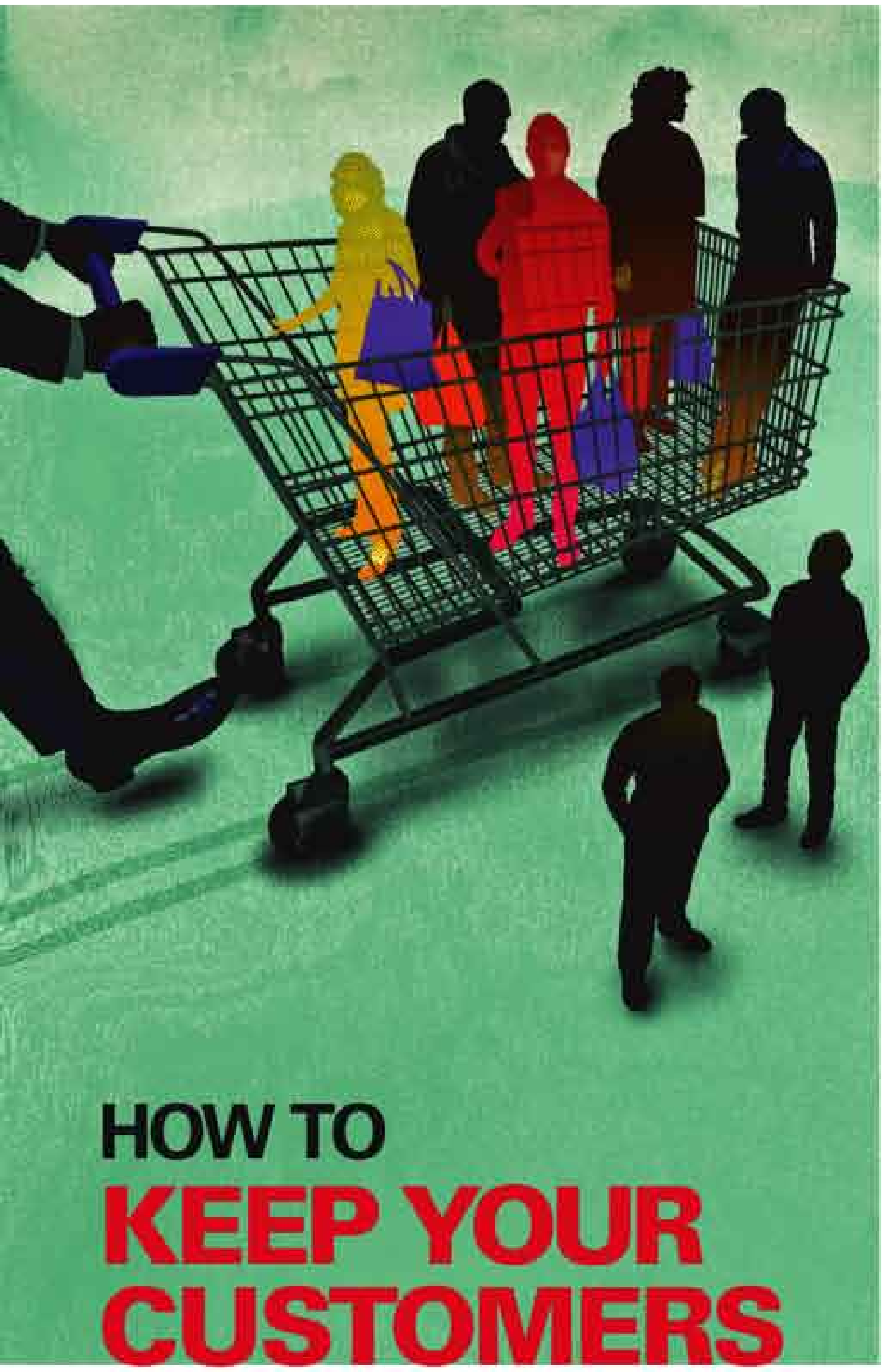
FORETHOUGHT MYTHS ABOUT "GREAT" COMPANIES...page 18

McKINSEY AWARDS PAGE 48

Harvard Business Review

www.hbr.org April 2009



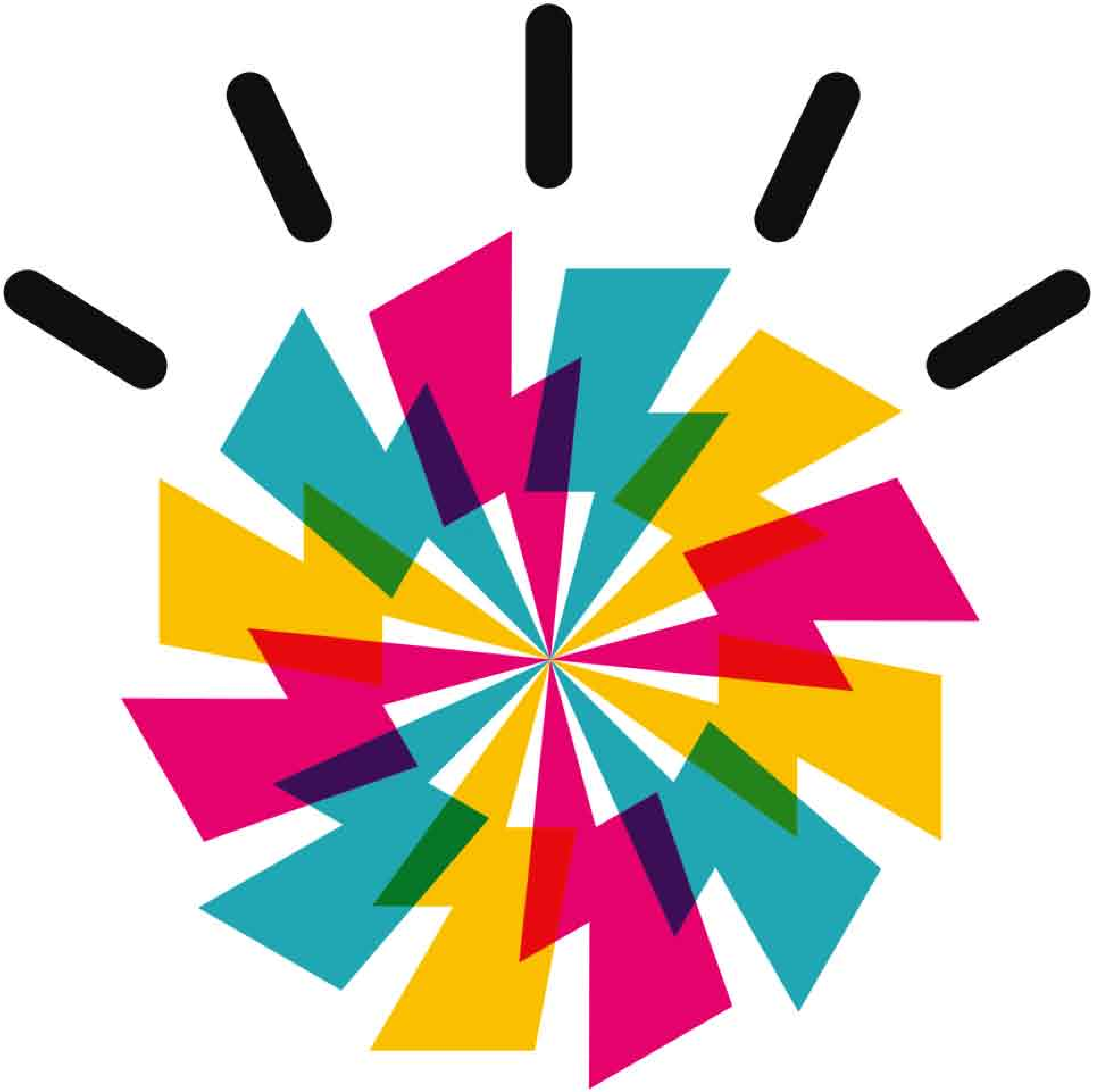
HOW TO **KEEP YOUR CUSTOMERS** IN THESE HARD TIMES

PAGE 52

FINANCIAL CRISIS SPOTLIGHT

HANGING ON TO YOUR CUSTOMERS

THINK



Conversations for a Smarter Planet

Smarter power for a smarter planet.

For most of the last century, our electrical grids were a symbol of progress. The inexpensive, abundant power they brought changed the way the world worked–filling homes, streets, businesses, towns and cities with energy.

But today's electrical grids reflect a time when energy was cheap, their impact on the natural environment wasn't a priority and consumers weren't even part of the equation. Back then, the power system could be centralized, closely managed and supplied by a relatively small number of large power plants. It was designed to distribute power in one direction only–not to manage a dynamic global network of energy supply and demand.

As a result of inefficiencies in this system, the world's creation and distribution of electric power is wasteful. With little or no intelligence to balance loads or monitor power flows, enough electricity is lost annually to power India, Germany and Canada for an entire year. If the U.S. grid alone were just 5% more efficient, it would be like permanently eliminating the fuel and greenhouse gas emissions from 53 million cars. Billions of dollars are wasted generating energy that never reaches a single lightbulb.

Fortunately, our energy can be made smart. It can be managed like the complex global system it is.

We can now instrument everything from the meter in the home to the turbines in the plants to the network itself. In fact, the intelligent utility system actually looks a lot more like the Internet than like a traditional grid. It can be linked to thousands of power sources–including climate-friendly ones such as wind and solar. All of this instrumentation then generates new data, which advanced analytics can turn into insight, so that better decisions can be made in real time. Decisions by individuals and businesses on how they can consume more efficiently. Decisions by utility companies on how they can better manage delivery and balance loads. Decisions by governments and societies on how to preserve our environment. The whole system can become more efficient, reliable, adaptive...smart.

Smart grid projects are already helping consumers save 10% on their bills and are reducing peak demand by 15%. Imagine the potential savings when this is scaled to include companies, government agencies and universities. And imagine the economic stimulus that an investment in smarter grids could provide in America's current crisis.

Actually, there's no need for imagination. The investment now being shaped in Washington could yield almost a quarter of a million jobs in digitizing the grid and in related industries such as alternative energy and automotive. It could enable new forms of industrial innovation by creating exportable skills, resources and technology.

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Our electrical grids can be a symbol of progress again–if we imbue the entire system with intelligence. And we can. Let's build a smarter planet. Join us and see what others are thinking at **ibm.com**/think

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Features

FINANCIAL CRISIS SPOTLIGHT

HANGING ON TO YOUR CUSTOMERS

continued on page 4

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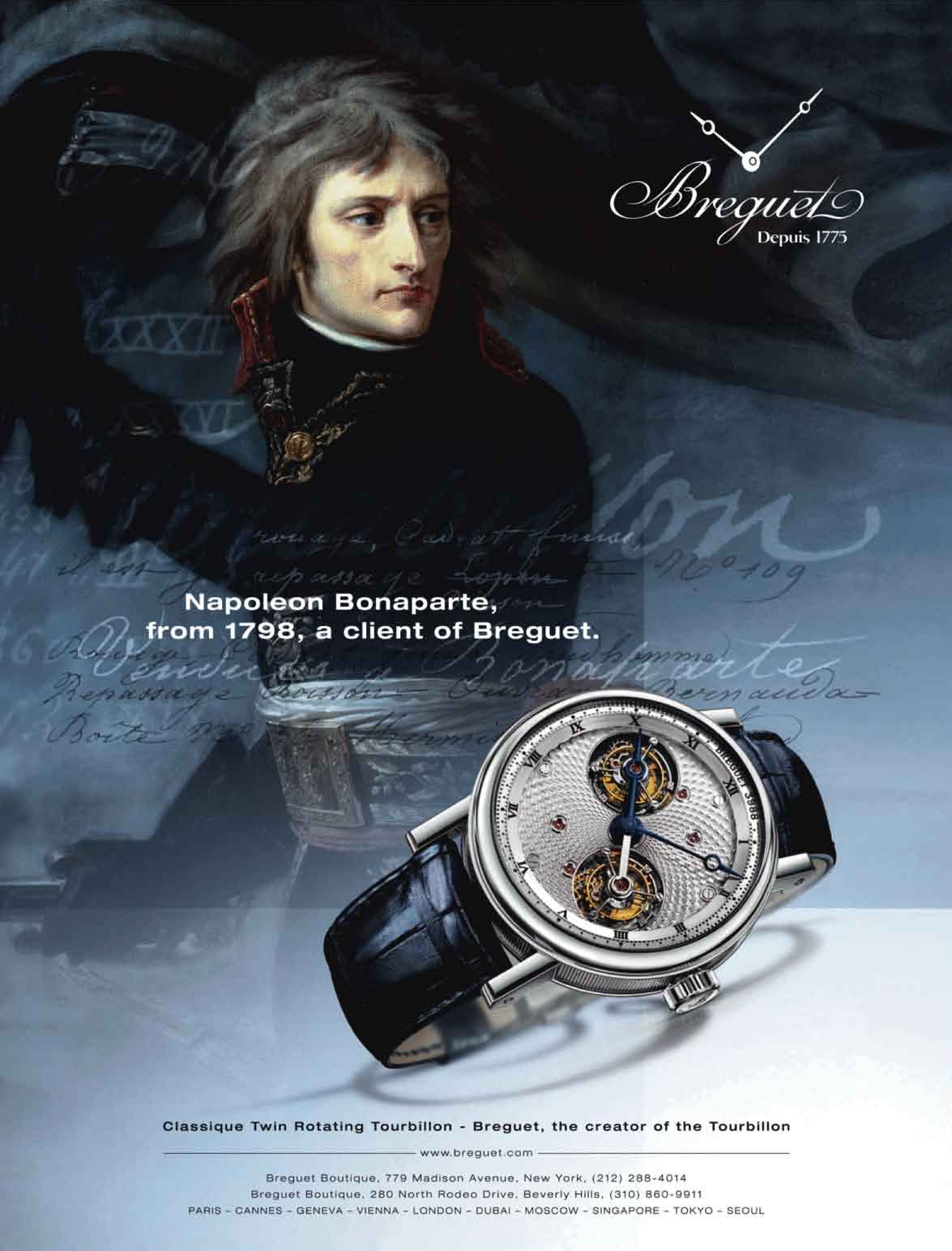
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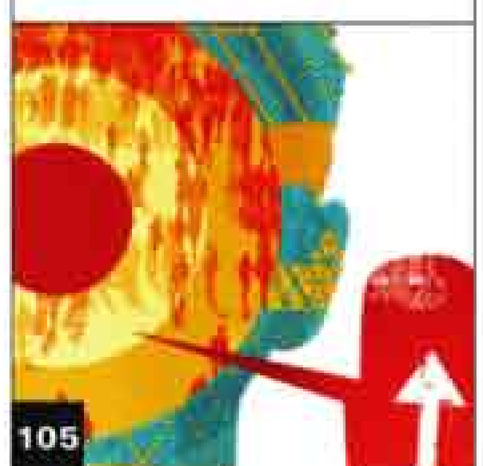

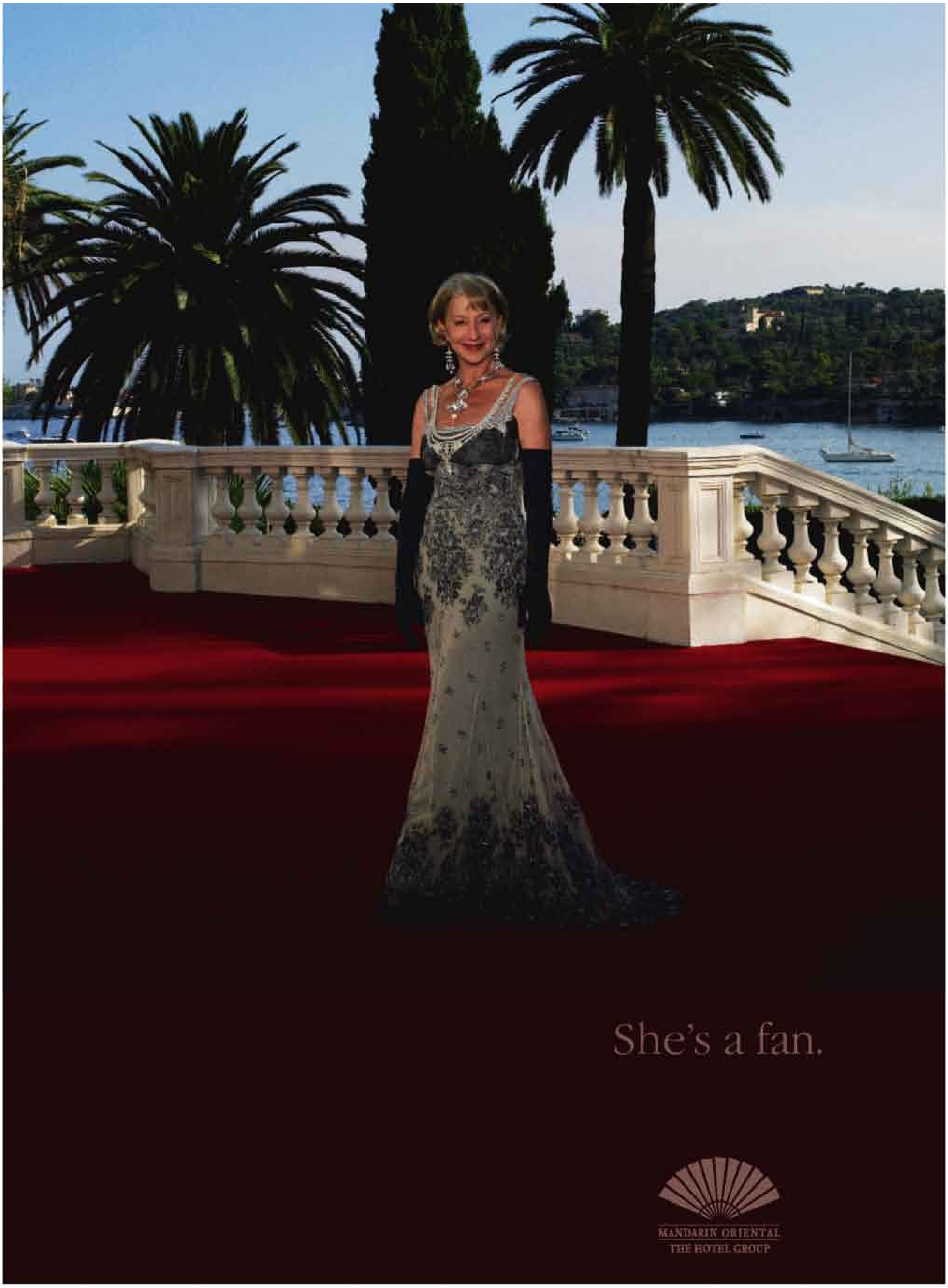
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The connection between personal health and organizational performance is clear – and executives don't pay nearly enough attention to it. Created in conjunction with Harvard Health Publications, this special section, at **health.hbr.org**, covers topics ranging from the pernicious effects of stress to the importance of work/life balance.

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

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

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"I'm terribly sorry. Your essay on why you deserve customer service is incomplete. You have to go to the back of the line."

Ted Goff


The centre of
the Gulf.


Not the centre
of attention.

Leadership in Hard Times

LEADERSHIP IS never easy, but it's incredibly tough right now: The global financial system is basically paralyzed, the recession is the worst we've seen in the better part of a century, and trust in institutions and the people who lead them is at an all-time low.

Who better to put the subject of crisis leadership in perspective than Doris Kearns Goodwin, the presidential historian? Goodwin has written extensively about Abraham Lincoln and Franklin Delano Roosevelt, the two presidents who led the United States during its biggest crises: the Civil War and the Great Depression. She combines a shrewd understanding of how these leaders shaped their times and a profoundly empathetic sense of their emotional makeup. Her Different Voice conversation with senior editor Diane Coutu is about political leadership, obviously, but the lessons Goodwin synthesizes work as well for business leaders as they do for politicians.

Her advice? Hire the best possible people to work for you, even if they fought you for your job. Surround yourself with a team of people who can challenge your thinking and whose strengths make up for your deficits. Share credit with your closest colleagues, so that they're fully committed to your mission. Be sure to communicate, often and authentically, with your larger public. And don't forget to relax. (FDR hosted a cocktail hour every evening, during which it was forbidden to discuss either politics or the war.)

If you're leading an organization through this downturn, you're undoubtedly introducing major changes – and inevitably encountering resistance to them. According to Jeffrey Ford and Laurie Ford in "Decoding Resistance to Change," it's wise to engage with the resisters, learn from them, and alter your course if they suggest smart adjustments to your initiatives. Your biggest critics can be turned into your best advocates if you have the courage to listen carefully. This advice feels all the more important right now, given that an organization's very survival may depend on making the right changes.

Two articles in this issue focus on how to hold on to – and better serve – customers during the recession. "How to Market in a Downturn," by John Quelch and Katherine Jocz, advises managers to resegment their customers on the basis of their recession psychology: Some consumers slam the brakes on their spending, but others don't change their behavior much at all unless they lose their jobs. It's essential to know which are which – and that's not always easy to predict. In "Five Rules for Retailing in a Recession," Ken Favaro, Tim Romberger, and David Meer note that retailers have been hit especially hard by this downturn. They suggest, counterintuitively, that retailers have the most to gain from catering to less-loyal customers rather than to new or loyal customers.

"What's Your Google Strategy?," by Andrei Hagiu and David Yoffie, will help strategists think through how to work with powerful intermediaries like Google, Amazon, and Blu-ray. They can help your business grow – and they can also cause its demise. Tread carefully. In "When Internal Collaboration Is Bad for Your Company," Morten Hansen notes that corporate leaders are so taken with the idea of "breaking down silos" that they rarely do a cost/benefit analysis of boundary-spanning collaboration. Turns out that plenty of collaborations should never get the go-ahead. Rounding out the issue, "Predicting Your Competitor's Reaction" outlines a surprisingly simple method that Kevin Coyne and John Horn developed for anticipating how other companies will react to your next strategic move.

During this tumultuous phase of history, the economic landscape changes daily. For timely commentary on the latest developments, please visit our recently relaunched website (hbr.org), and let us know what you think of it.

–The Editors

Robert Meganck

Harvard Business Review

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Volume 87, Number 4
April 2009
Printed in the U.S.A.

Harvard Business Review

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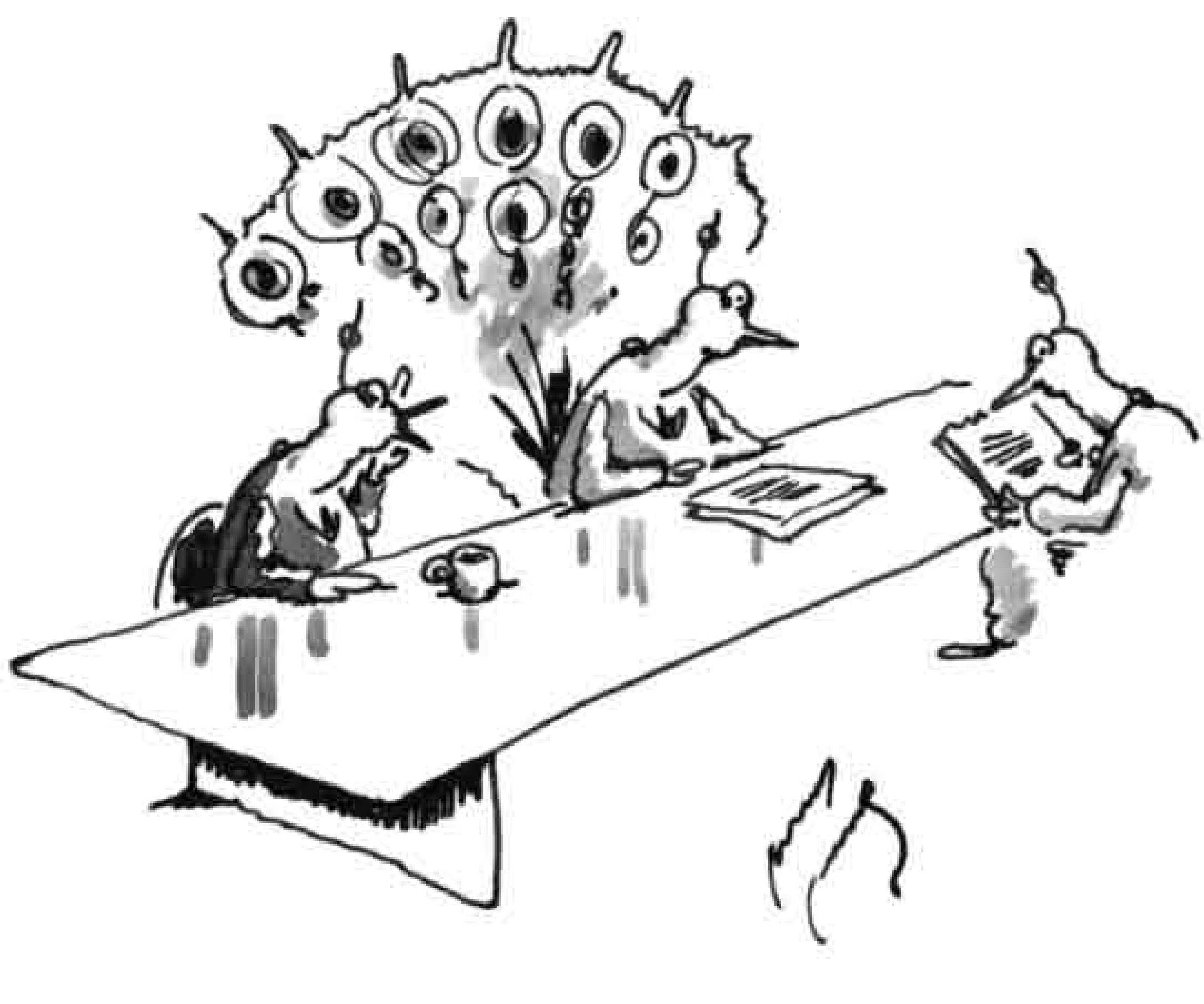
The Art of Negotiation

> "The name of the game is this: Be as sweetly unreasonable as possible in a convincingly logical fashion without permitting your opponent to decide that it is impossible to deal with you!"

Bruce D. Henderson
"Brinkmanship in Business"
Harvard Business Review
March–April 1967

"That may work on the street, but put it away for the meeting."

"No...*you* roll over!"



"Not yet, Davis! We haven't sealed the deal!"

Roy Delgado, Scott Arthur Masear, P.C. Vey

forethought

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

GRIST

Are "Great" Companies Just Lucky?

by Michael E. Raynor, Mumtaz Ahmed, and Andrew D. Henderson

Studies that examine high-performing companies to uncover the reasons for their success are both popular and influential. They're the basis of the insights behind best sellers like *In Search of Excellence* and *Good to Great*. But there's a problem: The "great" companies from which these studies draw their conclusions are mostly just lucky.

We're not the first to challenge success studies, but so far the criticism has focused on data collection and analysis. Our concerns go much deeper. Many of the "great" companies cited are, in fact, nothing special; consequently, the researchers are simply imposing patterns on random data. That's not science – it's astrology.

Professor Rebecca Henderson at MIT's Sloan School shows how easily we succumb to the temptation to "explain" seemingly significant outcomes that are entirely random. "I begin my course in strategic management by asking all the students in the room to stand up," she says. "I then ask each of them to toss a coin. If the toss comes up tails, they are to sit down, but if it comes up heads, they are to remain standing. Since there are around 70 students in the class, after six or seven rounds there is only one student left standing. With the appropriate theatrics, I approach the student and say, 'How did you do that? Seven heads in a row! Can I interview you in *Fortune?* Is it the T-shirt? Is it the flick of the wrist? Can I write a case study about you?'"

Henderson's charade reveals the folly of attributing outcomes arising from systemic variation (the random nature of coin tosses) to the supposedly unique attributes of a few individuals, who are really just the luckiest coin flippers. Similarly, we can credibly claim that a firm is remarkable only when its performance is so unlikely that systemic variation alone

Brucie Rosch

cannot account for its results. Most success studies don't address this fact, relying instead on the "self-evident" nature of exceptional performance.

To understand how lucky some firms might get because of systemic variation alone, we looked at the performance of a broad sample of companies traded on U.S. exchanges from 1966 to 2006 – more than 230,000 company years' worth of data. We ranked each company's performance in each year by deciles (0 to 9) and observed the frequency of transitions between deciles. Using that frequency to estimate the probability that an unexceptional firm would move from one decile to another simply because of systemic variation, we ran simulations that gave us a picture of how firms might do if they differed only in their luck. Finally, we compared actual results with simulated results, which allowed us to determine which firms had delivered performance so unlikely that it was probably due to something remarkable about them.

Using this method, we evaluated 287 allegedly high-performing companies in 13 major success studies. We found that only about one in four of those firms was likely to be remarkable; the rest were indistinguishable from mediocre firms catching lucky breaks. By our method, even in the study with the best hit rate, only slightly more than half the high performers had profiles that were credibly attributable to something special about the firms. In short, what qualifies as remarkable performance is anything but self-evident.

This doesn't mean you should necessarily dismiss the advice offered in success studies. The authors are savvy observers of the business world. Their recommendations can be useful, but only in the way that fables are. No one reads "The Tortoise and the Hare" and, faced with a chance to bet on such a race, chooses the tortoise. Rather, people take from this tale the idea that there is merit in perseverance while arrogance can lead to a downfall. Similarly, success studies should be treated not as how-to manuals but as sources of inspiration and fuel for introspection. Their value is not in what you *read* in them but what you read *into* them.

Michael E. Raynor (mraynor@deloitte.com) and **Mumtaz Ahmed** (muahmed@deloitte.com) are consultants at Deloitte Consulting. **Andrew D. Henderson** (andy.henderson@mccombs.utexas.edu) is an associate professor at the University of Texas at Austin. The full study on which this article is based is available at www.deloitte.com/persistence. Reprint F0904A

CUSTOMER RELATIONS

Employee Happiness Isn't Enough to Satisfy Customers

by Rosa Chun and Gary Davies

To win customers' hearts, a service business needs engaged employees who actively transmit their enthusiasm to customers. The idea that employee satisfaction simply rubs off and benefits the company is wishful thinking.

The assertion that happy workers equal happy customers pops up in the marketing and mission statements of a lot of service providers, from big government agencies to small start-ups. It has been advocated by high-profile chief executives, including Gordon Bethune, the former CEO of Continental, an airline that has won numerous best-employer awards. Many managers we've interviewed believe in the causal link or feel obliged by their bosses to accept it. At least some of this thinking stems from a much-quoted 1994 HBR article, "Putting the Service-Profit Chain to Work," and a subsequent book, by James L. Heskett and colleagues.

But we haven't seen any hard data supporting the idea. Our own surveys of the customers and staffs of 49 business units of 13 service organizations in the UK, in fields ranging from financial services to retailing, failed to confirm that service businesses with more-contented staff also have more-satisfied customers. In fact, we found a positive correlation between the two at only one firm, where the business units with happier customers had higher employee satisfaction. At two other firms, we found a negative correlation: We observed that factors that increased customer satisfaction decreased employee happiness.

Satisfying customers is crucial to a business – there's a great deal of evidence for a causal link between happy customers and higher profits. And satisfying employees is a worthwhile aim in itself for many reasons. To link the two, engage employees by giving them both reasons and ways to please customers; then acknowledge and reward appropriate behavior. Simply being served by a satisfied employee isn't enough to win customers' loyalty.

Rosa Chun (rosa.chun@mbs.ac.uk) is a professor of business ethics and corporate social responsibility and **Gary Davies** (gary.davies@mbs.ac.uk) is a professor of corporate reputation at Manchester Business School in the UK. Reprint F0904B

HEALTH CARE

Health Care Requires Big Changes to Complement New IT by Julia Adler-Milstein

The new administration in Washington and revised Medicare rules all but guarantee that there will soon be huge investments in health care IT in the United States. But the hoped-for efficiency and quality gains from electronic records and related applications will evaporate if hospitals and medical practices don't support them with organizational changes such as increased individual decision-making authority and more training.

Information technology has long been touted as both a solution to rising health care costs and a way to reduce medical errors. IT investment is central to President Obama's vision for health care reform, and his estimates of the savings from it have been substantial. During the election campaign, Obama cited a Rand Corporation finding that adoption of electronic health records (EHRs) by most doctors and hospitals would save up to $77 billion annually. Meanwhile, Medicare, the largest payer in the United States, has introduced the first financial incentive for doctors to adopt health IT.

Many health care organizations believe that gains will flow from the technology alone. Research shows that medical practices expect EHRs to improve work flow, accuracy, communication with patients, access to medical history, and clinical decision making. They give little thought to the organizational changes required to realize those benefits, however.

Studies by the MIT Sloan School's Erik Brynjolfsson and others show that organizations across a range of industries were able to take advantage of new IT capabilities only after making substantial changes: In addition to increasing training and individual decision-making authority, they flattened their hierarchies, made greater use of skilled labor, decentralized teams, and raised incentives for team performance. Organizations that failed to do those things often ended up worse off than if they had never invested in the new technology.

Such changes present a huge challenge in health care, where workers are trained for and expected to fill specific roles. But they're not impossible. After adopting an EHR system, Geisinger Health System in Pennsylvania gave nurses additional authority to respond to medical issues they saw cropping up in the patients' records and made better use of their skills by automating mundane tasks. The organization also created financial incentives for team performance, particularly in areas such as diabetes care, and developed an extensive training curriculum that included close observation of physicians as they used the system.

A recent paper on Geisinger's EHR-supported organizational redesign concludes that "much of today's policy discussions imply that EHRs will rapidly transform care delivery. The Geisinger experience suggests that this is not the case but, rather, that EHR adoption is the beginning of a long care-transformation journey."

Julia Adler-Milstein (jadlermilstein@hbs.edu) is a doctoral student at Harvard Business School. Reprint F0904C

STRATEGY

Superstition Undermines Alliances

by Koen Heimeriks

Many studies conclude that the more alliances a company forms, the better it becomes at them. That makes intuitive sense – but it's not always true. My own study of nearly 200 firms, which collectively had formed more than 3,400 alliances, found that on average the results of firms with the most experience were worse than those of firms with only moderate experience, as gauged by the percentage of alliances that achieved their goals.

Previous research has suggested that firms with a lot of experience can become overconfident of their skills and be misled by "superstitious learning" – learning based on unsupported notions about cause and effect. Often these firms have sophisticated, centralized alliance functions that codify and enforce standard practices. But if some of those practices draw on superstitious ideas about what specific actions account for good or bad outcomes, firms can perpetuate suboptimal practices, inhibit learning, and undermine alliance performance.

What, then, determines whether a firm that actively pursues alliances will perform well? My findings suggest that it is the nature of the firm's alliance mechanisms. The greater its alliance experience, the more likely it is to have *institutionalizing mechanisms*, which formalize decision making and enforce standardized practices such as protocols for selecting partners. But what those mechanisms offer in efficiency they lack in flexibility, particularly when it comes to learning from successes and mistakes that are clearly associated with specific actions. That's where *integrating mechanisms* can offer insight. They encourage employees to share experiences from previous alliances and engage in group problem solving, nurturing a collaborative mind-set and willingness to improvise. This fosters experimentation and allows companies to adapt practices to new contexts – processes that promote truly effective practices and continual improvement.

Most of the companies I studied use both institutionalizing and integrating mechanisms. How they balanced the two seemed to be a key to success. The highly experienced firms, which relied predominantly on institutionalizing mechanisms, achieved an alliance success rate of 50%, somewhat below average for the entire database. These mechanisms do not seem to improve competence but, rather, mirror confidence. Firms that, in contrast, extensively used integrating mechanisms realized an alliance success rate of 71% on average.

Managers often talk about how they tolerate productive mistakes – errors employees and the company learn from. In the case of alliances, my research suggests, mere tolerance is probably not enough. Managers should create mechanisms that encourage thoughtful trial-and-error approaches and deliberate lesson sharing.

Koen Heimeriks (kheimeriks@rsm.nl) is an assistant professor of strategy at the Rotterdam School of Management at Erasmus University. Further details on this study are available at www.koenheimeriks.com.

Reprint F0904D

INPUTS

Biomass – The Other Energy Source

by Marie E. Walsh

In all the talk about renewable energy alternatives to oil, natural gas, and coal, the most often overlooked are biomass resources – for example, prairie grasses, forestry and mill residues, nongrain parts of food crops, and urban wood wastes that are typically discarded in landfills.

