tomorrow, while the leader of a corporation building an overseas chemical plant needs a longer view. Strategists evaluating emerging markets must be especially vigilant (in fact, an emerging market may be defined as a state in which politics matters at least as much as economics). But even those businesses active only in developed nations should factor political risk into their planning scenarios.

Most companies are already navigating the choppy waters of globalization, and none, presumably, are sailing blind. But corporate leaders may lack the sophisticated understanding this very complex subject requires. Political risk analysis is more subjective than its economic counterpart and demands that leaders grapple not just with broad, easily observable trends but also with nuances of society and even quirks of personality. And those hard-to-quantify factors must constantly be pieced into an ongoing narrative within historical and regional contexts.

This article will help corporate leaders become better appraisers of information about the myriad shifting influences on global investments. Armed with that understanding, business strategists can minimize risks and seize opportunities far beyond their home shores.

***Ian Bremmer** is the president of Eurasia Group, a political-risk consulting firm, and a senior fellow at the World Policy Institute in New York.*

Politics Is Everyone's Business

Corporations with investments in such opaque countries as Zimbabwe, Myanmar, and Vietnam have long understood how political risk affects their bottom lines. In fact, historically, some of the business world's best political risk analysis has come from multinational corporations, like Royal Dutch/Shell and American International Group (AIG), that have entire departments dedicated to the subject. But today, any company with exposure in foreign markets needs early, accurate information on political developments. There are four principle reasons for this.

First, international markets are more interconnected than ever before. Tremors following a market shock in Argentina are quickly felt in Brazil and Venezuela, but they also rumble through Thailand. In 1997, capital flight from Southeast Asia roiled markets around the world. If China's rapidly growing economy overshoots a soft landing and crashes into recession, the impact on Chile, Russia, India, and the United States will be measurable within hours. China's political decisions today will have dramatic long-term effects on its markets. Companies with exposure anywhere in the world that China does business ignore those decisions at their peril.

Second, for good or ill, the United States is making the world a more volatile place, and that has changed risk calculations everywhere. The attacks on the World Trade Center in New York put foreign affairs and security front and center of federal government policy. Washington has shown its willingness to aggressively preempt threats to American security and national interests. The U.S. military has demonstrated an unprecedented capability to respond to international shocks – and to create them.

Third, the offshoring trend is growing. Businesses shift some operations to countries where labor is cheap – but the labor is cheap for a reason. In countries such as India (an established offshoring destination) and Kenya (an emerging one), living conditions for the working classes can be harsh, and there is greater threat of unrest than in developed countries with their large, relatively prosperous middle classes. Offshoring presents other risks as well. The Chinese government, for example, is already cavalier about intellectual property rights and shows signs of becoming more so. Companies moving manufacturing and other functions there may be hard-pressed to protect some of their most valuable intellectual assets.

Fourth, the world is increasingly dependent for energy on states troubled by considerable political risk – Saudi Arabia, Iran, Nigeria, Russia, and Venezuela among them. As global supply struggles to keep pace with rising demand, political instability in these oil-producing states can quickly produce shocks all over the world.

It is difficult to imagine a business that is not affected by at least one or two of these developments. And corporations' exposure will only grow as supply chains become more global and developing countries increasingly participate in international trade.

What Economics Can't Tell You

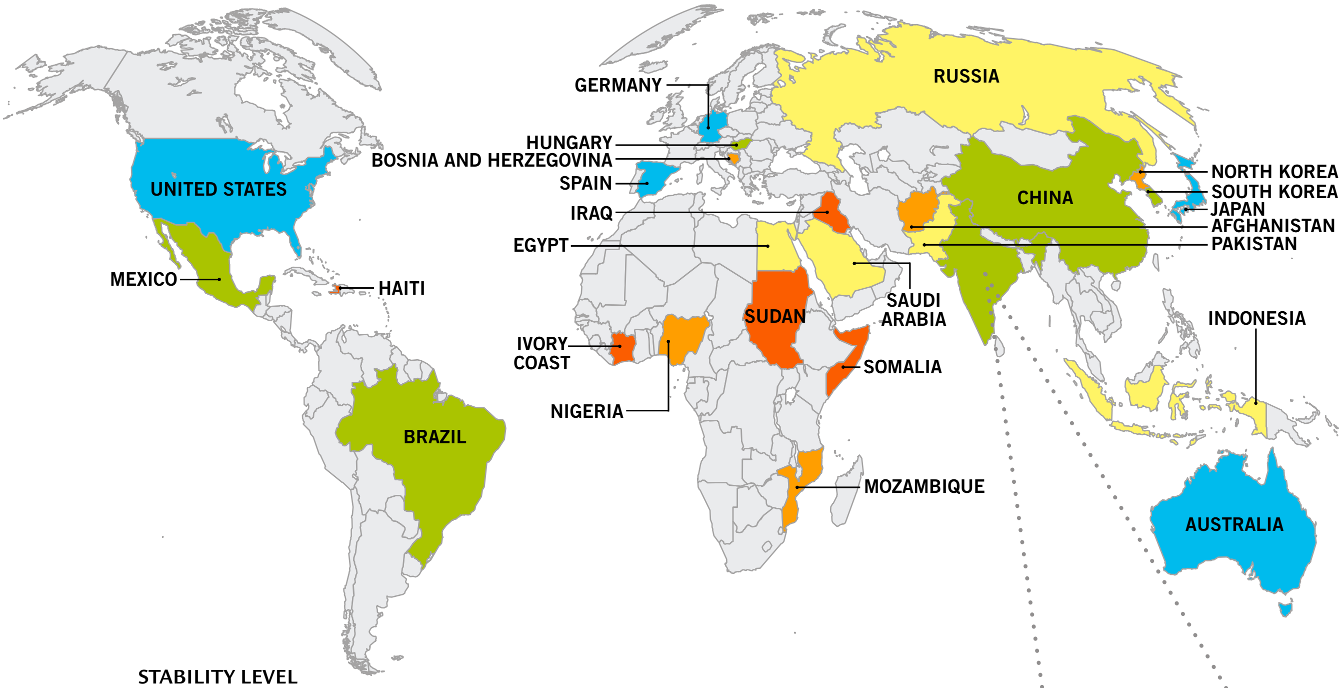
Economic risk analysis and political risk analysis address two fundamentally different questions. Economic risk analysis tells corporate leaders whether a particular country *can* pay its debt. Political risk analysis tells them whether that country *will* pay its debt. Two examples illustrate this distinction.

When 35-year-old Sergei Kiriyenko replaced Viktor Chernomyrdin as prime minister in March 1998, Russia's economy seemed to be emerging from post–Soviet era turmoil. Inflation had been reduced to single digits, the economy was growing, and the government appeared committed to a moderate reformist path. Economic analysts saw clear skies.

But political analysts recognized that an obstructionist parliament intended to block Kremlin attempts to tighten fiscal policy and streamline tax collection. They saw that an absence of consensus was producing incoherent monetary policies and that the absentee, alcoholic president wasn't going to enforce

Political Risk at a Glance

Political risk measures the stability of individual countries based on factors grounded in government, society, security, and the economy. Emerging markets are generally in the moderate- to high-stability range. The map shows how some countries scored in March 2005.



STABILITY LEVEL

- MAXIMUM [80–100]: Australia, Germany, Japan, Spain, United States
- HIGH [60–79]: Brazil, China, Hungary, India, Mexico, South Korea
- MODERATE [40–59]: Egypt, Indonesia, Pakistan, Russia, Saudi Arabia
- LOW [20–39]: Afghanistan, Bosnia and Herzegovina, Mozambique, Nigeria, North Korea
- FAILED STATE [0–19]: Haiti, Iraq, Ivory Coast, Somalia, Sudan

Anatomy of India's Political Risk

National stability scores are plotted over time and comprise dozens of measurements, ranging from hard economic data on growth and investment to more amorphous assessments of youth disaffection and corruption. At the beginning of this year, India was hovering between moderate and high stability. (The numbers used to obtain each average have been rounded off.)

FACTORS AFFECTING STABILITY	STABILITY SCORES (0–100)			COMMENTS
	Jan 2005	Feb 2005	Mar 2005	
GOVERNMENT (such as strength of current government, rule of law, and level of corruption)	67	64	62	Political missteps by the government led to poor performance in state elections and strengthened opposition parties.
SOCIETY (such as social tension, youth disaffection, and health, education, and other services)	58	58	58	Low per capita income and literacy levels lead to a low human development index. Simmering social tensions keep the society score low.
SECURITY (such as level of globalization, geostrategic condition, and emergencies and disasters)	53	48	48	Peace talks with Pakistan and China have eased security fears. But a Maoist insurgency in Nepal and continuing Kashmir violence keep the score low.
ECONOMY (such as fiscal condition, growth and investment, and external sector and debt)	75	75	76	Economic growth and expanding trade keep the numbers healthy. The fiscal deficit remains a worry.
Cumulative National Stability Score	63	61	62	

Source: Deutsche Bank Eurasia Group Stability Index (DESIX), March 2005 discipline on an increasingly chaotic policy-formulation process. When oil prices fell, political analysts underlined the country's lack of fiscal discipline as a cause for immediate concern.

In short, political analysts produced a darker – and more accurate – portrait of Russia's market instability in the period leading up to the financial crisis of 1998. When Russia ultimately defaulted on international debt and devalued the ruble, companies that had studied both economic and political risk weathered the storm with far fewer repercussions than those that had relied on economic analysis alone.

In other instances, political risk analysts have been able to detect the silver linings in economists' dark clouds. The value of Brazilian bonds and currency fell sharply in 2002 when it became clear that Luis Inacio Lula da Silva would be elected that country's president. In earlier campaigns, Lula had criticized the International Monetary Fund and Brazil's fiscal conservatives, whom he accused of widening the gap between rich and poor. Comparisons of Lula with Cuba's Fidel Castro and Venezuelan president Hugo Chávez spooked economic risk analysts, who feared that the election of Brazil's first "leftist" president would produce a politically driven market crisis.

But many political analysts considered such an outcome unlikely. In Lula they saw not an ideologue or a theoretician but a man who made his name as a tough, pragmatic labor negotiator. They observed in his campaign an inclusive, conciliatory electoral strategy. They heard in his speeches a determination not to allow Brazil to fall into the kind of financial crisis that had inflicted so much damage on Argentina. And so they argued that Lula's victory would be more likely to produce political and economic stability. If Lula won, they predicted, his government would enfranchise the poor. And he would keep his campaign promise to reserve an IMF-established percentage of tax revenue for the repayment of debt, instead of spending it on social programs and make-work projects.

The political analysts were right. Lula won the election and kept his promises of fiscal discipline. Within weeks, Brazilian bonds staged a dramatic recovery.

Strength Against Shocks

In both Russia and Brazil, political analysts focused on how a specific leadership change would affect the country's *stability* – the unit of measure for political risk. A nation's stability is determined by two things: political leaders' capacity to implement the policies they want even amidst shocks and their ability to avoid generating shocks of their own. A country with both capabilities will always be more stable than a country with just one. Countries with neither are the most vulnerable to political risk.

Shocks themselves are another important concept in political risk. They can be either internal (demonstrations in Egypt; a transfer of political power in Cuba) or external (thousands of refugees fleeing from North Korea into China; the tsunami in Southeast Asia). The presence of shocks alone, however, is not a sign of instability. Saudi Arabia, for example, has produced countless shocks over the years but has so far ridden out the tremors. It will probably continue to do so, at least in the near

Why China Keeps Us Up at Night

China bestrides the world of political risk like a colossus. Many experts tout it as the great investment opportunity of the new millennium, but it is also a great unknown. Among the questions political risk analysts are studying: Can China's explosive economic growth survive its corrupt and inefficient political system? Do the country's political leaders agree that preparations for a soft landing to avoid recession are necessary? Would reform that opens its political process make China more stable or less?

China's continued expansion depends on the central government's capacity to handle complex economic transitions and avoid instability. At the same time, the state must juggle huge security, demographic, and political challenges. Imminent agricultural, banking, and urban policy reforms will probably produce even more complex management problems for the country's dysfunctional bureaucracy.

China appears to be inching toward instability as reforms strain the relationships between national and regional leaders, increasing the probability of an economic shock followed by a political one. Complicating matters, China's bureaucracy lacks the administrative control necessary to modulate the pace of an economic slowdown.

Analysts of economic risk tend to base projections for China's growth rates on its past performance. But there are few countries for which past performance is so poor a predictor of future results. With a few notable exceptions, such as the 1989 protests in Tiananmen Square, social unrest in modern-day China has been rare. But the risk of popular unrest is going up as a result of widening income inequality, slowing – although still intense – economic growth, and continuing official abuse and corruption. The urban unemployed and migrant workers could stage protests; rural rebellion over land reclamations and onerous administrative fees could escalate. China's leaders might then clamp down on the media, religious groups, use of the Internet, and other forms of expression and communication. Faced with international criticism, the government could become more antagonistic and dogmatic about issues of concern to the United States and East Asia.

The probability of such events occurring in the short-term is low, but China's risk indicators suggest it is rising.

term: The nation is built on political and religious fault lines, but its strong authoritarian control and deep pockets allow the Saudi elite to adapt to quite dramatic changes.

Saudi Arabia's relative stability is grounded in its capacity to withstand shocks; other countries depend more on their capacity not to produce them. Kazakhstan's political structure, for example, is less supple and adaptable than that of Saudi Arabia. But the country also stands much further from the epicenter of political earthquakes.

Clearly then, two countries will react differently to similar shocks, depending on how stable they are. Say an election is held and a head of state is chosen but the victory is challenged by a large number of voters, and the nation's highest judicial body must rule on a recount. That happened in the United States in 2000 without any significant implications for the stability of the country or its markets. When similar events erupted in Taiwan in 2003 and Ukraine in 2004, however, demonstrations closed city streets, civil violence threatened, and international observers speculated on the viability of those nations' economies.

The 2000 U.S. elections point to another complicating factor in political risk: the relationship between stability and openness. The United States is stable because it is open – information flows widely, people express themselves freely, and institutions matter more than personalities. Consequently, the nation weathered its election controversy without a Wall Street panic; investors knew the problem would be resolved and that the outcome would be broadly perceived as legitimate.

But other countries – such as North Korea, Myanmar, and Cuba – are stable because they are closed. What's more, the slightest opening could push the most brittle of these nations into dangerous territory. Twenty minutes' exposure to CNN would reveal to North Korean citizens how outrageously their government lies to them about life outside; the result might be significant unrest. And while there is considerable world pressure on closed countries to open up, the transition from a stable-because-closed state to a stable-because-open state is inevitably marked by instability. Some nations, for instance South Africa, survive that transition. Others, like the Soviet Union, collapse.

Plotting where nations lie on the openness-stability spectrum, and in which direction they are heading, is tricky. And no country poses a greater challenge than China, which appears equally at home on two different points along this range. Politically, China is stable-because-closed; it is a police state with absolute control over public expression. For example, security forces severely restricted media coverage of the recent death of Zhao Ziyang, a relatively progressive politician, in order to prevent the kinds of uprisings sparked by the deaths of Chou En-lai in 1976 and Hu Yaobang in 1989. Economically, however, China is opening at a rapid clip, as diplomats and negotiators globe trot in search of new trade relationships to feed the country's growth.

When a country is politically closed but economically open, something has to give. Whether China's political system will follow its economic trend line or vice versa is a fascinating and hotly contested subject in the political analyst community. (See the sidebar "Why China Keeps Us Up at Night.")

Corporate executives, however, generally focus on more immediate concerns when assessing a country's ripeness for investment. Broadly speaking, decision makers must know three things: How likely is it that a shock will occur? If likely, when will it probably occur? And how high are the stakes if it does?

The greatest risk, not surprisingly, is when shocks are likely, imminent, and

Why Saudi Arabia Keeps Us Up at Night

Saudi Arabia's stability is under fire from religious and secular forces. Islamic extremists hope to undermine the legitimacy of the royal family. Real unemployment is estimated to be between 20% and 25%; frustrated, jobless young men are flocking to mosques and schools where religious leaders thunder against the infidels. Western nations, meanwhile, are calling on the royals to move toward political liberalization. And the flight of expatriates will eventually take its toll on the Saudis' ability to diversify their economy.

Such volatility complicates financial deals – particularly those that take years to assemble – and extends the exposure to political risk over time.

But while companies with long-term investments must worry, short-term investors in Saudi Arabia have less cause for concern. That's because oil money stabilizes the political system, and the royal family can count on those revenues for years to come. Yes, oil supplies are a tempting target for terrorists; but the country's oil infrastructure is isolated from population centers, and redundancies in the pipeline system make it almost impossible to inflict lasting damage with a single blow. In addition, the national oil company has the technology, the trained engineers, and the spare capacity to continue producing significantly more than 9 million barrels per day. Finally, in light of concerns that foreign governments might freeze Saudi assets following September 11, 2001, a great deal of money flowed back into the kingdom, providing the House of Saud with more ready cash.

Clearly, any project in Saudi Arabia that needs a decade to show a profit is deeply problematic. But those willing to brave volatility in the near term may profit from opportunities that more risk-averse companies forgo.

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have widespread consequences. All three conditions exist in North Korea, which has remained stable only by resisting movement toward market economics and more open government. North Korea's stability is so dependent on Kim Jong Il and the country's military elite that any threat to their safety could destroy the regime and destabilize the entire region very quickly. And the stakes are high because the most valuable products North Korea has to sell – military and nuclear components – tend to produce political shocks.

In other nations, shocks are likely and expected to occur relatively soon, but the stakes for world markets are much lower. Fidel Castro, for example, is 78, and the fate of the revolution after his death is unclear. Castro's hard-line younger brother Raul might assume power, but he is also in his 70s; if he replaces Castro, political uncertainty will build until the next transfer of power. Similarly, if a reformer like Carlos Lage steps forward to begin a process of gradual opening, the release of long-repressed dissent could spark violence. So either outcome will probably produce instability. But because Cuba is not an exporter of nuclear technology, oil, or any other vital resource, the shock's effect on world markets will be minor.

Risk by the Numbers

Speculation on the outcomes of these and other scenarios appears in numerous publications, but corporations debating operational or infrastructure investments abroad need more objective, rigorous assessments than those found in the op-ed pages. Companies can either buy political risk services from consultants or, like Shell and AIG, develop the capacity in-house. Either way, a complete and accurate picture of any country's risk requires analysts with strong reportorial skills; timely, accurate data on a variety of social and political trends; and a framework for evaluating the impact of individual risks on stability.

The Analysts. Politics never stops moving, and risk analysts must be able to follow a nation's story as it develops. Usually, that means being on the ground in that country. And in the case of a particularly opaque regime, it can mean being there a very long time. Some information is published in official reports or in the media, but analysts will gather most of their intelligence from primary sources: well-connected journalists in the local and foreign press, current and former midlevel officials, and think tank specialists.

Companies should bear in mind that political analysis is more subjective and consequently more vulnerable to bias than its economic counterpart. One danger is that analysts with their own political opinions may view their research through a particular philosophical scrim. In addition, political analysts will probably have subject-matter – as well as nation-specific – expertise that can color their reports. A Taiwan analyst with a background in security, for example, may overemphasize such risk variables as cross-strait tensions and the growing imbalance of military power between Taiwan and China. An Eastern Europe analyst studying social unrest may insist that demonstrations by pensioners have the largest political impact on the government. As decision makers peruse analysts' reports, they should be alert for any potential bias and correct for it.

The Data. Because of their very nature, political risk variables are more difficult to measure than economic variables (although in some countries, such as China and Saudi Arabia, even the reliability of government-produced economic data is open to question). Politics, after all, is influenced by human behavior and the sudden confluence of events, for which no direct calibrations exist. How do you assign numbers to such concepts as the rule of law?

To accurately quantify political risk, then, analysts need proxies for their variables. Instead of trying to measure the independence of a nation's judiciary, for example, analysts can determine whether judges in a particular country are paid a living wage, whether funded programs exist to inform them about new legislation, and whether – and how often – they are targeted for assassination. Political risk analysts also study the percentage of children who regularly attend school, how police and military salaries compare with criminal opportunities, and how much access to medical care is available in towns with populations of 10,000 to 50,000 people. They look at such statistics as the unemployment rate for people between the ages of 18 and 29 and determine how many of them are in prison. And, of course, they add economic variables to the mix: per capita income, balance of payments, and national debt.

Taken together, this often anecdotal information reveals much about a country's underlying sources of strength or vulnerability. Comparing data from neighboring countries provides a good sense of where shocks from unstable nations might rumble into stable ones. Comparing a single nation's data points over time tells the analyst whether that nation is becoming more stable or less so, and how quickly.

The Framework. Different companies and consultancies will have different methods for measuring and presenting stability data. We at Eurasia Group have developed a tool that incorporates 20 composite indicators of risk in emerging markets. Distributed as part of a strategic relationship with Deutsche Bank, the Deutsche Bank Eurasia Group Stability Index (DESIX) scores risk variables according to both their structural and temporal components. Structural scores highlight long-term underlying conditions that affect stability. They then serve as a baseline for temporal scores, which reflect the impact of policies, events, and developments that occur each month.

The indicators are organized into four equally weighted subcategories: government, society, security, and the economy. Ratings for all four subcategories are aggregated into a single composite stability rating, which is expressed as a number on a scale of zero to 100 – from a failed state to a fully institutionalized, stable democracy. (See the exhibits "Political Risk at a Glance" and "Anatomy of India's Political Risk.")

Very often, the numbers that make up the stability rating are as interesting as the stability rating itself. Consider Turkey, whose March 2005 stability rating was 60, five points lower than Brazil's and two points higher than Russia's. Within that composite number, components are moving in opposite directions.

Specifically, Turkey's government rating rose as a consequence of the European Union agreement to open accession talks with Ankara in October 2005. Prime Minister Recep Tayyip Erdogan's administration now has greater incentive to continue reforms that strengthen the independence of Turkey's institutions, increase media freedom, and protect the rights of minority groups – such as Turkish Kurds – who might otherwise provoke unrest. Turkish membership in the EU would also bind the country more closely to European institutions, further increasing stability.

Yet Turkey's security rating is pushed lower by the continued presence of Kurdistan Workers' Party militants in northern Iraq. Ankara worries that the Kurds – empowered by the Iraqi elections – may try to regain control of the oil-rich northern Iraqi town of Kirkuk, which would provide the financial basis for an independent Kurdish state. A Kurdish state on Turkey's borders would likely fan separatist flames in that country's own Kurdish population.

Once You Know the Odds

How companies apply such analysis obviously depends upon their industry, strategy, and risk tolerance profile. Of necessity, companies in the energy industry, for example, have demonstrated a high tolerance for risk, relying on mitigation techniques to manage their exposure. By contrast, light manufacturers and midsize companies in industrial supply chains tend to bide their time to see how situations evolve. And pharmaceutical corporations generally shy away from investment when presented with infrastructure or intellectual property risks.

Companies making extended commitments in unstable nations must give top priority to long-term risk – issues related to demographics and natural resources, for example – when making decisions. In May 2004, Japan's Sumitomo Chemical agreed to a $4.3 billion joint venture with Saudi Aramco to build a major petrochemical plant at Rabigh in Saudi Arabia. The plant isn't scheduled to open until 2008, so Sumitomo is particularly vulnerable to such pernicious demographic trends as the exodus of technical talent and the joblessness of young men.

Sumitomo's risk tolerance is already being tested by an Islamic extremist campaign of kidnapping and beheading foreigners who do business in the country. But while violence and corruption dominate headlines, such near-term risks are much exaggerated. (See the sidebar "Why Saudi Arabia Keeps Us Up at Night.") In fact, although Saudi Arabia – and China, too – may be risky bets for companies engaged in ventures that won't see profitability for a decade, in the short run there is money to be made. Among others, General Motors, Kodak, and a number of investment banks have already done so – though they've stumbled a bit in the process.

Once companies have determined that a particular investment is worth the danger, they can use traditional techniques to mitigate the risk – recruiting local partners, for example, or limiting R&D in nations with leaky intellectual property protection. In addition, a growing number of commercial and government organizations now offer insurance against political risks such as the expropriation of property, political violence, currency inconvertibility, and breach of contract. (Such insurance is expensive, however, because risks are so hard to assess.) Otherwise it's mostly a matter of hedging – locating a factory in Mexico as well as Venezuela, say, so as not to bet the entire Latin America strategy on a single opaque regime.

Finally, it is worth remembering that though instability translates into greater risk, risk is not always a bad thing. Political risk in underdeveloped countries nearly always carries an upside because such nations are so unstable that negative shocks can do little further damage. On the stability ladder, for example, Afghanistan and Cambodia simply don't have far to fall; only favorable external conditions – such as debt relief from the developed world or loans from international institutions – could have much effect on their political stability. For some companies, that could make investments in such countries an attractive part of an enterprise risk portfolio.

Politics has always been inseparable from markets; the world's first transnational trade organizations were moved by the political waves of their time. Today, goods, services, information, ideas, and people cross borders with unprecedented velocity – and the trend is only intensifying. For company leaders seeking profit in places that are socially, culturally, and governmentally alien, the complementary insights of political and economic risk analysts are vital.

Whether China's political system will follow its economic trend line or vice versa is a fascinating and hotly contested subject in the political analyst community.

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To order, see page 151.

LEIGH WELLS

Strategies That Fit Emerging Markets

Fast-growing economies often provide poor soil for profits. The cause? A lack of specialized intermediary firms and regulatory systems on which multinational companies depend. Successful businesses look for those institutional voids and work around them.

by Tarun Khanna, Krishna G. Palepu, and Jayant Sinha

CEOs and top management teams of large corporations, particularly in North America, Europe, and Japan, acknowledge that globalization is the most critical challenge they face today. They are also keenly aware that it has become tougher during the past decade to identify internationalization strategies and to choose which countries to do business with. Still, most companies have stuck to the strategies they've traditionally deployed, which emphasize standardized approaches to new markets while sometimes experimenting with a few local twists. As a result, many multinational corporations are struggling to develop successful strategies in emerging markets.

Part of the problem, we believe, is that the absence of specialized intermediaries, regulatory systems, and contract-enforcing mechanisms in emerging markets – "institutional voids," we christened them in a 1997 HBR article – hampers the implementation of globalization strategies. Companies in developed countries usually take for granted the critical role that "soft" infrastructure plays in the execution of their business models in their home markets. But that infrastructure is often underdeveloped or absent in emerging markets. There's no dearth of examples. Companies can't find skilled market research firms to inform them reliably about customer preferences so they can tailor products to specific needs and increase people's willingness to pay. Few end-to-end logistics providers, which allow manufacturers to reduce costs, are available to transport raw materials and finished products. Before recruiting employees, corporations have to screen large numbers of candidates themselves because there aren't many search firms that can do the job for them.

Because of all those institutional voids, many multinational companies have fared poorly in developing countries. All the anecdotal evidence we have gathered suggests that since the 1990s, American corporations have performed better in their home environments than they have in foreign countries, especially in emerging markets. Not surprisingly, many CEOs are wary of emerging markets and prefer to invest in developed nations instead. By the end of 2002 – according to the Bureau of Economic Analysis, an agency of the U.S. Department of Commerce – American corporations and their affiliate companies had $1.6 trillion worth of assets in the United Kingdom and $514 billion in Canada but only $173 billion in Brazil, Russia, India, and China combined. That's just 2.5% of the $6.9 trillion in investments American companies held by the end of that year. In fact, although U.S. corporations' investments in China doubled between 1992 and 2002, that amount was still less than 1% of all their overseas assets.

Many companies shied away from emerging markets when they should have engaged with them more closely. Since the early 1990s, developing countries have been the fastest-growing market in the world for most products and services. Companies can lower costs by setting up manufacturing facilities and service centers in those areas, where skilled labor and trained managers are relatively inexpensive. Moreover, several developing-country transnational corporations have entered North America and Europe with low-cost strategies (China's Haier Group in household electrical appliances) and novel business models (India's Infosys in information technology services). Western companies that want to develop counterstrategies must push deeper into emerging markets, which foster a different genre of innovations than mature markets do.

If Western companies don't develop strategies for engaging across their value chains with developing countries, they are unlikely to remain competitive for long. However, despite crumbling tariff barriers, the spread of the Internet and cable television, and the rapidly improving physical infrastructure in these countries, CEOs can't assume they can do business in emerging markets the same way they do in developed nations. That's because the quality of the market infrastructure varies widely from country to country. In general, advanced economies have large pools of seasoned market intermediaries and effective contract-enforcing mechanisms, whereas less-developed economies have unskilled intermediaries and less-effective legal systems. Because the services provided by intermediaries either aren't available in emerging markets or aren't very sophisticated, corporations can't smoothly transfer the strategies they employ in their home countries to those emerging markets.

During the past ten years, we've researched and consulted with multinational corporations all over the world. One of us led a comparative research project on China and India at Harvard Business School, and we have all been involved in McKinsey & Company's Global Champions research project. We have learned that successful companies work around institutional voids. They develop strategies for doing business in emerging markets that are different from those they use at home and often find novel ways of implementing them, too. They also customize their approaches to fit each nation's institutional context. As we will show, firms that take the trouble to understand the institutional differences between countries are likely to choose the best markets to enter, select optimal strategies, and make the most out of operating in emerging markets.

Successful companies develop strategies for doing business in emerging markets that are different from those they use at home and often find novel ways of implementing them, too.

Why Composite Indices Are Inadequate

Before we delve deeper into institutional voids, it's important to understand why companies often target the wrong countries or deploy inappropriate globalization strategies. Many corporations enter new lands because of senior managers' personal experiences, family ties, gut feelings, or anecdotal evidence. Others follow key customers or rivals into emerging markets; the herd instinct is strong among multinationals. Biases, too, dog companies' foreign investments. For instance, the reason U.S. companies preferred to do business with

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China rather than India for decades was probably because of America's romance with China, first profiled in MIT political scientist Harold Isaacs's work in the late 1950s. Isaacs pointed out that partly as a result of the work missionaries and scholars did in China in the 1800s, Americans became more familiar with China than with India.

Companies that choose new markets systematically often use tools like country portfolio analysis and political risk assessment, which chiefly focus on the potential profits from doing business in developing countries but leave out essential information about the soft infrastructures there. In December 2004, when the McKinsey Global Survey of Business Executives polled 9,750 senior managers on their priorities and concerns, 61% said that market size and growth drove their firms' decisions to enter new countries. While 17% felt that political and economic stability was the most important factor in making those decisions, only 13% said that structural conditions (in other words, institutional contexts) mattered most.

Just how do companies estimate a nation's potential? Executives usually analyze its GDP and per capita income growth rates, its population composition and growth rates, and its exchange rates and purchasing power parity indices (past, present, and projected). To complete the picture, managers consider the nation's standing on the World Economic Forum's Global Competitiveness Index, the World Bank's governance indicators, and Transparency International's corruption ratings; its weight in emerging market funds investments; and, perhaps, forecasts of its next political transition.

Such composite indices are no doubt useful, but companies should use them as the basis for drawing up strategies only when their home bases and target countries have comparable institutional contexts. For example, the United States and the United Kingdom have similar product, capital, and labor markets, with networks of skilled intermediaries and strong regulatory systems. The two nations share an Anglo-Saxon legal system as well. American companies can enter Britain comfortable in the knowledge that they will find competent market research firms, that they can count on English law to enforce agreements they sign with potential partners, and that retailers will be able to distribute products all over the country. Those are dangerous assumptions to make in an emerging market, where skilled intermediaries or contract-enforcing mechanisms are unlikely to be found. However, composite indices don't flash warning signals to would-be entrants

The Trouble with Composite Indices

Companies often base their globalization strategies on country rankings, but on most lists, it is impossible to tell developing countries apart. According to the six indices below, Brazil, India, and China share similar markets while Russia, though an outlier on many parameters, is comparable to the other nations. Contrary to what these rankings suggest, however, the market infrastructure in each of these countries varies widely, and companies need to deploy very different strategies to succeed.

	Brazil	Russia	India	China
Growth Competitiveness Index ranking* (out of 104 countries; for 2003)	57	70	55	46
Business Competitiveness Index ranking* (out of 103 countries; for 2003)	38	61	30	47
Governance indicators (percentile rankings)** (out of 199 countries; for 2002)				
Voice and accountability	58.1	33.8	60.2	10.1
Political stability	48.1	33.0	22.2	51.4
Government effectiveness	50.0	44.3	54.1	63.4
Regulatory quality	63.4	44.3	43.8	40.2
Rule of law	50.0	25.3	57.2	51.5
Control of corruption	56.7	21.1	49.5	42.3
Corruption Perceptions Index ranking*** (out of 145 countries; for 2004)	59	90	90	71
Composite Country Risk Points**** (for January 2005; the larger the number, the less risky the country)	70	78	72	76
Weight in Emerging Markets Index (%)***** (for February 2004; out of 26 emerging markets)	6.96%	5.16%	5.02%	4.76%

Sources:
* World Economic Forum, "Global Competitiveness Report," 2004–2005
** World Bank Governance Research Indicator Country Snapshot, 2002
*** Transparency International, Corruption Perceptions Index, 2004
**** The PRS Group, *International Country Risk Guide*, January 2005
***** Barclays Global Investors, iShares "2004 Semi-Annual Report to Shareholders"

about the presence of institutional voids in emerging markets.

In fact, composite index–based analyses of developing countries conceal more than they reveal. (See the exhibit "The Trouble with Composite Indices.") In 2003, Brazil, Russia, India, and China appeared similar on several indices. Yet despite the four countries' comparable standings, the key success factors in each of those markets have turned out to be very different. For instance, in China and Russia, multinational retail chains and local retailers have expanded into the urban and semi-urban areas, whereas in Brazil, only a few global chains have set up shop in key urban centers. And in India, the government prohibited foreign direct investment in the retailing and real estate industries until February 2005, so mom-and-pop retailers dominate. Brazil, Russia, India, and China may all be big markets for multinational consumer product makers, but executives have to design unique distribution strategies for each market. That process must start with a thorough understanding of the differences between the countries' market infrastructures. Those differences may make it more attractive for some businesses to enter, say, Brazil than India.

Can companies sustain strategies that presume the existence of institutional voids? They can. It took decades to fill institutional voids in the West.

How to Map Institutional Contexts

As we helped companies think through their globalization strategies, we came up with a simple conceptual device–the five contexts framework–that lets executives map the institutional contexts of any country. Economics 101 tells us that companies buy inputs in the product, labor, and capital markets and sell their outputs in the products (raw materials and finished goods) or services market. When choosing strategies, therefore, executives need to figure out how the product, labor, and capital markets work – and don't work – in their target countries. This will help them understand the differences between home markets and those in developing countries. In addition, each country's social and political milieu–as well as the manner in which it has opened up to the outside world – shapes those markets, and companies must consider those factors, too.

The five contexts framework places a superstructure of key markets on a base of sociopolitical choices. Many multinational corporations look at either the macro factors (the degree of openness and the sociopolitical atmosphere) or some of the market factors, but few pay attention to both. We have developed sets of questions that companies can ask to create a map of each country's context and to gauge the extent to which businesses must adapt their strategies to each one. (See the exhibit "Spotting Institutional Voids.") Before we apply the framework to some developing countries, let's briefly touch on the five contexts.

