Thoughts on Corporate Strategy

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> I swear by Apollo the Physician and all the gods and goddesses, and by whatsoever I hold most sacred, that I will be loyal to the profession of Medicine and just and generous to its members; that I will lead my life and practice my art in uprightness and honour; that into whatsoever house I shall enter, it shall be for the good of the sick to the utmost of my power, holding myself far aloof from wrong, from corruption, from the tempting of others to vice; that I will exercise my art solely for the cure of my patients and will give no drug, perform no operation for a criminal purpose, even if solicited, far less suggest it; that whatsoever I shall see or hear of the lives of men and women which is not fitting to be spoken, I will keep inviolably secret. Now if I keep this oath and break it not, may I enjoy honour, in my life and art, for all time.
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> Hippocratic Oath

The primary problem in corporate strategy is very bad practice. Despite research and teaching and the best advice of the best consulting firms, large companies tend to seek size and diversity rather than innovation and value creation. In consulting with large firms the primary problem is an ethical one. If one refuses to help a client to do harm, won't someone else do it anyway? And mightn't an advisor with principles sway the client a bit in the better direction?

Corporate Strategy

In the field of corporate finance there are three fundamental questions. They are: (1) how should real assets (projects, businesses, and companies) be valued? (2) What should be the capital structure of the firm (how much debt should it carry)? (3) What should be the firm's dividend policy? Despite the fact that finance is the only "business" subject in which Nobel prizes have been given, despite the fact that finance is generally considered to have made the most dramatic "advances" over the last twenty-five years, only the first question has an approximate answer. I say approximate, because the answer is to discount expected cash flows at the appropriate cost of capital, but the cost of capital remains an elusive concept. For a while it was thought that the CAPM gave us the cost of equity: the "beta" adjustment captured non-diversifiable risk. But it is now clear that CAPM is fundamentally flawed and that using "betas" to adjust for risk is largely a waste of time. In addition, we now know that the real options embedded in projects and firms often make up a large portion of their value; yet methodologies for identifying and valuing these real options are crude at best.

In the field of corporate strategy there are three fundamental questions. They are (1) how diverse should the corporation be (What limits scope)? (2) How large should the corporation be (What limits scale)? (3) What is the appropriate organizational (managerial) logic of the corporation?

My own judgment is that we have made more progress on these questions than finance has on its questions. With regard to diversity, there has been a gradual build-up of research results

indicating that diversification reduces performance. This is not a “strong” force; else there would be no widely diversified firm. Nor is it true that every diversified firm performs poorly. But, as a good general statistical rule, greater diversity reduces the rate of return on capital and reduces the market-to-book ratio of the corporation. The clearest results to date are those of Lang and Stultz [1996]. They compared the actual market-to-book ratios of corporations to the values “expected” based on the industry average market-to-book ratios for the industries in which they were active. For single-business firms the ratio of actual to expected market-to-book was, necessarily, 1.0. For corporations active in two or more industries, the average ratio of actual to expected market-to-book values was about 0.7. The decline is not gradual; there is a sharp drop in the ratio as you move from corporations active in one to those active in two industries.

With regard to size, the answer is simple. If diversity is controlled, size proxies market-share and, therefore, is an indicator of success. Size relative to the market is positively related to performance. It is not clear from the empirical data that market share *causes* performance, only that it indicates performance. If diversity is not controlled, size mixes market-share and diversity and has no impact on performance. Size gained through diversity alone damages performance.

A related result comes from the intersection of strategy and finance. It is that acquisitions are usually value-reducing. About two-thirds of acquisitions reduce the value of the acquirer, and one-third increase the value of the acquirer. The source of value destruction appears to be the large premiums paid to obtain control.

The Practice of Corporate Strategy

Now the fact that we have pretty clear answers to these questions does not mean they are settled. The business press loves size as do investment bankers and many senior executives. Daimler-Benz’s plan to acquire Chrysler was called “brilliant” by Wall Street analysts, largely because there is no overlap between the companies. More recently, Time Warner chairman Gerald Levin said of the acquisition of Turner Broadcasting, "This is the company that I've always dreamed of and we are now here, complete, one team and one family." In explaining the rationale for the combination, he said that his company owned cables and Turner had programs to move over the cables, so they were a “strategic fit.”

AT&T and BT have just announced discussions to combine their companies. Are there global economies of scale in telecommunications? The economics of a world network is that plugging in anywhere give you access to the whole thing. Can AT&T plus BT give multinationals better service? Only if they are US-British in scope *and* if the customer is foolish enough to use the advice of service providers rather than work with an independent consultant to design the best communications set-up for their needs.

