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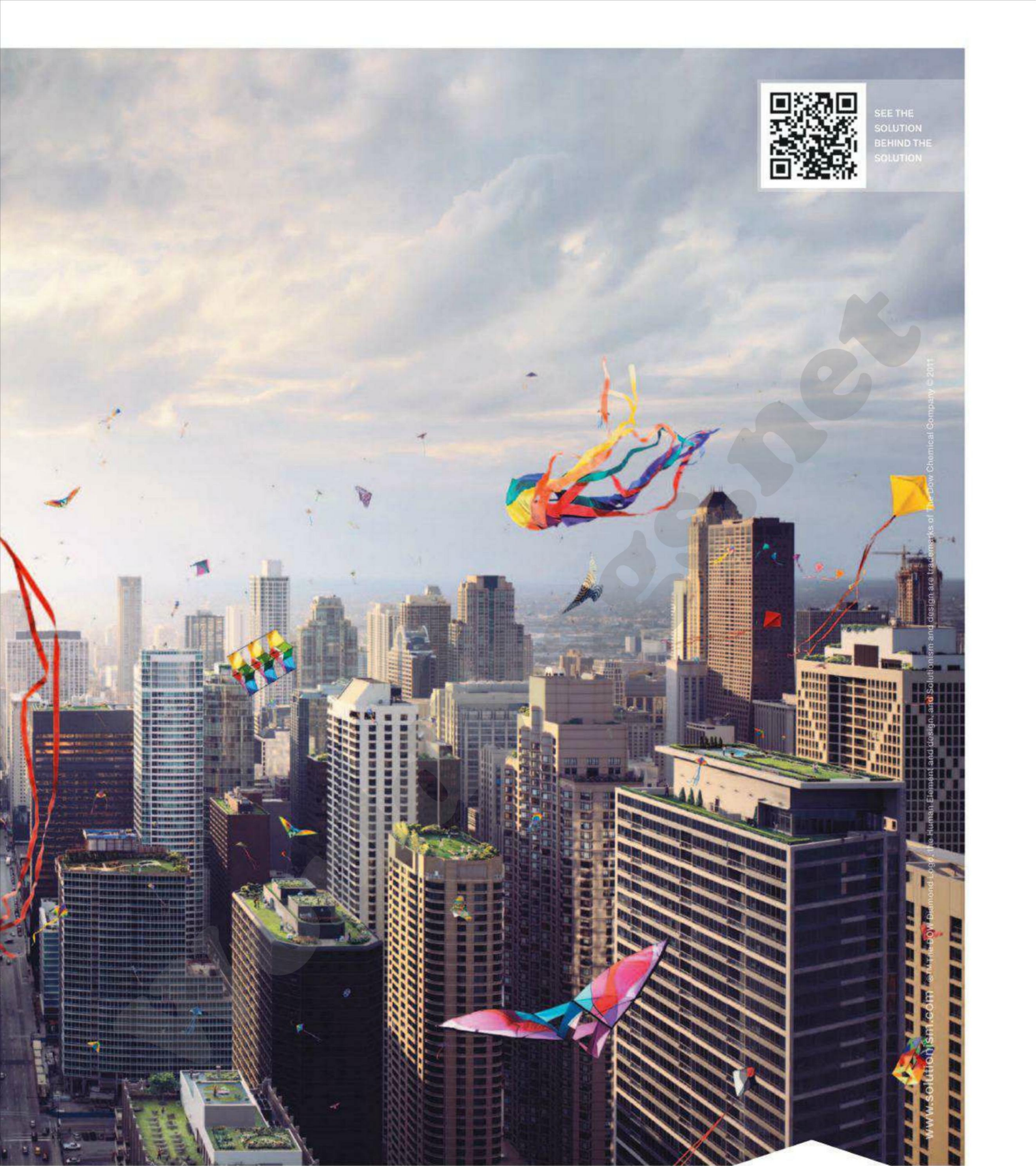
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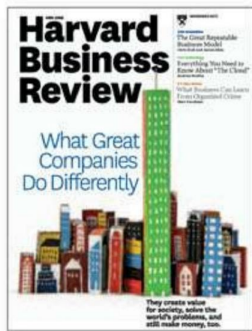
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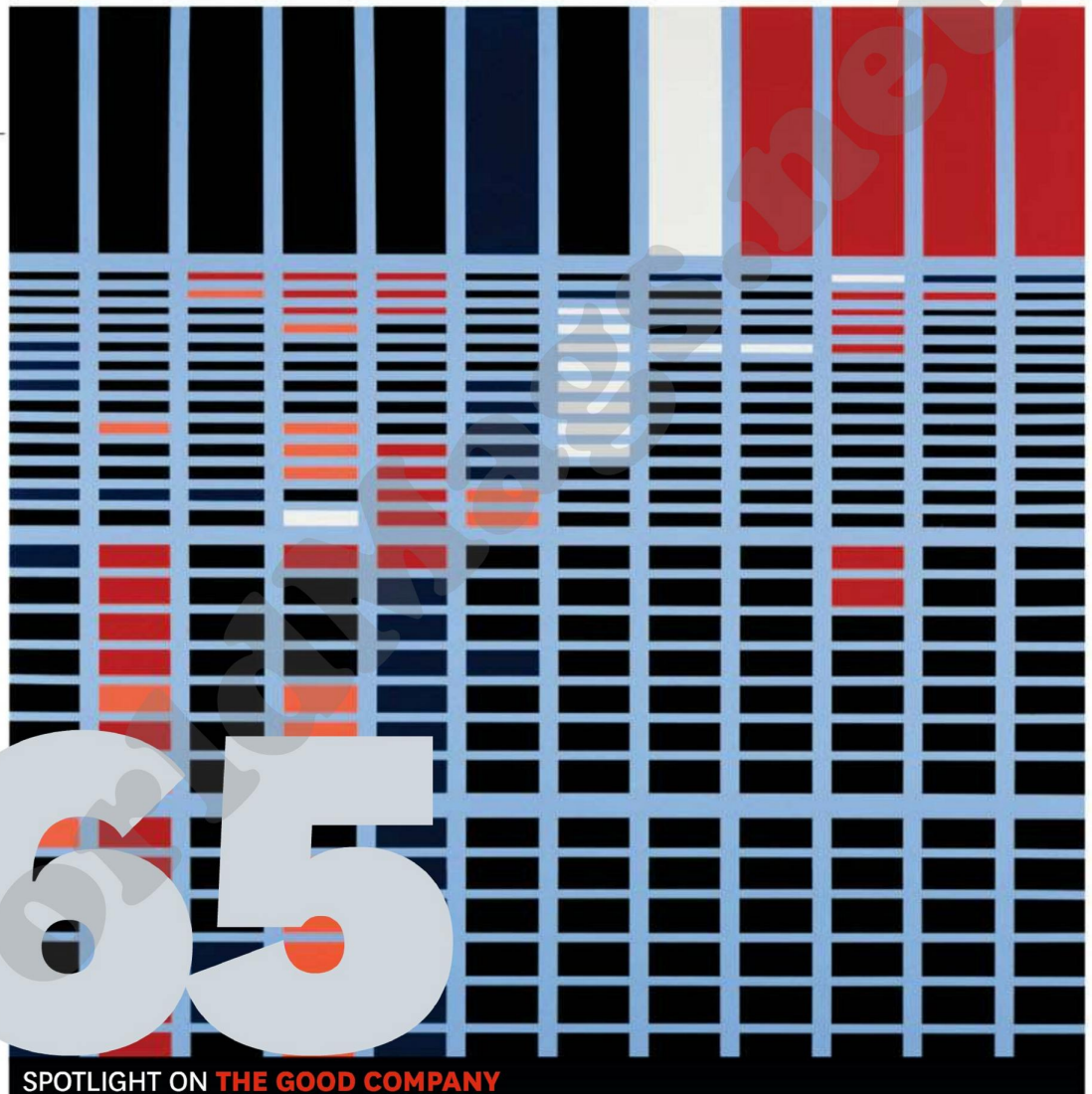


PORSCHE



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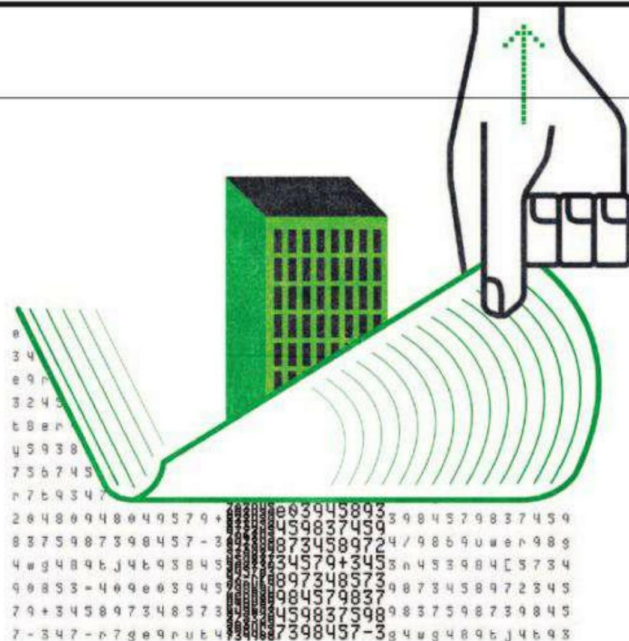
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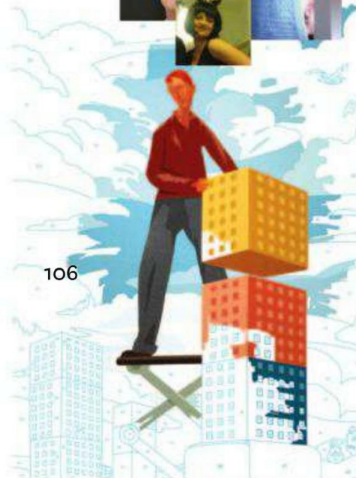
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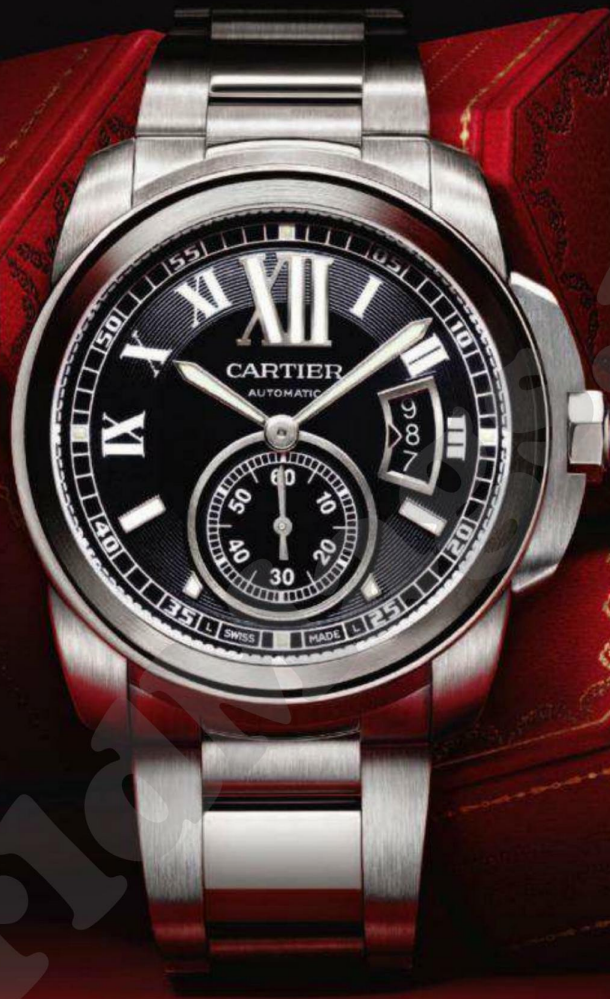
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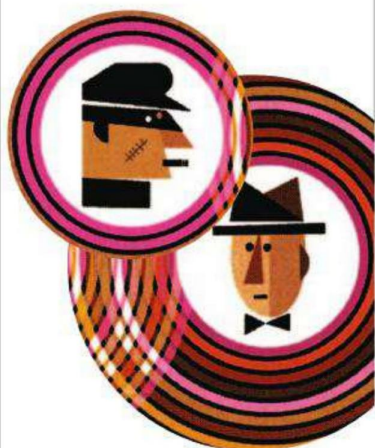
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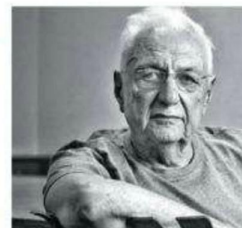
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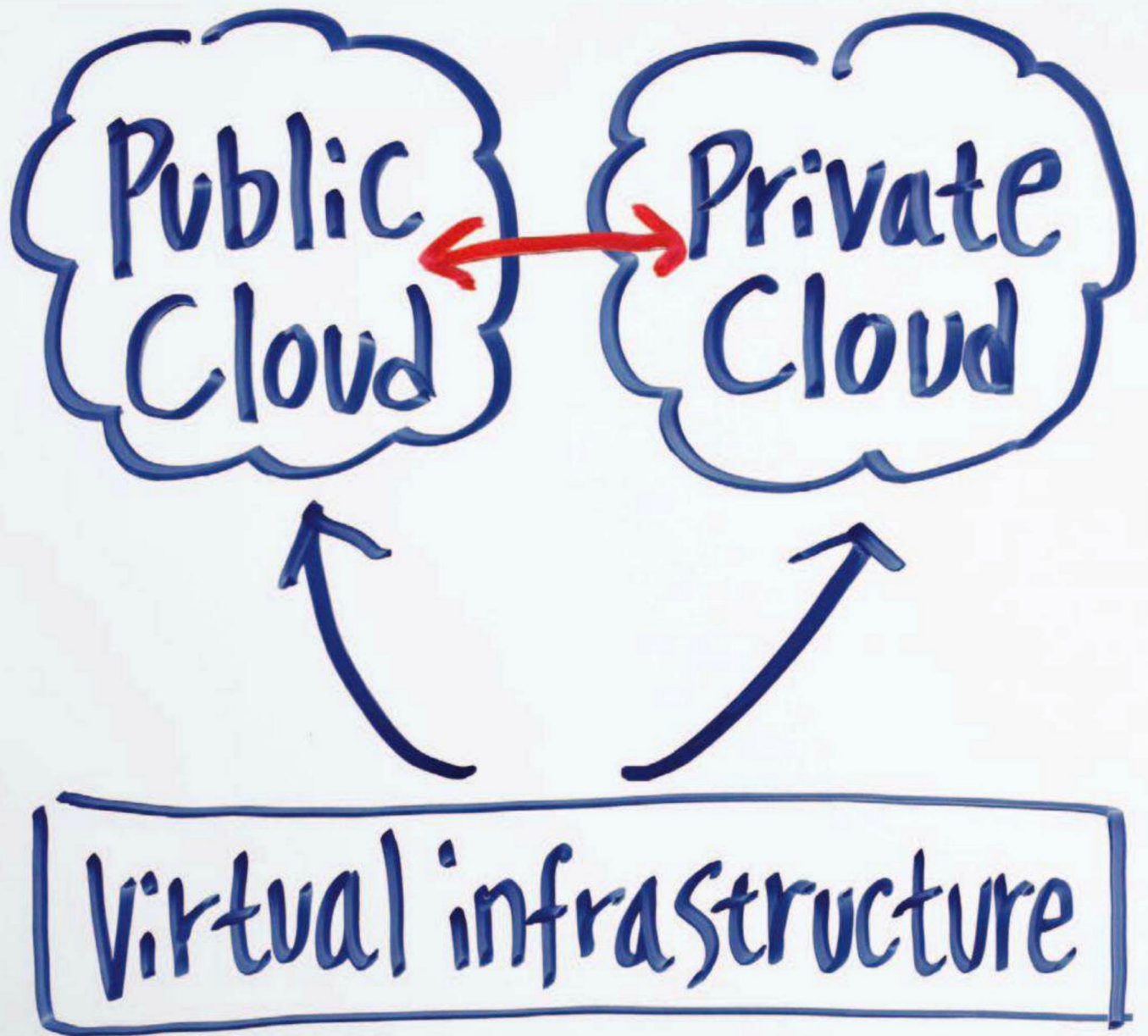
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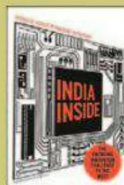
WEBINAR

Harvard Business School professor Tarun Khanna debunks the common wisdom about selecting emerging markets on November 3 at 12:00 PM EST. Register at hbr.org/multimedia/webinars.



VIDEO

Watch commentary from the CEOs profiled in this month's article "Fire, Snowball, Mask, Movie: How Leaders Spark and Sustain Change" at hbr.org/spark-sustain.



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Organizations don't have to choose between people and profits, says Michael Beer, a coauthor of *Higher Ambition: How Great Leaders Create Economic and Social Value*. hbr.org/multimedia/audio

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From the Editor

Getting to Good

A few months ago, the editors at HBR set out to produce a Spotlight on the “good” company. The challenge was deciding what in the world that meant.

Any manager will tell you that his or her company stands for more than just the bottom line: It takes care of its workers, limits its carbon emissions, improves the welfare of its communities. Google’s unofficial slogan, “Don’t be evil,” sums up the attitude. It might sound airy, and Google’s critics say the company does sometimes cross over to the dark side. But inserting such an ambitious principle into its mission statement helps ensure that managers will at least reflect on the slogan’s meaning with every big decision they make.

Notions of good practice change over time. In the early 1900s Henry Ford fattened his workers’ paychecks to help turn them into consumers. Later, big companies began rewarding employees for their loyalty with jobs for life. In recent years corporate social responsibility became an imperative. Now, in the information age, when we can more easily measure our effect on the world around us, companies are increasingly taking responsibility for their big footprints. Perpetually running counter to all this, of course, is Milton Friedman’s famous observation that the only true responsibility of business is to make money. As long as that happens, the argument holds, benefits will flow freely to society.

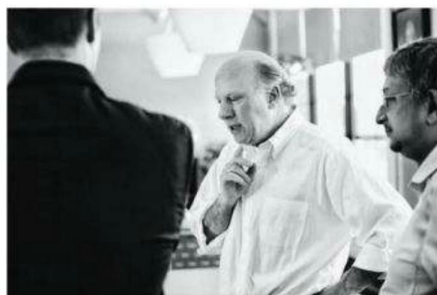
In this issue, beginning on page 65, we take a fresh look at the meaning of “good.” Harvard Business School’s Rosabeth Moss Kanter leads off with her research showing that the best companies build into their institutional logic the principle that they are not merely vehicles for making money but also enduring instruments for accomplishing societal purposes.

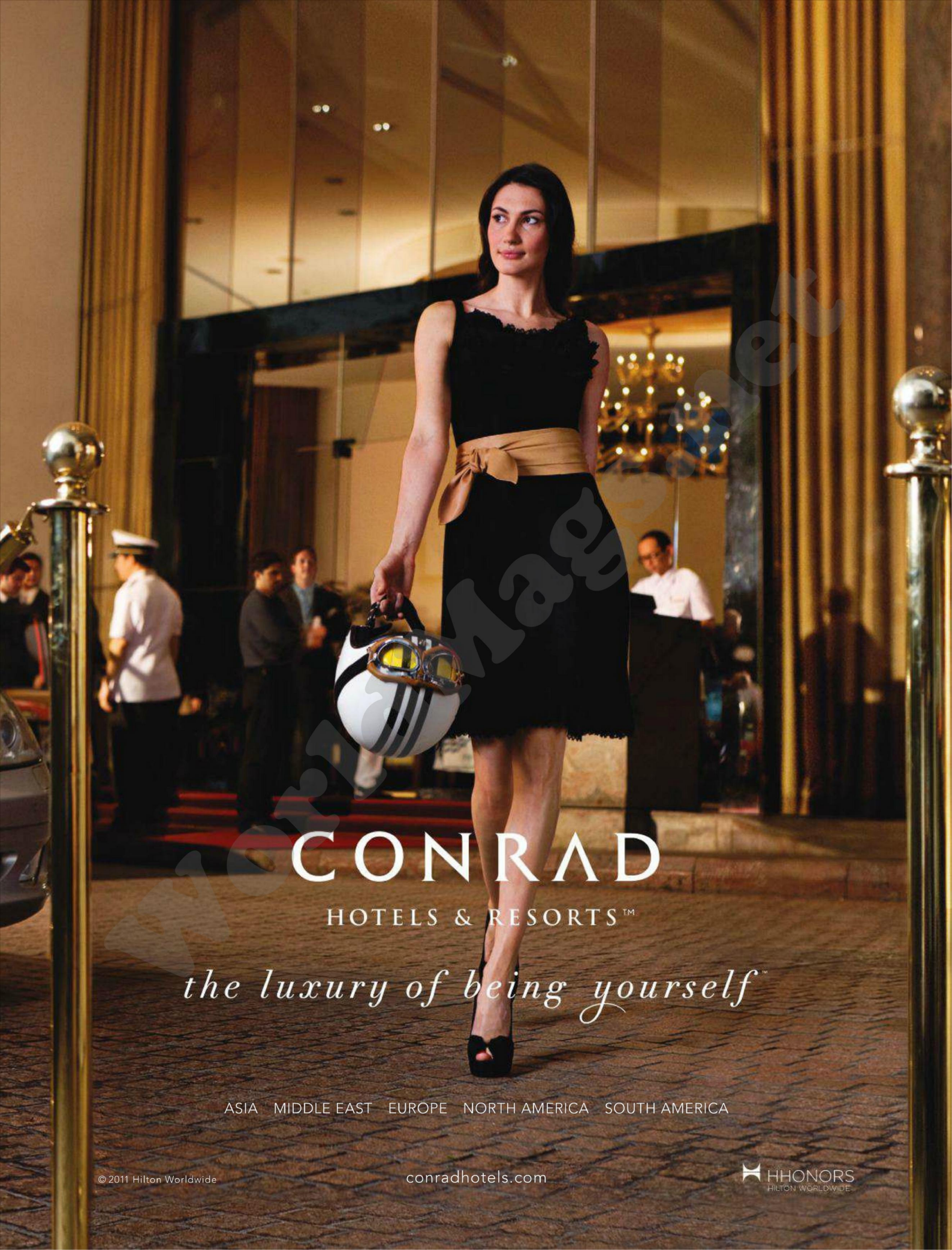
To complement her findings, we provide short profiles of five companies, selected by a panel of experts, that have achieved a level of goodness by excelling in one or more of these key areas: employee relations, community engagement, supply-chain management, environmental protection, and corporate governance.

It’s hard to be good. But more and more, the public demands it.



Adi Ignatius, Editor in Chief





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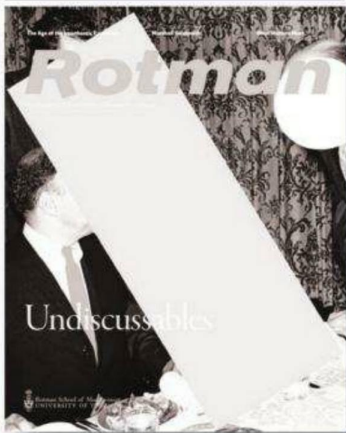
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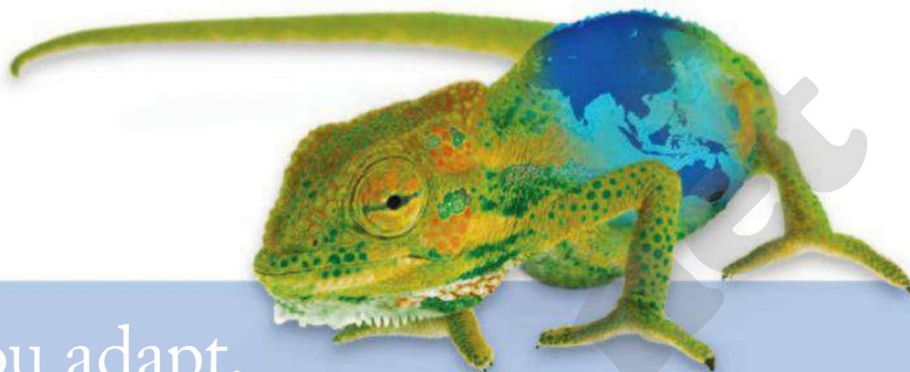
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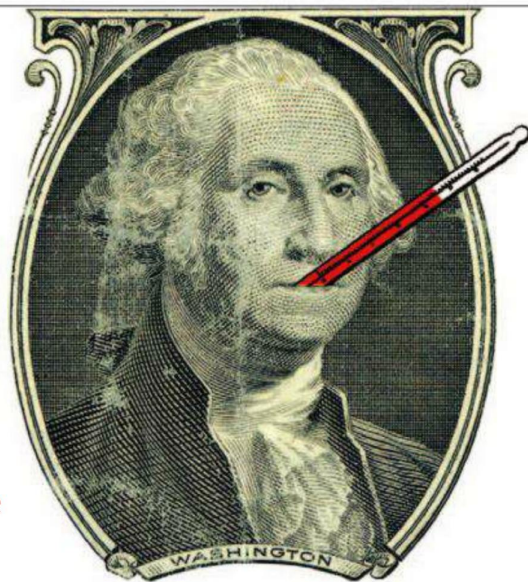
Interaction



How to Solve the Cost Crisis in Health Care

HBR article by **Robert S. Kaplan** and **Michael E. Porter**, September 2011

“U.S. health care costs currently exceed 17% of GDP and continue to rise,” say Harvard Business School professors Kaplan and Porter. They trace spending to its source: health care providers. Doctors, nurses, and specialists do not understand the value of medical care to the consumer; they overspend because they can’t accurately measure health outcomes. The authors take a look at providers that are measuring costs the right way, and then prescribe a cost-measurement system based on individual patient conditions.



Kudos to Robert Kaplan and Michael Porter for their illustration of careful process analysis and cost accounting in health care. Their idea is terrific—but it is hardly novel. Geisinger Health System in Pennsylvania and Intermountain Healthcare in Utah have long employed process analysis, and in my 1997 book, *Market-Driven Health Care*, I advocated activity-based costing of medical care bundles, which I called “health care focused factories.”

Kaplan and Porter barely mention, however, that people are not fungible, so their costs cannot be measured like the costs of

widgets in manufacturing. Some patients are much sicker than others. A process frequently called risk adjustment accounts for these differences. The impact of risk adjustments on costs can be enormous. In a risk-adjustment and activity-based costing analysis that my students and I performed for a total-knee-replacement procedure, we found that while the average payment was \$35,000, the top decile averaged \$615,000. Useful risk adjustment requires complex statistical analysis. If it were done as the authors suggest, by simply adding comorbidities, the analysis could create

thousands of different products, each requiring separate analysis.

Furthermore, the implementation of activity-based costing can “solve the U.S. health care cost crisis” only if, as the authors suggest, payers switch to reimbursing providers for value and bundles of care. But those adopting the Kaplan-Porter methods could repeat the mistakes of the California health care providers that used process analysis to price their offerings to insurers in the 1990s: Many suffered substantial financial losses, in part because their prices lacked risk adjustments and reinsurance to protect them against adverse selection by very sick patients.

Regina E. Herzlinger, Nancy R. McPherson Professor of Business Administration, Harvard Business School



Why Your IT Project May Be Riskier Than You Think

HBR article by **Bent Flyvbjerg** and **Alexander Budzier**, September 2011

The authors’ research found that one in six IT projects finishes wildly over budget, with an average cost overrun of 200%.

The article avoids the root cause of IT failures: the lack of a framework for effective collaboration. Far too many organizations can’t do joined-up think-

ing across the enterprise. I see only one universal language that can facilitate this essential communication: the language of end-to-end business

process management. Combine that with the ubiquitous need for compliance, and it’s clear why effective process management is emerging as a core capability for Enterprise 2.0.

Michael Gammage, VP product marketing, Nimbus Partners

Outlining how the project will potentially affect both internal and external people (for example, partners and customers) is essential to understanding the project’s



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The authors respond: *We are pleased that Professor Herzlinger endorses our approach of building cost models based on good process maps, but her letter contains numerous errors. Like many in the health care sector, she confuses charges with costs (Myth #1 in our article) when she describes her students' analysis of the variation in total-knee-replacement payments. She errs in her assertion that we introduce an adverse selection problem. We explicitly solve the problem by capturing costs at the individual patient level. Providers and payers can use patient-specific information to explain and predict the cost and outcome variations caused by some being "much sicker than others." Herzlinger asserts that we assume all patients are as alike as widgets. Just the opposite! Our approach captures how costs vary when providers respond to the different medical needs of individual patients. And her concern that costing thousands of different patient types would be complex is unfounded. The scale of the model is driven by a provider's different processes and resources, not by the number of different types of patients it serves.*



risk factors. And incorporating them into a risk-management plan helps companies better navigate through tricky project waters. Savvy IT and project sponsors acknowledge that human factors must be considered when building the business case.

Alicia A. Lewis, manager,
PricewaterhouseCoopers

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Problem



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Embracing Complexity

HBR interview with **Michael J. Mauboussin**
by **Tim Sullivan**, September 2011

Legg Mason chief investment strategist **Mauboussin** has developed a healthy appreciation for our complicated world. He contends that the world is full of complex adaptive systems, such as ant colonies, where you can't understand the system by looking at the behavior of the individuals—and so can't readily identify cause and effect.

I claim there is no such thing as “complexity theory.” A theory usually has some basic equation, a characteristic constant. What does this one have? Also, if something constitutes the central concept in a theory, it should be measurable. And if you can't measure it, you can't manage it.

Jacek Marczyk, founder and chief technical officer, Ontonix

Using the definitions of scientific measurements in a social interpretative paradigm is like using the rules of football during a volleyball match.

Rudy Snippe, PhD candidate,
Nyenrode Business University

Goodhart's Law states that when a measure becomes a target, it ceases to be a good measure. Complex systems are never measured or managed, they are only served.

John Maloney, founder, Net Intelligence

We don't have to prove complexity theory because we see it at work every day—if we are willing to look. All measurement in itself builds on assumption and theory and produces no more than data points. The worst illusion is believing that data correlations prove causation. All causation is assumption, and therefore so are all conclusions drawn from measurement.

Max J. Pucher, chief architect,
ISIS Papyrus Software



Stopping the Mid-Career Crisis

HBR blog post by **Athena Vongalis-Macrow**, September 2011

Mid-career professionals are more likely than others to experience career transitions as crises, says Vongalis-Macrow, and she blames lack of leadership intervention. During this pivotal time, leaders should actively show that the organization needs them.

Wearing a mask and playing the good soldier when you are unfulfilled is a sure ticket to a midlife crisis. Bosses, colleagues, and HR staff need to ask better questions—not just about the jobs employees are doing, but about who they are and want to be. It is no longer enough to be a faceless drone. Companies need employees to give a damn.

David Kaiser, CEO,
Dark Matter Consulting

A mid-career transition is a great opportunity for a leader to help an employee assess her current interest areas and identify areas of satisfaction as well as development opportunities. In addition, a leader can look at burnout areas and determine if there are opportunities to rekindle that interest.

Bette Krakau, senior consultant,
Career Systems International



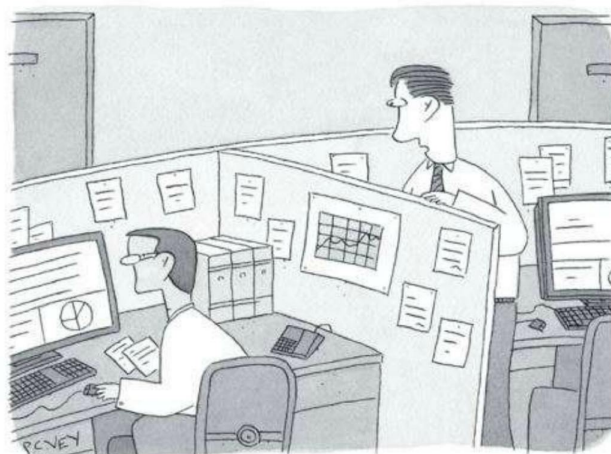
The best solution is a macro solution, entrepreneurship, which needs to be funded and nurtured with much greater emphasis than what we see in today's market. The leaders of today and tomorrow aren't coming from the ranks of corporate veterans anymore. The leaders of today are college students with a huge passion for innovative ideas and technology.

Myron Murray, owner and CEO, DW Strategists

So what exactly is mid-career?

Sankhya, online commenter

Author responds: *Mid-career is not about age but about work, goals, and aspirations. I presume that many younger people may experience more than one mid-career crisis as they change jobs and have successive careers. The premise is the same: Expect more from leaders.*



“if anyone asks, I'm in the cubicle next to yours doing pretty much the same job.”



Was Marx Right?

HBR blog post by **Umair Haque**,
September 2011

Although a self-proclaimed “staunch believer in capitalism,” Haque argues that Marx’s critiques of industrial age capitalism resonate in the context of today’s volatile economy. Marxist or not, Haque forecasts huge shifts in capitalism’s future.

When Marx sat in the British Library studying dry economic reports, he was trying to understand the basic mechanisms of capitalism. He discovered how capitalism naturally moves through boom-and-bust cycles, how it is perpetually in crisis, how value is created by labor, how

some capital must be destroyed to restore profit margins, how unemployment levels are used to control the price of labor, and much more. Having an accurate picture of capitalism is essential no matter which political party you subscribe to, but unfortunately, we can’t look at Marx’s work in this area without triggering partisan responses from both the left and the right, which is a shame.

It’s time to look at Marx with fresh eyes. Our economists and politicians are continually surprised by economic busts and try to avoid or mitigate them, yet they are a fundamental characteristic of capitalism. Politicians point fingers of blame as if the busts can be avoided. They can’t. It’s high time to rediscover capitalism’s fundamental cycles and integrate them into government plans so that we aren’t surprised by events that are natural to our economic

system. That’s not Marxism or communism—it’s just plain common sense.

Tom Foremski, publisher, Silicon Valley Watcher

Capitalism is probably the most efficient way we can distribute wealth within a society. It may lead to uneven distribution, but at least things get distributed. We typically do not have bread lines and mass starvation in free capitalistic societies. One problem we do see is people becoming complacent. Things are good. Why worry? But when a populace becomes complacent, its governing body starts to seize more and more power. Power corrupts. Capitalism ends. Government abuse of power ensues. Tyranny. Revolt? We will see.

Ford White, computer programmer and technician, Unison Micro-computer Center



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Idea Watch

New Thinking, Research in Progress hbr.org



FIRST

What Business Can Learn From Organized Crime

Global criminals are now sophisticated managers of technology and talent. A guide to their best practices by Marc Goodman

When 10 men attacked the Taj Mahal Palace hotel in Mumbai, in November 2008, they executed one of the best-orchestrated, most technologically advanced terrorist strikes in history. Before the assault they had used Google Earth to explore 3-D models of the target and determine optimal entry and exit routes, defensive positions, and security posts. During the melee they used BlackBerrys, satellite phones, and GSM handsets to coordinate with their Pakistan-

based command center, which monitored broadcast news and the internet to provide real-time information and tactical direction. When a bystander tweeted a photo of commandos rappelling from a helicopter onto the roof of one of the buildings, the center alerted the attackers, who set up an ambush in a stairwell. It took three days for authorities to kill nine of the terrorists and arrest the tenth; his confession provided details of the operation, which had resulted in 163 deaths and hundreds of injuries.

Atrocities like this one are an extreme example, but the fact remains that technology is increasingly put to nefarious uses. Consumers and businesses must deal with the results, from small-bore, almost laughable “I’m stranded in England please send money” e-mail scams to large-scale appropriations of credit card data. During the 25 years I’ve spent in law enforcement—as a police officer, a counterterrorism consultant, and, for the past decade, a cyber-risk and intelligence specialist—the most striking trend I’ve seen is the growing sophistication of global crime syndicates and terrorists (the former are now believed to bring in \$2 trillion a year). Some of this isn’t new: Colombian drug cartels, for instance, have been technologically advanced since the days of *Miami Vice*. But more-recent international crime groups, including the Russian Business Network, South America’s Superzonda, and the worldwide ShadowCrew, have become especially adept at expropriating legitimate business tactics to create highly efficient global teams and set new best practices in adaptive strategy, supply chain management, the use of incentives, global collaboration, and other disciplines. Here are five lessons companies can learn from the activities of such groups:

Use the news to create opportunity.

Criminal groups have made an art of scanning the environment and quickly deploying technology to capitalize on what they find. Within hours of the 2010 Haiti earthquake, for example, scammers were circulating e-mails urging people to use Western Union to wire money to the British Red

Cross. The cause sounded noble—but the British Red Cross doesn't accept donations by way of Western Union. Ever-adaptive criminals are also creating "Text this number to donate \$10" scams after disasters.

Thieves are exploiting long-term technology trends as well. While corporations struggled to monetize their social media followers, criminals quickly figured out that tweets and Facebook updates were invaluable tools for planning home burglaries and that social media data could facilitate identity theft. *The lesson: Watch the headlines, move quickly, and try to get out in front of developing trends.*

Outsource to specialists. Modern organized crime has abandoned the top-heavy structure of dons, capos, and lieutenants made famous in *The Godfather*. Most of today's gangs, along with Al Qaeda and other terrorist groups, are loosely affiliated cooperative networks—and are as likely to recruit website designers and hackers as they are thugs and enforcers. They routinely turn to niche markets for specific expertise. (For instance, Dubai offers the best talent for laundering money.) They are con-

Many criminal groups attract people who seek intellectual stimulation—not unlike the people drawn to the work environment of a start-up.

stantly networking to develop sources with the specialized skills they need, much as Hollywood studios scout for talent to cast a given film. For example, identity theft specialists know where to find artists who can replicate the holograms on ID and credit cards, and they routinely utilize a call center in Russia whose multilingual employees work 24/7 and are accomplished at making fraudulent calls to banks during which they might impersonate anyone from a rich Italian housewife to a Brazilian doctor. *The lesson: Don't limit yourself by overreliance on in-house talent. Cultivate e-lancers and other contractors who can provide the precise skills your project demands.*

Cash isn't the only incentive. Criminal organizations pay well, both to compensate for the legal risks involved and

because their high profit margins allow them to. But they realize that team members usually aren't in it just for the money. Most enjoy the thrill of breaking the law. Many, particularly hackers, are also motivated by the challenges of sophisticated security systems and the bragging rights they gain when they foil them. Although criminal organizations still employ a fair share of thugs, they're increasingly attracting highly educated people who seek autonomy and intellectual stimulation—not unlike the people who are drawn to the risky, demanding work environment of a start-up. *The lesson: Socially oriented businesses aren't the only ones that can use workers' desire for meaning as a motivating force. Find a way to tap into employees' needs for recognition, challenge, and belonging.*

Exploit the long tail. Until the internet came along, many criminals pursued a "blockbuster" approach: They were always on the lookout for a single heist—say, a bank robbery—that could provide a huge payoff. Terrorists still strive for spectacular attacks, seeking to maximize the societal shock and disruption. But global criminals have learned that they can reap big profits by executing smaller operations over and over again—a strategy that allows for efficiency gains, continual improvement, and reduced risk. If you've ever been the victim of credit card fraud, you probably noticed a flurry of midsize purchases, usually made online; these can be received and forwarded by a "mule" who may not even realize he's part of an illegal scheme. (Syndicates often tell such mules they're part of an import-export operation.) The purchases on any one card might not exceed \$1,000. Multiply that amount by thousands of transactions, though, and the payoff becomes huge. The perpetrators of small but high-volume frauds also constantly conduct experiments aimed at improving results. They may use different subject lines in the same e-mail scam, comparing the response rates and then fine-tuning the language in the next round. *The lesson: A business model that aims for many small transactions instead of a single big hit can*





These four words were painted on our early aircraft. And our pilots still wear them with pride. In the lining of their jackets and on the peaks of their hats. They're rarely noticed, but they've always been at the heart of everything we do. Because they're not a slogan. They're a promise. We're committing to this promise once again, with the certainty that we face our future with the same pride we feel for our past.

To Fly. To Serve.
It's what we do. It's who we are.

PROTECTING YOUR BUSINESS FROM INFORMATION THEFT


CONTINUED FROM PAGE 28

result in larger long-term profits and provide numerous opportunities to improve efficiency along the way.

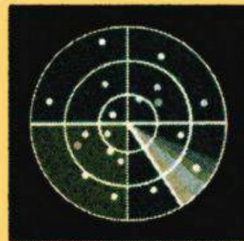
Collaborate across borders. Various radical Islamic splinter groups now work alongside Al Qaeda, even though the entities remain distinct. So, too, with organized crime: The Hong Kong-based triads and the Japanese Yakuza have joined forces to market synthetic drugs, and Colombia's cartels cooperate with Russian and Eastern European mafias to expand the reach of their products. Although "going global" has been an important way for businesses to extend market opportunities, the strategy delivers an additional benefit to organized crime: It can create legal obstacles for law enforcement officials, who often aren't as adept at cross-border collaboration as the criminals they're tracking. *The lesson: Don't look at competitors simply as rivals. Consider the mutual benefits of partnerships.*

COMPARING THE practices of criminal and terrorist organizations with those of corporations is by definition an imperfect exercise. Despite their sophistication and managerial prowess, crime groups are unconcerned with the human and social costs of their acts; they will remain ruthless no matter how many computer scientists they employ. But it's also true that as organized crime has come to rely more on technology for competitive advantage, its craft has developed a greater resemblance to the activities of law-abiding businesses. In some cases, criminal enterprises are now the ones pushing the frontiers of knowledge and innovation. Given the high profitability of global cybercrime networks and the limited threat they face from legal authorities, legitimate businesses will undoubtedly become targets more frequently. Managers need to pay close attention to the tactics being used against them—and perhaps even learn to profit from some of the global gangsters' insights. ▣

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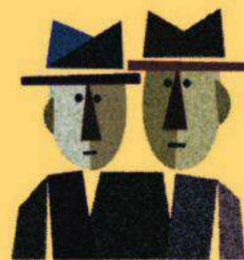
 **Marc Goodman** is a senior adviser to Interpol and the founder of the Future Crimes Institute.

Your security system needn't be perfect—it just has to be better than most. Routine maintenance can make a big difference. Cybercriminals continually do the digital equivalent of testing your doors and windows. Simply upgrading the locks—and actually using them—can cause criminals to move on to the next house. Here are four additional steps worth taking:



KNOW WHERE YOUR INFORMATION IS AND WHO CAN ACCESS IT.

This used to be simple: Employees came to the office each day and turned on their computers. Now people often work remotely, using laptops, smartphones, and tablets. And a vast amount of data is stored in the cloud, on servers whose location may be unknown. Though mobile and cloud computing drive big savings, they greatly complicate the task of securing data.



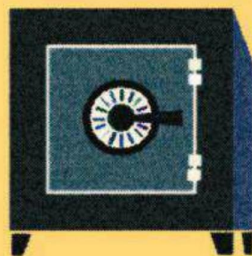
COLLABORATE WITH YOUR COMPETITORS ON SECURITY MATTERS.

As unnatural and unnerving as this may seem, it could be your single best defense against orchestrated attacks. Take a page from the book of criminal organizations, which regularly swap intelligence with one another (and use that intelligence to perpetrate new crimes). A united front on security, even though it means sharing ideas with your rivals, can make your company stronger.



ATTACK YOUR OWN IT NETWORK.

It might strike you as logical to set up a wide array of protective systems and wait until the alarm goes off, but purely reactive measures are doomed to fail. If you don't explore whether you can penetrate your own defenses, how can you know they're secure? Red teaming—simulating all the ways in which your adversaries might try to breach your security—can uncover serious gaps.



THINK BEYOND HACKING: PHYSICAL SECURITY AND PERSONNEL ARE IMPORTANT, TOO.

If your IT network is bulletproof but anybody can walk into your building and take documents the old-fashioned way, you've failed. And if your network and physical plant are safe but your background checks are lax and you inadvertently hire a hacker or someone with ties to organized crime, you've got an even bigger problem. Your approach to security must be comprehensive.



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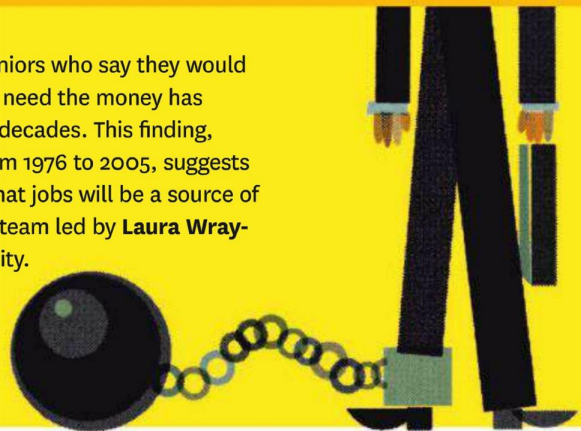
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Show Me the Meaning

The proportion of U.S. high school seniors who say they would work in adulthood even if they didn't need the money has dropped from 78% to 70% in recent decades. This finding, from an annual survey conducted from 1976 to 2005, suggests that fewer adolescents now expect that jobs will be a source of satisfaction, according to a research team led by **Laura Wray-Lake**, of Claremont Graduate University.

70%



MANAGEMENT by Carl Senior, Robin Martin, Michael West, and Rowena M. Yeats

How Earlobes Can Signify Leadership Potential

Evolutionary biologists have learned that people with greater “genetic fitness,” as manifested by a high degree of left-right body symmetry, are not just considered better looking but also tend to be healthier, more intelligent, and more dominant than others. They’re the classic alphas who rise to the top of rigidly hierarchical organizations such as the military.

But our research shows that people with subtle asymmetries—for example, imbalances in ear or finger length—are often better “transformational” leaders, able to inspire followers to put self-interest aside for the good of the group. Furthermore, teams they lead outperform teams whose leaders have more-symmetrical bodies.

These findings add a new twist to the debate about whether effective leaders are born or made. We believe it’s not asym-

metry per se that positions people to be good transformational leaders. Instead, we argue, these individuals’ childhood responses to others’ perceptions shape them for success.

