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The Executive Guide to Strategy



INSIDE: FAVARO Strategy vs. execution throwdown / **MAINARDI** Your right to win / **SULL** How to spot opportunity / **KHOSLA & SAWHNEY** Life beyond budgets ...AND MORE

A strategy+business Electronic Book
Published by Booz & Company

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Cover illustration: Otto Steininger

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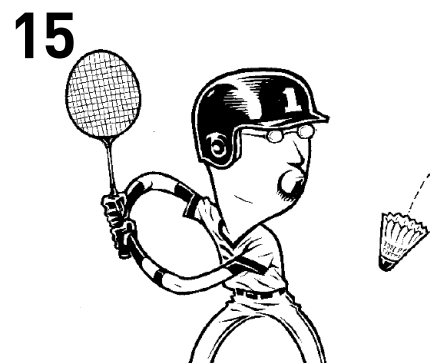
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This e-book was originally published before March 31, 2014, when Booz &
Company became Strategy&, part of the PwC network of firms. For more
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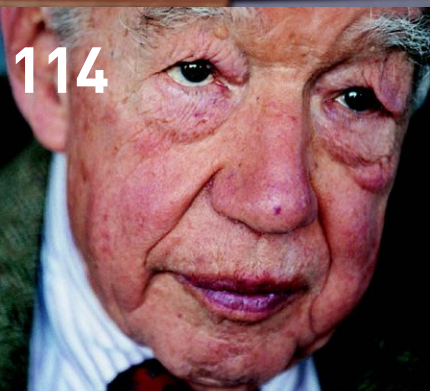
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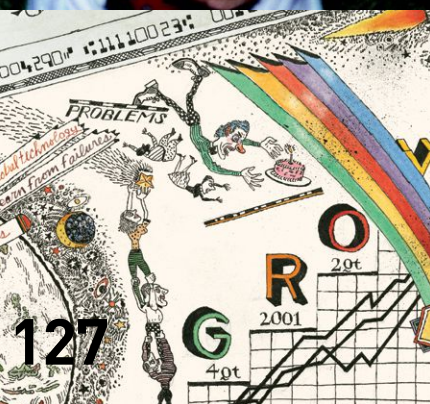
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Introduction: A Strategic Imperative

Although it is fundamental to business success, the discipline of strategy remains elusive to many of us. Indeed, if asked to provide a simple definition of the term, many experienced business leaders may not have it at their fingertips—or even agree with descriptions provided by their colleagues. Perhaps that’s one reason so many companies operate without well-articulated strategies—or at least without strategies that are widely understood and embraced across their organizations.

But finding the right strategy—the formula for ongoing success that differentiates your firm and unlocks your capacity to create value—is well worth the effort.

And with that lofty, yet essential, aspiration in mind, we offer this collection of *strategy+business* articles, videos, and columns representing the best of our thinking about strategy. Although these works range from pragmatic on a day-to-day level to quite high-minded, all share at least one trait. Each stands to make a substantial contribution to your understanding of strategy and your ability to create and implement the right strategy for your organization.

Paul Michelman
Executive Editor
strategy+business

Executive Summaries

Strategy: An Executive's Definition

by Ken Favaro with Kasturi Rangan and Evan Hirsh

It's much simpler to identify what strategy isn't than what it is—but in this article, Ken Favaro, a senior partner at Booz & Company, does both. Having a vision, drafting a mission statement, setting benchmarks, and establishing priorities are not the same as creating a tactical blueprint. A true business strategy should guide decision makers in identifying core customers and target markets, and differentiate the business model from those of competitors.

Strategy or Execution: Which Is More Important?

by Ken Favaro with Kasturi Rangan and Evan Hirsh

Companies often blame their missteps on subpar execution. But drawing on the experiences of Toyota and Southwest Airlines, the authors demonstrate that firms' fundamental choices about where to play and how to win precede any lapses or leaps in execution. Only firms with a strong strategic foundation succeed in the long term.

How to Win with a Capabilities-Driven Strategy

by Cesare Mainardi, Paul Leinwand, and Steffen Lauster

When faced with a changing or uncertain business landscape, companies can't settle for playing by the same rules as their competitors. Instead, they should fundamentally change the way they approach their markets by developing strategies based on what they do better than anyone else. A fresh, outward focus is the key, especially when it comes to meeting the needs of existing customers and attracting new ones. Using examples from the automobile, financial-services, and healthcare industries, a team of Booz & Company experts describe how companies that deploy a portfolio of complementary, supporting capabilities win out over their competitors.

The Right to Win

by Cesare Mainardi with Art Kleiner

Declaring that you have a *right to win* might seem arrogant—unless you can deliv-

er. That's what successful companies do by consistently engaging in those markets where they have the best chance of success. Few of these companies ever reinvent themselves all at once. Rather, they define a coherent strategy through the way they distinguish themselves from their competitors. This article takes you inside a boardroom to see how these conversations play out, and then on a guided tour of the four main schools of strategy, and their implications for executive decisions. With a clear understanding of your own theories of success, you can make more pragmatic choices about which products and services to offer, which customers to target, and how best to earn the *right to win*.

Is Your Company Fit for Growth?

by Deniz Cagar, Jaya Pandrangi, and John Plansky

Throughout the Great Recession, many companies endured lengthy periods of cost containment: trimming budgets, reducing headcount, and eschewing large-scale initiatives. But as the economy bounces back, many firms may suddenly find themselves strategically and financially “out of shape.” Having concentrated for so long on survival, some companies have lost their ability to seize opportunities and expand. To get back in the game, firms need to enter new markets, innovate, and attract a fresh crop of customers. Having a forward-thinking mind-set is not enough. Based on the Booz & Company *Fit for Growth** framework, this article recommends a corporate fitness regimen designed to help companies set clear strategic aims, invest in the right infrastructure, optimize costs, and reorganize for growth.

How Leaders Mistake Execution for Strategy (and Why That Damages Both)

by Ken Favaro

When reflecting on your strategic aims, which are the right questions to ask? Ken Favaro writes that most executives fall back on the *corporate* line of introspection—focusing on broad issues such as purpose and plans. But as IBM's turnaround in the 1990s illustrates, solving the five essential *strategic* problems—which address

* *Fit for Growth* is a registered service mark of Booz & Company Inc. in the United States.

the nuts and bolts of how a company should best apply its resources and engage with customers—provides a better way forward.

The Two Levels of Strategy

by Ken Favaro

Don't confuse *corporate strategy*, which represents the big-picture outlook of the organization, with *business strategy*: the tactical decisions made by sub-units of the company. Corporate strategy must be coherent, enabling different businesses to operate under the same umbrella (or in some cases articulating why they might be better off breaking away). This column outlines questions for executives at both strategic levels that will ensure the two levels are in sync.

The Thought Leader Interview: Cynthia Montgomery

by Ken Favaro and Art Kleiner

Harvard Business School strategy professor Cynthia Montgomery argues that a strategic leader is more than what she calls a “caretaker,” designing and implementing a plan. Yes, strategists should seek to secure a competitive advantage, develop unique assets, and react prudently to unexpected events. But as Montgomery describes, they must also conduct ongoing conversations about the direction, function, and role of the company. The quality of this dialogue informs, to a huge extent, the fortunes of the firm. “A strategy shouldn't be only a document or an occasional exercise,” Montgomery says. “It should be a way of looking at the world, interpreting experience, and thinking about what a company is and why it matters.” Montgomery's perspective reflects her wide-ranging experience as both an executive educator and a board member of large corporations and nonprofits.

Strategic Bets

by Ram Charan and Michael Sisk

When Dow Chemical Company used all its financial clout to acquire specialty manufacturer Rohm & Haas in 2008, forking out US\$18.8 billion in cash, it was what CEO Andrew Liveris called a “transformational” move. It signaled a fundamental shift in Dow's core business model. For a company founded in 1897, the risky move was the equivalent of a poker player pushing all of his chips to the center of the table. But in a fast-paced business landscape, the authors say, most

large corporations will probably have to make a similar decision to go “all in” at some point. To win a big strategic bet, as Dow did, a leader must have an outlook informed by his or her company’s potential, aided by due diligence, and shaped by a thorough evaluation of the possible scenarios. Above all, leaders must prepare themselves and their organization to recognize when a game-changing moment is at hand, and then seize it. The future of the company is at stake.

10 Clues to Opportunity

by Donald Sull

Psychologists use the term *confirmation bias* to describe the tendency for people to cling to their preconceived notions, dismissing information that challenges their point of view. The same affliction can strike businesses. When executives overlook unexpected clues that could lead to breakthroughs, preferring to stick with an established plan, they sell their shareholders and employees short. But your company doesn’t have to miss the signs, and managers who consistently perceive and exploit anomalies have a significant advantage over their rivals. In this article, Donald Sull—professor at the London Business School and author of *The Upside of Turbulence: Seizing Opportunity in an Uncertain World* (HarperBusiness, 2009)—presents 10 easy-to-miss indicators of important opportunities.

Seven Chapters of Strategic Wisdom

by Walter Kiechel III

You can skip all those books. The essence of strategy can be found by reading just the most canonical chapters in the history of the genre. Here, Walter Kiechel III, who has been the managing editor of *Fortune* and the editorial director of Harvard Business Publishing, identifies essential reading spanning almost six decades. The seven selected chapters offer a window into the evolution of strategic thinking. Whereas Alfred D. Chandler Jr.’s landmark 1962 book *Strategy and Structure: Chapters in the History of the American Industrial Enterprise* (MIT Press) is widely considered the first work to consider strategy in the corporate realm, thought leaders such as Andrew S. Grove and Henry Mintzberg have moved the field forward in recent years. Kiechel traces the main themes that crop up throughout the literature, noting that the conversation has grown more sophisticated and nuanced since its inception.

Professor Chandler's Revolution

by Art Kleiner

Alfred D. Chandler Jr., who died in 2007 at the age of 88, was the United States' most eminent business historian. The Harvard Business School professor is still widely regarded as the man who legitimized business history through his groundbreaking teaching and writing during the 1960s and '70s. Outside the classroom, Chandler's work showed managers how industrial change and the interplay of large corporations underpin the modern business landscape. In his Pulitzer Prize-winning book, *The Visible Hand: The Managerial Revolution in American Business* (Belknap Press, 1977), Chandler traced the origin of business strategy and its influence on markets and industries: In his view, the "visible hand" of large corporations, with capabilities that outpaced those of smaller rivals, determined the viability of economies. But it wasn't until the last years of his life, with his final books on the electronics and pharmaceutical industries, that Chandler felt he had cracked the code of organizational success. In this profile from 2002, Chandler expounds on his idea of the "integrated learning base" and an array of other topics, from pre-World War II cartels to the modern problems of market dominance. Chandler was one of the true giants in his field, and his insights continue to guide and inspire managers today.

Blank Checks: Unleashing the Potential of People and Businesses

by Sanjay Khosla and Mohanbir Sawhney

What could you do with a blank check? That's what the managers of Kraft Foods asked their Tang division colleagues in an effort to kick-start the global sales of one of their iconic, but flagging, brands. Given no budget constraints and limited only by their own imagination, the Tang team created several new products aimed at emerging markets—like a mango drink for the Philippines—and tailored their marketing efforts to specific cultures, doubling their global sales in five years. As this case illustrates, having a blank check doesn't mean being fiscally irresponsible or setting unachievable goals. Instead, blank checks can provide the freedom to identify new opportunities, break the mold, and innovate broadly. This article spells out the questions companies should ask themselves before writing a blank check—and why they should consider it in the first place. +

It's much simpler to identify what strategy isn't than what it is—but in this article, Ken Favaro, a senior partner at Booz & Company, does both. Having a vision, drafting a mission statement, setting benchmarks, and establishing priorities are not the same as creating a tactical blueprint. A true business strategy should guide decision makers in identifying core customers and target markets, and differentiate the business model from those of competitors.

**What *is* a business strategy?
It is the result of choices made
to maximize long-term value.**

Strategy: An Executive's Definition

by Ken Favaro with Kasturi Rangan and Evan Hirsh



The question “What is strategy?” has spurred numerous doctoral dissertations, countless hours of research, and hearty disagreement among serious management thinkers. Perhaps this is why many executives also struggle with it. Nonetheless, decision makers seeking to steer a business to sustained success need a succinct and pragmatic response. After all, it can only help executives to have a shared definition of strategy when they are creating, communicating, and implementing a strategy for their business.

So, what is a business strategy? Strategy is different from vision, mission, goals, priorities, and plans. It is *the result of choices executives make, on where to play and how to win, to maximize long-term value.*

“Where to play” specifies the target market in terms of the customers and the needs to be served. The best way to define a target market is highly situational. It can be defined in any number of ways, such as by where the target customers are (for example, in certain parts of the world or in particular parts of town), how they buy (perhaps through specific channels), who they are (their particular demographics and other innate characteristics), when they buy (for example, on particular occasions), what they buy (for instance, are they price buyers or service hounds?), or for whom they buy (themselves, friends, family, their company, or *their* customers).

Having a differentiated approach to a target market can be a source of great advantage in its own right. Southwest Airlines is a case in point. Early in its development, Southwest defined its target market to include regular bus travelers—people who wanted to get from point A to point B in the lowest-cost, most convenient way. In contrast to the industry’s hub-and-spoke standard, Southwest’s

point-to-point operations and hassle-free service model comprised a compelling value proposition for people who would otherwise choose bus travel. This gave the company a unique growth path compared to the traditional airlines.

Or consider Sir Brian Pitman, the former CEO of Lloyds TSB: He had a policy of defining the company's target markets at one level of segmentation lower than the competition did. For example, Lloyds was the first "High Street Retail" bank in the U.K. to carve out "high net worth" as a separate business with its own unique target customer, value proposition, and system of essential capabilities. Similarly, it was the first British commercial bank to drop large companies as a target customer (with a few "flagship" client companies as exceptions). Sir Brian's insight that you could win by being sharper than the competition in choosing your target market turned Lloyds from the U.K.'s banking laggard to its leading bank.

In both the Southwest and Lloyds cases, "where to play" was an essential part of what made the company's strategy so successful for such a long time.

"How to win" spells out the value proposition that will distinguish a business in the eyes of its target customers, along with the capabilities that will give it an essential advantage in delivering that value proposition. Choices must be made because there is at least one way to win in every market, but not everyone can win in any given market. With good choices, a business gains the right to win in its target markets. The target market, value proposition, and capabilities must hang together in a coherent way. And good strategies call for the right amount of "capabilities stretch": not too much or too little change from the capabilities a business already has.

Every company faces innumerable options for where to play and how to win. Often they have to sort out seemingly conflicting objectives, such as the need for both long-term growth and short-term profitability, to choose which options to pursue. To "maximize long-term value" means—when there are mutually exclusive options—to select those that will give the greatest sustained increase to the company's economic value. We once heard a corporate leader ask, "But how can you ever know when you have maximized value?" The fact is, you can't, because you can never know with certainty if there's a better option than those you've considered so far. To "maximize long-term value" is to never stop looking for those higher-value options.

It's worth emphasizing that "maximizing long-term value" is not the same thing as "maximizing share price" or "maximizing shareholder value." Those objectives typically represent the most short-term demands of current shareholders or their advisors, and they do not always align with what is best for all shareholders, particularly long-term owners. On the other hand, "maximizing long-term value" does not mean forgetting about the short term. Economic value takes into account growth and profitability, short-term and long-term value, and risk as well as reward.

In the end, to define the fundamentals of your business strategy, you need only to answer three questions:

1. Who is the target customer?
2. What is the value proposition to that customer?
3. What are the essential capabilities needed to deliver that value proposition?

Without clear and coherent answers to these three questions, you may have an exciting vision, a compelling mission, clear goals, and an ambitious strategic plan with many actions under way, but you won't have a strategy. +

Companies often blame their missteps on subpar execution. But drawing on the experiences of Toyota and Southwest Airlines, the authors demonstrate that firms' fundamental choices about where to play and how to win precede any lapses or leaps in execution. Only firms with a strong strategic foundation succeed in the long term.

Many business leaders think they'd rather have great execution than superior strategies, but you can't have the first without the second.

Strategy or Execution: Which Is More Important?

by Ken Favaro with Kasturi Rangan and Evan Hirsh

I once heard a business leader say, “Strategy is results.” He meant that

strategy doesn't matter as long as you are producing results. Many other business leaders feel the same way. Often, this is because they associate strategy with analysis and execution with getting things done, and they attribute more value to doing than to analyzing. From that perspective, a strategy is a lofty, self-evident statement such as “Our strategy is to maximize customer value” or “Our strategy is to become the market leader.” Such “strategies” don't contribute much to producing results. Possibly, they motivate the troops, although even that is highly debatable.

On its surface, this view that strategy is less important than execution is hard to refute. If that's all strategy is, execution is clearly more important.

But any seasoned strategist knows that strategy is not just sloganeering. It is the series of choices you make on where to play and how to win to maximize long-term value. Execution is producing results in the context of those choices. Therefore, you cannot have good execution without having good strategy.

Most everyone would agree that you cannot achieve good results without having good execution; similarly, most would agree that having a good strategy alone is no surefire formula for success. But too many jump to the wrong conclusion that this makes execution more important than strategy.

Consider the Toyota Motor Corporation and General Motors Company. Yes, Toyota produced better results than GM for many years because it executed better than GM. But it was able to out-execute GM because it made much clearer and more coherent choices about where it would play and how it would compete. This included sharper choices about its target customers; its value proposition in terms of products, features, and price points; and the superior capabilities it

needed to deliver that proposition to those customers. In other words, Toyota out-executed GM primarily because it had a clearer, better strategy than GM. The fact that Toyota faltered in 2010 and 2011 reinforces the point that good strategy alone isn't enough; you have to have good execution too. But this shouldn't be confused with the point that the quality of your execution depends a lot on the quality of your strategy.

The airlines industry provides another example. Southwest Airlines Company has outperformed American Airlines Inc. for decades. Is this because Southwest has executed better than American? Absolutely. But it's no coincidence that Southwest also has a better strategy. It has a more sharply defined target market (the point-to-point economy traveler), a more compelling value proposition (lowest price, most convenient, and most passenger friendly), and a more coherent set of capabilities to deliver that proposition (maintaining a simpler fleet, running a point-to-point operation). Having a better strategy has made it possible for Southwest to consistently out-execute American.

In fact, no matter how much American Airlines improves its execution, it will never be enough to overcome the lousy economics of the airline industry and make it a big value creator. The company would have to find a more distinctive strategy. Likewise, no matter how much GM improves its decision-making culture, product development processes, or dealer operations, that effort won't be enough to produce superior results without a coherent strategy. Fortunately, bankruptcy has given both companies breathing space to find distinctive and coherent strategies.

To be sure, both American and GM face challenging industry conditions in which earning an attractive level of profitability is reserved for only the most advantaged players. But even when industry economics are attractive, standout results do not come from standout execution alone.

Another example is retail banking. A typical retail bank doesn't really need a distinctive strategy to produce an attractive return on capital as long as it executes well. Most retail banks have strategies that are virtually indistinguishable from one another. Their leaders all talk about targeting the same customers; having intimacy with those customers; and being the best at service, relationship management, product development, and risk management. However, the ones that truly excel have created distinctive, coherent strategies that enable them to have superior ex-

ecution. Think of Wells Fargo in the U.S., Standard Chartered in Asia, and Lloyds Bank in the U.K. when Sir Brian Pitman was its chief executive.

So the next time you hear statements like these—

- “I’d rather have great execution with a mediocre strategy than the other way around.”
- “You don’t win by having a better strategy: instead, you win through superior execution.”
- “We don’t need a new strategy to fix our performance; we just need to execute the one we have.”

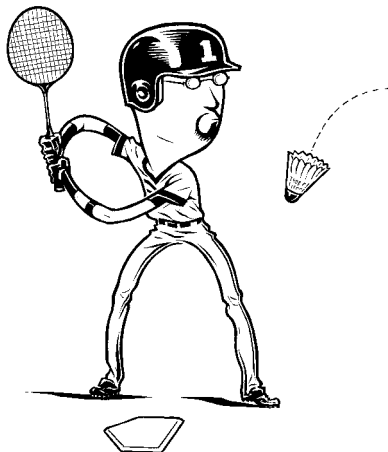
—remember this: You need a good strategy to have good execution. Yes, having a good strategy alone isn’t enough to win, but your ability to execute well depends on how good your strategy is and how well it’s understood by everyone who makes major decisions for your business. When your business or company is not executing well, take a look at your strategy. Improving it—and your most important stakeholders’ understanding of it—may hold the key to unlocking better execution. +

When faced with a changing or uncertain business landscape, companies can't settle for playing by the same rules as their competitors. Instead, they should fundamentally change the way they approach their markets by developing strategies based on what they do better than anyone else. A fresh, outward focus is the key, especially when it comes to meeting the needs of existing customers and attracting new ones. Using examples from the automobile, financial-services, and healthcare industries, a team of Booz & Company experts describe how companies that deploy a portfolio of complementary, supporting capabilities win out over their competitors.

**By focusing investment
on the things you do best, you
will equip your company for
growth in uncertain times.**

How to Win with a Capabilities- Driven Strategy

by Cesare Mainardi, Paul Leinwand, and Steffen Lauster



Also contributing to this article were Booz & Company partners Leslie Moeller and J. Neely, principals Jaya Pandrangi and Juan Carlos Webster, and consulting editor Tara Owen.

Originally published by *s+b* as “How to Win by Changing the Game” on Nov. 25, 2008 (Winter 2008)

The Wm. Wrigley Jr. Company stuck to its gums for more than a century. The company, founded in 1891, specialized in chewing gum; it did not branch out into mints, candies, or breath strips until 1999. Over the years, Wrigley built up its core capabilities in a way that few other companies could match: It focused innovation on new flavors and developed a consistent ability to influence retailers to display its products prominently on the candy racks. Thus, by the early 1980s, Wrigley had achieved operating margins twice those of competitors more than 15 times its size. This was quite an accomplishment, especially in an industry (consumer packaged goods) that has historically relied on scale, in both manufacturing and marketing, for its profitability.

Wrigley, in effect, was one of the few consumer packaged goods enterprises that prospered on its own terms, instead of adapting its plans to mimic its competitors. This paid off handsomely for the company’s shareholders in April 2008, when chocolate giant Mars Inc. swept in with a rich US\$23 billion all-cash offer. So irresistible was the lure of this deal that investing sage Warren Buffett committed \$4.4 billion of the purchase price and a further \$2.1 billion to purchase a stake in the Wrigley division.

The key to Wrigley’s enviable position was not its single line of products—there are many single-category companies that are less successful—but rather its distinctive capabilities. One bit of evidence for this was Mars’s decision to leave Wrigley as a stand-alone business after the deal, indicating that the acquisition was motivated primarily by the leverage that capabilities can offer. Mars knows chocolate and candy. Wrigley knows gums and candy. Together, the combined company knows how to launch and market confectionary products. Mars then

transferred its nonchocolate brands, Starburst and Skittles, to Wrigley's portfolio to consolidate and leverage these differentiating capabilities. Mars CEO Paul Michaels summed it up best when he said the deal was “not about being bigger—it's about being the best.”

When most corporate leaders hear about using capabilities as a strategic advantage, they tend to think internally. They assume that building capabilities is a job for their human resources, training, or R&D departments. Or they squander their efforts on a variety of unrelated skill- and technology-building initiatives that don't fit well together and don't address the real needs of customers or reflect the company's overall direction. By contrast, the Wrigley story—and similar examples in financial services, automobiles, transportation, healthcare, and many other industries—suggests that an effective capabilities-driven strategy is outward-looking. It starts and ends with customers. It involves building up a portfolio of ideas, skills, and competencies that, when put together, enable the company to consistently attract its primary customers.

A portfolio of capabilities might include intellectual capital—ideas, patents, products, and distinctive practices—but those elements are not enough. Patents expire. Premium products become commoditized. However, a distinctive combination of skills, tools, or processes, deployed in day-to-day business, will tend to get better over time, at a pace that prevents competitors from catching up. Walmart's supply management prowess, Southwest Airlines' asset utilization expertise, Toyota's mastery of the automotive production system, and Procter & Gamble's ability to leverage innovation across product categories have all benefited from continuous improvement. Honed and strengthened over years (or sometimes decades), these focused bundles of capabilities confer and support a “right to win” in their companies' respective industries.

A true capabilities-driven strategy is the most reliable way for a company to thrive when the rules of the game for its industry are in flux. Instead of looking inward at the capabilities you already have and trying to discern your strengths, start by looking outward at the capabilities you need. What must you be able to do to reach the customers you fundamentally want to attract? By designing a portfolio of skills and tools needed to win customers, you can end up changing the game instead of playing by the rules.

The Case for Capabilities

As we write this article, in October 2008, much of the global financial-services industry is in crisis, and it is not clear how wide or deep the economic fallout will be. At the same time, many economic fundamentals remain unchanged. Emerging markets are still growing; an enormous amount of financial capital is still looking for investment vehicles; and productivity in many parts of the world continues to increase. Some industries, such as energy and heavy construction, are doing very well right now; even in the most “difficult” industries, such as manufacturing and financial services, some companies are thriving even as others collapse.

As the crisis unfolds, it is becoming more important to distinguish the companies that are managed effectively from those that have just managed to get by in good times. Those that seem positioned to win—P&G, Toyota, Walmart, and Southwest, along with other well-regarded companies—have spent the past years explicitly building up a coherent portfolio of capabilities as the center of their strategy. When situated in a well-designed portfolio, capabilities naturally drive value for a company; they also drive decisions about mergers, acquisitions, high-level executive talent, divestitures, alliances, and other strategic concerns.

Capabilities have been ignored by many companies over the years, because many leaders don't have experience in building them and because they are often regarded as nonessential. Strategies based on scale used to be sufficient in most operations-oriented enterprises. As a senior executive, if you gained enough heft in your industry (through aggressive M&A or cost cutting to drop prices), you could capitalize on economies of scale that ensured both production efficiencies and market clout. Leverage over retailers gave you better access to customers; leverage over advertising agencies gave you enhanced access to marketing media; and a larger amount of innovation investment gave you (or so it seemed) a greater likelihood of developing breakthrough products.

But the ability to establish competitive differentiation through scale has begun to erode. The rise of outsourcing and offshoring, along with more sophisticated telecommunications and the use of strategic alliances, allows smaller and newer firms to punch beyond their weight, competing with larger or more established companies. In marketing, one-on-one customer processes and more differentiated digital media have similarly leveled the playing field. And in many larger companies, economies of scale are often undermined by higher overhead costs or

“We kept asking ourselves what value Honda would bring to the customer [in] that category [of engine]. There was just no benefit for us,” noted Dan Bonawitz, head of corporate planning in the United States.

entrenched bureaucracy.

There’s no such thing as free capabilities; they require concerted investment. But they become far more cost-effective when they help corporate leaders decide where to expand and where to cut back. For example, Honda Motor Company has built much of its profitable growth around expertise in designing and manufacturing small high-performance engines. From motorcycles and lawn mowers, the company moved up to automobiles and light sport-utility vehicles. But it has drawn the line at larger V-8 engines that it believes lie outside its core business. “We kept asking ourselves what value Honda would bring to the customer [in] that category [of engine]. There was just no benefit for us,” noted Dan Bonawitz, head of corporate planning in the United States, in an August 2008 *New York Times* article.

As a result of this focus, combined with the public’s increasing demand for fuel efficiency, Honda has emerged as the only car company to register sales gains in the U.S. in 2008. Through the first seven months of the year, Honda’s revenues were up 3 percent in a market that had fallen 11 percent. In addition, whereas its American counterparts have hemorrhaged billions of dollars, Honda’s bottom line has never been stronger; it reported record profits of nearly \$1.7 billion during the first quarter of FY08.

Portfolio Coherence

Will a capabilities-driven strategy yield similar results for any company? That depends on many factors—and the largest is probably the coherence of the company’s capabilities portfolio. Many corporations maintain a portfolio of comple-

Kimberly-Clark's customer immersion and design center allows all consumer-oriented business units and product lines to benefit from its capabilities in retail-based consumer insight.

mentary businesses. But few understand how to build a portfolio of mutually reinforcing capabilities that cross business unit lines, and that distinguish the company as a whole.

Kimberly-Clark Corporation's customer immersion and design center represents one leading-edge example. Retailers visiting the center can walk into a virtual version of their store and interact with products on the shelf just as consumers would. Using 3-D virtual-reality technologies, Kimberly-Clark can mock up a typical Target store, for instance, complete with the red bull's-eye logo and signage, and experiment with different merchandising, assortment, pricing, shelving, and execution options. The center allows all consumer-oriented Kimberly-Clark business units and product lines, including diapers, paper towels, and feminine care products, to benefit from its capabilities in retail-based consumer insight. Staffers can learn directly from retail customers and thus improve many subtle but high-leverage aspects of product innovation and marketing: design and packaging, in-store locations and displays, product differentiation, and more. Other parts of the company also benefit; for example, as *Information Week* reported in September 2007, Kimberly-Clark's internal R&D staff bring in their specs and watch the products they are building come to life.