One only has to read the business press on a regular basis to get the point: big business is about combinations, and the logic of these combinations has nothing whatsoever to do with business or corporate strategy as we think of it. Rather, the logic of these combinations is what might be called “strategic assembly.” It amounts to envisioning a mix of businesses that seem to have some family resemblance, and then to assemble them into a single firm, paying little or no heed to the literally enormous premiums that must be paid to do so and the often stupendous problems of organizational co-alignment that must be solved if any synergies are to be obtained.

The business world flunks our final exams every day; the logic we use in the classroom and the best logic deployed by the consulting industry have little real impact on practice. We argue about the right way to relate businesses one to another, we examine the details of organizational

practice that allows flexibility in the face of rapid change, we pile nuance upon nuance in the study of competitive strategy. Yet in the real world, people who have very different ideas about corporate strategy control the bulk of the assets. Yes, there is the occasional Jack Welch, but the very large bulk of corporate strategy moves are simply strategic assembly.

The best business writing is, of course, about real corporate strategy issues. And the enormous growth and success of the fast-paced U.S. electronics industry makes it the template for much current strategic thinking. The best of breed in this industry are indeed remarkable firms, combining efficiency and innovation to a degree thought impossible until recently. Yet it is also worth noting that the electronics industry business segments tend to be dominated by new firms, by relatively "pure plays." As one looks across the electronics landscape, the strongest players in the fast-growth segments are firms that have aggressively pushed aside larger, more diversified, more "competence rich" corporations. Microsoft, for all its size, is essentially a pure-play grown large---compare it to IBM or SDC or any other firm that had software skills in 1982. Cisco Systems is a garage operation that has pushed aside AT&T, Northern Telecom, Alcatel, Siemens, etc. When these firms are growing, taking big risks in the first full flush of their success, they don't diversify, they don't engage in strategic assembly. They know that focus is essential to success and they pour all their efforts behind innovation and staying ahead of the curve. It is only later, when the entrepreneurial spark has dimmed, that strategic assembly replaces strategy.

Why is this so? For the reasons we all know. Because growth is more exciting than efficiency. Because innovation is rare. Because trusted very smart advisors earn large fees by helping to make deals. Because when you are faced with a problem that is intractable, there are only two real alternatives: the honorable course of handing it over to someone else who may be better qualified to deal with it, or the exciting course of burying the problem in a much larger assembly. By merging and growing the firm, old problems become someone else's problem and may even "go away" as reorganization and realignment redefine the issues faced by management.

What can be done about it? Make management a profession. Move from the pre-classical to the Hippocratic era. Write cases about bad practice. Develop journals and news media that criticize business the way the press examines the political arena. Refuse to help a client do harm. The essence of being professional is not technique, but integrity.

Managerial Logic

Before you assume that I am a hopeless cynic, or move to agree with me that corporate strategy is a sham, it is important to examine the third fundamental question: what should be the organizational or managerial logic of the corporation? In this area, interesting things are happening, mostly led by practice.

Chandler [1962] chronicles the innovation of the M-Form at DuPont in 1921, a new administrative structure responsive to the inability of top management to plan and coordinate the operations of an increasingly diversified product line. The M-Form structure assigned to top management the entrepreneurial and administrative roles. The entrepreneurial role was that of determining strategy and the proper accumulation and deployment of technical and physical resources. Administratively, top management's role was to monitor and evaluate the performance of the operating divisions and their managers.

By the mid-1970s the continued growth and diversification of M-Form companies, together with the views on size, organization, and management then dominant in US society, had created what I call the *Full-Fledged M-Form*. This type of organization differed in several ways from the original M-Form:

- The FFM-Form possessed at least two levels of "division" managers. Normally, business units were aggregated into groups, which then reported to top management. In some cases, like General Electric, SBUs[1] managers reported to business units, which reported to divisions, which reported to sectors, which finally reported to headquarters, giving five layers of general managers.

- The FFM-Form delegated the entrepreneurial function of strategy to the divisions or SBUs. Higher levels of general management sat in a review capacity over the plans generated by lower level managers.

- Aided by tools such as the BCG Portfolio Chart, top-management strategy at the FFM-Form centered on acquisitions and divestitures and the pattern of cash generation and cash use among the business units.

- The FFM-Form took great pains to eliminate the sharing of resources whenever possible. The objective was to give each business full control over the resources necessary to carry out its mission and, therefore, to generate clear and comparable measures of business performance.

- Although the FFM-Form attempted to maintain patterns of relatedness among businesses, the end result of long logical chains of relatedness was that General Electric operated in jet engines and broadcasting, General Mills operated in breakfast cereals and knitwear, and Eastman Kodak operated in photographic supplies and pharmaceuticals. With this level of product diversity, top management had little choice but to control via financial results rather than provide strategic leadership.

The fascinating thing that has happened in the last fifteen years is the eclipse of the FFM-Form. It has not been replaced by a single new doctrine, but by an era of organizational experimentation and innovation.