Political and Social Systems. As we've discussed, every country's political system affects its product, labor, and capital markets. In socialist societies like China, for instance, workers cannot form independent trade unions in the labor market, which affects wage levels. A country's social environment is also important. In South Africa, for example, the government's support for the transfer of assets to the historically disenfranchised native African community – a laudable social objective–has affected the development of the capital market. Such transfers usually price assets in an arbitrary fashion, which makes it hard for multinationals to figure out the value of South African companies and affects their assessments of potential partners.

The thorny relationships between ethnic, regional, and linguistic groups in emerging markets also affects foreign investors. In Malaysia, for instance, foreign companies should enter into joint ventures only after checking if their potential partners belong to the majority Malay community or the economically dominant Chinese community, so as not to conflict with the government's longstanding policy of transferring some assets from Chinese to Malays. This policy arose because of a perception that the race riots of 1969 were caused by the tension between the Chinese haves and the Malay have-nots. Although the rhetoric has changed somewhat in the past few years, the pro-Malay policy remains in place.

Executives would do well to identify a country's power centers, such as its bureaucracy, media, and civil society, and figure out if there are checks and balances in place. Managers must also determine how decentralized the political system is, if the government is subject to oversight, and whether bureaucrats and politicians are independent from one another. Companies should gauge the level of actual trust among the populace as opposed to enforced trust. For instance, if people believe companies won't vanish with their savings, firms may be able to raise money locally sooner rather than later.

Openness. CEOs often talk about the need for economies to be open because they believe it's best to enter countries that welcome direct investment by multinational corporations – although companies can get into countries that don't allow foreign investment by entering into joint ventures or by licensing local partners. Still, they must remember that the concept of "open" can be deceptive. For example, executives believe that China is an open economy because the government welcomes foreign investment but that India is a relatively closed economy because of the lukewarm reception the Indian government gives multinationals. However, India has been open to ideas from the West, and people have always been able to travel freely in and out of the country, whereas for decades, the Chinese government didn't allow its citizens to travel abroad freely, and it still doesn't allow many ideas to cross its borders. Consequently, while it may be true that multinational companies can invest in China more easily than they can in India, managers in India are more inclined to be market oriented and globally aware than managers are in China.

The more open a country's economy, the more likely it is that global intermediaries will be allowed to operate there. Multinationals, therefore, will find it easier to function in markets that are more open because they can use the services of both the global and local intermediaries. However, openness can be a double-edged sword: A government that allows local companies to access the global capital market neutralizes one of foreign companies' key advantages.

The two macro contexts we have just described – political and social systems and openness – shape the market contexts. For instance, in Chile, a military coup in the early 1970s led to the establishment of a right-wing government, and that government's liberal economic policies led to a vibrant capital market in the country. But Chile's labor market remained underdeveloped because the government did not allow trade unions to operate freely. Similarly, openness affects the development of markets. If a country's capital markets are open to foreign investors, financial intermediaries will become more sophisticated. That has happened in India, for example, where capital markets are more open than they are in China. Likewise, in the product market, if multinationals can invest in the retail industry, logistics providers will develop rapidly. This has been the case in China, where providers have taken hold more quickly than they have in India, which has only recently allowed multinationals to invest in retailing.

Product Markets. Developing countries have opened up their markets and grown rapidly during the past decade, but companies still struggle to get reliable information about consumers, especially those with low incomes. Developing a consumer finance business is tough, for example, because the data sources and credit histories that firms draw on in the West don't exist in emerging markets. Market research and advertising are in their infancy in developing countries, and it's difficult to find the deep databases on consumption patterns that allow companies to segment consumers in more-developed markets. There are few government bodies or independent publications, like *Consumer Reports* in the United States, that provide expert advice on the features and quality of products. Because of a lack of consumer courts and advocacy groups in developing nations, many people feel they are at the mercy of big companies.

Labor Markets. In spite of emerging markets' large populations, multinationals have trouble recruiting managers and other skilled workers because the quality of talent is hard to ascertain. There are relatively few search firms and recruiting agencies in low-income countries. The high-quality firms that do exist focus on top-level searches, so companies must scramble to identify middle-level managers, engineers, or floor supervisors. Engineering colleges, business schools, and training institutions have proliferated, but apart from an elite few, there's no way for companies to tell which schools produce skilled managers. For instance, several Indian companies have sprung up to train people for jobs in the call center business, but no organization rates the quality of the training it provides.

Capital Markets. The capital and financial markets in developing countries are remarkable for their lack of sophistication. Apart from a few stock exchanges and government-appointed regulators, there aren't many reliable intermediaries like credit-rating agencies, investment analysts, merchant bankers, or venture capital firms. Multinationals can't count on raising debt or equity capital locally to finance their operations. Like investors, creditors don't have access to accurate information on companies. Businesses can't easily assess the creditworthiness of other firms or collect receivables after they have extended credit to customers. Corporate governance is also notoriously poor in emerging markets. Transnational companies, therefore, can't trust their partners to adhere to local laws and joint venture agreements. In fact, since crony capitalism thrives in developing countries, multinationals can't assume that the profit motive alone is what's driving local firms.

Several CEOs have asked us why we emphasize the role of institutional intermediaries and ignore industry factors. They argue that industry structure, such as the degree of competition, should also influence companies' strategies. But when Harvard Business School professor Jan Rivkin and one of the authors of this article ranked industries by profitability, they found that the correlation of industry rankings across pairs of countries was close to zero, which means that the attractiveness of an industry varied widely from country to country. So although factors like scale economies, entry barriers, and the ability to differentiate products matter in every industry, the weight of their importance varies from place to place. An attractive industry in your home market may turn out to be unattractive in another country. Companies should analyze industry structures – always a useful exercise – only after they understand a country's institutional context.

Applying the Framework

When we applied the five contexts framework to emerging markets in four countries – Brazil, Russia, India, and China – the differences between them became apparent. (See the exhibit "Mapping Contexts in Brazil, Russia, India, and China.") Multinationals face different kinds of competition in each of

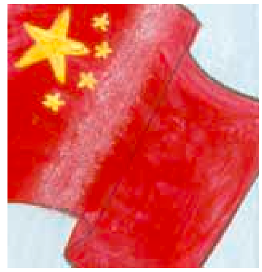
continued on page 73

Mapping Contexts in Brazil, Russia, India, and China

The five contexts (below) can help companies spot the institutional voids in any country. An application of the framework to the four fastest-growing markets in the world reveals how different those countries are from developed nations and, more important, from one another.







POLITICAL AND SOCIAL SYSTEM

U.S./EU	Brazil	Russia	India	China
POLITICAL STRUCTURE				
Countries have vibrant democracies with checks and balances. Companies can count on rule of law and fair enforcement of legal contracts.	The democracy is vibrant. Bureaucracy is rampant. There are pockets of corruption in federal and state governments.	A centralized government and some regional fiefdoms coexist. Bureaucracy is stifling. Corruption occurs at all levels of government.	The democracy is vibrant. The government is highly bureaucratic. Corruption is rampant in state and local governments.	The Communist Party maintains a monopoly on political power. Local governments make economic policy decisions. Officials may abuse power for personal gain.
CIVIL SOCIETY				
A dynamic media acts as a check on abuses by both companies and governments. Powerful nongovernmental organizations (NGOs) influence corporate policies on social and environmental issues.	Influential local media serves as a watchdog. The influence of local NGOs is marginal.	The media is controlled by the government. NGOs are underdeveloped and disorganized.	A dynamic press and vigilant NGOs act as checks on politicians and companies.	The media is muzzled by the government, and there are few independent NGOs. Companies don't have to worry about criticism, but they can't count on civil society to check abuses of power.

OPENNESS

U.S./EU	Brazil	Russia	India	China
MODES OF ENTRY				
Open to all forms of foreign investment except when governments have concerns about potential monopolies or national security issues.	Both greenfield investments and acquisitions are possible entry strategies. Companies team up with local partners to gain local expertise.	Both greenfield investments and acquisitions are possible but difficult. Companies form alliances to gain access to government and local inputs.	Restrictions on greenfield investments and acquisitions in some sectors make joint ventures necessary. Red tape hinders companies in sectors where the government does allow foreign investment.	The government permits greenfield investments as well as acquisitions. Acquired companies are likely to have been state owned and may have hidden liabilities. Alliances let companies align interests with all levels of government.

PRODUCT MARKETS

U.S./EU	Brazil	Russia	India	China
PRODUCT DEVELOPMENT AND INTELLECTUAL PROPERTY RIGHTS (IPR)				
Sophisticated product-design capabilities are available. Governments enforce IPR and protect trademarks, so R&D investments yield competitive advantages.	Local design capability exists. IPR disputes with the United States exist in some sectors.	The country has a strong local design capability but exhibits an ambivalent attitude about IPR. Sufficient regulatory authority exists, but enforcement is patchy.	Some local design capability is available. IPR problems with the United States exist in some industries. Regulatory bodies monitor product quality and fraud.	Imitation and piracy abound. Punishment for IPR theft varies across provinces and by level of corruption.
SUPPLIER BASE AND LOGISTICS				
Companies use national and international suppliers. Firms outsource and move manufacturing and services offshore instead of integrating vertically. A highly developed infrastructure is in place, but urban areas are saturated.	Suppliers are available in the Mercosur region. A good network of highways, airports, and ports exists.	Companies can rely on local suppliers for simple components. The European region has decent logistics networks, but trans-Ural Russia is not well developed.	Suppliers are available, but their quality and dependability varies greatly. Roads are in poor condition. Ports and airports are underdeveloped.	Several suppliers have strong manufacturing capabilities, but few vendors have advanced technical abilities. The road network is well developed. Port facilities are excellent.
BRAND PERCEPTIONS AND MANAGEMENT				
Markets are mature and have strong local and global brands. The profusion of brands clutters consumer choice. Numerous ad agencies are available.	Consumers accept both local and global brands. Global as well as local ad agencies are present.	Consumers prefer global brands in automobiles and high tech. Local brands thrive in the food and beverage businesses. Some local and global ad agencies are available.	Consumers buy both local and global brands. Global ad agencies are present, but they have been less successful than local ad agencies.	Consumers prefer to buy products from American, European, and Japanese companies. Multinational ad agencies dominate the business.

LABOR MARKETS

U.S./EU	Brazil	Russia	India	China
MARKET FOR MANAGERS				
A large and varied pool of well-trained management talent exists.	The large pool of management talent has varying degrees of proficiency in English. Both local and expatriate managers hold senior management jobs.	The large pool of management talent has varying degrees of proficiency in English, and it is supplemented by expatriate managers. Employment agencies are booming.	The country has a highly liquid pool of English-speaking management talent fueled by business and technical schools. Local hires are preferred over expatriates.	There is a relatively small and static market for managers, especially away from the eastern seaboard. Many senior and middle managers aren't fluent in English. A large number of managers are expatriates. Some members of the Chinese diaspora have returned home to work.

More Mapping Contexts: Turn page >>

Source: Media reports and interviews with academics and businesspeople

LABOR MARKETS

U.S./EU	Brazil	Russia	India	China
WORKERS MARKET				
The level of unionization varies among countries. Industrial actions take place in Europe, especially in the manufacturing and public sectors, but not in the United States.	Trade unions are strong and pragmatic, which means that companies can sign agreements with them.	Trade unions are present, but their influence is declining except in certain sectors, such as mining and railways.	The trade union movement is active and volatile, although it is becoming less important. Trade unions have strong political connections.	Workers can join the government-controlled All-China Federation of Trade Unions. Historically, there were no industrial actions, but there have been recent strikes at Hong Kong– and Taiwan-owned manufacturing facilities.

CAPITAL MARKETS

U.S./EU	Brazil	Russia	India	China
DEBT AND EQUITY				
Companies can easily get bank loans. The corporate bond market is well developed. The integration of stock exchanges gives companies access to a deep pool of investors.	A good banking system exists, and there is a healthy market for initial public offerings. Wealthy individuals can invest in offshore accounts.	The banking system is strong but dominated by state-owned banks. The consumer credit market is booming, and the IPO market is growing. Firms must incorporate local subsidiaries to raise equity capital.	The local banking system is well developed. Multinationals can rely on local banks for local needs. Equity is available to local and foreign entities.	The local banking system and equity markets are underdeveloped. Foreign companies have to raise both debt and equity in home markets.
VENTURE CAPITAL (VC)				
VC is generally available in urban areas or for specific industry clusters. VC is not as readily available in southern Europe.	A few private equity players are active locally.	Only companies in the most profitable businesses, such as real estate development and natural resources, can access VC.	VC is available in some cities and from the Indian diaspora.	VC availability is limited.
ACCOUNTING STANDARDS				
Apart from off-balance-sheet items, a high level of transparency exists. In the European Union, accounting practices should become more uniform after 2005 because of new norms.	The financial-reporting system is based on a common-law system and functions well.	The modified Soviet system of financial reporting works well. Banks are shifting to international accounting standards.	Financial reporting, which is based on a common-law system, functions well.	There is little corporate transparency. China's accounting standards are not strict, although the China Securities Regulatory Commission wants to tighten disclosure rules.
FINANCIAL DISTRESS				
Efficient bankruptcy processes tend to favor certain stakeholders (creditors, labor force, or shareholders) in certain countries.	Processes allow companies to stay in business rather than go out of business. Bankruptcy processes exist but are inefficient.	Bankruptcy processes and legislation are fully developed. Corruption distorts bankruptcy enforcement.	Bankruptcy processes exist but are inefficient. Promoters find it difficult to sell off or shut down "sick" enterprises.	Companies can use bankruptcy processes in some cases. Write-offs are common.

Key questions for identifying institutional voids: See inside >>

Spotting Institutional Voids

Managers can identify the institutional voids in any country by asking a series of questions. The answers – or sometimes, the lack of them – will tell companies where they should adapt their business models to the nation's institutional context.

POLITICAL AND SOCIAL SYSTEM

1. To whom are the country's politicians accountable? Are there strong political groups that oppose the ruling party? Do elections take place regularly?
2. Are the roles of the legislative, executive, and judiciary clearly defined? What is the distribution of power between the central, state, and city governments?
3. Does the government go beyond regulating business to interfering in it or running companies?
4. Do the laws articulate and protect private property rights?
5. What is the quality of the country's bureaucrats? What are bureaucrats' incentives and career trajectories?
6. Is the judiciary independent? Do the courts adjudicate disputes and enforce contracts in a timely and impartial manner? How effective are the quasi-judicial regulatory institutions that set and enforce rules for business activities?
7. Do religious, linguistic, regional, and ethnic groups coexist peacefully, or are there tensions between them?
8. How vibrant and independent is the media? Are newspapers and magazines neutral, or do they represent sectarian interests?
9. Are nongovernmental organizations, civil rights groups, and environmental groups active in the country?
10. Do people tolerate corruption in business and government?
11. What role do family ties play in business?
12. Can strangers be trusted to honor a contract in the country?

OPENNESS

1. Are the country's government, media, and people receptive to foreign investment? Do citizens trust companies and individuals from some parts of the world more than others?
2. What restrictions does the government place on foreign investment? Are those restrictions in place to facilitate the growth of domestic companies, to protect state monopolies, or because people are suspicious of multinationals?
3. Can a company make greenfield investments and acquire local companies, or can it only break into the market by entering into joint ventures? Will that company be free to choose partners based purely on economic considerations?
4. Does the country allow the presence of foreign intermediaries such as market research and advertising firms, retailers, media companies, banks, insurance companies, venture capital firms, auditing firms, management consulting firms, and educational institutions?
5. How long does it take to start a new venture in the country? How cumbersome are the government's procedures for permitting the launch of a wholly foreign-owned business?
6. Are there restrictions on portfolio investments by overseas companies or on dividend repatriation by multinationals?
7. Does the market drive exchange rates, or does the government control them? If it's the latter, does the government try to maintain a stable exchange rate, or does it try to favor domestic products over imports by propping up the local currency?
8. What would be the impact of tariffs on a company's capital goods and raw materials imports? How would import duties affect that company's ability to manufacture its products locally versus exporting them from home?
9. Can a company set up its business anywhere in the country? If the government restricts the company's location choices, are its motives political, or is it inspired by a logical regional development strategy?
10. Has the country signed free-trade agreements with other nations? If so, do those agreements favor investments by companies from some parts of the world over others?
11. Does the government allow foreign executives to enter and leave the country freely? How difficult is it to get work permits for managers and engineers?
12. Does the country allow its citizens to travel abroad freely? Can ideas flow into the country unrestricted? Are people permitted to debate and accept those ideas?

PRODUCT MARKETS

1. Can companies easily obtain reliable data on customer tastes and purchase behaviors? Are there cultural barriers to market research? Do world-class market research firms operate in the country?
2. Can consumers easily obtain unbiased information on the quality of the goods and services they want to buy? Are there independent consumer organizations and publications that provide such information?

3. Can companies access raw materials and components of good quality? Is there a deep network of suppliers? Are there firms that assess suppliers' quality and reliability? Can companies enforce contracts with suppliers?

4. How strong are the logistics and transportation infrastructures? Have global logistics companies set up local operations?

5. Do large retail chains exist in the country? If so, do they cover the entire country or only the major cities? Do they reach all consumers or only wealthy ones?

6. Are there other types of distribution channels, such as direct-to-consumer channels and discount retail channels, that deliver products to customers?

7. Is it difficult for multinationals to collect receivables from local retailers?

8. Do consumers use credit cards, or does cash dominate transactions? Can consumers get credit to make purchases? Are data on customer creditworthiness available?

9. What recourse do consumers have against false claims by companies or defective products and services?

10. How do companies deliver after-sales service to consumers? Is it possible to set up a nationwide service network? Are third-party service providers reliable?

11. Are consumers willing to try new products and services? Do they trust goods from local companies? How about from foreign companies?

12. What kind of product-related environmental and safety regulations are in place? How do the authorities enforce those regulations?

LABOR MARKETS

1. How strong is the country's education infrastructure, especially for technical and management training? Does it have a good elementary and secondary education system as well?

2. Do people study and do business in English or in another international language, or do they mainly speak a local language?

3. Are data available to help sort out the quality of the country's educational institutions?

4. Can employees move easily from one company to another? Does the local culture support that movement? Do recruitment agencies facilitate executive mobility?

5. What are the major postrecruitment-training needs of the people that multinationals hire locally?

6. Is pay for performance a standard practice? How much weight do executives give seniority, as opposed to merit, in making promotion decisions?

7. Would a company be able to enforce employment contracts with senior executives? Could it protect itself against executives who leave the firm and then compete against it? Could it stop employees from stealing trade secrets and intellectual property?

8. Does the local culture accept foreign managers? Do the laws allow a firm to transfer locally hired people to another country? Do managers want to stay or leave the nation?

9. How are the rights of workers protected? How strong are the country's trade unions? Do they defend workers' interests or only advance a political agenda?

10. Can companies use stock options and stock-based compensation schemes to motivate employees?

11. Do the laws and regulations limit a firm's ability to restructure, downsize, or shut down?

12. If a company were to adopt its local rivals' or suppliers' business practices, such as the use of child labor, would that tarnish its image overseas?

CAPITAL MARKETS

1. How effective are the country's banks, insurance companies, and mutual funds at collecting savings and channeling them into investments?

2. Are financial institutions managed well? Is their decision making transparent? Do noneconomic considerations, such as family ties, influence their investment decisions?

3. Can companies raise large amounts of equity capital in the stock market? Is there a market for corporate debt?

4. Does a venture capital industry exist? If so, does it allow individuals with good ideas to raise funds?

5. How reliable are sources of information on company performance? Do the accounting standards and disclosure regulations permit investors and creditors to monitor company management?

6. Do independent financial analysts, rating agencies, and the media offer unbiased information on companies?

7. How effective are corporate governance norms and standards at protecting shareholder interests?

8. Are corporate boards independent and empowered, and do they have independent directors?

9. Are regulators effective at monitoring the banking industry and stock markets?

10. How well do the courts deal with fraud?

11. Do the laws permit companies to engage in hostile takeovers? Can shareholders organize themselves to remove entrenched managers through proxy fights?

12. Is there an orderly bankruptcy process that balances the interests of owners, creditors, and other stakeholders?

those nations. In China, state-owned enterprises control nearly half the economy, members of the Chinese diaspora control many of the foreign corporations that operate there, and the private sector brings up the rear because entrepreneurs find it almost impossible to access capital. India is the mirror image of China. Public sector corporations, though important, occupy nowhere near as prominent a place as they do in China. Unlike China, India is wary of foreign investment, even by members of the Indian diaspora. However, the country has spawned many private sector organizations, some of which are globally competitive. It's difficult to imagine a successful business in China that hasn't had something to do with the government; in India, most companies have succeeded in spite of the state.

Brazil mixes and matches features of both China and India. Like China, Brazil has floated many state-owned enterprises. At the same time, it has kept its doors open to multinationals, and European corporations such as Unilever, Volkswagen, and Nestlé have been able to build big businesses there. Volkswagen has six plants in Brazil, dominates the local market, and exports its Gol model to Argentina and Russia. Brazil also boasts private sector companies that, like Indian firms, go head-to-head in the local market with global firms. Some Brazilian companies, such as basic materials company Votorantim and aircraft maker Embraer, have become globally competitive.

Russia is also a cross between China and India, but most of its companies are less competitive than those in Brazil. A few multinationals such as McDonald's have done well, but most foreign firms have failed to make headway there. There are only a few strong private sector companies in the market, such as dairy products maker Wimm-Bill-Dann and cellular services provider VimpelCom. The Russian government is involved, formally and informally, in several industries. For instance, the government's equity stake in Gazprom allows it to influence the country's energy sector. Moreover, administrators at all levels can exercise near veto power over business deals that involve local or foreign companies, and getting permits and approvals is a complicated chore in Russia.

One level deeper, the financial markets in Brazil, Russia, India, and China vary, too. In Brazil and India, indigenous entrepreneurs, who are multinationals' main rivals, rely on the local capital markets for resources. In China, foreign companies compete with state-owned enterprises, which public sector banks usually fund. The difference is important because neither the Chinese companies nor the banks are under pressure to show profits. Moreover, financial reporting in China isn't transparent even if companies have listed themselves on stock exchanges. State-owned companies can for years pursue strategies that increase their market share at the expense of profits. Corporate governance standards in Brazil and India also mimic those of the West more closely than do those in Russia and China. Thus, in Russia and China, multinationals can't count on local partners' internal systems to protect their interests and assets – especially their intellectual property.

The Three Strategy Choices

When companies tailor strategies to each country's contexts, they can capitalize on the strengths of particular locations. Before adapting their approaches, however, firms must compare the benefits of doing so with the additional coordination costs they'll incur. When they complete this exercise, companies will find that they have three distinct choices: They can adapt their business model to countries while keeping their core value propositions constant, they can try to change the contexts, or they can stay out of countries where adapting strategies may be uneconomical or impractical. Can companies sustain strategies that presume the existence of institutional voids? They can. It took decades to fill institutional voids in the West.

Adapt your strategies. To succeed, multinationals must modify their business models for each nation. They may have to adapt to the voids in a country's product markets, its input markets, or both. But companies must retain their core business propositions even as they adapt their business models. If they make shifts that are too radical, these firms will lose their advantages of global scale and global branding.

Compare Dell's business models in the United States and China. In the United States, the hardware maker offers consumers a wide variety of configurations and makes most computers to order. Dell doesn't use distributors or resellers, shipping most machines directly to buyers. In 2003, nearly 50% of the company's revenues in North America came from orders placed through the Internet.

The cornerstone of Dell's business model is that it carries little or no inventory. But Dell realized that its direct-sales approach wouldn't work in China, because individuals weren't accustomed to buying PCs through the Internet. Chinese companies used paper-based order processing, so Dell had to rely on faxes and phones rather than online sales. And several Chinese government departments and state-owned enterprises insisted that hardware vendors make their bids through systems integrators. The upshot is that Dell relies heavily on distributors and systems integrators in China. When it first entered the market there, the company offered a smaller product range than it did in the United States to keep inventory levels low. Later, as its supply chain became more efficient, it offered customers in China a full range of products.

Smart companies like Dell modify their business model without destroying the parts of it that give them a competitive advantage over rivals. These firms start by identifying the value propositions that they will not modify, whatever the context. That's what McDonald's did even as it comprehensively adapted its business model to Russia's factor markets. In the United States, McDonald's has outsourced most of its supply chain operations. But when it tried to move into Russia in 1990, the company was unable to find local suppliers. The fast-food chain asked several of its European vendors to step up, but they weren't interested. Instead of giving up, McDonald's decided to go it alone. With the help of its joint venture partner, the Moscow City Administration, the company identified some Russian farmers and bakers it could work with. It imported cattle from Holland and russet potatoes from America, brought in agricultural specialists from Canada and Europe to improve the farmers' management practices, and advanced the farmers money so that they could invest in better seeds and equipment.

Then the company built a 100,000 square-foot McComplex in Moscow to produce beef; bakery, potato, and dairy products; ketchup; mustard; and Big Mac sauce. It set up a trucking fleet to move supplies to restaurants and financed its suppliers so that they would have enough working capital to buy modern equipment. The company also brought in about 50 expatriate managers to teach Russian employees about its service standards, quality measurements, and operating procedures and sent a 23-person team of Russian managers to Canada for a four-month training program. McDonald's created a vertically integrated operation in Russia, but the company clung to one principle: It would sell only hamburgers, fries, and Coke to Russians in a clean environment – fast. Fifteen years after serving its first Big Mac in Moscow's Pushkin Square, McDonald's has invested $250 million in the country and controls 80% of the Russian fast-food market.

Change the contexts. Many multinationals are powerful enough to alter the contexts in which they operate. The products or services these companies offer can force dramatic changes in local markets. When Asia's first satellite TV channel, Hong Kong–based STAR, launched in 1991, for example, it transformed the Indian marketplace in many ways. Not only did the company cause the Indian government to lose its monopoly on television broadcasts overnight, but it also led to a booming TV-manufacturing industry and the launch of several other satellite-based channels aimed at Indian audiences. By the mid-1990s, satellite-based TV channels had become a vibrant advertising medium, and many organizations used them to launch products and services targeted at India's new TV-watching consumer class.

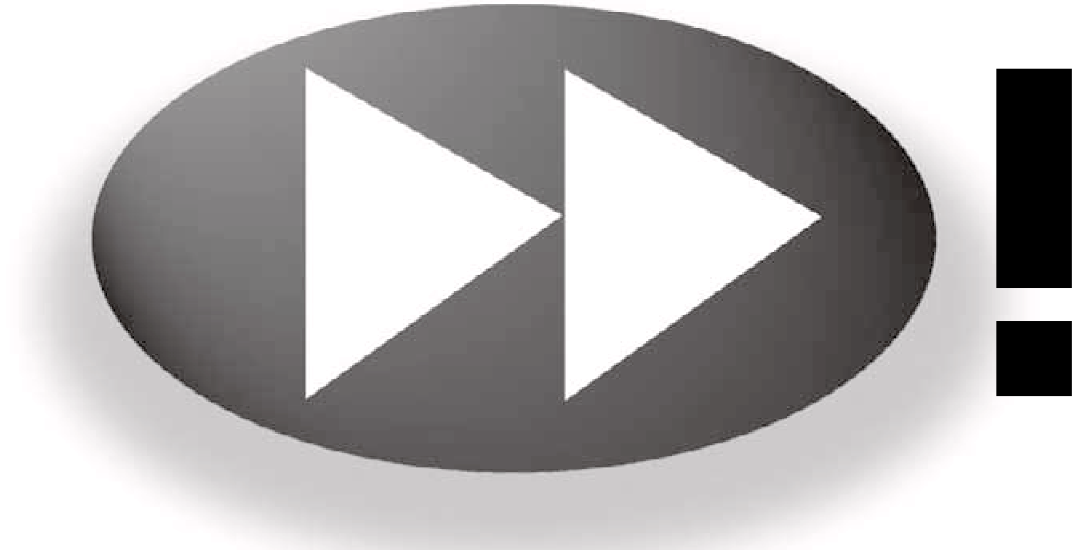
The entry of foreign companies transforms quality standards in local product markets, which can have far-reaching consequences. Japan's Suzuki triggered a quality revolution after it entered India in 1981. The automaker's need for large volumes of high-quality components roused local suppliers. They teamed up with Suzuki's vendors in Japan, formed quality clusters, and worked with Japanese experts to produce better products. During the next two decades, the total quality management movement spread to other industries in India. By 2004, Indian companies had bagged more Deming prizes than firms in any country other than Japan. More important, India's automotive suppliers had succeeded in breaking into the global market, and several of them, such as Sundram Fasteners, had become preferred suppliers to international automakers like GM.

Companies can change contexts in factor markets, too. Consider the capital market in Brazil. As multinationals set up subsidiaries in those countries, they needed global-quality audit services. Few Brazilian accounting firms could provide those services, so the Big Four audit firms – Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and Pricewaterhouse-Coopers – decided to set up branches there. The presence of those companies quickly raised financial-reporting and auditing standards in Brazil.

In a similar vein, Knauf, one of Europe's leading manufacturers of building materials, is trying to grow Russia's talent market. During the past decade, the German giant has built 20 factories in Russia and invested more than $400 million there. Knauf operates in a people-intensive industry; the company and its subsidiaries have roughly 7,000 employees in Russia. To boost standards in the country's construction industry, Knauf opened an education center in St. Petersburg in 2003 that works closely with the State Architectural and Construction University. The school acts both as a mechanism that supplies talent to Knauf and as an institution that contributes to the much-needed development of Russian architecture.

Multinationals may have to adapt to the voids in a country's product markets, its input markets, or both. But companies must retain their core business propositions even as they adapt their business models.

Indeed, as firms change contexts, they must help countries fully develop their potential. That creates a win-win situation for the country and the company. Metro Cash & Carry, a division of German trading company Metro Group, has changed contexts in a socially beneficial way in several European and Asian countries. The Düsseldorf-based company – which sells everything to restaurants from meats and vegetables to napkins and toothpicks – entered China in 1996, Russia in 2001, and India in 2003. Metro has pioneered business links between farmers and small-scale manufacturers in rural areas that sell their products to small and midsize urban companies.



For instance, Metro invested in a cold chain in China so that it could deliver goods like fish and meats from rural regions to urban locations. That changed local conditions in several important ways. First, Metro's investment induced farmers in China to invest more in their agricultural operations. Metro also lobbied with governments for quality standards to prevent companies from selling shoddy produce to hapless consumers. By shifting transactions from roadside markets to computerized warehouses, the company's operations brought primary products into the tax net. Governments, which need the money to invest in local services, have remained on the company's side. That's a good thing for Metro since, in developing markets, the jury is always out on foreign companies.

Stay away. It may be impractical or uneconomical for some firms to adapt their business models to emerging markets. Home Depot, the successful do-it-yourself U.S. retailer, has been cautious about entering developing countries. The company offers a specific value proposition to customers: low prices, great service, and good quality. To pull that off, it relies on a variety of U.S.-specific institutions. It depends on the U.S. highways and logistical management systems to minimize the amount of inventory it has to carry in its large, warehouse-style stores. It relies on employee stock ownership to motivate shop-level workers to render top-notch service. And its value proposition takes advantage of the fact that high labor costs in the United States encourage home owners to engage in do-it-yourself projects.

Home Depot made a tentative foray into emerging markets by setting up two stores in Chile in 1998 and another in Argentina in 2000. In 2001, however, the company sold those operations for a net loss of $14 million. At the time, CEO Robert Nardelli emphasized that most of Home Depot's future growth was likely to come from North America. Despite that initial setback, the company hasn't entirely abandoned emerging markets. Rather, it has switched from a greenfield strategy to an acquisition-led approach. In 2001, Home Depot entered Mexico by buying a home improvement retailer, Total Home, and the next year, it acquired Del Norte, another small chain. By 2004, the company had 42 stores in Mexico. Although Home Depot has recently said that it is exploring the possibility of entering China, perhaps by making an acquisition, it doesn't have retail operations in any other developing countries.

Home Depot must consider whether it can modify its U.S. business model to suit the institutional contexts of emerging markets. In a country with a poorly developed capital market, for example, the company may not be able to use employee stock ownership as a compensation tool. Similarly, in a country with a poorly developed physical infrastructure, Home Depot may have difficulty using its inventory management systems, a scenario that would alter the economics of the business. In markets where labor costs are relatively low, the target customer may not be the home owner but rather contractors who serve as intermediaries between the store and the home owner. That change in customer focus may warrant an entirely different marketing and merchandising strategy – one that Home Depot isn't convinced it should deploy yet.

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While companies can't use the same strategies in all developing countries, they can generate synergies by treating different markets as part of a system. For instance, GE Healthcare (formerly GE Medical Systems) makes parts for its diagnostic machines in China, Hungary, and Mexico and develops the software for those machines in India. The company created this system when it realized that the market for diagnostic machines was small in most low-income countries. GE Healthcare then decided to use the facility it had set up in India in 1990 as a global sourcing base. After several years, and on the back of borrowed expertise from GE Japan, the India operation's products finally met GE Healthcare's exacting standards. In the late 1990s, when GE Healthcare wanted to move a plant from Belgium to cut costs, the Indian subsidiary beat its Mexican counterpart by delivering the highest quality at the lowest cost. Under its then-CEO, Jeff Immelt, GE Healthcare learned to use all its operations in low-income countries – China, Hungary, Mexico, and India – as parts of a system that allowed the company to produce equipment cheaply for the world market.

Parent company GE has also tapped into the talent pool in emerging markets by setting up technology centers in Shanghai and Bangalore, for instance. In those centers, the company conducts research on everything from materials design to molecular modeling to power electronics. GE doesn't treat China and India just as markets but also as sources of talent and innovation that can transform its value chain. And that's how multinational companies should engage with emerging markets if they wish to secure their future.

While companies can't use the same strategies in all developing countries, they can generate synergies by treating different markets as part of a system.

Andy Klump, Niraj Kaji, Luis Sanchez, and Max Yacoub provided research assistance for the Dell and McDonald's examples in this article.

