

Harvard Business Review

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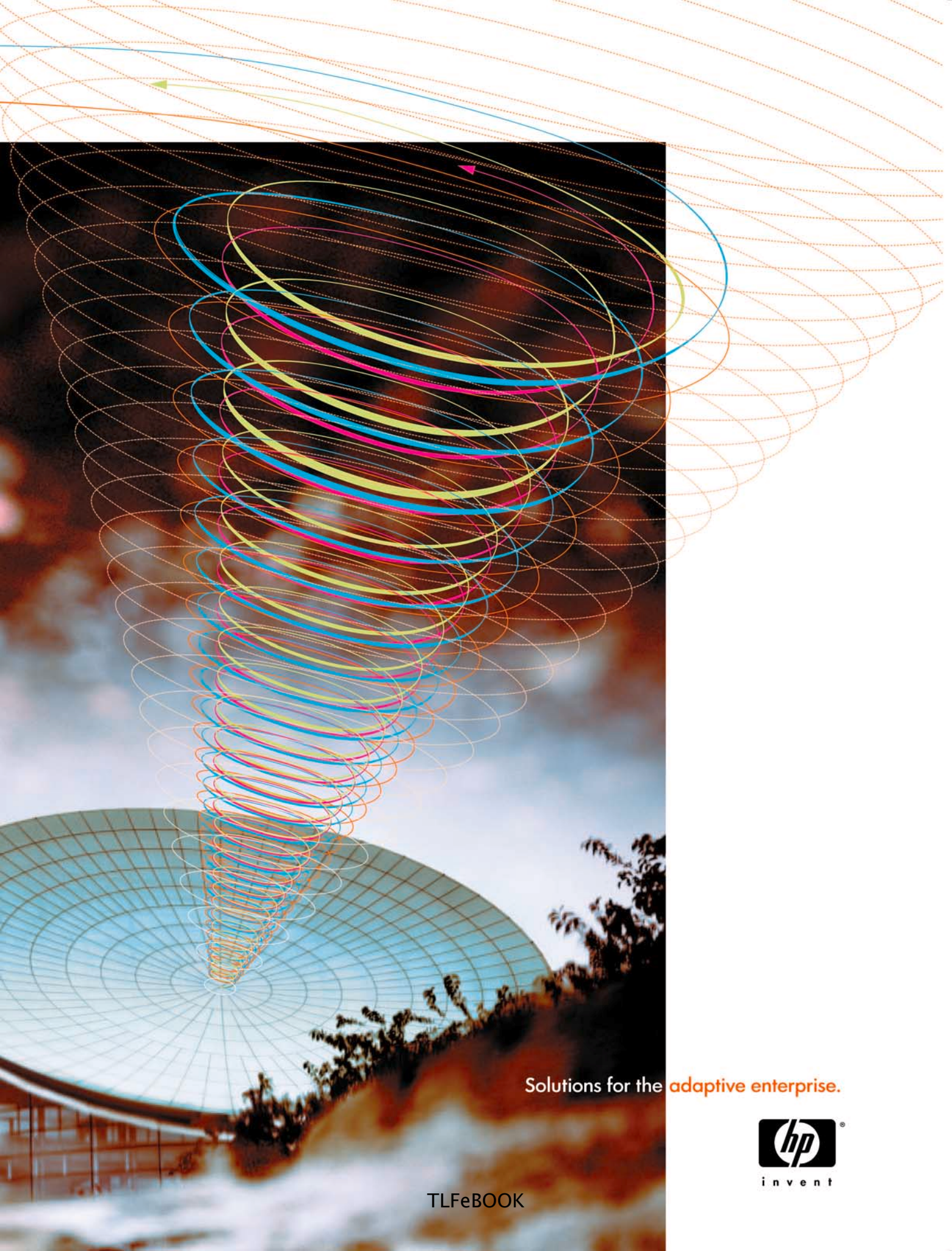


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Running a business and managing risk are synonymous: every venture can expose you to a new and problematic outcome that needs to be acknowledged and answered. Today, executives are facing a new challenge — the shadowy threat of terrorism — which not only jeopardizes your operational capabilities, but the welfare of your employees as well. And most vulnerable to subversion are your mail operations, the nerve center of your organization and its principal conduit for commerce.

› WHAT'S AT STAKE: Mail and Your Revenue Stream

Despite business' growing reliance on electronic communication, mail — packages, correspondence, invoices and payments — is still your company's primary means of receiving and delivering information, building and maintaining customer relationships, and perhaps most important, generating cash flow. Now imagine a suspect letter enters the mail stream. How will you respond? Do nothing and you could place your employees in harm's way. Shut down your mail operations and you effectively shut down your business.

What you need is a security solution that can distinguish the actual threats from the false alarms. There are simple measures available you can implement yourself. Or you can enlist the aid of security specialists with more extensive capabilities. Although no system is 100% failsafe, you can effectively minimize the risk to your company's financial well-being while maintaining the vital flow of mail into, out of and throughout your organization.

› ASSESSING THE LEVEL OF RISK

How vulnerable are you? 600,000,000 pieces of mail are delivered each day to businesses across the U.S. Although certain organizations are considered most at risk — government agencies, utilities, oil companies, and financial institutions — the universal use of automated, high-speed sorting equipment enables cross-contamination of mail, which means a dangerous substance intended for someone else could arrive in your mailroom, too.

Responsible executives can't overlook the possibility that it could happen to them. And if it did happen, what would the cost be in lost worker productivity and downtime? Assessing your level of risk — both the likelihood of an incident and the financial liability your business would incur — will help you determine the scope of solution you need.

› DO-IT-YOURSELF OR OUTSOURCE?

At the very least, employees handling mail require training to protect themselves and your facilities from a possible threat. Procedures need to be in place for identifying hazards, isolating areas of contamination, and alerting management to the need for immediate intervention.

In the aftermath of 9/11, companies at greater risk have chosen to outsource their mail operations, which allows experienced professionals to deploy rigorously designed systems and state-of-the-art detection technology as your first line of defense. Security solutions are now available that can verify the origin and authenticity of metered mail, distinguish between real and false biohazards, and safely cleanse suspect pieces of mail of biohazardous material.

However you manage the risk, your reward is the same: employees, business partners and customers who feel confident that adequate security measures are in place. And you can't put a price on that.

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November 2004

60 **Getting Past Yes: Negotiating as if Implementation Mattered**

Danny Ertel

Why do so many deals that look good on paper end up in tatters? Negotiators are often so focused on doing whatever's necessary to close a deal that they pay little attention to how—or if—the parties can actually make the agreement work.

70 **Bringing Customers into the Boardroom**

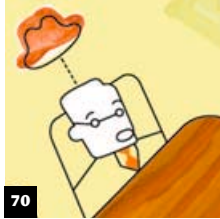
Gail J. McGovern, David Court, John A. Quelch, and Blair Crawford

Most boards lack a clear understanding of how well their marketing functions support their strategies for top-line growth. Here's a simple set of tools boards can use to ensure that marketing is effectively aligned with strategy.

82 **The Wild West of Executive Coaching**

Stratford Sherman and Alyssa Freas

Bad executive coaching is widely available, wastes lots of money, and can even do harm. Good coaching, on the other hand, produces clear business results by recognizing that there are three key parties in any good coaching relationship: the coach, the coachee, and the client who pays the bills.



HBR
Spotlight

The 21st-Century Supply Chain [Part 2 of 3]

94 **Aligning Incentives in Supply Chains**

V.G. Narayanan and Ananth Raman

A supply chain works well only if companies' incentives are aligned—that is, if the risks, costs, and rewards of doing business are distributed fairly across the network. Otherwise, the network is flirting with disaster: excess inventory, stock-outs, incorrect forecasts, inadequate sales efforts, and poor customer service.

104 **Rapid-Fire Fulfillment**

Kasra Ferdows, Michael A. Lewis, and Jose A.D. Machuca

To maximize your entire supply chain, you may have to make some pretty counterintuitive moves—like sending trucks away from the warehouse half empty or running factories only during the day shift. Find out why such penny-foolish tactics add up to a pound-wise strategy.

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Don't get too confident. You never know where
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November 2004

10 FROM THE EDITOR

Bound to Fail, or Set Up to Succeed?

The highest measure of leadership is that it creates circumstances under which great things happen without heroics. Much of the art of good management lies in designing systems and incentives in such a way that people will naturally do the right things.

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Give consumers control of their purchasing data...Big ideas from small countries...It's easy to misjudge decisions...Less leadership, please...Not all U.S. manufacturing is headed offshore...Young employees itching to stay put...New patent laws inhibit innovation...An antidiscrimination law makes life worse for workers...Why companies should care about national security...Secrets of a successful joint venture...What's in a brand name?... Managers, polish your silver and host an innovation party.

35 HBR CASE STUDY

Take the Money—or Run?

John W. Mullins

Everything's going well for start-up Petrolink until a venture capital firm makes an unapproved change to the contract. Even if the deal still looks promising, will the fledgling company later regret doing business with the firm?

51 FIRST PERSON

The CEO's Real Legacy

Kenneth W. Freeman

Most chief executives are loath to give up the power, perks, and prestige that come with the job. Here's the story of an incumbent CEO who set ego aside to actively manage the process of finding and grooming a successor—and helped strengthen his company along the way.



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92 STRATEGIC HUMOR

118 BEST PRACTICE

CRM Done Right

Darrell K. Rigby and Dianne Ledingham

Customer relationship management systems don't have to be technological black holes into which organizations throw money. There's a smart way to approach CRM that delivers competitive advantage.

131 TOOL KIT

Time-Driven Activity-Based Costing

Robert S. Kaplan and Steven R. Anderson

Traditional activity-based costing takes too long to implement, is expensive to build and maintain, and is badly suited to the complexity of most businesses' operations. A new scalable approach provides meaningful cost and profitability information, quickly and inexpensively.

141 LETTERS TO THE EDITOR

The best way for an organization to transfer "deep smarts" is to have backup people work side by side with experts and go through the fundamentals, almost from scratch.

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Go and Look

Don Moyer

It's tempting for executives to let others tell them what's going on outside the workplace. But the only way they'll know the truth is to see it for themselves.



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UPS can help you shorten your supply chain. For a technical explanation, see figures A. and B.

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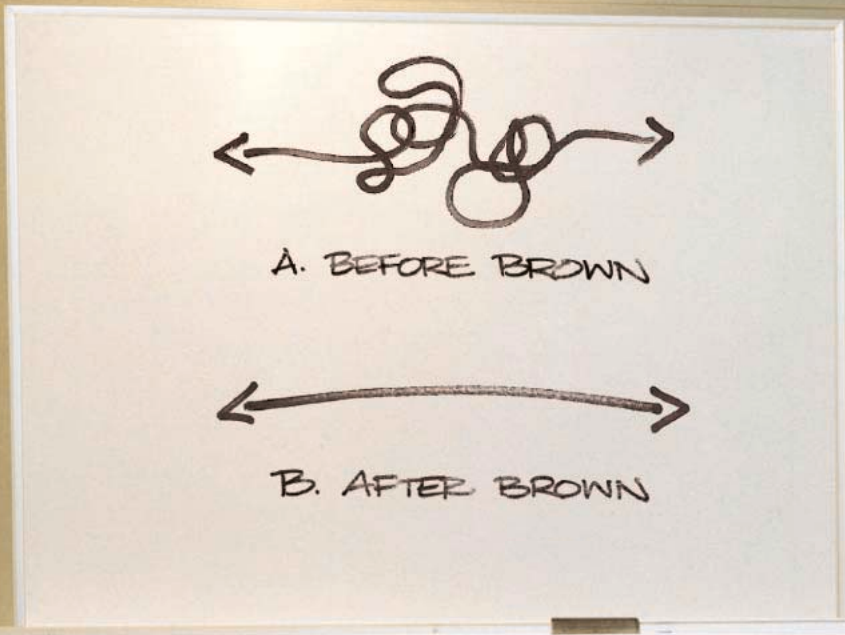
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Bound to Fail, or Set Up to Succeed?

IN A SHORT STORY by Dorothy Parker, a young couple, married just hours before, sits on a train. “Well, here we are,” the man says. “Here we are. Aren’t we?” his bride replies. Then he: “I should say we were.” And so it goes. They have no idea what to do or what to talk about, no way to start their new life together. They can say only, “Here we are.” The knot they have just tied is starting to feel like a noose. Nowadays we’d say this couple is a sure bet for marriage counseling.

Businesses have their own version of this newlywed hell – and in this issue we bring you an expert counselor, Danny Ertel, with his article “Getting Past Yes.” Every executive has had the painful experience of seeing a great deal go sour in the execution: a merger that ought to work but doesn’t, a distribution deal that delivers more bad than goods, a promise made that cannot be kept. Ertel, a founder of the consulting firm Vantage Partners, shows that in many cases, the very process by which a deal is done creates conditions that are almost certain to undo it later. Like ardent suitors who mislead the objects of their affection, negotiators can be so eager to get to yes that they promise what they can’t deliver; or they “win” the negotiation and leave the other guy without the resources or incentives he will need thereafter. Good intentions alone won’t keep you from making these mistakes. To be sure of getting past yes, you’ll have to change the design and structure of the negotiation process itself – and Ertel’s article particularly shines in this dimension.

Just as good bargaining anticipates the need to execute, a successful HBR article ought to explore an opportunity or a problem – one that matters to senior management – and offer a path to progress and change. I like to say we should answer two questions: “So what?” (Why is this important?) and “Now what?” (What can we do about it?). I’m especially pleased when we’re able to point out how to change organizations and systems in ways that help people be their best selves. It’s not enough to say, “To seize this



opportunity, find a great leader.” That’s like advising someone to buy stock on the basis of the CEO’s celebrity. Peter Lynch, the fabled former manager of Fidelity’s Magellan Fund, told investors, “Go for a business that any idiot can run – because sooner or later, any idiot probably is going to run it.” Similarly, I’d suggest that the highest measure of leadership is that it creates circumstances under which great things happen without leadership heroics.

In this issue, we continue our six-article series on managing supply chains in twenty-first century corporations. (We published the first two articles last month; the concluding pair will come in December.) We are focusing on this topic because we believe that senior executives need a new understanding of what it means to manage operations. Not long ago, “operations” mostly referred to functions and processes inside a company and had little to do with suppliers or customers. Operations management was mostly about bottom-line issues like costs and quality. That intramural scrimmage is now an intermural game with top-line implications. “Rapid-Fire Fulfillment,” by Kasra Ferdows, Michael A. Lewis, and Jose A.D. Machuca, reveals how the innovative Spanish clothier Zara manages its supply chain not to minimize costs but to maximize revenue. And V.G. Narayanan and Ananth Raman, both of Harvard Business School, show that incentives in supply chains should be aligned so as to take into account every player’s motivations; indeed, their article, “Aligning Incentives in Supply Chains,” underscores the point I made above, that a great deal of the art of good management lies in designing systems and incentives in such a way that people will naturally do the right things.

Thomas A. Stewart

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NOVEMBER 2004

Printed in the U.S.A.

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

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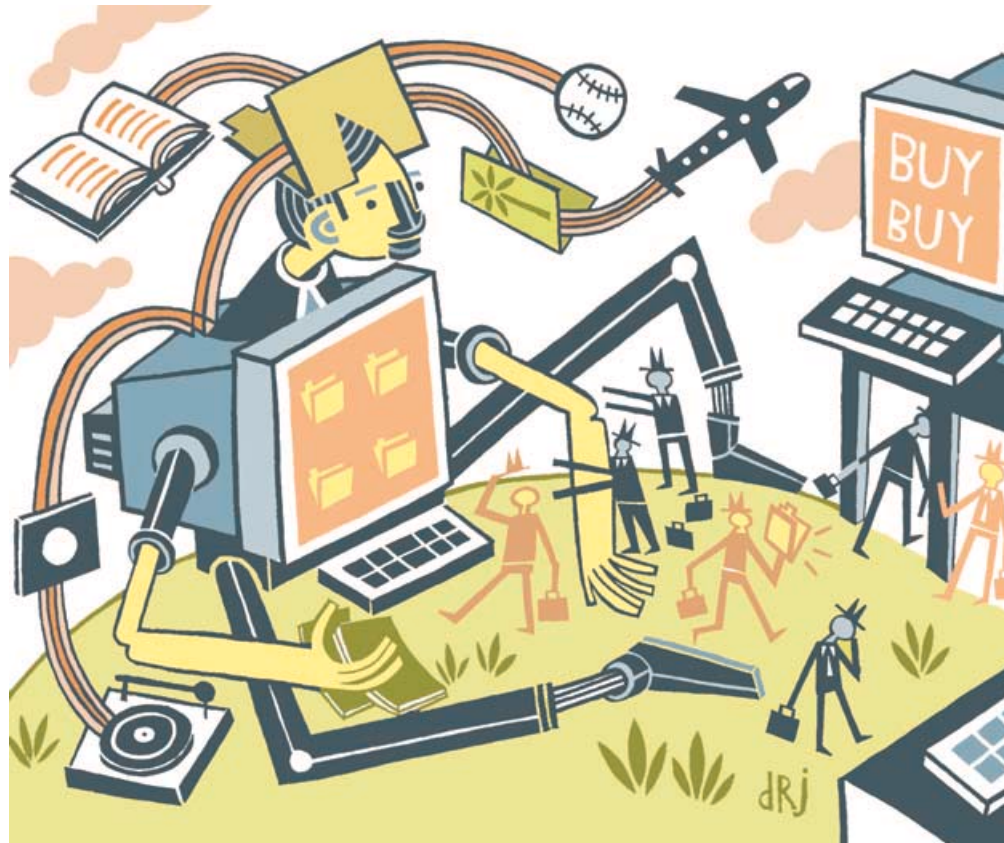
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GRIST

I Am My Own Database by RICHARD T. WATSON

Individuals and businesses have long tussled over who owns consumers' personal data. The decisive blow may be struck by customer-managed interaction, a new service model whose implementation is on the horizon. Superficially, CMI declares consumers victorious by ceding them total control over information about their past purchases and product preferences. But it also helps companies harvest the deep consumer knowledge that customer relationship management (CRM) only promises.

A group of MIS and marketing professors from the University of Georgia, Cornell University, Queen's University, and the University of Miami developed the concept of CMI after three years of studying Internet-based customer service at 36 companies. But CMI's roots go even further back: John Hagel and Jeffrey Rayport described some implications of customer control in a 1997 HBR article. (See "The Coming Battle for Customer Information" in the January–February 1997 issue.)

DAN JAMES

Like the blind men who famously struggled to understand an elephant by touch, CRM systems have always been victims of limited perspective. For example, to truly understand a customer, a bookseller must know which titles that customer has purchased from all sources or has borrowed from friends or libraries. It must distinguish between volumes that have engrossed her and those she's tossed aside after reading a few pages. And it must purge from its records any purchases meant as gifts. Armed with a clean and complete set of data and some knowledge of the customer's future needs and preferences, the bookseller has a good shot at making recommendations that translate into sales. But with CRM data—information that is restricted to a consumer's transactions with one company, lives inside the company, and is deployed at the company's discretion—there's a risk of producing bad recommendations and undermining customers' trust.

CMI, by contrast, lets customers wield complete control of the content, mode, and timing of data exchange for all vendor and service encounters. In many respects, it is a highly scaled and automated business-to-consumer version of the business-to-business process for sending out a request for proposal (RFP). Under CMI, when a consumer buys merchandise online, he receives an electronic file that describes his purchases and that can be automatically imported into a database he's installed on his home PC. If he wants to record purchases made earlier or offline, the consumer can obtain an electronic list of common products, like books and CDs, from the Library of Congress or commercial sources such as the Internet service Gracenote. He also registers an opinion of each purchase by using rating software incorporated into the database. The database remains in the consumer's control at all times, so if he decides that the Led Zeppelin period of his life has irretrievably passed, he can simply change his ratings

of Led Zeppelin CDs he's purchased from all sources.

Let's return to that enigmatic book buyer. When her bedside table is bare, CMI lets her transmit a file listing books purchased from all sources and on topics of current interest, along with her ratings, to an electronic intermediary. After stripping out the identifying information (to protect the customer's privacy), the intermediary forwards the RFP to multiple booksellers. Each bookseller analyzes the file and applies such techniques as collaborative filtering to produce recommendations based on the preferences of similar customers. (Because the vendors draw from different customer bases, their recommendations will likely differ.) The vendors then send offers, competing on the quality of their recommendations and on price.

In some cases, consumers may use their personal data to negotiate discounts. Take travelers, for instance. When someone buys a plane ticket, the airline sends an e-mail message with reservation specifics: service class, seat, city pair, price, flight numbers. As a customer interacts with multiple travel providers over time, his repository of transaction data grows. At some point, it becomes large enough to be a good gauge of his potential value as a customer. With CMI, that's when he transmits his travel history to a number of airlines and asks them to bid for his business. The airlines use his aggregate data to calculate an appropriate discount for future travel; they then get back to him with their offers. The consumer henceforth bases his airline choices on those responses.

Companies hoping to benefit from CMI will need technology that can transform data into recommendations—and will need pricing systems flexible enough to capture new customers without harming profitability. Traditionally, companies set prices by analyzing supply-and-demand patterns. Using CMI, they'll have to assess the impact of a prospec-

tive customer on resources and revenues when making an offer.

Although CMI is not yet in use, some of its features are. For example, Mediachest at www.mediachest.com lets customers electronically store descriptions of their CDs, DVDs, computer games, and books, along with personal ratings. And in April, computer students at the University of Illinois released a prototype music recommendation system for Apple iTunes users willing to supply their personal picks.

CRM lets companies *guess* what consumers *might* buy based on their histories. CMI lets companies *know* what consumers *will* buy based on preferences they voluntarily share. By ceding control of information, companies can learn everything they need to know about their customers. Reprint F0411A

INNOVATION

All Those Unfamiliar Places

by WILLIAM DUNK

Innovation experts advise executives to seek new thinking beyond their national borders. For companies based in the major economies, that generally translates into studying how things are done in other major economies. Unfortunately, today we encounter the same bad—or just plain old—ideas in New York, London, Frankfurt, Tokyo, and Hong Kong.

Such locations are the geographic counterpart of the “personal social networks” from which University of Chicago sociologist Ronald Burt urges us to break free. Those desiring genuinely new approaches to pervasive problems should look past the usual large markets and trading partners to small countries



that are, in writer Pico Iyer's words, "falling off the map." A surfeit of intellectual capital awaits importation from these overlooked countries.

Tiny Denmark, for example, harbors Vestas, the world's most significant wind-power company and biggest manufacturer of wind turbines. The Danes have greatly improved the cost and reliability of this alternative energy source, leaping ahead of the United States, where commercial wind farms and pioneering wind technologies came into being. Great Britain now has a major wind initiative in the works, and General Electric has made considerable commitments to

dying from heart disease or lung cancer has declined about 70%. Nothing in the panoply of expensive drugs, therapies, and surgical efforts coming from the most powerful developed nations measures up.

Education, meanwhile, is Cuba's grand success. The country's literacy rate is reputed to be well over 90%. The government turned loose more than 280,000 teachers after its revolution, perhaps 100,000 of them in their teens. Teachers often lived in the homes of those they educated, bringing literacy to the people wherever they might be. There are tales of "stoop learning" in the sugar cane—



wind power. But it is the Danes who are generating better than 15% of their energy from what blows offshore.

And then there's Finland, which has reduced its rates of cancer and heart disease by double-digit percentages. More than 30 years ago, Dr. Pekka Puska, now the director general of the National Public Health Institute in Finland, led a forceful public-health effort—including an all-out assault on smoking and poor diets—in the Karelia region. (Puska's campaign later expanded throughout Finland.) Since then, the incidence of Karelians suffering heart attacks or

workers mastering reading while they're in the fields. Lectors sit on elevated platforms in Havana cigar factories, helping laborers fight monotony by reading to them from novels or reports of current events.

The list goes on and on. Chile has successfully privatized its social security scheme. Visitors to Ulaanbaatar, the aggressively digital capital of Mongolia, can jump on the Internet from any phone. And denizens of South Korea, the world's most wired nation, participate in virtual pastimes undreamed of in Japan, Europe, and the United States.

Of course, the developed world has managed to pick up a few such innovations. U.S. restaurant entrepreneurs are importing eateries other than ubiquitous burger chains. Pollo Campero (from Guatemala and El Salvador) and Jollibee (from the Philippines), for instance, both of which are appealingly ethnic and boast attractive margins, have proved popular with natives of California after following immigrants there. On the technology front, the "smart cities" movement—patterned after the very networked Singapore—has spread through the United States and into Europe.

There are many reasons for the big successes of small nations. These countries lack the expensive, often flawed infrastructures of the larger powers that can block or dilute innovation. They can't afford systems that don't work, so they tend to devise practical inventions that are relatively bulletproof. And yes, new ideas can spread more easily through smaller, closely connected populations. The Cold War ended suzerainty in geopolitics. Likewise, globalization and the market economy ethic have increased the intellectual and economic influence of countries that were once vassals of the great powers. Reprint FO411B

DECISION MAKING

The Problem with Proxies

by MICHAEL USEEM

Effective decision making is among a corporate leader's most vital skills. Yet since major decisions are usually made in private, the leader's thinking is rarely visible to those who must live with the outcome.

The wise evaluation of such a decision requires direct information on the leader. Did the leader think strategically? Act decisively? Subordinate private interest to collective purpose? Unfortunately, shareholders, directors, and others seldom witness the decision-making process. To evaluate leadership decisions, they fall back on *proxies*: the circumstances under which a decision was made or the personal qualities of the decision maker.

continued on page 24



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TLFeBOOK

Enough Leadership

Leadership. We all know what that is. It stimulates teamwork. Takes the long view. Builds trust. And more. Right? So let me ask you a few questions:

- If leadership is about stimulating teamwork, how are the stock options distributed in your company?
- If leadership is about taking the long view, how many of those stock options can be cashed in in the short run?
- If leadership is about building trust, if people really are your “greatest assets,” how many of these assets have been shown the door in recent years? And how much trust has that engendered among those who remain?

In many companies, the answers to these questions expose a cult of leadership that is dragging business down. These companies embrace the notion of the single, isolated leader who is supposed to charge heroically ahead, formulating the grand strategies, making the tough decisions, pulling off the great mergers, while downsizing left and right. Frequently, such people sweep into companies where they have no roots, to save the day. They often succeed—for a year or two.

The assumption is that every company with a problem needs new leadership, more leadership. But I think many have had too much leadership. They need less leadership, maybe even an older kind of leadership: just enough leadership.

Some years ago, I read in *Fortune* magazine that within four years, Lou Gerstner added more than \$40 billion to IBM’s shareholder value. *All by himself?* When I read Gary Hamel’s account in these pages (“Waking Up IBM,” July–August 2000) about how Gerstner really did it—at least with respect to the company’s entering into e-business—I got a different story. A programmer with an idea joined up with an open-minded staff manager who had more insight than budget—and together, they assembled a group that drove IBM into e-business. What role did Gerstner play? When he first heard about the initiative, he encouraged it. That’s all. Instead of setting direction, he supported the direction setting of others. He provided less leadership, but appropriate leadership. Just enough leadership!

How do we encourage just enough leadership? For starters, let’s stop the dysfunctional separation of leadership from management. We all know that managers who don’t lead are boring, dispiriting. Well, leaders who don’t manage are distant, disconnected. Instead of isolating leadership, we need to diffuse it throughout the organiza-



tion, into the ranks of managers and beyond. Anyone with an idea and some initiative can be a leader. Like those guys in the IBM story.

Next, let’s involve followers in the selection of leaders. True leaders earn their leadership through the enthusiastic support of their followers. Yet how many companies give people a voice in choosing who leads them? I know of just one, which is very successful indeed: McKinsey. The senior partners there elect the managing director to a three-year term in a closed vote. Has McKinsey ever recommended that approach to any of its clients?

Finally, let’s recognize the importance of being engaged. Leaders engage others by, above all, engaging themselves. They commit to *their* industry, *their* company, *their* job—seriously, quietly. Instead of preparing to spring to better ones, they stick around to live the consequences of their actions. That is how they earn the respect of those they lead, and so engage them.

Such leaders care a lot more than they cure, they connect a lot more than they control, they demonstrate a lot more than they decide—not least through their own compensation and the retention of their people. These leaders are not perched “on top.” They work throughout. We talk so much about knowledge workers and networks yet remain so enamored with top management. A manager who sits on top of a network is out of it.

“Unhappy the land that has no heroes,” says a character in a Bertolt Brecht play. “No,” replies another. “Unhappy the land that needs heroes.” It’s time to bring management and leadership back together and down to earth.

Reprint FO411D

Smoke detectors Taximeters Airport screening devices Batteries Exit signs Conveyor belts Diapers Water disinfection Laboratory planning and design High-speed serial data cable assemblies Pneumatic filters Electric valve actuators Warning lights Coffee cups Power strips Strainers Electrical raceways Integrated fire protection cabinets Static control devices PC boards Master terminal boxes Lighting controls Bus and expansion slot connectors Subsystem integration and full-system assembly Variable-flow regulator assemblies Protection against electrical supply interruption Abrasion protection products Vehicle tactical repeaters Air conditioning equipment and systems Multi-coaxial cables Nasopharyngeal sensors Wastewater treatment plant design and engineering Rotational sensors Micro K relays Industrial automation Plastic knives, forks, and spoons Fire and emergency annunciators Drawer connectors LEDs Microelectronic sub-assembly Firefighter breathing systems Ground fault detector protective relays Solenoids Heavy-duty miniature applicators Absorbents and dessicants Voice networks Sea plows for undersea excavation Insulators Medical electrode gels Welded steel tubing Micropatch antennas Filters Thermocouple cables Avionics Polyethylene stretch films Backplane connector systems **Aircraft wire and power cables** Lamps Conformal antennas Serving trays Battery chargers Drills Panel boards Audio receivers Wire basket cable trays Pressure vessel clamps Snow melting mats Matrix switchers Amplitude measurement equipment Salve Telephony analysis Automatic door controls Well cleaners and developers Automotive micro power relays Plastic protective sheeting Patch cable Automotive mini power relays Transmission line accessories hazard detection products Building wraps Vending machine components Scales Intuitive LCD and CRT touchmonitors USB connectors Cable clamps Micropneumatic systems Cable ducting systems Sealants and gels Electrical metallic tubing set-screw connectors and couplings Insulation facers Call center monitoring services Relays with forcibly-guided contacts Spa controls Industrial control hybrids Gas masks Laser rangefinders Sodium bicarbonate based extinguishing agents Flame-retardant drapery systems Resuscitators for infants and children Digital watch parts Shade canopy accessories Barrier strips Chalkboards Therapeutic ultrasound PIN photo diode modules Medical monitoring services Check valves Resin systems Chemical oxygen generators All-in-one touch computers Chartering cable ships Elastic bandages Wireless systems Chillers Semiconductor heat sinks Digital audio services Automotive module relays Surface mounted cabinets Rotary switches Flame retardants Pressure seal closures Electric portable air compressors Circuit breakers Automotive quality inspection equipment Solid-state components Gas discharge tube replacements Components for camcorders Panel indicators Heat isolation devices Explosion-proof detectors Climate monitoring Hazardous material protective suits Solid-state subsystems Signal magnetics Passive electronics Medical oxygen delivery Grounding connectors Telescoping sign support systems Broadband driver amplifiers Champagne glasses Drinking bottles Polymeric and porcelain surge arrestors for distribution and transmission networks Automotive power relays Garment hangers Microcoaxial assemblies Snack food packaging Modem cable assemblies Industrial control switches Continuous-slot metal framing Landfill development Multi-mode radar Patch cable assemblies Shielded and coaxial cable slices Wine glasses Flame-retardant tape Range hoods Halogen-free cables for commercial and offshore applications Absorbable monofilament sutures Cable TV converters Terminals and connectors for underground networks Syringe dispensers Cordless telephone batteries Fire protection systems Tubing for outdoor furniture framing Sensor wraps Esels PIN diodes High-performance solid state relays and power controllers Wire harness tape Ceramic burners Electrical equipment for saunas Cylindrical control connectors Terminals and splices Security systems Relay sockets and accessories Arson detection Galvanized steel tubing Paperboard Counters and timers Sealed connectors Databus assemblies Television sets DC converters Subcutaneous sensors Pipe and tube products Electrical tape High pass filter inductors Pistol grip hand tool systems for IDCs Adhesive tape Segmentally welded pipe fittings USB cables Construction management Deactivators International mains adaptors Suction instruments Test equipment Steel box connectors Calibration equipment and services Plastic tumblers Cable trays Verified audio detection Thermoplastic piping systems Coaxial cable terminators Pigtail cable assemblies Waveguides Plastics engineering Institutional timekeeping Photocopiers Cabled and blind-mats power connectors High-performance connectors Safety relief valves Access floor modules Halogen-free wire Power systems Raised face flanges Connectors for high-voltage substations Flexible non-metallic conduit Reduced wall flexible metal conduit Catheters Medication nebulizers Digital metering systems Wiring harness sockets Automobile steering columns Pediatric monitoring equipment Cable design conductors Flame-retardant tubing for nuclear environments Rooftop walkways Digital products Air sampling equipment Voltage wheels Customized point-of-sale receipts Digital proofing Power tool switches Chokes Medical diagnostics Sound mixers Air traffic control equipment Digital visual interface products Vertical drain membranes and radiant barriers Cabinet power systems Wall track systems DIP switches Resistor protection Thermostats Electrical transformers High-performance RF/microwave antennas Lighting for public services Video cables Thermal circuit breakers Video endoscopy Cable assemblies Irrigation pipe Heat-tracing connectors Potassium bicarbonate-based extinguishing agents Megaphone components Calculators Institutional can liners Voltage-variable attenuators Wafer gear Varactors Coaxial cables Patient monitoring cables Drop cloths Alarms for hazardous areas Power splitters Chassis components Stormwater and wastewater stuffers Card readers with web-based authentication Printer cable assemblies Engineering services Amusement machine components Diagnostics and resuscitators Systems for offshore oil and gas installations Patch panels Airport lighting systems Soldering equipment Long haul telecommunication cable systems Entry modules Microsurgical needles Cryogenic valves Wiring harness design software Automotive components and systems Customized design services Porcelain disc insulators Flex and rigid circuits Diagnostic procedure trays Inkjet fluids Diagnostic and stress testing instruments Plastic sheeting Rechargeable car flashlights Memory card receptacles Spirometry systems Automatic blood pressure **Infusers Cord and cloth-backed building and construction tapes** Power magnetics Exhausters Ultraviolet disinfection systems Moisture analysis equipment **Flange gaskets** with bulb elastomers Exotic alloys Professional fire department hardware Custom sterilizable cable assemblies **Skin effect trace systems** Dental dressings and sutures Parts for lawn and garden equipment Tape measures Flame detectors Ribbon cables **Carpet backing Parallel groove clamps** Graphic arts tape Extended coverage fire sprinkler heads Hand pumps Climate control monitoring **Satellite radio** **Audio systems** Jacket compounds Galvanized steel armor with PVC jackets Irrigation pumps Utility cabinets **Cyanoacrylate Adhesive tapes** Large-screen video projectors Eye pads **Arterial extension sets** Paper mill wraps Fence framework Distribution panels Continuous timers Protective breathing equipment **Special purpose spiral antennas** Automatic pick, place and press **Power toggle switches** Fiber-optic connectors **Veterinary medical products** Bypass valves Carbon dioxide gas transmitters Specialty chemicals Rainfall gauges Alarms for motor vehicles Water sampling and analysis Fingerprint identification Mobile security systems Cable ties Firefighting flares Multiplier diodes Fireproof cables Drum core magnetics Audio receivers Flexible exhaust connectors Isolators and circulators Magnet wire termination machines Dual hybrids Static measuring equipment **Hand-held radios** Cable management accessories Steam-tracing products Extrusion laminates **Parking deck PVC-jacketed metal clad cable** Factory automation cables **Steelwork fixings** Airport construction management instrument waterization Cotton balls Pipe for recreational equipment **Self-adhesive cable clips** Multi-pair high flexibility cables **Fixed cable termination adapters** Butterfly valves Portable memory Components for CD recorders and players **Telemetry systems** Audio production services Integrated molding/plating technology Telephone systems Safety goggles Reverse cutting sutures Decorative shields Temperature and pressure gauges **Commercial-quality steel tubing** Laser diodes Temperature sensors Connection droppers Dry-erase marker boards **Feminine hygiene products** Storage tanks Analgesics First aid kits Thermal controls Computer-assisted surgery Power modules Subminiature D connectors Front-connected sockets Digital attenuators Automated teller machine components Spring pin coax probe assemblies Control panels **Wet pipe sprinkler systems** Alarm verification Security keypads Pain management products Helical gears Roadway and tunnel management systems Printed circuit terminals Galvanized round signposts Rocker and paddle switches **Microwave components** Roof and gutter heating cables Arson detection Voice amplifiers Fall arrest systems High-voltage connectors Power entry modules Custom broadband networks Steel threaded pipe sprinkler pipe **Accounting software** Ultrasound cable assemblies Protective clothing for emergency workers **Flare launchers** Dry pipe systems Cable tie guns **Broadband amplifiers** Rectangular heavy-duty connectors Discharge devices **Vibration dampers** Electromagnetic flow readers Laser components Advanced composites Coaxial connectors Adhesive covers Flat steel plates Elastomeric connectors Passive fiber-optic hardware Singulation systems Electrosurgical devices Coffee service kits Automotive radar sensors Electrical metallic tubing compression connectors and couplings Intercommunication devices Customized valves Dry pipe valves Flexible hoses Curing ovens Insulated ground metal clad cables Digital satellite radio antennas Perimeter door and window protection systems Anemometers Cosmetic surgery needles Flexible non-metallic conduit Supply cylinder assemblies Alarm communication systems Identification products Flexible piping equipment Rayon balls Dedicated fiber pair monitoring Hardened and tempered steel strip Plug-in relays Interior motion detectors Floor-mounted power points Specialty electrodes Alcohol preps Fire sprinkler monitoring systems Thermochromic color-changing ink Food service plates Taper cutting sutures Carbon

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They consider who was in the room rather than the options weighed. They focus on whether the decision maker looked and sounded – rather than thought and acted – like a responsible leader.

Proxy voting can work well for absentee shareholders – but in general, proxies are weak surrogates for the real thing, and they’re misleading when it comes to judging leadership talent. During the Civil War, Union general George B. McClellan was beloved by his soldiers and initially respected by his president, yet those signs of leadership potential were belied by his inability to make strategic and timely decisions in the battle of Antietam.

Even so, hiring managers often rely on such rudimentary proxies as personal bearing and public poise. During Bill Clinton’s presidency, a cabinet secretary hired two assistant secretaries – one, by all outward signs, far more “leaderly” than the other. The more-promising underling spoke brilliantly, dressed impeccably, and glad-handed effortlessly; the other spoke awkwardly, dressed nondescriptly, and mixed stiffly. After six months, it was the less-dynamic player whom both the secretary and Capitol Hill called upon more often and whose policy decisions were deemed superior. Only after the assistants’ decisions were observed did the initial proxies for leadership prove false and did the real leader become evident.

Regrettably, the trappings of leadership sometimes dominate the debate over corporate governance, as well. Reformers call for smaller boards, greater independence, and outside chairs – all good proxies but ones that have little sure effect on what happens when a board convenes. Consider the governing board of Enron before its bankruptcy: 13 blue-chip independent directors led by a nonexecutive chairman. On the surface, it had all the right stuff to make judicious decisions. Yet a look at its inner workings showed otherwise. For example, CFO Andrew Fastow’s request for an ethics code suspension to enable one of his special-purpose entities hit directors’ fax machines just three days before a board meeting. The agenda was jam-packed

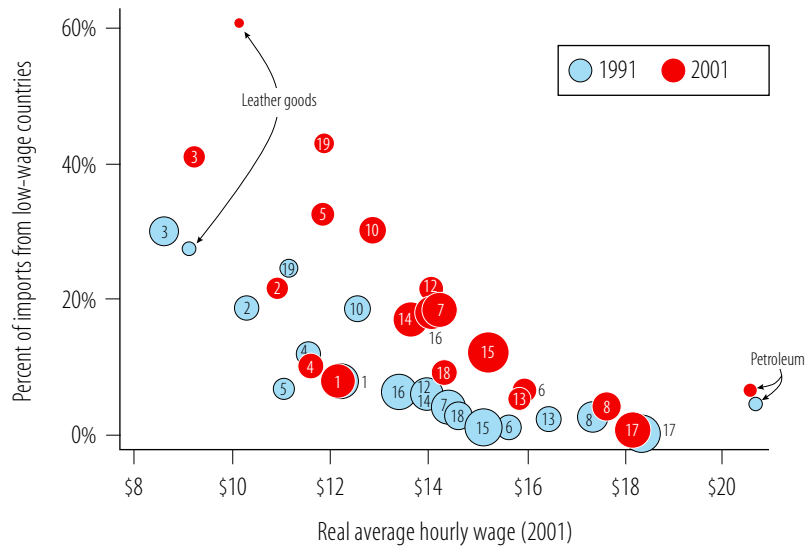
Data Point

How Offshore Work Affects Your Industry

by ANDREW B. BERNARD, J. BRADFORD JENSEN, AND PETER K. SCHOTT

Fact: U.S. manufacturing industries vary substantially in their exposure to competition from low-wage countries.

This chart depicts the relationship between hourly wages in 19 U.S. manufacturing industries and competition from low-wage countries in 1991 and 2001. For each industry, this competition is defined as the percent of imports originating in low-wage countries. The size of each dot represents the industry’s share of U.S. manufacturing jobs; numbers within the dots correspond to the industry key below. The pattern and sizes of dots reveal that the competition from poor countries has been, and continues to be, concentrated in small, low-wage industries like leather goods.



Industry key			
1. Food	6. Paper	11. Leather goods	16. Electronics
2. Textiles	7. Printing	12. Stone, concrete, and porcelain	17. Transportation equipment
3. Apparel	8. Chemicals	13. Primary metal	18. Instruments and controls
4. Lumber and wood products	9. Petroleum	14. Fabricated metal	19. Miscellaneous (toys, jewelry, and so on)
5. Furniture	10. Plastic and rubber products	15. Industrial machinery	

This chart dispels the popular myth that *all* U.S. manufacturing is headed offshore. Companies need to be aware not only of their own susceptibility to competition from low-wage countries but also of the threat faced by their suppliers and customers. Be prepared to take advantage of potential benefits from China’s arrival in upstream markets, such as lower prices for your inputs, and be alert to the risk of losing downstream customers who migrate offshore and substitute your products with those of local suppliers.

DATA SOURCE: U.S. Department of Commerce and the Bureau of Labor Statistics. The industry key is adapted from the Standard Industrial Classification System.

Send Data Point chart proposals to **Edward E. Leamer** (Leamer.HBRGraph@anderson.ucla.edu), the consulting editor of Data Point. Leamer is a professor of management, economics, and statistics at the University of California, Los Angeles, and the director of the UCLA Anderson Forecast.

Reprint FO411E

with other matters, and no board committee had vetted the proposed suspension. The directors conducted the meeting by telephone. The teleconference ended in an hour, and the ethics suspension sailed through. The problem wasn't who was in Enron's boardroom, but rather the abbreviated way in which the board reached its decisions.

An overreliance on proxies also troubles executive searches. Charisma and repute are assets but tell us little about how a leader will perform in a new situation. In recent years, British Airways, Coca-Cola, and Xerox all replaced retiring CEOs with seemingly appealing successors. But the successors' radiance soon turned radioactive when early judgment calls proved faulty.

Sometimes, though, truth and trappings are the same. Like McClellan, Confederate general Robert E. Lee was revered by his soldiers and admired by his president. *His* battlefield decisions, however, displayed brilliant leadership. Yet such examples can be dangerous if they misdirect attention to the appearance of leadership. Shareholders and directors must zero in on the content of their agents' decisions, not the context.

Conversely, corporate leaders should explain the thinking underlying their decisions. Only then can constituents determine whether those with leadership responsibilities are living up to them.

Reprint FO411C

DEMOGRAPHICS

The Young and the Restful

Today's teenagers are characterized by ambition, energy, hunger for stimuli – and the overwhelming desire to stay put at one company for as long as possible. Watching their parents suffer through months – sometimes years – of unemployment has left once peripatetic youth with a need for professional security, according to a new study by Deloitte and the Institute for the Future (ITFF).

More than twice as many people between the ages of 14 and 21 would prefer

job mobility within a single company as would choose career advancement in the open market, the study shows. That's in striking contrast to the late 1990s, when young people flitted from company to company in search of new skills, contacts, and experiences. Now, 80% say they'd like to have no more than five jobs over the course of their career, while only 65% expect they'll be able to make that happen. "They've been profoundly affected by the downsizing and rightsizing of the adults in their lives," says Lyn Jeffery, the research director at ITFF. "This has implications for recruiting strategies, which we believe should stress both opportunities for variety and the stability of a long-term commitment from an employer."

Students may worry about employment, but they haven't paid much attention to what employers want. Asked what skills they needed to succeed at work, respondents gave the lowest marks to mathematics, speaking a foreign language, public speaking, selling things or ideas, writing, and editing. They ranked highly such habits as working patiently and diligently, working independently, multitasking, and developing personal connections.

Those last three traits are typical of the technologically immersed – which, not sur-

prisingly, includes the majority of respondents. For teenagers, work has become something that gets done amid instant messages, ringing cell phones, blaring music, and incoming e-mails. Integrating these "technology natives" into traditional office environments may be difficult, warns Stan Smith, the national director of next-generation initiatives at Deloitte. "Businesses will be challenged to balance new workers' expectations for boundary-less inquiry with legitimate business needs for data security and preservation of intellectual property," he says. "On the other hand, employers might well look to entry-level workers for new solutions to knowledge management and business generation in virtual environments."

– Leigh Buchanan

Reprint FO411F

INTELLECTUAL PROPERTY

Patent Medicine

by ADAM B. JAFFE AND JOSH LERNER

For the better part of two centuries, the U.S. patent system has driven America's extraordinary innovativeness. In the last two decades, however, the system of laws that for so long fueled the innovation engine has become sand in its gears. Two apparently mundane changes in law and

policy have transformed the patent system. The results? Weakened examination standards, a runaway increase in marginal patent applications, and indiscriminate filing of patent infringement suits as a generic competitive weapon.

The origin of these pathologies goes back to 1982, when the process for judicial appeal of patent cases in the federal courts was changed. Such appeals are now all heard by a single, specialized appeals court rather than by the 12 regional courts of appeal, as had previously been the case. The new court of appeals has interpreted patent law to make it easier to get



patents, easier to enforce them, easier to get large financial awards from such enforcement, and harder for those accused of infringement to challenge the patents' validity. Shortly after this change, in the early 1990s, Congress modified the structure of fees and financing of the U.S. Patent and Trademark Office, trying to turn it into a kind of service agency whose operation costs are covered by fees that its clients (the patent applicants) pay.