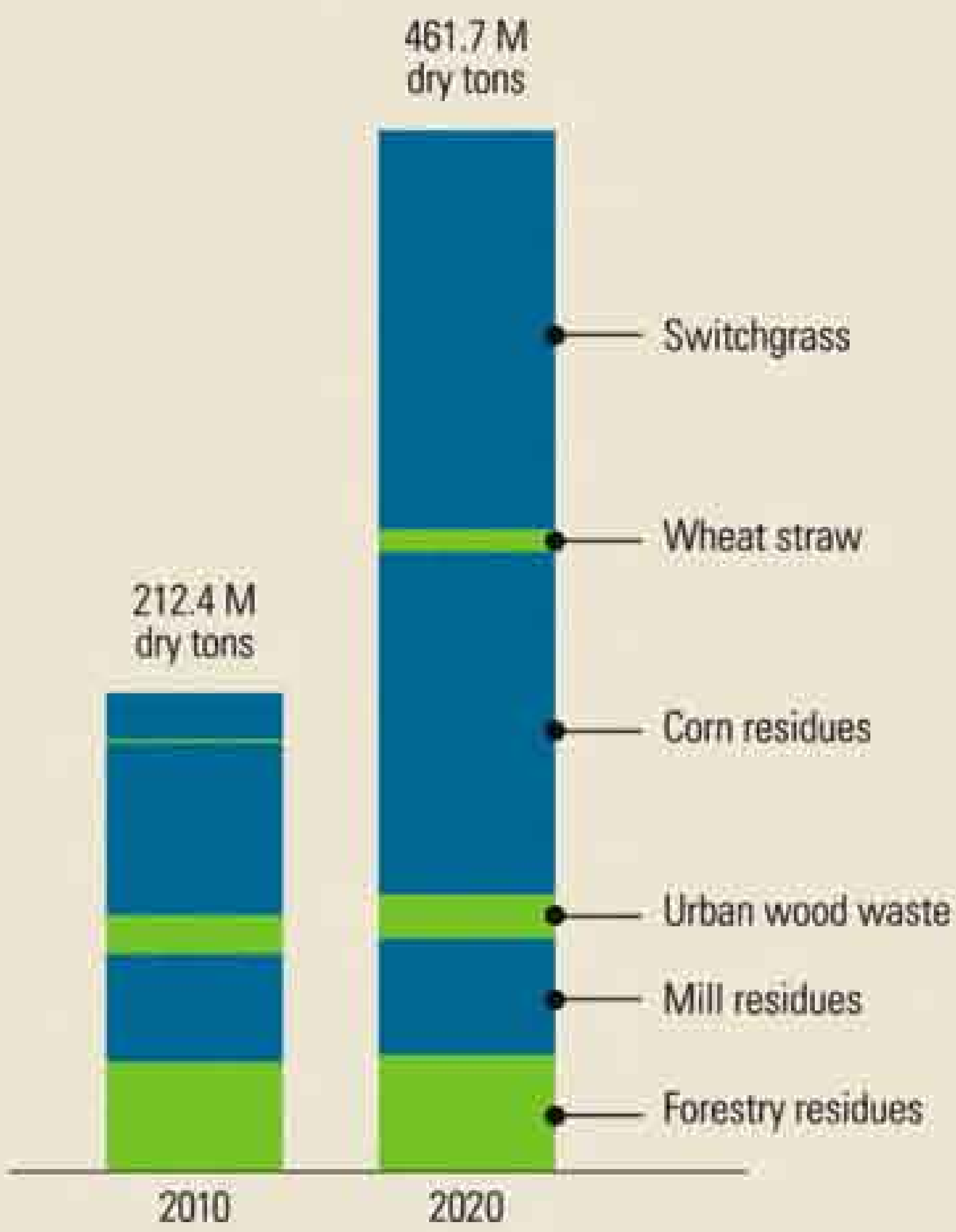
Most of this material is not currently used commercially, but steady improvements in technology and agricultural and forestry practices are paving the way for biomass to become an important energy source in the not-too-distant future. It can be used to produce electricity and transportation fuels, as well as organic chemicals, biodegradable plastics, and composite materials.

My research indicates that although biomass resources are abundant worldwide, the amount available for energy will depend primarily on three things, all of which vary by resource type and location: environmental sustainability needs (excessive removal of cornstalks, for instance, can harm soil productivity); collection, production, storage, and transportation costs; and prices paid for competing uses.

If the price of biomass rises, more will enter the market. Technology and productivity improvements will reduce its costs, increasing the quantity that can be used to produce energy. But in the near term, prices of biomass will most likely be highly volatile as suppliers adopt new production practices, government policies are clarified, and markets for its various uses emerge, falter, and ultimately stabilize.

The Biomass Boom
The graph at right shows the quantities of select biomass resources that could be collected in the U.S. for (as an example) $50 a dry ton or less, in 2010 and 2020. Some of these resources are nascent industries that will develop over time.

Note: For comparison, one dry ton of biomass contains the energy equivalent of 2.5 to 3 barrels of crude oil.



Marie E. Walsh (m.e.biomass@comcast.net), a former research scientist at Oak Ridge National Laboratory, is an adjunct associate professor in the University of Tennessee's department of agricultural economics and a biomass energy consultant. Reprint F0904E

Conversation

CARE CEO **Helene Gayle** on shaking up a venerable organization

When the nonprofit CARE was launched in 1945, it had a single purpose: delivering food parcels to survivors of World War II. Over the years it diversified its efforts, moving beyond emergency relief into long-term development and extending its reach across many regions. By the time Helene Gayle, a physician, came on board as CEO in 2006 – after about two decades of work in public health at the Centers for Disease Control and Prevention and five years at the Bill and Melinda Gates Foundation – CARE had programs in more than 60 countries. But with that growth the organization had lost focus. Gayle is working to give CARE a clearer direction and increased global clout for its mission to end extreme poverty.

What was it like, as a new CEO, to try to incite change at such a sprawling organization?

It was an organizational challenge and a personal one. CARE wasn't fulfilling its potential and for a number of reasons was very decentralized. The country offices raised most of their own funds and were used to being on their own, having a lot of autonomy, and not thinking about the greater whole. Although the organization was most comfortable with this model, field-workers were tired of doing great projects but not seeing long-lasting change take hold. It was clear to me and the rest of CARE's leadership that the real value of being one of the world's largest NGOs was the potential to be a global force. To do that, we had to ask, How can we make the whole greater than the sum of its parts? We determined that we needed to share information across countries more than we had done, be more rigorous about measuring our impact, and make the best use of our voice as an advocate for policy change. I had considerable experience achieving these types of objectives in my other jobs, but the actual content of CARE's work on the ground was largely new to me. Only a small part of what it does is health. CARE is an astonishingly complex organization geographically, technically, financially, and culturally. And this was a bigger leadership role than I'd ever had.

So how did you build support for your plan?

I knew I couldn't achieve anything simply by being the new sheriff in town, by saying, "This is my vision" – not that such an approach is who I am as a person anyway. If there was to be change, it would be because people saw for themselves how a new strategy could amplify their ability to have an impact on poverty – a mission that people in the organization hold very dear. So I drew on my background in public health. For 20 years I was a government employee at the CDC, where we were taught how to be a good partner, how to bring people together, and not to worry about who gets the credit. Our role was very often to be in the background, helping support states and community health organizations. I put those lessons to use. To me it is about being a servant leader and listening to people, having them feel that everything I do is to enable them to do the things they need to do. I constantly remind myself that even though I'm the leader of the team, the people around me know a lot more about their work than I do.

Is the whole now greater than the sum of its parts?

I make sure we are always trying to have a large impact on the greatest possible number of people. If you do a program that's big enough and bold enough, there's a potential for bringing other partners into the effort, reaching a tipping point, and really beginning a movement. For example, we're starting a major new multicountry program to expand access to financial services like savings accounts, credit, and insurance to the poor in Africa. We hope this program, Access Africa, will touch hundreds of millions of people, producing substantial economic growth that could not have happened otherwise. In 10 years we'd like to be able to look back and say, "Wow, this is very different than if we had all continued to function as separate country units or technical groups." That said, there is creating a vision and then there is making that vision a reality. Execution seems to me the real challenge of a senior leader. I think you're constantly acting and assessing and adapting to changing circumstances, and I don't think I'll ever be at a point where I clap my hands and say, "It's over."

– Rasika Welankiwar

Reprint F0904F

MARKETING

What Do Customers Really Want?

by Eric Almquist and Jason Lee

What happens when you combine product design virtuosity, high-powered market research techniques, and copious customer data? Too often, the result is gadgets that suffer from "feature creep" or the return of billions of dollars' worth of merchandise by customers who wanted something different after all. That kind of waste is bad enough in normal times, but in a downturn it can take a fearsome toll.

The trouble is that most customer-preference rating tools used in product development today are blunt instruments, primarily because consumers have a hard time articulating their real desires. Asked to rate a long list of product attributes on a scale of 1 ("completely unimportant") to 10 ("extremely important"), customers are apt to say they want many or even most of them. To crack that problem, companies need a way to help customers sharpen the distinction between "nice to have" and "gotta have."

Some companies are beginning to pierce the fog using a research technique called "Maximum Difference Scaling." "MaxDiff" was pioneered in the early 1990s by Jordan Louviere, who is now a professor at the University of Technology, Sydney. (As with most cutting-edge academic developments, it took time to translate Louviere's research into practical tools.) MaxDiff requires customers to make a sequence of explicit trade-offs. Researchers begin by amassing a list of product or brand attributes – typically from 10 to 40 – that represent potential benefits. Then they present respondents with sets of four or so attributes at a time, asking them to select which attribute of each set they prefer most and least. Subsequent rounds of mixed groupings enable the researchers to identify the standing of each attribute relative to all the others by the number of times customers select it as their most or least important consideration.

A popular restaurant chain recently used MaxDiff to understand why its expansion efforts were misfiring. In a series of focus groups and preference surveys, consumers agreed about what they wanted: more healthful meal options and updated decor. But when the chain's heavily promoted new menu was rolled out, the marketing team was dismayed by the mediocre results. Customers found the complex new choices confusing, and sales were sluggish in the more contemporary new outlets.

The company's marketers decided to cast the range of preferences more broadly. Using MaxDiff, they asked customers to compare eight attributes and came to a striking realization. The results showed that prompt service of hot meals and a convenient location were far more important to customers than healthful items and modern furnishings, which ended up well down on the list. The best path forward was to improve kitchen service and select restaurant sites based on where customers worked.

The ability to predict how customers will behave can be extremely powerful – and not just when budgets are tight. Companies planning cross-border product rollouts need a tool that is free of cultural bias. And as customer tastes fragment, product development teams need reliable techniques for drawing bright lines between customer segments based on the features that matter most to each group. Companies are starting to apply MaxDiff analysis to those issues as well.

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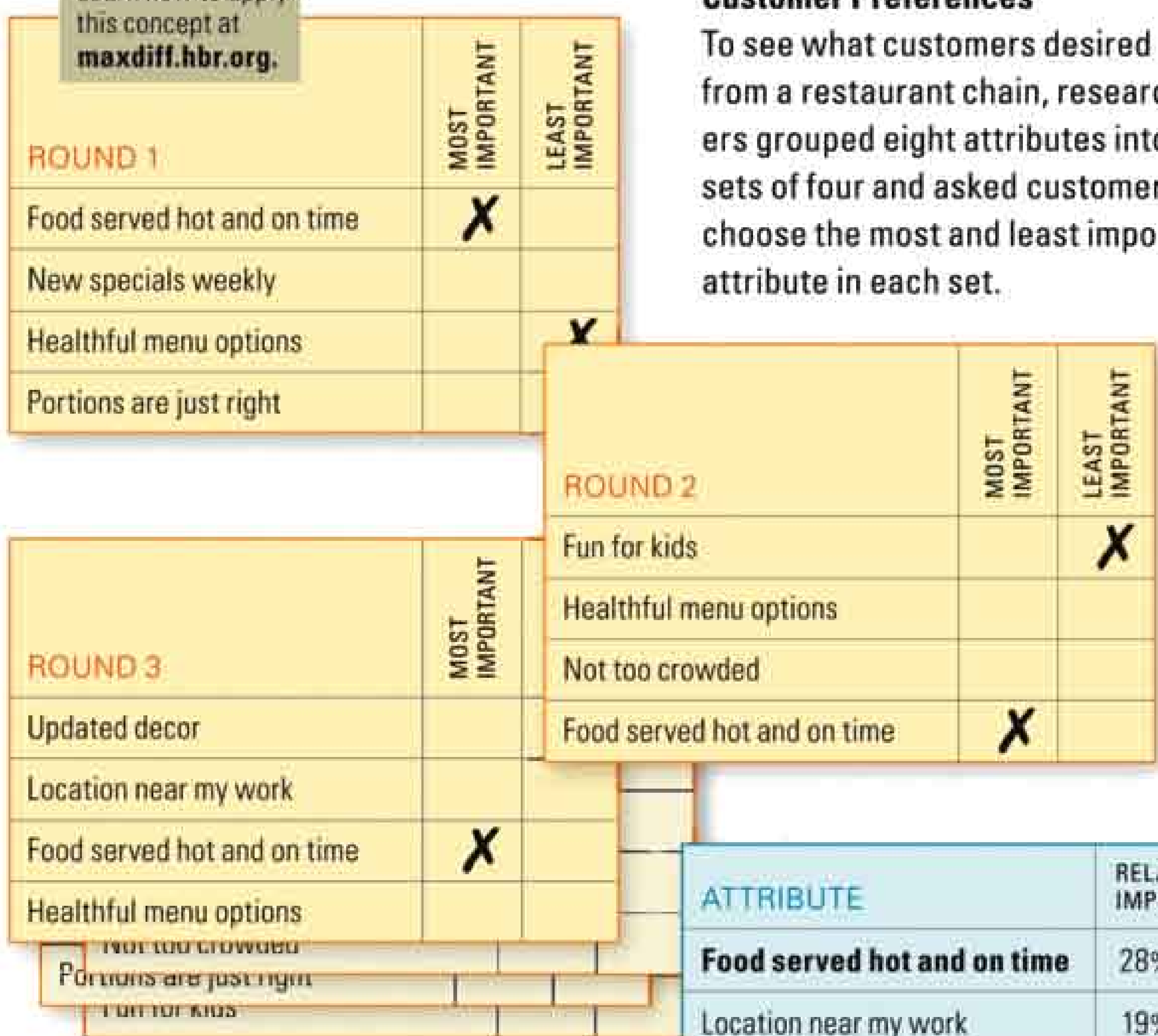
Learn how to apply this concept at **maxdiff.hbr.org.**

A Clearer Read on Customer Preferences

To see what customers desired most from a restaurant chain, researchers grouped eight attributes into six sets of four and asked customers to choose the most and least important attribute in each set.



ATTRIBUTE	RELATIVE IMPORTANCE
Food served hot and on time	28%
Location near my work	19%
Portions are just right	15%
Not too crowded	13%
Updated decor	13%
New specials weekly	8%
Healthful menu options	5%
Fun for kids	1%

Through successive rounds of comparisons, respondents' choices moved each attribute's importance score higher or lower. "Food served hot and on time" emerged as the restaurants' most important attribute while "fun for kids" came in last.

INNOVATION

Nurturing Good Ideas

Jan van den Ende and Bob Kijkuit

Managers know that simply generating lots of ideas doesn't necessarily produce good ones. What companies need are systems that nurture good ideas and cull bad ones – before they ever reach the decision maker's desk. Our research shows that tapping the input of many people early in the process can help ensure that the best ideas rise to the top.

It's not uncommon for companies' idea-generation activities to produce thousands of ideas. Reviewing all of them to find the best is resource intensive and doesn't guarantee high-quality results. After all, how seriously will reviewers consider idea number 532? Probably it will get only superficial attention, and it will be selected for development only if its usefulness is immediately apparent. This screening approach is likely to leave potential blockbuster ideas on the cutting-room floor.

Some firms, however, are taking steps to systematically improve the quality of ideas before they're submitted for review. They're encouraging employees to first discuss ideas with their colleagues to gain insights about their technical and market feasibility or how they fit with company objectives, which will either enhance the ideas' value or lead to their early and appropriate demise.

Consider how this works at Unilever, where we followed the development of ideas at the company's food labs in a 14-month study. Employees there usually discussed an idea with colleagues and, based on their feedback, made changes in the idea before submitting it. People who tapped colleagues outside their departments were more successful; discussing an idea with them increased its chances of adoption, whereas discussions with colleagues from the same department didn't. Interestingly, communication with friends or trusted colleagues appeared to aid adoption, probably because their input tended to be richer and offered more constructive and critical feedback, leading to more substantial changes to the idea itself. What's more, the greater the number of perspectives an employee got, the higher his idea's chances of being adopted were.

Other firms take a similar tack. At the biotechnology research company KeyGene, management advises employees to discuss ideas with others before submitting them to a review committee. In IBM's ThinkPlace program, "catalysts" create networks of people around ideas. Employees post ideas on an intranet site; catalysts select promising ones and invite comment or support from people in their network. Eventually, they ask one or more network members, not necessarily the idea originator, to present the concept to a line manager or an internal innovation fund.

This approach to idea development offers a clear payoff in efficiency and in the quality of ideas. But it has another benefit as well: It enhances motivation by improving the odds of success and reducing the chance that an employee will invest unduly in an idea that's likely to fail.

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Reprint F0904H

MANAGING PEOPLE

How Toxic Colleagues Corrode Performance

by Christine Porath and Christine Pearson

We've been studying incivility for a decade, and we've found that common (and generally tolerated) antisocial behavior at work is far more toxic than managers imagine. Berating bosses; employees who take credit for others' work, assign blame, or spread rumors; and coworkers who exclude teammates from networks – all of these can cut a swath of destruction that's often visible only to the immediate victims. Targets of bad behavior become angry, frustrated, and even vengeful. Job satisfaction falls, and performance plummets. Some employees leave. But those who stay may take a bigger toll on the organization. As a senior vice president of a *Fortune* 50 firm told us, "They can and do sit in the boat without pulling the oars... and that may be worse than leaving."

To understand the impact of incivility on performance, we polled several thousand managers and employees from a diverse range of U.S. companies about their responses to rudeness at work and learned that among those on the receiving end,

48% decreased their work effort,
47% decreased their time at work,
38% decreased their work quality,
66% said their performance declined,
80% lost work time worrying about the incident,
63% lost time avoiding the offender, and
78% said their commitment to the organization declined.

As companies slash workforces and depend on the staff left behind to do more, they can't afford to let a few noxious employees corrode everyone else's performance. Uncivil behavior should be penalized and repeat offenders cut loose.

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Reprint F0904J

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It's rough out there. Economic realities are daunting. And yet, as with every competitive challenge, some businesses will respond proactively and effectively, while others are left behind. The winners will be those who
It's not a setback. It's a test.
act quickly, make the right decisions and execute them flawlessly. From our work with the world's most successful companies – through up cycles and down – Accenture has developed the unique perspective and broad capabilities to help you come out on top. At a time when it's tougher than ever to be a Tiger, it's even more crucial to know what it takes. Talk to us to see how we can help.
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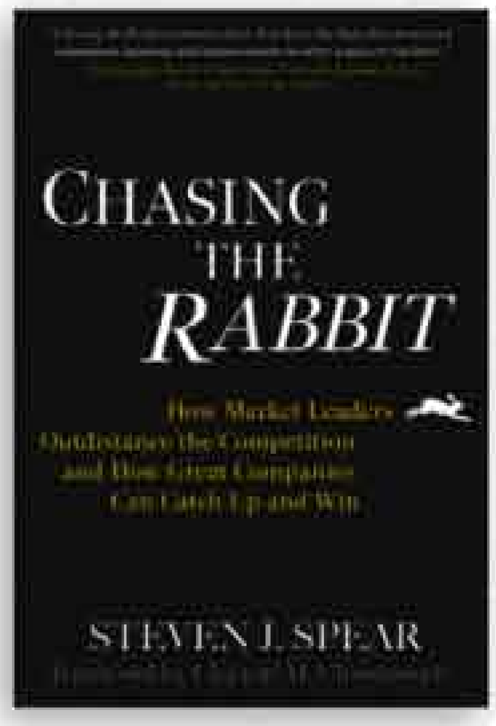
Reviews

Chasing the Rabbit
How Market Leaders Outdistance the Competition and How Great Companies Can Catch Up and Win

Steven J. Spear
(McGraw-Hill, 2008)

Steven Spear is no stranger to Toyota watchers, students of the Toyota Production System, or HBR readers. Over the past 10 years, ever since he cowrote (with H. Kent Bowen) his first HBR article, "Decoding the DNA of the Toyota Production System," Spear, now a senior lecturer at MIT, has dazzled readers with his insights into what makes Toyota tick and his understanding of how any organization can use those ideas to improve its effectiveness. Not surprisingly, his first tome was highly anticipated, and it's probably an understatement to say that it won't disappoint.



Writing in an eminently approachable fashion, Spear quickly sets up the problem he plans to tackle: namely, how companies can catch up with what he calls high-velocity organizations, such as Alcoa, Southwest Airlines, and, of course, Toyota. He argues that the reason companies like these excel is that they accept, first, that because systems are complex, problems are bound to occur, and second, that because processes cross boundaries, problem solving has to cut across functions.

Spear draws on the ideas in his HBR articles but elevates the argument, suggesting that to get to the front of the pack, companies should

- See problems as they occur. He describes this capability in different ways as the book unfolds – a slightly confusing approach that he doesn't explain.
- "Swarm" those problems (by which Spear seems to mean solve them quickly and treat the causes systematically) to create fresh knowledge.
- Share that new knowledge throughout the company.
- Lead – by developing those three capabilities.

Spear's arguments are fascinating, and he pays meticulous attention to detail, but a couple of small issues arise. First, is Toyota really a rabbit? Most people believe that the Japanese company is more like a tortoise: slow, steady, and a long-term thinker – as one of the book's first customer reviews on Amazon pointed out too.

Second – and this is just a personal preference – why didn't Spear write a book about just Toyota? He has packed in a great deal of his research on the company – chapters six to 10 are all about Toyota – but other industries, such as health care, and other companies, such as Alcoa, share the spotlight in the book's first half. There's a lot about Toyota that we still don't know, particularly how it has adapted its systems as it chases growth at an unprecedented pace globally. The strains are showing: In 2009, Toyota is likely to report its first operating loss in 70 years as sales in the United States, Japan, and Europe plunge. This, I daresay, would be the perfect moment to read Spear's description of the changes the company is making to stay ahead of its rivals.

These are mere quibbles, though. I have a dozen books on Toyota stacked on my shelf, in order from the least read to the most referred to – and *Chasing the Rabbit* is probably going to stay right on top of the pile.

– Anand P. Raman

The Truth About Middle Managers: Who They Are, How They Work, Why They Matter

Paul Osterman
(Harvard Business Press, 2009)

American companies have been playing a dangerous game. While promoting a collaborative culture of empowered knowledge workers, they've widened the pay gap between top executives and the rest of the organization. Will the divide make it harder for these executives to lead? Osterman, a business professor, interviewed dozens of middle managers and found them increasingly cynical about their leaders. They're still devoted to their immediate tasks, but they shy away from the cross-departmental work that bosses now urge them to tackle. Osterman also blames declining job security and fewer opportunities for promotion in flattened organizations for their alienation. Though his sample is too small and his historical comparisons are too limited to make his findings definitive, they are provocative.

Helping: How to Offer, Give, and Receive Help

Edgar H. Schein
(Berrett-Koehler, 2009)

Corporate mentoring has changed significantly in the past decade or two: Today's protégés often have serial or topical advisers rather than the godfathers of old. With mentoring now informal and short-lived, both sides have to work harder to establish and maintain productive relationships. Schein, an eminent business professor, provides many anecdotes about mentoring from his consulting practice, and his short, practical book is rich in insights. For instance, he argues that giving help is an inherently threatening act. The recipient fears losing status and often struggles to accept the gift – and perceives advice to be unrealistic or even antagonistic. Helpers are most effective, he says, when they refrain from providing expert diagnosis or advice right off the bat. Instead, they should assist with an inquiry into the problem and only later, after a trusting relationship is established, offer suggestions.

– John T. Landry

A VICIOUS TORNADO. AN UPCOMING RACE. YET THE *ATLANTA MOTOR SPEEDWAY* COULD REMAIN

CALM.

A true story: On July 6, 2005, a powerful tornado tore through Atlanta, leveling everything in its path. When it reached the *Atlanta Motor Speedway*, entire sections of the track vanished. Three-and-a-half months later, the fall race weekend opened as planned. To make this happen, the people at the speedway worked in tight partnership with their FM Global client service team. And the damage was quickly repaired. So on race day, the only wind the fans were aware of came from the cars flying by at 170 mph. **To read more true stories, visit fmglobal.com/insuranceevolved**

Insurance Evolved FM Global®

BY MICHAEL CRAIG MILLER, MD

Getty Images

Go Ahead, Have Regrets

There is an upside.

DURING UNCERTAIN TIMES, people tend to look back and wonder, How did it get to this? They feel more keenly their missed opportunities and failures in judgment. Regret – the sense that things could have turned out better if only a different choice had been made – becomes pervasive.

But regret needn't be a garment rending, self-flagellating emotion. Instead, it can be something to value and use. According to a recent study by Colleen Saffrey at the University of Victoria in Canada and colleagues at the University of Illinois, most people hold regret in high regard. Of all the negative emotions, regret was identified as the most valued because it helped people make sense of life events and remedy what went wrong.

Regret is hardwired into human biology, underscoring its importance in behavior. Advances in neuroimaging show that when a person experiences regret, a part of the brain involved in both reasoning and emotion – the orbitofrontal cortex – becomes active. (It may be comparing real outcomes with imagined alternatives; the precise function is grist for future research.) Neuroscience also tells us that learning probably works best when there is an intense emotional component to it, so it could be that regret bolsters our ability to learn from experience.

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Here are a few suggestions to help you manage this emotion and turn it into a tool for growth.

Beware of hindsight bias. What you should have done always seems clearer in retrospect than it was at the time. As the Danish philosopher Søren Kierkegaard put it, "Life can only be understood backwards, but it must be lived forwards." He might have said, "So don't be so hard on yourself."

Use regret to improve decision making and clarify values. Instead of ruminating over what might have been, let what happened point the way. The regret you may feel from a frank reappraisal of your decision making need not undermine your self-confidence. Rather, it might help you prioritize your investments in relationships, service to the community, meaningful avocations, health, and time, as well as help you set reasonable financial goals.

Balance regret and risk. Instead of choosing a less risky option that you are least likely to regret, choose the one that will maximize your chance of reaching realistic goals. In fact, past experiences of regret may have given you a better appreciation of risk – and what is worth risking – which is a sign of growth.

Don't worry alone, especially if you are drowning in regret. If misery loves company, it's because perspective helps. It's good to know you're not the only "idiot" in the neighborhood. On some level, we're all idiots. The most successful people are those who have been resolute in the face of failure. Support from colleagues, mentors, or coaches can boost your resilience. Sometimes, though, regret spirals downward into depression. If your thoughts turn morbid, get professional help so you can go back to striving toward your personal and career goals.

Michael Craig Miller, *an assistant professor of psychiatry at Harvard Medical School, is the editor of the* Harvard Mental Health Letter. *This article was created in partnership with Harvard Health Publications.*

Reprint R0904A
To order, see page 119.

~~As Numbers Continue to Slide, Many Companies are Finding Comfort in Data Hoarding.~~

Microsoft

"Listen, if there's one thing we can never get enough of, **it's** data," mentioned Erin Hagens, an employee of the North Carolina-based Fabrikam. "As far as I can see, **everybody's** fallen in love with the new system." In this day and age, more CEOs than ever are saying "bring on the numbers," because, according to a recent survey, numbers suggest **business** activity around the office. "It doesn't really matter what the numbers say, just having them means we're doing a good job. Sometimes. Other times it means we're doing a bad job. You really never know."

Indeed, according to Fabrikam's employees the meaning of the numbers isn't the point at all. Which is precisely the point. It has, in fact, become one of the hottest trends in business today. "You pile up numbers, and drop them into conversations in a confusing way, and it's really hard to screw things up at this place. Think of it as a bulletproof vest. Except instead of a vest, it's numbers."

Findings in business science suggest that this might be the best approach for companies to maintain the status quo, at least for a little while. When people are exposed **to** huge numbers, the brain tends to recoil, which can quickly **turn** interest into confusion and/or boredom. In many instances, excess **data** can cause lapses in judgment, cognitive impairment, and slow reaction time. As to whether or not this can be harmful to the business? "We're looking **into** it, but there's really no way to know," mentioned Hagens.

And so far, employees say, it's working. "Hey, my job is pretty cushy, and I'm hoping things stay that way. I just spent eighty thousand **dollars** on a boat."

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HBR Case Study

BY PHIL TERRY

COMMENTARY BY JAITHIRTH RAO,
SUSAN J. ASHFORD,
AND STEPHEN J. SOCOLOF

Who Can Help the CEO?

With pressure mounting for better results, the CEO of TrakVue needs help. But every avenue he tries turns out to be a dead end.

ELIOT ROBBENS STOOD at his living room window. Though it was still dark, he sensed the dawning of a beautiful April Saturday. He gazed at the fading stars above and at the illuminated plaid of Manhattan below and decided – why not? – to indulge himself and do something really fun: go to the office.

There it was. He was a workaholic. The CEO of TrakVue, a struggling but still viable start-up, Eliot felt that none of the pleasures of a warm spring weekend in New York could compare to work. So he rode the elevator 22 floors down to the street and hailed a taxi by waving his BlackBerry aloft, using its bright screen as a beacon.

He was already pecking at his e-mail before the cab had gone a block. Here were the travel details for his upcoming board meeting on the West Coast – his assistant worked nearly the same crazy hours he did. And here was a furtively sent "I love you" message from his wife, Kate, now on day two of a weeklong no-phones, no-internet meditation retreat in Lake Tahoe with two college friends. Then he blinked. An e-mail from Jayson Frantz, his sales VP, had a one-word subject line: "Sorry."

Sorry?

He opened it. A glance was all he needed: "Hard decision…feel really terrible leaving you at this crucial time…" Eliot was stunned. This was bad, really bad. He scrolled up and down, but the message contained no explanation.

He let himself into the office and called Jayson, despite the hour. "What's going on?" he asked.

Jayson clearly didn't want to have this conversation, particularly since he'd just woken up. He spoke vaguely and euphemistically before finally admitting that he'd had an irresistible offer from a competitor in the inbred world of web-based project-management software.

"I'll match it," Eliot said. "I'll *beat* it."

But location was also an issue – the rival was based in Jayson's home state of Washington.

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

Daniel Vasconcellos

"You've been here only six months," Eliot said. "After I hired you, I thought, That's it – now I've got the perfect person in that job."

"Thanks, but – "

"And our being a year behind in our results was your predecessor's fault, not yours. I've told you that. You're doing great."

But it was all too clear that Jayson's mind was made up.

After he hung up, Eliot paced among the empty cubicles. He wanted to talk to someone. He wished Kate weren't out of reach.

He thought of Amory Essler, an old friend and a venture capitalist on TrakVue's board. He would be in London right about now.

"Amory," Eliot said when his friend picked up. "I'm so glad I reached you." He could hear a PA announcement in the background. Amory explained that he was at the airport, about to board a flight to the States. Eliot's heart sank. Amory wouldn't have the time for a phone call like this.

"What's up?" Amory asked.

"I've just lost my sales VP – again!" Eliot said.

"No way."

"I need some advice," Eliot said. "Can you call me later, when you're free to talk?"

"I've got a layover in Chicago, but, Eliot..." Amory sounded flustered. "If you're asking me about a new VP, I don't think I have another really good sales executive in my network. Certainly no one of Jayson's caliber. And don't take this personally, but there's a very real problem with the board's perceiving me as your confidant."

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"Listen," he continued. "I think there's a bigger issue here than just Jayson. I'm going to set you up with an executive coach."

Eliot groaned inwardly. "I'm not sure I need that."

"I'll get you a few names. If the first one doesn't work out, you can try the next one. Keep going until you find one you like."

Eliot wished he hadn't made the call.

Squash-Court Consult

As Eliot went out to the deli for coffee, paper debris swirled and rose from the sidewalk in gusts of wind. The cashier greeted him, as always, with "Hi, Boss."

Boss. It was a position he had longed for during all those years he'd repeatedly tried to scale the corporate hierarchy. There had always been people ahead of him. Then he had been put in charge of an internal venture and, after a year, had proposed that it be spun off, with himself as CEO. He'd been given the green light and had assembled a terrific board for TrakVue; Amory had been the first to say yes.

Eliot relished his new challenges. He loved having to hunt his own game, as he often put it. In the first few months he'd confidently announced a number of ambitious revenue projections – which, two years later, were coming back to bite him.

Frustrated and restless after his coffee, he decided to go to the gym, which was around the corner. He was suited up and ready to run – the treadmills, on an upper floor, had a great view of midtown and of the golden roof of the New York Life building shining among the bricks and stones – when someone called his name. It was Bob Gellingham, a PR guy by trade, who occasionally played squash with Eliot.

"The G," as he liked to be called, suggested they play. "How's your knee?" he asked when they were on the court.

Eliot rubbed it, remembering the diving shot that had won him their last game. "Still sore," he said.

"Good," The G said, winking. "This time I'll have a chance." Gellingham had been on the varsity team in college, but Eliot usually found a way to win.

Maybe it was the knee, maybe it was his head – in any case, Eliot was soon behind. He slammed his racket against the wall. The sound reverberated.

"Rule 23: Don't abuse the equipment," Gellingham said amiably.

There was something appealing about The G, who seemed easygoing and nonjudgmental. While they were taking a water break, Eliot blurted out, "I've just lost a sales VP for the second time." He explained that Jayson's leaving had cranked up the pressure in a particularly rough patch: The board saw Eliot as being a year behind in his results, mainly because of foolish projections he had made two years earlier.

"Foolish projections – they'll kill you every time," The G said.

Eliot repeated what various board members had said to him – that he was having trouble building the kind of team they had expected him to build, that the company wasn't growing as fast as it should. He couldn't bring himself to repeat a warning from one of the directors – that he was "on probation" – but he added that the upcoming directors' meeting might prove to be the denouement.

"Ah, the denouement," said Gellingham, serving the ball.

Eliot reached for the rebound but missed. "I shouldn't have told you all this," he said.

"People always confess their troubles to me," The G said philosophically. "I don't know why. I must look smart." He was a nice guy, Eliot thought, but he didn't look particularly bright. "Here's

> "I think there's a bigger issue here," Amory said. "I'm going to set you up with an executive coach."

what you should do," Gellingham said, pointing his racket at Eliot, who felt a sudden surge of hope. Maybe The G *was* smart. "Land a great big mother of an account. That's what you should do."

Or not. Eliot closed his eyes.

"Better yet," Gellingham said, "land two! Two big mother accounts. That's all you need to do." He picked up the ball, which had rolled into a corner. "The board will forget about everything else."

"But I can't – I can't just go out and land two accounts."

"That's what I would do," said The G.

He hit the ball and it bounced off Eliot's sore knee.

A Cavalcade of Coaches

Eliot's meetings over the next few days with the executive coaches that Amory had lined up were like blind dates. An energetic man with an outmoded pompadour accused Eliot of being in denial about the business's problems. "It's *not* denial," Eliot protested. "I'm more aware of them than anyone else!"

A woman with piercing eyes promised (threatened?) to call and e-mail Eliot multiple times a day to remind him to stay focused on the key task of recruiting a new sales VP. That was just what he needed, Eliot thought: incessant reminders of the obvious.

A man who bore a striking resemblance to Dr. Phil probably did offer some good advice, but it was hard to absorb through the jargon it was wrapped in: "Sure, we all want to stay on the cutting edge, but when we look in that mirror, all we get is socked in the jaw by the unrelenting reality that we're pigeonholing ourselves. In other words, we are our own jailers. Yes. Believe it. Your born-with-it gifting is sorely in need of rounding out, my friend."

Where are the trapdoors when we need them? Eliot thought.

The last coach took a very different approach. She advised Eliot to seek advice. He burst out laughing and said, "Isn't it *your* job to provide that?"