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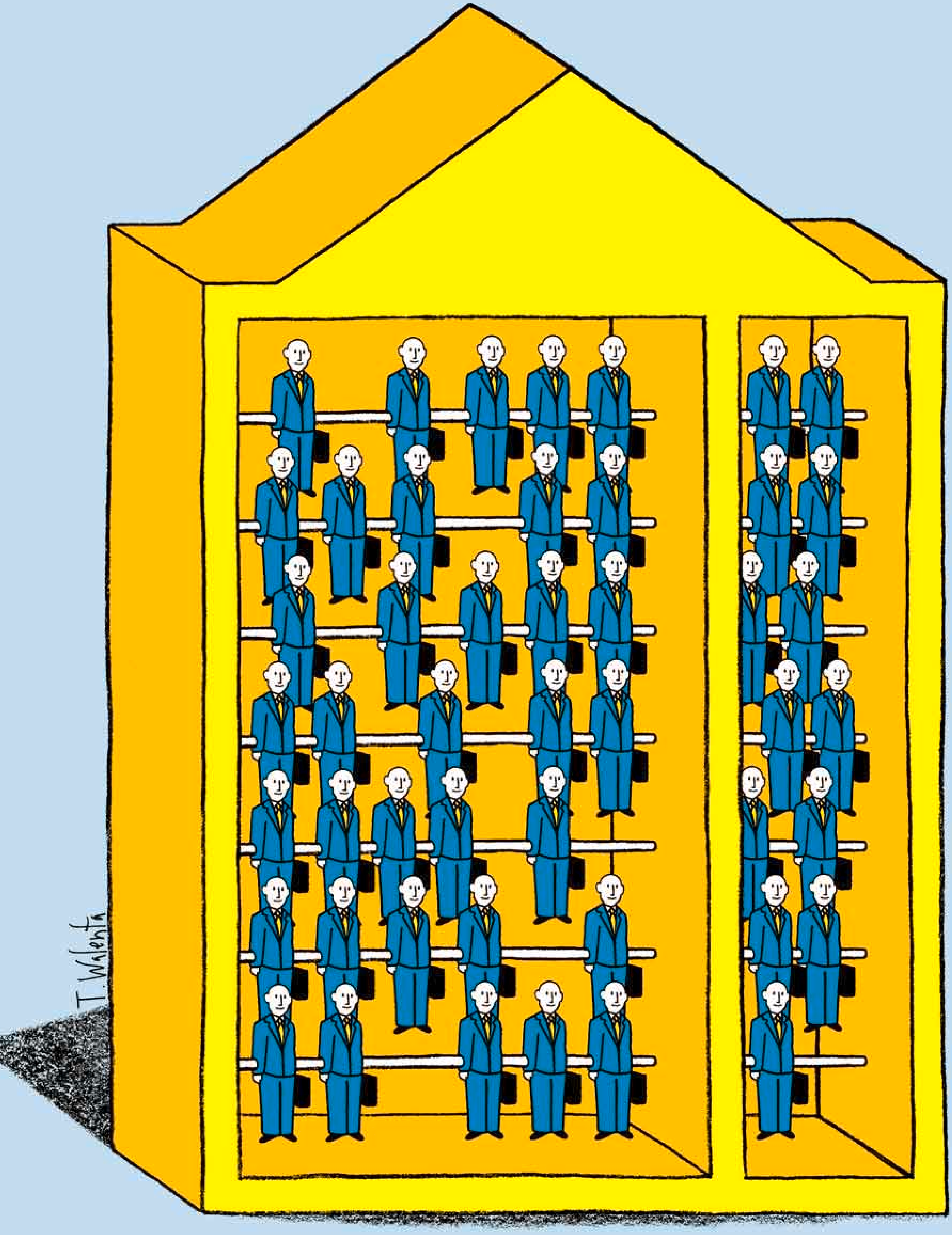

TOMASZ WALENTA

People-intensive companies and business units ought to be managed and measured in ways that reflect their unique economics. Some standard practices can lead you dangerously astray.

The Surprising Economics of a "People Business"

by Felix Barber and Rainer Strack

IT'S NO SECRET that business success today revolves largely around people, not capital. Many traditional manufacturers are now essentially service businesses. In most industries, people costs are much higher than capital costs. Even when a company isn't people intensive overall, a people-based business embedded in the company often drives corporate performance.

Yet for the most part, today's business performance measures and management practices don't reflect the particular economics of people-driven businesses. Most managers fail to see that, economically speaking, IBM more closely resembles, say, advertising giant Omnicom or oil-field services firm Schlumberger than it does an industry neighbor like Intel. That is, even though cooperative and competitive relationships with Intel are important to IBM's strategy, the company's operational performance will be driven mainly by the things it has in common with seemingly dissimilar people-oriented businesses.

Indeed, when people are your most important resource, some standard performance measures and management practices become ill suited to their tasks. Consider, for example, the concept of economic profit, whose widespread adoption as a performance metric represented a major breakthrough in measuring business performance. Economic profit, measured using such methods as Economic Value Added (EVA) and Cash Value Added (CVA), takes into account something ignored by the traditional profit-and-loss statement – the full cost of capital, both debt and equity. But there's a problem with such measures for companies with relatively high people costs and low capital costs: The metrics, at least as conventionally calculated, offer little information about the real drivers of business performance. In order to identify where and how value is being created–or squandered – people-intensive businesses need performance metrics that are as financially rigorous as economic profit but that highlight the productivity of people rather than of capital.

The distinct but generally unappreciated economics of people-intensive businesses call not only for different metrics but also for different management practices. For instance, because even slight changes in employee productivity have a significant impact on shareholder returns, "human resource management" is no longer a support function but a core process for line managers.

While many of these metrics and practices apply to any business whose people costs are greater than its capital costs, they are most relevant for what we call *people businesses.* Strictly defined, these are operations – whether entire companies or business units–with

1) high overall employee costs, 2) a high ratio of employee costs to capital costs, and 3) limited spending on activities, such as R&D, aimed at generating future revenue. (For a look at the cost structures of a variety of people, and other, businesses, see the exhibit "Where Does the Money Go?") Understanding the special qualities of a people business is particularly important when it is embedded in an otherwise capital-intensive company and risks being damaged, if not destroyed, through the application of traditional performance metrics and management practices.

Why the Old Rules Don't Apply

People businesses don't fit neatly into the familiar categories that have emerged over the past several decades. Yes, many people businesses are "service businesses." But some large service-oriented companies, such as McDonald's, aren't people businesses because they have substantial assets (brand and real estate, in the case of the fast-food giant) and relatively low people costs (the restaurant chain's people costs are borne, for the most part, by McDonald's franchisees rather than by the company itself). Yes, numerous people businesses are indeed "knowledge businesses." But many others are low-valued-added operations – for example, hotel management companies – where employees' intellectual contribution isn't paramount. And some people businesses are in traditional industrial sectors: Think of elevator makers like Otis and Schindler, whose revenues come primarily from service activities. In fact, people businesses–with their distinctive cost structure–span industries ranging from IT consulting to facilities management, from insurance brokering to telecommunications services.

People businesses play a significant role in developed economies. They account for around 25% of private sector employment in North America and Western Europe and well over half of employment growth during the past decade. Because of consolidation in traditionally fragmented industries–such as advertising, contract catering, and financial advice – people businesses today are often large, publicly quoted companies. (See the exhibit "The People Business 40.")

People costs exceed capital costs in an array of other businesses, as well. For example, at an airline, employee costs are typically about one-and-a-half times the amount of capital costs, despite airlines' giant equipment purchases. (Although fuel is a major cost for airlines, fuel expenditure isn't a good lever for improving performance because, as a commodity, fuel is sold at roughly the same, though often volatile, price to all players in the industry.) Even at a heavy-industry company like an automaker, employee costs usually exceed capital costs. At a minimum, most diversified companies have large units engaged in employee-intensive activities–for instance, sales and customer service – that give those units many of the economic characteristics of a people business.

These characteristics are often ignored or unappreciated by top managers. Companies mistakenly focus on capital productivity rather than employee productivity and rely on capital-oriented metrics, such as return on assets and return on equity. These aren't much help in assessing a people business, as they tend to mask weak performance or indicate volatility where it doesn't exist. A struggling advertising agency or software company may show what seems like a satisfactory return on assets largely because it has so few of them. Similarly, even modest capital investments or productivity improvements may cause big swings in ROA for a company whose asset base is relatively small. For example, if employee costs are five times assets – not uncommon in a people business – then it takes only a 5% increase in employee productivity or a 5% reduction in employee costs to increase profits by 25% of assets.

Return on equity is often an even more questionable benchmark of operational performance. For example, because they have so few other assets, many people businesses that have grown by acquisition find that goodwill, for which accounting conventions vary considerably, accounts for a substantial share of their total capital. Indeed,

Capital-oriented metrics aren't much help in assessing a people business, as they tend to mask weak performance or indicate volatility where it doesn't exist.

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after subtracting goodwill, many of these companies are left with negative equity. Given this and other difficulties, interpreting the return on equity of people businesses becomes an arcane science.

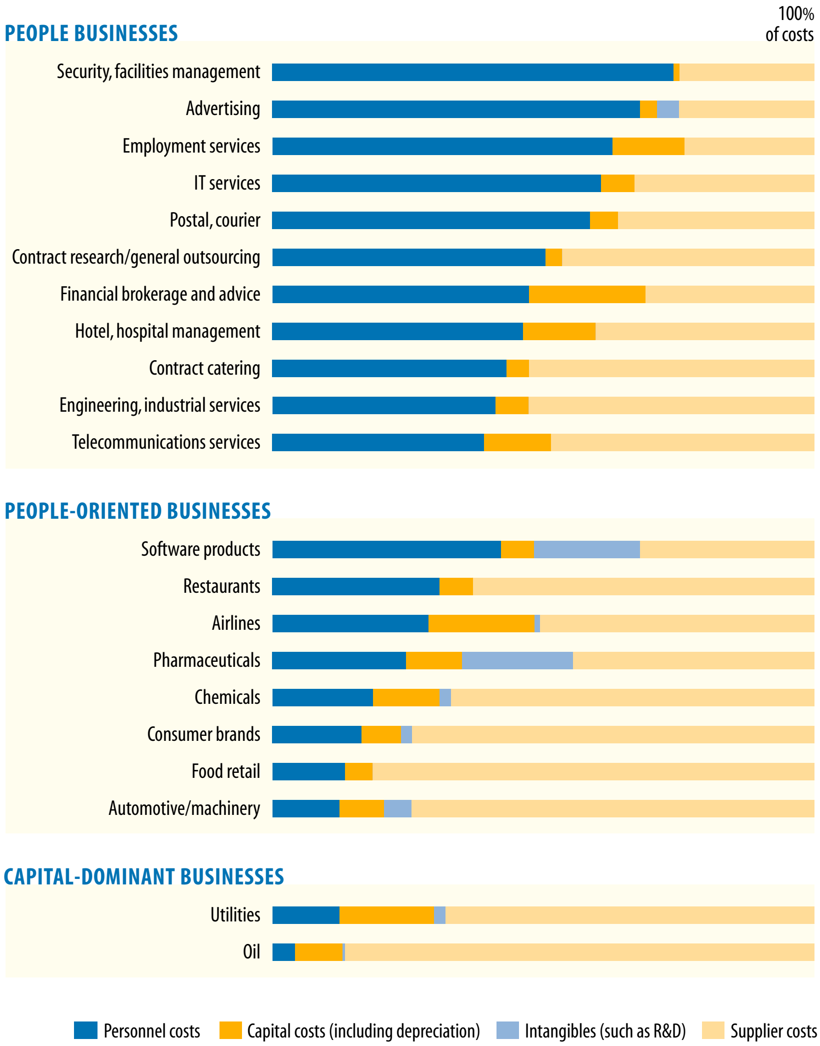
Just as problematic are the conventional metrics designed to measure employee productivity. While more suited to people businesses, they usually don't carry much weight with top management. That's because the most common ones, such as sales per employee and profit per employee, are easily distorted. Sales per employee, for instance, is strongly influenced both by outsourcing and by the level of capital investment. If a company outsources activities performed by half its employees and the cost of outsourcing is the same as keeping those activities in-house, sales per employee doubles but productivity doesn't budge. Similarly, if a company makes a capital investment and replaces employees with machinery whose capital costs exceed the costs of the employees replaced, an increase in sales per employee may be accompanied by a fall in productivity.

We are hardly the first observers to note the measurement and management challenges posed by the increasingly people-heavy and capital-light nature of business. But in our view, most efforts to take account of this shift focus on the wrong things. For example, attempts have been made to "fix" the balance sheet by including intangible assets. While these attempts certainly have value, they miss a crucial point: The critical resource of most businesses is no longer capital – that is, assets that a company owns and utilizes at as high a level as possible. Rather, the critical resources are employees whom a company *hires* and must motivate and retain. The fact that companies don't own their employees, as they do their capital assets, is why methods for valuing "human capital" on balance sheets are so tortuous.

Focusing on intangible assets is troublesome for people businesses in other ways. Whereas the level and nature of traditional capital investment largely determine how productively employees can work, there is huge variation in employee performance at a people business – an investment bank, a hotel, an advertising agency – and the variation is completely independent of assets, tangible or intangible. And while the value employees create in some businesses does take the form of intangible assets – intellectual property, brands, and the like – most employees in people businesses create short-term value directly for customers, month for month and year for year, without the intermediary step of creating an intangible asset.

Where Does the Money Go?

People businesses are those with relatively high employee costs, a high ratio of employee costs to capital costs, and limited spending on activities, such as R&D, aimed at generating future revenue. But people costs exceed capital costs in an array of other businesses as well, as the following breakdown of typical costs by industry shows.



Source: Annual reports and Boston Consulting Group analysis

At a certain point, struggling to make things fit into an existing model no longer makes sense. Liberated from the straitjacket of capital-oriented approaches, a people-intensive business can measure and manage performance by focusing on employees as employees, without having to pretend that they're "capital" or that their value comes entirely from the creation of intangible assets.

People-Oriented Measurement and Management

So if you run a people business – or a company that includes one or more of them – how do you figure out your true performance? And once you know what it is, how do you enhance that performance operationally, reward it appropriately, price it advantageously, and, ultimately, transform it strategically?

Performance Measurement. You start with the right set of performance indicators. The ideal measures will highlight the major drivers of business results, alert you to emerging problems, and provide some hints about their causes. You can get this kind of information by relating performance to people employed rather than to capital employed. Fortunately, doing this is remarkably easy. You simply reinterpret economic profit – for example, EVA or CVA – so that it reveals the difference between employee productivity and employee cost rather than the difference between capital productivity and capital cost. In other words, you calculate economic profit using a people rather than a capital denominator.

The logic isn't complicated. You start with sales per employee and subtract supplier costs (including outsourced activities) per employee and capital costs (including depreciation and a capital charge to cover the cost of debt and equity) per employee. The remainder is a measure of employee productivity. Subtract employee costs per employee, and you have economic profit per employee. (For an explanation of the process and how it can be applied to an actual company, see the sidebar "Measuring the True Performance of a People Business.")

The beauty of this approach is threefold. First, unlike many people-oriented metrics, it is grounded in hard financial information gleaned from a company's own accounts rather than in soft assumptions about the impact of human performance on outcomes. Second, it yields realistic returns because the employee denominator of the performance ratio is substantial. Third, it provides meaningful employee-oriented comparisons across a portfolio of operations within a company that aren't skewed by such things as outsourcing or capital investment.

People Management. It goes without saying that managing people is a key task for any company. But in a people business, this task becomes central to success. Because employees represent both the major cost and the major driver of value creation, people-management moves that lead to even small changes in operational performance can have a major impact on returns. Consider a typical security and facilities management company in which operating profit is 10% of employee costs and economic profit is 8% of employee costs. In such a case, a 5% improvement in employee productivity increases operating profit by 50% and economic profit by over 60%.

Given the high financial stakes, people management needs to be a core operational process and not solely a support function run by the human resource department. Line managers have a vital role to play in improving employee productivity, in terms of both business issues (such as whether to concentrate on large or small accounts) and management issues (such as how to create an organization and work environment that foster productive output). If success in a capital-intensive business comes primarily from making the right investment decisions, success in a people-intensive business comes from hiring the right people and putting in place processes and an organization that makes them productive.

Managers also need to ensure that employees' interests are aligned with a company's business objectives and their execution. Companies often use surveys and other tools to assess how well they are meeting employees' personal goals. Too often, however, these tools focus only on traditional HR issues, such as work/life balance, benefits, and training. But employee satisfaction and engagement are more likely to be destroyed by conflicts at work than by conflicts between work and "life." A sales manager is

The fact that companies don't own their employees, as they do their capital assets, is why methods for valuing "human capital" on balance sheets are so tortuous.

charged with selling products from several divisions, but each division gives him a sales target that assumes he will focus on that division's product. Another manager's career depends on a promotion within two years, but she oversees a new service line that will take at least four years to gain traction in the marketplace. The right survey can help spot such conflicts between employee interests and company objectives. Diagnosing and addressing them – however uncomfortable for the senior line managers who may be the source of the problem – is crucial to keeping employees engaged and productive.

Finally, people can't be effectively managed in the absence of relevant performance information – information that can and will be acted upon. It's astounding how little of this exists at many companies. We've already seen that the major metric, employee productivity, is often calculated using misleading methods. But consider this as well: If employees are, indeed, a company's "greatest asset," you might expect to find some hard information about them in the annual report: How many employees are there? How much do they cost? How productive are they? After all, you'll find detailed answers to equivalent questions about a company's capital assets. The most you'll find in many annual reports – at least in the United States, where only banks are required to report their employee costs – is a round estimate of total head count. And even that number is suspect, as Finance and HR often have different methods of defining and counting full-time employees. While more information is available internally, there still are usually big information gaps in areas such as wanted-versus-unwanted attrition, average tenure of employees, and allocation of training funds.

Of course, people businesses need more than people-specific information: For example, customer-related metrics are central to any company and are often needed to measure the productivity of individual employees. But all too often, the problem is not a lack of information but the failure to use it. Information generated and reported by a company remains just that – reported. In one company we worked with, the HR department had nearly 50 employee-related metrics at its disposal – for example, unwanted attrition – but only a handful were actually used by line managers in making operations-management decisions.

Compensation. The economics of people businesses raise unique compensation challenges. Just as people businesses are particularly sensitive to employee productivity, so are they many times more sensitive to pay than traditional businesses. Indeed, the unwitting chief executive who focuses on investing in a company's "human assets" to achieve competitive advantage may be surprised to find that employees (unlike inanimate assets, such as manufacturing plants and brands) expect to receive all the returns. Furthermore, in a people business, compensation involves more than how much to pay employees; it

The People Business 40

Major people businesses are emerging across a variety of industries. These include companies in traditional people-oriented industries as well as major business units in capital-oriented companies.

RANK	COMPANY	INDUSTRY	($ billion 2003) REVENUE
1	IBM Global Services*	IT services	42.6
2	UPS	Postal and courier	33.5
3	Deutsche Post World Net*	Postal and courier	30.5
4	FedEx	Postal and courier	24.7
5	Hospital Corporation of America	Hospital management, health care	21.8
6	EDS	IT services	21.5
7	Compass Group	Contract catering	18.4
8	Deloitte Touche Tohmatsu	Accounting, consulting	16.4
9	PricewaterhouseCoopers	Accounting, consulting	16.3
10	Bechtel	Oil, engineering, industrial	16.3
11	Halliburton	Oil, engineering, industrial	16.3
12	La Poste*	Postal and courier	15.7
13	Computer Sciences Corp.	IT services	14.8
14	Ernst & Young	Accounting, consulting	14.5
15	Schlumberger	Oil, engineering, industrial	13.9
16	Accenture	IT services	13.4
17	TPG*	Postal and courier	13.3
18	Tenet Healthcare	Hospital management, health care	13.2
19	Sodexho	Contract catering	13.2
20	Hewlett-Packard Services*	IT services	12.3
21	KPMG	Accounting, consulting	12.2
22	T-Systems*	Telecommunications services	12.0
23	Marsh & McLennan	Financial brokerage and advice	11.6
24	Suez*	Oil, engineering, industrial	10.6
25	Siemens*	IT services, industrial	10.4
26	Aon	Financial brokerage and advice	9.8
27	Aramark	Contract catering	9.4
28	BT Global Services*	Telecommunications services	9.4
29	Fidelity Investments	Financial brokerage and advice	9.2
30	Merrill Lynch	Financial brokerage and advice	8.9
31	Fluor Corporation*	Oil, engineering, industrial	8.8
32	Marriott*	Hotels	8.7
33	Omnicom Group	Advertising	8.6
34	United Technologies Corp.*	Oil, engineering, industrial	8.4
35	Accor	Hotels	7.7
36	Tyco*	Security, facilities management	7.4
37	Securitas	Security, facilities management	7.3
38	NTT Systems Integration*	Telecommunications services	7.3
39	SAIC	Contract research	6.7
40	WPP	Advertising	6.7

* Services business only or people-oriented business units
Source: Annual reports, company Web sites, Hoovers

How People Businesses Fit In

A major fault line runs through the business landscape – and even through individual industries and companies – separating organizations that are, to varying degrees, people intensive from those that are, again to varying degrees, capital intensive. Companies whose shareholder value is clearly driven by people – whose employee costs can be three or more times their capital costs – share some important qualities, including the need to use employee-oriented instead of capital-oriented operating performance measures.

This divide is intersected by another fissure (somewhat less evident but crucial nonetheless) that separates businesses whose activities are oriented toward creating value in the present from those whose activities are designed to create future value. In most businesses, the majority of employees are engaged in activities – manufacturing a computer, repairing an elevator, selling a car – that create current value for their company. In some businesses, however, a substantial percentage of employees (or contractors) are engaged in activities – developing a new generation of software, researching a potential new drug, or, to some extent, building a brand – that are aimed at creating future value through the development of intellectual capital or some other intangible asset.

A business that is not only people intensive but also future oriented is different in some important respects from the people businesses that focus on generating current value. For one thing, employee performance is harder to assess using measures based on annual financial accounts, as this year's work may create value only in subsequent years. Although it is usually possible to measure employee productivity fairly accurately at a corporate level, methods to assess the current performance of an individual or a team are more problematic. Consequently, performance-related compensation needs to be long-term – stock for the software engineer or pharmaceutical researcher as opposed to annual bonuses for the investment banker or the department store manager. In addition, while the performance of current-oriented people businesses is exceptionally sensitive to day-to-day operations and employee management, future-oriented businesses tend to be extremely scale sensitive: When the value of R&D expenditures becomes predictable, those investments effectively become fixed costs that can generate increasingly large winner-take-all revenue numbers.

The matrix presented here looks at the distinct economics and strategic challenges facing businesses categorized along the two dimensions: current value versus future value and people intensive versus capital intensive. A company is positioned on the matrix according to the different ways in which it creates value. It can be even more interesting to position different activities of a single company on the matrix. For example, a pharmaceutical company deconstructs into three types of businesses: those whose value is derived from physical assets (pharmaceutical production), from intangible assets (R&D), and from "human assets" (sales and marketing) – the latter being the strictly defined people business whose human resources aren't really assets at all because they aren't owned by the company. Given the different characteristics of these three businesses, each must be managed in a different way. The matrix highlights the performance levers that are best suited to each type of business.

	CAPITAL INTENSIVE	PEOPLE INTENSIVE
FUTURE VALUE	**Physical and Intangible Assets** (INTEL) ▪ Use capital- and employee-oriented performance indicators ▪ Focus on scale effects (high market share = high market value) ▪ Offer fixed and variable compensation	**Intangible Assets** (SAP) ▪ Use employee-oriented performance indicators ▪ Focus on scale effects (fixed cost of investment = leverage potential) ▪ Offer long-term variable compensation (options)
CURRENT VALUE	**Physical Assets** (BP) ▪ Use capital-oriented performance metrics ▪ Focus on investment choices to drive performance ▪ Offer fixed salaries (except for top management)	**People Businesses** (OMNICOM) ▪ Use employee-oriented performance metrics ▪ Focus on operational improvements to drive performance ▪ Offer short-term variable compensation (annual bonuses)

is also the primary determinant of shareholder risks and returns.

Variability is at the heart of people-business compensation because productivity differs dramatically from one employee to another, depending on an employee's capabilities and the efforts of individuals or teams. Compensation that recognizes this variability and that is calculated and paid accordingly, on an annual basis, is an appropriate strategy when it comes to most employees in people businesses.

Performance-based variable pay needs to reach far down into the organization. In people-based businesses, unlike typical capital-based businesses, mid- and low-level employees can have a tremendous impact on performance, regardless of investment decisions made by the CEO. A good store manager, for example, can improve store productivity by 5% of sales. This may sound obvious, but it isn't by any means appreciated universally. People businesses embedded in asset-intensive corporations, in particular, often operate with little variable compensation. And we have seen some surprising inconsistencies in people-based businesses: For instance, a large retail franchisor that also operated and managed many of its own stores offered the store managers almost entirely fixed compensation, while its franchisees' earnings were sharply dependent on the performance of the stores they managed.

An emphasis on variable compensation in a people business has benefits beyond the obvious one of generating those operational improvements that can so dramatically boost performance. It can also significantly reduce the volatility of earnings and thus make the company more attractive to investors by reducing their risk. Because employee costs represent such a large portion of total costs, even small changes in the level and structure of compensation can have a major impact on the level of profits. Take a typical people business with operating profits that are 15% of employee costs. If, over the course of an economic cycle, the company pays out 85% of employee costs in fixed salaries and 15% of employee costs in the form of profit-variable bonuses, operating profits will be half as volatile as they would be if the company paid out, over that cycle, an equal amount but all in the form of fixed salaries. The compensation for this shift in risk from shareholders to employees: Companies with strong performance typically pay their employees better than their competitors.

Pricing. Economies of scale and experience in people businesses have tended to be less significant than in industrial businesses, where processes are embodied and learning institutionalized in machinery or software. That means large people businesses don't necessarily have cost advantages over smaller competitors–indeed, often quite the reverse. A people-oriented business such as a software company, with a big investment in future-focused and largely fixed-cost activities such as R&D, will clearly see a cost benefit as sales volume increases. But a strictly defined people business, with its near-term value creation, generally won't. This makes it critical for people businesses to price their products or services in ways that enable them to capture a share of any additional value they create for customers.

The most basic approach is *pricing by the hour* – what you might call a body shop model. Even high-skill businesses such as IT services commonly "shop bodies" at an hourly rate to customers that want to manage capacity flexibly. The value added by the company above that created collectively by its employees typically is limited – as is the return to the company.

A potentially more attractive pricing scheme is the *fixed-price-for-output* contract. A company that works more effectively and thus delivers a product or service at a lower cost or of a higher quality than its competitors (or its customers) can benefit from this approach. By completing the work in less time and with fewer people, the business adds value beyond that delivered by the employees. One way for an organization to achieve this is to focus on a particular activity in order to accumulate experience and know-how – think of a company that offers a specific medical procedure, such as dialysis, at hundreds of clinics. This will typically lead to higher returns because, with the right management, experience will improve the speed, quality, and cost with which the service can be performed.

For organizations whose advantage lies in providing a potentially very high value-add for the customer, a *success fee or commission* may offer the best returns – especially when customers have a lot at stake and the value of the service offered could far outweigh what customers are charged. Some of the highest rates of return on employee costs are earned by financial services advisers operating on a commission basis in highly leveraged activities such as investment or private banking. Although the percentage-based fee for, say, managing the funds of wealthy individuals is relatively small, the absolute amount of the fee is substantial. (Of course, when the stakes are lower, the reverse may be the case: A typical employment agency must take a relatively large percentage of an employer's pay to a new employee in order to earn an adequate return.)

Since industry pricing structures can change over time, people businesses should try to influence them to their advantage. In advertising, for example, the typical pricing structure has shifted from a percentage of a client's advertising spend (good for agencies that develop long-running campaigns, but risky) to fixed-fee structures (which limit the agency's returns on superior value creation for the customer) to, more recently, pricing based on a fixed fee but with a performance incentive specifically related to the success of the campaign.

Measuring the True Performance of a People Business

A New Way to Calculate Economic Profit

The standard calculation for economic profit can be reformulated – by substituting some basic components and by using standard algebra – to focus on the productivity of people rather than capital. This equation yields the same result but highlights the employee-related performance drivers of a people-intensive business.

Start with the calculation of economic profit from a capital-oriented perspective:

$$\text{ECONOMIC PROFIT} = [\underbrace{ROI}_{\text{\% Return on Investment}} - \underbrace{COC}_{\text{\% Cost of Capital}}]\ \underbrace{IC}_{\text{Invested Capital}}$$

Replace "return on investment" with its equivalent, "earnings divided by invested capital":

$$= [\underbrace{E/IC}_{\text{Earnings/Invested Capital}} - COC]\ IC$$

Use algebra to arrive at:

$$= E - [COC \times IC]$$

Replace "earnings" with its equivalent, "revenue minus personnel costs minus supplier costs minus depreciation":

$$= \underbrace{R}_{\text{Revenue}} - \overbrace{PC}^{\text{Personnel Costs}} - \underbrace{SC}_{\text{Supplier Costs}} - \overbrace{D}^{\text{Depreciation}} - [COC \times IC]$$

Use algebra to factor in a key people-oriented element, the number of people employed, and introduce two metrics, namely, employee productivity and average personnel cost per person employed:

$$= \left[\underbrace{\frac{R - SC - D - [COC \times IC]}{P}}_{\text{Employee Productivity}} - \underbrace{\frac{PC}{P}}_{\text{Avg. Cost/Person}}\right]\underbrace{P}_{\text{People Employed}}$$

The result is a calculation of economic profit that is meaningful to people-intensive businesses:

$$\text{ECONOMIC PROFIT} = [\underbrace{EPR}_{\text{Employee Productivity}} - \underbrace{ACP}_{\text{Avg. Cost/Person}}]\ \underbrace{P}_{\text{People Employed}}$$

The new, people-oriented equation mirrors the capital-oriented one. Employee productivity corresponds to capital productivity – that is, return on investment. The average personnel cost per person employed corresponds to the cost of capital. The number of people employed corresponds to the amount of invested capital.

Note: From a capital perspective, economic profit is usually calculated on a post-tax basis to be comparable with (post-tax) capital costs, while from a people perspective, it is usually calculated on a pretax basis to be comparable with (pretax) employee costs.

When a business has relatively high employee costs, traditional capital-oriented performance measurements such as return on assets can be irrelevant, if not misleading. An alternative approach, based on a company's existing financial information but focused on employees, can tell you how the business is truly doing and suggest ways to improve performance.

This method starts with a variation on the usual technique for calculating a business's economic profit. Instead of asking how much capital is used in the business and what the productivity of that capital is compared with its cost, you ask how many employees work in the business and what their productivity is in comparison to their cost. (For a depiction of the two approaches and how one leads to the other, see the exhibit "A New Way to Calculate Economic Profit.") While both methods yield the same measure of economic profit, the employee-oriented calculation, by highlighting the productivity of people rather than of capital, isolates the main driver of performance in a people-intensive business. This information can be used to identify meaningful levers for improving performance both at the corporate level and among business units within the organization. It is also useful in assessing the performance of your business in comparison to your rivals'. (One caveat: The employee cost data needed to do the people-oriented calculation, although reported to investors by European companies, are sometimes only available internally for U.S. companies.)

Take the case of a high-tech company with a portfolio of businesses, many of them engaged in manufacturing. As part of a regular review of its operations, the company decides to focus on its IT Services business. This business is profitable, and, although its return on sales is lower than those of the company's manufacturing businesses, its return on capital and its economic profit in relation to capital invested are higher than for the company as a whole. Using the tools they are familiar with, senior managers conclude that IT Services is doing just fine.

But is it really? Relating its performance to its few assets – mainly receivables and employees' personal computers – is practically meaningless. By contrast, a people-oriented performance metric offers valuable insights. (For a look at how IT Services uses this metric, see the exhibit "Isolating the People Performance Drivers.")

At the level of the overall business, the new metric reveals a problem that conventional financial measures have obscured. While IT Services' capital productivity is satisfactory, its employee productivity is low. The return exceeds employee costs by only 3%, compared with an average of 12% achieved by rivals (whose businesses are analyzed using the same people-oriented metrics). Furthermore, competitors are paying their employees nearly 15% more than IT Services is, in the form of higher benefits and performance-related compensation. In fact, if pay were adjusted to match competitors', IT Services' slim margins would be wiped out.

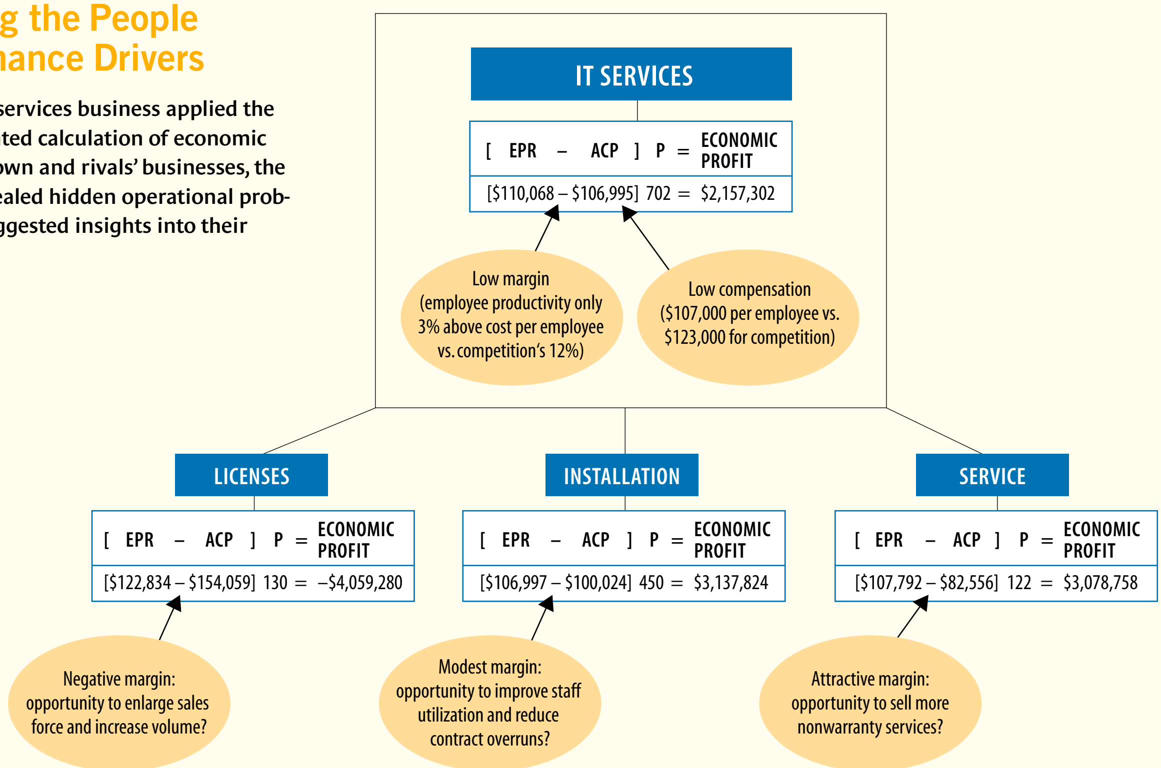
The same method can be used to pinpoint specific problems deeper in the organization. IT Services has three main revenue streams: software licenses, installation, and follow-up service. The analysis indicates that the product license operation is doing poorly, with fees insufficient to cover the R&D costs. Service margins are attractive, but the relatively small number of people in the operation is a sign of low service volume. In software installation, where most of the employees work, the (modest) margins are achieved only because employees are paid below industry levels. Extending the quantitative analysis of productivity further down into the installation business reveals that there is poor utilization of software engineers, who spend only 65% of their time handling customer orders, and that the group has contract overruns on orders amounting to more than 10% of budgeted time.

A more complete version of such an analysis – covering these and other factors, such as recruiting success, attrition, and overhead staff ratios, all of them quantitatively linked to employee productivity, average cost per person, and number of employees – creates a management dashboard that is a first step toward identifying the causes of problems. For example, license fees fail to cover R&D costs primarily because the company's small sales team, although productive and making good margins on contracts, isn't able to attract new recruits and thereby drive up volume. This is because of both poor compensation and the sales team's low status relative to the value-added resellers that the company has identified as its strategic sales channel (even though this new channel has yielded little in the way of revenue). Problems in the service operation stem from the fact that service engineers generally don't see themselves as salespeople and therefore don't look for opportunities to sell service updates that aren't covered by warranty. As for the installation business, contract overruns result largely because installing "basic" software remains time-consuming, despite IT Services' years of experience. The problem: Knowledge is not transferred to new employees when experienced engineers move on to more complex assignments.