The office's new orientation and the appeals court's legal interpretations have made it simple to patent even inane inventions. (Witness the recently patented "Method for Swinging on a Swing," which was "invented" by a five-year-old.) More worrisome, the number of patent infringement cases has doubled in a decade and continues to rise, as does the cost of defending against them. (See accompanying charts.) Increasingly, the

firm with the best lawyers or the greatest willingness to risk litigation wins the innovation wars—rather than the company with the brightest scientists or the most original, valuable ideas.

Reversing the perverse incentives in the current system requires fundamental changes in both the patent office and patent law. In our book *Innovation and Its Discontents*, we describe several needed changes—among them, systems that encourage challenges to questionable applications and ways of reducing the burden on nonexpert juries (and, hence, the opportunity for error) in highly technical patent infringement cases.

Whatever the solutions, when issues of U.S. patent policy are considered by the courts, the Congress, and the executive branch, you can be sure that the opinions of patent lawyers and patent holders will

DIVERSITY

The Bias Backfire by PAUL OYER AND SCOTT SCHAEFER

Opposition to the Civil Rights Act of 1991 was vociferous, with critics branding it a "quota bill." That concern turned out to be unwarranted, but the legislation has hurt some of the people it was meant to protect, according to our study of pre- and post-Civil Rights Act employment data.

Proponents of this landmark legislation were as ardent as its critics. They hailed the act, which increased damage awards available to women and minorities who prove unlawful discrimination by employers, as an important tool for opening labor markets. By making discrimination more costly, supporters argued, the law would force greater fairness in dealings with protected workers. Earlier antidiscrimination provisions, such as the Civil Rights Act of 1964 and affirmative action, did, in fact, improve things.

The 1991 act, however, was passed in the midst of a significant shift toward firing-based litigation and away from hiring-based litigation. It took little account of the fact that one way an employer can avoid a large legal bill for firing a protected worker is simply not to hire that worker in the first place.

Our research documents three ways in which the act appears to have worked against protected workers in terms of employer response:

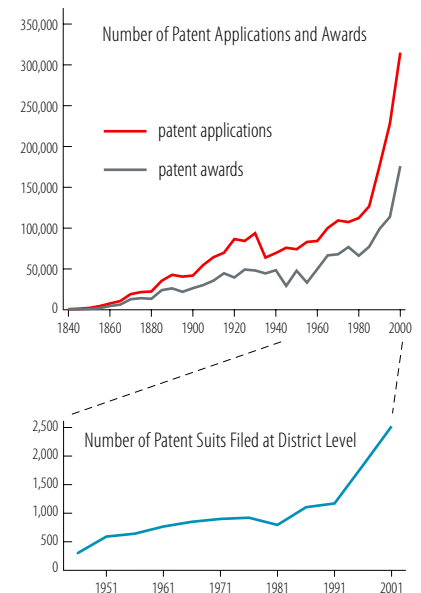
First, a decades-long trend of greater labor-market integration ended around 1991. Women and minorities had been making gains in historically unwelcoming sectors, but then employers became less willing to hire protected workers.

Second, employers are taking fewer chances on untested protected workers. The law makes it more expensive for managers to hire someone and then find out they made a mistake. As a result, businesses have tilted their hiring of protected workers toward those with track records because they present less litigation risk than their more sparsely credentialed counterparts.

Third, while the overall rate at which protected workers are terminated has remained steady, companies have changed how they terminate. For white men, the balance of firings and layoffs hasn't changed. But black men have experienced a big reduction in firings and an offsetting increase in layoffs. In other words, a manager who wants to dismiss a protected worker may be more likely to wait until a downturn provides cover.

The upshot: While well-intentioned, the law seems to have had some negative consequences. Measures that ensure access to education or encourage hiring may do more to improve the lot of protected workers.

Reprint FO411H



be heard. While their arguments will often be couched in terms of the public interest, at bottom their focus will be on improving their own profits and livelihoods, not on designing a patent system to foster the overall rate of innovation. Even the patent office itself cannot be expected to advocate necessary reform if such reform will reduce its revenues (by discouraging bogus applications) and threaten its established mode of operation. When our lawmakers turn their attention to this pressing issue, they'd

continued on page 30

CANCER

At Bristol-Myers Squibb, our mission is clear. To discover and develop innovative treatments for the world's most serious diseases, such as cancer, AIDS and mental illness. To erase their devastating

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Conversation

RANDALL YIM ON SECURITY



Protect Your Interests

Frequent-flying executives may view national security as a mild pain in the neck, but not, generally speaking, as *their* pain in the neck. That's the wrong attitude, says Randall Yim, managing director in charge of homeland security for the Government Accountability Office. Yim recently spoke with us about the costs of federal security measures to business and the role companies should play in homeland defense.

Why should business care about security on a national level?

First off, because the business sector controls much of what needs protecting. Remember that 85% of U.S. critical infrastructure is privately owned. Think about airlines and trucking and shipping and the power grid and the health care system and office buildings in urban areas. The Department of Homeland Security is drawing up national preparedness goals meant to protect that infrastructure, but business has scarcely been involved.

The national goals DHS has set so far are very general: something akin to “promote the common defense.” There’s no guidance for businesses on how to design strategy and allocate investment relative to security. We need timetables and milestones and measurable readiness priorities. The private sector knows best how to balance economic viability and efficiency against security. Companies also need a say in how those measures will be funded, because the government is inevitably going to pass some additional security costs on to business. And businesses will want carrots as well as sticks—things like tax policy and grants and liability legislation.

An example of where industry has been successfully involved is the Customs-Trade Partnership Against Terrorism—a container security initiative. DHS asked shippers where they could make security enhancements without too much negative impact on their business model. The shippers know from insurance company studies that cargo is most vulnerable when it’s standing still, so they’re working on processes and technology to keep it moving. I’d like to see that kind of partnership model replicated in many areas: border security, passenger screening, IT security for financial markets.

How else should business contribute?

It can play a big role in foresight analysis and technology assessment. Tragic events tend to make us retrospective and reactive. After 9/11, everyone focused on airport security; after Madrid, we focused on trains. Meanwhile, the executive and legislative branches of the U.S. government are reluctant to look at anything beyond a two- to five-year time horizon. The private sector needs a longer-term perspective, and it is in a position to identify emerging security concerns in areas like nanotechnology, bioengineering, and information technology.

We need to resurrect something like the Office of Technology Assessment that would draw on the private sector’s expertise. Until it was closed down a few years ago, the OTA was responsible for giving Congress objective analyses of different technologies so that it could write legislation and regulations based on scientific evidence. That would make the business climate more stable, so companies could make better decisions about where to invest and what market forces to anticipate, and they wouldn’t have to worry so much that rules would change.

What can businesses do within their own walls?

The corporate attitude today reminds me of the late 1970s, after Love Canal. Then, companies complained that the new environmental protocols would be very costly. But over time they began to think, “Well, let’s look for alternative products with less environmental liability.” Those products were often more effective than the old ones; plus, the companies could market themselves as environmentally friendly.

Companies had to acquire environmental management skills, the same way they now have to acquire security skills. Industries like software or transportation or energy or real estate need to incorporate security into their products, and the smart thing to do is to design it in from the beginning. After 9/11, “security experts” came out of the woodwork offering to advise companies about hiring guards and building firewalls. But security has to become the concern of ordinary resource and infrastructure managers. It shouldn’t be a separate cost and activity center, but what you do to get your product or service on the street. Security must become an integrated and essential part of operations.

— Leigh Buchanan

Reprint FO411J

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HOW WE DID IT

Crafting a JV Prenup

by L. GORDON CROVITZ

Joint ventures are like marriages. Half of them fail. When Reuters and Dow Jones set out in 1999 to create Factiva, a news and business-information joint venture, we knew the odds. The two companies had a long history of head-to-head rivalry for newswire scoops, and their corporate cultures were rooted in very different national traditions (Reuters being based in London and Dow Jones in New York). With the deck stacked against us, my chief negotiating counterpart at Reuters, Phillip Melchior, and I agreed that we'd need to make some unorthodox moves at the outset for the venture to have a chance. We decided on three main tactics.

First, we eliminated Dow Jones's larger entitlement because we knew that Factiva had to be—and had to be perceived as—an autonomous entity with its own management that wasn't dominated by either partner. To that end, Dow Jones agreed to receive cash payments over time and to split ownership of the venture 50/50—even though Dow Jones's greater revenues and profitability would have entitled the company to a financial advantage over Reuters, perhaps a 60/40 balance.

Second, to prevent parent-child competition and squabbling between the parents, we immediately established Factiva's place in the parent companies' shared hierarchy. We agreed that Factiva would be the exclusive distributor of archival content for both Dow Jones and Reuters in the enterprise market. Our individual companies would continue to be separate and sometimes com-



peting businesses in the financial professional market as well as in the broader consumer market—through the *Wall Street Journal Online*, for instance, and Reuters.com—but Factiva would have its own clear opportunities to sell to global enterprises.

Finally, we ensured our mutual, long-term commitment to the venture by deliberately creating obstacles to retreat. Although companies designing JV contracts often build in exit clauses in case the venture stumbles, Dow Jones and Reuters did the opposite, putting up legal barriers to impede the exit of either partner. In essence, we made sure that the bottom-line impact of leaving the deal would be so unattractive to both parties that neither would be likely to consider bailing out except in the direst circumstances. Not only would these contractual barriers legally enforce the partnership; they were an important gesture of commitment—a way for both parties to say, “We’re in this for the long haul.”

Factiva is marking its fifth birthday this year. With 1.6 million paying subscribers and more than 80% of the *Fortune* Global 500 firms as clients, it is solidly profitable and has revenues that rank it second in its market.

MARKETING

By Any Other Name

Conjuring up a successful brand name involves art, science, luck, and, often, lots of money. In his new book, *From Altoids to Zima*, Evan Morris explores the origins of dozens of brand names, finding many familiar brands that—and this is where the luck comes in—were initially (or almost) given names that now seem clumsy at best.

The Gap was very nearly named “Pants and Discs.” Google came *this* close to being “BackRub” (in which case, we’d now be “BackRubbing” people to find out about them). Scrabble sold early on (and not very well) as “Criss-Crosswords,” and Barbie, named after the inventor’s daughter Barbara, luckily got the girl’s nickname.

How do you get it right the first time when you name a new product? You might boost your odds if you spend six years and millions of dollars developing the name, as Standard Oil reportedly did before settling on “Exxon.” But you can do just fine by pulling a name out of a phone book. That’s how P&G cooked up “Pringles.” If there’s any rule of thumb for picking a brand name, perhaps it’s to trust your gut. You have to wonder who signed off on the repelling name “Caverject” for Pfizer’s injectable impotence drug, and

whether he or she didn’t have second thoughts. One thing’s for sure: The pharmaceutical company learned from its mistake. Three years after it first marketed Caverject, Pfizer launched a new drug for impotence and cleverly named it “Viagra.”

– Gardiner Morse

Reprint FO411L



Reprint FO411K

Confronting Reality: Doing What Matters to Get Things Right

Larry Bossidy and Ram Charan
(Crown Business, 2004)

In *Execution*, Bossidy and Charan told readers how to get things done. Here, they explain what things to do: specifically, whatever the business model requires. *Confronting Reality* scolds managers for stubbornly emphasizing internal benchmarks over external realities. With globalization and cheap capital creating a capacity glut and a buyer's market, companies must reevaluate each of their businesses to see whether they are still making money. The advice isn't new, and the examples are less vivid than those in the earlier book. But the problem is real and the prose hard-hitting.

Faith and Fortune: The Quiet Revolution That Is Transforming Corporate America

Marc Gunther
(Crown Business, 2004)

Despite the subtitle, this account of social responsibility in business is more a hopeful sermon than a broad empirical analysis. Gunther, a journalist, profiles a variety of effective leaders—from the owner of a local bakery to the CEO of Timberland—whose religion or spirituality influences their companies' missions. The book is predictably earnest and, yes, inspirational. Yet at the end, Gunther restrains his enthusiasm, having found no evidence that corporations overall are emphasizing stewardship over profitability.

Overachievement: The New Model for Exceptional Performance

John Eliot
(Portfolio, 2004)

Here's good news for the psychically lethargic. Mental preparation actually hurts performance, at least if you aim to be world-class. Eliot, a psychologist, recommends that those intent on excellence eschew goal setting, visualization, stress management, and other techniques that start in the head. Instead, he advocates relying on the power of dreams to achieve extraordinary dynamism in any endeavor. The book is lively and persuasive, but its advice will be hard to follow if the fire in your belly isn't already raging.

Reviews

Innovation: The Missing Dimension

Richard Lester and Michael Piore
(Harvard University Press, 2004)

The lone inventor is a romantic but impractical figure. Innovation is a social process; the more successful the innovation, the more social the process.

Inside companies, however, innovation's social, informal aspects are often compromised by managers' rigid control of R&D. By emphasizing budgets, team timetables, and other constraints over the free-form exchange of ideas, management condemns organizations to a future of unimaginative product extensions.



Innovation: The Missing Dimension suggests a better role for managers: party host. Richard Lester and Michael Piore—professors at the mecca of rational problem solving, MIT—describe the early stages of innovation as a cocktail party. Diverse people gather and chat, casually but seriously, about a variety of topics. In a safe and stimulating environment, they explore ideas they wouldn't normally venture, eliciting

frank reactions from listeners who might not otherwise take time to respond. Engaged, occasionally contentious conversations stimulate big new ideas.

The authors found such conversations at the root of advances in several industries. Cell phones arose from a fruitful exchange between the radio and telephony groups at Bell Labs. A major laundry company, Martelli, worked with jeans makers and washing machine manufacturers to find new techniques for finishing high-fashion blue jeans. And several medical devices were born when product developers joined professors or doctors in informal gatherings. These breakthroughs happened because people abandoned their specialized, analytic perspectives and collaborated on free-form interpretation of vague or inconsistent data.

Being a good party host requires both rigor and finesse. The guest list matters. Aspect Medical Systems thought the beta version of its new anesthesia-monitoring device would benefit if product developers chatted with customers—but only highly motivated users. Rather than give the early version away, Aspect charged a significant amount of money for it, thereby ensuring a conclave of the committed.

The host may also need to administer a “lubricant” to encourage unfettered exchange. When Martelli met with members of its network to discuss improvements, they were often chary about sharing information. So Martelli selectively revealed a few trade secrets, including some from other companies in the group. Levi Strauss, which stopped working with independent laundries, ended up losing market share to Martelli's network.

Finally, the authors say, good hosts leave guests free to ramble. Ambiguity and uncertainty are resources to be exploited, not problems to be analyzed away.

Although *Innovation* will appeal to managers' analytical side, it lacks a creative richness. Social interactions are colorful; yet the academic authors rely on dry, often cursory examples. Their theory makes sense. Too bad they didn't animate it with some of that cocktail party energy. — John T. Landry



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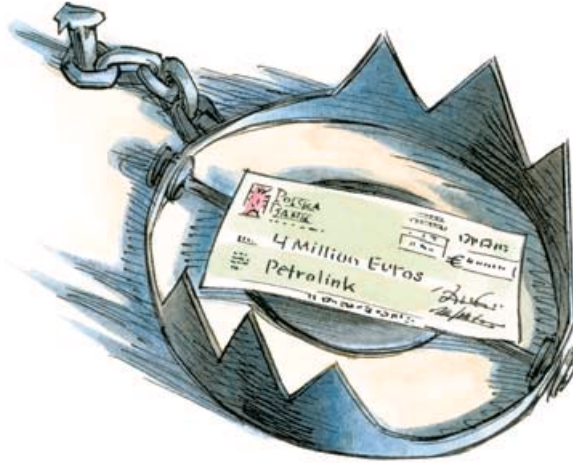
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At long last, Petrolink's founders have the start-up capital they need. The VC's check is in hand – but so is news that the investor may have breached the founders' trust. Now what?

Take the Money – or Run?

by John W. Mullins

IT WAS NEARLY 9 PM. Robert Jameson, Karl Fenstermann, and Nigel Ritson of Petrolink Transport Technologies had been huddled since early morning with their lawyers and with BRX Capital's Lech Wojtalik and Walter Cronbach and their two lawyers. They were in the final, exhausting stages of negotiating a €4 million investment that would give Petrolink the cash it needed to build a natural gas pipeline in the Baltic Sea. The check lay on the table.

After working all day and taking only a short break for supper, they were back at the table. There were only six items in the shareholders' agreement to work out; everything else was already settled. Robert and Karl knew they could give in on these points if they had to, though they were prepared to negotiate to get the best deal they could.

The BRX lawyers provided a fresh draft of the documents that included the agreed-upon changes from earlier in the day. "Just look at the highlighted passages," said Walter. "They're the only ones that we need to reach agreement on. Everything else is OK. We should have this wrapped up very soon."

With a sigh, Robert picked up the newest draft. Despite Walter's recommendation, he read carefully through the whole document, wanting to be sure he had not overlooked anything that he or Karl would later regret. The financing was his responsibility, and he knew that the Petrolink team was relying on his expertise to ensure that this part of the deal would be well managed.

As he read the antidilution clause, something caught his eye. He reread it, then read it once more. A quick check

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

against an earlier, predinner version of the shareholders' agreement confirmed his suspicions. The clause had been changed to language far more onerous to management. "What is this?" asked Robert. "This antidilution clause is not the same as the one in the previous versions."

The Opportunity

The story had begun some 15 months earlier, on a cold and blustery Baltic night. Karl was then the managing director of the Eastern European division of Beckman Engineering, the world's

Once the gas started flowing, whoever operated the pipeline would be drowning in cash.

largest developer and builder of rigs and pipelines for the oil and gas industry. Given the opportunity, he loved getting out of the office and out to sea. So when the president of Balto Gas & Oil invited him to visit the company's new Beckman-built rig on its first day of operations in the recently developed Helmark field in the Baltic Sea, Karl jumped at the opportunity.

The weather turned nasty as the helicopter carrying Karl and Balto's president, Per Persson, approached the rig. It took the pilot three attempts to set down the aircraft. "We may have to spend the night here," he shouted to the passengers.

The wind and spray hit them full in the face as they scurried under the still-revolving blades. It was a relief to get indoors. "I'm sorry to get you out on a day like this," said Per. "We didn't expect this weather. I don't think we'll be doing anything today unless it calms

down soon. But we can put you up, and the radio operator can get you in touch with your family."

Karl didn't mind. A night on board offered him a perfect opportunity to get to know Per, a smart move in light of Balto's interest in purchasing more rigs down the line. And he felt a certain pleasure in being warm and safe inside while the wind and sea battered the rig outside.

Despite a brief flash of sunshine, the wind stayed strong, and at 3:00 PM, Per announced that the start of operations would be postponed until the morning. Following a tour to inspect some of Beckman's latest innovations in rig design, the two men joined the rig's senior management in the mess for dinner, and they spent a lively evening swapping war stories. Per and the production superintendent went way back, and Karl's presence didn't inhibit them.

After dinner, although the rig was officially dry, the production superintendent invited Per and Karl to his quarters for a nightcap. Per produced a bottle of Polish vodka from his coat pocket. "I was going to take this back home," he said. "But we'll get better use out of it now."

Over drinks, the production superintendent asked Per how negotiations were going with Gazprom, the Russian oil and gas giant, which currently operated the only available pipeline for shipping gas from Helmark to the mainland. Per grimaced and took a shot from his glass before answering. "Well, we've agreed to access," he said. "And they swear that they'll put in safeguards to keep the flow data confidential. But I don't trust them."

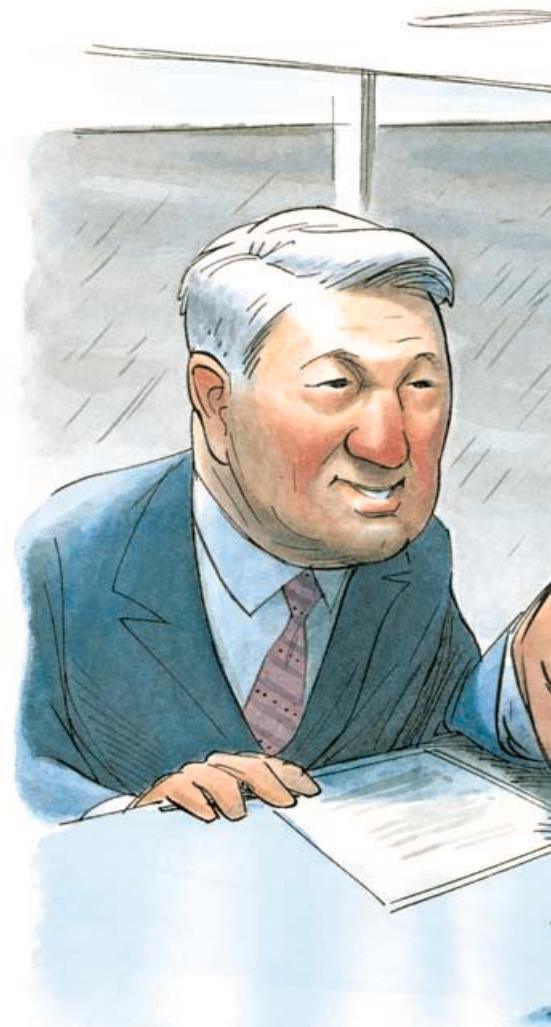
Per's concern was understandable. Like all independent gas producers, he was unhappy at having to rely on an archcompetitor to take his gas to market. No one wanted Gazprom to know exactly how much gas each portion of the field would be producing, which is

exactly what Gazprom would know from its flow meters if its pipeline were used. The information would give the deep-pocketed competitor an edge as additional leases were auctioned.

"Anyway," he continued, "it's only a temporary solution. That 16-inch pipeline won't have the capacity to handle Helmark's output. The independents will need their own—one twice the size, if the field's as rich as I think it is."

Karl leaned forward. Was this an opportunity for Beckman?

"Have you thought of building your own pipeline?" he asked. "Obviously not by yourselves; you couldn't afford it. But you could get together with the other independents."



John W. Mullins (jmullins@london.edu) is an associate professor of management practice at the London Business School. He is a coauthor of "How Fast Can Your Company Afford to Grow?" (HBR, May 2001) and the author of The New Business Road Test: What Entrepreneurs and Executives Should Do Before Writing a Business Plan (FT Prentice Hall, 2003).

“They won’t bite,” replied Per. “Everyone wants to save their money for the new leases. Anyway, none of us has any experience in managing a pipeline. And we’d probably still have trouble keeping the flow data under wraps. Why would we trust each other any more than we trust Gazprom? No, we really need a third party to do it for us. Do you think Beckman might be interested?”

Karl didn’t think so. “We’d love to build it,” he said. “But I doubt we’d be interested in operating it. I’ll make some noises.”

The conversation moved on, and Karl reckoned it was time to leave the others to it. Besides, he needed to clear his head, and the wind had eased a little, so

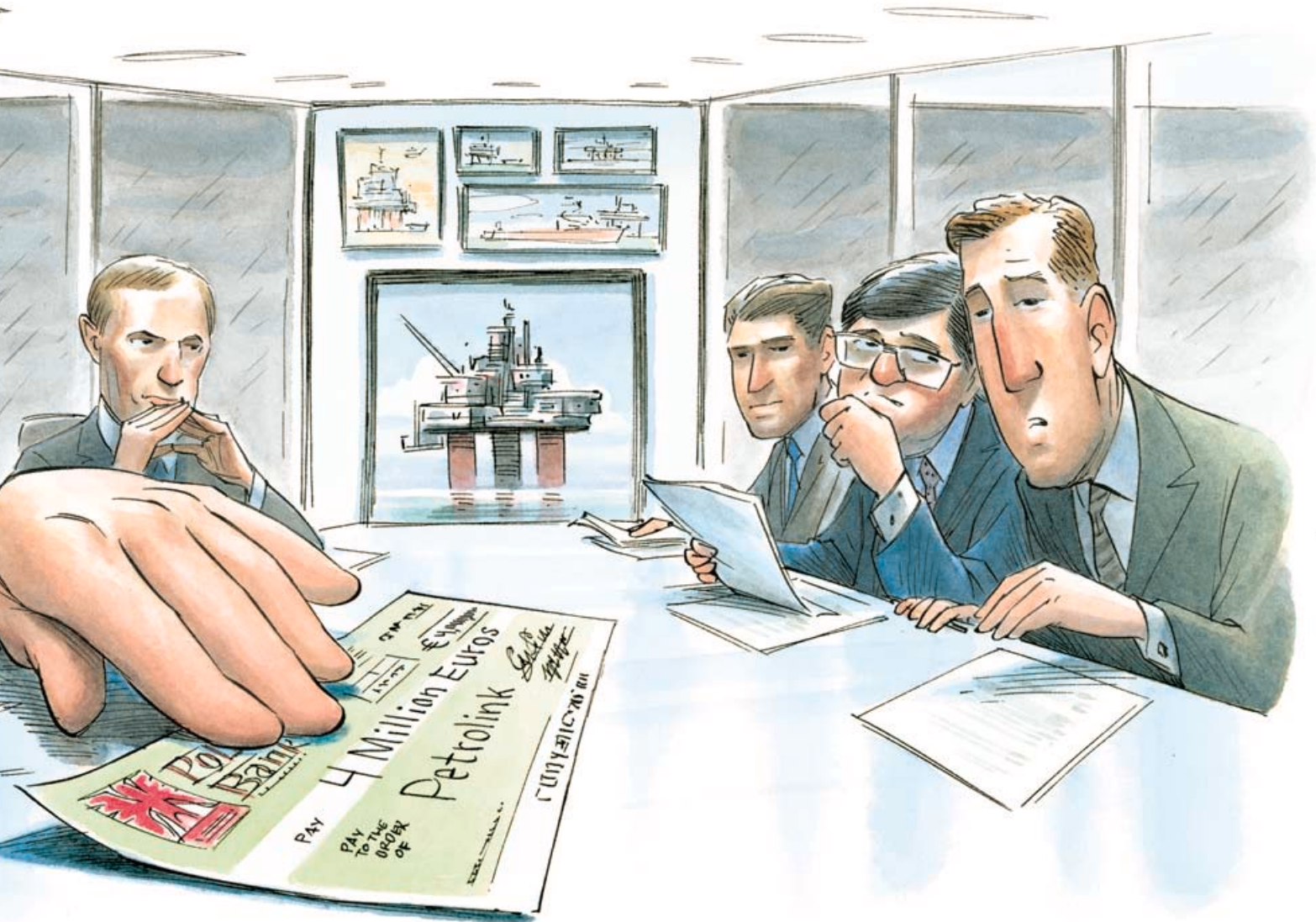
he could stay on deck. The talk had put a crazy idea in his head that he needed to think through. Beckman, he knew, wouldn’t bite. The company had turned down this kind of business before.

But what if he, Karl Fenstermann, were to operate the pipeline? As a vendor, Beckman could finance some of the construction, and if he could get commitments from Per and the other independent producers that they would use the pipeline, why shouldn’t he be able to raise more money? Once the gas started flowing, whoever operated the pipeline would be drowning in cash. He looked up, and for a moment the clouds parted and he saw a brilliant full moon, high in the sky.

The Team

Karl knew he would need help. In spite of having built his division from nothing into Beckman’s fastest-growing unit in five years, he had never been a real entrepreneur. Besides, he was not about to walk away from Beckman without being more certain that his idea would work. What if he built the pipeline and the independent producers decided to use Gazprom’s existing pipeline instead? What if someone else beat him to market with a competing pipeline? What if, despite the projections, Helmark didn’t play out?

His first call was to Robert Jameson, an entrepreneur whom Karl had met in the 1980s, when both were working



for Siemens's railway engine business in Germany. Although the two men had kept in touch, their careers had diverged, with Karl eventually joining Beckman and Robert moving to Berlin to start and successfully sell four ventures, three of which served Eastern European markets.

To Karl's delight, Robert was immediately sold on the idea: "We're perfectly matched. I've got the experience raising money and setting up a new business from scratch. You know the people in government and business we'll have to

deal with, and you're well placed to find someone with operational experience. Once we've got our candidate, we can go to the VCs."

The biggest sticking point was that LDP—despite its lack of experience in the oil and gas business—expected to have de facto veto power over most important decisions.

over several rounds of equity and debt. He suggested they offer the first-round equity investors a 28% stake for an initial €4 million.

Unfortunately, venture capital investors had grown very cautious following the dot-com bust, the downturn in technology company valuations, and the recent dearth of IPOs. After six weeks of knocking on doors in various European financial capitals without success, the Petrolink team members were introduced to Charles Jackson-Poole, a managing partner at London Development

Partners, a large, well-established venture capital firm.

LDP's roots were in private equity investing, and over the past 20 years it had built a portfolio of early-stage investments in companies that were mostly, but not exclusively, technology based.

LDP typically would provide a relatively small early round of investment to enable the founders to prove the viability of their concept, build prototypes, and attract beta customers, and then follow with additional rounds of investment to help the company develop. It was common for LDP to bring additional investors into syndicates to fund these later rounds, both to share the risk and to provide the sometimes large amounts of capital that were necessary to fully take advantage of the opportunity as it developed.

Robert was delighted that LDP was interested in investing in Petrolink. He viewed LDP's interest as validation of the project. "If they think we have a viable business here," crowed Robert over beer and kielbasa one night in Warsaw, "then we probably do!"

LDP was certainly serious. Over the next several weeks, Robert and Karl made numerous visits to London to answer what seemed a never-ending array

of questions from Charles and his associates. Why would the independent oil producers do business with a start-up instead of with Gazprom, and on what terms? How would Petrolink's competitive advantage be sustained? Could a price war be avoided? Could Petrolink really fend off Gazprom in the marketplace? How important was Gazprom's political and market clout? Did the Petrolink team have what it would take to successfully build the business?

Karl was impressed with this professionalism. "They ask great questions," he said to Robert after one of the meetings. "Charles would be a great person to have on our board, even though he doesn't know all that much about the oil and gas business. I really like his approach in dealing with us. He tells us what his concerns are and trusts us to figure out the solutions."

After six weeks, LDP finally came to the point. "It's good to see you chaps again," said Charles, welcoming them to LDP's oak-paneled offices in London Wall. "The material you sent last week has eased our concerns about the Gazprom situation, so we'd like to talk today about what sort of deal might be possible for us."

"Great!" replied Robert. "We look forward to hearing the terms."

But Karl and Robert's enthusiasm was short-lived. The package Charles outlined was far from what they'd been hoping for. Instead of €4 million, LDP would commit a mere €1.5 million for the first round, for which it would receive a 20% stake, and would make no tangible commitments to future rounds. What's more, management's 80% stake would vest over a three-year period and would be diluted in future rounds, though it was not clear by how much.

But the biggest sticking point was that LDP—despite its lack of experience in the oil and gas business—expected to have de facto veto power over most important decisions, through board control and a detailed set of shareholders' agreements to be negotiated to align with LDP's "standard" terms.

Robert thought it best to put their cards on the table. "Karl and I really

The Backers: Part 1

With the team in place, the Petrolink project moved forward quickly. Nigel and Karl negotiated a draft contract for the pipeline construction with Beckman and secured letters of intent from Balto and three other large independent producers, accounting for half of the potential independent gas production in the Helmark field.

Robert brought in Philip Calthorpe, a former senior vice president of a large London-based investment bank, as a financial adviser. He felt that a deal could be struck with a capital structure of approximately one-third equity, one-third debt, and one-third vendor finance, which Beckman would provide. Philip estimated the funding requirements at nearly €42 million (of which €37 million was capital expenditure), phased

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appreciate your interest, Charles, and we've really benefited from all of the tough questions that you've raised about our business plan. I think you should know, though, that we've been in discussions with another prospective investor, and we're meeting later this week. We want to hear what that company has to say before making any commitments. We'll be in touch next Monday with our response."

The Backers: Part 2

Shortly after their second meeting with LDP, Robert and Karl had been introduced by their financial adviser to a Polish venture capital firm, BRX Capital. Although BRX had been in business fewer than five years, it had already made several investments in infrastructure deals in Eastern Europe, including two in the oil and gas industry, one of which was with an independent producer that had signed a letter of intent with Petrolink.

Karl and Robert hit it off well with BRX's senior partners. Karl in particular got on well with Lech Wojtalik, one of the firm's founders, whose background

a real oil and gas man, and Walter has the entrepreneurial background. And don't be worried about the Party thing—anyone who wanted to be anything joined back then. Of course, we should keep an eye on them, but BRX really wants to be in this business, and they're much more likely to give us the deal we want."

Karl's optimism seemed to be justified. BRX not only agreed to the capital structure that Robert had proposed, but it also agreed to invest both the first- and second-round equity amounts, totaling €8 million. On completion of the first two rounds, management would hold 55% of the equity and BRX 45%. The funding would come in as convertible loans that would convert to equity upon certain management milestones, which were also tied to a management share-option scheme.

BRX, however, was not interested in participating in the third round of equity or the debt financing. The proposed arrangement met Karl and Robert's main objectives in several important ways. Not only would both the first- and second-round funding be in place,

BRX Capital, in the offices of BRX's lawyers in Warsaw on a stormy October night.

The Dilemma

"What's the story here, Walter?" asked Robert. Walter's face went red. His body language made it plain that the changes in the antidilution clause had been intentional. The lawyers, however, were much smoother, blaming the discrepancy on a typing error made by a junior staff member. They left the room, ostensibly to find out what had gone wrong. "We've worked with them for years," said Lech. "It must be a clerical error."

Lech and Walter then left the room as well. In a few minutes, they returned, and Lech said, "It's no problem; we're putting the earlier language back in."

Robert asked for a recess. He, Karl, and Nigel went next door to discuss what to do. "Doing business with people we can't trust isn't my idea of fun," said Robert. "If they're trying to screw us before our deal is even done, what will they try to do to us in the future? Can we expect them to help us if we get into trouble, or will they try and steal the business? Even if this is a better deal now, I'm not sure we won't regret it later."

"I don't think we have a choice," said Karl. "We've spent almost six months getting here. Maybe LDP will still do a deal with us, but we already know it won't be anything like this. And we don't know how long LDP's due diligence will take and whether its deal will actually come through at the end of the day. What if someone else is working on a Helmark pipeline? There isn't room for two of us. I think we still have to go with these guys, even though we'll have to watch them."

"I don't like this any more than you do," added Nigel. "But remember, Karl and I are planning to leave Beckman at the end of this month. We don't have the cash to pay our salaries yet, and both of us will need to be working full-time soon."

"Doing business with people we can't trust isn't my idea of fun. If they're trying to screw us before our deal is even done, what will they try to do to us in the future?"

was in the oil industry. Robert, for his part, developed an easy camaraderie with Walter, a former entrepreneur whose career mirrored Robert's own.

Nigel was more skeptical. "Do you trust these chaps?" he asked one day over lunch with Robert and Karl. "It all seems a bit too friendly. I'd be happier if they asked more questions. And these guys don't have the track record of LDP—they've only been going five years. And I'm sure Lech used to be a Party member."

"Don't worry," said Karl. "It's easier because they know our business. The reason LDP was all over us was because they were new to the gas business. Lech's

but the third-round funding from a different investor would ensure that no one investor would wield too much clout over Petrolink.

The deal was irresistible. Karl called LDP's Charles Jackson-Poole to tell him of their decision. "I'm disappointed," said Charles. "We like your team, and we like your business. I'm sorry we cannot meet the terms proposed by your other investor, but if things don't work out, we'll still be here." Robert then called Walter Cronbach and said, "Let's wrap up our deal."

And so, after a hectic three weeks of due diligence and drafting, there they were with their prospective investors,

Should Petrolink make the deal with BRX? • Four experts weigh in on page 42.

New beginning.

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George G. Brenkert
(brenkg@msb.edu) is a professor at Georgetown University's McDonough School of Business in Washington, DC. He is also the director of the Georgetown Business Ethics Institute.

Even if the altered contract had been legally enforceable, it is still morally damaged. Morality and the law do differ.

Robert Jameson, Karl Fenstermann, and Nigel Ritson are facing a problem: what to do about BRX's deceptive alteration of the antidilution clause in the contract offered to them. But they are also confronting difficulties because of their desires and decisions concerning the BRX contract.

If the legal circumstances surrounding this contract are unclear, the ethical circumstances are not. It is hard to imagine any plausible ethical system that would condone what BRX did. Even if the altered contract had been legally enforceable, it is still morally damaged. Morality and the law do differ.

In these situations, managers should consider not only their own best interests but also their responsibilities to others. If Robert, Karl, and Nigel sign the contract with BRX, they will hire employees, make agreements with suppliers and customers, and eventually seek other investors. These groups will be Petrolink's stakeholders. If BRX acts again as it has acted in this instance, it is plausible that these stakeholders will be harmed. One way to discharge their responsibilities is to protect stakeholders from any future malfeasance by BRX. Another way would be to advise the stakeholders of the risks of being involved with BRX. If Robert, Karl, and Nigel are uncertain whether they can do the former and are not prepared to do the latter, they should consider pulling out of the deal. Part of looking at matters ethically is considering the consequences for all affected parties. Informed choice is crucial both to ethics and to economics.

Finally, trust (or distrust) is a theme that runs throughout the case. Because of the change in the contract, Robert, Karl, and Nigel do not trust BRX. This lack of trust will impel them to write a tighter contract, to monitor BRX's behavior more closely, and to protect important Petrolink information. This will be costly and may have a negative snowball effect on the relationship. Even the best-constructed contract will not give scruples to scoundrels.

It's easy to see how the team got into this mess. Sometimes we want things so badly we don't see the warning signs. And if they are brought to our attention, we dismiss them with facile explanations. BRX, we are told, wasn't asking many questions. The Petrolink team chose to think it must have been because the company knew all the answers. Furthermore, BRX was ready to make a seemingly irresistible deal, but no one else would make a similar offer. The team members should be alert to the possibility that they are treading in treacherous territory, their judgment clouded by their own desires and aims.

There is also the problem of psychological commitment. We often get so bound up in projects that it is difficult to back away. The psychologist John Darley, a professor at Princeton University, has discussed the problems to which committing to a course of action may lead. One need only think of the space shuttle *Challenger*, the Ford Pinto, and the brakes B. F. Goodrich initially manufactured for the Air Force's A7D aircraft. In all these cases, individuals and organizations committed themselves to certain projects and then sought excuses, explanations, and evasions when bad news cropped up so as to permit these troubled projects to go ahead. The Petrolink team seems headed down a similar road in its relationship with BRX.

What should the team do? If it can meet its responsibilities to other stakeholders, it might go ahead with the present deal. But it is a perilous course and should be taken only after the team has looked closely at BRX and its past dealings with other ventures. Absent a better explanation of BRX's behavior than we currently have, Petrolink should explore how far LPD might go to improve its offer. Even if the team does not get a better offer, Petrolink would be working with a solid, reputable firm that it can trust. Once committed to this project, LPD might well help Petrolink to find other sources of funding. If this is not possible, it may be a sign that the project is fraught with so many difficulties that, both personally and morally, the risks outweigh the advantages of going ahead.

WENDY WRAY

~~I FIND IT A CONSTANT STRUGGLE TO RECONCILE MY
EARNINGS WITH MY BLUE COLLAR UPBRINGING
'GUESS HOW MUCH I BLEW IN VEGAS.'~~



THE NEW FINE OAK SINGLE MALT WHISKY RANGE. THE LIGHTER SIDE OF THE MACALLAN.

Is Petrolink willing to say no to both BRX and LDP and go back to the venture capital markets looking for a new investor?



Sonia Lo is the cofounder and a managing partner of Chalsys Partners, an investment and financial advisory firm based in London. She was selected as one of the top 100 Technology Pioneers to the World Economic Forum at Davos in 2001 and 2002.

In my career as an entrepreneur and an adviser to entrepreneurs, I have faced this dilemma before, and I would recommend that Petrolink take BRX's money – but only the first tranche. Robert is correct that accepting funding from potentially untrustworthy investors is very risky, but Petrolink's management can mitigate this risk by meeting the plan's targets; bringing in a strong second investor quickly; continuing to control the majority of the company; basing the company in a jurisdiction where the rule of law is powerful; and controlling the local operations.

At the same time, the team needs to go back to LDP and ask what terms the firm might want in order to be the second-round investor and what structures it would consider unacceptable. Many of the corporate-governance control measures that LDP seems to be insisting upon now may be moot by the time a second round is needed. (For example, the team will have met its plan or the business will need serious thinking “outside the box,” LDP's key strength).

If the team really feels BRX can't be trusted or managed, I would return to LDP, ask the firm to lead the round, and then bring BRX to the table as part of a syndicate. Petrolink should also insist on the full €4 million. The team can also argue that if LDP can't indicate its commitment to further rounds of funding, then the VC needs to remove clauses from the terms that later-round investors will find unacceptable. Petrolink will need to ask its financial adviser to conduct research into second-round financing term sheets. If LDP is as experienced as the case indicates, the firm will appreciate this argument.

The members of the team have only themselves to blame for this situation. They gave notice to Beckman without securing the cash to fund themselves after their departure. Now their idea is in the market, and a

team with comparable knowledge and capital could very easily take their opportunity. They also should have continued the LDP process in parallel with the BRX one—there's no evidence that either VC had requested Petrolink to enter an exclusive negotiation. If the team had moved LDP along to a point where it and BRX both had checks on the table, and then mentioned to LDP that someone else had offered better terms, Petrolink's negotiating position would have been stronger. Now, if the team returns, LDP will realize that something has gone wrong with Petrolink's other potential funder and perhaps tighten the terms.

Before making any decisions, however, they need to ask themselves some hard questions. Are they willing to say no to both BRX and LDP and go back to the venture capital markets looking for a new investor? How long are they willing to continue the search for capital? They also need to get a better grip on the competitive situation. With such a large infrastructure opportunity, it's odd that the team wouldn't know whether there is someone else looking to build a pipeline. What do they want from their investing partner: industrial expertise (BRX) or analytical expertise (LDP)? Most venture capitalists place themselves in one of these two camps, and many entrepreneurs won't take funding from what they consider “dumb” money. Who really is the dumb money here?

Finally, Petrolink's founders need to reconsider their financing structure to see whether they can build any more wiggle room into the deal. Can they spread out the financing rounds at all? Can they afford to spend time looking for money as well as developing the venture? There is a trade-off between the comfort of having one investor cover two rounds and having the kind of control they seem to want, and they need to revisit that issue.

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COMPREHENSIVE HR/BENEFITS OUTSOURCING



In these situations, the first and foremost issue is one of trust. Whenever you take VC money, you are simultaneously paying for it and hiring a partner.



William A. Sahlman is the Dimitri V. D'Arbeloff - MBA Class of 1955 Professor of Business Administration at Harvard Business School in Boston. He is the author of several HBR articles, most recently "Expensing Options Solves Nothing" (December 2002).

This situation is not uncommon. I've seen at least a dozen cases where lawyers have come back with very different documents than the entrepreneurs thought they had agreed to. In these situations, the first and foremost issue is one of trust. Whenever you take VC money, you are simultaneously paying for it and hiring a partner, someone who's going to help you succeed. Given the harshness of the VC's terms, you're paying a lot; you should get a partner who will help rather than harm you.

There are many ways in which VCs can quite legally make life miserable for entrepreneurs. As in the case of Petrolink, VCs stage their capital commitment, which means that the venture is guaranteed to need more money. First-round VCs have a huge impact on the pricing and availability of that new money. If they are supportive, new capital can be obtained on fair terms from helpful investors. If not, the process can be messy and expensive. Moreover, because the VCs have seats on the board, they can be helpful—in tasks like hiring, setting strategy, forming partnerships, and raising money—or they can be difficult. Bad directors often meddle in operations and make obstreperous or self-interested financial decisions. Some VCs have hidden agendas. They back another horse in the same race or have secret plans to replace management soon after the deal is consummated.

I should point out that the dilution clause is only about sixth or seventh on the list of things an entrepreneur should care about. There's a distinct possibility that there are other agreed-upon terms in the contract that are more damaging than the new dilution clause. Karl and Robert need to begin by reviewing what they did agree to as well as checking the document for changes.

They must also assess how these VCs behave when the chips are down. There's a

wonderful description of the due diligence carried out by LDP. They asked a ton of questions, called lots of people, and checked references. There's no evidence that the entrepreneurs have done the same kind of due diligence on their potential investors. They need to find venture-founding CEOs who have worked with BRX—ones who were fired and ones who lasted the course. Because BRX has already committed a breach of trust, the due diligence will need to be especially thorough. If Karl and Robert find any indication that BRX has behaved badly toward other entrepreneurs, they should walk away.

LDP made much more sense as a partner. Of course, there was less money on offer, and Karl and Robert were quite reasonably worried about running out of money before producing enough information to justify a second round. But for all Karl and Robert knew, LDP might have a good history of supporting their companies by helping them raise money elsewhere or by providing interim funding themselves. Perhaps they routinely lowball their first offer to see how the entrepreneurs react and are actually quite open to bargaining. Choosing so quickly between LDP and BRX is further evidence of these entrepreneurs' inexperience.

Karl and Robert's worries about control are typical. But control, in these kinds of situations, is a nuanced issue. I may own 70% of the stock, but if the venture capitalist has only given me enough money to get to the first milestone, at which I have nothing really valuable, then I have no control, by definition. If the entrepreneurial team has only 1% of the equity, but they're doing a terrific job and the investor can't hire equally good replacements, then the entrepreneurs are the ones in control. For Karl and Robert to assume that the size of their stake determines their level of control only underscores how naïve they are.

This project is much riskier than Robert, Karl, and Nigel seem to realize. In Eastern Europe, the gas pipeline industry is politically sensitive, and Gazprom, the dominant player, is rich and immensely well connected. Although Poland is changing, it retains much of the mentality and work habits imposed by 50 years of Soviet rule; I would not want to rely on Polish officials or courts to protect me against Gazprom. For that very reason, my company has always avoided investing in raw materials businesses. A gas pipeline attracts more attention from governments than a chocolate factory. Last, but not least, Petrolink's partners have never operated as a management team.

There are many imponderables to a new venture in Eastern Europe. Institutions are still fragile, business environments unstable, and courts inexperienced in dealing with complex business agreements. These considerations make trust crucial. Because each party has a certain measure of control, the VC–entrepreneur relationship is inevitably interdependent. The VCs may hold the purse-strings, but they usually need the entrepreneurs to run the company and for information, expertise, and local networks. Unless each side feels that it can trust the other not to abuse its power, the relationship will not produce a win-win outcome.

BRX has blatantly proved its untrustworthiness. Lech Wojtalik and Walter Cronbach's crude attempt to swindle Karl and Robert by changing the dilution clause is typical of the apparatchiks (if indeed Lech was a Party member) whose networks still have clout in the raw materials industries in Eastern Europe. The move also suggests that BRX wants control of Petrolink—certainly in terms of ownership and probably also in terms of managerial decision making. Robert is right to worry about what BRX might do down the road. With 45% ownership already agreed to, it doesn't have far to go.

LDP would make a much better partner. It is large and well established, and it has a long track record in investing and helping successful ventures. Both Karl and Robert were engaged in and positive about the due dili-

gence process, which suggests that LDP's questions were to the point. LDP's limited expertise in oil and gas is actually an advantage; it means LDP needs management's expertise more than BRX would. LDP also has a much healthier approach to control. It simply wants to mitigate the high risks of this investment.