They had met at her office. To put him at ease, she was playing a CD of a flute and guitar duet, but the jazz only made Eliot tense. What she meant, she said, was that Eliot's description of his company's workings indicated that he rarely sought input from anyone: subordinates, peers outside his company, customers. "That might be why you lost your VP."

She suggested that he find colleagues he could speak candidly to – people who would have no agenda except to help him. Eliot shook his head. He resented advice from a person who seemed uninformed about the dynamics of his business. He started to explain, very patiently, why he didn't have the time to search for such people, and that even if he did find someone, he'd never be able to be completely open.

"You sound almost fearful," she said.

"Hardly," Eliot replied. "It's my role as the CEO to be strong and to know how and where to lead the company. My team needs to believe in my plan. I can already sense a rising anxiety when I talk to my people. I need to stay focused and get them to execute or there's no way I'll ever meet my objectives."

At the end of the session he agreed to meet with her again, though he added that it would all be moot if the board fired him.

The insipid quotation made Eliot feel even lonelier. No one seemed to understand his situation.

His Vanishing Mojo

Eliot craned his neck, unsuccessfully trying to get a glimpse of Lake Tahoe as his plane flew westward over the mountains. He missed Kate terribly – he couldn't wait to see her. The plan was for her to meet him in San Francisco the next day, by which time the board meeting would be over and he might be out of a job. He finally reached her by phone when he got to the hotel. He asked if she thought that the retreat, which had just officially ended, had been a life-changing religious experience.

Her friends had been really into it, she said, adding, in her bone-dry way, "But I'm not ready to quit being a Methodist just yet."

There was so much to tell, Eliot said. "Jayson quit, for one thing."

In perfect unison they said, "That's the second sales VP."

Eliot told her he was nowhere near finding a replacement for Jayson, and virtually all of TrakVue's biggest prospects were showing signs of balking, partly because of the economy. He rubbed his knee, which had been aching since the flight. In exasperation, he asked, "What happened to my mojo, Kate?"

"I know what they'd say here at the retreat," she said. *"Speak your mind with confidence. Allow positive consequences to flow."*

The insipid quotation made Eliot feel even lonelier. No one seemed to understand his situation, not even his beloved Kate. Later, as Eliot drove up to the hotel where the board was meeting, he felt as though he had run out of avenues – that there was nowhere to turn for advice that would really help.

Whom and how can Eliot ask for help? Three commentators offer expert advice.

Phil Terry *(pterry@creativegood.com) is the founder of the Creative Good Councils, peer-to-peer leadership and learning networks for senior executives, executives, and associates.*

Jaithirth (Jerry) Rao *(raojerry@hotmail.com) is a visiting entrepreneur at Harvard Business School in Boston and the founder of MphasiS, an IT and business-process outsourcing company that was bought by Electronic Data Systems in 2006.*

I KNOW what it feels like to be in Eliot Robbens's situation. I was running my own company – vastly bigger than his – and we were going through a rough time with our financials. I was keeping all the problems to myself. Outwardly I played an optimistic tune, but I was under a lot of pressure. I wasn't sleeping well.

I was suffering from the myth of the self-reliant leader, the idea that if the CEO is brilliant enough, he doesn't need help from anyone. I've seen this happen to other executives too, including some who have worked for me. Instead of asking for guidance, they try to spin or cover up the truth or practice avoidance, burying themselves in their e-mails. Project managers – especially men – seem the most prone to getting tangled in these webs of their own creation.

I said to myself, "This isn't right. People need to know what I'm going through." So I sent the board a long message explaining the company's situation. I received a few reasonable suggestions, but the important thing was that I had gotten the troubles off my chest and now had a larger group to help bear the responsibility. At least three board members said they thought the problems were trivial and that I shouldn't worry about them. That was a huge relief.

Clarity often emerges after people simply articulate their problems. The catharsis of admitting they need help makes them stronger and more clearheaded.

You have to be careful when choosing a confidant, of course. Colleagues may have agendas that lead them to give detrimental advice. That's why many executives turn to management consultants or coaches. But coaches may fail to perceive the ambiguities in a situation. If a CEO seems paralyzed, it may be because any possible action entails significant risk to the company. Simply telling him that he's paralyzed isn't useful.

Family members can sometimes help. My father once pointed out that by blaming my boss for my unhappiness, I was personalizing my problems. He said my conflict with my boss was "just a signal that maybe you should move on." He was right.

Talking to other executives in a network of peers, especially if they're in industries different from your own, often pays off. Not worrying about competitive issues can free you up to say, "These are the kinds of problems I'm having, and this is what I'm trying. What do you think?" I am told that the Creative Good Councils and other organizations do just this: They bring hundreds of executives together in small groups with competitors separated and diverse industries represented. The group members are encouraged to ask one another for help in meaningful ways. An environment that gives executives license to ask for help can lead to better decision making and better leadership development.

> Talking to a network of peers, especially in different industries, often pays off.

Another approach has worked very well – for me, at least. A couple of my assistants have been excellent sounding boards. Assistants see all of their bosses' correspondence and can be quite insightful. If you develop a decent rapport with them, they will share their insights. I once had an assistant who could get to the nub of things and had some really interesting perspectives. For example, she knew that one of my employees tended to fall so deeply in love with his own ideas that nothing got done. She advised me to insist that he hire an assistant who would keep him on track – a great solution. She was tactful as well as perceptive. I'm sure that if she had thought I was doing something wrong, she would have been able to tell me so without upsetting me. She was that classy.

Wendy Wray

THOUGH ELIOT has been successful in his career, his present troubles expose fault lines that threaten his future. There is a growing consensus among researchers that people learn leadership by carefully reflecting on experience and thoughtfully setting goals for how to proceed. The ability to absorb experience's lessons in this way is known as learning agility. Eliot doesn't yet possess this ability. He reacts rather than reflects, and his actions are based mostly on his anxiety. Whether he keeps or loses his current job as chief executive, his long-term issue is developing learning agility.

But that will require Eliot to admit his weaknesses, which he, like many leaders, isn't comfortable doing. He speaks openly to few people: his friend on the board, his squash opponent, and his wife. They prove to be of little help. He avoids seeking advice from colleagues who might be able to offer him some real guidance. He imagines that they would react negatively, thinking less of him and perhaps feeling nervous about the company's prospects. But in fact the responses would depend to a great extent on Eliot's mind-set and behavior as he sought help.

If he went to his colleagues or directors thinking that he was failing and embarrassed to be seeking guidance, he would indeed engender negative feelings. But people who don't see anything shameful about asking for help tend not to create anxiety in others. Confident people ask for help all the time. They call it getting input.

Eliot might feel greater confidence if he could focus more on the business and less on himself. By keeping the company and its needs at the center of his thinking, he'd reduce the "ego cost" of appearing to be less than all-knowing. This mind-set shift is the hallmark of a true leader.

A significant challenge for Eliot is that the people best able to help him are either below him (subordinates) or above him (the board) in the hierarchy, and any communication across a power differential is difficult. Eliot would have to take certain steps to ensure that he received useful advice.

For one thing, Amory Essler can no longer be his confidant, given their respective roles. All Eliot's interactions with board members (including Amory) should be measured and well considered. Moreover, he should avoid presenting general problems and instead lay out details of the company's situation and propose specific solutions. He should push for focused reactions to his proposals.

Eliot must deal with two typical employee concerns if he seeks input from subordinates: They worry about how they will look (critical, not team players), and they're quick to assume that nothing they say will make a difference. To address those concerns, Eliot needs to work hard to create a culture in which input is valued. He should also take pains to show that any advice he receives from employees is given real consideration.

Despite Eliot's misadventures with coaches, I do think he could benefit from one. To find one who is right for him, he first needs to be clear about why he seeks coaching. I suspect that Amory's goal was to help prepare Eliot for long-term success, not to help him find someone to solve the company's immediate business problems. The coach's role should be to prod Eliot into understanding that he's not just an individual performer now, but is responsible for leading a collective of many people. He must come to realize that the collective needs him to reach out and get help – not just once or twice but on a continuing basis. It's no longer appropriate for him to see himself as the rugged, all-powerful individualist.

Confident people ask for help all the time. They call it getting input.

Susan J. Ashford *(sja@umich.edu) is the associate dean for leadership programming and the executive MBA program and the Michael and Susan Jandernoa Professor of Management and Organizations at the University of Michigan's Stephen M. Ross School of Business in Ann Arbor.*

I've found that sometimes CEOs can surprise you by adapting and growing.

Stephen J. Socolof
(ssocolof@nvpllc.com) is a founder and managing partner of New Venture Partners, a global venture capital firm dedicated to corporate technology spinouts that is headquartered in Murray Hill, New Jersey.

ELIOT IS right to be apprehensive about the upcoming board meeting. One of the biggest things you worry about as a board member of a start-up or a spinout during the company's early growth is whether the CEO is still right for the job. If I were on Eliot's board, I don't know that I'd want to move him out of the CEO position at this point, but I do think there are things a person in his situation can do to reassure his directors and investors about his effectiveness and to solidify his standing.

First, he should make it a practice to ask for help and advice from mentors and other experienced people. A CEO should always have an active network like that, whether formal or informal. One CEO I work with, who came out of a big-company career and wasn't used to the entrepreneurial world, belongs to a peer group of tech CEOs in the Dallas area. He can talk with them about human-resources issues, for example, or ask how best to get a large manufacturing partner to work with him.

The mentors should probably be outside the company; it often doesn't work for a CEO to ask for guidance from an executive he or she works with. Usually the relationships aren't well suited to it and the colleague lacks the kind of knowledge the chief executive needs to tap into. A spinout I work with was started by two partners who came out of the same corporation together. One of them is the CEO of the new venture, and the other is the technical guru. They're close – they're practically joined at the hip. But I don't know that the CEO would feel comfortable asking his partner to comment or advise him on management issues, and if he did, the technical guru probably wouldn't be able to give him a good answer, never having had that kind of experience.

Second, Eliot should regularly ask for help from his board. Maintaining open communication during tough times takes courage, but boards really appreciate it. They want CEOs to get them involved and keep them informed. They definitely don't want to hear about important things indirectly. That only raises their concerns about the CEO.

When a board is first being formed, I usually encourage the new CEO to nominate at least one outside director he or she knows and trusts – a person who is running another company or has corporate leadership experience and may be more sympathetic than the other directors to the CEO. That person can help the CEO communicate better with the board. For example, the CEO of a company I work with in California recruited his old boss as an outside director, so now he has an experienced person he can talk to on the board and can rely on to try to get a little more understanding from the other directors. Amory, Eliot's friend on the board, feels uncomfortable in that role; Eliot should think about finding someone who would be a better liaison.

If I were on that board with Eliot, I'd probably feel that he has a couple of strikes against him for not forming and making use of a network of people who can give him guidance and for not getting the board involved to a great enough extent. But I've found that sometimes CEOs can surprise you by adapting and growing. In one case, the board of a spinout had decided that although the chief executive's heart was certainly in the fight, the company hadn't made enough progress, so it began recruiting an experienced CEO. Meanwhile, the CEO landed a couple of large customers and brought in some investment capital from one of them. The board was so impressed that it called off the search.

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Different Voice

A CONVERSATION WITH
HISTORIAN DORIS KEARNS GOODWIN

Tony Rinaldo

Leadership Lessons from Abraham Lincoln

IN JANUARY 2008, CBS anchor Katie Couric asked Barack Obama which one book he would take with him to the White House, apart from the Bible. The eventual winner of the presidential election singled out *Team of Rivals,* Doris Kearns Goodwin's 2005 best-selling account of President Abraham Lincoln's leadership during the Civil War.

In the months following his election victory, President Obama has made it clear that he is modeling his leadership on the style of his presidential predecessor from Illinois. By bringing heavyweight politicians who are themselves past and future presidential contenders into his cabinet, Obama has reprised Lincoln's strategy of creating a team composed of his most able rivals, people who are unafraid to take issue with him and are confident of their own leadership abilities.

If the new U.S. president can learn from Abraham Lincoln so too can business leaders who are grappling now with similar questions of how to lead in turbulent times. To find out what the lessons from Lincoln are, HBR senior editor Diane Coutu interviewed *Team of Rivals* author Goodwin, a Pulitzer Prize–winning historian whose other books include *No Ordinary Time* (about Franklin and Eleanor Roosevelt and their era), *The Fitzgeralds and the Kennedys,* and *Lyndon Johnson and the American Dream.*

In the course of a wide-ranging, two-hour conversation, Goodwin described the qualities that made it possible for Lincoln to "bring disgruntled opponents together to create the most unusual cabinet in history," offered some advice to the new president as he confronts the current economic crisis, and expressed her belief that the United States will weather this storm as it has weathered worse before. What follows is an abridged and edited version of the interview.

IDEA IN BRIEF

- **Abraham Lincoln's genius was to manage the ambitions and egos of his rivals to form a team that could confront the challenges of civil war.**
- **His ability to create a team of rivals was rooted in an extraordinary level of emotional intelligence. He learned from his mistakes, he shared responsibility for the mistakes of others, and he did not hold grudges.**
- **Lincoln's experience, like that of other presidents in times of emergency, gives hope that the United States and other democracies will weather the current crisis.**

What lessons can President Barack Obama and other leaders take away from studying Abraham Lincoln's presidency?

There are several, but the first one President Obama focused on in discussions during the election campaign concerns the way Lincoln surrounded himself with people, including his rivals, who had strong egos and high ambitions; who felt free to question his authority; and who were unafraid to argue with him.

For example, Lincoln brought Salmon Chase into his cabinet as treasury secretary and kept him there for three years, knowing full well that Chase craved the presidency with every fiber of his being and knowing that Chase was undermining him all the time with cabinet members, Congress, and the rest of the country. So long as he was doing a good job at his post, that was more important than personal feelings. Obama is obviously trying to do the same thing by choosing his chief rival, Hillary Clinton, to be secretary of state; by picking rival Joe Biden as his vice president; and by including powerful Republicans in his cabinet like Robert Gates and Ray LaHood.

But you have to remember, the idea is not just to put your rivals in power – the point is that you must choose the best and most able people in the country, for the good of the country. Lincoln came to power when the nation was in peril, and he had the intelligence, and the self-confidence, to know that he needed the best people by his side, people who were leaders in their own right and who were very aware of their own strengths. That's an important insight whether you're the leader of a country or the CEO of a company.

What's the downside of creating a team of rivals?

If you are as inclusive a leader as Lincoln was, or as President Obama seems to be, then the danger is that you're constantly talking and arguing about things late into the night without reaching a consensus. It can be paralyzing. So you have to be prepared to vote on decisions, and if a vote results in a stalemate, then you have to make the decision yourself and be ready to tell the team, "Like it or not, here's what we're doing."

For example, for months Lincoln let his cabinet debate about if and when slavery should be abolished. Finally, though, he made up his mind to issue his historic Emancipation Proclamation to free the slaves. He brought the cabinet together and told them he no longer needed their thoughts on the main issue – but that he would listen to their suggestions about how best to implement his decision and its timing. So even though some members still did not support Lincoln's decision, they felt they'd been heard. And they had been. When one cabinet member suggested that Lincoln wait for a victory on the field to issue the proclamation, Lincoln took his advice.

You've written biographies of three other American presidents. What, in your opinion, are the essential qualities of a successful leader?

I can't emphasize strongly enough the fact that you've got to surround yourself with people who can argue with you and question your assumptions. It particularly helps if you can bring in people whose temperaments differ from your own.

When Lincoln brought Edwin Stanton into the cabinet in 1862 as secretary of war, for example, Stanton was much tougher, much more secretive, than Lincoln, who was often too kind to subordinates and at times too open. Their opposite temperaments balanced each other out. Where Lincoln was too lenient, issuing pardons for soldiers who had run away from battle to the point of hurting military discipline, Stanton was relentless in his desire to punish cowardice. By working together, pardons were issued, but not in the numbers they had been under Lincoln alone.

You also have to be able to figure out how to share credit for your success with your inner team so that they feel a part of a mission. Basically, you want to create a reservoir of good feeling, and that involves not only acknowledging your errors but even shouldering the blame for the failures of some of your subordinates. Again and again, Lincoln took responsibility for what he did, and he shared responsibility for the mistakes of others, and so people became very loyal to him.

History also shows that it's essential to know how to connect to the larger public, whether that's through radio, in the case of Franklin Roosevelt, or in Lincoln's case, through speeches that were filled with such poetry and clarity that people felt they were watching him think and that he was telling them the truth.

I would add here that one more success factor is key for great leadership, be it in business or politics, and it's one that's usually overlooked. As a leader you need to know how to relax so that you can replenish your energies for the struggles facing you tomorrow.

Lincoln went to the theater about a hundred times while he was in Washington. And although he suffered from a certain melancholy, he had a tremendous sense of humor and would entertain people long into the night with his stories. Franklin Roosevelt was the same way. He had this cocktail hour every evening during World War II when you just couldn't talk about the war. He needed to remain free from thinking about the bad things for a few hours. Or he would play with his stamps. This ability to recharge your batteries in the midst of great stress and crisis is crucial for successful leadership.

More books have been written on Lincoln than on any other American president. What does Lincoln's magic as a leader really come down to?
Well, it wasn't anything so immediately felt as charisma. In fact, it took the country some time to warm to Lincoln; his popularity almost came from the inside out. His cabinet was the first to see something unusual about him.

Take William Seward, who originally was a rival. Some eight weeks after becoming secretary of state, Seward wrote to his wife that Lincoln was unlike anyone he'd ever known. Other members of the cabinet came to think so, too. One after another, they came to power thinking Lincoln was rather unexceptional and ended up believing that he was as near a perfect man as anyone they'd ever met.

What Lincoln had, it seems to me, was an extraordinary amount of emotional intelligence. He was able to acknowledge his errors and learn from his mistakes to a remarkable degree. He was careful to put past hurts behind him and never allowed wounds to fester. The rare example I could find of Lincoln's being unable to forgive someone was his father. Lincoln never visited his father when he was dying, which suggests that he could not let go of the anger he felt toward the man who considered the future president's fierce desire to learn a sign of laziness.

He had flaws, of course; every leader has flaws. Lincoln's greatest flaw came out of his strength, which was generally liking people and not wanting to hurt them. He always wanted to give somebody a second or even a third chance. This weakness proved disastrous with George McClellan, who was head of the Union Army for some months near the beginning of the war. Lincoln should have fired McClellan within weeks of seeing how narcissistic and insubordinate he was. In part, Lincoln didn't because

> Again and again, Lincoln shared responsibility for others' mistakes, and so people became very loyal to him.

at that time he didn't have enough confidence in his own understanding of military affairs. He was still learning about how to wage war by going to the Library of Congress and reading books on military strategy. But in the end it was his inability to hurt people that made Lincoln keep McClellan on far too long. As a result, battles were lost, and thousands of soldiers died who might have lived had Lincoln fired McClellan earlier. So it wasn't just a small flaw.

In your biography of Lincoln, you rely heavily on the intimate letters between wives and husbands. What will historians do without such letters in the future?
It's a big issue for historians – and for leaders who are trying to learn from history – because traditionally it's in people's private correspondence that you get the emotional understanding of what leaders are really feeling and doing as history is being made.

Unfortunately, Lincoln left few personal letters, but Seward would write to his wife daily to tell her what Lincoln did that day or about some of the arguments that went on in the cabinet, and those letters provide a unique insight into what Lincoln thought and felt as great decisions were being made.

Looking back, the thing that's really impressive is that here were these leaders running the Civil War, and people like Seward still had time to meditate on the day's events and to write these long letters to his wife at night. These were the days of no television. Leaders weren't worried about cable news or their BlackBerrys. They weren't multitasking; they had time to reflect. It's a luxury many leaders just don't have today, and that's a real loss.

For historians, the biggest loss is going to be the time between the rise of the telephone in the 1940s and the advent of e-mail in the 1990s. There's a 50-year period that is almost completely gone from history, unless, like Richard Nixon and Lyndon Johnson, you taped conversations. Today, at least we have e-mails, which are in some way reviving the art of letter writing. I don't know whether or not, 200 years from now, we'll be able to retrieve e-mails found on old computers. But I think – or at least I hope – that if people send a long e-mail to somebody now, and they know it's something important, they will have the foresight to print it out.

> There was no TV or cable news or BlackBerrys. Leaders weren't multitasking; they had time to reflect.

Obama took your book with him to the Oval Office. What else would you recommend he read?
Obama does seem to have a sense of history, and were I to speak with him again, I would suggest that he read about other presidents going through difficult times. I would certainly recommend Roosevelt's fireside chats, where he explains in such simple language terribly complicated problems like the banking crisis, the economic crisis, and the war. And since Obama is interested in the moments in history when people come together to produce change from the bottom up, he also might want to look at the Progressive movement at the turn of the twentieth century – which led to curbs on the giant trusts, pure-food-and-drug legislation, railroad

regulation, and conservation measures – or the civil rights movement, to learn how it created the pressure that allowed the voting rights and desegregation acts to pass.

I find it interesting, though, that Lincoln didn't read biographies – at least you don't hear about him reading of Washington or Jefferson, the people you would imagine he'd be very interested in. He was more impressed by their words. It's the documents of American history – the Constitution and the Declaration of Independence – that became his inspiration. He said himself that he never had a thought that didn't come from the Declaration of Independence. If Lincoln is Obama's role model, then he might want to go back to those documents and study them in great detail. I think that appreciating them and their great promise is what makes you understand what hope is all about.

Do you really have such hope when everything seems to be crashing down around us?

Yes, I really do. In times of crisis, things become possible that wouldn't be possible in ordinary times. The way the U.S. government is set up, with so many checks and balances, means that it almost takes a deep crisis to move forward. So there are only certain moments in history when great change can take place. FDR had this opportunity in the Depression; Lincoln did during the Civil War. Obama has that same great opportunity now. The challenges Americans are now facing give him a chance to pull the country together in new ways, working across party lines.

Also, history is a great reminder that, however bad things look today, they've been worse before, and Americans still pulled through. Today's crisis is not as bad as the Great Depression, let alone the Civil War that Lincoln confronted. One of my favorite FDR speeches is one he made in 1942 that was very similar to Obama's victory speech in Chicago. FDR warned his listeners that there would be many failures before the country won World War II. But he reminded them that America had faced disasters before and had come out the other side. Despite the cruel winter at Valley Forge, for example, Americans still won independence. FDR's speech was so successful that thousands of affirming telegrams flooded into the White House.

Obviously there's a fine line between optimism that's simply not credible and a sense of real confidence that there's something about the United States and its people and its system that's going to make the country pull together and get out of this hole. Roosevelt once said something like, "The most efficient dictatorship could never compete with the free energies of a free people in a democratic system." I think that's right – and not just for the United States but for democracies around the world.

Of all the politicians you've written about – the Kennedys and the Fitzgeralds, FDR, LBJ, Lincoln, and now Theodore Roosevelt – whom would you choose to spend an evening with?

Lincoln, without question. It took me 10 years to write his biography, and he was a very amiable companion all those years.

If I did get to meet him, though, I wouldn't ask him what I, as a historian, know I'm supposed to ask him – about what he would have done to bring the country together after the Civil War, had he lived. I'd ask him to tell me stories. Everyone remarked upon his extraordinary sense of humor, and he was widely admired as a storyteller. He said himself that a good story is better than a drop of whiskey. I'd just sit at the kitchen table with him and have him tell me one story after another, for then he would truly come to life again.

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To order, see page 119.

The 50th Annual McKinsey Awards

RECOGNIZING EXCELLENCE IN MANAGEMENT THINKING

Harvard Business Review is pleased to announce the 2008 McKinsey Award winners. Two articles share first place: "Can You Say What Your Strategy Is?" by David J. Collis and the late Michael G. Rukstad, and "When Growth Stalls," by Matthew S. Olson, Derek van Bever, and Seth Verry. Second place goes to "Reinventing Your Business Model," by Mark W. Johnson, Clayton M. Christensen, and Henning Kagermann.

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Since 1959, McKinsey & Company and *Harvard Business Review* have presented annual awards recognizing the best articles published each year in the magazine. The awards are judged by an independent panel of business leaders and scholars. (See page 50 for a list of the judges.)

HBR congratulates 2008's winning authors and invites readers to go to hbr.org to explore 50 years of agenda-setting management ideas from past award recipients, including Michael E. Porter, Peter F. Drucker, Gary Hamel, and others.

FIRST-PLACE WINNERS (TIE)

DAVID J. COLLIS AND MICHAEL G. RUKSTAD

"Can You Say What Your Strategy Is?"

April 2008

It's a dirty little secret: Most executives can't articulate their business strategy in a simple statement. And if they cannot, of course, then neither can anyone else.

In this article Harvard Business School's Collis and (the late) Rukstad urge companies to develop a clear, concise definition of their strategy. Most executives, however, don't even know what all the elements of a strategy statement are, which makes it impossible for them to develop one. Once they understand the components, two things happen: Formulation becomes easier because they know what they're trying to create. And implementation becomes much simpler because the strategy's essence can be easily communicated to and internalized by all employees. Using the brokerage firm Edward Jones as an example, the authors show how the process of defining the objectives, scope, and advantage of a strategy will force companies to make trade-offs and find the sweet spot where their capabilities and customers' needs align in a way that competitors cannot match.

This article is a reminder that rhetoric should not be underestimated. Words can lead to action. A simple 35-word strategy statement can energize employees and improve long-term company performance.

David J. Collis *(dcollis@hbs.edu) is an adjunct professor at Harvard Business School in Boston and the author of several books on corporate strategy.* **Michael G. Rukstad** *was a senior research fellow at Harvard Business School, where he taught for many years until his death in 2006.*

WINNERS | 2008

MATTHEW S. OLSON, DEREK VAN BEVER, AND SETH VERRY

"When Growth Stalls"

March 2008

An abrupt and lasting drop in revenue growth is a crisis that can strike even the most exemplary organization. And unless its management can turn the company around within a few years, odds are, it will never again see healthy growth.

Drawing on in-depth research and sobering analysis, Olson, van Bever, and Verry uncover and categorize the most common causes of stalled growth. In doing so they refute a number of common assumptions – for example, that big external factors like economic downturns most commonly bring companies down. In fact, executives may be surprised to discover, the biggest threat to companies' continued growth is poor management decisions about strategy or organizational design.

The authors offer a diagnostic that will help executives guard against these hazards and continually test the accuracy of their strategic worldview. This powerful article shows that whatever other concerns on the strategy agenda are, guarding against growth stalls should be at the top.

Matthew S. Olson *(olsonm@executiveboard.com) is an executive director,* **Derek van Bever** *(vanbeverd@executiveboard.com) is the chief research officer, and* **Seth Verry** *(verrys@executiveboard.com) is a senior director at the Corporate Executive Board, an advisory network of leaders of the world's largest public and private organizations, based in Washington, DC. Olson and van Bever are the authors of* Stall Points *(Yale University Press, 2008).*

SECOND-PLACE WINNER

MARK W. JOHNSON, CLAYTON M. CHRISTENSEN, AND HENNING KAGERMANN

"Reinventing Your Business Model"

December 2008

All businesses eventually have to reinvent themselves or suffer the consequences. In a turbulent economy rocked by market disruptions, reinvention has become a matter of survival. Indeed, a recent survey shows that two-thirds of corporate CEOs believe that extensive changes to their business models are required.

Too bad, then, that so few companies understand their current business model well enough to change it to capture a new opportunity. Into this confusion comes this timely article by Johnson, Christensen, and Kagermann. The authors offer a practical definition of the much-misunderstood term "business model," a guide for knowing when it's time to throw the old model out and build a new one, and a description of the barriers that organizations create to avoid having to do that.

Groundbreaking new business models have reshaped entire industries and redistributed billions of dollars of value – Apple's iPod and iTunes Store combination is a striking example of how smart business model innovation can catapult a company to market leadership. But as the authors show, truly transformative businesses are never exclusively about the discovery and commercialization of a great technology or product. Their success comes from enveloping those things in an appropriate, powerful business model.

Mark W. Johnson *(mjohnson@innosight.com) is the chairman of Innosight, an innovation and strategy-consulting firm he cofounded in 2000 with* **Clayton M. Christensen** *(cchristensen@hbs.edu), the Robert and Jane Cizik Professor of Business Administration at Harvard Business School. They are both based in Boston.* **Henning Kagermann** *(henning.kagermann@sap.com) is the co-CEO of SAP AG, in Walldorf, Germany. Johnson is the author of* Seizing the White Space: Business Model Innovation for Transformative Growth and Renewal *(Harvard Business Press, forthcoming in 2009).*

JUDGES

McKinsey Awards

HBR wishes to thank this year's panel of judges for their hard work on behalf of the 2008 awards.

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FINANCIAL CRISIS SPOTLIGHT

HOW TO MARKET IN A DOWNTURN

IN EVERY RECESSION marketers find themselves in poorly charted waters because no two downturns are exactly alike. However, in studying the marketing successes and failures of dozens of companies as they've navigated recessions from the 1970s onward, we've identified patterns in consumers' behavior and firms' strategies that either propel or undermine performance. Companies need to understand the evolving consumption patterns and fine-tune their strategies accordingly.

During recessions, of course, consumers set stricter priorities and reduce their spending. As sales start to drop, businesses typically cut costs, reduce prices, and postpone new investments. Marketing expenditures in areas from communications to research are

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STOP
Sale

often slashed across the board – but such indiscriminate cost cutting is a mistake.

Although it's wise to contain costs, failing to support brands or examine core customers' changing needs can jeopardize performance over the long term. Companies that put customer needs under the microscope, take a scalpel rather than a cleaver to the marketing budget, and nimbly adjust strategies, tactics, and product offerings in response to shifting demand are more likely than others to flourish both during and after a recession.

IDEA IN BRIEF

» In recessions, companies must understand customers' shifting needs and then adjust their communications strategies and offerings.

» Marketers should segment customers according to their recession psychology (from fearful to carefree) and how they categorize their purchases (from essentials to expendables).

» Through carefully targeted appeals, brands can connect emotionally with consumers – as Crest did with its Whitestrips ads during the 2008 holiday season, for instance. Aleve connected with people, too, when it reminded them that buying the brand is a sound decision. ("That's value. That's Aleve.")

» Companies that employ such tactics will perform better now and in the long run than those that make cuts across the board.

Understanding Recession Psychology

In frothy periods of national prosperity, marketers may forget that rising sales aren't caused by clever advertising and appealing products alone. Purchases depend on consumers' having disposable income, feeling confident about their future, trusting in business and the economy, and embracing lifestyles and values that encourage consumption.

But by all accounts, this recession is the severest since the Great Depression. The wave of bad economic news is eroding confidence and buying power, driving consumers to adjust their behavior in fundamental and perhaps permanent ways. They now realize that spending in much of Europe and the United States over the past two to three decades was built on a quicksand of debt and dwindling savings and home equity. Marketers abetted consumers in defining the good life in material terms and urging them to live beyond their means. In the ensuing meltdown, consumers face piles of bills, stagnant or falling incomes, and shrinking nest eggs. At the same time, a series of corporate scandals; failures in the financial, housing, and insurance sectors; and taxpayer bailouts of mismanaged businesses have fostered consumer distrust and skepticism of marketers' messages. It's no surprise that in January 2009 the Conference Board's U.S. Consumer Confidence Index sank to the lowest level since tracking started in 1967.

These combined effects create a profound challenge for marketers, not only during the downturn but in the recovery that will eventually follow. The first step in responding must be to understand the new customer segments that emerge in a recession. Marketers typically segment according to demographics ("over 40," say, or "new parent" or "middle income") or lifestyle ("traditionalist" or "going green"). In a recession such segmentations may be less relevant than a psychological segmentation that takes into consideration consumers' emotional reactions to the economic environment.

Think of your customers as falling into four groups:

The *slam-on-the-brakes* segment feels most vulnerable and hardest hit financially. This group reduces all types of spending by eliminating, postponing, decreasing, or substituting purchases. Although lower-income consumers typically fall into this segment, anxious higher-income consumers can as well, particularly if health or income circumstances change for the worse.

Pained-but-patient consumers tend to be resilient and optimistic about the long term but less confident about the prospects for recovery in the near term or their ability to maintain their standard of living. Like slam-on-the-brakes consumers, they economize in all areas, though less aggressively. They constitute the largest segment and include the great majority of households unscathed by unemployment, representing a wide range of income levels. As news gets worse, pained-but-patient consumers increasingly migrate into the slam-on-the-brakes segment.

Comfortably well-off consumers feel secure about their ability to ride out current and future bumps in the economy. They consume at near-prerecession levels, though now they tend to be a little more selective (and less conspicuous) about their purchases. The segment consists primarily of people in the top 5% income bracket. It also includes those who are less wealthy but feel confident about the stability of their finances – the comfortably retired, for example, or investors who got out of the market early or had their money in low-risk investments such as CDs.

The *live-for-today* segment carries on as usual and for the most part remains unconcerned about savings. The consumers in this group respond to the recession mainly by extending their timetables for making major purchases. Typically urban and younger, they are more likely to rent than to own, and they spend on experiences rather than stuff (with the exception of consumer electronics). They're unlikely to change their consumption behavior unless they become unemployed.

Regardless of which group consumers belong to, they prioritize consumption by sorting products and services into four categories:

- *Essentials* are necessary for survival or perceived as central to well-being.

- *Treats* are indulgences whose immediate purchase is considered justifiable.
- *Postponables* are needed or desired items whose purchase can be reasonably put off.
- *Expendables* are perceived as unnecessary or unjustifiable.

All consumers consider basic levels of food, shelter, and clothing to be essentials, and most would put transportation and medical care in that category. Beyond that, the assignment of particular goods and services to the various categories is highly idiosyncratic.

Throughout a downturn, all consumers except those in the live-for-today segment typically reevaluate their consumption priorities. We know from previous recessions that such products and services as restaurant dining, travel, arts and entertainment, new clothing, automobiles, appliances, and consumer electronics can quickly shift in consumers' minds from essentials to treats, postponables, or even expendables, depending on the individual. As priorities change, consumers may altogether eliminate purchases in certain categories, such as household services (cleaning, lawn care, snow removal), moving them from essentials, say, into expendables. Or they may substitute purchases in one category for purchases in another, perhaps swapping dining out (a treat) for cooking at home (an essential). And because most consumers become more price sensitive and less brand loyal during recessions, they can be expected to seek out favorite products and brands at reduced prices or settle for less-preferred alternatives. For example, they may choose cheaper private labels or switch from organic to nonorganic foods. (See the exhibit "Consumer Segments' Changing Behavior.")

IDEA IN
PRACTICE

During a downturn, changing patterns in consumers' behavior and companies' marketing strategies either propel or undermine performance. The firms that understand consumers' recession psychology and fine-tune marketing efforts and product portfolios accordingly are the most likely to prosper throughout the recession and afterward.

Understand recession psychology. Divide customers into four groups based on their emotional response to the recession: a hard-hit *slam-on-the-brakes* segment, which curtails all spending; a *pained-but-patient* segment, which selectively economizes; a *comfortably well-off* segment, whose high-end purchasing continues, if less conspicuously; and a *live-for-today* segment, whose spending remains largely unchanged. Next, assess how each segment allocates its purchases among the following categories: *essentials, treats, postponables,* and *expendables.*

EXAMPLE Slam-on-the-brakes consumers will reduce purchases overall and seek lower-cost substitute brands for essentials such as groceries, deeply reduce or eliminate treats such as dining out, delay purchases of postponables such as dental cleanings, and eliminate purchases of expendables such as resort vacations.

Manage investments. Use your analysis to determine which brands have the poorest prospects, and cut them loose. Stabilize core brands by maintaining or increasing marketing investments, make strategic brand acquisitions, and launch new products with care. You'll also need to balance the communications budget, shifting spending to ads with more-measurable results and higher ROI.

EXAMPLE In the 2001 downturn, Smucker's acquired the Jif and Crisco brands from Procter & Gamble. These brands were too small for P&G and not in a core category but proved to be a good strategic fit for Smucker's. P&G, meanwhile, successfully launched the Swiffer WetJet to establish a new category.

Market throughout the recession. Drive short-term sales while investing in long-term brand health in three ways: Reduce complexity (such as trivial differences among models) in product portfolios by killing offerings, make products and services more affordable (for example, with lower thresholds for quantity discounts), and bolster trust (by treating customers well and reinforcing their emotional connection with the brand).

EXAMPLE To build trust, some supermarkets have prepared flyers describing nutritious, low-cost meals. American Express took a different tack by inviting card members to vote on which charity the company would support on their behalf.