Other companies that build coherent portfolios of capabilities enjoy similar advantages. Procter & Gamble's "open innovation" program, Connect + Develop, allows the company to exploit the product, packaging, and cost innovation capabilities of external firms along with its own—and the program coherently fits with its human capital and expansion strategies (see "P&G's Innovation Culture," by A.G. Lafley with Ram Charan, s+b, Autumn 2008). Unilever's distribution net-

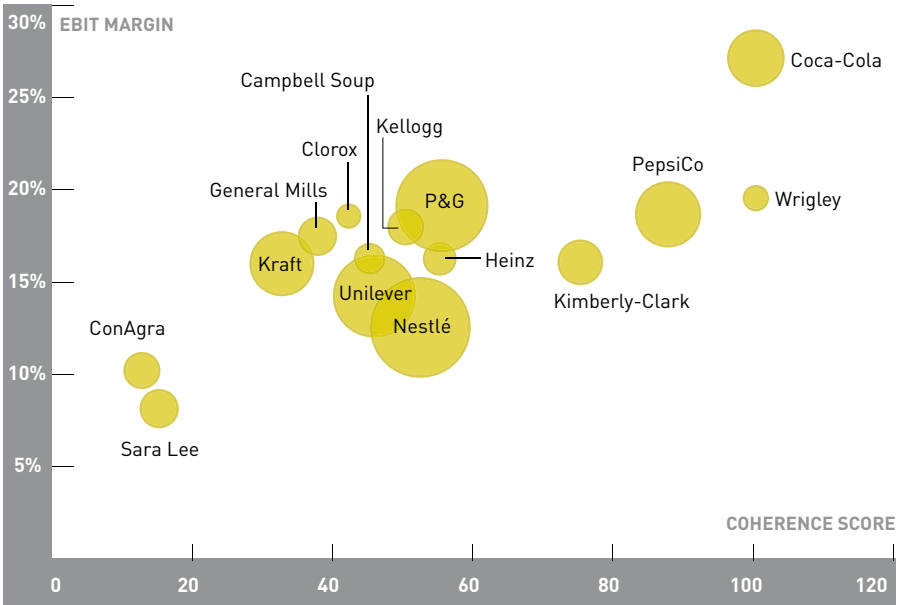
work incorporates its strong global supply chain capabilities in the developing world, where, according to the *Economist* in January 2008, the company generates 44 percent of its annual revenues.

Building a portfolio of an enduring, unified set of capabilities means making a variety of decisions—including those regarding acquisitions, divestitures, human capital investments, recruiting, IT and other technologies, and alliances—in terms of how well they fit with the company’s other efforts to expand its skill and prowess. If those decisions are managed well, then a portfolio coherence strategy need not result in a substantial increase in a company’s overall investment. In fact, it can be a major source of cost savings, because it eliminates investments that do not help position the company for long-term advantage.

Perhaps that’s why research suggests that companies that have defined and leveraged their capability coherence typically enjoy higher operating margins. That correlation, at least, held true in a recent Booz & Company study of consumer packaged goods companies (see *Exhibit 1*). The clear relationship between portfo-

Exhibit 1: The Benefit of Capability Coherence

A 2008 study of leading consumer products companies shows that as “portfolio coherence” in capabilities increases, so does overall corporate profitability and health (as indicated by EBIT margin). The size of the circle represents the size of the company, in revenues.



Note: Portfolio coherence score is determined by overlap among firm-wide investments in capabilities; EBIT margin is earnings before interest and taxes divided by net revenue.

Source: Booz & Company, Capital IQ

lio coherence and operating margin performance—regardless of revenues—suggests that capability coherence will increasingly drive corporate strategy over the next five to 10 years.

Identify, Build, Divest

How, then, do you institute a capabilities-driven portfolio? You articulate those capabilities that could help you succeed in your key markets, and then deliberately allocate the bulk of your support to them. Your thinking might unfold through a step-by-step process.

- **Identify the capabilities you need to build.** Start by identifying the drivers of demand in your market—those that will most help you deliver the products and services that people need and want. How engaged are the customers of this category? How diverse are the product or service segments? How large is the potential market, and what is its core interest? For a basic food staple like milk or bread, for example—a highly commoditized product with relatively low consumer engagement—investing in small-scale innovation capabilities will not generate enough returns, but retail placement capabilities could. So could significant innovation capabilities that could break the commodity barrier.

Wrigley has long understood that adults and children respond to different flavors, but the ability to innovate in particular domains (such as sugar-free gum or the use of candy coatings) is important to both audiences. Wrigley wisely built up that capability to meet its customers' demands. So did Jeep. This division of Chrysler LLC, with highly engaged customers who understand a lot about the special qualities of its vehicles, has kept up its innovation in off-road travel. No matter what other features Jeep offers, every car must be Rubicon Trail-rated: that is, capable of navigating a well-known and difficult off-road vehicle trail near Lake Tahoe, Calif.

Sometimes lack of market demand makes a capability less valuable. Disposable-diaper manufacturers in some emerging countries built their capabilities for low-cost production and product expansion, hoping to lower the price of diapers and thus expand their markets. But gradually they discovered that for most diaper-purchasing parents, it was cheaper to hire someone to clean up the baby's messes than to buy a disposable diaper at any price.

Once you have articulated your highest-potential markets, identify the few

If you have a highly skilled procurement and outsourcing function, this might help you begin developing an overseas innovation footprint.

enterprise-wide capabilities that could, in combination, enable you to satisfy customers in all your key businesses. Focus on capabilities that would characterize your entire company, not just one business unit. General Electric Company, for example, is best known for its approach to leadership development and Six Sigma, not for its approach to turbine manufacturing or television scheduling. Spell out the ways in which these capabilities would distinguish your company. Don't simply say that you want to develop more innovation or channel expansion capabilities; stipulate precisely what tools or processes will enable superior performance.

On the innovation front, for instance, is your objective to unleash rapid innovation in product attributes (such as food flavors, automobile cupholders, and credit card benefits)? Do you hope to establish more fundamental technological innovation, to lead the next wave of telecommunications or industrial manufacturing? Or are you seeking business model innovation—new ways of cooking, driving, spending—that will influence how customers fundamentally use your product?

Most likely, you already have some of the capabilities you need; otherwise, you wouldn't be in business. But you are probably not deploying them effectively in every part of your organization, and there are probably other natural opportunities that you are overlooking. For example, if you have a highly skilled procurement and outsourcing function, this might help you begin developing an overseas innovation footprint (see *"Beyond Borders: The Global Innovation 1000,"* by Barry Jaruzelski and Kevin Dehoff, s+b, Winter 2008).

In the early 2000s, leaders in Pfizer Inc.'s consumer healthcare unit engaged in the exercise of capabilities identification. At the time, the unit was the producer

of Listerine, Nicorette, and several other household-name brands, but it did not have the kind of growth that these brands would suggest. The leaders undertook a capabilities-driven strategy, focused on combining capabilities for clinical testing with deep consumer insight. This allowed them to make the kind of differentiated product claims that would matter most to their customers. For example, Pfizer advertised that Listerine, when added to brushing and flossing, reduced plaque. Backed up by innovations that in turn had been made possible by investments in R&D capability, this approach brought Listerine (and several other Pfizer products) to large new groups of customers.

Other parts of the company were also guided by this capabilities-driven strategy. For example, professional recommendations often play an important part in consumers' decisions about over-the-counter products. Pfizer used its scientifically backed claims to gain professional support to include in consumer marketing campaigns. This pursuit also meant developing a capability to license some of its products to healthcare practitioners around the world, rapidly screening and prioritizing candidates on the basis of both commercial and technological considerations.

The strategy was dramatically successful. Business expanded fivefold in five years; then, in 2006, Pfizer's consumer healthcare unit was sold to Johnson & Johnson for \$16.6 billion (more than 20 times earnings).

- **Fill in the gaps.** The second step in the process of instituting a capabilities-driven portfolio is to focus on the product development investments and business acquisitions that would give you the capabilities you need most, while complementing the capabilities you already have. Along the way, increase your own capacity to learn and execute.

In the financial-services arena, the Bank of America Corporation has spent years building up a massive, omnipresent retail banking footprint throughout the country. Now that it has an extensive capability for attracting retail customers, it is developing a complementary ability to create new financial-services products for them. In 2005, Bank of America acquired MBNA, making it one of the world's largest credit card issuers; in the summer of 2008, it stepped in to purchase Countrywide Financial (the largest originator and servicer of housing loans in the U.S.); and in September, it agreed to purchase Merrill Lynch & Company (probably the major investment bank most known for promoting its services to

“mass affluent” consumers). The latter two acquisitions were made as a response to the financial crisis, but both were wholly consistent with the bank’s focus on consumer banking capabilities. Indeed, in his early statements about the Merrill Lynch purchase, Bank of America CEO Kenneth D. Lewis indicated that Bank of America was most interested in gaining retail brokerage capabilities.

In our experience, those companies that do not build a portfolio of complementary, reinforcing capabilities often lose to those companies that do. Accordingly, Bank of America beat analysts’ forecasts for the second quarter of 2008 and announced that Countrywide was expected to turn a profit for the year. (Few banks could have achieved the same synergy with Countrywide, because they would not have built up the same prowess at retail banking.) On July 22, 2008, Lewis was quoted in the *New York Times* as saying, “We are actually having great success in the marketplace given that others are so inwardly focused.”

- **Divest businesses that don’t fit.** This final step in building a capabilities-driven strategy is where you save money. Streamline or sell those businesses that do not exploit or further the development of your highest-priority capabilities. The challenge for most management teams is marshaling the confidence to focus—to disproportionately invest in the few capability areas that make a difference, rather than spreading your selling, general, and administrative expenses across all possible bets.

Most of the companies mentioned in this article have visibly (and sometimes painfully) let go of businesses that did not fit their capabilities portfolio. Bank of America’s retrenchment from its institutional businesses provides one example. In 2008, the bank sold its prime brokerage operations on the heels of extensive layoffs in its investment banking operations. P&G has similarly been selling its food businesses—Sunny Delight, Jif, and, most recently, Folgers—as it focuses its portfolio on health and beauty and consumer healthcare, where it has built distinctive innovation capabilities that are not applicable to the food categories. *(Editor’s Note, 2013: Between 2008 and 2012, the value of Bank of America’s acquisitions of both Countrywide and Merrill Lynch was openly questioned as both subsidiaries were investigated by the U.S. government and hidden liabilities came to light.)*

Thinking outside the Cave

As many senior executives will confirm, this focus on capabilities is easy to write about but surprisingly difficult to execute, especially in highly turbulent times. But the alternative is worse. This is not the time to find a cave and hibernate until the economic storm passes—for it's unlikely the storm will pass anytime soon, and a capabilities-driven strategy is the only way to remain equipped for perpetually stormy weather.

Take care to build those capabilities you genuinely need, rather than those that do not serve your customers—even if some of the latter feel important or mattered in the past. Remember that capabilities do not manifest themselves overnight; they take time to grow. That's why foresight—particularly the ability to anticipate future industry dynamics and customer needs—is so crucial.

As you look for ways to foster growth, consider every move through the lens of your ultimate aspiration: your ability to thrive by consistently attracting customers. To achieve that goal in today's global business environment, it's not only what you do that matters—it's how well you are equipped for it. +

Reprint No. 08401

Declaring that you have a *right to win* might seem arrogant—unless you can deliver. That's what successful companies do by consistently engaging in those markets where they have the best chance of success. Few of these companies ever reinvent themselves all at once. Rather, they define a coherent strategy through the way they distinguish themselves from their competitors. This article takes you inside a boardroom to see how these conversations play out, and then on a guided tour of the four main schools of strategy, and their implications for executive decisions. With a clear understanding of your own theories of success, you can make more pragmatic choices about which products and services to offer, which customers to target, and how best to earn the *right to win*.

Business strategy is at an evolutionary crossroads. It's time to resolve the long-standing tension between the inherent identity of your organization and the fleeting nature of your competitive advantage.

The Right to Win

by Cesare Mainardi with Art Kleiner



Disclosure

At least four people named in this article have been contributors to *s+b*: Ram Charan, Walter Kiechel III, Henry Mintzberg, and C.K. Prahalad. Others named in the article have had associations with *s+b* staff members, with Booz & Company, or with its competitors. Where we assess individuals' contributions and impact, we have tried to do so independent of any such associations.

Originally published by *s+b* on Nov. 23, 2010 (Winter 2010)

It's 8 a.m. in the executive conference room of a large global packaged-foods manufacturer (a real company, its name withheld to preserve confidentiality). For the past two months, a team made up of 15 senior people has been exploring options for growth, winnowing them down to three basic strategies. Each is now summed up in a crisp 20-minute presentation.

The first option focuses on innovation. The company would rapidly develop and launch many new types of snacks and foods, packaged in new and interesting ways, offering leading-edge nutrition and convenience.

Under the second option, the company would get closer to its customers, producing the food people ask for. It could incorporate ideas gathered online into its offerings and provide busy working families with customizable, convenient, and well-balanced meals.

The third option would involve transforming the dynamics of the relevant food sectors by competing more aggressively. The company would become a category leader by investing in new process technology, rightsizing operations to push costs down, and completing key acquisitions.

After the screen goes blank, the CEO leans forward and asks a simple question: "Which strategy would give us the greatest right to win?" His tone, calm and direct, makes everyone sit up a little straighter. And they probably should, for this is the core question underlying every business strategy, although it isn't always phrased that way.

A right to win is the ability to engage in any competitive market with a better-than-even chance of success—not just in the short term, but consistently. Imagine a coach, observing a player entering a sports competition, saying, "That kid has

the right to win out there.” Or a teacher, watching a student about to take a test, saying, “That student deserves to excel.” What they are really saying is, “That contestant is the right player, in the right type of contest, with the precise capabilities needed to meet this particular challenge.” Of course, the contestant will lose at times, but over the years, a consistent innate advantage will establish itself, giving this contestant the ability to pull off seeming miracles while making it all look easy. This essential advantage is particularly rare in business—a more free-form and unpredictable game than sports or academia. But it is increasingly important at a time of unprecedented competitiveness.

The phrase *right to win* may strike some observers as arrogant. After all, no company has this kind of assurance handed to it. But that’s precisely the point. The right to win cannot be taken for granted. It must be earned. You earn it by making a series of pragmatic choices that align your most distinctive and important capabilities with the way you approach your chosen customers, and with the discipline to offer only the products and services that fit. At Booz & Company, where we call this approach a capabilities-driven strategy, research and experience have led us to conclude that only high levels of coherence—among market strategy, capabilities systems, and a company’s portfolio of offerings—can give any firm the right to win.

All corporate strategies are at heart theories about the right to win. That is why, for those trying to understand the nature of business success, the history of strategy is both helpful and fascinating. One valuable recent source is *The Lords of Strategy: The Secret Intellectual History of the New Corporate World* (Harvard Business Press, 2010), in which former *Fortune* managing editor Walter Kiechel recounts the prevailing theories of business strategy over the past 50 years, and the stories of the people who developed them. Drawing on Kiechel’s history and those of others, such as Henry Mintzberg, Bruce Ahlstrand, and Joseph Lampel in *Strategy Safari: The Complete Guide through the Wilds of Strategic Management* (2nd ed., FT Prentice Hall, 2009), we have created a map of this conceptual landscape, organized on the basic principles underlying theories of the right to win (see *Exhibit 1*). The map depicts four broad schools of strategy; each represents a hypothesis about the nature of long-term success in a competitive world.

The Basic Tension in Strategy

Business strategy, as we know it today, has a relatively short history. The word *strategy* was first applied in print to mainstream business in 1962, with the publication of Alfred D. Chandler Jr.'s book *Strategy and Structure: Chapters in the History of the Industrial Enterprise* (MIT Press). Since then, at least a dozen major trends and ideas have appeared under the rubric of business strategy, often in great conflict with one another, often drawing companies in very different directions. Despite their differences, all four schools of strategy represent attempts to resolve the same basic underlying problem: the tension between two conflicting business realities.

The first reality is that advantage is transient. Even the most formidable market position can be vulnerable to technological disruptions, upstart competition, shifting capital flows, new regulatory regimes, political changes, and other facets of

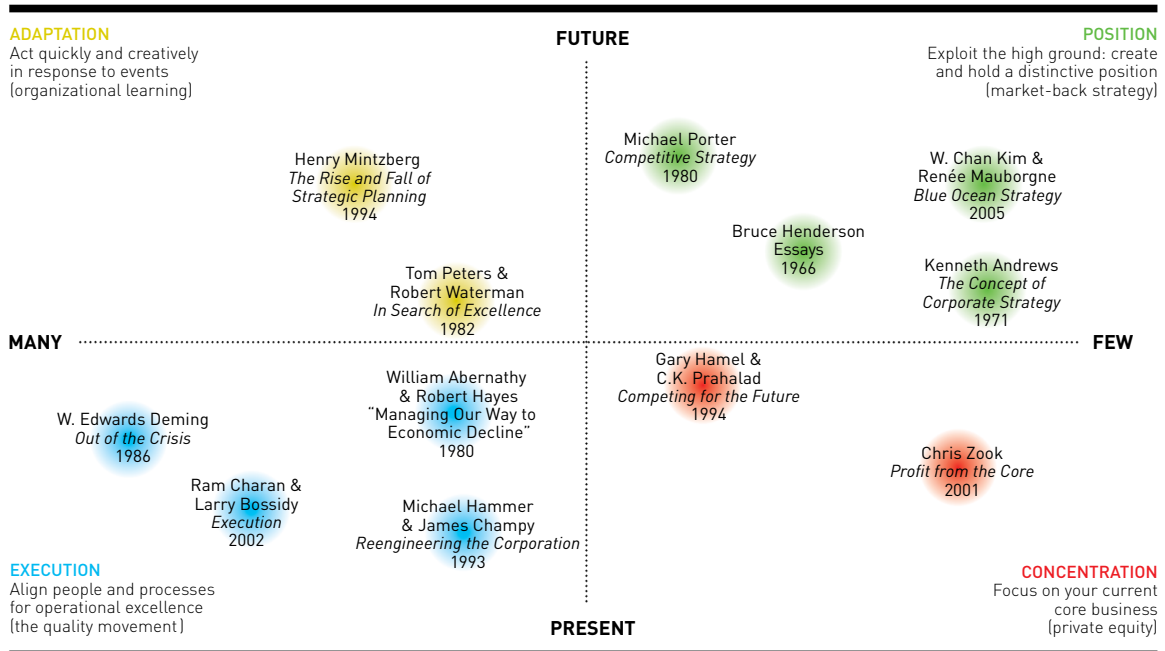
Exhibit 1: A Landscape of Strategy Concepts

Each of these four quadrants represents a basic school of thought in business strategy about the nature of the right to win. Starting at the upper right, the schools are Position (winners select favorable markets as defined by external forces); Concentration (winners make the most of current core strengths and businesses); Execution (winners gain advantage through operational excellence); and Adaptation (winners develop an overall direction through experimentation and rapid change). From the 1960s to today, many companies have bounced from one quadrant to another.

The grid itself reflects views of the best approach for developing business strategy. The X-axis represents the point of view on

authorship: Who is responsible for major strategy decisions? At left are those who favor collective choice (strategic thinking is instilled among as many people throughout the company as possible). At right are those who favor top-down formulation (strategy is developed by the few, the designated expert planners and senior executives, while the rest of the enterprise is dedicated to execution).

The Y-axis depicts time orientation: the degree to which strategy is seen as present- or future-oriented. At the top are those who favor moving toward a long-term destination that may be different from the company's current position. At the bottom are those who favor letting the company's strategic direction emerge from its current state.



Source: Walter Kiechel, *The Lords of Strategy*; Art Kleiner, *The Age of Heretics*; Henry Mintzberg, Bruce Ahlstrand, and Joseph Lampel, *Strategy Safari*

a chaotic and unpredictable business environment. As William P. Barnett showed in *The Red Queen among Organizations: How Competitiveness Evolves* (Princeton University Press, 2008), this turbulence can never level off into stability; as companies copy and outdo one another's proficiencies, the game of business continually becomes more challenging. Rapid economic growth in emerging markets has made advantage even more transient, bringing billions of people into the global economy, along with hundreds of energetic new business competitors.

One might assume that the answer is to become completely resilient, morphing to match the changing demands of the market. But companies can't, because of the second reality: Corporate identity is slow to change. The innate qualities of an organization that distinguish it from all others—its operational processes, culture, relationships, and distinctive capabilities—are built up gradually, decision by decision, and continually reinforced through organizational practices and conversations. Very few companies have thoroughly reinvented themselves, and those that have managed it have typically had to force many people out, including top executives, and to replace them with new recruits chosen for a different set of attitudes and skills. Even when leaders recognize the need for change or know that the company's survival is at stake, this identity is difficult to shift; if no deliberate effort is made to refresh it, it can stagnate to the point where it erodes advantage from within. As writers such as Jim Collins, Clayton Christensen, and Donald Sull have noted, it's all too easy for established companies to fall prey to complacency and hubris (Collins), entrenched customer relationships and disruptive technologies (Christensen), or inertia (Sull).

Yet although the "stickiness" of a company's identity is typically regarded as a weakness, it's also a great source of strength. No company can survive long, let alone distinguish itself, without a rich body of capabilities and a resonant corporate culture. Indeed, the fundamental enabler of strategy—the source of competitive advantage—is a distinctive, coherent corporate identity. This is the quality that attracts customers, investors, employees, and suppliers. It is grounded in internal capabilities (that is, the things your company can do with distinction) and in market realities (that is, the games in which your company chooses to play).

The yin and yang of strategic fad and fashion—the movement of business leadership from one trend to another over the past 50 years—has often led companies to make incoherent and ineffective moves. The answer is not to keep adopt-

ing new theories in hopes of finding the right answer, but to develop your own capabilities-driven strategy: your own theory of coherence for your business. How do you capture value, now and in the future, for your chosen customers? What are your most important capabilities, and how do they fit together? How do you align them with your portfolio of products and services? The more clearly and strongly you make these choices, the better your chances of creating a corporate identity that gives you the right to win in the long run. Not surprisingly, each of the four basic schools of thought in Exhibit 1 (position, execution, adaptation, and concentration) has something significant to offer business strategists, so long as they are adopted in an appropriately balanced way.

The Value of Position

According to Walter Kiechel, strategy became relatively formal in the 1960s for two reasons. The first was an increasing amount of available data on business costs, prices, and operational performance. The second reason was uncertainty, and the anxiety that went with it. The economic stability of the early 1960s dissolved into the turbulence of the 1970s and '80s, striking different components of society with different degrees of prosperity and calamity. No company could ever be sure it would remain on top (even in established industries such as steel and automobiles), global economies were highly interconnected (although it wasn't always quite clear how they might interact), and corporate decision making was increasingly constrained by fiercer capital markets and upstart technologies.

When intuitively obvious decisions fail, people yearn for better guidance. Thus, starting in the mid-1960s, the idea of strategic planning, with echoes of Napoleon, Carl von Clausewitz, and Sun Tzu, evolved into an irresistible business management fashion. In its pure form—as delineated by Kenneth Andrews and Igor Ansoff, the premier authorities on business strategy at that time—a strategy was an overarching plan for growth, usually written up in a formal document and endorsed by the CEO, aimed at creating an unassailable position for the company in the marketplace.

These early efforts by the position (or positioning) school assumed that the right to win would be held by companies that comprehensively analyzed all critical factors: external markets, internal capabilities, and the needs of society. Although Andrews said the goal should be a simple “informing idea” about the direction of

the business, it inevitably became a complex checklist of strengths, weaknesses, opportunities, and threats (the origin of the SWOT analysis still prevalent today). This was long before the invention of the spreadsheet program, so big companies hired armies of planning staffers to compile all this data into elaborate documents, which were debated in annual strategy sessions that became exercises in bureaucratic complexity. Only gradually did it become clear that the plans did not correlate with real-world performance or issues.

A breakthrough in the position school occurred in 1966 when Bruce Henderson, founder of the Boston Consulting Group (BCG), began to market services based on what he called the “experience curve.” Analyzing cost and price data across companies and industries, Henderson showed that as experience with operations led to greater proficiency, the capacity to produce increased and costs dropped. The phenomenon was hardly noticeable month by month, but every few years, capacity doubled and costs dropped 10 to 30 percent, so reliably that many companies could plan their investment cycles and competitive marketing accordingly. For example, Texas Instruments Inc. (TI) cut the prices of its semiconductor chips and electronic calculators every few months. Sales rose as customers switched to TI from competitors, and production costs then fell further, which allowed TI to drop prices even more. Even the billing procedures and advertising budgets became more efficient as those departments managed greater volumes.

To Henderson, the right to win went to companies that made the best use of the experience curve by holding the leading position in market share for their sectors. This meant emphasizing the value of some divisions over others, basing those judgments on the dynamics of each business’s customer base (Henderson was an early proponent of market segmentation) and on its competitive position. The famous growth-share matrix divided a company’s businesses into “stars” (high growth and market share), “dogs” (low growth and share), “question marks” (high growth, low share), and “cash cows” (low growth, high share), thus providing a clear rationale for reallocating investment. For instance, it was worth borrowing money to keep a star shining, because a star might end up dominating its market niche.

The experience curve and growth-share matrix rapidly became popular because they worked powerfully well—at first. But in practice, these tools had a serious flaw: As retroactive analyses of a company’s past success, they made it ir-

resistible to continue that same behavior into the future, even when circumstances changed (for example, when competitors began to apply the same approach). This led many companies into counterproductive strategies. Some, including Texas Instruments, got caught up in ruthless price wars that contributed to the commoditization of their own products.

More generally, many business leaders became disenchanted with the idea of formal strategic planning. It was expensive, and it didn't necessarily make companies profitable. For example, Ford and General Motors experienced losses of more than US\$500 million in 1979 and 1980—their first such losses in decades. In the aftermath of these and other sharp reversals, mainstream business leaders began to question the wisdom of the position school, and its claim on the right to win.

Execution Strikes Back

Those most annoyed by the position school tended to be in production and operations. No wonder, then, that the first great contrary reaction came from operations; specifically, from the Harvard Business School's (HBS) operations management department, which had been gradually losing status to finance. Two members of the faculty found themselves in Vevey, Switzerland, during the summer of 1979: William Abernathy, the HBS expert on auto manufacturing, and Robert Hayes, known for his studies of assembly lines. Researching the differences between European and U.S. multinationals, Hayes visited a small machine tool manufacturer in southern Germany. Sophisticated Americans barely understood computer-aided manufacturing software, but this firm of 40 people was using it on a daily basis, and producing custom-made tools. Other plants in Germany, Switzerland, France, and even Eastern Europe were using machine tools in ways that the Americans couldn't match.

At a seminar that summer, a European businessman asked Hayes why American productivity had declined so much during the past 10 years. Hayes hauled out the standard answers: organized labor, government regulations, the oil crisis, and the attitudes of the younger generation (which, at the time, meant the baby boomers). The attendees looked at him with polite amusement. "We have all those factors here," one said, "and our productivity is increasing."

Confused and shaken, Hayes began taking regular hikes and having long conversations with Abernathy, who had just arrived in Vevey and saw similar stagna-

tion in the U.S. auto industry. Only one explanation made sense to them: The reliance on market share and financial growth as strategic objectives was crippling U.S. industry. For example, many companies had cut back any initiative that didn't seem to guarantee rapid returns, and the entire U.S. economy was suffering as a result.

Abernathy and Hayes wrote up this conclusion in an article for the *Harvard Business Review (HBR)* called “Managing Our Way to Economic Decline,” published in July/August 1980. It is still one of the magazine's most requested reprints, and one of the most controversial articles in its history. They had introduced another school of strategic thought, based on the idea that the right to win came from execution and operational excellence: the development and deployment of better practices, processes, technologies, and products.

The execution message was bolstered by companies such as General Electric and Motorola, which provided influential examples of operations-oriented strategies with their reliance on executive training and such practices as Six Sigma.

Operational excellence was also a basic tenet of the quality movement—the continuous improvement practices that were developed at the Toyota Motor Corporation and a few other Japanese companies in the 1950s and '60s and are now generally known as lean management. Of the many people associated with the quality movement, including Toyota's influential chief scientist Taiichi Ohno, the most significant for corporate strategy was W. Edwards Deming. Deming was an American statistician born in 1900. He began consulting regularly in Japan just after World War II, helping Japanese companies develop their production systems. Ignored in the West at first, he became prominent in the United States after 1980, and actively taught and consulted with many of the world's leading companies until his death in 1993. Deming saw his methods as critical for escaping economic malaise (his most prominent book was titled *Out of the Crisis* [MIT Press, 1986]). In his view, the right to win was held by companies that honed and refined their day-to-day processes and practices, eliminating waste, training people throughout the company to use statistical methods, and cultivating the intrinsic “joy in work” that people feel when they are truly engaged in their jobs.