In our study, conducted with Geoff Thomas and Anna Topakas, of the UK’s Aston University, 80 students filled out questionnaires exploring their leadership styles. In a second study, 42 students each led a small team that, using a computer simulation, spent 22 weeks manufacturing and marketing a car. In both studies we measured participants’ earlobes, wrist widths, and finger lengths and assigned them a score reflecting their degree of asymmetry.

The first study showed that highly asymmetrical people had greater self-reported leadership abilities—aptitudes for considering others’ feelings, recognizing

others’ needs, and inspiring others. The second showed that the more asymmetrical the leader, the better the team’s performance, according to independent assessments: Teams with asymmetrical leaders scored nearly 20% higher than others.

Although the sorts of asymmetries we examined are barely perceptible, humans are unconsciously sensitive to them. We posit that people born with asymmetries tend to develop greater empathy, social intelligence, and motivational skills as a way of overcoming perceptions that they’re unattractive or unintelligent. And those skills can be more helpful than pure dominance in attaining certain leadership positions.

We’re not the first to suggest that biology contributes to leadership potential. For instance, a recent twins study led by Sankalp Chaturvedi, of Imperial College London, indicates that 49% of transformational leadership qualities are genetic, and the psychologist Mark van Vugt has shown that humans evolved to value leaders with such traits as nonverbal sensitivity and self-sacrifice. We believe that organizations can benefit from a greater awareness of the many ways in which biological cues can influence leadership potential and that they should design leadership training to hone people’s abilities to encourage and inspire—particularly when people haven’t picked up those abilities naturally.

HBR Reprint F1111B

Carl Senior is an associate professor and **Robin Martin** is a professor at Aston University. **Michael West** is a professor at the University of Lancaster. **Rowena M. Yeats** is a doctoral researcher at the University of Birmingham. All four are in the UK.

WHAT'S YOUR SCORE?

Subtle asymmetries aside, most research shows that facial symmetry conveys beauty and can help boost careers. How symmetrical is your face? To find out, upload a headshot to anaface.com. Here are three CEOs’ results (a perfect score is 10):



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CHARLES SCHWAB

MARGARET C. WHITMAN
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Research Watch



It's Not What You Say but How You Say It

A leader with an attractive speaking voice—think of Bill Clinton—is more likely to be perceived as effective than one with an unappealing voice—say, George H.W. Bush. A team led by **Timothy DeGroot**, of Midwestern State University, in Texas, reached this conclusion after studying the speech patterns of 19 U.S. presidents and nine Canadian prime ministers, analyzing such elements as pitch variability, speech rate, and pauses. However, the researchers found no link between voice quality and *actual* effectiveness as a leader.



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MARKETING by Juliano Laran, Amy N. Dalton, and Eduardo B. Andrade

Why Consumers Rebel Against Slogans

Brand names, logos, and slogans are integral parts of any company's marketing message. All have the same aim: to make consumers react positively to a product or a business.

Our research shows, however, that many slogans backfire—for example, causing consumers to spend money when they're told they can save, or vice versa.

In five studies of several hundred undergraduates each, in which computers were used to simulate shopping behavior, we found that consumers typically follow the prompt of a brand name or a logo. After participants were exposed to brands associated with luxury (such as Tiffany and Neiman Marcus), they decided to spend 26% more, on average, than after they were exposed to neutral brands (such as Publix and Dillard's). After they were exposed to brands associated with saving money (such as Dollar Store and Kmart), they decided to spend 37% less than after they were exposed to neutral brands. The brands had the intended "priming" effect.

But when it came to slogans, the same participants exhibited the opposite of the desired behavior. After reading a slogan meant to incite spending ("Luxury, you deserve it"), they decided to spend 26% less than after reading a neutral slogan ("Time is what you make of it"). When a slogan invited them to save ("Dress for less"), they decided to spend—an additional 29%, on average. The slogans had a "reverse priming" effect.

LOGOS CAN BE TRICKY, TOO

Bigger isn't always better. Unsurprisingly, consumers of low-end goods favor unobtrusive logos—but so do many consumers of ultra-high-end goods, who prefer to send a quiet signal to others in the know.



SOURCE: JONAH BERGER AND MORGAN WARD, "SUBTLE SIGNALS OF INCONSPICUOUS CONSUMPTION," *JOURNAL OF CONSUMER RESEARCH*

In many cases, then, brands and slogans work at cross-purposes. For example, the name Walmart tends to induce thriftiness, but the company's slogan ("Save money. Live better") causes indulgence.

What makes slogans so different? Our studies suggest that reverse priming occurs because consumers recognize that slogans deliberately attempt to persuade them, whereas (in their perception) brands do not. The recognition may not be conscious: We found that consumers automatically resisted a slogan's message.

There's actually good news here for marketers, who need not simply abandon slogans for fear of adverse reactions. Slogans can exert a positive influence, we believe, if the consumer is led to focus on something other than the effort to persuade. To test this theory, we asked one group of participants to rate a set of slogans

on the basis of intent to persuade, while a second group rated them on creativity. The group that evaluated creativity decided to spend 58% more than the other group. Of course, getting consumers to focus on creativity instead of persuasion may be easier in a lab setting than in real-world marketing.

More research is needed to understand why consumers perceive certain tactics as efforts to persuade. In the meantime, marketers should be aware that messages seen even subconsciously as manipulative can cause significant backlash. ▣

HBR Reprint F1111C

Juliano Laran is an assistant professor of marketing at the University of Miami. **Amy N. Dalton** is an assistant professor of marketing at Hong Kong University of Science and Technology. **Eduardo B. Andrade** is an associate professor of marketing at the Haas School of Business at the University of California, Berkeley.



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Defend Your Research



HBR puts some surprising findings to the test

Eric von Hippel is the T. Wilson (1953) Professor in Management at MIT's Sloan School of Management.

People Don't Need A Profit Motive To Innovate

The finding: Innovations developed by individuals who give them away increasingly compete with patent-protected, for-profit innovations in many parts of the economy.

The research: Recent studies of representative samples of adults in the U.S., Japan, and the UK have found that many consumer products are developed by consumers themselves instead of by companies intending to sell them. For example, in the UK, 6.1% of adults had created or modified consumer products within the past three years. In aggregate, UK consumers spent 2.3 times more on consumer innovation than all UK firms combined. Only 2% of these innovating consumers patented their ideas, and many distributed them free of charge.

The challenge: Can innovation thrive if ideas aren't protected and paid for? **Professor von Hippel, defend your research.**

Von Hippel: There's no question that what we call user innovation—innovation by people and firms who invent things intending to use them rather than sell them—is increasing, for lots of clear economic reasons. Many costs associated with innovating have fallen precipitously because of advances in technology. Users are finding it cheaper and cheaper to develop exactly the products they want for themselves. We know that only a very small proportion of user innovators protect their ideas from imitators via patents or other means, yet innovation by users is thriving.

HBR: Why wouldn't people want to protect their innovations from being copied? Unlike commercial developers, users are motivated by the private return they get

from using their innovations. They generally don't expect to profit from selling them. If others do adopt the innovation for free, it often doesn't hurt the user innovators—in fact, it may even help them.

Say I build a new kind of mountain bike and ride it every day. I built it to use it, and I've gotten the private benefit I planned on as payback on my investment. So now I'm riding my new bike around and people see it, try it out, and ask me questions. At some point someone else decides to build a copy. Does that hurt me? No, it enhances my reputation, and that other user may make improvements to the bike that I can copy. If a bike company makes a commercial product out of my unprotected innovation and makes a lot of money from it, that may annoy me, but it doesn't affect

my original incentive for innovating. I got the reward I expected for the investment I made.

Same story with respect to user firms that innovate. Say a firm creates a new machine to use in its manufacturing process. My coresearcher Jeroen de Jong and I have found that the firm often will reveal its innovation to suppliers for free. Why? Because user firms frequently benefit if a supplier starts to build their innovations commercially: They don't have to keep building copies for themselves in-house. **Still, at some point it must pay to protect ideas. I don't see Gillette sharing its razor-production innovations.**

True, Gillette is tight about its blade-making machines. It's a big competitive advantage for them. In general, what we see is that the free sharing of ideas goes down as rivalry goes up. For example, a competitive biker may not reveal his bike improvement just before a race. Similarly, a manufacturer that thinks that a novel process machine it has developed is critical to its competitive edge will not reveal it.

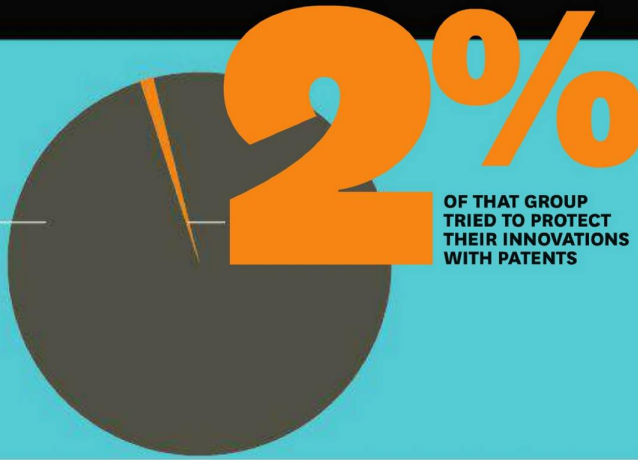
But users are not always rivals, and our research shows that they generally do reveal their innovations for free. **That thinking is a radical departure from current theory.**

True. Ever since Schumpeter in 1934, the fundamental assumption among economists and policy makers has been that only producers innovate, and that they do it in order to sell their creations. Without intellectual property protection, the conventional wisdom goes, there will be free copying, innovating producers' profits

Key Numbers

2.9 MILLION

CONSUMERS CREATED
INNOVATIONS IN THE UK



will shrink or disappear, and there won't be enough innovation to serve society's needs. At the same time, economists have always known that intellectual property rights were a devil's bargain. Society pays a huge price when it grants monopoly rights to people and firms. Monopolies created and supported by the patent system are known to increase prices and retard follow-on innovation.

But IP and the profits it produces fuel the economy. There's no growth without profit.

Companies compete on, and profit from, many things besides invention: brand, excellence in production, service, distribution, and so on. You can build a healthy economy around all those other things.

I have a hard time envisioning businesses participating in a user-innovation economy.

That's ironic, because businesses are living and thriving in a user-innovation economy right now! User innovation has not been measured previously because it's not supposed to exist, according to traditional theory. But my colleagues and I have now measured it at national levels in a number of studies—and the evidence is very clear that users today do generate a very important feedstock of free innovations that producers of both consumer and industrial products adopt and improve. I don't see companies complaining about it.

Are companies wising up to this paradigm shift?

Some have. More should. All eventually will. Think of platform companies that actually rely on user innovation, like Twit-

ter. Twitter knows well that its users are the ones who initially develop the new functions that the firm eventually adopts and monetizes. Think about video games where producers invite users to modify scenery and characters. In scientific statistics, researchers constantly develop tests they need, and statistical test sellers incorporate the most popular of these in their own commercial products. As a very recent example, think about Microsoft's experience with the Kinect accessory

Monopolies created and supported by the patent system increase prices and retard follow-on innovation.

it introduced for the Xbox 360. Shortly after that product came out, many users modified it and improved it and created new applications. Microsoft first deplored this "hacking" of its product by users. Then, within days, it reversed course and applauded and offered support to those same users. It recognized the potential for profit and mutual gains.

The traditional paradigm of "producers innovate—users don't" has turned out to be wrong. The model of freely shared innovation by users is steadily gaining ground. As firms and nations learn to adapt to it, users and producers will benefit, and so will economic growth. ♣

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Corporate Boards: Now and Then

Each year the executive search firm Spencer Stuart examines proxy statements for the S&P 500 to look for trends in the makeup of boards of directors. It has done variations of this study since 1987.* Here is an advance look at some results from its soon-to-be-released 2011 report—and at how much the world of corporate governance has changed during the past quarter century. ▽

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*THE DATA FOR 1987 COME NOT FROM THE S&P 500 BUT FROM A REPRESENTATIVE SAMPLE OF 100 LARGE COMPANIES.

Directors Are Older

As fewer sitting CEOs are willing to serve on outside boards, many boards are opting to hold on to seasoned directors by raising the retirement age. They are also calling on retired executives.

37%
OF BOARDS HAVE AN AVERAGE AGE OF 64 OR OLDER. **2011**

3% **1987**

Directors Are Still Well Paid

Boards recognize the increased time commitment and personal liability that directors today face; and, although many factors other than money motivate directors to join a board, companies understand the need for competitive compensation.

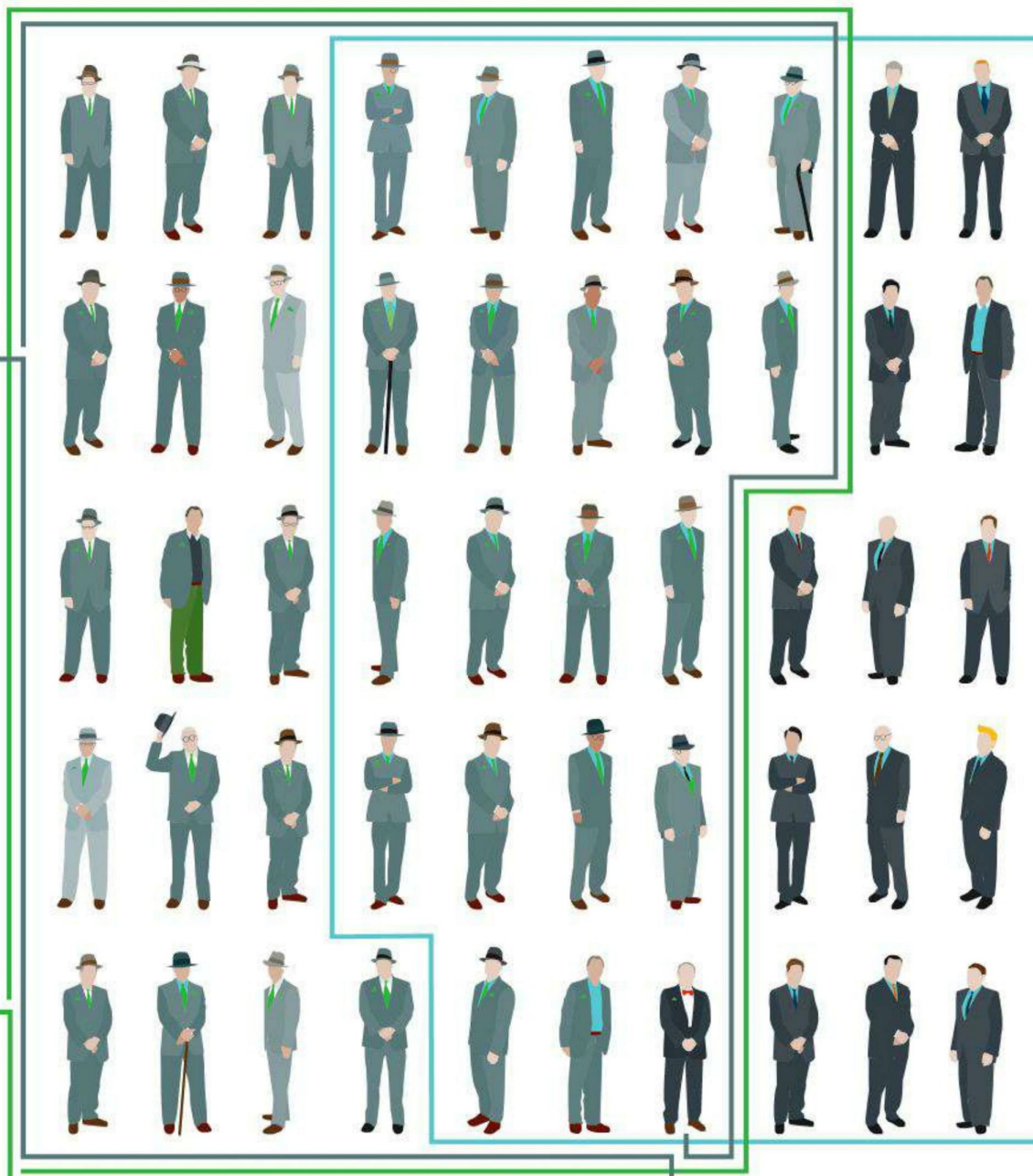
37%
OF BOARDS PAY MEMBERS FOR MEETING ATTENDANCE. **2011**

92% **1987**

\$36,667
1987

\$95,262
2011 AVERAGE BOARD RETAINER PLUS MEETING FEES PER DIRECTOR

The Oldest Director
MORTIMER M. CAPLIN, AN INDEPENDENT DIRECTOR AT DANAHER CORPORATION, IS 95.



2011

Most Directors Are Still White Men

Most boards continue to define the ideal director as a current or former CEO—a position in which women and minorities are still underrepresented. Although numerous boards are broadening their sights, progress has been slow.

15.3%

OF DIRECTORS AT THE TOP 200 COMPANIES ARE AFRICAN-AMERICAN, HISPANIC, OR ASIAN.

2011

LARGEST
32
CME Group

1987

27
DuPont

SMALLEST
5
Microchip Technology

8
Digital Equipment Corporation

Boards Are Smaller

As their role has professionalized over the years—from both the strategic and the fiduciary standpoint—boards have evolved from larger groups, often populated by business, academic, or political luminaries, to leaner decision-making bodies composed of directors with specific skill sets.

83%
OF BOARDS HAVE 12 OR FEWER MEMBERS.

2011

22%

1987

Directors Are More Independent

The Sarbanes-Oxley Act of 2002 tightened the definition of independence and increased the percentage of independent directors on boards. In addition, boards today have a more independent leadership structure, as directors have become more comfortable with the lead or presiding director role and with separating the CEO and chair roles.

84%
OF DIRECTORS ARE INDEPENDENT.

2011

68%

1987

The Youngest Director

NATALIE BANCROFT, NOW 31, JOINED NEWS CORP.'S BOARD IN 2007.

2011

9%
OF BOARDS HAVE NO FEMALE DIRECTORS.

2011

16.2%
OF CORPORATE DIRECTORS ARE WOMEN.



Strategic Humor



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This month’s winning caption was submitted by **Eoghan Curtin** of Galway, Ireland.

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Pfeffer



Jeffrey Pfeffer is the Thomas D. Dee II Professor of Organizational Behavior at the Stanford Graduate School of Business. His most recent book is *Power: Why Some People Have It—and Others Don't* (HarperCollins, 2010).



Could We Manage Not to Damage People's Health?

As health care costs continue to spiral upward while outcomes improve only incrementally, research suggests a promising focus for intervention: curbing the many ways that companies inflict damage on workers' health. But that's not where the effort is going. Recently, I sat in a meeting where insurance executives reprised a common theme: The problem is that people choose to eat too much, smoke too much, drink too much, and exercise far too little. The solution, these experts said, is for companies to promote better choices (by, say, changing cafeteria menus or adding gyms and showers) and offer incentives (apparently the answer to everything these days) to make healthier personal decisions.

While working to influence individuals' health-related decisions is helpful, an enormous body of epidemiological research shows that management's decisions contribute to mortality and morbidity at least

The costs of corporate decisions promoting poor health remain largely hidden from companies' view.

as much as, if not more than, the employees' own actions. For example:

Layoffs. Layoffs have been shown to increase the risk of dying from cardiovascular disease by 44% over a four-year period. Other studies demonstrate that layoffs produce numerous unhealthy behaviors and increase the incidence of suicide.

Long work hours. Members of the U.S. labor force put in more time on the job than the workers of almost any other industrialized country, and those long hours lead to accidents, hypertension, and a host of problems related to lack of sleep.

Failing to provide health insurance. Only 60% of employers now offer health insurance. Meanwhile, mortality and mor-

bidity are on the rise, in part because the uninsured are much less likely to undergo preventive screenings, such as mammograms and cholesterol checks.

Lack of control over one's job. A worker who faces high job demands but has little discretion over when and how to meet those demands is likely to suffer from stress and its correlates, including increased cardiovascular disease.

Economic insecurity. Workers who feel financially vulnerable are prone to stress and its associated mental and physical health costs.

The research consistently shows that individual choices are negatively influenced by all these things. Longer hours at desks, for example, often translate into a more sedentary lifestyle and greater consumption of high-sugar, fatty foods. And on-site gyms don't do much good if people think they've got neither the time nor the company's support to use them.

At the moment, corporate decisions promoting poor health result in costs that are certainly real to individuals and society but are largely hidden from companies' view. After all, a company is not responsible for a laid-off worker who has a heart attack, and no corporate payroll supports a person who is too ill to work to begin with. If a company does not currently pay for those costs, then where's the motivation to invest in the fixes?

In some instances, companies do see the direct economic consequences of their choices. Unemployment insurance rates, for example, are customarily based on an employer's history of creating job loss. Environmental regulations largely prevent companies from externalizing the costs of fouling the air and water. Prices and markets, too, can help businesses make good decisions, though only if they reflect the full costs—and consequences—of those decisions.

If we are to create healthier workplaces, companies need to pay attention to this growing body of evidence and open their eyes to the costs of decisions that cause ill health. ♥

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Ilene H. Lang is the president and CEO of Catalyst, a nonprofit focused on expanding opportunities for women and business.

Co-Opt the Old Boys' Club: Make It Work for Women

Catalyst, where I am CEO, has advised companies for decades on how to create women's networks, mentorship programs, and other initiatives that boost women's career advancement. These efforts make great talking points at conferences, but they have not dramatically changed the landscape for women in business leadership.

Women have long constituted roughly half of the U.S. workforce and just over half of managerial and professional positions. Yet their rise to senior-executive posts and corporate boards has stalled at about 15%. What's more, the gender pay gap persists. Women earn, on average, \$4,600 less than their male peers in their first post-MBA job—a gap that widens to more than \$31,000 as their careers advance. Without intervention, the lost pay accumulates to \$431,000 over 40 years.

Catalyst research points the way to closing that gap. The solution involves the much-maligned Old Boys' Club, which the Urban Dictionary calls the "Old Boys' Network" and defines in frank yet accurate terms: "It is not necessarily purposeful or malicious, but...it entails establishing business relationships on high-priced golf courses, at exclusive country clubs, in the executive sky-boxes at sporting events...arenas from which women and minorities are traditionally excluded and thus are not privy to the truly 'serious' business transactions or conversations."

The club is alive and well because it works. In elite circles, decisions are made behind closed doors. Certain candidates bypass others because of close connections with advocates. The club doesn't favor employees who simply work hard but keep their heads down. Rather, it divides those who are sponsored from those who are not.

People in influential positions become sponsors when they see terrific work and potential from an employee. Sponsors take

protégés under their wing. They ensure that they're visible when opportunities arise. They defend them from backstabbers and risk their own reputations for them.

Sponsorship seems to be the key to closing the leadership gender gap. Catalyst has found that women are mentored more than men, but men's mentors are more senior and more likely to advocate visibly for up-and-comers who, perhaps, remind them of their younger selves.

Women gain sponsors most effectively by promoting their own accomplishments, as Catalyst research has shown: Women who highlighted their achievements advanced further, were more satisfied with their careers, and had greater compensation growth than women who failed to blow

High-potential women must be sponsored by C-suite executives, most of whom are men.

their own horns. Indeed, that strategy—of apprising your manager of your accomplishments, seeking feedback and credit appropriately, and asking for well-deserved promotions—was the only one associated with compensation growth.

Unfortunately, self-promotion is often considered unladylike, and women who negotiate on their own behalf are penalized. How can we break through this double bind?

Smart companies recognize that their high-potential women must be sponsored by C-suite executives, most of whom are men. After all, it's in a company's best interest to ensure that its future leadership reflects the full range of available talent. These firms appreciate that the scarcity of women in their uppermost ranks is most likely due more to a self-promotion gap than to a talent gap, and they hold male executives accountable for the success of female rising stars.

The Old Boys' Club isn't going away. For decades we've tried to dismantle it. Instead, simply be the best kind of leader—one who makes a difference: Co-opt the club so that it works for women. ♣

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How I Did It...

Kevin Peters is Office Depot's president for North America.

Office Depot's President on How "Mystery Shopping" Helped Spark a Turnaround



THE IDEA

The office products retailer was measuring customer service using metrics—such as the cleanliness of bathrooms—that didn't drive sales. Its new president is trying to fix that by retraining the staff and transforming the company.



by Kevin Peters

When I became the leader of Office Depot's retail stores in the United States, in 2010, the first thing I tried to do was figure out the meaning of a puzzling set of facts. Our sales had been declining, and although that's not unusual in a weak economy, they had declined faster than the sales of our competitors and of retailers in general. At the same time, the customer service scores our third-party mystery-shopper service was reporting were going through the roof. This didn't make any sense. How could it be that we were delivering phenomenal service to our customers, yet they weren't buying anything?

To understand these contradictory data points, I decided to do some mystery shopping myself. I didn't wear a suit. I didn't wear a blue Office Depot shirt like the ones employees wear in all our U.S. stores. Instead I wore a faded pair of jeans, a T-shirt, and a baseball cap. I didn't tell anyone I was coming to visit, and in most cases I didn't let anyone know afterward that I'd been in the store. What I wanted was to experience Office Depot in the same way our customers do. Over the next several weeks I visited 70 stores in 15 or more states.

At each location I followed the same routine. First I pulled into the parking lot and just watched customers go in and out

PHOTOS Peters (center at upper right; on the right below) with Office Depot employees

for a few minutes. When I went into the store, I'd spend 20 to 30 minutes observing what was going on. I'd talk to customers, in the aisles and as they were leaving the store. Some of the most interesting conversations took place when I followed people out who weren't carrying shopping bags and asked them why they hadn't bought anything. Some of them gave me an earful.

I could tell you a lot of stories about the things I saw, but two scenes stand out in my mind. In one store I watched an employee argue with a customer about whether or not we carried a calculator that her son needed for first grade. An employee arguing with a customer—it was unbelievable.

At another store, I parked and saw an associate leaning up against the brick facade smoking a cigarette. Meanwhile, customers were walking out without any bags. This employee did nothing—he just watched them leave empty-handed. At that point I had a tough decision to make: Should I blow my cover and alert the store manager, or should I stay silent? I sat in the car a few minutes, thinking it over. Finally I decided, I just can't let this go.

I went into the store and looked at the stanchion that stands at the front of every location, displaying the name of the manager and his or her picture. Guess who the store manager was? Yes—the guy smoking outside the store. So I went up to him and introduced myself, and we had a good long talk. He was ashamed of his behavior—and he was sweating during the conversation. He promised he'd do a better job of taking care of customers, and I promised to keep in touch. Even today we exchange e-mails every month to discuss his performance.

Get In, Get Out

During most of my visits, though, I managed to stay incognito, and I came away having learned a big lesson: Our mystery-shopping scores were correct. You know what was flawed? Our scoring system. We were asking the wrong questions. We were asking, Are the floors clean? Are the shelves full of inventory? Are the store windows clean? Have the bathrooms been cleaned recently? Think about that for a moment: How often do you go to the bathroom while shopping for office supplies? It turns out

that customers don't really care about any of that. Those factors don't drive purchases, and that's why our sales were declining. It would be easy to blame our associates for ignoring shoppers, but under the system we'd built, they weren't doing anything wrong. They were doing exactly what we'd asked them to do—working to keep stores clean and well stocked instead of building relationships with customers.

My conversations with customers gave me three insights into how we should transform our business to become more competitive: One, we had to reduce the size of our stores. They were too large and too difficult to shop in. Two, we had to dramatically improve the in-store experience for our customers. That meant retraining our associates to stop focusing on the things our existing system had incentivized them to do and focus on customers instead. Three, we had to look beyond office products to provide other services our customers wanted. They wanted copying, printing, and shipping. They wanted help installing software and fixing computers. We needed to expand our offerings if we were to remain relevant to our customers.

Talking directly with dozens of customers also reminded me of a cold, hard fact: They have many choices. Office products are a \$300 billion industry, and the top three players—Staples, Office Depot, and OfficeMax—account for less than 10% of that. Approximately 65% of our customers are small and midsize businesses, and buying office supplies doesn't add value to what they do. It's a chore. They want to get in and get out—they care about convenience above all else.

Less Stocking, More Selling

On the basis of that feedback, we began to transform our business. It's probably one of the most challenging journeys I've taken in my life. We started by designating two test stores, one in Chicago and one in south Florida.

Many of the changes we made were done behind the scenes, in parts of the business that customers don't see. We al-

Our mystery-shopping scores were correct, but our scoring system was not. We were asking the wrong questions.



What We Say Matters...

Office Depot wanted to dramatically improve its customers' in-store experience. That included making the questions employees asked more open-ended.

INSTEAD OF ASKING

PLEASE ASK...

Hi, how are you?

What brings you to Office Depot today?

Are you finding everything okay?

What can I help you find today?

Is this all you need today?

What else are you looking for today?

Are you doing okay?

What other items are on your list today?

Thanks...

Thank you for shopping at Office Depot today.

tered the way our supply chain operates so that we could accept deliveries from vendors even when no one was in the store to sign in the merchandise. We began separating stock onto U-boats (the narrow stocking carts we use in aisles) assigned to different parts of the store and delivering the U-boats to an optimal spot—marked with an X on the floor—to minimize the labor required by associates to stock shelves. We also divided the store into zones and began having the same associates stock the same sections repeatedly. Becoming expert in one area of the store allowed them to restock faster, reducing labor.

Many people think that in order to improve service, you need to hire more front-line workers. But in fact, by finding ways to reduce the time employees spend on functions such as stocking shelves, we've been able to repurpose their time for selling to customers. Each of our stores employs 18 people on average; by finding ways to work smarter, we've been able to save 80 hours a week—the equivalent of hiring two full-time salespeople but at no added cost.

Once our associates had more time to serve customers, we needed to ensure



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A New Approach To Sales and Service

Office Depot simplified its sales process from five steps to three. It's now called ARC, for "Ask, recommend, and close."

ASK 3 questions

- Start with an open-ended welcome question.
What brings you in today?
- Follow with at least 2 qualifying questions.
How are you planning to use the product?
What has worked for you in the past?

RECOMMEND 3 products

- Use your product knowledge to suggest 3 items that match the customer's needs.
These 3 are the best for you. Let me tell you about the differences between them.

CLOSE and cross-sell in 3 steps

- Make a closing statement.
It sounds like this one is your top choice. Should I bring it up front?
- Answer the objection.
Ink is really not expensive when you factor in the cost per page.
- Cross-sell at least 2 items or attachments.
We have great deals on ink and paper today. Would you like me to share them with you?

that they knew how. We simplified our sales process from five steps to three—it's now called ARC, for "Ask, recommend, and close"—and trained them to implement it. We taught them to ask customers open-ended questions. Our research indicated that in certain departments—such as furniture—sales go up by more than 100% when associates with really good product knowledge are assigned to those zones. So in addition to sales training, we invested in product training.

When a retailer delivers poor service, many people are quick to blame the employees. In my experience, it's more complicated than that. We have 22,500 associates in our retail organization; one of the things we did as part of our change program was to have every one of them take a test built on the Myers-Briggs Type Indicator

We found that we had been hiring people who were most comfortable with their backs, rather than their bellies, to the aisle.

to help us understand their skills, behaviors, and attributes as they relate to serving customers. An interesting thing we found was that we'd been hiring people who were most comfortable with their backs, rather than their bellies, to the aisle. Roughly one in five associates preferred performing tasks on merchandise over interacting with customers. A challenge we faced in rolling out these initiatives was how to help those workers become comfortable with the ARC culture—or, frankly, to help them find other meaningful jobs within the company if they couldn't acquire the right selling skills.

Smaller Is Better

You can't drive changes like this overnight. Our business has been around since 1986, and that's a long time for employees and

customers to establish expectations and behaviors. These changes won't be completed in the next month or the next quarter—maybe not even in the next year. In addition to the two "lab" stores in Chicago and Florida, we've rolled out 30 pilot stores, and we're seeing encouraging evidence of an improvement in sales. We're also hearing positive anecdotal feedback from customers and associates. (There has been a

dramatic improvement at the store where I caught the manager smoking outside: Today it is one of the top performers in the company.) We hope that by the end of 2011, 325 of our stores will be utilizing the new system.

We've also made progress in shrinking the size of our stores. Today they average 24,000 square feet. We've already had success with new stores of 15,000 to 17,000 square feet. We are introducing a small-format store that's about 5,000 square feet. It carries only 5,000 SKUs—compared with 8,500 SKUs in our traditional stores—but because they're our most popular products, they represent 93% of what we sell in a traditional store. This format will allow us to be in downtown markets like New York City or in remote markets where we wouldn't consider putting a large-format store.

As we work to make these changes, I still try to visit our stores as frequently as possible. It's really the only way you can know how your business is doing. You have to see how customers are being treated, and you can't rely on reports or scores or hearsay—you have to experience it yourself. If you think your company is doing well with customer service, ask yourself, Am I really sure? Do I know what the customer experiences?

What I pay attention to most of all is how many people are leaving the store without a shopping bag. I'd be glad if people came to our stores to browse, but this is not a browsing industry—people are shopping with a very specific purpose in mind. If they don't make a purchase, something has gone wrong. If we can reduce this "balk rate" by just 10%, it will have a meaningful impact on both our top-line revenue and our margins.

You also have to make sure you're measuring things that really matter to customers. I can tell you from firsthand experience what happens when you measure the wrong things. I always try to remember that we need our customers more than they need us—and we'd better act like it. ♥

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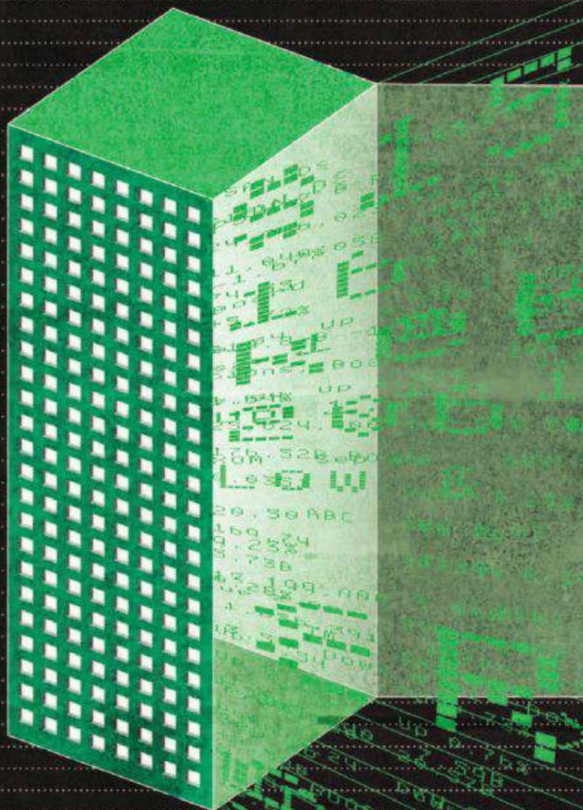
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The Big Idea



How to Win Investors Over

They want information—lots of it.
The case for telling Wall Street more
by Baruch Lev

Providing earnings guidance—publicly releasing managerial forecasts of a company’s profits—is controversial. Warren Buffett has been a frequent critic. The Business Roundtable and the CFA Institute (the financial analysts’ trade group) have

WHAT HAPPENS TO EXECUTIVES WHO DON’T SHARE INFORMATION?

INFORMATION ASYMMETRY

Managers are better informed than investors, thereby increasing investors’ information risk.

INFORMATION RISK PREMIUM

Investors require extra return to compensate for information risk.

EXCESSIVE COST OF CAPITAL

This extra return increases the company’s cost of capital.

LONG-TERM CONSEQUENCES

Stunted corporate investment and growth; low stock prices and high takeover threat; low managerial compensation and high turnover

jointly concluded that it’s an unproductive and wasteful exercise that leaves executives too focused on short-term results. A team of McKinsey consultants has determined that guidance is misguided. The U.S. Chamber of Commerce is against it, too.

Yet more than a thousand publicly traded corporations in the United States, including many of the biggest, issue such forecasts every year, if not every quarter. What to make of this contradiction? To cut to the chase: The guidance givers are for the most part right, their do-gooder critics mainly wrong. Earnings guidance doesn’t work miracles, but research by me and other academics indicates that guidance increases analyst following and cuts down on unwelcome surprises, which in turn reduces stock price volatility and lessens the threat and consequences of shareholder lawsuits. No mean feat.

And providing earnings guidance is just a start. Giving more information to investors generally, and doing it in an honest and understandable way, is good business. That’s not a loose assertion. It has its roots in the economic theory of information asymmetry. When one party to a transaction knows more than the other, someone suffers—and it’s not whom you might think. When sellers have information about the quality of a product that buyers don’t, the sellers are actually the primary losers, as suspicious buyers drive down prices or abandon the market altogether (the economist George Akerlof won a Nobel prize for demonstrating this). Would you buy a house if you were denied inspection, termite, and ground-pollution reports? Corporate managers who don’t share relevant information face a substantial share price discount, a higher cost of capital, and a more volatile stock price.

Furthermore, interacting with investors is not only about giving information. Managers often ignore the fact that information flows both ways: Executives can learn from investors, too. Stock price movements around earnings announcements reveal

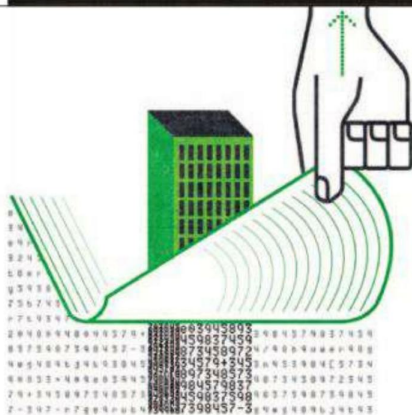
a lot about investors’ growth expectations and their perceptions of management’s credibility. Short sellers often signal serious operating and accounting problems that managers need to fix. Wide bid-ask spreads and a large variability in analysts’ forecasts both point to investor uncertainty about the future course of the business. And so on.

The idea that corporate managers and investors can have a mutually beneficial relationship has, unfortunately, taken a beating over the past decade. Since the turn of the millennium, economic upheavals, corporate scandals, stock market crashes, and regulatory turmoil have been the order of the day. Capital markets have become hostile territory for investors and managers alike.

In reaction, some in the corporate world and at business schools have advised managers to pay less attention to Wall Street. Shareholders are just one class of stakeholders managers must answer to, they say, and they may not be the most important class. Most investors focus on the short term, and catering to their whims interferes with long-term growth and wastes valuable management time. Managers should do their thing—run the business—and investors will fall in line. The controversy over earnings guidance is part of this discussion.

There’s no denying that some managers have become unhealthily obsessed with quarterly earnings. But disengagement from the market isn’t an option; the heads of publicly traded companies *can’t* run their businesses without reference to the capital market. The market determines a company’s cost of capital and therefore affects its future growth. Capital markets play important monitoring and governance roles in managers’ compensation and careers. Researchers have determined that share price setbacks have been a major reason for managerial turnover in recent years. Share price patterns serve as beacons, guiding highly qualified employees to join, stay with, or leave an organization (no one enjoys holding un-

Idea in Brief



The relationship between corporate executives and stock market investors has turned testy, even hostile. Some have advised that managers retreat from the market and stop providing earnings guidance.

But managers can't run their businesses without reference to the stock market. Share price movements can

affect a company's prospects and provide useful information about its perceived strengths and weaknesses.

The key for executives is not to ignore Wall Street but to be smarter in their dealings with it. Recent research offers clear lessons about what investors value. Above all, they want honesty and transparency. Through

prudent use of earnings guidance, pro forma earnings, and conference calls, executives can convey solid, credible information about their corporation's prospects. Investors will reward them if they do.

derwater stock options). And, as noted, markets provide information that managers can use to better run their companies.

The key for executives is not to ignore Wall Street but to be smarter in their dealings with it. Finance, economics, accounting, and management scholars, myself included, have for years studied the interactions between managers and markets. We've discovered profound lessons about what investors do and don't value. Much of this research has focused on U.S. companies and markets, simply because there are better data on them. But the lessons apply everywhere.

One of the most important lessons is that honesty does pay: Attempts to deceive investors by sugarcoating poor results or, worse, manipulating sales and earnings eventually lead to lower stock prices (and sometimes career-ending scandals) as investors wise up. It's this kind of behavior that critics of guidance and other aspects of the "earnings game" are presumably out to stop. But the best way to stop it, the evidence shows, is with more—not less—engagement with investors.

I'll focus in this article on three ways in which managers can impart useful information to investors: earnings guidance; "pro forma" (that is, non-GAAP, or Generally Accepted Accounting Principles) earnings releases; and "soft" information (narrative and tone). In all three instances managers and corporations reap greater rewards through clarity and transparency than through obfuscation and deceit.

How Investors Think

Executives need to start with a clear sense of the strengths and weaknesses of investors. In one caricature prevalent in the corporate world, those who buy and sell stocks are skittish, myopic ninnyes. In the view that has long held sway in academia, they are cold-blooded, all-knowing information processors. During recent years, though, researchers have be-

gun to develop a more nuanced view: On the whole, investors are neither incompetents nor automatons. They are, well, people.

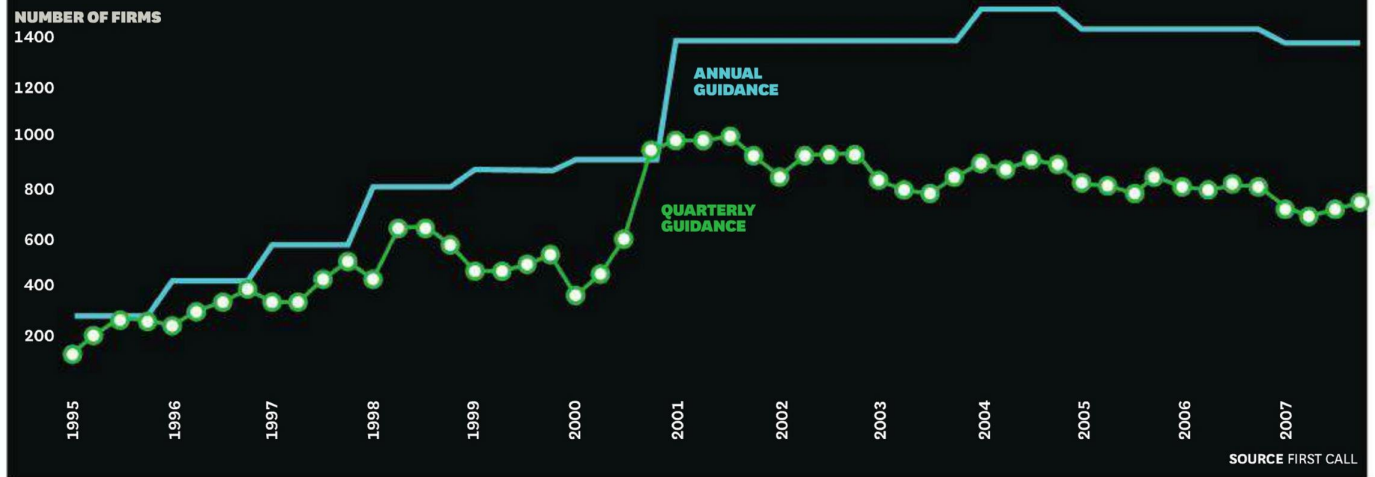
First we'll dispense with the myopic ninnyes. Investors are actually more interested in corporations' medium- to long-term prospects than in what is happening today. Evidence for this argument can be found in a study of the S&P 500 companies conducted by Tom Copeland, Aaron Dolgoff, and Alberto Moel, who looked at the period from 1992 to 1998. The trio, partners in two major consultancies, examined how analysts' revisions of near-term earnings forecasts (one to two years out) and long-term forecasts (three to five years out) affected stock prices. If myopic investors dominated markets, share prices would be most sensitive to short-term news. Instead, the researchers found that long-term forecast revisions had a much stronger impact on share prices—"consistent," they wrote, "with an interpretation that shareholder returns in the current year are primarily related to expectations about long-term performance."

I took a different approach to the myopia issue, separating the portion of companies' stock prices that reflected the short term from the portion that reflected long-term growth potential. I did this by regressing the market value of a large sample of companies on their net assets (book value) and analysts' consensus forecast of earnings for the following year. This statistical regression yielded an estimate of the

Giving more information to investors is good business. Would you buy a house if denied inspection and termite reports?

U.S. Firms Providing Earnings Guidance

The spike in 2000–2001 resulted from a new SEC rule



portion of the variation in companies' capitalization, or share value, attributed to the short term—that is, current asset values and near-term earnings. The remaining portion, by default, primarily reflected the value investors placed on long-term growth prospects. In most of the industries I studied, long-term growth accounted for more than half the share value. In some—oil and gas, measuring and medical equipment, and computers—the long-term portion was as much as 60% to 70%.

But investors aren't all-knowing, either. Consider what happened in 1998, when the *New York Times* ran a front-page article about a promising drug developed by the biotech company Entremed. The company's stock price catapulted from \$12 to \$52, despite the fact that, as the Columbia University researchers Gur Huberman and Tomer Regev put it, "the new-news content of the *Times* story was nil." The drug's attributes and prospects had been thoroughly analyzed months earlier in scientific journals and covered at the same time by the popular media, including the *Times* (though not on its front page).

In a similar vein, research shows that pro forma earnings statements prominently displayed in the headline or first paragraph of a company's news release have a much stronger impact on stock prices than pro forma earnings reported elsewhere in the document. Obviously, investors suffer from what behavioral researchers call "limited attention"—a restricted ability to process and analyze vast amounts of information, in this case information relevant to companies' values. In the words of the Nobel laureate economist Herbert Simon, "The scarce resource is not information; it is processing capacity to attend to information." That's why investors focus on *salient cues*—items that stand out in the crowded data mess.

The upshot is that investors are somewhere between naive and all-knowing. They care a lot about

what drives a company's long-term growth—why else would they support massive long-term investments in R&D, IT, and brands and technology acquisitions? But they often need help understanding what those drivers really are. That's where guidance, pro forma earnings statements, and the narrative and tone of managers' communications come in.