Karl and Robert's real dilemma is not about taking BRX's money—they absolutely should not—but whether they should go back to LDP or abandon the deal all together. If they go back to LDP, they should focus on understanding the logic behind the deal structure LDP proposed. Perhaps its stringent terms reflect a history of investing in businesses that are not capital intensive or a sense of not knowing enough about the industry. If so, it may be that Karl and Robert can persuade LDP to put in more money. To do this, though, they need to work harder at winning LDP's trust. Greater trust will also make LDP more relaxed about the control issues that clearly worry the Petrolink team and will make the VCs more likely to give the team latitude.

If the team members cannot reach a compromise with LDP, they should go back to their old jobs. None of them will have lost more than six months of their time over the deal, and Karl and Nigel will not find going back to Beckman as hard as they seem to think. Beckman was willing to support them in the venture, so it clearly values them. What they have already gained in terms of experience in dealing with VCs will stand each of them in good stead in any future venture.

Robert also needs to ask himself whether he, Karl, and Nigel can function as a management team. His reaction to BRX's move is quite measured; the others are a little hysterical and lacking in business instincts. ☹

Reprint R0411A

To order, see page 151.



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If the team members cannot reach a compromise with LDP, they should go back to their old jobs.

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The CEO's Real Legacy

by Kenneth W. Freeman

It's hard to give up the reins. But a chief executive who initiates and manages his own succession can add enormous value to the company.

THE LITERATURE ON CEO succession planning is nearly unanimous in its advice: Begin early, look first inside your company for exceptional talent, see that candidates gain experience in all aspects of the business, help them develop the skills they'll need in the top job. It all makes sense and sounds pretty straightforward.

Nevertheless, the list of companies with CEOs who last no more than a few years after taking the reins continues to grow. No need to rattle off the names here—they're known to any casual reader of business publications. But we can draw a conclusion from this parade of chief executives marching out the door: Implicit in many, if not all, of these unceremonious departures is the absence of an effective CEO succession plan.

Anyone would think this discouraging track record—not to mention the increased regulatory pressure on corpo-

rate boards to play a more active governance role—would spur directors to take steps to avoid similar disappointments at their own companies. But during good times, most boards simply don't want to talk about CEO succession. Why rock the boat when things are going well? Why offend an incumbent CEO who is doing a great job? Why take valuable board time to discuss a succession that is unlikely to occur for years? During bad times, when the board is ready to fire the CEO, it's too late to talk about a plan for smoothly passing the baton.

So if boards aren't likely to take responsibility for succession planning, who should? The answer is obvious: the current CEO. Early—and I mean early—in your tenure as CEO, you should initiate and then actively manage the process of selecting and grooming a successor. You should follow the textbook rules: Identify the best talent, combine

strategic planning with leadership development, and work closely with the chosen successor to ensure a seamless transition. But these principles should be expanded to include a few that the management literature overlooks—principles that apply specifically to the incumbent CEO.

One reason for you to take the lead in managing the succession process—and, if necessary, to prod the board to collaborate with you—is the unfortunate possibility that your term may be cut short by illness or accident. More important, aggressive succession planning is one of the best ways for you to ensure the long-term health of your company. There is one other, somewhat counterintuitive benefit: Thinking early and often about a successor will likely improve your performance during your time in the position.

Dealing with the Big E

Before we get to my own recent hand-off at Quest Diagnostics, let's take a look at one of the biggest barriers to adopting the succession approach I am advocating—the CEO ego.

It's no secret that few chief executives are in any hurry to bring up the topic of succession. Most of them, justifiably or not, believe their own laudatory press. They can't imagine that an adequate replacement exists. Whatever the validity of these perceptions, most CEOs are understandably loath to give up the power, perks, and prestige that the boss enjoys. Consequently, they stay in their jobs too long. I know a company in which the chairman and CEO brought in a chief operating officer as his heir apparent—and then fired him. He brought in another COO—and fired him, as well. When the third COO joined the company, the board had to say to the chairman, "This one is going to become the CEO."

Kenneth W. Freeman (ken.w.freeman@questdiagnostics.com) is the chairman and former CEO of Quest Diagnostics, the largest medical testing company in the United States. The company is based in Teterboro, New Jersey.

I've long been committed to the notion of CEO term limits for reasons that relate both to the organization and to the individual. Companies and individuals achieve greatness when they embrace change, taking risks to move to the next level. Occasionally, a CEO can continually reinvent both himself and his organization; most often, though, the CEO's actions become predictable over time. The company gets comfortable with the status quo, and the organization's ability to change is severely diminished. I've come to realize that it's better to give your all during the finite time your leadership is still fresh and people are still on their toes. Furthermore, knowing that your days are numbered injects a sense of urgency into your work.

But there's another reason that a CEO shouldn't view his or her job as a permanent position. As the issues facing a business evolve, the CEO must also evolve. At some point, though, evolution isn't enough: The chief executive's talents will no longer be matched to the strategic challenges facing the company. At this stage—or, even better, before it—the CEO should yield to someone with skills better suited to the issues at hand. Even here, the ego problem can rear its ugly head. I think it is safe to say that some CEOs are so attached to the prestige they have enjoyed in their leadership roles that they secretly hope to see their successors stumble, thereby making their own achievements look better in retrospect.

Well, I don't think I was guilty of secretly harboring that perverse emotion. But let me tell you that my ego, too, knows how difficult it is to let go of the helm. One day I had 37,000 employees looking to me for direction, depending on me for their paychecks. The next day I woke up, and those 37,000 people were looking to someone else. It's hard not to feel like your identity is being stripped away when you relinquish the CEO title. I experienced that acutely this past spring when *BusinessWeek* was putting together its annual ranking of corporate America's 50 best-performing companies, right around the time that

Surya N. Mohapatra was preparing to take over from me as CEO. Quest Diagnostics was ranked 34, and though I can't say I'm proud to admit it, I wanted my picture to accompany the business profile in the magazine. Luckily for me, the article appeared before the transition. Although I was prepared to accept my place out of the spotlight, I would have been disappointed to do so.

Keeping your ego in check through the discipline of managing your succession yields a benefit more immediate than the long-term health of the company: It can make you a better CEO. While you're thinking about the skills your successor will need, you'll also be dispassionately evaluating your own strengths and limitations. You may even identify organizational problems that, because of your temperament or talents, you aren't currently tackling. Whether you take these on or decide they are best left to a successor, the very act of thinking in this way provides you with a particularly clear-eyed view of the company and its challenges.

Anyway, as someone aware of his own ego, I tried from the beginning to avoid the usual mistakes CEOs make in succession planning. At the risk of falling into another ego trap—the unwarranted assumption that my approach is a blueprint for succession success—let me say that I think my experience offers a useful perspective on the process. Perhaps the most important lesson, one that even my own ego can endorse: Your true legacy as a CEO is what happens to the company *after* you leave the corner office.

From Survival to Evolution

I stepped down as CEO of Quest Diagnostics in May 2004 after nearly nine years in the job. My own route to the chief executive's office ran through Corning Incorporated, where, beginning in 1972, I held numerous financial and general management positions. In 1995, I joined Corning Clinical Laboratories, the predecessor company to Quest Diagnostics, as CEO. Quest Diagnostics performs medical tests on patients' blood and other specimens to



help doctors diagnose and treat everything from cardiovascular disease to cystic fibrosis. When the company was spun off to Corning shareholders at the end of 1996, I became chairman and CEO. I took the job vowing to live up to my good intention not to linger too long. I couldn't imagine staying in the position for more than eight to ten years. But sticking to my guns was harder than I had imagined.

During my early days as CEO, succession planning wasn't near the top of anyone's agenda. The board and senior management team had their hands full just trying to save the company. The business had made several major acquisitions in 1993 and 1994, and it was facing some serious integration challenges and a heavy debt load. One of the acquired companies was accused of Medicare fraud, which ultimately led to a \$100 million settlement with the government. We were also trying to stem the flight of physician groups and hos-

pitals that were unhappy with the quality of our service and dealing with the downward slide in prices caused by overcapacity in the industry and competition for big managed-care contracts. Quest Diagnostics was in survival mode.

Nonetheless, because of my views on CEO tenure, I forced myself almost from the beginning to think about possible candidates to succeed me. First, I carefully considered people inside the company. There were some wonderful people on the senior team, but I quickly concluded that none of them possessed the unique attributes that the business would need in the future. In many ways, the strengths of the best internal candidates mirrored mine. Though I lacked experience in the health care industry, I did know operations and finance. And that was the functional expertise we would need to achieve our first goal, surviving, and our second, becoming the leader in our industry by improving quality and forcing industry consolida-

tion. The team I had was perfect for trying to meet those goals. But once we achieved them, we would need a different set of leadership skills to help us meet the next wave of challenges.

To drive improvements in quality and to create a common culture, we embarked on an aggressive Six Sigma program that focused on such areas as increasing the accuracy and turnaround times of our tests. After we had stabilized the company and achieved marginal profitability, we once again turned to acquisitions to fuel our growth, taking particular care to integrate an acquired company before embarking on another major deal. With the \$1.3 billion acquisition in 1999 of our biggest competitor, SmithKline Beecham Clinical Laboratories, Quest Diagnostics more than doubled its revenue and became the leading provider of diagnostic testing, information, and services in the United States. Last year, the company had earnings of about \$436 million on revenue of \$4.7 billion. Quest Diagnostics performs testing on behalf of more than 130 million patients a year—managing, arguably, more clinical encounters than any other health care services company in the United States.

The majority of the company's rapid growth historically had come from acquisitions. But it was clear we also needed to move in directions that would allow us to capitalize on advances in medicine, science, and information technology. For example, cutting-edge procedures—such as gene-based and other highly sophisticated tests—generate only about 20% of our revenues, but they are highly profitable and a vital part of the company's future. With this necessary evolution in mind, I began to think more actively about the kind of successor who would be best suited to that future, knowing that the right person did not exist inside the company. I was 48 years old and had been CEO just over three years.

We cast our net widely and settled on several candidates, including Surya, who was then a senior vice president and a member of the executive committee at Picker International, a manufacturer of



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advanced medical-imaging technologies (now part of Philips Medical Systems). After an exhaustive due diligence and interview process—including seven conversations with me—Surya joined Quest Diagnostics in February 1999 as senior vice president and chief operating officer. His medical and scientific knowledge—he holds an undergraduate degree in electrical engineering, a master's degree in medical electronics, and a doctorate in medical physics—and 20 years of broad experience in the health care industry were just the right credentials for the job. Four months later, he was named president.

With the aim of weighing the relative strengths and weaknesses of two potential successors, we did consider another candidate who came to us through an acquisition. The fit with this candidate just wasn't right. Surya, meanwhile, clicked with the business from day one. He understood the bigger health care issues, and he had a keen appreciation for the importance of providing exceptional care for patients. For five years, Surya and I worked together with an eye toward him succeeding me if his performance merited it. In that period, the board's assessment of Surya shifted from "he might" to "he could" to "he should" to "he will" become CEO.

During his apprenticeship, Surya had two jobs. One was to help manage the business, including the integration of SmithKline Beecham and the development of new sources of growth based on science and research rather than acquisitions. The other was to learn the leadership skills necessary to be CEO. He was a master of the content side of the new business—but there were some areas for improvement on the leadership side.

Will Surya be successful? Time will tell. He took over as CEO in May, and he will succeed me as chairman next month. One thing is clear: The board and I are confident that he is the right CEO at the right time for Quest Diagnostics. I've had my day at the company. This new frontier—the convergence of diagnostic testing, diagnostic imaging, and advances in information

technology for medicine—will be Surya's to explore. If, as we expect, he proves to be a terrific success, it will be due in part to several principles that helped drive the process by which he became CEO.

Force the Board to Pay Attention

When I first raised the issue of succession with the board at Quest Diagnostics, its initial response was, without exaggerating too much, one of wonder. The directors were generally encouraged by my performance and appeared comfortable with my serving as CEO for as long as I wanted.

Certainly, the cozy relationships that some CEOs have with their directors can exacerbate boards' natural tendency to shy away from the issue of CEO succession. In my case, though, this was not a group of people with whom I had long-standing personal ties. In fact, it was a very independent bunch—proof, if any was needed, of the importance of a CEO's initiating the discussion about his own succession.

Even as the process moved forward over the years, I had to work to keep the issue front and center with the board. And when it was clear to me that Surya was the right person to take my place, I tried to facilitate a process through which directors would become as comfortable with him as I was.

Surya, like many scientists, was a bit reserved. Partly because of his cultural background, he also was instinctively respectful, if not deferential, to board members, whom he rightly viewed as his ultimate bosses. I could see that I needed to articulate for the board, which was used to my more outgoing style, that Surya was bringing something different to the table. I encouraged Surya to think of the directors as colleagues as well as superiors, and I suggested that he systematically schedule one-on-one meetings with them, which he did. A year before Surya formally joined the board in the fall of 2002, I changed a few things in the way meetings were conducted. I mixed up the seating chart, for example, so that Surya was sitting among the board

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members and not at the head of the table. And I started leaving the room when Surya was making presentations to encourage more informal and unfiltered interactions between him and the board members.

Over time, Surya became more assertive in his boardroom dealings, and the directors took more ownership of the succession process. In retrospect, I wish I'd engaged the board even earlier in the process of getting to know Surya and evaluating whether he was the right person for the job.

Look for Differences

As I have said, it was clear to me that Quest Diagnostics needed a new kind of CEO if the company was to be successful in its next stage of growth. I don't think that's unusual. At most companies, if a CEO has accomplished what he set out to do, the company's needs will have changed, and the successor will require different skills and experience, as well as a different personality.

Finding such a person won't happen automatically. In the hiring process, we all tend to choose the people who most resemble us. But instead of looking in the mirror for the essential characteristics of a successor, we should look out the window toward the real future of the company and let that guide our choice.

Surya and I are very different people. He is introspective; I am outgoing. He grew up in rural India; I am from the suburbs of New York City. I have an MBA; he has a PhD. The most relevant difference, though, relates to our professional skills. Surya's background is heavily – and impressively – scientific. He not only is steeped in the worlds of science and engineering but also has written about and holds a number of patents in the areas of the human cardiovascular system and magnetic resonance imaging.

If Surya is about science, I am more about the arts. One semester of physics in college was enough for me. Music was my passion; for a short time, I wanted to become a professional musician, making my living at the keyboard. But I also wanted to eat, and I soon decided to

pursue a career at Corning on the financial side of things.

I recognized that given the way the diagnostic-testing industry was changing, if I stayed on as CEO for another four or five years I'd lack some crucial skills needed for success in the job. I had to be honest with myself. If future strategic discussions involved the latest innovations in genetics or proteomics rather than the next acquisition, I not only wouldn't bring much to the table but I also wouldn't feel the necessary fire in my belly to implement our strategy.

All that being said, Surya and I did share one key characteristic: a fierce determination—and proven capability—to deliver strong business results.

Make Your Successor's Success Your Own

Unfortunately, a new CEO with a different style and different skills can find it hard to get out from under his predecessor's shadow—a shadow that the organization may find familiar and com-

forting. In such a case, the incumbent must make a serious commitment to help his successor step into his new role. With this in mind, I worked closely with Surya in the years before he became CEO, exploring with him the nature of our business and offering advice on matters that I thought would make him a stronger leader.

Our main forum for this was a Sunday afternoon phone call, an hour or so long, which we had at 4 PM nearly every week for five years. (We were disciplined in keeping this appointment—and missed more than a few tempting football games and concerts because of it!) Although our offices were right next to each other, there never seemed to be time during the week for this kind of uninterrupted conversation, one that mixed coaching, advice, and a mutual exchange of ideas.

During the calls, we covered everything from acquisition negotiations to scientific developments, from the Six Sigma program to personnel planning,

from the highest-level strategic issues to how each other's families were doing. We'd each bring two or three things to discuss. In my case, these would often involve management skills I thought Surya needed to work on in order to enhance his existing strengths. The feedback I gave Surya on his performance and leadership skills was the kind that could come only from someone who saw him in action at close range—and who was rooting for his success. The advice could get very granular.

During Surya's first week on the job, he and I visited a lab in Baltimore, where I conducted a "town meeting" with the employees and roamed through the lab greeting everyone individually at their work areas—doing the sort of thing that comes naturally to me. Afterward, Surya, ever the reticent scientist, said, "I could never do that." My instantaneous reply was, "If you want to be CEO someday, you'll have to." So I suggested he get some coaching to develop his communications skills and, over the years,

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pushed him to test his new skills in public meetings with employees and investors.

We'd also use the phone conversations to talk about setting priorities and making decisions. Someone with a scientific bent is always in search of ever more information that will ultimately lead to the right answer. But in business, often what you need is *an* answer. I like to joke that Surya can get to "know" in his sleep; my job was to help him get to "no" at work. I remember a conversation when I said something like, "We've been talking about this personnel issue in Atlanta for the last four weeks. When are we going to do something? And what are we going to do?"

I don't mean to sound patronizing. If someone were providing me with detailed advice on my management style—indeed, if it were Surya himself doing so—that person could easily find similar areas for improvement. And though our meetings never involved lengthy critiques of me, the tables did begin to turn over the years. One Sunday afternoon, we were talking about a relatively small acquisition in the medical IT area that Surya had been pushing us to make. I saw it as a distraction; he saw it as a foothold in an area that offered significant potential. He persistently made his case—just as I had persistently prodded him to work on some of his management skills. In a very deliberate and forceful manner, he convinced me it was the right move to make.

Over time, Surya became more assertive not only with me but with the board. He became a polished and confident speaker. He was able to make decisions based on the crucial—even if not comprehensive—information.

Would our mentoring relationship have worked if the personal chemistry had been different? Our exchanges were full of candor and sometimes sharp disagreements, but Surya was an eager and ambitious learner, which allowed me to play in my own power alley as a coach. It certainly is possible that someone else might have bristled at what I felt was well-intentioned guidance. But I believe that, as long as there is mutual trust and



respect, two people in this situation can find a comfort zone that will allow an incumbent to increase the successor's chances of success.

Don't Drag Your Feet

I was 53 years old when I stepped down as CEO of Quest Diagnostics. If I were 63 and had only a couple of years to go until retirement, maybe I would have stayed on. But then there would have been the risk that, when I turned 65, the board would have extended my contract for another three years and, as so often happens with a CEO, I'd have become a predictable part of the furniture.

There's a lot to be said for leaving at the top of your game. I often think of Sandy Koufax, the former Los Angeles Dodgers pitcher. Unlike many other all-star players who stayed on long past their primes—adding a coda of sadly failing skills to some of the greatest careers

of all time—Koufax left baseball when he was still the best pitcher in either league. I like to think that I, too, stepped down at the right time.

Even if your skills are no longer ideal for a particular company, they are still highly valuable. I plan on embarking on a second career, running another organization, possibly even in an arena other than business, where my skills can provide value.

I should mention one other risk facing CEOs: the return appearance. With increasing regularity, executives are being called back by their former companies to resume the chief executive's job. But think twice before you do it. It means not only that your successor failed, but that you did, too—at succession planning. ▢

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GETTING PAST YES

Negotiating as if
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Techniques that can help you seal a deal may end up torpedoing the relationship when it's time to put the deal into operation.

IN JULY 1998, AT&T AND BT ANNOUNCED a new 50/50 joint venture that promised to bring global interconnectivity to multinational customers. Concert, as the venture was called, was launched with great fanfare and even greater expectations: The \$10 billion start-up would pool assets, talent, and relationships and was expected to log \$1 billion in profits from day one. Just three years later, Concert was out of business. It had laid off 2,300 employees, announced \$7 billion in charges, and returned its infrastructure assets to the parent companies. To be sure, the weak market played a role in Concert's demise, but the way the deal was put together certainly hammered a few nails into the coffin.

For example, AT&T's deal makers scored what they probably considered a valuable win when they negotiated a way for AT&T Solutions to retain key multinational customers for itself. As a result, AT&T and BT ended up in direct competition for business—exactly what

the Concert venture was supposed to help prevent. For its part, BT seemingly outnegotiated AT&T by refusing to contribute to AT&T's purchase of the IBM Global Network. That move saved BT money, but it muddied Concert's strategy, leaving the start-up to contend with overlapping products. In 2000, Concert announced a complex new arrangement that was supposed to clarify its strategy, but many questions about account ownership, revenue recognition, and competing offerings went unanswered. Ultimately, the two parent companies pulled the plug on the venture.¹

Concert is hardly the only alliance that began with a signed contract and a champagne toast but ended in bitter disappointment. Examples abound of deals that look terrific on paper but never materialize into effective, value-creating endeavors. And it's not just alliances that can go bad during implementation. Misfortune can befall a whole range of agreements that involve two

by Danny Ertel

or more parties – mergers, acquisitions, outsourcing contracts, even internal projects that require the cooperation of more than one department. Although the problem often masquerades as one of execution, its roots are anchored in the deal’s inception, when negotiators act as if their main objective were to sign the deal. To be successful, negotiators must recognize that signing a contract is just the beginning of the process of creating value.

During the past 20 years, I’ve analyzed or assisted in hundreds of complex negotiations, both through my research at the Harvard Negotiation Project and through my consulting practice. And I’ve seen countless deals that were signed with optimism fall apart during implementation, despite the care and creativity with which their terms were crafted. The crux of the problem is that the very person everyone thinks is central to the deal – the negotiator – is often the one who undermines the partnership’s ability to succeed. The real challenge lies not in hammering out little victories on the way to signing on the dotted line but in designing a deal that works in practice.

The Danger of Deal Makers

It’s easy to see where the deal maker mind-set comes from. The media glorifies big-name deal makers like Donald Trump, Michael Ovitz, and Bruce Wasserstein. Books like *You Can Negotiate Anything*, *Trump: The Art of the Deal*, and even my own partners’ *Getting to Yes* all position the end of the negotiation as the destination. And most companies evaluate and compensate negotiators based on the size of the deals they’re signing.

But what kind of behavior does this approach create? People who view the contract as the conclusion and see themselves as solely responsible for getting there behave very differently from those who see the agreement as just the beginning and believe their role is to ensure that the parties involved actually realize the value they are trying to create. These two camps have conflicting opinions about the use of surprise and the sharing of information. They also differ in how much attention they pay to whether the parties’ commitments are realistic, whether their stakeholders are sufficiently aligned, and whether those who must implement the deal can establish a suitable working relationship with one another. (For a comparison of how different mind-sets affect negotiation behaviors, see the exhibit “Deal-Minded Negotiators Versus Implementation-Minded Negotiators.”)

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This isn’t to say deal makers are sleazy, dishonest, or unethical. Being a deal maker means being a good closer. The deal maker mind-set is the ideal approach in certain circumstances. For example, when negotiating the sale of an asset in which title will simply be transferred and the parties will have little or no need to work together, getting the signatures on the page really does define success.

But frequently a signed contract represents a commitment to work together to create value. When that’s the case, the manner in which the parties “get to yes” matters a great deal. Unfortunately, many organizations structure their negotiation teams and manage the flow of information in ways that actually hurt a deal’s chances of being implemented well.

An organization that embraces the deal maker approach, for instance, tends to structure its business development teams in a way that drives an ever growing stream of new deals. These dedicated teams, responsible for keeping negotiations on track and getting deals done, build tactical expertise, acquire knowledge of useful contract terms, and go on to sign more deals. But they also become detached from implementation and are likely to focus more on the agreement than on its business impact. Just think about the language deal-making teams use (“closing” a deal, putting a deal “to bed”) and how their performance is measured and rewarded (in terms of the number and size of deals closed and the time required to close them). These teams want to sign a piece of paper and book the expected value; they couldn’t care less about launching a relationship.

The much talked about Business Affairs engine at AOL under David Colburn is one extreme example. The group became so focused on doing deals – the larger and more lopsided the better – that it lost sight of the need to have its business partners actually remain in business or to have its deals produce more than paper value. In 2002, following internal investigations and probes by the SEC and the Department of Justice, AOL Time Warner concluded it needed to restate financial results to account for the real value (or lack thereof) created by some of those deals.²

The deal maker mentality also fosters the take-no-prisoners attitude common in procurement organizations. The aim: Squeeze your counterpart for the best possible deal you can get. Instead of focusing on deal volume, as business development engines do, these groups concentrate on how many concessions they can get. The desire to win outweighs the costs of signing a deal that cannot work in practice because the supplier will never be able to make enough money.

Think about how companies handle negotiations with outsourcing providers. Few organizations contract out enough of their work to have as much expertise as the providers themselves in negotiating deal structures, terms and conditions, metrics, pricing, and the like, so they fre-

quently engage a third-party adviser to help level the playing field as they select an outsourcer and hammer out a contract. Some advisers actually trumpet their role in commoditizing the providers' solutions so they can create "apples to apples" comparison charts, engender competitive bidding, and drive down prices. To maximize competitive tension, they exert tight control, blocking virtually all communications between would-be customers and service providers. That means the outsourcers have almost no opportunity to design solutions tailored to the customer's unique business drivers.

The results are fairly predictable. The deal structure that both customer and provider teams are left to implement is the one that was easiest to compare with other bids, not the one that would have created the most value. Worse yet, when the negotiators on each side exit the process, the people responsible for making the deal work are virtual strangers and lack a nuanced understanding of why issues were handled the way they were. Furthermore, neither side has earned the trust of its partner during negotiations. The hard feelings created by the hired guns can linger for years.

The fact is, organizations that depend on negotiations for growth can't afford to abdicate management responsibility for the process. It would be foolhardy to leave negotiations entirely up to the individual wits and skills of those sitting at the table on any given day. That's why some corporations have taken steps to make negotiation an organizational competence. They have made the process more structured by, for instance, applying Six Sigma discipline or community of practice principles to improve outcomes and learn from past experiences.

Sarbanes-Oxley and an emphasis on greater management accountability will only reinforce this trend. As more companies (and their auditors) recognize the need to move to a controls-based approach for their deal-making processes—be they in sales, sourcing, or business development—they will need to implement metrics, tools, and process disciplines that preserve creativity and let managers truly manage negotiators. How they do so, and how they define the role of the negotiator, will determine whether deals end up creating or destroying value.

Negotiating for Implementation

Making the leap to an implementation mind-set requires five shifts.

1. Start with the end in mind. For the involved parties to reap the benefits outlined in the agreement, goodwill and collaboration are needed during implementation. That's why negotiation teams should carry out a simple "benefit of hindsight" exercise as part of their preparation.

Imagine that it is 12 months into the deal, and ask yourself:

Is the deal working? What metrics are we using? If quantitative metrics are too hard to define, what other indications of success can we use?

What has gone wrong so far? What have we done to put things back on course? What were some early warning signals that the deal may not meet its objectives?

What capabilities are necessary to accomplish our objectives? What processes and tools must be in place? What skills must the implementation teams have? What attitudes or assumptions are required of those who must implement the deal? Who has tried to block implementation, and how have we responded?

If negotiators are required to answer those kinds of questions before the deal is finalized, they cannot help but behave differently. For example, if the negotiators of the Concert joint venture had followed that line of questioning before closing the deal, they might have asked themselves, "What good is winning the right to keep customers out of the deal if doing so leads to competition between the alliance's parents? And if we have to take that risk, can we put in mechanisms now to help mitigate it?" Raising those tough questions probably wouldn't have made a negotiator popular, but it might have led to different terms in the deal and certainly to different processes and metrics in the implementation plan.

Most organizations with experience in negotiating complex deals know that some terms have a tendency to come back and bite them during implementation. For example, in 50/50 ventures, the partner with greater leverage often secures the right to break ties if the new venture's steering committee should ever come to an impasse on an issue. In practice, though, that means

A New Mind-Set

Five approaches can help your negotiating team transition from a deal maker mentality to an implementation mind-set.

1. Start with the end in mind. Imagine the deal 12 months out: What has gone wrong? How do you know if it's a success? Who should have been involved earlier?

2. Help them prepare, too. Surprising the other side doesn't make sense, because if they promise things they can't deliver, you both lose.

3. Treat alignment as a shared responsibility. If your counterpart's interests aren't aligned, it's your problem, too.

4. Send one message. Brief implementation teams on both sides of the deal together so everyone has the same information.

5. Manage negotiation like a business process. Combine a disciplined preparation process with postnegotiation reviews.

executives from the dominant party who go into negotiations to resolve such impasses don't really have to engage with the other side. At the end of the day, they know they can simply impose their decision. But when that happens, the relationship is frequently broken beyond repair.

Tom Finn, vice president of strategic planning and alliances at Procter & Gamble Pharmaceuticals, has made it his mission to incorporate tough lessons like that into the negotiation process itself. Although Finn's alliance management responsibilities technically don't start until after a deal has been negotiated by the P&G Pharmaceuticals business development organization, Finn jumps into the negotiation process to ensure negotiators do not bargain for terms that will cause trouble down the road. "It's not just a matter of a win-win philosophy," he says. "It's about incorporating our alliance managers' hard-won experience with terms that cause implementation problems and not letting those terms into our deals."

Finn and his team avoid things like step-down royalties and unequal profit splits with 50/50 expense sharing, to name just a few. "It's important that the partners be provided [with] incentives to do the right thing," Finn says. "When those incentives shift, you tend to end up [with] difficulties." Step-down royalties, for instance, are a common structure in the industry. They're predicated on the assumption that a brand is made or lost in the first three years, so that thereafter, payments to the originator should go down. But P&G Pharmaceuticals believes it is important to provide incentives to the partner to continue to work hard over time. As for concerns about overpaying for the licensed compound in the latter years of the contract, Finn asserts that "leaving some money on the table is OK if you realize that the most expensive deal is one that fails."

2. Help them prepare, too. If implementation is the name of the game, then coming to the table well prepared is necessary – but not sufficient. Your counterpart must also be prepared to negotiate a workable deal. Some negotiators believe they can gain advantage by surprising the other side. But surprise confers advantage only because the counterpart has failed to think through all the implications of a proposal and might mistakenly commit to something it wouldn't have if it had been better prepared. While that kind of an advantage might pay off in a simple buy-sell transaction, it fails miserably – for both sides – in any situation that requires a long-term working relationship.

That's why it's in your best interest to engage with your counterpart before negotiations start. Encourage the other party to do its homework and consult with its internal stakeholders before and throughout the negotiation process. Let the team know who you think the key players

are, who should be involved early on, how you hope to build implementation planning into the negotiation process, and what key questions you are asking yourself.

Take the example of Equitas, a major reinsurer in the London market. When preparing for commutations negotiations – whereby two reinsurers settle their mutual book of business – the company sends its counterpart a thorough kickoff package, which is used as the agenda for the negotiation launch meeting. This "commutations action pack" describes how the reinsurer's own commutations department is organized, what its preferred approach to a commutations negotiation is, and what stages it follows. It also includes a suggested approach to policy reconciliation and due diligence and explains what data the reinsurer has available – even acknowledging its imperfections and gaps.

The package describes critical issues for the reinsurer and provides sample agreements and memorandums for various stages of the process.

The kickoff meeting thus offers a structured environment in which the parties can educate each other on their decision-making processes and their expectations for the deal. The language of the commutations action pack and the collaborative spirit of the kickoff meeting are designed to help the parties get to know each other and settle on a way of working together before they start making the difficult trade-offs that will be required of them. By establishing an agreed-upon process for how and when to communicate with brokers about the deal, the two sides are better able to manage the tension between the need to include stakeholders who are critical to implementation and the need to maintain confidentiality before the deal is signed.

Aventis Pharma is another example of how measured disclosure of background and other information can pave the way to smoother negotiations and stronger implementation. Like many of its peers, the British pharmaceutical giant wants potential biotech partners to see it as a partner of choice and value a relationship with the company for more than the size of the royalty check involved. To that end, Aventis has developed and piloted a "negotiation launch" process, which it describes as a meeting during which parties about to enter into formal negotiations plan together for those negotiations. Such collaboration allows both sides to identify potential issues and set up an agreed upon process and time line. The company asserts that while "formally launching negotiations with a counterpart may seem unorthodox to some," the entire negotiation process runs more efficiently and effectively when partners "take the time to discuss how they will negotiate before beginning."

"Leaving some money on the table is OK if you realize that the most expensive deal is one that fails."

Deal-Minded Negotiators

Versus

Implementation-Minded Negotiators

Assumption

“Surprising them helps me. They may commit to something they might not have otherwise, and we’ll get a better deal.”

Behaviors

Introduce new actors or information at strategic points in negotiation.
Raise new issues at the end.

Negotiation Tactics

Surprise

Assumption

“Surprising them puts us at risk. They may commit to something they cannot deliver or will regret.”

Behaviors

Propose agendas in advance so both parties can prepare.
Suggest questions to be discussed, and provide relevant data.
Raise issues early.

Assumption

“It’s not my role to equip them with relevant information or to correct their misperceptions.”

Behaviors

Withhold information.
Fail to correct mistaken impressions.

Information sharing

Assumption

“I don’t want them entering this deal feeling duped. I want their goodwill during implementation, not their grudging compliance.”

Behaviors

Create a joint fact-gathering group.
Commission third-party research and analysis.
Question everyone’s assumptions openly.

Assumption

“My job is to get the deal closed. It’s worth putting a little pressure on them now and coping with their unhappiness later.”

Behaviors

Create artificial deadlines.
Threaten escalation.
Make “this day only” offers.

Closing techniques

Assumption

“My job is to create value by crafting a workable agreement. Investing a little extra time in making sure both sides are aligned is worth the effort.”

Behaviors

Define interests that need to be considered for the deal to be successful.
Define joint communication strategy.

Assumptions

“As long as they commit, that’s all that matters. Afterward, it’s their problem if they don’t deliver.”

Behaviors

Focus on documenting commitments rather than on testing the practicality of those commitments.
Rely on penalty clauses for protection.

Realistic commitments

Assumption

“If they fail to deliver, we don’t get the value we expect.”

Behaviors

Ask tough questions about both parties’ ability to deliver.
Make implementability a shared concern.
Establish early warning systems and contingency plans.

Assumption

“The fewer people involved in making this decision, the better and faster this will go.”

Behaviors

Limit participation in discussions to decision makers.
Keep outsiders in the dark until it is too late for them to derail things.

Decision making and stakeholders

Assumption

“If we both fail to involve key stakeholders sufficiently and early enough, whatever time we save now will be lost during implementation.”

Behaviors

Repeatedly ask about stakeholders:
Whose approval is needed?
Whose cooperation is required?
Who might interfere with implementation?

3. Treat alignment as a shared responsibility. If their interests are not aligned, and they cannot deliver fully, that's not just their problem – it's your problem, too.

Unfortunately, deal makers often rely on secrecy to achieve their goals (after all, a stakeholder who doesn't know about a deal can't object). But leaving internal stakeholders in the dark about a potential deal can have negative consequences. Individuals and departments that will be directly affected don't have a chance to weigh in with suggestions to mitigate risks or improve the outcome. And people with relevant information about the deal don't share it, because they have no idea it's needed. Instead, the typical reaction managers have when confronted late in the game with news of a deal that will affect their department is "Not with my FTEs, you don't."

Turning a blind eye to likely alignment problems on the other side of the table is one of the leading reasons alliances break down and one of the major sources of

vider that the buyers will dedicate internal resources to change-management and communication efforts. No one asks whether business unit managers support the deal or whether function leaders are prepared to make the transition from managing the actual work to managing the relationship with an external provider. Everyone simply agrees, the deal is signed, and the frustration begins.

As managers and employees work around the new self-service system, the provider's costs increase, the service levels fall (because the provider was not staffed for the high level of calls and faxes), and customer satisfaction plummets. Finger-pointing ensues, which must then be addressed through expensive additions to the contract, costly modifications to processes and technology, and additional burdens on a communication and change effort already laden with baggage from the initial failure.

Building alignment is among negotiators' least favorite activities. The deal makers often feel as if they are wasting precious time "negotiating internally" instead of working their magic on the other side. But without acceptance of the deal by those who are essential to its implementation (or who can place obstacles in the way), proceeding with the deal is even more wasteful. Alignment is a classic "pay me now or pay me later" problem. To understand whether the deal will work in practice, the negotiation process must encompass not only subject matter experts or those with bargaining authority but also those who will actually have to take critical actions or refrain from pursuing conflicting avenues later.

Because significant deals often require both parties to preserve some degree of confidentiality, the matter of involving the right stakeholders at the right time is more effectively addressed jointly than unilaterally. With an understanding of who the different stakeholders are – including those who have necessary information, those who hold critical budgets, those who manage important third-party relationships, and so on – a joint communications subteam can then map how, when, and with whom different inputs will be solicited and different categories of information might be shared. For example, some stakeholders may need to know that the negotiations are taking place but not the identity of the counterpart. Others may need only to be aware that the organization is seeking to form a partnership so they can prepare for the potential effects of an eventual deal. And while some must remain in the dark, suitable proxies should be identified to ensure that their perspectives (and the roles they will play during implementation) are considered at the table.



conflict in outsourcing deals. Many companies, for instance, have outsourced some of their human resource or finance and accounting processes. Service providers, for their part, often move labor-intensive processes to Web-based self-service systems to gain process efficiencies. If users find the new self-service system frustrating or intimidating, though, they make repeated (and expensive) calls to service centers or fax in handwritten forms. As a result, processing costs jump from pennies per transaction to tens of dollars per transaction.

But during the initial negotiation, buyers routinely fail to disclose just how undisciplined their processes are and how resistant to change their cultures might be. After all, they think, those problems will be the provider's headache once the deal is signed. Meanwhile, to make requested price concessions, providers often drop line items from their proposals intended to educate employees and support the new process. In exchange for such concessions, with a wink and a nod, negotiators assure the pro-

4. Send one message. Complex deals require the participation of many people during implementation, so once the agreement is in place, it's essential that the team that created it get everyone up to speed on the terms of the deal, on the mind-set under which it was negotiated, and on the trade-offs that were made in crafting the final contract. When each implementation team is given the contract in a vacuum and then is left to interpret it separately, each develops a different picture of what the deal is meant to accomplish, of the negotiators' intentions, and of what wasn't actually written in the document but each had imagined would be true in practice.

"If your objective is to have a deal you can implement, then you want the actual people who will be there, after the negotiators move on, up front and listening to the dialogue and the give-and-take during the negotiation so

they understand how you got to the agreed solution," says Steve Fenn, vice president for retail industry and former VP for global business development at IBM Global Services. "But we can't always have the delivery executive at the table, and our customer doesn't always know who from their side is going to be around to lead the relationship." To address this challenge, Fenn uses joint hand-off meetings, at which he and his counterpart brief both sides of the delivery equation. "We tell them what's in the contract, what is different or nonstandard, what the schedules cover. But more important, we clarify the intent of the deal: Here's what we had difficulty with, and here's what we ended up with and why. We don't try to reinterpret the language of the contract but [we do try] to discuss openly the spirit of the contract." These meetings are usually attended by the individual who developed the statement of

Negotiating Credibility

HP SERVICES is growing in a highly competitive market, and its success is partly due to its approach to negotiating large outsourcing transactions. In a maturing market, where top tier providers can demonstrate comparable capabilities and where price variations inevitably diminish after companies bid against one another time and time again, a provider's ability to manage a relationship and build trust are key differentiators. The negotiation and the set of interactions leading up to it give the customer a first taste of what it will be like to solve problems with the provider during the life of the contract. "Decisions made by clients regarding selection have as much to do with the company they want to do business with as with price, capability, and reliability," acknowledges Steve Huhn, HP Services' vice president of strategic outsourcing. "Negotiating these kinds of deals requires being honest, open, and credible. Integrity is critical to our credibility."

Huhn's team of negotiators uses a well-structured process designed to make sure that the philosophy of integrity is pervasive throughout the

negotiation and not just a function of who happens to be at the table on any given day. It begins with the formation of a negotiation team. Because transition in complex outsourcing transactions represents a period of high vulnerability, it is important to involve implementation staff early on; that way, any commitments made can be validated by those who will be responsible for keeping them. A typical negotiation team consists of a business leader, or pursuit lead, who is usually responsible for developing the business and structuring the transaction; a contract specialist, who brings experience with outsourcing contract terms and conditions; and the proposed client manager, who will be responsible for delivery.

Negotiation leads work with a high degree of autonomy. Huhn believes that a negotiator without authority is little more than a messenger, and messengers are unlikely to earn trust or build working relationships with counterparts. At HP, negotiators earn that autonomy by preparing extensively with templates and by reviewing key deal param-

eters with management. A negotiator's mandate does not just cover price: It also encompasses margins, cash flow, and ROI at different times in the life of the contract; the treatment of transferred employees; the ways various kinds of risk will be allocated; and how the relationship will be governed. All these interests must be addressed—both in preparation and at the negotiation table.

HP's outsourcing negotiators are subject to informal reviews with full-time deal coaches as well as formal milestone reviews. The reviews, which are designed to get key stakeholders committed to implementation, happen before the formal proposal is delivered and before the deal is signed.

The pursuit team leaders aren't finished once the agreement is signed. In fact, they retain responsibility during the transition phase and are considered "liable" for the deal's performance during the next 18 to 24 months. That means negotiators can't simply jump to the next alluring deal. On the contrary, they have a vested interest in making sure the closed deal actually meets its targets.

work, the person who priced the deal, the contracts and negotiation lead, and occasionally legal counsel. This team briefs the project executive in charge of the implementation effort and the executive's direct reports. Participation on the customer side varies, because the early days in an outsourcing relationship are often hectic and full of turnover. But Fenn works with the project executive and the sales team to identify the key customer representatives who should be invited to the hand-off briefing.

Negotiators who know they have to brief the implementation team with their counterparts after the deal is signed will approach the entire negotiation differently. They'll start asking the sort of tough questions at the negotiating table that they imagine they'll have to field during the postdeal briefings. And as they think about how they will explain the deal to the delivery team, they will begin to marshal defensible precedents, norms, industry practices, and objective criteria. Such standards of legitimacy strengthen the relationship because they emphasize persuasion rather than coercion. Ultimately, this practice makes a deal more viable because attention shifts from the individual negotiators and their personalities toward the merits of the arrangement.

5. Manage negotiation like a business process. Negotiating as if implementation mattered isn't a simple task. You must worry about the costs and challenges of execution rather than just getting the other side to say yes. You must carry out all the internal consultations necessary to build alignment. And you must make sure your counterparts are as prepared as you are. Each of these actions can feel like a big time sink. Deal makers don't want to spend time negotiating with their own people to build alignment or risk having their counterparts pull out once they know all the details. If a company wants its negotiators to sign deals that create real value, though, it has to weed out that deal maker mentality from its ranks. Fortunately, it can be done with simple processes and controls. (For an example of how HP Services structures its negotiation process, see the sidebar "Negotiating Credibility.")

More and more outsourcing and procurement firms are adopting a disciplined negotiation preparation process. Some even require a manager to review the output of that process before authorizing the negotiator to proceed with the deal. KLA-Tencor, a semiconductor production equipment maker, uses the electronic tools available through its supplier-management Web site for this purpose, for example. Its managers can capture valuable information about negotiators' practices, including the issues they are coming up against, the options they are proposing, the standards of legitimacy they are relying on, and the walkaway alternatives they are considering. Coupled with simple postnegotiation reviews, this information can yield powerful organizational insights.

Preparing for successful implementation is hard work, and it has a lot less sizzle than the brinkmanship charac-

teristic of the negotiation process itself. To overcome the natural tendency to ignore feasibility questions, it's important for management to send a clear message about the value of postdeal implementation. It must reward individuals, at least in part, based on the delivered success of the deals they negotiate, not on how those deals look on paper. This practice is fairly standard among outsourcing service providers; it's one that should be adopted more broadly.

Improving the implementability of deals is not just about layering controls or capturing data. After all, a manager's strength has much to do with the skills she chooses to build and reward and the example she sets with her own questions and actions. In the health care arena, where payer-provider contentions are legion, forward-thinking payers and innovative providers are among those trying to change the dynamics of deals and develop agreements that work better. Blue Cross and Blue Shield of Florida, for example, has been working to institutionalize an approach to payer-provider negotiations that strengthens the working relationship and supports implementation. Training in collaborative negotiation tools and techniques has been rolled down from the senior executives to the negotiators to the support and analysis teams. Even more important, those who manage relationships with providers and are responsible for implementing the agreements are given the same training and tools. In other words, the entire process of putting the deal together, making it work, and feeding the lessons learned through implementation back into the negotiation process has been tightly integrated.

•••

Most competitive runners will tell you that if you train to get to the finish line, you will lose the race. To win, you have to envision your goal as just beyond the finish line so you will blow right past it at full speed. The same is true for a negotiator: If signing the document is your ultimate goal, you will fall short of a winning deal.

The product of a negotiation isn't a document; it's the value produced once the parties have done what they agreed to do. Negotiators who understand that prepare differently than deal makers do. They don't ask, "What might they be willing to accept?" but rather, "How do we create value together?" They also negotiate differently, recognizing that value comes not from a signature but from real work performed long after the ink has dried. ▢

1. For more perspectives on Concert's demise, see Margie Semilof's 2001 article "Concert Plays Its Last Note" on InternetWeek.com; Brian Washburn's 2000 article "Disconcerted" on Tele.com; and Charles Hodson's 2001 article "Concert: What Went Wrong?" on CNN.com.

2. See Alec Klein, "Lord of the Flies," the *Washington Post*, June 15, 2003, and Gary Rivlin, "AOL's Rough Riders," *Industry Standard*, October 30, 2000, for more information on the AOL Business Affairs department's practices.

Reprint R0411C; HBR OnPoint 8339

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Uncommon Insights. Uncommon Solutions.

Forward-Thinking in Treasury

Forward-thinking enterprises find the opportunity in any challenge. The Massachusetts Port Authority's (Massport) CEO, Craig Coy, outlined two strategic objectives: become the center of excellence for security at all of its facilities and transform a 50-year-old agency to act more like a business — with focus on profitability. Massport wished to significantly upgrade its banking technology to enhance administrative processes and strengthen management controls. This was the opportune moment to align its banking structure with these broader objectives.

Massport issued an RFP in March 2004, but timing posed a serious challenge — the banking transition had to be completed by July. With a 15 percent reduction in administrative staff imposed one year earlier, a leaner staff heightened the challenge of introducing new technology and controls in a short time. For this reason, customer focus was a top priority for Massport in its call for a banking partner.

Wachovia answered the call. "Our turnaround couldn't wait. Due to the technological changes and the tight schedule, we knew that implementation and service would be critical to success. Wachovia promised and delivered both of these," says Coy.

Massport — with annual revenue and operating expense at \$450 million and \$280 million, respectively, and a five-year capital plan of \$1.2 billion — owns and operates Boston-area airports, bridges and various facilities in the Port of Boston. The economic activity across these sites generates significant transaction volume and increases its treasury management complexity. In addition to

enhancing its payment efficiency, a cash-concentration capability was particularly important to Massport, given daily cash collection across multiple locations.