Although the execution school would be frequently challenged, it continued to gain influence through the early 1990s—especially after it was adapted by Michael Hammer, an MIT computer science professor, into an approach called “re-

engineering.” According to Hammer, the right to win went to companies that looked freshly at all their processes, as if redesigning them from scratch. Unfortunately, many companies used reengineering as a launching pad for across-the-board layoffs that left them weaker, and operational excellence couldn’t compete with the exuberance of the high-tech bubble. By the end of the 1990s, execution-based strategy had been largely relegated to the production side of the business.

The idea of building value through managerial methods returned to strategic relevance after the dot-com bubble burst. Its return was symbolized by the business bestseller *Execution: The Discipline of Getting Things Done*, by strategy expert Ram Charan and then Honeywell CEO Larry Bossidy, a well-known GE alumnus (with Charles Burck; Crown Business, 2002). Many leaders now understood, through experience, both the value of improving execution and its challenges. It generally required major changes in managerial and employee behavior. As BCG strategist George Stalk complained to Walter Kiechel, “That was a lot more difficult than just ‘buying a concept off a shelf.’”

Michael Porter’s Advantage

The other major limit of the execution school was best articulated by HBS professor Michael Porter—probably the most influential thinker on corporate strategy in the institution’s history, and a source of new vitality for the position school. In his early publications, from the late 1970s to the early 1990s, Porter brought positioning to a level of unprecedented sophistication. He recast the turbulence of a company’s business environment into a “value chain” and “five forces” (competitors, customers, suppliers, aspiring entrants, and substitute offerings): two frameworks that could be used to analyze the value potential and competitive intensity of any business.

Then, in his flagship *HBR* article called “What Is Strategy?” (November/December 1996) Porter pointed out that operational excellence could guarantee competitive advantage for only a limited time. After that, it too would lead to diminishing returns as other companies caught up. (Indeed, most observers believe that Ford, GM, and other Western automobile manufacturers have done exactly that between 1980 and 2010; it may have taken them 30 years, but the quality and resale value of their motor vehicles is, as a whole, rising to meet that of Toyota and Honda.)

To Porter, execution-oriented ideas like reengineering, benchmarking, outsourcing, and change management all had the same strategic limit. They all led to better operations, but ignored the question of which businesses to operate in the first place. Porter argued for picking industries or markets where either overall conditions were favorable—where most companies were relatively weak, suppliers had relatively little clout, and aspiring entrants were few—or where a company could differentiate itself. In “What Is Strategy?” Porter used Southwest Airlines Company as an example of differentiation in a relatively unattractive industry. Southwest’s market power came from the choice not to follow the spoke-and-hub routing model of other airlines, but to offer “a unique and valuable strategic position”—flying only direct routes, with one type of aircraft, using automated ticketing and limited services (for example, no assigned seats). These and other strategic choices allowed the airline to operate a different type of flying business, one that could offer attractive prices and convenience even when compared with travel by bus, train, or car. Sure, operational excellence was involved: Southwest had perfected fast turnarounds and friendly customer service. But the core strategic decision was the pursuit of simplicity through a clear market strategy.

The position school became a major driver of the resurgence of corporate competitiveness in the West during the 1980s and ’90s. W. Chan Kim and Renée Mauborgne took the position argument to its extreme with *Blue Ocean Strategy: How to Create Uncontested Market Space and Make the Competition Irrelevant* (Harvard Business School Press, 2005). Big companies, they advised, should look for new upstart positions themselves, in places where there were no competitors already, breaking out of conventional ways of looking at their industry. The popularity of that approach demonstrated the pressure that business leaders felt to break free of established practices and find a niche that they could dominate with first-mover advantage.

The limits of the position school became evident in the 1990s and 2000s. Although Michael Porter took pains to explain that industry structures can change and can be shaped by the actions of leading companies, he was interpreted as saying that some industries are innately good and others are irredeemably bad. To many corporate leaders in tough businesses, or in highly regulated industries like electric power generation, there was no real advantage to developing distinctive capabilities or facility with execution. Some companies tried to escape by entering

new businesses where they had no distinctive capabilities, “blue oceans” where they didn’t know how to swim. These efforts generally failed. And as the 2000s unfolded, companies with enviable market positions, such as Microsoft, also saw their advantage fade when new competitors, such as Google, emerged. This didn’t disprove Porter’s hypothesis, but it gave others an opening to criticize his thinking.

Adaptation and Experimentation

Starting in the 1990s, another group of strategy thinkers provided an alternative to the position and execution schools. This was the idea of strategy as perpetual adaptation, best represented by Henry Mintzberg, professor of management studies at McGill University. In his history *The Rise and Fall of Strategic Planning: Reconceiving Roles for Planning, Plans, Planners* (Free Press, 1994), Mintzberg dismissed the position school (which he called the design school) as formulaic. He acknowledged that execution was important, and much of his work was dedicated to analyzing what managers did in practice, but, like Porter, he felt execution was insufficient for success. His strategic approach centered on finding a more creative, experimental approach to executive decision making.

Thus, instead of analysis and planning, executives in the adaptation school (or, as Mintzberg called it, the learning school) sought to gain the right to win by experimenting with new directions. In Mintzberg’s words, they “let a thousand strategic flowers bloom...[using] an insightful style, to detect the patterns of success in these gardens of strategic flowers, rather than a cerebral style that favors analytical techniques to develop strategies in a hothouse.”

Adaptation has helped many companies; it’s been the source, for example, of the vitality of the Chinese manufacturing industry. It’s also been the most central guiding theme of Tom Peters’s work. The companies applauded by Peters—starting with his seminal business bestseller, *In Search of Excellence: Lessons from America’s Best-Run Companies* (with Robert Waterman; Harper & Row, 1982)—have varied enormously in their industries, approaches, and philosophies, but they all share a willingness to experiment with new ideas and directions, discard those that won’t work, and adjust their efforts to meet new challenges.

But the adaptation school is also seriously limited, because its freewheeling nature tends to lead to incoherence. A multitude of products and services that all have different capability needs and different market positions cannot possibly be

brought into sync. The more diverse a company's efforts become, the more it costs to develop and apply the advantaged capabilities they need. Letting a thousand flowers bloom can lead to a field full of weeds—and to businesses that can't match the expertise and resources of more focused, coherent competitors.

Concentration at the Core

Hence the appeal of the fourth group of strategy thinkers—the concentration school. Its forerunners were Gary Hamel and C.K. Prahalad, authors of *Competing for the Future* (Harvard Business School Press, 1994), who argued that the most effective companies owed their success to a select set of “core competencies”: These were the bedrock skills and technological capabilities (such as new forms of hardware, software, systems, biotechnology, and financial engineering) that allowed companies to compete in distinctive ways. Companies that focused on these, and used them to develop a long-range “strategic intent,” would claim the right to win.

Chris Zook of Bain & Company, drawing on his firm's experience with private equity, has been the most prominent recent exponent of this school. In his book *Profit from the Core: A Return to Growth in Turbulent Times* (2001, with James Allen; Harvard Business Press, 2010), he argues that the right to win tends to accrue to companies that stick to their core businesses and find new ways to exploit them for growth and value. This means differentiating a company by starting with its central capabilities: Enterprise, Dollar/Thrifty, and Avis all prospered by focusing on, respectively, rentals for people with car repairs, vacationers, and business travelers.

However, in practice, the concentration strategy often becomes a way of holding on to old approaches, even when they become outdated. Many companies (and private equity firms) translate this strategy into slash-and-burn retrenchment. They cut costs and minimize investments in R&D and marketing to create a pared-down company that produces more profits at first, but that can't sustain the growth required for a healthy bottom line. When they seek to grow, it's through “adjacencies”: products or services that seem related to their existing core businesses. But many adjacencies are less profitable than they were expected to be, in part because they may require very different capabilities—and in part because the truly successful game-changing leaps, like Apple's into consumer media or

Tata's into the inexpensive Nano automobile, can't be managed from a concentration strategy alone.

Strategy as a Way of Life

It's important to note that most of the thinkers who introduced these strategies to business leaders saw the challenges and limits of their approaches, and even warned against misapplying them. But businesspeople misapplied them nonetheless. Each theory thus backfired, and created opportunities for the next.

How can your company gain the most from considering all these theories of the right to win? Only by stepping back, away from any particular answer, to look at your company's identity as a whole, encompassing the way you expect to compete, the capabilities with which you will compete, and the portfolio decisions that fit. In fact, that's exactly what happens with the packaged-foods company described at the beginning of this article.

The CEO's question about the right to win has sparked many levels of discussion. For several more days, spread over a few weeks, the executive team talks through its three proposed strategies in detail: the estimated market value of each, the risks involved, and the capabilities required. All three strategies have roughly the same potential for increasing enterprise value, but the differences among them become clear when the functional leaders speak.

For example, the head of operations explains that the three strategies would require completely different investments. Becoming an innovator would mean configuring a flexible value chain to launch new products rapidly and economically. The closer-to-customers option would mean selling more food at different temperatures: some frozen, some fresh. It would also mean building a more direct, collaborative relationship between operations and R&D. And the category transformation strategy would require new process technologies, economies of scale, and deftly managed acquisitions.

The head of marketing and sales has a similar presentation. As an innovator, the company would focus advertising and promotion on new products, while ensuring rapid, widespread retail distribution. Being a solutions provider would move the company directly into engagement with consumers, through websites, social media, and better in-store displays. As a category leader, the company would seek to own the grocery shelf through "sharp pencil" tactics (in other words, tac-

tics tailored to each brand and geographic region) for pricing, promotion, and merchandising.

The company executives ultimately settle on the category leader strategy. It fits best with the capabilities that they already have. Another company, even with the same market dynamics, might choose differently—appropriately so, because of very different capabilities and customs.

A capabilities-driven strategy process, like this one, takes into account “market back” aspirations (the position the leaders want to hold) and “capabilities forward” concerns (the company’s ability to deliver). In the course of discussion, ideas from all four schools of thought come forward: ideas about holding an unsailable position, executing with new capabilities, adapting rapidly to competitive pressures, and focusing on the core business as a platform for growth. It takes time to complete this process, and it is very difficult and stressful at times, but the company gains, in the end, from a far higher level of coherence.

It’s taken 50 years for the field of business strategy to reach the point at which many companies can conduct this kind of conversation effectively. Most companies have relied on business strategists for strategic answers. But now we see that we have to generate our own answers—our own theory of the right to win for each company, with its unique identity and circumstances—and that we have the tools to do so. Given the pressures that business continues to face, this leap in knowledge is coming just in time. +

Reprint No. 10407

The Sirens of CPG Strategy

by Steffen Lauster

Some strategic concepts, if they’re held as sacrosanct, can lead an entire industry in the wrong direction. Something of that sort has happened during the past two decades in the consumer packaged goods (CPG) industry. Two of the most influential strategy ideas are so widely held, so intuitively appealing, and so apparently true in practice that they are very hard to give up. Yet they can also be quite dangerous to follow.

The first of these misleading ideas is that “bigger is better.” Since the 1980s, CPG companies have tried hard to expand. The conventional wisdom said that the

best shareholder returns would accrue to companies with huge brands and the scale to compete in developing markets. The second idea is that “consolidation is inevitable.” For years, experts have predicted that most consumer packaged goods segments would end up like carbonated beverages, shaving products, and disposable diapers—dominated by just two or three big players that took advantage of their scale to acquire or crowd out rivals, while a handful of niche players battled over the scraps.

Recent studies conducted by Booz & Company of total shareholder return among CPG companies show that both of these ideas are, at best, incomplete. Companies that follow them end up sacrificing performance. To be sure, there are categories where scale matters, where one or two players dominate. But many food and consumer products sectors are fragmenting instead, with room for many profitable entrants. In coffee, ready-to-eat meals, shampoos, and pasta sauces, for example, there are more small companies than there used to be; mass and price don’t matter as much as perceived quality. In the New York area, jars of Rao’s Homemade marinara sauce (the same sauce served in the famous Rao’s restaurant of East Harlem) are flying off the shelves.

These days, the best-performing consumer products companies—whether large or small—are those with the greatest coherence. Their market strategy, capabilities system, and product lineup all fit together. They invest their capital and attention in just three to six differentiated capabilities, supporting all the products they offer. This gives them a level of efficiency and effectiveness that most of their competitors can’t match.

In the end, the problem with strategy concepts is not that they’re wrong; they are, in fact, often right. But they are not universal. Beware any strategic idea that most other companies find beguiling. The right strategic destination is different for every company, even in a mature industry like consumer packaged goods.

Resources

Walter Kiechel, “Seven Chapters of Strategic Wisdom,” *s+b*, Spring 2010: Distills business strategy down to seven critical book chapters, including four mentioned in this article (by Porter, Mintzberg, Chandler, and Peters).

Walter Kiechel, *The Lords of Strategy: The Secret Intellectual History of the New Corporate World* (Harvard Business Press, 2010): Engrossing narrative history of strategic thinkers, their concepts, and their influence.

Art Kleiner, *The Age of Heretics: A History of the Radical Thinkers Who Reinvented Corporate Management* (2nd ed., Jossey-Bass, 2008): How financial thinking shaped corporate power and the emergence of alternative views (including those of Abernathy, Hayes, and Peters).

Art Kleiner, “The Life’s Work of a Thought Leader,” *s+b* [online only], Aug. 9, 2010: In an interview conducted shortly before his untimely death, C.K. Prahalad looked back on core competencies and how ideas evolve.

Paul Leinwand and Cesare Mainardi, “The Coherence Premium,” *Harvard Business Review*, June 2010: Why it is so rare for a company to align its differentiating capabilities with the right external market position.

Paul Leinwand and Cesare Mainardi, *The Essential Advantage: How to Win with a Capabilities-Driven Strategy* (Harvard Business Review Press, 2011): Overview of the path to coherence, the value it creates for your company, and the nature of your right to win.

Henry Mintzberg, Bruce Ahlstrand, and Joseph Lampel, *Strategy Safari: The Complete Guide through the Wilds of Strategic Management* (2nd ed., FT Prentice Hall, 2009): Detailed, academically comprehensive, and barbed view of strategic thinking (divided into 10 schools of thought).

The Essential Advantage website: Source for further ideas and online tools related to capabilities-driven strategy.

For more thought leadership on this topic, see the *s+b* website’s Strategy & Leadership page.

Throughout the Great Recession, many companies endured lengthy periods of cost containment: trimming budgets, reducing headcount, and eschewing large-scale initiatives. But as the economy bounces back, many firms may suddenly find themselves strategically and financially “out of shape.” Having concentrated for so long on survival, some companies have lost their ability to seize opportunities and expand. To get back in the game, firms need to enter new markets, innovate, and attract a fresh crop of customers. Having a forward-thinking mind-set is not enough. Based on the Booz & Company *Fit for Growth** framework, this article recommends a corporate fitness regimen designed to help companies set clear strategic aims, invest in the right infrastructure, optimize costs, and reorganize for growth.

A more strategic approach to costs can help you prepare for the next round of expansion.

IS YOUR COMPANY Fit for Growth?

by Deniz Caglar, Jaya Pandrangi, and John Plansky



Illustration by Paul Wearing

This article is based on a body of work on cost fitness and organizational change developed at Booz & Company. For more information, see booz.com/fitforgrowth. Also contributing were Booz & Company senior partners Vinay Couto, Mike Connolly, and Barry Jaruzelski; partners Scott Corwin, Ashok Divakaran, Marco Kesteloo, and Martha Turner; and principals Bas Kemme and Tara A. Owen.

Originally published by *s+b* on May 29, 2012 (Summer 2012)

Is your company fit for growth? Many companies today are not. The way they manage costs and deploy their most strategic resources is preventing the expansion they need. But they don't realize it—at least not yet.

To be sure, many of those companies are in better financial shape today than they've been in for a long time. Having implemented cost-cutting and austerity programs during the recession, they have relatively healthy balance sheets and sizable reserves of working capital. They have strengthened their ability to weather downturns and improved their productivity in ways that could potentially last for years. All these restructuring actions were required for survival between 2008 and 2011.

But as they shift their focus from the cost side of the ledger to the revenue side, searching for ways to move beyond cost cutting—entering new markets, commercializing innovative products and services, offering more compelling customer value propositions—these companies are strategically and financially out of shape. They have not made the hard choices involved in channeling investments to the capabilities that are needed most, and deemphasizing or eliminating their other expenses.

How can you tell if your company is fit for growth? Here is a simple, three-question diagnostic:

- Do you have clear priorities, focused on strategic growth, that drive your investments?
- Do your costs line up with those priorities? In other words, do you deploy your resources toward them efficiently and effectively?
- Is your organization set up to enable you to achieve those priorities?

The easiest way to answer these questions is to imagine the opposite.

If you do not have clear growth priorities, there are several warning signs. You have so many initiatives that you can't remember them all. Your executives go to multiple meetings on unrelated topics every day. Asked to name the most important capabilities your company has (the things it does well) or how they relate to your strategic objectives, different leaders give different answers. Your best people are working on so many programs and projects, they are burning out. Meanwhile, you are underinvesting in some areas—which might include parts of R&D, market development, and customer experience—where you could potentially build a distinctive edge against your competitors.

If your costs are not deployed appropriately, that's also painfully apparent—especially in the amount you spend on nonessentials. Staffing levels in different parts of the organization are out of sync; for instance, you might have twice as many finance people counting the money as salespeople bringing it in. Your highest-priority initiatives falter because their investments do not get sufficient attention, while legacy programs with very little impact continue to be funded. Every function pursues an agenda of professional excellence, striving to be “best in class,” no matter what the cost. Each department's annual budget is calculated as “last year's, plus 3 percent.” Every once in a while, in moments of high pressure, you institute across-the-board cost-cutting programs that force the businesses to temporarily reduce overhead, but everyone knows that it won't make any long-term difference.

If you don't have a well-designed organization, that is evident as well. You are not nimble enough to move quickly, or aligned enough to work in harmony. It takes a week to get a sales quote approved, while your competition wins the business. Information is not readily available to the people who need it. Managers oversee fewer than four employees, on average, and get far too involved in their subordinates' work. Incentives (such as bonuses and rankings) motivate people in ways that actually undermine the behaviors needed to achieve the company's stated growth priorities—for instance, people put internal reports ahead of customer responsiveness. You have “shadow” HR, finance, and IT staffs popping up in places outside your shared-services organization. Since most suggestions are rejected, people become afraid to take calculated risks—and that derails the most innovative growth- or savings-oriented ideas.

These are common symptoms, even among well-run and well-managed com-

panies. Unfortunately, company leaders cannot afford to be complacent about them right now—not if their goals involve expansion and profitable revenue growth. In just about every industry and region, companies are contending with a deflationary economic environment. It is relatively easy to find capital, but difficult to find attractive markets and opportunities that can offer promising returns. Emerging economies are still alluring but remain challenging, and achieving scale in them requires patience. Many companies have understandably implemented share buybacks to increase their stock price so as to offer a higher near-term return to shareholders, but that won't make them competitive. Nor can companies wait for expansionary economic conditions to return; the global economy will probably be facing macroeconomic headwinds for some time.

However, the fact that everyone is struggling also provides a great opportunity for companies that are willing to prepare for growth through a more deliberate, lean, fit-for-purpose operating model. Some companies are already doing this. They are streamlining their operations by making disciplined choices concerning their capabilities, and undertaking continuous improvement of their efficiency and effectiveness. This is the corporate equivalent of a fitness regimen that focuses, in effect, on building muscle—developing the capabilities that define a company's distinction—while cutting fat. By contrast, across-the-board cost reductions are the corporate equivalent of crash diets—they are ineffective because they do not last, and at worst they can cut into productive muscle. A successful program to become fit for growth contains three main elements:

- Set clear strategic priorities, and invest in the capabilities that allow you to deliver them.
- Optimize your costs, developing lean and deliberate practices that will deploy your resources more appropriately and efficiently.
- Reorganize for growth, establishing a nimble, well-aligned organization that can execute your new strategic priorities.

These elements reinforce one another; when launched together, they provide the wherewithal for growth, even for companies facing today's macroeconomic challenges.

Setting Clear Priorities

A growing body of research and experience has shown the importance that capabilities have in strategy. A capability, in this context, is the combination of processes, tools, knowledge, skills, and organization that allows your company to consistently produce results. Walmart's virtuosic supply chain management, Southwest Airlines' energetic customer service and asset utilization (of which its rapid turnaround time is an example), and Procter & Gamble's open architecture innovation model are all well-known examples of distinctive capabilities that few, if any, of those companies' competitors can match. These capabilities don't stand alone; in each case, they are part of a mutually reinforcing system that works to give the company its advantage. Walmart's supply chain management, for example, combines with the retail chain's signature approach to store design, its in-depth knowledge of its rural and suburban customers, and its renowned expertise in real estate and store location.

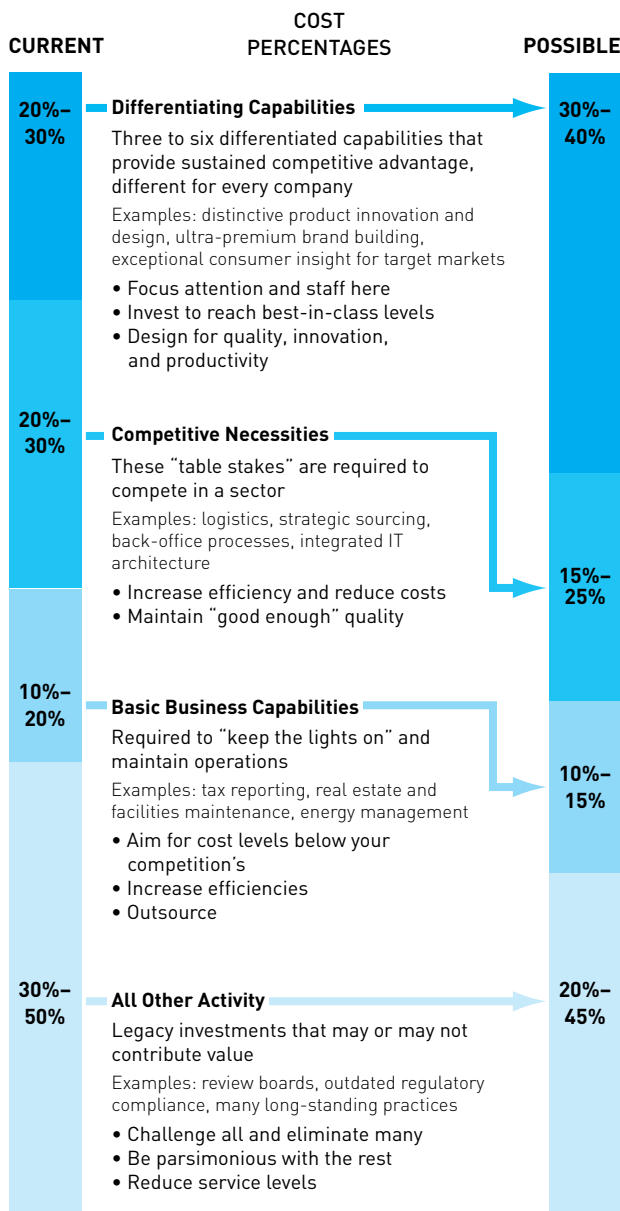
Because a company's most distinctive capabilities are cross-functional and are applied to most products and services, they require a great deal of attention and investment; even the largest companies have only three to six distinctive capabilities in their capabilities system. Hence the need to set clear priorities. Business leaders recognize that working capital is finite. They know they must marshal their resources according to strategic need, not to corporate politics or to legacy (*for more about capabilities and their strategic role, see Paul Leinwand and Cesare Mainardi, The Essential Advantage: How to Win with a Capabilities-Driven Strategy [Harvard Business Review Press, 2011]*).

When you focus on priorities, costs are not problems. They are choices. The priorities most worthy of high levels of investment are those that align with the growth priorities of your business, helping to build the capabilities that distinguish your company and contribute substantially to its success. These capabilities are steadily funded—their investment levels may even increase—while other categories of expense are seen as necessary but not special. The other expenses receive just enough cash to be on par with competitors' spending or to simply "keep the lights on" in the company's operations (*see Exhibit 1, page 49*). They are subject to strict scrutiny, constant pruning, and a continuous search for leaner efficiency.

In setting clear spending priorities, your first step is to identify which capabilities are worthy of greater investment. The precise mix is unique for each com-

Exhibit 1: Becoming Fit for Growth

A cost-fitness effort must address four types of investment priorities, each changing to meet its own level of strategic relevance. This chart shows how a hypothetical company might evaluate its expenses.



Note: Cost percentages are illustrative, based on hypothetical examples.

Source: Paul Leinwand and Cesare Mainardi, *The Essential Advantage: How to Win with a Capabilities-Driven Strategy* (Harvard Business Review Press, 2011), Booz & Company

pany; articulating the priorities requires strategic clarity on the part of your management team. We have found that management teams at most companies generally agree about which capabilities matter most. After their first exercise in distinguishing strategic costs, they often become devoted to the practice, and thereafter they continuously review resource deployment to fund capabilities for growth while keeping other expenses relatively low.

Ikea, the Swedish manufacturer and retailer of affordable customer-assembled furniture, went through this kind of exercise in the late 2000s, when it reworked its priorities. It was already a frugal organization; from its founding in 1943, the drive to reduce costs has been integral to Ikea’s culture. As company founder Ingvar Kamprad once wrote, “Wasting resources is a mortal sin at Ikea.... Expensive solutions to any kind of problem are usually the work of mediocrity.”

But this new fit-for-growth initiative was defined as far more than a cost-cutting effort. Ian Worling, Ikea’s director of business navigation, introduces the strategy by quoting Kamprad’s original statement of the company’s ambition: “to create a better everyday life for the many people.” As Worling explains, “That

means we offer home furnishings at such low prices that as many people as possible can afford to buy them. That colors everything we do.” Thus, for example, Ikea’s executives travel economy class and stay in moderately priced hotels, and the company maintains relatively inexpensive office space.

Like many other housing- and consumer-related businesses, Ikea was hit hard in the global recession, while the price of many of its materials went up. “We asked ourselves what we could do during this period to lower our costs and, instead of increasing the bottom line, turn every euro back to lower prices for our customers,” recalls Worling.

The chain’s leaders chose to continue investing in the capabilities that differentiated Ikea—for example, its custom-designed stores, which included distinctive Swedish restaurants and child-care facilities, needed to be places where customers felt at home. “To make up the difference,” says Worling, “we had to become very good at lowering operational costs.” With that goal in mind, Ikea sought additional efficiencies in its supply chain, collaborating with suppliers where possible. Industrial designers worked diligently on reducing packaging: “Even a few millimeters can make a big difference in fitting more pieces into a container. We hate transporting air,” says Worling. Nonessential costs were pared as much as possible. Before authorizing an expense, says Worling, “we always ask ourselves, ‘Would our customers want to pay for that particular item themselves?’ If the answer is no, then we try to find a way to do without it or to do it in a cheaper way.”

Optimizing Your Costs

Fit-for-growth companies are lean and deliberate in spending money. They manage their costs for both efficiency and effectiveness. In all their investments, they seek long-term value. This means continually pursuing the lowest-cost way to run their operations and organization, taking full advantage of economies of scale and scope. In our experience, companies that become fit for growth do not see cost optimization as a single, “big bang”-style event. Instead, they make it a continuous process, embedded in the daily fabric of business.

This type of ongoing discipline represents a natural outgrowth of your work on setting priorities. Indeed, by choosing to cut costs proactively, you can operate from a position of strength. Without the panic and aggression displayed by business leaders who feel pressure from outside, you can allocate your cuts more

rationally—and be far more effective in reinvesting your savings. (To be sure, sometimes a more dramatic shift in your cost structure is called for; see “When a Step Change Is Needed,” page 56.)