Earnings Guidance

The practice of providing explicit guidance gained popularity in the 1990s, as the consensus earnings forecasts of Wall Street analysts became an established benchmark for corporate performance. Then, in 2000 and 2001, the number of companies providing guidance rose sharply. The reason: The SEC's Regulation Fair Disclosure, which took effect in October 2000. Reg FD requires managers who wish to disclose material nonpublic information on, say, forthcoming earnings, sales trends, or significant new contracts to do so publicly to all investors at the same time, generally via press releases or conference calls. The regulation—very controversial at the time of its enactment—was aimed at curtailing the widespread practice of managers' privately communicating ("whispering") with select analysts and investors.

Since 2001 the number of guiders has held relatively steady. In 2007, just prior to the upheaval of the financial crisis, about 800 companies regularly provided quarterly earnings guidance (most also releasing annual guidance) and about 1,400 released annual earnings estimates (roughly half also releasing quarterly estimates). Guidance tends to skew negative (toward warnings), although ratios change with economic conditions. Of the quarterly guidance issued in 2007, about 20% was positive, 40% was negative, and 40% was of an in-line, confirmatory nature. The 2:1 preponderance of negative to positive guidance is puzzling. Aren't managers known to

exude optimism? Forestalling shareholder lawsuits by giving early warnings of bad news is one possible motive (researchers have found that positive guidance is more common in Canada, where litigation is less of a threat). Another is the belief of many executives that good news will take care of itself. Recall the well-known behavioral “prospect theory,” which was succinctly summed up by its creators, the Nobel laureate Daniel Kahneman and the late cognitive scientist Amos Tversky, as “losses loom larger than gains.”

The standard critique of guidance is that (1) it takes up too much managerial time and attention and yields to the market’s short-termism, and (2) it doesn’t impart useful information. The second assertion is pretty easy to test. With the University of Florida’s Joel Houston and Jenny Tucker, I examined a large sample of quarterly earnings forecasts issued by managers from 2002 to 2005. We compared the accuracy of their guidance (in light of subsequently reported earnings) with that of the most recent analyst estimates issued prior to the guidance. The managers were more accurate 70% of the time, the analysts only 26% of the time (the remaining 4% were ties). Our findings corroborate other studies indicating that management guidance enriches the information environment in capital markets. Improved information has been shown to lead, in turn, to higher stock prices, lower volatility, and reduced cost of capital. Good things indeed.

What happens when companies halt guidance? In 2010 Houston, Tucker, and I studied 222 companies that had heeded the critics and stopped providing quarterly earnings guidance from 2002 to 2005. We compared them with 680 companies that maintained quarterly guidance during the same period. The companies that stopped saw analysts’ coverage decrease—an undesirable result. And investors’ uncertainty, as indicated by the error rate of analysts’ estimates, rose significantly. Eliminating guidance obviously reduces transparency, and both the company and its shareholders suffer. No wonder, then, that the accounting researchers Shuping Chen, Dawn Matsu-moto, and Shiva Rajgopal—focusing on companies that, from 2002 to 2006, publicly announced decisions to stop giving quarterly guidance—recorded a mean 5% stock price drop upon the announcement. You aren’t doing your investors or yourself any favors by stopping guidance.

A caveat is in order: Guidance doesn’t make disappointments disappear. Consider what Stanford University’s Ron Kasznik and I and, in a separate study,

SHARE OF INDUSTRY MARKET VALUE THAT REFLECTS LONG-TERM PROSPECTS

72%

PETROLEUM & NATURAL GAS

65%

MEDICAL EQUIPMENT

38%

FINANCIAL TRADING

DATA SOURCE: COMPUSTAT AND I/B/E/S

Jenny Tucker, found: Companies that warned of an earnings decline experienced a combined price drop at the time of the warning and at the next earnings release that was close to the price decline of companies that experienced similar earnings disappointments but had chosen not to warn shareholders. Investors clearly react to the substance of news, not its packaging. But warnings do have advantages: They reduce defection among financial analysts (analysts hate surprises) and enhance the credibility of managers, who are seen as straight shooters.

Warnings can also temper shareholder litigation and its consequences. A price drop in response to a warning decreases the drop that occurs upon the event itself—say, a disappointing earnings announcement or a revelation of misdeeds—thereby decreasing estimates of the damage to investors, which are generally based on the drop at the time of the event. Lower damage estimates also decrease lawyers’ incentives to file suits. And judges often consider warnings a mitigating factor.

In short, don’t expect miracles—permanent price increases, for example—from sharing forward-looking information with investors a few weeks or even months before an earnings release. Still, under the right circumstances guidance is a potent communications tool. Here are some guidelines for guiders:

Guide investors only if you are a better predictor of earnings or sales than analysts are. Compare the accuracy of your company’s internal forecasts—or your guidance, if you already give it—with that of the analysts’ consensus forecasts. If your predictions are consistently better (say, in at least 75% of individual quarters), you’re a good candidate for providing quarterly guidance. If not, repeat this test with annual earnings. If the results are no better, forget about guidance.

Don’t stand out as a guidance refusenik. If guidance is prevalent in your sector and/or multiple analysts follow your company, strongly consider providing guidance.

If you want to convince investors of your favorable earnings prospects, include guidance about major drivers of income. Many companies (close to 40% of S&P 500 firms) provide guidance about key income items, such as sales, margins, and major operating costs, in addition to earnings. Benjamin Lansford, of Penn State; Jenny Tucker; and I have found that this sort of guidance is characteristic of companies with an optimistic earnings view, large institutional ownership, and wide analyst coverage.

Avoid losing credibility. There's a fine line between steering investor expectations toward realistic earnings or sales and manipulating—"walking down"—expectations so that reported earnings will comfortably exceed them. No doubt some managers practice the latter. Analysts will eventually wise up and pay less attention to their guidance.

Pro Forma Earnings

Another potent communications tool, albeit one often mocked in the financial media and by some investors, is pro forma earnings. These are performance measures—the best known is EBITDA, for Earnings Before Interest, Taxes, Depreciation, and Amortization—that don't accord with GAAP measures.

Why aren't GAAP earnings good enough? For three reasons: First, the hodgepodge nature of the income statement, which mixes recurring items that point toward a business's future (core sales and cost of sales, for instance) with one-time revenues and expenses (gains from asset sales and goodwill write-offs, for example). Second, the inclusion of expenses (such as R&D and brand development costs) that are actually investments. Third, multiple imprecise estimates, such as stock options expenses and gains from fair-value changes of nontraded assets. The amalgamation of these items of highly varied reliability in a single earnings number blurs the performance picture. No wonder that, as my recent research with the University of Illinois professors Siyi Li and Theo-

dore Sougiannis shows, GAAP earnings are no better at predicting corporate performance than are "naive" forecasts based on past cash flows.

I see nothing wrong with managers' honest attempts to improve on GAAP earnings by releasing alternative numbers, particularly after the 2003 SEC requirement that non-GAAP measures included in earnings releases and statutory filings be reconciled with GAAP numbers. Because pro forma earnings are disclosed along with, not in lieu of, GAAP earnings—and the differences between the two measures are highlighted—investors cannot be worse off with pro forma earnings. On the contrary, they are better off.

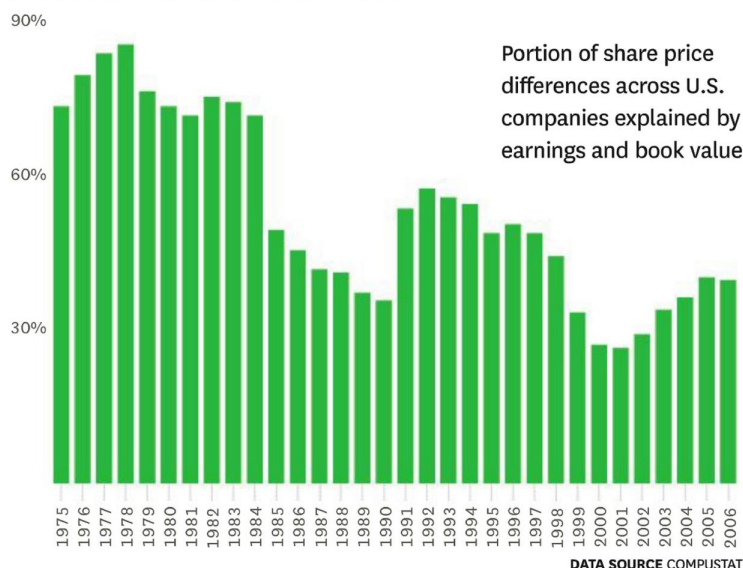
Research clearly corroborates the usefulness of pro forma numbers to investors. It indicates, for example, that pro forma earnings have a stronger association than GAAP earnings with stock returns and with revisions of analysts' earnings forecasts—and that they are better predictors of future profits. Furthermore, as the accounting researchers Daniel Collins, Oliver Li, and Hong Xie have noted, starting in the early 1990s (a period that saw a substantial increase in intangible investments and one-time restructuring charges, all of which lessen the usefulness of GAAP data), pro forma numbers triggered a higher volume of trade—an indication of information's usefulness—than GAAP earnings did.

When you're deciding whether or how to issue pro forma earnings, here are some factors to consider:

A pro forma earnings number is useful if it improves the prediction of business performance provided by GAAP earnings. Accordingly, transitory income or expense items and GAAP expenses that are really investments expected to enhance future performance (building a telecom's franchise, for example) are legitimate candidates for exclusion from pro forma earnings. Similarly, there's no reason pro forma earnings can't serve to alert investors to highly unreliable expense estimates, such as dubious gains or losses from fair-valuing nontraded assets or liabilities. In sum, use pro forma numbers to convey *your* view of your company's performance and prospects.

GAAP is particularly deficient at satisfying investors' information needs about "change" companies. These include innovative, intangibles-intensive enterprises; high-growth and early-life-cycle businesses; and organizations undergoing strategic restructuring. If your company has any of those characteristics, you should give serious thought to systematically releasing pro forma earnings and other non-GAAP information, such as the number of pat-

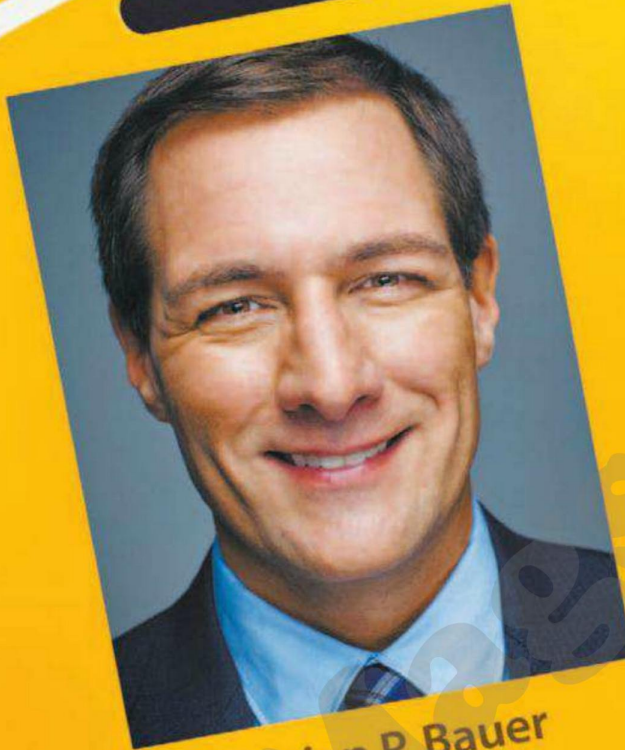
THE DECLINING RELEVANCE OF GAAP DATA



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What to Do If Earnings Fall Short

It's a nightmare scenario: The end of the quarter is approaching, and you realize that earnings will fall short of the consensus estimate. Something must be done. But what? A last-minute sales blitz with deeply discounted prices? Shifting certain expenses to the next quarter? Recording some of the next quarter's revenues in the current one? None of the above.

The best course of action is to issue a public warning as soon as possible, coupled with a detailed, credible plan for fixing the business fundamentals. Then report the grim results truthfully and keep investors engaged, sharing the progress of the remedial moves, whether successful or not. A warning will not completely mollify investors: Your stock will probably take a hit on the earnings announcement. But it will enhance your credibility and may lessen your company's exposure to shareholder litigation. In financial reporting, honesty pays.

How do we know this? In 2009 Sanjeev Bhojraj and other researchers at Cornell University's Johnson Graduate School of Management reported what happened to 1,686 companies that missed the consensus estimate by a penny without managing earnings and to 2,893 others that beat the consensus by a penny, apparently with the help of earnings management. To assess whether or not a company had managed its earnings, the researchers tracked unusual changes in the major expense items that are susceptible to manipulation—accounting

accruals (based on subjective reserves, provisions, and estimates), R&D, and advertising expenses. An unusual decrease in bad-debt reserve, R&D, or advertising expenses at a company that beat the consensus led to a presumption of earnings management.

The outcome of this analysis is both surprising and reassuring. Although the companies that apparently manipulated earnings and beat the consensus saw, on average, a 3% to 4% bump in stock price on the heels of the earnings announcement, they lost it by year's end. The firms that resisted the temptation to manage earnings in order to avoid a miss suffered no price decline after the announcement. Roughly a year later their share prices had increased significantly—they handily beat the "consensus beaters."

ents granted during the period specified, the churn rate of customers, and the gains from online activities.

Not all pro forma numbers currently disclosed are paragons of truth. Some deserve the joking moniker "earnings before bad stuff"; certain managers do bend the truth to avoid missing earnings targets, the research shows. To maintain credibility, refrain from manipulation and be consistent. If you don't adjust for a given expense item in your pro forma earnings one year, don't adjust for it the next. If you exclude one-time expenses, exclude one-time gains, too.

Soft Information

The post-earnings-announcement conference call with investors and analysts has become a corporate ritual. Is it a frivolous one? Executives certainly don't think so. Working with a group of doctoral students (Karthik Balakrishnan, Richard Carrizosa, and Alina Lerman—all young professors now), I recently analyzed hundreds of these calls, each lasting one to two hours. All but one were conducted jointly by the CEO and CFO, sometimes with other executives present; all were watched over, of course, by legal counsel. These were not special events, mind you—such calls have become routine. But with just one exception, the top two corporate guns ran them all.

Can you think of another corporate activity that is never delegated? Subordinates typically make crucial production, investment, marketing, and R&D decisions; lobbyists often handle relations with leg-

islators and government institutions. But talking to investors is not entrusted to underlings, and for good reason: What is said in those conference calls *matters*.

The evidence clearly shows that conference calls impart useful information to investors. For example, studies have documented an abnormally high volume of stock trades and increased price volatility during and immediately after the calls. It's hardly surprising that the calls produce action: Why else would analysts and investors continue to participate in them? The important question for managers is how to enhance their effectiveness.

Many believe that investors' limited attention span and constrained cognitive capacity sway them toward *hard information*, which is easily reduced to numbers and thereby made salient, and away from *soft information*, or narrative, which is difficult to encapsulate in a quantitative score. Here's a startling finding, then: The key hard corporate data—earnings and book values (net assets)—account for no more than 10% of stock price changes that occur around the time financial reports are released. Clearly, soft information colors many investors' decisions. It's crucial that managers learn how best to convey it—and to investigate this matter, you have to listen to the calls, not just record their impact.

Using transcripts from the Thomson Street-Events database, the doctoral students and I conducted an intensive analysis of thousands of quarter-end calls made from 2001 to 2007, all in the wake of



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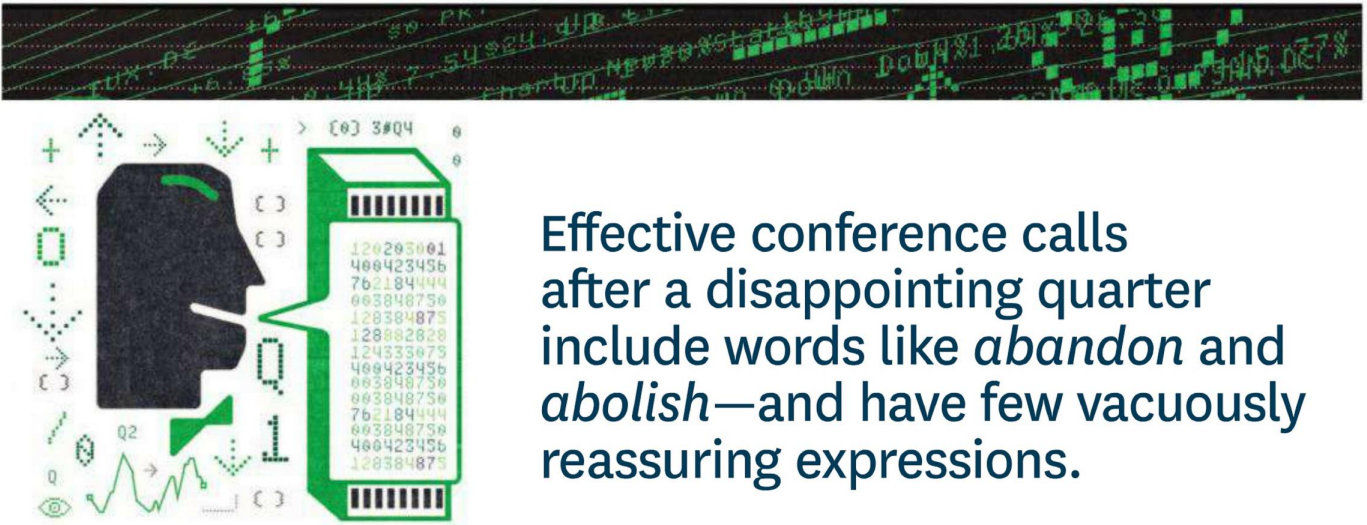
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Effective conference calls after a disappointing quarter include words like *abandon* and *abolish*—and have few vacuously reassuring expressions.

disappointing results—a miss of analysts’ consensus estimates. We divided the sample into effective and ineffective calls, defining an effective call as one that created buzz and triggered an unusually high volume of trade—or, better yet, drove an increase in stock price.

We discovered that effective calls had substantially more analysts participating, more questions asked, and more responses given, with several executives chiming in; in addition, the executives’ discussions and responses were lengthier. Effective calls were also characterized by more-quantitative responses (a higher ratio of numbers to words) and fewer of the big-picture words (such as *growth*, *strategy*, and *reputation*) that are typical in the vocabulary of CEOs. Managers in these calls spent less time than managers in ineffective calls discussing competitive position, pricing issues, and the economy at large.

Interestingly, effective calls contained more negative words (*abandon*, *abolish*, and so on) than ineffective calls did—remember, all these calls followed a disappointing quarter—and had fewer vacuously reassuring expressions. Finally, buzz-creating calls contained more forward-looking quantitative guidance and fewer flights of fancy.

What lessons can we draw from all this?

Make your calls worth listening to. You want lots of analysts and investors on the line. To keep them coming back quarter after quarter, provide new information and original insights. Don’t give in to advice from legal counsel to be cryptic or bland. Focus on providing useful information, not on avoiding lawsuits. A defensive stance sometimes works in boxing; it doesn’t do much good in conference calls.

Stick to the facts and don’t blather. Lighten up on the concepts and models you learned in MBA strategy and leadership classes; most analysts skipped those classes anyway. Hard, forward-looking information (not mushy pronouncements like “We eagerly antici-

pate the many opportunities that lie ahead”) is central to an effective call.

Don’t duck the truth. Honesty and specificity in the face of adversity are more helpful and credible than vagueness and sugarcoating are. This makes obvious sense but is often overlooked by executives under duress from a consensus miss.

THESE ARE NOT easy times to be a corporate executive dealing with financial markets. Congress imposed tough new regulations with the 2002 Sarbanes-Oxley Act and the 2010 Dodd-Frank financial reform law. Hedge fund managers and others prey on companies to gain board seats, deplete cash reserves, and change corporate strategies. The mean CEO tenure in the U.S. has dropped by a quarter—from eight to six years—over the past decade. And the relentless drive for director independence and the growing number of thumbs-down votes by shareholders at directors’ elections have transformed many boards from counseling bodies into supervisors and monitors—sometimes even adversaries. To top it all off, stock prices have gone nowhere so far this millennium.

But running away from disillusioned investors only makes things worse. Far better is to figure out what investors value and what drives them away and to shape your financial reporting and communications strategy accordingly. There’s a wealth of new empirical research on how investors react to various corporate behaviors—information that goes far beyond the three tactics discussed above. Make use of it, and you may notice capital markets becoming a friendlier place. ▾

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Baruch Lev is the Philip Bardes Professor of Accounting and Finance and director of the Vincent C. Ross Institute of Accounting Research at NYU’s Stern School of Business. This article is adapted from his book *Winning Investors Over: Surprising Truths About Honesty, Earnings Guidance, and Other Ways to Boost Your Stock Price* (Harvard Business Review Press, 2011).



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The Good Company

The companies that perform best over time build a social purpose into their operations that is as important as their economic purpose.

ARTWORK Sarah Morris
Mogul [Clips], 2009
Gloss household paint on
canvas, 48.03" x 48.03"

Spotlight



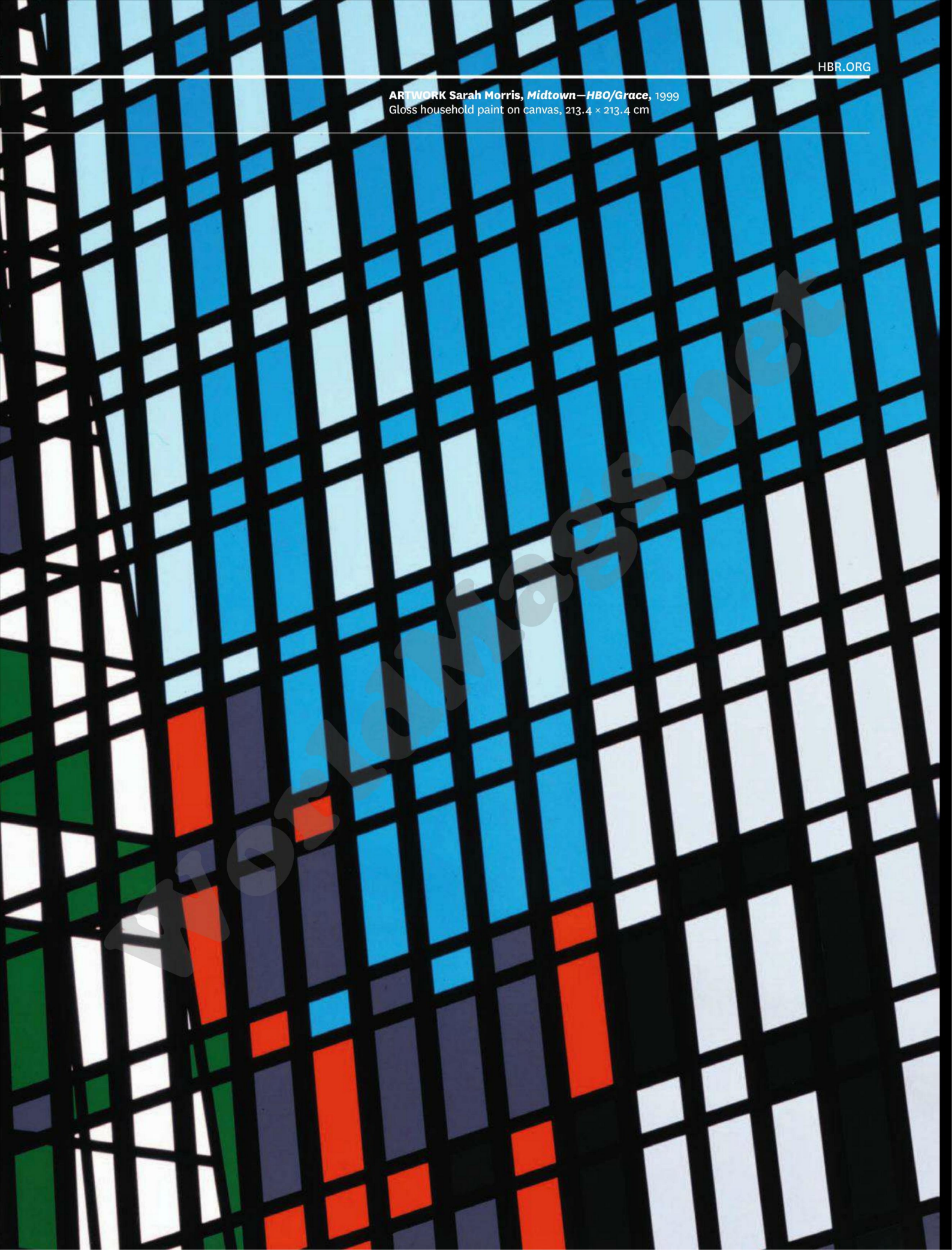
Rosabeth Moss Kanter is the Ernest L. Arbuckle Professor of Business Administration at Harvard Business School and the chair and director of Harvard University's Advanced Leadership Initiative. Her most recent book is *SuperCorp: How Vanguard Companies Create Innovation, Profits, Growth, and Social Good* (Crown, 2009).

How Great Companies Think Differently

Instead of being mere money-generating machines, they combine financial and social logic to build enduring success.

by Rosabeth Moss Kanter

ARTWORK Sarah Morris, *Midtown—HBO/Grace*, 1999
Gloss household paint on canvas, 213.4 × 213.4 cm



IT'S TIME THAT BELIEFS and theories about business catch up with the way great companies operate and how they see their role in the world today. Traditionally, economists and financiers have argued that the sole purpose of business is to make money—the more the better. That conveniently narrow image, deeply embedded in the American capitalist system, molds the actions of most corporations, constraining them to focus on maximizing short-term profits and delivering returns to shareholders. Their decisions are expressed in financial terms.

I say convenient because this lopsided logic forces companies to blank out the fact that they command enormous resources that influence the world for better or worse and that their strategies shape the lives of the employees, partners, and consumers on whom they depend. Above all, the traditional view of business doesn't capture the way great companies think their way to success. Those firms believe that business is an intrinsic part of society, and they acknowledge that, like family, government, and religion, it has been one of society's pillars since the dawn of the industrial era. Great companies work to make money, of course, but in their choices of how to do so, they think about building enduring institutions. They invest in the future while being aware of the need to build people and society.

In this article, I turn the spotlight on this very different logic—a social or institutional logic—which lies behind the practices of many widely admired, high-performing, and enduring companies. In those firms, society and people are not afterthoughts or inputs to be used and discarded but are core to their purpose. My continuing field research on admired and financially successful companies in more than 20 countries on four continents is the basis for my thinking about the role of institutional logic in business.

Institutional logic holds that companies are more than instruments for generating money; they are also vehicles for accomplishing societal purposes and for providing meaningful livelihoods for those who work in them. According to this school of thought, the value that a company creates should

be measured not just in terms of short-term profits or paychecks but also in terms of how it sustains the conditions that allow it to flourish over time. These corporate leaders deliver more than just financial returns; they also build enduring institutions.

Rather than viewing organizational processes as ways of extracting more economic value, great companies create frameworks that use societal value and human values as decision-making criteria. They believe that corporations have a purpose and meet stakeholders' needs in many ways: by producing goods and services that improve the lives of users; by providing jobs and enhancing workers' quality of life; by developing a strong network of suppliers and business partners; and by ensuring financial viability, which provides resources for improvements, innovations, and returns to investors.

In developing an institutional perspective, corporate leaders internalize what economists have usually regarded as externalities and define a firm around its purpose and values. They undertake actions that produce societal value—whether or not those actions are tied to the core functions of making and selling goods and services. Whereas the aim of financial logic is to maximize the returns on capital, be it shareholder or owner value, the thrust of institutional logic is to balance public interest with financial returns.

Institutional logic should be aligned with economic logic but need not be subordinate to it. For example, all companies require capital to carry out business activities and sustain themselves. However, at great companies profit is not the sole end; rather, it is a way of ensuring that returns will continue. The institutional view of the firm is thus no more idealized than is the profit-maximizing view. Well-established practices, such as R&D and marketing, cannot be tied to profits in the short or long runs, yet analysts applaud them. If companies are to serve a purpose beyond their business portfolios, CEOs must expand their investments to include employee empowerment, emotional engagement, values-based leadership, and related societal contributions.

What Counts As Good?

—Compiled by HBR's editors

Since the rise of the modern corporation, in the late 19th century, America has subjected the question of what a good company is—or ought to be—to near-constant debate.

THE GILDED AGE

The titans of American industry view the good company as part of an enlightened oligopoly, favoring cooperation over socially destabilizing competition.



Paternalistic corporations oversee their workers' health and moral improvement in company towns like Bisbee, Arizona, and Pullman, Illinois.

Idea in Brief

Traditional theories of the firm are dominated by the notion of opposition between capital and labor, disconnecting business from society and posing conflicts between them. According to this view, companies are nothing more than money-generating machines.

By contrast, great companies use a different operating logic. They believe that business is an intrinsic part of society, and like the family, government, and religion, has been one of its pillars for centuries.

Great companies work to make money, but in their choices of how to do so, they consider whether they are building enduring institutions. As a result, they invest in the future while being aware of the needs of people and society.

There are six facets of institutional logic, which radically alters leadership and corporate behavior: a common purpose; a long-term view; emotional engagement; community building; innovation; and self-organization.

Business history provides numerous examples of industrialists who developed enduring corporations that also created social institutions. The Houghton family established Corning Glass and the town of Corning, New York, for instance. The Tata family established one of India's leading conglomerates and the steel city of Jamshedpur, Jharkhand. That style of corporate responsibility for society fell out of fashion as economic logic and shareholder capitalism came to dominate assumptions about business and corporations became detached from particular places. In today's global world, however, companies must think differently.

Globalization increases the speed of change; more competitors from more places produce surprises and shocks. An intensely competitive global economy places a high premium on innovation, which depends on human imagination, motivation, and collaboration. Global mergers and acquisitions add further complexity, with their success resting on how effectively the organizations are integrated. Moreover, seeking legitimacy or public approval by aligning corporate objectives with social values has become a business imperative. Corporations that cross borders face questions of cultural fit and local appropriateness; they must gain approval from governmental authorities, opinion leaders, and members of the public wherever they operate. Their employees are both internal actors and the company's representatives in the external community.

Only if leaders think of themselves as builders of social institutions can they master today's changes

and challenges. I believe that institutional logic should take its place alongside economic or financial logic as a guiding principle in research, analysis, education, policy, and managerial decision making. In the following pages, I will describe six ways in which great companies use institutional logic, how it gives them an advantage, and how the perspective can radically change leadership and corporate behavior.

A Common Purpose

Conceiving of the firm as a social institution serves as a buffer against uncertainty and change by providing corporations with a coherent identity.

As companies grow, acquire, and divest, the business mix changes frequently and job roles often vary across countries. So what exactly gives a company a coherent identity? Where are the sources of certainty that permit people to take action in an uncertain world? Purpose and values—not the widgets made—are at the core of an organization's identity, and they can guide people in their efforts to find new widgets that serve society.

Consider the Mahindra Group, an \$11 billion multi-business company based in Mumbai that employs 117,000 people in 100 countries. Like many emerging-market enterprises, the Mahindra Group operates in many industries, including automobiles, finance, IT, and several dozen others. And like the great companies, it invests in creating a culture based on a common purpose to provide coherence amidst diversity, proclaiming that it is “many companies united by a common purpose—to enable people to rise.”



About the Spotlight Artist

Each month we illustrate our Spotlight package with a series of works from an accomplished artist. We hope that the lively and cerebral creations of these photographers, painters, and installation artists will infuse the pages with additional energy and intelligence to amplify what are often complex and abstract concepts.

This month we showcase **Sarah Morris**, a British-born American artist whose emotive graphic paintings consciously reference architectural motifs. The busy imagery hints at the challenges individuals and institutions confront in trying to stand out in the urban “theater,” an apt comparison with the effort that mission-driven companies face in trying to be recognized for their efforts.

View more of the artist's work at petzel.com/artists/sarah-morris.

PHOTOGRAPHY BELOW: GETTY IMAGES; TOP RIGHT: JASON SCHMIDT



1906

Upton Sinclair publishes his exposé of bad corporate practices, *The Jungle*, provoking stricter food safety regulations but no improvement in working conditions.

TEENS AND TWENTIES

1913

J.C. Penney introduces a code of conduct that urges employees “to serve the public, as nearly as we can, to its complete satisfaction.”



1914

Henry Ford's “Five-Dollar Day” dramatically increases paychecks, promising to turn workers into consumers. Business leaders denounce his extremism.

At many large companies, mild profit-sharing and stock-ownership plans discourage unions and unrest.

Globalization detaches organizations from one specific society but at the same time requires that companies internalize the needs of many societies. Establishing clear institutional values can help resolve this complex issue. For example, PepsiCo has made health a big part of its aspiration to achieve Performance with Purpose. Nutrition, environmental responsibility, and talent retention are pillars supporting the slogan. Performance with Purpose provides strategic direction and motivation for diverse lines of business in many countries. It requires a gradual shift of resources from “fun for you” to “better for you” to “good for you,” in PepsiCo parlance. It provides a rationale for acquisitions and investments. It is the logic behind the creation of a new organizational unit, the Global Nutrition Group, and new corporate roles, such as chief global health officer. It guides a quest to reduce or eliminate sugar and sodium in foods and beverages. Above all, it provides an identity for the people who work for PepsiCo all over the world.

Leaders can compensate for business uncertainty through institutional grounding. Great companies identify something larger than transactions or business portfolios to provide purpose and meaning. Meaning making is a central function of leaders, and purpose gives coherence to the organization. Institutional grounding involves efforts to build and reinforce organizational culture, but it is more than that. Culture is often a by-product of past actions, a passively generated outgrowth of history. Institutional grounding is an investment in activities and relationships that may not immediately create a direct road to business results but that reflect the values the institution stands for and how it will endure.

Institutional grounding can separate the survivors from those subsumed by global change. A sense of purpose infuses meaning into an organization, “institutionalizing” the company as a fixture in society and providing continuity between the past and the future. The name can change, but the identity and purpose will live on. In 2007, Spain’s Grupo Santander acquired Brazil’s Banco Real and folded

it into its Brazilian assets. But Banco Real’s spirit involved much more than its financial assets. Its then-CEO Fabio Barbosa was put in charge of creating the combined entity, Santander Brazil. Although the new organization faced pressure to increase branch profitability, under Barbosa’s leadership Banco Real’s focus on social and environmental responsibility, along with its private banking model, were infused throughout Santander Brazil and the parent.

Successful mergers are noteworthy for their emphasis on values and culture. When the merger of two Swiss pharmaceutical companies formed Novartis in 1996, CEO Daniel Vasella wanted the new company’s mission to be globally meaningful and central to the integration and growth strategy. The question was how to provide employees with a tangible experience that reflected those values. When I floated the idea of a global day of community service—unheard of in Europe at that time—Novartis agreed. The company allowed each country organization to determine how it wanted to serve local communities, based on its interpretation of what the two histories and one future would suggest. The day of service has become an annual Novartis event, held on the merger’s anniversary.

Affirming purpose and values through service is a regular part of how great companies express their identities. In June 2011, IBM celebrated its 100th anniversary by offering service to the world. Over 300,000 IBMers signed up to perform 2.6 million hours of service on a global service day. They contributed training and access to software tools, many of them developed specially for the occasion, to schools, governmental agencies, and NGOs. Projects included training on privacy and antibullying in 100 schools in Germany; a new website developed in India for the visually impaired, with a launch at 50 locations; and access to small-business resources for women entrepreneurs in the United States. The company gave the tools away, even in cases where the software could form the basis for commercial products, to demonstrate IBM’s commitment to being a contributor to society.

THE GREAT DEPRESSION

Faced with a deep and long-lasting crisis, the public expects the government to ensure good corporate behavior.



1933

The New Deal restrains price competition, regulates banking, and forces companies to negotiate with unions. Most businesspeople oppose these popular measures.

1935

Congressional investigations reveal that on the eve of the Depression, executive pay ran high, igniting debates over how profits should be shared among investors, business leaders, and employees.

A Long-Term Focus

Thinking of the firm as a social institution generates a long-term perspective that can justify any short-term financial sacrifices required to achieve the corporate purpose and to endure over time.

Keeping a company alive requires resources, so financial logic demands attention to the numbers. However, great companies are willing to sacrifice short-term financial opportunities if they are incompatible with institutional values. Those values guide matters central to the company's identity and reputation such as product quality, the nature of the customers served, and by-products of the manufacturing process. Banco Real, for instance, created a screening process to assess potential customers' societal standards as well as their financial standing. The bank was willing to walk away from those that did not meet its tests of environmental and social responsibility. This short-term sacrifice was prudent risk management for the longer term.

Companies using institutional logic are often willing to invest in the human side of the organization—investments that cannot be justified by immediate financial returns but that help create sustainable institutions. In South Korea, after the Asian financial crisis of the late 1990s, Shinhan Bank set out to acquire Chohung Bank, a larger and older bank that the government had bailed out. The moment the acquisition was announced, 3,500 male employees of a Chohung Bank union, whose ranks extended to management levels, shaved their heads in protest and piled the hair in front of Shinhan's headquarters in downtown Seoul. The acquirer then had to decide whether to go ahead with the acquisition and, if it did so, what it ought to do about Chohung's employees.

Shinhan's leaders applied institutional logic. They negotiated an agreement with the Chohung union, deferring formal integration for three years, giving equal representation to both Shinhan and Chohung managers on a new management committee, and increasing the salary of Chohung employees to match the higher wages of Shinhan employees.

Great companies identify something larger than transactions to provide purpose and meaning.

The acquirer also handed out 3,500 caps to cover the heads of the protestors. Shinhan invested heavily in what it called "emotional integration," holding a series of retreats and conferences intended not only to spread strategic and operational information but also to foster social bonding and a feeling of being "one bank." According to financial logic, the acquirer was wasting money. In terms of Shinhan's institutional logic, the investments were an essential part of securing the future.

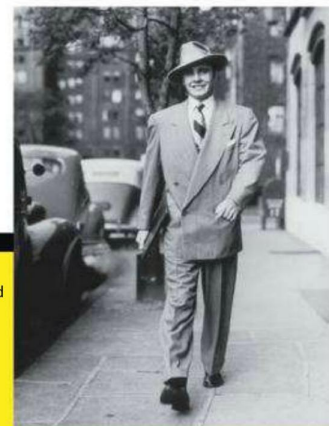
The result: Within 18 months, Shinhan had grown both banks' customer bases, and the Chohung union was having a hard time fomenting discontent against the benign acquirer. Although a formal merger wouldn't occur for another year and a half, Shinhan and Chohung employees were working together on task forces and discussing best practices, and ideas were spreading that began to make the branches look more similar. Employees were, in essence, self-organizing. By the third year, when formal integration took place, Shinhan was outperforming not only the banking industry but also the South Korean stock market.

Emotional Engagement

The transmission of institutional values can evoke positive emotions, stimulate motivation, and propel self-regulation or peer regulation.

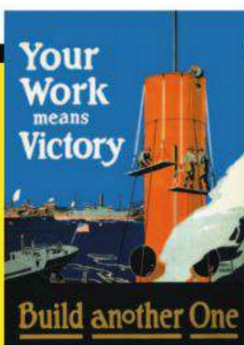
Utilitarian rationality is not the only force governing corporate performance and behavior inside organi-

PHOTOGRAPHY: GETTY IMAGES



WARTIME

Supporting the war effort is seen as a duty—or at least as smart PR. Good companies limit profits on the matériel they supply to the government.



Technical innovation and creativity, crucial to military production, are important criteria in the public's definition of a good company.

When stability returns, employment is idealized as a compact between worker and employer: loyalty in exchange for a job for life.

The Benefits of Institutional Logic

Companies that operate using institutional logic reap substantive benefits.

INSTITUTIONAL LOGIC

is built on a foundation of purpose and values, which serve as a buffer against uncertainty and change.

CONCEIVING OF THE FIRM

as a social institution generates a long-term perspective. Short-term financial sacrifice becomes permissible in the interest of positioning the firm for sustainable success.

STRONG INSTITUTIONAL VALUES

can evoke positive emotions, stimulate intrinsic motivation, and propel self- or peer regulation.

zations; emotions play a major role, too. Moods are contagious, and they can affect such issues as absenteeism, health, and levels of effort and energy. People influence one another, and in doing so they either increase or decrease others' performance levels, as my study of teams and organizations on winning and losing streaks reveals (see my book *Confidence*, Crown, 2004). Well-understood values and principles can be a source of emotional appeal, which can increase employee engagement. Having a statement of values has become common, so the issue is not whether a set of words called "values" exists somewhere in the company. Adhering to institutional logic makes the regular articulation of values core to the company's work. The CEOs of companies I studied, whether headquartered in the U.S., Mexico, the UK, India, or Japan, allocated considerable resources and their own time to breathing new life into long-standing values statements, engaging managers at many levels in the institutional task of communicating values. The point was not the words themselves but the process of nurturing a dialogue that would keep social purpose at the forefront of everyone's mind and ensure that employees use the organizational values as a guide for business decisions.

As a Procter & Gamble executive, Robert McDonald had long believed that the company's Purpose, Values, and Principles was a cornerstone of its culture, evoking strong emotions in employees and giving meaning to the company's brands. Within a month of becoming CEO in 2010, he elevated the

purpose—improving the lives of the world's consumers—into a business strategy: improving more lives in more places more completely.

In P&G West Africa, for instance, every employee has a quantitatively measurable purpose-driven goal: How have I touched this year? So P&G West Africa's Baby Care Group set up Pampers mobile clinics to reduce high rates of infant mortality and help babies thrive. A physician and two nurses travel the region in a van, teaching postnatal care, examining babies, and referring mothers to hospitals for follow-ups or immunization shots. They also register mothers for mVillage, a text-message service (many of the poor in West Africa have cell phones) that offers health tips and the chance to ask questions of health care professionals. At the end of each mobile clinic visit, everyone gets two Pampers diapers. The emotional tugs for P&G employees are strong; they feel inspired by the fact that their product is at the center of a mission to save lives. They also feel proud that Pampers' sales have soared and that West Africa is among P&G's fastest-growing markets.

In companies that think of themselves as social institutions, work is emotionally compelling and meaning resides in the organization as a whole rather than in a less sustainable cult of personality. Top leaders exemplify and communicate the company's purpose and values, but everyone owns them, and the values become embedded in tasks, goals, and performance standards. Rather than de-

THE FIFTIES

Good companies make good products: appliances, cars, and other conveniences that improve the lives of the burgeoning middle class.



1955

For businesspeople, big becomes shorthand for good. The first *Fortune* 500 index of the largest companies appears, with General Motors at the top.



Even advertising is seen as playing a positive social role. By making people want more and better things, the argument goes, ads raise the standard of living.

GREAT COMPANIES SEE BUSINESS

as a primary pillar of society. This focus facilitates the kind of cross-border and cross-sector engagement needed to tap global opportunities. Through the formation of public-private partnerships, firms consider the public interest along with business priorities.

THE ATTENTION PLACED ON

social conditions often generates experiences and ideas that lead to learning for innovation in products, services, and business models.

IN A FIRM STEERED BY INSTITUTIONAL

logic, employees can be treated as self-determining professionals, coordinating and integrating activities and producing innovation through self-organization in addition to formal assignments.

pending on charismatic figures, great companies “routinize” charisma so that it spreads throughout the organization.

Partnering with the Public

The need to cross borders and sectors to tap new business opportunities must be accompanied by concern for public issues beyond the boundaries of the firm, requiring the formation of public-private partnerships in which executives consider societal interests along with their business interests.

One paradox of globalization is that it can increase the need for local connections. To thrive in diverse geographies and political jurisdictions, companies must build a base of relationships in each country with government officials and public intermediaries as well as suppliers and customers. Only by doing so can companies ensure that agendas are aligned even as circumstances—and public officials—keep changing. Those external stakeholders are interested as much in the corporations’ contributions to the local community as they are in their transactional capabilities. At the same time, great companies want both an extended family of enduring relationships and a seat at the table on policy matters affecting their business.

Public-private partnerships to address societal needs are growing in number and importance, and are especially prevalent among enterprises that think institutionally. Partnerships can take many forms: International activities, conducted in collaboration with the United Nations and other global

organizations (such as Procter & Gamble’s Children’s Safe Drinking Water program with UNICEF and several NGOs); large domestic projects, undertaken in collaboration with government ministries and development agencies (PepsiCo’s agricultural projects in Mexico with the Inter-American Development Bank, for example); product or service development to address unmet societal needs (for instance, P&G’s linkages with public hospitals in West Africa); or short-term volunteer efforts (IBM’s work following the Asian tsunami, Hurricane Katrina, and earthquakes in China and Japan to provide software to track relief supplies and reunite families).

In companies that adhere to an institutional logic, executives cultivate relationships with public officials neither as a quid pro quo nor to push through particular deals. Rather, they seek to understand and contribute to the public agenda even as they influence it. For example, PepsiCo’s chief global health officer, who came from the World Health Organization, is planning a cross-sector project to reduce childhood obesity. IBM’s CEO, Samuel Palmisano, circumnavigates the globe six or seven times a year to meet with national and regional officials, discussing how IBM can help their countries achieve their goals. This is not sales or marketing; it’s a high-level conversation to demonstrate the company’s commitment to furthering the development of the countries it operates in. Such engagement at the top helps other IBM leaders get a seat at the table when discussions about the country’s future take place.

PHOTOGRAPHY GETTY IMAGES, AP IMAGES

THE SIXTIES**1964**

The Civil Rights Act passes, and lack of discrimination becomes the new ethical bar that companies must clear. A year later the first black director joins a major company board.

**1965**

Ralph Nader’s *Unsafe at Any Speed* exposes disregard for safety concerns at car companies, raising consumer awareness. Product safety emerges as a new standard of goodness.



Companies' claims that they serve society gain credence when they allocate resources to community projects without seeking immediate returns.