While there are specific actions the company can take in response to each of these problems, more generally the company needs to address the issue of employee retention. Because the parent company hadn't realized that its margins were based in part on below-market compensation for its employees, the performance gap is greater than simple profit differences from competitors had suggested. Using the new employee-oriented data, the company can transform IT Services into a truly high-performing business.

Isolating the People Performance Drivers

When an IT services business applied the people-oriented calculation of economic profit to its own and rivals' businesses, the analysis revealed hidden operational problems and suggested insights into their causes.



Note: Numbers have been rounded to the nearest dollar.

Implications for Strategy

These progressively more advantageous pricing strategies suggest a number of larger business strategy issues raised by the economics of a people business. Because the most important "assets" of such a business can walk out the door when they choose, the company needs to leverage its people with something that *it* creates, something that *is* scale sensitive, something that will allow shareholders to share returns with employees.

Truly successful people businesses – those with economic profit that is 30% or more above their employee costs, rather than the typical 10%–have created assets that make the companies much more than the sum of their employees. For example, H&R Block, which provides personal tax preparation services in the United States, has invested heavily in its brand–it spends nearly $200 million a year on marketing and advertising–and has developed such innovative services as the first widespread e-filing of income taxes. Rentokil Initial, which provides hygiene and pest control services, has standardized processes and uses its high network density in the United Kingdom to create a cost advantage in customer service. Software company SAP converted previously customer-specific software development activities into standardized products with reusable elements.

Each of these companies, despite the people-intensive nature of their businesses, moved far beyond an offering based on the short-term value of individual employees' work, in the process becoming less like strictly defined people businesses. In fact, the goal for many people businesses looking to increase returns will be to move out of that category by leveraging the value of their people-oriented activities to build intellectual or brand capital–or even physical capital, such as the data centers of IT services companies. Ironically, as companies develop proprietary content and add value beyond that which their employees provide in their daily work, top management may conclude that shareholder value can best be created by outsourcing or franchising people-intensive activities. In the case of business services companies, this would complete a cycle that started with their providing, on an outsourced basis, those very services for someone else.

Such a shift reflects the constant evolution of an increasingly people-based economy and highlights the need for senior managers of people-intensive businesses – as well as the investment community–to creatively develop and apply a new set of performance measures and management practices.

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Competent Jerks, Lovable Fools, and the Formation of Social Networks

by Tiziana Casciaro and Miguel Sousa Lobo

ONE OF MANAGEMENT'S GREATEST CHALLENGES ARISES from a natural tension inherent in every organization. People are brought together because they have the variety of skills that, in concert, are needed to carry out a complex activity. But this variety inevitably leads to fragmentation of the organization into silos of specialized knowledge and activity.

It's an understatement to say that resolving this tension is crucial to success in today's knowledge-based and collaborative business environment. How do you ensure that relevant information gets transferred between two parts of an organization that have different cultures? How do you encourage people from units competing for scarce corporate resources to work together? How do you see to it that the value of a cross-functional team is more, not less, than the sum of its parts?

The answers to such questions lie not in an examination of organization charts but largely in an understanding of

MARCOS CHIN

New research shows that when people need help getting a job done, they'll choose a congenial colleague over a more capable one. That has big implications for every organization – and not all of them are negative.

informal social networks and how they emerge. Certainly, organizations are designed to ensure that people interact in ways necessary to get their jobs done. But all kinds of work-related encounters and relationships exist that only partly reflect these purposefully designed structures. Even in the context of formal structures like cross-functional teams, informal relationships play a major role.

In this article, we offer somewhat surprising insights into how informal networks take shape in companies – that is, how people choose those they work with. We then discuss some of the benefits and drawbacks of this phenomenon and offer ways for managers to mitigate its negative effects and leverage the positive ones.

How We Choose Work Partners

When given the choice of whom to work with, people will pick one person over another for any number of reasons: the prestige of being associated with a star performer, for example, or the hope that spending time with a strategically placed superior will further their careers. But in most cases, people choose their work partners according to two criteria. One is competence at the job (Does Joe know what he's doing?). The other is likability (Is Joe enjoyable to work with?). Obviously, both things matter. Less obvious is how much they matter–and exactly *how* they matter.

To gain some insight into these questions, we studied four organizations selected to reflect a wide range of attributes – for-profit and nonprofit, large and small, North American and European. We asked people to indicate how often they had work-related interactions with every other person in the organization. We then asked them to rate all the other people in the company in terms of how much they personally liked each one and how well each did his or her job. (For a more-detailed description of the studies, see the sidebar "Who Is Good? Who Is Liked?")

These two criteria–competence and likability–combine to produce four archetypes: the competent jerk, who knows a lot but is unpleasant to deal with; the lovable fool, who doesn't know much but is a delight to have around; the lovable star, who's both smart and likable; and the incompetent jerk, who…well, that's self-explanatory. These archetypes are caricatures, of course: Organizations usually–well, much of the time–weed out both the hopelessly incompetent and the socially clueless. Still, people in an organization can be roughly classified using a simple matrix. (Indeed, with relative ease you can probably populate the four boxes depicted in the exhibit "Whom Would You Choose?" with the names of people in your own company.)

Our research showed (not surprisingly) that, no matter what kind of organization we studied, everybody wanted to work with the lovable star, and nobody wanted to work with the incompetent jerk. Things got a lot more interesting, though, when people faced the choice between competent jerks and lovable fools.

Ask managers about this choice–and we've asked many of them, both as part of our research and in executive education programs we teach–and you'll often hear them say that when it comes to getting a job done, *of course* competence trumps likability. "I can defuse my antipathy toward the jerk if he's competent, but I can't train someone who's incompetent," says the CIO at a large engineering company. Or, in the words of a knowledge management executive in the IT department of a professional services firm: "I really care about the skills and expertise you bring to the table. If you're a nice person on top of that, that's simply a bonus."

But despite what such people might say about their preferences, the reverse turned out to be true in practice in the organizations we analyzed. Personal feelings played a more important role in forming work relationships–not friendships at work but job-oriented relationships – than is commonly acknowledged. They were even more important than evaluations of competence. In fact, feelings worked as a gating factor: We found that if someone is strongly disliked, it's almost irrelevant whether or not she is competent; people won't want to work with her anyway. By contrast, if someone is liked, his colleagues will seek out every little bit of competence he has to offer. And this tendency didn't exist only in extreme cases; it was true across the board. Generally speaking, a little extra likability goes a longer way than a little extra competence in making someone desirable to work with.

If someone is liked, his colleagues will seek out every little bit of competence he has to offer.

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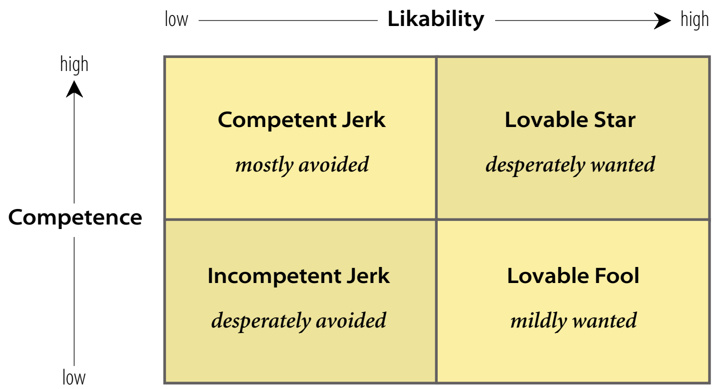
Whom Would You Choose?

If you were faced with the need to accomplish a task at work, what sort of person would you pick to help you – someone able to get the job done or someone enjoyable to be around? Studies done in four very different organizations consistently showed that most people would choose a "lovable fool" (someone who, to varying degrees, is more likable than competent) over a "competent jerk."



Of course, competence is more important than likability in some people's choice of work partners. But why do so many others *claim* that to be the case? "Choosing the lovable fool over the competent jerk looks unprofessional," suggests a marketing manager at a personal products company. "So people don't like to admit it – maybe not even to themselves."

Yet *is* such a choice unprofessional? Is it a mistake to steer clear of the competent jerk when we have a job to do? Sometimes, yes. We may forgo the opportunity to tap a competent jerk's knowledge and skills because we don't want to deal with his patronizing, brusque, or otherwise unpleasant attitude – which is arguably a modest price to pay for the valuable assistance he can provide. We may even shun the jerk simply to deny him the satisfaction of lording his knowledge over us.

But there are justifiable reasons to avoid the jerk. Sometimes it can be difficult to pry the needed information from him simply because he is a jerk. And knowledge often requires explanation to be useful – you might, for instance, want to brainstorm with someone or ask follow-up questions – and this kind of interaction may be difficult with a competent jerk. Furthermore, in order to learn, you often have to reveal your vulnerabilities, which also may be difficult with the competent jerk – especially if you are afraid of how this might affect your reputation in his eyes or in the eyes of others to whom he may reveal your limitations. By contrast, the lovable fool may be more likely to freely share whatever (albeit modest) information or skills he has and, without any intention of gaining an advantage, help others put them to use.

The Likability Bias: Pros and Cons

Some people are liked pretty much universally. In other cases, likability is relative: One person's friend may be another one's jerk. This is because our positive feelings can result from people's inherent attributes or from the situations we find ourselves in with them. This distinction is important to keep in mind as we try to manage this tendency of people to favor likability over competence in their choice of work partners.

Social psychologists have long known that we like people who are *similar* to us; people we are *familiar* with; people who have *reciprocal* positive feelings about us; and people who are inherently *attractive,* either in their appearance or their personality – that is, they are considerate, cheerful, generous, and so on. Each of these sources of personal likability can contribute, for better or worse, to the formation of an informal network.

For Better. That we like people who are similar to us – for example, in their background, their beliefs, their interests, their personal style – is one of the most solidly documented findings in the social sciences. After all, these people make us feel good because they reaffirm the validity of our own characteristics and attitudes. But there's a business, as well as a psychological, benefit when similar people choose to work together: Their similar values, ways of thinking, and communication styles help projects flow smoothly and quickly.

Benefits also result when we work with people who aren't necessarily similar, but are familiar, to us. When you launch into a task with those you already know, you don't waste a lot of time figuring out what to expect from them or explaining what you mean every time you say something. In addition, because you are usually relatively comfortable with individuals you know, you're likely to be more accepting of their differences.

We also like to work with people who seem to like us. This can produce a virtuous circle in which everyone is more open to new ideas, more willing to help, and more trusting than would typically be the case. A similarly positive environment can be created if you work with someone who has an attractive personality – someone who is empathetic, for example, or generous. You know that you'll have liberal access to her intellectual resources, however abundant or modest they may be, and are likely to reciprocate by freely sharing your own knowledge.

And a person who is physically attractive? Well, in such a case, the job you do together can be, in some indefinable way, simply a bit more enjoyable than usual.

For Worse. One of the greatest drawbacks of choosing to work with similar people is the limited range of perspectives that a homogeneous group often brings to bear on a problem. A diverse collection of colleagues – whatever the tensions and misunderstandings that arise because of their differences – provides an array of perspectives that can lead to truly innovative approaches to accomplishing a task.

Even groups composed not of similar souls but merely of people who are very familiar with one another miss the chance to integrate the fresh perspective that new players bring to a project. Working with the same old colleagues can also dampen debate: People may hesitate to challenge or reject a bad idea put forward by someone they know and like.

There is also an obvious downside when we gravitate toward people because they like us or because they are pleasant to work with. These individuals, however terrific they may be, aren't necessarily the ones most suited to tackling the task at hand. The required expertise or knowledge may lie elsewhere, in someone who in fact doesn't like us that much or isn't attractive.

One other danger of people working primarily with those they like: They may simply have a good time and get nothing done. An experienced venture capitalist recalls the case of a very capable manager who hired individuals based on his personal affinity with them. "His team had a great time going out for a beer, but the quality of their work was seriously compromised," says the dismayed investor. "If you keep hiring only people you like, you can kill a company."

The objective, therefore, is to leverage the power of liking while avoiding the negative consequences of people's "affect-based choice" – to use the psychological term – of work partners. Keep in mind that we're not talking here about formal work relationships: You work with your boss and your direct counterparts in other divisions whether you like them or not. We're talking only about people's choices of informal, though work-related, interactions. Even so, that doesn't preclude executives from doing some things that will positively affect those interactions and the often task-crucial informal networks that grow out of them.

We offer three basic approaches. First, where possible, manufacture liking in critical relationships. Second, carefully position universally likable people so they can bridge organizational divides. Third, to put it bluntly, work on the jerks. The first tactic acknowledges that whether you like some-

Who Is Good? Who Is Liked?

To test our theory of work relationships, we conducted a series of social network surveys at four organizations: an entrepreneurial technology company in Silicon Valley, a unit of a multinational IT corporation, a U.S. university, and the Spanish country office of a global luxury goods corporation. We also surveyed a large group of MBA students at a U.S. business school. In all, we collected data about more than 10,000 work relationships.

We conducted multiple studies for two reasons. First, we wanted to see if the findings would remain consistent across different industries, types of organizations, and national cultures. Second, we wanted to see if the findings would remain consistent if we used different measures of likability, competence, and work-related interaction. For example, the definition of work interaction in the survey questions ranged from the very general ("We interact at work" – in which any kind of work-related interaction counted, whether formal or informal, but not other unrelated socializing) to the more specific ("When I have a question or issue about my job, I go to this person for advice or help" or "When I need to engage in creative problem solving regarding my job, I go to that person to help me think out of the box and consider different aspects of the problem innovatively"). Although our results clearly were limited to the five groups we studied, the consistency of the findings on both counts was striking.

Our analysis of the responses took into account biases often present when someone is asked to rate other people. We corrected, for instance, for the fact that some people are generally very generous with their ratings and others are very stingy. We took into account the fact that people working in the same department or in the same part of the building would naturally interact more frequently, regardless of liking or competence. And we adjusted for the fact that evaluations of competence and likability tend to go together: If I like you, I'm more likely to rate you as competent, and, conversely, if we've worked together in the past, I'll tend to like you better. We were able to disentangle this overlap in our analysis, as well. For details of our statistical approach, see our working paper at www.people.hbs.edu/tcasciaro/AffectInstrumentalTies.pdf.

one or not may depend on the situation. The second and third tactics acknowledge that being a jerk or being likable can be an intrinsic characteristic of a person, almost regardless of the situation.

Manufacture Liking

Given the central role that our feelings about people play in our work relationships, is there anything a manager can do to foster positive feelings toward one another? The answer, perhaps surprisingly, is yes.

Promote familiarity. In a well-known psychological experiment, a person shown a photograph of himself and a reversed image of the same picture consistently preferred the reversed photograph–simply because it was the image he was used to seeing in the mirror! And just as people like the images they're used to seeing, so they tend to like other people they're used to seeing around–they, too, are known and predictable. Familiarity is, in turn, one of the reasons why physical proximity strongly affects the degree to which people like each other: Research has shown that regular exposure to someone generally increases the comfort and pleasure of interaction.

The power of familiarity to generate positive interpersonal feelings argues for some careful thinking about the design of office space. This could involve anything from mixing up people's work spaces ("I generally don't care for people in Finance, but I've actually grown to like Sarah since she moved into the next office") to creating areas in an office that foster informal, watercooler-style chats.

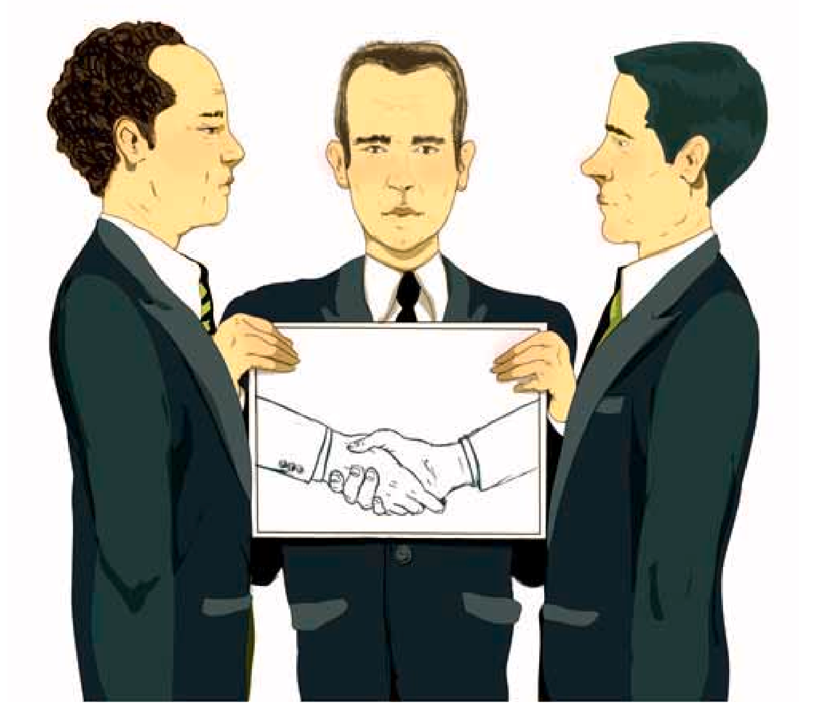
You can also design processes that give people an opportunity simply to become acquainted and thus make them more comfortable with each other. The "peer assist," a knowledge management process in which team members aim to capture the expertise of other colleagues before starting a project, generally involves some initial interaction–say, a cocktail party–the evening before work begins and any work-specific goals are addressed. This allows people to get to know one another a bit, independently from the work at hand, while relationships are still emotionally neutral and haven't yet been subjected to any task-related interference, such as the potentially competing interests of the assisting and assisted parties. Less formally, all-office get-togethers on Friday afternoons can be more than culture- and morale-building exercises. They offer an opportunity for people from different functions and units to become familiar with one another, thus making it easier for them to share knowledge in the future.

Redefine similarity. Similarities can be created where they might not naturally arise. It's no secret, for example, that marketers and researchers tend to be wary of one another. Their personalities, as well as their departmental allegiances, are generally very different. But if you create a product management team that includes both marketers and researchers, there is a chance their similar identities as "Product X people" may begin to feel stronger than their dissimilar identities as "marketing people" and "R&D people." Superimposition of the shared identity, by overriding natural differences, may lead to increased cross-functional cooperation, both formal and informal.

Foster bonding. Often, however, cooperation fails to emerge despite a redefinition of similarities. Where there exists powerful forces of distrust or animosity, either because of strong dissimilarities (for instance, loyalty to different premerger companies) or because of a troubled history (years of competition between functional areas over budget allocations, for example), you won't be able to get people to like each other simply by inviting them to some TGIF gatherings or by sticking them on a cross-functional team. Promoting positive feelings in those circumstances requires stronger methods.

One involves putting people through an intense cooperative experience. In a famous experiment conducted more than 40 years ago by social psychologist Muzafer Sherif, groups of 11- and 12-year-old boys were brought together in a camp setting. Initially, they were randomly assigned to two groups. These were kept separate to foster ties within each group, and competitive activities were designed to produce animosity between the two groups. Then, to see if exposure to one another in a fun environment could reduce the hostility that had been generated, the competitive activities were suspended, and the boys got together for such benign activities as watching movies. In fact, though, hostility increased, with fights erupting at every turn. Sherif figured that something else was needed: a situation that would force the boys to cooperate with one another. So he created several. For instance, a truck taking the two groups on a camping trip broke down, and all of the boys had to push it up a steep hill to get it going

Sometimes it can be difficult to pry the needed information from the jerk simply because he is a jerk.



again. Over time, episodes like this decreased hostility and, by the end of the camp experience, the number of boys who said that they had a best friend in the other group quadrupled.

The Outward Bound–style off-site experiences used by many companies are based on this venerable psychological principle. Such tactics can be problematic, however, because novelty and authenticity are critical to their success. The moment they become trite or feel manufactured, they lose their effectiveness. The challenge for managers, therefore, is to constantly find new ways to take advantage of this old concept.

Leverage the Likable

What should managers do to make effective use of people–fools or otherwise–who are likable almost regardless of the situation? Perhaps the best way to capitalize on their personal qualities is to have them play the role of "affective hubs"–people who, because they are liked by a disproportionate number of people, can bridge gaps between diverse groups that might not otherwise interact.

We don't necessarily like such people because they are similar or familiar to us. More likely, we are drawn to their attractive personality traits, sophisticated social skills, and old-fashioned "chemistry" – a chemistry that may arise from our sense that these people genuinely like us. Such individuals aren't necessarily the best performers (although they can be–that's the lovable star). More commonly, because of the time they devote to interacting with people, they may actually lag slightly behind their peers in terms of measurable performance. But their ability to establish positive working relationships between groups that would otherwise tend to be disconnected can be crucial to an organization's success. Managers can do several things to get the most out of such people.

Identify them. Attentive managers know if they have someone who could play–or is already playing–the role of an affective hub. But most managers aren't closely enough attuned to the emotional dimension of work to recognize such an individual. Take the case of an employee in one company's IT department. She was the person who dealt with breakdowns in the technical infrastructure of the company. Although less technically proficient than many of her colleagues, she acted, in the words of one, "as a coral reef barrier when the user community in the company had problems. Because she was liked by everyone, she could deflate users' frustration and anger, insulating us geeks from complaints and allowing us to solve the problem." After she was laid off in a cost-cutting move, her job was divided among more technically competent people. The result? "It was a disaster," according to her former colleague.

Granted, it's often difficult for a manager several steps up in the firm to identify and assess the value of such a person. One aid is the increasingly common 360-degree evaluation, which typically includes questions about how pleasant someone is to deal with. A more systematic approach is to perform a social network analysis with surveys whose questions are specifically designed to collect information on relationships between workers and on the structure of the network formed by those relationships.

Protect them. Even when affective hubs are identified and their value to the company is acknowledged, such soft contributions may be deemed less important than more quantifiable ones. When told about the concept of affective hubs, members of a management team at a large technology company exclaimed almost in unison: "Damn, we just fired him!" They went on to describe someone who was beloved within and outside the organization, a person other people would turn to when they wanted to make contact with someone in another part of the business or at an alliance partner. "It's not just that he knew everybody," according to one member of the team. "It's that everybody really liked him, and they were happy to do him a favor." Even though people were aware of his critical informal role, it wasn't enough to save him from being one of the first to go in a round of downsizing.

Position them strategically. Clearly, you don't want to waste the talents of an affective hub by letting the person languish in a job that is only loosely connected with other functions. Such individuals should be put in a position to link people from different parts of the organization who might otherwise resist – or never think of – collaborating with one another. Affective hubs also are useful in positions central to the diffusion of new ideas. Think, for example, of a program designed to communicate new practices or principles throughout an organization. How do you select participants? Do you chose managers? Star performers? Or do you chose the people who, because others will listen to them, are going to be good evangelists for the new ideas?

Work on the Jerk

Competent jerks represent a missed opportunity for the organization because so much of their expertise goes untapped. Dealing with jerks is so unpleasant that colleagues simply can't be bothered with them. What can you do with such people?

Reassess their contribution. The individual performance of the competent jerk is great. But how does he contribute to the performance of the organization as a whole? Does he help the people who work with him or actually hinder them? Take the case of an investment bank that hired an extraordinary rainmaker in a difficult and highly profitable market the bank wanted to enter.[1] Unfortunately, the qualities that made the new hire a phenomenal producer in this rough-and-tumble market also alienated lots of his colleagues. Over time, it became clear that the newcomer's manner was violating the culture of respect and polite behavior that helped define the company. What, then, to do about it?

Jerks who can be charming when they wish – but choose to do so only when convenient – may respond to incentives.

Reward good behavior; punish bad behavior. If the contributions of the competent jerk are significant, it's probably worth trying to turn him into a tolerated, even if not actively liked, star performer. Changing the behavior of adults is never a straightforward proposition, of course, but some things can be done. Jerks who can be charming when they wish – but choose to do so only when convenient – may respond to incentives. The rainmaker was one of those. He could be very charming to potential clients but was not to his coworkers. So when it came time for him to be considered for a managing director position, the bank denied him the promotion.

Socialize and coach. Although the rainmaker could have quit, taking his revenue-generating skills with him, he did not. His boss adopted an aggressive coaching stance, scolding for bad behavior immediately after the fact, rather than waiting for a year-end performance review. The boss was effective in explaining in detail how the behavior was self-defeating – information that a self-interested and ambitious individual is likely to take to heart. After coaching from his boss, the rainmaker's behavior improved, and he was promoted the following year. (Sadly, there are people who are disliked because they are socially incompetent and probably never will be truly charming. For them, interpersonal-skills training, rather than incentive-based coaching, may be preferable.)

Reposition. If likable people can improve an organization when they operate in highly interdependent roles, competent jerks will probably do best when they work independently. There is often a place for people who don't need to be liked so long as they get their jobs done – even if you must sacrifice widespread access to their expertise.

• • •

Obviously, simply being liked doesn't mean a person is valuable to an organization. We all know the fellow that people adore whose performance is continually disappointing – to the point that his colleagues end up disliking him because he repeatedly lets them down. We all know the woman who builds relationship after relationship that ultimately go nowhere, at least as far as the organization is concerned.

Still, it's easy to be mistakenly dazzled by a high performer, even if his expertise is never tapped or shared because people don't want to work with him. And too many managers fail to appreciate the benefits that a likable person can offer an organization, particularly if those benefits come at the expense of some measure of performance. Building an environment in which people like one another – whether by creating situations that make liking people easy, by fostering those likable people who can play the role of an affective hub, or by improving the behavior of competent jerks – can help all employees work more happily and productively and encourage the formation of strong and smoothly functioning social networks.

1. "Rob Parson at Morgan Stanley (A), (B), (C) (Abridged), (D)," HBS case nos. 9-498-054, 9-498-055, 9-498-057, and 9-498-058.

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Business processes – from making a mousetrap to hiring a CEO – are being analyzed, standardized, and quality checked. That work, as it progresses, will lead to commoditization and outsourcing on a massive scale.

The Coming Commoditization of PROCESSES

Throughout the history of business, most firms have built their own processes for almost everything that needed to be done. Producing widgets. Paying vendors. Administering payroll. Whether the processes involved were critical to the organization's strategy or incidental to it, they were generally performed by people within the organization. Sometimes they were done well, sometimes they were done badly – but since a company had no way of determining how well an outside business might perform these processes, they were kept in-house.

In the 1970s and 1980s, companies improved their processes with total quality management. In the 1990s, they attempted to radically advance them through business process reengineering. In the current decade, many firms have returned to process improvement with Six Sigma programs. Yet the process improvements often don't deliver quick cost reductions or balance-sheet enhancements. Toward the end of the twentieth century, the idea of outsourcing processes and capabilities began to gain currency as a means to achieve more rapid benefits. Companies may have previously outsourced a few ancillary

by Thomas H. Davenport

PAUL WEARING

activities like building maintenance or specialized legal work, but now they were beginning to outsource major capabilities involving thousands of people. The first step in this evolution occurred when firms such as Kodak and DuPont outsourced their information technology management. Later came business process outsourcing when companies such as AT&T and BT outsourced human resource administration processes like payroll, pensions, and benefits management; recruiting; and HR advisory and information services. Companies such as BP and Procter & Gamble outsourced major pieces of their finance and accounting functions, and Nike and Hewlett-Packard outsourced their manufacturing to a substantial degree, often sending it overseas. These companies were drawn to the idea of outsourcing processes largely because of the potential for reduced costs and leaner balance sheets, but they gained greater flexibility and access to specialized expertise as well. Most recently, companies have begun to internationalize much of their outsourcing, sending not just manufacturing but also service work to India, China, the Philippines, and other countries with low labor costs.

Despite the trend toward outsourcing, however, most companies have remained in do-it-yourself mode for most processes. (Huge multinationals are the most likely to take advantage of outsourcing, but even then, only for highly transactional and administrative activities.) Because of a paucity of process standards, it would be risky to do otherwise. With the exception of IT system development, there is generally no clear basis by which companies can compare the capabilities provided by external organizations with those offered in-house, or to compare services among multiple outside providers. As a result, firms that choose to outsource their capabilities have to proceed on two criteria: faith that the external provider will do a good job, and cost. Given the lack of comparability, it's almost surprising that anyone outsources today. But it isn't surprising that cost is by far the primary criterion that companies apply in evaluating outsourcers, and that cost reduction is their primary objective. The lack of standards may also explain why, in the few broad studies of satisfaction with outsourcing, many companies – up to half in some studies – are dissatisfied with their outsourcing relationships.

However, a new world is coming, and it will lead to dramatic changes in the shape and structure of corporations.

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A broad set of process standards will soon make it easy to determine whether a business capability can be improved by outsourcing it. Such standards will also make it easier to compare service providers and evaluate the costs versus the benefits of outsourcing. Eventually these costs and benefits will be so visible to buyers that outsourced processes will become a commodity, and prices will fall dramatically. The low costs and low risk of outsourcing will accelerate the flow of jobs offshore, force companies to look differently at their strategies, and change the basis of competition. These changes are already happening in some process domains, and there are many indications that they will spread across virtually all commonly performed processes.

Three Types of Process Standards

A business process is simply how an organization does its work – the set of activities it pursues to accomplish a particular objective for a particular customer, either internal or external. Processes may be large and cross-functional, such as order management, or relatively narrow, like order entry (which could be considered a process in itself or a subprocess of order management). The variability in how organizations define processes makes it more difficult to contract for and communicate about them across companies.

Firms seek to standardize processes for several important reasons. Within a company, standardization can facilitate communications about how the business operates, enable smooth handoffs across process boundaries, and make possible comparative measures of performance. Across companies, standard processes can make commerce easier for the same reasons – better communications, more efficient handoffs, and performance benchmarking. Since information systems support processes, standardization allows uniform information systems within companies as well as standard systems interfaces among different firms.

Standard processes also allow easier outsourcing of process capabilities. In order to effectively outsource processes, organizations need a means of evaluating three things in addition to cost. First is the external provider's set of activities and how they flow. Since companies have not reached consensus on just what comprises cost accounting or HR benefits management, for example, it remains ambiguous what services should be performed between buyers and providers. Therefore, organizations need a set of standards for process activities so that they can communicate easily and efficiently when discussing outsourced processes.

These *process activity and flow standards* are beginning to emerge in a variety of businesses and industries. Some are the result of efforts by process groups such as

Given the lack of comparability across companies, it's almost surprising that anyone outsources.

the Supply-Chain Council, which has more than 800 businesses as members. It has developed the Supply-Chain Operations Reference (SCOR) model, which lays out a top-level supply chain process in five key steps: plan, source, make, deliver, and return. The model also specifies typical activities for second-, third-, and fourth-level subprocesses with increasing levels of detail. For many activities, the council also has defined key metrics (but not benchmarks) such as "fill rate" or "returns processing cost." Hundreds of organizations (from Alcatel to the U.S. Navy) have begun to use the SCOR model to evaluate their own processes; software vendors such as SAP have begun to incorporate SCOR flows and metrics into their supply chain software packages. Some companies have already benefited greatly from a SCOR-based analysis of their supply chain processes:

- Alcatel increased its on-time delivery from 10% to 50% in nine months and reduced its material acquisition costs by a third.
- Mitsubishi Motors reduced the number of vehicles in ports from 45,000 to zero, saving the organization more than $100 million in costs.
- United Space Alliance, a partnership between Boeing and Lockheed Martin, improved several aspects of its parachute refurbishment process, including its on-time delivery performance and productivity.

Of course, a process standard by itself doesn't achieve such benefits. The SCOR model is only a catalyst for change and a framework for analysis. As with any approach to process improvement, firms must still make difficult changes in how they do their work and to associated systems and behaviors.

Some process activity and flow models are for multiple processes. For example, a few years ago a group of researchers at MIT created the Process Handbook, an online library of more than 5,000 processes and activities. Several companies have applied MIT's model to their own operations. Dow Corning, for instance, used the handbook to model its own processes during a large SAP implementation and then added its own new process flows to a repository (and also created a Dow Corning–specific version of the SCOR model). The APQC (American Productivity and Quality Center) created a Process Classification Framework that describes all processes in an organization; the group has used this framework to organize the process benchmarks it has collected for more than a decade. A number of telecommunications companies around the world, organized as the TeleManagement Forum, have created the eTOM process flow standard for business processes in telecom firms. Following on the success of the SCOR model, a number of organizations (including representatives from the Product Development Management Association, firms such as Hewlett-Packard and Intel, and several consulting firms) are together attempting to create a SCOR-like model for all major processes in organizations. In addition to the supply chain, it will address processes for product development, customer relationship management, and customer

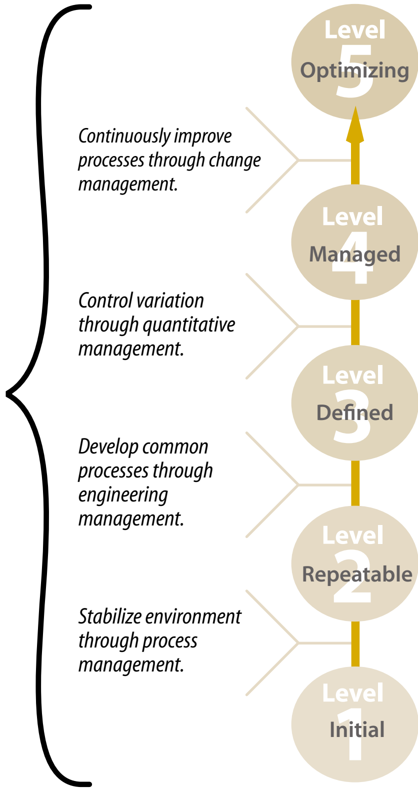
service, as well as support processes such as finance, accounting, and HR management.

A second set of needed process evaluation approaches are *process performance standards.* Once companies in a particular industry achieve consensus about which activities and flows constitute a given process, they can begin to measure their own processes and compare their results with those of external providers. If there is agreement, for example, on what it means to "process a new employee," managers can analyze how much it costs the internal HR function to provide that service, on average, and how long it takes. They can also have an informed discussion with external service providers about their process performance measures.

Again, this sort of performance benchmarking is beginning to occur. Benchmarks for the SCOR model are already available, and more are being gathered. The APQC is working with a consortium of companies called the Open Standards Benchmarking Collaborative to create one standard public database of process definitions, measures, and benchmarks to help organizations worldwide quickly assess and improve their performance. Organizations as diverse as Bank of America, Cemex, IBM, Shell Oil, and the World Bank are participating. It's clear that there will eventually be good performance benchmarks for each major process in an organization.

The SEI's Capability Maturity Model

The Software Engineering Institute's Capability Maturity Model (CMM), now a worldwide process management standard for software development, moves from Level 1 – where a company has a very ad hoc development environment – up to Level 5, where the organization has repeatable project management routines, quality and engineering standards, detailed measures of performance, and an environment that encourages continuous improvement.



Finally, organizations need a set of *process management standards* that indicate how well their processes are managed and measured and whether they're on course for continuous improvement. Because this third type of process standard doesn't require consensus on process activities and flows, it is the easiest to create and the most widely available today. Process management standards are based on the assumption that good process management will eventually result in good process flows and performance. In some domains such as information technology and manufacturing, these standards are already in wide use (via the Software Engineering Institute's Capability Maturity Model and the ISO 9000 series, respectively). They are beginning to lead to the commoditization of capabilities that will eventually transform organizations.