Managing Marketing Investments

During recessions it's more important than ever to remember that loyal customers are the primary, enduring source of cash flow and organic growth. Marketing isn't optional – it's a "good cost," essential to bringing in revenues from these key customers and others.

Still, company budget cuts often affect marketing disproportionately. Marketing communication costs can be trimmed more quickly than production costs – and without letting people go. In managing their marketing expenses, however, businesses must take care to distinguish between the necessary and the wasteful. Building and maintaining strong brands – ones that customers recognize and trust – remains one of the best ways to reduce business risk. The stock prices of companies with strong brands, such as Colgate-Palmolive and Johnson & Johnson, have held up better in recessions than those of large consumer product companies with less well-known brands.

Surgically trimming the budget is easier to do during a downturn than in prosperous times. Tough times provide an imperative to cut loose poor performers and eliminate low-yield tactics. When survival is at stake, it is easier to get companywide buy-in for revising marketing strategies and reallocating investments. Managers can defy old mind-sets and creatively search for superior solutions to customer needs instead of relying on the next line extension. The challenge is to make well-defended, case-by-case recommendations about where to cut spending, where to hold it steady, and even where to increase it.

Assess opportunities. Begin by performing triage on your brands and products or services. Determine which have poor survival prospects, which may suffer declining sales but can be stabilized, and which are likely to flourish during the recession and afterward.

Your strategic opportunities during the downturn will strongly depend on which of the four segments your core customers belong to and how they categorize your products or services. For example, prospects are reasonably good for value-brand essentials sold to slam-on-the-brakes consumers, who will forgo premium brands in favor of lower prices. Value brands can also effectively reach out to pained-but-patient consumers who previously bought higher-end brands, a strategy Wal-Mart aggressively used with its "everyday low prices" policy in the 2001 recession. Value brands have opportunities

Consumer Segments' Changing Behavior

KEY
STABLE MARKET Slight or no change in opportunities for companies
MIXED MARKET Slight or no change for stronger competitors; a reduction for others
DECLINING MARKET Substantial reduction in opportunities for companies

RISK OF SALES DOWNTURN: LOW → HIGH
BEHAVIOR CHANGE: HIGH (top) → LOW (bottom)

	ESSENTIALS	TREATS	POSTPONABLES	EXPENDABLES
Slam-on-the-Brakes	Will seek lower-cost product and brand substitutes such as private labels	Will deeply reduce or eliminate treats or seek lower-cost substitutes	Will put off all durable purchases unless forced to make emergency replacements; will delay repairs and personal services, such as dental cleanings	Will eliminate purchases in this category
Pained-but-Patient	Will seek out favorite brands at lower prices but settle for cheaper, less-preferred alternatives; will stock up on good deals	Will cut back somewhat on frequency and quantity and emphasize value	Will delay major purchases, repair rather than replace, seek value and low ownership costs rather than extra features, and negotiate at point of sale	Will deeply curtail expendables
Comfortably Well-Off	Will continue to buy favorite brands at prerecession levels	Will be more selective in purchasing luxuries	Will seek better quality for the price; will negotiate harder at point of sale	Rarely regards any purchase as unjustifiable but may reduce the most conspicuous consumption in this category
Live-for-Today	Will continue to buy favorite brands at prerecession levels	Will continue to buy favorite brands at prerecession levels	May buy if there is a great deal; otherwise may postpone	Is reluctant to regard any customary purchase as unjustifiable; may not want to expand consumption to new types of purchases

with postponable products, as well. Repair services can market to the pained-but-patient group, who will try to prolong the life of a refrigerator rather than buy a new one.

Where the business opportunities are uncertain or declining, it may be time to part with brands or products that were ailing prior to the recession and are on life support now. For those that remain, companies should concentrate their marketing resources on maintaining relevance to core customers in order to sustain brands through the recession and into the recovery.

Allocate for the long term. When sales start to decline, companies shouldn't panic and alter a brand's fundamental proposition or positioning. For instance, marketers catering to middle- or upper-income consumers in the pained-but-patient segment may be tempted to move down-market. This could confuse and alienate loyal customers; it could also provoke stiff resistance from competitors whose operations are geared to a low-cost strategy and who have intimate knowledge of cost-conscious customers. Marketers that drift away from their established base may attract some new customers in the near term but find themselves in a weaker position when the recession ends. Their best course is to stabilize the brand. Even cash-poor firms would be wise to commit a substantial portion of their marketing resources to reinforcing the core brand proposition. Reminding consumers of how the brand matters can add to the cushion provided by previous investments in building the brand and customer satisfaction. De Beers came to this realization after it reduced its U.S. marketing budget early in 2008 in response to the grim economic outlook. When research revealed that diamonds represent enduring value to a majority of consumers, the company doubled its Christmas advertising spending over the previous year's. Brand-awareness ads in several media proclaimed, "Here's to less," and enjoined us to buy "fewer, better things" because "a diamond is forever." Although Christmas sales in the United States softened compared with the previous year's, prices were stable – and trends in consumers' desire to buy diamonds remained healthy.

Where opportunities are stable or uncertain (but leaning toward stable), firms should push their advantage. In past downturns, consumer goods companies that were able to increase share of voice by maintaining or increasing their advertising spending captured market share from weaker rivals. What's more, they did it at lower cost than when times were good. On average, increases in marketing spending during a recession have boosted financial performance throughout the year following the recession. (Of course, not all increases have raised performance. Therefore, especially in the current, deep recession, resources should be judiciously targeted to viable business opportunities.) Firms with deep pockets can make cost-effective acquisitions that strengthen their brand portfolio or customer base. In the 2001 downturn, Smucker's acquired the Jif and Crisco brands from Procter & Gamble. These brands were too small for P&G and not in any of its core categories, but they proved to be a good strategic fit for Smucker's. In the current recession, Smucker's is acquiring another such brand from P&G – Folgers. Though it does not meet P&G's margin targets, with renewed marketing attention it has the potential to be an important source of future sales for Smucker's.

In deciding which marketing tactics to employ, it's critical to track how customers are reassessing priorities, reallocating budgets, switching among brands and product categories, and redefining value. It's therefore essential to continue investing in market research. As the recession winds down, consumers will regain buying capacity but possibly will not return to their old purchasing patterns. Market research should explore whether consumers will go back to familiar brands and products, stay with substitute products, or welcome innovations.

It's critical to track how customers reassess priorities, reallocate funds, switch brands, and redefine value.

In recessions, marketers have to stay flexible, adjusting their strategies and tactics on the assumption of a long, difficult slump and yet be able to respond quickly to the upturn when it comes. This means, for example, having a pipeline of innovations ready to roll out on short notice. Most consumers will be ready to try a variety of new products once the economy improves. Companies that wait until the economy is in full recovery to ramp up will be at the mercy of better-prepared competitors. Even during a recession, new products have an important place. Live-for-today customers, with their undiminished appetite for goods and experiences, often appreciate novelty. And the other segments will embrace new products that offer clear value compared with alternatives. Because new-product activity slows in recessions overall, launches can economically gain visibility. In 2001, for example, Procter & Gamble's successful introduction of the Swiffer WetJet established a new product category that eased the chore of mopping floors and weaned consumers away from cheaper alternatives.

Balance the communications budget. During recessions cash-strapped marketing departments are under pressure to do more with less and demonstrate high returns on investment. Typically, the share of the advertising budget devoted to broadcast media shrinks, whereas the share that goes toward efforts with more-measurable results, such as direct marketing campaigns and online ads, grows. Point-of-purchase marketing – promoting price cuts or generating in-store excitement – also tends to pick up during recessions.

Internet advertising in particular is targeted and relatively cheap, and its performance is easily measured. Despite a deepening recession, marketers spent 14% more on online ads over the first three quarters of 2008 than they did over the same time frame in the previous year. Another factor driving this growth in digital-ad spending is consumers' migration to online social media such as MySpace, Facebook, and LinkedIn, which help people intensify networking efforts amid layoffs and a tough job market. The new-member sign-up rate at LinkedIn, a site that focuses on professional networking, has doubled in the past year.

That said, broadcast media still remain important for building mass-market consumer brands. Although strong brands can be carried for a period on the momentum of previous brand-building investments, no brand can afford to coast solely on earlier efforts. Brands that are out of sight on the television screen will sooner or later be out of mind for a large percentage of consumers. Indeed, while advertising in newspapers and magazines and on radio and local television all declined in 2008, advertising on the four national broadcast television networks in the United States remained steady.

Tailoring Your Tactics

	ESSENTIALS	TREATS	POSTPONABLES	EXPENDABLES
Slam-on-the-Brakes	▪ Emphasize price; hit wallet-friendly retail price points ▪ Offer smaller pack sizes for less money ▪ Expand retailer private labels ▪ Promote low-cost value products ▪ Introduce fighter brand	▪ Shrink sizes ▪ Hold prices down ▪ Advertise as a "you deserve it" small indulgence	▪ Offer layaway plans ▪ Provide low-cost financing ▪ Promote exceptional deals ▪ Challenge penny-wise, pound-foolish behavior (such as dangerously postponing tire replacement)	▪ Offer do-it-yourself alternatives to doing without ▪ Continue awareness advertising (for instance, for future vacations)
Pained-but-Patient	▪ Offer a lower-priced option ▪ Hit retail price points ▪ Promote bonus packs to encourage stockpiling ▪ Emphasize dependability of branded product or service	▪ Reward loyal consumers, even if they consume less (for example, offer frequent-patron points) ▪ Advertise products as morale raisers ▪ Advertise products as affordable alternatives to more expensive luxuries	▪ Offer simpler models, lower prices ▪ Promote lower-operation-cost models ▪ Promote repair services	▪ Continue awareness advertising ▪ Invest in core product improvements that will accelerate customers' reentry into the market
Comfortably Well-Off	▪ Continue awareness advertising	▪ Emphasize outstanding quality ▪ Advertise as a product you deserve because you are successful	▪ Promote savings from buying now ▪ Advise customers they're "missing out" by postponing	▪ Enable discreet purchasing that avoids the appearance of flaunting in front of less wealthy people ▪ Advertise benefits of impressing wealthy friends
Live-for-Today	▪ Continue awareness advertising ▪ Remind consumers, "You can't live without it"	▪ Offer convenient automatic credit card billing ▪ Promote as opportunity to seize the moment	▪ Offer monthly payment plans ▪ Promote quality-of-life benefits of buying now	▪ Offer exciting new products and promote as "must have" ▪ Advertise as products you can aspire to buy when your income grows

Consider how PepsiCo has adjusted its marketing: Management first used past experience to assess the impact the downturn would have on each category of drinks. It then reassigned marketing resources to volume-growth opportunities rather than making across-the-board cuts. For instance, even though carbonated beverages (especially nondiet) had been gradually losing share before the recession, consumers consider them to be a good refreshment value – so management reasoned that the recession should not force a steep decline in the category. All four consumer segments view them as either essentials or treats, and the tried-and-true Pepsi brand should hold up well in a recession.

PepsiCo's goal is to reinvigorate its carbonated soft drink category with substantially increased marketing investments in Pepsi, Mountain Dew, and other products. These investments include a new upbeat "Optimism" ad campaign, new packaging, and new point-of-purchase materials. PepsiCo also plans to increase activity in digital media specifically to target the youthful live-for-today segment.

Marketing Throughout a Recession

During downturns, marketers must balance efforts to pare costs and shore up short-term sales against investments in long-term brand health. Streamlining product portfolios, improving affordability, and bolstering trust are three effective ways of meeting these goals. (See the exhibit "Tailoring Your Tactics" for a detailed look at how to appeal to each consumer segment.)

Streamline product portfolios. In the comparatively mild recession of 2001, marketers were able to get by with temporary, minor adjustments to production quantities and avoid wholesale revisions of prices or product lines. In a deeper recession, marketers can benefit by cleaning up their product lines and so should seize the initiative early rather than waiting to be forced into making changes.

When faced with declining demand, marketers should continue to reduce excessive complexity in product lines that feature too many marginally performing sizes and flavors or trivial differences among product models. Overly broad product lines soak up marketing costs and tie up resources and working capital in slow-moving inventory. However, as we said before, streamlining the product portfolio does not mean shutting down the innovation pipeline. Innovative improvements to core products will grab attention and motivate purchases, particularly of expendable goods and services.

Realignment with market conditions requires frequent reforecasting of demand for each item in a product line as customers' buying habits shift. For instance, slam-on-the-brakes consumers will sacrifice variety or customization in favor of simplicity and lower prices on essentials and treats. In the case of durables purchases that cannot be postponed, pained-but-patient consumers will trade down to models that stress good value rather than enhanced features. Consumers in both segments will reject products with features that diminish durability or increase operating costs.

Improve affordability. Slam-on-the-brakes and pained-but-patient customers in particular will be shopping around for the best deals. All businesses will increasingly compete on price.

In tough times, discounts that require little effort from consumers and give cash back at the point of sale are more effective than delayed-value promotions such as sweepstakes and mail-in offers. Many marketers will need to increase the frequency and depth of temporary price promotions. At the same time, they must carefully monitor consumers' perceptions of "normal" price levels: Excessive promotions lead consumers to revise their expectations about prices downward and can threaten profitability in the recovery period because people will resist the steep increases as prices return to "normal." Extreme price deals can also lead to costly price wars.

While premium-brand market leaders shouldn't move their brands down-market, they can introduce a "fighter brand," a lower-priced version of the premium offering sold under a

7 Smart Ways to Economize on Advertising

1. Shift from 30-second to 15-second television spots.
2. Substitute cheaper radio advertising for television, especially when it's important to deliver frequent messages in order to remind consumers to act.
3. Switch to media that allow precise targeting of consumers and detailed tracking of their response. For example, choose search-related advertising on Google over banner advertising.
4. Advertise brands jointly with a marketer in a different product category that targets a similar consumer segment.
5. Adapt or extend an existing campaign rather than commission a costly new campaign.
6. Consolidate advertising at a single agency to maximize media-buying discounts.
7. Avoid long-term media commitments at the outset of the downturn; wait for falling spot rates before buying media. Companies with deep pockets should consider locking in favorable rates for the future.

different name and backed by minimal advertising. On the heels of the 1991–1992 recession, Anheuser-Busch, for example, introduced its Natural Pilsner brand, priced lower than Budweiser, and Miller brought out value-priced Colders 29; in the early 1980s downturn, Procter & Gamble developed Banner as a cheaper alternative to Charmin. When the recession ends, the fighter brand can either be quietly withdrawn or continue as a value entry in the overall product line.

Restaurants and other businesses often configure offerings by using key retail price points proven to resonate with customers, as with the 99-cent burger or the $399 dishwasher. PepsiCo sets prices suited to different consumer segments – for example, selling the 24-pack size at $5.99 for pained-but-patient consumers who can afford to stock up as well as the two-liter bottle at 99 cents for slam-on-the-brakes consumers with slim wallets.

In addition to offering temporary price promotions or list-price changes, companies can improve affordability by reducing the thresholds for quantity discounts, extending credit to their customers, or having layaway plans. Reducing item or serving sizes, and then pricing them accordingly, is another effective tactic. For service businesses such as cable and mobile telephone companies, lowering consumers' up-front adoption costs and reducing penalty charges can help attract cost-conscious and cash-poor consumers. Depending on whether customers are seeking the lowest absolute price or the most bang for their buck, service businesses can, respectively, unbundle offerings or fold more services into the bundle – or offer both options.

Bolster trust. Worried consumers – even in the comfortably well-off and live-for-today segments – see familiar, trusted brands and products as a safe and comforting choice in trying times. Reassuring messages that reinforce an emotional connection with the brand and demonstrate empathy (for example, by conveying a sense that "we're going to get through this together") are vital. As Dell fights to regain the ground it lost in the past few years, it has released various print ads containing different messages that seem designed to resonate with each of the four segments: "Out of the box, within your means" (which will appeal to the slam-on-the-brakes segment), "Depend on Dell for simple solutions in tough times" (pained-but-patient), "The ideal laptop works anywhere, in any economy" (comfortably well-off), and "Weak economy, powerful you" (live-for-today). Crest has also focused on fortifying its emotional connection. Before the 2008 Christmas season, Crest ran spots for its Whitestrips product that centered on the theme of "I'll Be Home for Christmas": As the song played in the background, a young woman arrived back in her small hometown, flashing a smile showing off her white teeth. While the ad clearly conveyed the product's cosmetic benefits, it also tugged at viewers' heartstrings with its depiction of a Christmastime family reunion.

Reassuring messages that reinforce an emotional connection with the brand and demonstrate empathy are vital.

Empathetic messages must be backed up by actions demonstrating that the company is on the customer's side. If sales are declining, the last thing to do is take the problem out on customers by reducing quality while raising prices. Loyalty programs should reward not just big-time spenders but also people who purchase small amounts frequently. Rather than simply impose ever higher fees on customers who exceed their credit-card limits, card issuers should alert people when they are close to going over their limits. Retailers can educate consumers on how to shop smart and save money. For instance, some supermarkets during previous recessions prepared flyers detailing nutritious, low-cost meals. And companies can engage customers in brand activities that convey caring. An American Express campaign, for example, invited card members to vote on which charity the company would support on their behalf.

While it is important to build emotional connections, don't neglect to reinforce trust by reminding customers that buying the brand is a sound decision. Aleve got this right when it added to its pool of commercials an ad with the message, "That's value. That's Aleve."

Positioning for Recovery

Survivors that make it through this recession by focusing their attention on consumer needs and core brands will be strongly positioned for sunnier days ahead. However, companies must understand how people's behavior may change following the recession so they will be able to offer products and communicate messages aligned with the needs of new consumer segments.

After most recessions have ended, consumers' attitudes and behaviors return to "normal" within a year or two. Following more extreme downturns, though, consumers' heightened sense of economic vulnerability can persist for a decade or longer. The deeper and more prolonged a recession is, the greater the possibility that there will be profound transformations in consumers' attitudes and values. Witness the long-lasting caution regarding consumption characterizing Americans who lived through the Great Depression or present-

Product Winners and Losers in a Recession

The great majority of people in a recession fall into the pained-but-patient segment. While they economize in all areas, they'll still spring for occasional treats. Here's how they change their behavior in a sampling of product markets.

SKIN-CARE REGIMES

Sales fall as consumers who formerly applied individual moisturizers, cleansers, toners, and the like cut back on these pricey treats and trade down to cheaper multipurpose products.

HOME SECURITY SYSTEMS

Sales climb in response to recession-related increases in crime and consumers' anxiety about safety as they spend more time at home.

COMPUTER REPAIR SERVICES

Demand rises, as it does for all durables repair, because consumers postpone replacement purchases.

UPSCALE MAGAZINES

Ad revenues and issue sales fall as consumers purchase fewer luxury and discretionary goods, high-end product and service advertisers place fewer ads, and consumers buy fewer copies.

TIRES

Sales to auto manufacturers drop in tandem with new-car sales, but replacement-tire sales should rise correspondingly, unless consumers drive less or postpone buying replacements.

TELEVISIONS

Sales typically fall for big-ticket items, but as consumers go out less, a big-screen TV may seem like a justifiable entertainment investment.

FROZEN VEGETABLES

Sales increase as people eat out less often and trade down from fresh and organic.

HEALTH CLUBS

Memberships drop as consumers defect to less expensive alternatives such as walking, jogging, and home workouts.

ICE CREAM

While shop and restaurant sales decline along with all eating out, purchases at supermarkets climb as consumers seek affordable treats (perhaps to curl up with in front of the new television).

day Japanese who endured a stagnant economy throughout the 1990s.

Usually, repercussions are not so extreme as that. In the United States, postwar recessions have lasted an average of 10 to 11 months. The harshest were the 16-month-long recession of 1973–1975, during which consumption growth was –0.9%, and the 18-month "double-dip" recession of 1980 and 1981–1982, during which consumption growth was negative in the first dip but rebounded in the second. The last recession, in 2001, saw no decline in *overall* consumer spending, although many individuals cut back.

Marketers should prepare now for a possible long-term shift in consumers' values and attitudes.

However, the current recession, as noted, is unusually severe, and consumer confidence and trust in business are at record-breaking lows. Given these facts, there is a good possibility that consumer attitudes and behavior shaped during this recession will linger substantially beyond its end. While the comfortably well-off and live-for-today segments may carry on as usual, the slam-on-the-brakes and pained-but-patient segments – by far the large majority of consumers – may well retain the consumption habits they've learned. They'll seek value and trusted brands, remain considered in their purchases of treats, and continue to delay purchases of postponables. Consumers can also be expected to retain their distrust of business, an attitude forged by the corporate malfeasance that fueled this recession.

This profile suggests two lessons for marketers. First, the discipline around marketing strategy and research they developed during the recession – and the ability to respond nimbly to changes in demand – will continue to serve them when the economy recovers. And second, they should prepare now for a possible long-term shift in consumers' values and attitudes. The shock of the downturn and anger about the abuses that drove it promise to accelerate preexisting trends toward reduced materialism, commitment to sustainability, higher expectations of corporate social responsibility, and resentment of cynical marketing that treats people as soulless and mechanical consumers. Increasingly, customers will demand that business act in their and society's best interests and will factor company practices into their brand choices. During and after the recession, it would be foolhardy for marketers to ignore those changing expectations. While businesses are putting customers under a microscope, their customers are, in turn, examining them more closely than ever.

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"I'm not easily impressed by hyphenated names, Mr. Sm-ith."

Ron Morgan

FINANCIAL CRISIS SPOTLIGHT

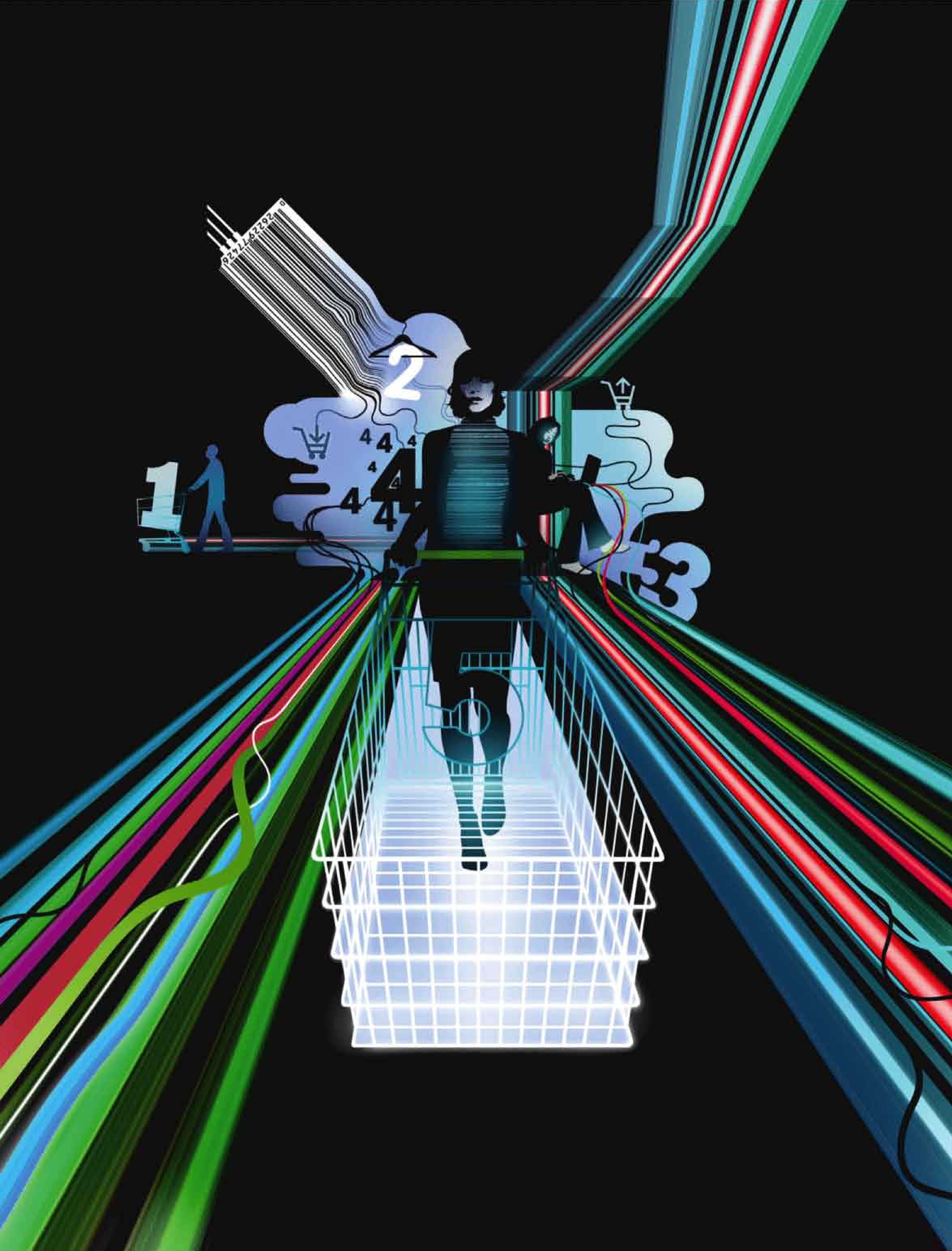
FIVE RULES FOR RETAILING IN A RECESSION

IT WAS GREAT to be in retailing during the past 15 years. Inflated home values, freely available credit, and low interest rates fueled unprecedented levels of consumer spending. Retailers responded by aggressively adding new stores, launching new concepts, building an online presence, and expanding internationally. While the U.S. economy grew 5% annually from 1996 to 2006, in nominal terms, the retail sector grew at more than double that rate – an eye-popping 12%. Revenues rose sharply, profits ballooned, and share prices soared.

But that's all gone now. Even before the financial crisis and recession began, retailers were hitting a wall. Same-store sales – or "comps" – have dropped by double digits for many chains, store closures have accelerated,

by Ken Favaro, Tim Romberger, and David Meer

Phil Wheeler



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store openings have slowed, and shareholder-value destruction has been massive. Starbucks – an icon of the good times – is a case in point. Last fall, it decided to shutter some 600 stores and cut back new-shop openings after the company suffered a first-ever year-over-year drop in same-store traffic and sales. The result: Its share price collapsed by almost 60% from the fall of 2007 to the summer of 2008, and it continued to slide as the economy worsened in the autumn.

Still, hard times – even a deep recession – can be an opportunity to win the loyalty of more customers, increase productivity, and strengthen market position. In this article, we draw on a study of more than 50 major U.S.-based retailers and over 20 years of global consulting experience and research to show how retail executives can respond to a downturn in their business and emerge from it even stronger than before. By following the recommendations laid out in these pages, companies like Starbucks will discover that a larger universe of growth and productivity opportunities is open to them than they might believe. What's more, they don't need to overhaul their entire business model to tap into these opportunities; they just need to alter their operating rules.

IDEA IN BRIEF

» Consumers are tightening their belts, and retailers are feeling the pinch.

» But even in these tough times, retailers can win new business and gain customer loyalty by focusing on people who aren't their best customers – and by making sure they offer what those customers really value.

» Apply these five rules to gain market share and protect margins:

1. Focus on customers who are loyal neither to you nor to your competitors.
2. Close the gap between their needs and your current offering.
3. Reduce the "bad costs" – those producing benefits customers won't pay for.
4. Cluster your stores according to local similarities and differences in customers' needs and purchase behavior.
5. Retool your processes – customer research, merchandise planning, performance management, strategic planning – to better position your company to apply rules 1 through 4.

RULE 1
Go Where the Headroom Is

In tough times, managers instinctively rush to unleash a host of new programs and initiatives – they extend store hours (or cut them back), implement a new staffing system, reallocate store space, introduce or extend loyalty programs, offer "triple point days" and special promotions for big spenders, reorganize store operations or the merchandise or marketing department – even tinker with the parking lot. But without a clear sense of where the opportunity for profitably retaining market share is most promising – let alone where they can win new share – managers engage in too many initiatives that produce too little impact. That can prove expensive, perhaps fatal, at a time when resources are suddenly more limited and getting the highest return on those resources is paramount.

To avoid that trap, you need to understand where your true headroom lies and use that to guide a measured, targeted response. We define "headroom" as *market share you don't have minus market share you won't get.* Customers who are loyal to your competitors represent market share you don't have and will likely not get. Customers who are loyal to you represent market share you already have. Protecting your most loyal customers is an obvious priority in a downturn. But if they are suddenly spending 25% less, most of that will come directly out of what they spend in *your* stores. Your headroom, therefore, lies with customers who are loyal neither to you nor to your competitors – we call them "switchers." You may be collecting only 20% of what they're spending today; taking that to 30% will represent a net gain even when their total spending drops by 25%.

Let's see how that applies to Starbucks. Earlier in its history, a high proportion of its customers were loyalists for a simple reason: No one else offered the experience they were seeking – high-quality coffee, individualized service, that comfortable coffeehouse atmosphere. But the company has added things like over-the-counter food, drive-through windows, and cookie-cutter store formats, which have made the Starbucks experience more akin to that of fast-food chains than perhaps was ever intended. And this at a time when those chains have become more direct competitors, since corporate investment by such powerhouses as Dunkin' Donuts and McDonald's has allowed franchisees to install new, higher-quality coffee machines in their restaurants. As a result, according to customer research we recently conducted, about half of Starbucks's customers are now spending an average of only 40% of their coffee-related dollars at the Seattle-based firm's coffeehouses; they're taking the rest of their money to competitors. These "switchers" are loyal neither to Starbucks nor to its competitors. While loyalists remain Starbucks's best customers and have been willing to give it the benefit of the doubt, they are not where its headroom exists (see the exhibit, "The Real Opportunity for Starbucks").

You can measure headroom in many different ways – identifying switchers by category, by local market, by where or how customers shop, or even by competitor. One electronics retailer found its headroom by examining how customers relate to technology, seeking switchers among early adopters, mainstream users, and late adopters. A camera store chain organized its search by segmenting customers according to their level of product sophistication and the amount of service they require.

Whatever the analysis and measures used, we find, generally speaking, that over two-thirds of any given retailer's opportunity for new market share is concentrated in only one-third of its business. Yet we also find that many – if not most – of its initiatives are aimed at those parts of the business with the least headroom. That explains why such programs multiply: Because they are not targeted at the true opportunities, they fail, and managers respond by firing off yet more projects.

When companies go where the headroom is, they avoid that vicious circle. The initiatives are more likely to work – or, at any rate, it's clearer how they can be made to work. In either case, that means successful projects get more funding and attention, and people don't start clutching at straws.

That lesson was not lost on one specialty retailer we worked with, which had long been a must-shop destination for younger women seeking fashion at a good price. Increasing competition eventually hit its sales, which had a devastating effect on performance. Management and the board could not agree on what to do in response: "Should we reformat our existing stores, invest in our brand, open new stores more quickly, develop new formats, or try something else?"

To answer that question, managers analyzed the customers in each product category and geographic market (using large-sample, panel-based research conducted mainly over the internet) to determine who the switchers were, where they were shopping, what they were buying, and why. They found that their loyalists were mostly the "fun and value shopper," but their opportunity was with the "everyday-trendy dresser." These customers were in their stores but not finding what they were looking for – and therefore not spending nearly as much as they were at several other chains, including the retailer's closest competitor. Managers realized that by capturing more of what those customers spent, the sales and profit potential for their existing stores could be three times what they had previously thought. And by changing specific elements of their total offering – including product assortment, store environment, and space layout – they could do a

IDEA IN PRACTICE

Retailers can survive – even thrive – in a recession by following these five rules:

» **Rule1: Go Where the Headroom Is.** The biggest opportunity for profitable share gains comes from focusing on your disloyal, not your loyal, customers.

EXAMPLE One fashion retailer realized that many of its customers were in its stores but not spending as much as they were at competitors.

» **Rule 2: Close the Needs-Offer Gap.** To capture more business, you must entice those customers spending elsewhere to spend with you instead. That means closing the gap between what they want and what you offer, not merely ordering more of what's already selling well.

EXAMPLE By lowering the cost of work clothes, expanding its line of basics, introducing different brands, and shrinking designer collections, a high-end department store chain got its disloyal apparel customers to spend more at its stores and less at others', seeing an immediate improvement in its apparel sales – and record profits soon after.

» **Rule 3: Go After Bad Costs.** Cost cutting can be dangerous unless you know how to relate your costs to customer benefits.

EXAMPLE A struggling German convenience retailer found that it was overinvesting in cleaning facilities and underinvesting in friendly staff. Management decreased funding for cleaning by 20% and used the money saved to establish new training programs, a new time-allocation system, and new in-store standards. The net result was a 20% increase in return on capital – and a five point market share gain.

» **Rule 4: Cluster Stores.** Uncover growth and cost opportunities by looking at similarities and differences in customer needs and purchase behavior across stores.

EXAMPLE One large general-merchandise retailer discovered that five quantifiable factors explained most of the differences in local customer needs – and therefore purchasing behavior. By segmenting its stores into groups representing unique combinations of these five factors, it uncovered previously invisible differences in its growth and cost-saving opportunities.

» **Rule 5: Retool Core Processes.** In a downturn, all of the basic retailing processes – customer research, merchandise planning, performance management, and strategic planning – must focus primarily on seeking out and serving the switchers with as few bad costs as possible.

EXAMPLE One leading retailer manages its performance by store cluster for each of six key variables using both external measures such as headroom per store and internal measures like comps and average sales per square foot. As a result, it has actually improved its performance since the retailing downturn intensified last summer.

much better job of attracting these particular customers. As a result, the company managed to sustain flat comps while its competitors suffered double-digit declines, thus strengthening its market position and slowing the effects of a rapidly weakening overall market.

RULE 2

Close the Needs-Offer Gap

In our experience, most retailers have a lot of customers who could be spending more money at their stores than they are. The challenge is to entice them to do so. This is both easier and harder than it would seem. It's easy because all you need to do is give them what they want. But it's hard because what they want is not more of what you're currently providing. And to fill the gap between what they're looking for and what you're offering, you must forsake the incremental "last year, plus-or-minus" optimization approach that may have served you well in headier times.

Such "needs-offer gaps" can take any number of different forms. They can reside not only in the makeup of your product mix but also in your service levels, in-store environments, or the brand positioning itself. For Starbucks, the proliferation of new stores, together with the emergence of new competition, has created an enormous gap between the experience customers want from the company and the experience they get. For some, it takes too long to buy a simple cup of coffee. For others, Starbucks's plain vanilla format, particularly in suburbia, makes it difficult to justify the premium they pay there relative to independent coffeehouses, local coffeehouse chains, and even McDonald's and Dunkin' Donuts. Many coffee drinkers want a self-serve food experience much like that offered by such outlets as Pret A Manger. Coffee connoisseurs want the espressos, cappuccinos, and experience that can be found in Italy's best coffee bars. And many just want their original Starbucks back – the socially responsible "third place" between the office and home. Needs-offer gaps such as these explain not only why half of Starbucks's customers are now spending more of their coffee-related dollars at competitors than at Starbucks but also how the company can change that.

To survive a downturn, retailers must constantly work to identify and close their needs-offer gaps to win as much of their headroom as they can. This is how they gain share and offset the sales they must inevitably lose when their most loyal customers reduce spending. In our experience, though, many retailers do not do that work. Ironically, this is largely owing to an unintended consequence of the explosion of information technology. Most retailers can track on a daily basis what items are selling in which store – and often even to whom and when during the day. But while this information has led to much greater efficiency in inventory management and purchasing, it conditions merchants and store managers to stock up on what's selling well and pare down on what's not. This then leads to big gaps between a retailer's offer and what customers want precisely where the headroom is greatest, since it says nothing about what customers might be buying elsewhere.