Institution building requires the efforts of many people. The more interested that top leaders are in external relations, the more likely they are to involve others and to reward them for building relationships with the nation and community. Although relatively few people might hold formal responsibility for these external interfaces, a great many might perform institutional work by volunteering, attending public meetings, and participating in community service. Such activity projects a sense of authentic motivation. Community building is not a hard sell for people native to an area or for long-term residents; there is an emotional pull of place that makes such work desirable. For others whose careers take them across geographies, this work is a way to connect their organizational roles with the places they now live, making them feel more rooted.

When leaders come to see themselves as having societal purpose, they can choose to get involved at local, national, and even global levels. A few years ago, the head of IBM Greater China organized a personal diplomatic mission to Washington, meeting with White House officials and U.S. politicians to discuss the impact of China's emergence as an economic superpower. He had a desire to see both nations thrive and believed that his role in a global company afforded him a unique perspective. After retiring in 2009, he remained an IBM "super alum," in company parlance, and was supported by IBM in attending a major U.S. university for a year, with the company's support, to learn about health care. At the end of 2010, he returned to China and launched an initiative with a Chinese government institute to

develop an IT-enabled evidence base for traditional Chinese medicine that will build on IBM ties.

Innovation

Articulating a purpose broader than making money can guide strategies and actions, open new sources for innovation, and help people express corporate and personal values in their everyday work.

Companies' claims that they serve society become credible when leaders allocate time, talent, and resources to national or community projects without seeking immediate returns and when they encourage people from one country to serve another. IBM's Corporate Service Corp, for instance, develops future leaders by sending diverse teams of the company's best talent on monthlong projects around the world. The attention placed on social needs often generates ideas that lead to innovations. For Cemex, operating by institutional logic and considering unmet societal needs produced innovations such as antibacterial concrete, which is particularly important for hospitals and farms; water-resistant concrete, useful in flood-prone areas; and road surface material derived from old tires, desirable in countries that are building roads rapidly. An idea from Egypt for saltwater-resistant concrete, helpful for harbor and marine applications, became a product launched in the Philippines.

Institution building helps connect partners across an ecosystem, producing business model innovation. Cemex started Construrama, a distribution program for small hardware stores, in 2001 as a response to competition from Home Depot and Lowe's, which were then entering Latin America. Construrama offers the small stores training, support, a strong brand, and easy access to products. In accordance with its values, Cemex sought dealers who were trusted in their communities, rejecting candidates whose business tactics didn't meet the company's ethics standards. Cemex owns the Construrama brand and handles promotions but doesn't charge distributors, operate stores, or have decision-making authority. It requires, however, that

THE SEVENTIES

As companies struggle to survive "stagflation," efficiency becomes a mark of goodness.

1978

The Airline Deregulation Act introduces competition to an inefficient industry. Major airlines, unions, and safety advocates all oppose the act, but consumers like the prospect of lower fares.



Encouraged by the success of Japanese imports—and by Peter Drucker—good companies emulate Japan's quality-obsessed industrial practices.

THE EIGHTIES

Under pressure from global competition, business leaders focus increasingly on a single measure of goodness: shareholder value.

stores meet its service standards. Among those is participation in community-building philanthropic endeavors—expanding an orphanage or improving a school, for instance. By the mid-2000s, Construrama had opened enough stores to qualify as a large retail chain in Latin America and was expanding into other developing countries.

Creating opportunities for individuals to use company resources to serve society furthers institution-building goals. Novartis employees serve in hospitals, where they see firsthand the challenges of disease and how their drugs are used. In 2011, P&G employees set out in Tide Loads of Hope vans to visit communities in the southern U.S. ravaged by floods. In the mobile Laundromats, managers and other professionals washed and folded clothes for local people, getting to know them and their circumstances. These kinds of interactions express corporate values and produce valuable learning, too.

Self-Organization

Great companies assume they can trust people and can rely on relationships, not just rules and structures. They are more likely to treat employees as self-determining professionals who coordinate and integrate activities by self-organizing and generating new ideas.

Institutional logic holds that people are not paycheck-hungry shirkers who want to do the bare minimum, nor are they robots that can be ordered to produce high performance. Instead, employees make their own choices about which ideas to surface, how much effort to put into them, and where they might contribute beyond their day jobs. Resource allocation is thus determined not only by formal strategies and budgetary processes but also by the informal relationships, spontaneous actions, and preferences of people at all levels.

Fully understanding a company requires knowledge of its social structure and informal networks, and optimizing performance requires social investments. At Shinhan Bank, the two banks self-integrated through social bonds and relationships well in advance of the three-year mark when official

integration was to take place. The new connections manifested in such actions as each bank's voluntarily hanging the other's banner in its headquarters. At Procter & Gamble, managers in Brazil turned strategic and organizational traditions on their head to develop low-cost, high-quality alternatives to premium products. They undertook this risky initiative on their own and self-organized to ensure closer cross-functional teamwork and partnerships with customers. They felt that they had an obligation to improve the lives of consumers who could not afford premium products. Similar institutional logic led the P&G Himalaya team, a global cross-functional group, to find ways to make Gillette razors affordable and desirable to men often bloodied by barbers using rusty or worn-out blades.

Managers in great companies understand that formal structures can be too general or too rigid to accommodate multidirectional pathways for resource and idea flows. Rigidity stifles innovation. Informal, self-organizing, shape-changing, and temporary networks are more flexible and can make connections between people or connect bundles of resources more quickly. Employees' formal roles come to resemble the home base from which they are continuously mobile as they carry out daily tasks and projects, develop work relationships, and participate in team or group activities. Matrix organizations—in which individuals report to two or more bosses depending on the different dimensions of their tasks—become what I dub a matrix on steroids. People are accountable along many dimensions

Articulating a purpose broader than making money can open new sources for innovation.

PHOTOGRAPHY GETTY IMAGES, FAR RIGHT: AP IMAGES

1981

President Reagan's firing of striking air traffic controllers, combined with widespread corporate layoffs, leads to a dramatic falloff in union influence over companies.



1983

Fortune publishes its first list of "America's Most Admired Companies," based on a survey of business leaders. The tech and pharmaceutical industries dominate the top 10.

THE NINETIES

The idea of corporate social responsibility, which has been stuck in academia for 40 years, goes mainstream. Now good companies create CSR departments.



Silicon Valley's success redefines the best companies as the most innovative. Intel and 3M draw envy for disrupting their industries.

Trusting people to make choices about where, when, and with whom they should work makes jobs more engaging.

simultaneously, attending to multiple projects and using their networks to assemble resources for all those projects, often without going through a decision-making hierarchy.

Although there is a drudgery and confinement component to many jobs—plenty of Cemex employees work in factories, Shinhan's banks have tellers stuck behind counters, and every company has stay-at-desk support staff—trusting people to make choices about where, when, and with whom they should work makes jobs more engaging. For example, on any given day about 40% of IBMers in the U.S. do not go to an IBM office. They work at home or at customer sites, moving between locations and taking vacations at times of their choosing. IBM's work-at-home programs, such as the one started in Japan in 2001, have caught the attention of governments interested in keeping women with technical degrees in the workforce. In some cases, IBM offers allowances to support infrastructure in the home, which has enabled a Harvard graduate working in India to combine project work with child-rearing, for instance, and a software manager from Egypt to move with her husband to Dubai.

Institutional logic assumes that people can be trusted to care about the fate of the whole enterprise—not just about their own jobs or promotions—and to catalyze improvements and innovations with-

out waiting for instructions or sticking to the letter of a job description. Job descriptions nowadays document only part of what people do; performance reviews and salary bands capture only some of the activities through which people might add the most value for the company.

When people self-organize to create networks to share information, new initiatives or innovations are often the result. Organizations must encourage the creation of such networks, of course, and facilitate them through communication platforms or meeting spaces, but the networks usually flourish best if they spring from volunteers who do things that bosses might not have anticipated. What's more, these self-organized networks often keep good ideas alive long after an organization would have abandoned them.

For example, three PepsiCo managers in Latin America had shared a dream for around a decade of developing new kinds of potatoes that were suitable for southern climates, less starchy, and environmentally sustainable. They felt that the initiative should be based in Peru, the potato's birthplace. The troika remained in contact despite their moving to different locations, and even after years of ho-hum response, they presented their ideas wherever they could. They eventually received a boost when a new Peruvian potato chip whose creation they championed became a sensation. The chips, which used multicolored potatoes from small farmers in remote villages in the Andes, combined nutrition, tastiness, and social contribution. Proof of concept turned the dream into reality: In August 2010, CEO Indra Nooyi announced the establishment of a global potato development center in Peru, headed by one of the three champions.

Self-organizing communities can be a potent force for change, propelling companies in directions they might not have taken otherwise. People with no formal orders serve as explorers and entrepreneurs. For example, had it not been for self-forming networks, IBM might have lagged behind or even missed out on two big business ideas: virtualization and green computing. These emerged as among

PHOTOGRAPHY: GETTY IMAGES

1997

The public's rising awareness of sweatshop labor and environmental damage pushes corporations like Nike to keep a closer eye on their global supply chains.

THE NEW CENTURY

In a decade bookended by burst bubbles, corporate reputations suffer as the public directs its anger at corruption and executive pay.



Social entrepreneurs and multinationals see opportunities to make money by finding innovative ways to solve problems in the developing world.



Companies from GE to Walmart redefine their missions to include producing social as well as economic value.

**“THE DISCUSSION
GAVE US GLOBAL
EXPERIENCE
IN VASTLY DIFFERENT
COMPANIES
AND INDUSTRIES.”**

—Chet Szablak,
General Management Program 2008



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**“I LEARNED TO
CHALLENGE
MYSELF, MY PEERS,
THE BUSINESS,
AND THE BOSS.”**

—Jennifer Goodwyn,
Advanced Management Program 2006

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IBM's top strategic priorities after an Innovation Jam in July 2006, a web chat spanning several days to which over 140,000 employees contributed ideas.

The virtualization initiative came together outside of formal structures and, initially, as a voluntary activity. Some 200 early adopters of virtual platforms—such as Linden Labs' Second Life and similar platforms—found each other through the company's chat rooms and created an ad hoc group of people who shared ideas in their free time through avatars and weekly phone calls, with conference lines sometimes open in the virtual world, too. After a year of informal self-organization, the network found an IBM executive sponsor. IBM then designated virtualization an emerging business opportunity and provided funding for it.

MY ARGUMENT has come full circle. A logic that justifies treating employees as self-determining volunteers—in essence, as true professionals who care about high performance because they believe in the company as institution—makes it important to have a motivating purpose and values to provide coherence and common identity. The first enables the last. The six principles I describe in this article are interrelated and share many characteristics. Especially for great global companies, institution building is not the result of carrying out specific activities but a coherent, holistic pursuit in which elements reinforce one another, are inextricably intertwined, and

reflect a logic and leadership style that permeate the corporation.

Skeptics abound, of course. Firms that present themselves as institutions concerned with serving society often come under more scrutiny than others do, and they must withstand criticism about the gap between stated aspirations and performance, financially and socially. If they make money while doing good, they will be criticized for manipulation; if they do some good but not enough to solve complex problems, they will be criticized for lack of courage or commitment. Despite a growing number of advocates for a new kind of capitalism that finds win-win opportunities by creating value for both business and society, there is still controversy over the obligations of business.

The great global enterprises are not waiting for grand new theories or perfect answers. Their leaders already use an institutional or social logic to supplement economic or financial logic in guiding and growing their enterprises. Institutional logic cannot be captured by cost-benefit equations or reduced to the language of economics, and yet it turns out to be a powerful driver of financial performance.

Leaders in the great companies can tell a different story about the basis for their decisions. In so doing, they are able to produce new models for action that can restore confidence in business and will change the world in which we live. ♣

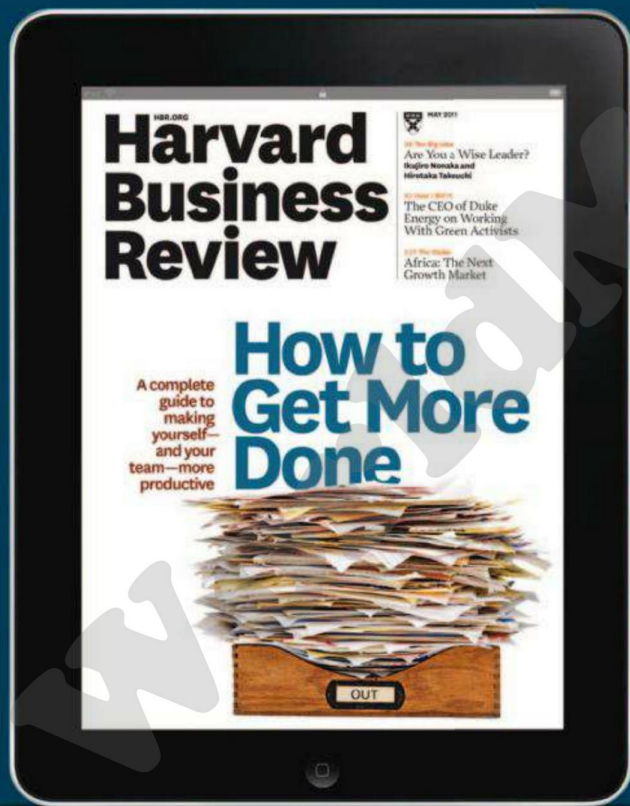
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"I was the firm's cutting edge, pushed the envelope, did the heavy lifting, and was the rainmaker. Then I ran out of metaphors."

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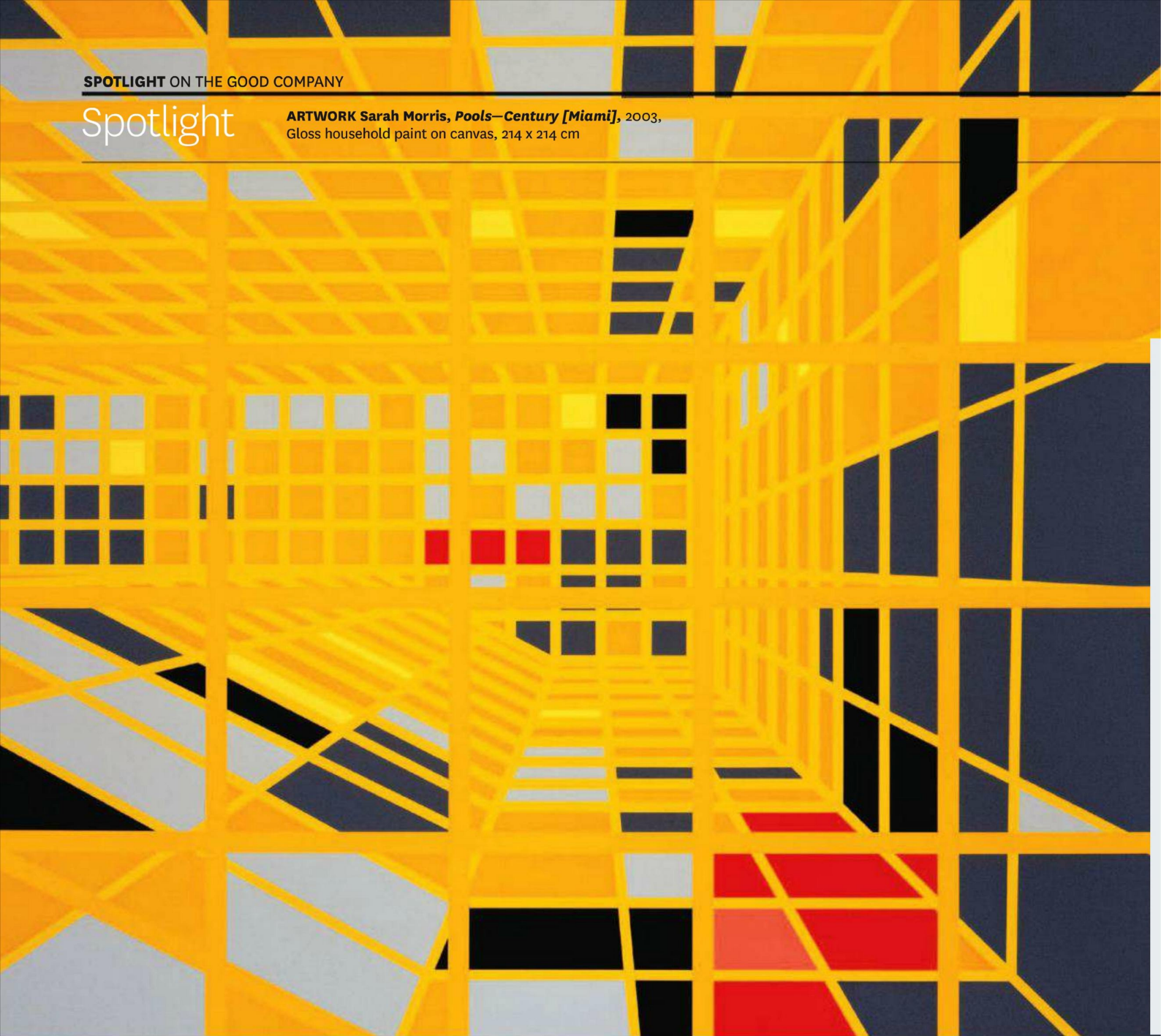
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“Why Don’t We Try To Be India’s Most Respected Company?”

He may not appear to be one, but **N.R. Narayana Murthy** is quite the contrarian. At a time when few Indians felt they could become entrepreneurs, he founded Infosys with just \$1,000 in the bank. When no one believed that India could offer the world high-tech products, he dared to develop software services for export. In an era when conducting business ethically was virtually unheard of, he created a values-based corporation. Today, as public anger against rampant corruption in India boils over, Infosys faces a turning point, with Murthy stepping down as chairman. In this edited conversation with HBR's Anand P. Raman, Murthy reflects on his tenure and explains that for companies to be financially successful and good, leaders must demonstrate that values matter at every turn, with every employee.

HBR: "Powered by intellect, driven by values"—that's the Infosys credo. How could you imagine creating a values-driven company in the India of 1981, where corruption, nepotism, and profiteering were—and by all accounts still are—a way of life?

Murthy: In May 1981, seven of us crowded into the tiny bedroom of my rented apartment in Mumbai. I had decided to quit my job to create a professionally managed software company and had invited six colleagues to join me. The meeting was to develop our vision for the new company. One of us suggested that we should try to become India's largest software company. Someone else said that our goal should be to become the country's biggest job creator. A third opinion was that we should strive to be the software firm with the highest market capitalization. When my turn came, I pushed back on those ideas, saying, "Why don't we aim to be India's most respected company?"

What did you mean by that in practice?

If we sought respect from all our stakeholders, I felt, we would achieve our vision. If you seek respect

from customers, that means you must deliver what you promise. If you seek respect from employees, you must treat them fairly and with dignity. If you seek respect from investors, you must operate with transparency and accountability. If you seek respect from vendor-partners, you must deal with them on merit. If you seek respect from governments, you must never violate any laws. If you seek respect from society, you must live in harmony with it and create goodwill. If we could do all that, I argued, we would attract customers, employees, vendors, and investors; revenues, profits, and market capitalization would follow.

After much discussion, we agreed to create a values-based organization. The vision statement we drafted that night was to be India's most respected company delivering best-of-breed technology solutions and employing best-in-class professionals. The conversation also laid the foundation for Infosys's value system: C-LIFE, which stands for Client focus; Leadership by example; Integrity and transparency; Fairness; and Excellence in everything we do. Our vision was the answer to the question, What

are we trying to achieve collectively? The values answered the query, How will we achieve the vision?

Why would you wish to seek respect—not profit, as other entrepreneurs do? Didn't your cofounders think you were being idealistic or inauthentic?

Not at all. Seeking respect was natural for us. We were all born into Indian middle-class families and had developed a strong sense of values from childhood. Our parents taught us the importance of education, hard work, decency, courtesy, honesty, respect for others, and putting the community's interest ahead of that of the individual. Our external role models were our teachers, both in school and university, who taught us to be inquisitive, analytical, articulate, and team-oriented. Setting up a values-based company was therefore like a reflex action for us—like breathing.

Since we came from the middle class, our financial expectations were not very high. Making money wasn't essential; earning respect was. Business would come, we believed.

In preliberalization India, where the government regulated business extensively and paying bribes was essential to getting things done, wasn't Infosys at a disadvantage because of your convictions?

When you say that you are committed to values, it implies that you are willing to pay a price for them. Otherwise, there is no meaning in saying you are a values-driven company.

Can you give me an example?

Let me tell you a story that I often tell our people. In February 1984, Infosys decided to import a super minicomputer so that we could start developing software for overseas clients. When the machine landed at Bangalore Airport, the local customs official refused to clear it unless we "took care of him"—the Indian euphemism for demanding a bribe. A delay could have meant the end for us before we had even started. When an Infosys manager informed me about the problem, my only question was, "What is the alternative to paying a bribe?" The manager hesitantly replied that we could pay a customs duty of 135% and then appeal for a refund. I told him: "Do that."

We didn't have enough money to pay the duty and had to borrow it. However, because we had decided to do business ethically, we didn't have a choice. We would not pay bribes. We effectively

paid twice for the machine and had only a slim chance of recovering our money. But a clear conscience is the softest pillow on which you can lay your head down at night.

Apart from providing a good night's rest, did any business benefits accrue to Infosys because of your principled stand? You suffered from a competitive disadvantage, I'm sure, since not all your rivals—except TCS and Wipro—followed your example.

It takes time to benefit from putting values first. You feel the pain immediately and you reap the gains only in the long run. The customs episode immediately sent a signal that Infosys's leaders would back employees whenever they chose to take values-based decisions. It gave our people the confidence to follow the right path, even when everyone around them was bending the rules. It also boosted their enthusiasm; they became more committed to the company and more productive. It took just a few years for corrupt officials to stop approaching us for favors. Because of Infosys's ethical image, our clients entrusted us with increasingly bigger projects. Our values have thus become our advantage, gaining us larger revenues, top-flight talent, and great investors and earning us the respect of governments and societies.

How did you deal with senior executives in developed countries who wanted their palms greased? Adhering to values must have been tougher in those cases; outsourcing is a cutthroat business.

To our clients and their representatives, we have always offered our sincere thanks, deep commitment, hard work—and nothing else. We have had an extraordinary set of values-based customers, but there are always exceptions. In the early years, I remember, Infosys bid for a \$1 million contract from a large enterprise in a developed economy. When I visited the company, the CIO invited me out for dinner. During the meal, he mentioned several times how much he desired a particular car. Each time, he followed that up by saying that it would be nice if Infosys landed the contract. I guess I was naive. I kept turning it into a joke, saying that while it would be easy for him to buy the car, bagging the contract over the competition wasn't as simple. Finally, the CIO decided to be blunt: "Why don't you buy me that car and I will award you the contract?" he said. That's when I realized that he was asking for a bribe. I politely told him that Infosys didn't do

such things, and the dinner ended quickly. The CIO didn’t get his car, but Infosys got the contract, by the way. You have to learn to stand by your principles; it’s wrong to believe you have to bribe your way to success.

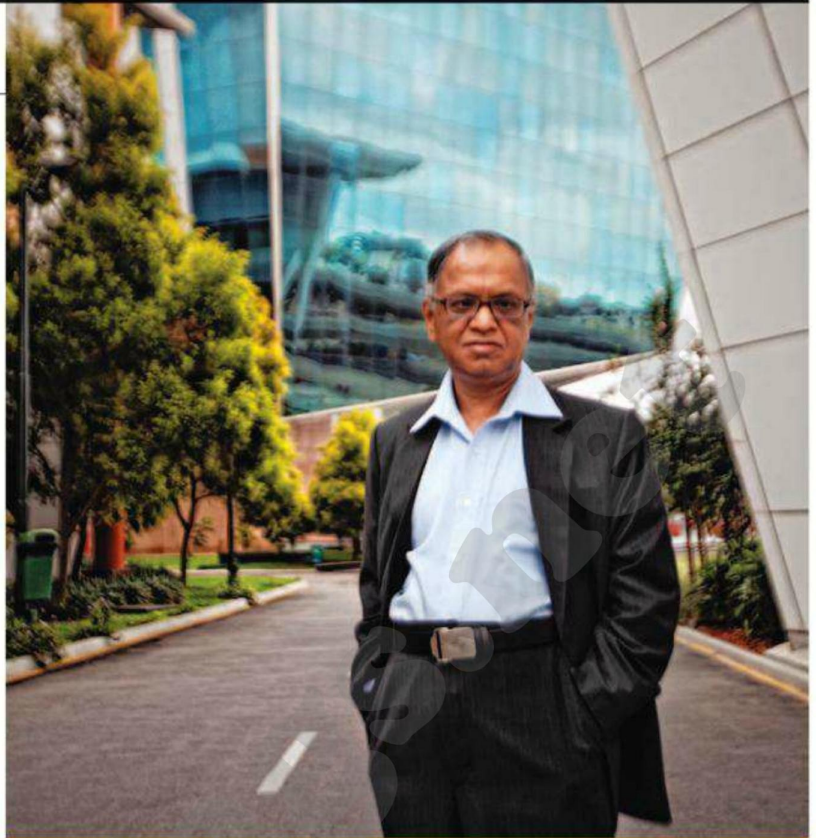
Surely, it isn’t as simple as that. Don’t you have to be willing to walk away from customers, segments, and even markets? Why did Infosys exit the packaged software business in India in the late 1980s? You’re right; we had to give that up because we wanted to do business by the book. In those days, we used to import and distribute software packages. The government of India used to levy a customs duty of 135% on imported software packages, but most companies manipulated their invoices to avoid paying duties. This enabled our rivals to reduce the landed cost of software, which was good for the customer, I guess. However, my colleagues and I decided that we would not follow that practice even though it wasn’t illegal, according to many lawyers. Infosys needed the cash flow, but since we wouldn’t operate in a gray area, we couldn’t successfully pursue that opportunity. Getting out was a no-brainer for us.

Isn’t it enough for a good company to follow the laws?

A good company must always go beyond following the law. Ethical behavior transcends legal compliance: It’s about satisfying your conscience, whereas legal compliance is about satisfying the authorities. Let’s say I am walking alone on a deserted path along the Charles River in Cambridge, when I see a \$100 bill lying on the ground. There is no one around and no house for miles. No one will know if I pick up the money and walk away. I can hand over that bill to the police, or I can spend the money. Spending it may not be illegal, but it would be unethical. That, to me, is a value—something that stays with you even when you are alone.

Does Infosys have a zero tolerance policy?

Whenever we receive a complaint that an employee is violating our values, we investigate it, give a fair chance to the individual to argue his or her case, come to a conclusion, and take action. We have let several extraordinarily bright and useful people go because they violated the spirit or the letter of our value system. For instance, we fired a project manager for fudging a taxi bill to the tune of \$40.



“Making money wasn’t essential; earning respect was.”

He was a crucial member of the team, but our zero tolerance policy would not allow us to continue to employ him.

We also applaud good behavior. As part of our annual awards function, we honor the individual who, according to his or her peers, has demonstrated the best commitment to our values that year.

Not every manager in Infosys has always adhered to its values. Take the former head of Infosys’s worldwide sales, whose executive assistant in the U.S. accused him of sexual harassment. He had to resign, and Infosys and its insurers paid over \$3 million to settle the charges in 2002. How could something like that happen in a values-based company?

I would prefer not to comment on the case, which still saddens me. The person was brilliant, a star performer, brought lots of value to the company, and many considered him my favorite! Still, the moment I learned of the issue, I initiated an investigation and informed the board. The board made

a considered decision, and we implemented it immediately. The individual concerned paid a price for his mistake, and the chapter is now closed.

Infosys has recently been accused of breaking U.S. visa laws by providing full-time workers with visas meant only for visitors. That doesn't sound like something an ethical company would do.

I can't comment on that, either; the matter is sub-judice. I can say only that I am saddened that Infosys has been issued a subpoena by a U.S. grand jury.

Should CEOs be totally honest with shareholders, or are there things they are better off not knowing?

Let the good news take the stairs, but make sure the bad news takes the elevator, I always say. Companies must be honest with all stakeholders except on issues that may create asymmetry of information and lead to insider trading. Infosys has demonstrated complete transparency in dealing with our investors, which has always worked in our favor. We learned that in 1995, while waiting for approval from the Reserve Bank of India to open a sales office

conscious; to lead a movement to improve the standards of corporate governance; to help the community when there are floods and other calamities. It isn't just the man on the street who demands that—our 130,000-plus employees do, too. They're smart, draw their own conclusions, and question us. Infosys must meet those expectations if it isn't to lose employees' hearts, and we do our best on all those counts.

Since you are unlikely to believe that business should be business's only business, how broadly do you define Infosys's social contract?

Don't get me wrong: Maximizing shareholder value is essential. If Infosys doesn't do that, we won't be strong and will not be able to serve any stakeholders. However, we must maximize shareholder value legally, ethically, and fairly.

The best index of a corporation's success is its longevity, which comes from living in harmony with society. We achieve that objective in many ways. Fifteen years ago, we set up the Infosys Foundation, to which we contribute a certain percentage of our profits every quarter, to address some of the basic needs of the poorest of the poor in India and the United States. In India, the foundation has built hospitals and homes for the destitute, given scholarships to poor children, built libraries in over 15,000 villages, and rehabilitated prostitutes. We have donated PCs to thousands of schools in India. In the United States, we support initiatives to improve science and mathematics education in inner city schools.

You said that values govern your decisions about whether or not to enter businesses and countries. Are Infosys's values therefore part of its strategy process?

Yes. Strategy is what we have to do to create and maintain sustainable differentiation vis-à-vis competitors. One aspect of our differentiation is our emphasis on values. Our values give our customers confidence that we will deliver on our promises, stand by them in every situation, and that we will spare no efforts to make them look good in front of their customers. Still, values cannot be just part of the strategy process; they have to be second nature for everyone in the organization.

Which brings us to the key question: How do you sustain a values-driven culture when the company

“Let the good news take the stairs, but make sure the bad news takes the elevator.”

abroad. We decided to invest the amount allocated for the purpose in the stock market, hoping to make a quick return. Unfortunately, we incurred a significant loss on our investment. At that time, according to the Indian GAAP, Infosys need not have provided the details of its loss to shareholders. But we believed that this was a moment to demonstrate our commitment to the Infosys principle, when in doubt, disclose. We went public with the details, and to our delight, Infosys shareholders took our disclosure as a sign of our transparency and didn't punish us in any way.

Does Infosys's reputation as a values-based firm put pressure on you to do more in other areas?

As Infosys has grown, society's expectations have risen. People expect us to be environmentally



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“We didn’t lose our health, suffer trauma, or break up our families because we followed a values system.”

is growing at over 50% per annum, its operations are globalizing, and more than 30,000 young people join the firm while 10,000 leave every year?

For many years, Infosys’s values system was unwritten but well practiced. In 1998, we decided to document it. Our employees come from different nationalities, genders, religions, and political points of view, so we have to work to transform that plurality into a shared worldview of ethics and values.

Infosys has a three-step process for disseminating the C-LIFE system: Communication, engagement, and enablement. C-LIFE sessions are mandatory for new entrants and lateral hires. We use Infy TV and Infy Radio to spread Infosys’s convictions about values, and we have created points of contact for solving ethical dilemmas. A C-LIFE manual works as a ready reckoner for employees. Our 700 leaders are constantly reinforcing our values; many spend their lunch breaks with young employees, discussing our values.

What is the role you personally play in communicating Infosys’s values?

From the day I started Infosys, I made it a point to address every new batch of employees. I told them that I could guarantee them only three things. One, every Infosys transaction will enhance their respect and dignity. Two, the company will conduct itself in a fair, transparent, and ethical manner, so they will never have to hang their heads in shame. Three, they will learn three times more at Infosys than at any other company.

I then recount the Infosys story, lacing it with anecdotes about the difficulties we faced, the bold decisions and sacrifices we made, and how we resolved ethical and moral dilemmas. I describe our progress: From a 100-square-foot office (my bedroom) to 28 million square feet of space today; from \$250 of capital to a market capitalization of \$36 billion; from a \$10,000 kitty to \$3.8 billion of cash today. Yet, we didn’t lose our health, suffer psychological trauma, or break up our families because we followed a values system.

Managers often say that leaders don’t walk the talk when it comes to values. How do Infosys’s leaders avoid that trap?

The best instrument for gaining trust is leadership by example. Most leaders forget that employees and stakeholders are watching them closely and that their every action will be discussed, lauded or criticized, and, often, imitated. Leaders have to be careful not to create dissonance between what they say and do. When we set up Infosys, I took a cut in pay while my colleagues got small increases. Similarly, we awarded 70% of Infosys’s equity to people who had hardly 18 months of experience. Decisions like these gave Infosys’s employees confidence in their leaders. My younger colleagues didn’t hesitate to make sacrifices later because they had seen me do so from the start.

We also follow protocols about punishments whether the person is a CEO or a janitor. On at least three occasions, board members have had to pay heavy penalties for what could be considered minor infractions. Setting an example at the top is the best way to instill confidence throughout the company.

Before this interview is published, you will step down as Infosys’s chairman, a position you held for three decades. How confident are you that Infosys will continue to be a values-driven company?

Listening to your conscience helps you do the right thing, so every employee—or Infoscion, as we call them—must be guided by that inner voice in making every decision. As long as Infosys’s leadership continues to foster an environment in which employees feel a responsibility to their conscience, it will deliver results.

After August 20, 2011, my title will be chairman emeritus; I will no longer have a role in strategy formation or execution. However, every Infoscion will have the right to consult me, particularly on issues relating to our values. I hope to help Infosys continue to be strong and adhere to its values even in moments of great temptation. ▣

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RioTinto

Rio Tinto Finance (USA) Ltd.
\$2 billion
Three tranche due
2016/2021/2040
Active bookrunner
September 2011



Toyota Motor Credit Corp.
\$2.5 billion
Dual tranche due
2016/2021
Active bookrunner
September 2011



H.J. Heinz Co.
\$700 million
Dual tranche due
2016/2021
Active bookrunner
September 2011



PepsiCo, Inc.
\$1.25 billion
Dual tranche due
2014/2021
Active Bookrunner
August 2011



Dominion Resources, Inc.
\$500 million
4.900% due 2041
Active Bookrunner
August 2011



BAA Funding Ltd.
\$1 billion
4.875% due 2021
Active Bookrunner
June 2011



WEA Finance LLC
\$1 billion
4.625% due 2021
Active Bookrunner
May 2011



Pernod Ricard S.A.
\$1 billion
5.750% due 2021
Active Bookrunner
April 2011



Time Warner Inc.
\$2 billion
Dual tranche due 2021/2041
Active Bookrunner
March 2011



Dell Inc.
\$1.5 billion
Four tranche
Active Bookrunner
March 2011



Sanofi-aventis S.A.
\$7 billion
Six tranche
Active Bookrunner
March 2011



BP Capital Markets p.l.c.
\$3.7 billion
Three tranche due
2016/2021/2014 FRN
Active Bookrunner
March 2011

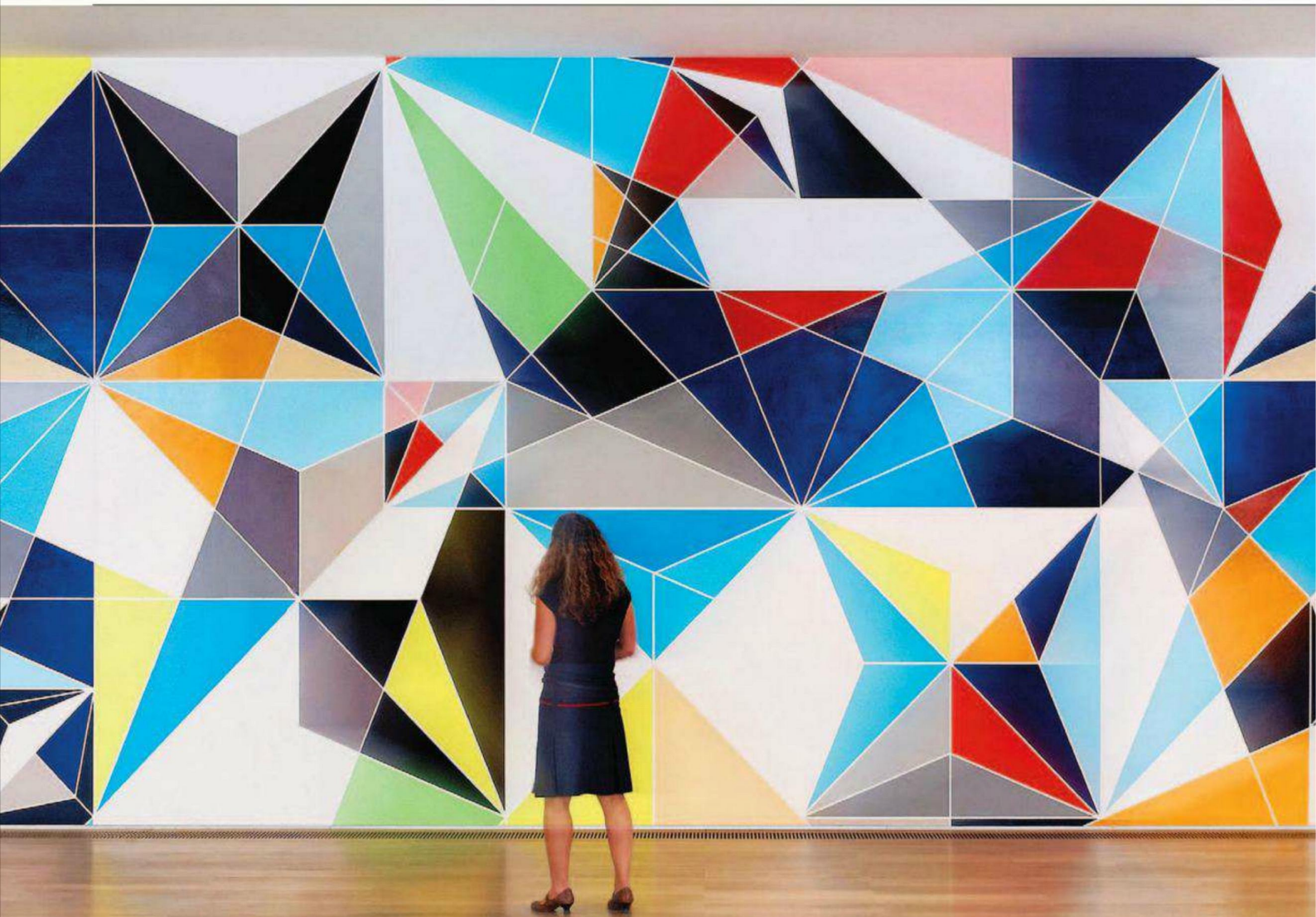


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It's Hard to Be Good

But it's worth it. Here are five companies whose success is built on responsible business practices. by Alison Beard and Richard Hornik



ON THE FOLLOWING PAGES, HBR profiles five “good” companies that do more than just pay lip service to community engagement, labor relations, environmental protection, corporate governance, and supply chain accountability. Neither our editors nor the academics we consulted have voted them the world’s most socially responsible corporations. But each excels in one or more of the areas just listed, and does so by making them part of its internal corporate

logic—something that Rosabeth Moss Kanter argues, in another article in this Spotlight, that all businesses should do.

These firms have also succeeded commercially—hard evidence that doing the right thing as a company doesn’t conflict with bottom-line imperatives. As Zhang Yue, the founding chairman of Broad Group, says, “The survival and growth of a company is the same thing as its social responsibility.”

The Experts

Pamela Hartigan is the director of the Skoll Centre for Social Entrepreneurship at the University of Oxford's Saïd Business School. She is also a founding partner of Volans.

Thomas Kochan is the George Maverick Bunker Professor of Management and a codirector of the Institute for Work and Employment Research at the MIT Sloan School of Management.

Christopher Marquis is an associate professor in the organizational behavior unit at Harvard Business School.

Roger Martin is the dean of the Rotman School of Management at the University of Toronto.

Dan Esty is the Hillhouse Professor of Environmental Law and Policy at Yale University. He is also the director of the Yale Center for Environmental Law and Policy and the Center for Business and the Environment at Yale, and the commissioner of the Connecticut Department of Energy and Environmental Protection.

NOTE ALL TOTAL SHAREHOLDER RETURN FIGURES ARE AS OF AUGUST 2011

Alison Beard is a senior editor, and **Richard Hornik** is a contributing editor, at HBR. **Heather Wang, Meghan Ennes, Erin Rush,** and **Samantha Presnal** provided additional reporting for this article.

Royal DSM



NOTABLE STRENGTH

Community Engagement

CORE BUSINESS Chemicals
COUNTRY Netherlands
YEAR FOUNDED 1902
EMPLOYEES 22,000

2010 REVENUE

€8.2 billion

10-YEAR ANNUALIZED TOTAL SHAREHOLDER RETURN 9.6%

FACT A group of South African primary school children who ate porridge fortified with MixMe, a DSM multi-micronutrient powder, saw their mean store of body iron double over the course of a 23-week company-sponsored clinical study.

A DECADE AGO, Royal DSM's core offerings were petrochemicals, plastics, and base chemicals and materials. Today the Dutch firm is in the same sector, but its output is very different: nutritional supplements, pharmaceutical ingredients, and energy-efficient building materials.

If the company's first step on the path to being a good corporate citizen was to develop and sell more-sustainable, health-enhancing technologies and products, the second step is even bolder—and less obviously commercial: giving them away to those who need them most.

But both moves are strategic and designed to

promote long-term corporate success in an increasingly complex global economy. The biggest initiative is a partnership with the World Food Programme to distribute DSM's vitamins, nutrient mixes, and fortified food to malnourished people in Nepal, Kenya, Bangladesh, and Afghanistan;

"A lot of companies' CSR initiatives have nothing to do with their core business. DSM, by contrast, has used its savoir faire, its expertise, and mobilized staff to improve the nutrients in the food given in situations of famine or hunger. If we could clone Feike Sijbesma, the CEO, the world would be a better place."
Pamela Hartigan, Saïd Business School

10 million will be served by the end of this year. But the company, which has 250 sites in 50 countries, also participates in many smaller initiatives. For instance, it has contributed lightweight composite modules to a new school in Pune, India, which reduced the costs, time, and environmental impact of construction; the

ILLUSTRATION: BRETT AFFRONTI

school's students will also be given access to a DSM nutrition program. Elsewhere in India, one of DSM's anti-infectives units offers free medical services to nearby villagers. And in Mexico, DSM employees hold monthly seminars on safety, health, and the environment for local schoolchildren.

Fokko Wientjes, the director of sustainability at DSM, says the company believes that providing aid is both the right thing to do and critical to the future growth of the business. "The benefit isn't difficult to explain," he says.

"First, in the war for talent, this way of thinking makes DSM an attractive employer. This is a company that's doing more than just working for shareholders. We have extremely low turnover.

"Second, it helps us understand what the needs are in the different countries where an organization like the World Food Programme operates, which helps us innovate.

"And third, when you work with these groups you really get the message out on issues like the importance of nutrients. And in the end that will lead to interventions and investments that could be profitable."

The service mentality starts at the top with CEO Feike Sijbesma, who spearheaded the sustainability-focused rebalancing of DSM's product portfolio. Rank-and-file employees participate by nominating small projects for the company to fund. In the middle, local managers are encouraged to budget for outreach and engagement in their communities.

"You look at your environment and think, What can I contribute here?" says Wientjes, whose stints with DSM's South American and Egyptian operations involved work on safer house construction and environmental cleanup. There's just one rule: "It needs to be linked to our strategy, to our expertise. We wouldn't do language lessons for children. But chemistry and math? That suits our company. That's what we know.

"With big projects, you have to find the right partner and the right cause. You have

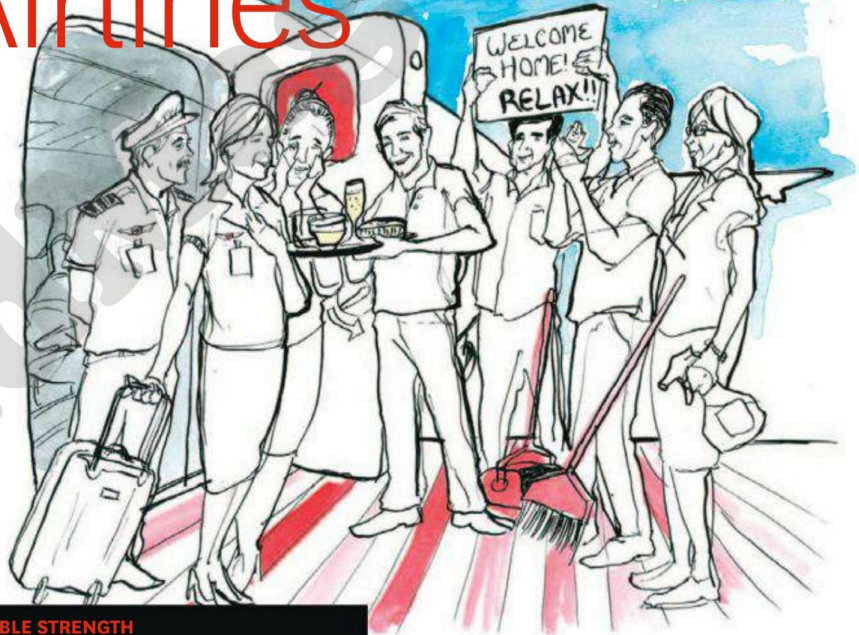
to think, What more can I do with these competencies to build something both for society and for the company?"

It's not just donations. In India, one of DSM's most important growth markets, the company has a subsidiary tasked with helping local base-of-the-pyramid businesses move toward more-sustainable production, primarily in agriculture (for example, by using better cow feed to improve milk

yields) and energy (by providing enzymes to improve the efficiency of gas plants powered by animal manure).