With hindsight it seems evident that the FFM-Form took things "too far." In particular, it seems apparent that corporate managers in the FFM-form can all too readily lose contact with the human system. In addition, one can observe that it tended to substitute acquisitive growth for Schumpeterian competition. Additionally, the FFM-Form replaced strategic thinking based on the detailed specifics of a business with easy to digest bland generalities. Indeed, the incremental, periodic re-balancing of the portfolio on the Spartan basis of "feed the successful; starve the weak" served to stifle attempts at renewal or renaissance within the organization. Its eclipse seems to be due to challenges from new quarters: Japanese competition, an invigorated market for corporate control, deregulation, globalization, and advances in information technology.

In general, the interest in "transformation" and the cacophony of voices providing different views about corporate management all stem from the collapse of the FFM-Form as a dominant paradigm. The quest is now to move beyond the logics of the FFM-Form and hierarchical coordination—to undo what was yesterday's "ideal form" and develop a new managerial logic. The task is difficult because incremental adjustment doesn't help and because there is no clear outstanding model to emulate. In general, the kinds of initiatives transforming companies have undertaken are these:

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[1]Strategic Business Units (SBUs) were the smallest unit responsible for having strategic plans.

1. *Delayering*. The creation of "flat" organizations, or "horizontal" organizations, is accomplished by removing middle-management roles, decentralizing authority, and dramatically increasing the span managed by senior officers. The idea is to eliminate waste and bureaucratic impediments to action. It is also claimed that a delayered organization, like a "just-in-time" factory, is less complex and hence easier to comprehend, evaluate, and lead.
2. *Vision*. As companies increase their focus there is a simultaneous demand for decentralization of entrepreneurship and overall guidance for the whole. The idea of strategic "vision" has come to replace the portfolio charts of the FFM-Form. "Vision," like "intent," implies an overall sense of direction that guides but does not direct the strategies and actions of individual business units.
3. *TQM*. Total Quality Management programs have played a significant role in altering the managerial logic of Western companies. At first seen as somewhat "soft," these programs have proven themselves to hard-headed cost-conscious managers. The heart of the program is establishing the legitimacy of a superordinate goal other than profit and generating the coordinative mechanisms to follow through on its accomplishment. Companies have found that product quality, or customer satisfaction, is a much more motivating goal than owner's profit. They have also discovered that the coordination created by TQM programs helps identify new efficiencies. Finally, they have discovered that savings from higher quality more than pay for the effort.
4. *Coordination*. At the heart of many transformations is a move away from incentive-based individual action and hierarchical coordination. Instead, the new managerial logic emphasizes close coordination between units, sharing of information and resources, and the use of cross-functional teams to solve problems.
5. *Decentralization*. For many companies, shedding bureaucracy means increased decentralization—more operating autonomy and responsibility for business units. This managerial logic is in line with a long-term trend in Western management practice, but it can come into conflict with the logic of vision-led strategy and tight coordination.
6. *Speed*. Quality or customer orientation replaces abstract profit goals with more tangible intermediate objectives; another objective frequently placed in this role is *time*. Many companies have turned to time-based definitions of competitiveness. Some stress faster factory throughput, others look at speed of response to customer orders, while others focus on the speed with which business managers respond to opportunities or threats.
7. *Empowerment*. Moving from hierarchical to mutual-adjustment modes of coordination and problem solving *requires* empowering employees. If these modes are not required, empowerment may not be necessary. Some firms have mistakenly tried to empower employees without changing the other aspects of their managerial logics, with predictable results.
8. *Leveraging*. Benchmarking and leveraging internal capabilities are specific areas of coordination and resource sharing that deal with intellectual capital—the firm's capabilities. Under this new logic, managers are expected to seek out best practice and install it in their own operations. Managers who have best-practice operations are expected to help spread the know-how to other units.

These elements of managerial logic all (except decentralization) represent departures from the logic paradigm of 1980. All have helped some companies make a transition to a new way of managing. And while there is a great deal of emphasis on decentralization in almost all

transformation programs, these changes in logic actually represent a considerable increase in the role of the senior management group. Delayering pushes tasks that were previously assigned to middle managers both up and down. Vision-led strategy burdens the CEO with a much greater responsibility for entrepreneurial leadership than did the old methods of financial or strategic control. And the old “full autonomy” has been replaced by a set of principles and methods—empowerment, re-engineering, time-compression, etc.—that each business manager is expected to master. The new logic of decentralization no longer means “do what you want, just make your budget;” it now means “make your budget *and* walk the talk.”

Conclusion

Corporate strategy is both sick and well. Within those firms that have taken seriously the need to be both innovative and efficient, and to seek out new ways to coordinate across functions, businesses, and geographies, corporate strategy is about organization and management. Within the larger group of corporations which have been protected from this necessity, or which have developed protections against shareholder revolts, corporate strategy continues to mean strategic assembly.