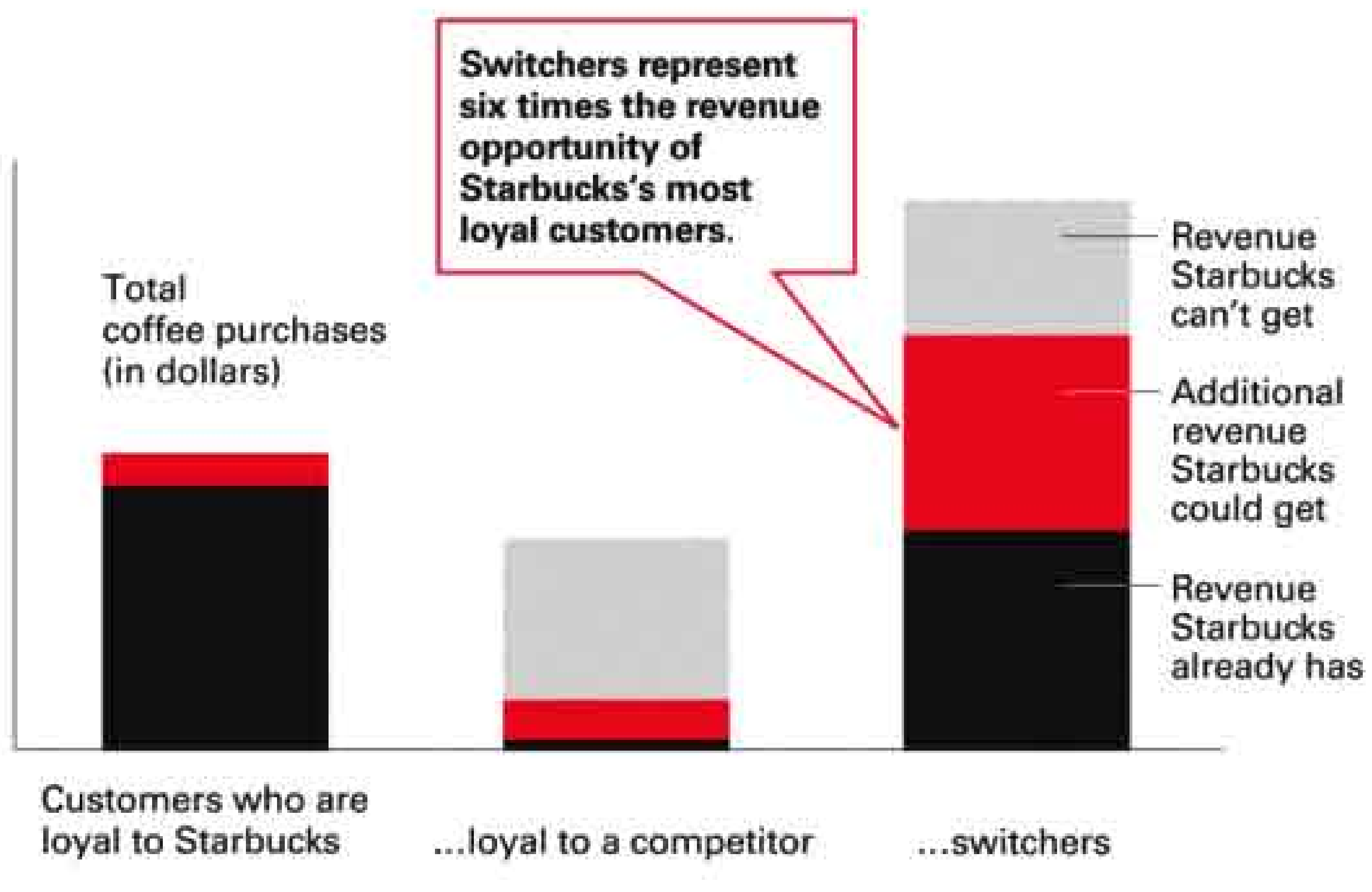
This was a trap profitably avoided by one department store retailer we studied. Its apparel sales had been declining, so space productivity (sales and profit per square foot) had fallen below what it was in the rest of the store. The optimization mind-set – ration space according to what is selling the best – would have suggested reallocating the areas devoted to apparel on the floor and in the stockroom to more productive departments, such as handbags and accessories. However, this retailer's

"HEADROOM"
Market share you don't have minus market share you won't get.

"SWITCHERS"
Customers loyal neither to you nor to your competitors.

The Real Opportunity for Starbucks

Starbucks already has almost 90% of the business of its most loyal customers. Not much room for growth there. And it's not likely to get much business from people who are loyal to competitors. So it needs to focus on the sizable group of "switchers" – those who go both to its shops and to others. By giving these customers more of what they need, Starbucks can dramatically turn around its business, even if its most loyal customers are cutting back.



headroom in apparel was disproportionate to the sales it was realizing. Even its most frequent shoppers were going elsewhere to purchase their clothing. So instead of simply reducing apparel space to make it more productive, which would essentially have resulted in overserving its most loyal customers, the retailer compared its apparel assortment with the attributes its customers most wanted but were going elsewhere to get, namely: clothing for the right occasions, in the right styles, at the right price, and with the right fit. The retailer was able to close these gaps through a few targeted merchandising initiatives, such as offering more wear-to-work clothing at a better price; introducing new in-house and external brands in more modern and expressive styles; and expanding mix-and-match basics at the expense of designer collections and "flair" fashions.

Within nine months, the apparel division's comps went from negative to positive, inventory turns and margins improved, and record operating profits were generated. In some apparel departments, achieving higher levels of productivity required a significant shift in the merchandise mix to fill the needs-offer gaps. When these gaps were pointed out to one of the top executives, he responded: "I just don't get it. We plan down what doesn't sell and stock up on what does. How can we be so far off?" The problem with that method is, of course, that current and recent sales data can tell you only what *is* selling, not what *could* be selling. By doing the work required to understand the needs-offer gaps, this retailer was able to turn around a business in a way it could never have done by analyzing historical sales data alone.

"I just don't get it. We plan down what doesn't sell and stock up on what does. How can we be so far off?"

RULE 3
Go After Bad Costs

When sales stall, retailers confront a stark choice: Cut costs or face declining margins. Most choose to take out costs to preserve as much of their margins as they can. And who can blame them? But all too often they take out the good with the bad.

If you think about it, it's obvious what the good costs are – they're the ones essential to producing what your customers value and are willing to pay for. Perhaps these are costs associated with providing convenience, a particular shopping experience, a distinctive service, or a better range of goods than competitors offer. Taking out good costs might improve margins initially, but sooner or later revenue will begin to suffer and margins will come under further pressure, thus defeating the very purpose of taking out the costs in the first place.

Conversely, bad costs are those that add nothing to what customers are ultimately willing to pay for. Even the best run companies incur a lot of bad costs: These might result from ever-evolving consumer needs or competitors' innovations that change what customers are willing to pay for. Technological advances and process innovations can turn once-necessary costs into unnecessary ones. Costs can creep in through operational complexity resulting from growth in scale and scope. Starbucks's bad costs might involve too much seating in stores used primarily by take-out customers, or unnecessarily extended hours in certain local markets, or too much inventory and space dedicated to accessories (those coffeepots, movies, and whatnot) that few customers purchase. Or they could be the systemic costs of complexity arising from a proliferation of blends and flavors that have only an incremental impact on the benefit of the Starbucks experience for the bulk of its customers.

Certainly the retailers that do the best job of going after their bad costs while preserving their good costs will have the best chance of both protecting their sales and margins in a downturn and building for the future. But our experience suggests that most retailers don't have the tools to do this effectively. Like most companies, retailers tend to manage their costs on either a line-item or an activity basis, a practice widely known as "activity-based costing." Unfortunately, tracking costs in those ways does little to establish two critical links: the link between cost and each aspect of the offer – the product range, store ambience, service levels, and so on – and the link between each aspect of the offer and the customer benefit it produces (which, after all, is what customers are willing to pay for). Viewing expenditures in this way is what we call "customer-benefit costing." Without this tool, retailers struggle to work out which – or how much – changes in particular costs affect revenue. This prevents them from knowing how to protect margins in ways that won't also weaken the top line.

What's more, retailers typically control their costs through the annual budgeting process and become entrenched in the way they've always done things. Worse, costs are thought of monolithically (that is, they are considered all necessary or all bad) and tend to be raised or lowered all together, incrementally, rather than in a targeted fashion. A certain German convenience retailer illustrates our point. Customers were equally aware of this retailer and its competitors; as many people shopped there as elsewhere; and customers bought as much in its stores as they did in competitors'. But they visited this retailer less frequently than others, making its costs per customer visit much higher and its share of the total profit pool available to all convenience retailers much lower. Why? It was overinvesting in some areas and underinvesting in others.

Traditional attitudinal research suggested that having clean facilities was very important to customers, and this explained why all competitors were heavily invested in satisfying customers on this score. What that meant, though, was that having bright, inviting shops was merely the table stakes, which in effect turned incremental investment in one of the most important attributes into a bad cost, since outspending competitors on it would garner no marginal gain in business. A careful analysis of customers' true switching behavior suggested that the more important driver of their loyalty was how friendly the staff was. For our client, the lack of sufficient investment in friendly staff (good costs) and the costs of exceeding customers' expectations for clean facilities (bad costs) created a deadly combination of lower margins and lower market share.

Managers found that they could reduce the budget for ensuring clean facilities by 20% with no impact on sales or market share. They then reinvested half the budget savings to establish new staff-training programs, a new time-allocation system, and new in-store standards to dramatically improve customer service – and took the rest in margin improvement. The net result was a triple play: lower total costs, a higher share of visits (from 25% to 30%), and a 20% increase in return on capital.

In tough times, there is often no avoiding the need to take out costs. But with the right level of insight, retailers can tie their costs to the benefits that customers are willing to pay for when shopping in their stores. That gives them an important tool for managing their expenses more precisely.

RULE 4

Cluster Stores

Most retailers will tell you that no location is exactly the same as the next one. This doesn't matter much when the opportunities for rolling out a successful formula in new locations are plentiful. All that matters is opening as many new stores as possible while the formula is still working. But differences among locations are especially crucial when managing through a downturn.

Merchants have been tailoring stores to local markets for years by adjusting assortment, layout, and overall shopping experience to reflect local peculiarities. But that can add immense operational complexity and overwhelm any benefits. Winning retailers master this benefit-cost equation by clustering their stores. A "cluster" is a group of stores representing a set of communities that are very similar to one another in terms of their competitive situations and their customers' needs and behavior but very different from the communities (and stores) found in other clusters. The stores in a particular cluster can be found in geographically adjacent local markets, but more often they are not.

Many retailers think that clustering stores is the same thing as segmenting customers. But that's frequently not the case. If you want to use customer segmentation to cluster stores, your segmentation scheme has to fulfill three requirements.

First, you need to segment in such a way that you can identify the proportion of each segment that shops in each of your stores. Otherwise, you can't uncover opportunities to tailor the product mix, space allocation, staffing, and so on of your stores according to the different needs of each segment.

Second, to use segmentation to establish clusters of stores that can exploit different opportunities to go after headroom, close needs-offer gaps, and take out bad costs, each cluster must contain substantially different proportions of each customer segment. This was a problem for one retailer we worked with: Once we located where different segments of customers were shopping, it turned out that all of the stores had pretty much the same 40%/35%/25% mix of its three segments. So using that segmentation scheme, the retailer could not identify different clusters of stores that could be profitably treated differently.

Third, your segmentation has to cover just about 100% of your customer base. To see why, consider Best Buy. As part of its "customer centricity" strategy, Best Buy tags each of its 900-plus U.S. stores to one or more of five customer segments: affluent young professional males ("Barry"), young entertainment enthusiasts ("Buzz"), upscale suburban moms ("Jill"), middle-class married men who are on a budget ("Ray"), and small-business owners. Best Buy skews the mix of products and services in each of its stores according to particular customer segments. The problem is that these segments represent substantially less than 100% of Best Buy's customer base in any one of its stores (and probably overall, as well). Thus, in each store, Best Buy has to retain and gain an unrealistically high market share in its target customer segments to protect that store's overall sales in a downturn. Clustering would allow Best Buy to tailor its stores according to differences in the total customer population of its local markets, not just an important minority.

Starbucks could certainly benefit from clustering its stores. Local differences in the prevailing reasons why customers have occasion to drink coffee at Starbucks's 10,000-plus U.S. shops – from that first cup of coffee in the morning, to social meetings, to business meetings, to relaxation time – combined with differences in competitive intensity and other factors mean that there is likely to be, in our estimation, a 20% to 30% variation in the level and nature of Starbucks's headroom across its outlets. A one-size-fits-all solution would miss the mark in any one coffee shop, since specific adjustments to the offer would be needed to capture that variation. But treating each store as entirely unique would be too hard to manage, confuse customers, and take too long to be effective in turning around the business. Clustering would enable Starbucks to vary its stores – both their local offerings and cost structures – according to local differences among the high-potential switchers in its customer base.

There is no best way for all retailers to cluster stores because the factors that explain differences in customer behavior are different for each company. The specialty retailer we cited earlier clustered according to a combination of three factors: the nature of local competition, mall location, and density of local population. Bigger multicategory retailers may find it best to cluster their stores in different ways for individual categories or departments. Then such a retailer could more easily see the various dynamics underpinning demand in different stores. Income level might determine how to cluster stores in a certain category, for instance, but ethnic makeup might be more important in another category.

One large general-merchandise retailer groups its stores into a dozen clusters, ranging from as few as 50 to as many as hundreds of stores. This retailer discovered that differences in five quantifiable factors explained most of the differences in local customer needs among its stores (and therefore the factors that motivated switchers): ethnicity; location (urban, suburban, or rural); family composition (young single professionals, couples with kids, empty nesters, retirees, and so on); income; and level of competitive intensity. Each store cluster represented a unique combination of these five factors. In fact, the retailer had tested as many as 50 potential factors before landing on those five as the ones that best explained the locally distinctive shopper population in terms of customer needs and behavior for each of its stores.

Category by category, this retailer uncovered dramatic variations in the nature of its headroom and needs-offer gaps and, consequently, in its growth opportunities across the business. For example, in its computer category, it found that stores in high-income areas could use a much richer mix of laptops than it was currently providing, whereas its rural stores needed more desktops. Its suburban stores required a different range of brands (Dell, HP, Compaq, and Gateway) than both the high-income cluster (Toshiba, Sony, IBM, and Apple) and the rural cluster (eMachines, Gateway, Compaq, HP, and Dell). The service needs of customers varied a great deal from cluster to cluster as well: The high-income cluster valued installation options, repair, and warranties. The suburban stores favored internet service packages and detailed in-store product information. The rural stores required hands-on technical assistance. This example throws into stark relief exactly how much this retailer's value proposition had to be tailored from cluster to cluster in each of its main categories and how poorly a one-size-fits-all approach would have suited the needs of its customers with the highest profit potential.

RULE 5

Retool Core Processes

To find headroom, expose needs-offer gaps, reduce bad costs, and cluster stores correctly requires changes to all four of the processes that are core to managing every retailer's business: customer research, merchandise planning, performance management, and strategic planning.

When sales slow and margins erode, retailers' decisions tend to become more inward looking. The *customer research* process must help to prevent this from happening. Traditionally, such research asks, Who is shopping at our stores? What do they buy from us? How satisfied are they with us? and Who are our most profitable customers? These are fine questions, but it would be much better to ask, Why are customers shopping our stores? What do they buy from other retailers? What are their needs relative to what we offer? and Who are the most profitable customers that we don't have but could get? Answering these kinds of questions is what will give retailers the information they require to find and exploit their headroom and determine which costs they can cut to protect margins without undermining sales.

> In addition to "Did you find what you need?" clerks should ask, **"Is there something you want that we don't carry?"**

The good news is that most retailers don't have to overhaul their research processes to get the right information on their customers. One supermarket chain we know of, for instance, routinely asks patrons, "Did you find what you need?" at checkout. But when the answer is "no," the next question clerks ask is, "Did you ask for help in finding it?" In other words, the clerks are focused on determining whether current offerings are in stock. But if, when a shopper said no, the clerks responded by asking, "Is there somewhere else you'd expect to find that item?" and if they also asked, "Is there something you want that we don't ever carry?" the company would end up with a treasure trove of much more useful customer research. As a bonus, customers would see that the company really does care about meeting their needs.

As we pointed out at the beginning, *merchandise planning* for most retailers is a process of stocking up on what's selling well and stocking down on what's not. But in a recession, the process should be governed by answers to these four questions:

Which merchandise lines should be expanded because both their headroom and current productivity (sales and profit per square foot) are high? Which should be shrunk because both their headroom and productivity are low? Which should be fixed (rather than shrunk) because their productivity is low but their headroom is high? And which should remain as they are because their productivity is high but their headroom is low? A retailer's merchants should be able to produce a merchandise-planning map that lays out the answers to those four questions for each of their categories. The map should also specify the needs-offer gaps that have to be closed to grow, shrink, or fix each category's merchandise lines. (Having such a map for each store cluster would be even better.) This gives merchandisers a practical way to avoid the incremental decisions that traditional merchandise planning entails.

Performance management typically means monitoring progress against budget, as well as benchmarking stores and categories using such measures as comps, gross margins, and sales and profits per square foot. But in a recession, retailers' scorecards should also indicate where they stand in capturing headroom, closing needs-offer gaps, and taking out bad costs. And they should track their performance by store cluster to avoid the apples-to-oranges comparisons that inevitably occur when monitoring stores by region, district, or other geographically defined territories. One retailer we know does exactly that and has actually improved its performance since the retailing downturn began to intensify last summer, in part because it has the right information at the right level to manage its performance.

Finally, there is *strategic planning*. Blue-sky planning doesn't make a lot of sense when the sky seems to be falling. But that isn't the only role for strategic planning. Strategic decisions still need to be made regarding space allocation, chain investment, store format, cost structure, and staffing. When facing a downturn, the imperative in every one of these areas must be to go where the headroom is, close the needs-offer gaps, go after bad costs, and exploit the differences among store clusters. Let us be clear: The strategic-planning process must be entirely focused on meeting those imperatives. Otherwise, it is just a distraction from what needs to be done in the short-term to protect and strengthen the business for the long haul.

...

In all likelihood, the current generation of retail executives will not soon see anything like the prolonged tailwind that steadily propelled their sector over the past 15 years. An era of consumer frugality has begun, shifting that tailwind into a nasty headwind. Some retailers will turn this into an opportunity to strengthen their business and gain market share at the expense of the weaker competition. Follow the rules in this article, and you could be one of them.

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"Your salary won't be very large to start with, and with luck we'll be able to keep it that way."

P.C. Vey

The power of intermediaries like Google, Amazon, and Blu-ray is rapidly growing. Be prepared.

What's Your Google Strategy?

by Andrei Hagiu and David B. Yoffie

When Toys "R" Us executives signed a 10-year "exclusive" agreement with Amazon in 2000, they saw the deal as the perfect solution to a vexing challenge: how to establish an online retail business that would dominate its category and achieve profitability sooner rather than later. Having struggled to build an online business on their own, they believed they needed Amazon's internet savvy and order-fulfillment skills. They agreed to pay Amazon a hefty $50 million annually plus a percentage of the toy retailer's online sales in exchange for Amazon's building and running a Toys "R" Us virtual storefront on its e-commerce site. Less than four years later, the deal had turned into a money loser for Toys "R" Us, and the company sued Amazon, seeking $200 million in damages.

Jessica Hische

What went wrong? To fuel its own growth and profitability, Amazon had recruited small, third-party merchants to sell toys and games directly through its website. In a two-year court battle, Toys "R" Us argued that Amazon had violated the exclusivity agreement and that the rising competition had hurt its online sales. Amazon tried to justify its actions by contending that the other merchants were addressing customer needs that Toys "R" Us couldn't or wouldn't satisfy. In the end, the court ruled that Amazon had violated the agreement; it allowed the companies to sever their relationship but didn't award Toys "R" Us damages.

Toys "R" Us's frustration is not unique. Companies large and small have been wandering in the wilderness, trying to figure out how to play with the rapidly growing number of multisided platforms such as Amazon. MSPs are products, services, or technologies that connect different types of customers to one another. Credit-card companies and eBay link consumers and merchants. Google's search engine connects advertisers and users of its services. Microsoft's Windows platform has three sides (application developers, users, and OEMs), as does the Blu-ray standard for high-definition DVDs (content providers, manufacturers of DVD players, and consumers). Once a relatively obscure strategic problem, multisided platforms have become important for all companies today, thanks to the power of the internet and related technologies. As new intermediaries have emerged to facilitate search capabilities and reduce transaction costs, companies find themselves acting either as an MSP or as a player on someone else's MSP.

MSPs are doubled-edged swords for the average company. On the one hand, a platform can make a company more efficient or increase its customer reach. For example, by advertising on Google, a firm can gain access to an audience that otherwise may be impossibly expensive to attract. On the other hand, just because an MSP has a great installed base of customers or offers platform services that can significantly reduce costs does not mean that joining it guarantees success. Before Toys "R" Us struck its deal with Amazon, it should have recognized that the two companies' long-term interests were fundamentally at odds. The success of Amazon's platform depended on covering the "long tail" of consumer demand by offering any product in any category. By contrast, Toys "R" Us's success was driven by the "short tail" of toys: pushing mainly hot products in high demand. Toys "R" Us should have anticipated that as soon as it succeeded in establishing the toys and games category on Amazon's platform, Amazon would have the upper hand and would try to wiggle out of the exclusivity pact. Toys "R" Us probably should not have agreed to put its online store inside Amazon's site. At the very least, it should have extracted more concessions

IDEA IN BRIEF

» Multisided platforms (think intermediaries like Amazon or eBay that connect interdependent groups of customers) can lower your transaction costs and increase customer reach. But, as Toys "R" Us learned when it teamed up with Amazon, choosing the wrong MSP can lead to stiffer competition and loss of control over customers. To select the right MSP for your business, consider three crucial decisions:

» Should you use an existing MSP or build your own platform?

» Should your company partner with one MSP or many? For instance, many companies advertise on both Google and Yahoo.

» Which MSP features should you adopt or reject to maintain competitive advantage? Target preserved its brand by selectively using Amazon's order-fulfillment services on its own website.

Pure Platforms

Platforms are products, services, or technologies that serve as foundations on which other parties can build complementary products, services, or technologies. Pure platforms do not have any contact with players' customers.

EXAMPLES **SAP's ERP software, E-Ink's electronic ink technology (used in the Amazon Kindle), Qualcomm's CDMA technology for mobile devices**

Pure Market Intermediaries

Market intermediaries are firms that make a living by reducing search and transactions costs for two or more distinct groups of players. These firms generally take full possession or control of the goods and services whose sale they facilitate.

EXAMPLES **Wal-Mart, 7-Eleven, Whole Foods**

Multisided Platforms

An MSP is both a platform and an intermediary. MSPs can insert themselves between you and your customers, though they don't take ownership of the goods and services whose sale they facilitate. MSPs support players that are interdependent, which creates indirect network effects.

EXAMPLES **Nintendo Wii, Amazon.com, Match.com** (including tougher restrictions on adding other toy vendors) up front, when its power was the greatest.

Without a clear strategy for dealing with multisided platforms, firms can easily find themselves ceding control over customers or being unwittingly turned into commodities. A few basic steps can help managers set a clear platform strategy:

- First, decide whether to play with an existing MSP, build your own platform, or do both.
- If you conclude that a third-party MSP can benefit your business, determine whether your company should join one or many.
- Once you know which MSPs to play with, figure out how to play – which features or services you should adopt and which you should reject in order to maintain your competitive advantage.

IDEA IN PRACTICE

Companies that understand the balance of power between themselves and multisided platforms can avoid being commoditized and maximize the benefits they extract from their relationships with MSPs.

» **LinkedIn,** the social network for professionals, faced the challenge of dealing with Google's OpenSocial platform for developing applications that would run across multiple social networks. LinkedIn chose to develop its own platform and also play with OpenSocial, to take advantage of the greater efficiency and market reach that the MSP would provide. To preserve its ability to differentiate itself from competitors, LinkedIn allowed only certain OpenSocial applications to work on its platform and developed proprietary extensions that were available only to LinkedIn users.

» **Electronic Arts,** the world's largest video-game developer, used its clout to check the power of Microsoft's Xbox Live platform and maximize the value it captured from the relationship. Microsoft's online gaming service included many features that lowered game developers' costs but also required contract terms that gave Microsoft control over end users. Electronic Arts refused to go along with Microsoft's terms. Instead, EA enabled the online function only in the version of the games it produced for the Sony PlayStation 2, refusing to do the same for the Xbox Live versions. Recognizing that this put Xbox Live at a severe disadvantage, Microsoft caved and allowed EA to retain control of user data, marketing, and billing and reportedly agreed to pay EA financial compensation.

To Play or Not to Play?

It might seem obvious that all companies should play with platforms that can add value to their business. Indeed, in some industries there is no choice: If you want to write applications for PCs or games, you have to work on MSPs such as Windows, Macintosh, or PlayStation. Your initial bias should be to join an MSP for two reasons: the immediate opportunity to reduce search and transaction costs and the expense and risk of building your own. But before leaping onto an MSP, you should carefully consider one major risk: the potential for the company (or companies) that owns or controls an MSP to hold you up – to use its power against you to capture more value for itself.

The most obvious form of holdup is the price increases that companies can and often do impose once their MSPs become successful. After the PC market tipped to Windows, Microsoft raised the price of its license to OEMs almost every other year for two decades. A company can also hold up players by using the MSP to vertically integrate into their businesses. The more successful a player is, the greater the temptation is for the MSP to try to capture that value for itself. And the MSP has considerable power to do so: The company that controls a successful MSP controls the interface between players and end users and dictates the rules of engagement. This form of holdup has become pervasive in technology-based industries where the dividing line between players and platforms is easily crossed. Microsoft's practice of invading other companies' turf by adding features to Office and Explorer is well known, but it's hardly the only example: eBay expanded into payment systems; Google has been bundling more and more applications into its core offerings; and Facebook has been introducing features previously provided by its third-party vendors.

The third way an MSP can hold you up is by using its power to weaken your relationship with your customers – either by gradually taking control over end customers or by inviting other players to compete in your product category. Obviously, this can greatly reduce a player's ability to extract value. Aside from Toys "R" Us, several other retailers, including Borders, Circuit City, Gap, and HMV, rushed to join the Amazon platform between 2000 and 2001, only to realize a few years later that they were having a hard time differentiating their offerings from the increasing numbers of smaller merchants piling onto the site. Eventually, all these big retailers dropped Amazon and went with their own web platforms. But by that time, they had lost valuable years.

Some companies claim that they will never use their MSPs to compete with their players, but you should not take such commitments at face value. The president of one multibillion-dollar online retailer we interviewed had the right attitude. He told us that even though a platform's initial sales pitch may sound great, "I assume they want to screw us. For example, PayPal and Google want us to take their payment system, but for us, they are a Trojan horse." In the face of holdup threats, you should seriously consider building a platform on your own or with other players. If you wield substantial power in the market or can team up with enough other players to gain the upper hand, building a platform yourself or with others may be the way to go. The test of whether you have enough power is: Can you influence the MSP's actions? Those companies that can we call "strategic players."

Strategic players can choose from two broad do-it-yourself approaches. The first is to build a proprietary platform (by yourself or with partners) in order to create value and capture as much of it as possible. The second do-it-yourself approach is to create an open MSP, which prevents any platform from ever claiming value. Google's Android operating system (for mobile phones) and OpenSocial application programming interface (for developing applications for social networks) can be viewed as an attempt to do just that. The search giant wants to prevent Symbian, Microsoft, or Apple from becoming the dominant operating system for mobile devices, and it wants to prevent Facebook and MySpace from dominating social networks.

Companies make two common mistakes in deciding whether or not to play with an existing MSP. First, they fail to fully understand the objectives of the MSP's owner and how those objectives might change over time as the MSP's growing power creates opportunities to extract more value from its players. For instance, providing technology or order-fulfillment services to third-party sellers makes up only 5% of Amazon's revenues but accounts for a full 30% of the company's profits. Some retailers recognized the benefits and dangers of the Amazon platform and played their cards well. Target, for example, decided not to create a storefront within Amazon.com and instead built a 100% Target-branded website that used some of Amazon's order-fulfillment services.

The second common mistake in deciding whether to build their own proprietary platform is that some companies grossly overestimate their own ability to persuade other players to support it. Nokia fell into this trap.

After introducing smartphones in 1996, Nokia realized that it needed a software platform that would encourage the development of sophisticated applications and mobile services. Rather than rely on Palm OS or Microsoft's Windows Mobile, the leading software platforms for handheld devices at the time, Nokia persuaded three other handset manufacturers to join it in creating Symbian, a for-profit consortium that would develop a new operating system. Initially, Nokia held the largest stake, around 40%.

To Play or Not to Play?

Questions to ask when deciding whether to play

- **What parts of our business are we doing ourselves that would be better handled by using an existing multisided platform?**
- **What are the things that we rely on MSPs for that we should be doing ourselves?**
- **Can existing MSPs add value to our business by lowering our costs or increasing our customer reach at a reasonable price?**
- **What are the risks that an MSP will use its power against us to capture more value for itself?**
- **What conditions might allow the MSP to raise prices over time?**
- **Is there a danger that the MSP will try to take control of our customers and reduce our differentiation?**
- **Should we pursue a "do it yourself" (DIY) strategy and build our own platform?**
- **What are the feasible DIY options (by ourselves or in a coalition with other players)?**
- **Would we pursue a DIY strategy to claim value for ourselves or to prevent other MSPs from claiming value?**
- **If we build a platform, will other players join us? Can we achieve sufficient scale without working through an established MSP?**

Symbian licensed its operating system to its shareholders as well as to any other mobile phone manufacturer that wanted it, and it quickly became the leading smartphone operating system, with a market share of more than 60%. But to differentiate themselves in the fiercely competitive market, licensees then developed customized, incompatible versions of the operating system. The resulting fragmentation prevented the platform from becoming popular with application developers. After more than seven years on the market, only about 5,000 applications had been built. (More than 10,000 applications were built for Apple's iPhone OS in less than a year.)

In addition, Nokia's leading stake in the venture caused other handset manufacturers to fear that Nokia would use its power to gain an advantage over them. They hedged their bets by supporting various versions of Linux and Windows Mobile as well as Symbian. That left a huge opening

An MSP can use its power to take control of your customers, greatly reducing your ability to extract value.

for existing competitors to catch up and for newcomers such as Google's Android and Apple's iPhone to enter the fray.

In a last-ditch effort to save the Symbian operating system, Nokia bought out its partners and spun off the enterprise in June 2008 as an open source consortium that gave its software away. In essence, Nokia recognized that it had erred in trying to use a proprietary platform to contain or deter competing platforms while also attempting to extract value for itself. But it may have learned this too late. Companies rarely get a second chance to tip a market.

Which MSP Should We Play With?

If you decide that you should play with one or more MSPs, then you have to figure out which to join. More specifically, should you go with one MSP exclusively or affiliate with several?

Some MSPs may not require exclusivity, in which case you should consider joining all those that offer positive net value. For example, since neither Google nor Yahoo requires exclusive arrangements, there's no reason not to advertise on both.

Other MSPs may demand exclusivity, which can be an opportunity. If an MSP wants and needs you, it may offer money or other forms of compensation in exchange for an exclusive relationship. The most visible example in recent times was the battle between the Toshiba-led HD DVD camp and the Sony-led Blu-ray camp to be the dominant platform for high-definition DVDs. Both sides reportedly offered large sums to Paramount, DreamWorks, Disney, and other studios to persuade them to join on an exclusive basis.

Similarly, hot content producers have been able to rake in enormous sums by getting rival radio and TV broadcasters to bid against each other for exclusive access to their content. Satellite radio provider Sirius paid $500 million for a five-year exclusive contract with radio personality Howard Stern to gain the upper hand over its rival XM.

In the long run, perhaps the most critical considerations for strategic players are: Would an exclusive relationship with you tip the market to one platform or another? If so, do you want to tip the market and allow one winner to take all? Tipping is desirable when adopting one standard would expand the market for all players and it's still possible to prevent the MSP from holding you up. Otherwise, a strategic player should steer clear of the arrangement and maintain support for two or more competing MSPs. Samsung and Motorola adroitly adopted this approach in mobile phones and played with multiple MSPs: Symbian, Windows Mobile, Linux, and Palm OS. This strategy made sense for them because it was (and still is) very hard to tell which platform might win, and neither was large enough to tip the market to one operating system. The downside of this hedging strategy, of course, is obviously the extra engineering, marketing, and support required to play with several MSPs.

Indecisiveness in choosing where to play can be expensive. Time Warner arguably made this mistake in the high-definition DVD standards war. For more than two years, Time Warner supported both HD DVD and Blu-ray. It initially hoped that HD DVD would win for a number of reasons: Time Warner had a higher market share for content on HD DVD than it did on Blu-ray (50% versus 20%); HD DVD players were cheaper, which meant that the market for machines and content would grow faster if that standard prevailed; and the company was reluctant to throw its weight behind a platform led by Sony, one of its main competitors. But with the overall market evenly split between the two standards, Time Warner was unwilling to gamble and exclusively back HD DVD – especially since Sony, which had lost the VHS-Betamax wars in the 1980s and had bet its PlayStation 3 franchise on Blu-ray, could be expected to fight until the bloody end.

Eventually, Time Warner's fears about helping Sony were supplanted by the concern that the long-term opportunity to sell high-definition DVDs was shrinking. One factor was that the continuing uncertainty about which standard would prevail was slowing consumer purchases of high-definition players. The second was that digital downloads were rapidly eating into the market for DVDs. Time Warner couldn't do much about the second factor, but it could do something about the first by helping tip the market to one standard. Realizing that its 50% share of HD DVD content gave it more power over HD

Where to Play?

Questions to ask when deciding where to play

- **Does the multisided platform require exclusivity, or can we play on multiple MSPs?**
- **How does the increase in customer reach from playing on multiple MSPs compare with the increase in costs from supporting multiple MSPs?**
- **Can we extract extra compensation from an MSP if we go exclusive? Does the extra compensation outweigh the loss of customer reach and flexibility from playing with multiple MSPs?**
- **Would we tip the market to one MSP by going exclusive?**
- **Do we want or need to tip the market, or do we want to prevent it from tipping?**
- **What are the benefits and costs associated with the market tipping?**
- **What are the benefits and costs associated with the market not tipping?**

DVD's fate than its 20% share of Blu-ray content gave it over Blu-ray's, Time Warner decided in early 2008 to abandon the HD DVD camp, which immediately called it quits.

But Time Warner's indecision clearly hurt its long-term profits. It would have been better off making an exclusive commitment earlier – in exchange for a sufficiently large payment to compensate for the risk of guessing wrong about who the ultimate winner would be. Given all the previous occasions when delays in resolving standards wars had opened the gate for new technologies to leapfrog existing ones, Time Warner should have known better.

How to Play

In choosing how to play on a given platform, companies must keep two main questions in mind: How can we differentiate ourselves from competitors that are conducting business on the same platform? And how can we reduce or mitigate the risk of holdup once we have decided to play?

For nonstrategic players that lack the power to influence an MSP's actions, deciding how to play usually boils down to choosing from the menu of contracts offered by an MSP. For example, after a company has decided to place online ads through Google, the only remaining choices are how much to spend and which keywords to bid on. But in some cases, even a nonstrategic player can make choices that will differentiate it from competitors and avoid contract options that could commoditize its business. LinkedIn clearly kept those issues in mind when deciding how to play on Google's OpenSocial platform.

When Google announced in 2007 that it was going to launch OpenSocial, a new platform for developing applications that would work on all social network websites that joined it, LinkedIn had to decide whether it should play with Google and, if so, how. The decision to play was relatively easy. LinkedIn, as the third-largest social network behind MySpace and Facebook, needed to extend its reach and potentially lower its costs in order to compete. The critical question was, how to play?

Google's motive for launching OpenSocial was clear: to commoditize the leaders, increase competition among social networks in general, and make it easier for Google to sell advertising. If "gated" communities such as Facebook or MySpace were more open to everyone on the web, there might be huge opportunities to sell advertising.

Recognizing these dangers, LinkedIn crafted a strategy that would exploit the advantages of the platform but mitigate most of the risks. It decided to build its own platform and invite third-party application developers to join. In addition, it decided it would not allow all applications developed for OpenSocial members to work on LinkedIn. It would continue to offer proprietary applications and would use OpenSocial to increase their value. For example, it added to its proprietary calendar application an OpenSocial feature that allows a LinkedIn member to find out who else from LinkedIn and other networks is attending an event. Though it was a nonstrategic player in the space, LinkedIn consciously took steps to avoid becoming trapped in a commodity world, by mixing and matching the advantages of the MSP with its own products.

Strategic players have more options. They can either order from the menu or use their power to obtain a custom deal. A good example is the way Electronic Arts, the world's largest video-game developer and publisher, forced Microsoft's Xbox division to accede to its demands in online gaming.