As an example of the differences between types of process standards, let's consider order management, an important process for many organizations. Process activity and flow standards for order management (which have not yet been agreed upon) would address what the key activities in order management should be – perhaps beginning with order entry and concluding with the receipt of cash. Process performance standards for order management would posit how much time, money, and other resources it should take to perform the order management process and its key subprocesses – suggesting, maybe, that a company should have a certain number of full-time employees per million dollars of revenue who are dedicated to entering, processing, and tracking orders. A process management standard for order management would specify what constitutes good handling of the order management process, including how it is measured, controlled, and documented.

The Standards-Driven Commoditization of Software Development

Software development is a good example of a process that needs an overhaul. Whether done internally or externally, software development is error-prone, expensive, and time-consuming. The overall level of software quality is low;

a 2002 study from the U.S. National Institute for Standards and Technology estimated that software bugs cost the U.S. economy almost $60 billion a year. Software quality is particularly unpredictable when purchased from a provider – and virtually every organization buys software. There are many providers of software – package vendors, consultants, and lower-cost "body shops" – each with uncertain quality levels.

One reason for quality and cost problems is the way – or ways – in which software is usually developed. There has been no standard method or approach for software development or engineering; it is normally a "craft" process. Some individual software developers are much more productive and offer much higher quality than others. Some development shops have standard methods and tools, but most don't. The variations in both practice and outcome are enormous, in part because no process activity and flow standards or process performance standards exist. In addition to the quality problems with software, poorly managed processes often result in late projects and high costs. The Standish Group estimated in 2003 that only 34% of software projects were implemented on time and within budget.

Carnegie Mellon's Software Engineering Institute (SEI) has developed the Capability Maturity Model (CMM) to address a number of these problems. (See the exhibit "The SEI's Capability Maturity Model.") The model, created in 1987, has become a worldwide standard for software development processes and is now embedded within many government and industry organizations. It has provided an objective basis for measuring progress in software engineering and for comparing one software provider's processes to another's. This in turn has facilitated the growth of offshore providers in India and China by commoditizing software development processes and making them more transparent to buyers.

Of course, a process standard by itself doesn't achieve anything. Firms must still make difficult changes in how they do their work.

The CMM is a process management standard, not a process flow or process performance standard. It doesn't require that organizations follow a particular process for software development or that they achieve a certain number of "lines of code per day" or other metric – only that they have processes in place for addressing quality issues. Each of the five levels (initial, repeatable, defined, managed, and optimizing) defines greater degrees of management control and sophistication. Level 1 describes a very ad hoc software organization that has few defined processes. Organizations that reach Level 2 have basic, repeatable approaches to project management that track costs, schedules, and functionality. Level 3 organizations embed basic tenets of both good management and good software engineering, such as quality assurance, into a standard software process. Level 4 organizations collect detailed measures of software process and quality. And Level 5 organizations have all of the previous capabilities but also an environment that encourages continuous improvement, with learning from quantitative feedback and controlled experiments.

The SEI offers training courses on the Capability Maturity Model and its derivatives and has created processes to authorize appraisers (though the SEI does not conduct appraisals itself). Since 1987, more than 2,700 certified appraisals have been performed on organizations in 51 countries – from Argentina to Latvia to Vietnam. Indeed, the number of appraisals in a particular country is a good measure of its ambitions in the software industry. The United States has had the largest number of appraisals since 1987 with 1,896. India is second with 359. China is third with 182. The UK is fourth with 135, and Japan fifth with 131.

It's clear that both Indian and Chinese companies see CMM certification as key to their software industry objectives. Indian companies dominate the list of published Level 5 appraisals, with more than twice as many as U.S.-based organizations. (The SEI in 2003 stopped publishing a list of organizations achieving certain CMM levels, but data show that U.S. defense contractors have come on strong in recent years.)

If a country wants to establish sufficient credentials in software development so that global customers might hire its programmers unseen, there are few better ways to do this than to qualify for Level 5 of the CMM. In India, CMM Level 5 certification is becoming so common that software providers say they typically compete only with other Level 5 providers for software outsourcing business – a sure sign of commoditization.

SEI's appraisal data on the CMM also suggest that there has been global progress in the software industry. The number of appraisals has increased from fewer than 50 in 1990 to more than 500 in 2003. Of the organizations that reported their maturity levels to SEI before 1992, 80% were appraised at Level 1, and only 0.3% were at Level 5. In 2004, only 26% of appraisals were at Level 1, and 6.6% were at Level 5. Eighty-five percent of the more than 500 organizations that have been reappraised moved up in their CMM level, and over 25% moved up more than one level. This is clear evidence that using the CMM leads to improvement in software development processes and that this once-chaotic process is becoming more predictable and commodity-like. As other evidence, software used by the U.S. military, for which CMM Level 3 compliance is required, has error rates one-sixth to one-tenth that of commercial software.

How Does a Process Standard Become Successful?

A process standard has impact only if the world adopts it. Therefore, it's important to understand why a process model like the CMM has been so influential in improving software processes around the world.

One major factor in the CMM's success is the simplicity of the idea. The five-level rating system is easily understood and offers a clear indication of progress, or lack thereof. Of course, there is some complexity beneath the five levels – for example, there are 18 key process areas, such as software quality assurance and software subcontract management, that can be evaluated with respect to their maturity. But the simplicity of the overall model makes it possible for nontechnical workers and managers to understand and apply it.

Another factor in the CMM's growing influence and success is the support of the U.S. government and defense sectors. Certain divisions within the Defense Department advanced the CMM further by making it a requirement among contractors. A major player in another industry, such as Wal-Mart in consumer products, could mandate compliance with a process in a similar fashion.

Various aspects of the CMM's governance structure have also been important factors in its success. The SEI is somewhat evangelistic; it produces a large amount of documentation around the standard and its application and also facilitates a number of software process improvement networks around the world. In addition, the independence of the SEI and Carnegie Mellon has aided the CMM by keeping the standard free of ties to any particular company. A third governance-related factor in the CMM's growth has been the network that has grown up around the SEI and the standard. A variety of large and small companies offer consulting, education, and appraisal services that support the CMM.

Finally, a key reason for the popularity of the CMM is the flexibility of its use and application within organizations. It provides a framework for improvement but doesn't specify how an organization should improve. The CMM supports both process-heavy methods, in which there are detailed specifications for each aspect of software engineering, and agile process methods such as extreme programming, in which the process is largely left up to developers.

Generalizing Process Management Standards

The successful adoption and implementation of process standards in software development seems to be providing inspiration in other business domains. The five-level maturity model has been modified by the SEI, for example, to assess HR management practices, software acquisition, and other forms of engineering. At one point, the SEI was supporting five different types of CMMs. Brett Champlin, a process improvement manager at Allstate, has recently identified more than 180 versions of capability maturity models. Some, such as one from the IEEE (Institute for Electronic and Electrical Engineers), employ alternative capability models for software development. Others, such as one from the Electronics Industries Association, focus on development of software-intensive products. Others have nothing to do with software and deal with process management maturity in general. Several academics, consultants, and process-oriented companies are attempting to establish a standard for process management maturity.

The SEI has decided to implement a broader approach to process standards that can be used for any engineering process, not just software development. Called CMMI (the "I" stands for integration), the new model is a suite of standards that allows for the addition of new processes in a modular fashion. For example, the SEI is currently working on adding a module for the Department of Defense acquisition community. CMMI already includes standards for software development and engineering, systems engineering, software product development, and supplier sourcing. There is, of course, a risk to broadening the CMM; its clear focus on software development processes was a key element of its appeal. Thus far, however, adoption rates for the CMMI are ten times as rapid as those for the software CMM, so in practice this broader application appears to be working.

Other Process Management Standards

The CMM is not the only process management standard that has transformed its industry. A variety of such standards are now in use around the world. Perhaps most prominent among them are the ISO 9000 family of quality standards for product manufacturing. These standards primarily assess whether certain processes and systems are in place. The broadest ISO quality standard, ISO 9000, involves the design, development, production, installation, and servicing of products. Unlike the CMM five-level standard, the ISO 9000 standards are binary – an organization either passes or it doesn't.

The ISO 9000–9003 were created by the International Organization for Standardization, a global consortium of national standards bodies. These criteria have been applied and certified in more than 130,000 firms around the world. The ISO has created more than 14,000 standards–for manufacturing everything from screw threads to telephone and bank card formats–since its founding in 1947. The SEI has been collaborating with the ISO to create an international standard for software development quality, called ISO 15504.

Certain industries have created tailored versions of these ISO standards. For example, the U.S. automotive industry has created the QS-9000 standard for the certification of supplier quality. If an automotive supplier wants to sell to GM, Ford, or DaimlerChrysler, it must meet the QS standards. Virtually all suppliers have qualified, which means greater commoditization of the automotive supply industry. As another example, the U.S. Food and Drug Administration requires that makers of medical devices meet standards called the Quality System Regulation, which is based on ISO 9000 approaches.

Other standards focus less on the management process itself and more on the output of the process. The well-known Six Sigma standard, for example, focuses on defect reduction to a high level of statistical reliability. Unlike the CMM and the ISO standards, however, organizations certify themselves as meeting Six Sigma standards; there are no external certifiers. Therefore, Six Sigma is less likely to lead to changes in how organizations buy and sell process capabilities to each other.

Where Will Process Standards Lead Us?

Process standards could revolutionize how businesses work. They could dramatically increase the level and breadth of outsourcing and reduce the number of processes that organizations decide to perform for themselves. With objective criteria to evaluate whether a company can save money or get better process performance by outsourcing, it's likely that more firms will take advantage of external capabilities. As the global market for process services matures and providers learn what it takes to succeed with a process according to the standard, the number of providers will undoubtedly increase, and the prices of their services will likely drop. In turn, this external market for capabilities will force companies to look more closely at their own strategies. What processes are truly core to our organization? If another firm has been certified as doing the work better, why not let that firm do the work? And if our company can't certify a particular capability as being world-class, what is the value of that capability to customers?

Once process capabilities have become commoditized, providers of process outsourcing services will have to find other sources of differentiation. Perhaps they'll begin to supply not only the efficient execution of business processes but ideas, insights, and innovations for how to perform them better. It's increasingly common, for example, for IT outsourcers to be evaluated not just on their CMM level or their costs but on their ability to identify and implement innovative IT-enabled business initiatives for their clients.

The external market for capabilities will force companies to ask themselves, What processes are truly core to our organization?

The standardization and commoditization of processes will also require changes in strategy. As an increasing number of processes become common within and across industries, executives will need to revisit the basis for competition in their businesses. They'll have to decide which of their processes need to be distinctive in order to make their strategies succeed and which can be performed in a relatively generic and low-cost fashion. Even in today's environment, most executives have yet to decide what processes are core and noncore, but doing so will become much more critical in the future. Process standardization may also mean that it's feasible to combine certain processes with competitors'; if these processes offer no competitive advantage, why not? Creating shared-services processes across companies can offer scale efficiencies. BP and several other oil firms have already combined and outsourced certain finance and accounting processes for their North Sea exploration activities. When process standards take off, we're likely to see more collaboration among competitors.

Process standards will also change how information systems are bought and implemented (and not just because of the CMM). Today, many systems are custom-built to support local and idiosyncratic processes. Even when a company buys a packaged system, it often has to customize it or adapt its processes to suit the package. In a world of widespread process activity and flow standards, software vendors can make available standard packages that support processes that customers have already adopted. Unless a process needs to be unique to a company for strategic reasons, it will become much easier to buy and employ systems in the future. In fact, it makes a lot of sense to ask key software vendors to get involved in standard-setting initiatives at an early stage; a process design is far less valuable without software to enable it.

Though I've described several areas of business where process standards are emerging, many other areas still conspicuously lack them. The growth of the business process outsourcing industry has been inhibited by the fact that there are virtually no standards for how most business processes should be performed. An organization wishing to outsource human resource management, billing and collections, or a call center would like to ensure that providers have well-honed capabilities in these domains that exceed their internal capabilities. Yet there is no defined approach for evaluating or certifying potential providers of those services. The speed at which some businesses have adopted process standards suggests that many previously unscrutinized areas are ripe for change. Just as the CMM has made it possible for organizations needing software services to contract with confidence from providers all over the world, the development of new process standards will facilitate – and eventually commoditize – a wide variety of business process outsourcing services.

Process standards will undoubtedly proliferate into most domains of business operations. If there isn't one for the processes your organization performs, it makes sense to begin working with customers, competitors, software providers, potential providers of the processes, and objective researchers and standards-setters to create a new standard. As with the CMM, setting standards is likely to lead to the improvement of the process both within your organization and from external providers.

If there is a firm or organization that can accelerate the adoption process, such as the Department of Defense in software processes or Wal-Mart in supply chain processes, be sure to get it involved in your standard-setting efforts. If your processes are world-class, you may have an opportunity to begin providing the service to others. Fidelity Investments, for example, moved from offering mutual funds to company retirement plans to broad outsourcing of benefits administration.

If your organization provides process services, you may have mixed feelings about the development of process standards. Standards will lead to commoditization, more competitors, and lower prices for the services you offer. However, the move to process standards makes so much economic sense that it is probably inexorable – whether or not your company gets involved. It's better to help shape a standard than to be put out of business by it.

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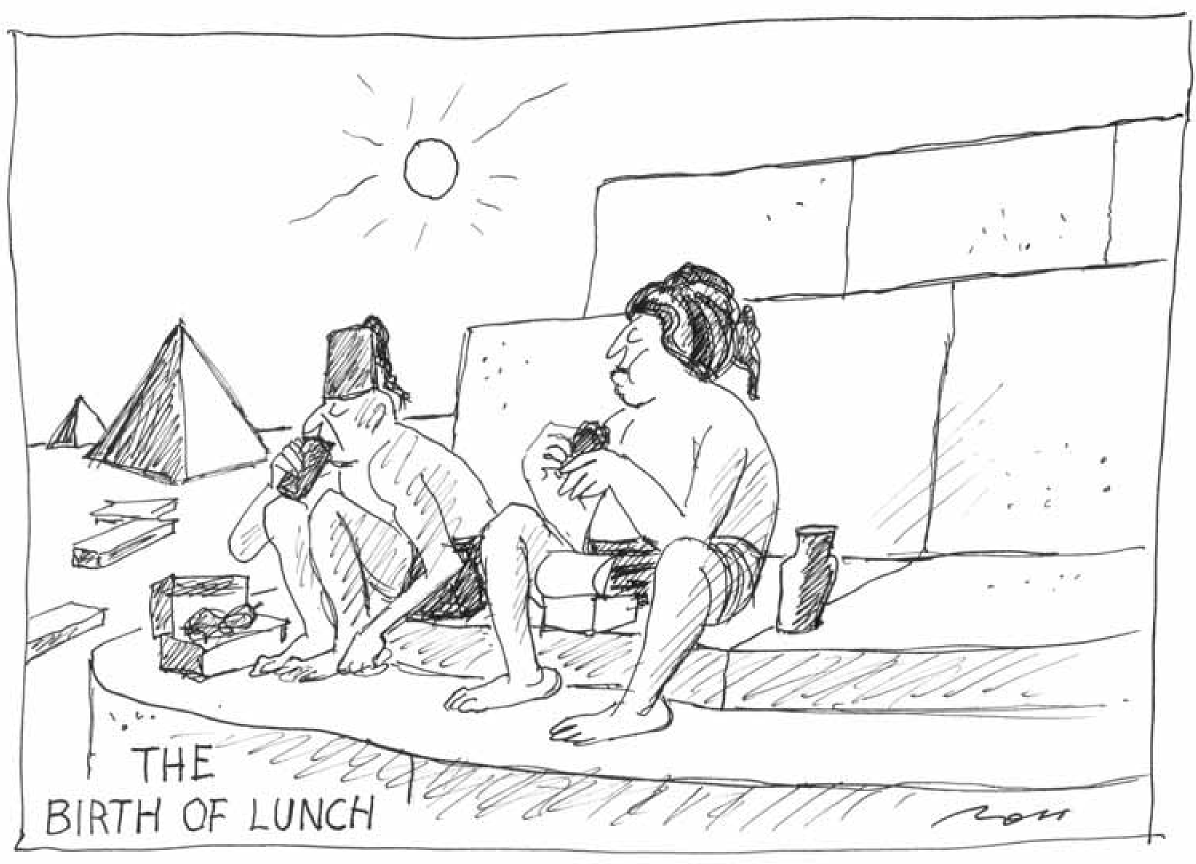

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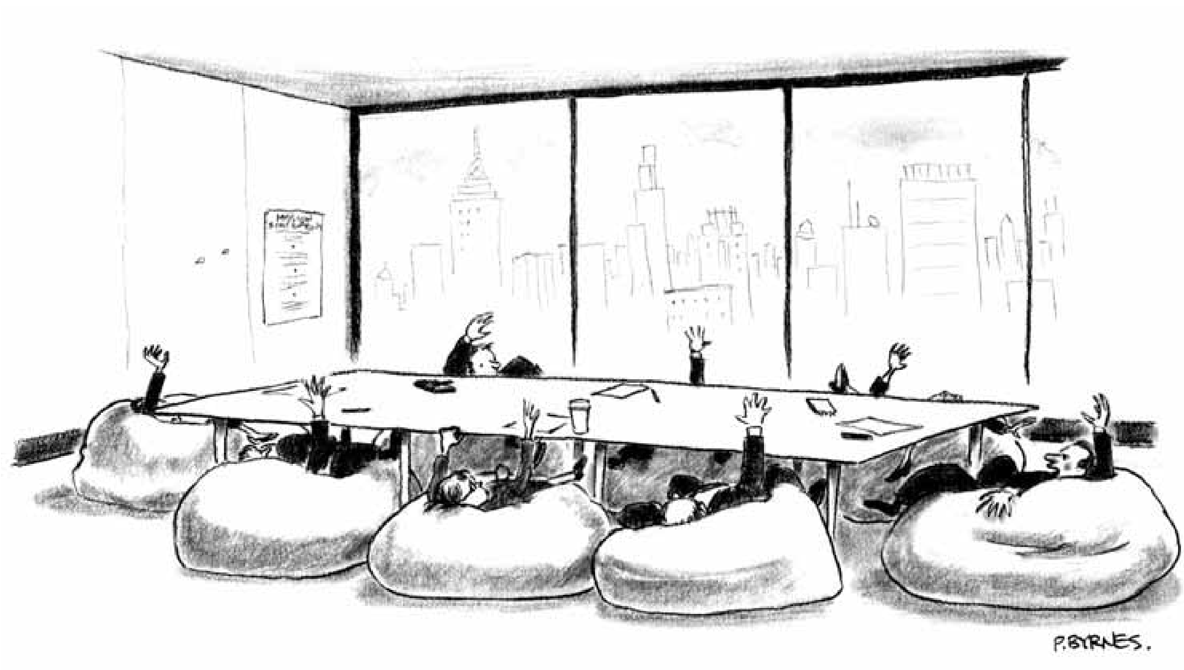
Leslie Perlow and Stephanie Williams
"Is Silence Killing Your Company?"
Harvard Business Review
May 2003

"Oh, just thinking up new ways to avoid everyone I work with. And you?"



"All in favor of the old, uncomfortable chairs?"

PATRICK BYRNES, DAVE CARPENTER, LEO CULLUM, MIKE SHAPIRO, AND P.C. VEY

"We encourage fresh innovations, but we'll take a gimmick."

"You've come to me in your hour of need, Paulson. I hate that."

"We appreciate all the hard work you've done to get to the top, but we really need you back at the bottom."

NICK DEWAR

How can you make sure that your company's frontline managers–the backbone of the organization–feel committed and involved? Here's how one of the world's largest corporations answered that question.

DEVELOPING FIRST-LEVEL LEADERS

by Andreas Priestland and Robert Hanig

WHEN IT COMES TO TRANSLATING a company's strategy into results, there's no denying the importance of first-level leaders–those who manage others who *do not* manage others. At BP Group, these leaders oversee operations at retail outlets, manage work crews at chemical plants or refineries, and handle operations at drilling platforms. Some supervise more than ten people; others work with few subordinates in R&D, marketing, or human resources. First-level leaders are the ones who are most responsible for a firm's day-to-day relationships with customers and the bulk of employees. As Harvard professor Linda Hill wrote in *Becoming a Manager,* "…managers on the front line are critical to sustaining quality, service, innovation, and financial performance."

Yet high-quality training programs for these people are notoriously difficult to create and maintain. They're typically set up as one- or two-day seminars, and trainees return to the shop floor with little or no follow-up. The process is decentralized: Local HR departments run the programs, and local executives decide which supervisors will attend, based on their subjective assessments or other nonstrategic considerations. As a result, the potential of these managers is left largely unfulfilled, and the entire organization suffers accordingly.

BP, an oil and energy corporation with operations on every continent and more than 100,000 employees, faced precisely this challenge. The company's senior management was aware of the importance of BP's "frontline managers," as it had called them. About 70% to 80% of BP's employees reported directly to them. There were about 10,000 such supervisors around the world (nobody knew the precise number), ranging in age from 25 to 40. They worked in every part of the company, from solar plants in Spain to drilling platforms in the North Sea to marketing teams in Chicago to service stations in China. They brought to their jobs a wide variety of ethnic and cultural backgrounds, education and professional experience, and attitudes about work, the company, and life. Their decisions, in aggregate, made an enormous difference in BP's turnover, costs, quality, safety, innovation, and environmental performance. They were also the people usually called upon to prevent small problems from becoming full-scale operational disasters. Yet BP didn't have a comprehensive training program for them. The corporation didn't even have a name for these supervisors. In internal HR parlance, they were managers "up to and including Level G," meaning they were separated by six or more hierarchical levels from the topmost executives.

No wonder the frontline managers felt disconnected; it was often hard for them to understand how their individual decisions contributed to the growth and reputation of BP as a whole. A lower-level manager might typically find himself promoted to lead a team with no clear instructions about how to manage people, how to handle appraisals, how to talk about high-stress subjects, or even whom to ask for advice. And if a unit supervisor wanted to move from, say, India to Canada or Australia, no one could be sure that his or her skills and experience could be easily transferred.

"There wasn't any sign that the company wanted to hear from people like me," recalls Ian Mullins, formerly a logistics supply chain manager at BP Chemicals and currently a compliance adviser for the BP Group. "We weren't aiming for the top of the house, but we had leadership ability and ambition – and we felt ignored."

During the past five years, BP has finally learned to connect with this population. There is now a companywide name for the group – "first-level leaders," a title deliberately chosen to emphasize the managers' significance to BP. And there is now a comprehensive training program for this cohort. Since the program was first offered in early 2002, more than 8,000 of the 10,000 first-level leaders (FLLs) have attended training sessions. The attendees, a notoriously tough group, have consistently given the courses average ratings of 8.5 on a scale of one to ten. More important, the managers who've been through training are consistently ranked higher in performance than those who haven't, both by their bosses and by the employees who report to them.

Some of the signature aspects of the program, such as the emphasis on team dynamics and the fact that much of the content is delivered by senior BP executives, have been specifically credited by people throughout BP with helping to make the organization much more collaborative and capable.

Why hadn't BP created such a program before? Because it is much harder than it seems. Indeed, it was only possible because we designed and developed this initiative in a highly participative way – unusual for BP and, we suspect, for many organizations. The year and a half we spent creating the program included surveys of those we had deemed first-level leaders and others throughout BP; extensive benchmarking of other companies' efforts; and a series of design and piloting sessions that involved dozens of advisers and cocreators. We managed to combine all these efforts into a cohesive whole, in which nearly everyone's contribution was not just recognized but also deeply valued.

In the end, this was the broadest and most comprehensive leadership development process BP had ever engaged in; the company invested $1.5 million in its research and development. But it was considered successful enough to have become a model for other such initiatives throughout the company, in part because it represents a $1 million annual savings over the plethora of BP training courses that it has replaced around the world – without creating a backlash. In 2002, BP Group Chief Executive John Browne honored the FLL program with one of the company's Helios awards for distinguished service to BP.

We both helped to develop the first-level leaders training initiative – of course, as part of a much larger team. The story of that team and its work not only details a best practice in leadership development but also demonstrates that broad change is possible at BP – or, indeed, at any company.

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Aspirations and Limits

The project began in early 2000, when a Learning and Development Committee composed of eight senior BP executives was appointed by Lord Browne to rethink the organization's approach to learning and development for its executives and employees. At that time, BP was emerging from a dramatic series of mergers and acquisitions. Three large oil firms–British Petroleum, Amoco, and ARCO–and several smaller companies had joined to form the third-largest oil-producing enterprise in the world. The associated turbulence had taken its toll: Job satisfaction surveys showed that supervisors, team leaders, and other BP managers working on the front lines were unhappy with their own supervisors or their career tracks. As the committee considered this information, its members voiced an aspiration: BP should be composed of bolder, more powerful leaders, from top to bottom.

But how? The committee members were pragmatic enough to realize that they didn't have the answer. They decided to conduct experiments to educate not just themselves but people throughout the company on the fundamental opportunities for learning at BP. The first-level leaders initiative described in this article was one of six experiments the committee oversaw. The others included a project to develop initiatives for better social responsibility and regional governance at BP; a cross-platform learning initiative linking several business subsectors in Asia; a redesign of BP's leadership development program for fast-track executives; an effort to monitor innovation at BP; and a series of "salons" – executive dialogues on wide-ranging but relevant business topics. The experiment in developing first-level leadership was not only a learning and development project but also a moral imperative for BP: If this group was truly the backbone of the company, then the committee felt a responsibility to embrace it.

The committee members agreed to sponsor the first-level leaders initiative but weren't exactly sure how it would unfold. The conventional approach would have been to design a prototype training program, test it once or twice, and then roll it out through the entire corporation. But the committee members understood that a one-size-fits-all program wouldn't take at BP; it wouldn't recognize people's individual jobs, cultures, aspirations, or futures. The group had seen too many well-intentioned, expensive training programs instituted with great fanfare from the top, with no lasting results. At the same time, it understood that BP couldn't keep its current ad hoc, haphazard approach to training lower-level managers. The committee had to find some solution that paradoxically recognized BP's diversity while providing global cohesion.

Andy Inglis, the deputy chief executive of BP Exploration and Production and a member of the Leadership and Development Committee, was the lead sponsor for the first-level leaders initiative. He viewed his involvement as an opportunity to help managers on the front lines understand their piece of the corporate strategy and the drivers for its delivery, as well as the factors behind high performance in their domain – particularly those related to the issues of health, safety, and the environment. Andy's sponsorship was critical; he showed us, for example, how to present our ideas to *his* constituencies – senior and upstream people – more effectively.

WE MET IN A REMOTE BRITISH HOTEL WHOSE PROPRIETOR HAD A KNACK FOR BREAKING IN AT OUR MOST INTENSE MOMENTS, DECLARING: "IT'S TEATIME NOW. THE SCONES ARE ON THE TABLE."

Three individuals were tapped to design and develop the initiative – us and project leader Dominic Emery, a senior BP executive with commercial and operational experience. We worked closely with Kate Owen, then BP's head of organizational and learning development, who helped us clarify our thinking and canvass senior executives companywide. She also introduced us to Robert Mountain, an experienced training and development consultant, who briefed us about other companies he had studied that had sought to train their lower-level managers. Cisco, for example, used electronic media extensively, and GE targeted newly appointed managers as part of its comprehensive learning program for supervisors.

It soon became clear that BP had some unique requirements. First, the training initiative would have to embody BP's new, still-evolving corporate culture. Second, while some corporations designed their training initiatives so entire teams could attend two or three sessions over the course of a year, that wasn't practical for BP. We had too many frontline managers scattered in too many places. We would need a more individualized program, in which some people might go to one session and others to two or more. Third, it also wasn't practical for us to use Web-based courses to fill in the gaps between face-to-face sessions, as other companies had done. A fair number of our frontline supervisors worked offshore or in other remote locations not easily accessible by Internet. Fourth, most other companies relied on internal or external training professionals to facilitate their programs. But at BP, we had learned the value of leaders training leaders in our existing executive-level seminars, and we wanted to bring that same concept to the frontline supervisor level. Ultimately, more than 250 senior managers would deliver sections of the FLL courses. Finally, to gain their sponsorship, we needed to assure the members of the Learning and Development Committee of not just superior performance results but potential cost savings as well.

We based the FLL initiative on a theory of corporate change called the "generative spiral model," which was developed by Dialogos founder William Isaacs and colleagues in the organizational learning movement. This model posits that successful organizational innovations start with a small group of "thoughtful, committed citizens" (as Margaret Mead famously put it) that gradually broadens in sponsorship and deepens in awareness. As the relationship between the core group of innovators and various allies becomes more vibrant, the organization's ability to sustain change becomes stronger. By the time the change initiative is extended throughout the company, the organization is ready to accept it.

In the early stages of such a process, it may seem like nothing much is happening, but, in fact, the groundwork is being laid for the change to take hold. By contrast, change initiatives that are rolled out within a month or two of their announcement generally end up failing because they haven't followed a deliberate sequence for building commitment among constituencies, establishing sponsors, and developing the capacity to act in new and different ways.

Getting the System in the Room

One of the first moves suggested by the spiral model is to get the whole system in the room. That is, our design process needed to include representatives from every key constituency – not only the lower-level supervisors we were targeting but also their managers and direct reports. It needed to include people from all of BP's businesses (Exploration and Production, Refining, Trading, Retailing, and Chemical Production); from a range of geographic areas; and from all the organizational heritages (BP, Amoco, ARCO, Castrol, and others). We made sure that all the participants understood one another's backgrounds and perspectives. We gently but relentlessly reached out to people who had reason to be suspicious of us; some managers in the technology groups, for instance, had their own training initiatives that they thought might be threatened by the FLL program. But we persisted, and the extra hassle and costs paid off.

We started by conducting a telephone survey, interviewing about 175 BP managers around the world who played various supervisory roles. Using the data from that survey, and through our network of learning and organizational development professionals across BP, we identified about 250 people spanning all the groups we wanted to include in the program's design process. We brought them together, 30 or 40 at a time, for several one-day workshops between February and April 2001.

The workshops all started with the same statement, generally delivered by Dominic Emery: "First, we're going to take inventory of all the training that is done today for employees below a certain job grade. Second, we want to understand the needs of that group of employees. Third, we want to develop a whole new training program that is, at minimum, cost neutral to our current offerings. This program has to operate globally – and we have only a few months in which to design it. We want you to tell us what you think."

From there, the sessions would move into structured dialogue, in which carefully selected small groups reflected together on the role of the first-level leader, the major challenges such leaders faced, and the development opportunities they should get at BP.

The sessions were energetic and lively. Attendees received materials to read ahead of time – critical insights from previous sessions and summaries and updates as time went on. As we got several of these fact-finding sessions under our belt, we continued to be impressed by the amount of time and effort our participants invested in what was essentially a volunteer initiative. We were especially gratified when some of the senior executive sponsors, who had hesitantly agreed to spend part of a day in these dialogues, became more intrigued. We slotted some time in each session for a senior executive to talk about his or her understanding of leadership and then to take questions. The response from the attendees was so positive that it galvanized the executives themselves. They were starting to feel a pull from the organization – a desire to learn. The sessions also showed that senior leaders could talk to frontline managers not simply as employees but as fellow leaders, thus initiating them directly in the larger community of leadership at BP.

Defining and Understanding the Audience

Since the group we were trying to reach didn't have a name, we had to find one. The titles already in use at BP – "frontline managers," "supervisors," "team leaders" – had regional (and sometimes negative) connotations. "Team leader" might sound senior in one country and junior in another. In one of the Learning and Development

Committee's first dialogues, back in April 2000, it had settled on "first-level leaders." "First" suggested that BP put this group of managers foremost in the company's consciousness. "Level" connoted the hierarchical rank these individuals shared, and "leader" connected this group with BP's keen interest in developing strong leadership.

In all the workshops we conducted early in 2001, we learned a lot about the distinct needs of each group. The first-level leaders wanted a better understanding of the whole corporation and its priorities. For example, increases in oil prices generally led to increases in feedstock costs for BP's refining businesses. Since lower-level supervisors in refining and chemicals typically didn't know the dynamics of the upstream businesses (exploration and production, for instance), they couldn't give customers (or train their staff to give customers) a credible explanation for the pricing change. So, they couldn't explain: "Well, the current wave of demand and the latest OPEC policies have forced the price of oil up. This means extra costs for our own raw materials. We aren't passing on the full costs to you – but we do have to recapture some of them."

The senior executives in our sessions had no idea that the first-level leaders felt so disconnected. Listening to the frontline supervisors talk gave the senior leaders a visceral understanding of the performance gains those managers could reap if they understood how different parts of the organization fit together. It also gave them pause; they realized they would have to stop acting as controllers and gatekeepers, parsing out messages on a need-to-know basis, and become creative partners, nurturing and channeling the enthusiasm and interest of the first-level leaders.

It was also important to hear in those sessions from the hourly staffers who reported to first-level leaders. The workers were more performance-oriented than anyone expected: If there were slackers in an operation, they wanted the first-level leaders to deal with those people promptly – and fire them if necessary.

Moving Slow to Go Fast

We knew that we wanted our training program to teach the first-level leaders the value of being thoughtful and deliberate. We understood this meant we had to live up to the same ideal ourselves. But BP's culture did not traditionally support a reflective pace. Early in 2001, members of the Learning and Development Committee showed their impatience. "Do you really need to bother with all of these workshops?" they asked. We stood our ground, putting ourselves in the uncomfortable position of defending a principle (time for reflection) that our bosses had espoused against their doubts. Here, it made a difference that there were three of us, including one outsider (Robert Hanig) who had seen in other organizations the importance of taking time to reflect. The issue came to a head in a conference call with Andy Inglis. We explained to our chief sponsor how much we had learned in the workshops and the need to take the time to include diverse perspectives.

Andy listened and said, "That's not the way we usually operate. Make sure you do it properly." But then he said something that became a catchphrase for the entire endeavor: "Sometimes you have to go slow to go fast." By the end of the research phase in April 2001, we saw how our deliberation had paid off. We had built up our own capacity to the point where we could competently cross an important threshold – we could turn this initiative into a global program.

Until now, we had assumed that local business units and regions would put their own spin on the main FLL courses. That is, we would develop the basic materials that they would use as they wished, and they would pay for them from their learning and development budgets. But the first-level leaders, their direct reports, *and* their bosses had all agreed: They wanted a truly global program. The design could tolerate some flexibility in implementation, but basically it should be uniform. The first-level leaders, in particular, pushed for a single program. We had not expected this mandate, and it was very welcome, especially when it led directly to the group's next point: The FLL program should get central funding. Otherwise, the first-level leaders said, the program would last only until the next budget cutback. Some divisions would send people; others wouldn't. With central funding, the FLL initiative could replace existing training programs. We took that message to the Learning and Development Committee, and it backed us up, approving our basic ideas and timetable. We were exultant – ready to move directly into designing the curriculum.

COULD WE REALIZE THE COST SAVINGS WE HAD PROMISED?… "WE'LL SHOW THAT IT'S POSSIBLE," WE TOLD THE COMMITTEE, "AND YOU SELL IT TO THE ORGANIZATION."