Wientjes acknowledges that DSM's return on its social investment is hard to quantify. "We don't really put a value on it right now, and maybe we should to have the investor community better understand," he says. "But shareholders haven't ever called me and said, 'Please stop.'" ■

Southwest Airlines



NOTABLE STRENGTH

Labor Relations

CORE BUSINESS Airline
COUNTRY United States
YEAR FOUNDED 1967
EMPLOYEES 35,000
2010 REVENUE

\$12.1 billion

10-YEAR ANNUALIZED TOTAL SHAREHOLDER RETURN -6.9%

FACT Southwest consistently has the lowest ratio of complaints per passengers boarded of all major U.S. carriers reporting statistics to the U.S. Department of Transportation.

SOUTHWEST'S FIRST NEWSPAPER ad, published in 1971, promised that its flight attendants—then called air hostesses—would serve from the heart. (Later commercials made it clear they would also wear hot pants.) But what the marketing campaigns didn't explain was how the company planned to create its energetic corps of customer-loving, costume-wearing employees. The strategy was simple: Southwest would make its staff happy. Customer satisfaction and profits would follow.

Today that doesn't sound new. But back then it was. And the philosophy has paid off.

Southwest is now the largest U.S. domestic air carrier and has been profitable for 38 consecutive years, during which many competitors declared bankruptcy or operated in the red.

Last May, on the day the company finalized its \$3.2 billion merger with AirTran, Southwest's management team flew to AirTran's Atlanta headquarters to throw an air-hangar barbecue for the 6,000 acquired employees based there. CEO Gary Kelly helped serve brisket. The next day the executive group went back to work on a plan that will merge seniority lists in 16 collective bargaining agreements and preserve the job of every manager below the C-suite, though some might be required to relocate. This approach highlights two key elements of Southwest's employees-first strategy: meaningful interaction between staff and management, and good relationships with organized labor.

The company also champions a corporate culture—"warrior spirit, servant's heart, fun-loving attitude"—that promotes collaboration. There is a "culture committee," which is made up of 200 employees from all levels and meets quarterly to plan activities. One favorite initiative is "Delight and Surprise," when committee members unexpectedly greet the crew of an arriving flight with food and drink and relieve them of plane-cleaning duties.

Employee development starts with intense onboarding and continues through the company's six-week MIT (managers-in-training) program. Two poster children for career advancement at Southwest are Mike Ryan, a VP of labor relations who started in the mail room, and Teresa Laraba, senior VP of customer services, who began as a part-time agent in the El Paso airport.

Southwest's pay and benefits are above the industry average. In 1973 it was the first airline to establish profit sharing, and employees now own 5% of company stock. Diversity is a priority, and HR policies allow for small but critical concessions like letting flight attendants trade hours.

Much of this is negotiated with the unions, with which Southwest has always worked well. Senior labor relations counsel Joe Harris, who has represented the company since 1972, remembers the initial thinking of founder and CEO Lamar Muse and his legendary successor, Herb Kelleher. "They simply adopted the position that our employees needed an effective voice so we would partner with these organizations," Harris recalls. Of course, "we've had very contentious negotiations over the years. But we're not like the Hatfields and the Mc-

Coys, where we keep fighting after the fight is over. At the end of the day we have a common objective to keep the company healthy and prosperous."

Southwest reinforces the employee ownership mentality through aggressive internal communication at live events like Kelly's annual "message to the field" speaking tour and through new technologies. The company offers text alerts for corporate news and has a

smartphone app for its intranet, where Kelly posts a weekly audio update and senior managers blog and respond to comments.

Will Southwest be able to keep it going and remain a profit leader among airlines even as the economy stagnates, margins tighten, and competitors cotton on to the employees-customers-shareholder continuum? "It's a tremendous challenge," Harris acknowledges. "But this philosophy really does still permeate the entire organization." ■

"Southwest has been consistently successful by staying true to its values. Other airlines have said, 'We know we should improve labor relations, but we have 9/11, Asian flu, gas prices...' It's always, 'We'll get to that.' Southwest has said, 'The only way we can turn these planes around quickly is by having committed, problem-solving employees that work together. So what kind of HR practices promote that?'"

Thomas Kochan, MIT Sloan School of Management

Broad Group



"RESPONSIBILITY IS MORE important than growth." "Protecting the environment is more important than profit." "Love is more important than anything else."

You might expect to find those lines in the values statement of a company that makes energy-efficient air conditioners. But would you expect them from one based in hypercompetitive, high-pollution China? From one with industrial customers in more than 70 countries and more than \$500 million in sales? From one led by a man worth an estimated \$850 million? From one that might soon go public?

Broad Group, the Changsha-based business we've just described, doesn't see a trade-off between responsibility and growth. Instead, the company—which makes not only air conditioners but also air filtration systems and prefabricated



NOTABLE STRENGTH

Environmental Protection

CORE BUSINESS Industrial Products
COUNTRY China
YEAR FOUNDED 1988
EMPLOYEES 2,600

2010 REVENUE

RMB 3.6 billion

10-YEAR ANNUALIZED

TOTAL SHAREHOLDER RETURN Undisclosed
FACT Broad Town, the company's one-square-kilometer headquarters, comprises 28 buildings made of recycled packing crates and shipping pallets. Three times a day, employees there are served meals sourced from an on-site organic farm.

“Broad Group continually pushes forward new ideas, products, and services that not only help them meet bottom-line objectives but also satisfy their core mission—solving environmental problems in a way that connects to their existing business.”

Christopher Marquis,
Harvard Business School

energy-efficient buildings—is proof that the two can go hand in hand.

“Being good itself is competitive,” says Zhang Yue, who founded the company with \$3,000 in 1988 and is now its chairman. “A bad company may be competitive in a market for a while, but it won’t last long. If you offer something of social value, you will survive, and you will prosper.”

Of course that wasn’t clear in the 1990s or even the early 2000s, when Broad was trying to persuade industrial customers to switch to its air conditioners. Its technology, which counterintuitively uses natural gas or waste heat to cool, is better for the environment—it avoids the ozone-depleting refrigerants used in electric cooling, reduces the load on power grids, and requires less energy overall. But the up-front costs are

still significantly higher than those of less environmentally friendly options, making it a harder sell.

The company’s earliest successes were in locales with unstable electric systems. Now Broad Group exports to developed markets around the world, supplying airports from Madrid to Bangkok as well as military bases in the United States. It claims to triple the energy efficiency of facilities while dramatically reducing emissions.

The company’s other “good” products were developed partly as a response to social and environmental crises: Its air purification systems were designed after the 2002–2003 SARS outbreak in Asia (a cell phone that monitors air quality is on the way); its prefab building system—which allows for fast, zero-pollution construc-

tion of sturdy, well-insulated structures—followed the 2008 Sichuan earthquake.

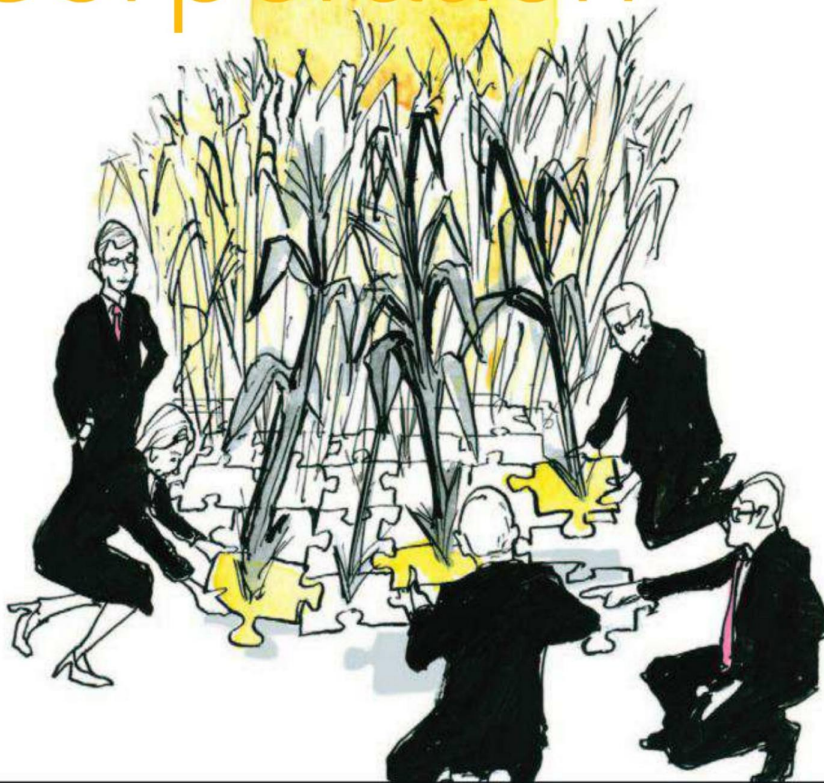
Zhang sees that system, the BSB (Broad Sustainable Building), as the company’s future. “Buildings consume 40% of the world’s energy,” he explains. As soon as the BSB standards are verified by the Chinese government, the company will tackle its goal of producing 700 million square feet of energy-conserving space by 2020. Working through 100 franchised distributors, it hopes to win a 30% share of the global construction market. “We boldly dream that one day the whole world will cut CO₂ emissions by 40% using this technology,” Zhang says.

Observers have been impressed by a video showing a prototype 15-story hotel built in 90 hours. But it’s a long way to world domination—hence the desire to raise more capital by taking the company public.

A stock market listing will bring new stakeholders, but Zhang thinks he can hold fast to the company’s ethos and culture. Indeed, investors will know exactly what they’re buying into: a company with environmental protection at its core, led by an outspoken tycoon who recently renounced his private jet and who refuses to contribute to overpopulation by having a second child.

Zhang really does seem to think he can build a global business on love. “If everybody and every business becomes socially responsible,” he says, “then the earth will become a beautiful hometown for us all.” ■

Potash Corporation



NOTABLE STRENGTH

Corporate Governance

CORE BUSINESS Fertilizers
COUNTRY Canada
YEAR FOUNDED 1975
EMPLOYEES 5,500

2010 REVENUE

US\$6.5 billion

10-YEAR ANNUALIZED

TOTAL SHAREHOLDER RETURN 27.4%

FACT After BHP Billiton launched a hostile takeover of PotashCorp last year, the company's board of directors met 35 times (compared with eight times in a typical year), with an attendance record of 97%. The bid was eventually quashed by the Canadian government.

“Potash shows leadership in the clarity and forthrightness of its compensation disclosure. Rather than giving the minimum required and forcing the investor to try to figure out what the compensation really is, it voluntarily reports how much its executives earn from exercising stock options—even though in recent years it has been an embarrassingly high number. And it does so with a very user-friendly and transparent chart.”

Roger Martin, Rotman School of Management

before such measures were customary or mandated. Most initiatives—such as the stock-option plan based on three-year performance that covers 220 managers and goes up for shareholder vote each year—are taken proactively. But PotashCorp also reacts to outside pressures. Not long ago a big Canadian investor group requested direct contact with board members about executive pay, without management or counsel listening in. “The instinct is to say, ‘We can’t do that,’” Podwika says. “But we looked at it and decided we ought to”—even at a time when CEO William Doyle’s annual package of about \$10 million (he also held roughly \$400 million in stock and options) was generating controversy.

PotashCorp is not without critics. As recently as 1989 it was a debt-burdened government entity. Its mining operations create serious short-term environmental damage, even if it invests heavily in land reclamation. The company also still places “maximize long-term shareholder value” at the top of its key goals, followed by ones related to customers, communities, employees, and the environment (in that order).

But when it comes to governance, PotashCorp is by all accounts doing the right thing. What benefit does the company get as a result? “One way to think about the ROI is that it’s like an insurance policy,” says Podwika. “There’s a generally understood principle that the real value of the company is our reputation. I’d say that everybody has it on their consciousness—our CEO, our CFO, and certainly our board. People in every part of the company. We talk about it all the time.” ■

A DECADE AGO, after the grand corporate frauds at Enron and WorldCom unleashed a wave of scandal-inspired regulation, the executives and directors of Potash Corporation made a decision. The Canadian fertilizer producer wouldn’t just follow the new rules. It would get ahead of them.

“There was this groundswell around governance in the academic, shareholder, and regulatory communities, and that made us stop and take a comprehensive look at what we were doing,” says Joe Pod-

wika, general counsel. “We had established a sustainability committee, and we realized one of the pillars had to be good corporate governance. Instead of adhering to the minimum requirements, we could implement best-practice programs that in the long run would be good for the company.”

What started with a core values statement and code of conduct has grown to include a host of shareholder-friendly initiatives, from directors elected by major vote to “say on pay” for executives—all

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Unilever

TO UNDERSTAND THE challenge of making Unilever's supply chain sustainable, consider this: Each year, the company sells 170 billion products across 180 countries, sourcing materials from 150,000 suppliers and operating more than 250 factories. It's hard to manage that network, much less improve its performance on sustainability. But, according to Pier Luigi Sigismondi, Unilever's chief supply chain officer, doing better in that area is a strategic imperative. "We have to do business this way to sustain our long-term business goals," he says. After all, the maker of Lipton tea, Knorr soup, and Dove soap can't ignore farmland degradation or threats to the world's water supply. And a leading consumer goods company must respond to consumer demand for sustainably sourced products.

Execution rests on a "prioritize and conquer" approach. For agricultural sourc-

ing, Unilever identified its top 10 raw materials (as measured by volume, strategic importance, and consumer interest in sustainability) and set out goals for moving to sustainable supply (as measured by 11 factors from soil quality to labor practices). For example, it buys 1.4 million tons of palm oil annually, or 3% of the global yield, but this year more than half of that will come from growers certified by the Roundtable on Sustainable Palm Oil, a group it helped establish. By 2015 the company intends to use sustainable palm oil exclusively.

In manufacturing and logistics, the company has set goals for reducing its environmental impact both directly (in factories, distribution centers, and transport) and indirectly (via better packaging and consumer education). Factories are required to submit monthly scorecards on their

waste disposal and energy and water use. "We monitor it just as we monitor cost and sales," Sigismondi says. By 2020 the company aims to reduce CO₂ emissions from manufacturing and logistics by more than 40% from a 1995 baseline. So "we know we need to do 4% or 5% a year."

Unilever typically works with governments and NGOs to ensure that its supply chain is following best practices. Though Sigismondi was recently in India visiting vegetable farms, he admits "it's impossible to do it all on a one-to-one basis." Suppliers in markets with no certification bodies are told to "self-certify" against Unilever's Sustainable Agriculture Code; their progress is monitored with software tools and audits. And when activist groups unearth problems, as Green-

peace did in some of Unilever's Southeast Asian palm plantations, the company responds (in the plantations' case by revoking their contracts).

All this requires investment, and the return is variable. Tea growers certified by the Rainforest Alliance offer higher yields, which reduce product costs, but for sustainable palm oil the balance-sheet defense has yet to materialize. Still, "we're big enough to afford the premiums, and we believe this is the future of the industry," Sigismondi says. "Today we're investing. We'll see the return in years to come."

There's more to do. Unilever has not set targets for sustainable sourcing of chemicals, minerals, and packaging other than paper and board. It continues to explore ways to convince customers that they must behave responsibly, too. "Sixty-five percent of our environmental footprint is related to how consumers use our products," Sigismondi says. "We have to lead beyond our own four walls." ▣

NOTABLE STRENGTH

Supply Chain Accountability

CORE BUSINESS Consumer products

COUNTRY UK/Netherlands

YEAR FOUNDED 1930

EMPLOYEES 167,000

2010 REVENUE

€44.3 billion

10-YEAR ANNUALIZED

TOTAL SHAREHOLDER RETURN 4.2%

FACT It takes 3.5 million pounds of eggs from 125,000 cage-free hens to make the 30 million jars of Hellmann's Light mayonnaise sold in North America.

"Unilever has developed a pathbreaking framework for looking at products in a cradle-to-grave, value-chain-wide way. That represents a real step forward in companies' taking on a higher burden."

Dan Esty, Yale Law School

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Spotlight

ARTWORK Sarah Morris, *Alpine Coil [Knots]*, 2009
Gloss household paint on canvas, 214 x 214 cm



A fourth sector of the economy is emerging, with the power to transform the course of capitalism. by Heerad Sabeti



Heerad Sabeti is a serial social entrepreneur and a cofounder and trustee of the Fourth Sector Network.

The For-Benefit Enterprise

WE ARE IN A NEW ERA. For-profit businesses are tackling social and environmental issues, nonprofits are developing sustainable business models, and governments are forging market-based approaches to service delivery. Out of this blurring of traditional boundaries, a different model of enterprise is emerging, driven by entrepreneurs who are motivated by social aims.

When these entrepreneurs begin to create an entity to carry out their ideas, they often face a crippling and seemingly arbitrary question: whether to be a for-profit or a nonprofit. To some readers the distinction may seem straightforward, but a growing number of entrepreneurs chafe under those classifications. How, for example, would you label the commercial car-sharing service I-GO in Chicago, which is structured as a nonprofit? What about China's Qifang, an online platform dedicated to giving low-income students a way to pay for their education, which is structured as a for-profit?

Neither of these enterprises is strictly for-profit or nonprofit; both could be called "for-benefit." That's the term entrepreneurs are increasingly using to describe organizations that generate earned income but give top priority to an explicit social mission. The hybrid approach they employ can already be found

across a wide range of industries and in pursuit of myriad important goals: eliminating homelessness, fighting drug addiction, reducing deaths from malaria, producing renewable energy.

Many more such enterprises would exist, except that most entrepreneurs haven't been able to choose "for-benefit" as a legally recognized organizational structure. Most countries' legal and economic systems allow either for-profit or nonprofit activity, not a blending of the two. Many socially minded entrepreneurs end up shoehorning their vision into one structure or the other and accepting burdensome trade-offs in the process.

All this is destined to change. For-benefit enterprises will become more commonplace as entrepreneurs learn to better navigate existing constraints, and as an ecosystem of specialized support—including public policy, financial markets, accounting standards, and professional services—develops around them. The even bigger news is what will happen then. With formalization of the for-benefit structure, we will see the emergence of a fourth sector of the economy, interacting with but separate from governments, nonprofits, and for-profit businesses. The rise of that sector is likely to reshape the future of capitalism.

To understand the kinds of gains the new sector will make possible, let's take a look at the breakthrough solution offered by a for-benefit structure in one important arena.

A Healthful Compromise

In the 2009 debate over U.S. health care reform, proponents of the "public option"—a government-run health insurance plan—were pitted against those who wanted to maintain the status quo of private insurance. Neither side won, but out of the tension a new idea was born: The Patient Protection and Affordable Care Act included an innovative compromise provision encouraging the creation of "community operated and oriented plans." Hoping to intensify the competition in markets served by incumbent for-profit and nonprofit insurers, a bipartisan group of lawmakers crafted the provision for this entirely new kind of health insurance entity, appropriated \$6 billion in start-up loans, and set a goal of each state's having at least one COOP by 2014.

COOPs combine the best of nonprofit, for-profit, cooperative, and public models. They are private, consumer-governed health plans designed to serve the social purpose of furthering the well-being of their members. They are exempt from federal income tax. Like other insurers, COOPs must attract customers, charge premiums, and generate profits in order to maintain solvency and grow their membership. But their profits must be directed toward improving benefits, enhancing quality of care, reducing premiums, or otherwise advancing their mission.

Very quickly the COOP provision attracted attention from various groups interested in alternative health insurance models. Take, for example, the Freelancers Union, a New York-based nonprofit dedicated to developing a social safety net for independent workers. Its founder, Sara Horowitz, sees the COOP model as a perfect fit for an organization whose membership, numbering in the tens of thousands, constitutes a risk pool that can be insured at a reasonable cost. She and other proponents believe that COOPs can play a significant role in fostering higher quality of care, greater cost efficiency, and broader access throughout the U.S. health care system.

In hindsight, the COOP solution seems obvious: It's a market-based approach that addresses concerns about government bureaucracy and inefficiency, yet is driven by a social purpose and has a governance structure that puts the health of members before the maximization of profits. So why wasn't the

solution obvious all along? Because it required reimagining entrenched organizational structures that many considered immutable.

For-benefit models have broad applicability throughout the economy, but bringing their potential to life depends on just such reimagining, on two fronts: organizational architecture and ecosystems of support.

Creating a For-Benefit Enterprise

What, exactly, does it mean to be a for-benefit? Two primary characteristics distinguish these organizations: a commitment to social purpose and a reliance on earned income. Most for-benefits also have one or more secondary characteristics (see the sidebar "The Anatomy of a For-Benefit Organization").

The first step in forming a for-benefit enterprise is to be explicit about the fact that one is doing so. Because the law usually forces a nascent for-benefit to organize as a for-profit or a nonprofit, the enterprise defines itself accordingly. This can lead to confusion, mistrust, and low credibility among stakeholders—which is why many for-benefits attempt to distinguish themselves through branding or product messaging, invoking terms such as "social enterprise," "sustainable business," "fair trade," and "green."

Rare is the entrepreneur who devotes much thought to organizational architecture—the rules, incentives, roles, and systems at the heart of an organization's operations. Entrepreneurs tend to be excited about the new products or services they will offer, or the better way they will meet customers' needs, or the underserved market they will reach. When it comes to administrative details, they are usually happy to rely on experts—legal counsel and accountants who have served many entrepreneurs before them.

Architecture can be implemented through a variety of elements, including legal form, governance structure, ownership design, performance-assessment tools, and contracts with investors, employees, suppliers, and other stakeholders. The right architecture is critical for the success of any organization; for-benefits face unique challenges, however, because their default choices come from either for-profit or nonprofit norms. A for-benefit entrepreneur who is ready to form a legal entity will typically consult either a corporate or a nonprofit attorney, and thus be channeled into one body of law and legal options or the other. The choice of legal form will dictate the type of capital the enterprise can easily

Idea in Brief

A new type of entity is appearing in many mature economies: the “for-benefit” enterprise, so called because it operates like a traditional business in many ways, but is founded primarily to provide social benefits rather than to maximize financial returns.

For-benefits would be more plentiful if socially minded entrepreneurs were more aware of the consequences of architectural decisions they make at the start, and if they had access to a more supportive ecosystem.

With new legislation granting legal status to for-benefits, those barriers are falling. Specialized law and accounting practices

and other resources are focusing on the challenges of blending financial and social value. Indeed, for-benefit enterprises are emerging as a whole new sector of the economy—one powerful enough to change the course of capitalism.

access: private investment in the case of a for-profit, philanthropic funds in the case of a nonprofit. Although there are exceptions, most for-benefit entrepreneurs find themselves in a binary world that forces them to compromise their objectives, complicate their organizational structures, and waste resources.

Socially minded entrepreneurs should realize that they don't have to accept convention. They have license to be inventive and to question advice that seems inconsistent with their objectives. Form should follow function. Imagine starting out as an enterprise builder with no preconceived notions about structure. How might you create a reliable system for tracking social and environmental impacts throughout your supply chain? Could you build an investment structure that provides what economists call a “satisficing” level of return—sufficient to incentivize investment—without giving away perpetual ownership rights? Would a structure that allowed anyone to benefit from selling your offering make more sense than one that assumed a captive or formally contracted sales force? These questions merely hint at the range of possibilities. Coloring outside the lines requires more imagination, effort, and expense than a start-up typically requires, but it can maximize the potential for achieving financial, social, and environmental objectives in the long run.

The following items should be given priority on any for-benefit entrepreneur's agenda:

Stakeholder value. Whereas for-profits emphasize shareholder value, for-benefits pay more attention to their impact on all stakeholders. After identifying the groups that are essential to the or-

ganization's success, and clarifying the value proposition for each, entrepreneurs should feel free to negotiate unconventional roles, responsibilities, and incentives that will increase stakeholders' engagement with the mission. The British start-up Riversimple, which makes cars powered by hydrogen fuel cells, allows all its stakeholders to have a voice in the governance of the business and a share in the profits.

The company licenses its designs to an independent, open-source foundation, which makes it possible for engineers, designers, and manufacturers anywhere in the world to help develop and produce the cars.

Capitalization. A key challenge that for-benefits encounter is to design a structure that balances the financial interests of capital providers with the enterprise's mission and stakeholder commitments. This balance should be reflected in shareholder agreements, loan contracts, and other financial instruments. Upstream 21, a holding company in the Pacific Northwest, chooses its portfolio companies on the basis of their demonstrated concern for stakeholders and local communities, and provides them with both growth capital and assistance in improving their financial, social, and environmental performance.

Ownership and governance. Will subsequent CEOs, directors, and investors share the commitment that inspired the founders? Preservation of the social mission after an ownership transfer is one of the thorniest challenges that for-benefits face. It's often assumed that owners drive governance, but in fact ownership is a collection of legal rights that can be unbundled and repackaged in creative ways.

Rare is the entrepreneur who devotes much thought to organizational architecture.

The Anatomy of a For-Benefit Organization

For-benefits are a new class of organization. Like nonprofits, they can pursue a wide range of social missions. Like for-profits, they can generate a broad range of products and services that improve quality of life for consumers, create jobs, and contribute to the economy.

Combining social and commercial ends is not new—think of hospitals, universities, arts organizations, Goodwill. But the for-benefit model does much more than that. It redefines fiduciary duty, governance, ownership, and stakeholder relationships in fundamental ways. Here are some key for-benefit characteristics that are being codified in new legal structures:

Primary

Embedded purpose.

A commitment to mission is in the organization's DNA. Fiduciary duty is tied to purpose.

Earned income. Sales of goods and services generate most of the income.

Secondary

Inclusive ownership.

Ownership rights are allocated among stakeholders in accordance with their contributions.

Stakeholder governance. Decision rights regarding information and control are distributed among stakeholder constituencies.

Fair compensation. Employees and other stakeholders are compensated in proportion to their contributions.

Reasonable returns. Limitations on investment returns protect the organization's ability to achieve its mission.

Social and environmental responsibility.

Social and environmental performance is constantly improved throughout the stakeholder network.

Transparency. Social, environmental, and financial performance and impact are fully and accurately assessed and reported.

Protected assets. Social-purpose assets are preserved upon dissolution, conversion, or ownership transfer.

Thoughtful ownership and governance design can protect the mission over the long term and deepen stakeholder engagement. Cafédirect, the United Kingdom's largest fair-trade purveyor of hot drinks, was founded by a worker-owned cooperative, a public limited company, an international confederation of nonprofits, and an NGO. Since 2003 the producers that supply Cafédirect have been represented on the board and have held 5% of the company's shares.

Legal form and tax treatment. For-profit and nonprofit legal and tax models are not designed for the simultaneous pursuit of social and financial bottom lines. For example, when founders choose a for-profit form, they have no reliable way of ensuring commitment to the social mission. And board members, mindful of their fiduciary duty, may find it hard to prioritize social and environmental concerns over the interests of shareholders. The Danish pharmaceutical company Novo Nordisk, founded with a mission to rid the world of diabetes, avoided those difficulties. It has a publicly traded operating company that is controlled by a foundation—which prevents hostile takeovers, enables executives to focus on the long term, and allows profits to be used for humanitarian purposes.

Some jurisdictions have started to recognize various types of for-benefits: the “community inter-

est company” in the UK and the “low-profit limited liability company” (L3C), “benefit corporation,” and “flexible purpose corporation” (pending the signature of California's governor) in various U.S. states. Although these models may not withstand the test of time, they are a harbinger of more-sustained attention by lawmakers to the needs of for-benefit enterprises.

Performance measurement and reporting.

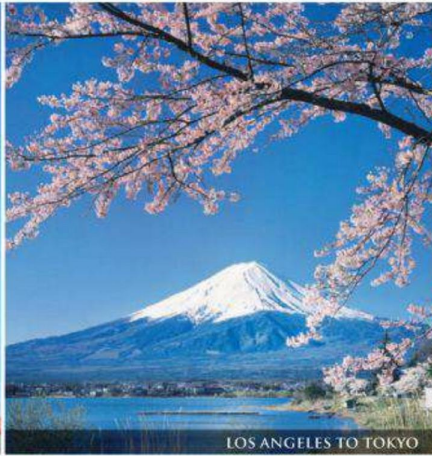
The fundamental value proposition for a for-benefit requires that the organization be able to account for its total impact and performance—financial, social, and environmental. Few conventional accounting systems and metrics are designed for such reporting, but efforts are under way to create new tools. Last May the sports apparel company Puma announced the initial results of its Environmental Profit & Loss Account, which relies on emerging methodologies to calculate the impact of the company's operations and supply chain on greenhouse gas emissions and water consumption.

Cautionary tales are associated with all five of these areas. Many of the pitfalls that for-benefits face as they mature can be attributed to flaws in their architecture. Entrepreneurs are well served by adopting a long-term perspective as they think through the consequences of key structural decisions.

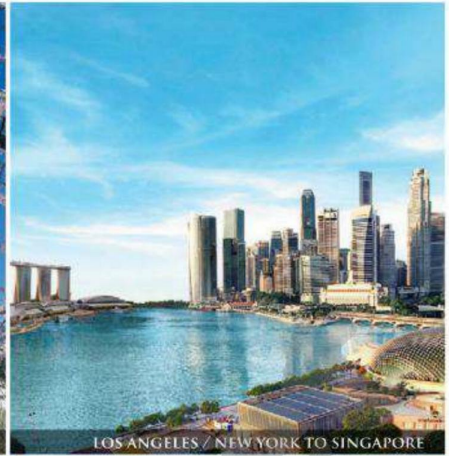
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HOUSTON TO MOSCOW



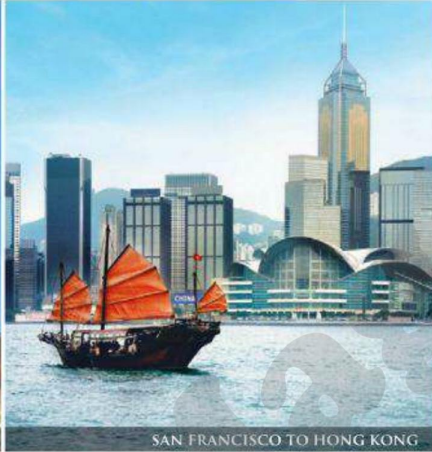
LOS ANGELES TO TOKYO



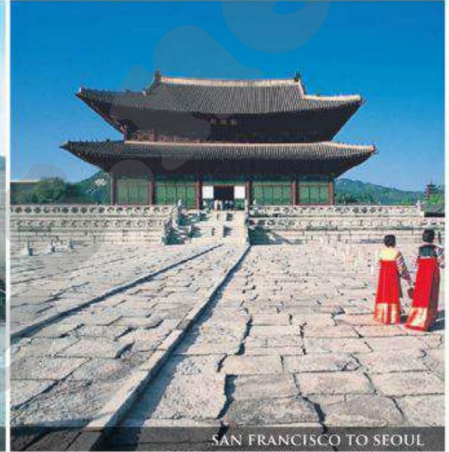
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Finding a Suitable Ecosystem

For-profits and nonprofits exist within supportive ecosystems consisting of well-established laws, accounting standards, financial markets, trained pools of talent, and customized tools and services. When an entrepreneur starts a conventional company, lawyers, accountants, investors, and consultants share an understanding of what that means and can provide tools and services that fit seamlessly together. For-benefit enterprises have had to rely mostly on these ecosystems—but now they can find resources and support that are better suited to their requirements.

For example, they can obtain specialized legal assistance through the Lex Mundi Pro Bono Foundation. Access to sympathetic sources of capital is becoming easier with the rise of so-called impact investors and the advent of intermediaries such as the Global Impact Investing Network. (The financial opportunity is certainly there: According to a 2010 J.P. Morgan research report, five sectors of the global bottom-of-the-pyramid market collectively offer the potential over the next decade for up to \$1 trillion in invested capital and up to \$667 billion in profits.)

The management consulting world is beginning to address the technical challenges of delivering “blended value”; Bridgespan and the Monitor Institute are in the vanguard here. Duke University’s Center for the Advancement of Social Entrepreneurship and other business school programs are developing high performers who want to work in a for-benefit environment. Fellowship programs at Ashoka, the Schwab Foundation for Social Entrepreneurship, and Harvard Kennedy School’s Center for Public Leadership help further the careers of top-tier entrepreneurs who have a demonstrated commitment to leading social change. Assessment and certification tools include LEED certification for green buildings, ISO 14000 environmental management standards, and Green Plus and B Corporation certifications for small and midsize enterprises.

Social Enterprise UK and Social Venture Network are among the better-established support networks; since their beginnings in informal relationships and best-practice swapping, they have taken on the trap-

pings of professional societies and trade associations. Conferences like the Skoll World Forum on Social Entrepreneurship and SOCAP provide vital cross-pollination, bringing together entrepreneurs, funders, and service providers from around the world.

The Emergence of the Fourth Sector

In the past several decades a steadily growing number of innovators have been pushing against the boundaries that separate for-profits, nonprofits, and governments. Their activities go by various names: corporate social responsibility, sustainability, cause-oriented marketing and purchasing, venture philanthropy, social investing, microfinance, civic and municipal enterprise. When the for-benefit model is broadly recognized, all this innovation will constitute a large fourth sector—which has been there all along, though cloaked by conventional adherence to old categories. As governments, markets, and entrepreneurs adopt the for-benefit model, more light will be cast on the fourth sector. It will grow in proportion to the other three as a cadre of socially motivated entrepreneurs, supported by appropriate legal and market structures, create enterprises that combine a social mission with a business engine—and refuse to compromise on either front.

Our current model of capitalism has generated prosperity and improved the quality of life, but not without undesirable environmental and social consequences. Calls for its reform are getting louder, and many approaches have been put forth. Whatever their labels—creative capitalism, philanthrocapitalism, new economy, impact investing, blended value, shared value—these approaches are all rooted in the observation that no genuine reform can take place as long as profit-maximizing businesses remain the sole engine of capitalism. Governments and markets must recognize and support for-benefits as an equally legitimate model.

As entrepreneurs continue to prove that for-benefit organizations can balance economic, social, and environmental performance, demand for such organizations will grow. For-benefits cannot replace for-profits, governments, or nonprofits; a resilient, competitive 21st-century economy needs all four sectors. But they can fill the gaps created by the failure of the three-sector model. As their DNA takes hold, the entire system will evolve. It will become clear that in organizing their enterprises for benefit, entrepreneurs have been the architects of a new, more sustainable capitalism. ♣ **HBR Reprint R1111F**

For-benefits can't replace the other three sectors of the economy; but they can fill the gaps.

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The Great Repeatable Business Model

Leveraging a simple formula allows corporations to create new and more-lasting differentiation.

by Chris Zook and James Allen

DIFFERENTIATION IS THE essence of strategy, the prime source of competitive advantage. You earn money not just by performing a valuable task but by being different from your competitors in a manner that lets you serve your core customers better and more profitably.

The sharper your differentiation, the greater your advantage. Consider Tetra Pak, a company that in 2010 sold more than 150 billion packages in 170 markets around the world. Tetra Pak's carton packages extend the shelf life of products and eliminate the need for refrigeration. The shapes they take—squares and pyramids, for example—stack more

efficiently in trucks and on shelves than most cans or bottles. The packaging machines that use the company's unique laminated material lend themselves to high-volume dairy operations. These three features set Tetra Pak well apart from its competitors and allow it to produce a package that more than compensates for its cost.

In studying companies that sustained a high level of performance over many years, we found that more than 80% of them had this kind of well-defined and easily understood differentiation at the center of their strategy. Nike's differentiation resides in the power of its brand, the company's relationships with top athletes, and its signature performance-focused product design. Singapore Air's differentiation comes from its unique ways of providing premium service at a reasonable cost on long-haul business

flights. Apple's differentiation consists of deep capabilities in writing easy-to-use software, the integrated iTunes system, and a simplicity of design and product line (Apple has only about 60 main SKUs).

You can find high performers like these in most industries. The cold truth about hot markets is this: Over the long run, a company's strategic differentiation and execution matter far more to its performance—our research suggests at least four times as much—than the business it happens to be in. Every industry has leaders and laggards, and the leaders are typically the most highly differentiated.

But differentiation tends to wear with age, and not just because competitors try hard to undermine or replicate it. Often the real problem is internal: The growth generated by successful differentiation begets complexity, and a complex company tends to forget what it's good at. Products proliferate. Acquisitions take it far from its core. Frontline employees, more and more distant from the CEO's office, lose their sense of the company's strategic priorities. A lack of consistency kills economies of scale and retards the company's ability to learn. Small wonder that "reinvention" and "disruption" have become leading buzzwords; companies struggling with complexity and fading differentiation come to believe they must reimagine their entire business models quickly and dramatically or else be overwhelmed by upstarts with disruptive innovations.

Most of the time, however, reinvention is the wrong way to go. Our experience, supported by more than 15 years of research into high performance, has led us to the inescapable conclusion that most really successful companies do not reinvent themselves through periodic "binge and purge" strategies. Instead they relentlessly build on their fundamental differentiation, going from strength to strength. They learn to deliver their differentiation to the front line, creating an organization that lives and breathes its strategic advantages day in and day out. They learn how to sustain it over time through constant adaptation to changes in the market. And they learn to resist the siren song of the *idée du jour* better than their less-focused competitors. The result is a simple, repeatable business model that a company can apply to new products and markets over and over again to generate sustained growth. The simplicity means that everyone in the company is on the same page—and no one forgets the sources of success.

Let's look in more detail at what this involves.

The Differentiation Map

We cataloged 250 assets or capabilities that can make up a company's differentiation. We then sorted them into three major clusters, each with five categories, to create the Differentiation Map. Assuming that four or five categories are required to achieve differentiation, these 15 basic categories generate more than 5,000 distinct ways in which a company can differentiate itself. (It is possible, however, to break the categories down further, in which case the number of ways to differentiate explodes into more than a million.)

Vanguard's differentiating strengths are highlighted below.

MANAGEMENT SYSTEMS

PORTFOLIO MANAGEMENT AND FINANCE	M&A, JOINT VENTURES, AND PARTNERING Unique setup as a "mutual company of mutual funds"	REGULATORY MANAGEMENT	BUSINESS UNIT STRATEGY AND DRIVING PRIORITIES	HR MANAGEMENT AND CULTURE
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OPERATING CAPABILITIES

SUPPLY CHAIN AND LOGISTICS	PRODUCTION AND OPERATIONS Lowest cost, no-load mutual fund "engine" skewed to index funds	DEVELOPMENT AND INNOVATION	GO-TO-MARKET Direct distribution, avoiding middle man when possible	CUSTOMER RELATIONSHIPS Loyalty leader for strong customer service; no outsourcing
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PROPRIETARY ASSETS

TANGIBLE ASSETS	SCALE	TECHNOLOGY AND IP	BRAND	TIED CUSTOMER NETWORK
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Idea in Brief

Really successful companies build their strategies on a few vivid and hardy forms of differentiation that act as a system and reinforce one another.

They grow in ways that exploit their core differentiators by replicating them in new contexts. And they turn the sources of their differentiation into routines, behaviors, and activity systems that everyone in the organization can understand and follow.

Powerful differentiations deliver enduring profits only when they are supported by simple, non-negotiable principles and robust learning systems that drive constant improvement across the business.

Sources of Differentiation

Opportunities for differentiation are rich and varied in virtually every industry. To examine them more closely, we built a database of 8,000 global companies and tracked their performance over 25 years. We created another database of 200 global companies, which we studied in detail. We supplemented that research with two other data sets: a survey conducted with the Economist Intelligence Unit of nearly 400 global executives, and 50 interviews with chief executives around the world. Building on the data, we cataloged 250 assets or capabilities that can contribute to differentiation and sorted them into three major clusters of five categories each. (See the exhibit “The Differentiation Map.”)

The most enduring performers, we found, built their strategy on a few vivid, robust forms of differentiation that acted as a system, reinforcing one another. To illustrate, let’s examine the factors that make the mutual fund company Vanguard one of the most consistently high-performing businesses in our study.

Ever since its founding, in 1974, Vanguard has been a different kind of company. Its founder, John Bogle, believed passionately in the value of index funds. He saw that a company based on them would need few fund managers and researchers and could therefore charge considerably less than companies with actively managed funds. Bogle also felt he should deal directly with customers and offer them highly responsive service, thus building loyalty. These characteristics are at the core of Vanguard’s differentiation today, as can be seen in “The Differentiation Map.” The company has the lowest-cost mutual fund “engine,” a distribution system that avoids middlemen and allows direct contact with customers, and the highest level of customer loyalty in the industry.

The strongest sources of differentiation in a company’s strongest businesses are its crown jewels. Yet

our research shows that most management teams spend little time discussing or measuring them and therefore don’t agree on what they are. This lack of clarity permeates entire organizations. For instance, more than half of frontline employees say in surveys that they are not clear on their companies’ strategic tenets and differentiators. Customers are even more mystified: Although 80% of managers told us they thought their companies were strongly differentiated, fewer than 10% of customers agreed. Yet understanding and agreeing about differentiation, where it can be applied, and how it must evolve is what makes a strategy work.

A systematic approach to understanding your sources of differentiation is key to rectifying this situation. It enables you to have a meaningful discussion of what distinguishes your company from competitors and what you can build on. When we

Most innovations, even disruptive ones, affect only one part of a business model.

ask each of a company’s top 15 managers privately what he or she feels are the most differentiated and important assets and capabilities, we often find a surprising lack of agreement.

One way to bring data to bear on this range of views is to rate the success of your company’s past 20 growth investments and determine what they have in common. This is a starting point for mapping the company’s differentiation. Discussions of what really differentiates a business from its competitors are, however, often based on past beliefs more than on current data. As you deliberate about your own key differentiators, you might consult these criteria: Are they (1) truly distinctive? (2) measurable against

Making Your Differentiation Easier to Repeat

1

2

Replicating your greatest successes means deeply understanding their root causes, maintaining a 360-degree view of where they could be adapted, and ensuring that the entire organization internalizes the strategy and the differentiation on which they are built. **Here are six actions to consider:**

Make sure that you and your management team agree on your differentiation now and in the future. You may want to ask each person to write it down; then you can collate the results in advance for discussion. At a minimum, consider three questions: (a) What do our core customers see as our key sources of competitive differentiation? (b) How do we know? (c) Are these sources becoming more or less robust?

See whether the front line of your organization agrees with what you come up with. Can employees and supervisors describe the strategy and the areas of differentiation as you do? Do they feel that they understand the strategy? Is it simple and clear? Online surveys, anonymously tabulated, can be a big help with this task.

competitors? (3) relevant to what you deliver to your core customers? (4) mutually reinforcing? (5) clear at all levels of the company? Though each of the five seems obvious, reaching agreement on your differentiation and testing it against these criteria is not as easy as it sounds. The harder it proves, the more valuable the exercise. In our experience, many companies fail these tests—but the most successful ones pass them every time.

The ability to recognize and test the sources of your differentiation in this way is important for focusing innovation. Most innovations, even disruptive ones, affect only one part of a business model, leaving the rest intact. The shift from glasses to contact lenses, for example, had little effect on the basic customer need for vision correction, the industry's distribution system, or the network of eye doctors. The shift from wired to wireless telephony caused chaos for many incumbents, yet some used their infrastructure, customer access, brand, and ability to work with regulatory organizations to prevail. The more precise your understanding of your model and the sources of its success, the more precisely you can focus innovation resources on the areas where the threats and the need for change are greatest.

Growth Based in Differentiation

The best way to grow is usually by replicating your strongest strategic advantage in new contexts. Companies typically expand in one or more of four ways: They create or purchase new products and services, create or enter new customer segments, enter new geographic locations, or enter related lines of business. A company can pursue each of these strategies in various ways—for example, adding new price points or finding new uses for a product or service that will appeal to new customers.

The power of a repeatable model lies in the way it turns the sources of differentiation into routines,

behaviors, and activity systems that everyone in the organization can understand and follow so that when a company sets out on a particular growth path, it knows how to maintain the differentiation that led to its initial success. The global agribusiness Olam is a case in point. The company began as a cashew trader. It purchased nuts directly from farmers in Nigeria and sold them to a dozen customers in Europe, managing a supply chain from the farm gate to the shop door. This approach was unusual for the industry. It cut out middlemen, safeguarded Olam's access to products, and increased the company's market intelligence and speed of reaction. To do this well, of course, Olam had to learn to work closely with small farmers. It also had to develop a risk management system that drew on information garnered from farmers, customers, and commodities and foreign exchange markets to minimize the risks of crop problems, price and currency volatility, and supply disruption.

These capabilities translated into other contexts. Olam realized that its knowledge of small farmers in Nigeria could be applied to small farmers in, say, Burkina Faso. Its risk management skills could be applied to peanuts or coffee beans as well as to cashews. The company accordingly added both farmers and customers in new countries and new products. It now sources 20 agricultural products from farmers in 65 countries and delivers them to more than 11,000 customers across the world.

Of course, Olam's differentiation evolved as the company grew. For instance, as it expanded into certain countries, it found opportunities to acquire and fold in small operations based in those countries. Although Olam had no experience with M&A, its capabilities and assets, including good contacts at the ground level in its countries of operation, gave it an advantage in recognizing promising opportunities

3

Write your strategy on a page, or even on an index card. Does your description of it center on the key sources of differentiation? Is your page sharp and convincing to others, including customers and investors, and backed by data?

4

Conduct a postmortem of your 20 most recent growth investments and initiatives. Are your greatest successes or disappointments explained, in part, by the central differentiators that were transferred?

5

Translate your strategy into a few nonnegotiables. Can you describe simple principles that the organization believes in and that define the key behaviors, beliefs, and values needed to drive the strategy? Are they embedded in day-to-day routines, or are they simply words on a page?

6

Review how you monitor the most important health indicators of your core business and its differentiators, both for short-term adjustment and for long-term investment in new capabilities. Does your method drive learning and adaptation? Is quickness to adapt a competitive advantage? Are you sure?

and understanding how to negotiate with and integrate acquisitions.

Over time, the company has developed playbooks for M&A and deal integration and now considers them important differentiating features that frontline managers (and everyone else in the organization) understand and value. As Olam's CEO, Sunny Verghese, explains, "Our line managers find and consummate transactions at the local level. It is sort of a hidden asset that we have because our

widely understood principles across the organization, while only 26% of the worst performers had done so. Indeed, a link between well-defined, shared core principles and frontline behavior was more highly correlated with business performance than any other factor we studied.