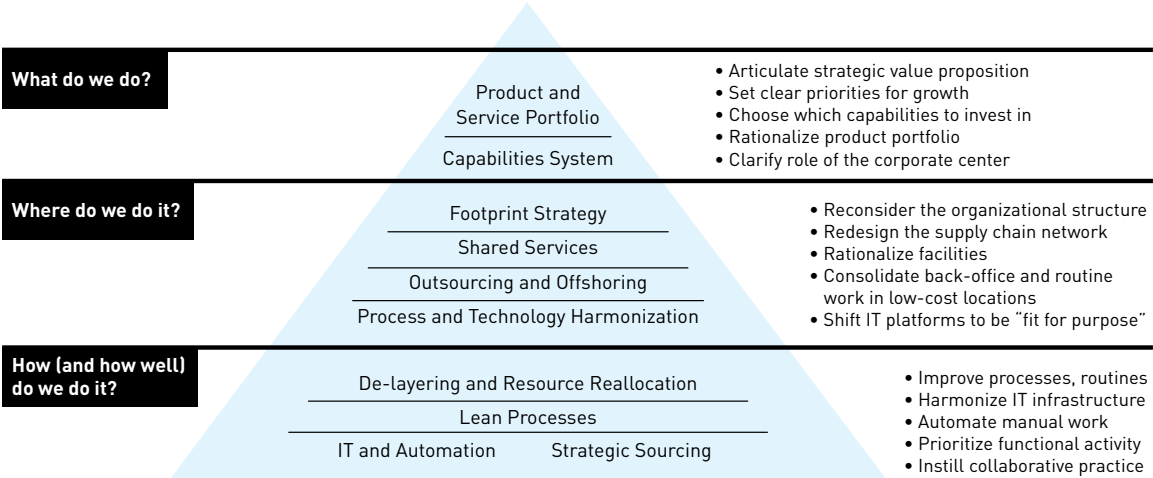
When you are ready to rethink and streamline your operations, organization, and management practices in this way, you have a large menu of techniques, practices, and analyses to choose from (*see Exhibit 2*). They can be implemented at many levels of the organization, by many different teams that, ideally, learn from one another as they work. These methods include the kinds of continuous improvement associated with lean management, the efficiencies of scale that come from consolidating separate activities, the savings that emerge from relocating nondistinctive work to lower-cost sources, and the value derived from strategic sourcing that reduces the expenses of materials and components. Whichever techniques you choose, depending on your circumstances and needs, the object is the same: to be deliberate in taking out costs, making sure you don’t cut into productive muscle.

Some of these methods may seem familiar to you, but they take on new meaning in the context of a capabilities-driven growth initiative. By reducing expenses in this way, you release cash for potential investment. This is generally the most reliable way to fund the development of distinctive capabilities that are strategically important for growth (*see Exhibit 3, page 52*).

One company that has used cost optimization to fund its development of stra-

Exhibit 2: Leverage for Cost Management

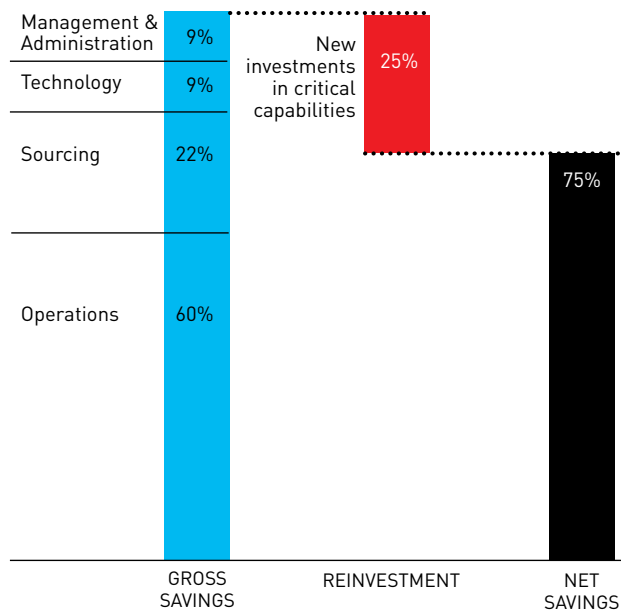
A multifaceted effort to become fit for growth can involve a large number of tools and practices, generally grouped into three categories: Focusing on distinctive capabilities (“What do we do?”), shifting the sources of activity (“Where do we do it?”), and streamlining your operations and organization (“How [and how well] do we do it?”). The width of the pyramid at each level illustrates the comparative number of people involved.



Source: Booz & Company

Exhibit 3: Cash Released by an Exemplary Cost Transformation Program

This initiative, conducted by a Fortune 500 company, released more than a billion dollars in gross savings. About one-fourth of that money—a remarkably large percentage, compared with most cost initiatives—was reinvested to bolster and expand the company’s distinctive capabilities.



Source: Booz & Company

tegic capabilities is Aetna Inc., a US\$34 billion diversified health-care-benefits company. “With the enactment of healthcare reform, 40 million Americans are theoretically going to be entering the market for health insurance,” says Meg McCarthy, executive vice president of innovation, technology, and service operations. “There will be significant growth in the cost-competitive individual business. Our aim is to be the global leader in empowering people to lead healthier lives. That’s our strategy.”

Developing the necessary consumer retail capabilities—

“the art and science of getting and keeping every single customer every single day,” as McCarthy puts it—requires significant new investment. As part of building and strengthening these capabilities, Aetna has prioritized investment in several areas, including information, health information exchange, and clinical decision support. Of course, in a market that is highly price-sensitive, such as small group and individual insurance, cost vigilance is a necessity. “Our infrastructure—both process and technology—needs to operate at the lowest possible unit cost,” says McCarthy, “so that we’re market-competitive and attractive to consumers. We still have further progress to make, but we’ve taken significant first steps to reduce the costs of complexity.” For example, Aetna is restructuring its back-office operations—including claims processing and customer service—to realize greater efficiencies.

“We used to take a step-change approach to cost management,” McCarthy adds. “Now we are adopting a continuous improvement methodology, in which we remove waste constantly. We’re searching for nickels and dimes and any way to reuse assets. It’s like a can of Legos—we need to put the pieces together in new and different ways to grow our business.”

Reorganizing for Growth

A well-designed organization model is critical to enabling growth in two important ways. First, it makes possible and sustains the cost reductions that are required to invest in differentiating capabilities. It does this by sharing resources across businesses and functions, and by trimming management overhead. In most large organizations, long-standing relationships have developed in an ad hoc fashion among the central core, the local business units, and the shared pools of resources that provide, for example, human resources and information technology services. Local leaders may have too much power over functional activities (thus duplicating one another's efforts and promoting inconsistencies), or the central hub may be too controlling (which generates unnecessary work).

The solution typically involves redesigning the company to create more appropriate structures and spans of control. This may mean having more people report to each manager and reducing the number of hierarchical layers. Pay scales may be rationalized so that compensation matches the complexity of the job performed, or the company may take more deliberate approaches to sharing resources and outsourcing less-critical functions. When these measures are consistent and broadly understood, they are typically supported by people throughout the company.

Second, a well-designed organization model can fuel dramatic growth by empowering managers to act like owners of the business. The managers of business units are given explicit financial and operational targets, along with clear decision rights that spell out what they can and cannot do by themselves to reach those targets. They are also given greater control over the resources assigned to them, and they can deploy these resources more flexibly. With incentives (such as bonuses and promotions) determined accordingly, business unit leaders become accountable for results, which are aligned with the company's broader objectives in both the long term and the short term.

This tightly linked chain of empowerment, accountability, decision rights, and incentives allows the company to make decisions as close to the front lines as possible. Managers can capture opportunities in the market, while the corporate core focuses on building and maintaining the capabilities that all the business units share and on driving the company's overall strategy and performance. People respond quickly to opportunities, collaborate across organizational boundaries well, make decisions resolutely, and execute effectively. Executives spend less time

fighting political turf wars and more time thinking about their customers and competitors. Finally, costs naturally come down, and the potential for growth improves, because the organizational structure reinforces the practices developed through cost optimization.

A number of large companies have used organizational design to become fit for growth, without publicly explaining their internal changes. One example is a global energy company, which adopted a new cost-restructuring initiative in the early 2010s. During the previous decade, the company had grown rapidly through acquisition, buying a number of companies and developing an overly complex structure along the way. As one executive leader later noted, the company had gradually become “a bit of a patchwork.” Some of the business units were centered on countries or regions, whereas others were built around product lines. There were also functional groups—charged, for example, with marketing and sales or with manufacturing—that operated either globally or within regions, sometimes duplicating others’ efforts.

The cost-restructuring initiative was conceived as a multiple-year project, affecting the company’s processes, systems, people, and way of doing business. It reorganized the hierarchy into several global strategic business units, a tightly knit collection of corporate functions such as HR and finance, and a group of shared services to provide support. Although the concept of regions was preserved, P&L accountability shifted entirely to the strategic business units. To manage this new streamlined structure, the company created a single global framework for decision rights: It determined at a central level who would make critical company-wide decisions involving finance, planning, legal liability, procurement, the supply chain, sales credit risk, human resources, manufacturing, and technology. This new structure allowed the company to realize massive savings through scale and by eliminating redundancies. At the same time, the organizational units—strategic business units, shared services, and corporate functional groups—all had their own explicit decision rights. In short, the company created a new common global framework for its organization, while providing the business units and functions with sufficient latitude to run their operations nimbly.

Some companies use cost-restructuring efforts to dig deep into business units, reorganizing every process. This effort did not micromanage in that way; separate operational change initiatives were embedded in the new business units and cor-

porate functions. But this program aligned the organization for growth, enabling it to be, as one observer put it, “a truly global company.”

Sustaining the Gains

When a large company pursues cost management and growth simultaneously, it must act as one unified entity. Avoiding disconnects and misalignments requires effective governance and business management practices. Financial, strategic, and operational planning processes should be treated as leading activities: They should set clear priorities and plans that involve all parts of the organization in the company’s “way to play” and central capabilities system. A business unit or function that does not fit with the common strategy is probably too expensive to keep in its current form. Corporate, business unit, and shared-services leaders should also collaborate informally to exchange knowledge and make sure that business units receive the support they need, consistent with their local conditions and the company’s overall way of creating value.

As anyone who has lost weight and kept it off can tell you, the secret to fitness is to never return to old habits and to instead follow an ethic of continuous improvement. Fit-for-growth companies commit to a lean mind-set and are always honing their capabilities and cost structure, so they don’t have to undertake large programs every several years. They reorient themselves for growth as well, adjusting their resource deployment year after year. Most importantly, they do all this with a watchful eye on their unique value proposition and the distinctive capabilities that will allow them to grow.

Becoming fit for growth may seem like an onerous task. But as suggested by the examples of Ikea, Aetna, and Pitney Bowes (*see page 57*), it can also be the beginning of a new virtuous cycle. As resources move from nonessential to critical capabilities, your company can put more capital into growth strategies. The cost side of your ledger will read less like a list of burdens and more like a register of enabling choices, with a direct link between the money you spend and your prowess in the marketplace. +

Reprint No. 12205

When a Step Change Is Needed

by Deniz Caglar, Jaya Pandrangi, and Ashok Divakaran

Companies may need to address their cost structure suddenly for one of many reasons, such as reacting to dramatic changes in the marketplace, correcting a large drop in profitability, or enabling a new strategy. Companies in such straits can still operate from a position of strength, by following these principles in a cost-transformation program:

- **Look for early quick wins.** Rapid cuts in nonessential costs help motivate people and provide cash to fund the initiative. If you reinvest those funds in more productive directions, these early wins also demonstrate that you are serious.
- **Start with the end in mind.** You are cutting costs not just to survive, but to focus your future efforts. Start by determining your value proposition and the capabilities you need.
- **Tackle the root causes of high costs.** Think freshly about the business; look for dramatic step-change shifts that can free up capital.
- **Establish stretch targets.** Target an aggressive but credible figure, representing enough funds to reinvest in growth and build a cushion for savings erosion. Such stretch targets stimulate new ideas and help high-potential managers reach beyond comfortable limits.
- **Hold managers accountable for specific targets.** Otherwise, savings tend to evaporate.
- **Make a public commitment to the program and explain the “fit for growth” philosophy to your shareholders.** Commitment reinforces the strategic importance of the program and protects your ability to reinvest some of the savings in your most important capabilities.
- **Explicitly describe how you expect to identify and implement cost savings.** The top team should deliver this message, convey a sense of urgency, and set an example by cutting back costs associated with their own day-to-day practices.
- **Design a single cohesive process, not a collection of separate expense-reduction projects.** Put a single steering committee in charge, overseeing cross-functional teams that suggest specific measures. Schedule frequent reviews to assess progress and make decisions.
- **Assign good people to carry it out.** Staff the cross-functional teams with up-and-comers; give them the information and authority they need.

- **Take on sacred cows.** Some nonstrategic capabilities have entrenched supporters. Encourage people to bring these controversial opportunities and thorny issues to light, and give them ways to do so without becoming vulnerable.

- **Track progress in a standardized way, tied to the bottom line.** Report results on an ongoing basis.

- **Stick to your purpose.** Some managers will say, “Give me my cost reduction number, and let me take care of it.” This is not that kind of effort. Its purpose is to redefine the work and to position the company for enhanced growth, using a shared understanding of the value and differentiation provided by each activity and capability. If you keep your eye on that goal, others will follow.

Becoming Fit for Growth at Pitney Bowes

by Michael Monahan

Before the global recession hit in 2008, my company, Pitney Bowes Inc., had already embarked on a concerted effort to evolve the business and rebalance revenues toward growth areas. Nearly a century old, with 33,000 employees and US\$5.6 billion in revenues, Pitney Bowes had two different businesses. Our traditional business, serving small and medium-sized customers, was very focused on hardware—the sale, servicing, and financing of postage meters and other mail and workflow equipment. Our enterprise segment, on the other hand, was much more of a services- and software-based business model, selling to large, multinational companies. Those revenues had grown considerably over the last decade, in part through acquisition.

In May 2009, we decided to launch a thoughtful and comprehensive review of our progress. Everything was on the table: sales, general, and administrative expenses (SG&A); engineering and manufacturing; indirect and direct procurement; the size and skills of our workforce; IT, HR, and finance; and, most importantly, the overall structure of the company. We had grown up as a set of vertically integrated individual businesses managed as a loose portfolio. We needed to become a much more integrated company with an infrastructure and business model that served the distinct needs and growth potential of our two very different customer segments.

In addition, one of my personal key goals was to create a lot more variability in our cost structure, so we could migrate resources across businesses as we saw opportunities arise. Naturally, at the height of the recession, we looked for cost-saving measures that we could implement quickly and temporarily, like deferred wage increases and temporary changes to employee benefit programs. But more importantly, we also explicitly looked for the type of cost savings that were sustainable over time.

We created nearly a dozen cross-functional teams to examine every company resource and process, and a project management office to coordinate these teams. They were responsible for developing and defending the business case for their proposed actions and investments. These were then brought to senior management for review. The senior management team dedicated a half day every month to considering these action items and investments. I was part of a smaller subset of that team, called the Transformation Steering Committee, which was focused on formally approving, monitoring, and implementing the resulting projects.

To create room for the new priorities, we looked at our historical investments and either limited or eliminated many old systems and processes. We redirected that investment into the new platforms and new capabilities that we needed.

Our senior management team identified three key areas for investment. The first and most basic was infrastructure. We replaced our old Web infrastructure with a much more contemporary and flexible platform that consolidated the websites from all of our various acquisitions and enabled direct interaction with our customers. Behind the scenes, we consolidated 85 disparate data centers into six regional centers.

We called the second capability “the agile workforce”: communication tools to provide employees with the flexibility to work anywhere rather than being bound to a particular facility or office. For example, we began using voice over IP and aggressively reduced our real estate footprint.

Third, we gave more employees the ability to interact with our customers on a more holistic basis and cross-sell to them. We built an enterprise selling organization, unifying around common processes and technologies (such as using Salesforce.com as a sales automation tool).

In addition to these priorities, we launched a number of new digital products (some internally developed, others created through partnership) to drive revenue

growth per customer as well as our overall customer base.

As a result of this initiative, we've gone to a much higher degree of global shared services. The finance and marketing groups, for example, have moved from regional to global models, leaving decision support to the individual businesses. We have a global learning and development organization focused not only on product training, but also on education about our company's core mission—customer communications management.

Pitney Bowes has also expanded its use of outsourcing and offshoring. First, we aggregated and standardized certain high-cost and transactional work internally. Then we outsourced much of it; nearly half of our finance transactions, for example, are conducted by suppliers.

We continue to look for ways to move from fixed to variable costs on a day-to-day basis, so we won't have to undertake another restructuring.

Our hard goal when we started this process was \$150 million to \$200 million in annual cost savings, net of reinvestment back in the business. We announced in our 2011 fourth quarter that we had exceeded our revised target of \$300 million, one year ahead of schedule. Almost 45 percent of the savings came from non-personnel-related actions, such as better procurement, smaller facility requirements, systems automation, and similar efforts. Out of the total savings, we reinvested about \$200 million back into the business.

We had plenty of challenges along the way. We had the typical organizational boundary issues that you encounter when solutions cut across traditional lines of demarcation. Often, we worked through these issues by using cross-functional teams. We are still working on the concept of continuous improvement, incorporating into our culture the requirement that everyone look at efficiency and productivity as the funding source for future investment in the business, and driving home the concept of competition for finite resources.

At the end of the day, the best parts of the Pitney Bowes culture prevailed. We have an organization of people who are very committed to the company. Once everyone accepted that we were serious about this transformation, they got on board and drove its incredible success.

Resources

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For more thought leadership on this topic, see *s+b*'s Organizations & People page.

When reflecting on your strategic aims, which are the right questions to ask? Ken Favaro writes that most executives fall back on the *corporate* line of introspection—focusing on broad issues such as purpose and plans. But as IBM’s turnaround in the 1990s illustrates, solving the five essential *strategic* problems—which address the nuts and bolts of how a company should best apply its resources and engage with customers—provides a better way forward.

**When leaders substitute visions,
missions, purposes, plans, or goals
for the real work of strategy,
they set their firms adrift.**

How Leaders Mistake Execution for Strategy (and Why That Damages Both)

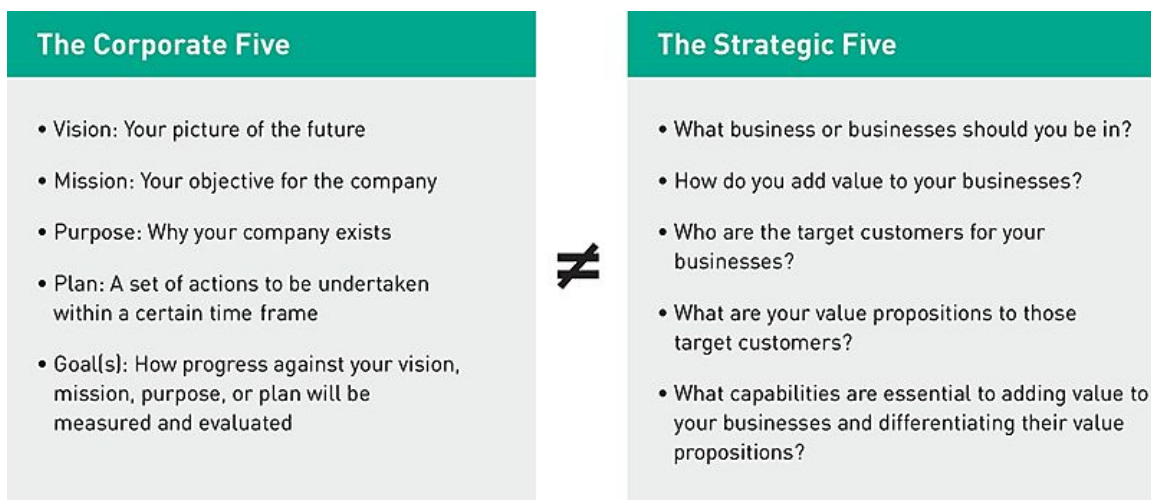
by Ken Favaro

When discussing strategy, executives often invoke some version of a vision, a mission, a purpose, a plan, or a set of goals. I call these “the corporate five” (*see exhibit*). Each is important in driving execution, no doubt, but none should be mistaken for a strategy. The corporate five may help bring your strategy to life, but they do not give you a strategy to begin with.

Nevertheless, they are often mistaken for strategy—and when that happens, real damage can ensue. If the corporate five are the cart and strategy is the horse, leaders who put the cart first often end up with no horse at all.

Before they get to the corporate five, companies need to address five much more fundamental, and difficult, questions. Let’s call them the “the strategic five”:

- What business or businesses should you be in?
- How do you add value to your businesses?
- Who are the target customers for your businesses?



- What are your value propositions to those target customers?
- What capabilities are essential to adding value to your businesses and differentiating their value propositions?

Although most companies can articulate a vision (for instance, “to be the leading biotech company”), a mission (“to find and commercialize innovative drug therapies”), a purpose (“to improve patients’ lives”), a plan (“to develop molecule X, enter market Y, and partner with company Z”), or a goal (“to bring three innovative molecules to market by 2025”), few convincingly answer all five strategic questions, especially with one voice across their top teams and down their organizations.

They can’t answer those questions because often they haven’t asked them in a very long time, if at all. Instead, the corporate five have become a mask for strategy. When that happens, the real substance of strategy—making deliberate and decisive choices about where to play and the way to play—is lost. There is no foundation for decision making and resource allocation. Everything becomes important. Indiscriminate cost-cutting and growth become the order of the day and, sooner or later, with no strategy as a guide, a business drifts. Consider Procter & Gamble. It has a mission (“to touch and improve the lives of more consumers, in more parts of the world, more completely”) and a CEO who says he is “totally focused on the plan.” Yet the company is struggling to regain its footing and direction because the strategic five has been lost while the vast, complex enterprise strives to operate in a more volatile economic environment.

IBM, on the other hand, is an example of getting it right. When Lou Gerstner took over the reins of the troubled company in 1993, he famously declared, “The last thing IBM needs right now is a vision.” This was widely interpreted as a statement that execution would be the priority and strategy would take a backseat, at least while Gerstner was busy turning around the company. But he proceeded to redefine IBM’s business boundaries (from computer hardware to hardware, software, and services), value proposition (from best products to corporate solutions), and essential capabilities (for example, from selling to the IT department to selling to the C-suite). In other words, he focused on the strategic five—not the corporate five—to make his elephant dance. Gerstner was as strategic a CEO as they come. James E. Burke, former CEO of Johnson & Johnson and former IBM board director, said of him, “He thinks strategically about everything. I once

asked him if he thought strategically about his dog.” Gerstner knew that IBM was suffering from a lack of clear and coherent strategic choices and that fixing this was far more important to the company’s immediate needs than was envisioning the company’s longer-term future. Without the former, there would be no need for the latter.

All this is not to denigrate the role and power of having visions, missions, purposes, plans, and goals. Strategy is the primary tool a leader uses to guide decision making and resource allocation for a business and its people, but the corporate five give the leader a means to excite, focus, inspire, mobilize, and challenge. A vision paints a picture of the future around which your company can rally; a mission articulates an objective that defines what the company is seeking to achieve; a purpose describes why your company exists and gives meaning to what it does and the people who do its work; a plan lays out a set of actions to be undertaken within a certain time frame; and goals define how your success and progress will be measured and evaluated. None of these gives you a strategy, but they do play an important role: They motivate an organization to perform at its very best in the context of that strategy. That is what execution is all about.

Gerstner knew this too. After stabilizing the company and establishing IBM’s strategic five, he did, in fact, create a vision: “To lead big companies into the brave new networked world, IBM will devise their technology strategies, build and run their systems, and ultimately become the architect and repository for corporate computing, tying together not just companies but entire industries.” But, even then, he recognized the need to connect that vision to the strategy (and execution). “Vision is easy. It’s just so easy to point to the bleachers and say ‘I’m going to hit one over there,’” Gerstner told a CNN interviewer in 2004. “What’s hard is saying, ‘OK, but how do I do that? What are the specific programs, what are the commitments, what are the resources, what are the processes in play that we need to go implement the vision, to turn it into a working model that people follow every day in the enterprise?’ That’s hard work.”

If you want to have a bit of fun sometime, just ask your head of strategy or general manager how the corporate five differ from strategy. A typical response will be, “Who cares? Aren’t they all about giving direction to a business? Does it matter what you call ‘direction,’ as long as you have it?” Now, you have an answer. Without addressing the strategic five, your company will lack the foundation and

the context for making the choices and allocating the resources that are critical to superior execution. Without the corporate five, your organization will lack the perspective, commitment, and alignment required to perform at its very best. +

Don't confuse *corporate strategy*, which represents the big-picture outlook of the organization, with *business strategy*: the tactical decisions made by sub-units of the company. Corporate strategy must be coherent, enabling different businesses to operate under the same umbrella (or in some cases articulating why they might be better off breaking away). This column outlines questions for executives at both strategic levels that will ensure the two levels are in sync.

Business strategy is best distinguished from corporate strategy by the different perspectives that business leaders and strategic planners must bring to bear.

The Two Levels of Strategy

by Ken Favaro

The word *strategy* has many modifiers in the business world: *portfolio, diversification, differentiation, growth, market share, shareholder value, customer, brand, product, pricing, cost, manufacturing, supply chain, channel, distribution, sourcing, IT, digital, people, communications, investor relations, and M&A* among them. All of these forms of strategy are variations of the two most fundamental types: corporate and business. Typically, corporate strategy is seen as being relevant to a company as a whole, whereas business strategy is reserved for the individual businesses within a company.

But things get more complex when you consider the most fundamental questions that a strategy needs to answer:

1. Who is the target customer?
2. What is the value proposition for this target customer?
3. What are the essential capabilities required to deliver that value proposition?

In considering a company operating in multiple businesses (think Siemens, UBS, Unilever, Reliance, and Saudi Aramco), these questions are difficult to answer for the company as a whole—if not meaningless. They can only really be answered for each of the individual businesses within a company. Does this mean that a company's corporate strategy is just a rollup and integration of the strategies for its individual businesses? No, not at all. A corporate strategy adds two more critical questions to the list:

4. What businesses should the company be in?
5. How should the company add value to those businesses?

Adding value to the businesses means contributing to the ability of each business to outperform its peers. In other words, the individual businesses should be

able to draw on some distinctive capabilities that are available to all parts of the enterprise, and that give the businesses an edge in their own target markets. For PepsiCo, direct store delivery is one of these enterprise-wide capabilities; corporate sales and marketing is one for IBM; General Electric has a distinctive capability in developing general managers; and so on. Those enterprise-wide capabilities that are truly differentiating may reside in the corporate center or in particular businesses. Either way, to the degree that all the businesses are able to benefit from such capabilities, they create a “coherence premium”: the ability of a company to be worth more than its sum-of-parts valuation. Without a coherence premium, there is no economic rationale for the individual businesses to be under the same corporate roof and, thus, there is no *raison d’être* for the company itself.

A coherent corporate strategy results from an iterative approach to addressing questions 4 and 5. It must be iterative because the answers to these two questions depend a lot on each other. In other words, the businesses that should define a company’s shape depend in part on its capabilities and how they add value to the businesses’ performance. Likewise, how a company should add value to its businesses depends in part on which businesses make up—or could make up—its portfolio.

Unfortunately, most strategists hardly bother with how the company adds value to its businesses (question 5), much less give the question an honest answer. This is why the so-called conglomerate discount is so prevalent, even for companies operating in highly integrated businesses. It also explains why companies such as ConocoPhillips, Fortune Brands, Sara Lee, Kraft, McGraw-Hill, Tyco (again), and ITT (again) have begun to break up or divest businesses in recent years, with shareholders applauding.

Finally, an important nuance: For most large, complex companies, the questions of corporate strategy—questions 4 and 5—are relevant at multiple levels, not just for the company overall. For example, a division with multiple businesses (consider consumer banking at Citi or GE’s industrials group) represents more of a corporate portfolio than a single business unit. In fact, most divisions, segments, groups, and even business units can be thought of as having a portfolio of smaller businesses within them, thus making the questions of both corporate and business strategy relevant to their strategies.

Business leaders, strategic planners, and even strategy consultants often con-

fuse business and corporate strategy. You can keep them straight by being clear on the questions that are relevant at your level. +

Harvard Business School strategy professor Cynthia Montgomery argues that a strategic leader is more than what she calls a “caretaker,” designing and implementing a plan. Yes, strategists should seek to secure a competitive advantage, develop unique assets, and react prudently to unexpected events. But as Montgomery describes, they must also conduct ongoing conversations about the direction, function, and role of the company. The quality of this dialogue informs, to a huge extent, the fortunes of the firm. “A strategy shouldn’t be only a document or an occasional exercise,” Montgomery says. “It should be a way of looking at the world, interpreting experience, and thinking about what a company is and why it matters.” Montgomery’s perspective reflects her wide-ranging experience as both an executive educator and a board member of large corporations and nonprofits.

A Harvard Business School professor observes that leaders become better strategists by engaging in conversations about the purpose of a company.

The Thought Leader Interview: Cynthia Montgomery

by Ken Favaro and Art Kleiner



When you look at strategy as a frame of mind to be cultivated, rather than as a plan to be executed, you are far more likely to succeed over the long run. That is the core premise put forth by Cynthia Montgomery, the Timken Professor of Business Administration and former chair of the strategy unit at Harvard Business School, in her book *The Strategist: Be the Leader Your Business Needs* (HarperBusiness, 2012). The book is based in part on her work over the past five years teaching executive education programs at Harvard for leaders of owner-managed companies. It is also grounded in her work with large diversified companies. For example, she has served on the boards of Newell Rubbermaid, UnumProvident, and several mutual funds, as well as on the board of McLean Hospital, a not-for-profit organization based near Boston.

VIDEO FEATURE

Rebranding Strategy: Why Traditional Strategy Planning Needs a Makeover

Cynthia Montgomery speaks with Booz & Company partner Ken Favaro about why strategy needs to be reimaged, and how a leader can help define what a business is and why it matters.