"Wachovia explained the full range of alternatives and recommended the best choices with the features that we needed," says Betsy Taylor, Director of Finance. Wachovia provided a Web-based solution to increase electronic payments, concentrate cash and improve information reporting. "The sophistication of Wachovia's solution enables the Authority to manage cash from any location with Internet access," adds Taylor. The solution

also includes Controlled Disbursement with the added security feature of Positive Pay, allowing the Authority to increase its control over payments from any location while maximizing its daily cash position. "Wachovia's system gave a tremendous level of flexibility and mobility, which not all banks offered."

Notes Taylor, "Instituting management control usually means separating processes that require additional staff. One of the remarkable

aspects of Wachovia's solution is the ability both to streamline daily cash management and increase management control while offering significant cost savings."

"Wachovia is a forward-thinking organization that will help us integrate the latest technology to support our continued vigilance toward security and efficiency. We are very pleased with the way Wachovia helped us solve our problems and are confident that they could help us anticipate and overcome any challenges that may arise in the future," says Coy.



"Wachovia explained the full range of alternatives and recommended the best choices with the features that we needed."



WACHOVIA

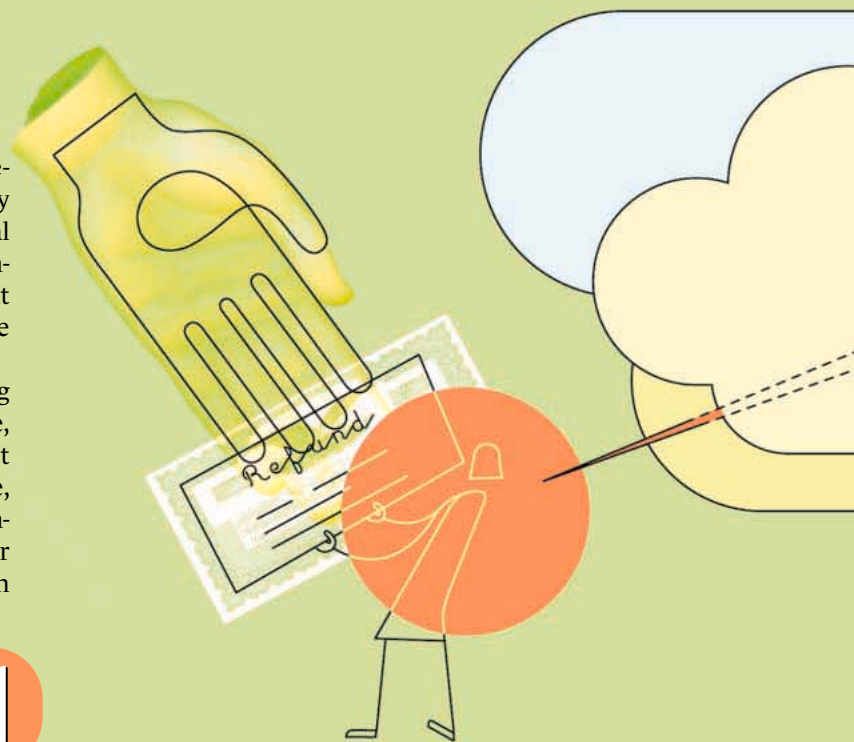
Uncommon Wisdom

CORPORATE BANKING ■ INVESTMENT BANKING ■ EQUITY CAPITAL MARKETS ■ FIXED INCOME

Most corporate boards are completely in the dark about their companies' marketing strategies. A simple series of management reports can give them the light they need.

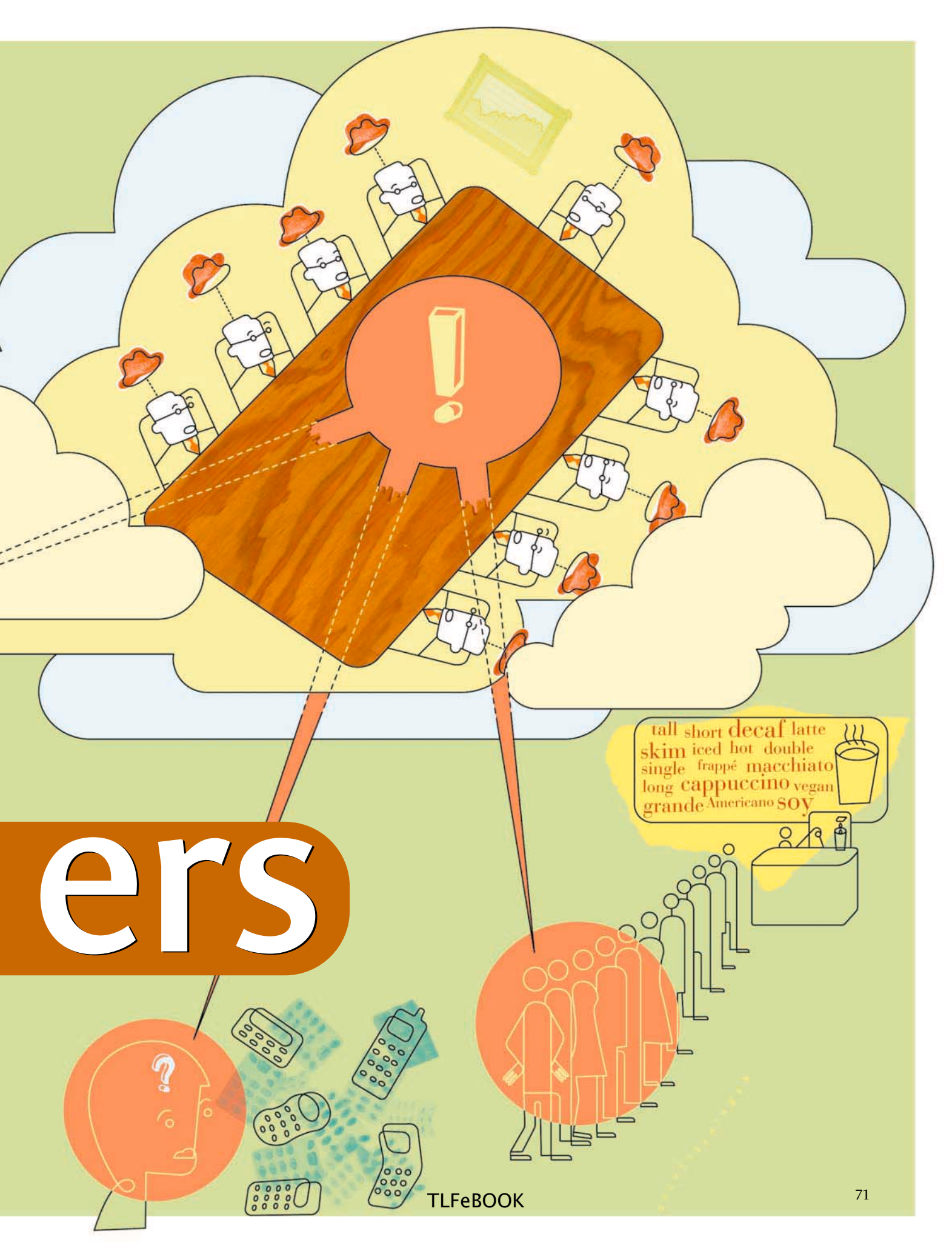
MISGUIDED MARKETING STRATEGIES have destroyed more shareholder value – and probably more careers – than shoddy accounting or shady fiscal practices have. In almost every industry – telecommunications, airlines, consumer products, finance – it is easy to point to poor marketing as a major cause of low growth and declining margins.

If marketing were simply the sum of advertising and promotion, as some marketers seem to believe, this would be a doubtful claim. But marketing is a lot more, as the famous “four Ps” (product, price, place, and promotion) suggest. Classical marketing encompasses all the activities organizations engage in to hear and respond to their customers – from market research



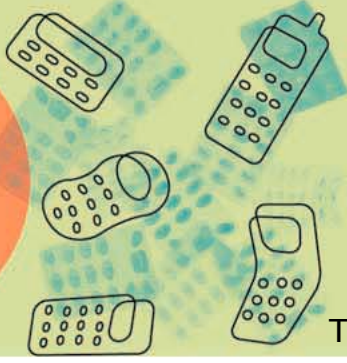
Bringing Custom into the Boardroom

by Gail J. McGovern, David Court, John A. Quelch,
and Blair Crawford



ers

tall short decaf latte
skim iced hot double
single frappé macchiato
long cappuccino vegan
grande Americano SOY



to product development to customer management to sales. Marketing discovers what customers want, drives the creation of products that meet customers' needs, and ideally generates profitable relationships. Indeed, a company that excludes marketing from its product development may build faster, lighter widgets, but it could miss what customers really want – widgets that have longer battery life.

When marketing activities are tightly aligned with corporate strategy, they drive growth. But in too many companies, marketing is poorly linked with strategy. Marketing may seem to be performing well according to standard metrics, like the number of repeat purchases customers make, but if the company's strategy is to, say, build market share, simply boosting repeat purchases isn't enough. In many organizations, marketing exists far from the executive suite and boardroom. Marketing managers are rarely held accountable for ROI and rarely expected to explain, exactly, how what they do supports corporate strategy. This isn't a case of dereliction; most companies are struggling to make their marketing work.

Rather, it's a case of myopia. No one in the organization sees the relationship between marketing and strategy well enough to diagnose the problem and begin to fix it.

The failure of marketing strategy is a crisis that requires attention at the highest levels of the organization – from the corporate board itself. Here we provide a simple set of tools that can bring companies' marketing performance into focus, help directors gauge how well marketing supports corporate strategy, and allow boards to direct repairs that can revive their companies' growth.

Mismanaged Marketing

To understand how marketing fails, it's helpful to look first at a success. After the events of September 11, Southwest Airlines swiftly agreed to grant refunds to all customers who asked for them, putting hundreds of millions of dollars on the line. A potential flood of refund requests never came. Southwest's risky but brilliant gesture (ensuring that its customers felt they were being taken care

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of) reflected how well its marketing strategy was aligned with its customer-centric business strategy. And the airline's smart marketing is one reason why it has remained profitable in every quarter since the twin towers fell. Most other carriers – American, Delta, and Northwest among them – have missed customer cues and bungled their post-September 11 marketing, as their dire situations make plain. They fussed about adding leg room and in-flight services. Meanwhile, Southwest gave customers what they really wanted: cheap seats and a hug.

Similarly, in the retail sector, a significant factor in Kmart's decline was its misjudged shift from high-low pricing to "every day low prices" in an attempt to compete with Wal-Mart. But Kmart's core customers were deal

In a survey of large U.S. companies, more than one-third reported that their boards spend less than 10% of their time discussing marketing or customer-related issues.

hunters, and the new value proposition didn't satisfy their needs. Lucent Technologies missed an important customer trend and chose not to enter the networking services business, electing instead to sell only hardware. In 2000, Lucent was one of *Fortune's* top ten most admired companies, and its stock was trading at more than \$60 per share. Today, the company's stock price is down to about \$3 per share.

To execute their corporate strategies successfully, companies must back up those strategies with superior marketing. Boards of directors, it would seem, have a compelling reason to monitor their companies' marketing activities. Our research shows, however, that marketing and customer management issues are receiving less and less attention in boardrooms. In a survey of 30 large U.S. companies, more than one-third reported that their boards spend less than 10% of their time discussing marketing or customer-related issues. Today, few CEOs have marketing experience, and few boards have customer management, marketing, or strategy committees. Only a handful of boards visit or receive presentations from major customers, and if companies have customer councils, few boards ever get to hear what they have to say. In many boardrooms, discussions about customers are purely anecdotal.

Part of the problem is the current corporate climate, in which questions of governance and financial purity dominate CEOs' and boards' attention. But the seeds of the problem were planted long before the ethical crises at the turn of this century. For at least the past two decades,

boards have neglected marketing in favor of presumably more pressing issues such as mergers and acquisitions, executive incentive packages, and succession planning.

Additionally, boards, and even CEOs, have been lulled into complacency by the new executive on the block—the chief marketing officer (CMO). With the emergence of the CMO position, one might expect that oversight of marketing would be efficiently consolidated. After all, with a CMO holding the marketing reins, why should the board have to ride shotgun? Because marketing decision-making has been increasingly pushed down through the corporate hierarchy. While CEOs have commonly delegated advertising and advertising strategy to outside agencies, now they are delegating sales, distribution strategy, pricing, and product development to CMOs, who often lack overarching strategic responsibility. Many CEOs have the right aspirations for their CMOs; they want better ideas, more growth, and higher marketing ROI. But CMOs are often hamstrung: They are senior executives with broad responsibilities for marketing—but without profit-and-loss accountability.

With a high-profile CMO in place, business unit managers may lose control of or, at best, share responsibility for the marketing communications that touch their customers. CEOs expect their CMOs to drive marketing decisions, but no one is singularly accountable for the results. This lack of accountability makes it very difficult to track the financial impact of marketing investments. And so marketing becomes abstract to both the CEO and board.

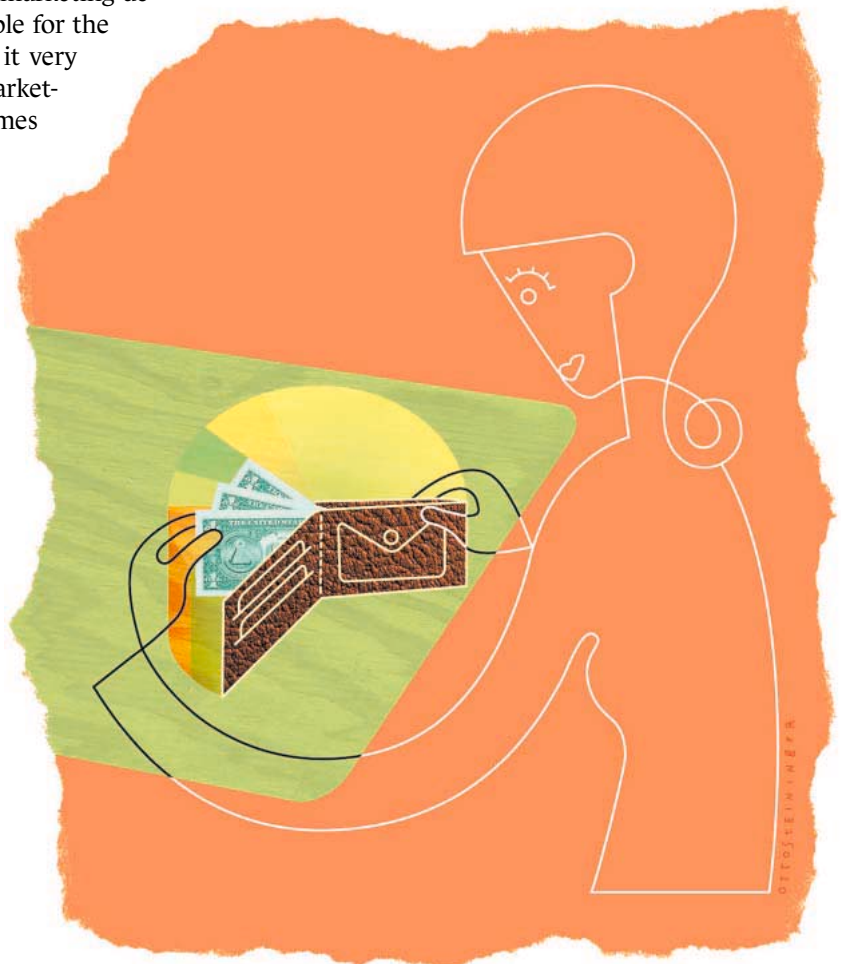
The New Curriculum

No doubt companies and their shareholders would have benefited from the board's attention to marketing decades ago. But today such attention isn't a luxury; it's a must, for three reasons. First, top-line revenue growth, especially organic growth, ultimately boosts shareholder value, so investors increasingly demand it. In fact, the presumption of organic growth is baked into companies' stock value. If you decompose the stock prices of the leading consumer product companies, you'll see that future growth accounts for as much as 54% percent of the stocks' total value. Still, boardroom discussions of growth almost always focus on alliances and acquisitions, which may be glamorous but are notoriously poor at generating increases. As a result, many companies and their boards are faced with a requirement for organic growth that they're unsure how

to meet. For these companies, the yawning gap between actual revenue growth and investors' expectations is a ticking time bomb.

Second, responsibility for brand equity still resides in the marketing function, which is often far removed from top management—yet brand equity has never been more volatile and important than it is today, and so it must be a concern of the board's. These days, powerful brands can emerge almost overnight. Thanks to its savvy global marketing, Samsung is now ranked by consultancy Interbrand as the 21st most valuable brand in the world; five years ago, it wasn't even rated. And another survey ranked Google as the world's most powerful brand in 2003, ahead of Coca-Cola. Similarly, in recent years, brands have toppled virtually overnight. Just look at Ford, Nokia, and Kodak, all of which have seen steep declines in their brand ranking and, consequently, in shareholder value. Why? While there were many factors at play, poor marketing was surely one of the most significant. When so much shareholder value is tied up in the corporate brand, the board must become a watchdog, aggressively guarding the brand's health.

Third, and perhaps most important, the fundamental nature of marketing has changed so rapidly that many



companies have not kept pace, making them vulnerable to savvy competitors and unable to capitalize on new growth opportunities.

To counter this trend, every board should have on its agenda a regular review of the company's marketing talent. For most of its history, marketing has been a creative, right-brain discipline that puts a premium on innovative, out-of-the-box thinking. As a result, the field is chockablock with creative thinkers, yet it's short on people who hew toward an analytic, left-brain approach to the discipline. Expertise in the left-brain fields of IT, finance, and data analysis is no longer optional in marketing departments. Information technology has become central to the intensive and critical data gathering and analysis companies use to segment customers, track their behaviors, and calculate their lifetime values. And IT is driving the rapid evolution of strategies for targeting these precisely monitored and measured customers; these strategies include multichannel marketing, dynamic pricing, and microsegmentation.

Hand in hand with basic IT smarts, marketing executives need (but often lack) a solid grasp of corporate finance to align marketing strategy with financial goals. A creative product promotion that extends customers' credit terms may boost sales, but unless the marketing manager has some financial literacy, he or she probably isn't thinking about the impact of extended credit on the company's balance sheet.

Consider also how the marketing curriculum has changed in just the last few years. The Web is only ten years old; online marketing is in its infancy. Multichannel marketing is also a new discipline. Customer relationship management is not much older, and the software to support it has been in wide use only for the last five years. The growth of ethnic populations has created a need for nuanced and sophisticated go-to-market strategies across segments. The proliferation of cable channels has produced a sliced-and-diced viewing population that would have seemed unimaginable ten years ago. The growing clout of downstream channel partners such as Wal-Mart—a customer tier in and of itself—presents manufacturers with the complex challenge of managing pricing and product assortment through these mammoth intermediaries for sale to the consumer.

The board's job in this new era isn't to direct specific remedies for its company's marketing deficits. Few boards would have the necessary expertise. But it is the board's responsibility to expose inadequate marketing, direct management to address the problem, and monitor management's progress. The brand and the company depend on it. But how does the board—already stretched thin—execute this responsibility without being crushed by it? By calling on its CMO and CFO to create a marketing dashboard that will efficiently reveal the true performance of the company's marketing activities.

A Glance at the Dashboard

Many marketing managers will tell you that marketing performance can't be measured—or at least that doing so is of little strategic value. But the situation is rarely as simple as this. It's not that managers are short on measurement tools or that marketing metrics lack utility. The problem is that these managers don't know what to measure or how to interpret the results. They may collect all manner of plausible performance metrics—such as customer satisfaction scores and customer retention rates—but if these can't be correlated to marketing activities and revenue results, the data aren't very helpful.

Measuring marketing performance isn't like measuring factory output—a fact that many nonmarketing executives don't fully grasp. In the controlled environment of a manufacturing plant, it's simple to account for what goes in one end, what comes out the other, and then determine your productivity. But the output of an advertising campaign can be measured only long after it has left the “plant.” Countless factors influence customers' behavior between the time they receive a marketing message and the time they act on it. Determining the ROI on an advertising campaign can be as much an art as it is a science.

So what do boards need to see? Plainly, they'd have little use for a flood of unfiltered marketing data. At UK-based grocery chain Tesco, the marketing group has developed a scorecard that attempts to measure the impact of marketing activities across roughly 20 variables, including consumer awareness, brand image, and customer conversions. But this is probably too many metrics for any board to track.

At the same time, boards should not be handed one or two generic measures of marketing performance and be expected to interpret them. Popular metrics such as customer satisfaction, acquisition, and retention have turned out to be very poor indicators of customers' true perceptions or the success of marketing activities. Often, they're downright misleading. High overall customer satisfaction scores, for example, often mask narrow but important areas of major dissatisfaction, such as customers' unhappiness with long wait times or bad service. They can also mask any backsliding the company is experiencing relative to competitors; gently climbing satisfaction scores may be reassuring to management and the board, but if competitors' scores are increasing faster, that should be cause for alarm. Acquisition rates may be robust, but if old customers are abandoning ship as fast as new ones are coming on board, those rates may be offering a deceptive picture of marketing's performance. And what, exactly, should the board make of stable customer retention rates? If customers are staying on because they're being held hostage by a contract, good retention figures may be obscuring the truth that customers will flee the instant they can.

Even if today's boards wanted to exercise their governance over marketing activities, they wouldn't have the information they need to make sound judgments. Boards need a thorough understanding of how their companies are meeting customers' needs and how their marketing strategies support those efforts. No company we know of provides its board with a scorecard that allows this.

The dashboard we've devised can give the board critical knowledge. Regardless of what industry a company is in, or what products or services it supplies, the dashboard is structured to reveal the fundamental relationships between a company's main business drivers, its growth strategy, and its marketing talent pool. Unlike isolated measures of marketing performance that are often insufficient, irrelevant, or misleading, the dashboard allows the board to quickly and routinely assess how effectively marketing is supporting corporate strategy and to determine when marketing and strategy are misaligned. Armed with a clear understanding of marketing's role and performance, the board can optimize this critical function in the organization. Let's take a closer look at the dashboard's structure, the best way to build one for your company, and how to interpret the information you uncover.

PART I Business Drivers

What are our company's key business drivers, and how well does our marketing strategy support them?

Any marketing dashboard must lead with a survey of the company's main business drivers. Astonishingly, many companies don't fully know what those drivers are, or they understand their drivers but don't measure them correctly.

A driver is a business condition that, when manipulated or otherwise changed, will directly and predictably affect performance. Business drivers are, by definition, leading indicators of revenue growth. Net new business and share of wallet are business drivers. Increase or decrease either, and you'll see a direct impact on revenues. Customer satisfaction, on the other hand, isn't always a business driver. Consider the case of a low-volume product with a low repeat-purchase rate and limited word of mouth – home air conditioners, for example. If market research revealed that current customers were unhappy with the product's performance, fixing the problem would not have a direct and immediate impact on sales. In this case, customer satisfaction wouldn't be a useful metric for the board to monitor. However, customer satisfaction could be a business driver in the case of a high-

volume product with a high repeat-purchase rate, such as a soft drink. A real or perceived quality problem with such a product could instantaneously translate into a drop-off in revenues. Similarly, an improvement that boosted customer satisfaction could be expected to rapidly translate into new revenues.

As these examples show, business drivers that are critical in one company may be unimportant in another. Thus, marketers must accept that there's no one-size-fits-all dashboard they can use; they must customize the tool for themselves. After establishing what the company's true business drivers are, management must cull the

It is the board's responsibility to expose inadequate marketing, direct management to address the problem, and monitor management's progress. The brand and the company depend on it.

myriad possibilities down to the three or four key ones that will be the most fruitful to follow. At least one of these drivers, such as share of wallet, should indicate performance relative to competitors. At least one, such as loyalty, should clearly measure the customers' experience. And one, such as customers' average annual expenditures or lifetime value, should measure the growth of retained customers' business. Finally, any driver on the dashboard must be one the company can manipulate. It may be informative for an automotive company to track the size of the population that is over the legal driving age, but the company can't influence that number, so it's not a useful metric for the board to follow. (See the sidebar "Designing a Dashboard.")

Although it's currently rare for an analysis of business drivers and marketing strategy to reach the boardroom, managers at some companies have linked the two. Harrah's Entertainment, the \$4 billion hotel casino operator, for example, is famous in the industry for its strategic use of customer data. Unable to match the opulence of the top Las Vegas casinos, Harrah's in 1999 took a close look at its business drivers and devised a customer-service-based marketing strategy that would cement existing customers' loyalty and lure new customers away from the Trump Taj Mahal's fountains and chandeliers. Rather than track the traditional customer-satisfaction, retention, and acquisition metrics, Harrah's monitored three crucial business drivers that were directly correlated to revenue growth: share of wallet; percentage of customers who were cross-sold (that is, during a given year, their revenues were derived from two or more Harrah's properties); and customer loyalty as measured by the percentage

of customers who, because of their increased spending at the casino, ascended to the highest tiers of Harrah's rewards program.

The company built customer segmentation and marketing programs around the expected lifetime value of each customer and created a loyalty program (using frequent-player cards) that captured detailed customer data and allowed the company to understand individual customers' behavior. When customers walk into Harrah's, they immediately feel like high rollers. They're treated like royalty. The wait staffers greet them by name and reward them for returning. The most profitable customers are reeled back in with lavish promotions such as free dinners and overnight stays. Within five years, Harrah's shrewd alignment of its marketing strategy and its business drivers increased its share of wallet from 36% to 43%, and its revenues tripled.

By contrast, consider the confusion at Starbucks when it failed to appreciate one of its important business drivers – customer wait times. A crucial part of Starbucks's value proposition is innovation, a promise enshrined in its famously complicated menu. To drive growth, the company put a tremendous amount of effort into new product development, and it continually researched metrics to tease out customer attitudes about new beverages.

Popular metrics such as customer satisfaction, acquisition, and retention have turned out to be very poor indicators of customers' true perceptions or the success of marketing activities.

What Starbucks missed was that as it added complex, innovative offerings, it increased the amount of time the wait staff took to serve customers. As menu innovations increased – and, therefore, demand for labor-intensive customized drinks – customer satisfaction mysteriously dropped.

According to the company's research, a "highly satisfied customer" spent \$4.42 on average during each visit and visited an average of 7.2 times each month. An "unsatisfied customer" spent \$3.88 per visit and averaged only 3.9 visits each month. Clearly, corrosion in customer satisfaction was a serious threat. Further market research revealed that 75% of customers highly valued friendly, fast, convenient service, while only 15% considered new, innovative beverages to be highly important. Innovative offerings are a cornerstone of Starbucks's proposition, but they lose their luster if customers have to wait too long for them. Starbucks spent \$40 million adding staff to cut wait times. The company also streamlined the processes

for taking customer orders and preparing drinks, and it introduced the Starbucks Card to speed payment. Before these changes, only 54% of customers were being served in under three minutes; with the new systems and more help behind the counter, the figure jumped to 85%, and customer satisfaction levels increased 20%.

If Starbucks were to create a dashboard for its board of directors, customer wait times would be one sensible driver to include. The board should also have an abiding interest in the development of any marketing innovations that promote the company's fast, convenient service.

PART II Pipeline of Growth Ideas

What do our customers want, and how is our knowledge of their desires being translated into a pipeline of innovations?

The trends revealed by the main business drivers give the board important insights about customers and revenue growth. But these trends indicate only the rate of growth, not the company's strategy for sustaining it. How does management plan to reach its growth targets? Certainly, not by remaining so focused on short-term earnings that it clings to low-risk initiatives. Too often, product managers simply launch line extensions or repackaged "new and improved" products that fail to advance

the innovation and growth agenda over the long term. This is partly the fault of senior management, which often responds coolly to speculative, high-risk initiatives that have long payback periods but that could secure longer-term growth.

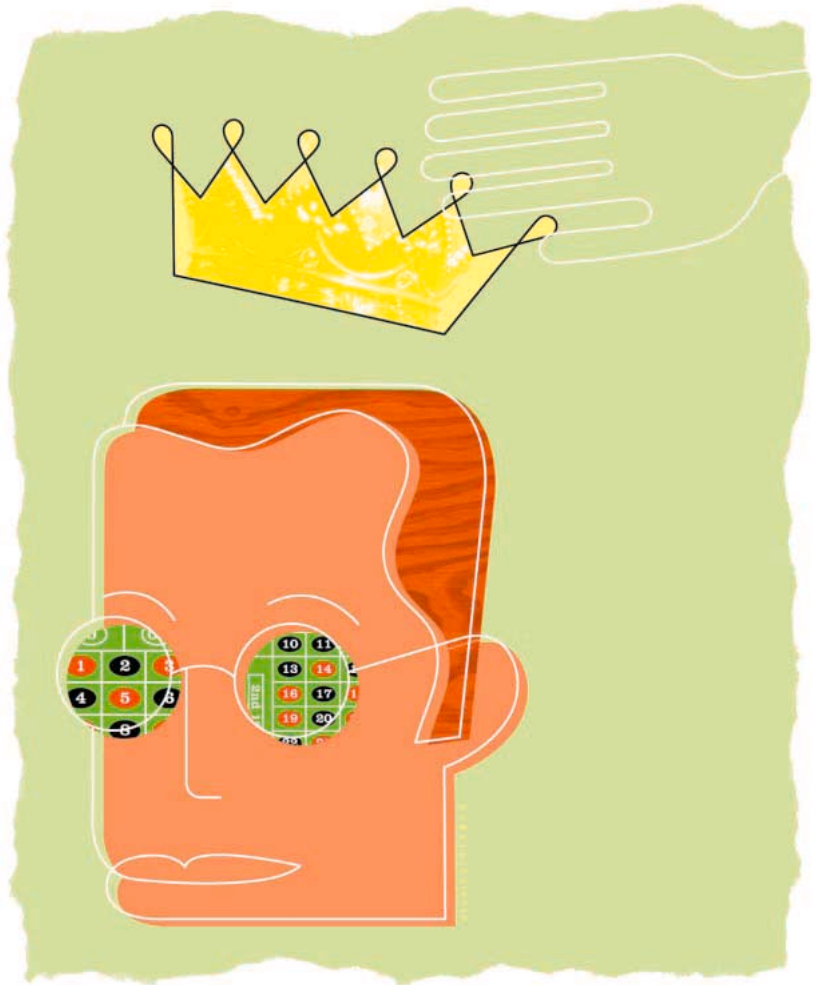
To keep customers, you have to delight them, exceed their expectations, and anticipate, discover, and fulfill their latent needs. With the increasing sophistication of market research tools, it's becoming easy and inexpensive to track customers' needs, and most companies now do this effectively. The board needs to be attuned to this research. Once or twice a year, marketing should review for the board how the customer base is segmented, how the size and profitability of each segment is changing, and how the company's products and services address the needs of each segment. If the board can't get a succinct answer to the question, "How are your customers' needs changing?" marketing isn't doing its job.

Assuming that marketing does have a handle on what customers want, the organization must be able to show the board how it is translating this knowledge into product or service innovations that will drive growth. The second part of the dashboard must describe the specific innovations in a pipeline of growth ideas that will allow the company to reach its short- and long-term revenue goals. And it must detail how revenues and profits associated

with each innovation will add to those from core products to achieve growth objectives at least one to three years out. The total projected revenue stream should meet – and, in most cases, exceed – the organic-growth expectation embedded in the firm’s stock price. If it doesn’t, all priorities pale in comparison to the need to identify new sources of growth.

For a given innovation – let’s say it’s a sleek new MP3 player – the dashboard must indicate anticipated revenues, their timing, and the assumptions behind these estimates. What are the product’s odds of success in the marketplace? What is the anticipated take rate – the percentage of the market that will buy the MP3 player? What portion of revenues will be captured through ancillary sales – purchases of player accessories or song downloads? The board should review the company’s pipeline of growth ideas quarterly and inspect the assumptions behind the revenue estimates, challenging any that seem questionable. The board also should use these regular updates to track the performance of previous product launches by comparing their projected and actual revenues. If management misses targets for new-product revenues it has some explaining to do: Why the shortfall, and what’s the strategy for closing the gap?

Consider Gillette’s sophisticated management of its innovation pipeline. Over the past 30 years, the company has parlayed its unparalleled understanding of men’s grooming needs to drive the development and mass adoption of successive razor technologies—from the first twin-blade razor, the Trac II, in 1971, to the recently introduced vibrating M3Power shaver. Today, Gillette dominates its market, with more than a 65% dollar-market share in North America across its portfolio. Given its strong position in the category, Gillette has to be extremely thoughtful about the timing and strategy for each new product launch so it can grow the category while minimizing the cannibalization of existing product sales. Since the introduction of its trendsetting Trac II, the company has rolled out a series of increasingly advanced razors, including the Atra, SensorExcel, Mach3Turbo, and M3Power, each of which outperformed its predecessor. For each of these innovative new products, the company’s elaborate revenue projections include detailed analyses of revenue sources and, crucially, the potential effect of these new products on existing product revenue streams. Gillette’s is the sort of careful growth analysis that any board should expect to see – and should demand if it doesn’t.



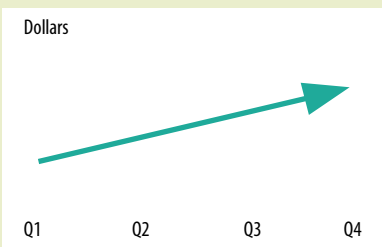
Korean consumer-electronics giant Samsung offers another example of a shrewdly managed innovation pipeline and marketing machine. Five years ago, Samsung bet the ranch on digital technology and transformed itself from a middling manufacturer of analog televisions into one of the leading consumer electronics companies in the world. Samsung’s 17,000 scientists are charged with translating insights gleaned from the company’s massive customer research programs into a flow of new product concepts that can be moved from the drawing board to commercialization in less than five months. From among these innovations, the chief marketing officer selects and ranks four or five so-called “pillar” products—those judged most likely to win in the marketplace – and is given additional marketing dollars to back them. This ranking exercise allows Samsung to match marketing expenditures with perceived opportunities for revenue growth, and it makes the CMO accountable, to some degree, for generating a return on investment.

Contrast Gillette’s and Samsung’s strategic approach to R&D and marketing with Callaway Golf’s growth struggles. In 1991, Callaway introduced its now legendary Big Bertha golf club, a technological breakthrough that

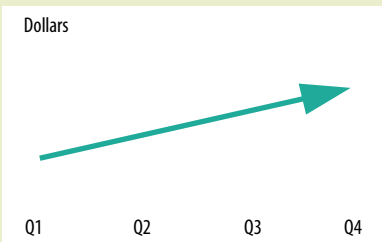
Designing a Dashboard

With a set of reports that lay out the organization’s main business drivers, product development plans, and marketing skills, the board can gauge the effectiveness of the company’s marketing strategy and see emerging threats to revenues. Let’s consider what a marketing dashboard for a hypothetical cellular phone company, TelecomCo, might look like.

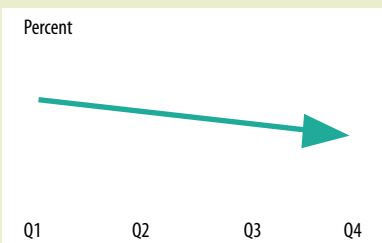
PART I Business Drivers



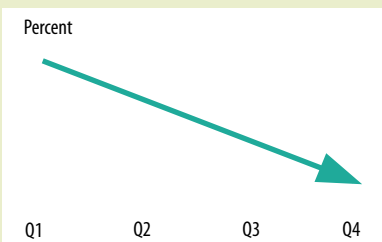
Revenue
(average annual revenue per retained customer)



Value
(retained customers' average lifetime value)



Market Share



Loyalty
(the average likelihood that customers will renew their service)

TelecomCo’s marketing seems adequate at attracting and keeping customers. Here we see that average annual revenue per retained customer and average lifetime value of retained customers are both increasing.

Despite the encouraging charts above, the company’s declining market share shows that, in fact, TelecomCo is not attracting enough new customers.

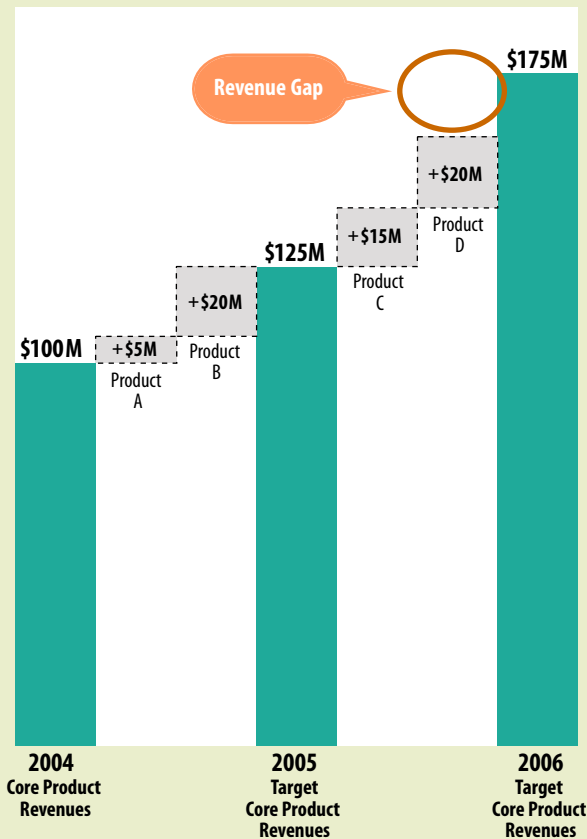
Of equal concern, existing customers’ decreased likelihood of renewing their plans suggests that many of them are bound by service contracts—and will abandon the company when those contracts expire.

The first part of the marketing dashboard surveys the company’s main business drivers. At least one driver, such as share of wallet, should indicate the company’s performance relative to competitors; one, such as loyalty, should clearly measure the customers’ experience; and one, such as retained customers’ average annual expenditures, should measure the growth of existing customers’ business. The board should review these business drivers monthly. At left is the business driver outlook for TelecomCo.

Taken as a whole, the dashboard panels indicate that TelecomCo’s increasing revenues are masking significant customer dissatisfaction. The company must conduct market research to uncover the source of this dissatisfaction and address the threat. Marketing must launch promotional, product development, and pricing strategies to attract new customers. The board’s monthly review of these metrics will quickly show whether marketing’s efforts are effective.

PART II Pipeline of Growth Ideas

The second part of the dashboard describes new products or services in the pipeline and details the expected revenues from each, their timing, and their contribution to growth objectives one and two years out. The board should review the pipeline of growth ideas quarterly, and it should inspect the assumptions behind revenue estimates. TelecomCo’s growth agenda outlook appears below:



For each new product, the dashboard must indicate expected annual revenues and their timing; revenue assumptions such as success and failure rates, assumed pricing, length of time customers will stay, number of repeat purchases, and so on; and the product’s performance relative to the company’s plan.

In TelecomCo’s case, revenues from products in the 2005 pipeline will probably not meet target core revenue goals for 2006. The board should hear from management how it plans to close the revenue gap and then continue to monitor the company’s revenue performance under those strategies.

PART III Marketing Talent Pool

The third part of the dashboard gives the board a detailed review of the marketing skills the company needs, its inventory of talent, and the recruitment and development plans that will address any gaps in the personnel pipeline. The board should review its marketing talent annually. TelecomCo’s talent pool outlook appears here:

Skills Required	Skills Inventory*	Action Plan
Product Development	1	
Brand Management	2	
Marketing Strategy	3	recruit talent
Market Research	3	executive education
Direct Marketing	1	
Mass-Media Advertising	2	
Channel Management	3	executive education
Vendor Management (Contracts)	1	
Strategic Pricing	2	
Customer Relationship Management	4	outsource
Customer Analysis	4	outsource
Database Management	4	outsource

* Scale of 1 to 5, where 1 equals “superior” and 5 equals “inadequate”

Although the company has superior product development skills, it is weak in marketing strategy and lacks the capabilities it needs in market research, channel management, CRM, and customer-data management and analysis. These shortcomings may explain why TelecomCo was blindsided by falling loyalty scores. Management plans a combination of recruitment, executive education, and outsourcing to address these weaknesses.

allowed average golfers to hit expert drives. Big Bertha helped Callaway penetrate retail channels and pro shops, which improved the efficiency of the company's marketing. And the price premium the club commanded allowed Callaway to invest more in marketing and product development. Though Callaway has steadily improved the product, it has been unable to come up with a new club as formidable as Big Bertha that could seize market share back from encroaching competitors. Had the board been tracking the innovation pipeline more closely, it might have seen earlier that Callaway's R&D lacked the bench strength it needed and that the company's marketing executives were having trouble translating laboratory discoveries into products customers wanted.

PART III Marketing Talent Pool

What marketing skills do we need, and how do we acquire the skills we lack?

A company doesn't need to excel in all areas of marketing, just those that support its main business drivers. The question it should be asking isn't, "Do we have enough marketing talent?" It's, "Do we have the *right* marketing talent?" A company may have the best mass-marketing capability money can buy, but if it's a customer-service-driven firm with a pipeline of service innovations, what it really needs are customer-relationship-management skills.

The board should expect a thorough appraisal of the company's marketing strategy and its inventory of marketing capabilities. If senior managers understand the company's key drivers and the company's overall strategy, it should be apparent to them what marketing skills will be required. This may seem self-evident, and, in fact, many companies do know what marketing capabilities they need and have developed world-class performance in those areas. Procter & Gamble excels at product positioning, advertising strategy, and account management. MBNA is outstanding in customer relationship management. Gillette has superior skills in new-product development. But at a surprising number of organizations, marketing needs and marketing skills are poorly aligned.

Most consumer goods companies, for example, have been slow to transition from mass-marketing programs targeted at consumers to tailored marketing plans developed in partnership with major retailers. Their expertise in advertising and brand building may have served these companies well in the past, but what they increasingly need are skills in push marketing and major-account management so they can collaborate effectively with powerful retailers like Wal-Mart. To return to the beleaguered airline industry, a lack of market awareness and a mismatch of marketing skills and needs lies at the heart of many carriers' tribulations. Recall that American Airlines and other carriers missed a shift in customer needs a few years ago—away from frequent-flier programs, more leg-


room, and premium in-flight services to, simply, low-cost fares. American's powerful CRM marketing capability was of little use when what the carrier needed was a 15% reduction in costs, a simpler product offering, and the marketing skills to push competitive pricing. American's CRM and loyalty programs actually added costs for the carrier.

As these examples suggest, the third part of the marketing dashboard must identify the skills needed to achieve the revenues promised in the growth agenda and the steps required to develop or acquire any skills the company lacks. Once a year, the company's chief talent officer or other HR executive should provide the board with a detailed review of the recruiting and people-development plans that will address any gaps in the required marketing skill set. Do you need to hire a CMO with a strong background in finance? Should you send your senior marketing managers to executive education programs in IT? Do you have people who can anticipate customer trends rather than just react to them? Are there marketing capabilities such as database management that you could acquire through outsourcing?

Harrah's offers a prime example of brilliantly aligned marketing skills and needs. CEO Gary Loveman knew that the best way for Harrah's to compete with its more posh competitors was to coddle its customers. To do this, Loveman invested heavily in CRM and database management capabilities, hiring a group of propeller-heads, as he called the IT-savvy marketing team, to give Harrah's an unprecedented level of detail on customers' behavior. This intelligence gathering and analysis, as we saw earlier, allows Harrah's to deliver the superb customer experience that keeps people coming back—and spending more.

Mind the Gap

Companies need to close the gap between their boards and their marketing functions if they are to meet their expectations for growth. The dashboard we describe here can help bridge the divide, but for it to be truly useful, it must be accompanied by a change in organizational mindset. The board of directors needs to welcome the company's customers and marketing strategies into the boardroom and pay careful attention to them. And marketers need to start thinking of themselves as general managers who can drive the business forward rather than as functional specialists who are isolated from the company's strategy.

Organizations take their cues from the top. When the board turns its attention to the company's customers, the entire organization will become more market driven, more customer-centric, and more focused on generating organic growth. 

Reprint R0411D

To order, see page 151.



Jess Jackson — Adobe House, Alexander Valley



The French taught me about “terroir.”

I learned to be stubborn on my own.

It wasn't until I applied my stubbornness to this classically proven French concept that we were able to create Kendall-Jackson wines. First, a bit about terroir. The French developed this concept centuries ago — the location, soil and climate of a given vineyard

site have a direct affect on the flavor and characteristics of the wine produced from that vineyard. Armed with this knowledge, I found that the grapes grown on California's cool coastal mountains, ridges, hillsides and benchlands produced the richest and most intense flavors with unique character. Low-yield farming on high

elevation terrain takes a tremendous commitment in terms of time and cost. But anything else would require compromise. And my stubbornness will never allow it. I understand that many of you enjoy the taste of my wines, but you're not sure why. Hopefully, I can help with the facts. So you can enjoy **A Taste of the Truth.**

TLFeBOOK

The WILD WEST of Executive Coaching

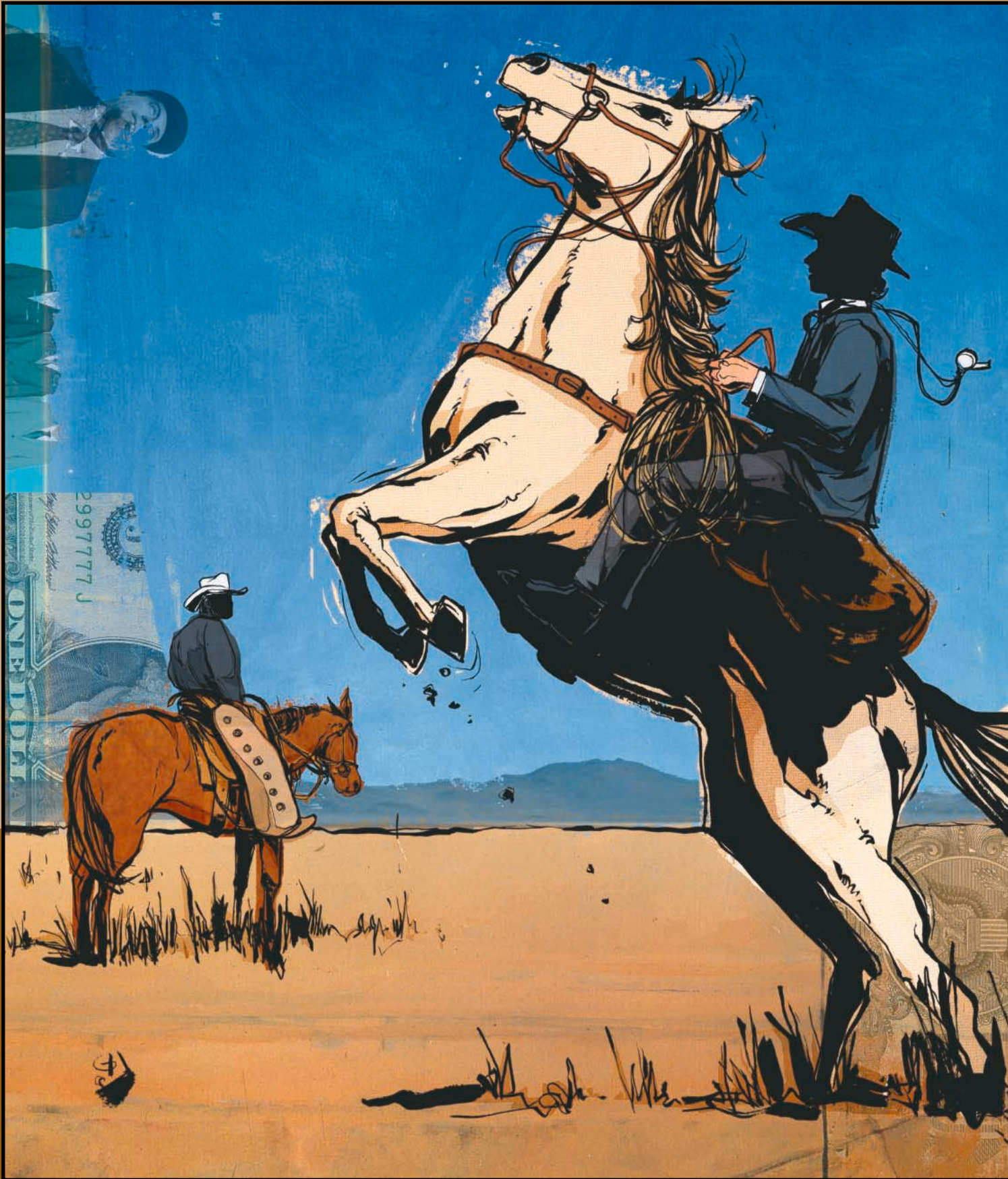
by Stratford Sherman
and Alyssa Freas

It's not just individuals who benefit from one-on-one coaching – their employers can gain immensely, too. But in an industry without universally accepted standards, all the parties need to be clear about their goals and how to reach them.