The logic of this connection seems clear. Nonnegotiables translate the most important beliefs and assumptions underlying the company's differentiation into a few prescriptive statements that all

The power of a repeatable model lies in the way it turns the sources of differentiation into routines, behaviors, and activity systems.

people are in the market at a lower level of contact than anyone else. Our ability in transactions is now part of our core, and we manage it centrally with a unique repeatable formula of clear rules and criteria."

Supporting Your Differentiation

Although differentiation is at the heart of a repeatable model, it needs the support of a rigorously focused yet flexible organization. Our research shows that powerful differentiations create the most enduring profits when a company delivers them to the front line in the form of simple, nonnegotiable principles and when it creates robust learning systems that facilitate constant adaptation. Let's look at these factors in turn.

Nonnegotiable principles. This is a fundamental building block of repeatability, a way of keeping everyone on the same page. Analysis of our 200-company database reveals that 83% of the best-performing businesses had established explicit,

employees can understand, relate to, and use as a reference point for making trade-offs and decisions. In effect, they are the headlines of the user's manual for a company's strategy.

To illustrate how companies use nonnegotiables, let's go back to Olam. A key differentiator is that the company manages supply chains right from the farm gate. To support this, Olam requires managers to live in the rural areas of developing countries in order to learn what really goes on at the farms. This nonnegotiable principle is the foundation for hiring criteria, assignments, and the structure and content of training. Another nonnegotiable is that each manager give highest priority to relationships with local farmers. Olam's field operating manual captures many of the routines that support this requirement. The company's principles, and the practices that support them, are central to its culture and provide a bonding experience for managers, who respond to trade-offs and challenges at all levels with remarkable consistency.

Tetra Pak has different but equally powerful non-negotiables. One of them is that the package must save more than it costs, an idea that originated with the company's founder and was the reason for developing its signature tetrahedron-shaped package for milk or juice. Every major new product, package design, or line of equipment must meet that standard. Tetra Pak has developed sophisticated methods for evaluating the systems cost of packaging, including production costs, spoilage, transportation and storage, and disposal costs. It claims that it can reduce operating costs by as much as 12% for a dairy or juice company.

To understand the power of this consistency, consider that from the moment a business is founded, management becomes increasingly distanced from the customer and the front line. Up and down the organization, information slows and grows distorted—the corporate equivalent of the classic game

ing systems, compared with only 9% among the rest. The travails of Kodak, General Motors, Xerox, Nokia, Sony, Kmart, and many others can be seen as cases of arrested adaptation—great formulas that simply did not change fast enough. Most such cases, we should note, didn't involve disruptive innovations that caught the incumbent flat-footed. Stalls and stagnation stem from a failure to learn much more often than from a hard-to-predict disruption.

The most common method of learning in companies with great repeatable models comes from direct, immediate customer feedback. The most powerful demonstration we have seen is through Net Promoter systems, which are used at Vanguard, in Apple's retail division, and at many other companies. In this approach, customers are usually asked one or two questions shortly after contact about their satisfaction with the experience and their willingness to recommend the product, service, or company to

The travails of Kodak, General Motors, Xerox, and others can be seen as cases of arrested adaptation—great formulas that simply did not change fast enough.

Telephone, in which a message is relayed around a table in whispers and has become unrecognizable by the time it completes the circuit. When a company internalizes a set of principles, the message no longer gets garbled. A shared point of view, core beliefs, and a common vocabulary improve everyone's ability to communicate and foster self-organization, permitting fewer layers, fewer handoffs, and shorter communication lines. All this increases the speed of a business, which means you can capture more growth opportunities ahead of competitors and accomplish more per unit of time.

Robust learning systems. Clear differentiation supported by nonnegotiables confers a competitive advantage—for a while. As markets shift, however, successful organizations must also be able to learn quickly and adapt to new circumstances. Both our research and the recent history of business reflect the importance of supporting your differentiation with rapid learning and adaptation. Some 48% of managers in our top group of performers felt that their companies were characterized by strong learn-

ing systems. The power of the Net Promoter Score lies in its simplicity. Companies that chase more-detailed feedback typically find that customers don't bother to engage, so data are fewer and poorer as a result.

In more-complex environments, companies with direct sales forces have other interesting opportunities to create strong feedback loops with customers. Take the toolmaker Hilti. Founded in 1941 by Martin and Eugen Hilti as a mechanical workshop with five employees in Schaan, Liechtenstein, the company focused on innovative tools for difficult construction jobs. Martin Hilti spent much time at job sites, observing and interacting with customers. This was the start of the Hilti direct sales force. Over the decades, the business grew one tool at a time. The company would develop a basic design and then innovate intensively on the details, using information its salespeople acquired at job sites. Today, in an industry where about 75% of products are sold through indirect channels, this direct customer contact remains a differentiated strength. It accounts in part for Hilti's



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ability to command significant price premiums over competitors.

Real-time response is a competitive weapon of growing importance in a world of increasing speed and complexity. The companies that move fastest can often operate within competitors' decision cycles, so competitors are always responding to them rather than the other way around. Marcia Blenko, Paul Rogers, and Michael Mankins recently studied 760 companies worldwide through 40 questions regarding perceptions of decision speed, quality, and ability to execute. When they synthesized the responses into an index of decision effectiveness, they found that companies ranked in the top quintile produced, on average, a total shareholder return about 6 percentage points higher than the returns of other companies. Companies with robust learning systems usually score higher than average on all three counts.


A repeatable differentiation can falter and even collapse without nonnegotiable principles and robust learning systems—and without strong management to preserve and protect it. Think of Nokia. Its leaders created a formula for tablet-shaped handsets that allowed it to achieve enormous economies of scale and dominate the market for more than a decade. Yet despite considerable surplus resources during that time, the company's leaders failed to adapt and invest aggressively in the future. As a result, in just a year Nokia lost its market position to Apple, Google, and Research In Motion. This lesson is all the more sobering given that Nokia's R&D and product development teams had many years earlier created some of the basic concepts later used in the iPhone: a large display, a touchscreen, internet readiness, and an app store.

THE SEARCH for profitable growth is becoming increasingly difficult. Today fewer than 10% of companies achieve more than a modest level of profitable growth over a decade, and the odds of success are declining. A series of interviews we conducted with CEOs regarding their challenges on the job spotlight two reasons for this state of affairs. One is that companies are forced to adapt faster than ever. The other—and this one was at the top of the list—is the need to control ever-growing levels of complexity. Sluggish, too-complex organizations are the silent killers of corporate growth and profitability. Interestingly, only 15% of executives in our survey cited a lack of attractive opportunities as a major barrier to

growth. Internal complexity and barriers to speed of adaptation were far more important.

Our findings show that the simplest strategies, built around the sharpest differentiations, have hidden advantages not only with customers but also internally, with the frontline employees who must mobilize faster and adapt better than competitors. When people in an organization deeply understand the sources of its differentiation, they move in the same direction quickly and effectively, learning and improving the business model as they go. And they turn in remarkable performance year after year. ♣

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 **Chris Zook** and **James Allen** are partners at the global consulting firm Bain & Company and lead its strategy practice. They are the authors of *Repeatability: Build Enduring Advantage in a World of Constant Change* (Harvard Business Review Press, forthcoming in 2012).



"Say what you want about the new regime, but I'm rather fond of my title change from Hangman to Gallows Administrator."

CARTOON: TERESA BURNS PARKHURST

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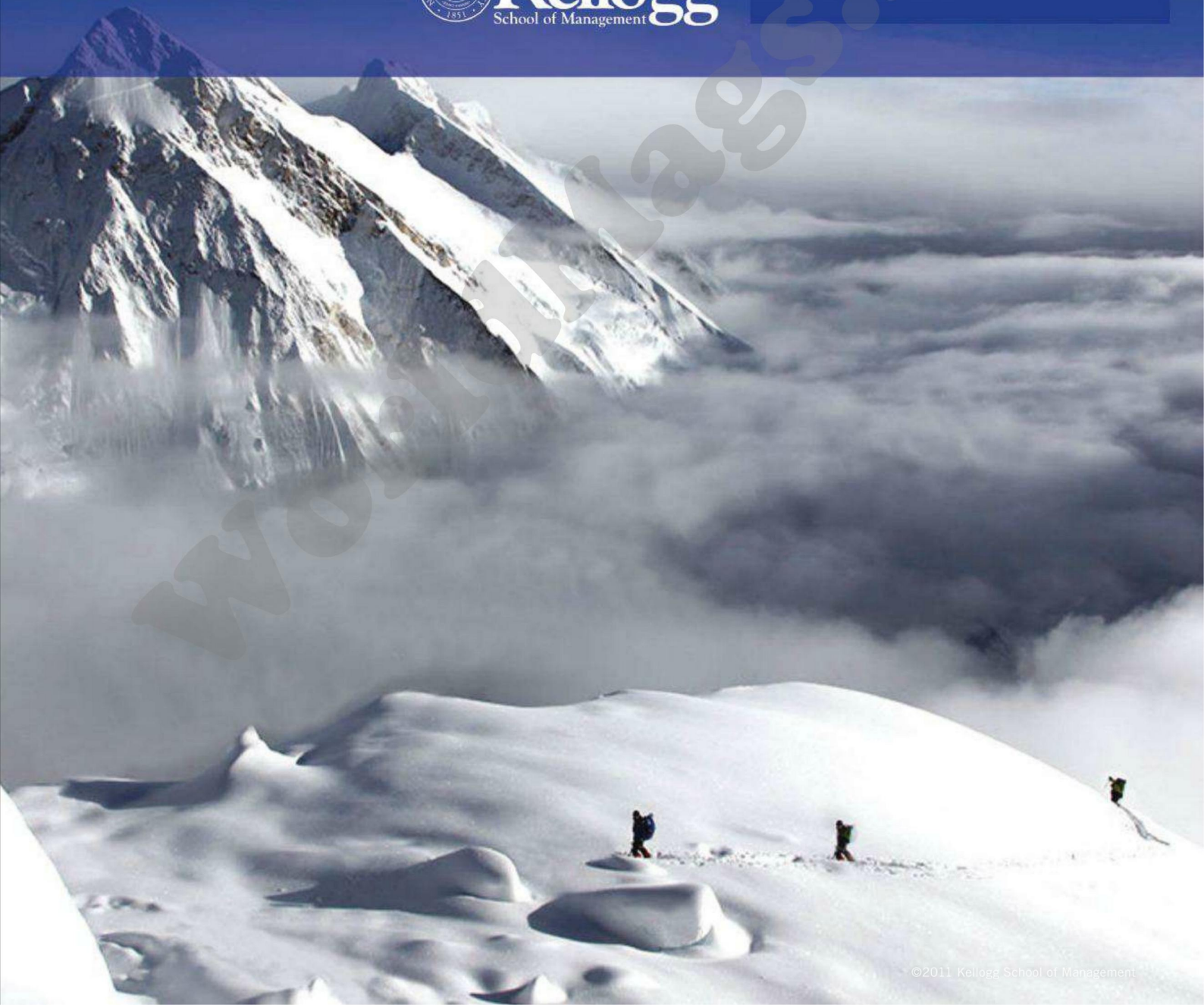
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Social Strategies That Work

Businesses that thrive on social platforms don't just sell stuff—they also help people connect.

by *Mikołaj Jan Piskorski*



More than a billion people use social platforms such as Facebook, eHarmony, Renren, and LinkedIn. What's the attraction? They satisfy two basic human needs: to meet new people and to strengthen existing relationships. Fee-based dating websites, which collectively grossed \$1 billion in 2010 by connecting strangers, now account for an estimated one in six new marriages. Facebook, which fortifies friendships, boasts a staggering 750 million users and a valuation in excess of \$100 billion.

Numbers like those attract traditional companies, which have launched Facebook fan pages and Twitter accounts in hopes of finding new customers and engaging existing ones. But few of those companies succeed in generating profits on social platforms, despite collecting lots of “friends” and “followers.”

To find out why some firms fail while others succeed in these venues, I studied more than 60 companies across industries ranging from manufacturing to consumer packaged goods to financial services as they ventured into online social realms. What the poorly performing companies shared was that they merely imported their *digital strategies* into social environments by broadcasting commercial messages or seeking customer feedback. Customers reject such overtures because their main goal on the platforms is to connect with other people, not with companies. That behavior isn't hard to understand. Imagine sitting at a dinner table with friends when a stranger pulls up a chair and says, "Hey! Can I sell you something?" You'd probably say no, preferring your friends' conversation over corporate advances. Many companies have learned that lesson the hard way.

In contrast, the companies that found significant returns devised *social strategies* that help people create or enhance relationships. These work because they're consistent with users' expectations and behavior on social platforms. To return to our dinner analogy, a company with a social strategy sits at the table and asks, "May I introduce you to someone or help you develop better friendships?" That approach gets a lot more takers. (See the exhibit "Digital Strategy vs. Social Strategy.")

You Scratch My Back...

To explain successful social strategies, I find it useful to characterize them in a simple statement with three components that all the strategies share:

Successful social strategies (1) reduce costs or increase customers' willingness to pay (2) by helping people establish or strengthen relationships (3) if they do free work on a company's behalf.

This definition yields four types of successful social strategies that firms can pursue (see the table "Four Ways to Pursue Social Strategies"):

- Reduce costs by helping people meet.
- Increase willingness to pay by helping people meet.
- Reduce costs by helping people strengthen relationships.
- Increase willingness to pay by helping people strengthen relationships.

The work people do on a company's behalf can include customer acquisition, supplying inputs such as R&D and web content, and selling the company's products or services.

To see how the strategy of reducing costs by helping people strengthen relationships works, consider Zynga, a three-year-old company whose free social games, including FarmVille and CityVille, are on track to generate \$1 billion in revenue in 2011. The games run inside the Facebook environment and have attracted more than 250 million users (the typical player is a middle-aged woman). The Facebook platform allows the games to access the demographic data of players and lists of their "friends," as well as to post status updates that those friends can see. In CityVille, players plant seeds on a virtual plot, cultivate the land, harvest crops, and sell them to local virtual businesses. They then use the profits to buy more seeds, build businesses, or expand the city.

The game presents players with obstacles such as limits on the number of plots or businesses they can possess. To increase the limit, players can pay with virtual goods they buy from Zynga—a major source of the firm's revenues. Or, to the social-strategy point, they can enlist friends, via Facebook status updates or Zynga's messaging system, to help. And they can return the favor by sending virtual gifts to friends and by visiting their plots.

The positive impact that Zynga's games have on players' social lives is clear. According to a survey done by Information Solutions Group, almost a third of players reported that the games helped them connect with family and current friends; another third said games facilitated connections with old friends; and a third used the games to make new friends. My interviews with dozens of players revealed how. Many use the opportunity as an excuse to connect. A woman with two children told me, "When I am done with work and kids, I want to reach out to my friends, but it's too late to call. So I go to play, and see if I can help them out with something. They notice it, which helps us stay connected." Others consider posting a game-status update on Facebook as an invitation to contact them. A younger male player said, "I am not going to post on Facebook that I had a bad day, but I might mention something about it, when I post, that I need something in a game. My friends will see it and often someone will call or e-mail."

To obtain these social benefits, people undertake actions that help Zynga. In exchange for an opportunity to reestablish and maintain contact with friends, players encourage others to join or return to Zynga's games. By my estimates, those social mechanisms slash Zynga's customer acquisition and retention costs by half, improving its profitability by



People's main goal on social platforms is to connect with other people—not with companies.

Idea in Brief

Most companies don't succeed in online social platforms.

That's because they merely import their digital strategies to these venues. But commercial messages and feedback opportunities are not what customers primarily seek. They want to connect with people, not companies.

Businesses that win in this arena adopt a social strategy that (1) reduces costs or increases customers' willingness to pay (2) by helping people establish or strengthen relationships (3) if they do free work on the company's behalf.

Successful social strategies have all three components. They're built, bit by digital bit, through helping people with the social challenges of connecting and interacting with friends and strangers.

approximately 20 percentage points. Hence, Zynga's social strategy (1) reduces its acquisition and retention costs (2) by allowing people to reconnect with friends (3) if they invite them to return to the game.

The reviewing site Yelp uses a different type of social strategy: It reduces costs by acquiring its most valuable content for free by helping people meet. Advertisers provide Yelp's revenues, but its content—18 million reviews of local establishments so far—is written by an educated cadre of volunteers, called Yelpers, mostly in their twenties and thirties. The site traffic, about 50 million visitors a month, attests to the usefulness of the reviews; it's the company's social strategy that significantly accounts for that quality.

The most passionate and prolific Yelpers may be invited to join the Elite Squad, a select tier in the Yelp community. Squad membership gives them access to exclusive Yelp-hosted events that range from the refined, such as cocktail parties at museums, to the rowdy, like a Mardi Gras-themed bacchanalia at San Francisco's Bubble Lounge, which attracted hundreds of revelers in 2009. Such events commonly produce new friendships and other relationships that continue beyond the confines of Yelp.

To maintain these social benefits, Squad members must continue to produce reviews, as the elite status is renewed—or not—every year. My interviews with elite Yelpers indicate that they will continue to write reviews specifically to maintain their status. The effects for Yelp's business are substantial. My research shows that an average elite Yelper will write reviews at a constant rate for nearly two years, whereas otherwise identical nonelite Yelpers without such social benefits will reduce their contributions after about six months. Therefore, the average elite Yelper will produce about 100 more reviews than a nonelite; without these elite contributions, Yelp's review stream would fall by about 25%. Thus, Yelp's social strategy (1) helps it

obtain quality content for free (2) by allowing the best contributors to meet like-minded people (3) if they write reviews.

Business and Pleasure

Because Zynga and Yelp are online startups with inherently social products, devising their social strategies is relatively straightforward. But companies in very different sectors are developing social strategies as well.

Consider eBay's Group Gifts online application, launched in late 2010, which people use to pool funds to buy gifts for their friends. A group organizer logs on to eBay and names a gift recipient, either directly or by picking the name from a list of her Facebook friends. eBay then offers a set of general gifts, or the organizer can authorize an eBay application to access the recipient's Facebook "about me" profile and base a gift recommendation on that. The organizer then selects a gift and issues an invitation to other contributors by posting a request to contribute on her Facebook page. The invitation contains a link to the eBay gift page, where contributors can contribute and write a note to the recipient. When the gift price is reached, eBay sends the gift and well-wishers' notes. The social benefits are clear: Group Gifts helps people purchase better-targeted and more-expensive gifts than they might otherwise. That not only strengthens relationships with the recipient but also can help enhance relationships among the joint gift givers. As one interviewee said, "If it wasn't for the Facebook update, I would never know about the farewell gift for this guy, and no one asked me to contribute. But I saw this and chipped in, and just yesterday I got a thank-you note....I think it will be easier to stay in touch with him."

To obtain such social benefits, people must advertise Group Gifts to their friends and respond to their friends' advertisements. Such friend-to-friend advertising generates dramatic results: A third of

Digital Strategy vs. Social Strategy

Group Gifts participants sign up for new PayPal accounts, and a third return to eBay within a month to purchase other items. What's more, the average price of Group Gifts goods is five times higher than that of an average eBay sale. Thus, eBay's social strategy (1) increases willingness to pay (2) by allowing people to strengthen their friendships through gift giving (3) if they ask their friends to buy from eBay.

Social strategies can also be tailored to address the challenges of meeting people for professional purposes. American Express developed such a strategy for its OPEN credit cards, which target small business owners. Customer churn is a challenge in the credit card business, so AmEx set about making OPEN cards stickier. Initially, the company hosted conferences focused on small business management for card members and then launched an online platform, called OPEN Forum, to showcase conference content. The forum site was a hit, attracting more than a million visitors a month.

Management observed that cardholders were connecting with one another through the content and launched a members-only social network called Connectodex, which allows users to post profiles, list services they offer and need, and freely connect for business. More than 15,000 small businesses have joined the network. Although members could use other professional networks such as LinkedIn, they report preferring Connectodex, as small businesses with which they interact are already vetted by AmEx. A Forrester Research study confirmed this need when it found that nearly half of owners of small businesses with more than \$100,000 in revenues say they wanted to learn from other owners.

To reap social and networking benefits from Connectodex, small business owners must obtain or continue holding an AmEx OPEN card. As a result, the service has effectively reduced customer churn and increased willingness to pay for the card. At the same time, platform users' net promoter scores (a gauge of their likelihood of recommending the card) now significantly surpass nonusers' scores. Thus, the American Express social strategy (1) increases willingness to pay (2) by helping professionals to meet others like them (3) if they maintain their card membership.

How to Build a Social Strategy

I have observed many companies seek to build social strategies, with vastly different outcomes. Those that failed in the effort focused on their business

The primary advantage of a social strategy over a purely digital one is in tapping into how people *really* want to connect—with other people, not with a company. A business with a successful social strategy helps people form and strengthen relationships in ways that also benefit the company.

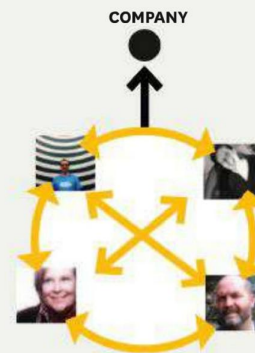
DIGITAL STRATEGIES

broadcast commercial messages and seek customer feedback in order to facilitate marketing and sell goods and services.



SOCIAL STRATEGIES

help people improve existing relationships or build new ones if they do free work on the company's behalf.



goals and paid less attention to customers' unmet social needs. These strategies didn't effectively help people with relationships, so they were unwilling to do jobs for the company. In contrast, companies with successful strategies first thought through how to address unmet social needs and then connected the proposed solutions to business goals. Because the process of identifying unmet social needs is often hard, I recommend that firms focus on helping people with four types of social challenges: connecting with strangers, interacting with strangers, reconnecting with friends, and interacting with friends.

Let's look at how a major credit card company I'll call XCard devised and tested a social strategy (the company requested that its name be disguised). The CMO assembled an eight-person team that included members from marketing, product development, and IT—plus consultants, myself included. The group ultimately reported directly to the CEO. We led the team in a structured strategy-development process in which team members devised at least one strategy for each of the four types of social challenges that card members may face. In each case, the goal was to increase card-member spending or retention, or acquire new customers, in exchange for

solutions to those challenges. Each of the four social strategies of course adhered to the core principle: They reduced costs or increased customers' willingness to pay by helping people establish or strengthen relationships if they did free work on the company's behalf.

Social challenge A: Reconnecting with acquaintances and friends outside a core group can be awkward.

Social strategy A: Help people reconnect through shopping with friends. The team devised a program that would give cardholders an excuse to reconnect by inviting others who already had the card or who had agreed to sign up for one to join them for shopping. Shopping together at the same retailer at the same time would yield additional reward points.

Social challenge B: People need help interacting with acquaintances and friends outside a core group.

Social strategy B: Help people interact through gift giving. The XCard team envisioned a gift program in which, upon request, XCard would examine another member's purchases or purchase locations (only if they had opted into the program) and recommend gifts targeted to their purchase profile. The program would give members an incentive to use XCard more in order to build an accurate purchase history, resulting in well-targeted recommendations for friends.

Social challenge C: Finding strangers with whom you have something in common isn't easy.

Social strategy C: Connect executive women who have XCard's high-end charge card. Many of these customers travel frequently and have few opportunities to socialize with women like themselves. The team devised invitation-only events at exclusive hotels in major cities to convene these cardholders when they traveled.

Social challenge D: People find it uncomfortable to interact with strangers without first knowing more about them.

Social strategy D: Help moms with young children learn something about one another. These customers have an appetite for information about child care products, but some have difficulty finding trusted advice about them. The team conceived a branded card that would allow moms to access a dedicated social platform, search for other cardholding moms who had bought a particular product, and connect to them. Only moms who made themselves searchable and continued to make purchases with the card would be allowed to search.



First think through how to address customers' unmet social needs; then connect the proposed solutions to business goals.



Theory into Practice

Having identified several potential strategies for helping people create or improve relationships, the team evaluated them using three tests.

Social utility test: Will the strategy help customers solve a social challenge they can't easily address on their own? This test requires that you focus on an important—but unmet—social challenge for the target group. People doing such analyses often assume that if they don't personally experience a given social challenge, others don't either. That is usually wrong. Social-strategy development requires an unprejudiced look at the target group's social needs.

The shopping-with-friends, executive-women, and moms strategies passed the test's requirement to address an important, unmet social need. This evaluation required researching the demand for social solutions in each group—for example, executive women's interest in networking opportunities. The research revealed that although networking groups are plentiful, invitation-only events for executive women that capitalize on their heavy travel schedules are not. The team also confirmed that moms want to find other moms who have bought a specific product and that no existing tools allowed them to do so. Similarly, the research revealed a substantial appetite for shopping with friends. However, the team found that people would hesitate to use a program that, by making gift recommendations based on their purchase patterns, in effect revealed their purchase preferences to others. For that reason, the team disqualified the gift-giving strategy.

Social solution test: Will the strategy leverage the firm's unique resources and provide a differentiated, hard-to-copy social solution? The team realized that the card's leadership in an exclusive segment and its superior rewards program were distinctive. Those resources conferred a hard-to-replicate advantage for the executive-women strategy and offered a better-than-alternatives option for that segment. Likewise, the shop-with-friends strategy continued to look promising, primarily because it leveraged the card's superior rewards program. The moms strategy didn't fare as well in this analysis because the firm lacked the detailed transaction data needed to create a service that competitors couldn't readily replicate or even outperform. Concerns also surfaced that large retailers of children's products, such as Toys "R" Us or Walmart, could create a more effective platform. The team sought to address this concern, but ultimately the moms strategy was disqualified.

FOUR WAYS TO PURSUE SOCIAL STRATEGIES

Here’s how four companies have successfully implemented their social strategies. Each firm reduces costs or increases customers’ willingness to pay by helping people establish or strengthen relationships if they do free work on the company’s behalf.

		STRATEGY IMPACT	
		REDUCE COSTS	INCREASE WILLINGNESS TO PAY
SOCIAL IMPACT	ESTABLISH RELATIONSHIPS	<p>Yelp acquires valuable content by helping people meet if they write reviews.</p>	<p>American Express helps professionals to meet others like them if they maintain their card membership.</p>
	STRENGTHEN RELATIONSHIPS	<p>Zynga helps friends stay in touch if they recruit new players and retain existing ones.</p>	<p>eBay allows people to strengthen friendships through gift giving if they ask friends to buy from eBay.</p>

Business value test: Will the social solution directly lead to improved profitability? This test requires that the strategy directly lower costs or increase willingness to pay. The executive-women strategy that had thus far survived stumbled here because of the small size of the target group—only 0.2% of cardholders. Although reducing defection among this small but disproportionately profitable segment could have a measurable bottom-line impact, the team determined that it was not as large as that offered by the shop-with-friends option.

Before piloting this option, the team checked that the activities intended to improve relationships were directly related to jobs that help the company lower costs or increase willingness to pay. That was true, for example, in the Zynga and eBay Group Gifts strategies, which allowed people to connect only if they posted status updates advertising the product. Indeed, the shop-with-friends strategy tightly aligned social and economic benefits: The social act of inviting a friend to shop is the very act that yields profits, by generating fees if the friend becomes a new card member, makes a purchase with the card, or both. Because each new customer recruited, for free, by a card member roughly halves customer-acquisition costs, the team calculated that the strategy had great economic potential. As this strategy performed best on all three tests, the team chose it as the one to pilot.

The Pilot Takes Off


By e-mail, XCard invited 10,000 customers in one metropolitan area to receive a pilot Facebook shop-with-friends application. Almost 45% of recipients checked out the application; half of that subgroup signed up. Signatories were required to enter their credit card number for validation and then were asked to pick a time to go shopping with friends. Subsequently, they were prompted to post a Facebook status update announcing when they would like to shop and informing others that all involved would receive additional XCard rewards for coshopping.

When friends clicked on the update, they were returned to the application, where they could sign up for an XCard or register their existing card and confirm their attendance. During the two-month pilot, a fifth of those who had signed up posted a status update, of whom three-quarters received at least one response (some received as many as six responses). A third of those who responded became new cardholders, and 75% of invitations to shop together resulted in purchases.

Pleased with the results, the CEO and CMO greenlighted the social strategy for a full rollout in 2012. With changing corporate priorities and increased focus on the exclusive cards, the executive team also asked the group to pilot the executive-women strategy. Most important, the company established a permanent social-strategy unit that reports to the CMO and is tasked with developing and testing new social strategies.

AS MOST BUSINESSES are accustomed to helping people meet their economic rather than their social needs, creating social strategies will require fundamental changes in the way companies approach strategy development. As social platforms become even more central to consumers’ lives, companies that don’t figure out how to appropriate their value and create true social strategies will find it harder and harder to compete with those that do. Starting this process soon, even in small steps, is both a critical defensive and offensive move. ♡

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Andrew McAfee is a principal research scientist at MIT's Center for Digital Business and the coauthor, with Erik Brynjolfsson, of the e-book *Race Against the Machine* (Harvard Business Review Press, 2011).
Twitter: @amcafee.



The true benefits of cloud computing will surprise you. But you'll need the right people to lead the transformation.

What Every CEO Needs to Know About The Cloud

In 2010 an IBM survey

of more than 1,500 CEOs worldwide revealed a troubling gap: Close to 80% of them believed their environment would grow much more complex in the coming years, but fewer than half thought their companies were well equipped to deal with this shift. The survey team called it “the largest leadership challenge identified in eight years of research.”

Unfortunately, the information technology infrastructure at many large companies only makes this challenge more difficult. Their technology environments actually impede their ability to sense change and respond quickly. While there is no simple fix for this problem, help is at hand in the form of cloud computing, a new suite of digital tools and approaches.

Cloud computing is a sharp departure from the status quo. Today most companies own their software and hardware and keep them “on premise” in data centers and other specialized facilities. With cloud computing, in contrast, companies lease their digital assets, and their employees don’t know the location of the computers, data centers, applications, and databases that they’re using. These resources are just “in the cloud” somewhere.

To advocates of cloud computing, that’s the whole point. Customers don’t have to concern themselves with details; they just rent what they need from the cloud. (For a more detailed explanation, see the sidebar “What Is the Cloud?”)

How important is cloud computing? I would argue that it’s a sea change—a deep and permanent shift in how computing power is generated and consumed. It’s as inevitable and irreversible as the shift from steam to electric power in manufacturing, which was gaining momentum in America about a century ago. And just as that transition brought many benefits and opened up new possibilities to

factory owners, so too will the cloud confer advantages on its adopters.

At present, there’s a lot of uncertainty and skepticism around the cloud, particularly among technology professionals who have deep expertise with, or attachment to, on-premise computing. Companies shouldn’t give such people too much influence over plans to move into the cloud; that would be like putting the crew that ran the boiler and steam turbine in charge of electrifying a factory. The CEO and other senior business executives need to take responsibility for bringing their organizations into the era of cloud computing.

When I talk to executives about the cloud, three questions always come up: Why will the cloud be a big deal beyond the IT department? What are the main concerns and areas of skepticism, and how valid are they? And how should we get started? In this article I’ll address those questions. I’ll explain the cloud and its benefits, highlight how perceived barriers and other concerns will keep many companies from taking full advantage of it, discuss the implications of various responses, and recommend actions.

The Benefits of the Cloud

Some people maintain that there’s nothing magic about the cloud—that anything it can do, on-premise approaches can also accomplish. That argument is correct in theory, at least for large companies that can afford comprehensive enterprise software and top IT talent. Such companies can buy or build software for collaboration or analytics—or anything else—and install it in their own data centers. They can enable these applications for different devices—desktops, laptops, tablets, and smartphones—and make them accessible to employees at home and on the road via web browsers. They can also open this infrastructure to people outside the organization, such as contractors, suppliers, and joint venture partners.

They can—but they rarely do. This is not because their IT departments are incompetent. It’s because they’re stretched, and doing all the things listed above is surprisingly difficult, expensive, and time-consuming, especially if a company is trying to repurpose older legacy technology for the modern age.

On average, only 11% of a company’s IT budget is spent on developing new applications, according to Microsoft; the rest goes to maintenance and infrastructure. Much of that 11% is devoted to big “strategic” efforts like purchasing and deploying a core

Delegating the move to the cloud to traditional IT people is like putting the crew running the boiler and steam turbine in charge of electrifying a factory.

Idea in Brief

Many criticisms of cloud computing are ill-informed and overhyped, giving executives cover for not investigating the potential of the technology. This is a mistake.

The cloud is a topic CEOs must engage on, because many of the executives they typically delegate technology decisions to are precisely the wrong people to offer unbiased guidance.

Most IT departments today are stretched thin with maintenance activities, leaving pre-

vious little bandwidth for development and new initiatives. The cloud offers a way for companies to pursue opportunities nimbly and, in many cases, cost-effectively.

What's more, many unanticipated cloud benefits arise after a project is launched and

employees discover novel ways to use the technology.

Typical concerns about cost, security, and reliability are red herrings because those concerns are comparable for on-premise approaches.

enterprise system. That leaves very few resources for, say, ensuring that employees have access to all the documents they need no matter where they are, what device they are using, and whom they're working with.

Making individuals more productive. For global contractor Balfour Beatty, that kind of access is a critical capability. The company's design and construction professionals spend much of their time on job sites overseas, where they need instant and reliable access to cost estimates, photos, blueprints, and other large files. For 10 years, Balfour had been managing uploads and downloads of all those documents with an internal FTP server maintained by the IT department, which was difficult to use and constantly running out of capacity.

So the company turned to Box, a provider of cloud-based content management and file sharing. As is often the case with cloud offerings, resources stored on Box can be accessed via a web browser or applications developed for computers, tablets, and smartphones. As long as Balfour employees have an internet-connected device, they have access to all their files when on the road.

Though the company had implemented Box to get easier access to its information, it soon noticed other advantages. With the FTP server, the IT department had to sign up each new user and create a unique folder for him or her. If a user wanted to invite a collaborator into that folder, the request also had to be routed through IT. With the new cloud-based solution, in contrast, users could administer their own accounts and digital properties, saving valuable time. Director of IT operations Rick Roman explains: "One of the comments we were continually getting from our end users was that they wanted an up-to-date solution that was powerful and flexible enough to fit the way they work. With Box, not only did we find a solution that met the requirements that our employees were asking for, but it gave us a use-

ful suite of collaboration features that has improved productivity tremendously."

Balfour's experience illustrates a common pattern in the introduction of novel technologies: The unanticipated benefits often outweigh the intended ones. On each job, Balfour employees need to share documents with an ever-shifting mix of customers, contractors, inspectors, and so on. This is easy to do when they can administer their own accounts, and hard to do in the pre-cloud world. Cloud-based file management was initiated to make individuals more productive but ended up delivering group-level benefits as well.

Facilitating collaboration. In fact, some of cloud computing's greatest successes to date have come from allowing groups and communities to work together in ways that were not previously possible. To improve the way knowledge was captured and shared among its 90,000 people, the consulting firm CSC turned to Jive, a maker of cloud-based collaboration software. The first step was an experiment to see if people would be receptive to working with the software. Jive was made available to all employees, an approach that would have been prohibitively expensive if CSC had needed to buy all the hardware and software licenses itself. People could use the platform to, among other things, pose a question to the whole company, visit and contribute to digital forums like "Where Have We Done This Before?" and "Excel Power Tips," and set up new communities on the fly.

During the initial 20-week experiment, more than 25,000 people registered for the new cloud-based resource, called C3. They created more than 2,100 groups and logged as many as 150,000 activities per month. Those results persuaded the company to make C3 permanent. "C3 has been simply stunning," Lem Lasher, the company's president and chief innovation officer, told the audience at an Enterprise 2.0 conference in 2010. "It is the de facto

What Is the Cloud?

The cloud computing industry is growing and evolving rapidly—and also generating lots of jargon. As a result it can be difficult to understand exactly what the cloud is and how its offerings differ.

To oversimplify just a bit, those offerings can be divided into three categories: raw computing capacity, computers that are ready for software, and software itself.

The first of these, called **INFRASTRUCTURE-AS-A-SERVICE (IAAS)**, is the most basic; it's a server or servers out there in the cloud, or a bunch of storage capacity or bandwidth. IaaS customers, which are often tech companies, typically have a lot of IT

expertise; they want access to computing power but don't want to be responsible for installing or maintaining it.

The second tier is called **PLATFORM-AS-A-SERVICE (PAAS)**. This is a cloud-based platform that companies can use to develop their custom applications or write software that integrates with existing applications. PaaS environments come equipped with software development technologies like Java, .NET,

Python, and Ruby on Rails and allow customers to start writing code quickly. Once the code is ready, the vendor hosts it and makes it widely available. PaaS is currently the smallest segment of the cloud computing market and is often used by established companies looking to outsource a piece of their infrastructure.

SOFTWARE-AS-A-SERVICE (SAAS), the third category, is the largest and most mature part of the cloud. It's an ap-

standard for how we collaborate. It's the language of the company.”

Mining insights from data. Analytics has been one of the other areas of greatest activity in the cloud. Companies today gather a massive amount of data, and cloud providers are supplying the hardware and algorithms to help businesses generate advantages from it. Many of these efforts have focused on understanding, predicting, and influencing customer behavior both online and offline. But Radiant Systems, which supplies the Aloha point-of-sale system to thousands of restaurants and keeps their data, is using cloud analytics in a different way—to help its clients control their operations more tightly.

Shrinkage, a polite term for employee theft, is a serious problem in the food service industry, but it's hard for restaurant owners to closely monitor servers and bartenders in their busy work environments. Radiant realized that the huge amounts of low-level transaction data it kept for each customer could be analyzed for suspicious patterns, such as a volume of large tips far above average for bartenders on a Friday night. When this occurs, it's likely that the bartender is not charging people for drinks in hopes of getting a big tip.

Using data from all its customers, Radiant developed a set of algorithms to detect many types of shrinkage and bundled them into an offering called Aloha Restaurant Guard (ARG), which generates a weekly set of reports on suspicious activity by site and by employee. These are sent to restaurant owners and managers, who use them to take corrective

action. The results can be surprising and dramatic. According to the company, one casual dining restaurant in Marina del Rey, California, saw a profit increase of \$20,000 to \$40,000 a year after using ARG to detect employee theft. To acquire this capability from the cloud, the restaurant owner didn't have to buy or install any new software, hire technologists or analysts, or alter his technology infrastructure in any way. He simply had to request ARG from Radiant.

Developing and hosting applications. Before the cloud, software developers typically had to buy, configure, and maintain their own servers. Those activities are often perceived as a hassle and a distraction from the core work of writing good code.

That was a problem 3M hoped to avoid as it developed its Visual Attention Service, a set of software tools that indicate where people will focus their attention when looking at an image. The company wanted to make these tools available to graphic designers and others via a web-based application but was unsure how much demand there would be for the offering. “To play it safe, we would have had to invest in significant server capacity, especially since our service is so computationally intensive,” says 3M business manager Bill Smyth. 3M therefore turned to the Windows Azure cloud platform from Microsoft to host the application. According to Smyth, “The cloud gave us the ability to add capacity quickly and easily, and with no capital.”

In addition to hosting applications, cloud providers are making their own powerful software available to customers. Google Earth Builder, for

plication or suite of applications that resides in the cloud instead of on a user's hard drive or in a data center. One of the earliest SaaS successes was Salesforce.com's customer relationship management software, which provided an alternative to on-premise CRM systems when it was launched, in 2000. More recently, productivity and collaboration software—spreadsheets, word processing programs, and so on—has moved into the cloud

with Google Apps, Microsoft Office 365, and other similar offerings.

Cloud offerings share a few similarities across these three categories. First, customers rent them instead of buying them, shifting IT from a capital expense to an operating expense. Second, vendors are responsible for everything “beneath the hood”—all the maintenance, administration, capacity planning, troubleshooting, and backups. And

finally, it's usually fast and easy to get more from the cloud—more storage from an IaaS vendor, the ability to handle more PaaS projects, or more seats for users of a SaaS application.

Some large organizations are planning to build “private clouds” that they will own and maintain. These are essentially data centers that use many of the cloud's technologies. Private clouds hold the promise of offering all the advantages

of the public cloud while addressing security and regulatory concerns. However, I'm skeptical. The scale economies of public cloud companies lead to great cost decreases over time, and because their environments are intensely competitive, those decreases will surely be reflected in their prices. I doubt that most private clouds will be able to keep up.

example, is a set of digital tools for geospatial data visualization and analysis that allows organizations to upload their own data and layer them onto popular resources like Google Earth, Google Chart Tools, and Google Maps. Ergon Energy, the electricity supplier for Queensland, Australia, plans to fly a customized airplane over its 150,000 kilometers of power lines, gather data about them, and transfer the data to Google Earth Builder. Ergon CEO Ian McLeod says that the company will use the data-rich maps and pictures that result to “understand the environmental status of the network and its associated risks. With this intelligence we can make better business decisions around our investments and improve operational response and business performance in key areas such as vegetation management, disaster response, designing customer connections, and augmenting the networks.”

As these examples illustrate, the cloud offers benefits at the level of the individual and the group, and of the data and the application. It allows companies to increase the scale and power of their IT and the speed at which it can be accessed and deployed. It eliminates administrative headaches and works across locations, devices, and organizational boundaries. All these advantages will increase as we move deeper into the era of cloud computing.

Recognizing this, forward-looking companies are making aggressive use of the cloud even when they have the technical, financial, and human resources to pursue any computing strategy. The video service Netflix, the social game maker Zynga, and eBay are

among the companies that have stated publicly that the cloud is a major part of their computing strategy. They have realized that they don't have to own technology themselves to compete effectively. They see, in fact, that owning all the computing assets they use is actually more likely to hamper their progress than accelerate it.

The Skeptics' Concerns

For all its compelling advantages and leading proponents, the shift to cloud computing has been slow. A 2009 Forrester study found that 37% of large companies were “not interested” in the cloud. Another 39% were interested but had no immediate plans to explore it. A 2011 survey by *InformationWeek* found that only 29% of respondents had analyzed the impact of the cloud on their internet-facing architecture. And the technology research firm Gartner predicts that while cloud computing will grow at an annual rate of 19% through 2015, it will account for less than 5% of total worldwide IT spending that year.

Why so slow? Moving an enterprise's legacy IT into the cloud is difficult because it forces tough decisions about consolidation and standardization. Most organizations that have been around awhile have a hodgepodge of hardware, operating systems, and applications, often described as “legacy spaghetti.” It can't simply be transferred to the cloud but must first be untangled and simplified. And though everyone may grouse about legacy spaghetti, few are willing to give up their portion of it just so their company can move to the cloud.

How to Start Moving into the Cloud

Most companies are just starting to explore the possibilities of cloud computing. Here are a few guidelines on how to get started.

Identify restrictions and gray areas. In some industries and geographies, laws and regulations prohibit putting data in the cloud or create confusion about what's permissible. Executives should begin by understanding as clearly as possible the risks and no-gos of the cloud for their companies and should involve their general counsels and compliance departments from the start. They'll have to decide whether to adopt a conservative or aggressive approach in the face of those risks. Because of the cloud's growing importance, I advise boldness for most companies, with possible exceptions including those handling data that involve personal health information and information subject to export restrictions.

Start running experiments with software-as-a-service. A wide variety of powerful business software is currently available in the cloud. This includes applications for office productivity and collaboration (such as Google Apps, Microsoft Office 365, Jive, Socialtext, Yammer, and Spigit), customer relationship management (Salesforce.com), human resource management (SuccessFactors, Workday), and social media monitoring (HubSpot, Radian6).

Pick a couple of apps and experiment with them. Experiments are very different from pilots or trials. Well-designed business experiments have control groups (parts of the company that don't get the cloud software) and data collection (compared with the control group, did total IT support costs go down, employee satisfaction go up, and business results improve?). Results from these experiments will indicate whether use of the cloud should be expanded.

Do your next development project in the cloud. If you're still buying servers and other gear to create development "sandboxes" for the software you write yourself, stop and ask why. Infrastructure-as-a-service offerings are now quite mature, and platform-as-a-service ones are getting there quickly. They free developers from the headaches of buying, maintaining, and adding gear and let them concentrate on the real work of writing good code.

The cloud also contains powerful software resources that developers can plug into. Google Maps and Chart Tools, for example, can be easily integrated with a company's data to produce a wide range of visualizations. Over time, more and more of the business world's software is going to live in the cloud. You probably want to be part of this trend sooner rather than later.

Talk with your core enterprise software vendors to understand their plans for the cloud. Many if not most of their offerings are currently available only on-premise. When are they going to release cloud versions of their applications? How are they going to help their current customers migrate to them?

As you take steps into the cloud, you'll very likely be working with your company's IT department and CIO. Their attitudes toward cloud computing will be critical and highly revealing. In my view, a CIO's lack of enthusiasm about the cloud these days is about as red a flag as a factory manager's disinterest in electrification would have been a century ago.

Cost. The widespread uncertainty about the cloud may be most apparent in debates over its comparative cost.

The findings about cost have been contradictory. For instance, in 2009 a McKinsey case study involving a disguised client concluded that putting the client's entire data center into the cloud would increase costs by 144%. The following year a report by Microsoft (a company with a stake in cloud computing) concluded that it would be cheaper for all enterprises to put their servers in the cloud. Such sharp differences of opinion make it difficult to follow the advice of a 2011 *Wall Street Journal* article, which

recommended, "When considering which systems are candidates for the cloud, companies need to start with the basics: Is this move going to save money?"

The focus on cost is misguided for two reasons. First, most companies don't spend massive amounts on technology, so even substantial changes in the IT budget won't make a large difference on the income statement. Gartner estimates that for S&P 500 companies, all IT-related costs accounted for just 3.2% of revenue, on average, in 2009.

Second, over time the economics of building and running a technology infrastructure will favor the cloud. Cloud providers purchase massive amounts

of hardware, bandwidth, and power, and so can get better prices. Because they also buy gear all the time, they can take continual advantage of the computing cost declines predicted by Moore's Law. These factors will combine to constantly drive down the costs of cloud computing and the charges to customers. Amazon Web Services, for example, has reduced its prices a dozen times in the past three years, even though it does not yet face intense competitive pressure.