Throughout her career, Montgomery, who has also taught business strategy at Northwestern University's Kellogg School and the University of Michigan, has found herself in the middle of a little-known but strongly felt debate that has gone on since the early 1980s in executive education and similar milieus. On one side is the "positioning school" of business strategy: Success depends on analyzing industry dynamics and competitive advantage, and staking out a position that is most resistant to competition on the basis of industry forces. Montgomery's credentials on this side include numerous articles in leading economics and management journals, and co-editorship with Michael Porter of the influential anthology *Strategy: Seeking and Securing Competitive Advantage* (Harvard Business School Press, 1991). On the other side is a perspective known in academia as the "resource-based view of the firm": Success depends on cultivating the capabilities and assets that no one else can match. One of the leading developers of this field is Montgomery's husband, MIT Sloan School professor Birger Wernerfelt. Montgomery and David Collis built on the resource school's insights in "Competing on Resources: Strategy in the 1990s" (*Harvard Business Review*, July/August 1995), one of the most reprinted articles in the history of *HBR*.

Montgomery's new book and her ongoing research into strategists' attitudes and actions represent an effort to move past the dichotomy, and to focus on what it means for a leader to be a strategist. To Montgomery, a business strategist is not primarily an analyst of position, or of resources; nor is the strategist purely adaptive, responding reactively to the vagaries of fate. He or she is someone who engages in a conversation about the purpose of a company. The company rises or falls on the quality of that conversation and the way it is used to make decisions about the ongoing work of the enterprise.

To get a clearer view of that approach, and what it might mean for senior executives, we sat down with Cynthia Montgomery in her office at Harvard Business School in November 2012. (She subsequently obtained permission to publish the anecdotes in which students are named.) This interview provides a glimpse of the direction that we think many business schools will take in the years ahead: combining the positioning and resource views, the entrepreneurship and management roles, and the strategy and execution imperatives into a single discipline that could be described as "identifying and realizing the purpose of your organization."

S+B: You've written that a leader who wholeheartedly embraces a strategic perspective is not the same as a conventional manager. Why not?

MONTGOMERY: Think about who does strategy in most large companies and where the strategist typically resides in an organization. It's not the CEO; it's a specialist function. Of course, everybody says that strategy is the CEO's responsibility. But it's just one of many things that the CEO is responsible for. So strategy becomes an area for experts. The company draws on specialists to help with external analysis, to do a deep dive on competitors, and to look at trends around the world.

All of that may indeed provide incredible added value. It's certainly helpful in setting the stage. But underlying all this activity is a fundamental question that any company's leader must ultimately answer: What will this firm be, and why will it matter? This is not a soft, philosophical question. It is a hard-nosed, economic one. As my former colleague Adam Brandenburger puts it, "Why would the world need this business? What would be different if it didn't exist?"

And a leader can't consider the question just once and be done with it. That question needs a compelling answer every day of a firm's existence, an answer that's relevant as the business evolves, and as markets and customers evolve. To enable that kind of continuous evolution, strategy should never be thought of as a problem that's been solved and settled. There are occasional dramatic changes, but mostly it's an evolutionary process, with the CEO at the center.

In some executive courses, I ask students to describe the strategy for their companies. Many of them start out thinking that the goal is to have a product, get it all down in writing, and they're done. But the process doesn't end there. We bring the strategies up for critique, and they have to defend them. It's always surprising to see how the same individuals who are good on their feet and have brilliant things to say when talking about a case study like Nike or General Electric falter when they're talking about their own companies. They revert to the same old generics that could apply to any company: "We will succeed because we're the quality leaders, we're best in class, we have the lowest costs," and so on.

S+B: The same old "blah, blah, blah."

MONTGOMERY: Exactly. For many leaders, there's an immense gap between intellectually understanding the theory of strategy and being able to apply it in

their own businesses. It's only by directly engaging in strategy themselves that most leaders internalize the important questions and get a clear sense of what's involved—the trade-offs, choices, commitments, and actions—in bringing a strategy to life. In working with these executives in class, my goal is to help them confront the gap between the high standards they're developing for others' strategies, and the often considerably less rich reality of their own.

S+B: How do you try to accomplish this in the programs you teach?

MONTGOMERY: I've taught some courses with 180 owner–managers coming to campus for three, three-week sessions, spaced a year apart. When they enter the program's third session, they work on their own strategies. First they write up a strategic plan on their own, with input from their teams back home, then they share their work with one another. That's when things get really serious.

We usually divide the group into cohorts of eight to 10 people. Each person presents his or her strategy to the cohort, and then each cohort selects one strategy to present to the full class. I ask them to select the one that makes the most use of the principles we've talked about together. We end up with about 20 strategies presented to the full class, 10 each in two long sessions. Each strategy is critiqued by another group, and then discussed openly by the whole class. The sessions go on for hours. The people in the room typically have very helpful things to say, so much so that we now give an award for the best critique, along with an award for the best strategy presentation.

The tone for the critiques was set several years ago by Jack, an executive from Venezuela. Between the second and third year of the program, as pressures from Hugo Chavez's government increased, Jack's business suffered; it lacked a clear growth path. He came back for the third year anyway, and as he dealt with his own challenges, he became a major presence in the class.

Jack was a regular at the pre-class lounge sessions, which often went on well past midnight. Students came there to test out their strategies with me and whoever else was interested, and often 30 or 40 people would show up.

Jack took the seat next to mine, night after night. He asked each presenter the same question: "What are you doing that's really distinctive?" Sometimes he'd put it as I did in class: "Help me understand why your business really matters." And he kept after them until they gave a thorough answer. By the end of those sessions,

everybody had internalized those questions. I came to feel that this process was the heart of a strategic conversation. A leader builds a strategy through in-depth conversations with a group of his or her peers, testing the ideas against a variety of situations. Knowing how to do that well will serve the graduates better as leaders than any particular plan they develop at Harvard Business School.

S+B: Are you saying that in a well-run company, the CEO should have a group of senior executives who play the same questioning role?

MONTGOMERY: That's right. And yet that's not the way it works in many companies today; business heads make presentations, but often they're choreographed ahead of time, and they often don't question their peers as much as they could. I'd like to see the managers at all those meetings raise the game by challenging one another.

A strategy shouldn't be only a document or an occasional exercise. It should be a way of looking at the world, interpreting experience, and thinking about what a company is and why it matters. The formal strategic planning process is only part of it; the deeper responsibility is ongoing and continuous. I often refer to a quote from the great 19th-century Prussian military strategist Helmuth von Moltke: "Certainly the commander in chief will keep his great objective continuously in mind, undisturbed by the vicissitudes of events. But the path on which he hopes to reach it can never be firmly established in advance. Throughout the campaign he must make a series of decisions on the basis of situations that cannot be foreseen.... Everything depends on penetrating the uncertainty of veiled situations to evaluate the facts, to clarify the unknown, to make decisions rapidly, and then to carry them out with strength and constancy."

That's the job of a business strategist, no less than a military commander, and it's a challenging balancing act—an ongoing, not a periodic, responsibility. Unfortunately, that's not the way strategy is generally taught in business schools, and it hasn't been for a long time.

The Capstone Course

S+B: How has the teaching of strategy changed?

MONTGOMERY: Back when I was an MBA student in the 1970s, strategy at most schools was taught as part of a course called Business Policy and General

Management. It was thought of as the capstone course; it came last in the sequence, after marketing, finance, production, and organizational behavior. Having seen all the pieces, the student was supposed to put them together. The course combined thinking and doing, strategy formulation and strategy execution. The main textbook, *Business Policy: Texts and Cases*, was written by legends in the field: C. Roland Christensen, Joseph Bower, and Kenneth Andrews [Irwin, 1965, rev'd. 1982]. The very first chapter was called "The Presidential Point of View." Another major section was called "The Accomplishment of Purpose." To this day, I tell the executives I work with, "If someone asks you what you do for a living, just look them in the eye and say, 'I'm an architect of organizational purpose.'"

Many business schools began to change their approach to strategy in the early 1980s after Michael Porter introduced the idea of competitive analysis. His course material on the subject was wildly popular because he brought economic rigor to the analysis of strategy. On its own, that was absolutely good. It transformed the era. My own work followed in that wake. Using large-sample statistical analysis, I examined the relationship between the overall profitability of a corporate enterprise and the average profitability of the industries in which it competed.

But over time, the economics began to distract people from the leadership aspect of strategy. Before long, strategy at many top business schools was taught by economists focused on theory and analytics. If you do this, how will your competitors respond? How do the structural characteristics of an industry shape competitive behavior? All important issues, to be sure, but gradually strategy became an exercise in getting the analysis right, providing the answer, and letting someone else implement it. That reinforced the idea that strategists were a group with specialized training.

Today, Harvard doesn't even have a course called General Management. Nor do most other business schools. Many students have come to view entrepreneurial management courses as the capstone experience of the MBA curriculum, where you learn about defining businesses, moving them through growth, changing course, and doing it again. But entrepreneurship courses don't teach people how to run a large company; they teach them how to create and finance a startup. If we care about improving the quality of large-enterprise strategy, we management academics have to avoid hoisting ourselves on our own petard.

S+B: Hasn't the specialized, analytic approach to strategy lost some of its value in recent years?

MONTGOMERY: Yes. It started to level off in the early 2000s. I saw that recently when, as part of my work on *The Strategist*, I talked with several speakers bureaus, thinking the subject of strategy would be hot. But instead, they said they would market me as a speaker on innovation or change management. Their interest in my book came not from the topic of strategy per se, but from its focus on what strategy means for business leaders.

The discussions helped me come to terms with how much strategy had lost its vitality—its edginess—and the tremendous opportunity we have to embrace it in a new way. I think other academics are beginning to see the same potential. For instance, at a strategy conference in celebration of the Harvard Business School centennial, our theme was “putting leadership back into strategy.”

S+B: When did you realize the limits of the analytic approach yourself?

MONTGOMERY: A lot of it came through executive education, working with managers who had an opportunity to use strategy to make a powerful difference in their companies. In countless late-night conversations, I learned a lot about the challenges they faced and their aspirations, and I saw what happened to companies where no one stepped up. The existentialist philosopher Jean-Paul Sartre wrote about the “courage to choose,” and understood that choosing isn't just an intellectual thing; it takes guts.

Strategy books don't talk about that. They also rarely talk about how to get others involved, or how to serve as a champion of the process. Thomas Saporito, the coauthor of *Inside CEO Succession: The Essential Guide to Leadership Transition* [Wiley, 2012], has written about CEOs who fail because they know their strategy is correct, and they assume that's enough to overcome any lack of buy-in. He reminds them that “executives don't get paid to be right. They get paid to be effective.”

In working with leaders, I also realized how vitally important creativity is in strategy. It takes the whole brain—intuition and analytic skills—to do it well. But creativity isn't considered very important in the culture that has grown up around strategy. That has to change.

S+B: What does strategy work look like when it is action-oriented?

MONTGOMERY: Let's say you're a business leader, and you have an idea for your business. That's just the beginning. You have to articulate it, choose to invest in it, and create the organizational context where people can bring it [to life]. That means building a system of advantage—a business model tailored to that purpose, where the pieces work in sync, and where the whole is more than the sum of the parts. Done well, it turns a concept into an animating idea: A clear view of *what* your company will bring to the world, *why* it will matter, and *how* you will do it. A lot of those *hows* will be determined by others throughout the organization, but that can't happen unless there's clarity at the core.

Look at a business like Ikea, which I wrote about in *The Strategist*. The founder, Ingvar Kamprad, stated his animating idea back in the 1940s. They would offer a line of practical, well-designed furnishings at prices so low everyone could afford them. When you walk into an Ikea store, every detail goes back to that idea. It's not in a document on a desk; it's the energy that gives life to the company. Ikea's system of advantage, built around that idea, is one of the company's most important resources. Anders Dahlvig, former group president, put it this way: "Many competitors could try to copy one or two of these things. The difficulty is when you try to create the totality of what we have." For instance, copying the low prices would not work without copying their approach to sourcing, their flat-pack distribution concept, the way they design their stores and catalogs, and their Scandinavian furniture design—"which is not easy," he says, "without a Scandinavian heritage."

S+B: Ikea has essentially one business. Can a multi-business, diversified company also be built around an animating idea?

MONTGOMERY: Certainly. One of my favorite examples comes from Apple. In 2001, when Steve Jobs had only been back at the company for a couple of years as CEO, he gave a presentation at the Macworld Expo in which he talked about the three ages of the PC. First came the age of productivity, then came the age of the Internet, and now would be the age of the digital hub. He talked about MP3 players, cell phones, and digital cameras, which at the time accounted for only 15 percent of all camera sales, but, "in a couple of years," he said, "it will be 50 percent." Going forward, Apple would add value to a host of digital devices, and

be the company whose computers would tie them all together.

Some people argue that a strategy is understood only in hindsight, retrospectively trying to make sense of a group of haphazard, reactive moves. But here's a case where, when the stock price was still very low, Steve Jobs laid out his animating idea in public, in advance. When Apple came out with iTunes, the iPod, and the Apple Store, it all made sense in light of that idea.

S+B: In *The Strategist* you write that people respond to this story by saying, "Sure, but I'm not a genius like Steve Jobs." Does a good strategist have to be a genius?

MONTGOMERY: Jobs is widely praised as a genius today, but one of the things I appreciate most about him is his failures—the Lisa computer at Apple and the ego-busting demise at NeXT, the startup Jobs founded when he was ousted from an operating role at Apple. When you dive into that story, you can see that his victories were hard won. I'm trying to get people excited about being strategists and to see why it's a distinctive way that they as leaders can add value to their businesses. I'm also trying to help them understand that strategy is far more than an idea. There's a conundrum you sometimes hear in business school: "Would you rather have a brilliant, fully worked-out strategy and poor execution, or a half-baked strategy well executed?" The point is supposed to be that good execution is preferable every time. At least it gets you some results. But, at root, it's a vacuous question. How can you implement the hell out of something if you don't know what you're trying to accomplish?

I can understand that you might be tempted to favor execution because you don't really know if your strategy will succeed. If your strategy says you should take dramatic, disruptive risks, do you really dare to stand with it and keep supporting it? But frankly, a lot of businesses face more pedestrian choices, with much less risk—and they're still not living deliberately, and are still flying by the seat of their pants.

More importantly, strategy is not a matter of immaculate conception, where you get a single answer and forever rule out other options. As a business, you operate in a complex system of other companies in which any advantage is fragile. Even Steve Jobs embellished and subtracted as time went on. You need to think about your strategy as an open, living thing. You start out by defining who you are

as a company. But then you try it out, and discover that it's not working so well, so you adjust it.

For example, we teach David Yoffie's case on the Gucci Group. The company hit the skids in the 1980s, when counterfeit products and an undisciplined licensing strategy nearly destroyed the brand. Maurizio Gucci, grandson of the founder, stepped in and tried to reposition the company, but customers balked and were slow to come back. A new CEO, Domenico De Sole, was hired in 1993 to pick up the pieces. De Sole forged a new purpose built around providing fashion-forward clothing at good value, and rebuilt every activity in the company to align with it. Did Gucci survive? Yes. Did it thrive? Yes. But it was a different company than it had been in its former heyday, a company that mattered for a different reason.

Similarly, when Ingvar Kamprad started out, he was forced to leave Sweden. The existing Swedish retailers didn't like his low prices and put pressure on local manufacturers to refuse to supply him. In fear that he'd lose the whole business, he went to Poland in search of new suppliers; their prices proved to make not just a difference in degree, but a difference in kind. In other words, this wasn't just an incremental shift in one factor—it led Ikea into a completely different business model. Kamprad's strategy developed because he was open to redefining the business.

S+B: So the point of a strategy is to keep improving your animating idea, and to keep building your own capacity to develop and execute it.

MONTGOMERY: Yes, usually that's true. Isn't that preferable to the dichotomy we've been talking about, between conception and execution? Isn't it better than being just the caretaker of a plan? Isn't it a much better insight to pass on to the other managers in your company, who could be developing their strategic perspective along with you?

One must also acknowledge, though, that sometimes the animating idea itself has run its course and more radical action is necessary. The question remains the same: Why does the world need this company?

The Education of a Strategist

S+B: If you could spend time with a group of prospective chief executives, could you tell the strategists from the caretakers?

MONTGOMERY: Yes. A leader who is a strategist has clarity not only about what's being done, but why. He or she understands that the quality of execution begins there. No matter how successful an operator or executor you are, no matter how good your product innovation or manufacturing processes are, if your company doesn't have a meaningful distinction, you won't be effective; and if you can't move it forward, your company will stagnate.

You learn those skills over time. Robert Katz, who wrote a classic article called "Skills of an Effective Administrator" [*Harvard Business Review*, September 1974], said that when you start your career, to succeed, you need a functional skill: For example, you need to be good at accounting, engineering, or HR. At the next level up, you need to be good with people. And at the very top, you need conceptual skills. Years later, someone asked him if he still agreed with that statement, and he said he was even more fervent about it now. But he thought that people either had those skills by the time they were teenagers, or they would never have them.

I don't agree with that part of it. I think those skills can be developed later in life. But I do agree that such skills are the key to becoming an architect—or, better yet, a steward—of organizational purpose. As it happens, I've been at the boardroom table with Bob Katz, and he has incredible conceptual skills himself. But he also understands that they create value only when they're intimately linked to action.

I am sometimes asked to help develop the search criteria for an incoming chief executive, and I always underscore the need to marry the ability to conceptualize with the ability to translate those concepts into action. Generally, I'd look for people who have transformed a business—redefined what it was and why it mattered, rebuilt the business model, and delivered. To lead, you need to be able to do more than just clean up operations or coast on an existing path.

And I've worked with enough CEOs to know that they need to be able to make meaning for an organization, to connect the efforts of everyone in it with a purpose that really matters to some set of customers.

S+B: What is the future of strategy education?

MONTGOMERY: Thinking about the cultural connections among business leaders as an ecosystem, we want to create an atmosphere where a new type of conversation can be held—not just in a university class or in a management consult-

ing firm engagement, but among leaders in general. We want to set up the kind of conversation that opens the window to new strategic possibilities and allows people to move a company in a new direction.

One of our students, Yegs Ramiah, is an executive at Santam, the largest short-term insurance company in South Africa. Santam operates in a category where there is little differentiation, with high levels of commoditization, rampant price competition, and a race to the bottom that has been threatening the profitability of the industry. Moreover, Santam had been in the game for 95 years; it was perceived as old-school, conservative, and expensive, mainly serving the country's older white population. To ensure future success, Santam had to tap into the growth market—it had to appeal to people of all races and ages and extend its reach into the growing middle class.

Yegs led a process to redefine the brand positioning and the personality, refresh the logo and the visual identity, and develop an integrated communication and marketing campaign. She realized that in order to challenge accepted norms, Santam would have to redefine the short-term insurance category. She looked for ways to change the conversation about insurance from its being trivial and dispensable, cheap, and a little bit nasty, to its being important and meaningful, with enduring value and substance. This meant inspiring South Africans to take the issues of managing risk and preparing for their future more seriously.

Yegs hired Oscar-winning actor Sir Ben Kingsley to narrate a new series of ads. In one of them, he stands in a restaurant, with a bartender behind him mixing drinks, moving in and out of the frame. He reminds the audience how easy it is to wear blinders and overlook things that are right in front of you. If you go for the cheapest home insurance, you might miss an important detail. “What if I told you,” he concludes, “that Floyd’s uniform has changed four times while I’ve been talking?” The ad caught on, and people wanted to watch it carefully to see where the bartender’s outfit changed. It won several accolades, including a Silver Clio award as well as a Bronze Lion in Cannes.

Nando’s, a large South African fast-food chain renowned for their satirical advertising, then parodied the ad with one of their own, stealing the concept. Instead of ignoring it, or threatening to sue, Yegs got the same agency to create a response. “Under normal circumstances we’d be upset, but frankly we’re flattered,” said a Kingsley-like narrator in the new ad. Then he made a demand: Santam

would “overlook the indiscretion” if Nando’s delivered a package of food—a list of dishes from the Nando’s menu—to the Johannesburg Children’s Home.

Santam’s challenge to Nando’s took South Africa by storm. The ad got more than 250,000 hits on YouTube, and Santam’s name is now everywhere, as an example of a company that is humane, progressive, contemporary, and accessible to a growing group of customers. The campaign reinvented the brand and, with that, the business.

That’s strategy. It’s not unlike what Steve Jobs did for Apple, or what Alfred Sloan did for General Motors when he first went up against Henry Ford. Nobody could beat Ford at his own game, but Sloan reinvented the auto company. A really good strategy doesn’t happen on the margin; it doesn’t simply perpetuate an industry game that is mature and may be decaying.

A really good strategy revitalizes the company, and to do that, you need to assemble a group of people who have the courage to confront business at its roots. You need people who can say, in effect, “Strategy is dead. But long live strategy.” +

Reprint No. 00163

When Dow Chemical Company used all its financial clout to acquire specialty manufacturer Rohm & Haas in 2008, forking out US\$18.8 billion in cash, it was what CEO Andrew Liveris called a “transformational” move. It signaled a fundamental shift in Dow’s core business model. For a company founded in 1897, the risky move was the equivalent of a poker player pushing all his chips to the center of the table. But in a fast-paced business landscape, the authors say, most large corporations will probably have to make a similar decision to go “all in” at some point. To win a big strategic bet, as Dow did, a leader must have an outlook informed by his or her company’s potential, aided by due diligence, and shaped by a thorough evaluation of the possible scenarios. Above all, leaders must prepare themselves and their organization to recognize when a game-changing moment is at hand, and then seize it. The future of the company is at stake.

Sooner or later, most global business leaders will have to put their entire enterprise at risk. Here’s how to do it successfully.

Strategic Bets

by Ram Charan and Michael Sisk



The Dow Chemical Company bet its future on the acquisition of Rohm & Haas. Announced in July 2008, the deal was an audacious move; not only would it take all of Dow's financial resources to acquire this specialty chemicals maker, but it represented a fundamental shift in Dow's business model, one that challenged the prevailing assumptions of the industry. CEO Andrew Liveris used the word *transformational* to describe the US\$18.8 billion all-cash deal: He said it would lower his company's reliance on low-margin, highly volatile, highly cyclical commodities and bring in specialty products whose differentiation offered global opportunities and higher margins.

This was not an ordinary M&A exercise; it was a dramatic strategic bet with life-or-death consequences for this venerable company founded in 1897. Many chief executives would have avoided this strategic bet, yet it was the kind of move that many companies must make in today's fast-changing business environment. Nonetheless, during the first few months after the announcement, it looked as if the deal might fall apart. Wall Street was dubious from the start, and financing was hard to come by. Dow had a long history as a dominant player in commodities. According to most industry analysts, the change in course was too great, the timing too abrupt, the chances of success too uncertain, and the price tag too high—even given Dow's solid balance sheet and industry prowess as the world leader in sales.

But Liveris had put together a meticulous plan over many months to pave the way for the deal. Now he met frequently with board members and institutional investors to win their support. They discussed how to finance the deal, what to divest, and whether the timing was right. There were setbacks. Several potential

financial partners whom he sought as sources of capital turned him down. He persisted, and in December 2008, Dow signed a binding agreement for a joint venture with the Kuwaiti state-run Petrochemical Industries Company (PIC), which would infuse Dow with \$9 billion to partly finance the Rohm & Haas acquisition and thus greatly reduce the risk involved.

The majority of large global corporations will probably have to make this sort of strategic bet sometime in the next 10 years. A number of companies are ahead of the curve, including some from emerging markets. Brazil's Vale, Mexico's Cemex, India's United Breweries, South Africa's SABMiller, and Luxembourg's ArcelorMittal have already become world leaders in their industries through strategic bets. Other companies, including major corporations from the U.S., Canada, Europe, and Japan, are facing big changes or maturity in their markets. They will, from time to time, find themselves forced into strategic bets as their best option for thriving in the future.

Some companies may have to make more than one strategic bet during the course of a decade—they may have to bet the company two or three times in succession. Their ability to recognize the need for a game-changing move, to seize the moment, and to execute the decision will be critical. To succeed, they will need to alter their whole framework for conceiving and shaping strategy. It behooves them to build the necessary mental and organizational resolve and fortitude in advance—and not wait until the moment of truth to find out whether they have it.

A Test of Leadership

As Andrew Liveris discovered, a chief executive embarking on a strategic bet should expect to face a series of harsh tests that might stretch over several years, severely straining the resolve and creativity of everyone closely involved. Those tests began for Dow Chemical on December 31, 2008, two days before the close of the deal with PIC, when the Kuwaiti government abruptly backed out, throwing all of Liveris's plans into jeopardy. "We were shocked by this news, and this was completely unexpected, given the approvals already received and the behavior, actions, and words from our partners," Liveris said at the time.

Once the financial foundation of the deal had been destroyed and the other critical building blocks were wobbling, most observers expected Dow Chemical to shut down the deal and retreat. But Liveris was in a corner. Retreat would be

a defeat for him personally and could put Dow in a difficult legal situation. The contract with Rohm & Haas was airtight, and its leaders would not budge. It was also a cash deal, and a replacement for PIC's promised investment was not easily found in early 2009. Even in normal times, investors are often fearful to commit money to a strategic bet, but at that moment, as the capital markets were coping with the worst economic crisis in 65 years, and the world financial system was teetering, their fear was compounded. Both the debt markets and equity firms were paralyzed, and the stock market was in free fall, down 60 percent. Meanwhile, Dow's own stock, which had been at \$30 per share when the Rohm & Haas deal was announced in the summer of 2008, plummeted to \$7 by March 2009, and Andrew Liveris was facing the prospect of a serious debt downgrade to junk status by Standard & Poor's and Moody's.

Liveris had to keep the board committed to the deal, find new sources of financing, and convince the capital markets that Dow's strategy had hit a bump, not a brick wall. Tackling these issues tested Liveris's leadership abilities. He needed to summon his own mental toughness and perseverance, and to project continued conviction about the merits of the move he had championed. He had to persuade board members, institutional investors, Wall Street analysts, and rating agency analysts that the course he'd chosen was still correct and viable. He also had to be resourceful and creative in finding solutions, including alternative sources of funding.

In the end, Liveris succeeded. He kept the directors on board, convinced the rating agencies to maintain the company's investment-grade rating, and lined up alternative financing from Warren Buffett and two members of the Rohm & Haas family. And the deal was in fact transformational; it set up the combined Dow–Rohm & Haas enterprise for better performance than either company might have expected alone. Today, specialty chemicals make up about two-thirds of Dow's revenue, up from 50 percent before the merger, and Liveris says he's aiming to tilt the mix toward 80 percent. The capital markets have warmed up accordingly. The deal closed in July 2009, and by January 2010 Dow's stock was above \$29. Matthew Norris, a portfolio manager and equity-research director at the investment management firm Waddell & Reed, told *Barron's* in an interview that Dow's transition “means a faster-growing business that deserves a higher multiple.” Liveris said at a New York City investor conference in December 2009 that Dow could

return to record earnings levels of \$4.50 per share by 2012.

As an example of strategic thinking, the Dow deal is of great significance. It represents the kind of challenge that more companies will find themselves facing in the future. Liveris and his board put their company on the line because they understood that the global environment affecting the chemicals industry was changing rapidly, and that they would be forced, sooner or later, to change too. They would be much better off if they could find a way to stay ahead of this inexorable change, even if it meant putting their entire enterprise at risk. It might not have taken a genius to see that commodity chemicals were going to become less profitable, given new entrants from emerging and resource-rich countries in the industry; the real genius was in moving quickly to a new business model and acquiring and deploying the necessary capabilities before competitors fully accepted or woke up to this reality.

The Dow Chemical example is instructive in another way; it shows the inherent uncertainty that leaders must navigate even after a strategic bet is made. Liveris had to execute the deal with Rohm & Haas under conditions neither he nor anyone else could have imagined—a global financial system turned upside down.

Preparing for Upheaval

Strategic bets were once a matter of choice, not necessity. In the 1980s, '90s, and early 2000s, though the business environment grew steadily more turbulent, large mainstream corporations could still survive through gradual change, honing core capabilities and creatively extending them to new markets. But pursuing incremental improvements is no longer a reliable path to success. No matter what a company's business model, at some point in the future, that model will become irrelevant or obsolete or will lose value against new competitors and new opportunities. That point can arrive abruptly, without clear advance signals.

There are several reasons for this. The first is the digital revolution. It has been in play for 20 years, but only now has it begun to routinely cause cross-industry disruptions. As Amazon and Apple have famously shown, a company with a new value proposition that takes advantage of digital media can change the game swiftly. Additionally, many innovations can become commoditized with unprecedented speed, because digital media makes it easier for other companies to learn about them and copy them.

Meanwhile, the extraordinary economic growth in China, India, and Brazil is elevating a billion people or more to higher levels of prosperity. Coupled with increasing demand for scarce resources in the Middle East and other emerging markets, this phenomenon will lead to seismic (and still unpredictable) political and economic change.