WHEN THE SENIOR VICE PRESIDENT for organizational development at a leading U.S. bank first sought executive coaches for a few senior leaders, she faced a stampede. Kicking up dust were hundreds of applicants with wildly diverse qualifications, each expecting an interview. To make the selection process manageable, the VP established arbitrary criteria: Candidates needed some sort of coaching certification, plus five years of coaching experience at *Fortune* 500 financial services companies. The executive readily admitted to having no evidence that these criteria would identify good coaches. “I have to screen people somehow,” she said. “So I am making stuff up.”

Such is life in the untamed terrain of executive coaching. Like the Wild West of yesteryear, this frontier is

P.J. LOUGHRAN



chaotic, largely unexplored, and fraught with risk, yet immensely promising. Reliable information about executive coaching is scarce, mainly because major companies did not use coaching much before the 1980s. Last year, Anthony M. Grant, who teaches coaching psychology at the University of Sydney, Australia, surveyed research on coaching of all kinds. He located only 131 peer-reviewed studies published since 1937. Of these, just 56 were empirical, and few met standards of reliable methodology. “In general,” Grant said, “the quality of the research is extremely poor.” Although capable scholars are now crowding into the field, years may pass before they can map out authoritative guides for coaching.

Meanwhile, companies that use coaches to help their top executives become more effective must chart their own courses. No one has yet demonstrated conclusively what makes an executive coach qualified or what makes one approach to executive coaching better than another. Barriers to entry are nonexistent—many self-styled executive coaches know little about business, and some know little about coaching. At best, the coaching certifications offered by various self-appointed bodies are difficult to assess, while methods of measuring return on investment are questionable. “I don’t think ROI is ever going to be able to measure the true success of coaching, so we assess the value with qualitative data,” says Wendy Gabriel, the manager of executive coaching at Deloitte & Touche USA. What is clear is that the market has spoken. Many of the world’s most admired corporations, from GE to Goldman Sachs, invest in coaching. Annual spending on coaching in the United States is estimated at roughly \$1 billion.

The growing popularity of executive coaching is a response to compelling needs. Many of the new business practices that so greatly improved productivity in recent decades also introduced contradictions into the relationships between corporations and their top executives. The most bedeviling of these has been a gradual warping of the traditional alignment of companies and their leaders. Developing more fruitful ways for businesses and executives to work together has become a priority and a new source of economic value.

It was long overdue. For centuries, businesses thrived while treating employees as commodities. Laborers were “hands,” a status scarcely superior to that of horses or oxen. With the publication of *The Principles of Scientific*

Stratford Sherman (stratsherman@excn.com) is a senior vice president at Executive Coaching Network. He coauthored *Control Your Destiny or Someone Else Will* (revised edition, HarperBusiness, 2001). *Alyssa Freas* (alyssa@excn.com) is the founder and CEO of Executive Coaching Network. She coedited *Coaching for Leadership: How the World’s Greatest Coaches Help Leaders Learn* (Jossey-Bass/Pfeiffer, 2000).

Management in 1911, Frederick Winslow Taylor extended this dehumanization to include executives, arguing that even great individual leaders will be bested by efficiently organized groups of “ordinary men.” He wrote, “In the past the man has been first; in the future the system must be first.” By 1956, when William Whyte styled the executive of his age as the “organization man,” the transformation of leaders into commodities had gone about as far as it could.

What might be called the rehumanization of executives began during the 1970s, when successive waves of change—including the globalization of competition, a growing demand for services, and the acceleration and restructuring of business processes through information technology—battered traditional organizations. Struggling to respond, U.S. corporations launched a vast, decades-long rethinking of organizational structures and work processes. Among the casualties were employees suddenly deemed redundant. The demise of job security created a new career model—Me, Inc.—which eliminated loyalty to employers.

Nowhere did this idea take hold more powerfully than in the executive suite. At the same time, companies seeking speed and competitive agility were granting leaders unprecedented influence by delegating to them vastly more autonomy and authority. Increasingly, attention was focused on the unique value embodied in specific human beings. That balding CFO was no longer a commodity but a living vessel of “intellectual capital”—a resource regarded as no less precious than money itself.

For their part, managers of leaner, faster-moving organizations began to recognize the need for a subtler set of competencies: the communication and relationship skills required to influence and energize employees, adaptability to rapid change, and respect for people of diverse backgrounds. Today, executives expect emotional intelligence from supervisors and colleagues but find it’s in scarce supply.

Despite all the progress made in other business disciplines, and all the preaching by charismatic business gurus, today’s corporations remain ill-equipped to resolve whole categories of employee-related dilemmas. For instance, objective assessments and candid feedback are seen as essential to executives’ development, yet supervisors of all ranks generally don’t provide such feedback to subordinates. Why don’t they? Candor generates emotion, and emotion can be scary.

Some companies have found new ways to structure mutually satisfactory relationships with their best people and to foster their employees’ development in line with organizational goals. Many others have not. Companies still groping for solutions need something management science lacks: a systematic means of engaging with senior leaders as individuals.

Enter executive coaching.

No one has yet demonstrated conclusively what makes an executive coach qualified or what makes one approach to executive coaching **BETTER THAN ANOTHER.**

Why Executive Coaching Works

Unlike most business processes, which tend to reduce information to abstractions, executive coaching engages with people in customized ways that acknowledge and honor their individuality. It helps people know themselves better, live more consciously, and contribute more richly. The essentially human nature of coaching is what makes it work—and also what makes it nearly impossible to quantify.

Executive coaching is distinct from other types of coaching. The broader field of coaching includes life planning, career counseling, health and nutritional advice, New Age aura readings, and training in skills from public speaking to flirtation. We don't do that stuff. Our role is to help "coachees"—the people being coached—produce business results for their employers. Executive coaching is also distinct from psychotherapy; indeed, people who need therapy tend to make poor candidates for coaching. That said, most executive coaching is intellectually indebted to a small number of disciplines, including consulting, management, organizational development, and psychology.

At the most basic level, coaches serve as outsourced suppliers of candor, providing individual leaders with the objective feedback needed to nourish their growth. The data often come from 360-degree surveys of the people who work most closely with a given individual—a boss, peers, and direct reports—and sometimes customers or family members. Well-constructed 360s can identify particular behaviors with great precision and link them to corporate goals, values, and leadership models. By aggregating subjective judgments and making them anonymous, 360s generate statistical data with a helpful patina of objectivity and legitimacy. While the judgments are not always fair, they represent actual perceptions. For that reason, 360s can provide priceless insight into the subject's interpersonal environment. Even coaches of modest attainment can add value by delivering such information.

It is remarkable how many smart, highly motivated, and apparently responsible people rarely pause to contemplate their own behavior. Often more inclined to move on than to reflect deeply, executives may reach the

top ranks without addressing their limitations. Coaching gets them to slow down, gain awareness, and notice the effects of their words and actions. That enables coachees to perceive choices rather than simply react to events; ultimately, coaching can empower them to assume responsibility for their impact on the world.

Coaching doesn't end with self-awareness. It is a form of active learning that transfers essential communication and relationship skills. Strategic coaching should integrate personal development and organizational needs. This approach can help leaders adapt to new responsibilities, reduce destructive behaviors, improve retention with a perceived perk, enhance teamwork, align individuals to collective goals, facilitate succession, and support organizational change. Systematic coaching programs, reaching whole cadres of executives, provide a disciplined way for organizations to deepen relationships with their most important employees while increasing their effectiveness. The most valuable coaching fosters cultural change for the benefit of the entire organization.

Working the Triangle

Our executive coaching consists of highly personal one-on-one and team interventions between coaches and senior executives, and it usually lasts several months. Such coaching is fundamentally a business proposition. Its purpose is to produce learning, behavioral change, and growth in the coachee for the economic benefit of a third party—the client that employs the coachee. On a personal level, we are deeply committed to helping our coachees lead better lives, but coaching succeeds only when that benefit comes in addition to business results.

Coaching creates a triangular relationship between the coach who provides the service, the coachee who receives the coaching, and the client that pays the coaching bills. The client actually is a collection of interested parties, usually including the coachee's boss—a key player—and the human resources department. The work succeeds when all the people involved agree on explicit goals that genuinely further their own interests as well as the common good.

TRIANGULAR relationships generate productive tensions. The key to exploiting them is through effective contracting: defining the goals, roles, and accountability of each party.

To understand how the triangular relationship works, consider Saphra Marker (we have changed all the names in our examples to protect our clients' identities), an executive vice president at a leading financial services company: forward-thinking, rational, extremely competent – and volatile. When her coaching began, she was up for a promotion to a high rank on the firm's leadership council. Saphra's boss, Will Powers, was her strongest supporter, but he also perceived she had significant development issues. The company was dedicated to teamwork, but Saphra, a hard-driving former accountant, was reluctant to share resources, frequently abrasive with colleagues, and often "too busy" to develop her direct reports. A couple of Saphra's colleagues were consciously avoiding her in an unspoken standoff that was gumming up important work. The client decided to get involved. Will asked an HR specialist to get Saphra a coach. From a roster selected by HR to match her needs, Saphra chose someone to work with.

Coaching persuaded Saphra to take stock. Her 360-degree feedback confirmed both her outstanding abilities and the problems Will had observed. Analyzing the feedback with her coach, Saphra realized that her behavior was inhibiting her progress. Like most coachees, she was stung by the straight talk and needed courage and compassionate support to confront herself. Once she digested the feedback, though, Saphra was ready to change. Together with her coach, she focused on three areas for improvement: maintaining composure under pressure, mentoring direct reports, and developing more trusting relationships with peers.

Saphra took the coaching plan to Will and, after incorporating his suggestions, won his agreement. Then Saphra and her coach began their private work together. For example, Saphra's coach asked her to keep a journal, noting each time she lost her cool, along with the person involved, the provocation, her responses, and the outcome. By discussing her issues more or less candidly with Will and her colleagues, Saphra created a network of people interested in supporting her ongoing growth. Simple stuff, but it was enough to help Saphra dig herself out of the hole. By the end of her coaching, Saphra had mastered the basic mechanics of keeping her cool, mentoring

subordinates, and strengthening relationships with peers. She also had acquired a precious new skill: the ability to monitor her behavior and consciously adjust it as needed. And, yes, she got the promotion.

In this instance, the coaching worked because the triangular nature of the coaching relationship was acknowledged right from the start. The coach focused on business objectives. Will helped shape those objectives. And, significantly, Saphra was determined to learn and change. The stars were aligned.

Qualification, Qualification, Qualification

The intervention with Saphra succeeded, but what about bad coaching? Obviously, it is widely available, wastes lots of money, and can even do harm. All three parties in a triangular relationship – the coach, the coachee, and the client – can contribute to failure. The best way to maximize the likelihood of good results is to qualify all three parties. Even novice clients recognize the need to assess coaches' qualifications, though they may not know how to do it. But clients are far less likely to consider coachees' qualifications – or their own.

Let's start with the client. Long before selecting a vendor, a potential client should candidly examine itself and ask, "What is the point of the coaching program?" Companies can back into coaching with no plan at all. A senior executive hears good things about coaching and unilaterally decides to try it. Or HR arranges coaching, in ones and twos, for individuals at risk of derailing. Only after a tangle of inconsistent, ad hoc coaching reveals itself does anyone stop to establish policies and goals.

Start with clear intentions about how coaching will further important goals. Once the end is in mind, design systems to support it. If you want coaching to advance strategic aims or embed values, think about how to integrate coaching with other initiatives and systems, such as compensation, evaluation, and job assignment. Many HR professionals struggle to sustain coaching programs on their own, but they shouldn't have to do that. For coaching to command serious attention from the busy executives it

aims to help, it needs top-level support and visible links to business imperatives.

Let's turn now to the coaches. The best ones ground their work in the coachee's environment: relationships at all levels, plus the values, goals, and dynamics of the client's business. An effective coach helps a coachee achieve agreed-upon goals, while also transferring the knowledge and skills needed to sustain ongoing development. Like good parents, good coaches foster independence.

Great coaches sniff out hidden truths. They tend to be curious and ask penetrating questions. The ability to turn over rocks and discover what lies beneath is critical because business conversations – including briefings to coaches – often omit essential issues. For instance, the CEO of a privately held manufacturer brought us in without revealing that he wanted his son to replace him as CEO—or that the other family members on the company's board of directors viewed the son as unqualified. This set of hidden agendas proved to be far more important than the overt issues our coaching program was supposed to address.

Accomplished coaches that have different backgrounds, relying on widely varying techniques, can produce similar results. Until a body of knowledge about coaching wins acceptance, we'll remain skeptical of current efforts to introduce universal standards and high barriers to entry. For now, clients will best serve their needs by evaluating coaches individually.

Because no universally reliable credential exists to identify capable coaches, that task requires subtlety. References from previous clients and coachees always merit careful review. But coaching remains as much art as science, best practiced by individuals with acute perception, diplomacy, sound judgment, and the ability to navigate conflicts with integrity. Perhaps the most important qualifications are character and insight, distilled as much from the coach's personal experience as from formal training. Pay close attention to chemistry and the matching of coach to coachee. In certain situations, a coach's doctorate degree, or prior experience as a CEO, or background in psychology may indeed be highly relevant. In other situations, a coach with the same credentials may be inappropriate. Mental health professionals are swelling the ranks of executive coaches and many do excellent work. But a skilled psychologist may be, for example, too naive about business to win an executive's trust.

Finally, it's important to qualify the executive to be coached. More companies should adopt the systematic approach of LSG Sky Chefs, a Lufthansa subsidiary that provides food services globally. No leader at LSG Sky Chefs gets coaching until an internal panel has evaluated his readiness and suitability for coaching and approved a

preliminary plan showing how coaching will deliver results. In a less ideal environment, a client can try to identify coaching candidates by answering these basic questions: Is the executive motivated? Can we identify an important development need? Is the executive coachable? Does she have support? Is he valuable enough to justify the cost of coaching?

When qualifying potential candidates, remember that people need motivation and commitment to benefit from coaching. Think about it: The coachee does the hard work, while everyone else contributes from the sidelines. The only time we'd recommend inducing someone to get coaching involuntarily is when an entire layer of management receives coaching as part of a larger strategic effort.

Clients should consider coaching to meet candidates' development needs – to address potential problems and growth opportunities. For instance, coaching can help leaders in transition, such as those moving from jobs in operations to positions of enterprise leadership that require



“soft” interpersonal skills as well as execution ability. But coaching cannot ameliorate deep-seated psychological problems, such as chronic depression. We try not to take on problems we can't solve, and when an executive needs help that we can't provide, we suggest engaging professionals with appropriate qualifications. Whatever the situation, when qualifying an executive, clients should make sure that coaching is something the executive really wants – and that her efforts to change and grow will be appreciated and nourished by her boss and critical colleagues. Such support is what sustains and enhances the benefits of coaching.

Hakim Alaoui was a gifted financier hired from outside who had undercut his success with a brusque, seemingly selfish manner that alienated his new colleagues. The CEO, who valued Hakim, wanted him “fixed.” In this case, the coach had to determine whether Hakim, who knew he was in trouble, actually wanted to cultivate a more collegial style. Discussing his options with the coach, Hakim realized that combining his outstanding professional skills with better relationships at work could make him substantially more valuable – regardless of which company employed him. So he committed himself to the coaching process with a zeal that reflected his outsized ambition and favorably impressed the CEO. After three months of coaching and corporate support, Hakim started helping colleagues. He began sponsoring teams that worked across organizational boundaries, even in cases where the teams’ work helped the company at the expense of Hakim’s own area. People started to enjoy collaborating with him. Last we heard, Hakim was still with the company and thriving.

It goes without saying that in qualifying coaching candidates, clients should look at the specific business payoffs the coaching will provide. Experienced clients are less likely than newcomers to invest coaching dollars in repairing people problems, preferring to concentrate coaching investments on their best employees. That makes sense for two reasons. Extended one-on-one coaching can be far more costly, per capita, than many other learning techniques. And executives flee from coaching when it becomes a badge of career trouble. Most clients will find it easy to decide whether a particular executive is valuable enough to justify the cost of coaching. Many, including Raytheon CEO William H. Swanson, believe that executives with high potential should receive coaching as early in their careers as possible.

Contract Early – and Often

Triangular relationships generate conflict. As in the classic film comedy *Ninotchka*, Russia’s communist bureaucrats once sent emissaries abroad in groups of three, on the theory that if one wanted to defect, at least one of the others would squeal. The coaching triangle needn’t be so Machiavellian, but it does generate productive tensions. The key to exploiting them is through effective contracting. By “contracting,” we mean not just documenting the legal and financial aspects of coaching, but also defining the goals, roles, and accountability of each party. It works when each term gains the uncoerced agreement of all concerned: client, coach, and coachee.

Central to our contracting philosophy is the action plan, a living document that fleshes out the goals initially defined in the legal contract. We recommend setting measurable goals, usually three, that coaching realistically can achieve. Typically, action plans are expressed in terms of

specific behaviors: Being a good listener, for instance, comes up all the time. Evidently, listening isn’t what business schools teach.

Together, the three parties should choose goals that maximize mutual interests. If the client has a strategic objective and the executive has a career objective, for example, they must identify a goal that integrates both aims. Here’s how it worked for Ellen Rinaldo, a manufacturing executive operating near the top of a complex matrix organization. She underwent a 360-degree evaluation, which showed that she was ineffective at engaging groups led by others. Her response was tactical: She proposed a goal of improving her presentations before large groups. Her boss and coach transformed that into a strategic goal of working more effectively across organizational boundaries.

The more explicit these conversations are, the better. We encourage vigorous, candid debate, clear boundaries of confidentiality, and defined accountabilities for each participant. Indeed, making things explicit is a best practice in itself. No standard template for coaching action plans or metrics exists; our process induces coaching participants to devise terms that will produce the specific outcomes they want. Designing action plans is an iterative process that should continue as new insights emerge. We may renegotiate plans months after they’re set if new information reveals a path that will produce significantly better results. That adaptability sometimes surprises clients and coachees accustomed to off-the-rack solutions. Too bad. Our service is tailored and requires fittings.

To produce results, coaching goals should be measurable. If your goal is to stop infuriating colleagues, after coaching you’d better ask those colleagues whether you still infuriate them. If a CEO wants leaders to embody professed values, we would define particular behaviors that express those values; incorporate questions about them into a 360-degree instrument; and, once feedback is in, base individual coaching goals on the particular values in which each person falls short. After coaching, we would measure feedback on precisely the same key behaviors. Measurements should take human complexities into account, such as how the coachee achieves results. We often create custom mini-360 assessments, narrowly focused on specific coaching goals. Using the same people to rate the executives before and after coaching, these assessments measure the amount of perceived change on each scale. A secondary value of follow-up assessments is that they give colleagues a chance to reconsider their views. Otherwise, first impressions tend to stick. It’s sometimes easier to improve a coachee’s behavior than it is to win acknowledgment of positive change.

Coaching contracts should reflect the sensitive nature of the task. Ours usually include a no-fault escape clause, permitting any party to terminate a coaching relationship that isn’t working. When we find ourselves in an en-



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The contracting process enables the people at each point of the triangle to contemplate the unfamiliar terrain of coaching and increase their readiness for the **HARD WORK AHEAD.**

agement that isn't working for one reason or another, we exit. That's awkward, but it saves clients money and improves results.

Good contracting generates discussions that test interpersonal chemistry, while subjecting the potentially wild and woolly process of coaching to businesslike discipline. Reaching explicit agreements about goals, measures, and accountabilities brings the parties into closer alignment even before the supposed real work of coaching has begun. The contracting process enables the coach to engage the boss's active participation and to start indoctrinating the boss in coaching techniques. These conversations lead the people at each point of the triangle to contemplate the unfamiliar terrain of coaching and increase their readiness for the hard work ahead.

While our approach to contracting requires effort up front, our advice is to do the hard work and don't be shy about it. Discuss what needs to be discussed – and do it candidly. Insist on genuine commitments. Identify conflicts and iron them out. Be explicit. And when the stars are not aligned for a particular coaching intervention, don't be afraid to give up. The triangular nature of coaching generates friction, but it is also the source of great benefits. Take full advantage of it.

Coaching for Strategic Change

Worthy as it is to help one person or team, the most valuable executive coaching comes from developing an organization's entire senior executive rank. In most organizations, lasting change usually proceeds slowly, one person at a time, gaining momentum as more people buy in. To accelerate change and make it stick, we recommend systematically coordinating one-on-one coaching interventions that serve a larger strategic objective.

When an organizationwide perspective guides coaching, you don't fully qualify individual candidates; instead, you qualify the circumstances under which such a coaching program makes sense. You want to have a compelling business reason why executives should participate wholeheartedly in being coached. That could be as simple as making sure leaders live the company's values or as sub-

tle as planting the seeds of a companywide culture of coaching.

It's best to launch any coaching program only after it has won enthusiastic endorsements from top management, preferably including the CEO – who should be interested in those executives who are senior or promising enough to merit coaching. Because coaching, by its nature, brings uncomfortable subjects to light, these programs need an active champion with the power (including staying power) to protect them. CEO participation is good for ordinary coaching, but it's essential for coaching programs that support significant organizational change. That is why we recommend that such programs start with the CEO and top management and then spread across organizational boundaries. When senior leaders serve as role models and champions, coaching programs gain traction and credibility.

If the responsible chief is not involved, we always ask why. To be frank, we don't always get good answers. Two years before his mandatory retirement, one CEO, the head of a major technology company, ordered coaching for his top team to address succession issues. His HR staff handpicked a team of coaches from diverse sources who had not collaborated before. The program the company designed did not touch on team development or alignment with the organization's strategic intention. The CEO chose not to receive coaching himself. Outcome? Although each coachee benefited personally, the strategic impact on the organization was nil.

However, when a business chief truly commits to a thoughtful coaching process, the results can be outstanding. Just ask Harry Minkowski, president of an extremely successful multibillion-dollar unit that produces much of the profit at a premier entertainment company. "To make a project like this work," he said, "you need a top manager who is really putting his heart and soul into this thing, letting people know it is a requirement, and making sure people face the consequences if they don't fully participate in the process."

The problem at Harry's organization was familiar. During the previous two years, the complexity of the business had increased tenfold while headcount remained steady.

Everyone was working flat out. “We should have had perfect harmony because our results were great and getting better,” he recalled. “But we were seeing the worst of people’s behavior. And I noticed something: Every single person had a clear window onto everyone else. Their complaints about others were dead on. But they had no insight into themselves. They all had a great window and a bad mirror. That’s what I wanted to fix.”

We collaborated with Harry to design a coaching program that fit his needs. It included 360-degree feedback and coaching for all top managers, Harry included, as well as team coaching for the group. Each manager was obliged to develop an action plan based on individual feedback, share it with her supervisor and colleagues, and, after several months, demonstrate results via a mini-360. The managers also created and pursued a team action plan. Along the way, we ran custom workshops to explain and support the process.


Here’s Harry’s account of the result: “I said that if half the people changed half their behaviors half the time, I’d be thrilled. But we have changed 95% of the behaviors in 100% of the people 95% of the time. Nobody learned anything they didn’t know already – the difference now is that they act on it. The result was the most profound, incredible change. They treat each other better. They get into fewer conflicts. And when they do get into a conflict, they usually resolve it without coming to me.” Much of the credit for these improvements goes to Harry.

There’s another advantage to starting at the top: Once senior leaders have changed their behavior, it’s easier for them to influence subordinates to do the same. Then change can cascade down from the top. João Morais, the CEO of an overseas consumer-products outfit that had famous brands but not enough oomph, set a strategic goal of increasing revenue growth. He created a three-year, companywide campaign to improve managers’ coaching skills. First, he and all his division presidents underwent 360-degree feedback evaluations, followed by six months of coaching to help the leaders become better coaches themselves. Phase two was a leader-as-coach program that introduced coaching skills into the organization, layer by layer. It succeeded because João and the senior leaders served as role models. The widely observed changes in their behavior convinced others that the program was for real. Over time, the accumulation of

managers with coaching skills improved the work environment for thousands of employees.

When you create a culture of coaching, the results may not be directly measurable in dollars. But we have yet to find a company that can’t benefit from more candor, less denial, richer communication, conscious development of talent, and disciplined leaders who show compassion for people.

The Wild West of executive coaching isn’t for everyone. Some individuals can’t overcome their discomfort with personal inquiry, just as some organizations can’t muster the necessary respect for people. But for those who recognize the value of bringing individuals and organizations into alignment, the considerable difficulties and uncertainties of executive coaching are outweighed by the benefits of creating a new kind of enterprise that knows how to capitalize on the human qualities of its employees.

As long as there are human beings doing the work, businesses can profit by creating more fruitful relationships with them. 

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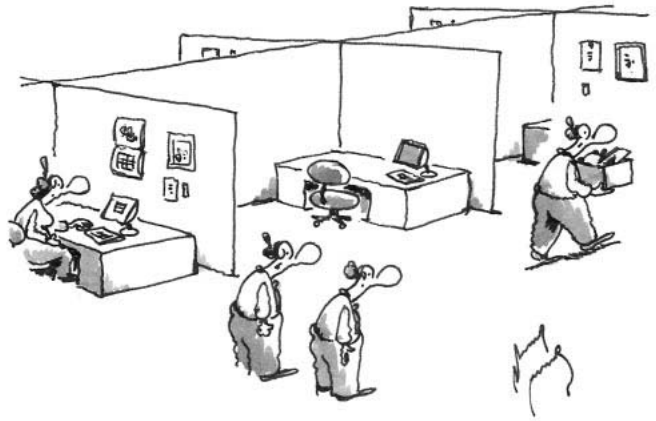
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Harvard Business Review
July 2002



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"Of course I trust you. I'm just waiting for the trace to come through."

A supply chain stays tight only if every company on it has reasons to pull in the same direction.

by **V.G. Narayanan and Ananth Raman**

Aligning Incentives in Supply Chains

Wall Street still remembers the day it heard that Cisco's much-vaunted supply chain had snapped. On a mad Monday, April 16, 2001, the world's largest network-equipment maker shocked investors when it warned them that it would soon scrap around \$2.5 billion of surplus raw materials—one of the largest inventory write-offs in U.S. business history. The company reported in May a net loss of \$2.69 billion for the quarter, and its share price tumbled by approximately 6% on the day it made that announcement. Cisco was perhaps blindsided by the speed with which the United States had advanced into recession, but how could this paragon of supply chain management have misread demand by \$2.5 billion, almost half as much as its sales in the quarter? Experts blamed the company's new forecasting software, and analysts accused senior executives of burying their heads in sockets, but those experts and analysts were mostly wrong.

In truth, Cisco ended up with a mountain of subassembly boards and semiconductors it didn't need because of the way its supply chain partners had behaved in the previous 18 months. Cisco doesn't have production facilities, so it passes orders to contract manufacturers. The contractors had stockpiled semifinished products because demand for Cisco's products usually exceeded supply. They had an incentive to build buffer stocks: Cisco rewarded them when they delivered supplies quickly. Many contractors also boosted their profit margins by buying large volumes from component suppliers at lower prices than Cisco had negotiated. Since the contractors and component makers had everything to gain and nothing to lose by building excess inventory, they worked overtime to do so without worrying about Cisco's real needs.

CALVIN RAMBLER



When demand slowed in the first half of fiscal 2000, Cisco found that it couldn't cut off supplies quickly. Moreover, it wasn't clear what Cisco had asked its suppliers to produce and what the contractors had manufactured in anticipation of Cisco's orders. Many contractors believed that Cisco had implicitly assured them it would buy everything they could produce. Since Cisco hadn't stipulated the responsibilities and accountability of its contractors and component suppliers, much of the excess inventory ended up in its warehouses. However, the supply chain imploded because Cisco's partners acted in ways that weren't in the best interests of the company or the supply chain.

It's tempting to ask, in retrospect, "What *was* everyone thinking?" But Cisco's supply chain is the rule rather than an exception. Most companies don't worry about the behavior of their partners while building supply chains to deliver goods and services to consumers. Engineers—not psychologists—build supply networks. Every firm behaves in ways that maximize its own interests, but companies assume, wrongly, that when they do so, they also maximize the supply chain's interests. In this mistaken view, the quest for individual benefit leads to collective good, as Adam Smith argued about markets more than two centuries ago. Supply chains are expected to work efficiently without interference, as if guided by Smith's invisible hand. But our research over the last ten years shows that executives have assumed too much. We found, in more than 50 supply chains we studied, that companies often didn't act in ways that maximized the network's profits; consequently, the supply chains performed poorly.

That finding isn't shocking when you consider that supply chains extend across several functions and many companies, each of which has its own priorities and goals. Yet all those functions and firms must pull in the same direction to ensure that supply chains deliver goods and services quickly and cost-effectively. Executives tackle intra-organizational problems but overlook cross-company problems because the latter are difficult to detect. They also find it tedious and time-consuming to define roles, responsibilities, and accountability for a string of businesses they don't manage directly. Besides, coordinating actions across firms is tough because organizations have different cultures and companies can't count on shared beliefs or loyalty to motivate their partners. To induce supply chain partners to behave in ways that are best for everybody, companies have to create or modify monetary incentives.

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A supply chain works well if its companies' incentives are aligned—that is, if the risks, costs, and rewards of doing business are distributed fairly across the network. For reasons that we shall later discuss, if incentives aren't in line, the companies' actions won't optimize the chain's performance. Indeed, misaligned incentives are often the cause of excess inventory, stock-outs, incorrect forecasts, inadequate sales efforts, and even poor customer service.

When incentives aren't aligned in supply chains, it's not just operational efficiency that's at stake. In recent years, many companies have assumed that supply costs are more or less fixed and have fought with suppliers for a bigger share of the pie. For instance, U.S. automobile manufacturers have antagonized their vendors by demanding automatic price reductions every year. Our research, however, shows that a company can increase the size of the pie itself by aligning partners' incentives. Thus, the fates of all supply chain members are interlinked: If the companies work together to efficiently deliver goods and services to consumers, they will all win. If they don't, they will all lose to another supply chain. The challenge is to get all the firms in your supply network to play the game so that everybody wins. The only way you can do that is by aligning incentives.

Why Incentives Get out of Line

Companies often complain to us that their supply chain partners don't seem to want to do what is in everyone's best interests, even when it's obvious what's best for the supply chain. This obstructive attitude, we believe, is a telltale sign that incentives have gotten out of line and companies are chasing different goals.

There are three reasons why incentive-related issues arise in supply chains. First, when companies cannot observe other firms' actions, they find it hard to persuade those firms to do their best for the supply network. A simple illustration: Whirlpool relies on retailers like Sears to sell its washing machines because retailers' salespeople greatly influence consumer decisions. If Whirlpool doesn't offer lucrative margins on its products, Sears will plug products that do or will encourage shoppers to buy its private-label brand, Kenmore. However, Whirlpool can't observe or track the effort that Sears expends in pushing its products. Since Sears's actions are hidden from Whirlpool, the manufacturer finds it tough to create incentives that induce the retailer to do what's best for both companies. Such "hidden actions," as we call them, exist all along the supply chain.

Second, it's difficult to align interests when one company has information or knowledge that others in the supply chain don't. For example, most U.S. automotive

The Economics of Incentive Alignment

If a company aligns the incentives of the firms in its supply chain, everyone will make higher profits. This isn't an idle claim; we can easily demonstrate it in the case of a two-company supply chain.

Let's say a publisher prints newspapers at a cost of 45 cents per copy and sells them to a news vendor for 80 cents each, and the newspaper retails for \$1.00. Let's also assume that demand for the newspaper is uniformly distributed between 100 and 200 copies a day.

The vendor has to throw away unsold copies, so he has to compare two kinds of costs before deciding how many copies to stock. He loses 80 cents for every unsold copy, but if demand exceeds supply, his opportunity cost is 20 cents per copy. The vendor's inventory level will be optimal when the marginal understocking cost equals the marginal overstocking cost – in this case, when he orders 120 copies. The vendor will stock fewer copies than the average demand of 150 per day because the overstocking cost (80 cents) is four times higher than the understocking cost (20 cents). That could lead to frequent stock-outs.

If the publisher produced and sold the newspaper himself, he would incur an understocking cost of 55 cents (the retail price less the printing cost) and an overstocking cost of 45 cents (the unit cost of printing). According to our calculations, the publisher's profits would be greatest if he were to stock 155 copies, not 120. (For details on how we arrived at the numbers presented here, see V.G. Narayanan's technical note "The Economics of Incentive Alignment," Harvard Business School, 2004.) In fact, both the publisher and the consumers would be happier if there were more

copies of the newspaper on the stands, but the vendor would not be. The vendor stocks less than everyone else would like him to because it is in his best interest to do so. The publisher therefore needs to change the incentives of the news vendor so that when the vendor chooses an inventory level that is in his best interest, it increases the publisher's profits.

One way the publisher could do that is by using a revenue-sharing contract and lowering the price the vendor pays for each copy from 80 cents to 45 cents. In return, the vendor could retain, say, 65% of the sale price and pass on 35% to the publisher. The retailer's understocking costs would remain 20 cents, but his overstocking costs would fall because he'd pay less for each copy. The retailer would now be inclined to stock 131 copies instead of 120. The profits of both the retailer and the publisher would rise (see the table below).

Alternately, the publisher could pay the retailer markdown money of, let's suppose, 60 cents for every unsold copy. That would lower the overstocking cost of the retailer and encourage him to stock more copies. The publisher would more than make up for bearing some of that cost because of profits he'd gain in higher sales. In this case, the retailer would stock 150 copies.

As the exhibit shows, both the publisher and the retailer would earn more profits under the revenue-sharing and markdown-money contracts considered here than under the traditional system. The increase in profits would not come at the expense of consumers, who'd pay the same retail price. Inventory levels would also go up, which would result in greater consumer satisfaction.

Costs and Profits	Traditional Contract	Revenue-Sharing Contract	Markdown-Money Contract
Retail Price	\$1.00	\$1.00	\$1.00
Printing Cost	\$0.45	\$0.45	\$0.45
Wholesale Price	\$0.80	\$0.45	\$0.80
Vendor's Share of Revenue	100%	65%	100%
Vendor's Compensation for Unsold Copies	—	—	\$0.60
Vendor's Understocking Cost	\$0.20	\$0.20	\$0.20
Vendor's Overstocking Cost	\$0.80	\$0.45	\$0.20
Inventory Level	120 copies	131 copies	150 copies
Vendor's Daily Profit	\$22.00	\$23.08	\$25.00
Publisher's Daily Profit	\$42.00	\$44.17	\$45.00
Supply Chain's Daily Profit	\$64.00	\$67.25	\$70.00

vendors fear that if they share their cost data, the Big Three auto manufacturers will use that information to squeeze the vendors' margins. For that reason, suppliers are reluctant to participate in improvement initiatives that would let manufacturers or other companies collect such data. Since the suppliers insist on hiding information, the Big Three's supply chains don't function as efficiently as they could.

Third, incentive schemes are often badly designed. Our favorite example of this problem is a Canadian bread manufacturer that felt it needed to increase its stocks in stores. The manufacturer allotted deliverymen a certain amount of its shelf space in stores and offered them commissions based on sales off those shelves. The deliverymen gladly kept the store shelves filled – even on days when rival bread makers were offering consumers deep discounts on their products. The Canadian baker had to throw away heaps of stale loaves, and its costs soared as a result. The deliverymen earned handsome commissions, but the company's profits fell because of an ill-conceived incentive scheme.

Straightening Things Out

Our research suggests that companies must align incentives in three stages. At the outset, executives need to acknowledge that there's misalignment. Then they must trace the problem to hidden actions, hidden information, or badly designed incentives. Finally, by using one of three approaches that we describe in detail later in the article, companies can align or redesign incentives to obtain the behavior they desire from their partners.

Accept the premise. When we conduct straw polls with executives, almost all of them admit they hadn't thought that incentive alignment was a problem in their supply chains. We're not surprised. Most companies find it difficult at first to come to grips with the relationship between incentives and supply chain problems. Executives don't understand the operational details of other firms well enough to realize that incentives could be getting out of whack. In addition, companies tend to avoid the subject of monetary incentives because, if they raise it, their partners may suspect them of merely trying to negotiate lower prices for the products or services they buy.

Once companies get past these mental barriers, it's relatively easy for them to detect incentive misalignment. They should expect problems to surface whenever they launch change initiatives, because these modify the incentives of key stakeholders – and most stakeholders protest loudly when incentives get out of line. For instance, in the late 1990s, businesses ranging from Campbell Soup to Liz

A Step-by-Step Approach

Companies face incentive problems in their supply chains because of

- >hidden actions by partner firms.
- >hidden information – data or knowledge that only some of the firms in the supply chain possess.
- >badly designed incentives.

They can tackle incentive problems by

- >acknowledging that such problems exist.
- >diagnosing the cause – hidden actions, hidden information, or badly designed incentives.
- >creating or redesigning incentives that will induce partners to behave in ways that maximize the supply chain's profits.

They can redesign incentives by

- >changing contracts to reward partners for acting in the supply chain's best interests.
- >gathering or sharing information that was previously hidden.
- >using intermediaries or personal relationships to develop trust with supply chain partners.

They can prevent incentive problems by

- >conducting incentive audits when they adopt new technologies, enter new markets, or launch supply chain improvement programs.
- >educating managers about processes and incentives at other companies in the supply chain.
- >making discussions less personal by getting executives to examine problems at other companies or in other industries.

Claiborne fought the bullwhip effect – amplified fluctuations in demand – by managing inventory themselves. Rather than relying on distributors and retailers for orders, the companies set up central logistics departments to make purchasing decisions. Although these initiatives could have helped the companies' supply chains, they failed because of open resistance from distributors and retailers, who were convinced that the manufacturers had marginalized their roles.

Pinpoint the cause. Executives must get to the root of incentive problems, so they can choose the best approach

to bring incentives back into line. In our consulting work with companies, we often use role play for this purpose. We ask senior managers to identify decisions that would have been made differently if they or their suppliers had focused on the supply chain's interests instead of their own interests. We then ask why decision makers acted as they did. In some cases, the answers suggest improper training or inadequate decision-support tools for managers; most of the time, however, they point to mismatched goals. And we try to figure out whether the decisions were motivated by hidden actions, hidden information, or badly designed incentives.

Aligning incentives is quite unlike other supply chain challenges, which are amenable to structured problem-solving processes that involve equations and algorithms. In our experience, only managers who understand the motivations of most companies in their supply chain can tackle incentive-related issues. Since alignment also requires an understanding of functions such as marketing, manufacturing, logistics, and finance, it's essential to involve senior managers in the process.

Align or redesign. Once companies have identified the root causes of incentive problems, they can use one of three types of solutions—contract based, information based, or trust based—to bring incentives back into line. Most organizations don't have the influence to redesign an entire chain's incentives—they can change only the incentives of their immediate partners. While it is often the biggest company in the supply chain that aligns incentives, size is neither necessary nor sufficient for the purpose. In the late 1980s, the \$136 million Swedish company Kanthal, a supplier of heating wires, said that it would impose penalties whenever the \$35 billion GE changed specifications without warning. The mighty GE agreed to contract changes requested by its small partner, and incentives became better aligned as a result.

Rewriting Contracts

One way companies can align incentives in supply chains is by altering contracts with partner firms. When misalignment stems from hidden actions, executives can bring those actions to the surface—unhide them, as it were—by creating a contract that rewards or penalizes partners based on outcomes. To return to an earlier example, Whirlpool may not be able to see what Sears's salespeople do to promote the manufacturer's washing machines, but it can track the outcome of their efforts—namely, increased or decreased sales—and draw up agreements to reward them accordingly.

It's necessary to alter contracts when badly designed incentives are the problem. Let us think back to the

Canadian bread manufacturer whose deliverymen overstocked stores when they were paid sales-based commissions. The company changed the deliverymen's behavior by altering their contracts to include penalties for stale loaves in stores, which could be tracked. While the penalties reduced the incentive to overstock stores, the commissions ensured that the deliverymen still kept shelves well stocked.

That may appear to be a minor change, but it's a significant one. Companies often underestimate the power of redesigning contracts. Small changes in incentives can transform supply chains, and they can do so quickly. Take the case of Tweeter, a consumer-electronics retail chain that in May 1996 acquired the loss-making retailer Bryn Mawr Stereo and Video. For years, Bryn Mawr's stores had reported lower sales than rivals had. Tweeter's executives realized early that the incentives that Bryn Mawr offered its store managers would not lead to higher sales. For instance, while Tweeter penalized managers for a small part of the cost of products pilfered from their stores, Bryn Mawr deducted the full value of stolen goods from their pay. Since store managers faced more pressure to prevent shoplifting than to push sales, they behaved accordingly. They placed impulse-purchase products like audiotapes and batteries behind locked cases, which reduced theft but killed sales. They spent more time tracking merchandise receipts than they did showing products to consumers. They shut down stores while receiving merchandise to ensure there was no loss in inventory; never mind the sales they lost in the process.

After the acquisition, Tweeter stopped deducting retail shrink from Bryn Mawr store managers' salaries and started paying them a percentage of the profits from their stores. While both sales and shrink affect profits, the retailer effectively increased the importance of sales relative to shrink. The store managers therefore directed their efforts toward increasing sales rather than decreasing shrink. Although Tweeter left the store name unchanged, kept the product mix intact, and retained the same store managers, Bryn Mawr's sales rose by an average of 10% in 1997. As managers moved merchandise to shelves where consumers could touch products, shrink also increased, from \$122 a month to \$600 a month per store. Net-net, however, Bryn Mawr's profits rose by 2.5% of sales in those 12 months. Tweeter didn't have to change people to create a new culture at Bryn Mawr; it just changed their incentives. (For more details, see Nicole DeHoratius and Ananth Raman's "Impact of Store Manager Incentives on Retail Performance," a Harvard Business School Working Paper, September 2000.)

By changing how, rather than how much, they pay partners, companies can improve supply chain performance.

When that happens, all the firms in the chain make more money than they used to. (See the sidebar “The Economics of Incentive Alignment.”) In the 1990s, Hollywood movie studios, such as Universal Studios and Sony Pictures, found that frequent stock-outs at video retailers, like Blockbuster and Movie Gallery, posed a major problem. A lack of inventory on store shelves meant that everyone suffered: The studios lost potential sales, video rental companies lost income, and consumers went home disgusted. Inventory levels were low because the incentives of the studios and the retailers weren’t in line. The studios sold retailers copies of movies at \$60 a videotape. At an average rental of \$3, the retailers had to ensure that each tape went out at least 20 times to break even. The studios wanted to sell more tapes, but the retailers wished to buy fewer tapes and rent them out more often.

When the studios and the retailers explored the possibility of sharing revenues, incentives began to tee up. Since it cost the studios only \$3 to create a copy of a movie, they could recoup their investment the first time a consumer rented a tape. In theory, that meant the studios

went away disappointed. Industry experts estimated that rental revenues from videotapes increased by 15% in the United States, and the studios and the retailers enjoyed a 5% growth in profits. Perhaps most important, stock-outs at video rental stores fell from 25% before revenue sharing to less than 5% after revenue sharing.

Revealing Hidden Information

Companies can also align incentives across the supply chain by tracking and monitoring more business variables, thereby making actions visible, or by disseminating information throughout the supply chain.

The most effective way to reveal hidden actions is to measure more variables. In the late 1980s, Campbell Soup offered distributors discounts several times every year, hoping that the savings would be passed on to retailers. However, distributors bought more units than they sold to retailers, so Campbell’s sales fluctuated wildly. For instance, the company sold 40% of its chicken noodle soup

By changing how, rather than how much, they pay partners, companies can improve supply chain performance. When that happens, everyone in the chain makes more money.

could stock many more copies than the retailers could. For the model to work, though, the studios needed to derive income not from tape sales but from rentals – as the retailers did.

In the late 1990s, when video rental companies proposed revenue-sharing contracts, the studios raised no objections. They agreed to sell tapes to the retailers for around \$3 per tape and receive 50% of the revenues from each rental. However, the studios needed to track the retailers’ revenues and inventories for the revenue-sharing system to work. The studios and the video rental companies relied on an intermediary, Rentrak, which obtained data from the retailers’ computerized records and conducted store audits to ensure that all tapes were accounted for. In fact, the contract-based solution wouldn’t have worked if Rentrak hadn’t revealed previously hidden information in the supply chain.

In less than a year, it became clear that revenue sharing had led to a happy ending in the video rental industry. The studios saw a bounce in their bottom lines, retailers began to earn more money, and consumers no longer

each of those years during six-week promotional periods. The uptick put a lot of pressure on the company’s supply chain. When Campbell realized that it gathered data on distributors’ purchases but not on their sales, it invested in information technology systems that could track both. Then, by giving the distributors discounts on sales but not on purchases, Campbell eliminated the incentive to forward-buy large quantities. That helped improve the supply chain’s performance.