Designing the Curriculum

At this point, the process design group hit a snag that almost unraveled the entire program. In canvassing support, we had delayed our work with a critical constituency: BP's extensive staff of learning and development professionals operating in regional offices around the world. We had been reluctant to involve them in early research until we knew for sure that the program would continue. Then, buoyed by our great response from the first-level leaders, we invited some of these professionals to talk with us about integrating their work into the FLL initiative. We expected them to share our enthusiasm. Instead, to our initial annoyance, they balked. Or so it appeared. In fact, they were asking the right questions: "Would this replace our existing programs? How would it meet local needs? How would we be involved?" We realized that, from their perspective, we were imposing yet another new program from BP's central headquarters on their long-decentralized efforts.

To recoup, we returned to our sponsorship-seeking mind-set, talking with them one by one, listening to their concerns. The learning and development professionals wanted a large role, for example, in choosing the trainers for sessions in their geographic areas – a request that, from our perspective, was ideal. It helped that several of BP's most respected regional practitioners became impressed with the quality of the training modules we had developed. Once they saw the value of the project, they recruited other professionals from places like Zimbabwe and China, whom we otherwise would have missed.

With the learning and development professionals on board, we could move into our nuts-and-bolts design process. In June 2001, we convened 15 HR and learning professionals to settle on the curriculum. We did our best to replicate in this group the diversity of the company. We invited people from BP operations in Alaska, Australia, Belgium, China, Germany, Ireland, Zimbabwe, the United States, and the United Kingdom and gathered in a remote British hotel that reminded us of Fawlty Towers. The proprietor had a knack for breaking in at our most intense moments, declaring: "It's teatime now. The scones are on the table." Many of the people who attended will remember that four-day off-site meeting as one of their most creative periods at BP because of the process: We would disagree, hash things out, take a break, talk some more, reach a mutual decision, and start all over again on a new topic.

In the end, we developed six pilot FLL courses, one each in Houston and Chicago in the United States; Port of Spain, Trinidad; Cape Town, South Africa; Aberdeen, Scotland; and Milton Keynes, England. We invited some of the first-level leaders from the early design sessions to each. We also asked some participants from our early sessions to join an informal Sponsorship Group to critique and comment on the pilot courses. This group comprised not just senior executives but also first-level leaders, their bosses, their direct reports, and some staff members from HR and organizational development. The group later helped to recruit local executives and support teams and to organize on-the-ground coordination efforts where the courses were delivered.

"One thing that can't be overstated," says BP's Douglas Frisby, a project manager and a member of the Sponsorship Group, "is the amount of work and effort it took during the implementation phase from local reps–setting the classes up, arranging for people to be there, recruiting trainers, and making sure it was delivered properly. The process design team could not do this without the solid engagement of local people, mostly within the HR and learning-development functions."

In September, the Learning and Development Committee agreed to provide the budget for the first-level leaders initiative. By now the project involved a Web site so that first-level leaders could easily register for the courses, a set of evaluation measures, and a schedule for courses that would start in January 2002. The committee members now held us to our pledge: Could we realize the cost savings we had promised? We said we could, but only if BP as a whole remained committed to the first-level leaders initiative and didn't compete with it. "We'll show that it's possible," we told the committee, "and you sell it to the organization." BP's executive leadership would have to visibly sponsor the FLL initiative or people throughout the company would feel vulnerable supporting it. The committee members agreed, and the conversations turned to logistics. The attack on the World Trade Center had taken place only two weeks before, and business travel was being cut back. We were worried the organization would postpone this global program–but it didn't.

At that same meeting, the committee members had advised us to get a good marketer. We were skeptical at first, but we took their advice and recruited to the team a BP marketing expert, Duncan Blake. This turned out to be crucial, not only for establishing a professional presence but also for deepening our awareness of the FLL population. Getting word out to the entire organization turned out to be more of a challenge than we expected. There was no distribution list that covered the 10,000 or so first-level leaders who work for BP–or even a list of sites. We had to develop our own. We could not simply use the Internet, because BP managers in remote parts of the world, or on offshore oil rigs, don't necessarily have e-mail. Nor do some of our retail staff.

What We Delivered

Having one course of training meant we needed to tie the curriculum tightly into BP's overall learning and development objectives. It helped that we had a rationale for this, laid out in the early days of the initiative by two key high-level sponsors: Kate Owen and John Manzoni, then group vice president, now BP's chief executive of refining and marketing. For the courses to be deemed successful, trainees needed to be able to answer yes to the following questions:

- "Do I have enough awareness of the direction of this organization?" In other words, am I exposed to BP's strategic thinking?
- "Do I have the skills and support I need to deal with the challenges of my immediate business?" In other words, are they giving me what I need to do my job?
- "Do I have the skills and support I need to deal with the leadership challenges I face now?" In other words, can I be the kind of person I need to be in this position?
- "Am I getting enough support and feedback from BP to make the right personal choices about my life and work?" In other words, does BP support my aspirations as well as its own?

To help first-level leaders answer in the affirmative, we developed a training program with four components. Most first-level leaders, we expected, would engage in at least one (and possibly two or three) of them. The four components remain in place today.

Supervisory Essentials. This segment of the program focuses on the basics of management. First-level leaders are trained on the particulars of project management and technology in their businesses, and they discuss relevant health, environment, safety, and social responsibility issues. This course is delivered through a combination of face-to-face sessions, Web-based programs for those with Internet access, and CD-ROM modules.

Context and Connections. This two-day session covers BP's overall strategy and its implications for all parts of the global organization. The design is continually revamped as corporate priorities change.

The Leadership Event. This is the most intensive component of the FLL program, a four-day session for 24 to 36 people. It includes briefings from senior executives, who often incorporate personal stories about their own management dilemmas into their lectures; in-depth training on how to develop better communication, management, and leadership skills, along with sessions on how to build greater confidence and self-awareness; and action learning. Some of the course's role-play exercises promote attentiveness to diversity and inclusion; others teach people how to make less-ambiguous statements or enable more-effective analysis of a team's communication style.

Peer Partnerships. This coaching course pairs new first-level leaders with more-experienced colleagues as they progress through the entire FLL training program, thereby laying the groundwork for continued learning and development after the sessions end.

The dialogues built into the courses tend to focus on handling difficult managerial and leadership issues, ranging from local concerns (such as community development near BP's African production sites) to generic topics like the BP brand. "In one [FLL session] that I ran, some people from Exploration and Production couldn't see how the brand related to them," recalls Janet Ashdown, BP's vice president of field supply for retail in Europe. "'A brand is a marketing thing,' they said. But by the end of the conversation, I think they understood that the brand is not just the logo that appears on the gas station pole. It represents the values of the company, the role you play in communities, and the kinds of behaviors that make it easier or more difficult, and more or less expensive, to go into a new market or make a new investment somewhere."

Ashdown also notes that participating in the FLL courses gave senior leaders unprecedented insights into the grass roots of the company. "It's very refreshing to get out and talk to potential leaders. They're a different generation; they see things differently, and they are pretty challenging."

By bringing together people from different parts of BP, the FLL program is also creating unexpected synergies. For example, Castrol Reprocessing Services, a BP maintenance facility, and BP Solar now share a building for some of their technical operations, including Solar's slurry reclamation process, after two first-level leaders met at a Context and Connections session. The program also brings together people who didn't communicate much before; for example, FLL sessions are produced by a combination of local line managers, local HR and organizational development staff, and central HR directors. That in itself has helped learning and organizational development at BP become more consistent and coherent.

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The success of the FLL initiative has spawned a similar program for BP's 6,000 senior-level leaders. Within two years, every first- and senior-level leader in the organization will have gone through some form of leadership development. As that population increases, practices such as supplemental meetings and follow-up coaching – FLL reunions, lunches, and briefing workshops – are also taking hold.

BP continues to evaluate the program by surveying the managers who have taken the courses, as well as their superiors and direct reports. The responses consistently show that first-level leaders who have gone through the program perform more effectively than those managers who have not, according to the people they report to and the people who report to them. For two years running, employees supervised by trained first-level leaders have rated their bosses higher by almost 10% in the following areas: communication, interpersonal skills, team leadership, and general management.

BP's success in this initiative has given it the confidence to take leadership development to another level. "We're not finished," Andy Inglis says. "It's been a volatile world for the past two or three years, particularly in the oil and gas industry. Our leadership training needs to match the pace of change around us. We especially need to equip our people to deal with ambiguity and to feel confident in the firm's direction as they go about their daily work. That's a job that is never finished."

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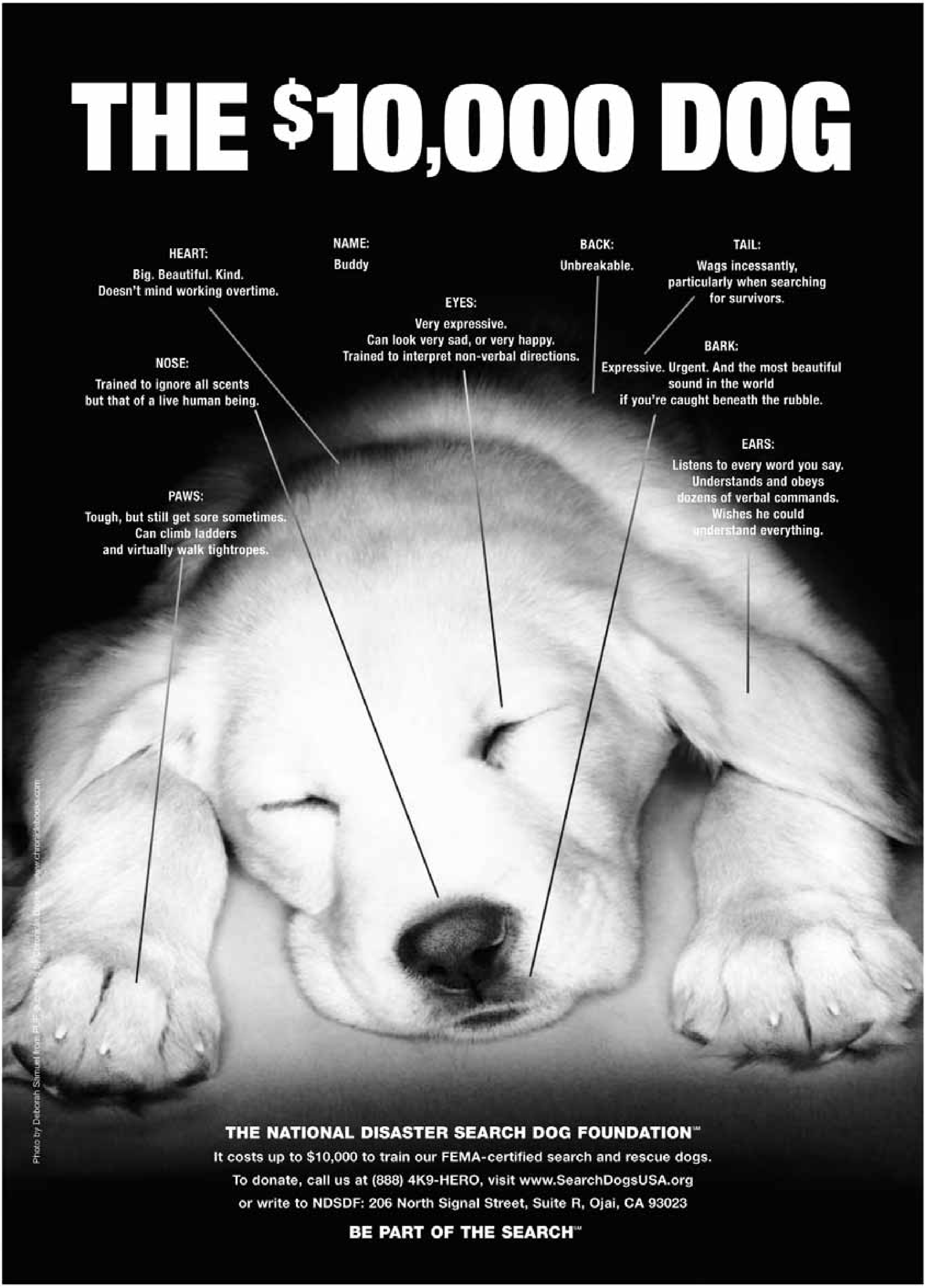
To order, see page 151.

"Some of the ideas in the staff development meeting on innovation seemed interesting but they've never been tried, so I think I'll hold off for now."

AARON BACALL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BARK:
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EARS:
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DAVID PLUNKERT

Every Employee an Owner. [Really.]

by Corey Rosen, John Case, and Martin Staubus

New accounting rules will soon require companies to place on their income statements, rather than in footnotes, the cost of stock options they issue to employees. Option plans will thus be subject to the same shareholder scrutiny as all other equity compensation programs. Shareholders have learned to be wary of the dilutive effects of equity grants and their potential for abuse by senior managers, so it's possible that executives will respond to the reforms by reducing the number of employees who are eligible to receive equity. In fact, surveys of human resource professionals suggest that almost half of companies with broad-based options programs will limit participation in them at lower levels of the organization. Kodak, Aetna, and Time Warner have already done so.

It's not uncommon for rank-and-file employees to have equity in their companies. But it takes more than that to make them think and act like owners.

But companies that reserve equity compensation for executives and leave the rest of the workforce out of ownership plans are bound to suffer in the long run. Top managers aren't the only ones who make a difference to a business. Study after study proves that broad-based ownership, when done right, leads to higher productivity, lower workforce turnover, better recruits, and bigger profits.

"Done right" is the key. United Airlines created an employee stock ownership plan (one of several types of broad-based equity plans available to companies) in 1994, but the ESOP was doomed from its inception. It was adopted under duress, rejected by a major segment of the workforce, and soon opposed by new management. The company declared bankruptcy in 2002.

Getting broad-based ownership right isn't a matter of choosing one type of equity plan over another (see the sidebar "The Varieties of Employee Ownership"). As far as we can tell, the form of participation, whether it be options, a 401(k) plan, an ESOP, or a restricted stock plan, is unimportant in comparison with four factors: A significant percentage of the workforce – generally, most of the full-time people – must hold equity; employees must think the amounts they hold can significantly improve their financial prospects; managerial practices and policies must reinforce the plan; and employees must feel a true sense of company ownership. In essence, management must encourage rank-and-file workers to "own" their responsibilities once it has allowed them to own, literally and legally, their employer's equity.

The four factors add up to an ownership culture in which employees' interests are aligned with the company's. The result is a workforce that is loyal, cooperative, and willing to go above and beyond to help make the organization successful. In the following pages, we'll examine the factors and explain how to achieve an ownership culture. We'll also look at United's ESOP and explore the examples of two widely differing firms, one a California R&D contractor, the other a Rust Belt forge shop, that have achieved excellence in implementing broad-based employee ownership.

Management must encourage workers to "own" their responsibilities once it has allowed them to own, literally and legally, their employer's equity.

Owning a Piece of the Action

In 2004, close to 11,500 U.S. companies had ESOPs involving a total of nearly 10 million workers. An additional 4,000 companies sponsored different types of broad-based stock option programs covering an estimated 10 million employees. Thanks to these and other programs, roughly 23 million individuals, or about 39% of people working for stock corporations, owned stock, or options to buy stock, in their employers. A few thousand companies are wholly or majority owned by their employees. This group includes multibillion-dollar corporations such as the Publix supermarket chain as well as a host of small and midsize companies.

Rutgers University's Douglas Kruse and Joseph Blasi, the preeminent scholars in the field of employee ownership, examined 105 publicly traded companies that provided stock options to at least 75% of their employees. In the three years following the implementation of their options plans, the companies improved productivity 17% and return on assets 2.3% per year, on average. Moreover, the grants made by these companies didn't exact a price from the employees: Wages were about 7% higher than in comparable companies that did not distribute options widely.

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The Varieties of Employee Ownership

An **employee stock ownership plan (ESOP)** is a tax-qualified employee benefit plan in which most or all of the assets are invested in the employer's stock. Like profit-sharing and 401(k) plans, an ESOP generally must include all full-time employees meeting certain age and service requirements. The company can finance the plan through cash contributions, debt the company repays, or share contributions. Employees receive their benefits when they leave the company. Some 10 million people in almost 11,500 companies, most of them closely held, participate in ESOPs.

A **stock option plan** grants employees the right – once the option has vested – to buy company stock at a specified price during a specified period. Stock options can be given to as many or as few employees as a company wishes. An estimated 7 million to 10 million employees – possibly more – in thousands of public and private companies currently hold stock options.

Restricted stock plans provide employees with shares or the right to buy shares at fair market value or at a discount. However, the shares employees acquire are subject to a vesting restriction. Most commonly, the employee must continue to work for the company for a certain length of time, typically three to five years; if the employee leaves sooner, the shares are forfeited to the company.

A **qualified employee stock purchase plan (ESPP)** is a little like a stock option plan. It gives employees the chance to buy stock, usually through payroll deductions, over a three-month to 27-month offering period. The price may be discounted from the market price by up to 15%. But an ESPP differs from a stock option plan in that employees can profit even if the stock price has gone down since the grant date. Millions of employees, virtually all of them at public companies, participate in ESPPs.

Under a **nonqualified employee stock purchase plan,** a company sells shares of its stock to employees without regard to the qualification rules that are prescribed for ESPPs. Many companies, especially those that are not publicly traded, find it impractical to sell stock to employees under the ESPP terms. The trade-off is a loss of certain favorable tax provisions for employee purchasers.

Unlike an ESOP, a **Section 401(k) plan** is designed to provide the employee with a diversified portfolio of investments for retirement. The plan may allow employees various investment choices, and the company may make matching contributions. Perhaps several million employees in a few thousand companies participate in plans with a heavy company stock component. As part of its 401(k) plan, a company can also contribute stock. Such plans are called KSOPs.

Synthetic-equity and **stock-appreciation rights plans** provide employees with a cash payout based on the increase in the company's stock value during a particular period. An emerging variant is appreciation rights settled in shares instead of cash. Synthetic-equity plans that pay cash may be simpler than programs that give shares, but they may not provide the same sense of ownership that share-based plans do.

In 2002 congressional testimony on Section 401(k) reform, Kruse summarized the results of some 30 studies, his own and many others, that looked at the financial results of companies in which a significant percentage of employees had equity stakes of various kinds. Most of the studies found that these companies did better than other firms. Some found that employee ownership made no difference, but none found that it hurt performance.

A 2003 study by Sibson Consulting (one that Kruse did not cite) found that, dollar for dollar, sharing ownership is the most effective way to lure employees to a new company or keep them at their current jobs. Other studies have shown that companies with substantial employee ownership are more likely than others to offer diversified retirement plans (in addition to the equity compensation), so employee-owners usually don't need to fret that their holdings are unduly concentrated in the stock of a single company – namely, their employer.

The Wrong Way

Employee ownership is not, however, a magic bullet. Some economists have long regarded it with skepticism, arguing, for example, that employees of all but the smallest organizations can rarely see a link between their efforts and the company's results; hence, ownership has little effect on business performance (see the sidebar "When Does Employee Ownership Make the Most Sense?"). They also point to the "free rider" problem: Even if employees as a group have an incentive to work harder and smarter, some individuals will be tempted to slack off and let others carry the burden. They suggest that employees don't value ownership as much as it costs a company to provide it. And if employee owners are in the majority and actually control the company, economists argue, workers will favor higher wages and other short-term benefits at the expense of investment in future growth and profitability.

The experience of United Airlines and the high-profile failures of certain other companies' employee-ownership programs have lent credibility to these views. But in reality, United failed because it defied almost all of the precepts of productive employee ownership.

At United, unionized pilots, unionized mechanics, and nonunion employees were given 55% of the company's shares through an ESOP in return for wage concessions. The experiment began in a rosy glow of collaboration. Task groups of employees from all over the company began attacking workplace problems and figuring out how to cut costs. Employees took on new responsibilities: "Everyone from gate agents to mechanics gained new authority to address customer complaints without consulting their supervisors," the *Chicago Tribune* reported in a 2003 retrospective. Even pilots got into the act, "checking wind conditions and other data to determine the most fuel-efficient routes."

The cooperative attitude brought results. By the end of 1995, the ESOP's first full year, grievances had fallen by 74% and sick time by 17%. Revenue per employee, a key measure of productivity in the airline industry, was up 10%. Surveys showed that employees enjoyed working at the "new" United. In 1995, the company's stock outperformed the Standard & Poor's 500 index by 67%, and shareholder value increased by more than $4 billion.

Five years later, however, the task groups were long gone; in fact, the company disbanded them just a year after establishing them. Gone, too, was the cooperative attitude. In the summer of 2000, pilots seeking a new wage deal staged a drastic slowdown. They refused to fly overtime, making it impossible for the airline to keep to its schedule. They taxied at a crawl. They flew low to burn more fuel. Shortly before takeoff, one pilot "walked off a full 747, claiming nerves," according to a postmortem by *New York Times* writer Roger Lowenstein. On-time performance, which had reached 81% the year the ESOP was put in place, dropped to an industry-worst 61% for the year (it was at 40% during the summer). Passenger traffic plunged.

The tale of how the ESOP's high hopes and promise were shattered is long and involved. But any account would surely highlight at least three elements.

Divisive Beginnings. The 1994 deal was controversial from the start. The Air Line Pilots Association and the International Association of Machinists gave up some $4.8 billion in prospective wages and benefits in return for equity. (This was unusual; fewer than 2% of stock ownership plans involve givebacks.) Meanwhile, United's other major unionized group, the flight attendants, refused to join the buyout on the grounds that members couldn't afford to make such large concessions. "You can't eat stock" would become a catchphrase for those who opposed the whole deal.

Fading Support. Changing any large, entrenched organization requires constant effort, and no such effort was forthcoming. The pilots' union, still riven with disagreement over the givebacks, voted out the leaders who had supported the ESOP only a few weeks after it was implemented. The union's new leaders had little interest in employee ownership. The machinists, never too excited about the scheme, became increasingly distracted by a challenge from a rival union. Within the company's executive ranks, says Chris Mackin, an employee-ownership consultant who worked with United at the time, "a cluster of 'old guard' management officials who openly criticized the original move to employee ownership began to gain strength."

Employee-owners are trusted to do what is best for the company. They know which numbers to watch, and they watch them.

When Does Employee Ownership Make the Most Sense?

In industries like software and biotech, a broad-based options program or an employee stock ownership plan (ESOP) is a competitive necessity – even in the post-dot-com era. In closely held companies, an ESOP may offer the owners tax-advantaged liquidity while providing employees with one piece of a valuable retirement plan. But for companies without such specific motives, the advantages of broad-based equity plans are less obvious. Many executives wonder, Under what circumstances does it make sense to begin building an ownership culture and teaching employees the disciplines that drive business performance? The research suggests that companies in five categories are particularly well suited to creating such a culture.

Young, Growth-Oriented Companies. Plenty of growth-oriented, entrepreneurial businesses that aren't based on high technology have discovered the dot-coms' secret: Offering equity is a great way to attract and keep high-quality people whom they couldn't afford otherwise. For example, the Scooter Store, based in New Braunfels, Texas, sells powered wheelchairs and electric scooters to the elderly and disabled. Founded in 1991, it has made *Inc.* magazine's list of the 500 fastest-growing privately held companies five times. Its 1,000 employees own 40% of the company through an ESOP. When a young company like the Scooter Store grows fast, its stock appreciates rapidly, and employees can build up huge account balances in a relatively short time.

"Destination" Workplaces. This is the term Vermont's Green Mountain Coffee Roasters uses to describe itself. It can be applied to any company that offers good jobs, generous rewards, and a supportive environment. For such companies, stock-ownership programs are a natural and expected complement to an employee-centered culture. One of the newer exemplars is Google, the Internet search-engine firm that went public in 2004. The company offers an extraordinary array of benefits, including free meals and on-site doctors and washing machines, and it allows employees to devote 20% of their time to their own projects. Accordingly, all employees receive options, and the shares they receive have ten times the votes of ordinary shares.

Companies Under Threat. Companies that have buttressed broad-based ownership with complementary management practices seem to be almost immune from competitive threats. Employee-owned Phelps County Bank – a community bank in Missouri that competes with national and statewide institutions – has grown substantially and has periodically taken market share away from its larger competitors. "Our competition has increased tremendously," says CEO Bill Marshall. "The largest bank in the United States, Bank of America, is right across the street. But our market share has continued to hold or increase." In some years, the bank has given employees equity equal to as much as 25% of salary, and it actively solicits ideas from staff members. Those ideas have been found to directly improve performance. Naturally, the reasons for the success of companies like Phelps are numerous, but none counts for more than the full-equity model.

Companies That Are Tortoises. Most companies, of course, aren't living on the edge of extinction, nor are they destination workplaces. They are more or less stable, middle-of-the-road enterprises trying to grow and make money. The equity model is a way for them to set themselves apart in customers' eyes from other companies in their industries. Established in 1943, Building Material Distributors (BMD) was a family-owned California company that sold to local markets. In 1991 it set up an ESOP, and in 1995 it created a training program and an ESOP advisory team and began involving employees in running the business. Today it has several branch offices throughout California, has hit more than $200 million in sales, and has begun to sell its building materials internationally. A "sizable chunk" of BMD's growth and prosperity is attributable to the ESOP and employee involvement in the business, says CEO Steve Ellinwood. Most of BMD's competitors have been acquired or have gone out of business, he says.

Companies Seeking a Reputation for Good Intentions. Employee ownership sets a company apart on an ethical level. Community Provider of Enrichment Services, an Arizona-based organization that offers services to people with developmental disabilities and mental illness, faced mistrust because it is a for-profit company. It solved that problem when it became owned by its 700 employees and opened its books to them and to the families of its clients. Young companies, in particular, have little or no track record to point to; for them, employee ownership conveys the message that the founders did not enter the business just to make a quick buck. Indeed, employee vigilance in an ownership-based company that is financially and operationally transparent makes pursuing a quick or questionable buck difficult.

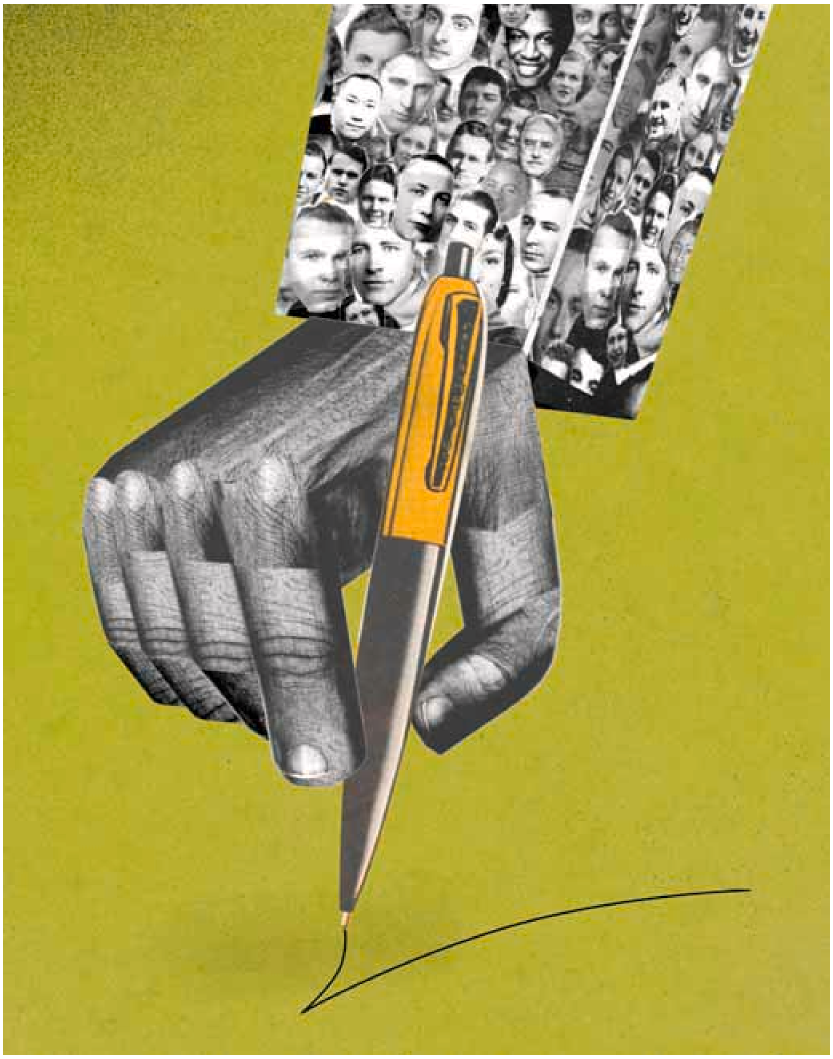
A Flawed Structure. Not only were the flight attendants on the outside looking in, but workers who were part of the ESOP would get stock for only five years. People who joined the company after that period would get none at all. Soon the ESOP wasn't anyone's priority. In 1999 and 2000, with the ESOP flagging and contract negotiations coming up, the pilots' union was in no mood for compromise. Then James Goodwin, the new CEO, announced that he had negotiated a merger with US Airways, a move that jeopardized the United pilots' seniority. That's when the infuriated pilots mounted their slowdown. (The proposed merger was subsequently nixed by the Justice Department on antitrust grounds.)

When United went bankrupt, a few commentators were quick to place the blame squarely on employee ownership. That made about as much sense as blaming US Airways' bankruptcy on investor ownership. But employee ownership certainly didn't save United. Both the union leadership and management, for different reasons, viewed employee ownership as a negotiating ploy rather than as a commitment to cultural change.

Success Stories

United's example notwithstanding, a wide variety of companies have recorded exceptional business performance with the help of employee-ownership programs reinforced by management policies. We visited dozens of such companies and spoke one-on-one with a broad cross section of people at each, from CEOs and other senior executives to frontline workers. Examining the particulars of company experiences seemed to us an important way to learn why some companies do very well with employee ownership while a few crash and burn.

Science Applications International Corporation (SAIC), a research and development contractor based in San Diego, employs about 45,000 people at its state-of-the-art facilities. Last year, it reported revenues of $6.7 billion, making it perhaps the largest employee-owned firm (and among the largest privately held companies) in the world. J. Robert Beyster, the physicist who founded SAIC in 1969 and until recently served as its chairman and chief executive officer, was passionately committed from the beginning to sharing ownership. Not surprisingly, many respected scientists scrambled to sign on when he offered equity in a growing company.



The firm has set up a unique infrastructure devoted to getting stock into employees' hands and to ensuring that people understand what it means to be owners. SAIC staff members, many of whom have PhDs or master's degrees, can buy shares outright, either for cash or through a payroll deduction. A program that adds a certain number of shares to those purchased by first-time buyers encourages employees to give ownership a try. A large percentage of workers are awarded stock as part of their compensation packages or bonuses. And every employee is included in SAIC's retirement plan, which awards a quantity of shares every year based on an individual's pay. An internal market, operated four times a year by a licensed, wholly owned broker, allows employees to buy or sell shares at a price set each quarter by the board of directors. (If there is an imbalance between buyers and sellers at a given price, the company typically steps in to make up the difference.) Meanwhile, an internal Certified Employee Owner training program offers courses in the company's financials and other aspects of stock ownership. At last report, nearly 17,000 employees had completed the course.

Scot Forge is a very different kind of employee-owned enterprise. At five locations in America's heartland, the company turns metal and other material into various shapes for use in industrial machinery. Its plants are hot and noisy. Its 500 workers are mostly high-school and community-college graduates. Unlike SAIC's employees, Scot Forge's workers can own stock only through the company's ESOP, and they can cash out only when they retire or leave the company.

But in important respects, SAIC and Scot Forge are similar. Both have recorded steady and at times exceptional revenue and earnings growth and today are highly profitable. SAIC officers share and discuss the firm's financial performance with employees in quarterly "town meetings" broadcast over the Web; Scot Forge's executives hold monthly all-hands lunch meetings in every plant to review sales, profits, and other aspects of the business. Like SAIC, Scot Forge makes a point of reminding people of their ownership stake at every opportunity. An elected ESOP council offers training programs and serves as a sounding board for employee shareholders. Many of SAIC's employees – about 3,000, according to one informed estimate – have accumulated at least $1 million worth of stock each. Scot Forge isn't quite in that league, but the company's performance has enabled many blue-collar workers to accumulate retirement accounts of $750,000 or more. Its worker-shareholders also receive dividend and profit-sharing payments. A 15-year employee can expect to receive an additional six weeks' worth of pay, on average, from these sources every year.

The employee-ownership plans at both SAIC and Scot Forge incorporate the four factors that add up to an ownership culture. At both companies, every employee with a year or so of service holds equity, and employees can accumulate a comfortable nest egg over a period of years. Management's sharing of financial information reinforces workers' sense of ownership. So does the fact that employees are expected to accept the responsibilities of ownership – and do. At Scot Forge, for example, employees will arrange to work weekends to finish an urgent job without any prompting from management. Workers with this kind of ownership attitude are trusted to do what is best for the company. They know which numbers to watch, and they watch them. They internalize their responsibilities and feel they have an obligation not only to management but to one another. Finally, they expect to make decisions that will boost the bottom line.

The Impact of Expensing Options

Particular forms of employee ownership tend to wax and wane with the vagaries of tax laws and accounting practices. This year (barring congressional action, which at this writing seems unlikely), companies will be required to start calculating the cost of stock options and expensing it on the income statement. Broad-based options programs may decline in popularity as a result. Or they may not.

Surveys of human resource professionals suggest that about half of companies with broad-based options programs will reduce them at lower levels of the organization. But many equity-compensation professionals believe that the surveys overstate what will happen. For one thing, companies know that cutting back on options programs would make it harder for them to compete for employees. For another, survey respondents may have been reacting to the expectation of downward pressure on share prices, and it's not clear whether expensing will really drive down stock prices. Research suggests that expensing may turn out to be the Y2K of equity compensation – much worried about, but having little impact. Studies of companies that already expense options show no significant effect on stock prices, even of companies with relatively high options expenses. If the effect of expensing options is negligible, there will be less incentive for companies to reduce options awards.

The most likely outcome: Companies with substantial plans will retain broad-based ownership in some form, while companies that were only marginally committed to broad-based equity compensation will eliminate their programs. In short, options will still play a central role, but other forms of equity pay will increase in importance.

What Ownership Means

A culture of ownership is common at companies with ESOPs, but it's still not typical of other employee-owned companies, even though granting stock options has been commonplace since the 1990s (ESOPs have been around since the 1970s). Many employees remain puzzled by the offer of equity. They wonder, Is it just one more benefit? Will we become owners in the sense that we can work whenever we feel like it? It's easy for a company to dispel some of the more misguided notions, but it's harder to communicate exactly what ownership means and to instill a sense of true ownership. The companies that have been the most successful at implementing employee-ownership plans follow these precepts:

Believe in what you propose. Senior management must want equity ownership to work and must devote the necessary resources to sustaining it over time. This commitment doesn't have to exist at a company's birth, as was the case at SAIC. Most of the companies we studied made a transition from conventional ownership to substantial employee ownership. But all had or found a CEO and a team of senior managers who believed in the idea and worked hard to make it a reality. Few of those companies reaped the rewards right away; most found that employee ownership began to "take" only after a year or two, as people gradually began to understand it.

Communicate the meaning of ownership. Signs reminding employees of their ownership are everywhere at SAIC, Scot Forge, and other successful implementers – on banners, on bulletin boards, on company stationery, and on Web sites. The chief executives of those companies manage to work the subject of employee ownership into their speeches, as well as into informal talks inside the company.