Perhaps the most significant and under-recognized force is the shift in global capital markets. They have become more volatile and less transparent, and trading has been hugely focused on the short term—even as regulators look to impose new long-term capital requirements and other constraints on trading in the wake of the Great Recession. Unpredictable movements in currency trading, often involving sudden shifts in currency value of 30 to 50 percent, add to this volatile environment. The comparative value of countries, industries, and companies can now change rapidly on any given day.

In this new business context, the power of the capital markets cannot be overstated. Capital today is more fluid, fickle, and abundant than ever; these traits exert a steady pressure on companies to either attract capital or risk seeing it flow to competitors—or, worse, flow to upstart predators that have not traditionally been in a company's competitive line of sight. No longer are the capital markets merely a tool to execute corporate strategy; they are integral to the way a company forms its corporate strategy.

Combined with the speed of the Internet and relentless commoditization, this means the market value of a particular asset—anything from a business operation to an oil well to a brand name—may decline sharply at any time against the intrinsic value of that asset. Factoring in the volatility of markets, leadership must pragmatically and unflinchingly evaluate the fundamental depreciation of its assets on a long-term basis, and react by making strategic bets about what to keep, what not to keep, what to buy, and what timing to use on any bet.

For example, consider what occurred in the materials sector starting in the early 2000s. China's consistent double-digit GDP growth reached a tipping point; that nation's economy started sucking up natural resources at a prodigious rate, and it had ripple effects across the globe. In response, BHP Billiton Ltd., an Australian mining company that had been formed by a merger in 2001, made a strategic bet to become a dominant player in China. It purchased Anglo Potash, Intercor, and WMC Resources and steadily cemented ties with China—even win-

ning the honor of producing the medals for the 2008 Beijing Olympics.

BHP's CEO, Marius Kloppers, has said he believes that the industry will consolidate further. In late 2009, BHP set aside a \$10 billion war chest to prepare itself to pounce on opportunities and make acquisitions. The capital markets rewarded Kloppers by pushing up BHP's stock price. By early 2010, the stock had grown 250 percent over five years, well ahead of peers such as Rio Tinto and Alcoa. Vale and ArcelorMittal made similar strategic bets before the financial meltdown, and the market also rewarded them with higher P/E ratios. All three now enjoy great influence over prices and control over resources, particularly iron ore, upon which China dearly depends for its growth. In a testimony to this foresight, the price of iron ore went up 95 percent between 2008 and 2009.

To stay ahead of trends like this, corporate leaders must embrace the idea of strategic bets and prepare for the moment when such a bet will be necessary. This means becoming acutely aware of changes in the external environment and anticipating new realities before others do. It means being willing, when necessary, to strike out in new directions with dramatic changes in capabilities, even if the organization lacks experience. Corporate leaders will also have to prepare critical stakeholders for the kinds of dramatic strategic bets that will be necessary.

Anatomy of a Strategic Bet

A strategic bet is a big, bold move made either to transform a company and create a new growth trajectory or to create a totally new enterprise. Almost all strategic bets are potential game changers for the company, its industry, and sometimes adjacent industries; indeed, strategic bets are so comprehensive that they tend to alter most of the company's staff, processes, and practices. Such bets require serious commitment from leaders and boards. In almost all cases, especially if the strategic bet involves a highly visible action, such as a large acquisition, there will be concerns about how the market, the analysts, and the rating agencies will react. Nonetheless, strategic bets work only if management and boards have the confidence and stamina to sustain themselves until the outside world sees the merit of their decision—a period that could last five or 10 years.

There are at least three basic reasons for making a strategic bet:

- 1. To acquire a controlling interest in, or even a stranglehold over, critical resources or competencies.** For example, in late 2010, several stra-

tegic bets were under way in the mining and metals industry. They were driven by competition among Chinese and Indian companies for the kinds of rare elements needed for new technologies—such as lithium, a metal expected to be in greater demand for the next generation of car batteries.

2. To escape a declining industry before others see its demise. Typically, this approach is taken when a company's leadership recognizes that part of the business is being commoditized or for some other reason is about to lose value and pricing power. Instead of riding the industry down, the company sells the business to cut its losses and puts its efforts into something with more promise.

In 1996, Allied Signal CEO Lawrence A. Bossidy made exactly that sort of clear-eyed assessment of the company's auto parts business, which was responsible for almost 15 percent of its total sales. The company sold off the lion's share of its car parts business for \$2.1 billion, moving instead to concentrate on aerospace and chemical products. Two years later, Bossidy led the purchase of Honeywell, which was about half the size of Allied Signal, for a stock swap worth approximately \$14 billion, creating a Goliath in the global aerospace and chemical products markets.

The strategic bet to escape a declining industry must not be confused with selling a business to simply rationalize operations. For example, many companies sell divisions with the assumption that the acquiring company will run them more efficiently, and to gain some cash in the process. Such divestitures are worthwhile, but unless the fate of the company is riding on their completion, they are not strategic bets.

3. To practice a form of large-scale entrepreneurship. This typically means acquiring companies, technologies, or core competencies needed to be successful in an emerging form of enterprise. For example, consider Bharti Airtel Ltd. It is the largest cellular service provider in India, with more than 120 million subscribers. Its global expansion strategy has been based on scale and efficiency: that is, acquiring customers with very low asset intensity (requiring little capital per dollar of revenue). This type of expansion can be risky, because it often requires extensive investment to move rapidly to gain first-mover advantage.

In 2009, Bharti Airtel's management negotiated for months to acquire MTN Group Ltd., a South Africa-based multinational mobile telecommunications company operating in many Middle East and African countries. The Bharti Airtel–MTN deal was an enormous strategic bet; it was championed by Bharti Airtel

chairman Sunil Mittal, but investors and analysts opposed it, in part because of the debt financing involved. Mittal eventually called off negotiations, in the autumn of 2009, but only when the South African government withheld support for the deal.

Nonetheless, Mittal was undaunted by his critics. In June 2010, Bharti Airtel acquired Zain Africa for \$10.7 billion. This branch of the Kuwaiti telecommunications company Zain had operations in 15 African counties; Mittal thus gained the foothold on that continent that he had missed with MTN. At about the same time, Bharti Airtel announced a deal to purchase 70 percent of Warid Telecom International Ltd. of Bangladesh. Analysts threw cold water on the plans, pressuring management and the board to abandon the strategy. But Mittal has resisted the pressure to withdraw; he has assembled a top-notch team of managers to go into the Middle East and Africa, and Bharti Airtel is clearly in it for the long term. Tellingly, bankers have competed aggressively to finance the deals.

Facing Up to Uncertainty

As Bharti Airtel's negotiations with MTN show, a strategic bet's outcome cannot be certain; indeed, that is one of the things that make it a bet. Bharti Airtel was fortunate that other acquisitions were available in its target area. The failure to acquire MTN was only a minor setback.

Sometimes, however, poor timing or external forces can produce grave consequences for a strategic bet—and threaten the life of the company. When the Federal-Mogul Corporation, a U.S. automotive parts supplier, purchased British manufacturer Turner & Newall in 1998, it inadvertently assumed an enormous asbestos liability that forced it into U.S. bankruptcy in 2001; it did not emerge until 2007. Similarly, in mid-2008, the Royal Bank of Scotland (RBS) Group's joint acquisition of the Dutch bank ABN Amro (with Fortis and Banco Santander) was a strategic bet to build a position on the European continent. But the bidding war with Barclays PLC over the deal left RBS too financially exposed to weather the credit crisis that arrived soon thereafter.

Keeping perspective is critical with strategic bets. They are so dramatic and compelling that there is always the chance of a misstep. Consider former Bank of America CEO Ken Lewis. His decision to acquire Merrill Lynch during the panicky days following the Lehman Brothers collapse was a bold strategic bet to

quickly acquire a new capability. It is likely to prove to be farsighted and rewarding for the bank and its investors, but it will take more time and suasion to realize the potential that Lewis saw at the time. He was ultimately undone by a detail of the deal—not the overall decision, but the disclosure of bonuses. Lewis was eventually forced to resign, which shows just how high the stakes are when managing these bets.

Some executives might blanch at the fate of Federal-Mogul, RBS, and Ken Lewis—and decide that making a strategic bet is just too risky. When facing uncertainty, people have a psychological reluctance toward taking on big strategic bets. This holds back many managements and boards. It is comforting, and often defensible, to continue with business as usual, especially if making a strategic bet would mean putting pressure on the board and the organization and having to convince them of a grand vision for corporate change.

Indeed, sometimes it is right to pull back from the brink of a poor strategic bet. In 2005, Johnson & Johnson abandoned its \$24 billion bid for the Guidant Corporation, a maker of pacemakers, defibrillators, and stents, after safety issues cropped up. The Boston Scientific Corporation stretched to buy the company instead and eventually had to cope with a huge legal liability. Shortly after the acquisition, *Fortune* magazine called it the second-worst acquisition of all time, after the AOL–Time Warner merger. The stock price sank, and the founders are now selling their holdings.

But *not* making a strategic bet is often a worse move—and, in some cases, fatal. A passive failure to act may not look like a move at all, but it is a bet just the same—a bet of omission. The consequences are potentially dire. Hesitation and a missed opportunity can quickly turn a company into an acquisition target. Executives who make bets of omission are in effect putting the fate of their company in the hands of outsiders: a government regulator, competitors, or private equity investors and hedge funds.

Take, for instance, AOL's decision not to build a search engine. In the mid-1990s, AOL was the dominant Internet player, ahead of Yahoo and a bevy of now extinct portals and search engines. AOL's decision eventually put its fate in the hands of a couple of brainy kids from Stanford whose creation, Google, ultimately relegated the Time Warner portal to also-ran status. Today, AOL CEO Tim Armstrong, formerly of Google, is making a new strategic bet: realigning the company

into a content provider through a series of acquisitions, partnerships, and organic growth initiatives. AOL's acquisition of the Huffington Post in February 2011 was a very visible component of this bet, with widely observed risks and many potential rewards.

Heroic Leadership

When senior management begins plotting a strategic bet, whether to combat the decline in the long-term value of an asset, to compete for natural resources, or for any other reason, the boardroom is often psychologically unprepared for such an audacious move. Even when the business case is compelling, the board or senior management team might resist—particularly if those groups are dominated by cautious people or people with little or no experience with strategic bets. We have seen board members, gripped by anxiety, break the momentum of a strategic bet with the assertion “Most acquisitions don't work, so we shouldn't do it.” Typically, directors fear the stock price will go down, the rating will be cut, or the adverse publicity will be too severe for the company and their own individual reputations.

Ultimately, it's the leader's job to get the board to face up to the risks of not making a decision. For companies the size of Siemens AG or Procter & Gamble Company, the risks may not be as great as for smaller companies. Traders can create negative press, but they cannot turn Siemens or P&G into takeover targets. The issue is trickier for companies already on the radar as acquisition targets. At such times, a frank boardroom discussion might convince directors that a takeover is inevitable if the company doesn't make the strategic bet. By choosing to take the bet, leadership could propel the company to the next level.

Given the high stakes and uncertainty of a strategic bet, what is the difference between a leader who makes a strategic bet and a gambler who goes “all-in” at the poker table? From a strictly analytical point of view, the gambler's calculations are easier.

Whether the game is poker or roulette or baccarat, a gambler deals with concrete probabilities. Business leaders don't have the same controlled and stable context for their strategic bets. Each play for the leader is unique. The timing is different and the context is different, and this puts extraordinary demands on leaders. In earlier years, the emphasis for strategic decision making was on analytics—which subtly de-emphasized the role of leadership. But analytics can carry

a company's executive team (and its board) just so far in their deliberations of whether to make a strategic bet. Indeed, gauging the odds of a strategic bet's success by looking at past successes can be fallacious, because the economic landscape is likely to have changed.

In making a strategic bet, the leader's conviction should be grounded, first and foremost, in a clear understanding of the future potential of the company. This understanding should be bolstered by quantitative forms of due diligence and analysis, alongside a careful qualitative approach that examines the bet through a variety of lenses and possible scenarios. This type of large-scale entrepreneurial judgment is a habit of mind that must be nurtured; it cannot be developed quickly. In an age of strategic bets, identifying and reinforcing that judgment will be the central task of leadership development.

The need to make strategic bets, and be prepared for them, will ultimately change the way many business leaders regard strategy. In addition to their existing concerns—their company's functional strengths, arrangement of business units, and portfolio—there will now be the presumption of a more dynamic, ambiguous, and difficult business environment. The only way to manage this environment, in a collected and capable manner, is to think in terms of external strategy, to continually cultivate an outside-in view of the company in which strategic bets are not automatically resisted, but are instead dispassionately evaluated.

The level of risk a strategic bet carries with it will feel uncomfortable to many. Indeed, if it feels thoroughly comfortable, it's probably not enough of a bet. But business, by definition, involves discomfort. You never have the control you want; you only have opportunities. You must be willing to step forward and risk your enterprise, boldly but thoughtfully, for the sake of its future. Andrew Liveris may not deliver a return on acquisition as quickly as Wall Street wants, and his strategic bet may be criticized for some time, but it has positioned Dow to capture growth on a worldwide basis. The market is just beginning to see what he saw years ago. He will be ready in a few years to make his next big move. That is leadership. +

Reprint No. 00063

Resources

Greg Farrell, *Crash of the Titans: Greed, Hubris, the Fall of Merrill Lynch, and the Near-Collapse of Bank of America* (Crown Business, 2010): A *Financial Times* reporter tells the dramatic story of one of the strategic bets mentioned in this article.

A.G. Lafley and Ram Charan, *The Game-Changer: How You Can Drive Revenue and Profit Growth with Innovation* (Crown Business, 2008): Procter & Gamble's great strategic bet began when Lafley became CEO.

Paul Leinwand and Cesare Mainardi, *The Essential Advantage: How to Win with a Capabilities-Driven Strategy* (Harvard Business Review Press, 2011): Why pursuing an effective strategy often means making a strategic bet by cutting away those parts of your business that are incoherent.

Bob Rice, *Three Moves Ahead: What Chess Can Teach You about Business (Even if You've Never Played)* (Jossey-Bass, 2008): Chapter 8 covers the "exchange sacrifice," in which you trade something that seems valuable now for a better advantage.

For more thought leadership on this topic, see *s+b*'s Strategy & Leadership page.

Psychologists use the term *confirmation bias* to describe the tendency for people to cling to their preconceived notions, dismissing information that challenges their point of view. The same affliction can strike businesses. When executives overlook unexpected clues that could lead to breakthroughs, preferring to stick with an established plan, they sell their shareholders and employees short. But your company doesn't have to miss the signs, and managers who consistently perceive and exploit anomalies have a significant advantage over their rivals. In this article, Donald Sull—professor at the London Business School and author of *The Upside of Turbulence: Seizing Opportunity in an Uncertain World* (HarperBusiness, 2009)—presents 10 easy-to-miss indicators of important opportunities.

Market anomalies and incongruities may point the way to your next breakthrough strategy.

10 Clues to Opportunity

by Donald Sull



During their heyday in the late 19th and early 20th centuries, transatlantic cruise lines such as the Hamburg America Line and the White Star Line transported tens of millions of passengers between Europe and the United States. By the 1960s, however, their business was being threatened by the rise of a disruptive new enterprise, namely, nonstop transatlantic flights. As it happened, the cruise ship lines had one potential strategy with which to save their business: vacation cruises. Starting in the 1930s, some of these lines had sailed to the Caribbean during the winter, thus using their boats when rough seas made the Atlantic impassable. And in 1964, when a new port was opened in Miami, Fla., the pleasure cruise business began to boom.

But the great cruise lines missed this breakthrough opportunity. They saw their profitability fall while dozens of startups, including Royal Caribbean and Carnival, retrofitted existing ships to offer pleasure cruises and built an entirely new travel and leisure category that continues to grow today.

Managers and entrepreneurs walk past lucrative opportunities all the time, and later kick themselves when someone else exploits the strategy they overlooked. Why does this happen? It's often because of the natural human tendency known to psychologists as *confirmation bias*: People tend to notice data that confirms their existing attitudes and beliefs, and ignore or discredit information that challenges them.

Although it is difficult to overcome confirmation bias, it is not impossible. Managers can increase their skill at spotting hidden opportunities by learning to pay attention to the subtle clues all around them. These are often contradictions, incongruities, and anomalies that don't jibe with most of the prevailing assump-

tions about what should happen. Here is my own “top 10” field guide to clues for hidden breakthrough opportunities, observed in a wide variety of industries, countries, and markets. If you find yourself noticing one or more of them, a major opportunity for growth could be lurking behind it.

1. This product should already exist (but it doesn't). As the accessories editor for *Mademoiselle* magazine in the early 1990s, Kate Brosnahan spotted a gap in the handbag market between functional bags that lacked style and extremely expensive but impractical designer bags from Hermès or Gucci. Brosnahan quit her job, and with her partner Andy Spade, founded Kate Spade LLC, which produced fabric handbags combining functionality and fashion. These attracted the attention of celebrities such as Gwyneth Paltrow and Julia Roberts. Many well-known product innovations—including the airplane, the mobile phone, and the tablet computer—began similarly, as products that people felt should already exist.

2. This customer experience doesn't have to be time-consuming, arduous, expensive, or annoying (but it is). Consumer irritation is a reliable indicator of a potential opportunity, because people will typically pay to make it go away. Reed Hastings, for example, founded Netflix Inc. after receiving a US\$40 late fee for a rented videocassette of *Apollo 13* that he had misplaced. Charles Schwab created the largest low-cost brokerage house because he was fed up with paying the commissions of conventional stockbrokers. Scott Cook got the idea for Quicken after watching his wife grow frustrated tracking their finances by hand.

3. This resource could be worth something (but it is still priced low). Sometimes an asset is underpriced because only a few people recognize its potential. When a low-cost airline such as easyJet or Ryanair announces its intention to fly to a new airport, real estate investors often leap to buy vacation property nearby. They rightfully expect a jump in real estate values. Similarly, the founders of Infosys Technologies Ltd., India's pioneering provider of outsourced information technology services, were among the first to recognize that Indian engineers, working for very low salaries, could provide great value to multinational clients. The company earned high profits on the spread between what they charged clients and what they paid local engineers.

4. This discovery must be good for something (but it's not clear what that is). Researchers sometimes recognize that they have stumbled on a promis-

ing resource or technology without knowing the best uses for it right away. The resulting search for a problem to solve can lead to great profitability. One example was the founding of the ArthroCare Corporation, a \$355 million producer of medical devices based on a process called coblation, which uses radio frequency energy to dissolve damaged tissue with minimal effect on surrounding parts of the body. Medical scientist Hira Thapliyal, who codiscovered this process, founded a company to offer it for cardiac surgery, but that market turned out to be too small and competitive to support a new venture. Undeterred, he looked for other potential uses, and found one in orthopedics, where there are more than 2 million arthroscopic surgeries per year.

5. This product or service should be everywhere (but it isn't). Sometimes people chance upon an attractive business model that has failed to gain the widespread adoption it deserves. Two archetypal retail food stories illustrate this. In 1954, restaurant equipment salesman Ray Kroc visited the McDonald brothers' hamburger stand in southern California, and convinced them to franchise their assembly-line approach to flipping burgers. In 1982, coffee machine manufacturing executive Howard Schultz visited a coffee bean producer called Starbucks in Seattle. He recognized the potential of a chain restaurant based on European coffee bars, and he joined Starbucks, hoping to convince the company's leadership to convert their retail store to this format. When they didn't, he started his own coffeehouse chain, later buying the Starbucks retail unit as the core of his new business.

6. Customers have adapted our product or service to new uses (but not with our support). Chinese appliance maker Haier Group discovered that customers in one rural province used its clothes washing machines to clean vegetables. Hearing this, a product manager spotted an opportunity. She had company engineers install wider drain pipes and coarser filters that wouldn't clog with vegetable peels, and then added pictures of local produce and instructions on how to wash vegetables safely. This innovation, along with others including a washing machine designed to make goat's-milk cheese, helped Haier win share in China's rural provinces, while avoiding the cutthroat price wars that plagued the country's appliance industry.

7. Customers shouldn't want this product (but they do). When Honda Motor Company entered the U.S. motorcycle market in the late 1950s, it ex-

pected to sell large motorcycles to leather-clad bikers. Despite a concerted effort, the company managed to sell fewer than 60 of its large bikes each month, far short of its monthly sales goal of 1,000 units. Then a mechanical failure forced the company to recall these models. In desperation, it promoted its smaller 50cc motorbike, the Cub, which Honda executives had assumed would not interest the U.S. market. When the smaller bikes sold well, Honda realized it had discovered an untapped segment looking for two-wheel motorized transportation. (The campaign is still remembered for its catchphrase, “You meet the nicest people on a Honda.”)

8. Customers have discovered a product (but not the one we offered). Joint Juice, a roughly \$2 million company that produces an easy-to-digest glucosamine liquid, was founded by Kevin Stone, a prominent San Francisco orthopedic surgeon. He learned about the nutrient from some of his patients, who took it for joint pain instead of the ibuprofen he had prescribed. Many doctors might have ignored this or even scolded their patients for falling prey to fads, but Stone recognized he might be missing something. He looked up the clinical research on glucosamine in Europe, where it was the leading nutritional supplement. (Veterinarians, he discovered, swore by it, and their patients fell for neither fads nor placebos.) Then he built a business around it.

9. This product or service is thriving elsewhere (but no one offers it here). In the early 1990s, a Swedish business student named Carl August Svensen-Ameln tried to store some of his belongings in Sweden while at school in Seattle, but found that all the local self-storage facilities were full. He studied the storage industry, already prevalent in the United States, and discovered a business model characterized by high rents, low turnover, and negligible operating costs. Yet self-storage, at the time, was virtually nonexistent in continental Europe. Svensen-Ameln and a friend from business school set up a partnership with an established U.S. company, Shurgard Storage Centers Inc. The resulting company, European Mini-Storage S.A., was the first of several such companies that Svensen-Ameln started in Europe, to great success.

10. That new product or service shouldn't make much money (but it does). Established competitors are often surprised when upstart rivals do well. In his 2008 book, *The Partnership: The Making of Goldman Sachs* (Penguin Press), Charles D. Ellis noted that for decades, Goldman Sachs partners had avoided

investment management, which they believed generated lower fees than trading and investment banking. When Donaldson, Lufkin & Jenrette Inc. published its financial performance as part of a 1970 stock offering, Goldman partners were startled to learn that fees and brokerage commissions on frequent trades added up to a highly profitable business. Shortly thereafter, Goldman expanded into managing corporate pension funds, and aggressively built its business.

Incongruities like these can offer a critical clue about where your assumptions no longer match reality. From there, you are more likely to uncover the kinds of opportunities that you might otherwise have missed—and that your competitors still don't recognize. Start by asking yourself, What are the most unexpected things happening in our business right now? Which competitors are doing better than expected? Which customers are behaving in ways we hadn't anticipated? Take yourself through the list of top 10 clues. Leaders who consistently notice and explore anomalies increase the odds of spotting emerging opportunities before their rivals. +

Reprint No. 11304

You can skip all those books. The essence of strategy can be found by reading just the most canonical chapters in the history of the genre. Here, Walter Kiechel III, who has been the managing editor of *Fortune* and the editorial director of Harvard Business Publishing, identifies essential reading spanning almost six decades. The seven selected chapters offer a window into the evolution of strategic thinking. Whereas Alfred D. Chandler Jr.'s landmark 1962 book *Strategy and Structure: Chapters in the History of the American Industrial Enterprise* (MIT Press) is widely considered the first work to consider strategy in the corporate realm, thought leaders such as Andrew S. Grove and Henry Mintzberg have moved the field forward in recent years. Kiechel traces the main themes that crop up throughout the literature, noting that the conversation has grown more sophisticated and nuanced since its inception.

**A shortcut to the big
themes in the conversation
about corporate strategy.**

Seven Chapters of Strategic Wisdom

by Walter Kiechel III



As of October 2009, the Amazon.com category for business strategy featured more than 74,000 books. Confronted with this mass of material, the despairing reader of management literature who just wants the essence of what it takes to compete successfully might well ask how much of the accumulation is really necessary. In fact, most readers of strategy books would probably agree that these tomes would nearly all work better as articles of, say, 3,000 words.

Strategy itself is a distillation; it's a tight, internally coherent statement of what a company is and wants to be. It may take weeks of data gathering to get the plot points for charting a new corporate direction, and days of managerial deliberation to boil it down to a set of actions, but the statement itself ought to be no longer than a few sentences. An employee woken by flashlight at 2 a.m. and quizzed on the subject should be able to spell it out in a minute or two. If that's the ideal form, why should anyone require 400 pages to explain what a strategy is or how to create one?

In that spirit, what follows is a review of the best writing on strategy: not books, but seven of the best chapters from books related to the topic. None will tell you all you need to know to make great strategic decisions; that's impossible to summarize, for reasons that a couple of the chapters will explain. But taken together, the seven cover the major themes running through the modern conversation about corporate strategy, a conversation that got started only as recently as the 1960s. The first three chapters (by Alfred D. Chandler Jr., Kenneth Andrews, and Michael E. Porter) and perhaps the last (by Henry Mintzberg) might be considered canonical; any serious history of the discipline would probably include them. All seven serve up insights that every student of strategy, whether practi-

tioner or academic, should keep in mind. Amid all the seriousness are even a few witty surprises.

Structure and Self-definition

Alfred D. Chandler Jr.'s *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*, originally published by MIT Press in 1962, wasn't the first book to use the term *strategy* in connection with business, but it was the first to grapple with the concept in a way that informed much subsequent discussion. The book was a work of history, essentially about how four giant companies—DuPont; General Motors; Standard Oil of New Jersey; and Sears, Roebuck and Company—changed their organizational structures to meet the challenges of the early 20th century. In his introduction, effectively the book's first chapter, Chandler set out the key concepts that would emerge from his narrative.

The definition of strategy he provides will likely strike today's readers as massively ho-hum: "the determination of the basic long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals." You had to be there, in the torpid corporate mind-set of the 1950s and early 1960s, to appreciate what a departure Chandler's idea represented. Most companies felt themselves largely at the mercy of market forces, with little of the knowledge they would need to truly determine their own future. They might make a few plans, but they didn't have any framework for plotting the course of their growth using an integrated understanding of costs, customers, and competition.

The corporate histories Chandler recounted caught this note of passivity or, at least, inadvertence in establishing strategic direction. Strategies weren't the product of heroic, one-time decision making by top management; they grew instead out of a series of smaller, almost ad hoc decisions—decisions to enter a new territory to seek out new customers, or to respond to problems in a particular market by introducing a new product (see "*Professor Chandler's Revolution*," by Art Kleiner, page 114).

Chandler himself was more interested in the organizational aspect of his tale than in the strategic. His main conclusion, and the idea for which his book is principally remembered, is that "structure follows strategy." The lines of the organization chart, which may seem arbitrarily drawn, actually reflect the path laid out by

business decisions. As his four subject companies spread nationwide to serve the American market, for example, they were almost forced to organize themselves into relatively freestanding divisions, in which division heads had profit-and-loss responsibility for operations that integrated functions from production through sales.

In his book's introduction, Chandler was the first to lay out some of the themes that would later become recurrent, even gospel, as thinking about strategy evolved. A strategy is a response to changes in a business's environment, he wrote. It concerns itself with the long term, not so much the day-to-day. Responsibility for creating it lies with top management, or what Chandler quaintly called the company's "general office," as opposed to division or department headquarters. (Peter Drucker hadn't yet institutionalized the term *management* for either the function or the team doing it.) Chandler argued that there is a distinction between making strategy and implementing it, which is a distinction that still bedevils discussions of the subject. The historian also broached more subtle notions whose importance would become clear over time: that innovation is the driving engine for most successful strategies, and that strategy without structural change produces few gains in a company.

Although H. Igor Ansoff published his book *Corporate Strategy: An Analytic Approach to Business Policy for Growth and Expansion* (McGraw-Hill) in 1965, to my eyes the first work to organize itself entirely around the core idea is *The Concept of Corporate Strategy*, published in 1971 by Kenneth R. Andrews, a Harvard Business School professor. In its second, central chapter—which bears the same name as the book—Andrews made what we might think of as the grand existential claim for strategy, asserted in the conclusion to his definition of the term: A strategy is "the pattern of major objectives, purposes or goals and essential policies and plans for achieving those goals, stated in such a way as to define what business the company is in or is to be in and the kind of company it is or is to be." (That will be the last definition quoted in this review, I promise.) By the mid-1970s, thanks in large part to the efforts of the Boston Consulting Group (BCG)—a relentless publicity machine for strategy, which the firm had taken as its specialty—most businesspeople were familiar with the concept and the imperative for creating one, even if they didn't necessarily agree on what should go into it.