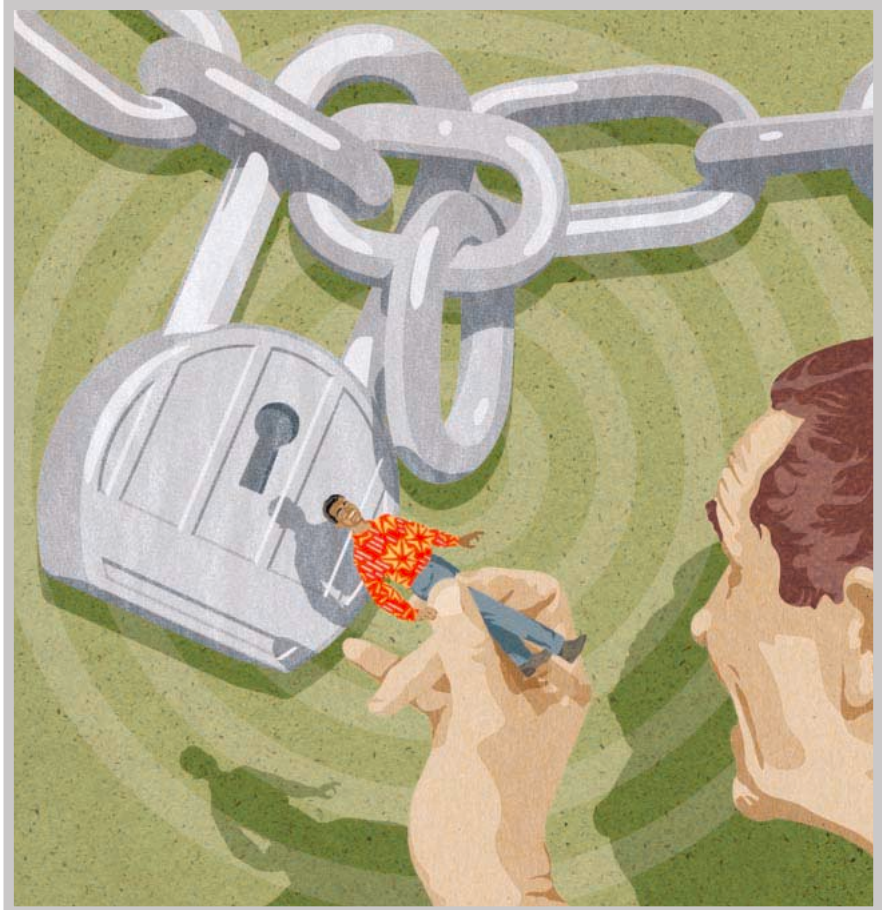
Technology isn’t always needed for managers to observe more variables. Some companies employ mystery shoppers – agents who pose as customers – to ascertain whether, say, distributors are pushing products or retailers are offering services. Like many franchisers, Mobil uses mystery shoppers to monitor restroom cleanliness and employee friendliness at its gas stations.

Information systems derived from the principles of activity-based costing are critical for measuring the costs associated with hidden actions. No company knows that better than Owens & Minor, a large distributor of medical supplies. Hospitals used to pay O&M a fixed percentage of

the cost of items delivered. They could, however, buy supplies directly from manufacturers if it was cheaper to do so. For example, the hospitals sometimes bought high-margin products such as cardiovascular sutures from manufacturers to avoid the distributor's markup. The hospitals expected O&M to supply products with high storage, handling, and transportation costs—adult diapers, for instance—even though those items gave the distributor low margins. Cost-plus contracts led to a misalignment in another area, too: In general, distributors were often reluctant to provide services such as just-in-time deliveries, while the hospitals demanded more such services for the same fixed markup.

O&M found an opportunity to realign incentives when it switched to an activity-based costing system and got a handle on the profitability of its services to hospitals. Until then, O&M knew when its customers requested services such as emergency deliveries; what it didn't know was the effect of those requests on its costs and profits. In other words, customers' actions weren't hidden from O&M, but the impact of those actions was. After O&M had figured out the cost of its services, the distributor asked customers for fees according to the services they desired. But first, to test the change, O&M approached a hospital that had rejected its overtures two years earlier. O&M explained that instead of offering a cost-plus contract, it would charge per service requested. It shared its cost data with the hospital to show that the fees weren't unreasonable.

The hospital's reaction was so encouraging that, in 1996, O&M offered all its customers a choice between an activity-based-pricing system and a traditional contract. O&M's activity-based contracts offered hospitals a menu of services and quoted a price for each one. A hospital could choose just-in-time deliveries, for example, but it would have to pay for them. O&M believed that by designing mutually beneficial incentives, it could induce hospitals to act in ways that would be good for both themselves and O&M. The company wasn't wrong; most hospitals were happy to have a distributor provide all the services they wanted, even if that meant paying extra. In



2003, O&M's sales from activity-based-pricing contracts reached \$1.35 billion, which was nearly one-third of its turnover of \$4.2 billion.

Developing Trust

Companies can sometimes use trust-based mechanisms to prevent incentive problems from cropping up in supply chains. That may sound like a contradiction, since firms are more likely to trust each other when their incentives are in line. When companies realize from the outset that working with partners will not be easy, though, they can use intermediaries to prevent supply chains from breaking down. The use of a middleman has become more popular as American and European companies have outsourced manufacturing to developing countries, where legal contracts are often harder to enforce.

When Western companies link up with Asian manufacturers or component suppliers, each party has misgivings about the other's interests. The importers are convinced that the vendors won't deliver on time, can't

produce consistent quality, and will give greater priority to companies that will pay higher prices. They also fear that the contractors will reduce their costs by bribing government officials or using child labor. As Nike found, those dubious practices give importers, rather than their suppliers, bad reputations. For their part, suppliers fear that importers might reject products. Since importers enter into contracts six to nine months in advance of delivery, vendors doubt companies' ability to predict consumer demand accurately. They worry that demand for products will be lower than anticipated and that importers will reject consignments, pretending that the quality wasn't up to snuff.

Under those circumstances, the presence of an intermediary can help align the incentives of the two parties. For instance, the Hong Kong-based supply chain intermediary Li & Fung has become adept at marrying the interests of manufacturers and suppliers. The company, which has created a network of factories in Asia, enforces a code of ethics that precludes its network from providing unhygienic work conditions, for example, or paying below the minimum wage. Li & Fung monitors its suppliers to ensure that they adhere to the quality and ethical standards that Western importers demand. It employs a chief compliance officer, who reports directly to the company's chairperson. Li & Fung accounts for roughly half the volumes of all its suppliers every year. If a vendor reneges on its promises, it stands to lose a great deal of business from Li & Fung. At the same time, Li & Fung keeps multinational companies honest. If they make frivolous demands of suppliers or refuse to take delivery of products at contracted prices, Li & Fung will deny them access to its network in the future. Thus, Li & Fung is able to align incentives because of the repeat business it offers importers and suppliers.

Just as Li & Fung's reputation reduces the need for formal contracts, so can the relationships between individuals in companies. Klaus Obermeyer, the founder of the fashion skiwear manufacturer Sport Obermeyer, formed a joint venture with the Hong Kong-based supplier Raymond Tse in 1985 to source raw materials, cut and sew garments, and coordinate shipping. Over the last 19 years, Klaus Obermeyer has left most production and investment decisions to Tse. He values his relationship with Tse and, given their history working together, believes that Tse will not make decisions that aren't in both companies' interests. The desire to preserve their relationship has been a sufficient incentive for Obermeyer and Tse to act only in ways that are mutually beneficial.

•••

Companies should explore contract-based solutions before they turn to other approaches, because contracts are

quick and easy to implement. They should bear in mind, though, that advances in technology have reduced the cost of information-based solutions. For instance, some organizations have made real-time sales data available throughout supply chains – and that was unimaginable five years ago. In fact, we recommend information-based solutions ahead of trust-based ones. Companies can adopt the latter only if they are able to identify trustworthy intermediaries, and that is often difficult.

Before we conclude, we must mention two caveats. First, a solution that resolves incentive misalignment for one company might exacerbate the problem for another. Executives should therefore coordinate the interests of all the companies in a supply chain at the same time. Second, companies must align the incentives of all the key decision makers in their supply chains. Although it is difficult for one company to change the incentives of executives in other organizations, it can point out possible misalignments to partners. Consider the following example: A Boston-based start-up placed kiosks for dispensing its products in retail stores. It offered incentives to retailers but failed to ensure that the retailers passed on those incentives to store managers. Since the store managers could decide where to place the kiosks but weren't motivated to display them prominently, the start-up found kiosks in corners where few consumers would notice them. By flagging the issue for the retailers, the start-up was able to tackle the problem before it got to be too late.

Companies should periodically study their supply chains, because even top-performing networks find that changes in technology or business conditions may alter the alignment of incentives. Firms can take three steps to facilitate discussions about misalignments. First, executives should conduct incentive audits whenever they adopt new technologies or enter new markets. Such audits verify that the incentives offered to key individuals and stakeholders are consistent with the behavior that companies expect of their partners. Second, companies should educate managers about their supply chain partners. Only then will manufacturers better understand distributors, for instance, or will retailers realize the constraints manufacturers face. Third, since executives are often uncomfortable discussing how incentives influence their decisions, it's useful to depersonalize the situation by getting managers to examine case studies from other industries. It's critical to get the conversation started – in most supply chains, having companies admit that incentive problems even exist is more than half the battle. ▢

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Spanish clothier Zara turns the rules of supply chain management on their head. The result? A superresponsive network and profit margins that are the envy of the industry.

Rapid- Fire Fulfillment

by **Kasra Ferdows,**
Michael A. Lewis, and
Jose A.D. Machuca

When a German wholesaler suddenly canceled a big lingerie order in 1975, Amancio Ortega thought his fledgling clothing company might go bankrupt. All his capital was tied up in the order. There were no other buyers. In desperation, he opened a shop near his factory in La Coruña, in the far northwest corner of Spain, and sold the goods himself. He called the shop Zara.

Today, over 650 Zara stores in some 50 countries attract well-heeled customers in luxury shopping districts around the world, and Senor Ortega is arguably the richest man in Spain. The clothing company he founded, called Inditex, has been growing ever since he opened that first Zara shop. From 1991 to 2003, Inditex's sales – 70% of which spring from Zara – grew more than 12-fold from €367 million to €4.6 billion, and net profits ballooned 14-fold from €31 million to €447 million. In May 2001, a particularly tough period for initial public offerings, Inditex sold 25% of its shares to the public for €2.3 billion. While many of its competitors have exhibited poor financial results over the last three years, Zara's sales and net income have continued to grow at an annual rate of over 20%.

LULU



The lesson Ortega learned from his early scare was this: To be successful, “you need to have five fingers touching the factory and five touching the customer.” Translation: Control what happens to your product until the customer buys it. In adhering to this philosophy, Zara has developed a superresponsive supply chain. The company can design, produce, and deliver a new garment and put it on display in its stores worldwide in a mere 15 days. Such a pace is unheard-of in the fashion business, where designers typically spend months planning for the next season. Because Zara can offer a large variety of the latest designs quickly and in limited quantities, it collects 85% of the full ticket price on its retail clothing, while the industry average is 60% to 70%. As a result, it achieves a higher net margin on sales than its competitors; in 2001, for example, when Inditex’s net margin was 10.5%, Benetton’s was only 7%, H&M’s was 9.5%, and Gap’s was near zero.

Zara defies most of the current conventional wisdom about how supply chains should be run. In fact, some of Zara’s practices may seem questionable, if not downright crazy, when taken individually. Unlike so many of its peers in retail clothing that rush to outsource, Zara keeps almost half of its production in-house. Far from pushing its factories to maximize their output, the company intentionally leaves extra capacity. Rather than chase economies of scale, Zara manufactures and distributes products in small batches. Instead of relying on outside partners, the company manages all design, warehousing, distribution, and logistics functions itself. Even many of its day-to-day operational procedures differ from the norm. It holds its retail stores to a rigid timetable for placing orders and receiving stock. It puts price tags on

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items before they’re shipped, rather than at each store. It leaves large areas empty in its expensive retail shops. And it tolerates, even encourages, occasional stock-outs.

During the last three years, we’ve tried to discover just how Zara designs and manages its rapid-fire supply chain. We conducted a series of interviews with senior managers at Inditex and examined company documents and a wide range of other sources. We were particularly curious to see if Zara had discovered any groundbreaking innovations. We didn’t find any. Instead, we found a self-reinforcing system built on three principles:

- **Close the communication loop.** Zara’s supply chain is organized to transfer both hard data and anecdotal in-

formation quickly and easily from shoppers to designers and production staff. It's also set up to track materials and products in real time every step of the way, including inventory on display in the stores. The goal is to close the information loop between the end users and the upstream operations of design, procurement, production, and distribution as quickly and directly as possible.

- **Stick to a rhythm across the entire chain.** At Zara, rapid timing and synchronicity are paramount. To this end, the company indulges in an approach that can best be characterized as “penny foolish, pound wise.” It spends money on anything that helps to increase and enforce the speed and responsiveness of the chain as a whole.

- **Leverage your capital assets to increase supply chain flexibility.** Zara has made major capital investments in production and distribution facilities and uses

annually, from which 10,000 are selected for production. Some of them resemble the latest couture creations. But Zara often beats the high-fashion houses to the market and offers almost the same products, made with less expensive fabric, at much lower prices. Since most garments come in five to six colors and five to seven sizes, Zara's system has to deal with something in the realm of 300,000 new stock-keeping units (SKUs), on average, every year.

This “fast fashion” system depends on a constant exchange of information throughout every part of Zara's supply chain – from customers to store managers, from store managers to market specialists and designers, from designers to production staff, from buyers to subcontractors, from warehouse managers to distributors, and so on. Most companies insert layers of bureaucracy that can bog down communication between departments. But Zara's

Empty racks at Zara don't drive customers to other stores. Being out of stock in one item helps sell another.

them to increase the supply chain's responsiveness to new and fluctuating demands. It produces complicated products in-house and outsources the simple ones.

It took Zara many years to develop its highly responsive system, but your company need not spend decades bringing its supply chain up to speed. Instead, you can borrow a page from Zara's playbook. Some of Zara's practices may be directly applicable only in high-tech or other industries where product life cycles are very short. But Ortega's simple philosophy of reaping profits through end-to-end control of the supply chain applies to any industry – from paper to aluminum products to medical instruments. Zara shows managers not only how to adjust to quixotic consumer demands but also how to resist management fads and ever-shifting industry practices.

Close the Loop

In Zara stores, customers can always find new products—but they're in limited supply. There is a sense of tantalizing exclusivity, since only a few items are on display even though stores are spacious (the average size is around 1,000 square meters). A customer thinks, “This green shirt fits me, and there is one on the rack. If I don't buy it now, I'll lose my chance.”

Such a retail concept depends on the regular creation and rapid replenishment of small batches of new goods. Zara's designers create approximately 40,000 new designs

organization, operational procedures, performance measures, and even its office layouts are all designed to make information transfer easy.

Zara's single, centralized design and production center is attached to Inditex headquarters in La Coruña. It consists of three spacious halls – one for women's clothing lines, one for men's, and one for children's. Unlike most companies, which try to excise redundant labor to cut costs, Zara makes a point of running three parallel, but operationally distinct, product families. Accordingly, separate design, sales, and procurement and production-planning staffs are dedicated to each clothing line. A store may receive three different calls from La Coruña in one week from a market specialist in each channel; a factory making shirts may deal simultaneously with two Zara managers, one for men's shirts and another for children's shirts. Though it's more expensive to operate three channels, the information flow for each channel is fast, direct, and unencumbered by problems in other channels – making the overall supply chain more responsive.

In each hall, floor to ceiling windows overlooking the Spanish countryside reinforce a sense of cheery informality and openness. Unlike companies that sequester their design staffs, Zara's cadre of 200 designers sits right in the midst of the production process. Split among the three lines, these mostly twentysomething designers – hired because of their enthusiasm and talent, no prima donnas allowed – work next to the market specialists and

procurement and production planners. Large circular tables play host to impromptu meetings. Racks of the latest fashion magazines and catalogs fill the walls. A small prototype shop has been set up in the corner of each hall, which encourages everyone to comment on new garments as they evolve.

The physical and organizational proximity of the three groups increases both the speed and the quality of the design process. Designers can quickly and informally check initial sketches with colleagues. Market specialists, who are in constant touch with store managers (and many of whom have been store managers themselves), provide quick feedback about the look of the new designs (style, color, fabric, and so on) and suggest possible market price points. Procurement and production planners make preliminary, but crucial, estimates of manufacturing costs

The constant flow of updated data mitigates the so-called bullwhip effect – the tendency of supply chains (and all open-loop information systems) to amplify small disturbances. A small change in retail orders, for example, can result in wide fluctuations in factory orders after it's transmitted through wholesalers and distributors. In an industry that traditionally allows retailers to change a maximum of 20% of their orders once the season has started, Zara lets them adjust 40% to 50%. In this way, Zara avoids costly overproduction and the subsequent sales and discounting prevalent in the industry.

The relentless introduction of new products in small quantities, ironically, reduces the usual costs associated with running out of any particular item. Indeed, Zara makes a virtue of stock-outs. Empty racks don't drive customers to other stores because shoppers always have new

Few managers can imagine sending a half-empty truck across Europe or running factories for only one shift.

and available capacity. The cross-functional teams can examine prototypes in the hall, choose a design, and commit resources for its production and introduction in a few hours, if necessary.

Zara is careful about the way it deploys the latest information technology tools to facilitate these informal exchanges. Customized handheld computers support the connection between the retail stores and La Coruña. These PDAs augment regular (often weekly) phone conversations between the store managers and the market specialists assigned to them. Through the PDAs and telephone conversations, stores transmit all kinds of information to La Coruña – such hard data as orders and sales trends and such soft data as customer reactions and the “buzz” around a new style. While any company can use PDAs to communicate, Zara's flat organization ensures that important conversations don't fall through the bureaucratic cracks.

Once the team selects a prototype for production, the designers refine colors and textures on a computer-aided design system. If the item is to be made in one of Zara's factories, they transmit the specs directly to the relevant cutting machines and other systems in that factory. Bar codes track the cut pieces as they are converted into garments through the various steps involved in production (including sewing operations usually done by subcontractors), distribution, and delivery to the stores, where the communication cycle began.

things to choose from. Being out of stock in one item helps sell another, since people are often happy to snatch what they can. In fact, Zara has an informal policy of moving unsold items after two or three weeks. This can be an expensive practice for a typical store, but since Zara stores receive small shipments and carry little inventory, the risks are small; unsold items account for less than 10% of stock, compared with the industry average of 17% to 20%. Furthermore, new merchandise displayed in limited quantities and the short window of opportunity for purchasing items motivate people to visit Zara's shops more frequently than they might other stores. Consumers in central London, for example, visit the average store four times annually, but Zara's customers visit its shops an average of 17 times a year. The high traffic in the stores circumvents the need for advertising: Zara devotes just 0.3% of its sales on ads, far less than the 3% to 4% its rivals spend.

Stick to a Rhythm

Zara relinquishes control over very little in its supply chain – much less than its competitors. It designs and distributes all its products, outsources a smaller portion of its manufacturing than its peers, and owns nearly all its retail shops. Even Benetton, long recognized as a pioneer in tight supply chain management, does not extend its reach as far as Zara does. Most of Benetton's stores are franchises, and that gives it less sway

over retail inventories and limits its direct access to the critical last step in the supply chain—the customers.

This level of control allows Zara to set the pace at which products and information flow. The entire chain moves to a fast but predictable rhythm that resembles Toyota's "Takt time" for assembly or the "inventory velocity" of Dell's procurement, production, and distribution system. By carefully timing the whole chain, Zara avoids the usual problem of rushing through one step and waiting to take the next.

The precise rhythm begins in the retail shops. Store managers in Spain and southern Europe place orders twice weekly, by 3:00 PM Wednesday and 6:00 PM Saturday, and the rest of the world places them by 3:00 PM Tuesday and 6:00 PM Friday. These deadlines are strictly enforced: If a store in Barcelona misses the Wednesday deadline, it has to wait until Saturday.

Order fulfillment follows the same strict rhythm. A central warehouse in La Coruña prepares the shipments for every store, usually overnight. Once loaded onto a truck, the boxes and racks are either rushed to a nearby airport or routed directly to the European stores. All trucks and connecting airfreights run on established schedules—like a bus service—to match the retailers' twice-weekly orders. Shipments reach most European stores in 24 hours, U.S. stores in 48 hours, and Japanese shops in 72 hours, so store managers know exactly when the shipments will come in.

When the trucks arrive at the stores, the rapid rhythm continues. Because all the items have already been pre-priced and tagged, and most are shipped hung up on racks, store managers can put them on display the moment they're delivered, without having to iron them. The need for control at this stage is minimized because the shipments are 98.9% accurate with less than 0.5% shrinkage. Finally, because regular customers know exactly when the new deliveries come, they visit the stores more frequently on those days.

This relentless and transparent rhythm aligns all the players in Zara's supply chain. It guides daily decisions by managers, whose job is to ensure that nothing hinders the responsiveness of the total system. It reinforces the production of garments in small batches, though larger batches would reduce costs. It validates the company policy of delivering two shipments every week, though less frequent shipment would reduce distribution costs. It justifies transporting products by air and truck, though ships and trains would lower transportation fees. And it provides a rationale for shipping some garments on hangers, though folding them into boxes would reduce the air and truck freight charges.

These counterintuitive practices pay off. Zara has shown that by maintaining a strict rhythm, it can carry

less inventory (about 10% of sales, compared to 14% to 15% at Benetton, H&M, and Gap); maintain a higher profit margin on sales; and grow its revenues.

Leverage Your Assets

In a volatile market where product life cycles are short, it's better to own fewer assets—thus goes the conventional wisdom shared by many senior managers, stock analysts, and management gurus. Zara subverts this logic. It produces roughly half of its products in its own factories. It buys 40% of its fabric from another Inditex firm, Comditel (accounting for almost 90% of Comditel's total sales), and it purchases its dyestuff from yet another Inditex company. So much vertical integration is clearly out of fashion in the industry; rivals like Gap and H&M, for example, own no production facilities. But Zara's managers reason that investment in capital assets can actually increase the organization's overall flexibility. Owning production assets gives Zara a level of control over schedules and capacities that, its senior managers argue, would be impossible to achieve if the company were entirely dependent on outside suppliers, especially ones located on the other side of the world.

The simpler products, like sweaters in classic colors, are outsourced to suppliers in Europe, North Africa, and Asia. But Zara reserves the manufacture of the more-complicated products, like women's suits in new seasonal colors, for its own factories (18 of which are in La Coruña, two in Barcelona, and one in Lithuania, with a few joint ventures in other countries). When Zara produces a garment in-house, it uses local subcontractors for simple and labor-intensive steps of the production process, like sewing. These are small workshops, each with only a few dozen employees, and Zara is their primary customer.

Zara can ramp up or down production of specific garments quickly and conveniently because it normally operates many of its factories for only a single shift. These highly automated factories can operate extra hours if need be to meet seasonal or unforeseen demands. Specialized by garment type, Zara's factories use sophisticated just-in-time systems, developed in cooperation with Toyota, that allow the company to customize its processes and exploit innovations. For example, like Benetton, Zara uses "postponement" to gain more speed and flexibility, purchasing more than 50% of its fabrics undyed so that it can react faster to midseason color changes.

All finished products pass through the five-story, 500,000-square-meter distribution center in La Coruña, which ships approximately 2.5 million items per week. There, the allocation of such resources as floor space, layout, and equipment follows the same logic that Zara

applies to its factories. Storing and shipping many of its pieces on racks, for instance, requires extra warehouse space and elaborate material-handling equipment. Operating hours follow the weekly rhythm of the orders: In a normal week, this facility functions around the clock for four days but runs for only one or two shifts on the remaining three days. Ordinarily, 800 people fill the orders, each within eight hours. But during peak seasons, the company adds as many as 400 temporary staffers to maintain lead times.

Even though there's ample capacity in this distribution center during most of the year, Zara opened a new €100 million, 120,000-square-meter logistics center in Zaragoza, northeast of Madrid, in October 2003. Why is Zara so generous with capacity? Zara's senior managers follow a fundamental rule of queuing models, which holds that waiting time shoots up exponentially when capacity is tight and demand is variable (see the exhibit "For Fast Response, Have Extra Capacity on Hand"). By tolerating lower capacity utilization in its factories and distribution centers, Zara can react to peak or unexpected demands faster than its rivals.

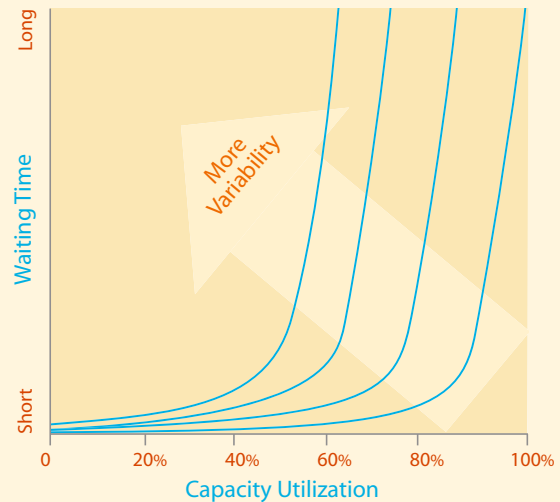
Surprisingly, these practices don't burn up investment dollars. Thanks to the responsiveness of its factories and distribution centers, Zara has dramatically reduced its need for working capital. Because the company can sell its products just a few days after they're made, it can operate with negative working capital. The cash thus freed up helps offset the investment in extra capacity.

Reinforcing Principles

None of the three principles outlined above – closing the communication loop, sticking to a rhythm, and leveraging your assets – is particularly new or radical. Each one alone could improve the responsiveness of any company's supply chain. But together, they create a powerful force because they reinforce one another. When a company is organized for direct, quick, and rich communications among those who manage its supply chain, it's easier to set a steady rhythm. Conversely, a strict schedule for moving information and goods through the supply chain makes it easier for operators at different steps to communicate with one another. And when the company focuses its own capital assets on responsiveness, it becomes simpler to maintain this rhythm. These principles, devotedly applied over many years, help to put together the jigsaw puzzle of Zara's practices.

Perhaps the deepest secret of Zara's success is its ability to sustain an environment that optimizes the entire supply chain rather than each step. Grasping the full impli-

For Fast Response, Have Extra Capacity on Hand



Zara's senior managers seem to comprehend intuitively the nonlinear relationship between capacity utilization, demand variability, and responsiveness. This relationship is well demonstrated by "queuing theory" – which explains that as capacity utilization begins to increase from low levels, waiting times increase gradually. But at some point, as the system uses more of the available capacity, waiting times accelerate rapidly. As demand becomes ever more variable, this acceleration starts at lower and lower levels of capacity utilization.

cation of this approach is a big challenge. Few managers can imagine sending a half-empty truck across Europe, paying for airfreight twice a week to ship coats on hangers to Japan, or running factories for only one shift. But this is exactly why Zara's senior managers deserve credit. They have stayed the course and resisted setting performance measures that would make their operating managers focus on local efficiency at the expense of global responsiveness. They have hardwired into the organization the lesson Ortega learned almost 30 years ago: Touch the factories and customers with two hands. Do everything possible to let one hand help the other. And whatever you do, don't take your eyes off the product until it's sold. ▢

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Illustrated by Chris Murray

by Robert McGarvey

In the past three decades, the biotechnology industry has matured immensely. At the same time, though, biotechnology has just begun to hit its targets. That's the duality of biotechnology today, which in the United States alone consists of 314 publicly traded companies with a market cap of more than \$311 billion, and 1,150 privately held companies. In addition to the dozens of biotech drugs that already have been approved and are on the market, more than 370 biotech drugs are in clinical trials, according to BIO, the Washington, D.C. trade association. Collectively, this output is transforming global healthcare.

To see how far the biotechnology industry has come, visit Genentech's Web site (www.genentech.com), the company that started it all. The list of pipeline drugs is astounding: Eight are in phase-three testing, attacking stubborn killers such as lung cancer, colorectal cancer, breast cancer, and acute heart failure; in phase two, Genentech is developing substances to address everything from peanut allergies to renal cell carcinomas. Clearly, this illustrates that the ambitions of researchers now are so broad that no disease is outside the sector's reach.

Yet much still needs to be done. In the next two years, a half-dozen blockbuster drugs are losing patent

protection. These include Zocor (cholesterol), Zoloft (depression), Paxil (depression), Prevacid (acid-related disorders), Lovenox (deep-vein thrombosis), and Prevachol (cholesterol) – which together represent nearly \$15 billion in annual sales. While every drug that is going off patent offers substantial opportunities for manufacturers of generics, their loss is impetus for more biotech R&D because drug makers need new, more desirable drugs to replace the newly lost revenue streams. This cycle of innovation is inexorable in life sciences today. As a result, the big pharmaceutical companies increasingly recognize that they need biotech's talent to fill their pipelines.



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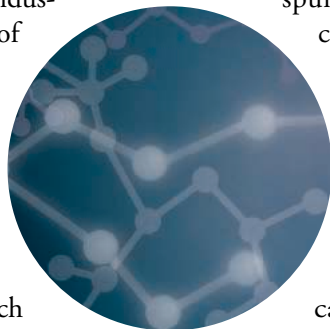
As biotechnology becomes not only more successful but more complex, the big pharmaceutical giants' focus on blockbuster drugs has motivated them to spin out smaller product lines, often to eager biotech start-ups that are ready to nurture these drugs into tiny but useful successes.

And this year, suddenly, there is newfound interest in "industrial biotech" –the use of biotechnology principles and tools to reengineer industrial processes and to create new substances that work smarter and more cost-effectively. Industrial biotech is already producing bottom-line results, benefiting manufacturers and customers alike.

Prompted by pressure to achieve greater fiscal responsibility, another industry trend is the growth of so-called NRDOs (no research/development only). These companies acquire rights to biologically significant substances and enter into a fast-track development cycle. With all of these developments, clearly, biotechnology is increasingly a part of our lives.

Big Drugmakers' Leftovers

Today's largest pharmaceutical companies are swinging for the fences. Their new product development aims to generate blockbusters – mass-market successes. Given their infrastructure, they are set up to achieve these broad-scale successes. It follows, then, that potentially useful products targeting small markets don't always suit the big drug companies. "In a 'big pharma,' the focus is on products with substantial top-line growth," says Anne VanLent, CFO of Barrier Therapeutics. Barrier's core intellectual property



comprises a collection of dermatology drug candidates purchased from Johnson & Johnson and its subsidiaries. "Dermatology has been a stepchild," says VanLent, in part because the potential profitability is modest by big drugmakers' standards.

Enter Barrier Therapeutics, a firm which, in many ways, exemplifies a new-style biotech company that has spun out of a pharmaceutical giant. Barrier's intellectual property is solid; it already has four product candidates in advanced stages of development. Zimyran treats diaper dermatitis associated with candida. Sebazole treats seborrheic dermatitis.

Hyphanox treats a medley of fungal infections. Liarozole treats congenital ichthyosis, a rare genetic disease characterized by dryness and scaling of the skin. While none of these conditions represent a huge market, each drug candidate addresses a real need. Thousands of patients await drugs such as these and, by keeping overhead down, a start-up such as Barrier aims to profitably combat diseases that scarcely register on a big drugmaker's radar screen.

Aerovance is another recent spin-off. Originating at Bayer Pharmaceuticals, it has two potential products: an IL4/13 receptor antagonist (AER-001) designed to treat severe asthma; and Bikunin (AER-002), a recombinant therapeutic protein to treat cystic fibrosis and chronic obstructive pulmonary disease (COPD). Aerovance's CEO is Wolf-Dieter Busse, formerly senior vice president of biotechnology at Bayer Pharmaceuticals. A team of Bayer researchers also joined Busse. "Aerovance is a start-up on a very large scale," says Lori Rafield, a ven-

ture capitalist with Apax Partners, which invested \$32 million in the biotech firm. "There are many oncology companies. How do you distinguish yourself? Far fewer companies focus on respiratory diseases and we believe in this opportunity," says Rafield. So does Bayer, which retains a minority stake in its spin-off company.

Industry insiders are watching this space closely. More "big pharma" spin-offs are being created, yielding lean biotech start-ups that are founded on proven intellectual property.

Biotech's Next Wave

"We call it biotech's third wave. Just in the past five years, industrial use of biotechnology is becoming very important," says Brent Erickson, a vice president at BIO. Industrial biotechnology is already changing how U.S. businesses operate.

In the paper business, for example, some producers now are using enzymes to help bleach paper pulp. This results in a 10 percent to 15 percent decrease in the use of chlorine chemicals which, Erickson contends, translates into environmental benefits.

More dramatic, perhaps, is how enzymes developed by industrial biotech leader Genencor have transformed blue-jeans manufacturing. For decades, denim was washed with pumice to achieve a faded, worn look. But quality control was elusive. Some fabrics were worn too much, others didn't fade enough. Another problem was that the washing machines utilized for this process literally took a beating.

Enter Genencor's bioengineered enzymes, which reduce energy costs and produce a more uniform fading process, with less damage to fabrics and machinery. Since enzymes clearly deliver better results, more and more manufacturers are abandoning the use

of pumice altogether and are employing bioengineered enzymes instead.

Enzymes, too, are replacing phosphates in laundry detergents. Biotech processes are also helping textile manufacturers reduce water consumption by as much as 50 percent.

Industrial biotech leaders are also looking into ways to convert agricultural waste into motor fuels. Given the potential, some experts are already talking about a “bio-fuels revolution” in which automobiles will be powered by corn husks, wheat straw, and other farmyard debris. Far-fetched? While corn certainly won’t power our cars this year, researchers believe it is conceivable in the next decade.

While industrial biotechnology is a relatively new sector, it already has at least one area of clear-cut dominance. BIO estimates that biotechnology’s method of producing vitamin B2 (Riboflavin) increased from 5 percent in 1990 to 75 percent in 2002. Why? Biotech firms have been able to lower costs and produce superior products.

Wherever industrial processes revolve around a catalytic ingredient – a natural enzyme, say – biotech labs are racing to create better and less-expensive bioengineered substitutes. Industrial biotech operations—which include most of the name-brand chemical makers as well as specialty companies such as Genencor—are attractive largely because of their short lead times. Eighteen months is a conceivable development cycle to go from concept to market, says Jack Huttner, a Genencor executive; a typical development cycle in biotech drug labs is 10 to 12 years.

Development First

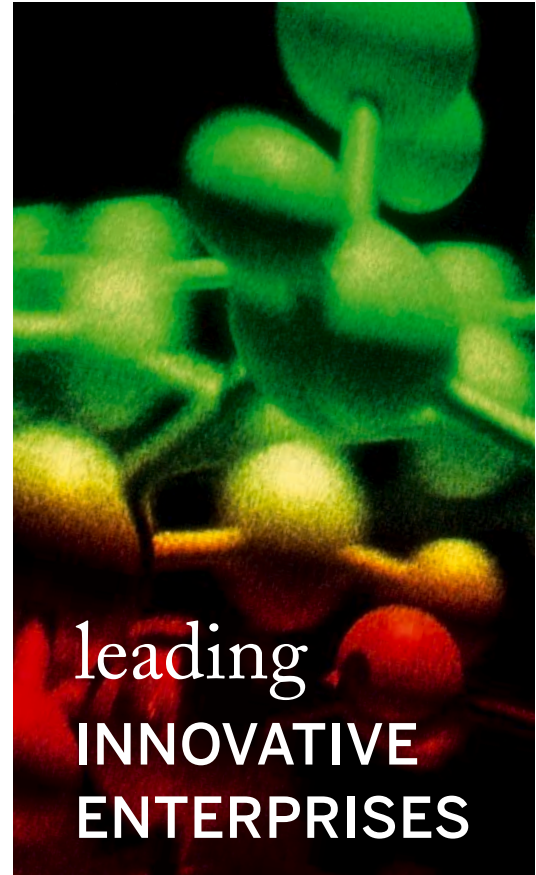
The truly expensive part of biotech, of course, is the research—years and countless dollars are invested in promising ideas that, too often, turn

into dead-ends. One shortcut to faster-track profitability is to buy promising intellectual property from the big drug companies that aren’t suited to nurturing the product candidates. Another option is to define an area of concentration with enough promise to make it interesting (but not so much so that the field is cluttered), then go hunting for orphan products, abandoned product candidates, and high-potential academic research that might fill the bill. That’s the strategy behind AlgoRx Pharmaceuticals, which pursues one avenue: pain management.

What’s attractive about pain management to a young biotech firm is that “not much has changed in 50 years in terms of how we treat pain,” says AlgoRx CFO Jeff Rona. The holy grail for pain researchers are products that are truly local. Most current pain relief effectively tries to turn off pain sensitivity, rather than attacking the pain source locally. But researchers remain confident that the big breakthrough will happen, soon. In that spirit, one AlgoRx drug candidate, ALGRX 4975, is designed to treat specific, localized pain such as osteoarthritis of the knee. The promise of ALGRX 4975 is that one injection may provide relief for several months.

The larger promise of an AlgoRx – a no research/development only firm – is that “this structure allows us to focus our talents on what we know we do well,” says Rona. NRDOs hope that, if they start with a drug candidate that already has leapt the proof-of-concept barrier, likely there will be a less treacherous, more predictable road to success.

These NRDOs are banking on the fact that there is an abundance of promising intellectual property ready to be bought. Most experts would agree. “Scientific innovation is going full bore. There are hundreds of



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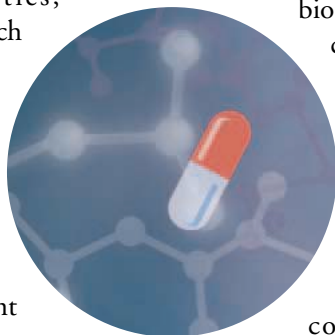
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promising discoveries every week,” says Cliff Gross, CEO of UTEK, a company that helps the private sector find and purchase intellectual property from universities, hospitals, and research facilities. Real finds are to be had, stresses Gross, who, for example, has recently come in contact with a researcher developing a way to manufacture tendon-replacement tissues, a solution orthopedic surgeons have been dreaming about for decades. Another researcher may have found a way to grow cultured skin using a patient’s own cells; if proven effective, this process may revolutionize how burn victims are treated. Gross believes that these examples illustrate that there is a plethora of promising research on the market for companies pursuing a development-only strategy.



Show Us the Money

Is the capital available to fund biotech firms and their acquisition of intellectual property? By any measure, biotechnology investment is costly, and when patient money is short, innovation suffers. But venture capitalists who follow biotechnology are optimistic: “Investments in biotech and life-sciences companies have been growing,” says Matt Rieke, a founding principal in Quaker BioVentures. Rick Kollender, another Quaker BioVentures principal, adds that today’s biotech investment strategy revolves around a new, 21st century discipline: “We’re looking for companies that understand the finish line, companies that are product-oriented.” Blue-sky research won’t attract VCs, but

companies whose work focuses on hitting well-defined targets are garnering attention.

After a spell of slow-going regarding biotech funding, there is newfound excitement. Why? Venture capitalists point to a variety of factors: First, as the industrialized world’s population ages, medical needs rise. Second, the industry is beginning to address serious cardiological and ontological problems. Third, biotech firms are getting more business-focused and are now better able to sharply define targets and hit them. Put simply, biotechnology has grown up. The industry has enjoyed successes and, as a growing number of VCs now believe, many more successes are well within its grasp.

Jersey City, NJ-based Robert McGarvey frequently writes about biotechnology for a range of leading magazines. He also has authored a number of special advertising sections on biotechnology for HBR.

Big Pharma Redux

Don’t count the big pharmaceutical companies out of the drug discovery race. In recent years, most eyes have been on aggressive biotechnology firms, both the mature category leaders and the multitude of fast-moving start-ups. But the world’s leading drug companies are responding to the challenges with stepped-up development programs.

One example is Tarceva, a drug candidate developed by Roche, Genentech and OSI Pharmaceuticals. When administered to advanced pancreatic cancer patients in Phase 3 trials, the drug yielded a 23.5 percent improvement in overall survival rates—dramatic results for treating Europe’s fourth-most terminal type of cancer. Tarceva also has helped patients suffering from non-small-cell lung cancer, the most common cancer. Roche has many more innovative drugs in its pipeline: among them, R744 is a promising drug candidate for treating renal anemia; Xeloda is for colon and breast cancers; and Pegasys is for treating chronic hepatitis B.

Other big drugmakers have also stepped up the hunt for so-called new molecular entities (NMEs), wholly new substances that are not recalibrations of existing drugs. As 2003 closed, Pfizer, GlaxoSmithKline, Roche, Novartis, and Johnson & Johnson were separately pursuing more than 300 NMEs. How many will, in fact, win FDA approval? While the odds are never high, what is important to note is how ambitious the discovery programs mounted by these companies have become. They have seen the competition offered by hungry biotech firms and they are responding.

Historically, healthcare experts have talked about the many differences between big pharmas and biotechnology firms. But the line is blurring, as top-tier innovation is occurring in both pharmaceutical and biotech labs. As a result, more targets seem reachable, more diseases seem to be beatable—promising better health for all of us.

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We Innovate Healthcare

Early adopters of customer relationship management systems were often disappointed by high costs and elusive benefits. Now some companies are reaping strong returns on their CRM investments.

CRM Done Right

by Darrell K. Rigby and Dianne Ledingham

THROUGH THE LATE 1990S and into 2000, managers plowed millions of dollars into information systems meant to track and strengthen customer relationships. Often built around complex software packages, these customer relationship management (CRM) systems promised to allow companies to respond efficiently, and at times instantly, to shifting customer desires, thereby bolstering revenues and retention while reducing marketing costs. But most firms failed to reap the expected benefits, and as executives dramatically reduced IT expenses in subsequent years, CRM sales plummeted. After rising 28% between 1999 and 2000, CRM sales dropped by 5% in 2001, 25% in 2002, and 17% in 2003, according to the technology market research firm Gartner. Many observers came to believe that CRM was destined to join enterprise resource planning (ERP) as another overhyped

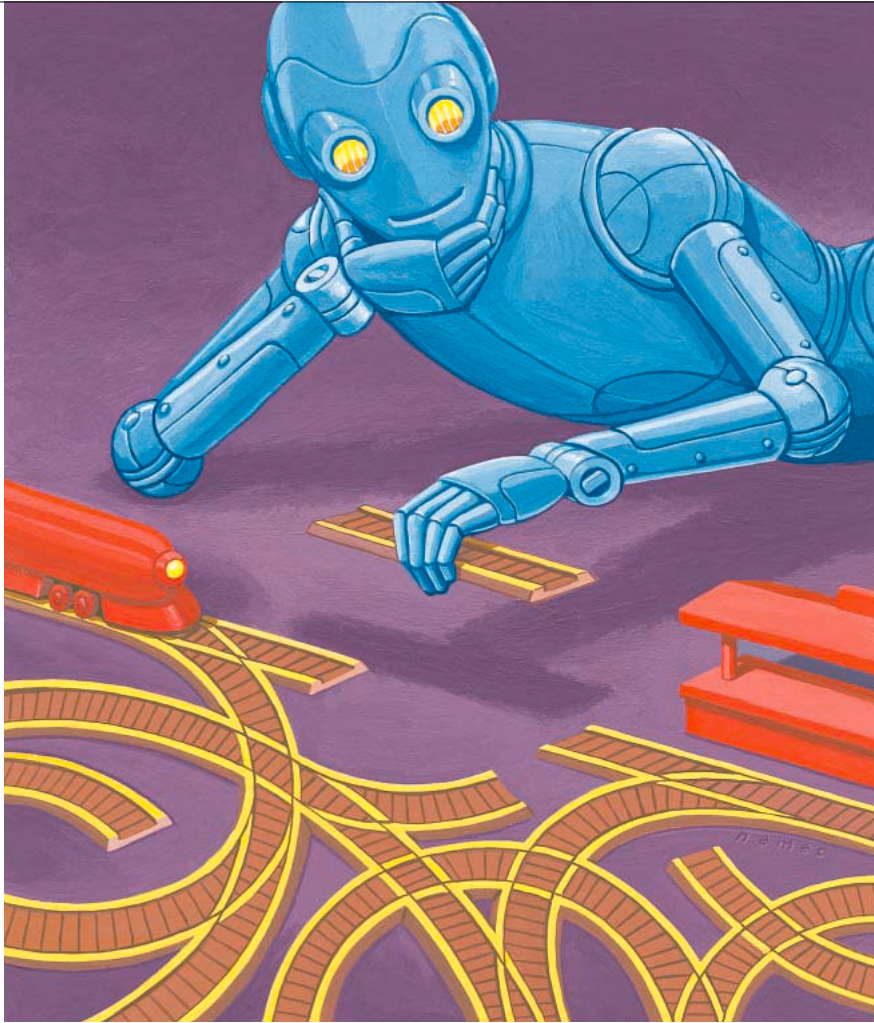
IT investment whose initial unmet promise nearly killed off the approach.

But something unexpected has happened: Senior executives have become considerably more enthusiastic about CRM. In 2003, Bain & Company's annual Management Tools Survey of 708 global executives found that firms actually began to report increased satisfaction with their CRM investments. In 2001, CRM had ranked near the bottom of a list of 25 possible tools global executives would choose. Two years later, it had moved into the top half. In fact, 82% of surveyed executives said they planned to employ CRM in their companies in 2003 – a large jump from the 35% who employed it in 2000. Today, CRM spending appears to be picking up. Gartner forecasts that overall CRM sales will rise another 10% by the end of 2005. So what's changed? Why has disappointment turned to satisfaction, pes-

simism to optimism, cutbacks to new spending?

To answer these questions, we studied a wide range of companies that have recently been successful in implementing CRM systems, and we discovered some common threads in their experiences. Most important, they've all taken a pragmatic, disciplined approach to CRM, launching highly focused projects that are relatively narrow in their scope and modest in their goals. Rather than use CRM to transform entire businesses, they've directed their investments toward solving clearly defined problems within their customer relationship cycle – the series of activities that runs from the initial segmenting and targeting of customers all the way through to wooing them back for more.

The successful users have also exhibited a healthy skepticism, discounting overblown claims that the ultimate pay-



back from a CRM system is the creation of a “real-time enterprise.” Understanding that highly accurate and timely data are not required everywhere in their businesses, they’ve tailored their real-time CRM initiatives to those parts of their customer relationships that truly do depend on “perfect” information. Once they’ve succeeded with the smaller, more-targeted CRM project, they’ve used their initial investments as springboards for solving additional problems.

We’ve distilled the experiences of the CRM leaders into four questions that all companies should ask themselves as they launch their CRM initiatives:

- Is it strategic?
- Where does it hurt?
- Do we need perfect data?
- Where do we go from here?

The questions reflect a new realism about when and how to deploy CRM to

its best advantage. When Darrell Rigby, Fred Reichheld, and Phil Schefter took stock of CRM’s effectiveness in these pages nearly three years ago (in “Avoid the Four Perils of CRM,” February 2002), lots of companies were still placing big bets that the technology would pay off—somehow. Lacking clear customer strategies and the organizational structures to support them, many firms got burned and grew distrustful of CRM. The difficult lessons such organizations learned have led them to sharpen their customer strategies, setting the stage for real gains from more-focused CRM applications.

In this article, we’ll show how several companies have implemented successful CRM efforts—aircraft parts distributor Aviall, consumer product giant Kimberly-Clark, diversified equipment maker Ingersoll-Rand, home- and office-machine company Brother Interna-

tional, and electronic connector manufacturer Molex. We’ll also lay out some basic considerations that can help firms determine which CRM projects are likely to yield the most value.