Share profit-and-loss information. Like any other business owners, employees of companies with broad-based ownership plans should be entitled to see all information about the company that doesn't run afoul of privacy restrictions or SEC regulations. Leaders at successful employee-ownership firms continually educate workers about the company's financials, explaining where profits come from and how they affect the value of the stock. Every employee-ownership exemplar makes a point of conducting some kind of business-literacy training program and sharing financial information with employees. The contrast with United, which did virtually nothing on this score after the first year, is striking.

Make it worthwhile financially. The switch to employee ownership has a built-in advantage that other change initiatives lack, namely the financial rewards the new system can offer. We have never seen a stingy equity-compensation program that had much effect on employees' attitudes or behavior. At United, the pilots and mechanics did own a significant stake in the airline, and the stake grew in the early years as the stock price increased. But they had given up substantial amounts in wages to get that stake, and they had no chance to earn additional stock over time. Many might have been better off financially had the deal never gone through. At SAIC and Scot Forge, by contrast, people's shareholdings increase every year of their tenure, creating many millionaires and near millionaires. Millionaires or not, the participants have enough to *feel* like owners.

Turn your owners into decision makers. That is, give them a say in how they do their jobs and in how things might be improved. If workers aren't given the prerogatives of ownership, their equity stake will make little difference. The cluster of practices known as "participatory management" – self-managing teams, ad hoc task forces, quality circles, and so on – are common at successful employee-ownership companies. For example, workers at Whole Foods Market are responsible for hiring people into their work groups. Because profit-sharing bonuses are based on team performance, a recent article noted, employees don't want "buddies on their teams," they want *workers* – people who will "make them some money." Some years ago, a Honeoye, New York, company called Stone Construction Equipment was manufacturing and selling roughly $20 million worth of machinery a year. Today the employee-owned company's sales are well more than twice that, yet the head count has stayed at just over 200. Its competitors have folded or moved their manufacturing to Mexico. The reason for Stone's success is the company's lean-manufacturing system, which depends on employees' extensive participation in decisions about how to meet constantly shifting production goals. According to CEO Lynne Woodworth, the system is so demanding that it can work only if employees have, in effect, an owner's commitment to the enterprise.

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Companies seeking to implement successful employee-equity plans needn't go as far as SAIC or Scot Forge did. But they certainly must make a serious commitment to the concept of employee ownership. That requirement helps explain why, despite broad-based equity's record of superior business performance, more companies haven't yet jumped on the bandwagon. Creating an ownership culture is an ambitious and time-consuming process. Many CEOs these days don't stay with one company long enough. Those who do are often more concerned with rapid growth through mergers and acquisitions (or rapid cost cutting through layoffs) than with organic growth through organizational development.

CEOs who offer their employees only a modest amount of stock ownership without making any of the other commitments are not necessarily throwing money away. Equity is certainly a nice benefit. Like any nice benefit, it may help attract and keep good employees, and it does seem to engender modest increases in performance. But a plan that gives meaningful and growing amounts of stock to employees within a culture of ownership can profoundly transform attitudes and behavior – and, in turn, financial results.

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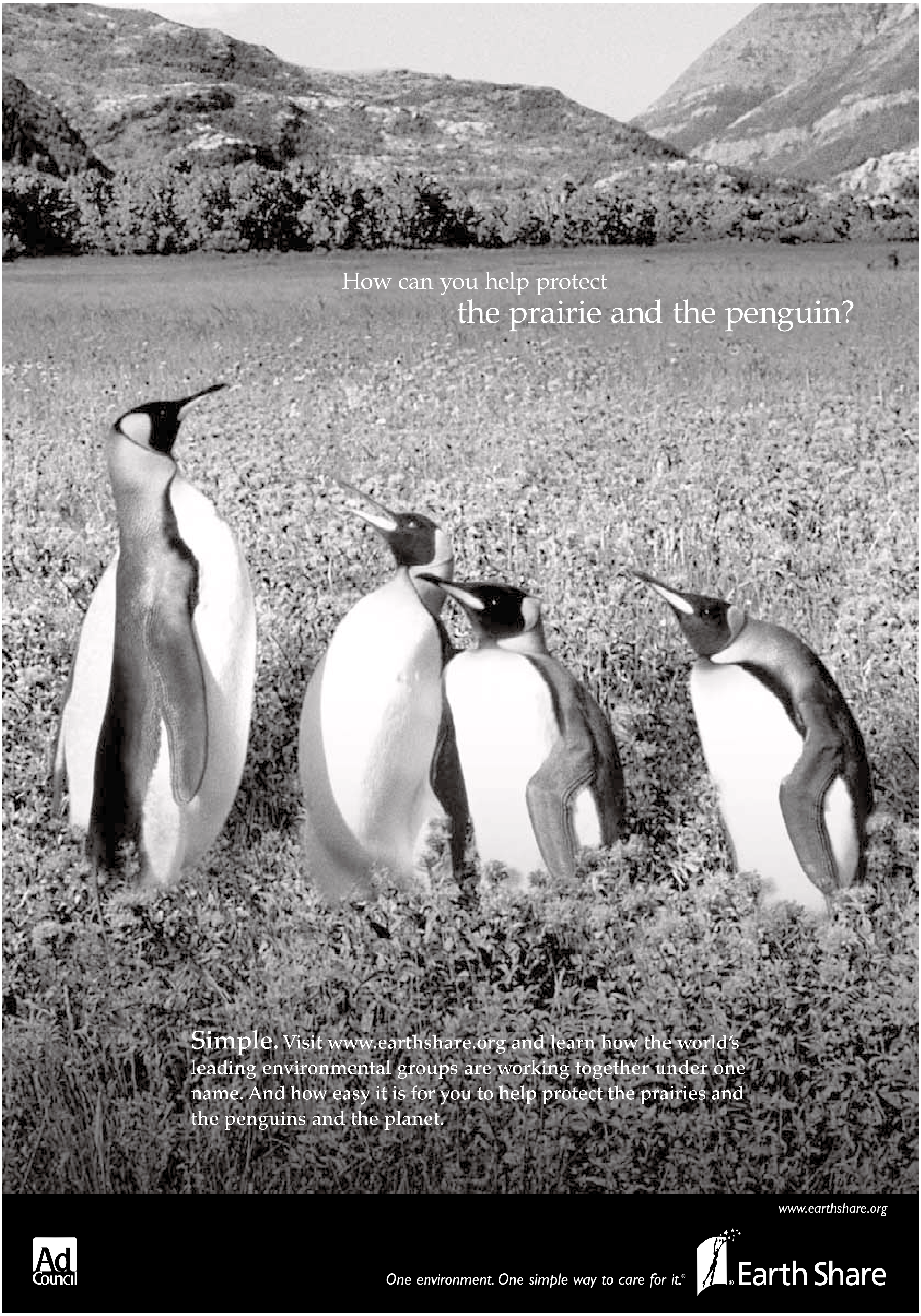
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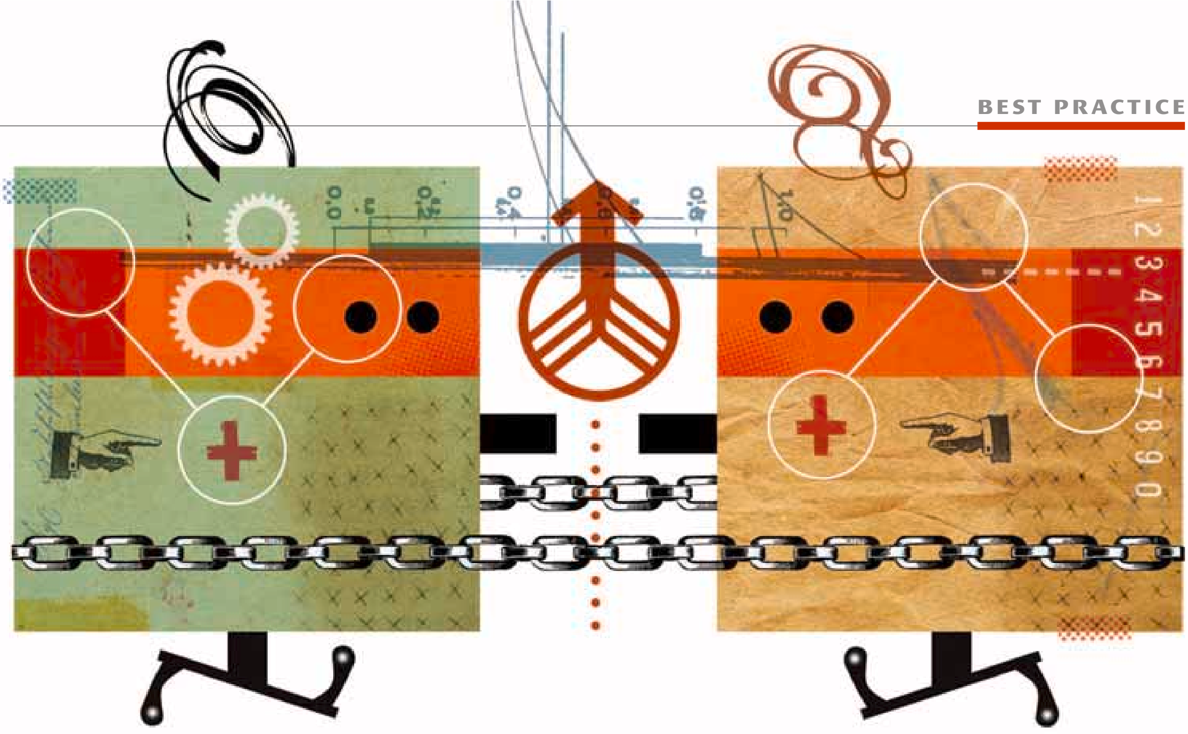

Your Alliances Are Too Stable

by David Ernst and James Bamford

Executives often bemoan the instability of their business partnerships. But what really makes them hard to manage is their rigidity.

Alliances play a major role in almost every industry–from airlines to oil exploration, from pharmaceuticals to semiconductors. In fact, we've found that the typical corporation relies on alliances for 15% to 20% of its total revenues, assets, or income. While some alliances are highly successful – Airbus, Cingular, and Visa International, for instance – many have a less-than-stellar track record. The overall success rate of alliances hovers near 50%, and the average life span of a joint venture is just five to seven years. It's no wonder executives complain about their inherent instability. But, in fact, they've got it backward; most alliances are actually too stable for their own good.

Organizations tend to use alliances in uncertain circumstances – to enter an unfamiliar market or to develop a disruptive technology, for instance – or in maturing industries as a step toward consolidation. Because these ventures operate in the midst of change, they must continually evolve to succeed. Yet their corporate parents routinely fail to intervene to correct their performance problems or address their exposure to risk. Some companies wait too long to expand successful ventures; others defer shutting down alliances that have served their purposes or have little hope of being successful under the current ownership structure.

Corporations are missing an enormous untapped opportunity: A 2004 McKinsey survey of 30-plus companies reveals that more than 70% of them have major alliances that are underperforming and in need of restructuring. Likewise, our research indicates that JVs that broaden or otherwise adjust their scope have a 79% success rate, versus 33% for ventures that remain essentially unchanged. In China, where

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most foreign investment has historically taken the form of joint ventures, our colleagues surveyed the alliance portfolios of 30 multinationals and discovered that top performers are twice as likely to have restructured their alliances as underperformers are. Companies that overhaul a single large alliance can generate an additional $100 million to $300 million in annual income.

It takes hard work to reap those benefits, however. For a host of reasons, retooling an alliance is far more complicated than restructuring a wholly owned business unit. But our work with more than 20 major alliance restructurings and our interviews on the topic with more than 50 executives, including board members and CEOs of many of the largest JVs in the world, have revealed some best practices.

We define an alliance as an agreement between two or more separate companies in which there is shared risk, returns, and control, as well as some operational integration and mutual dependence. As such, "alliance" is an umbrella term for a vast array of corporate relationships that fall between arm's-length deals and full mergers. The advice in this article is particularly relevant for large, equity joint ventures (where the partners each contribute resources to create a new company), complex nonequity alliances (where the partners may collaborate on marketing or development projects), and multiple-partner ventures; less so for straightforward contractual alliances.

Stifling Stability

Investors and regulators have put wholly owned businesses under the microscope in recent years, increasing transparency and accountability. And managers have taken vigorous action to improve performance by cutting costs, refining their pricing methods, closing plants, selling assets and businesses, and combining units for scale. But the story is fundamentally different for alliances. Many are weighed down by outdated strategies, are mired in governance conflicts between their parents, or suffer from a lack of consistent performance scrutiny. As a result, they perform much more poorly than they could.

Consider a multibillion-dollar joint venture in the metals industry. Formed in the 1970s, the JV was designed as a shared utility for its four corporate parents, each of which sold raw materials to and purchased finished products from the JV. By the late 1990s, the JV was operating one of the largest processing facilities in the world. But it was also stuck in a strategic and operational morass: The partners couldn't agree on a series of operational improvements and expansions to plant capacity that offered more than $1 billion in annual revenue increases. After several years of frustration and debate, the partners ultimately restructured the JV–but not before hundreds of millions in profits were forgone.

Corporate parents routinely fail to intervene to correct alliance performance problems or address their exposure to risk.

Or consider a pharmaceutical alliance formed to market a blockbuster drug that produced more than $1 billion in annual revenues. It was suffering from extensive operational inefficiencies, spending at least $60 million a year on excess labor and external contracts. The alliance was also experiencing governance frictions–the partners couldn't agree on how to pursue an adjacent $1 billion market opportunity. Because the executives didn't understand the extent of the costs and disagreed on the remedy, they didn't address these problems for two and a half years.

Examples like these are not unusual. Companies routinely delay needed restructuring by 24 to 48 months, and sometimes longer. And three-quarters of the 50-odd business development executives we surveyed say their organizations don't routinely evaluate the need for alliance restructuring or regularly intervene to address performance problems.

It's easy to see why. All alliances involve at least two corporate parents, so a venture overhaul requires separate corporate actors – each with its own (often divergent) interests – to agree to the changes. Likewise, because alliances are defined by contracts, restructuring often involves renegotiating and redrafting legal agreements, a process that can be both messy and time-consuming because the contracts typically don't anticipate future restructuring.

Restructuring an alliance also involves a broader set of issues than restructuring a wholly owned business does. A wholly owned business's plan for retooling tends to focus on optimizing business-unit strategy, operations, organization, or finance. A joint venture must focus on those areas, too, but it must also contend with board-level governance issues and the challenges of balancing financial arrangements between the partners, beyond basic P&L and balance sheet issues. Moreover, because a parent company often has various business relationships – as supplier or customer – with a partner, it may fear that tugging at the loose string in an alliance will cause a different part of the relationship to unravel. A natural reaction, therefore, is to avoid the risk and do nothing.

Beyond these inherent challenges are man-made problems, such as a faulty deal structure or weak governance and management processes. Many joint ventures, for instance, lack an effective challenge process – that is, the mechanisms for managers to ask penetrating questions about performance, risks, and future prospects. Alliances, including billion-dollar JVs, often exist outside the parent companies' standard corporate planning and review processes, and

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many don't have an independent governance system to instill discipline. The complexity of alliance economics and the frequent lack of robust performance metrics make it much harder for management to discuss a joint venture's performance than a similarly sized business unit's. In addition, restructuring almost always requires senior executives in both companies to become involved. Yet these executives may not be on the venture's board, and it might not be obvious who owns the decision about when to restructure.

To see how these barriers can delay change, consider a billion-dollar industrial materials joint venture that was formed in the mid-1990s. The JV aimed to combine the research efforts of two global competitors in order to pursue growth opportunities in new materials for the electronics industry. Then the industry headed south, partly because of low-cost Asian competition and partly because of a technology shift. But back when the parents had set up the venture, they hadn't agreed on threshold levels of performance that would trigger a reassessment. So for three years, the JV delivered a return on assets of between 5% and 7% – well below the U.S. parent's 13% corporate hurdle rate.

The parents were aware of the venture's low returns, but they could not agree on the root causes or the solution. Quite simply, they lacked enough data to make an informed plan. One board partner favored a major downsizing of the business and a major shift in product market focus, which would mean writing off hundreds of millions of dollars to shutter high-cost plants. The other partner felt the venture could restore its margins through some belt-tightening and by improving its operations and marketing functions. It's normal to have differences of opinion, but someone eventually has to make the final decision – and, in this case, no one did. Ultimately, more than $100 million in annual profit improvements were delayed for nearly two years while the parents debated, and the long-term viability of the business became more uncertain.

How to Restructure a Joint Venture

Executives who set up a joint venture have the luxury of being able to build in contingencies for restructuring. (See the sidebar "Building Flexibility into Alliances.") Managers who are charged

Building Flexibility into Alliances

If you're creating an alliance – as opposed to trying to salvage one – you have a golden opportunity before you. It's extremely likely that the venture you set up now will need rethinking in several years' time, but you can ease the eventual pain of restructuring by taking action now.

For one thing, approach your exit provisions differently. Most alliances' exit clauses are all-or-nothing affairs – that is, they spell out the situations or circumstances that would trigger full termination of the venture but rarely specify what would trigger less dramatic changes. Managers (and their lawyers) should create provisions that prompt restructuring based on specific performance metrics or external conditions. For example, if the venture misses baseline financial performance targets for two consecutive years, then it automatically initiates a restructuring review by the parents. Or if the alliance surpasses certain revenue targets, then the structure will change from, say, a nonequity alliance to a JV with its own staff and P&L.

When they discuss the exit provisions, the alliance partners will necessarily have to consider and talk about their desired endgame for the venture. Such a conversation can help the players create a tailored approach to venture management that's better than the classic buy–sell exit provision, in which one partner names a price and the other must buy or sell.

Companies should also put in place the people and systems to create robust performance data and an effective challenge process. To help companies improve oversight of their major alliances, we have developed JV Governance Guidelines, a set of governance minimums similar in spirit to the guidelines used by the California Public Employees' Retirement System. For example, we recommend that JV boards establish performance-review and challenge processes equal to those of similar-sized business units. The board should include at least one outside director (even if the director has limited voting rights) to inject objective performance discipline and to ask the tough questions. And each corporate parent should designate a nonexecutive chairman or "lead director" to spend 20 to 30 days a year on the venture and to act as a counselor and performance coach to the CEO.

Finally, companies should look at ways to institutionalize alliance restructuring. One approach is to conduct an audit every year or two to assess three to 15 crucial alliances in the corporate portfolio and rapidly identify a few prime restructuring candidates. One U.S. industrial company annually assesses alliances against two dimensions: strategic fit and financial performance. The company has restructured two large alliances as a result of its scans. Similar audits have been used successfully in oil and gas, consumer products, and electronics firms.

with revamping an existing venture don't have it so easy–but these four steps can help them overcome barriers to change and unlock value from underperforming alliances.

1. Launch the process. Why are so many underperforming alliances left to wallow for years? Inertia is probably the biggest reason. To successfully launch the restructuring process, executives from the initiating company need to formally choose how and when to start. Most companies wait until the venture is in the midst of a performance crisis or there's a major change in the business environment. But our research and experience show that the odds of successfully turning around a venture are much higher when the process starts early, before the problems lead to deeply entrenched positions, prolonged underperformance, or a cycle of mistrust. Some firms identify candidates for restructuring by auditing the major alliances in their portfolios every 12 to 18 months, testing them for financial performance and strategic fit. That practice can be a powerful complement to regular dialogues between the venture board and its management team.

Another tactical decision relates to the scope of the change. Ideally, the company should think as broadly as possible about restructuring solutions. But if there are clear boundaries – for instance, if one parent will not consider making major investments or selling out–it is critical to get these parameters on the table as soon as possible.

Additionally, the parent company that's initiating the move toward restructuring needs to decide when its partner (or partners) should become involved in the process. As a general rule, sooner is almost always better. The

Four Steps for Restructuring Your Alliance

1 Launch the process

These steps are usually conducted alone, without input from partners.

- Scan your major alliances to determine which, if any, need restructuring.
- Determine how to approach your partners: who, when, how to broach the topic.
- Designate an initial restructuring team, define the scope of change, and set a time line.

2 Diagnose performance

- Assess the venture's strategic fit with the parents' businesses and determine the attractiveness of continuing the venture's operations in light of future competitive requirements.
- Assess the venture's financial performance compared with targets, parents' hurdle rates, and so on.
- Evaluate total venture economics.
- Evaluate operating performance relative to competitors and industry benchmarks.
- Evaluate the fitness of the venture's governance structure, including decision speed, efficiency, transparency, and level of trust.
- Assess the quality and depth of the venture's talent and the JV's ability to attract, evaluate, and motivate employees.
- Estimate dollar amounts for each of the root causes of the venture's problems.
- *If there is limited need or value to be gained from restructuring, disengage from the process.*

3 Generate restructuring options

- Decide whether to fix, grow, or exit the alliance.
- Develop a robust list of restructuring options for all levers: strategy, financials, operations, governance, and organization and talent.
- Prioritize the list on the basis of the overall value and workability of the ideas.
- Assemble three or four packages of restructuring options.
- Test shareholder buy-in for different options.
- Get parent companies' initial approval, find champions for the change effort, and develop a detailed plan.

4 Execute the changes

- Assign accountability for executing the changes, and put incentives in place.
- Build support through one-on-one conversations between members of the restructuring team and high-level executives in the JV and parent companies.
- Embark on communication efforts to build alignment and momentum at all levels of the organization.
- Review performance, and make midcourse corrections as necessary.

obvious exception is if the probable outcome of the assessment is termination of the joint venture. In this scenario, the partners would be better off making their own evaluations before triggering the contentious, often zero-sum, discussions.

Executives also need to decide who will be on the restructuring team. It's important to have a senior sponsor, often a CEO or a division head from a parent, who can push the process along and make decisions on the future shape of the venture. The rest of the team can be composed of venture managers, parent company executives, outsiders or all three, depending on the nature of the problem. If the JV wants to, say, improve its internal operations, the team should include primarily venture managers, with some participation by the parent companies and possibly some outsiders. But if the JV is considering major changes in scope, structure, or management, then much of the core team should come from outside of the venture.

Finally, a time line needs to be set by the CEO or other senior executives championing the effort – and it should be short. Diagnosing the venture's performance, framing a set of options, and gaining agreement should take the team no more than two to three months, even for the largest JVs.

2. Diagnose performance. To diagnose venture performance, the team has to determine what needs to be fixed, how much value will be created, and what it might take to realize the full value. Again, this should be kept brief: Even for a billion-dollar joint venture, such a diagnostic should rarely take a team more than three or four weeks.

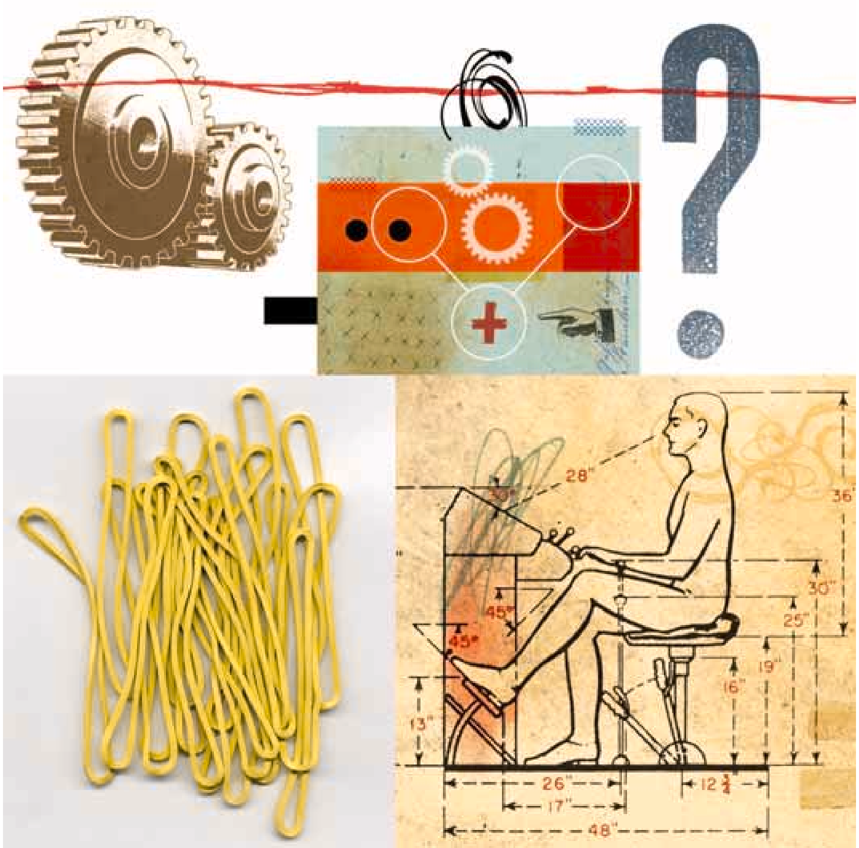
To promote buy-in and objectivity, an independent board member or outside adviser should work with the team to help drive the restructuring process. The team can use a short, anonymous survey of those involved in the alliance (for instance, the venture's top management team, its board members, and parent executives shaping decisions or spending more than 20% of their time on venture issues) to develop a fact base, gain quick agreement on sensitive issues, and build momentum for change. The survey can take as little as 20 minutes for respondents to answer and should include questions about overall venture performance; the effectiveness of specific elements of the governance system (such as time spent on approving the budget or responding to the parents' reporting requirements); and the degree of difficulty in and potential impact of implementing changes.

Whether the team uses a survey or not, it should evaluate the venture on the following performance dimensions: strategy, financials, operations, governance, and organization and talent. A broad-based diagnostic is critical given the structural complexities of alliances, the unlikelihood of having solid performance data, and the probable differences of opinion among key decision makers as to what is wrong with the venture.

On the strategic dimension, the diagnostic should answer such questions as: Is the alliance meeting each parent's strategic objectives? Given changes in the business environment, how should the original objectives for the venture be altered? Are the parents' strategies for the alliance sufficiently aligned to continue the venture, and is the venture still viable? And has the JV achieved its own strategic goals, such as target market share?

On financial performance, the team should ask the obvious business questions: Is the alliance meeting its baseline financial targets and performing above the parents' own corporate financial hurdle rates? The team also needs to assess "total venture economics," including profits from transfer pricing and other commercial arrangements between the parent companies and the joint venture.

In the realm of operations, the team should compare the alliance's performance with that of competitors and comparable internal business units on such metrics as per-unit production or sales costs, levels of product quality, and the degree of annual performance improvement.



Governance and organization questions to ask should include: Does the governance setup enable fast and solid decision making? For example, how long does the JV take to make capital expenditure or strategy decisions? How does that compare to similarly sized business units within the parent companies? Has the JV board approved a single set of objectives and a clear performance contract that provides incentives for top management? Is there an effective challenge process in place? Can the venture attract top talent from outside or from the parents?

When all the performance dimensions are factored in, the restructuring team should have a clear overview of the venture's problems. For instance, one natural-resource-processing JV was generating about $500 million in annual profits for its parents. These returns were largely the result of well-timed investments in capacity and a favorable shift in world commodity markets. Below its glowing financials, however, the JV was suffering from serious operating problems. Its plant experienced severe bottlenecks, and its production levels were well below baseline targets. The JV's governance system was off-kilter, and mistrust had built up between the partners, who battled continually over transfer-pricing arrangements. The partners also couldn't agree on important capital-improvement investments.

The parents wanted to determine if the venture could survive as it was or if it needed a fundamental change in ownership and control – through one partner buying out the other or through spinning off the business as an independent, or partially public, company. The restructuring team started by identifying the venture's sources of value and linking them to the underlying problems. There was a lot of friction among the partners and the JV's management because of poor governance, but the performance shortfall – which had cost the venture more than $100 million a year in income for the past several years – was caused by a small set of issues.

Once the team determined what those were, it became clear the problems could be solved without a radical restructuring. The main drivers of the JV's weak operating performance were a shortage of senior plant-level operating managers and an unwieldy capital-planning process, which was delaying a few crucial investments that would dramatically reduce bottlenecks at the plant. Also, the parents needed to agree on performance metrics so that the board and the JV management team could have a productive dialogue.

When creating a diagnosis, the team should take pains to separate the symptoms (poor operating performance, for example) from the root causes (skill shortages and cumbersome approval and reporting processes, for instance). Doing so provides a taxonomy for managers to talk about the issues and keeps them focused on what matters.

The diagnosis can generate a long list of problems, more than can reasonably be addressed. To ensure that it's tackling the most important issues, the assessment team should attach dollar amounts to each of the problems identified. It should ask, for example, How much is poor operating performance costing us per year? What is the attributable cost of slow decisions? Are there instances where a 12- or 18-month delay in capital-expenditure approval can be linked to missed revenue opportunities or forgone savings? The answers to these questions can help CEOs and other decision makers focus on the most important problems instead of on the irritants that can be tolerated. They also help build a powerful case for change.

3. Generate restructuring options. Generating restructuring ideas and options for JVs is, in many ways, similar to determining how to restructure a wholly owned business: Executives will evaluate three macro options – fix, grow, or exit. Assuming the answer is fix or grow, the restructuring team needs to determine whether fundamental or incremental change is needed and then evaluate five levers that might improve the business. (For more details, see the exhibit "Which Levers to Pull.")

Two of these levers–strategy and operations–would also be addressed in the turnaround of a wholly owned unit (along with some aspects of organization and talent). But JVs in particular must address the categories of governance and ownership and financial arrangements. Governance changes might include pushing more authority down from the JV's board to its CEO, streamlining the parents' reporting requirements or approval processes, or changing the fundamental operating model of the JV – for instance, shifting from a quasi-independent venture to one that is either very independent from the parents (think Dow Corning) or essentially run by one partner (think Verizon Wireless).

Why are so many underperforming alliances left to wallow for years? Inertia is probably the biggest reason.

Changes to the financial or ownership arrangements could include a redrawing of the terms of the alliance, such as the percentage of equity ownership, or a redesign of the venture's overall approach to profit sharing.

It is easy to generate ideas that could help reduce friction among the players; the real challenge at this stage is orchestrating a process that gets to a solution the parents can agree on. It is helpful to use the result of the diagnostic-phase work that assigned dollars to the problems; with those numbers, executives can pinpoint which restructuring ideas have the most potential.

The team should then start assembling three or four packages of restructuring options, which should range from minor tweaking of the venture to major surgery. One telecom JV, for instance, came up with the following options: a simple renegotiating of transfer prices on about a dozen administrative shared services; a redrawing of the organization to put more functions and power in the hands of the JV's CEO and management team; and a sale of the business to a third party, with some long-term access agreements granted to one of the parents.

Once the team has a menu of options, it needs to test shareholder buy-in for each one. A senior champion from each shareholder can ensure participation from his or her company. An independent process manager, such as an outside board member, is the best choice to gather reactions from each of the partners. And when presenting the options, the team should be ready to unbundle them to explain which restructuring levers each option rests on and to test for the partners' agreement on the details of each option.

For an example of a successful option-generation process, consider a global transport and logistics alliance. Its many members had very different operating styles, strategies, and initial opinions on how much restructuring was appropriate. But the following actions helped keep them on track.

First, the CEO of each parent company agreed to be directly involved in the effort to revitalize the venture's governance. Second, the team created several viable options, both in terms of the organizational structure of the alliance and the process for setting strategy and getting the partners to commit to (or opt out of) specific strategic initiatives. The companies convened group discussions to regain alignment on the definitions of "success" for the alliance and for its governance system. Then, on the basis of input from the stakeholders, the restructuring team developed a composite set of recommendations that could be accepted by all of the partners. The actions included streamlining the organization and involving the venture board more in shaping strategy for the alliance.

4. Execute the changes. How does a team move from making recommendations to setting the venture on a new path? The most critical component of the journey is widespread and consistent vetting and communication of ideas. As a general rule, restructuring an alliance requires two to three times the communications efforts that restructuring an internal business unit would, for obvious reasons: No single decision maker has final say; partners often are suspicious of one another's hidden interests; and the decision-making process frequently requires back-corridor conversations because the ultimate decision makers are outside the alliance's formal governance system. The more partners involved, the greater the need for communication.

The members of the team that restructured the transport and logistics alliance started building buy-in from the start. After the team created an initial set of options, it held one-on-one discussions about each with crucial stakeholders in the parent organizations. That step took three weeks and entailed more than 50 conversations. Many of the parent executives that the restructuring team spoke to were outside the venture's formal governance structure, but the functions they led worked closely with the alliance. This vetting process also involved the CEOs of the partners – first individually to help frame the solution and then collectively to get approval for the recom-

Which Levers to Pull

Once you've decided to retool your joint venture, probe these five broad areas to generate concrete plans for improving performance.

	Sample JV Restructuring Activities
Strategy	Redefine the scope of the JV's business; for instance, bring activities such as manufacturing and sales into the JV. Bring in additional partners with access to different markets, skill sets, and so on. Change exclusivity provisions; for instance, allow the JV to enter some of the parents' markets to pursue growth opportunities. Change the JV's market focus; for instance, stop making commodity products and focus on high-end ones.
Ownership and financials	Alter the JV's ownership stakes in exchange for additional capital infusion or other contributions from one parent. Sell a stake in the JV to investors or the public to raise capital and increase transparency and market discipline. Renegotiate the JV's long-term supply contracts or transfer-pricing agreements with the parents for services, products, or raw materials. Revise the terms of licensing, royalty, or commission structures with the parents.
Operations	Close facilities. Relocate the venture's manufacturing facilities to low-cost labor markets. Redesign the venture's operating processes to improve quality, reliability, and innovation. Redesign the venture's supply chain. Streamline manufacturing to increase throughput.
Governance	Change the JV board's composition; for instance, reduce numbers or bring in outsiders. Designate one partner as "operator" and others as nonoperating partners to speed decisions. Streamline approval processes inside the parent companies. Standardize parents' reporting requirements.
Organization and talent	Bring in an outside CEO to increase independence. Change the organizational structure to better reflect the JV's business so it can separate itself from its parents' legacies. Develop a performance-based contract for the CEO to create alignment and accountability. Redefine policies for rotating staff members into the JV to increase the level of talent. Increase alignment by having the JV CEO hire, fire, and conduct reviews for all employees.

The odds of successfully turning around a venture are much higher when the process starts early, before the problems lead to deeply entrenched positions, prolonged underperformance, or a cycle of mistrust.

mendations and to hold the organizations accountable for implementing the changes.

A restructuring team should think hard about the sequence of the changes it proposes. For instance, one cross-border industrial JV's corporate parents agreed to restructure because the team was explicit about the order in which changes would unfold. Instead of starting with the time-consuming and contentious issue of renegotiating certain supply agreements between the parents, the team decided to first fix the decision-making and reporting processes that had gummed up the system. Once these changes were made, other issues could be tackled more easily.

The restructuring team should also consider making certain changes contingent on early successes. For instance, the parents of one industrial JV agreed that the CEO's sign-off authority should be raised from $1 million to $25 million, but the CEO would earn this authority only after improving operating earnings by $50 million over 12 months.

Finally, because of their complicated decision-making structures and their parents' divergent corporate interests, alliances and joint ventures are prone to getting stuck in the middle of restructuring or defaulting to incremental, least-common-denominator changes. To avoid this, the venture's leaders and parents must affirm the need for change. The venture board also needs to escalate its role temporarily and define who is accountable for making which changes happen.