Microsoft had required that game companies use its proprietary tools in developing their online games, include standardized features such as voice chat and Gamertags (unique user names), and allow Microsoft to handle customer service, billing, and administration. EA feared that those terms would cede too much control of the user relationship to Microsoft and would level the playing field among game developers. It also worried that it would set a bad precedent, encouraging Microsoft to make even more onerous demands in the future. Moreover, EA felt that Microsoft's refusal to share Xbox Live subscription fees with game publishers was unfair. Consequently, it refused to go along. To put pressure on Microsoft,

How to Play?

Questions to ask when deciding how to play

- **Which services or features of the multisided platform will enhance our differentiation and which will commoditize our business?**
- **How do the MSP's terms affect our competitive advantage relative to other players on the MSP?**
- **Do the terms strengthen the MSP's ability to hold us up?**
- **Should we (and do we have to) choose from the menu of contracts offered by the MSP? Can we negotiate a custom offering to mitigate the risk of holdup or commoditization?**

Even a nonstrategic player can differentiate itself from competitors and avoid commoditization.

EA included online functionality in the versions of the games it made for the Sony PlayStation 2, but not for the Xbox versions. Recognizing that this put Xbox Live at a severe disadvantage, Microsoft caved. It allowed EA to maintain control over its own user data, marketing, and billing and reportedly also agreed to give EA financial compensation.

The biggest mistake you can make when deciding how to play is granting preferential terms to an MSP without carefully analyzing how the terms will affect the balance of power, both now and in the future. Failing to keep options open when you don't want the market to tip can put you at a significant disadvantage if the market does tip. This has been a painful lesson for the music studios in their relationship with Apple and iTunes. To contain the mortal threat posed by Napster and other file-sharing services, the studios hastily jumped on the iTunes platform in 2001. As a result, iTunes became the dominant platform for digital music, the studios found themselves dependent on it, and Apple has been able to extract most of the value of the business – mainly by keeping all the proceeds of its highly profitable iPod sales for itself. The studios should have considered the long-term implications of their decision to join iTunes more carefully and tried to negotiate more advantageous terms from the outset.

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Playing with multisided platforms soon will be a fact of life for all companies, big and small. MSPs reduce search and transaction costs and give companies vastly broader access to markets than they could achieve on their own. But over the past 10 years, we've also seen powerful owners of MSPs like Microsoft, Google, and Apple extract most of the value from platforms, because companies that played with them didn't adequately understand their motives and operating strategies.

So resist the herd mentality. Think twice before you join a popular platform. And remember that MSPs are moving targets and regularly review your strategy. The Google of tomorrow is unlikely to be the same platform as the Google of today. What's more, today's player can become tomorrow's platform. Until the iPhone was invented, most cell phone companies were players on the platforms of cellular networks. In the last two years, first the iPhone and then a slew of other cell phone manufacturers have rushed to turn themselves into the next-generation platform. Players should be on the lookout for opportunities to become the tail that wags the dog. If you play really well on an MSP, you may even be able to dictate the rules of the game.

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Reprint R0904F To order, see page 119.

When Internal Collaboration Is Bad for Your Company

by Morten T. Hansen

Working across organizational boundaries can create tremendous value – or destroy it.

INTERNAL COLLABORATION is almost universally viewed as good for an organization. Leaders routinely challenge employees to tear down silos, transcend boundaries, and work together in cross-unit teams. And although such initiatives often meet with resistance because they place an extra burden on individuals, the potential benefits of collaboration are significant: innovative cross-unit product development, increased sales through cross-selling, the transfer of best practices that reduce costs.

But the conventional wisdom rests on the false assumption that the more employees collaborate, the better off the company will be. In fact, collaboration can just as easily undermine

Jesse Lefkowitz

performance. I've seen it happen many times during my 15 years of research in this area. In one instance, Martine Haas, of Wharton, and I studied more than 100 experienced sales teams at a large information technology consulting firm. Facing fierce competition from such rivals as IBM and Accenture for contracts that might be worth $50 million or more, teams putting together sales proposals would often seek advice from other teams with expertise in, say, a technology being implemented by the prospective client. Our research yielded a surprising conclusion about this seemingly sensible practice: The greater the collaboration (measured by hours of help a team received), the worse the result (measured by success in winning contracts). We ultimately determined that experienced teams typically didn't learn as much from their peers as they thought they did. And whatever marginal knowledge they did gain was often outweighed by the time taken away from their work on the proposal.

The problem here wasn't collaboration per se; our statistical analysis found that novice teams at the firm actually benefited from exchanging ideas with their peers. Rather, the problem was determining when it makes sense and, crucially, when it doesn't. Too often a business leader asks, How can we get people to collaborate more? That's the wrong question. It should be, Will collaboration on this project create or destroy value? In fact, to collaborate well is to know when not to do it.

This article offers a simple calculus for differentiating between "good" and "bad" collaboration using the concept of a collaboration premium. My aim is to ensure that groups in your organization are encouraged to work together only when doing so will produce better results than if they worked independently.

IDEA IN BRIEF

» Are you promoting cross-unit collaboration for collaboration's sake? If so, you may be putting your company at risk. Collaboration can deliver tremendous benefits (innovative offerings, new sales). But it can also backfire if its costs (including delays stemming from turf battles) prove larger than you expected.

» To distinguish good collaboration from bad, estimate three factors:

Return. "What cash flow would this collaboration generate if executed effectively?"

Opportunity cost. "What cash flow would we pass up by investing in this project instead of a non-collaborative one?"

Collaboration costs. "What cash flow would we lose owing to problems associated with cross-unit work?"

» Would the return exceed the combined opportunity and collaboration costs? Initiate a collaboration project only if the answer is yes.

How Collaboration Can Go Wrong

In 1996 the British government warned that so-called mad cow disease could be transferred to humans through the consumption of beef. The ensuing panic and disastrous impact on the worldwide beef industry over the next few years drove food companies of all kinds to think about their own vulnerability to unforeseen risks.

The Norwegian risk-management services firm Det Norske Veritas, or DNV, seemed well positioned to take advantage of the business opportunity this represented by helping food companies improve food safety. Founded in 1864 to verify the safety of ships, DNV had expanded over the years to provide an array of risk-management services through some 300 offices in 100 countries.

In the fall of 2002 DNV began to develop a service that would combine the expertise, resources, and customer bases of two of the firm's business units: standards certification and risk-management consulting. The certification business had recently created a practice that inspected large food company production chains. The consulting business had also targeted the food industry as a growth area, with the aim of helping companies reduce risks in their supply chains and production processes.

Initial projections for a joint effort were promising: If the two businesses collaborated, cross-marketing their services to customers, they could realize 200% growth from 2004 to 2008, as opposed to 50% if they operated separately. The net cash flow projected for 2004 through 2008 from the joint effort was $40 million. (This and other DNV financial figures are altered here for reasons of confidentiality.)

The initiative was launched in 2003 and run by a cross-unit team charged with cross-selling the two types of services and developing new client relationships with food companies. But the team had trouble capitalizing on what looked like a golden opportunity. Individual business unit revenue from areas where the existing businesses had been strong – Norway for consulting services, for example, and Italy for certification – continued to grow, exceeding projections in 2004. But the two units did little cross-pollination in those markets. Furthermore, the team couldn't get much traction in the United Kingdom and other targeted markets, which was particularly disappointing given that the certification group had established good relations with UK food regulators in the years following the outbreak of mad cow disease.

As new business failed to materialize, the consulting group, which was under pressure from headquarters to improve its overall results in the near term, began shifting its focus from the food industry to other sectors it had earlier targeted for growth, weakening the joint effort. The certification group continued to make the food industry a priority, but with the two groups' combined food industry revenue lagging behind projections in 2005, DNV abandoned the initiative it had launched with such optimism only two years before.

Knowing When (and When Not) to Collaborate

DNV's experience is hardly atypical. All too often plans involving collaboration among different parts of an organization are unveiled with fanfare only to collapse or fizzle out later. The best way to avoid such an outcome is to determine *before* you launch an initiative whether it is likely to yield a *collaboration premium.*

A collaboration premium is the difference between the projected financial return on a project and two often overlooked factors – opportunity cost and collaboration costs. In simple form:

Projected return
– Opportunity cost
– Collaboration costs
Collaboration premium

The projected return on a project is the cash flow it is expected to generate. The opportunity cost is the cash flow an organization passes up by devoting time, effort, and resources to the collaboration project instead of to something else – particularly something that doesn't require collaboration. Collaboration costs are those arising from the challenges involved in working across organizational boundaries – across business units, functional groups, sales offices, country subsidiaries, manufacturing sites. Cross-company collaboration typically means traveling more, coordinating work, and haggling over objectives and the sharing of information. The resulting tension that can develop between parties often creates significant costs: delays in getting to market, budget overruns, lower quality, limited cost savings, lost sales, damaged customer relationships.

IDEA IN PRACTICE

In giving the green light to projects requiring collaboration, companies often fail to account for:

» **Conflict between groups.** Many cross-business project teams experience conflict over goals, budgets, and schedules as well as the division of work and the sharing of resources (including people, technologies, and access to customers).

EXAMPLE An initiative by the Norwegian risk-management services firm Det Norske Veritas (DNV) to increase sales by cross-selling services to food companies was undermined by the two units' unwillingness to share their customer relationships.

» **Competing individual objectives.** Team members are often pulled between a project's goals (such as jointly serving one group's customers) and existing financial incentives (such as bonuses based on revenue from their own customers).

EXAMPLE Members of DNV's cross-unit initiative were charged with meeting individual sales and profit targets within their own group while also cross-selling the other group's services.

» **Organizational challenges.** Even when conflict is minimal and incentives are properly aligned, the team will face challenges in coordinating logistics and meshing the participating groups' work practices.

Those problems result in collaboration costs, which include:

» **Delays** in completing a project or delivering products and services.

EXAMPLE Quarreling between DNV's certification and consulting groups delayed, and ultimately scuppered, efforts to build a common customer database.

» **Budget overruns,** often caused by those delays.

» **Lower quality,** resulting from errors and suboptimal service delivery but also from solutions that are less innovative than anticipated.

» **Limited cost savings,** because groups are reluctant to coordinate activities.

» **Lost sales,** primarily from a reluctance to share customer information.

EXAMPLE DNV's certification and consulting groups refused to freely share customer information (and used a number of rationales to justify their refusal), which forced the team to significantly reduce its estimates of the revenue to be generated by cross-selling.

» **Damaged customer relationships,** caused by conflicting messages from different parts of the company.

Including collaboration costs makes this analysis different from the usual go/no-go decision making for proposed projects. Obviously, such costs can't be precisely quantified, especially before a project is under way. Still, with some work you can arrive at good approximations. Given how much time managers already spend estimating the return on a project – and, occasionally, the associated opportunity cost – it makes sense to take the additional step of estimating collaboration costs, particularly because they can doom a project.

If, after going through this exercise, you don't foresee a collaboration premium – or if a collaboration *penalty* is likely – the project shouldn't be approved. Indeed, this sort of analysis might have helped DNV steer clear of a promising but ultimately costly business venture.

Collaboration During a Recession

INTERNAL COLLABORATION, often intended to spur new product development or increase revenue, may seem a low priority in a period of profit-focused cost cutting. That's a big mistake. Collaboration ought to be a crucial element of your recession strategy, because it will allow you to generate profits by exploiting existing assets – to do more with what you already have.

Wells Fargo headed into the 2002 recession with an enviable record of cross-selling 3.8 products, on average, per household customer. In 2002 the bank increased this number to an astonishing 4.2 – that is, it sold nearly one additional financial product for every two customers in the middle of a recession, squeezing additional profits out of its existing customer base.

Three kinds of collaboration are especially valuable in a recession:

Cross-selling. Follow the example of Wells Fargo and start programs to sell additional products to existing customers, who are more likely than those who don't know you to buy from you. This can increase your sales and lower the cost of selling, thus raising your profit per customer.

Best-practice transfer. Identify units in your company that are particularly efficient at certain activities – for example, the sales office with the lowest personnel costs – and get other units to follow their example. This can improve productivity and lower costs per employee.

Cross-unit product innovation. Find ways of combining existing technologies, products, and brands to create new products and services. This is cheaper than developing them from scratch and more likely to succeed because you draw on tested intellectual property. It can increase the number of new products, speed them to market, and lower development costs.

Avoiding Collaboration That Destroys Value

In calculating the collaboration premium, it's important to avoid several common errors.

Don't overestimate the financial return. Whether because of enthusiasm for collaboration or the natural optimism of managers, many companies place a mistakenly high value on collaboration. Especially when a team's work appears to be a model of collaboration – the parties freely share resources and cooperate in resolving differences while coming up with nifty ideas – it may be easy to overlook the fact that the work is actually generating little value for the company. Never forget that the goal of collaboration is not collaboration but, rather, business results that would be impossible without it.

In numerous well-known instances, collaboration premiums failed to materialize. Daimler's $36 billion acquisition of Chrysler in 1998 – with its promise of synergies between the two automakers – and the sale nine years later of 80% of Chrysler for a pitiful $1 billion constitute only the most conspicuous recent example. But collaboration's benefits are usually overvalued in much more mundane settings. Recall how the experienced sales teams at the IT consulting firm that Martine Haas and I studied shared expertise as a matter of course during the preparation of project proposals – never stopping to seriously consider whether they in fact benefited from doing so.

Don't ignore opportunity costs. Executives evaluating any proposed business project should take into account the opportunities they will forgo by devoting resources to that project. If the project requires collaboration, it's important to consider alternative noncollaborative activities with potentially higher returns. The opportunity cost is the estimated cash flow from the most attractive project *not* undertaken.

DNV didn't overestimate the potential financial return of its food initiative, but it did fail to assess the opportunity cost. "There was no consensus at the top level that food was interesting or a priority," said one senior manager. "We had not evaluated the food opportunity against other industry segments." In fact, food was only one of several sectors – including information technology, health care, and government – that DNV's consulting unit had targeted in 2001 as offering growth potential for its risk-management services. The opportunity in IT, which the consulting unit could have pursued on its own, undoubtedly had more potential. The unit made progress in 2004 generating new business in this sector, but it was constrained by a shortage of qualified consultants, some of whom were tied up with the food initiative. To pursue the food initiative, the consulting unit had to forgo additional business from the IT opportunity. I estimate the cost of this forgone opportunity at $25 million or more in lost cash flow.

Don't underestimate collaboration costs. In most companies it's difficult to get people in different units to work together effectively. Issues relating to turf, such as the sharing of resources and customers, often make groups resistant to

WHEN A TEAM'S WORK appears to be a model of collaboration, it may be easy to overlook the fact that it generates little value for the company.

collaboration. Individuals may resent taking on extra work if they don't get additional recognition or financial incentives. Even when collaboration delivers obvious and immediate benefits to those involved (for example, one unit's software package solves another's current problem), blending the work of two units that usually operate independently creates impediments.

These costs, which should be assessed before committing to a cross-unit project, can be tough to identify and quantify. And they will vary depending on the collaboration culture of an organization. But although they can be reduced over time through companywide efforts to foster collaboration, it's a mistake to underestimate them in the hope that collaboration can be mandated or will naturally improve during the course of a project.

As DNV decided whether to move forward with its food initiative, the project managers failed to consider the substantial collaboration costs the company would incur because it wasn't set up to collaborate. Mistrust between the consulting and certification units escalated as they tried – unsuccessfully, and with much quarreling – to build a common customer database. "All the team members tried to protect their own customers," one manager in the certification group admitted. Because of the reluctance to share customer relationships, the team had to significantly reduce its estimates of the revenue to be generated by cross-selling.

Individual members of the cross-unit team were also pulled by conflicting goals and incentives. Only one team member was dedicated to the initiative full-time; most people had to meet individual targets within their respective units while also working on the joint project. Some people got a dressing down from their managers if their cross-unit work didn't maximize their own unit's revenue.

Even those who saw the benefits of the initiative found it hard to balance their two roles. "We all had personal agendas," said one senior manager in the certification group. "It was difficult to prioritize the food initiative and to pull people out of their daily work to do the cross-area work."

Although assigning a financial number to collaboration costs is difficult, I estimate that the cash flow sacrificed as a result of tension between the two groups, which scotched probably one in two cross-selling opportunities, was roughly $20 million.

Had the likely opportunity and collaboration costs of DNV's food-safety project been estimated, the project would have looked decidedly less attractive. In fact, managers would have seen that, rather than a collaboration premium, it was likely to yield a collaboration penalty of something like $5 million – that is, the projected return of $40 million less an opportunity cost of $25 million and collaboration costs of $20 million.

How Collaboration Can Go Right

That's not the end of DNV's story, however. Several months after the firm abandoned the food-safety initiative, Henrik Madsen was named CEO. He had seen firsthand the poor business results, wasted management effort, and ill will spawned by the initiative, having been head of the certification unit at the time. But he also believed that performance could be enhanced by collaboration at the traditionally decentralized DNV.

Madsen quickly reorganized the firm into four market-oriented business units and began looking for collaboration opportunities. His executive committee systematically evaluated all the possible pairings of units and identified a number of promising opportunities for cross-selling. The unit-by-unit analysis also revealed something else important: pairings that offered no real opportunities for collaboration – an insight that would prevent wasted efforts in the future.

The disciplined process prompted the committee to assess the potential financial return of each opportunity. Estimates totaled roughly 10% of the company's revenue at the time. The projected returns helped the committee prioritize options and assess the opportunity cost of choosing one over another. On the basis of these findings, along with an assessment of likely collaboration costs, the company launched a round of collaboration initiatives.

One of these involved the maritime unit, which provides detailed classification of vessels for companies in the shipping industry, and the IT unit, which specializes in risk-management services for IT systems in many industries. Because ships today operate using sophisticated computer systems, someone needs to help shipping companies manage the risk that those systems will malfunction at sea. There was a clear opportunity to sell IT's services to the maritime unit's customers – if effective collaboration could be achieved between the two units. That opportunity has already borne fruit: The IT unit won a contract to develop information systems for a huge cruise ship being built by a longtime customer of the maritime unit.

The IT unit has also collaborated with the company's energy business to jointly sell services to oil and drilling companies – another opportunity identified in the executive committee's review. That effort enhances the IT unit's service offering with the energy unit's oil and gas industry expertise, a package that most IT competitors can't match. The two units split the revenue, which creates incentives for both.

In pursuing opportunities like these, DNV has worked to reduce some of the typical costs of collaboration. Annie Combelles, the chief operating officer of the IT business, says there was an obvious market for her unit's services among customers of the maritime and energy units. "My concern was that those units understand what we could deliver," she says. "My concern was internal, not external." The IT group appointed a business development manager who had worked at DNV for 12 years, including a stint in the maritime unit, and had a broad personal network within the company. This made him a trusted and knowledgeable liaison to the maritime and other units, reducing potential conflict between them and the IT unit.

What's more, the IT unit has moved cautiously in trying to capitalize on opportunities for internal collaboration. Although the maritime group's longtime relationship with the cruise ship operator provided entrée for the information technology group, maritime didn't want any missteps from IT to jeopardize that valuable relationship. IT therefore initially proposed a risk-assessment project in nonvital areas of the ship such as the "hotel" function, which included the Wi-Fi network, gambling computers, and the 5,000 personal computers to be used by guests. It evaluated each of these systems and identified 30 risks. This success led to a project involving vital areas of the ship, such as the power-management and positioning systems.

IT'S A MISTAKE to underestimate collaboration costs in the hope that collaboration can be mandated or will naturally improve during the course of a project.

DNV's renewed effort to encourage cross-unit collaboration is a work in progress that has nonetheless already produced some hard results: The portion of the IT unit's sales that came from cross-unit collaboration climbed from almost nothing to 5% in 2008, and is projected to be 10% in 2009 and 30% the following year.

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Business leaders who trumpet the benefits of working together for the good of the organization are right in seeing collaboration's tremendous potential. But they should temper those exhortations with the kind of analysis I've described here, which provides needed discipline in deciding when collaboration creates – or destroys – value. Ideally, as organizations become better at collaboration, through incentives and shifts in corporate culture, the associated costs will fall and the percentage of projects likely to benefit will rise.

Although the collaboration imperative is a hallmark of today's business environment, the challenge is not to cultivate more collaboration. Rather, it's to cultivate the right collaboration, so that we can achieve the great things not possible when we work alone.

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To understand how competitors will respond to your next move, evaluate the situation in their terms – *not yours.*

Predicting Your Competitor's Reaction

by Kevin P. Coyne and John Horn

ANY EXECUTIVE will tell you that understanding how competitors will respond to your actions should be a critical component of strategic decision making. But ask that same person how seriously her company actually assesses competitor reaction, and she will probably roll her eyes. In a recent survey conducted by McKinsey & Company, two-thirds of strategic planners expressed a strong belief that companies should incorporate expected competitor reactions into strategic decisions. Yet in a survey conducted by David B. Montgomery, Marian Chapman Moore, and Joel E. Urbany (published in 2005 in *Marketing Science*), fewer than one in 10 managers recalled having done so, and fewer than one in five expected to in the future.

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This disconnect arises because the only rigorous framework for explaining rivals' behavior – game theory – often becomes unmanageable in the real world. For a start, most game theory models presume that *all* players use the basic principles of game theory – an assumption that is manifestly false. Further, game theory models become unwieldy when a competitor has many options, when the strategist is unsure which metrics his rival will use to evaluate them, or when there are multiple competitors, each of whom might react differently. But when strategists instead use ad hoc predictions or war-gaming exercises, the analysis can become almost entirely arbitrary. The number of qualitative considerations that enter the prediction process – personal biases and hidden agendas, for example – risk rendering the results suspect and make senior management more likely to reject counterintuitive results.

IDEA IN BRIEF

» Research shows that few companies actually undertake competitor analysis seriously. That's because they find most approaches suspect or too complicated.

» But most companies respond fairly predictably to such moves as new-product launches and price changes, which means you really have to consider only three questions: Will your competitors react at all? What options will they consider? Which options are they most likely to choose?

» Thinking carefully through these questions will let you more accurately gauge your rivals' reaction to your next strategic move.

Over the past few years, as we have led McKinsey's efforts on modeling competitive behavior, we have worked with many companies to predict likely reactions to their strategic moves. Through that work, and through a survey of senior executives we conducted in 2008, we have developed a practical approach to predicting competitive behavior that stays close to the theoretical rigor and accuracy of game theory but is as easy to apply as most of the alternative methods. (See the sidebar "Our Research" for more on the survey we used.) Our approach involves distilling all possible analyses of a rival's response to a particular strategic move into a sequential consideration of three questions:

- Will the competitor react at all?
- What options will the competitor actively consider?
- Which option will the competitor most likely choose?

Two facts make this simplified process possible. First, if your adversary uses rudimentary analytic techniques – which our survey shows to be the case for most companies – then you can use those techniques to predict his response. Second, most large companies, we found in our research, follow a predictable pattern in determining their reaction to a competitor's move.

The payoffs from adopting the approach we advocate can be high – particularly compared with the cost of making no predictions at all. We helped the largest player in a transaction-processing industry recognize that a new direction in its strategy would probably provoke a constructive, rather than destructive, response from its biggest rival. The company implemented the strategy, the rival responded as predicted, and the result was a turnaround in the fortunes of the entire industry. We also watched from the sidelines as a telecom company failed to understand its rivals and so paid too much for a new telecom license – a mistake that cost the company \$1 billion and contributed to its bankruptcy within a few years.

In this article, we will examine each of the three questions above and reveal many of the norms, biases, and patterns that companies follow in studying their rivals. Please note that the results cited in this article are averages across industries, locations, company sizes, and competitive environments – all of which can affect these tendencies significantly. (In actual client situations, we use tendencies specific to the client's circumstances.) If you have specific information about how your market segment has behaved or, even better, how an adversary generally makes choices, you should substitute it for our averages. But, as you will see, knowing the tendencies of all companies helps simplify the process without unnecessarily sacrificing accuracy.

Will the Competitor React at All?

Even companies that do analyze their competitors usually fail to consider that a rival might choose not to respond to a strategic move. In ignoring that possibility, the strategist lowers his estimate of the expected value of his company's move: the higher the perceived probability of counteraction by competitors, the lower the expected payoff. And with a lower expected payoff, the company is less likely to take bold action.

Why do otherwise diligent strategists skip this step? First, all managers – including, somewhat ironically, those who don't bother with competitive analysis at all – are schooled in stories of companies that failed by ignoring their rivals, so they are afraid that in assuming no reaction they will end up being a protagonist in one of those narratives. If they actively predict no reaction, and the competitor does respond, they fear that they will look even worse. To avoid those scenarios, they err on the side of assuming a response. Second, in companies that use war-gaming exercises, individuals must represent the competitor. These people often think they will look smarter and more engaged if they predict a brilliant move or countermove by the competitor than if they simply report to the group, "We've thought about it, and we don't think we should do anything." Imagine if a day-long war-gaming workshop started off that way. The organizers would probably ignore the initial finding and force the group to continue the move-countermove exercise.

The first step in analyzing competitor reaction, therefore, is to address the likelihood of no reaction. To determine this, you must ask four subquestions. If the answer to any of them is no, the chances of a response are low.

1. Will your rival see your actions? Even if an action appears obvious to you, your competitor may not recognize it, for at least two reasons. First, most companies rely on incomplete data to assess changes in the marketplace. For example, most large consumer goods companies in China gather data on competitor volumes in only 30 large cities, which account for about half of the market. As a result, they simply do not detect new products targeting smaller cities. In the United States, a major consumer products company recently missed significant inroads by a competitor because the market-tracking service it (and most similar companies) used did not survey dollar stores, which accounted for 20% of the market for this type of good. Second, if your new product will affect several of your competitor's business units, it may not register as significant to any one unit and so may be overlooked. On average, only 23% of the participants in our survey learned about a competitor's innovation early enough to respond before it hit the market (although we asked respondents broadly about product or service innovations, we will use the term "new product" to describe these particular responses). When it came to competitors' pricing moves, only 12% of the respondents learned about a price change in time to prepare a preemptive response. (In our research, we asked one group about responses to an innovation and another group about responses to pricing moves.)

Remember also that you can improve your odds of escaping detection even more by exploiting your competitors' blind spots, some of which will become obvious as you consider the next three subquestions.

2. Will the competitor feel threatened? Even if your competitor sees your actions, he may not feel threatened – and, accordingly, will not think that mounting a response is worth the expense and distraction. Most organizations assess performance strictly against their annual budgets. If the financial goals in the budget can still be met despite your planned

IDEA IN PRACTICE

» Will your competitor react at all to a new-product launch or price change?
The authors' research suggests that your strategic move may go undetected: Of the senior executives they surveyed, only 23% learned about a competitor's new-product launch early enough to respond before it hit the market, and only 12% learned about a price change in time. Even if they detect the move, rivals may not feel threatened enough by it to interrupt their existing plans. There's probably a 30% chance that no competitors will react to your move unless it is very disruptive (and even if they do respond, you'll probably have the market to yourself for a while).

» What options will your competitor consider?
Few companies analyze more than three options. Almost everyone considers the most obvious ones: matching a price change or introducing a me-too product. For guidance, some examine what their business unit did the last time or what has happened elsewhere in their company. It's very likely that your rivals will also seek advice from board members and external advisers.

» Which option will your competitor choose?
Look at this question through a competitor's lens, not your own. Most companies use simple, short-term measures. Only about 15% track NPV. Seventeen percent use short-term market share, while another 17% use short-term earnings. Twenty percent look at long-term market share, and 21% look at long-term earnings. Do not take the phrase "long-term" too literally: Only 15% look more than four years ahead, and the time horizon varies across industries and locations.

23% **Only 23% of the executives we surveyed learned about a competitor's new offering early enough to respond before it hit the market.**

action, management will see the company as "on plan" and will feel safe. So, understanding whether your adversary will stay on track despite your action is central to determining whether he will respond and is often easier to figure out than you might expect. Some companies announce their goals by product line. Many companies release earnings targets. For public companies that don't formally release their targets, the earnings estimates of securities analysts – which many companies take as their targets – can substitute. If no such information is available, simply measure the previous year's growth rate in volume and assume the company will want to achieve a similar rate in the current year. After determining your competitor's likely goals, you can examine industry sales data to determine whether the company is on track. Add in the probable effects of your action, and you can make an initial prediction about whether the company will *stay* on track.

Will the Competitor React?

The first step in analyzing a competitor's reaction is to address the likelihood of no reaction. To determine this, you must ask four questions. If the answer to any of them is no, the chances of a response are low.

1. **Will your rival see your actions?**
2. **Will the competitor feel threatened?**
3. **Will mounting a response be a priority?**
4. **Can your rival overcome organizational inertia?**

3. Will mounting a response be a priority? Your adversary already has a full agenda before you make a move. On it are product launches, marketing campaigns, reorganizations, major acquisitions, plant openings, and cost reduction efforts – some or all of which must be curtailed in order to react to your move. Therefore, to the degree that your adversary has already committed to plans that will fully occupy his attention, he will be reluctant to shift priorities. By understanding the perceived "cost" to your competitor of forgoing his planned initiatives, you can sense whether he may choose to ignore you. Further, remember that some priorities of the business unit you are threatening will probably have been established by its corporate parent. For example, suppose a unit's parent faces earnings pressure from Wall Street. If the unit's orders are to generate current earnings, its management might not react (or might choose an inadequate response) despite feeling quite threatened – if a strong reaction would be even more expensive in the short-term than ignoring your action.

4. Can your rival overcome organizational inertia? Even if top management wants to react, the organization as a whole may resist. Several factors can contribute to this impediment. First, if reacting requires the company to make major organizational changes, it is very unlikely to do so unless the threat is immediate and deadly. We once worked with a telecom client that would face competition from new entrants within three years. To prepare, the client needed a new planning process, which would take the full three years to develop and implement. Because the threat did not affect current performance – even though managers acknowledged it – the company could not muster the will to do more than make small changes. As a result, it eventually lost more than 30% of its market share.

Second, managers are generally reluctant to abandon their success formula, and if they decide to go ahead and make a change, they are very poor at doing so. Employees follow thousands of procedures that were established to reinforce the formula. These die hard.

Third, companies have great difficulty mounting a response that requires the cooperation of third parties, which may not share their sense of urgency. In the late 1980s, a small U.S. pizza delivery chain called Papa John's noticed a change in consumers' perception of the quality of Pizza Hut and Domino's (the top two chains) and used the opportunity to create a differentiated value proposition captured in the slogan, "Better ingredients. Better pizza." Papa John's expanded rapidly throughout the 1990s and became the third largest pizza chain in the country, while the two bigger rivals stagnated. Unable to mobilize their franchises around quality until the threat became undeniable, the big chains did not respond with better pizzas of their own until 2000.

Whereas all competitors will notice a large move, our experience suggests that companies overestimate by 20% to 30% the likelihood that a medium to small action will be noticed. In addition, 17% of our survey respondents reported making no response even if they did notice. This is remarkable, because respondents were describing only situations they recalled most vividly, in which their company noticed a threat and classified the action as a "major" move with "the potential to significantly affect your view of your competitive position in your market segment." Thus, the likelihood of no response in the average real-world situation could be much higher. Considering all these factors, it is reasonable to assume that companies do not respond to their rivals' moves at least one-third of the time – certainly enough to justify an explicit effort on your part to determine whether your rival will. What's more, simply asking yourself whether a competitor will respond streamlines the entire task. If you predict the company won't respond, you can skip the remaining steps.

17%

Even if they noticed a rival's strategic move, *they did not respond to it*, 17% of our survey participants reported.

What Options Will the Competitor Actively Consider?

According to classical game theory, your next step would be to develop the full list of options your competitor could consider, on the assumption that it would study all of them before selecting one. This very assumption, however, lowers companies' confidence in their ability to predict and hence leads them to forgo analysis. In contrast, our experience with clients and the results of the survey indicate that although competitors may discuss many response options, they seriously investigate only a small number. The day-to-day responsibilities that prevent some competitors from responding at all can also prevent them from allocating time to analyzing all options.

When we looked at the number of options examined by companies searching for responses to a rival's new-product launch or price change, we found that the overwhelming majority consider fewer than four. The median number of options actively considered was almost exactly between two and three. The distribution was also tight: Almost 75% of the respondents looked at two or three; 10% or less looked at five or more. Because you can't *know* which options a rival will consider, you must analyze more than he does. That said, the number can be contained, because you can *predict* which options he will analyze. For both the innovation and pricing groups in our survey, the most common option competitors analyzed was "the single most obvious counteraction" (in these situations, that would be introducing a me-too product or matching a price change). In both cases, about 55% of the participants indicated that they considered this most obvious option, and over one in three of those who examined only one option selected that response. So, there's a good chance that a rival is seriously considering the most obvious response.

There were some differences, however, in the other options considered in a new-product context and those considered in a pricing context. Forty-three percent of pricing managers looked at what their business unit did the last time it faced a similar situation, whereas only 26% in the innovation group did so. Twenty-five percent of the innovation managers reported that they were likely to look at recent actions by other business units in the company, whereas 16% of pricing managers would take this approach. About 30% of managers in both groups sought advice from board members and external advisers. The second-least likely option (20% for both groups) was looking at the experiences of the business unit the time *before* last, and the least likely option (19% for both groups) was considering the prior experience of the executive in charge. The bottom line is that you don't need to look too far back to figure out which options your rivals will analyze.

Which Option Will the Competitor Most Likely Choose?

From the previous step, you will have developed a short list of options your adversary is likely to consider. Now your task is to home in on the one he will choose. For many strategists, this prediction causes the most anxiety. It does not need to. Remember that the only alternative to making this prediction – avoiding predictions – is much worse, so you do not have to be accurate 100% of the time for the effort to be valuable.

Classical game theory (the kind most strategists know) takes a complex route to that prediction: It says that a competitor will choose the option that maximizes his net present value after taking into account all sequential moves and countermoves by all competitors (each of whom typically has perfect knowledge of the others' motives, economics, and options) until a new equilibrium is reached. Unfortunately, no part of that prescription generally holds in the real world.

If strategists combine the *spirit* of game theory with the actual behavior of companies, prediction can be both simplified and improved. Our experience has taught us to begin with this

OUR RESEARCH The findings presented in this article combine our experiences helping clients make competitive predictions over the past 15 years with the results of a survey we conducted in 2008 at McKinsey & Company, in which senior executives reported on their responses to competitors' initiatives. The survey was intended to test the validity of the framework we have developed over the past few years and to quantify the underlying behavioral tendencies we have observed. Certain parts of the framework – such as estimating the likelihood of a company's failure to notice an adversary's move – could not be tested in such a survey and so are reported here on the basis of our experiences alone.

Of the approximately 4,700 individuals who received the survey, 1,825 – almost 40% – responded. Participants were preselected to answer either a set of questions dealing with responses to a product or service innovation or questions about responses to a price change. The total pool was split evenly between the two sets of questions, and the surveys we received mimicked this ratio (914 from innovation and 911 from pricing).

In both sets of questions, we asked participants to describe in detail (based on our framework) the decision-making processes they had followed to formulate a response to a recent "major" move by a competitor. We defined a major move as one with "the potential to significantly affect" the participant's view of her company's competitive position. While it's possible that a major move to one respondent was more or less severe to another, we chose this language to increase the comparability across respondents. Further, we asked them to supply quantitative and qualitative descriptions of the actual moves in order to allow even more precise comparisons.

In addition to asking about the steps taken to respond to the competitive change (the pricing group was asked to consider not only price decreases but also increases, so the moves weren't necessarily all "threats"), we obtained information on the respondent's location, industry, basic industry structure, relative size, competitive intelligence gathered, the basic type of innovation (modification or new, existing competitor or new entrant), size of the initial mover, when the company learned about the move, who was in charge of responding, the expected impact, the actual impact, whether the response tried to hurt the initial mover, and the exhaustiveness of the effort.

rule: Of the options your adversary seriously considers, he will choose the one that is most effective (according to *his* analytic technique) within the constraints of his trade-off between short-term and long-term pain. The rule makes sense, and it has proven accurate in our client work. To apply it, strategists need to examine the following two subquestions:

1. How many moves ahead does your competitor look? In chess, we are told that the best players look ahead five or more moves – a process that (intuitively) involves sorting through hundreds of thousands of "if he chooses *x*, I will choose *y*, and then he will choose *z*" scenarios. Thinking ahead in business is a similar process. We have constructed realistic experiments in which the optimal decision changes depending on whether one uses an even or odd number of rounds. Further complicating matters, your adversary's best response could differ depending on whether he considers only your reaction or those of other competitors as well.