Is It Strategic?

There’s no getting around it: A CRM program involves complicated business and technology issues and requires significant investments of time and money. CRM is not a tool for buffing a company’s performance at the edges; it should be applied only to processes vital to a company’s competitiveness—those that can distance a firm from its competitors or keep a function (such as call center response time) on par with the rest of the industry when parity counts. If the target is not truly strategic, the organization will be hard-pressed to summon the vigor necessary to tackle entrenched business processes or retool its organizational structure and garner expected returns. Before spending a dime on CRM, therefore, executives need to make sure they have the right targets in their sights.

Paul Fulchino knew the stakes involved when he brought CRM into Aviall after being appointed CEO in 2000. Fulchino had ambitious plans to transform the Dallas-based distributor of aircraft parts into the premier vendor of supply chain management services to the aviation industry. By becoming the preferred partner of both the big original equipment manufacturers (OEMs) and the commercial and military fleet owners, Aviall could consolidate customer demand and extend its reach worldwide, which would reinvigorate its sales and strengthen its margins.

But Fulchino faced a daunting obstacle to realizing his vision: Poor information and cumbersome processes hampered the company’s sales and service operation. Difficulties with an existing IT system had increased sales reps’ workloads, sometimes keeping salespeople trapped in local branches, helping managers input order information instead of making sales calls. What’s more, the company hadn’t trained the sales reps in proper time and territory

management, which led to inefficient phone call routing and haphazard calling schedules. Customer inquiries were often routed to distant call centers that lacked up-to-date data on orders, products, and prices.

The weak customer service left key accounts vulnerable to competitors' attacks and undermined the company's ability to charge the premium prices typically associated with flawless product delivery. A better-trained and more proactive sales force was a strategic necessity. Without one, Fulchino's aggressive plans for the company would go unfulfilled. So the new CEO, working closely with his sales and marketing head, Jim Quinn, and his technology chief, Joe Lacik, dedicated Aviall's initial CRM outlays to this critical challenge. Rather than attempt a full-scale implementation of a broad CRM program, the executives took a more focused approach, installing only the sales force, order entry, and call center applications to begin with. Their goal was to coordinate customer information seamlessly from the outside sales agents, first to the inside sales support staff, then to the customer service representatives who were manning the company's 36 regional call centers. The relatively narrow focus allowed the sales force to become familiar with the system without being overwhelmed and delivered quick victories that helped win broader management and line support and gather momentum behind the project.

The gains were striking. Before having the CRM system, the sales force relied on an outmoded database for managing client information. The system's inflexibility made it difficult for sales and service staffers to get even basic information on a customer's order history and credit status. "There's nothing more frustrating than having a customer spend 15 minutes on an order and then realizing at the very end that there's a credit issue," says Lacik. "In the

old system, credit problems didn't get flagged until you tried to place the order. Then the credit group would be called in, and you either had to have the customer on hold for a long time or call them back. In our business, there's a moment of truth: You have to have the right product, the right information, and the right price. If you don't have those three things put together, you lose the call – and if you lose the call, 90% of

It's possible to use CRM systems to manage the entire customer relationship cycle, but that's usually a bad idea.

the time you lose the sale." With the new system, a customer's credit history instantly popped up on the order screen.

The rich information the new system provided allowed Jim Quinn to flip a switch in the sales force. It helped the agents get organized and spurred them to make more customer calls, knowing they could immediately deliver firm quotes on tailored sets of products or services. Placing an order had once required them to go through 11 screens and nearly 50 steps; now they could do it with one screen and ten steps. Just four months into rolling out the CRM system, the number of daily sales calls tripled, and the customer base grew by 33%. In fact, the productivity of the entire sales and service operation skyrocketed, helping Aviall recapture market share and win large orders for new product lines. The number of orders handled per day jumped from 1,000 to 2,500, even as error rates declined, with no increase in staff.

The expanded capacity, together with the improvements in service, have built the platform the company needed to reshape itself as a full-service provider of

aviation logistics support. Aviall's sales and profits have grown rapidly, and it has steadily stolen market share from competitors. In a testament to Aviall's success, engine maker Rolls-Royce recently awarded the firm a ten-year supply contract worth \$3 billion—the largest deal ever struck by any company in the industry. Says CIO Lacik: "We showed Rolls-Royce the level of visibility we had into our customer base – visibility that we could share with them to give them a deeper understanding of customer buying trends and behavior....A simple analysis showed Rolls-Royce that it had several years' worth of supply in some products while being understocked in others because it was not matching manufacturing adequately with customer demand. That was a pivotal moment in winning the contract." Tightly focused on a single area of critical strategic importance, CRM has become a linchpin of Aviall's reinvention.

Where Does It Hurt?

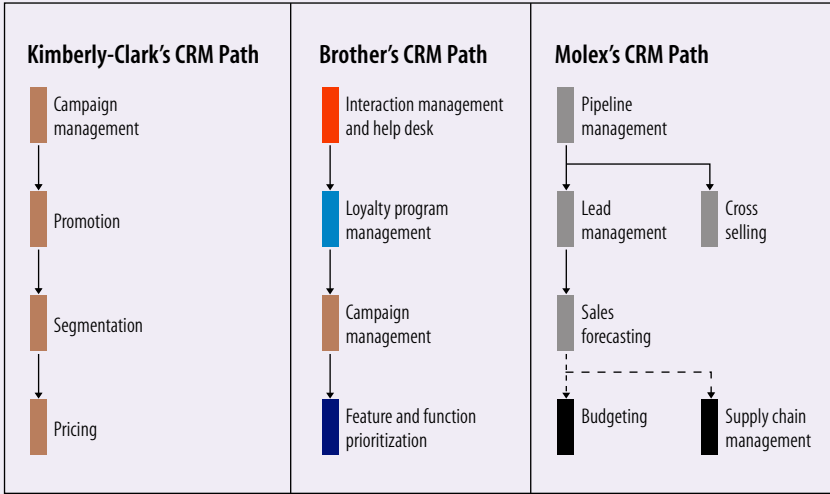
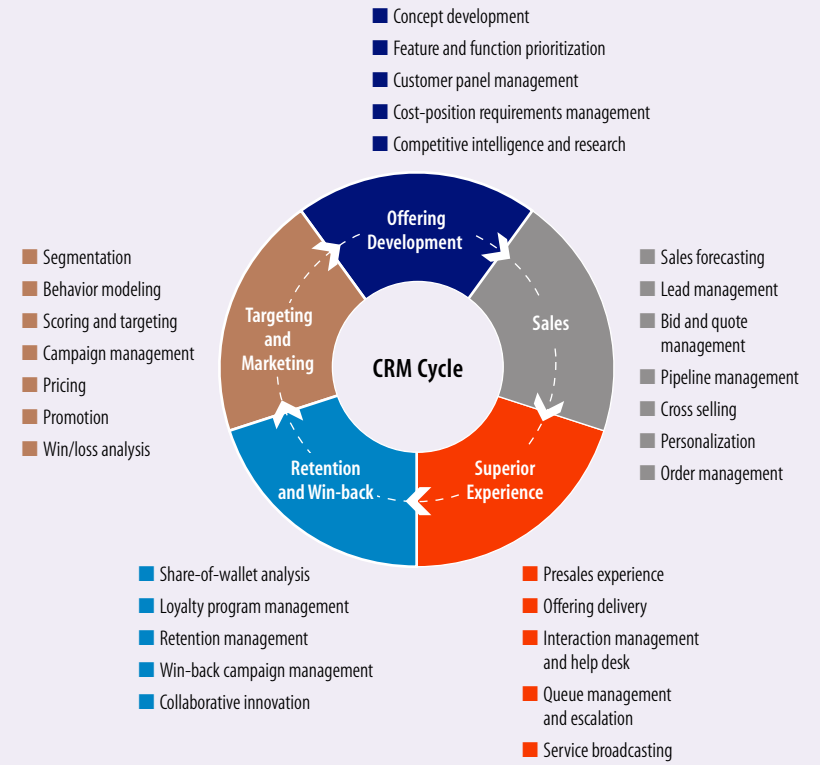
It's possible to use CRM systems to manage the entire customer relationship cycle all at once – initial purchase, after-sales service, subsequent purchases, recommendations to other customers (for the full range of functions a CRM system can automate, see the exhibit, "The Customer Relationship Cycle"). But as the most aggressive early adopters found, that's usually a bad idea. Such an approach ends up creating unused technology capacity, causes unnecessary business disruptions, and ultimately fails the payback test. When companies carefully examine their customer relationship cycles, they usually find some deep-seated, pernicious problems in a few areas that undermine overall performance. It is these pain points that should be the focus of the CRM effort.

For Kimberly-Clark, one of the world's leading consumer packaged-goods companies, the pain point lay in its vast retailer promotions operation. The manufacturer was running thousands of promotions every year, usually offering a discount on a particular product to a particular retailer, but it was unable to accurately gauge the success of any of

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The Customer Relationship Cycle

A comprehensive CRM system can, in theory, automate every aspect of a company's relationship with its customers, from all the activities needed to target customers through those for product development, sales, service, and retention. But smart companies sharply focus their CRM implementations, carefully choosing which segment of the cycle, and which functions within that segment, are likely to deliver the greatest return on an initial CRM investment. Success with this first effort often lights the way to subsequent projects—automating additional functions in the same segment (as Kimberly-Clark did), steadily moving from segment to segment (as Brother did), or even moving to critical business processes beyond CRM (as Molex did).



them. The firm had aggregate numbers on its trade promotions, but it couldn't break them down by individual customer, product, or shipment. As a result, Kimberly-Clark found itself spending huge quantities of marketing dollars, uncertain which promotions were producing retailer loyalty, shelf space, and sales, and which were going to waste. Company executives therefore reasoned that starting with a modest, customized CRM system to collect and analyze promotion data could substantially improve the effectiveness of its overall customer relationship cycle.

Kimberly-Clark started by building onto an existing software program for account management, called Profit Calculator, which its sales department had developed to track investments in individual promotion efforts. By integrating that with shipment data, the enhanced system could go beyond just providing general information about whether ROI was positive or negative. It could more precisely measure the impact of a particular promotion on sales and profits for both Kimberly-Clark and its retailer customers. Says Bruce Paynter, Kimberly-Clark's vice president for customer development: "Now we can see what the real-time impact on our sales and profit is when running promotions. Moreover, we can integrate this information into our sales and planning process with our customer." Renamed Business Planner, the software became the heart of the company's sales and marketing efforts: salespeople used the tool in the field to design promotional packages for specific retailers, while the company's marketing staff used it to plot broader promotion plans.

Rolled out to all of Kimberly-Clark's businesses in 2000, and supported by intensive training programs led by the organization's top executives, Business Planner rapidly proved a success. In its first year, the system was used to manage more than 2,300 promotional events involving all of the company's U.S. consumer product lines. "We applied real-time promotional-lift models [models of just how much a given promotion can lift sales] at the market, customer,

and category level to aid our planning efforts with customers,” Paynter says. “Using the knowledge gained through the Business Planner, we have been able to redirect \$30 million in marketing spending across all our U.S. consumer businesses to drive incremental sales and profit and further build brand for our customers and Kimberly-Clark.”

Equally important, managers say, Business Planner armed customer representatives with consistent data and business rules, which has broadened their perspective. Rather than think purely of managing sales, they think in terms of managing the business. Today, key-account reps can assess likely financial results and engage in scenario planning jointly with retailers.

And their effectiveness in reducing pain in trade promotions has revealed new opportunities. Building on the success of its Business Planner software, Kimberly-Clark is now implementing a more ambitious system designed to reach beyond its retailer customers into a wide array of consumer-advertising and promotional activities. The enhanced suite, coined Brand Builder, helps the company plan and evaluate the success of individual activities – a freestanding coupon inserted into the Sunday papers, for instance – and measure the combined effect of a number of integrated activities.

The Brand Builder suite comprises three related components: It includes a state-of-the-art collaborative tool that lets sales agents, designers, vendors, and retailers plan promotions online. It puts marketing research and information learned about consumers online in real time. And by integrating promotional-spending data with scanner and financial information, it provides a powerful analytical tool. In fact, with the new analysis tool, Kimberly-Clark has moved from relieving a pain point for its retailer customers to making a science of marketing. The company now knows, for example, that the payback for some consumer promotion programs is twice as high as for others intended to produce the same results. With that kind of information, the firm can identify which

elements of marketing – coupon value or creative impact, for instance – result in higher returns.

Focusing on pain points can not only be an effective way to build a successful CRM program but can also get an unsuccessful CRM initiative back on track. That was true for Ingersoll-Rand, the \$10 billion diversified manufacturer.

In 2001, Club Car, the Ingersoll-Rand division that makes motorized golf carts, or “golf cars” as the company calls them, was showing signs of trouble, with revenues beginning to drift downward as an economic downturn hit the golf industry. But management lacked the information needed to diagnose the reasons for the slowing sales. Individual reps and order managers used their own idiosyncratic processes for dealing with customers. Sales forecasts were made informally using guesswork and rudimentary spreadsheets, and the sales force had little influence over product customization.

Realizing it needed much better information, Ingersoll-Rand rushed to roll out a broad CRM system that was supposed to incorporate everything from lead evaluation to proposal generation and from product configuration to order entry. But the effort proved too much for the organization to digest. Club Car’s managers weren’t convinced of the ultimate benefits. After spending more than \$2 million and completing a first round of user testing, the company discovered that the system wasn’t delivering the anticipated productivity gains and reporting capabilities. In fact, the system would dramatically increase the administrative workload of the field sales reps instead of freeing them to spend more time with customers. The unit’s president had the foresight to halt the effort and made the organization back up and refine its goals. Club Car’s management team took a fresh look at the key processes in its customer relationship cycle and refocused its CRM initiative on the two deepest pain points: forecasting sales and taking orders.

Today, just two years after the CRM effort was relaunched, Club Car has

successfully automated its sales operation, significantly improving both customer service and business decision making. By more directly involving the sales force in the redesign of the system, carefully paring down the data and processes it encompassed, and improving the underlying technology, the company eliminated many of the CRM system’s original drawbacks. Sales reps use the new system at customers’ sites to modify the cars with them, and for the first time, the reps can see the financial implications of different configurations before setting prices and delivery dates. The order information the reps collect is automatically combined with general industry data on golf cart demand and equipment replacement cycles to generate reliable sales forecasts. That, in turn, has led to smoother, more predictable manufacturing schedules.

Do We Need Perfect Data?

Part of the early attraction of CRM systems lay in their ability to deliver real-time information – to give marketers, salespeople, and managers a clear picture of what’s happening in the market at any particular moment. But perfect information comes at a high cost. The systems required to collect and disseminate it are expensive; so are the finely tuned processes needed to react quickly to it. Despite the hype surrounding real-time enterprises, the fact is that few companies need perfect information throughout their customer relationship cycles.

Why pay for real-time information on business processes that customers don’t really value or that managers can’t rapidly adjust? A hotel manager certainly needs real-time data on the availability of rooms but not on the customer’s opinion of the carpets and drapes. A cable company needs real-time figures on service outages that demand immediate repairs but not on the profitability of its pay-per-view programs. Real-time information priorities are driven by real-time business opportunities and must be customized to each individual business. (See the sidebar “Calculating the Cost of CRM.”)



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Routine Aches Versus Strategic Pain Points

Doctors commonly distinguish between routine aches (“Take two aspirin and call me in the morning”) and perilous pains (“Meet me at the hospital in five minutes!”). Likewise, successful CRM practitioners have learned to distinguish between routine aches in the business (“Perhaps we might address that issue in our next five-year plan”) and strategic pain points (“Fixing this problem will double our profits”) before prescribing CRM solutions. Addressing strategic pain points typically promises superior financial rewards and the opportunity to build vital momentum for CRM programs. Here’s how to identify them:

Routine Aches	Strategic Pain Points
The problem is well known but minor, even though it affects some vociferous customers.	The problem is sometimes hidden but has a critical impact on the satisfaction and loyalty of the most valuable customers.
Solutions are quickly and easily copied by any competitor.	Solving the problem creates a substantial and sustainable competitive advantage.
The problem could have been fixed long ago without a CRM system.	Solving the problem cost effectively requires the speed, accuracy, and effectiveness of CRM technologies.
Solving the problem is not vital to the organization or its culture.	The solution will become a rallying point for the organization.
Solving the problem would fix one immediate problem.	Solving the problem would create important new capabilities that would open up additional opportunities.
Solving the problem would deliver soft, unquantifiable benefits.	Solving the problem would deliver tangible financial returns that would justify further investment—even in difficult times.
Solving the problem would not make much of a splash in the organization.	Solving the problem would represent a highly marketable success, both inside and outside the company.

Companies need to clearly distinguish between activities that truly demand perfect data and those that can get by with “good enough” information. The requirements for each are quite different. The approach Brother International took to its CRM implementation is a good case in point. The U.S.-based distribution arm of the Jap-

anese maker of typewriters, printers, fax-printer-copiers, and sewing machines, Brother International faced a persistent problem: a high rate of product returns. A leading cause of the returns, the company believed, was dissatisfaction with service from its call center. In the late 1990s, as office products became more sophisticated, end users began to re-

quire more assistance. But Brother’s call centers were answering only 46% of the queries coming in from new purchasers, and the quality of the help provided varied widely. Service representatives were failing to address recent buyers’ questions and complaints. In particular, call center staffers lacked accurate customer information and quick access to solutions for callers’ problems. To help customers troubleshoot technical issues, staffers often had to search through binders of product information. Frustrated consumers were returning their products to retailers.

Here, Brother’s executives saw, was a pain point that could be remedied only through the provision of “perfect” information; they therefore looked to CRM to bolster their call centers. The company rolled out the new system in stages, starting with the printer call center in September 2001 and then adding centers at two- to four-week intervals. This staggered approach allowed Brother to refine the system as it was implemented and adjust the training program as circumstances warranted.

The results have been impressive. The system can identify customers as they call in, quickly locate their purchase records, and supply call center workers with standard responses to common questions. That’s reduced individual call times by 43 seconds on average, resulting in substantial savings. Brother estimates, for example, that this year the total savings could reach \$635,000. What’s more, Brother is now answering an average of 140,000 calls a month, and the typical customer is left on hold for less than five minutes. The newly automated process has also cut the time required to train new call center operators, saving even more money. Product returns fell by a third, from 5.0% in fiscal 2000 to 3.4% the following year.

And the benefits reach beyond the call centers. Because the system can capture data on the nature of incoming calls, it has given the company important new insights into customers’ needs and behavior. That has improved Brother’s ability to tailor outreach campaigns,

continued on page 128

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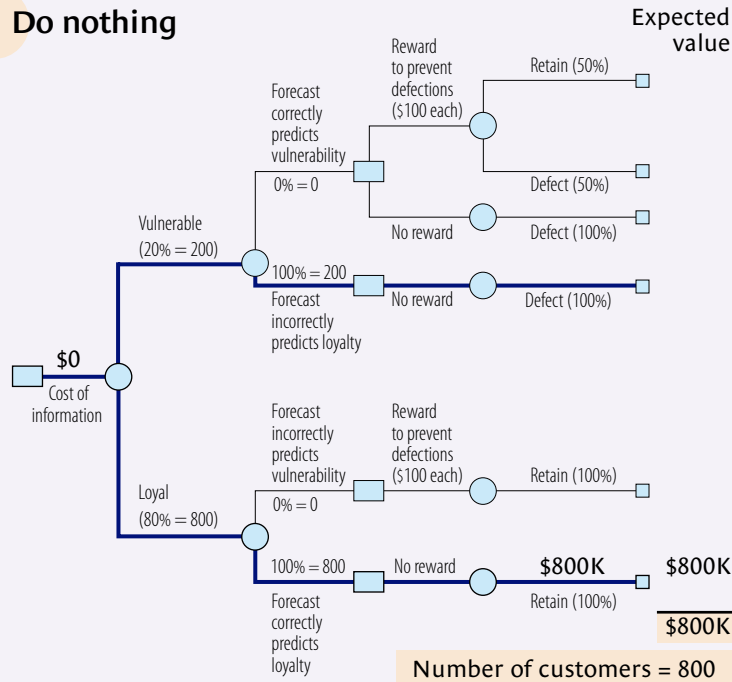
Calculating the Cost of CRM

With clear thinking and a basic grasp of decision diagrams, any manager can estimate the true value of information. Let's take a look at a disguised example we'll call Ace Grocery.

Todd Green, Ace's owner, was deeply concerned when a new competitor entered his area. A newspaper poll indicated that 20% of his customers planned to switch. But a consultant said that 50%

of the potential defectors could be retained if Ace offered each \$100 in retention rewards. Unfortunately, spending the \$100 on loyal customers would probably not make them more loyal, and Ace didn't know which customers were which. Todd began to sketch out his options.

1 Do nothing



1 Do nothing

Ace had 1,000 customers, each worth an average of \$1,000. If Todd did nothing, he'd retain only 80% of them, and Ace's value would fall from \$1 million to \$800,000. Todd tried another option.

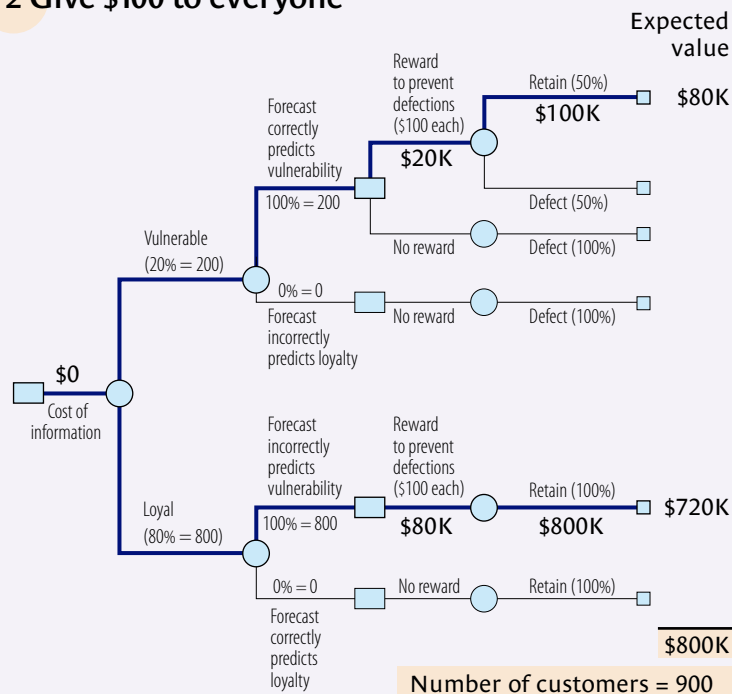
2 Give \$100 to everyone

Todd would lose fewer customers but would spend so much that the store's expected value would still fall to \$800,000. Todd began to wonder if he could use CRM data to predict which customers would defect. He estimated how much that would be worth.

3 Reward just the right customers

If Todd could manage to offer \$100 to all (and only) the potential defectors, Ace's expected value would only fall to \$880,000. So \$80,000 became the most Todd would pay for perfect information.

2 Give \$100 to everyone

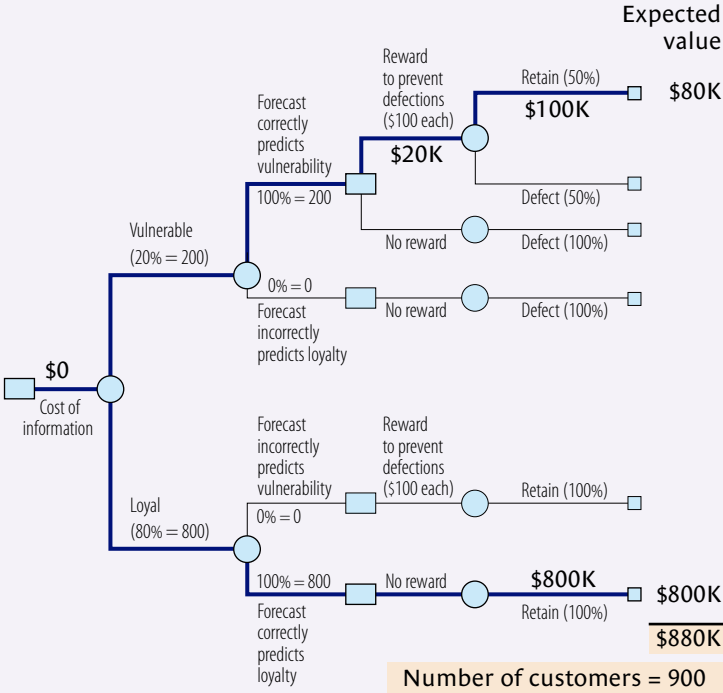


4 Purchase a CRM system

Todd called CRM Systems, a software vendor with the best package for predicting defectors. The system cost \$20,000, but Todd estimated that additional implementation costs would add another \$30,000. That \$50,000 was still far below the \$80,000 hurdle rate, so Todd asked for a meeting. He learned that the CRM system could correctly identify 60% of potential defectors. Unfortunately, 30% of loyal customers would also be identified as potential defectors. Todd calculated the value of this "imperfect" information.

Since the implementation of this software would drop Ace's value to \$774,000, Todd rejected the proposal. Todd decided that the best approach was to offer all customers \$100. Ace would retain 900 customers instead of 800, and his most loyal customers would not feel shortchanged.

3 Reward just the right customers



What Todd Learned

Through this process, Todd learned to address four critical questions.

How good is the information?

Todd knew that the value of information generally rises with its immediacy (making timely actions possible) and accuracy (making actions more productive). But Todd learned that reported accuracy often tells only half the story. Correctly predicting 60% of defectors sounded good until Todd’s analysis showed that 30% of the loyal 80% would also be wrongly labeled as potential defectors. That would mean that a customer identified as a potential defector would be a true defector only 33% of the time. Forecasting is not always more valuable than guessing.

What is it good for?

Information that helps satisfy customers is far more valuable than information that merely satisfies curiosity. Todd calculated that the imperfect CRM information combined with a \$100 retention program that saved only 50% of vulnerable customers created an expected value of just \$774,000. However, if the \$100 retention program could save 100% of vulnerable customers, the same CRM system would create an expected value of \$834,000. Of course, offering loyalty rewards to every customer would now create an even greater value – \$900,000.

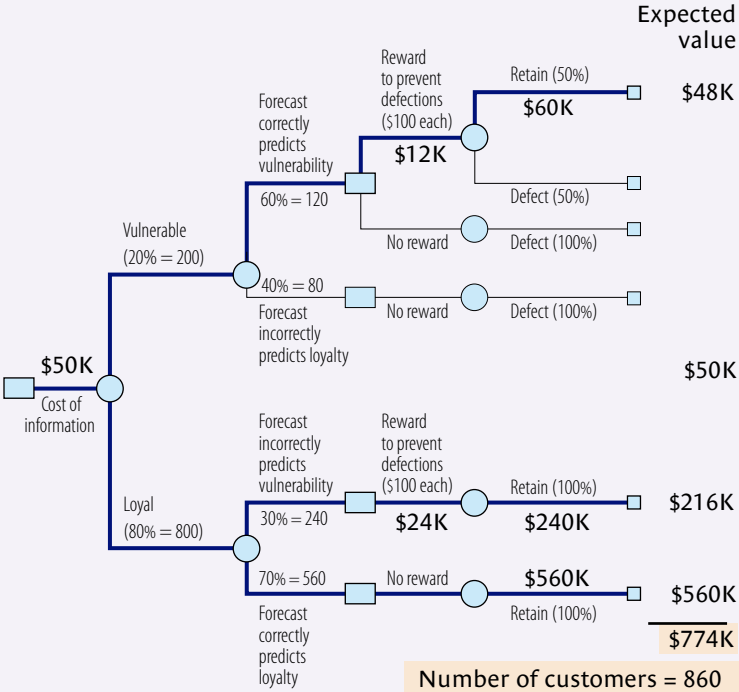
What are the costs?

Todd’s analysis demonstrated that the \$20,000 CRM costs were swamped by the additional expenses of training, data collection, data analysis, information dissemination, and implementation programs. If Ace had failed to include these costs, it would have incorrectly calculated an expected value of \$804,000, chosen to implement the system, and actually destroyed value.

Which results matter most?

Although expected values were necessary, they weren’t sufficient for the final decision. Several other considerations, including the number of retained customers and fairness to loyal patrons, proved crucial as Todd weighed Ace’s options.

4 Purchase a CRM system



McDonald's Tech Turnaround

It was nothing if not ambitious. In January 2001, fast-food giant McDonald's launched a five-year, \$1 billion initiative to overhaul its information systems to enhance customer service at its more than 30,000 restaurants around the world. The vast effort, dubbed "Innovate," involved installing a new, Internet-based data management infrastructure for the company that would cover everything from electronic links with suppliers to software for tracking customer purchasing patterns to sensors for remotely monitoring the temperature of fat in french-fry vats. The company believed that once the new systems were in place, it would be able to scrutinize every detail of its business in real time, ensuring that each outlet fine-tuned its operation to serve customers flawlessly.

But just two years after Innovate's launch, a new CEO, Jim Cantalupo, pulled the plug on the project, announcing that McDonald's would take a \$170 million write-off related to the termination of the initiative. Facing financial pressures and an eroding stock price, Cantalupo (who died suddenly a year later in April 2004) determined that, to revitalize itself, McDonald's needed to focus on two priorities: customers and existing restaurants. The massive IT program simply would not deliver enough improvements in those areas to justify the enormous expense and operational disruptions it presented.

McDonald's might be an extreme example—billion-dollar IT initiatives remain rare—but it also offers encouraging news. After disbanding the Innovate initiative, the company launched a series of more modest CRM efforts—such as installing touch screen-ordering systems and improving a customer service hotline—aimed at solving particular customer relationship problems. These highly targeted efforts have contributed to a resurgence in sales and profits.

which include surveys and newsletters, to well-defined buyer segments. Now that it has better information on the questions most frequently asked about its products, the company can use its campaigns to disseminate answers in advance. That, in turn, has reduced the volume of inquiries coming into the call centers. Each day, Brother sends data on types of inquiries and customer problems from the call centers to its corporate parent in Japan, where the information collected helps the company's product-planning, design, and customer-satisfaction groups evaluate both product performance and customers' preferences and experiences. Brother expects the exchange will lead to improved customer satisfaction and enhanced product performance over time.

Used the right way, real-time information can help companies cope with high levels of complexity in their cus-

tomers' relationship cycle, making priorities clear. Molex, an Illinois-based global manufacturer of electronic and fiber-optic interconnection systems, has a large customer base and a vast pipeline of potential orders. At any given moment, the company is pursuing close to 15,000 different sales opportunities worldwide. For years, Molex used e-mail and spreadsheets to keep track of its pipeline, but the resulting data were often weeks out of date. That made it difficult to consistently set sales priorities so the company could pursue the leads with the highest potential. The lack of updated information also made it hard to synchronize Molex's global efforts. Because the firm had so many major customers with operations in different parts of the world, several Molex locations could be working on similar or related programs for the same customer without knowing it.

In 2002, therefore, the company installed a CRM system to manage its order pipeline. For the first time, executives from the CEO on down could see the full range of sales opportunities in real time. That made it possible to measure the real value of those opportunities and get updated information about them 24 hours a day, rather than just a few times a year.

The gains were immediate: improved order management, more precise sales targets, and better global coordination of inventory and pricing between regions. Since implementation, both the number and the value of potential sales in the pipeline have climbed significantly, as the sales staff has used the shared information to identify opportunities earlier. Molex's management believes it is meeting the original goal of the project, which was a 5% increase in revenues.

Once the initial implementation was complete, moreover, management realized that the data being captured could also be used to improve budget planning. The pipeline data now form the foundation of the revenue portion of the budget process, and the company plans to use the information for parts forecasting and supply chain management as well.

Where Do We Go From Here?

As Kimberly-Clark, Brother, and Molex found, the data produced by a narrowly focused CRM system often reveal additional opportunities for important business refinements. And those refinements, taken together, can amount to a broad CRM application that extends across the company. The difference between this sort of wide-ranging CRM implementation and the prerecession CRM applications is that each step in building the system represents a carefully planned, well-defined advancement in strategic thinking. Kimberly-Clark started with trade promotion management then extended its tool set to include total retailer customer management and, more recently, consumer management. Brother's call centers have enhanced its U.S. marketing and out-

reach campaigns and even fed its product development and quality control processes on the other side of the world. Molex's clear view into its order pipeline has led to improvements in budgeting, procurement, and supply chain management.

Smart CRM adopters don't rest on their laurels. They rigorously analyze the data their systems produce to identify new, well-defined opportunities to extend the technology's power. In most cases, these opportunities lie in activities adjacent to the customer relationship cycle, as the natural path of these companies' CRM expansions show.

Aviall, for its part, plans to extend its CRM system in two directions—adding upstream links to its suppliers and downstream connections to its customers. These will give the firm an end-to-end view of the aviation supply chain, starting with the status of suppliers' inventory and extending all the way to customers' requirements for parts and maintenance. Because it will enable the firm to better match supply and demand, Aviall expects the expanded system to become an important source of competitive advantage.


It's also often possible to extend the benefits of CRM to related business units. Ingersoll-Rand, for example, recognized that the customers of its Club Car division—golf courses—were also potential buyers of its other divisions' products, such as Bobcat miniexcavators and loaders. Extending its CRM system to include those divisions could create new opportunities for cross selling. The company began to do just that in late 2002, and already the number of new leads generated has been substantial—an additional \$6.2 million worth of leads for other Ingersoll-Rand products in the first year. That success has led to even broader plans.

Today, Ingersoll-Rand wants to use CRM as the glue to bind together all four of its operating sectors (which represent more than 100 worldwide manufacturing facilities) so that the company can operate as one integrated enterprise in the eyes of its customers. Like Aviall, Ingersoll-Rand may utterly transform

its business through its investments in CRM, but again the changes will come in carefully measured stages, with success building on success.

Business Before Technology

You'll have noticed that we haven't spent a lot of time describing the details of the technology in this article. That's intentional. In evaluating and designing CRM systems, business needs should take precedence over technological capabilities. Managers should not be distracted by what CRM software *can* do; they should concentrate instead on what it *should* do—both for their companies and for their customers (see the sidebar, "McDonald's Tech Turnaround"). Fortunately, as competition among CRM vendors is increasing the software is rapidly becoming more flexible. It's not yet simple to install a CRM system, but the technology is getting more dependable, the implementation process is becoming more streamlined, and the failure rate is going down.

That gives companies the freedom to apply CRM with greater precision, targeting critical gaps in their customer relationship cycles where performance suffers. By setting priorities for their information requirements carefully, making sure they're guided by overall customer strategy, companies can launch highly disciplined CRM efforts that will have a greater impact with lower investment and less risk. CRM, in other words, is coming to resemble any other valuable management tool, and the keys to successful implementation are also becoming familiar: strong executive and business-unit leadership, careful strategic planning, clear performance measures, and a coordinated program that combines organizational and process changes with the application of new technology. No longer a black hole, CRM is becoming a basic building block of corporate success. 

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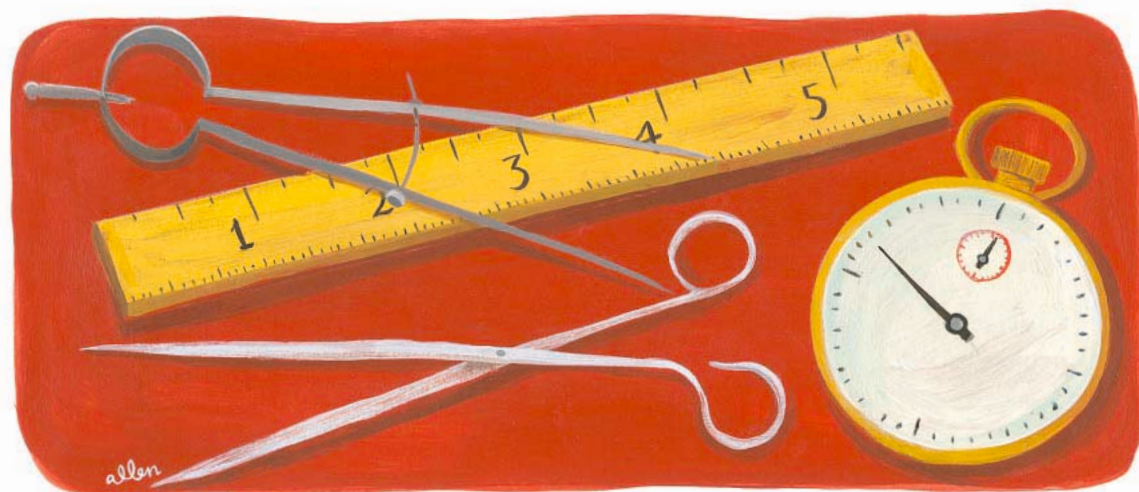


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Time-Driven Activity-Based Costing

by Robert S. Kaplan and Steven R. Anderson

Many companies abandoned activity-based costing because it did not capture the complexity of their operations, took too long to implement, and was too expensive to build and maintain. Here's a way around those problems.

IN THE CLASSROOM, activity-based costing looks like a great way to manage a company's limited resources. But many managers who have tried to implement ABC in their organizations on any significant scale have abandoned the attempt in the face of rising costs and employee irritation. They should try again, because the new approach we lay out in the following pages sidesteps the difficulties traditionally associated with large-scale ABC implementation by relying on informed managerial estimates rather than on employee surveys. It also provides managers with a far more flexible cost model to capture the complexity of their operations.

ABC Made Difficult

The roots of the problem with ABC lie in the way people traditionally construct ABC models. Assume you are analyzing a customer service department that performs three activities: processing orders, handling inquiries, and performing credit checks. The department's total expenses (the cost of the personnel,

management, IT, telecommunications, and other fixed resources) amount to \$560,000. The actual (or estimated) quarterly quantities of work in the three activities are 49,000 orders, 1,400 inquiries, and 2,500 credit checks.

To build a traditional ABC model for this department, you would survey employees to estimate the percentage of time they spend (or expect to spend) on the three activities and then assign the department's resource expenses according to the average percentages you get from the survey. Let's say employees report that they spend (or expect to spend) about 70% of their time on customer orders, 10% on inquiries or complaints, and 20% on credit checks. This implies, under ABC, that each order consumes \$8 of resource expense, each inquiry \$40, and each credit check \$44.80, as shown in the exhibit "Doing ABC the Traditional Way." Armed with these figures, known as the cost-driver rates, managers can assign the costs of the department's resources to the customers and products that use its services.

This approach works well in the limited setting in which it was initially applied, typically a single department, plant, or location. Difficulties arise, however, when you try to roll this approach out on a large scale for use on an ongoing basis. In one large bank’s brokerage operation, the ABC data-gathering process required 70,000 employees at more than 100 facilities to submit monthly reports of their time allocation. The company employed 14 people full-time just to manage the data collection, processing, and reporting.

unprofitable products and customers, and excess capacity.

Traditional ABC models also often fail to capture the complexity of actual operations. Consider the activity “ship order to customer.” Rather than assume a constant cost per order shipped, a company may wish to recognize the cost differences when an order is shipped in a full truck, in a less-than-truckload (LTL) shipment, using overnight express, or by a commercial carrier. In addition, the order may be entered into the system either manually or electronically, and it

to process one month’s worth of data. For example, the automated ABC model for Hendee Enterprises, a \$12 million fabricator of awnings, took three days to calculate costs for its 40 departments, 150 activities, 10,000 orders, and 45,000 line items.

These problems have become obvious to most ABC implementers. But a subtle and more serious problem arises from the interview and survey process itself. When people estimate how much time they spend on a list of activities handed to them, they invariably report

Doing ABC the Traditional Way

This table provides a traditional ABC analysis for a customer service department for its first fiscal quarter. The percentage of time spent on activities is determined from employee surveys. Once activity quantities are known or forecast, cost-driver rates are used to allocate the department’s costs based on customers’ utilization of the department’s activities.

Activity	% of Time Spent	Assigned Cost	Activity Quantity	Cost-Driver Rate
Process customer orders	70%	\$392,000	49,000	\$8 per order
Handle customer inquiries	10%	\$56,000	1,400	\$40 per inquiry
Perform credit checks	20%	\$112,000	2,500	\$44.80 per credit check
Total	100%	\$560,000		

The time and cost demands of creating and maintaining an ABC model on this scale is a major barrier to widespread adoption at most companies. Since the systems that are put in place are updated infrequently (because of the costs of reinterviewing and resurveying), the model’s estimates of process, product, and customer costs soon become inaccurate. What’s more, people waste their time arguing about the accuracy of cost-driver rates that are derived from individuals’ subjective beliefs rather than addressing the deficiencies the model reveals: inefficient processes,

may be either a standard or an expedited transaction. To allow for the significant variation in resources required by the different shipping arrangements, new activities must be added to the model, thereby expanding its complexity.

As the activity dictionary expands – either to reflect more detail about activities or to expand the scope of the model to the entire enterprise – the demands on the computer programs used to store and process the data escalate. Suppose a company has 150 activities in its enterprise ABC model, applies the costs in these activities to some 600,000 cost objects (products and customers), and runs the model monthly for two years. That would require data estimates, calculations, and storage for more than 2 billion items.

Such expansion has caused ABC systems to exceed the capacity of generic spreadsheet tools, such as Microsoft Excel, and even many ABC software packages. The systems could take days

percentages that add up to 100. Few individuals report that a significant percentage of their time is idle or unused. Therefore, cost-driver rates are calculated assuming that resources are working at full capacity. But as we all know, operations often run at considerably less than their capacity. That means that the estimated cost-driver rates are usually much too high. (Technically, they will be overstated by the reciprocal of the capacity utilization percentage: At 80% utilization, the rates are 25% too high; at 67% utilization, the rates are 50% too high.)

The New ABC

The solution to the problems with ABC is not to abandon the concept. ABC after all has helped many companies identify important cost- and profit-enhancement opportunities through the repricing of unprofitable customer relationships, process improvements on the shop floor, lower-cost product designs, and ratio-

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nalized product variety. Its potential on a larger scale represents a huge opportunity for companies. Fortunately, simplification is now possible through an approach that we call time-driven ABC, which we have successfully helped more than 100 client companies implement, including those described in this article. In the revised approach, managers directly estimate the resource demands imposed by each transaction, product, or customer rather than assign resource costs first to activities and then to products or customers. For each group of resources, estimates of only two parameters are required: the cost per time unit of supplying resource capacity and the unit times of consumption of resource capacity by products, services, and customers. At the same time, the new approach provides more accurate cost-driver rates by allowing unit times to be estimated even for complex, specialized transactions.

Estimating the cost per time unit of capacity. Instead of surveying employees on how they spend their time, managers first directly estimate the practical capacity of the resources supplied as a percentage of the theoretical capacity. There are various ways to do this. As a rule of thumb, you could simply assume that practical full capacity is 80% to 85% of theoretical full capacity. So if an employee or machine is available to work 40 hours per week, its practical full capacity is 32 to 35 hours per week. Typically, managers would allot a lower rate – say 80% – to people, allowing 20% of their time for breaks, arrival and departure, communication, and training. For machines, managers might allot a 15% differential between theoretical and practical capacity to allow for downtime due to maintenance, repair, and scheduling fluctuations. A more systematic approach, perhaps, is to review past activity levels and identify the month with the largest number of orders handled without excessive delays, poor quality, overtime, or stressed employees. Whichever approach you prefer, it's important not to be overly sensitive to small errors. The objective is to be approximately right, say within 5% to 10%

of the actual number, rather than precise. If the estimate of practical capacity is grossly in error, the process of running the time-driven ABC system will reveal the error over time.

Returning to our example, let's assume that the customer service department employs 28 reps to do the front-line work and that each puts in eight hours per day. In theory, therefore, each worker supplies about 10,560 minutes per month or 31,680 minutes per quarter. The practical capacity at about 80% of theoretical is therefore about 25,000 minutes per quarter per employee, or 700,000 minutes in total. Since we already know the cost of supplying

In the revised approach, managers directly estimate the resource demands imposed by each transaction, product, or customer.

capacity – the \$560,000 in overhead costs – we can now calculate the cost per minute of supplying capacity (\$0.80).

The capacity of most resources is measured in terms of time availability, but the new ABC approach can also recognize resources whose capacity is measured in other units. For example, the capacity of a warehouse or vehicle would be measured by space provided, while memory storage would be measured by megabytes supplied. In these situations, the manager would calculate the resource cost per unit based on the appropriate capacity measure, such as cost per cubic meter or cost per megabyte.

Estimating the unit times of activities. Having calculated the cost per time unit of supplying resources to the business's activities, managers next determine the time it takes to carry out one unit of each kind of activity. These numbers can be obtained through interviews with employees or by direct observation. There is no need to conduct surveys, although in large organizations, surveying employees may help. It is important to stress, though, that the question is not about the percentage of time an employee spends doing an activity (say, pro-

cessing orders) but how long it takes to complete one unit of that activity (the time required to process one order). Once again, precision is not critical; rough accuracy is sufficient. In the case of our example, let's suppose that managers determine that it takes 8 minutes to process an order, 44 minutes to handle an inquiry, and 50 minutes to perform a credit check.

Deriving cost-driver rates. The cost-driver rates can now be calculated by multiplying the two input variables we have just estimated. For our customer service department, we obtain cost-driver rates of \$6.40 (8 multiplied by \$0.80) for processing customer orders,

\$35.20 (44 by \$0.80) for handling inquiries, and \$40 (50 by \$0.80) for performing credit checks. Once you have calculated these standard rates, you can apply them in real time to assign costs to individual customers as transactions occur. The standard cost rates can also be used in discussions with customers about the pricing of new business.

Note that these rates are lower than those estimated using traditional ABC methods (see again the exhibit "Doing ABC the Traditional Way"). The reason for this difference becomes obvious when we recalculate the quarterly cost of performing the customer service activities. In the exhibit "The Impact of Practical Capacity," time-driven ABC analysis reveals that only 83% of the practical capacity (578,600 of the 700,000 minutes) of the resources supplied during the quarter has been used for productive work, and hence, only about 83% of the total expenses of \$560,000 were assigned to customers or products during this period. This takes care of the technical drawback of traditional ABC systems we mentioned earlier – the fact that surveyed employees respond as if their practical capacity were always fully utilized.

In the case of our customer service department, the traditional ABC survey produced a work distribution of 70%, 10%, and 20% of the employees' time performing the department's three activities. But while that distribution did reflect how workers spent their productive time, the fact that their total productive time was significantly less than their practical capacity of 32 hours per worker per week was completely

new investments in capacity. For example, the vice president of operations at Lewis-Goetz, a hose and belt fabricator based in Pittsburgh, saw from his time-driven ABC model that one of his plants was operating at only 27% of capacity. Rather than attempt to downsize the plant, he decided to maintain the capacity for a large contract he expected to win later that year, for which he otherwise would have created new capacity.

roduction of new technology can enable the same activity to be done in less time or with fewer resources. When permanent, sustainable improvements in a process have been made, the ABC analyst recalculates the unit time estimates (and therefore the demands on resources) to reflect the process improvements. For example, if the customer service department gets a new database system, the reps may be able to

The Impact of Practical Capacity

This table shows the effect on cost assignment when we use rates based on practical capacity (700,000 minutes), assumed here at 80% of theoretical full capacity. We can see that only about 83% of the customer service department's practical capacity was actually put to productive use during the first fiscal quarter.