Besides proclaiming the big S as the central act of corporate self-definition,

Andrews recited a formidably long list of elements required for the package to be complete. To capture the “present and projected character of the organization,” a strategy should indicate the company’s choice of products, markets to be served, channels to reach those markets, means of financing the operation, and profit objectives—which could be stated in earnings per share or return on investment. His criteria for evaluating a strategy included a few whose good sense is made all the more striking by the degree to which some subsequent practitioners neglected them: Does your company have the resources, including the skills, it will need to carry out the grand scheme? Is the level of risk appropriate? Have you bothered to tell your people what you intend to do? Other criteria will impress financially hyperfocused types, including hard-core Milton Friedmanites, as outrageous: Does the strategy make the “desired level of contribution to society”? And does it fit with the “personal values and aspirations of key managers”?

The Competitive Position

To sensibilities hardened by the corporate wars of the last 30 years, one omission by Andrews and Chandler stands out: They barely mention competition. Ah, for the halcyon days, extending for a couple of decades after the end of the Second World War, when the biggest companies (most of which were American) didn’t have to worry about such annoyances. By the time Michael E. Porter published *Competitive Strategy: Techniques for Analyzing Industries and Competitors* in 1980, that world was gone. And a message that management consultants had been trying to hammer home for a decade or more had finally begun to penetrate even the most refractory corporate minds: The main point of crafting a strategy was to achieve competitive advantage.

“Generic Competitive Strategies,” the lyrically titled second chapter of Porter’s famous opus (now in its 60th-plus printing), is notable in at least three respects. For starters, as Porter admits, it’s the only chapter in the book that is actually about strategy. The rest all focus on teaching the reader how to analyze industries. And whereas Andrews had resolutely refused to be prescriptive—he declined to lay out examples of particular strategies that might suit companies in particular situations, and indeed didn’t seem to believe that identifiable strategic archetypes even existed—Porter was bracingly clear that you probably had only three alternatives.

First, you could pursue overall cost leadership, essentially aiming to be the low-cost producer in an industry. (As examples Porter cited Briggs & Stratton in small-horsepower electric engines and Lincoln Electric in arc-welding equipment.) This should also mean that you were a market-share leader, your size affording a cost advantage that smaller players were never likely to catch up with. Second, you could seek differentiation, turning out a product or service perceived as unique (Caterpillar Tractor in construction equipment). Third, you could choose to focus, concentrating all your efforts on a particular set of buyers, a geographic territory, or a product segment (Illinois Tool Works in specialty markets for fasteners). And woe betide the company “stuck in the middle,” as Porter put it; if you hadn’t achieved advantage in one of the three ways but persisted in combining a little of each, you would be headed for nothing but trouble.

Despite the fact that it’s a mere 13 pages long, Porter’s chapter 2 also provides what is in effect a handy recap of some concepts that had sparked interest in strategy over the preceding decade. For example, his cost-leadership option builds on the menacing logic of the experience curve, a construct advanced by BCG. The experience curve posited that any company’s overall costs would decline predictably the more it focused on one particular category of product. With the accumulated experience of turning it out, the capabilities of the company increased. The competitor with the most experience should thus be able to produce the best product at the lowest cost, which advantage it should be able to perpetuate by maintaining the largest market share and continuing to drive down the curve faster than its rivals.

An Emergent Backlash

Only two years after Porter’s book appeared, the modern strategy revolution had been under way long enough to provoke a backlash. *In Search of Excellence: Lessons from America’s Best-Run Companies*, published in 1982, is chiefly remembered today for its sales—around 6 million copies—a few management lessons (stick to your knitting, stay close to the customer), and the fact that in short order a hefty percentage of the best-run companies featured therein fell off their pedestals. (Where is the Data General, Digital Equipment, or Westinghouse of yesteryear?) But authors Thomas J. Peters and Robert H. Waterman Jr. also offered up one of the first powerful critiques of strategy as an exercise in numbers and charts, one

that neglected the human energies and aspirations necessary to make any business go.

Their second chapter, “The Rational Model,” pilloried the prevailing strategic approach for its simple-minded assumptions—that bigger was better, that low cost was a surefire winner, and that a manager’s job was to make decisions. More subtly, it enumerated the often pernicious effects of management’s retreating to what the authors described as “analytic ivory towers,” citadels of executive decision making isolated from the cut-and-thrust of everyday operations. A company that followed the then dominant model of strategy would end up focused almost entirely on costs, to the neglect of quality or value. Experimentation and its handmaiden, mistakes, would be discouraged.

Instead, *In Search of Excellence* pointed toward a different, more organic view of strategy, one that came to be known as “emergent”—in contrast to the “positionist” school. A positionist such as Porter (and of course we’re oversimplifying here, as any brief intellectual history must) believes that you should conduct a rational analysis, decide on the competitive position you wish to occupy, develop the strategy to get there, then execute.

Fat chance, counter those of the emergent persuasion. Unless you’re a startup, you begin with the hand that you’ve been dealt. You go from there, with all the existing strengths and weaknesses, setting off in a general direction. You run into reality—including markets, products, and competitors that don’t behave the way you expect them to, learn from your mistakes, make corrections, and “execute like hell” (as Jack Welch would later advise). In the process, your strategy emerges.

The 1980s were not kind to positionists. As deregulation and increasingly global competition spread the liberating effects of free markets, companies had greater difficulty holding the strategic ground they thought they had staked out for themselves. To maintain your existing competitive advantage, or, even better, to create a new one, you would have to build into your strategy the capacity to innovate: to make big bets on new products, services, even management processes that gave you an edge over competitors. In Richard N. Foster’s 1986 book, *Innovation: The Attacker’s Advantage*, this imperative was nicely tied in with one of the enduring intellectual legacies of the positionist school: the notion that behind many successful strategies is an exercise in pattern recognition.

Not experience curves this time, but rather S-curves. In the fourth chapter of

his book, “The S-Curve: A New Forecasting Tool,” Foster recounts how the progress of an emerging technology typically begins with a period of slow, grinding performance improvement—the flat bottom of the “S”—then takes off, shooting upward before finally leveling off into maturity. His examples include the rates at which artificial hearts improved and watches became thinner.

What gave Foster’s insight its strategic punch was his observation that such curves typically come in successive waves, with the performance curves of newer technologies starting higher up than the curves of previous technologies. Each new technology grows slowly at first, but eventually improves so rapidly that it puts its older rival technologies out of business. And most companies can’t jump from one curve to the next. Every strategist should have in her or his desk drawer a copy of Foster’s chart (admittedly, you have to go to chapter 5 to find it) that shows that the list of the top three companies in vacuum tubes (RCA, Sylvania, GE) bears no relation to the list of industry leaders in the next wave, transistors (Hughes, Transitron, Philco), which in turn looks nothing like the list of the companies that came to dominate semiconductors (TI, Motorola, Fairchild).

Paranoia Strikes

You’d better be an attacker, even if it means innovating to supplant your current technology. Just how difficult it is to pull this off, or to make any major change in strategic direction, is wonderfully captured in “Why Not Do It Ourselves?” the fifth chapter in Andrew S. Grove’s *Only the Paranoid Survive: How to Exploit the Crisis Points That Challenge Every Company*, published in 1996. Grove tells how in 1985 he and Gordon Moore realized that Intel, the company they led, needed to get out of the business on which it was founded, making semiconductor memory chips, to concentrate instead on microprocessors. The reaction they encountered as they navigated their company through this “strategic inflection point” won’t surprise anyone who has tried to effect change in an organization. “How can you even think of doing this?” came the chorus from the heads of the company’s memory-chip operations. “Look at all the nifty stuff we’ve got in the pipeline” (even if we are losing our collective shirt to low-cost Japanese competitors).

Grove and Moore persisted, even though the effort entailed shutting down plants, laying off thousands of employees, and giving up what many thought of as the company’s birthright. Intel’s subsequent success in microprocessors, begin-

ning with its celebrated “386” model, would soon make it the world’s largest semiconductor company. Read over the tale of what it took to get there if, in a delusional moment, you’re ever tempted to think that putting strategy into practice is easy, even a seemingly emergent strategy.

The emergent school did get one huge point exactly right: You can’t predict the future, no matter how many studies you amass or alternative scenarios you gin up. Critics have used this sad fact to bash the whole idea of strategy. Why should companies go to the trouble if the future isn’t going to turn out the way anyone expected? In this they miss a crucial distinction. Figuring out and having a strategy for your company isn’t the same thing as so-called strategic planning, which almost never works.

You need to know who your customers are, who you compete against, and how your costs and capabilities stack up against those of your rivals. (At the beginning of the strategy revolution, a surprising proportion of companies didn’t have much grasp of the last two.) Most important, you have to understand, the more viscerally the better, what your competitive advantage is and how it is to be tended and enlarged. Arriving at such an understanding is not the same as spending weeks each year concocting projections of what toaster sales will be in northwest Brazil three years hence. This is one reason firms such as BCG and Bain & Company vastly prefer to work with the line executive in charge rather than with the corporate planners who labor over such projections. Some pioneers of strategy consulting have told me with great pride that over the course of 30-year careers they never wrote, or helped write, a single strategic plan.

The Evolving Irrationalists

Should you or your company get the urge to write such a plan, merely consult chapter 5 (“Fundamental Fallacies of Strategic Planning”) of Henry Mintzberg’s *The Rise and Fall of Strategic Planning*, published in 1994. In it the Canadian scholar—author of half a dozen other books on strategy—recounts and demolishes the reasoning behind three fundamental fallacies of strategic planning. He starts with the fallacy of predetermination, describing why most forecasts are nonsense (they almost inevitably fall prey to unanticipated developments thrown at companies by the real world). He then proceeds to the fallacy of detachment: Why would anyone think that the people making strategy could or should be iso-

lated from the legions charged with carrying it out? Finally, as probably the head druid of the emergent school, Mintzberg beats up on the fallacy of formalization, the idea that any detached analytic process could capture all that needs to go into charting the corporate destiny. No planning drill, however rich, can capture all the intuitions and nuanced judgments of the experienced manager responding to ever-changing business reality. As a bonus, Mintzberg debunks the concept of “marketing myopia” as presented by economist and Harvard Business School professor Theodore Levitt. Thinking of yourself as a “transportation provider” rather than as a railroad company inevitably results in your taking your eye off the ball of what you need to run a good railroad.

For all the fun he has exposing the folly of planning, Mintzberg recognizes that a company must have a strategy, albeit a living, breathing, in-the-heads-of-everybody and ever-ready-to-be-modified version of the thing. How else, he asks, will it be ready to meet all the uncertainties that await it?

Writings on strategy continue to evolve as academics and practitioners seek to cope with new realities. Much of their effort centers on how to make a company’s people—their talents and connections—the basis for its strategy. Other thinkers, fascinated by how Linux grew up to pose a challenge to the likes of Microsoft, are trying to incorporate network analysis into their calculations. Probably the hottest term in discussions these days is *adaptive*—as in “How can we make sure our strategy continuously, indeed almost automatically, adapts itself to our changing circumstances?” Although it’s too early to know what will be the enduring chapters on these salients, nobody need worry that the great river of literature on strategy will dry up anytime soon. †

Reprint No. 10109

Resources

Alfred D. Chandler Jr., *Strategy and Structure: Chapters in the History of the American Industrial Enterprise* (MIT Press, 1962): Introduction

Kenneth R. Andrews, *The Concept of Corporate Strategy* (Dow Jones-Irwin, 1971): Chapter 2, “The Concept of Corporate Strategy”

Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (Free Press, 1980): Chapter 2, “Generic Competitive Strategies”

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Richard N. Foster, *Innovation: The Attacker’s Advantage* (Summit Books, 1986): Chapter 4, “The S-Curve: A New Forecasting Tool”

Andrew S. Grove, *Only the Paranoid Survive: How to Exploit the Crisis Points That Challenge Every Company* (Currency Doubleday, 1996): Chapter 5, “Why Not Do It Ourselves?”

Henry Mintzberg, *The Rise and Fall of Strategic Planning* (Free Press, 1994): Chapter 5, “Fundamental Fallacies of Strategic Planning”

Alfred D. Chandler Jr., who died in 2007 at the age of 88, was the United States' most eminent business historian. The Harvard Business School professor is still widely regarded as the man who legitimized business history through his groundbreaking teaching and writing during the 1960s and '70s. Outside the classroom, Chandler's work showed managers how industrial change and the interplay of large corporations underpin the modern business landscape. In his Pulitzer Prize–winning book, *The Visible Hand: The Managerial Revolution in American Business* (Belknap Press, 1977), Chandler traced the origin of business strategy and its influence on markets and industries: In his view, the “visible hand” of large corporations, with capabilities that outpaced those of smaller rivals, determined the viability of economies. But it wasn't until the last years of his life, with his final books on the electronics and pharmaceutical industries, that Chandler felt he had cracked the code of organizational success. In this profile from 2002, Chandler expounds on his idea of the “integrated learning base” and an array of other topics, from pre–World War II cartels to the modern problems of market dominance. Chandler was one of the true giants in his field, and his insights continue to guide and inspire managers today.

**To the world's most renowned
business historian, what you know
is more important than what you do.**

Professor Chandler's Revolution

by Art Kleiner



At home in a Cambridge, Mass., apartment overlooking the Charles River, Harvard Business School Professor Emeritus Alfred D. Chandler Jr., 83, is thinking about why some companies succeed, and others fail. The reason, he asserts, has to do with how companies learn and apply what they learn. Pressed for an example, Chandler starts talking about the global consumer electronics industry in the 1980s. His body, which is slight and trim, leans forward passionately. His eyes light up. His speech, which is ordinarily an elliptical mumble (albeit with a deep, South Carolina–flavored timbre), suddenly resonates crisply and energetically.

The story he tells represents a turning point for the industry—the moment, around 1982, when Japan’s Sony Corporation and the Dutch Koninklijke Philips Electronics NV were both flush with cash from their successful cointroduction of the compact disc. Sony’s next step, the Digital Video Disc (DVD), also invented with Philips, was a modest advance in the technology. But, on its own, Philips took a much bolder, technologically seductive risk, investing billions in creating and marketing the compact disc interactive (CD-i), a new multimedia accessory for television. If the compact disc could transform audio recordings and computers, the Philips engineers reasoned, couldn’t a similar device, with one global operating standard, finally satisfy TV watchers’ hunger for digital photographs, video on demand, computer games, and on-screen encyclopedias?

As Chandler tells the tale, the enthusiasm of the engineers blinded them to the realities of the marketplace. Twenty years ago, television watchers were content to be passive. They didn’t *want* the CD-i’s multimedia interactivity. Philips ultimately lost more than US\$3 billion on its gamble. “By 1990,” he says, “[Philips

is] so broke that they can't afford to pay a billion dollars to ramp up to meet the demand for CDs or to manufacture DVDs at all. So they license out the manufacturing to firms like Matsushita and Toshiba.”

This move effectively ceded control of CD and DVD manufacturing to Philips's Japanese rivals, who naturally—Chandler might say inevitably—used that advantage to undercut Philips. Soon after, the electronics business that Philips had spent decades building dwindled to almost nothing.

“It's extraordinary,” says America's most eminent business historian. “It's just a wonderful story.”

The Philips CD-i episode is one of several dozen stories recounted in *Inventing the Electronic Century: The Epic Story of the Consumer Electronics and Computer Industries*. In its pages, this man who still writes on a pad of paper and has never learned to use a computer explains exactly how the cutting-edge technologies of our time have mesmerized corporate leaders, leading some companies to grasp key opportunities and others to miss them entirely.

Among academic business historians, Chandler is regarded as the man who made the field a legitimate course of study at Harvard Business School (and elsewhere). “When he arrived in 1971,” says his Harvard colleague and fellow business historian Richard Tedlow, “there were 13 people taking business history. Now there are 1,300.” The famous Harvard Business School case studies existed before Chandler arrived, but by all accounts, he helped influence such prominent Harvard strategists as Kenneth Andrews to train MBAs to look beyond immediate market and competitor data to consider the long-term trends.

But the core of Chandler's work (and the reason he is most relevant to business managers) is his theories about industrial change and the interplay of large corporations that he has spent 60 years articulating. “Al's data,” says his Harvard Business School colleague Associate Professor Nancy Koehn, “isn't the kind you call up on an Internet site. In an age of just-in-time analysis, Al Chandler is about getting the story right. Everything he does as a historian legitimates the value of in-depth research, and the study of history, as a calling.”

Chandler is not just a mentor to business historians and the developer of one of the most far-reaching theories of business success; he is also our most prominent fan of big business. He follows the Fortune 500 the way some of his Bostonian neighbors follow the Patriots, Celtics, and Red Sox. His writing can be dense

and dry, like that of Fernand Braudel, the great French historian of economic daily life, with whom he is often compared. Chandler generally eschews stories of heroic personalities and instead writes meticulously about comparative economic performance—the impact of organizational decisions on production costs, throughput, and the larger economy. He is fascinated with the fate of corporate titans, from the Erie Railroad to Cisco Systems Inc., as they clash and compete, allying with and betraying each other, continually seeking to control their fields, and shifting the economic landscape around them through their battles and alliances.

Alfred D. Chandler Jr.'s 1977 book, *The Visible Hand: The Managerial Revolution in American Business*, was the first business title to win the Pulitzer Prize; it is only one component of a body of work (more than 25 volumes published over 45 years) that established the nature and influence of large corporations in the modern economy. “He’s the Boswell of American capitalism,” says management writer Andrea Gabor, who devoted half a chapter to him in *The Capitalist Philosophers: The Geniuses of Modern Business—Their Lives, Times, and Ideas*, her survey of management thought.

Integrated Learning Bases

Chandler’s central idea about industrial change is unveiled gradually in each of his books, taking its fullest form to date in *Inventing the Electronic Century*, which is the first of a two-volume set, to be titled *Paths of Learning*. (The second volume, due out next year, will chronicle the chemicals and pharmaceutical industries.) Success, Chandler argues, comes to companies that cultivate an “integrated learning base,” as he calls it: the capabilities needed to lead in a particular business niche. “The key theme for any business,” he says, “is learning its boundaries: relating the firm, the markets, and the technology to your particular strengths.”

The theory helps to explain why Philips experienced its tribulations with CD-i, while the Sony Corporation recovered not just from the Betamax debacle, but also from a devastating investment in Columbia Pictures. As Chandler writes in *Inventing the Electronic Century*, Sony set the pattern for its success back in the 1950s, when it “commercialized Japan’s first audiotape recorder and became the world’s first-mover in miniaturization technologies.” Sony kept its early lead by continually expanding those miniaturization and marketing capabilities—to in-

egrated circuits and the Trinitron color TV tube in the 1960s, the Walkman in the 1970s, and a variety of disc formats in the 1970s and 1980s. As its reach and resources increased, Sony kept investing in corollary technologies, like plastics, adhesives, components, and picture tubes, which allowed it to build on past success. One by one, its competitors were downed, until, by the mid-1990s, Sony (along with the Sharp Electronics Corporation and the Sanyo Corporation on a smaller scale) became “the chief—indeed, the only—architects of the evolving consumer electronics path in the new Electronic Century.”

An integrated learning base is not just core competence. Sony, for example, maintained the center of a network of Japanese production plants, testing laboratories, components developers, and suppliers “all within a three-hour train ride,” close enough to continually experiment and learn from each other. An integrated learning base does not center on mastering technology; the Swiss company Novartis AG, currently dominant in biotechnology, developed its base in part through a merger of two major players (Ciba-Geigy and Sandoz) and the subsequent spinning off of its old-line chemical enterprises to concentrate on biotechnology. Each line of business has its own unique puzzle to solve—its own combination of technological challenge, market profile, and distribution patterns to decode and manage. An effective management style for consumer electronics, which requires miniaturization and the right choice of software platform, will not necessarily fit a chemical company trying to choose whether to produce low-margin commodity polymers or high-risk genetically engineered pharmaceuticals.

A company that masters its integrated learning base has an almost natural ability to monopolize its niche. To Chandler, that explains why companies like IBM, McDonald’s, Procter & Gamble, Microsoft, and DuPont stay dominant for decades. “That base, for those who get there first, becomes the barrier to entry for competitors,” he says. This natural tendency toward oligopoly appears as *keiretsu* in Japan, cartels in pre-World War II Europe, and “megamergers” in the U.S., with local variations stemming from differences in antitrust laws.

In the Chandler world view, it’s inevitable not just that large companies get larger, but also that they become more beneficial to society. Their learning base represents the source of the accelerated industrial creativity of our times, from Thomas Edison’s laboratories (which became General Electric Company’s) to the research labs at companies like the Intel Corporation and the Nokia Corporation

today. The real tragedies, to Chandler, are not the monopolies, but the break-ups and breakdowns. AT&T, pressured by the Justice Department, destroyed the learning base of the U.S. telephone system when it separated Bell Labs from the Baby Bells. RCA, pressured by Wall Street, squandered its learning base when it tried to enter the computer business. “They heard about stars and cash cows, and thought they were supposed to be a conglomerate,” says Chandler. “So they bought unrelated businesses, including Hertz and some food manufacturers, to get the money to push into computers. But RCA didn’t know how to run these companies. By 1985, they were all destroyed or spun off, and RCA, it was gone.”

Some might argue that such views are outmoded in the Internet-driven New Economy. After all, when the boundaries between organizations break down, it becomes increasingly difficult to corner the market on skills and capabilities. But to Chandler, the New Economy started not with the Internet, but with the railroads. Business is still adjusting to that transition, the one that started 160 years ago; until we understand its imperatives, we won’t succeed in any economy.

A Born Storyteller

The industrial transition from 1840 to now is, perhaps, the Great Epic of our time, and a story that, in an almost literal sense, Alfred Chandler was born to tell. Professor Chandler came from a patrician family in the du Pont country of Delaware. His maternal great-grandmother was raised in the du Pont family after her parents died of yellow fever. His maternal grandfather was chief engineer of the E. I. Du Pont de Nemours chemical company from 1903 to 1916. (The “D.” in Al Chandler’s name stands for DuPont). He is a former Harvard sailing teammate of John F. Kennedy’s; indeed, he comes from a family of passionate sailors. In the 1930s, his father took the entire family on a yearlong sail on the route of Charles Darwin to the Galápagos Islands. He is part of a large, close family full of fascinating people in their own right. His wife, Fay Chandler, is a sculptor; one of his sons (Alfred) is a documentary filmmaker. His sisters are Harvard child psychologist Nina Murray and Sophie Consagra, a former director and president of the American Academy in Rome, a distinguished classics and fine arts institute.

According to family legend, Alfred Chandler had announced his decision to become a historian by age 6; by his teens, he had already developed his analytical curiosity. “I asked Alfred once,” recalls his sister Sophie, “why in all northern

Delaware, with all this money, there wasn't one good painting on anyone's wall. 'That's easy,' he said. 'J.P. Morgan and the other American industrialists all have their headquarters in New York. They compete for the best paintings; the DuPont headquarters is isolated in Delaware, without any peers to compete with.' That was typical of the way he thought, even when we were children."

From the standpoint of the Great Epic, however, his most important relative was someone he never met. In 1945, after five years in the Navy, Alfred returned to graduate school at Harvard at age 26 with a wife, three small children, and a graduate study stipend. That year, an elderly great-aunt who lived in the Boston suburb of Brookline died. The Chandlers moved into her Brookline home, where Alfred discovered, in a storeroom, a collection of old papers belonging to his great-grandfather Henry Varnum Poor, the original Poor of Standard & Poor's. Mr. Poor was the first modern industry analyst; for 30 years, he gathered comparative data on the expansion of American railroads, which were more complex in their mix of new technologies, customers, rates, and multiple divisions than any business that had existed before. As Chandler later noted, he was writing "the *Wall Street Journal* of his day. His major customers became investors, so you watch the beginnings of modern management, modern finance, modern labor relations, modern accounting. They all came out of the railroads."

Fortunately for the young Alfred Chandler, there was a small institute at Harvard Business School where such issues could be discussed, and where he was welcomed as a research associate. The Research Center in Entrepreneurial History had been founded by Joseph Schumpeter, the economist who championed innovation and entrepreneurship as the drivers of capitalist prosperity. "Schumpeter had been dead for a few years," recalls Peter Mathias, an Oxford University historian and longtime friend of Chandler. "But the atmosphere was such that he might have just gone out to tea and would reappear at any moment." Al Chandler became immersed in debates about, for instance, why there had been an 18th-century industrial revolution in Britain, but not in France. This set the tone for his own interest in large corporations: not as villainous trusts or economic saviors, but as creative forces that were shaping the economy in ways most people did not recognize.

Over the next 30 years, he produced a series of books on this theme. He based them first on the records of his great-grandfather, and then on corporate papers

from DuPont (where family connections helped him gain access, and where he researched a biography of early-20th-century CEO Pierre du Pont) and other large companies. Three books in particular were groundbreaking. First, in 1962's *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*, he described four large managerial corporations: General Motors, Standard Oil, DuPont, and Sears, Roebuck and Company. In all four companies, he argued, the multidivisional line-and-staff form was not an arbitrary copy of the military. It was an inevitable, natural response to the unprecedented complexity of the business. For example, GM naturally succeeded with its strategy of different cars for every price range, and that, in turn, dictated the company's structure.

The Visible Hand described how a century ago customers suddenly found goods more plentiful and cheap than they had ever been. The book showed the dramatic impact the railroads had on the modern economy. Although the transition started in the 1840s, its most visible changes occurred between 1880 and 1920. Mass manufacturers of everything from typewriters to canned goods learned to bypass or swallow up the networks of jobbers, factors, merchants, and other independent middlemen who had controlled the flow of commerce throughout history. One of the fascinating aspects of *The Visible Hand* is the examination of how innovation in distribution and marketing preceded production. For example, the United Fruit Company started in the 1890s not with banana plantations, but with a refrigerated transportation network, modeled after those of meat packers, that kept fruit fresh. American Tobacco, Diamond Match, the National Biscuit Company, and Quaker Oats all built marketing networks (and networks of purchasers of farming goods) and then used the profits from sales to finance their new production. They rarely needed outside financing.

The Visible Hand was also a direct attack (signaled by the title) on Adam Smith's primary notion of a marketplace controlled by no one, but operating for the betterment of all. Chandler didn't argue that Smith was wrong, but that he was outdated. A global mass market had emerged. In this environment, large corporations had capabilities that smaller, upstart competitors couldn't match; the visible hand of the large corporation had replaced the invisible hand of the market. This heresy may have cost Alfred Chandler a Nobel Prize in economics, or so Peter Mathias believes. (In 1993, when the prize was preannounced as focused on economic history, Chandler was nominated; but it went to Douglass North and

Robert T. Fogel.)

In the final book of his trilogy, 1990's *Scale and Scope: The Dynamics of Industrial Capitalism*, Chandler proposed that the same type of evolution took place around the world and was thus an innate feature of capitalism, instead of being some kind of aberration unique to America. Borrowing the phrases of first-mover advantage from economics, he proposed that barriers to entry in a business stem not just from the dominant first mover's economies of scale, but also from its economies of scope—the expansion of production capabilities to reach several markets at once, usually by capitalizing on already existing knowledge. International Harvester (IH) trounced Ford in the tractor business in 1928, even though Ford was a far more efficient manufacturer. The reason? IH knew, from its plow and spreader business, how to sell to farmers, and Ford did not.

In the perennial war for legitimacy between professional managers and investors, all this puts Chandler firmly on the side of managers, particularly those steeped in production. He dismisses the argument that financial raiders improved corporate performance in the 1980s by forcing managers to break up (or merge) their companies. The ebb and flow of financial markets, in Chandler's story, is mere froth on the surface of the fundamental force of real-world technology and production, especially in the hands of the largest mass-market corporations. "He has never paid a lot of attention to banks," notes fellow economic historian Richard John of the University of Illinois at Chicago. Chandler also pooh-poohs the idea that we are moving toward a decentralized, entrepreneurial economy. "If the U.S. thinks it is going to regain global competitiveness through small businesses," he told *Forbes* in 1989, "it is fooling itself."

The Fates Step In

There is a curious passage toward the end of *Inventing the Electronic Century* when Alfred D. Chandler Jr. the analytical researcher steps aside and the epic business fan steps in. "In Greek drama," he writes, "the gods set the stage for human action but the Fates often intervened to change the course of events." And then he singles out several moments of fate in the history of electronics, moments when destiny seemingly took a hand, with unpredictable consequences and "extraordinary" drama.

For example: In 1982, just as Philips was investing in the CD-i and doom-

ing itself, IBM chose to release a new personal computer, licensing the processor and software production to two unknown firms called Intel and Microsoft. That simple act conferred immense first-mover advantage on both companies—a chance event from which Microsoft, in particular, has never looked back. Or in 1958, the U.S. Justice Department settled an antitrust suit with RCA by agreeing that only foreign companies would have to pay full price for the firm's electronics patents. This gave RCA a dramatic incentive to license technology outside the U.S., “force-feeding” (as Chandler put it) “the maturing of Japan's and Europe's color television sectors.”

Chandler doesn't say what specific integrated learning paths would, in his view, be most useful in the near future. “I'm a historian,” he says, “and historians don't predict.”