• • •

We hear a lot of grumbling these days about the frenetic pace of change. Last year's computer model is already obsolete; your home mortgage has been transferred to yet another servicer. It's true that change is rarely comfortable or easy. But too much stability can also be a bad thing. Evolution is necessary for success – not just in alliances but also in most relationships and other endeavors. Indeed, we are reminded of something Orson Welles said in *The Third Man:* "In Italy, for 30 years under the Borgias, they had warfare, terror, murder, and bloodshed, but they produced Michelangelo, Leonardo da Vinci, and the Renaissance. In Switzerland, they had brotherly love. They had 500 years of democracy and peace, and what did that produce? The cuckoo clock."

Reprint R0506J
To order, see page 151.

JOHN CALDWELL

"Oh, how nice. A résumé. It's all about you, you, you, isn't it?"

Off-Ramps and On-Ramps

In "Off-Ramps and On-Ramps: Keeping Talented Women on the Road to Success"(March 2005), Sylvia Ann Hewlett and Carolyn Buck Luce assert that, by failing to respect women's unique values and priorities, employers subtly discourage talented women from pursuing C-suite careers. Although this may be true, a more honest, responsible article would have emphasized that men and women alike must make conscious career choices in order to get ahead.


BIG PICTURE

Stepping off the career fast track is easy. What's hard is getting back on. Careers, companies, and economies suffer when highly skilled women cannot get back where they belong.

Off-Ramps and On-Ramps

Keeping Talented Women on the Road to Success

by Sylvia Ann Hewlett and Carolyn Buck Luce

THROUGHOUT THE PAST YEAR, a noisy debate has erupted in the media over the meaning of what Lisa Belkin of the *New York Times* has called the "opt-out revolution." Recent articles in the *Wall Street Journal*, the *New York Times*, *Time*, and *Fast Company* all point to a disturbing trend – large numbers of highly qualified women dropping out of mainstream careers. These articles also speculate on what might be behind this new brain drain. Are the complex demands of modern child rearing the nub of the problem? Or should one blame the trend on a failure of female ambition?

The facts and figures in these articles are eye-catching: a survey of the class of 1981 at Stanford University showing that 57% of women graduates leave the work force; a survey of three graduating classes at Harvard Business School demonstrating that only 38% of women graduates end up in full-time careers; and a broader-gauged study of MBAs showing that one in three white women holding an MBA is not working full-time, compared with one in 20 for men with the same degree.

The stories that enliven these articles are also powerful: Brenda Barnes, the former CEO of PepsiCo, who gave up her megawatt career to spend more time with her three children; Karen Hughes, who resigned from her enormously influential job in the Bush White House to go home to Texas to better look after a needy teenage son; and a raft of less prominent women who also said goodbye to their careers. Lisa Beattie Frelinghuysen, for example – featured in a recent *60 Minutes* segment – was building a very successful career as a lawyer. She'd been president of the law review at Stanford and went to work for a prestigious law firm. She quit after she had her first baby three years later.

MARIA RENDON

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As a woman who broke through the glass ceiling to become a CFO at a *Fortune* 500 company, I believe that, in any profession, success at the highest levels requires long hours and a dedication to excellence. Many individuals think you can have it all – professional achievement, a sophisticated social life, a happy marriage, and well-adjusted children – simultaneously and perpetually. This is naive.

You can use your talent to create new opportunities and realize your ambition. If you have reached an impasse at your current workplace, you need not accept it. For instance, if people view job sharing as "illegitimate" and this option is critical to you, then find a workplace more compatible with your priorities. In speaking about leadership with clients and at various conferences, I have found that smart leaders respond positively to employees who contribute to the success of the enterprise. They find ways to manage the costs of flexibility. Those men and women who stand out through excellent performance have the power and influence to manage and change their organizations.

Blythe McGarvie
President
Leadership for International Finance
Williamsburg, Virginia

I read "Off-Ramps and On-Ramps" with great interest. For the past year, I have been working with two colleagues, Mary Gross and Marla Driscoll, on a study that focuses on (a) understanding the challenges professional and executive women face when returning to work after an extended hiatus and (b) identifying measures that these women, as well as employers and universities, can take to ease the transition. Our preliminary data confirm a number of Hewlett and Luce's conclusions.

Because our study has a somewhat broader focus, we are reaching many additional findings, such as a marked migration to smaller companies upon career reentry, as well as significant movement across industries and functional roles. We agree with Hewlett and Luce that employers can do a number

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of things to "reverse this brain drain," but we are also discovering that these women can facilitate their own return to the workforce. For instance, those who structure their "step-out" period – to continue networking, keep up with industry and technology trends, and cultivate new skills – fare better during job searches than those who completely disconnect. We are learning, too, that universities could play a much greater role in preparing people for reentry into the workplace. They could offer programs with refresher courses and seminars on hot topics. Or, as part of an effort to bolster career services for alumni, universities could leverage their relationships with various companies to identify project roles or other temporary work assignments for alumni "step-outs" to perform during their career hiatus or upon reentry.

We expect to conclude our study in June 2005.

Monica McGrath
Adjunct Assistant Professor
The Wharton School,
University of Pennsylvania
Philadelphia

Reading "Off-Ramps and On-Ramps," I am struck first by the value of having hard facts to support anecdotal evidence that women still struggle to compete on equal terms with men in the workplace, and second by the authors' eminently practical solutions: seven steps that employers can take to help improve the situation. However, I hope that the Center for Work-Life Policy's task force will pursue further research into the point Hewlett and Luce raise about many women finding so little reason to stay with their employers. Home commitments tug at many of us; the lack of a counterbalancing pull from the workplace suggests to me that we still have a very long way to go before business demonstrates that it truly values its female employees.

In the UK, girls' performance in schools consistently beats that of boys. This trend seems to be rolling into higher education too. By the time they enter the workforce, women and men are on quite different trajectories: Women have an urgency to make their mark quickly, whereas men know that their career is for the long haul. I suspect that we have yet to see the full effect of women's capabilities at work. Until the linear career path is seen as but an option, women will continue to have to settle for second best. We're being assessed against standards that were designed for men.

The steps that Hewlett and Luce recommend might help us all to start seeing how much more women can contribute in their jobs when given the scope to address demands at home as well as at work. I know from personal experience that I can apply a very high level of skill in managing people while working from home, whether I'm finding a path into a prospective client company or firing the window cleaner for poor performance. Working for myself means that I have a boss who knows full well whether I'm stretched in my job – a situation I never encountered as an employee.

Karen Hands
Managing Director
Thought into Action Limited
Clitheroe, Lancashire, England

Two Executives, One Career

Like Cynthia R. Cunningham and Shelley S. Murray, the authors of "Two Executives, One Career" (February 2005), I've job-shared at Bank of America (formerly FleetBoston). In the past four years, I've held three different positions there with two different partners. I couldn't agree more that once you've job-shared, it's hard to imagine a better way to work. It does require lots of organization and constant communication between the partners, but the benefits to both the employer and the employees far outweigh any negatives.

Unlike Cunningham and Murray, though, I fell into job sharing rather than having to fight for it. After giving birth to twins, I knew I wouldn't be able to keep up the long hours required in Corporate Planning. Lucky for me, I'd been in the department for three years, so my manager was willing to be flexible in order to keep me. He suggested that I job-share with another woman, who was working for the group three days a week. After two years, my partner and I were ready for a change. Our move to the Line of Business Finance was a relatively smooth one because our new manager knew our reputation and our work situation. It wasn't until I started my current job in Consumer Real Estate – a role outside Finance, with a new partner – that I had to win my manager over to the idea of job sharing. Now, ten months in, I think she would agree that it works. She has even started alternating days for the weekly staff meetings so both my partner and I can attend at times. I guess I'm fortunate I've never had to deal with an utter lack of management support.

Working part-time in a job share, as opposed to having separate part-time positions, allowed the two of us to apply together for full-time positions. That was particularly helpful when Bank of America acquired Fleet and cut a number of jobs in our area.

We think the partnership is a winning situation for our group. There may be some extra work for our manager – while we have the same goals, we do get separate performance reviews. But we miss less work time for personal appointments since we schedule these for our days off. We take different vacations, so there's rarely a time we are both out for a whole week. I recently returned from maternity leave, something that usually makes a department shorthanded for a while, but my partner was there three days a week for my entire leave. And while we are the equivalent of one person in terms of cost (only one of us uses the company's medical plan), we have two heads to brainstorm projects, share ideas, and complement each other's skill sets.

Laurie Grenier
Vice President,
Market Information Manager II
Bank of America
Boston

Cunningham and Murray respond: We are encouraged to see another example of a successful job-sharing arrangement. Since our article was published in HBR, we have been contacted by people from all over the globe with interest in creating their own work/life balance. We hope that increasing numbers of companies will consider this and other types of alternative work arrangements, as they can help reduce the number of professionals who transition out of their careers. By retaining top talent, companies not only protect their most valuable asset – they also improve their bottom line.

Seek Validity, Not Reliability

Roger L. Martin's HBR List contribution "Seek Validity, Not Reliability" (February 2005) touches on long-standing process issues related to corporate systems that focus on consistency, such as Six Sigma. Although I agree that overemphasizing reliability despite market realities is a tremendous mistake, I contend that this behavior is more grounded in the mentality of the stockholders and managers than in the methodologies or models themselves. My process-engineering colleagues and I grouse that TQM does not mean "this quarter's margins." We deride what we call "operational bigotry," which leads many process engineers to create monolithic, plodding procedures for every activity. Martin's points about validity echo my view that a repeatable process is useless if a company is not addressing its market drivers or is focusing on low-yield improvements. I disagree, however, with the proposal that one must choose between reliability and validity.

The highest value in applying any process-centered discipline comes from reducing *unnecessary* variation, not *all* variation. Variation that is unacceptable in one business domain may be necessary in another. Perhaps a better approach would be to seek a balance between validity and *appropriate* reliability. Competitive organizations must think out of the box, but not all the time. Some, but not all, processes should provide high reliability. A tool such as CMMI (Capability Maturity Model Integration) should serve as a taxonomy to guide selective risk analysis. Six Sigma should generate data for activities where numerical management makes sense. TQM should support innovation, not stifle it.

Organizations that fail to grasp the principle of appropriate reliability violate the original intent of these process models and invite the purposeless results that Martin warns against.

Shawn Presson
Director of Organizational Practice
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Martin responds: I agree with most of what Shawn Presson has to say about validity and reliability. Indeed, the balance that should be sought is between validity and appropriate reliability. My core concern is with the widespread tendency to seek inappropriately excessive levels of reliability at the expense of validity.

However, I differ with Presson in that I don't absolve tools like Six Sigma and TQM of all responsibility for the tilt toward excessive reliability. He says that stockholders and managers are to blame instead, for using the tools to the wrong ends. I am afraid that is a bit like the tired old excuse "We gave them a great strategy, but their execution was bad."

If a tool keeps getting used "badly," rather than "the way it was supposed to work," maybe the tool isn't so great after all. Regrettably, people with guns don't stick assiduously to using them for self-protection, even though that might have been the original intent. Having a gun in one's pocket seems to encourage aggressive behaviors that sometimes go far beyond self-protection. I think that the same holds for Six Sigma, TQM, and other process systems. They may have been designed for something very different from mindless application, but they allow managers to substitute process for judgment and routine for thinking. Maybe, like pharmaceuticals, these tools should be accompanied by voluminous warnings as to the dire potential consequences of use: "Warning – users have been known to lapse into coma!"

A Taboo on Taboos

Scouring the management journals, I have rarely found anything that deals with taboos, except in a highly tangential way. So I appreciated "A Taboo on Taboos" (The HBR List, February 2005), Leigh Buchanan's attempt to illuminate the topic, which has its origins in anthropology but offers numerous lessons for business organizations.

Taboos are crucial to social and organizational functioning, so they are not an evil, per se. For better and worse, they are inherently stabilizing. They prevent organizations from rapidly changing.

What happens when taboos are broken? Are the "punishments" that are meted out affected by the status of the offenders? Can a commoner (employee) expect more severe sanctions than the tribal chief (CEO), or vice versa? Once violated, to what extent do taboos continue to have power over other members of the village (organization)? What purification ceremonies (actions and behaviors) are necessary to reconstitute various social boundaries? And who participates in these rituals? The witch doctor (organizational-development consultant) and the transgressor? In part, all of these things depend on how significant the broken taboo is.

I would contend that what the taboos actually are matters less in an organization than how a "taboo structure" functions. While specific taboos, like talking about death or God, might be eroded or dismantled over time, a taboo structure will not disappear as easily. It might be applied to all sorts of issues – diversity, religion, workplace gossip. In some areas (certain parts of the arts world, for instance), breaking a taboo is considered avant-garde. Within that taboo structure, perhaps it is taboo *not* to break a taboo.

We should not wish away taboos. But we can better understand how and why they actually operate in organizations. CEOs must pay attention to taboos, as they affect organizational outcomes by shaping employee attitudes, values, and behaviors.

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June 2005

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Michael C. Mankins and Richard Steele

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Richard Florida and Jim Goodnight

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FORETHOUGHT

The Eureka Myth In business lore, the eureka moment overshadows the more important matter of how an invention reaches the marketplace, says author Sir Harold Evans. **Reprint F0506A**

Outsourcing Integration An energy company's integration of a $2 billion firm it had acquired was smooth because much of the back end was outsourced, says consultant Jane C. Linder. **Reprint F0506B**

New Laws of the Jingle Does the ad jingle have a future? HBR senior editor Leigh Buchanan points out the appeal of simplicity in a complicated age. **Reprint F0506C**

Shareholder Votes for Sale To make legitimate and effective use of vote buying, managers should act with the company's best interests in mind, say Luh Luh Lan at the National University of Singapore and Loizos Heracleous at Oxford. **Reprint F0506D**

The Madness of Individuals Collective decisions are often better than individual ones, says researcher Laurence Prusak. **Reprint F0506E**

Little Decisions Add Up Consultant Frank Rohde describes a system for evaluating frontline workers' interactions with customers. **Reprint F0506F**

Knowing What to Listen For Blind since childhood, Herb Greenberg emphasizes character above presentation when he advises companies on how to make job interviews more meaningful. **Reprint F0506G**

The Low Value of Virtue Most consumers don't care where, how, or by whom products are made, says David Vogel at Berkeley's Haas School of Business. **Reprint F0506H**

Don't Blame the Metrics Improved measurement methods show marketing is losing its magic, say consultants Kevin J. Clancy and Randy L. Stone. **Reprint F0506J**

Hidden Harassment Workplace incivility can be as costly as sexual harassment, reports HBR senior editor Gardiner Morse. **Reprint F0506K**

Coal Cleans Up Its Act Coal is looking better as an energy source, says Amy Salzhauer of Ignition Ventures. **Reprint F0506L**

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HBR CASE STUDY

Holding Fast

John T. Gourville

CEO Peter Walsh faces a classic innovator's dilemma. His company, Crescordia, produces high-quality metal plates, pins, and screws that orthopedic surgeons use to repair broken bones. In fact, because the company has for decades refused to compromise on quality, there are orthopedic surgeons who use nothing but Crescordia hardware. And now these customers have begun to clamor for the next generation technology: resorbable hardware.

Resorbables offer clear advantages over the traditional hardware. Like dissolving sutures, resorbable plates and screws are made of biodegradable polymers. They hold up long enough to support a healing bone, then gradually and harmlessly disintegrate in the patient's body. Surgeons are especially looking forward to using resorbables on children, so kids won't have to undergo a second operation to remove the old hardware after their bones heal, a common procedure in pediatrics. The new products, however, are not yet reliable; they fail about 8% of the time, sometimes disintegrating before the bone completely heals and sometimes not ever fully disintegrating. That's why Crescordia, mindful of its hard-earned reputation, has delayed launching a line using the new technology.

But time is running out. A few competitors have begun to sell resorbables despite their imperfections, and these companies are picking up market share. Should Crescordia join the fray and risk tarnishing its brand? Or should the company sit tight until it can offer a perfect product?

Commenting on this fictional case study are Robert A. Lutz, vice chairman of product development at General Motors; Clayton M. Christensen, the Robert and Jane Cizik Professor of Business Administration at Harvard Business School; Jason Wittes, a senior equity analyst covering medical supplies and devices at Leerink Swann; and Nick Galakatos, a general partner of MPM Capital.

Reprint R0506A

HBR Spotlight

Risk and Reward in World Markets

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Managing Risk in an Unstable World

Ian Bremmer

With emerging markets like China and politically unstable countries like Saudi Arabia figuring more than ever into companies' investment calculations, business leaders are turning to political risk analysis to measure the impact of politics on potential markets, minimize risks, and make the most of global opportunities. But political risk is more subjective than its economic counterpart. It is influenced by the passage of laws, the foibles of government leaders, and the rise of popular movements. So corporate leaders must grapple not just with broad, easily observable trends but also with nuances of society and even quirks of personality. And those hard-to-quantify factors must constantly be pieced together into an ongoing narrative within historical and regional contexts.

As goods, services, information, ideas, and people cross borders today with unprecedented velocity, corporations debating operational or infrastructural investments abroad increasingly need objective, rigorous assessments. One tool for measuring and presenting stability data, for example, incorporates 20 composite indicators of risk in emerging markets and scores risk variables according to both their structural and their temporal components. The indicators are then organized into four equally weighted subcategories whose ratings are aggregated into a single stability score. Countries are ranked on a scale of zero (a failed state) to 100 (a fully institutionalized, stable democracy).

Companies can buy political risk analyses from consultants or, as some large energy and financial services organizations have done, develop them in-house. Either way, a complete and accurate picture of any country's risk requires analysts with strong reportorial skills; timely, accurate data on a variety of social and political trends; and a framework for evaluating the impact of individual risks on stability.

Reprint R0506B; HBR OnPoint 1126

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Strategies That Fit Emerging Markets

Tarun Khanna, Krishna G. Palepu, and Jayant Sinha

It's no easy task to identify strategies for entering new international markets or to decide which countries to do business with. Many firms simply go with what they know – and fall far short of their goals.

Part of the problem is that emerging markets have "institutional voids": They lack specialized intermediaries, regulatory systems, and contract-enforcing methods. These gaps have made it difficult for multinationals to succeed in developing nations; thus, many companies have resisted investing there. That may be a mistake. If Western companies don't come up with good strategies for engaging with emerging markets, they are unlikely to remain competitive.

Many firms choose their markets and strategies for the wrong reasons, relying on everything from senior managers' gut feelings to the behaviors of rivals. Corporations also depend on composite indexes for help making decisions. But these analyses can be misleading; they don't account for vital information about the soft infrastructures in developing nations. A better approach is to understand institutional variations between countries. The best way to do this, the authors have found, is by using the five contexts framework.

The five contexts are a country's political and social systems, its degree of openness, its product markets, its labor markets, and its capital markets. By asking a series of questions that pertain to each of the five areas, executives can map the institutional contexts of any nation.

When companies match their strategies to each country's contexts, they can take advantage of a location's unique strengths. But first firms should weigh the benefits against the costs. If they find that the risks of adaptation are too great, they should try to change the contexts in which they operate or simply stay away.

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The Surprising Economics of a "People Business"

Felix Barber and Rainer Strack

When people are your most important asset, some standard performance measures and management practices become misleading or irrelevant. This is a danger for any business whose people costs are greater than its capital costs – that is, businesses in most industries. But it is particularly true for what the authors call "people businesses": operations with high employee costs, low capital investment, and limited spending on activities, such as R&D, that are aimed at generating future revenue.

If you run a people business – or a company that includes one or more of them – how do you measure its true performance? Avoid the trap of relying on capital-oriented metrics, such as return on assets and return on equity. They won't help much, as they'll tend to mask weak performance or indicate volatility where it doesn't exist. Replace them with financially rigorous people-oriented metrics – for example, a reformulation of a conventional calculation of economic profit, such as EVA, so that you gauge people, rather than capital, productivity.

Once you have assessed the business's true performance, you need to enhance it operationally (be aware that relatively small changes in productivity can have a major impact on shareholder returns); reward it appropriately (push performance-related variable compensation schemes down into the organization); and price it advantageously (because economies of scale and experience tend to be less significant in people businesses, price products or services in ways that capture a share of the additional value created for customers).

Reprint R0506D

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Competent Jerks, Lovable Fools, and the Formation of Social Networks

Tiziana Casciaro and Miguel Sousa Lobo

When looking for help with a task at work, people turn to those best able to do the job. Right? Wrong. New research shows that work partners tend to be chosen not for ability but for likability.

Drawing from their study encompassing 10,000 work relationships in five organizations, the authors have classified work partners into four archetypes: the competent jerk, who knows a lot but is unpleasant; the lovable fool, who doesn't know much but is a delight; the lovable star, who's both smart and likable; and the incompetent jerk, who…well, that's self-explanatory.

Of course, everybody wants to work with the lovable star, and nobody wants to work with the incompetent jerk. More interesting is that people prefer the lovable fool over the competent jerk. That has big implications for every organization, as both of these types often represent missed opportunities.

Because they are liked by a disproportionate number of people, lovable fools can bridge gaps between diverse groups that might not otherwise interact. But their networking skills are often developed at the expense of job performance, which can make these employees underappreciated and vulnerable to downsizing. To get the most out of them, managers need to protect them and put them in positions that don't waste their bridge-building talents.

As for the competent jerks, too often their expertise goes untapped by people who just can't put up with them. But many can be socialized through coaching or by being made accountable for bad behavior. Others may need to display their competence in more isolated settings.

Intriguingly, managers aren't limited to leveraging people that others like and changing those that others loathe. They also can create situations in which people are more apt to like one another, whatever their individual qualities.

Reprint R0506E; HBR OnPoint 1118

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The Coming Commoditization of Processes

Thomas H. Davenport

Despite the much-ballyhooed increase in outsourcing, most companies are in do-it-yourself mode for the bulk of their processes, in large part because there's no way to compare outside organizations' capabilities with those of internal functions. Given the lack of comparability, it's almost surprising that anyone outsources today. But it's not surprising that cost is by far companies' primary criterion for evaluating outsourcers or that many companies are dissatisfied with their outsourcing relationships.

A new world is coming, says the author, and it will lead to dramatic changes in the shape and structure of corporations. A broad set of process standards will soon make it easy to determine whether a business capability can be improved by outsourcing it. Such standards will also help businesses compare service providers and evaluate the costs versus the benefits of outsourcing. Eventually these costs and benefits will be so visible to buyers that outsourced processes will become a commodity, and prices will drop significantly. The low costs and low risk of outsourcing will accelerate the flow of jobs offshore, force companies to reassess their strategies, and change the basis of competition.

The speed with which some businesses have already adopted process standards suggests that many previously unscrutinized areas are ripe for change. In the field of technology, for instance, the Carnegie Mellon Software Engineering Institute has developed a global standard for software development processes, called the Capability Maturity Model (CMM).

For companies that don't have process standards in place, it makes sense for them to create standards by working with customers, competitors, software providers, businesses that processes may be outsourced to, and objective researchers and standard-setters. Setting standards is likely to lead to the improvement of both internal and outsourced processes.

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Developing First-Level Leaders

Andreas Priestland and Robert Hanig

Oil and energy corporation BP was well aware of the importance of its work group managers on the front lines. Their decisions, in aggregate, make an enormous difference in BP's turnover, costs, quality control, safety, innovation, and environmental performance. There were about 10,000 such supervisors, working in every part of the company – from solar plants in Spain, to drilling platforms in the North Sea, to marketing teams in Chicago. Some 70% to 80% of BP employees reported directly to these lower-level managers. Yet, until recently, the corporation didn't have a comprehensive training program – let alone an official name – for them. For their part, the frontline managers felt disconnected; it was often hard for them to understand how their individual decisions contributed to the growth and reputation of BP as a whole.

In this article, BP executive Andreas Priestland and Dialogos VP Robert Hanig describe how BP in the past five years has learned to connect with this population of managers. After one and a half years of design and development, there is now a companywide name – "first-level leaders" – and a comprehensive training program for this cohort. The authors describe the collaborative effort they led to create the program's four components: Supervisory Essentials, Context and Connections, the Leadership Event, and Peer Partnerships. The design team surveyed those it had deemed first-level leaders and others throughout BP; extensively benchmarked other companies' training efforts for lower-level managers; and conducted a series of pilot programs that involved dozens of advisers.

The training sessions were first offered early in 2002, and since then, more than 8,000 of BP's first-level leaders have attended. The managers who've been through training are consistently ranked higher in performance than those who haven't, both by their bosses and by the employees who report to them, the authors say.

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Every Employee an Owner. Really.

Corey Rosen, John Case, and Martin Staubus

Surveys indicate that when new rules on expensing stock options take effect, many companies are likely to limit the number of employees who can receive equity compensation. But companies that reserve equity for executives are bound to suffer in the long run. Study after study proves that broad-based ownership, when done right, leads to higher productivity, lower workforce turnover, better recruits, and bigger profits.

"Done right" is the key. Here are the four most important factors in implementing a broad-based employee equity plan: A significant portion of the workforce – generally, most of the full-time people – must hold equity; employees must think the amounts they hold can significantly improve their financial prospects; managerial practices and policies must reinforce the plan; and employees must feel a true sense of company ownership. Those factors add up to an ownership culture in which employees' interests are aligned with the company's. The result is a workforce that is loyal, cooperative, and willing to go above and beyond to make the organization successful.

A wide variety of companies have recorded exceptional business performance with the help of employee-ownership programs supported by management policies. The authors examine two: Science Applications International, a research and development contractor, and Scot Forge, which shapes metal and other materials for industrial machinery. At both companies, every employee with a year or so of service holds equity, and employees who stay on can accumulate a comfortable nest egg. Management's sharing of financial information reinforces workers' sense of ownership. So does the expectation that employees will accept the responsibilities of ownership. Workers with an ownership stake internalize their responsibilities and feel they have an obligation not only to management but to one another.

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BEST PRACTICE

Your Alliances Are Too Stable

David Ernst and James Bamford

A 2004 McKinsey survey of more than 30 companies reveals that at least 70% of them have major alliances that are underperforming and in need of restructuring. Moreover, JVs that broaden or otherwise adjust their scope have a 79% success rate, versus 33% for ventures that remain essentially unchanged. Yet most firms don't routinely evaluate the need to overhaul their alliances or intervene to correct performance problems. That means corporations are missing huge opportunities: By revamping just one large alliance, a company can generate $100 million to $300 million in extra income a year. Here's how to unlock more value from alliances:

1. Launch the process. Don't wait until your venture is in the middle of a crisis; regularly scan your major alliances to determine which need restructuring. Once you've targeted one, designate a restructuring team and find a senior sponsor to push the process along. Then delineate the scope of the team's work.

2. Diagnose performance. Evaluate the venture on the following performance dimensions: ownership and financials, strategy, operations, governance, and organization and talent. Identify the root causes of the venture's problems, not just the symptoms, and estimate how much each problem is costing the company.

3. Generate restructuring options. Based on the diagnosis, decide whether to fix, grow, or exit the alliance. Assuming the answer is fix or grow, determine whether fundamental or incremental changes are needed, using the five performance dimensions above as a framework. Then assemble three or four packages of restructuring options, test them with shareholders, and gain parents' approval.

4. Execute the changes. Embark on a widespread and consistent communication effort, building support among executives in the JV and the parent companies. So the process stays on track, assign accountability to certain groups or individuals.

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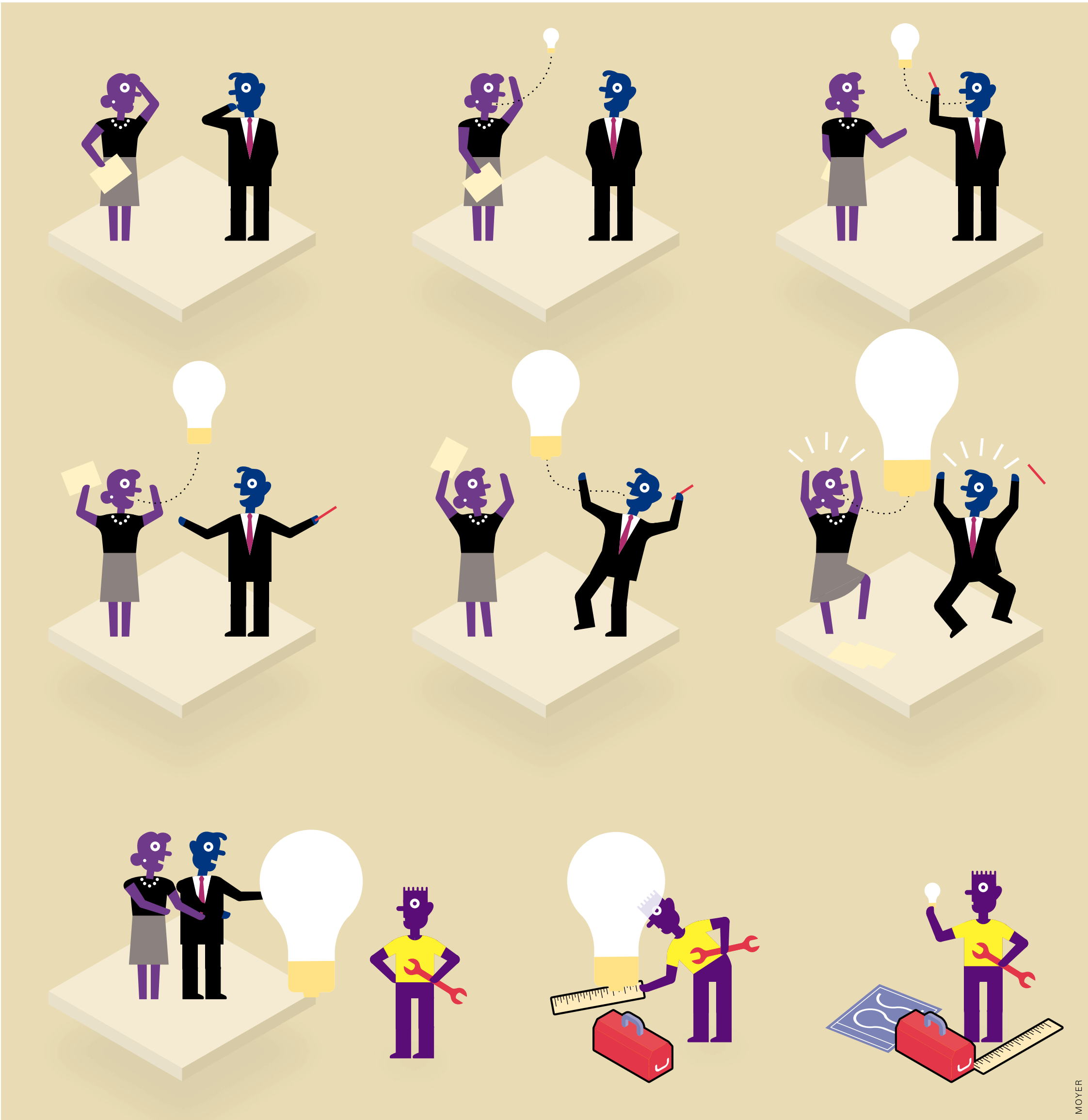
by Don Moyer



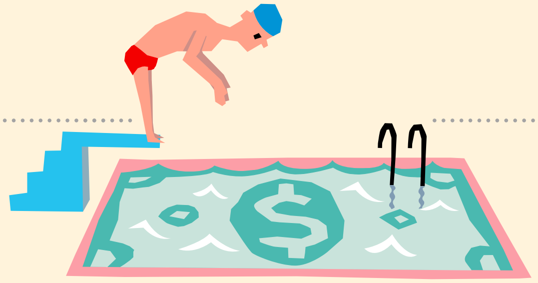
Imperfect Storms

For millennia, artists, scientists, and inventors achieved imaginative breakthroughs in splendid isolation. But creativity, the experts tell us, should be a group affair. Conceptual envelopes are notoriously unyielding, and pushing one requires the strength of many minds.

Now, there's nothing wrong with a freewheeling exchange, especially among folks with different perspectives, backgrounds, and thinking styles. But brainstorming sessions generate many ideas that can't survive outside the incubator. Stoked by enthusiasm and straining to include everyone's best suggestions, participants overreach on scale and ambition or lose sight of their end users. Those dangers are especially acute if the group includes more conceivers than executors.

In his book *Diffusion of Innovations,* Everett Rogers reminds us how often innovations fail in the real world (the only world that matters). To improve their odds, brainstormers should seek input from customers and from those charged with executing their plans. They may also need to impose a little self-discipline. One rule of brainstorming is that there are no bad ideas. Lacking bathwater, participants may have to toss out a few more babies.

Don Moyer can be reached at don@amsite.com.



Jon Anda, Chairman of Worldwide Equity Capital Markets

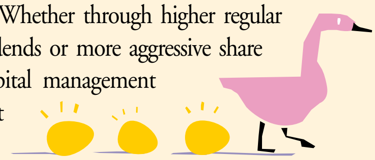
Corporate balance sheets:
swimming in cash or drowning in excess?

The corporate world is awash in liquidity. With the help of strong operating earnings, corporate balance sheets are in terrific shape. Since the end of 1999, the average cash holdings of S&P 500 non-financials has risen from 6% of assets to 11%, and the debt-to-equity ratio has fallen from 80% to 64%. While this might be cause to celebrate, it does pose a challenge for senior managements: how to make productive use of excess liquidity. The historical tendency — as we saw in the late 1970s and early '80s — is spending to gain market share in low-return core businesses or, perhaps worse, to diversify through acquisition into unfamiliar ones. And the result has often been the sacrifice of shareholder value.

Signs of this excess liquidity issue were everywhere in the early 1980s, when the U.S. economy was plagued by overcapacity in a wide range of industries. The U.S. capital markets came up with a solution to this problem in the form of leveraged acquisitions, LBOs and other leveraged recapitalizations. What did such deals accomplish? By replacing low and discretionary dividend payments with contractual payments of interest and principal, corporate managements made commitments to their investors to pay out excess capital. This not only curbed overinvestment but also dramatically lowered the cost of capital by substituting tax-advantaged debt for high-cost equity.

What makes liquidity such a critical issue in today's marketplace? The short answer is that investors are subjecting the levels and uses of liquidity to unprecedented scrutiny. Since the bursting of the Nasdaq bubble, many investors who once focused on earnings growth and P/E multiples have shifted their attention to free cash flow and return on capital. Thanks to recent increases in computing power, investors are using highly sophisticated models to track and forecast these factors. Most investors, especially the growing number of fundamentally driven hedge funds, care a lot about excess liquidity and how companies plan to use it.

So what should corporate managements be thinking about when it comes to liquidity? Capital expenditures and synergistic acquisitions offering high returns on capital obviously present terrific opportunities for shareholders. And many corporates are building up excess liquidity because their "hurdle rates" on such investments are too high for today's low-return world. But even without such opportunities, managements can take advantage of historically low borrowing costs and recently reduced tax rates on dividends to return capital more aggressively to shareholders. With the cost of even very high leverage having fallen dramatically ("BB" borrowing rates are now about 30% below 1999 levels), this opportunity is timely. Whether through higher regular dividends, special dividends or more aggressive share repurchases, active capital management can create significant value for shareholders.



Historically strong corporate balance sheets present many great opportunities. Active management of liquidity, leverage and hurdle rates are critical to realizing this opportunity.