Activity	Unit Time (minutes)	Quantity	Total Minutes	Total Cost
Process customer orders	8	49,000	392,000	\$313,600
Handle customer inquiries	44	1,400	61,600	\$49,280
Perform credit checks	50	2,500	125,000	\$100,000
Total			578,600	\$462,880

ignored. The calculation of resource costs per time unit forces the company to incorporate estimates of the practical capacities of its resources, allowing the ABC cost drivers to provide more accurate signals about the cost and the underlying efficiency of its processes.

Analyzing and reporting costs. Time-driven ABC enables managers to report their costs on an ongoing basis in a way that reveals both the costs of a business's activities as well as the time spent on them. In our customer service department example, a time-driven ABC report would look like the exhibit "ABC, the Time-Driven Way."

Note that the report highlights the difference between capacity supplied (both quantity and cost) and the capacity used. Managers can review the cost of the unused capacity and contemplate actions to determine whether and how to reduce the costs of supplying unused resources in subsequent periods; they can then monitor those actions over time. In some cases, the information can save companies that are considering expansion from making unnecessary

Updating the model. Managers can easily update their time-driven ABC models to reflect changes in operating conditions. To add more activities for a department, they don't have to reinterview personnel; they can simply estimate the unit time required for each new activity.

Managers can also easily update the cost-driver rates. Two factors can cause these rates to change. First, changes in the prices of resources supplied affect the cost per time unit of supplying capacity. For example, if employees receive an 8% compensation increase, the resource cost rate in our example increases from \$0.80 per supplied minute to \$0.864 per minute. If new machines are substituted or added to a process, the resource cost rate is modified to reflect the change in operating expense associated with introducing the new equipment.

The second factor that can cause a change in the activity cost-driver rate is a shift in the efficiency of the activity. Quality programs, continuous improvement efforts, reengineering, or the in-

perform a standard credit check in 20 minutes rather than 50 minutes. To accommodate the improvement, just change the unit time estimate to 20 minutes, and the new cost-driver rate automatically becomes \$16 per credit check (down from \$40). Of course, you then have to add back in the cost impact of purchasing the new database system by updating the cost per time unit estimate, so the final figure may be somewhat higher than \$16.

By updating the ABC model on the basis of events rather than on the calendar (once a quarter or annually), you get a much more accurate reflection of current conditions. Any time analysts learn about a significant shift in the costs of resources supplied or the practical capacity of those resources, or about a change in the resources required to perform the activity, they update the resource cost per time unit, or resource cost rate, estimates. And any time they learn of a significant and permanent shift in the efficiency with which an activity is performed, they update the unit time estimate.

Time Equations to Capture Complexity

So far, we have relied on an important simplifying assumption that all orders or transactions of a particular type are the same and require the same amount of time to process. But time-driven ABC does not demand this simplification. It can accommodate the complexity of real-world operations by incorporating time equations, a new feature that enables the model to reflect how order and activity characteristics cause processing times to vary. Time equations greatly

Let's say that if the chemical is already packaged in a way that meets standard requirements, it should take 0.5 minutes to prepare it for shipment. If the item requires a new package, however, the manager estimates, either from experience or from making several observations, that an additional 6.5 minutes will be required to supply the new packaging. And if the item is to be shipped by air, he or she knows (or can quickly determine) that it will take about 2 minutes to put the package in an air-worthy container.

than the traditional ABC system could, which might well have had to account for varying transaction times by treating each variant of the process as a distinct activity. Consider the case of Hunter Corporation (not its real name), a large, multinational distributor of scientific products, whose 27 facilities process more than one million orders each month to distribute up to 300,000 different product SKUs to 25,000 customers. Its old ABC model required that employees in its inside sales department (the salespeople handling phone and

ABC, the Time-Driven Way

This reporting template for time-driven ABC shows the customer service department's costs in the second quarter of operations. Here we assume that the department processes 51,000 customer orders, handles 1,150 inquiries, and performs 2,700 credit checks. The data reveal that the company supplied \$85,120 worth of unused resource capacity during this period, representing opportunities for savings or growth depending on the company's circumstances.

Activity	Quantity	Unit Time	Total Time Used (in minutes)	Cost-Driver Rate	Total Cost Assigned
Process customer orders	51,000	8	408,000	\$6.40	\$326,400
Handle customer inquiries	1,150	44	50,600	\$35.20	\$40,480
Perform credit checks	2,700	50	135,000	\$40.00	\$108,000
Total Used			593,600		\$474,880
Total Supplied			700,000		\$560,000
Unused Capacity			106,400		\$85,120

simplify the estimating process and produce a far more accurate cost model than would be possible using traditional ABC techniques.

The key insight is that although transactions can easily become complicated, managers can usually identify what makes them complicated. The variables that affect most such activities can often be precisely specified and are typically already recorded in a company's information systems. To take an example, let's assume a manager is looking at the process of packaging a chemical for shipment. In this situation, complexity arises from the potential need for special packaging and the additional demands of air as opposed to ground transportation.

This information allows the manager to estimate the time required for the packaging process:

$$\text{Packaging Time} = 0.5 + 6.5 \text{ [if special packaging required]} + 2.0 \text{ [if shipping by air]}$$

Many companies' ERP systems already store data on order, packaging, distribution method, and other characteristics. These order- and transaction-specific data enable the particular time demands for any given order to be quickly determined using a calculation like the one above.

Thanks to this extension, the time-driven approach to ABC can capture the complexities of business far more simply

Internet orders rather than dealing with customers face-to-face) estimate each month the percentage of their time that they spend on three activities: customer setup, order entry, and order expediting.

With the time-driven approach, Hunter's ABC team of analysts was able to group the three activities into a single departmental process, called inside sales order entry. The team learned that it took about 5 minutes to enter the basic order information, plus 3 minutes for each line item, and an additional 10 minutes if the order had to be expedited. If the customer were new, 15 more minutes would be required to set up the customer in the company's computer system.

Strategic Change at Kemps LLC

Kemps, headquartered in Minneapolis, is a full-line dairy, that produces milk, yogurt, sour cream, cottage cheese, and ice cream products. Its customers are retailers and distributors as large as SuperValu and Target and as small as convenience stores. Kemps markets its products under its own branded portfolio along with products sold through private label and copacking contracts. Like most dairies, Kemps was experiencing consolidation in its customer base. It decided to shift from its former customer relationship strategy – willing to do whatever the customer asked – to a lower-total-cost strategy. The new approach clearly required an accurate understanding of cost by product and customer that Jim Green, Kemp’s CEO, would use to instill a “low total cost” culture throughout the organization.

As a critical component of the cost-to-serve model, Kemps implemented a time-driven ABC system so it could track the costs of changeovers in producing and packaging all its products and the costs of picking, loading, and delivering products to its diverse customer base. The model captured differences in how the company entered orders from customers (customer phone call, salesperson call, fax, truck-driver entry, EDI, or Internet), how it packaged orders (full stacks of six cases, individual cases, or partial break-pack cases for small orders), how it delivered orders (commercial carriers or its own fleet, including route miles), and time spent by the driver at each customer location. The extra time for changeovers to clean out allergens (such as nuts, eggs, soy, or wheat) used in certain ice cream products could now be accurately assigned to those products. The model also captured the extra packaging costs for special promotions and customer-specific labels and promotions.

The company soon learned it was losing money with one of its customers, a chain of specialty high-end shops, because of the low volume and high variety of products ordered and the small just-in-time deliveries the chain re-

quested. Kemp’s vice president of sales called on the customer, explained the situation, and offered three options: accept a price increase and a minimum order size; eliminate its private-label ice cream, replacing it with Kemp’s standard branded product that was already being produced in efficient, high volumes; or find another ice cream supplier. When the customer inquired why Kemps was making the change, the VP responded that after 25 years, Kemps only now understood its true manufacturing costs and the impact of specialty production on its margins. The customer accepted a price increase of 13%, agreed to the elimination of two low-volume products, and agreed to accept full rather than partial truckload orders, thereby eliminating internal storage charges for Kemps. The changes produced immediate benefits of \$150,000 per year, transforming this unprofitable customer into a profitable one.

Kemps also used its time-driven ABC model proactively to become the leading dairy supplier to a national customer. Kemps demonstrated that it could identify the specific manufacturing, distribution, and order handling costs associated with serving this customer on the basis of actual order characteristics: DSD (direct store delivery) or shipments to distribution centers, gallon versus pint deliveries, and volume and mix of products. The time-driven ABC model facilitated an open, trusting relationship between supplier and customer that differentiated Kemps from its competitors.

Kemps also became aware that some of its smaller convenience store customers had been overordering and returning product when the date code expired. To avoid the high cost of these rebates and returns, Kemps offered these retailers a 2% discount if they would manage their own inventories without the return option. In this way, Kemps eliminated 95% of out-of-code returns, generating a net saving of \$120,000 per year.

Following the approach described earlier, the previous three-activity model was replaced by a single time equation:

Inside Sales Order Entry Process Time = 5 + (3 × number of line items) + 15 [if new customer] + 10 [if expedited order]

This was straightforward to implement since Hunter’s ERP system already tracked the number of line items for each order and included fields that identified whether it was a rush order and

whether the customer was new. The model multiplied the estimated sales process time by the departmental cost per minute to arrive at the cost of processing each order. Hunter could now obtain a more accurate and nuanced estimate of its costs in the unit while simultaneously reducing the complexity of the process for gathering and analyzing the data. Hunter has since rolled out time-driven ABC over all its operations. The results have been dramatic:

- Hunter has reduced the number of items tracked from 1,200 activities to 200 department processes.
- Managers can add complexity to the model by simply adding new elements to the time equations, which places less strain on Hunter’s accounting system than incorporating new activities would.
- Cost estimates are now based on actual order characteristics and direct observations of processing times, not on subjective estimates of where and how people spend their time.

• The new model is easier to validate. Hunter can reconcile the total process time – that is, the total absolute time spent on all the activities tracked in a given period – to other measures of resources supplied, such as head count. If the total process time is lower than the time implied by the head count, for example, managers know that some of their unit time estimates are too low or that people are not working to capacity. This validation is difficult with traditional ABC, which is based on estimated proportions of time spent and rarely incorporates idle or unused capacity time.

• Hunter's time-driven ABC model requires only two people working two days per month to load, calculate, validate, and report findings, compared with the ten-person team and three weeks that were necessary to maintain the previous model. Employees now spend time generating profits from the information rather than just updating and maintaining it.

The kind of rollout Hunter conducted is not difficult to achieve. Time-driven ABC models can be easily applied and customized for other plants and companies within an industry because the processes they use are similar. Dave Deinzer, CEO of Denman & Davis and president of the North American Steel Alliance, commented, "For the most part, we are all pretty much the same...cutting, sawing, and finishing metal with the same equipment and the same procedures. You could probably apply the same time-driven ABC model to all of us." The chief information officer of another steel distributor, TW Metals, noted, "We were able to roll out our time-driven ABC template model to all 36 of our facilities within three months."

The ability of time-driven ABC to identify and report complex processes in a simple way also provides a powerful negotiation tool when it comes to dealing with customers. Wilson-Mohr, an industrial controls company in Hous-

ton worked as a subcontractor to engineering contractors (ECs) on the construction of custom process-control systems for refineries and chemical plants. Its time-driven model revealed, for the first time, the high cost of engineering change orders issued by the ECs to replace parts or reconfigure the design. In the past, Wilson-Mohr charged an EC only for the predicted materials cost changes resulting from the change orders. Now it can also clearly itemize the cost of additional sales, design, engineering, and manufacturing labor time consumed when implementing change orders, which makes it easy to recuperate these costs through price recovery. (For a detailed example of how time-driven ABC helps companies manage customers, see the sidebar "Strategic Change at Kemps LLC.")

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introduce time-driven ABC into their processes. Most have reported substantial improvements in profitability that they attribute to the information generated by the new approach. Take the case of Banta Foods, a Midwest food

people to increase the net profits of their customers. It also renegotiated with vendors to recoup the cost of processing customer rebates. The general manager of sales used the information to transform his sales representatives

has increased revenues by 35% and generated immediate profit improvements of 43%, with a further 25% yet to come through from future opportunities. (See the exhibit “Profitable Decisions at Banta Foods.”) Its performance has led to the distinction of being named “Innovator of the Year” by the industry journal, *Institutional Distributor*.

Over the past 15 years, activity-based costing has enabled managers to see that not all revenue is good revenue and not all customers are profitable customers. Unfortunately, the difficulties of implementing and maintaining traditional ABC systems have prevented them from being adopted on any significant scale. Time-driven ABC has overcome these difficulties, offering a transparent, scalable methodology that is easy to implement and update. It draws on existing databases to incorporate specific features for particular orders, processes, suppliers, and customers. Activity-based costing is no longer a complex, expensive financial-systems implementation; the time-driven ABC innovation provides managers with meaningful cost and profitability information, quickly and inexpensively.

Profitable Decisions at Banta Foods

This table details the opportunities for profit revealed by the introduction of time-driven ABC and the estimated impact on total profits at a \$155 million food distributor.

Opportunities Identified	Total Profit Impact
Establish minimum order size	22%
Recover vendor rebate processing costs	21%
Conduct what-if profit analysis on new business	20%
Perform vendor reviews	5%
Total	68% (1.4% of revenues)

distributor with revenues of \$155 million from 17,000 SKUs and 5,000 customers. It operated on a razor-thin net margin of about 1%. Historically, its profit drivers were increasing the number of orders taken per day, increasing aggregate revenues, and controlling aggregate expenses.

Banta’s time-driven ABC system, which was fully implemented within 16 weeks, revealed much more granularity in its expense structure by tying costs to products, orders, customers, and territories. Managers learned that a \$1,000 order, previously considered the smallest size to break even, could either be quite profitable or a loss depending on the distance to the customer, the location of the product in the warehouse, the size of the order, the frequency of delivery, the type of service, and the credit rating of the customer – all of which were incorporated in the algorithms in its new time-driven ABC system.

Based on the data in its ABC model, Banta instituted a nonnegotiable minimum order size, reduced the inventory of unprofitable products, promoted sales of high-profit products, negotiated with customers either to reduce the demand for high-cost services or to reprice them, and offered incentives to its sales-

from order takers to consultants, helping them to create customers and territories that were more profitable for Banta. He reports, “Salespeople can now increase their gross profits not by simply adding points to their margin but by knowing which items to sell.”

By accurately projecting the cost and profits of proposed business, Banta has been able to take on new business that

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Deep Smarts

I enjoyed and identified with “Deep Smarts” by Dorothy Leonard and Walter Swap (September 2004). I head one of Roche’s largest biotech businesses worldwide – it has sales of over \$2 billion. My 300-strong team is multidisciplinary, multicultural, and geographically dispersed.

Transferring deep smarts on proprietary, highly scientific information is a difficult undertaking. I can hire people with appropriate skills but not the

material, and even videoconferencing are sorely wanting as mechanisms for the appropriate transfer of knowledge because they lack the crucial element of experience. For example, at one point I had a person in the United States back up an expert in Europe. The two individuals communicated via e-mail and videoconferencing and occasionally met in person, but it became obvious that this arrangement would not work. The only way to ensure knowledge transfer was to have the mentor and backup work in the same location for a substantial period of time so that the backup could go through the fundamentals, almost from scratch. A mentor must allow the backup to gradually engage in more and more guided work.

This process can be frustrating because of the time involved and the temptation for the backup to reinvent wheels, but it results in the backup having a deep, personal buy-in to the project. For the experts, it relieves the pressure often associated with being the sole holder of deep knowledge. Sometimes experts don’t like this system at first, but their fears are eased once they understand that the backup isn’t necessarily a successor and that the company is not aiming to replace them. The experts come to see that the system benefits them in other ways, too. As the backup learns, he or she is able to lighten some of the workload of the mentor, who goes on to take higher-level responsibilities.

I have put a system in place where the six most crucial members of my team systematically establish a backup person who is fully integrated into the project. Where a backup cannot be identified, I have increased the head count so that the work is shared more widely.



necessary smarts. They need to learn. Therefore, I spend a good deal of time dealing with how to transfer knowledge among appropriate team members and limit the damage when key people leave a project.

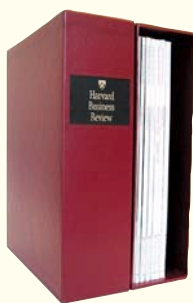
I firmly believe in the value of backup people who learn parts of experts’ knowledge (this is completely separate from succession planning, where the successor acquires knowledge only after it’s clear that the expert is leaving), and I share the authors’ belief about the benefits of guided experience. I have found that e-mail, phone calls, reading mate-

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Of course, the best way to prevent damage is to *keep* people with deep smarts. Key people know they are key, and companies must treat them that way.

John Michailidis

Global Head Anaemia Management

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Basel, Switzerland

My research as an educator in business settings confirms the authors' conclusions. As they suggest, there is a continuum of learning (we call it experience in adult education theory) ranging from simple to complex. There is evidence that deep smarts may be deeper than the cognitive level. Neuroscientists inform us that experience causes physical changes in the brain, creating new pathways and interconnections that speed the processing of thought. It's what happens as we develop expertise and why what once may have been very difficult for us becomes an unconscious process.

The most profound implication in the article is the authors' comment about "fast brain food." Our organizational memories reside in the neurons and expertise of people who have honed skills over many years through trial and error, novel situations, struggle, effort, wins, and losses. Indeed, they do have something to pass on to those around them, and once they walk out the door, they take their knowledge with them (or come back as consultants!). What's critical here is that organizational learning programs need to be developed to tap this resource in a more systematic way, given the baby boom issue mentioned in the article. Organizations with deep smarts will acknowledge the performance of their best and brightest by giving them forums where they can transfer what is deep in their neural pathways. This type of learning far exceeds the value of canned leadership programs. Witness, for example, the interest level in a group of learners when a "trainer" speaks about how to accomplish a leadership task versus when a true expert speaks. We attend to the ex-

pert because of the "Been there, did that, got the T-shirt" evidence of success. When the tsunami hits, organizations that have taken the time to shore up their incoming staff with learning from the "old-timers" are much more likely to survive against competition that for a variety of reasons, ranging from lack of interest to lack of concern to sheer inattention, did nothing to stem its losses.

James G. Bohn

Axios Consulting

Grafton, Wisconsin

Getting the Most out of All Your Customers

Having worked as a medical sales representative in the Specialty Division of a major pharmaceutical company for the past five years, I can relate firsthand to "Getting the Most out of All Your Customers" (July–August 2004). Jacquelyn S. Thomas, Werner Reinartz, and V. Kumar do an excellent job of pointing out fundamental issues that marketers face when formulating resource allocation decisions. One such issue is the challenge of balancing short-term costs against long-term gains. In my company, we sometimes must utilize resources for segments that are currently not well established or lucrative but that could become quite valuable in the future.

Another is the importance of low-maintenance customers (those with high acquisition costs and low retention costs). Under this category are high-prescribing physicians who are extremely busy and hard to access—it takes time and a variety of methods to initiate contact with them. But once physicians in this group become genuinely interested in a company's offering, it's likely that the company will be one of the few entities they regularly deal with—and hence these customers could become easier to retain.

The authors' comments on the law of diminishing returns certainly hit the mark, too, capturing the shortcomings of marketing departments in my industry and no doubt in others. Usually, medical sales representatives are expected to visit physicians' offices a certain num-

ber of times throughout the year and to utilize as many promotional tools as possible. But little consideration is given to the effect on the cost-to-revenue ratio of each additional visit or the production and use of promotional resources.

The only question that came to mind as I read the article was how resource allocation decisions might take into account the *quality* of acquisition and retention activities. My experience suggests that a conversation in which there is strong and meaningful communication between a representative and a physician can potentially reduce the number of visits the rep needs to make. A high-impact journal ad can similarly reduce acquisition and retention costs.

Can “quality” be injected into the profitability equation? I realize such a concept would be difficult to quantify. However, unless marketing departments consider this important factor, their quantitative myopia may cast doubt on the effectiveness of their resource allocation decisions.

Hormuz J. Dastur

*Therapeutic Area Specialist
Merck Frosst Canada
Mississauga, Ontario*

Thomas, Reinartz, and Kumar respond: We agree that quality is an important factor in the effectiveness of a sales call or other type of interaction and that it should therefore have an impact on resource allocation decisions. Integrating quality of interactions into a customer-level resource allocation model would be a logical next step in customer relationship research.

In the model we present in the article, the quality of all touch points is assumed to be the same; when this is not the case, quality can easily be incorporated into the model. One way to accomplish this is to obtain a valid measure of quality and interact it with the frequency of contacts. The real managerial challenge lies in obtaining a reliable and valid measure of interaction quality.

Ideally, a measure would be a score based on both objective and subjective components. Objective measures would vary greatly by industry but might in-

clude the duration of an interaction, the number of marketing tools used during it, the number of add-on products or services discussed, and whether the customer requested additional information. Subjective measures might include the customer’s self-reported level of satisfaction with the interaction and the degree to which the customer anticipates that his or her behavior will change as a result.

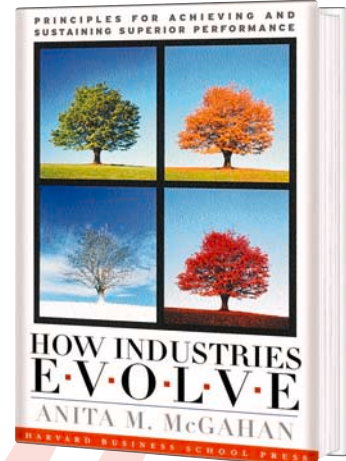
Quality is likely to vary across all interactions, but variations are most likely to affect the model in situations where sales depend heavily on dialogue with customers over an extended period of time and situations where the product or service has a short purchase cycle and thus the frequency of interaction is high.

Funding Growth in an Age of Austerity

After a decade and a half of practicing innovation, followed by a quarter century of studying it, I must underscore the findings that Gary Hamel and Gary Getz offer in elegant and practical terms in “Funding Growth in an Age of Austerity” (July–August 2004). I agree with four of their five imperatives—raise the ratio of innovators to the total number of employees; raise the ratio of radical innovation to incremental innovation; raise the ratio of externally sourced innovation to internally sourced innovation; and raise the ratio of learning over investment in innovation projects. (I don’t have sufficient knowledge of the fifth—raise the ratio of commitment over the number of key innovation priorities). And, by the way, the imperatives apply even in the absence of austerity pressures!

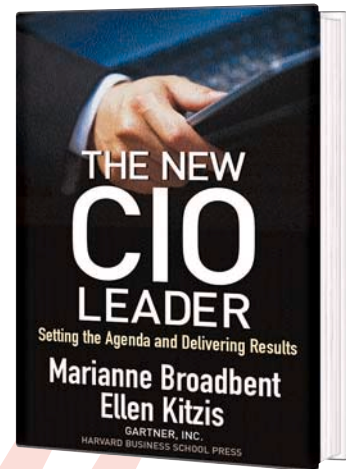
I’d like to submit a sixth imperative, one that would improve companies’ efforts to follow several of the others: Allow a greater percentage of ideas to survive the earliest stages of sifting and sorting. In other words, raise the ratio of the number of such “early survivor” ideas to the total number of ideas generated.

Novel ideas, particularly radical ones, are notoriously hard to grasp. Instead



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of summarily discarding odd-looking concepts, companies should invest in making them tangible. Furthermore, an idea is but a crude resource, sufficiently valuable only after considerable recombination, refinement, and adjustment. Such a process can't happen unless the idea gets a fair chance.

If you allow ideas lots of leeway, you demonstrate that they are taken seriously. That gives an important boost to employees' morale and encourages their engagement in creative endeavors. This supports the first Hamel-Getz imperative, raising the ratio of innovators to the total number of employees. And far from being costly, increasing the sixth ratio allows for significant productivity gains in R&D, because ideas are relatively inexpensive to keep alive in the early stages, and the more ideas you maintain, the greater the chances that you will keep alive a huge moneymaker.

Every idea's development demands some unique element or combination of elements, as Hamel and Getz point out. By acquiring more experience from a larger variety of projects, a company can increase its ability to "triangulate" successful paths for subsequent ones. In an organization attuned to increasing the investment in learning—the fourth Hamel-Getz imperative—lessons from those diverse projects aggregate to form an investment in learning the innovation game.

Bengt-Arne Vedin

*Professor in Innovation Management
Mälardalen University
Stockholm, Sweden*

Hamel and Getz respond: Thanks to Professor Vedin for his confirming comments on the ratios that lead to effective and affordable innovation for growth. While the observations on which we based our thoughts are drawn from an extensive set of both research findings and personal consulting experiences, Vedin's four decades of personal experience provide important, and welcome, validation.

In addition, we appreciate the further elaboration of the theme provided by his suggested (and paradoxically eco-

nomical) sixth ratio. As Vedin notes, this idea is linked to our fourth imperative—maximizing the ratio of learning to investment through targeted, learning-focused experimentation. It is also related to a concept of Henry Chesbrough's that we mention in passing, in our exhibit about the differences between testing and experimentation: the distinction between most existing development processes, whose principle is "Don't invest in losers," and effective experimentation, which stresses "Don't kill a great idea prematurely."

But Vedin's idea adds two important nuances: timing and portfolio composition. Within the bounds set by our fifth imperative (focusing on a limited number of key innovation priorities), a broad early-stage innovation portfolio that is being pursued through low-cost, learning-based market experiments plays a big role in affordable innovation. The key: challenging experimenters to resolve the most pressing learning requirements and uncertainties about their ideas as quickly as possible—and with the smallest possible level of investment and irrevocable commitment.

Even if many early ideas don't survive the experimentation process, what they teach us about other opportunities that do survive—and about how to shape our search for additional ideas—makes this approach to early-stage portfolio management worthwhile.

Darwin and the Demon

Searching for innovations in order to survive is a well-established management concept, but it should never be related to Charles Darwin's theory of natural selection, as in "Darwin and the Demon: Innovating Within Established Enterprises," by Geoffrey A. Moore, July–August 2004. Enterprises do not randomly mutate and then take the chance that a mutation will provide an advantage in the current business environment. Perhaps the scientist to cite is Jean-Baptiste Lamarck, who theorized (pre-Darwin) that organisms alter their behavior in response to changing envi-

ronmental conditions and the altered behavior leads to physical changes in the organisms.

Jordi Mas

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Top-Line Growth

While the July–August issue of HBR delivered some interesting information on growth, it was sadly deficient on growth's perils. Those perils can be described in two words: Wall Street. The friendly folks there often create an environment that encourages bad, sometimes irrevocable, things to happen. In a way, they set up a greenhouse for trouble.

The economist Milton Friedman put it perfectly when he said, "We don't have a desperate need to grow. We have a desperate desire to grow." That desire is at the heart of the corporate accounting scandals we've witnessed.

Consider the recent woes at Krispy Kreme Doughnuts, a formerly red-hot company whose revenues have slowed and whose profits have plunged. Krispy Kreme grew too quickly and diluted its cult status by selling in too many outlets while trying to impress Wall Street.

Today's real business heroes are the likes of James Sinegal of Costco, described as the only company Wal-Mart fears. Sinegal has been dramatically outperforming Sam's Club, but Wall Street has been criticizing Costco for paying people more than Wal-Mart does. His response, quoted in *Fortune*: "I care about the stock price. But we're not going to do something for the sake of one quarter that's going to destroy the fabric of our company and what we stand for."

Here's a CEO who has things in perspective. Perhaps someday you folks at HBR will do a special edition about the dark side of that desperate desire to grow. It's sadly needed, as a lot of CEOs could use a lot more backbone in standing up to Wall Street.

Jack Trout

*Author and consultant
Old Greenwich, Connecticut*

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FORETHOUGHT

I Am My Own Database. By allowing consumers to control data about their purchases and preferences, says business and technology professor Richard T. Watson, companies can get a better sense of what their customers want to buy.
Reprint F0411A

All Those Unfamiliar Places. Management consultant William Dunk argues that the best new thinking resides in often overlooked nations.
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The Problem with Proxies. We can't observe how leaders make decisions, so we judge—and often misjudge—those decisions by appearances, explains business professor Michael Useem.
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Enough Leadership. Management professor Henry Mintzberg argues that a little leadership goes a long way.
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How Offshore Work Affects Your Industry. Economics professors Andrew B. Bernard and Peter K. Schott, and J. Bradford Jensen of the Institute for International Economics, dispel the myth that all U.S. manufacturing is headed offshore.
Reprint F0411E

The Young and the Restful. Young employees are ambitious—yet hoping to stay at one company for as long as possible.
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Patent Medicine. For the past two decades, say economics professor Adam B. Jaffe and business professor Josh Lerner, U.S. patent laws have gummed up the gears of innovation.
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The Bias Backfire. Economics professor Paul Oyer and management policy professor Scott Schaefer explain how the Civil Rights Act of 1991 hurts those it's meant to help.
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Book Reviews. Innovation as cocktail party; reality checks for companies; divinely inspired leaders; the pitfalls of preparation.

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HBR CASE STUDY

Take the Money—or Run?

John W. Mullins

On the face of it, Petrolink's business plan looks like a winner. At present, the only available pipeline for operators in the Baltic Sea's newly developed Helmark gas field is owned and operated by the Russian oil and gas company Gazprom. But this gives Gazprom access to information about the productivity of individual leases and therefore an advantage in negotiating new ones. Petrolink's founders believe that the company that opens a new pipeline should find ready customers among the field's numerous independent producers.

The Petrolink team has been talking with two potential investors. After six weeks of due diligence, London Development Partners—a large, well-established venture capital firm with no experience in the gas business—offers a relatively small early round of investment without any tangible commitments to future rounds. The package is far from what the team had hoped for. Polish venture capital firm BRX Capital has been in business fewer than five years, but it has already made investments in the Eastern European oil and gas industry. BRX not only agrees to the capital structure that Petrolink proposes, it also agrees to invest both the first- and second-round equity amounts. One of the start-up's main objectives has been to ensure that no one investor has too much clout, so the arrangement proposed by BRX suits them.

But now that a €4 million check is on the table, there's been an apparent breach of trust by the Polish VC. Petrolink's founders discover that an agreed-upon provision covering ownership dilution has been changed. Should they take BRX's money or go elsewhere?

George Brenkert of Georgetown University; Sonia Lo of Chalsys Partners; William Sahlman of Harvard Business School; and Charalambos Vlachoutsicos, adviser to 7L Capital Partners Emerging Europe, comment on this fictional case.

Reprint R0411A

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FIRST PERSON

The CEO's Real Legacy

Kenneth W. Freeman

The literature on CEO succession planning is nearly unanimous in its advice: Begin early, look first inside your company for exceptional talent, see that candidates gain experience in all aspects of the business, and help them develop the skills they will need in the top job. It all makes sense and sounds pretty straightforward. Nevertheless, the list of CEOs who last no more than a few years on the job continues to grow. Implicit in many, if not all, of these unceremonious departures is the absence of an effective CEO succession plan.

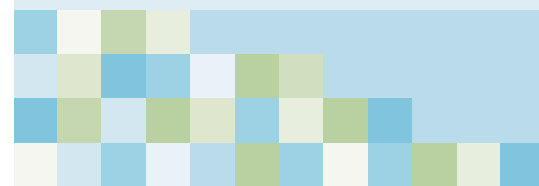
The problem is, most boards simply don't want to talk about CEO succession: Why rock the boat when things are going well? Why risk offending the current CEO? Meanwhile, most CEOs can't imagine that anyone could adequately replace them.

In this article, Kenneth W. Freeman, the retired CEO of Quest Diagnostics, discusses his own recent handoff experience (Surya N. Mohapatra became chief executive in May 2004) and offers his approach to succession planning. He says it falls squarely on the incumbent CEO to put ego aside and initiate and actively manage the process of selecting and grooming a successor. Aggressive succession planning is one of the best ways for CEOs to ensure the long-term health of the company, he says. Plus, thinking early and often about a successor will likely improve the chief executive's performance during his tenure.

Freeman advocates the textbook rules for succession planning but adds to that list a few more that apply specifically to the incumbent CEO: Insist that the board become engaged in succession planning, look for a successor who is different from you, and make the successor's success your own. After all, Freeman argues, the CEO's true legacy is determined by what happens *after* he leaves the corner office.

Reprint R0411B

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Getting Past Yes: Negotiating as if Implementation Mattered Danny Ertel

Many deals that look good on paper never materialize into value-creating endeavors. Often, the problem begins at the negotiating table. In fact, the very person everyone thinks is pivotal to a deal's success—the negotiator—is often the one who undermines it.

That's because most negotiators have a deal maker mind-set: They see the signed contract as the final destination rather than the start of a cooperative venture. What's worse, most companies reward negotiators on the basis of the number and size of the deals they're signing, giving them no incentive to change.

The author asserts that organizations and negotiators must transition from a deal maker mentality—which involves squeezing your counterpart for everything you can get—to an implementation mind-set—which sets the stage for a healthy working relationship long after the ink has dried.

Achieving an implementation mind-set demands five new approaches. First, start with the end in mind: Negotiation teams should carry out a “benefit of hindsight” exercise to imagine what sorts of problems they'll have encountered 12 months down the road. Second, help your counterpart prepare. Surprise confers advantage only because the other side has no time to think through all the implications of a proposal. If they agree to something they can't deliver, it will affect you both. Third, treat alignment as a shared responsibility. After all, if the other side's interests aren't aligned, it's your problem, too. Fourth, send one unified message. Negotiators should brief implementation teams on both sides together so everyone has the same information. And fifth, manage the negotiation like a business exercise: Combine disciplined negotiation preparation with post-negotiation reviews.

Above all, companies must remember that the best deals don't end at the negotiating table—they begin there.

Reprint R0411C; HBR OnPoint 8339; OnPoint collection “Masterful Negotiating, 2nd Edition” 8320

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Bringing Customers into the Boardroom

Gail J. McGovern, David Court, John A. Quelch, and Blair Crawford

Misguided marketing strategies have destroyed more shareholder value than shoddy accounting or shady fiscal practices. Yet marketing functions typically reside deep in the organization, far from the executive suite and boardroom, and they are often poorly aligned with corporate strategy. Boards of directors, it would seem, have compelling reasons to monitor their companies' marketing activities.

The authors argue that boards lack a clear understanding of how their companies are meeting customers' needs and how their marketing strategies drive (or often fail to drive) top-line growth. To help remedy that problem, they've devised a “marketing dashboard,” a series of management reports that could give the board this critical knowledge.

The dashboard has three parts, each of which the board should review regularly. The first part tracks the company's main business drivers—those business conditions that, when manipulated or otherwise changed, will directly and predictably affect the company's performance. The second part describes the specific innovations in a pipeline of growth ideas that will allow the company to reach its short- and long-term revenue goals. And the third part provides an overview of the company's marketing skill set so the board can determine not only if the company has *enough* marketing talent but also if it has the *right* marketing talent.

Unlike isolated measures of marketing performance that are often insufficient, irrelevant, or misleading, the dashboard allows the board to quickly and routinely assess the effectiveness of its company's marketing strategies. Armed with a clear understanding of marketing's role and performance, the board can expose inadequate marketing campaigns, direct management to address the problem, and monitor progress.

Reprint R0411D

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The Wild West of Executive Coaching

Stratford Sherman and Alyssa Freas

Annual spending on executive coaching in the United States is estimated at \$1 billion. Yet information about coaching's effectiveness is scarce and unreliable. No one has yet demonstrated conclusively what qualifies an executive coach or what makes one approach to executive coaching better than another. Barriers to entry are nonexistent—many executive coaches know little about business, and some know little about coaching. The coaching certifications offered by various self-appointed bodies are difficult to assess, and methods of measuring return on investment are questionable.

But *strategic* coaching can provide critical help both to individuals and to organizations. In this article, Stratford Sherman, a senior vice president of Executive Coaching Network, and Alyssa Freas, the founder and CEO, explore the popularity of executive coaching and investigate ways to make the most of the experience. They argue that coaching is inevitably a triangular relationship between the client, the “coachee,” and the coach. Its purpose is to produce behavioral change and growth in the coachee for the economic benefit of the client. The best way to maximize the likelihood of good results is to qualify all the people involved. Even so, many triangular relationships continue to generate conflict among all three parties.

At the most basic level, coaches serve as suppliers of candor, providing leaders with the objective feedback they need to nourish their growth. Coaching gets executives to slow down, gain awareness, and notice the effects of their words and actions. On a larger scale, the best coaching fosters cultural change for the benefit of the entire organization. It provides a disciplined way for businesses to deepen relationships with their most valued employees while also increasing their effectiveness.

Reprint R0411E

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Aligning Incentives in Supply Chains

V.G. Narayanan and Ananth Raman

Most companies don't worry about the behavior of their supply chain partners. Instead, they expect the supply chain to work efficiently without interference, as if guided by Adam Smith's famed invisible hand. In their study of more than 50 supply networks, V.G. Narayanan and Ananth Raman found that companies often looked out for their own interests and ignored those of their network partners. Consequently, supply chains performed poorly.

Those results aren't shocking when you consider that supply chains extend across several functions and many companies, each with its own priorities and goals. Yet all those functions and firms must pull in the same direction for a chain to deliver goods and services to consumers quickly and cost-effectively.

According to the authors, a supply chain works well only if the risks, costs, and rewards of doing business are distributed fairly across the network. In fact, misaligned incentives are often the cause of excess inventory, stock-outs, incorrect forecasts, inadequate sales efforts, and even poor customer service. The fates of all supply chain partners are interlinked: If the firms work together to serve consumers, they will all win. However, they can do that only if incentives are aligned.

Companies must acknowledge that the problem of incentive misalignment exists and then determine its root cause and align or redesign incentives. They can improve alignment by, for instance, adopting revenue-sharing contracts, using technology to track previously hidden information, or working with intermediaries to build trust among network partners. It's also important to periodically reassess incentives, because even top-performing networks find that changes in technology or business conditions alter the alignment of incentives.

Reprint R0411F; HBR OnPoint 8363

Harvard Business Review

Statement of Ownership, Management, and Circulation

HARVARD BUSINESS REVIEW: Publication No. 0017-8012

ISSUE FREQUENCY: Monthly

NUMBER OF ISSUES PUBLISHED ANNUALLY: 12

ANNUAL SUBSCRIPTION PRICE: \$99, \$118 (U.S.); \$128 (Canada); \$165 (international)

PUBLISHER: Cathryn C. Cranston, 60 Harvard Way, Boston MA 02163

EDITOR: Thomas A. Stewart, 60 Harvard Way, Boston MA 02163

DEPUTY EDITOR: Karen Dillon, 60 Harvard Way, Boston MA 02163

GENERAL BUSINESS OFFICE: 60 Harvard Way, Boston MA 02163; Middlesex County

OWNERS: Harvard Business School Publishing Corp., 60 Harvard Way, Boston MA 02163
 President and Fellows of Harvard College, Cambridge MA 02163

BONDHOLDERS, MORTGAGEES, OR OTHER SECURITY HOLDERS: None

The purpose, function, and nonprofit status of this organization and the exempt status for federal income tax purposes have not changed during the preceding 12 months.

ISSUE DATE FOR THE CIRCULATION DATA BELOW: June 2004 (filed and subject to audit)

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Rapid-Fire Fulfillment
 Kasra Ferdows, Michael A. Lewis,
 and Jose A.D. Machuca

Would you send a half-empty truck across Europe or pay to airfreight coats to Japan twice a week? Would you move unsold items out of your shop after only two weeks? Would you run your factories just during the day shift? Is this any way to run an efficient supply chain?

For Spanish clothier Zara it is. Not that any one of these tactics is especially effective in itself. Rather, they stem from a holistic approach to supply chain management that optimizes the entire chain instead of focusing on individual parts. In the process, Zara defies most of the current conventional wisdom about how supply chains should be run.

Unlike so many of its peers, which rush to outsource, Zara keeps almost half of its production in-house. Far from pushing its factories to maximize output, the company focuses capital on building extra capacity. Rather than chase economies of scale, Zara manufactures and distributes products in small batches. Instead of outside partners, the company manages all design, warehousing, distribution, and logistics functions itself.

The result is a superresponsive supply chain exquisitely tailored to Zara's business model. Zara can design, produce, and deliver a new garment to its 600-plus stores worldwide in a mere 15 days. So in Zara's shops, customers can always find new products—but in limited supply. Customers think, "This green shirt fits me, and there is one on the rack. If I don't buy it now, I'll lose my chance." That urgency translates into high profit margins and steady 20% yearly growth in a tough economic climate.

Some of Zara's specific practices may be directly applicable only in industries where product life cycles are very short. But Zara's simple philosophy of reaping bottom-line profits through end-to-end control of the supply chain can be applied to any industry. Reprint R0411C

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BEST PRACTICE**CRM Done Right**

Darrell K. Rigby and Dianne Ledingham

Disappointed by the high costs and elusive benefits, early adopters of customer relationship management systems came, in the post dot-com era, to view the technology as just another overhyped IT investment whose initial promise would never be fulfilled. But this year, something unexpected is happening. System sales are rising, and executives are reporting satisfaction with their CRM investments. What's changed?

A wide range of companies are successfully taking a pragmatic, disciplined approach to CRM. Rather than use it to transform entire businesses, they've directed their investments toward solving clearly defined problems within their customer relationship cycle.

The authors have distilled the experiences of these CRM leaders into four questions that all companies should ask themselves as they launch their own CRM initiatives: Is the problem strategic? Is the system focused on the pain point? Do we need perfect data? What's the right way to expand an initial implementation?

The questions reflect a new realism about when and how to deploy CRM to best advantage. Understanding that highly accurate and timely data are not required everywhere in their businesses, CRM leaders have tailored their real-time initiatives to those customer relationships that can be significantly enhanced by "perfect" information. Once they've succeeded with their first targeted CRM project, they can use it as a springboard for solving additional problems.

CRM, in other words, is coming to resemble any other valuable management tool, and the keys to successful implementation are also becoming familiar: strong executive and business-unit leadership, careful strategic planning, clear performance measures, and a coordinated program that combines organizational and process changes with the application of new technology.

Reprint R0411H; HBR OnPoint 8355; OnPoint collection "CRM—the Right Way, 2nd Edition" 8347

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TOOL KIT**Time-Driven Activity-Based Costing**

Robert S. Kaplan and Steven R. Anderson

In the classroom, activity-based costing (ABC) looks like a great way to manage a company's limited resources. But executives who have tried to implement ABC in their organizations on any significant scale have often abandoned the attempt in the face of rising costs and employee irritation. They should try again, because a new approach sidesteps the difficulties associated with large-scale ABC implementation.

In the revised model, managers estimate the resource demands imposed by each transaction, product, or customer, rather than relying on time-consuming and costly employee surveys. This method is simpler since it requires, for each group of resources, estimates of only two parameters: how much it costs per time unit to supply resources to the business's activities (the total overhead expenditure of a department divided by the total number of minutes of employee time available) and how much time it takes to carry out one unit of each kind of activity (as estimated or observed by the manager). This approach also overcomes a serious technical problem associated with employee surveys: the fact that, when asked to estimate time spent on activities, employees invariably report percentages that add up to 100. Under the new system, managers take into account time that is idle or unused. Armed with the data, managers then construct time equations, a new feature that enables the model to reflect the complexity of real-world operations by showing how specific order, customer, and activity characteristics cause processing times to vary.

This Tool Kit uses concrete examples to demonstrate how managers can obtain meaningful cost and profitability information, quickly and inexpensively. Rather than endlessly updating and maintaining ABC data, they can now spend their time addressing the deficiencies the model reveals: inefficient processes, unprofitable products and customers, and excess capacity. Reprint R0411J

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Volume 82, Number 11



Go and Look

Executive offices are a lot like Plato's cave. Roomy. Set apart. Insulated from the distractions of the real world.

That sounds good. After all, the real world is a noisy, confusing place. Why should executives let little operational details bog down their big strategic thoughts when others are eager to tell them what's going on outside? Those considerate others smooth and streamline, making vital feedback digestible for their harried bosses. But they also filter, interpret, and oversimplify—in a word, distort.

Peter Drucker had a better idea. In "The Effective Decision" (HBR, January–February 1967), he praised military commanders, who traditionally do not rely on reports from the field. Instead, they go and look. Executives, too, should go and look—at markets, customers, competitors, and products. It's the best way to get accurate feedback on decisions and to learn whether the assumptions underlying those decisions are as untrustworthy as shadows on a wall.

Don Moyer can be reached at don@amsite.com.



Byron Wien, US Senior Investment Strategist

Putting his two Euros in.

The Smartest Man in Europe sizes up the world.

Every year I try to spend several days with someone I consider The Smartest Man in Europe. He first got my attention in the mid-1980s by making a case for the collapse of Communism and the dismantling of the Berlin Wall, but there have been many other examples since then. His family roots in mercantilism extend back hundreds of years, to when his ancestors sold supplies to traders along the Silk Road. He continues to be sustained by the thrill of new ideas and the profit that can be made by watching them evolve. Here's some of what he had to say:

Earlier in my investment career I observed some clear patterns of economic and stock market activity and learned how to respond to them. The US economy would go into recession, the Federal Reserve would ease monetary policy to stimulate business, and the stock market would react favorably. Interest rates and inflation would then move higher, and the Fed would tighten, causing a recession and a stock market decline. Then the same thing would happen all over again.

Think about how different things are now. The economy slowed, the Fed eased significantly, the government applied massive fiscal stimulus, business picked up, but inflation remained tame and interest rates stayed low. Yet the stock market is going nowhere. The market is smarter than all of us and knows something is wrong.

The world is settling into three major blocs, and only one is especially interesting from an investment viewpoint. The first bloc is Europe, whose problems are well-known. The population is aging, the economy is mature, the continent is burdened by an accumulation of socialist policies, and the entrepreneurial spirit is dampened by regulation and bureaucracy.

The American bloc isn't much better. No politician can propose anything that involves sacrifice. The price of oil soars, and

you don't do anything to seriously encourage conservation. Your manufactured products are uncompetitive, and you don't provide the necessary incentives to expand the knowledge-based industries where you have an advantage.

Then there is Asia, which is only beginning a long cycle of opportunity. Both China

and India have educated populations willing to work very hard for modest wages, and every year

China moves further along the curve of manufacturing sophistication. Most Asian countries provide few healthcare benefits, and there is no plaintiff's bar. Environmental considerations are generally a low priority. It is a free-wheeling business atmosphere much as I imagine America was in the days of the Wild West.

But most stock markets in Asia are relatively undeveloped. If Asian markets were as liquid as the United States and had regulators making sure that trading practices were fair, I would have half of my money in developing Asia. While Japan is further along the maturity scale, it is a major beneficiary of Asian growth. I think the Japanese market has a long way to go on the upside.



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