Reliability. Whether or not the cloud is cheaper, many skeptics hold that it's not as reliable as a well-managed on-premise infrastructure. The infrastructure you control, they argue, is more stable than the one you don't.

The cloud's reliability was called into question most sharply in April 2011, when large portions of Amazon's Web Services infrastructure went down for as long as three days. This was a major blow to many companies that used it. But not all of them. Netflix, for example, relied heavily on Amazon, yet remained unaffected by the outage.

How did Netflix escape a crisis? By working hard to build in redundancy so that it could stay running in the event of a huge disruption. Amazon's failure was serious but affected only one of its U.S. data centers. Amazon had also explicitly advised its customers to design their architectures to withstand a service interruption. Netflix took that recommendation to heart, going so far as to build a system called the Chaos Monkey. This digital primate's job is to automatically and randomly shut down major parts of the company's technology environment. Because Netflix learned to handle its own Chaos Monkey, it was prepared to deal with the breakdown caused by Amazon.

Cloud companies are gradually learning this lesson and improving the redundancy and reliability of their offerings. Every outage by a prominent cloud vendor receives a great deal of attention, but overall cloud reliability records are admirable—and would be the envy of most on-premise operations. Google's Gmail service, for example, was available for 99.984% of 2010, or for all but seven minutes of each month. The Radicati Group, a technology market research firm, estimates that this is approximately 32 times more reliable than the average corporate e-mail system. Banks' trading systems might need greater uptime than this, but for most other uses it suffices.

Security. The security of the cloud is also frequently questioned. It's true that transmissions can

be intercepted; firewalls can be breached; viruses, worms, and other forms of malware can invade. Perhaps most unsettling, the people responsible for digital infrastructure can steal secrets or get sloppy and let thieves in. As the Harvard law professor Jonathan Zittrain wrote, "Before, the bad guys usually needed to get their hands on people's computers to see their secrets; in today's cloud all you need is a password." However, this is true for every computer network, including the ones that companies run themselves.

Like service interruptions, security breaches at cloud computing companies are big news, and the 2011 incidents at the storage provider Dropbox and the e-mail marketer Epsilon were well covered. But it's worth keeping in mind that 90% of businesses surveyed by the Ponemon Institute, a privacy research firm, had one or more security breaches a year.

The only way to have 100% computer security is to have zero computers. The next best approach is to constantly monitor the threat landscape; buy or build the best technologies to protect devices, networks, and transmissions; and hire and retain top digital security specialists. Cloud computing vendors are better able to do this than all but the very largest and most security-conscious organizations.

For most companies, however, security means more than just keeping the bad guys out. It also means controlling who's able to do and see what, over time and across changing conditions. The documents and spreadsheets related to a potential merger, for example, should be visible only to the team working on the deal, and when employees leave the company, it should be quick and simple to terminate their access to the company's digital resources.

Many organizations can exercise this kind of control pretty well with their on-premise computing

Over time the economics of building and running a technology infrastructure will favor the cloud over on-premise computing.

In 2011 the CIO of the United States called for moving \$20 billion, or one quarter, of all federal IT spending into the cloud.

environments, which include substantial administrative capability. Some cloud offerings, in contrast, can't. This is because they were originally designed for individuals or small groups of peers, not for hierarchical organizations in which some people have both the right and the responsibility to exercise control over others.

Cloud vendors who are interested in the large enterprise market are working to incorporate administrative functionality into their products; many have already done so. As it matures, this functionality should allay the most serious security concerns.

Regulation. It's not possible to discuss, or even list, all the legal and regulatory barriers to the cloud here, but many have to do with data access and transport. The U.S. Health Insurance Portability and Accountability Act, for example, puts in place strict access and audit requirements for organizations handling personal health data, and there's been much debate about whether cloud computing providers meet them.

Similarly, the EU prohibits consumers' data from being transferred to countries outside it without prior consent and approval. Companies outside the EU can overcome this restriction by demonstrating that they provide a "safe harbor" for data. Some countries, like Germany, however, have even more-restrictive data export laws, and it's not yet clear if the safe harbor process will satisfy them.

Such considerations mean that it often won't suffice for cloud computing customers or suppliers to blithely say, "The data's in the cloud somewhere; we don't know exactly where." Enterprise cloud vendors are aware of this and are working to modify their offerings so that, for example, they can assure customers and regulators that a specific body of data is being stored in one location and nowhere else.

But for now, current and potential cloud customers need to get as much clarity as possible on the le-

gal and regulatory considerations, if any, that accompany a shift to the cloud. (See the sidebar "How to Start Moving into the Cloud.") It's true that clarity is often difficult here; some regulations are vague, and case law has not yet had time to accumulate. But it's also true that many organizations are taking too conservative an approach to the cloud and that they're able to do far more than they think. For an example of a large organization that despite its many regulatory requirements is moving aggressively into the cloud, look no farther than the U.S. government. In 2011, Vivek Kundra, who was the government's CIO at the time, announced a strategy calling for \$20 billion, or about one quarter, of all federal IT spending to move into the cloud.

IF YOU'LL PARDON THE PUN, the near-term forecast for corporate computing is only partly cloudy. Uncertainty about the cloud's benefits and concerns over cost, reliability, security, and regulation will keep many (if not most) companies and their executive teams from making bold moves.

What are the business implications of this uneven adoption of cloud computing? If the cloud's only impact was on companies' IT budgets, the implications would be minor, but as we've seen, this is not the case. Cloud computing offers advantages in, at a minimum, productivity, collaboration, analytics, and application development.

How valuable are these? It's hard to measure, but here's some food for thought: How would you feel if your main competitors started pulling away from you in those areas simply by changing their computing infrastructure? And how much worse would it be if this change created other benefits that are not yet obvious? One common feature of major technological shifts is that their full effects are not visible at first. For example, it was inconceivable at the dawn of factory electrification that a separate motor might one day be placed on every machine in the plant, yet this is exactly what eventually happened.

As the cloud grows and matures, its vendors will continue to innovate and to differentiate their offerings. The results may not be as transformative as those from factory electrification, but I predict that they'll lead to corporate computing environments very different from the ones in place today. The only way to learn about them firsthand is to start moving into the cloud. ▣

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IN 1965, INTEL cofounder Gordon Moore famously sketched out his prediction of the pace of silicon technology innovation: the number of transistors that could be placed on a semiconductor chip would double every two years.

That prescient observation, now known as Moore's Law, has been Intel's guiding principle as it has built successive generations of microprocessors that offer more capability, greater functionality, and better energy efficiency—at lower cost.

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nology to tomorrow's markets. In addition, Intel's global venture capital investment organization—one of the largest of its kind in the world—seeks out and invests in promising technology companies that will deliver the next generation of breakthrough products.

A look at Intel's investments in the future:

Research and Development

Intel is committed to investing in world-class R&D, creating the technology to drive tomorrow's innovation, with a special focus on the design and manufacturing of silicon technology-based products. In 2010 alone, the company invested \$6.6 billion in R&D.

The recent announcement that Intel's new 3-D Tri-Gate transistor is ready for market, after a ten-year development cycle, is a case in point. Intel's engineers have created smaller and smaller transistors on a single microprocessor chip, which has boosted chip performance and energy efficiency. Smaller transistors shorten the distance that electrons must travel, so products con-

sume less power and process information faster. What's more, smaller transistors also make it less expensive to build microprocessors. These gains mean that Intel's Tri-Gate transistors require less energy to "switch" back and forth, making them ideal for use in small handheld devices—and making whole new devices possible.

New Factories and Upgrades

What also sets Intel apart is its ability to deliver higher computing power at lower cost, in high volume. As a result, manufacturing is a core piece of Intel's business: the company is able to fabricate some 10 billion transistors per second. With each new technological breakthrough necessitating the design and development of new production tools, microprocessor fabrication facilities require enormous investment in innovation.

Last year, Intel announced a fresh wave of investment in next-generation manufacturing technology across the United States. In addition to upgrades to existing plants, the company is investing more than



\$5 billion to build a new facility in Chandler, Arizona. This new plant, known as Fab 42, will be the most advanced high-volume semiconductor manufacturing facility in the world. The plant will begin operations on a leading-edge process to create transistors with a minimum feature size of 14 nanometers. (At one-billionth of a meter, the nanometer is one ninety-thousandth of the width of an average human hair.)

In making this investment, Intel will innovate new manufacturing processes that can be duplicated at other plants, creating capacity for continued growth and innovation in a new generation of devices. By continuing to advance manufacturing process technology, Intel is making it possible for additional features and functions to be integrated into chips, enabling the development of devices with sleeker designs, higher performance, and longer battery life at lower costs for users.

Intel Capital

Beyond Intel's microprocessor innovations, Intel is also investing in the future through its global investment organization, Intel Capital, one of the largest venture capital organizations in the world. Intel Capital seeks out and invests in promising technology companies and, since 1991, has invested more than \$10 billion in some 1,140 companies.

Intel Capital focuses on companies developing technologies that will complement Intel's businesses, including next-generation innovations throughout the ecosystem. For instance, Intel Capital recently invested in Omek, a company that provides 3-D gesture-recognition and body-tracking technology. This technology is particularly relevant for notebook and Ultrabook™ platforms, offering new ways to interact immersively with devices without the use of keyboards.

Other investments support broader business and engineering collaboration to extend Intel's capabilities into new territories or segments. For example, last year Intel Capital invested in Borqs, a China-based Android software integrator for mobile phones. The two companies are working together to help deliver Android-based phones powered by Intel chips.

Intel Capital made a similar investment in UQ Communications, a Japanese wireless broadband provider that will help extend Intel's reach within an existing market. UQ has launched a 4G mobile network in Japan, with Intel providing the embedded technology required to connect to the service. Intel's partnership with UQ will accelerate the availability of a faster wireless broadband experience throughout the country, thereby potentially attracting more people and more mobile devices based on Intel Architecture.

Transforming the Future—Every Day

Intel's commitment to investing for the future extends to investing in future innovators. That's why Intel has provided more than \$1 billion in education over the last ten years to ensure teachers and students have the skills and learning to be able to create new technology innovations in the future. In addition, through programs like The Entrepreneurship Challenge, Intel encourages pioneering companies with rewards for ideas that have the potential to become new businesses or industries.

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The Globe



At a KFC in Beijing

KFC's Radical Approach to China

To succeed, the fast-food giant had to throw out its U.S. business model. *by David E. Bell and Mary L. Shelman*

Global companies face a critical question when they enter emerging markets: How far should they go to localize their offerings? Should they adapt existing products just enough to appeal to consumers in those markets? Or should they rethink the business model from the ground up?

The typical Western approach to foreign expansion is to try to sell core products or services pretty much as they've always been sold in Europe or the United States, with headquarters watching closely to make sure the model is exported correctly. This often starts with selling imported goods to the expat community or opening one or two stores for a trial run. Once such

an approach is entrenched, companies are reluctant to rethink the model. U.S. retailers and food corporations that have spent years saturating the huge home market tend to cling to what has worked in the past. Domino's Pizza nearly failed in Australia because it underestimated the need to adapt its offerings to local tastes; only after it turned the country over to a local master franchisee did Domino's become the largest pizza chain there.

A master of adaptation is the Swiss food giant Nestlé, which has created an array of products that incorporate differing regional flavors—and cater to local tastes—in coffee, chocolate, ice cream, and even water. For a hundred years Nestlé's country

KFC China's Blueprint for Success

managers have been empowered to say no to the head office if a product or a campaign doesn't suit their locales. Perhaps the greatest tribute to the strategy is that many consumers around the world believe Nestlé is a local company.

One of the most impressive stories of a U.S. multinational in an emerging market is unfolding right now in China: KFC is opening one new restaurant a day, on average (on a base of some 3,300), with the intention of reaching 15,000 outlets. The company has achieved this success by abandoning the dominant logic behind its growth in the United States: a limited menu, low prices, and an emphasis on takeout.

We recently studied KFC China's transformation of the business model that had made Kentucky Fried Chicken a global brand, and we learned how, in the process, the company accumulated strengths and competencies that now pose formidable barriers to competitors. KFC China offers important lessons for global executives who seek to determine how much of an existing business model is worth keeping in emerging markets and how much should be thrown away.

Five Competitive Advantages

In 1987, when the first Chinese KFC opened in Tiananmen Square, Western-style fast-food restaurants were unknown in China. Many Chinese still wore the tunic suits of the Mao era, and bicycles were the main means of transportation. KFC was a novelty, a taste of America. It was a place where residents with spending money could go for a special occasion. Although customers didn't like the food much, KFC made steady progress, according to Sam Su, now the chairman and CEO of Yum! Brands China Division, which owns KFC and a number of other brands in the country.

In 1992, after the Chinese government granted foreign companies greater access to markets, KFC China's managers gradually developed the blueprint that would transform the chain. Like every other multinational in China, KFC made its way up the learning curve by trial and error. But the strategy that emerged was remarkably clear and embodied five truly radical elements: turning KFC into a brand that would be perceived as part Chinese; expanding rapidly into small and midsize cities; developing a vast logistics and supply chain organization; extensively training employees in customer service; and owning rather than franchising the restaurants.

KFC China's executives believed that the company's U.S. model, although good enough to do moderately well in the largest Chinese cities, wouldn't lead to the level of success the company sought. They understood that in China, as in many other developing countries, food is at the very heart of society, inextricable from national and regional cultures, and that an abundance of flavors and an inviting ambience would be necessary to win over consumers in great numbers.

Execution of the strategy turned on a fluke of corporate ownership. With a closely involved parent, KFC China might not have been free to pursue its home-grown strategy. But the chain was then a unit of PepsiCo, which took a hands-off approach—it was more concerned with beating Coca-Cola than with selling fried chicken. As long as KFC China's financial results were good, PepsiCo was happy. Su (who joined KFC China in 1989) created a knowledgeable, motivated top management team, hiring ethnic Chinese and painting a scenario they could believe in: The company they would build would make China a better place.

KFC China's success in winning over Chinese consumers grew out of a deep understanding of the differences between established and developing markets and a willingness to radically alter the U.S. business model. KFC's approach may not apply across the board, but it suggests a mind-set that can position multinationals to win in emerging markets.

KFC China's five competitive advantages all depart from the U.S. model.

Infusing a Western brand with Chinese characteristics. The company's managers sought to stretch the brand so that consumers would see KFC as part of the local community—not as a fast-food chain selling inexpensive Western-style items but as restaurants offering the variety of foods and the traditional dishes that appeal to Chinese customers. They enlarged the outlets, which are about twice the size of those in the U.S., to allow for bigger kitchens and more floor space where customers can linger. They made a special effort to welcome extended families and groups. In the United States, by contrast, KFC outlets are designed primarily for take-out—most of the dining is done at home.

KFC China's menus typically include 50 items, compared with about 29 in the United States. The menu variety adds traffic and encourages repeat visits. The company introduces about 50 new products a year (some of them are offered only temporarily), compared with one or two in the U.S. Its executives have what they consider to be a very aggressive program for new product development, which is handled by a committee of managers from marketing, operations, product safety, and the supply chain. Menus offer spicy chicken, rice dishes, soy milk drinks, egg tarts, fried dough sticks, wraps with local

KFC China's menus typically include 50 items, compared with about 29 in the United States.

LOCALIZE OFFERINGS BY COUNTRY AND REGION.

In an effort to please local consumers, the company reinvented its menu and varied spiciness levels from region to region.

MOVE QUICKLY TO ESTABLISH A BROAD PRESENCE.

KFC established 16 beachheads as a way of quickly expanding throughout the country.

TAKE CHARGE OF THE SUPPLY CHAIN.

In the absence of logistics providers, KFC China created a distribution system to ensure adequate and high-quality supplies.

BECOME A LEARNING ORGANIZATION.

Across the company, from logistics to food preparation to customer service, employees require extensive training, and experienced managers must be constantly developed as the company grows and changes.

MAINTAIN FLEXIBILITY.

Focusing on owned restaurants rather than franchises enabled the company to make changes where necessary to meet local needs.

GUARD AGAINST BACKLASH.

Concern in the West over high-fat, high-carbohydrate foods prompted the company to begin changing its menu and educating consumers about health.

saucers, and fish and shrimp burgers on fresh buns. Spiciness levels are very important to customers. In the chain's early days, when the same recipes were served at all outlets, Shanghai customers complained that dishes were too hot, while diners in Sichuan and Hunan complained that they were too bland. So the company changed its recipes to suit the regions. It also offers congee, a popular rice porridge that is hard to make at home, which is KFC's number one seller at breakfast.

The extended menu means that food preparation is more complex in Chinese KFCs than in American ones and requires more hands (thus the bigger kitchens). These outlets typically employ 60 people—nearly twice as many as in the U.S. Often one of those employees is a hostess who greets customers and organizes pastimes, such as learning English songs, for young children in play areas.

With all this activity to support, KFC can't position itself as the cheapest dining option—nor does it want to. Customers spend the equivalent of \$2.50 to \$3.50 per visit, a price point that puts KFC way above street vendors and local restaurants and even somewhat above other fast-food chains. Although young “white collars” in Shanghai might eat a KFC lunch with friends once or twice a month, a family in a smaller city might go once or twice a year, to celebrate a special event.

Expanding rapidly. Rejecting the measured growth of its China competitors and of KFCs in other countries, KFC China set its sights on rapid expansion. One factor in this decision was the presence of McDonald's in China's four largest cities. Rather than go head-to-head with the Big Mac, KFC decided to embrace smaller cities and to build a national business with outlets all over the country. Scale allows the company to reduce costs, and being the first to enter a city means getting the pick of locations with good foot traffic and visibility. Being first also means garnering free publicity when officials celebrate an outlet's opening as marking the city's coming of age. Moreover, a national presence means that KFCs (and other Yum! outlets) are popular with mall developers.

KFC rushed to establish a presence in 16 locations from which it could grow and develop. By 1999 it was opening dozens of restaurants a year, and in 2002 it picked up the pace even further. (In 2008 Yum! Brands' annual opening rate in China surpassed 500 restaurants, most of them KFCs—compared with 103 new KFCs in the United States.) From site selection to grand opening, it takes KFC China four to six months to bring a new restaurant into the world—about half the time required in the U.S. Some 700 Chinese cities now have outlets.

With KFC as its flagship chain, Yum! has become China's largest restaurant com-

pany by far, with more than 250,000 employees and about 40% of the market for fast-food chains. KFC's rapid expansion in China has allowed the company to widen the gap between itself and competitors: McDonald's has about one-third as many outlets and owns a 16% market share.

Developing a logistics network. In the United States and Europe, fast-food chains rely on networks of distributors to ensure that food is handled properly and kept refrigerated from the farm to the restaurant. No such networks exist in many of the world's emerging markets. To meet this challenge, KFC China established a distribution arm in 1997, building warehouses and running its own fleet of trucks. This was an expensive undertaking, but necessary if the company was to expand rapidly, carry a lengthy and complex menu, and introduce new products quickly. That same year the company implemented a supplier rating system that allows managers throughout China to concentrate purchasing with the suppliers that perform best.

Food safety is a matter of paramount importance, especially given Chinese consumers' concern in recent years over incidents involving tainted milk powder and contaminated livestock feed. KFC China had a brush with this issue a few years ago, when a colorant that had been linked to cancer was found in one of the company's sauces. Although the problem was resolved

quickly, Yum! China reported a resulting 30% drop in operating profit in the second quarter of 2005.

KFC China closely monitors the entire supply chain, all the way back to animal feed companies and other input providers, and it trains employees in personal hygiene, including how to dress for the workplace and how often to wash their hands. It now has the most advanced and integrated cold-chain system in China, with 11 full-service logistics centers and six satellite centers serving every province except Tibet. To circumvent the traffic jams that sometimes extend for miles in the winter, it relies on contingency plans that involve renting temporary warehouses and reserving space on cargo airlines.

Most products are sourced in China. Buying locally is essential to keeping costs low, and it strengthens the parent company's relationship with the Chinese gov-

ernment. The policy has a few unavoidable exceptions, including certain herbs and spices—for KFC's "secret" fried chicken recipe—that can't be obtained in China. But the company works with its suppliers to build their capabilities and capacity; it is even working with growers to introduce U.S. varieties of sweet corn.

Training employees in service. When KFC opened in Beijing, it was one of the first companies to promote excellent customer service—a concept then unfamiliar in China after decades of commu-

New recruits at KFC often have to be taught basic people skills in order to interact with customers.

nism. But despite an abundance of willing workers, staffing is a perennial obstacle. In fact, it is the limiting factor in the chain's expansion, according to Sam Su. To maintain its current restaurant-opening rate, KFC needs at least 1,000 new managers and 30,000 new crew members a year, and they must be ready the minute an outlet opens, because it is likely to be packed. The company prides itself on being a "learning organization." Teams of new employees work side by side with experienced ones in established outlets; once trained, they move to a new location.

Teaching employees how to interact with customers is no small matter. One-child families and the proliferation of home computers mean that Chinese children interact less with other people than they did in previous generations. New recruits at KFC often have to learn basic people skills and teamwork.

The Chain Restaurant Landscape in China

Ever since KFC China opened its first outlet, in Beijing in 1987, the number of foreign-owned chain restaurants has grown steadily in China. Here's a look at some of them.

BURGER KING has about three dozen restaurants in China, where its first outlet opened in 2005. In 2010 an executive said that Asia would be the brand's largest growth engine within three to five years but that BK planned to proceed cautiously in China.

DAIRY QUEEN has some 300 Chinese outlets.

MCDONALD'S opened its first restaurant in China in 1990 and plans to double the number of outlets there to 2,000 by

2013. The company says its strong sales in the Asia/Pacific, Middle East, and Africa regions are led by results in China, and it cites the appeal of such conveniences as delivery, drive-through, and extended hours. Some 70% of McDonald's Chinese outlets are open 24 hours a day.

PAPA JOHN'S plans to increase the number of its outlets in China from 155 to 300 within three years.

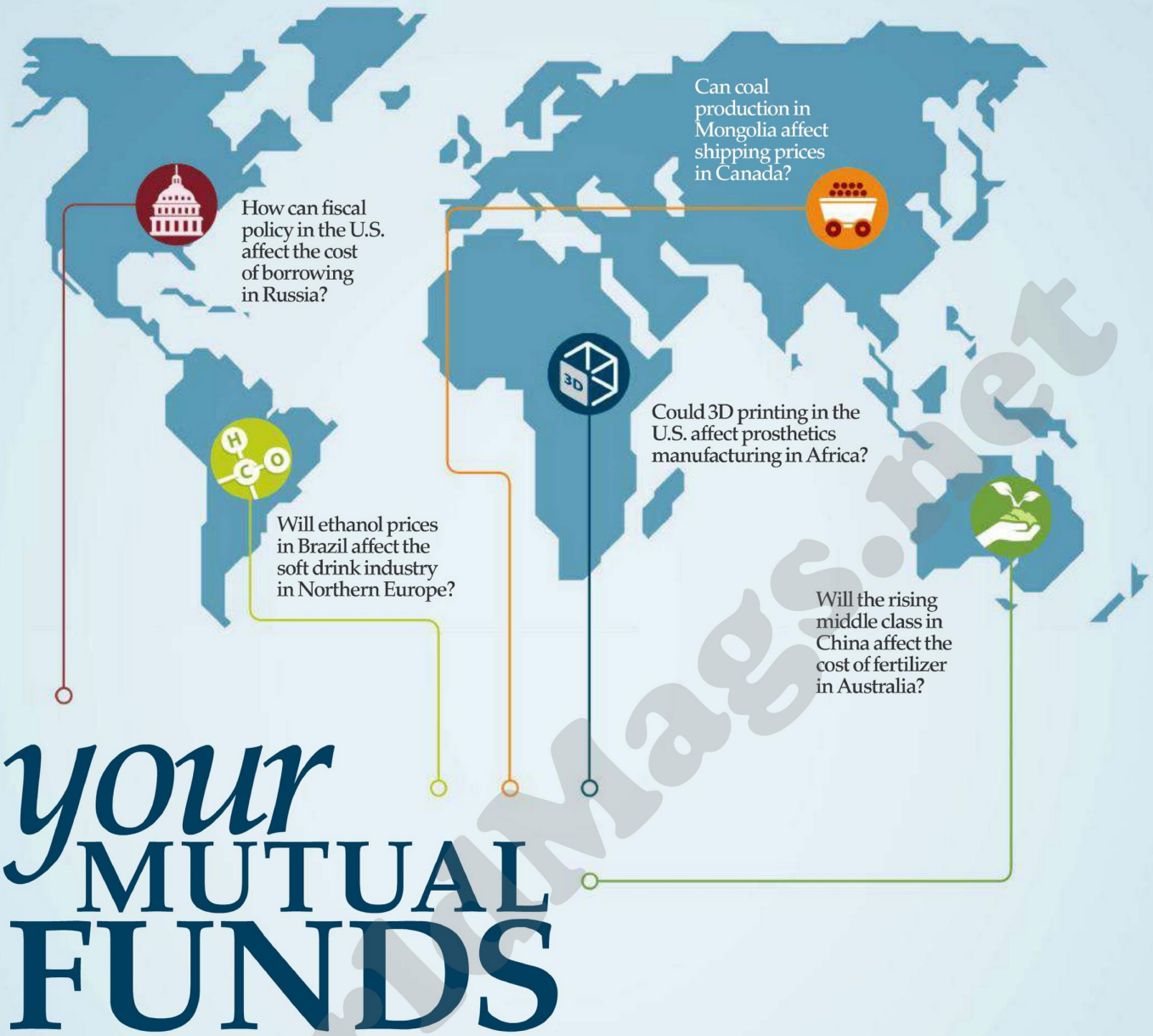
PIZZA HUT is a part of the Yum! portfolio; it has

some 500 dine-in restaurants and 120 delivery-only outlets. Like KFC, it has undergone a transformation in China. It now offers a lengthy menu that includes seafood pizza, beefsteak, and fried squid, and it attracts an older and more affluent crowd than KFC does.

STARBUCKS opened in China in 1999 and has about 450 shops there; the company plans to have 1,500 by 2015. Executives say they believe there is huge potential to drive coffee consumption in China.

TACO BELL was similarly positioned by Yum! as an upscale restaurant, but it was shut down in China after a five-year experiment. Mexican food, with its emphasis on dairy and beans, didn't appeal to Chinese consumers.

WENDY'S/ARBY'S has only about 300 restaurants outside North America. It announced earlier this year that it was considering expansion in China.



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Taking on a New Challenge: Chinese Food

Many other companies have followed KFC's example in customer service (last year McDonald's announced that it was opening a Hamburger University in China), but KFC's training program functions exceptionally well, churning out a continual stream of new managers. This, like the company's extensive logistics network, is an advantage that is difficult for any competitor to emulate.

Focusing on ownership rather than franchising. In KFC's early days, China required foreign companies to have local partners; but when the country became more receptive to wholly owned foreign enterprises, KFC China switched to a strategy of company-owned outlets—another way in which it challenged the dominant logic. (More than 90% of Yum!'s outlets in China are company owned, compared with 12% in the U.S. and 11% in other international markets.)

Franchising has long been a mainstay of the fast-food industry, because it reduces investment costs and risk and enables rapid geographic expansion. It works well when a pool of experienced, entrepreneurial candidates are available to run franchises and when restaurant operations are relatively simple—built around, for example, a limited menu of easy-to-make products. But KFC China's model was more complex and evolving rapidly. Owning the restaurants allows the company to closely control every aspect of their operation, from menu to decor, and to monitor results and the success of new products. It permits centralized purchasing, which reduces costs, and gives the company a larger share of outlet profits.

The Risk of a Backlash

KFC China's rapid growth poses challenges: A highly visible company could easily become the target of a consumer or government backlash against the perceived negatives of fast food. Some Western health problems are already showing up in China. The 2002 China National Nutrition and Health Survey revealed that 22.8% of Chinese adults were overweight, up from 6% in 1982. The number of overweight and

Yum! China's strengths in service, logistics, and training have positioned the company to support additional restaurant formats, including a local one with which it had no experience: Chinese fast food.

In recent years Yum! has experimented with developing **East Dawn-ing**, a chain that takes its name from a line in an ancient Chinese poem. The clean, efficiently run restaurants have Chinese decor and serve Chinese food exclusively—no U.S.-style fried chicken, no pizza, no burgers. The chain, which opened in Shanghai in 2005, offers such favorites as beef rice and bean curd at prices similar to KFC's.

Yum!'s initial hope was to create a large national chain, but Chinese food poses significant challenges in a fast-food context: Noodles and vegetables must be prepared just before serving; customers are highly discerning about freshness and traditional flavors; and tastes vary widely across regions. The chain has relatively few outlets, and nationwide expansion is still a distant goal.

Recently, Yum! has focused on acquiring a competitor, **Little Sheep**, a Hong Kong-listed chain of hundreds of Mongolian-style hot-pot restaurants. By 2010 Yum! held a 27% stake in Little Sheep, and earlier this year it proposed to increase its ownership level to 93%.

obese children aged seven to 17 has tripled to 8.1% over the past 10 years, according to the same agency.

In the mid-1990s a fellow participant at a seminar in the U.S. asked Su why he would want to bring “junk food” to China—a question that started him thinking deeply. Aware of a growing sense in the West that high-fat, high-carbohydrate foods play a role in the obesity epidemic, Su asked himself how Yum! Brands could take action to forestall such problems in China.

In 2005 the company developed the concept of a “new fast food” that would be “nutritious and balanced” and promote “healthy living.” It eliminated “supersize” items and added roast chicken, sandwiches, fish, shrimp, and more fruit and vegetable


dishes to its menus. KFC's children's meals are served with vegetables and juice, although fries and soda can be substituted on request. Tray mats carry educational messages. Nutrition information is printed on every package. Hostesses teach lessons on nutrition to kids.

A Confident, Dynamic Company

The results of the strategy of heavy localization have been impressive: In the first half of 2011 sales at Yum! China locations that had been open a year or more rose 16%, compared with a decline of 2% at U.S. locations. The restaurant margin for those six months was 22%—well above the U.S. margin of 11%. Yum! China revenues and operating profits in 2010 were \$4.1 billion and \$755 million, respectively; comparable figures for the overall company were \$11.3 billion and \$1.77 billion. The third quarter of 2010 marked the first time that China revenue (more than \$1.1 billion) had surpassed U.S. revenue, and many analysts expect that Yum!'s China business will be twice as large as its U.S. business within five years.

Over time, KFC China has come to reflect China itself in some respects: It is large, growing, confident, and eager for variety and new experiences. Most of all, it is, like China's economy, dynamic and capable of expanding still further—at a remarkable pace. Much of what the company has accomplished is the result of its homegrown strategy—and of the independence that PepsiCo gave Su and his leadership team in the early days. If there is an overriding lesson to be drawn from KFC's experience in China, it is that when entering an emerging market, a multinational must decide whether it wants to garner quick extra sales or to establish a long-term presence. If it's there for the long haul, it should install local managers whose vision is to build an organization that will last. ♣

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MANAGING YOURSELF

Fire, Snowball, Mask, Movie: How Leaders Spark And Sustain Change

by Peter Fuda and Richard Badham

What does it take for an ineffective manager to become a highly effective leader? Talk to 50 top CEOs, management consultants, and academics, and you'll get a different answer from each. There are countless books, models, and formulas for success. But the truth is this: Leadership transformation is deeply dependent on context. Everyone follows his own path, has her own story. The key for people who are seeking transformation is to identify the common threads in the experiences of others who have achieved success and absorb the insights they find there.

That was our ambition five years ago, when we embarked on a doctoral research project. We began with an in-depth study of seven CEOs whose success in transforming themselves, their leadership teams, and their organizations was well documented. They had all seen radical improvement in 360-degree feedback on their personal effectiveness, along with significant gains for their units or organizations in financial performance, customer approval, and employee engagement. We captured their stories through a series of lengthy interviews, conducted a rigorous linguistic analysis, and discovered that several themes were common to all seven in the challenges they faced and the strategies they used.

In ensuing conversations with these chief executives, we discovered that one of the best ways to elicit deep and broad discussion of those key themes—and to describe the CEOs' mastery of what they had learned—was through metaphor.

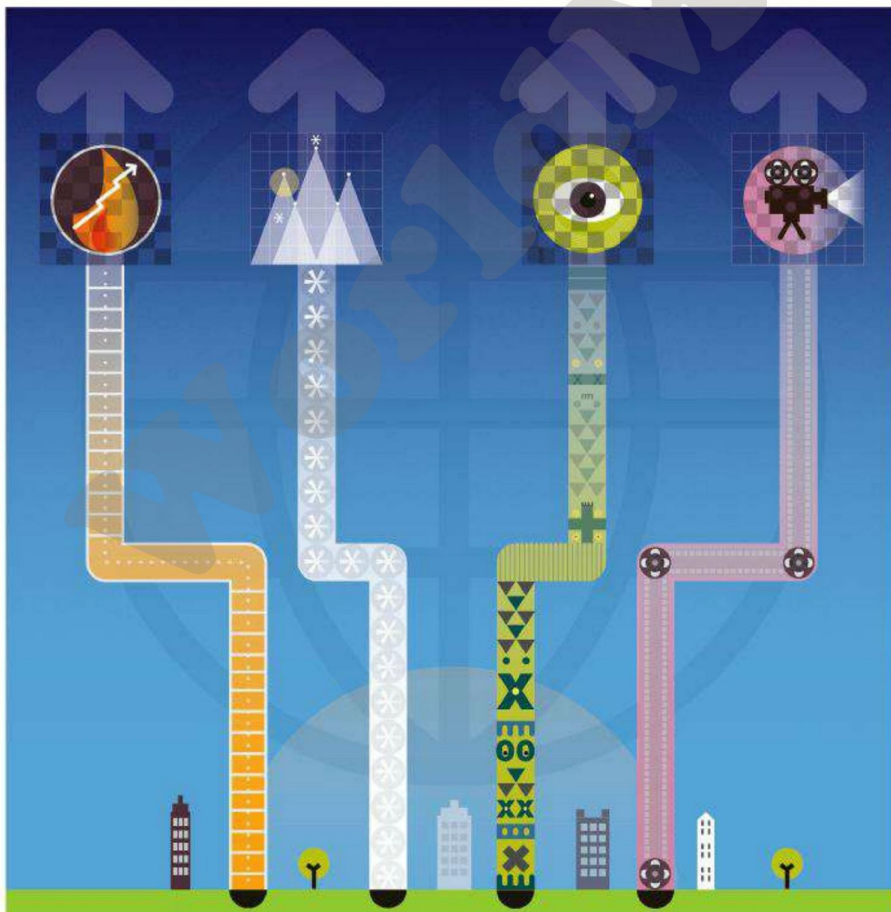


ILLUSTRATION: INFOMEN

Ultimately we uncovered seven interdependent metaphors, four of which are outlined in this article: fire (representing ambition), snowball (accountability), mask (authenticity), and movie (self-reflection). As familiar as these may sound, they contain useful insights about how leaders can become more effective. And their familiarity means you can recall them easily—which is helpful when trying to change entrenched behavior—and talk about them effectively with a group. As the organizational theorist Karl Weick once wrote, “People see more things than they can describe in words.”

Fear may provide the initial spark, but aspiration is a far more important motivator.

Since our initial CEO analysis, we have used the metaphors with more than 10,000 managers on four continents as a way of pushing them to ask tough questions and to make changes based on the answers. The feedback we’ve received suggests that they are a reliable catalyst for individual and organizational transformation. In the examples below, you’ll see how some of our initial study subjects—and other executives—embraced the metaphors with great success. We also offer a few prompts to help you kick off your own leadership transformation.

FIRE

In the modern business context, you can always find a crisis to respond to. That’s why there are a lot of these arsonist firefighters. I used to be that way, too. Nowadays I definitely prefer to move toward something rather than away from something.

—Tim, CEO research subject

In 2004 Tim was desperate to turn around his advertising company. Profits were down, employees were quitting, and competitors were gaining ground. He had

personal issues, too. He was insecure about his leadership ability and worried about his health. Listening to his story, and hearing similar ones from other executives, we couldn’t help thinking of the proverbial burning platform: Tim was putting out fires. But many conversations later, we found something else burning in Tim—ambition. He told us he wanted to “lead a big and authentic life” and to push his organization toward worthy social causes. Within three years he had done just that, helping to found the Earth Hour campaign, which in 2011 led more than one billion people around the globe to turn off their lights in a symbolic stand against climate change. This initiative won his agency a Titanium award, the most prestigious advertising award in the world.

For us, fire represents the forces that initiate a personal or organizational transformation and sustain it over time. Conventional change literature suggests that fear is a necessary and even desirable motivator. By contrast, our research suggests that although fear may provide the initial spark for action, aspiration is a far more important motivator. Sustainable change requires the fire of a “burning ambition.”

We recently used this metaphor with the executive team of a global IT services company—a group of presidents from 10 countries who were consumed by their burning platform: a huge budget, internal problems, and very difficult marketplace conditions. As the conversation shifted toward their collective aspirations, the president of strategy declared that it was time the team focused on the future instead of its current pain. The president of sales followed that provocation by explaining that he had grown up only a mile from the company’s head office and had always dreamed of working there. Now his dream was to make the company a leader



ASK YOURSELF

What are the forces compelling your organization to change?

What are the forces compelling you to change?

What do you want to gain personally from the transformation effort?

What legacy do you want to create for your organization?

in the emerging services economy. Inspired, the team agreed. Subsequently the company shifted investment dollars toward new services such as cloud computing and cybersecurity. The global head of sales and marketing later reflected, “The notion of a burning ambition was a revelation, and my focus shifted almost immediately. I hadn’t realized how consumed I had become fighting fires. The metaphor has helped me to ignite enthusiasm for the new direction.”

SNOWBALL

I shared with my team the kind of leader I aspired to be. I asked every member to hold me accountable to that vision. This set an expectation that each of them would mirror my commitment. Soon we added more layers of leadership to the process, all accountable to one another regardless of our position in the hierarchy. It felt like a massive snowball rolling down the hill, with me trapped in the middle. —Clynton, CEO research subject

Clynton, the managing director of a large German beauty corporation, was exhausted by the passive culture in his company: Everyone depended on him and avoided hard decisions. He wanted his senior managers to take more initiative. It took a 360-degree review to show him that his directive leadership style was a big part of the problem. He could have worked in private to change his behavior—but instead he stood up at an annual meeting of his top 60 managers, acknowledged his failings, and outlined both his personal and his organizational goals. He admitted that he didn’t have all the answers and asked his team for help leading the company. By exposing himself in this way, he set a standard—and an agenda—for others to follow. As more people got on board, the momentum increased. Over the next two years Clynton became very

adept at using silence and open-ended questions to encourage his team to step up. His effectiveness surged, and his team flourished; dependent behaviors gave way to initiative and innovation, and his organization has outperformed much larger competitors in the six years since.

The snowball represents a cycle of mutual accountability that creates momentum for change. It starts rolling when a leader opens himself up to the scrutiny of subordinates and asks for their support. This act of humility is seen as courageous and inspires others to follow suit. As more members of the team join the process (and those causing drag are removed), the snowball becomes more tightly compacted and almost impossible to stop.

The managing director of a large Australian grocery company used this



ASK YOURSELF

How open and accountable are you prepared to be?

How can you create accountability throughout your organization, from the leadership team down?

How might you address the potential sources of drag or friction?

metaphor with his top 30 leaders, acknowledging that he had been too hands-on as a manager and asking them to shoulder more responsibility for spurring growth. Affected by his candor, the team members committed to taking more initiative, increasing collaboration, and owning their units' performance. Once they started holding one another

accountable to these new standards, change was fast and dramatic. Leadership effectiveness ratings increased across the team (the managing director's scores rose the most), and the company grew in a declining market for the next two years. The managing director later said, "Before the metaphor, nothing seemed to move without my pushing it. Now we have so

much more forward momentum, and I'm not controlling any of it!"

MASK

I felt ill prepared for my promotion to such a big job, so I tried to bluff my way through. I thought, "OK, I will be the tough guy. It's working for my boss; he's scaring the hell out of me." But this didn't work, so I tried a different approach: "I'll be the nice guy. 'Thank you for saying thank you!'" That didn't work either. I was guessing and making it up as I went along. I was a bit of a fake."

—Mike, CEO research subject

Mike, the CEO of a multinational IT outsourcer, had a very difficult first three months in the job. The company's financial results were poor, and his credibility was being called into question. It quickly became clear that Mike himself was a major cause of the problems. His inconsistent behavior meant that his colleagues wasted energy trying to second-guess him. He realized that he would need to drop the imitations and rebuild his leadership identity. That meant focusing on his core business values—fairness and accountability—along with values he'd previously reserved for his family, such as empathy and connection. Once Mike started behaving more authentically at work, his team began to engage with him in increasingly positive ways, and his superiors became more trusting and supportive. Over the next five years Mike's leadership effectiveness ratings soared, and the company's profits more than tripled.

In our research we found two ways in which leaders use a mask. One is to conceal perceived inadequacies and flaws to preserve the polished facade we have come to expect of "great" leaders. The other, more subtle way is to adopt a certain persona at work that the leader feels is necessary for success. Both uses undermine trust and ef-

fectiveness. They also create inner conflict, as leaders struggle to align their work and home lives. By dropping the mask, a leader can craft a more meaningful and congruent identity, which enhances relationships and business outcomes.

We recently saw this happen with the head of a leading Australian wealth management business. He had adopted a highly intellectual, somewhat aloof persona at work, even though he was very warm and humble in private. This persona discouraged people from committing to him and promoted formality at

the expense of collaboration.

When presented with the mask metaphor, the leader quickly recognized himself. He saw that his once-helpful "smartest guy in the room" act was now hurting him. In preparation for a series of employee meetings, he decided to ditch the facts and figures and instead tell a personal story about his passion for the company and its customers and how he wanted to change perceptions about the industry. Though less polished than usual, he received enthusiastic applause and positive feedback from staff members. In the months that followed, staff turnover dropped by

15%, while employee engagement scores increased in equal measure. The leader later reflected, "The metaphor gave me both insight about the mask I was wearing and permission to drop it. I wish I'd done it sooner. Life has been so much easier and more rewarding since."



ASK YOURSELF

What imperfections might you be concealing from your stakeholders?

What personae are you adopting to be "successful"?

What are the costs of these masks for your personal life, well-being, and effectiveness as a leader?

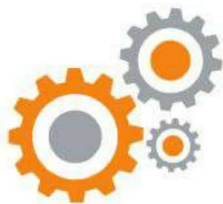
How could you bring more of your authentic self to work?

MOVIE

The biggest realization is that if you want change, you've got to stand outside yourself and look back as if you were seeing yourself replayed on video.

—Alan, CEO research subject

When Alan accepted his role as the CEO of a German chemical and pharmaceutical



MANAGEMENT TIP OF THE DAY

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Risk management departments are springing up in companies across the globe. They categorize and analyze risk to the company before it happens and in most cases, they create systems and processes to prevent risks from occurring. But the reality is that all hazards can't be predicted or avoided. Instead of simply staving off risk, focus on building resilience so that when the unthinkable happens, you're better prepared to face it. Look at all the risks you face and play out what you would do if any of them were to come to bear. Having systems in place to respond could save you valuable time, money, and resources.

Adapted from "The Benefits of Thinking the Unthinkable" by Rita McGrath.

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multinational, he was given a very simple brief from his boss: "Debuild the Prussian Empire." Employee engagement scores were terrible, and financial performance had stalled. But Alan's initial efforts to change the entrenched culture were failing. In an ironic twist, he had even started to adopt the same bullying behavior he was struggling to eradicate. At first he couldn't see it. But over time, as he was encouraged to review his interactions with colleagues, he could. As his self-awareness increased, he was able to make better choices under pressure, to more intentionally direct his own performance, and to encourage his team to do the same. Rather than competing with one another, as they had done in the past, his team members began to see the benefits of collaborating. Over the next three years the company exceeded all financial targets, and its culture changed so much that it earned a prestigious Hewitt Best Employers award.

The movie metaphor encourages leaders to "view" and "replay" their behavior, "edit" their performance, and "direct" a story that is more in line with their vision. Before our initial research subjects became effective leaders, they all seemed to be acting repetitively and perpetuating their own misery, a bit like Bill Murray in the film *Groundhog Day*. The first step toward change was a commitment to evaluate "raw footage" after an event or an interaction—on their own, with a coach, or with trusted colleagues—and think about what they could have done differently. Eventually they learned to edit themselves in real time and make a better movie.

One general manager of a large construction company used this metaphor to counteract the destructive competitive culture that pervaded his team. His attitude toward new project bids had always been "If we don't win, we've failed." His


aim was to motivate, but the result was fear. Any unsuccessful bid led to a blame game that consumed enormous energy and destroyed morale, hurting the team's chances of winning the next project.

After reflecting on his behavior and its consequences, the general manager realized that he needed to set an example by taking a new approach—"If we don't win, we have an opportunity to learn." He set up a new review process, in which everyone had to reject aggression and blame in favor of curiosity and learning. In the months following, the company's win rate for new bids increased, revenue went up by more than 250%, and staff turnover dropped to 7% against an industry average of 17%. "The movie metaphor forced me to see where I was my own worst enemy," the manager told us.

"Now I'm more thoughtful and far more effective as a leader."

THESE METAPHORS were forged in the brutally honest reflections of a select group of successful CEOs. We have used them to explain, inspire, and accelerate leadership transformation in managers at all levels, in all types of organizations, around the world. We encourage you to identify your own burning ambition, to create a snowball of accountability around your drive toward it, to drop any masks that are preventing you from getting there, and to constantly review and edit your story as a movie director would. These seemingly simple prompts will push you into the kind of organized reflection and purposeful action that mark highly effective leaders. 📌

HBR Reprint R1111L

 **Peter Fuda** is the founder and principal of The Alignment Partnership, a management consulting firm. **Richard Badham** is a professor of management and an associate dean at the Macquarie Graduate School of Management.