Fortunately, although there are many ways to analyze a situation, the large majority of companies want to avoid complexity as much as you do, so they restrict themselves to simple, easily replicable analyses. When asked the number of moves and countermoves they analyzed, about 25% of our respondents said that they modeled no interactions beyond their own response. In certain instances (for example, financial services responses to pricing moves), this figure was as high as 45%. The next two most-common answers were assuming a *single* round of counter-reaction either by the initial mover (the company making the innovation or price change to which the competitor is responding) or by multiple competitors. That is, about 35% worked with a one-stage reaction model. (Again, in certain industries, the percentage was much higher.) Fewer than 10% of the managers we surveyed looked at more than one round of response by more than one competitor.

2. What metrics does the competitor use? Companies often mistakenly assume that everyone measures success in the same way. This explains why many of our clients claim that their competitors are "irrational." But would your most important competitor, who by definition has made a succession of smart decisions (otherwise he would not be your most important competitor), choose this moment to take leave of his senses? Or is he simply pursuing a strategy that looks poor according to your preferred measures but looks very clever according to his? To discover your competitor's metrics, simply ask yourself, "What measure would have led my competitor to his recent decisions?" You will not have to search far for the answer. Most companies use simple, short-term measures. In our survey, only about 15% of respondents used NPV to evaluate their options. Seventeen percent used short-term market share, while another 17% used short-term earnings. Twenty percent looked at "long-term" market share, while another 21% looked at "long-term" earnings. Do not take our respondents' use of the phrase "long-term" too literally, though. When asked

25%

Only 25% of our survey participants considered *more than two or three options* for responding to a rival's move.

how far into the future they forecasted the costs and benefits of their possible responses, 85% said four years or less, and about 62% said two years or less. These figures varied by the respondent's location and industry. For example, in analyzing pricing moves, most respondents who were in Asia-Pacific shortened their time horizon to one year, whereas financial services firms expanded it to three to four years. Clearly, managers find it difficult to trade the certainty of short-term expense for the uncertainty of long-term gain.

Your final task is to mimic your adversary's decision-making process by applying his metrics and analytic techniques (including the rounds of competition) to the options you think he will look at in order to see which one (or ones) seems best. Sensitivity analyses should be conducted for the elements of greatest uncertainty to help determine whether or not the choice for your adversary is clear-cut. If these indicate that the decision is a close call, then you must also assess your adversary's recent actions in response to a competitive move. Our research suggests that even if companies consider multiple response options, most will have a clear preference for one or two. The companies represented in our survey that reacted to a strategic move at all (remember that 17% did not react) usually either made the most obvious response (22% in the innovation group, 18% in the pricing group) or relied on the instincts of the decision maker (19% of innovation managers, 13% of pricing managers). What you must do, therefore, is spend some time understanding the patterns the CEO or relevant executives have displayed in prior decisions: Get a gut feel for their gut feel. Talk to people who have worked with those executives and learn about the units they have led. Look at the history of the competitor's other units, as well.

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A rigorous analysis of competitors' behavior doesn't have to involve a lot of math and talk of Nash equilibria. The key is to focus on understanding how a competitor *actually* behaves rather than on the theory of how everyone *should* behave. By studying your competitor's past behavior and preferences, you can estimate the likelihood of his responding at all, identify the responses he is likely to consider, and evaluate which will have the biggest payoff according to his criteria. This information can give you an accurate idea of what your competitor is likely to do. And the competitor you can predict is the one you can learn to outsmart. Isn't that what strategy is all about?

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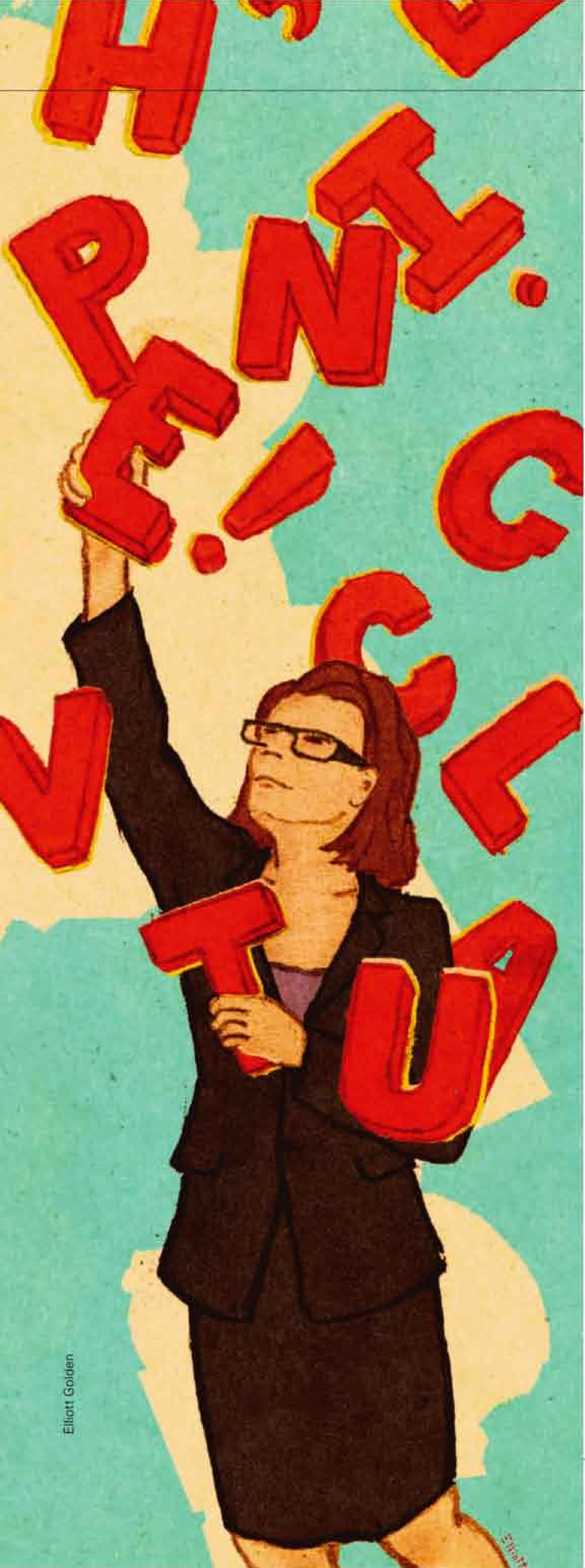
"I prefer to call it information rustling."

P.C. Vey


Elliott Golden

Managing Yourself

BY JEFFREY D. FORD AND LAURIE W. FORD

Decoding Resistance to Change

Strong leaders can hear and learn from their critics.

WHEN CHANGE INITIATIVES run aground – as they so often do – change agents can be quick to point a finger at the people who never got on board. The assumption is that they resisted a perfectly logical move, so it fell apart.

However, blaming resisters not only is pointless but can actually lead to destructive managerial behaviors. When managers perceive resistance as a threat, they may become competitive, defensive, or uncommunicative. They are sometimes so concerned with being right – and not looking bad – that they lose sight of their original goals. In stubbornly pushing things through without understanding the resistance, they sacrifice goodwill, put valuable relationships in jeopardy, and squander the opportunity to engage skeptics in service of a better plan. They don't hear about missing pieces and faulty assumptions. And, in true us-versus-them fashion, they presume that only the other folks – the resisters – need to alter their behavior and that the change would succeed if not for the resisters' irrational and self-serving actions.

It's true that resistance can be irrational and self-serving. But like it or not, it is an important form of feedback. Dismissing it robs you of a powerful tool as you implement change. It takes a strong leader to step up and engage when a change effort meets with pushback. If you can gain perspective by paying attention to, understanding, and learning from behaviors you perceive as threatening, you will ultimately deliver better results.

Resistance Is a Resource

In our research and consulting work, we've had the opportunity to study change initiatives at scores of large and small companies, and we've found that to understand resistance to a program, you need to start by adjusting your own mind-set. Ask yourself two questions: "Why am I seeing this behavior as resistance?" and "If I viewed the resistance as feedback, what could I learn about how to refine the change effort?" Once you've honestly answered those questions, you can begin to see resistance as a resource – as energy to be channeled on behalf of the organization. (See the sidebar "Defining Resistance.") Even difficult people can provide valuable input when you treat their communications with respect and are willing to reconsider some aspects of the change you're initiating. Here are five ways you can use resistance to effect change more productively.

1. Boost awareness. By the time you're ready to implement a change program, you've probably had ample opportunity to process what it will mean for you as an individual. It's easy to forget that the change hasn't been similarly internalized by those who will be most affected by it – in ways you can't imagine. Drop two levels down in the hierarchy, and the tasks people are doing are probably invisible to you. Their jobs will change in ways that you don't understand, and if you suppress dialogue, you'll miss opportunities to gain their buy-in. In the early stages, any talk – even a litany of complaints or a highly charged discussion – may be the one thing that keeps a conversation about change alive.

IDEA IN BRIEF

- **When change initiatives founder, leaders often blame resistance. They assume that if only people would stop complaining and get on board, all would be well.**
- **Resistance is, in fact, a form of feedback, often provided by people who know more about day-to-day operations than you do. It can be turned into a vibrant conversation that gives your change effort a higher profile.**
- **Dismissing the feedback deprives you of potentially valuable information, costs you goodwill, and jeopardizes important relationships.**
- **If you learn to embrace resistance, you can use it as a resource and find your way to a better solution.**

2. Return to purpose. Awareness is about *what;* purpose is about *why.* People who aren't involved in the planning need to understand not only what is about to change but also why their jobs are being upended.

We worked with Alison, an IT executive who was preparing for a change in her hospital's computer systems for registration and insurance reimbursement. With those two functions at the opposite ends of the business cycle, the new systems would touch almost every employee, including clinical and laboratory personnel, in some way. The initiative was a crucial one because delays in reimbursement are costly to hospitals, and the most common reason for rejecting claims is incomplete or inaccurate information. When a bill bounces back, it can take a long time to track down the error; some irregularities are never resolved.

Throughout the design process, Alison had communicated regularly with the rest of the executive team, preparing handouts for them to take back to their groups. Given that effort on her part, she'd assumed that the executives would explain to rank-and-file employees how the move would benefit not just the company's bottom line but also the patients the company served, by ensuring they received the right treatments and were not wrongly billed. As it turned out, the executives had been reluctant to deliver what they feared would be seen as bad news, and leaders from functions such as finance and clinical services didn't feel equipped to answer questions about the new technology. They'd hoped that Alison would take charge of the kickoff, so their people had heard only rumors – and no explanation of the rationale for the change. Consequently, her launch meetings were contentious. The insurance team, which feared that historical files would become inaccessible, was particularly annoyed.

Alison had to postpone the rollout and arrange a series of meetings to explain the changes, with IT team members at the ready to describe their implications. Though she was disappointed that the members of the management team hadn't communicated with their own people, she acknowledged a key lesson: The pushback from frontline employees made her appreciate the need to educate the entire hospital staff about the purpose of the systemic change.

3. Change the change. Frustrating though it is, resistance can lead to better results. People who are outspoken about their objections to a change are often those who genuinely care about getting things right and who are close enough to the inner workings of an organization to recognize a plan's pitfalls.

Consider Harold, the COO of a large manufacturing organization we worked with. He had drawn up a plan to consolidate two groups: the product design engineers, who worked at the main office, and the capital-planning engineers, who worked in the plants. His objective was to improve collaboration, communication, and efficiency. But when Harold announced his plan, Eric, the manager of the capital-planning engineers, voiced strong objections at every turn. As the meeting progressed, Harold grew reluctant to allow Eric to speak; his vague and ambiguous complaints were incomprehensible to Harold and made people uneasy about the change.

Harold later invited Eric in for a private discussion and, with some probing, discovered what was really bugging him. The capital-planning engineers worked closely with a third group, plant maintenance, to make decisions about what equipment to buy, lease, repair, and so on. "You don't want to have me reporting to the product design group or even the engineering VP," Eric told Harold. "I belong with the plants because that's where my work is." Furthermore, the head of maintenance had informed Eric that he would start looking for a new job – taking a couple of his best mechanics with him – if he was not on the same team with the capital-planning engineers. He didn't want to have to beg for engineering support or miss chances to offer his input about capital purchase decisions.

Eric was surprised when Harold asked him for alternative ideas that would still meet the objectives of the consolidation plan. Eric proposed a biweekly, half-day "consolidation meeting" of all the engineering teams in the company. The gathering would have a specific agenda: to address machine status and maintenance issues, equipment needs related to partnerships and product lines, and capital investment plans. "My consolidation plan was out the window," Harold admitted. But the new plan met the company's goals more effectively than his initial proposal had.

A litany of complaints may be the one thing that keeps a conversation about change alive.

4. Build participation and engagement. Buy-in can be a simple matter of being heard, as the experience of Sharon, the leader of a 110-person phone center we worked with, shows. Sharon was preparing to integrate a group of 30 billing specialists with the existing workforce. Her plan called for telephone staff to learn how to send and adjust bills, and for billing staff to become skilled at other customer service tasks. She believed the company would benefit from having a larger group of people who were cross-trained in the two aspects of customer relationships.

Sharon anticipated some pushback when she introduced the change in a series of meetings with the staff, and she got it in spades. So she took careful note of everyone's concerns and ideas, ultimately creating a "worry list" and an "idea list" from among the most common and important items. The biggest worries concerned pay scales and the apportionment of physical space when the groups merged. The idea list included proposals that had been offered in every group (for instance, mix the staff together in similar cubicles); ideas suggested by only a few people with specialized knowledge (get a second intranet server to support faster communication); and a few wild cards, which Sharon thought were unlikely to go anywhere. Among the wild ones: let the billers train the phoners and the phoners train the billers, and give the staff the unspent training dollars as a bonus; forget about cross-training and move everybody into the same area but keep their functions separate; go ahead with the cross-training but don't move the billers into the call center.

Sharon took the worry and idea lists to the rest of the executive team and, with their input, created a third "executive action list." She then brought the three lists into follow-up meetings with staff. Employees bypassed suggestions to reject cross-training and relocation; they knew those were basically nonnegotiable. But, to Sharon's surprise, they jumped at the prospect of training one another – a proposal she'd considered so ridiculous that she hadn't even taken it to the executive team. Employees were so enthusiastic about that idea that the group came up with a way to integrate it into the plan. Sharon said that, regardless of her own opinion, it was worth the effort to let them "get something they felt was at least partly their own." She willingly embraced the core concerns of her people – which were really about whether they'd get along and whether different groups would remain socially separate even after they were collocated – and she held events to forge stronger relationships among them. In the process, Sharon bonded with her employees and fostered good cooperation as they underwent training and then collaborated in their new location.

5. Complete the past. As employees listen to new proposals, they remember previous experiences. Given the dismal rate of success in change efforts, it's not surprising that people expect history to repeat itself – and resist going through it all over again. If you don't know the history, an explanation for the resistance can remain elusive.

George, the head of a vehicle service organization we studied, planned to upgrade his maintenance team's technology by giving the group GPS and computer communications systems. He had met with the fleet and service supervisors one-on-one, and he knew they wanted these systems. But when he spoke to them as a group about the installation and training schedules, the supervisors surprised him by saying, "This isn't going to be fair for the backroom machine guys," "You're going around us again," and "This won't work any better than last time."

When George probed into their skepticism, one supervisor finally mentioned an incident from a training program two years earlier. George's predecessor had promised promotions and pay raises to the purchasing and inventory staffers if they could switch to a new system within eight weeks. The four men involved buckled down and learned the new system, transferred inventory data, and updated their records in time – but they never received their promotions or pay hikes. Embarrassed, the manager at the time found a poor substitute for three of them – some overtime opportunities – and promised the fourth a promotion when he reached his two-year anniversary. But that never came to pass because the manager left the company before the anniversary.

The men believed that the manager had never intended to obtain raises and promotions. They'd also convinced them-

Defining Resistance

Managers have many terms to describe resistance: pushback, not buying in, criticism, foot-dragging, and so on. And they may perceive as resistance a broad spectrum of behaviors they don't like – from an innocent question to a roll of the eyes to overt sabotage.

Moreover, whether something constitutes resistance is a subjective matter, on both sides. Consider the experiences of David, Elaine, and Allen, managers at an insurance company who held meetings in their respective units to inform people about the launch of a new performance-management system. These meetings were the first opportunity for frontline employees to learn the particulars.

The three compared notes afterward. David said he'd gotten considerable "pushback" in the form of "a ton of questions." He'd felt as if he were being "interrogated"; employees were "irritated" when he didn't know the answers. Elaine didn't get a single question and characterized the shallow comments and silence as "stonewalling." Allen described his people as "very receptive." They'd asked many questions, and although some employees were disappointed when he didn't have an answer, he promised to get back to them. Overall, he reported a "very engaging and energizing" meeting.

We didn't attend these meetings, but disparate attitudes toward resistance are nonetheless evident in the managers' responses. Two opposite behaviors – asking questions and not asking questions – were perceived as resistance, depending on the manager. Asking questions was itself seen in different ways, either as resistance or as engagement. Meanwhile, so-called resisters probably didn't view their own behavior as inconsistent with the organization's objectives. (When managers themselves exhibit "resistant" behavior, they often rightly don't see it as such. Indeed, it's usually a manifestation of a rational, reasonable desire to be heard.)

Quite possibly, Elaine unconsciously discouraged questions; alternatively, the members of her group might legitimately have had nothing to ask – they'd heard enough. She simply chose to see stonewalling in their silence. David didn't consider the possibility that either his lack of answers or his failure to promise to get them might have contributed to people's irritation. His folks might even have been surprised to hear him label their questions as "pushback," given that the meeting was seemingly an opportunity to get answers. Allen, in contrast, appeared to enjoy the dialogue, questions and all – a receptiveness that exemplifies a productive reaction to resistance.

selves that his decisions had racial and cultural overtones. Although George hadn't been the cause of the problem, he knew he would have to live with its consequences. His solution: a heartfelt public apology to the employees, on behalf of the company, for their having been misled and for the lack of respect demonstrated by leaving the problem unresolved. He went further, offering his personal apology to each man and promising he would do what he could to "make it right."

George kept his promise. He met with the director of HR and the VP of operations to see that the purchasing and inventory personnel got their promised titles and the best pay increases the budget would allow. Three weeks later, the HR director met personally with the men to tell them when the pay hikes would take effect. As their skepticism finally began to dissolve, one inventory manager said, "You know what made the biggest difference to me? Seeing that George was shocked and sorry to find out we had been treated like that in the first place. The way he said he was sorry, even though he hadn't done anything, I knew we had a friend."

> To Sharon's surprise, they jumped at the prospect of training one another.

George's experience makes clear that responses to a change proposal may have little or nothing to do with the current plan. Unacknowledged failures in past change efforts, questionable ethical incidents, and negative cultural tendencies are often invisible backdrops to a newly planned change.

...

Our work has turned up many instances in which people resisted a change for no apparent reason other than that change didn't suit them. However, in the end, it doesn't really matter why folks are dragging their feet. When we pin failure on resistance, we risk overlooking opportunities to strengthen operational outcomes – and to correct our own biases. We also lose credibility in the eyes of change recipients, who may in turn withhold their specialized knowledge and sabotage the success of the change initiative. Resistance, properly understood as feedback, can be an important resource in improving the quality and clarity of the objectives and strategies at the heart of a change proposal. And, properly used, it can enhance the prospects for successful implementation.

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Molly Sadler

"I didn't mean to hurt his feelings. He's just not the incentive I had in mind."

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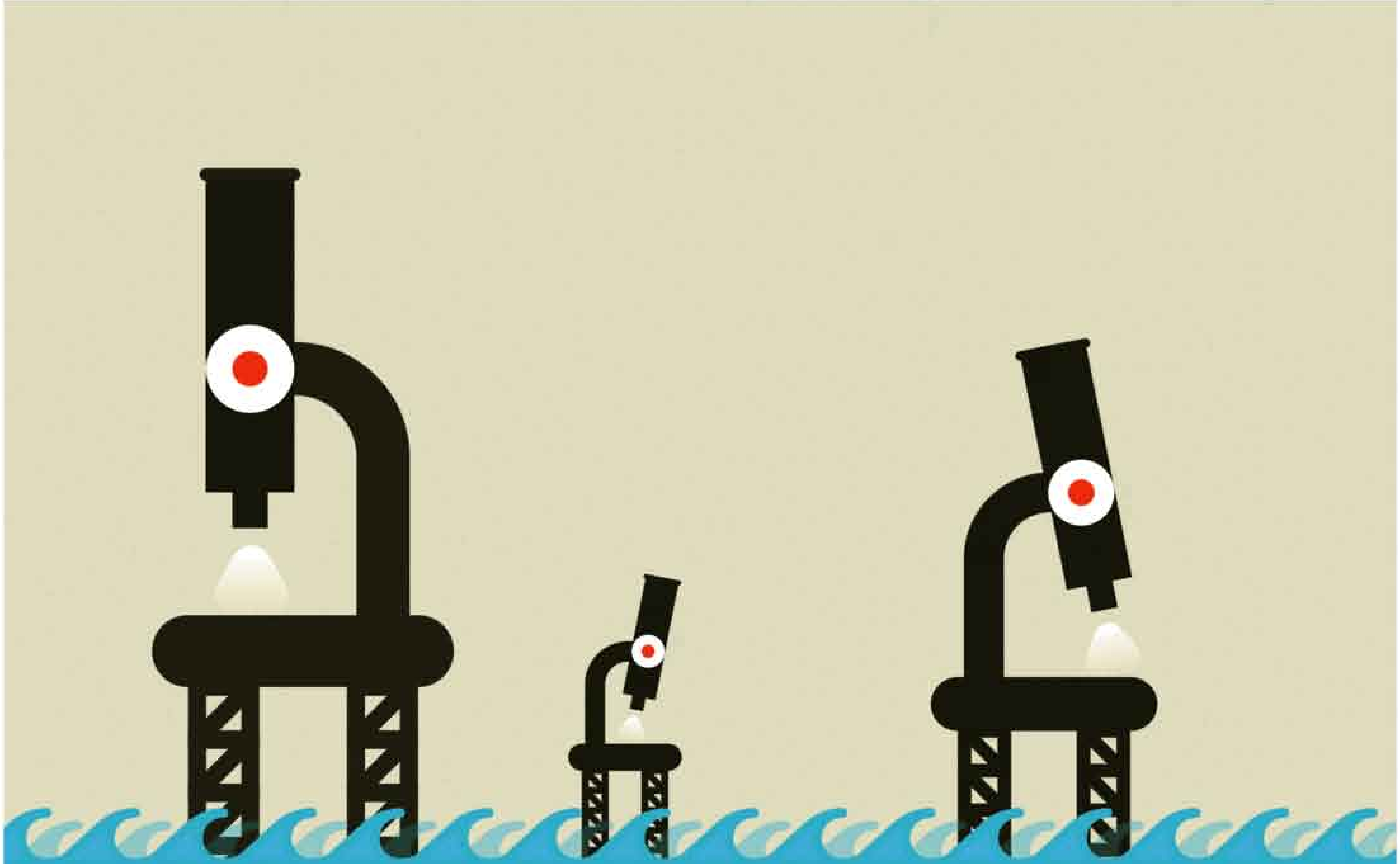

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BY SUSAN FOURNIER AND LARA LEE

Andy Potts

Getting Brand Communities Right

Embrace conflict, resist the urge to control, forget opinion leaders – and build your brand.

IN 1983, HARLEY-DAVIDSON faced extinction. Twenty-five years later, the company boasted a top-50 global brand valued at $7.8 billion. Central to the company's turnaround, and to its subsequent success, was Harley's commitment to building a brand community: a group of ardent consumers organized around the lifestyle, activities, and ethos of the brand.

Inspired by Harley's results and enabled by Web 2.0 technologies, marketers in industries from packaged goods to industrial equipment are busy trying to build communities around their own brands. Their timing is right. In today's turbulent world, people are hungry for a sense of connection; and in lean economic times, every company needs new ways to do more with what it already has. Unfortunately, although many firms aspire to the customer loyalty, marketing efficiency, and brand authenticity that strong communities deliver, few understand what it takes to achieve such benefits. Worse, most subscribe to serious misconceptions about what brand communities are and how they work.

On the basis of our combined 30 years of researching, building, and leveraging brand communities, we identify and dispel seven commonly held myths about maximizing their value for a firm. For companies considering a community strategy, we offer cautionary tales and design principles. For those with existing brand communities, we provide new approaches for increasing their impact. And as you'll see from our discussion and the online "Community Readiness Audit" at brandcommunity.hbr.org, your decision is not whether a community is right for your brand. It's whether you're willing to do what's needed to get a brand community right.

MYTH #1

A brand community is a marketing strategy.

THE REALITY

A brand community is a business strategy.

Too often, companies isolate their community-building efforts within the marketing function. That is a mistake. For a brand community to yield maximum benefit, it must be framed as a high-level strategy supporting business-wide goals.

Harley-Davidson provides a quintessential example. Following the 1985 leveraged buyback that saved the company, management completely reformulated the competitive strategy and business model around a brand community philosophy. Beyond just changing its marketing programs, Harley-Davidson retooled every aspect of its organization – from its culture to its operating procedures and governance structure – to drive its community strategy.

Harley management recognized that the brand had developed as a community-based phenomenon. The "brotherhood" of riders, united by a shared ethos, offered Harley the basis for a strategic repositioning as the one motorcycle manufacturer that understood bikers on their own terms. To reinforce this community-centric positioning and solidify the connection between the company and its customers, Harley staffed all community-outreach events with employees rather than hired hands. For employees, this regular, close contact with the people they served added such meaning to their work that the weekend outreach assignments routinely attracted more volunteers than were needed. Many employees became riders, and many riders joined the company. Executives were required to spend time in the field with customers and bring their insights back to the firm. This close-to-the-customer strategy was codified in Harley-Davidson's operating philosophy and reinforced during new-employee orientations. Decisions at all levels were grounded in the community perspective, and the company acknowledged the community as the rightful owner of the brand.

Harley's community strategy was also supported by a radical organizational redesign. Functional silos were replaced with senior leadership teams sharing decision-making responsibility across three imperatives: Create Demand, Produce Product, and Provide Support. Further, the company established a stand-alone organization reporting directly to the president to formalize and nurture the company-community relationship through the Harley Owners Group (H.O.G.) membership club. As a result of this organizational structure, community-building activities were treated not solely as marketing expenses but as companywide, COO-backed investments in the success of the business model.

IDEA IN BRIEF

- **Many companies that try to turn their customers into a cohesive "brand community" falter because of serious misconceptions. For instance, they relegate community building to the marketing department instead of treating it as a high-level strategy, or they assume that an interactive website will do the trick.**
- **To build and maintain strong brand communities, companies must understand the individual and social needs of members and do everything possible to support and engage them on their own terms. Rather than attempting to control the community, the company should be guided by it; indeed, the brand community experience should be central to the firm's business model.**
- **By managing their communities with a light, open touch – and sustaining them with corporate-level commitment – firms can build fierce customer loyalty, increase marketing efficiency, and enhance their brand.**

MYTH #2

A brand community exists to serve the business.

THE REALITY

A brand community exists to serve the people in it.

Managers often forget that consumers are actually people, with many different needs, interests, and responsibilities. A community-based brand builds loyalty not by driving sales transactions but by helping people meet their needs. Contrary to marketers' assumptions, however, the needs that brand communities can satisfy are not just about gaining status or trying on a new identity through brand affiliation. People participate in communities for a wide variety of reasons – to find emotional support and encouragement, to explore ways to contribute to the greater good, and to cultivate interests and skills, to name a few. For members, brand communities are a means to an end, not an end in themselves.

Outdoorseiten offers an extreme example of how the needs of a community can actually give rise to a brand. The European website outdoorseiten.net originated as a venue where hiking and camping enthusiasts could exchange information about their shared lifestyle: Where is a good place to hike with children? Which shoes are best for rocky terrain? Members collaborated in order to gain access to the resources and skills they needed to accomplish their goals. Eventually, the community created its own Outdoorseiten brand of tents and backpacks. The community's brand grew not from a need to express a shared identity but from a desire to meet members' specialized needs.

Often, people are more interested in the social links that come from brand affiliations than they are in the brands themselves. They join communities to build new relationships. Facebook provides a straightforward example, but country clubs and churches reveal similar dynamics. "Third place" brands such as Gold's Gym and Starbucks tap into this by providing bricks-and-mortar venues that foster interaction. In such instances, brand loyalty is the reward for meeting people's needs for community, not the impetus for the community to form.

Robust communities are built not on brand reputation but on an understanding of members' lives. Pepperidge Farm learned this lesson when its initial community effort – a website stocked with Goldfish-branded kids games – met with little success. Taking a step back from its brand-centric execution to identify areas where kids and parents really needed help, the Goldfish team uncovered alarming statistics about depression and low self-esteem among children. Partnering with psychologist Karen Reivich of the Positive Psychology Center at the University of Pennsylvania, managers recently launched an online community, fishfulthinking.com, that repackages academic research about failure, frustration, hopefulness, and emotional awareness into learning activities and discussion tools designed to help parents develop resiliency in their kids. Putting the brand second is tough for a marketer to do, but it's essential if a strong community is the goal.

MYTH #3

Build the brand, and the community will follow.

THE REALITY

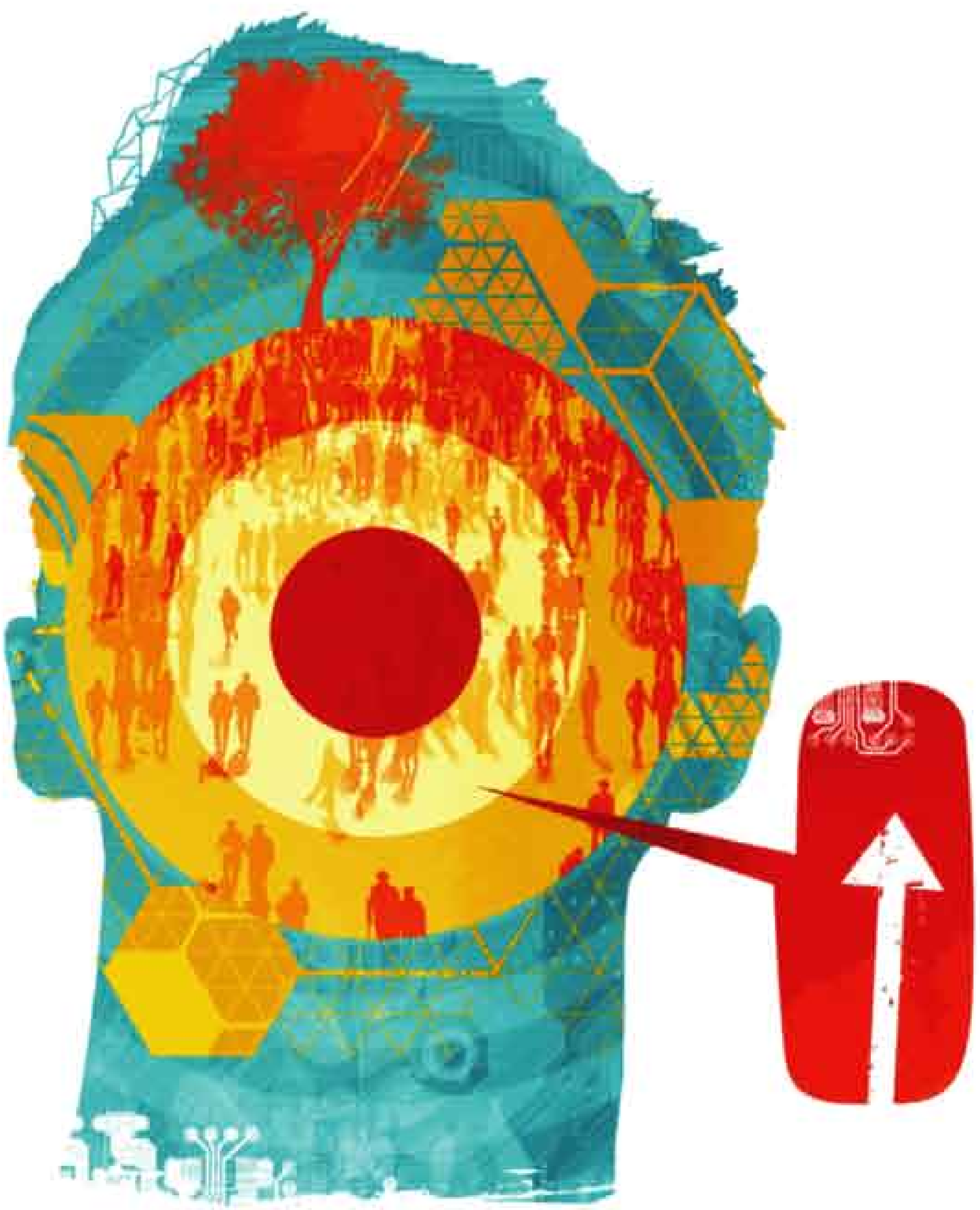
Engineer the community, and the brand will be strong.

Strategy consultancy Jump Associates has identified three basic forms of community affiliation: pools, webs, and hubs (see the exhibit "Three Forms of Community Affiliation"). Effective community strategies combine all three in a mutually reinforcing system.

Members of *pools* are united by shared goals or values (think Republicans, Democrats, or Apple devotees). Decades of brand management theory have schooled managers in a pool-based approach to brand building: Identify and consistently communicate a clear set of values that emotionally connect consumers with the brand. Unfortunately, pools deliver only limited community benefits – people share a set of abstract beliefs but build few interpersonal relationships. Further, the common meaning that holds members together often becomes diluted if the brand attempts to grow. Unless the affiliation to a brand idea is supplemented with human connections, community members are at risk of dropping out. The solution lies in using webs and hubs to strengthen and expand the community.

Web affiliations are based on strong one-to-one connections (think social networking sites or the Cancer Survivors Network). Webs are the strongest and most stable form of community because the people in them are bound by many and varied relationships. The Harley-Davidson Museum, for example, builds webs of interpersonal connections through features such as walls around the campus decorated with large, custom-inscribed stainless-steel rivets commissioned by individuals or groups. As museum visitors read the inscriptions on the rivets, they reflect

People are more interested in the social links that come from brand affiliations than in the brands themselves.



on the stories and people behind them. People who meet at the rivet walls soon find themselves comparing interesting inscriptions, and before long they're engaged in conversation, planning to stay in touch and perhaps even share a ride someday. Through rivet walls and other means of fostering interpersonal connections, the museum strengthens the Harley-Davidson brand pool by building webs within it.

Members of *hubs* are united by their admiration of an individual (think Deepak Chopra or Hannah Montana). The hub is a strong albeit unstable form of community that often breaks apart once the central figure is no longer present. But hubs can help communities acquire new members who hold similar values. Harley-Davidson, for instance, built a bridge to a younger audience through its association with professional skateboarder and Harley enthusiast Heath Kirchart. Hubs can also be used to create or strengthen a brand pool, a strategy Nike has used since its inception by associating with stars such as Michael Jordan and Tiger Woods. To build stable communities, hub connections must be bonded to the community through webs. With its Nike+ online community, which cultivates peer-to-peer support and interaction by encouraging members to challenge and trash-talk one another, Nike has found a brand-appropriate way of creating webs to strengthen its pool and hubs.

MYTH #4

Brand communities should be lovefests for faithful brand advocates.

THE REALITY

Smart companies embrace the conflicts that make communities thrive. Most companies prefer to avoid conflict. But communities are inherently political, and conflict is the norm. "In" groups need "out" groups against which to define themselves. PlayStation gamers dismiss Xbox. Apple enthusiasts hate Microsoft and Dell. Dunkin' Donuts coffee drinkers shun Starbucks. Dividing lines are fundamental even within communities, where perceived degrees of passion and loyalty separate the hardcore fans from the poseurs. Community is all about rivalries and lines drawn in the sand.

Dove's much-lauded "Campaign for Real Beauty" offers a vivid example of how companies can use conflict to their advantage. The campaign brought "real women" together worldwide to stand up against industry-imposed beauty ideals. Older women, large women, skinny women, and less-than-pretty women united in camaraderie against a common foe. Dove identified a latent "out" group and claimed it for its brand.

Firms can reinforce rivalries directly or engage others to fan the flames. Pepsi, renowned for taking on rival Coca-Cola in the original Pepsi Challenge, is now running advertising starring lackluster Coke drinkers in dingy retirement homes. Apple's PC-versus-Mac ads sparked not only Microsoft's "I am a PC" countercampaign but also a host of YouTube parodies from both camps. A group's unity is strengthened when such conflicts and contrasts are brought to the fore.