And yet the sense of forces that cannot be resisted runs throughout the body of his narratives. For example, biotechnology, consumer electronics, and the computer/Internet, in Chandler's view, all represent innovations that could shape the pattern of corporate triumphs and failures as profoundly as the railroad did. But that doesn't mean that these innovations, like the railroad, will put industrial society through a sweeping infrastructure transition that changes the fundamental economic game. These new industries are still subject to the same forces of business reality, the same first-mover advantage and scale-and-scope economies, that shaped chemicals, automobiles, and steel.

Biotechnology, still in its infancy, already has two clear favorites for first-mover advantage. They are both Swiss companies, based in Basel, with long-standing American operations: Novartis and Roche Group (operating in the U.S. for more than a century as Hoffman-LaRoche). Both firms gained their advantage in part by acquiring pioneering American biotech research firms, Chiron and Genentech, respectively. If they succeed, they may be impossible to dislodge. Novartis and Roche “seem to understand that time is moving quickly, and this is their opportunity,” says Chandler. Their ascent—and its contrast with older-line chemicals companies like DuPont and Dow Chemical Company—will be the subject of his next book.

Chandler agrees that the Internet is a “game-changing” new infrastructure—a source of sweeping changes in the pattern and flow of goods, services, and industrial relationships. But so is the barcode reader. (“The barcode,” says Chandler,

“was as much a revolution as the post office.”) Like the railroads, the Internet was spurred by government investment, but depended for its growth on privately created technology—in this case, the personal computer, the server, and software. If it follows the same pattern as the railroads, then the Internet will continue to foster a volatile investment market, and it will continue to be seen as a “level playing field” promoting diversity and small enterprise. But in the end, the Internet will also make it far easier for a handful of first movers to dominate their channels.

The Next Epic

What kind of strategy does the Chandler epic suggest in this business environment? The lasting companies will be those that act now, as Sony did in 1950 or Microsoft did in 1980. Focus on some key set of capabilities—miniaturization or operating-system software—that interests you and that fits the larger trends you see. Cultivate your capabilities and relationships. Rather than looking for investment capital, look for opportunities to grow your business from revenues, learning ever more about your customers and distributors in the process. Respect the value of “tacit knowledge”—the profound understanding of the business that pops up in corridor talk and informal email—rather than formal policies and procedures. (“I haven’t spelled that out in my books,” says Chandler. “And I should.”)

Don’t be tempted into mergers, like the proposed Hewlett-Packard–Compaq merger, for primarily financial reasons. (“These rarely work in high-tech industries,” snorts Chandler.) Above all else, resist cutting back R&D for your core businesses, because the development of a high-quality research operation is a clear way to build your own learning path.

This is a hard message to hear, at least for those of us who see ourselves as facing a world of infinite possibilities, where we can do anything we set our minds to. Chandler’s work, even down to the book titles—*The Visible Hand*, *Scale and Scope*—suggests that we are not nearly as free to act as we think we are. This is the kind of world view that you would expect from someone who has spent his life racing sailboats and studying business. We live in a world of continually shifting winds and currents. We cannot go against them, nor can we predict their direction and force. But we can learn to catch them in our sails; and if we are lucky enough to be the first to catch one of them, we can move so far out in front that no one else will come close. At least until the wind shifts. +

The Long View of the Short Run

Alfred D. Chandler Jr. on the economic issues of the moment.

The Microsoft Antitrust Suit. “The reason there was a lawsuit at all goes back to the original franchise that IBM granted Microsoft in 1982 for the IBM PC software. This generated the highest economies of scale and scope in the history of business. It was Microsoft’s lucky break, and they played it brilliantly. Today, they can undersell anybody. Gates was a master at using his products to improve each other and drive out competitors.

“Compared to the breakup of AT&T, breaking up Microsoft would not be a tragedy, but the question is how to do it. How can the government mandate an agreement to create competing operating systems? The only way is for someone else to develop an operating system that competes with Windows, and the only real candidate is Unix. It’s inevitable that Apple would adopt Unix. They should have done it 10 years ago.”

Enron. “This is a double whammy—the Internet bubble collapse and the scandals. The last time that sort of combination occurred was 1929. On the surface, the economy was booming; two years later, in 1931–32, the unemployment rate was 25 percent. That was the only time in the 20th century when there were net losses of \$2 billion to \$3 billion in market capitalization. Why did it happen then? Because of the scandals: The head of the stock exchange went to Sing Sing. That can happen again, and I think it may. One major weakness at Enron was a board of directors composed exclusively of outside people.”

Japan’s Economic Problems. “Japan’s long recession reminds me of America after 1929. We never recovered until World War II, and I see Japan in the same boat. Their situation may even be worse because their market is Europe and the United States. They don’t have a home market. The most successful Japanese electronics companies, like Sony, are focused on customers in the U.S. and Europe.”

The Chemicals Industry. “Outside of biotechnology, I don’t see a new technology coming along to transform the industry. All but two of the top 50 chemicals companies were established by the 1920s. The technology hasn’t changed much since the

1950s, with the coming of polymers and the petrochemicals revolution. Today, the biggest firms are almost all moving into pharmaceuticals. Out of seven major U.S. chemicals companies in 1970, only DuPont and Dow are left.”

Resources

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What could you do with a blank check? That's what the managers of Kraft Foods asked their Tang division colleagues in an effort to kick-start the global sales of one of their iconic, but flagging, brands. Given no budget constraints and limited only by their own imagination, the Tang team created several new products aimed at emerging markets—like a mango drink for the Philippines—and tailored their marketing efforts to specific cultures, doubling their global sales in five years. As this case illustrates, having a blank check doesn't mean being fiscally irresponsible or setting unachievable goals. Instead, blank checks can provide the freedom to identify new opportunities, break the mold, and innovate broadly. This article spells out the questions companies should ask themselves before writing a blank check—and why they should consider it in the first place.

**How an unusual management technique
inspires business teams to envision—
and achieve—breakthrough results.**

Blank Checks:

Unleashing the Potential of People and Businesses

by Sanjay Khosla and Mohanbir Sawhney



In 2007, Kraft Foods Inc. was facing a major challenge with Tang—the powdered breakfast drink that had long been one of its iconic brands, made famous in the 1960s when the National Aeronautics and Space Administration included the drink in the rations for U.S. astronauts. The brand was caught in a cycle of underperformance—a situation that commonly bedevils companies as they seek to drive organic growth. In 2007, the leadership team of Kraft’s developing markets identified Tang as one of their top 10 focus brands, and came up with an unusual strategy for boosting the brand’s sales back into the stratosphere: Tang leaders in key countries such as Brazil were given a “blank check,” essentially urging them to dream big and not worry about resources. The results have been astounding. Since then, Tang has doubled sales outside the U.S. and become a profitable, US\$1 billion brand there (in comparison, it had taken Tang 50 years to reach the \$500 million revenue mark). The transformation of brands like Tang helped grow Kraft Foods’ developing markets business from \$6 billion in revenues in 2007 to more than \$15 billion in 2011, significantly improving margins.

The secret of Tang’s turnaround was to free the team from resource constraints that could limit their imagination, inspiring them to achieve unprecedented results that would create a virtuous cycle of growth. This, of course, ran counter to one of the gospel truths in management, that people need to live within their means. Managers have always been taught that they have to work with the limited resources available. Unfortunately, resource constraints limit more than plans. They also limit the creative potential of people.

What if resources were not a constraint? If managers were free to dream and act big without worrying about busting their budgets, they would be limited not

by resources, but by their imagination. We believe that business leaders can unleash tremendous untapped potential by unshackling their people and their businesses from resource constraints (while still, of course, holding them accountable for results). The key insight is that business leaders, instead of defining budgets and resources, should focus on defining ambitious goals, while leaving it to their managers and their teams to ask for whatever resources they need to achieve these goals. When teams decide their own budgets, they act as owners and are inspired to achieve the impossible. At Kraft Foods (where coauthor Sanjay Khosla is president of the developing markets group), we call this idea a “blank check” initiative.

The Concept of a Blank Check

A *blank check* is a metaphor for the freedom a team is given to determine for themselves the financial resources they need to achieve a set of agreed-upon goals within a defined time frame. Blank checks exhort teams to “shoot for the moon,” while giving them the rocket fuel they need to break free of the gravitational pull of predetermined budgets and business as usual. However, blank checks are not a license to spend without limits, without guidelines, or without consequences. Teams have to define the resources they need—they must fill in the amount of the blank check. Every blank check initiative needs to be consistent with the company’s overall business strategy. And it needs to have the potential to produce sustained, profitable growth (see “*Driving the Virtuous Cycle of Growth*,” page 137). Blank checks are not meant to produce “one-hit wonders” that bring a short-term spike in results. The idea of the blank check is to empower big ideas that drive a virtuous cycle and change the business’s trajectory for the long term.

Moreover, teams that sign up for blank checks are held strictly accountable for quantifiable results. Blank checks represent freedom within a framework—freedom to act, but with a set of ground rules to ensure that the initiatives stay on strategy and produce results. For example, the framework might include a set of company priorities or areas of focus, innovation platforms, big bets, or even an acquisition strategy that guides the company’s overall strategy or vision. At Kraft Foods, for example, the company’s developing markets business has a focused growth strategy that concentrates on five key categories (e.g., biscuits and chocolate), 10 power brands (e.g., Oreo, Tang, Trident, and Cadbury), and 10 priority markets (e.g., Brazil, India, and China); the strategy is called 5-10-10 (see “*Growth*

The first step in a blank check initiative is for the business leaders to choose the business domains that should be targeted for growth.

through Focus: A Blueprint for Driving Profitable Expansion,” by Sanjay Khosla and Mohanbir Sawhney, s+b, Autumn 2010). The company uses this strategy as its framework, and gives freedom to select teams in the organization to drive the 5-10-10 growth agenda with blank checks.

How Blank Checks Work

To put the blank check idea to work, business leaders need to go through a systematic process of picking the best bets, selecting the team, defining goals and plans, kicking off the initiative, and monitoring the results. Here’s what happens at each of these five steps.

1. Picking the best bets. The first step in a blank check initiative is for the business leaders to choose the business domains that should be targeted for growth. Blank checks are designed to fund big bets, so it is important that the bets are chosen carefully. Business domains can be defined in different ways or viewed through different lenses—a geographic market (China, for example), a brand (Tang), a channel (food service), a category (beverages), or a consumer segment (teenagers). The domain can also be a combination of these (Oreos in China). Blank checks can be applied to functional areas, such as the supply chain or manufacturing. We recommend selecting two or three definitions for the domain, at most, and using these definitions to shape the larger strategic context within which to look for blank check projects. The objective is for the initiative to be performance-driven and values-led, as well as compliant with federal and local laws and the company’s compliance practices.

As the business leaders choose the domains for the blank check initiatives, they

need to keep three criteria in mind. At Kraft developing markets, we call these “the three Ms.” First, the business should ideally have significant Momentum. It is always easier to build on a business domain that is working well than to fix a domain that is broken. A key success factor is to “mine for gold”—to identify what is working and then scale up quickly when the reasons for success become evident. A second key success factor for driving a virtuous cycle of growth is Margin potential in the business. Growth for the sake of growth is often dangerous. Third, the business initiative should be Material—something that produces high impact with the least possible effort. There should be sufficient headroom for the business to grow.

2. Selecting the team. Blank checks are ultimately bets on people, rooted in the faith that they have the potential, the passion, and the perseverance to transform their businesses. Selecting the recipient of a blank check begins with the top leadership team working closely with the leader of a given business to identify the person who is most naturally accountable for a certain area of the business where the blank check can ignite transformation. Team leaders selected for blank check initiatives need not be the most senior or the most experienced—more important is for them to be the people with the most potential. But that is just the initial criterion.

The business leaders must ask themselves a series of questions about the blank check candidate. Is this person a natural choice for the challenge based on his or her current responsibilities and span of control? Will this person be willing to take on the responsibility and not be frozen by fear? Is this person capable of being stretched to think in new ways? Does this person have the capacity to inspire others to do things differently? Does this person have a track record of delivering results? If the answer to any of these questions is no, then the business leaders must consider alternative candidates. And if one cannot be identified, leaders may determine that the area of the business they were targeting is not appropriate for a blank check.

3. Defining goals and plans. Once the business leaders have selected a business domain and chosen the team leaders who will receive a blank check, they need to define the targets they expect the teams to achieve. Targets need to be quantified, aggressive, and time-bound. Quantified targets are unambiguous, so everyone clearly understands the nature and goals of the game. Targets should be measurable on well-defined metrics like revenues, gross margins, and cash flow

from the business. Targets also need to be aggressive, to the point that they should not be achievable simply by making incremental improvements. Teams should be forced to question all their assumptions about their business and to confront orthodoxies that have been blindly accepted by the company. Blank check initiatives also need to have a short time frame, limited to a few years at most. It is absolutely essential to have a clearly defined set of goals for the first 12 months. The short time frame forces the team members to produce results quickly. They do not have the luxury of pursuing marginal improvements or initiatives that will take a long time to produce results.

At this stage, the team leaders are asked to submit a short business proposal (no more than two pages) that reflects the “three Ms.” The time given to the team to develop the proposal is relatively short. This prevents the team from becoming paralyzed by overanalysis. In some cases, the team may take up to a month to produce a proposal so they can weigh the alternatives in order to ensure they are making prudent business decisions that will nonetheless change the business’s trajectory. In a few cases, the team will decide to turn down the blank check. This is fine, because undertaking a blank check initiative must always be voluntary.

The business proposal needs to define the initiative and the key steps that the team will take to produce the agreed-upon results. This includes the goals, the time frame in which the goals will be achieved, steps detailing how the plan will be executed, key milestones and deliverables, and financial projections. At the early proposal stage, the initial execution steps may be outlined, but the full project need not be fully fleshed out.

Along with the proposal, the team also must fill in the amount of the blank check—the financial outlay that they are asking for. The amounts of the blank checks we have been associated with have ranged from a few million dollars to \$20 million. The amount should be more than enough for the team to carry out the initiative without worrying about running out of money to invest.

4. Kicking off the initiative. Once the business plan has been agreed upon, business leaders need to formally “issue the check” by approving the amount the team has asked for and transferring it into an account that can be accessed by the team leaders.

The typical first reaction to a blank check challenge is skepticism. People in corporate settings have been conditioned to fight for every resource. They have

been trained to think in terms of budgets, cost cutting, and belt tightening. They have likely never been in a situation in which they can ask for unlimited resources, and may find the idea so foreign that it is difficult for them to believe it at first. Once the team realizes that their business leaders are serious, skepticism can easily give way to fear—fear of failure and fear of being in the spotlight. Fear is often followed by frenetic activity, when the team tends to focus on doing more of the same or doing the same things better. But the team quickly realizes that this linear and extrapolative thinking will not produce the breakthrough results that they need to achieve. This, in turn, leads the team to powerful insights because they are forced to focus on the essence of the business, the brands, and the market.

5. Monitoring results. As the blank check initiative begins, it is important to set milestones for key deliverables, and then to monitor them closely as the initiative proceeds. We recommend quarterly milestones, so that course corrections can be made quickly. As is true of a company's startup phase, blank check initiatives rarely go according to plan. The team will run experiments and take risks, and some of these experiments will inevitably fail. Failing is part of the learning process. What is important is to fail early, fail cheaply, and learn fast from the failures. Metrics for blank check initiatives should be kept simple enough so that progress can be measured on a single-page report.

How Blank Checks Drive Growth

To see how blank check initiatives work in practice and the results they can produce, consider the following three case studies. They all describe recent Kraft initiatives in developing markets: The acceleration of the Cadbury business in India, the revitalization of the Tang powdered beverage business, and the transformation of Kraft's China business.

Cadbury India's sweet success. When Kraft Foods acquired Cadbury in February 2010, India became one of the 10 priority markets for Kraft. It had taken Cadbury more than 40 years to grow the business to \$400 million by 2009. During one of management's first visits with the regional team in February 2010, the leadership team offered Anand Kripalu, president of Kraft South Asia and Indo China, a blank check to make India a half-billion-dollar business by the end of the year—which meant accelerating the region's growth plans for the year and increasing total sales by 25 percent. The Indian management team's proposal

called for expanding distribution, investing in sales, and increasing the marketing behind Cadbury Dairy Milk, Cadbury's biggest brand in India. The team based these choices on their conviction that Cadbury Dairy Milk had momentum, offered attractive margins, and was material because it was the most important part of Cadbury's Indian business.

"We turned around the proposal in just a few short days," says Kripalu. "It was quickly approved, and the next day we shared our new \$500 million target with our employees. At first, people thought we had lost our minds. But soon that fear turned to inspiration, once employees realized that we'd been given the freedom and resources to take our business to a new level."

The team took the challenge and ran with it, innovating on several dimensions. When they evaluated distribution channels, for example, the team observed that in some retail outlets, Cadbury Dairy Milk was stored and displayed in "visicoolers"—special display cases that give Cadbury visibility at the retail location and keep the chocolate from melting in the oppressive Indian summer heat. The outlets that had visicoolers generated sales that were 15 percent higher than those at comparable outlets. On the principle of leveraging what works, the team decided to double the number of locations with visicoolers, from 20,000 to 40,000 retail outlets. They also doubled permanent in-store displays for Cadbury Dairy Milk, from 5,000 to 10,000. They expanded distribution into 2,100 additional towns and villages—bringing the total number of sales outlets to 550,000 in India—and increased investment in Cadbury Dairy Milk advertising and promotions by 45 percent.

The team also looked beyond chocolate with the "Kuch Meetha Ho Jaye!" (Let's have something sweet!) campaign, tapping into the Indian tradition of having a sweet bite before life's most important moments. The idea was to expand the franchise into a larger market of sweets rather than just focusing on chocolate.

The results were transformational. In 2010, Cadbury India had its best year ever, with almost 28 percent revenue growth—doubling its original growth targets and exceeding the \$500 million blank check target. The momentum continued in 2011 with more than 30 percent growth. The best part? The team did not end up spending all the money they had asked for, and returned a significant portion of their blank check allocation.

Doubling the Tang business in five years. The developing markets leadership team decided to issue blank checks to a team of Tang leaders in key global markets, asking that they connect locally with consumers in their market, but leverage the resources of the \$50 billion global Kraft Foods organization.

The team came up with several innovations quickly. Using Kraft's global technology resources, they developed locally relevant flavors for Tang such as tamarind and horchata (a traditional drink flavored with lime and cinnamon) in Mexico, mango in the Philippines, passionfruit and soursop (a local fruit) in Brazil, and pineapple and lemon mint in the Middle East. Although Tang's original orange flavor tops the sales charts worldwide, these local flavors soon made up about 25 percent of Tang sales in developing markets.

With the realization that taste is king and children's diets in developing markets are often deficient in nutrients, the team repositioned Tang as an affordable (pennies per glass), nutritious beverage fortified with vitamins and minerals. True to Tang's heritage as a source of vitamin C, the team took the global idea of fortification and localized it to meet regional nutrition needs. For example, they fortified Tang with vitamin C in all geographies, but in Brazil and the Philippines, where children often are iron deficient, they added iron as well as other vitamins and minerals.

The team also crafted a marketing idea for Tang to create a kids' movement involving sustainability called the "Preparou, Bebeu, Faz" (Prep, Drink, Do) campaign. Tang is a very green brand—it takes less energy to produce and transport than other beverages because the water is added by the consumer—so the new campaign built upon the brand's green equity. The team standardized the pouch size and structure across Latin America to reduce 3 million pounds of packaging annually. They took this green idea to places like Brazil and encouraged children to recycle. More than 90,000 kids recycled more than a million packages in Brazil within the first few years. The used packages are recycled into soccer balls, bags, and building materials whose sale raises money for schools. This kids' movement has been expanded to other markets, including Argentina and Mexico.

Inspired by the blank check, the Tang team used local innovation and global technology resources and a collaborative approach to achieve phenomenal results. Tang is Kraft's newest billion-dollar brand. Its sales have almost doubled in five years, and it is now more than three times the size of its nearest competitor. In

2011, Tang was served 20 billion times in 90 countries.

“Having a blank check for Tang allowed us to think differently about this brand,” says Gustavo Abelenda, president of Kraft Latin America. “Our small, virtually connected team had the freedom to develop a global framework for the brand, quickly scale up local innovations, and use global technology to drive explosive growth.”

The Tang case illustrates several insights about blank checks. The aggressive targets forced the team to realize that the strategy they had in place at the time, creating new variants of Tang, would not be enough. They also realized, as teams frequently do when taking on a blank check challenge, that they did not have all the answers. They reached out to different types of outsiders, including packaging experts, supply chain experts, and marketing and advertising agencies. They held workshops to discover the essence of the brand, what was different and special about Tang. The packaging experts pointed them to the patented Boato machine from Italy that could mass-produce single-serving sachets of Tang. The team also discovered Tang’s core asset: It tastes better than water, and it is environmentally more sustainable and cheaper than carbonated beverages. This led the team to broaden the positioning of Tang by setting it up to compete against water rather than other powdered beverages. The team decided to “attack water” with the brand positioning “Tang makes water exciting.”

Breaking the mold in China. The Tang example was focused on brand success, but the blank check approach can also transform an entire business. Kraft Foods China shows how this can happen. Early on in its experience in China (beginning in 1984), Kraft had aspired to make Kraft Foods China a \$1 billion business—to match the 1 billion people in the country. But by 2006, the company’s China business was still very small, about \$100 million in annual revenues. And worse, it was plagued by low gross margins; growth for the sake of growth was a waste of time because there was no hope of making money. There seemed to be no point in scaling up something that was not working. It was time to take the way the company did business in China and flip it on its head—and a blank check initiative was the catalyst for that change.

“We knew that Lorna Davis, who was China’s new business leader, and Shawn Warren from our region office, who knew our categories and brands well, would make the perfect pair to lead this transformational initiative,” recalls Pradeep

Pant, president of Kraft Asia Pacific. “Both had the drive, the creativity, and an inspiring leadership style to make it happen.”

With a blank check in hand, Davis and Warren rose to the challenge. In eight weeks, the team came back with what many would consider a risky proposal that seemingly defied logic. Instead of continuing to pour money into the business to chase after unprofitable growth, the team proposed a counterintuitive approach to scale back the business they were trying to expand. “The business was stuck in a vicious cycle,” recalls Davis, who is now senior vice president in the company’s global biscuits category, “and we knew that expanding our current business model was not going to work. The principle of giving trust and support to the local

Driving the Virtuous Cycle of Growth

Although blank checks are designed to create a step change in the growth of a business, it is important that the growth in revenues and profits is lasting. There are many ways to create a short-term revenue increase, such as discounting, consumer promotions, and trade promotions. And there are many ways to produce short-term increases in profits, such as cost cutting and restructuring. But true shareholder value is created when the profitable growth is sustained over the long term.

To ensure that blank checks produce durable profit and revenue growth, it is important to embed the blank check initiatives within a well-defined process that ensures checks and balances on the initiatives. We call this the Virtuous Cycle of Growth. The virtuous cycle is based on a seemingly simple insight—the more you grow revenues and cut costs, the more resources you have available to invest in future growth. The essence of the virtuous cycle is that growth generates resources that drive more growth. The virtuous cycle consists of five steps; each step emphasizes an *outcome* and the *means* to achieve the outcome. These steps need to be followed rigorously to ensure that blank check initiatives remain on track.



management team with blank checks allowed us to break out of that cycle and transform the business.”

Their proposal aligned squarely with the company’s 5-10-10 strategic framework; the team decided to focus their portfolio on a few things that mattered, like biscuits (cookies). The team invested in deepening their local talent pool so they could get closer to Chinese consumers. And they tossed the “not invented here” syndrome out the window by leveraging a “glocal” approach that combined the best of global technology and expertise with local market know-how. Finally, they gave themselves an aggressive time frame to turn the business around. “Our proposal aligned with our 5-10-10 strategy,” says Warren. “Biscuits were one of five key categories, and the brands, like Oreo, were among our 10 power brands. Having the freedom of a blank check helped us take risks, think bigger, and look at the business with fresh eyes.”

Today, Kraft Foods China is a success story: The team doubled their innovation rate, transformed Oreo into the number one selling biscuit in China, and posted net revenues of more than \$800 million in 2011. Today the business’s advertising spend exceeds the business’s revenues in 2006. Most importantly, Kraft Foods China has a sustainable business model that is delivering a virtuous cycle of growth and is among the fastest-growing CPG companies in China today.

Dealing with Failures

Blank checks produce spectacular results when they work. However, as with all innovation efforts, a certain percentage of them will be unsuccessful. Business leaders need to be prepared for some of these initiatives to fail. There are two important lessons in dealing with failures—learn from the failures and overcome the fear of failure.

Kraft’s Royal affordable nutrition program in Latin America is an example of how to deal with a blank check initiative that doesn’t work out. Kraft believed that there was a large opportunity to drive growth at the “bottom of the pyramid” by developing nutritious yet affordable products for low-income Latin American consumers. A Latin American team took on a blank check challenge and came up with a new affordable nutrition product under the Royal brand—a line of gelatin and pudding desserts featuring fortification with vitamins and 45 percent less sugar. The products tasted good and the price points were affordable. The

team also managed to build awareness and secure good distribution for the brand. However, the products failed to sell well, and the gross margins were lower than expected. Kraft decided to pull the plug on this initiative.

The team learned many important lessons from this failure. The product involved changing consumers' attitudes and behavior—a difficult and lengthy process. The positioning of the product as a “treat” did not resonate with target consumers. And the business model was not sustainable: Costs were too high, and the company could not meet the affordability target it had set while still earning an acceptable gross margin. Importantly, the team leading the initiative was not penalized; the team leader was promoted to head the snacks business in Brazil despite the failure, because he took a risk and then learned from his mistakes.

Tips for Managing Blank Checks

Through our experience with several blank check initiatives in different product categories and markets, we have identified some important principles for improving the odds of success.

Focus on what matters. Blank checks must always focus on what matters to the business. In the case of Kraft Foods, blank checks are linked to the company's “winning through focus” strategy, which allocates resources in line with its 5-10-10 strategy.

Create a virtuous cycle of growth. Blank checks can produce phenomenal revenue growth, but this growth should be both profitable and sustainable over time. Business leaders should be careful that teams don't undertake initiatives that can boost revenues in the short term but that will hurt the business in the longer term. To ensure sustainable profitable growth that drives a virtuous cycle, blank check initiatives need to be gross-margin accretive. Margin expansion can come from increased revenues, from cost reduction, or from productivity improvement.

Innovate broadly. To harness the full potential of their business, teams need to take a broad view of innovation that goes well beyond creating new products. They need to innovate with packaging, promotions, advertising, distribution, and partnerships.

Simplify everything. Companies are often hamstrung by the complexity of their organizations and their operations. Complexity adds cost and slows down decision making. Blank check initiatives should strive for simplification. Simpli-

fication can be achieved in the product (for example, by reducing performance or features to the “just enough” levels desired by consumers), in the process (manufacturing, distribution, sales), in the organization (removing layers and moving decision making closer to local markets), and in administration (faster decision making and fewer meetings).

Don't overdo it. It is easy to get carried away by the success of blank checks and approve too many. Blank checks are powerful tools, but they are very demanding in terms of both financial resources and leadership bandwidth. They will produce revenue and profit increases in the long run, but they require significant investments in the short term. They also require a lot of personal attention from business leaders. Just as venture capitalists limit the number of startup investments they make and the number of company boards they serve on, business leaders need to limit the number of blank checks they issue simultaneously.

Create a family spirit. Blank check initiatives require every team member to put the collective good of the team above his or her ego and personal point of view. To encourage cooperation and interdependence, the team should think of itself as a family. This attitude can be fostered by adjusting incentives so that team members win when the team wins as a whole. It also helps to host “family dinners” before every major leadership team meeting. Each dinner has a clear agenda focused on two or three business issues that need input from the family. At the end of the dinner, the team arrives at a consensus on the business issues. This practice gives the team clarity on what they need to do and also promotes a sense of shared ownership of the outcomes.

Driving Organic Growth

It is not easy to find profitable organic growth. Faced with stagnant demand, intensifying competition, and greater pricing pressures, business leaders feel that their growth is constrained by the environment in which they find themselves. However, the constraints are sometimes of their own making. Even seemingly sleepy businesses hold tremendous untapped potential. If business leaders can liberate their people from the limitations of budgets and resources, they will find that their people will surprise both leaders and themselves with what they can achieve. This is the power of blank checks. +

Reprint No. 00124

Resources

Sanjay Khosla and Mohanbir Sawhney, “Growth through Focus: A Blueprint for Driving Profitable Expansion,” *s+b*, Autumn 2010: Rather than seek increased revenues and profits by expanding products and markets, companies should follow a seven-step strategy for achieving more with less.

Irene Rosenfeld, “Inside the Kraft Foods Transformation,” *s+b*, Autumn 2009: Top leaders from the largest food and beverage company in the U.S. talking about their three-year turnaround and their campaign to reorganize for growth.

For more thought leadership on this topic, see the *s+b* website’s Strategy & Leadership page.

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