Some companies make the mistake of attempting to smooth things over. Porsche's 2002 launch of the Cayenne SUV provides an instructive case in point. Owners of 911 models refused to accept the Cayenne as a "real" Porsche. They argued that it did not have the requisite racing heritage and painted Cayenne drivers as soccer moms who did not and could not understand the brand. Die-hard Porsche owners even banned Cayenne owners from rennlist.com, a site that started as a discussion board for Porsche enthusiasts and has grown to include pages devoted to Audi, BMW, and Lamborghini. The company attempted to mend the rift through a television campaign, complete with roaring engines at a metaphorical starting gate, aimed at demonstrating that the Cayenne was a genuine member of the Porsche family. The entrenched community was not convinced. Positioning the Cayenne as a race car was "a stretch that only delusional Porsche market-

Three Forms of Community Affiliation

People have strong associations with a shared activity or goal, or shared values, and loose associations with one another.

The shared activity, goal, or values are the key to this community affiliation.

Examples

- Apple enthusiasts
- Republicans or Democrats
- Ironman triathletes

People have strong one-to-one relationships with others who have similar or complementary needs.

Personal relationships are the key to this community affiliation.

Examples

- Facebook
- Cancer Survivors Network
- Hash House Harriers

People have strong connections to a central figure and weaker associations with one another.

A charismatic figure is the key to this community affiliation.

Examples

- Deepak Chopra
- Hannah Montana
- Oprah

ers could possibly attempt – and a flat-out insult to every great Porsche sports car that has come before it," one person wrote on autoextremist.com. Smart managers know that singing around the campfire will not force warring tribes to unite. Communities become stronger by highlighting, not erasing, the boundaries that define them.

MYTH #5

Opinion leaders build strong communities.

THE REALITY

Communities are strongest when everyone plays a role.

Opinion leaders and evangelists play important and well-documented roles in social networks. They spread information, influence decisions, and help new ideas gain traction. But whereas focusing on opinion leaders may be sage advice for buzz campaigns, it is a misguided approach to community building. Robust communities establish cultural bedrock by enabling everyone to play a valuable role.

From our examination of research on communities including the Red Hat Society, Burning Man, Trekkies, and MGB car clubs, we have identified 18 social and cultural roles critical to community function, preservation, and evolution (see the exhibit "Common Community Roles"). These include performers, supporters, mentors, learners, heroes, talent scouts, and historians, to name a few. In complementary research, Hope Schau of the University of Arizona and Eric Arnould of the University of Wyoming have documented 11 value-creation practices among community members, including evangelizing, customizing, welcoming, badging, competing, and empathizing. Companies with existing communities can evaluate the roles and behaviors currently being demonstrated and identify gaps that could be filled to improve community function. Those designing new communities can create structures and support systems to ensure the availability of a wide range of roles.

Recognizing that life changes often prompt people to reevaluate their affiliations, successful communities give members opportunities to take on new roles, alternate between roles, and negotiate tensions across roles in conflict – without ever leaving the fold. Nonprofit communities are particularly good in this respect. Saddleback Church of Orange County, California, maintains a cohesive community despite membership of over 20,000 by constantly monitoring individuals' needs and creating subgroups and roles to keep people engaged. Groups are organized not only by age, gender, and interests, but also by shared challenges, social commitments, and family situations. People are offered many types of roles, from active to passive, in small groups and large, and can participate in person, by phone, or online. Assorted print and digital tools help people identify options and map opportunities, so they can easily change roles or try on new ones.

Common Community Roles

Members of strong brand communities stay involved and add value by playing a wide variety of roles. In designing a new community or strengthening an existing one, companies should incorporate an assortment of roles into the community structure and help members take on new roles as their needs change. Below are 18 roles critical to a community's function, preservation, and evolution.

Mentor: Teaches others and shares expertise

Learner: Enjoys learning and seeks self-improvement

Back-Up: Acts as a safety net for others when they try new things

Partner: Encourages, shares, and motivates

Storyteller: Spreads the community's story throughout the group

Historian: Preserves community memory; codifies rituals and rites

Hero: Acts as a role model within the community

Celebrity: Serves as a figurehead or icon of what the community represents

Decision Maker: Makes choices affecting the community's structure and function

Provider: Hosts and takes care of other members

Greeter: Welcomes new members into the community

Guide: Helps new members navigate the culture

Catalyst: Introduces members to new people and ideas

Performer: Takes the spotlight

Supporter: Participates passively as an audience for others

Ambassador: Promotes the community to outsiders

Accountant: Keeps track of people's participation

Talent Scout: Recruits new members

MYTH #6

Online social networks are the key to a community strategy.

THE REALITY

Online networks are just one tool, not a community strategy.

Forming an online community is often a knee-jerk reaction to the CEO's demand for a Web 2.0 strategy. Online social networks get lots of buzz, and given today's enabling technologies it seems silly to pass up opportunities in the virtual world. Unfortunately, most company-sponsored online "communities" are nothing more than far-flung focus groups established in the hope that consumers will bond around the virtual suggestion box. There's nothing wrong with listening to customers, but this isn't a community strategy.

Online social networks can serve valuable community functions. They help people find rich solutions to ambiguous problems and serendipitous connections to people and ideas. Yet even a well-crafted networking site has limitations. The anonymity of web encounters often emboldens antisocial behavior, and the shallow, transient nature of many online interactions results in weak social bonds. And, lest we forget, a huge chunk of life still takes place off-line. Physical spaces play important roles in fostering community connections. According to Mark Rosenbaum of Northern Illinois University, communities that are developed in third places like gyms and coffee shops often provide social and emotional support equal to or stronger than family ties – a benefit that delivers price premiums of up to 20%.

Smart marketers use online tools selectively to support community needs. L'Oréal strikes the right balance with its methodical approach. The company maps its brands along two dimensions: (1) brands of authority versus brands of conversation, and (2) mainstream versus niche brands. Each cell in the grid suggests a different community approach. Brands of authority offer expert affiliation and advice. L'Oréal (the company's mainstream brand of authority) builds community through heavy TV advertising featuring celebrity spokespeople to inspire hub affiliations. La Roche-Posay (a niche brand of authority) nurtures a worldwide community of dermatologists, both online and face-to-face, to expertly represent the brand. Brands of conversation thrive on social interaction and engagement. L'Oréal's Garnier (the company's mainstream brand of conversation) enlists well-known bloggers to share what they're doing to make the world a better place, using these hub figures to strengthen the brand's pool. Kiehl's (a niche brand of conversation) uses a grassroots focus on local charity sponsorships, in-store customer bulletin boards, and required employee volunteerism in the surrounding community to create the social glue. Although the tactics vary, the goal of L'Oréal's community-building strategies is always to connect with the people who make up the community in ways that reaffirm the essence of the brand.

MYTH #7

Successful brand communities are tightly managed and controlled.

THE REALITY

Of and by the people, communities defy managerial control.

Excessive control has been the norm when it comes to community management. From Coca-Cola's pulling of its beloved soda off the shelves in 1985, to Microsoft's stifling of internal blogger Robert Scoble, to Hasbro's suing of fans for publishing content based on its brands, community managers tend to put corporate interests over those of their customers.

Such efforts have led to vigorous debate about how much control to assert over brand communities. That is the wrong question. Brand communities are not corporate assets, so control is an illusion. But relinquishing control does not mean abdicating responsibility. Effective brand stewards participate as community cocreators – nurturing and facilitating communities by creating the conditions in which they can thrive.

Vans, the famed maker of skateboarding shoes, has proved adept at building community through support rather than control. From the beginning, the company recognized its fan base of customers as the owners of its brand. Its self-appointed role was to stay close enough to the fans to understand where they were headed and then pursue the directions that would strengthen the community. From its earliest days, Vans worked with lead users within each of its sports communities to codesign new products. When privately owned skate parks began closing, Vans took care of enthusiasts by opening its own. Vans originally sponsored the Warped Tour, a traveling music festival appealing to young adults,

A Sampling of Community Scripts

A script suggests a set of behaviors that are appropriate for a particular situation. Companies can design brand communities by establishing and reinforcing a base script and then layering on new scripts over time. Vans, a maker of skateboarding shoes, initially sold its products to tight-knit surfer and skateboarding communities. Building direct relationships with these groups and cultivating lead users within them reinforced an implicit Tribe script. By sponsoring competitions and skate parks, Vans introduced the Performance Space script. And through skateboarding clinics and demonstrations, the company added features of the Sewing Circle.

The Tribe
A group with deep interpersonal connections built through shared experiences, rituals, and traditions.

The Fort
An exclusive place for insiders to be safe and feel protected.

The Sewing Circle
A gathering at which people with common interests share experiences, provide support, and socialize.

The Patio
A semiprivate place that facilitates in-depth, meaningful connections.

The Bar
A public space that grants reliable although shallow connections.

The Tour Group
A way to participate in new experiences while staying inside a comfort zone.

The Performance Space
A place where members can be sure of finding an audience for their talents.

The Barn Raising
An effective way to accomplish tasks while socializing.

The Summer Camp
A periodic experience that reaffirms connections.

as a way to support its customers' love of music. Later, realizing that amateur skateboarders were lacking a national championship event, Vans persuaded Warped Tour organizers to add one to their lineup and then acquired the Tour outright once it became a major celebration of skateboarding and bicycle motocross (BMX) culture. Warped Tour innovations now include air-conditioned "parental day care" lounges at tour stops to make it easier for young fans to attend, and an online community that supports year-round connections among fans and helps far-flung friends coordinate tour attendance.

Companies build effective communities through a design philosophy that replaces control with a balance of structure and flexibility. Jump Associates has identified nine archetypal community scripts that can be used as a framework for such design (see the exhibit "A Sampling of Community Scripts"). A script is a set of expected behaviors in a particular social situation. Think, for example, of the script you'd follow for a date at a fancy restaurant or a job interview in a CEO's office. Harley-Davidson offers a leading example of how to use scripts to build and enhance community. The Harley-Davidson brand ethos of the "brotherhood" is grounded in the script of the Tribe, in which deep social connections form through shared experiences and traditions. Management first reinforced this script to strengthen community identity and then gradually introduced elements of new scripts to enrich the experience over time. The Harley Owners Group introduced elements of the Fort (an exclusive place where insiders feel protected) through members-only events and special perks. Rallies and other recurring customer gatherings added the Summer Camp (a periodic experience that reaffirms connections). Both the Harley-Davidson Museum and dealerships were designed to leverage elements of the Patio (a semiprivate place that facilitates in-depth, meaningful connections) and the Bar (a public space that grants reliable but shallow connections) to foster different types of interpersonal connections. By layering those additional scripts over the Tribe foundation, Harley-Davidson was able to build multiple community experiences that appealed to different audiences while retaining a cohesive core.

Whether through constructive engagement, script-based design, or other means, smart companies define the terms of their community participation but discard their illusions of control.

Are You Ready?

Although any brand can benefit from a community strategy, not every company can pull it off. Executing community requires an organization-wide commitment and a willingness to work across functional boundaries. It takes the boldness to reexamine everything from company values to organizational design. And it takes the fortitude to meet people on their own terms, cede control, and accept conflict as part of the package. Is your organization up to the task? To find out, take our online "Community Readiness Audit" by visiting brandcommunity.hbr.org.

Community is a potent strategy if it is approached with the right mind-set and skills. A strong brand community increases customer loyalty, lowers marketing costs, authenticates brand meanings, and yields an influx of ideas to grow the business. Through commitment, engagement, and support, companies can cultivate brand communities that deliver powerful returns. When you get community right, the benefits are irrefutable.

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Reprint R0904K
To order, see page 119.

"Cigarette breaks, getting paid, and keeping my job are my top priorities. But you're right up there in my Top 10, sir!"

Letters to the Editor

Finding and Grooming Breakthrough Innovators

In their article "Finding and Grooming Breakthrough Innovators" (December 2008), Jeffrey Cohn, Jon Katzenbach, and Gus Vlak offer an excellent analysis of the important, yet challenging, need to identify and nurture breakthrough innovators in organizations. I disagree with one key aspect of their argument, however.

Truly successful innovators need – and learn particularly well from – failure. It is a big mistake, therefore, to return them to line positions or otherwise take them out of the game when they encounter initial challenges. Indeed, given the complexity of their roles and the challenges they face, they should be offered second, third, and possibly more chances to apply their learnings over time and improve their approach to executing ideas.

Innovation is not a silver bullet shot by a lone cowboy, but a capability that is sparked by rare breakthrough innovators and carefully nurtured by senior management.

Torsten Kuenzlen
Director, Commercial Leadership
The Coca-Cola Company
Bangkok

Cohn, Katzenbach, and Vlak respond: We appreciate Torsten Kuenzlen's comment on grooming innovators. Several successful organizations are mitigating their tolerance of failure by investing more heavily in the odds of success. Rather than encouraging many potential innovators to continue their efforts despite repeated failures, those companies carefully select a few innovators, help them acquire relevant skills and build extensive networks, and provide mentors. As a result, the firms increase their expectations of success.

Naturally, not all innovators' initiatives succeed. And we agree that innovators are adept at learning from missteps and making adjustments along the way. But innovators who are properly prescreened (for practical intelligence, social savvy, focused attention on key issues, and the ability to see things through) and groomed (so they recognize key influence makers and powerful networks across the organization) don't consider failure an option. Think Steve Jobs.

We welcome letters from all readers wishing to comment on articles in this issue. Early responses have the best chance of being published. Please be concise and include your title, company affiliation, location, and phone number. E-mail us at hbr_letters@harvardbusiness.org; send faxes to 617-783-7493; or write to The Editor, Harvard Business Review, *60 Harvard Way, Boston, MA 02163. HBR reserves the right to solicit and edit letters and to republish letters as reprints.*

Creativity and the Role of the Leader

Teresa M. Amabile and Mukti Khaire are absolutely right to bring attention to the growing challenges of fostering creativity and of leading creative people, and their article "Creativity and the Role of the Leader" (October 2008) will no doubt stimulate creative thought about leadership. However, I must point out two worrisome issues.

First, experts – such as those at Amabile and Khaire's conference – often recommend that managers of creative individuals act like shepherds and gardeners. But creative people are neither lambs nor flowers. In fact, my work on creativity in commerce over the past 18 years has led me to believe that pastoral and horticultural approaches *destroy* creativity. They create cultures of confession, absolution, and entitlement – not rebellion and radical innovation. Innovation grows when creative people see their leaders fighting passionately to bring innovations to market.

Second, as Howard Gardner so rightly noted at the conference, people want ethical work, but they are wrong if they think that ethics are best upheld when the work has evolved into a profession, insulated from market forces. In my experience, which includes 16 years as a professor, I have uncovered only two companies whose ethical standards were lower than those of academic institutions. What's more, leaders of those ethically poor companies actually thought that remaining sheltered from market forces made their companies ethically superior. The market, however, thrives on enabling good lives. Without the civilizing effects of active shareholders and other market forces, managers and professionals are free to act on spite and petty jealousies – and they do.

Charles Spinosa
Group Director
Vision Consulting
New York

When Steve Becomes Stephanie

As a second-year student at Harvard Business School, I found the issues discussed in Loren Gary and Brian Elliot's article "When Steve Becomes Stephanie" (December 2008) quite striking. I honestly don't know how I would handle a situation in which an employee's transgender journey resulted in conflicting feelings among others in the company.

I called my father, who owns an HR consulting firm, and asked him if he had ever had to deal with that situation. Since HBR is known for presenting the latest in management thinking, I assumed that this was a pretty recent phenomenon. He responded, "Lauren, I had to deal with this issue 20 years ago. This should be old news." I was shocked: If this was indeed old news, why had it never come up in class? And if this is a recurring, evolving issue in the workforce, why was the last article concerning the LGBT (lesbian, gay, bisexual, and transgender) community published 15 years ago?

Lauren Mehler
MBA candidate
Harvard Business School
Boston

Executive Summaries

APRIL 2009

> There is a good possibility that consumer attitudes and behavior shaped during this recession will linger substantially beyond its end.
> –page 52

MARKETING

FINANCIAL CRISIS SPOTLIGHT

COVER STORY

52 | How to Market in a Downturn

John A. Quelch and Katherine E. Jocz

Because no two recessions are exactly alike, marketers find themselves in poorly charted waters every time one occurs. But guidance is available, say Quelch and Jocz, who have studied marketing successes (by Smucker, Procter & Gamble, Anheuser-Busch, and others) as well as failures throughout past recessions and identified patterns in consumer and company behavior that strongly affect performance. Understanding consumers' changing psychology and habits, the authors argue, will enable firms to hone their strategies so they can both survive the current downturn and prosper afterward.

Consumers in a recession can be divided into four groups: The *slam-on-the-brakes* segment, which feels the hardest hit, reduces all types of spending. *Pained-but-patient* consumers, who constitute the largest segment, also economize in each area, though less aggressively. *Comfortably well-off* individuals consume at near-prerecession levels but become a little more selective (and less conspicuous) about their purchases. *Live-for-today* consumers pretty much carry on as usual, responding to the recession mainly by extending their timetables for making major purchases. People may switch segments if their economic situations change for the worse.

All groups prioritize consumption by sorting products and services into the following categories: *essentials* (central to survival or well-being), *treats* (justifiable), *postponables* (can be put off), and *expendables* (unnecessary or unjustifiable).

As firms manage their marketing investments, they must simultaneously assess their brands' opportunities, allocate resources for the long term, and balance their budgets. Many make the mistake of cutting costs indiscriminately, which can jeopardize long-term performance. Instead, firms should streamline their product portfolios, improve the affordability of their offerings, and bolster customers' trust.

Reprint R0904D

STRATEGY & COMPETITION

COVER STORY

FINANCIAL CRISIS SPOTLIGHT

64 | Five Rules for Retailing in a Recession

Ken Favaro, Tim Romberger, and David Meer

In tough times, many retailers focus on their most loyal customers. That seems sensible enough. But, paradoxically, your most loyal customers are not your best source of revenue growth in a recession. You're already collecting most of the money they're spending. If they suddenly spend 25% less, most of that will come out of what they spend in *your* stores.

It's not likely that you'll pry away customers who are fiercely loyal to other retailers either.

Your best opportunity lies with "switchers" – the people who spend money both in your shops and elsewhere. If you collect, say, only 20% of what they're spending today but can increase that to 30%, you'll still realize a net gain even if their total spending drops by 25%.

Drawing on a study of more than 50 major U.S.-based retailers and over 20 years of global consulting experience, consultants Favaro, Romberger, and Meer set out five operating rules to help retail executives determine where to direct recession-squeezed resources for the biggest return.

These rules basically boil down to: (1) Identify the people who are shopping both in your stores and in others'. (2) Figure out what they're buying elsewhere (or want and can't find at all) and adjust your offer so you can give it to them. (3) Analyze which of your costs contribute to producing the benefits the switchers want, then spend more on those activities and less on the ones that don't matter to them. (4) Organize your efforts efficiently by grouping your stores into clusters based on different populations of switchers. And, finally, (5) focus your customer research, merchandise-planning, performance management, and strategic-planning processes on the switchers.

By following those rules, struggling retailers will discover that they have a larger universe of growth opportunities than they might think.

Reprint R0904E

IDEAS & TRENDS

FORETHOUGHT

18 | Are "Great" Companies Just Lucky?

Michael E. Raynor, Mumtaz Ahmed, and Andrew D. Henderson

Studies that examine high-performing companies to unearth the secrets of their success have a critical flaw: Very few of those companies are truly remarkable. Data analysis reveals that most owe their success to luck, not smart practices. That puts the prescriptions of success studies in a whole new light. **Reprint F0904A**

Employee Happiness Isn't Enough to Satisfy Customers

Rosa Chun and Gary Davies

A new study busts the myth that happy workers create happy customers. **Reprint F0904B**

Health Care Requires Big Changes to Complement New IT

Julia Adler-Milstein

Many are counting on the adoption of electronic health records to help the health care system save billions of dollars. But to realize IT's promise, hospitals and medical practices need to empower employees. **Reprint F0904C**

Superstition Undermines Alliances

Koen Heimeriks

Often, the greater a firm's experience in forming alliances, the worse the performance of those alliances. That's most likely because those firms have become overconfident of their skills and drawn faulty conclusions about which practices lead to success. A focus on experimentation and adaptation can help break that pattern. **Reprint F0904D**

Biomass – The Other Energy Source

Marie E. Walsh

Prairie grasses, forestry and mill residues, nongrain parts of food crops, and urban wood wastes all could become a huge source of renewable energy. **Reprint F0904E**

A Conversation with Helene Gayle

The CEO of CARE reveals what it was like to incite change at a sprawling nonprofit and how she built support for her plan to increase its global clout. **Reprint F0904F**

What Do Customers Really Want?

Eric Almquist and Jason Lee

A customer-research technique that requires respondents to make a sequence of explicit trade-offs when choosing their preferred product attributes can help companies get a far more accurate read on what customers desire. **Reprint F0904G**

Nurturing Good Ideas

Jan van den Ende and Bob Kijkuit

Tapping the input of many people early in the innovation process helps companies find the blockbusters and weed out the bad ideas before they reach a decision maker's desk. **Reprint F0904H**

How Toxic Colleagues Corrode Performance

Christine Porath and Christine Pearson

Uncivil behavior at work damages productivity far more than most managers would imagine. **Reprint F0904J**

Reviews

Featuring *Chasing the Rabbit: How Market Leaders Outdistance the Competition and How Great Companies Can Catch Up and Win,* by Steven J. Spear

| SELF-MANAGEMENT |

HEALTH & WELLNESS

28 | Go Ahead, Have Regrets

Michael Craig Miller, MD

In this first in a series of articles created in partnership with Harvard Health Publications, a professor of psychiatry at Harvard Medical School discusses regret and its potential benefits. Regret needn't be a self-flagellating emotion, he says. In fact, when asked to rank negative emotions in terms of value, people placed regret at the top, crediting it with helping them make sense of life events and remedy what went wrong.

Reprint R0904A

> "Again and again, [Abraham] Lincoln shared responsibility for others' mistakes, and so people became very loyal to him."
> –page 43

| LEADERSHIP |

HBR CASE STUDY

33 | Who Can Help the CEO?

Phil Terry

Eliot Robbens is the CEO of TrakVue, a spinout launched two years ago with highly ambitious financial projections. His vice president of sales has just quit after only six months, becoming the second sales VP that Eliot has lost. The company is a year behind in achieving its results, and Eliot has a board meeting coming up in just a few days. Where to turn? His old friend Amory declines to advise him and suggests executive coaching. An affable squash opponent counsels that he save himself by landing a couple of big accounts. His beloved wife offers a vaguely Zen exhortation. How can Eliot get genuine help?

Jaithirth Rao, an IT entrepreneur and the founder of MphasiS, has experienced Eliot's difficulty himself. He calls it "the myth of the self-reliant leader." Rao cautions that colleagues' own agendas may color their advice and that executive coaches may fail to perceive the ambiguities in a situation. A formal network of peers can be powerful, he says – as can a loyal and perceptive assistant.

Susan J. Ashford, a dean and a professor at the University of Michigan's Ross School of Business, suggests that the biggest challenge for Eliot is developing greater learning agility. He must admit his weaknesses, share his concerns with colleagues and the board, and create a company culture in which input is valued.

Stephen J. Socolof, a founder and a managing partner of New Venture Partners, says that Eliot should acquire an active network of mentors and should regularly ask for help from the board, which will appreciate being kept in the loop.

Reprint R0904B
Reprint Case only R0904X
Reprint Commentary only R0904Z

| LEADERSHIP |

DIFFERENT VOICE

43 | Leadership Lessons from Abraham Lincoln

A Conversation with Historian Doris Kearns Goodwin

In January 2008, CBS anchor Katie Couric asked then-candidate Barack Obama what single book, apart from the Bible, he would bring with him to the White House. He cited *Team of Rivals*, Doris Kearns Goodwin's account of Abraham Lincoln's leadership during the Civil War. It was a signal that Obama intended to model his leadership during the current crisis on the style of his presidential predecessor from Illinois.

By bringing heavyweight politicians who are themselves past and future presidential contenders into his cabinet, Obama has indeed reprised Lincoln's strategy of creating a team composed of his most able rivals. If the new U.S. president can learn from Lincoln so, too, can business executives now grappling with similar questions of how to lead in turbulent times.

To draw out the lessons of Lincoln's administration, HBR senior editor Diane Coutu interviewed Goodwin, a Pulitzer Prize–winning historian whose other books include *No Ordinary Time* (about Franklin and Eleanor Roosevelt and their era), *The Fitzgeralds and the Kennedys*, and *Lyndon Johnson and the American Dream*.

In their wide-ranging conversation, Goodwin discusses the advantages of forming an executive committee of strong-willed, forthright individuals who won't insulate a leader from uncomfortable but important dissent. She describes how Lincoln managed a group of people who were capable of taking over the top job – and sometimes plotting to do so. She sheds light on Lincoln's magic, which she says was not so much a matter of charisma as of emotional intelligence. And she takes the historian's long view on the current economic crisis and the opportunities for political and business leaders alike to take advantage of these extraordinary times.

Reprint R0904C

STRATEGY & COMPETITION

74 | What's Your Google Strategy?

Andrei Hagiu and David B. Yoffie

Multisided platforms can lower your transaction costs and increase customer reach. But powerful MSPs like Microsoft, Google, and Apple have also tended to extract most of the value from their platforms, mainly because companies that played with them didn't adequately understand their motives and operating strategies. As a result, firms can easily find themselves ceding control over customers to MSPs or being unwittingly turned into commodities.

Hagiu and Yoffie, both professors at Harvard Business School, explore how MSPs can use their power to "hold up" companies that join them. The authors offer guidelines to help managers create an effective strategy for dealing with MSPs, identifying three basic issues that managers must address: (1) Whether to play with existing MSPs, build their own platform, or do both; (2) once they've concluded that at least one third-party MSP can benefit their business, deciding how many to join; and (3) figuring out how to play – that is, which features or services they should adopt and which they should reject in order to maintain their company's competitive advantage.

Some companies that lack the power to influence an MSP's actions may have few options. But many firms – either on their own or in alliances – can make choices that will differentiate them from competitors and curb MSPs' power over their businesses.

Reprint R0904F

ORGANIZATION & CULTURE

82 | When Internal Collaboration Is Bad for Your Company

Morten T. Hansen

Without question, internal collaboration can produce benefits for an organization. This doesn't mean, however, that the more your employees collaborate, the better off the company will be. It may, in fact, be worse off.

The author, a professor at UC Berkeley and at Insead, offers a simple method for determining when collaborating on a project makes sense. He calls it calculating the *collaboration premium* – what's left after you subtract opportunity costs and collaboration costs from a project's expected financial return. The opportunity cost is what's lost by devoting resources to the collaboration project rather than to something else – particularly something that doesn't require collaboration. Collaboration costs arise from the challenges – conflict over goals and budgets, competing objectives, logistical roadblocks – involved in working across organizational boundaries. Sometimes those costs are so high that the project results in a collaboration *penalty*.

The Norwegian company Det Norske Veritas (DNV) would have done well to apply Hansen's calculation before it launched a food-safety initiative combining the expertise, resources, and customer bases of two business units: standards certification and risk-management consulting. According to initial projections, from 2004 to 2008 the joint effort would quadruple the growth to be realized if the two units operated separately. Unfortunately, DNV hadn't formally evaluated food safety's potential relative to other promising sectors; the consulting unit might have more profitably pursued IT risk management on its own. Meanwhile, mistrust and quarreling between the two units scotched efforts to cross-sell, while conflicting goals and incentives pulled individual team members in opposing directions. Two years after launching the initiative, DNV abandoned it.

The challenge is to cultivate not *more* collaboration but the *right* collaboration. Hansen's formula can get you started.

Reprint R0904G

STRATEGY & COMPETITION

90 | Predicting Your Competitor's Reaction

Kevin P. Coyne and John Horn

Understanding how competitors will respond to your actions should be a critical component of decision making. Few companies, however, incorporate such insights into their strategic decisions, in large part because most methods for obtaining them are complex and unreliable.

The authors have drawn on their research and work with companies to develop an approach for predicting rivals' behavior that is both accurate and easy to apply. It involves considering just three questions:

Will the competitor react at all? Few strategic planners consider the possibility that a rival may not respond to a company's competitive move. Yet 17% of the companies surveyed by the authors did not react to a rival's major initiative. Some competitors may not detect a company's move, while others may not feel threatened by it or may simply be unable to coordinate a timely response.

What options will the competitor actively consider? Most companies seriously examine fewer than four response options, and it's likely that among them will be the most obvious, such as introducing a me-too product or matching a price change. To come up with a short list of options, companies will probably look at what they have done in similar situations.

Which option will the competitor most likely choose? Your adversaries will choose the option that they consider to be most effective. It helps to know that in anticipating competitive behavior, most companies analyze only one round of moves and countermoves, and they evaluate their options using simple, short-term measures. The key is to get inside your rival's head and look at the situation from that perspective, not yours.

Reprint R0904H

CHANGE MANAGEMENT

MANAGING YOURSELF

99 | Decoding Resistance to Change

Jeffrey D. Ford and Laurie W. Ford

When a change initiative falters, the knee-jerk response can be to blame those who won't get on board. Jeffrey Ford, of the Ohio State University, and Laurie Ford, of Critical Path Consultants, examine why that type of reaction is not only pointless but potentially destructive. Drawing on their years of research and consulting work, the authors recommend seeing resistance for what it really is – feedback – and propose five ways for leaders to use that feedback to effect change more productively.

Boost awareness. In the early stages, if the only way to keep the conversation about change alive is to entertain highly charged discussions, so be it. A complete lack of feedback can sound the death knell for change.

Return to purpose. Employees need to know not only *what* will change but *why* the new reality will be better. Don't be shy about offering explanations as directly as possible.

Change the change. People who resist change are often the ones most concerned about getting things right. Give them the chance to help you make a good change initiative better.

Build participation and engagement. Heed feedback even when it doesn't seem likely to yield objective improvements. The ownership people feel when you adopt their best ideas will pay off in ways you often cannot foresee.

Complete the past. A legacy of bad change can inhibit your change effort, even if you had nothing to do with the unfortunate history. Acknowledging – and, if possible, correcting – past change failures is often essential to future success.

Reprint R0904J

MARKETING

BEST PRACTICE

105 | Getting Brand Communities Right

Susan Fournier and Lara Lee

Marketers in a variety of industries are trying to increase customer loyalty, marketing efficiency, and brand authenticity by building communities around their brands. Few companies, however, understand what brand communities require and how they work.

Drawing from their research as well as their experience at Harley-Davidson, the authors dispel some common misconceptions about brand communities and offer design principles, cautionary tales, and new approaches to leveraging those communities.

For instance, many managers think of a brand community in terms of marketing strategy. In fact, for a community to have the greatest impact, it must be framed as a corporate strategy. Realizing this, Harley-Davidson, for example, retooled every aspect of its organization to support building and maintaining its brand community and treated all community-related activities not just as marketing expenses but as a companywide investment.

Another common misconception is that a brand community exists to serve the business. An effective brand community exists to serve its members, who participate in order to fulfill many kinds of needs, such as building relationships, cultivating new interests, and contributing to society. Strong communities work to understand people's needs and to engage participants by offering a variety of roles.

Finally, managers often think that a brand community must be tightly controlled. In reality, a robust community defies managerial control. Effective brand stewards can, however, create an environment in which a community can thrive – by, for example, designing multiple experiences that appeal to different audiences.

The authors offer an online "Community Readiness Audit" that can help you find out if your organization is up to the task of building a brand community.

Reprint R0904K

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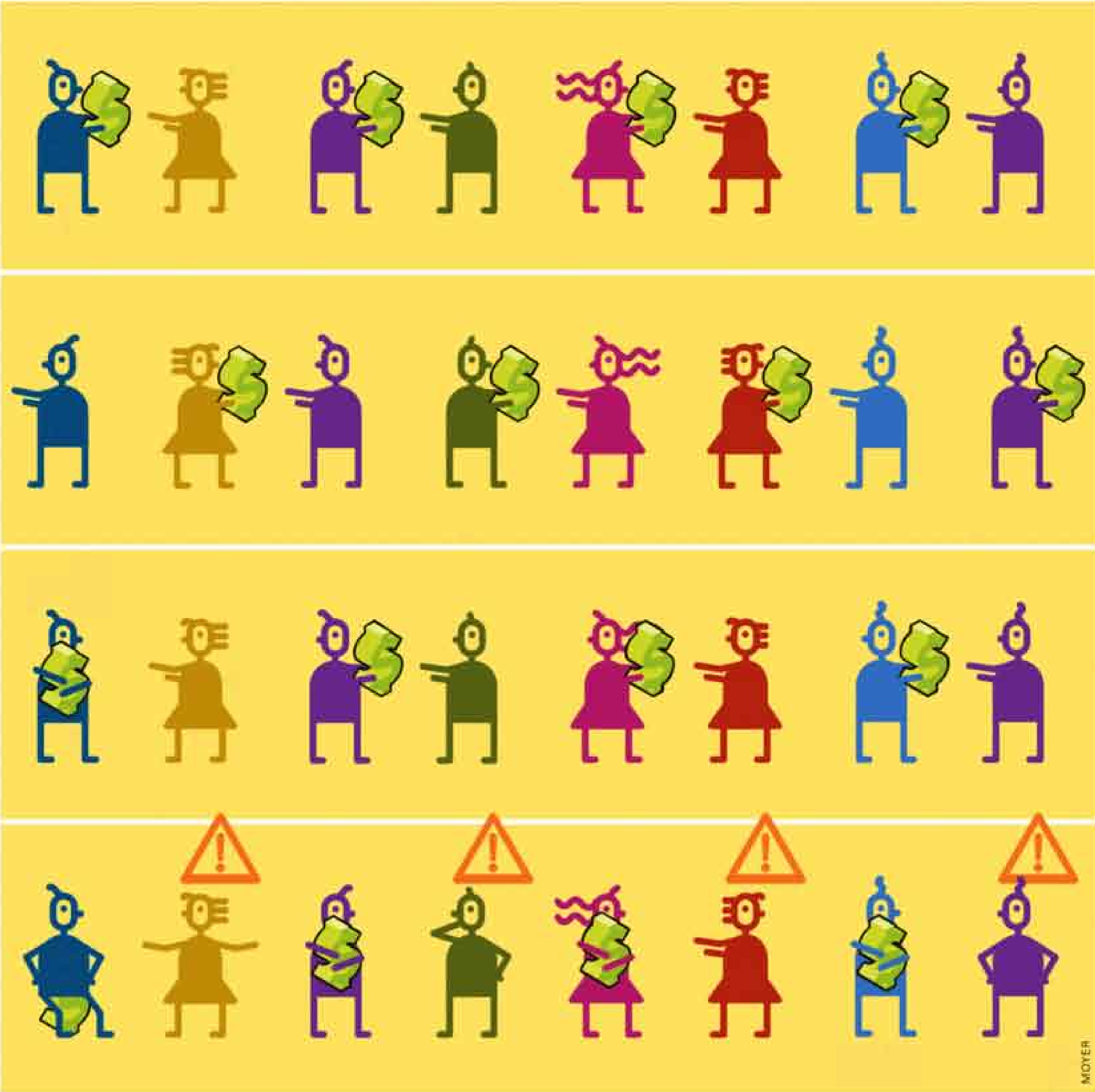

Broken Trust

AS MATTHEW BISHOP says in *Essential Economics*, trust is "one of the most valuable economic assets, hard to create but easy to destroy…" Certainly, the current economic crisis is evidence of just how fragile trust is. Before the crisis, there was a surplus of people who trusted too easily. Then their investments disappeared, their counselors didn't know what to do, and their respected advisers turned out to be crooks. The chain of trust broke. Now there is a trust deficit. The whole economy is holding its breath waiting for confidence to return. But doing nothing makes things worse.

David Rhodes and Daniel Stelter, in "Seize Advantage in a Downturn" (HBR February 2009), warn that "inaction is the riskiest response to the uncertainties of an economic crisis. But rash or scattershot action can be nearly as damaging." A disorganized response can produce a panic and distract people from finding opportunities hidden in the bad news. Companies must take decisive but measured action in tough times to secure their futures – action that can require, if not a complete renewal of trust, a leap of faith.

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