ASK YOURSELF

In what ways are you trapped in a "bad movie" and perpetuating your own problems?

What opportunities do you have to review the "footage" and reflect on your actions?

What methods could you employ to slow your movie down and "direct" a better one in the moment?

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Case Study

A spouse's misery casts doubt on Streuvels Chemicals' entire international mobility program. *by Boris Groysberg, Nitin Nohria, and Kerry Herman*




The Experts



John Bollman is the vice president of human resources for Sequa Corporation, a diversified industrial company, and its largest business unit, Chromalloy.



Ann Judge is the senior vice president for global human resources for Shire, a biopharmaceutical company with employees in 28 countries.

 HBR's fictionalized case studies present dilemmas faced by real leaders and offer solutions from experts. This one is based on the HBS Case Study "Solvay Group: International Mobility and Managing Expatriates" (case no. 409079) by Boris Groysberg, Nitin Nohria, and Kerry Herman. It is available at hbr.org.

The Expat Dilemma

As the senior HR executive in charge of managing overseas assignments, Anton Danois made a point of spending time with Streuvels Chemicals' expatriate employees and their families. But this evening, dinner at the Lobatos' home wasn't going well.

Ana Lobato, a Brazilian engineer, had been working at her headquarters assignment in Brussels for more than a year and was doing a great job, but her husband, Oswald, was increasingly unhappy. Right now, Oswald was even more than unhappy—he was enraged. He was glaring at Anton, who steeled himself for the remote but real possibility that Oswald would reach across the table and punch him. Instead, Oswald rose and looked around at his three dumbstruck sons, his wife, and the remains of dinner. Visibly mastering his anger, he made his way down the high-ceilinged hallway to the kitchen and closed the door. It was silent

in the Lobatos' elegant apartment except for the muffled sound of traffic outside. All eyes came around to Anton, whose hand trembled slightly as he reached for his napkin. In a moment, Ana got up and went to her husband, leaving the boys to stare at their visitor.

All Anton had said was that if Oswald enrolled in a Belgian medical school, Streuvels would pay part of the tuition. It was intended to be a helpful comment; Oswald's Brazilian medical degree didn't allow him to see patients in Europe. But Anton hadn't anticipated Oswald's outrage at the idea of repeating medical school, and now he wished he hadn't opened his big mouth.

When Ana had arrived in Belgium, she had been full of hope and excitement, ready to share with her headquarters colleagues the expertise she had acquired from high-level positions at polyvinyl chloride plants in Brazil and Argentina.

Streuvels sorely needed her skills and experience as it rolled out plants all over Eastern Europe and Russia. The Lobatos seemed like another set of happy customers of Anton's international mobility department. Ana, a star, had fit in from the first day. Her boys had adjusted to their new school, and at first Oswald had seemed to get along just fine, studying cochlear implants at UCL-St-Luc as part of his plan to acquire international stature as a researcher.

But it hadn't taken long for things to go sour for Oswald. First the head of the implant lab was out for three months for heart-valve surgery, leaving Oswald without a mentor. Then Oswald's project was folded into another, which made him feel useless. Soon he started complaining about the weather in Brussels. He then announced that his heart just wasn't in the lab; he missed going to work every day in an otolaryngology clinic and seeing patients, but he could not practice medicine in Belgium.

Ana emerged from the kitchen, looking pained. "It might be better if—" she began.

She didn't have to finish. "Please apologize for me," Anton said, getting up to leave. "I'm so sorry."

"It must have been a hard week for him," Ana said, following Anton to the front door. "He's always been such a positive person, but lately, well, he's been different."

Anton caught glimpses of his short but substantial self in darkened windows on his walk home. He looked like what he was: a business pro with decades of experience. But managing European chemical plants was what he knew best, not overseeing an international mobility department. He'd held the position for three years, and he couldn't get over how unprepared he was to be an HR exec and, specifically, to manage expats. Admittedly, he had a tendency to run off at the mouth and say things he later regretted—a trait that had hardly mattered when he was a general manager but was a definite liability in HR. Now he was worried about what was happening with Ana's

family—worried for the family and for the company.

The Strange World of Mobility

Ah, Anton said to himself—this is more like it. He felt truly at home here. All around him were steel vats with fittings painted in pastel pinks and greens. Yellow plastic drums stood in rows on pallets, a long black hose hung coiled on a hook, and two forklift drivers dodged each other as they moved to and from racks holding thousands of identical lengths of plastic pipe. Anton's shoes squeaked on the impeccably clean floor.

He spotted the HR head, Maria Claes, and waved. Maria had asked for a meeting, and her only unscheduled moment was right now, during her visit to this plant outside Brussels.

"You're really suggesting we write a new set of rules for every expat?" Maria raised her eyebrows. "I don't call that rationalization."

"Why can't my office be in a place like this?" Anton asked, only half joking, when Maria came down from the catwalk.

"You don't like the Labyrinth?" Maria responded, referring to the glass-walled executive offices at HQ.

"It's just that I love being in a plant," Anton said, taking a deep breath of the pleasantly vinegary air.

"You're an expat yourself then," Maria said. "An expat in the Labyrinth."

The point of the meeting quickly became clear as Maria searched for a room where she and Anton could talk. "Another one of your requests for a special exception came across my desk this week," Maria said, sounding a bit annoyed.

"He's the only caregiver—" Anton started to explain.

Maria held up her hand. "I brought you into HR to streamline and rationalize the mobility program, and to make sure employees see it as completely consistent and transparent," she said. "That's why I

picked someone who had been a general manager and not an HR professional. I've had too many complaints that the system seems illogical. But I get request after request from you for exceptions." She paused. "You're going to have to tell Sergio Gamelli that we can't pay to send his mother to China."

"I fully understand why you brought me into this job and what you want me to do, and I fully expect to excel at it," Anton said. "I've been streamlining and rationalizing things my entire career. But mobility—it's a strange world."

"How so?"

"Unlike those PVC pipes out there, every expat or would-be expat is unique," Anton said. "If you adhere to rules that are designed to save money, you sometimes end up spending even more. If

Sergio leaves his mother behind, he'll be distracted and unproductive, and his trips back to Milan will take time away from his work. What we're doing in China is too important for that."

"You're really suggesting we write a new set of rules for every expat?" Maria raised her eyebrows. "I don't call that rationalization."

As a much-decorated veteran of a company that valued its senior managers and hadn't fired anyone in living memory, he felt free to speak his mind: "You can rationalize something only if it has a rational basis," he said. "As a GM, I dug down to the fundamental questions: What's this program for? What's the ROI? Mobility, as far as I can tell, doesn't have a clear-cut purpose, and it seems to exist beyond the bounds of ROI. Am I right?"

Maria shrugged. "You're probably right about ROI," she said. "But mobility definitely has a purpose. Several, in fact, including recruitment and retention."

“Granted,” Anton said. “But a lot of companies in our sector are cutting down on mobility. In some ways, it’s an expensive throwback to corporate colonialism. Why send people from Europe to run our plants in Southeast Asia when the homegrown talent is perfectly capable of running the plants?”

“Corporate colonialism?” Maria said, making a face.

“The reason the system seems illogical,” Anton said, “is that it is illogical.”

An Expensive Sideshow?

“I traveled a lot as a girl,” Ana was saying. “My father was a diplomat. I love to travel. My boys take after me. Brussels is great for them.”

“Brussels is good,” Anton said. They were in his favorite café, at a small table near the door. People were filing in with sleet on their shoulders.

“But Oswald—” She shook her head. “We made the decision together. We saw big opportunities for me and him and for the boys: an international school, new horizons. We wanted to do something different.”

“I tried every which way to figure something out for him,” Anton said.

“I know, I know,” Ana sighed.

“I called every academic medical center in Belgium looking for research programs that he might apply to. I even got the company to agree to help out with his tuition if he wanted to get a medical degree here.” He paused a moment. “Is he talking about—going back?”

“Yes—and with the boys,” Ana said.

“That’s what kills me. The only reason he hasn’t gone is that the boys have rebelled.”

“I really don’t want him to go,” Anton said. “If he goes, you’ll be alone. That’s no way to live.”

Of course the real danger was that if Oswald left, Ana might be drawn back to Brazil herself, disrupting the company’s plans for its new polyvinyl chloride plants just as the joint venture in Nizhny was moving into high gear. Anton knew only

“The reason the system seems illogical,” Anton said, “is that it is illogical.”

too well that there were several major chemical companies in Brazil that would welcome Ana with open arms.

Ana looked down into her tea. Her calm demeanor seemed in danger of cracking. “I don’t want him to go, either,” she said.

Despite her emotions, Ana, ever the engineer, made a studied observation: “The spouse’s life—that’s the weakest point of expatriation, isn’t it?” she asked. “We seem to be relying on this model where one spouse is the leader and the other has to follow, whatever their genders. This is just too hard for a lot of couples. Maybe the standard three-year assignment is too long. Maybe we should switch to three months.”

To Anton, three months sounded more like a safari than an international assignment, but he didn’t give voice to the thought. “I don’t think spouses are the main issue,” he said. “The whole system is weak. I’ve got 30 French expats right now who have been abroad for 10 years or more, and every one of them is in a holding pattern; they all want to return to France. But our French operations are so minimal that we don’t have openings for them. Reintegrating people after they’ve been away is a constant headache. The mobility program is an expensive sideshow.”

“It’s not a sideshow,” Ana said sharply. “Not as long as the company insists on basing promotions on international experience. I’ve heard there’s an unwritten rule in this company: To get a senior leadership

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position, you have to have experience in at least two countries.”

Anton nodded slowly. She was right about that.

“So mobility is a matter of the highest importance for employees—especially young engineers like me,” Ana said. She shifted uncomfortably in her seat. “Could you—could you sweeten the deal?”

“You mean more money?” Anton asked.

“If the money were really good, I might be able to convince Oswald that another year or two would be worth it,” she said. “We’ve been having a hard time here, making it work economically. Everything in Europe is so expensive.”

“I don’t know,” Anton said. A big raise would have to be approved by Maria, who had continued to refuse several of Anton’s special requests, including the relocation of Sergio Gamelli’s mother.


Ana put another card on the table: “I should probably tell you, Anton, that the head of the Brazil operations is trying very hard to bring me back there. He wasn’t crazy about letting me go in the first place, as you know, and now that there have been a few retirements in the South America division, he has a big project in Bolivia for me.”

This was a shock. So Ana and the Brazil head had been working the back channels? Maria would go ballistic if Anton tried to transfer Ana back to South America prematurely. “But your assignment—you’re supposed to be doing a three-year stint here, with the possibility of renewal.”

“As I was saying, maybe we need to shorten the assignments,” Ana said. “I’ve already been very productive here. The Nizhny project is ready to go. I’ve gained a lot of useful experience that will help

me move up once I get back home. And of course Oswald would be very happy, and that’s important to me.”

She looked intently at Anton. “What do you think? Could you arrange to have me reassigned back to Brazil?”

 **Boris Groysberg** is a professor of business administration, **Nitin Nohria** is the George F. Baker Professor of Administration and dean of the faculty, and **Kerry Herman** is the assistant director of the Global Research Group at Harvard Business School.

Can Anton keep Ana happy in her foreign assignment?

See commentaries on the next page.

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The Experts Respond



John Bollman is the vice president of human resources for Sequa Corporation, a diversified industrial company, and its largest business unit, Chromalloy. He was an expatriate himself during his 19 years with Whirlpool.

ANA LOBATO'S comment that her family is having trouble making ends meet in Brussels is a red flag. So is Anton Danois's remark that he has 30 expats waiting to return to France. Both details tell me that Streuvels Chemicals isn't doing a good job of managing the company's global mobility program.

More and more multinational companies are realizing that a global mobility program is a critical part of the overall talent management process, whose purpose is to make sure that the right people are in the right places to help the organization deliver on its strategy.

That's where ROI comes in. Anton and Maria Claes are wrong to suggest that international mobility has nothing to do with ROI. Mobility, although expensive, has many quantifiable benefits. The company is enriched by a flow of people and skills; rising executives advance their careers through international experience; and many employees acquire valuable skills and stretch themselves in foreign assignments. The most progressive companies today conduct periodic reviews of an expat's ROI based on the measurable impact he or she has on such aspects of the company's performance as productivity and top-line growth.

Accommodating the spouse's career needs is certainly a challenge. If you don't get the spouse's situation right, the international assignment will fail. That's why companies must address this issue at the front end, before an employee takes a foreign post.

Both the employee and the spouse must be involved in determining what the move would mean for the employee's future with the company, how important it is for the spouse to maintain his or her career, and how difficult it would be to pursue that career in the new location. A thorough discussion of those issues with Ana and Oswald might have resulted in the family's

Companies must address the spouse's situation at the front end, before an employee takes a foreign post.

remaining in Brazil, despite the potential value to Ana of being transferred to headquarters—undoubtedly a plum assignment for a high-potential employee.

Once a family says yes to an international assignment, the company must be there to support it—but in a way that gives the family the maximum decision rights. Companies used to pay directly for such basics as housing. Today, my company and many others provide a lump sum for those expenses, allowing expatriates and their families to make their own lifestyle choices.

The same approach applies to compensation for the loss of income if a spouse has to stop working because of an international assignment. Although it's not necessary to compensate for the entire lost income, the company should provide a significant lump-sum payment. Increasing the expatriate's salary to cover spousal income is usually not the best route, because a higher salary can create problems later on when the employee returns home.

Speaking of going home, it's not clear whether anyone at Streuvels discussed with Ana possible roles for her once her assignment in Brussels ends. The careers of expatriates should be actively managed. In Ana's case, that should include assigning her a mentor, perhaps based in Brazil, so that she can fit right into a job there just as easily as she fit in when she arrived in Brussels.



WHAT WOULD YOU DO?

SOME ADVICE FROM THE HBR.ORG COMMUNITY

ANTON DEFINITELY needs to bend the rules to keep Ana happy. She is a high potential, she has completed her project ahead of time, she is levelheaded, and she offers alternatives to her continued tenure in Belgium. The company would lose out if she left.

Thapelo L. Lippe, founder, *The RightSource management consultancy, Gaborone, Botswana*

IN MY experience as a "trailing spouse," I haven't seen organizations seriously address spousal adjustment. Employers should make it clear at the outset that spouses might not find suitable work. Spouses can then see postings as adventures, not career moves.

Sue Johnston, president, *It's Understood Communication, Waterloo, Ontario*

I AM not aware of any evidence that international experience automatically makes for better managers. I coached a regional vice president from a bank where international experience was becoming a requirement, but he had no interest in an overseas assignment. He had excellent interpersonal skills and was getting lots of exposure to diversity. The bank risked losing an excellent manager because of a policy that had no basis in reality.

Mel Blitzner, senior partner, *Partner2Win, Calgary, Alberta*



Ann Judge is the senior vice president for global human resources for Shire, a biopharmaceutical company with employees in 28 countries.

AN UNHAPPY spouse or partner is a serious problem for both an expatriate and her company, hurting her productivity and potentially undermining the value of her international assignment. And it's easy for a spouse to feel disheartened, even if all other aspects of the family's living situation are working: the finances, the housing, the children's schooling. That's because the partner and family are usually more exposed to the foreign culture than the employee.

After a former employer transferred me to Germany, my workplace life remained largely unchanged. I interacted with the same global network of people I had been working with before, and I spoke English at work. But my husband was immediately thrown into the culture in a way I wasn't. Using English was not an option for him while figuring out where to do the shopping, learning the metric system, and purchasing a car in a new currency.

The spouse or partner is acutely vulnerable to feeling out of place, and if you add to that the kind of career uncertainty that Oswald Lobato is facing, you've got a crisis brewing. But the solution isn't as simple as transferring Ana back to Brazil. That would defeat the purpose of the original assignment, from both the company's point of view and Ana's. The company needs Ana's expertise at headquarters at a crucial time, and Ana knows that employees with global experience are the ones who will have the qualifications to advance their careers.

If Oswald remains determined to return to Brazil, the answer may be to inject some flexibility into Ana's situation. Three-month stints, as Ana suggests, probably wouldn't provide enough benefits to offset the costs, but 12- to 18-month assignments can work well. Sometimes extended business trips are the solution. At Shire, we allow employees to shuttle between their home countries and sites where their expertise is needed. Another option is the permanent transfer, which families sometimes prefer because settling into a new country for the long term can eliminate or minimize stress

If Oswald is determined to return to Brazil, the answer may be to inject some flexibility into Ana's situation.

over whether the spouse or partner should try to adapt or just wait out the assignment. Today's relocation policies require much more flexibility to manage employees' diverse needs and expectations.

I believe employees are more assertive today about their needs, and that's not a bad thing—it reflects a greater sense of balance in their lives. A company creates loyalty and trust by understanding employees' needs and helping them develop so that they can contribute in a meaningful manner. Employees have options, and they will not—and should not—stay with a company whose values are not aligned with their own.

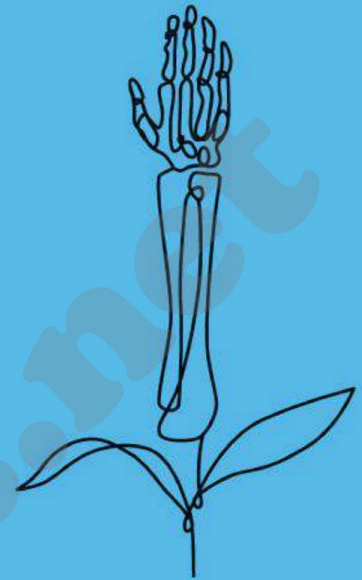
My experience living and working internationally has significantly shaped my views. I grew up on a farm in Iowa, and when I accepted my first international position, I didn't even have a passport. I consider the time I lived outside my home country a gift that broadened my perspective and helped me to embrace the differences in cultures around the world.

One thing is certain: International mobility isn't going away, even though sending someone abroad is significantly more expensive than hiring someone locally. At Shire, the number of expatriates has risen over the years as the company has grown and become more global in its reach and operations. It's a competitive advantage for Shire to have employees who can thrive in different cultures—and who can go into a market and know what questions to ask in order to deliver better results. You get that by having truly global employees. ♥

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Talent: Growing the Competitive Advantage in the Middle Market

Middle market companies—firms with revenues between \$10 million and \$1 billion—represent the core of our local, regional, and national economies, employing more than 41 million people and contributing one-third of the gross domestic product in the U.S.

A new research survey of 2,000 middle market executives, sponsored by GE Capital and The Ohio State University, found that despite critical external headwinds, middle market companies are focused on growth—how to grow faster and make that growth sustainable were top focuses for middle market companies. They are thinking about how to gain new customers and strengthen existing relationships. And as they look at the

shifting economic conditions, they are looking for ways to create more agile enterprises and develop long-term growth strategies.

As the middle market prepares to meet these challenges, talent management and the development of future leaders is a high concern with more than 80 percent of middle market executives surveyed highlighting this area as one of their most pressing challenges. About three-fourths of the executives say they are also concerned about attracting top talent or providing employees with appropriate career paths and development opportunities to promote long-term retention.

This research is part of an ongoing commitment from GE Capital to

better understand and meet the needs of the middle market. GE Capital is a leading lender to the middle market, offering commercial loans and financing to mid-sized companies across multiple industries and geographies. And GE Capital can deliver more than just leases and loans, providing all forms of capital—human, financial, and intellectual—to help these companies grow.

With its long dedication to the middle market, GE Capital is in touch with its customers' needs and strategies. This enables GE Capital to match its capabilities to the complex dynamics that govern this segment, thus meeting the challenges of tomorrow's marketplace today.

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imagination at work

BUILDING THE TALENT PRODUCTION LINE: WHEN SIMPLE DELIVERS MORE



Marc Effron, president of the Talent Strategy Group, has worked with companies around the globe on building their talent pipelines. His latest book is One Page Talent Management: Eliminating Complexity, Adding Value. He recently talked with Harvard Business Review about how companies win the new war for talent.

While unemployment is high, we still hear frustration over finding and keeping the right talent. Is there a disconnect?

Companies' inability to find the right talent and to grow talent successfully have the same root cause—a broken talent production line. This creates a talent shortage inside the firm and limits the quality of talent being put into the marketplace.

Sixty years of scientific research on people and organizations tells us how to drive higher performance, accelerate individual development, and increase engagement. Companies can use that information to structure a talent production line that churns out talent in the same way as any other product.

A talent production line is a disciplined, reliable, and lean approach to producing the requested amount of talent, on time and to spec. Identifying what you're trying to produce is the first step in this process and one where many companies fail. If you're trying to build a great general manager, can you clearly specify what it means to be a great general manager? Once those specifications are established, you need to understand exactly how that production process should work. Do you know what combination and sequence of experiences, exposure, and assignments can produce a fully formed general manager in the time allowed?

The final step is execution—making sure that the production line is moving at the required pace. This may sound

like an analogy, but it's a reality at firms that effectively produce talent.

Aren't pay and benefits the most powerful tools for hiring and retaining talent?

The three factors that most effectively drive engagement (and therefore retention) are having a good manager, having the opportunity to grow and develop, and having confidence in the company. If companies focus on just these three, they'll find themselves in a far stronger talent position than their competitors.

Pay typically becomes an issue only when it's so uncompetitive that other factors are irrelevant until that issue is addressed. In fast-growing economies like India and China, recruitment and retention challenges may make pay a more significant issue. This doesn't mean that the three key factors can be ignored, because talent will simply leave your company even faster if those aren't present.

Why is simple better in creating talent depth and quality?

Companies have included every bell, whistle, calculation, assessment, and box they possibly can in performance management. Companies need to strip away that complexity by focusing on the few things that the science says matter—clear goals, regular coaching, and a fair link to rewards.

Simple is better for three reasons. First, simplicity ensures implementation.

Talent-building practices work but only if they're actually used. The easier we make it for a manager to execute a practice—like setting goals—the more likely it is that the practice will actually be implemented.

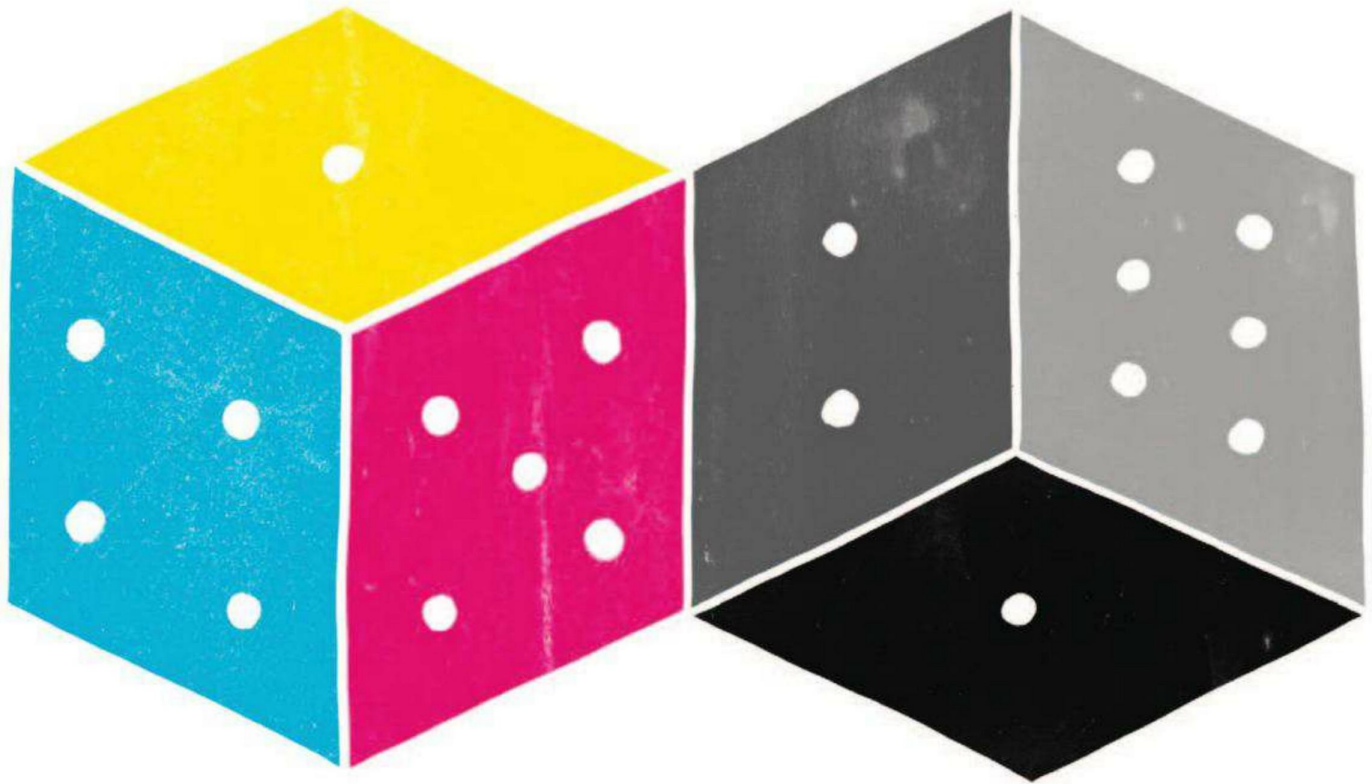
Second, simplicity increases the effectiveness of the process. An engagement survey is a potentially powerful tool to increase corporate performance. Managers are frequently left to their own devices, however, to interpret the data and identify priorities. This delays their ability, and often reduces their commitment, to act. A simple engagement summary would tell the managers the three most powerful items for improving engagement in their groups, so they can quickly take actions where it matters most.

Third, simplicity accelerates talent growth. The typical 360° assessment is a perfect example. Traditional 360°s provide managers with thick, confusing reports that are difficult to understand or take action from. A simple report would focus managers on three things they could improve and tell them exactly how to improve them. This would allow them to more quickly improve their capabilities and deliver benefits to the organization in much less time.



Synthesis

A review of emerging ideas in the media



Can Risk Managers Manage Risk?

What the quants miss by Justin Fox

If you go by job titles, rhetoric, and even resources allocated, the financial sector has made a massive effort to improve risk management over the past three decades. Look at results, though, and the whole thing seems to have been a bust. Financial risk management became a profession in the 1980s. Soon after, markets began to career from crisis to crisis. The risk managers' arcane tools—from portfolio insurance in the 1987 stock market crash to Value-at-Risk (VaR) in 1998 to the Gaussian copula in 2008—have had a curious habit of turning up at the scene of the crime.

Does this mean the quantitative approach to managing risk that has risen to dominance in the financial sector is bunk? Howard Marks thinks so. “The bottom line is that, looked at prospectively, much

of risk is subjective, hidden and unquantifiable,” he writes in *The Most Important Thing: Uncommon Sense for the Thoughtful Investor* (Columbia University Press, 2011). Marks is a money manager whose insightful letters to investors in his Oaktree funds were long passed around like samizdat. They have now been organized into a book, linked together with some new commentary from Marks. Risk is a constant theme.

Quantitative risk-management methods generally equate risk with volatility. As a result, Marks argues, they miss the most important risk factor of all: price. A more expensive financial asset is a riskier one. That sounds obvious enough, but many quant models actually deliver the opposite answer. Real estate prices in the U.S. had been following a low-volatility

upward trajectory for decades; ergo, low risk, until prices collapsed.

Veteran quant Emanuel Derman, trained as a physicist, used to be head of quantitative strategies at Goldman Sachs. He says such blind spots are inherent in any model of how the world works, not just the financial variety. In *Models.Behaving.Badly: Why Confusing Illusion with Reality Can Lead to Disaster, on Wall Street and in Life* (Free Press, 2011), his prescription isn't to throw out all the quant models, just to leaven them with caution, humility, and empiricism. “The invisible worm of financial economics is its dark secret love of mathematical elegance regardless of efficacy,” Derman writes, “and its belief that rigor can replace fact and intuition.”

Derman is one of a long list of people Aaron Brown thanks in the acknowledg-



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ments to *Red-Blooded Risk: The Secret History of Wall Street* (John Wiley & Sons, 2011) for reading and commenting on the manuscript. So is trader-author-philosopher Nassim Nicholas Taleb, the most prominent scourge of modern risk management. (So am I—although, as my commenting consisted of e-mailing “I like it a lot so far” after reading about 10% of the draft, I think it's safe to say my words didn't have any impact on the final product.)

A veteran Wall Street risk manager, Brown is well acquainted with just about every criticism of his line of work. But he's still willing to defend it. In his quirky but immensely ambitious book, he describes an approach to risk taking that combines quantitative precision with intuition and judgment. He doesn't argue that his “red-blooded” methods are foolproof—one can follow them and still go bust—but he does make the case that they amount to an optimal balancing of risk and reward. Along the way, Brown claims to have reconciled the rival frequentist and Bayesian approaches to statistical theory, tells amusing tales of past exploits on Wall Street and at the poker table, and gets in a lot of wonderfully sharp observations. (“In the history of human follies,” he writes of the 17th-century Dutch tulip bubble, “one that results only in too many flowers has to be counted as a relative success.”)

Brown's red-blooded risk takers are comfortable with quantitative methods

and dedicated to testing their efficacy on a daily basis. But they are also aware of the limits of those quant methods and willing to follow their intuition when appropriate. Brown insists that it's important to combine those traits: It is only if you are able to make bets and manage risk successfully day-to-day that anyone should take you seriously on big-picture risk

“The problem is that a lot of people avoid validation, and they are tolerated by the rest.”

Aaron Brown, *Red-Blooded Risk: The Secret History of Wall Street*

issues. Coming from a risk manager at a hedge fund, that's pretty self-serving—which doesn't necessarily make it untrue.

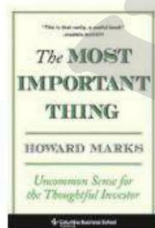
Brown's arguments kept running through my head as I read Daniel Kahneman's new book, *Thinking, Fast and Slow* (Farrar, Straus and Giroux, 2011). Psychologist Kahneman is the cofounder, along with the late Amos Tversky, of modern behavioral economics. In recent years the intellectual territory he pioneered has been the subject of best-selling books and countless conference keynotes. But Kahneman has never broken through to a mass audience, even though he did win the

2002 Nobel Prize in Economic Sciences and gives a great speech. He still may not: *Thinking, Fast and Slow* is a wonderful, revelatory book, but at a dense, experiment-filled 512 pages, it's not something to be tossed off on an airplane flight (unless you're flying across time zones).

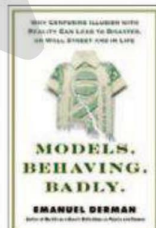
The “fast” and “slow” in Kahneman's title refer to the two main thinking styles identified by psychologists: System 1 and System 2. System 1 is our unthinking, instinctive, intuitive self. System 2 is the rational mind. As Kahneman describes it, System 1 is fleet and relentless, System 2 slow and lazy. For the purposes of most knowledge work, the path to improved decision making involves blocking out System 1 to give System 2 a fighting chance. But not always.

“[Y]ou should know that correcting your intuitions may complicate your life,” Kahneman cautions. “A characteristic of unbiased predictions is that they permit the prediction of rare and extreme events only when the information is very good.” In financial markets, allowing for the possibility of rare and extreme events—if not necessarily *predicting* them—is crucial to long-term success. And the information at our disposal is seldom very good.

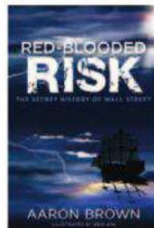
That's where Brown's red-blooded risk takers come in. They keep System 2 in charge of day-to-day risk decisions, while leaving System 1 to work on the big picture. It's pretty much the opposite of how most people—on Wall Street or elsewhere—go about their business. However, it may be worth a try. Although few of us are ever going to back-test a Value-at-Risk model, we *can* back-test our own assessments and predictions. Management thinker Peter Drucker called this practice “feedback analysis” and recommended it as a way to identify one's personal strengths. It could also be a good antidote to sloppy thinking. ♥



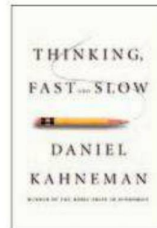
The Most Important Thing: Uncommon Sense for the Thoughtful Investor
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Red-Blooded Risk: The Secret History Of Wall Street
Aaron Brown
John Wiley & Sons, 2011



Thinking, Fast And Slow
Daniel Kahneman
Farrar, Straus and Giroux, 2011

Justin Fox is the editorial director of Harvard Business Review Group.

UPS and Retail Logistics: Five Ways to Improve the Customer Experience



In today's increasingly complex, multichannel retail environment, consumers have more choices and more information than ever before. With a quick glance of a smartphone screen, a shopper standing in a store aisle can quickly hunt for a better deal at competitor websites and stores around the country. And with so many options, online and off, customers have come to expect every shopping experience to be seamless, transparent, and easy, with access to detailed, accurate information about availability and delivery at any moment. These expectations will grow as online retail sales increase from 11% in 2010 to 15% of all retail sales by 2015 (Forrester Research, U.S. Online Retail Forecast, 2010 to 2015, February 2011).

In this fiercely competitive environment, retailers need to do more than offer attractive pricing. Trust, product assortment, convenience, previous buying experience, and customer service all determine whether a customer decides to return to a company's store or website—or not. With a flatter globe and consumer-driven technology, a superior customer experience is an important way to differentiate and gain the competitive edge. In fact, "research shows that a better customer experience drives improvement for three types of customer loyalty: willingness to consider another purchase, likelihood to switch

business to a competitor, and likelihood to recommend to a friend or colleague" (Forrester Research, *The Business Impact of Customer Experience*, December 2010).

Multichannel or online retailers that often stop measuring customer experience at the point of sale are at an increasing disadvantage in a world where consumers may never see the store at all. To the consumer, the shopping experience—from product selection through checkout, to final delivery and even returns—is one single experience that can determine future customer loyalty and growth.

UPS helps retailers deliver superior customer experiences across all of their sales channels. With a comprehensive portfolio of products, UPS improves a retailer's ability to provide customers with more options, more control of their orders, and a higher level of service and self-service in the shopping experience. Optimizing distribution and transportation networks and streamlining global supply chains is just the beginning of logistics.

1. Building Better Storefronts

Companies of any size can enhance their websites with the UPS Developer Kit, a set of online tools that can easily integrate UPS shipping and tracking systems directly into a company's digital business model and e-commerce website. This makes the back-end operation of websites more efficient—saving time, money, and resources.

And these tools also give customers accurate information to help them make a decision about a purchase. For instance, when UPS OnLine Tools are embedded in a website, shoppers have instant access to a choice of guaranteed delivery options, from ground service to UPS Next Day Air®, as well as a national shipping-schedule map and UPS delivery-



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time calculator. As a result, shoppers can choose items, review shipping options and guaranteed shipping costs, and compute delivery times, all without leaving the site.

2. Tracking Shipments

Once a customer clicks the “buy” button, customer service agents and logistics managers—not to mention the customer—need access to up-to-the-minute information on the purchase. With UPS, they receive in-transit shipment information through two primary visibility tools: UPS’s Tracking API allows consumers to track packages directly through the retailer’s website; and Quantum View® Manage provides end-to-end tracking, allowing customer service teams and sales associates to quickly respond to any inquiries about orders. In addition, customers can use the UPS Mobile™ site, m.ups.com, and UPS Mobile™ Apps on their smartphones to track packages, calculate time and costs, or find UPS shipping locations anywhere.

3. Empowering Consumers

Consumers want to schedule deliveries around their busy lives—and avoid those tried-to-deliver notices. With UPS My ChoiceSM, consumers receive alerts by email, phone, or text message that day

which includes an approximate four-hour delivery window so they can plan better. Consumers have the flexibility to reroute their package to another address, reschedule delivery for another time, or have it delivered to a location of The UPS Store® for later pickup. They also can sign for their package online, so drivers can release packages that would otherwise require a physical signature. These features can be accessed online or by mobile device.

4. Simplifying Returns

Consumers are looking for peace of mind, so the right returns service can facilitate a policy that eases consumer concerns. In this environment, an easier returns process translates into higher customer loyalty and a willingness to spend more and buy more often.

UPS Returns® allows companies to easily process and track return shipments around the world. A UPS Returns® label can be printed and attached to outbound packages, return labels can be sent separately, or UPS can send return labels to customers via mail or email. Customers can initiate returns right from the company website, print a return label from the site, easily track their return’s transit, and receive a quick return of goods through UPS. In addition, UPS Returns® Flexible Access uses a unique return label, so that customers can drop off return packages at thousands of UPS and U.S. Postal Service locations, including their personal mailboxes. And the tracking function allows retailers to track the location of items so they can plan appropriate staff levels for returns and quickly get inventory back into stock for resell.

5. Controlling Shipments

One gap in service occurs when customers want to change delivery destinations after purchase. For example, a customer

ordering a birthday gift can ask that a delayed order ship directly to the recipient. Retailers and their customers can use UPS Delivery Intercept® to get products to the right place at the right time. With UPS Delivery Intercept®, a retailer tracking the progress of delivery can ask UPS to return the product to them, deliver to another address, or reschedule the delivery—a definite boost in customer service.

Sharing Expertise with Customers

Omnichannel Retail: Delivering on Customer Expectations featuring Darrell Rigby

In today’s retail environment, information and ideas can flow freely. Retailers that encourage this flow and optimize it will be well-positioned for success. Join *Harvard Business Review* and Darrell Rigby, author of *Omnichannel Retailing*, for a free webinar that looks at how companies are integrating their digital and physical channels to create the best customer experiences.

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Adhering to nonfinancial corporate principles can be difficult, especially in tough times. To succeed, develop a rationale that aligns with your other strategic objectives; attract dedicated capital; create an effective, supportive organizational structure; and nurture the right talents.

STRATEGY

How Great Companies Think Differently

Rosabeth Moss Kanter | page 66

Corporate leaders have long subscribed to the belief that the sole purpose of business is to make money. That narrow view, deeply embedded in the American capitalist system, molds the actions of most corporations, constraining them to focus on maximizing short-term profits and returns to shareholders at the expense of worker safety and health, the environment, and society in general. In this article, HBS professor Kanter argues that a very different logic informs the practices of most high-performing and sustainable companies: An *institutional logic*.

These companies believe that they are more than money-making machines; they are a vehicle for advancing societal goals. They deliver more than just financial returns; they also build enduring institutions.

At great companies, institutional logic takes its place alongside economic logic in research, analysis, and managerial decision making. Six facets of institutional logic—a common purpose, a long-term focus, emotional engagement, partnering with the public, innovation, and self-organization—radically alter leadership and corporate behavior and form the building blocks of a more sustainable competitive advantage.

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LEADERSHIP

“Why Don’t We Try to Be India’s Most-Respected Company?”

An interview with Infosys founder N.R. Narayana Murthy by Anand P. Raman | page 80

He may not appear to be one, but Murthy is quite the contrarian. At a time when few Indians felt they could become entrepreneurs, he founded Infosys with just \$1,000. When no one believed that India could compete in the high tech arena, he dared to develop software services for export. In an era when hardly anyone in India conducted business ethically, he set out to create a values-based corporation.

Over his 30-year tenure, Murthy has largely succeeded. He helped create a \$6 billion technology firm with over 134,000 employees, pioneered an innovative way of delivering software services globally, and strove to make Infosys the epitome of a “good” company.

That’s a reputation that is hard won and easily lost, especially in India today, where companies are notorious for their lack of transparency. In fact, public outrage against corruption reached a flashpoint in August 2011, with millions taking to the streets in protest.

As businesses gird for change in India, Infosys faces its own turning point. In August, Murthy stepped down as chairman, according to plan. In this interview, Murthy explains that building a values-based firm is a never-ending process. Leaders must demonstrate that values matter every day, at every turn.

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ORGANIZATION & CULTURE

It’s Hard to Be Good

Alison Beard and Richard Hornik | page 88

Excellence in community engagement, labor relations, environmental protection, corporate governance, and supply chain accountability isn’t easy to achieve. But in the long run, top performance in those areas strengthens an organization, as the five companies profiled in this article demonstrate. They prove that doing the right thing isn’t at odds at all with building the bottom line, and in fact it can be integral to a firm’s economic logic.

Dutch chemical maker Royal DSM, for instance, not only specializes in nutritional and environmental products but gives them away to people in need. That unconventional move is helping DSM win the talent war and crack critical markets. Southwest has become America’s largest domestic airline by committing to employee happiness. China’s Broad Group has won industrial customers worldwide with its energy-efficient air conditioning and filtration systems and is now moving into sustainable building construction. PotashCorp, a Canadian fertilizer company, has raised the bar on transparency in governance—and is reaping the reputational rewards. And Unilever has proved that it is possible to make your supply chain more sustainable, even if you sell 170 billion products across 180 countries a year and run 250 factories.

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**FINANCE & ACCOUNTING****How to Win Investors Over**

Baruch Lev | page 52

Providing earnings guidance—publicly releasing managerial forecasts of a company's profits—has become a highly controversial practice, with critics ranging from Warren Buffett to a McKinsey team to the U.S. Chamber of Commerce. Yet more than a thousand U.S. corporations issue such forecasts each year. Are they making a mistake?

On the contrary, argues Lev, an accounting professor at NYU Stern: Investors want more information, and they will reward companies that make it available. Conventional wisdom notwithstanding, Lev maintains that investors care a lot about what drives a company's long-term growth; however, they often need help understanding what the drivers are. Guidance, non-GAAP pro forma earnings statements, and executive conference calls with investors and analysts after the release of earnings statements are potent tools. Done right, they can bring higher stock prices, lower volatility, and reduced cost of capital, and they may also temper shareholder litigation and its consequences.

Some guidance for guiders is in order: Offer guidance only if your predictions are consistently better than analysts' consensus forecasts. Don't stand out as a "guidance refusenik" in a sector where guidance is prevalent. Maintain credibility and don't duck the truth—manipulating expectations so that reported earnings will comfortably exceed them breeds mistrust. Resist legal advice to be cryptic or bland, and don't overlook the value of "soft" information; executives' narrative and tone color many investors' decisions and account for most stock price changes in the wake of financial reports.

These are not easy times to be an executive dealing with financial markets. But running away from disillusioned investors only makes things worse. Far better is to figure out what they value and to shape your financial reporting and communications strategies accordingly.

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GOVERNANCE**The For-Benefit Enterprise**

Heerad Sabeti | page 98

A growing number of socially motivated entrepreneurs have been creating new kinds of organizations that combine a social mission with a business engine. Unlike typical for-profits, these "for-benefit" enterprises have social or environmental outcomes as their ultimate bottom line; and unlike typical nonprofits, they derive their income mostly from the sale of goods and services rather than from grants and donations. They defy classification as pure business or nonprofit; rather, they are a blend of the two.

Many more such enterprises would exist, except that few entrepreneurs have been able to choose for-benefit as a legally recognized organizational structure. Most countries' legal and economic systems allow only for-profit or nonprofit activity; entrepreneurs must shoehorn their vision into one or the other structure.

All this seems destined to change. For-benefits will become more commonplace as entrepreneurs learn to better navigate existing constraints, and as an ecosystem of support—including financial markets, accounting standards, and professional services—develops around them. The even bigger news is what will happen then, writes the author. With formalization of the for-benefit structure, we will see the emergence of a fourth sector of the economy, interacting with but separate from government, nonprofits, and for-profit businesses. The rise of that sector is likely to reshape the future of capitalism.

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Features

THE GLOBE

GROWTH

The Great Repeatable Business Model

Chris Zook and James Allen | page 106



The sharper a company's differentiation, the greater its competitive advantage. In studying companies that sustained a high level of performance over many years, the authors, both partners at Bain, have found that more than 80% of those companies had a well-defined and easily understood differentiation at the center of strategy. But differentiation can wear with age: The growth it generates creates complexity, and complex companies tend to forget what they're good at. Often they respond by trying to reimagine their entire business models quickly and dramatically.

That's rarely the answer, the authors write. Really successful companies relentlessly build on their fundamental differentiation, going from strength to strength. They learn to deliver it to the front line, creating an organization that lives and breathes its strategic advantages day in and day out. They learn to sustain it through constant adaptation to changes in the market. And they learn to resist the siren song of today's hot market better than their less-focused competitors do. The result is a simple, repeatable business model that a company can apply to new products and markets over and over again to generate sustained growth.

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STRATEGY

Social Strategies That Work

Mikotaj Jan Piskorski | page 116



Although most companies have collected lots of friends and followers on social platforms such as Facebook, few have succeeded in generating profits there. That's because they merely port their digital strategies into social environments by broadcasting their commercial messages or seeking customer feedback.

To succeed on social platforms, says Harvard Business School's Piskorski, businesses need to devise social strategies that are consistent with users' expectations and behavior in these venues—namely, people want to connect with other people, not with companies. The author defines successful social strategies as those that reduce costs or increase customers' willingness to pay by helping people establish or strengthen relationships through doing free work on a company's behalf.

Citing successes at Zynga, eBay, American Express, and Yelp, Piskorski shows that social strategies can generate profits by helping people connect in exchange for tasks that benefit the company such as customer acquisition, marketing, and content creation. He lays out a systematic way to build a social strategy and shows how a major credit card company he advised used the method to roll out its own strategy.

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MANAGING TECHNOLOGY

What Every CEO Needs to Know About the Cloud

Andrew McAfee | page 124



Cloud computing is a sea change in the way companies use technology; it's as inevitable and significant as the shift from steam power to electricity on the factory floor. Because criticisms of the cloud have gotten a lot of hype, however, many companies are hesitant to explore it. In this article McAfee, a principal research scientist at MIT's Center for Digital Business, debunks commonly cited concerns about the cloud. When it comes to cost, reliability, and security, he says, the cloud promises to equal or better on-premise computing. Moreover, as the experiences of companies like 3M, the global contractor Balfour Beatty, and the consulting firm CSC show, cloud computing offers sizable benefits, such as improved productivity, easier collaboration, the ability to mine data for insights, and higher capacity without major capital investment.

Here, McAfee walks readers through the three basic categories of cloud computing: *infrastructure-as-a-service* (the leasing of raw computing capacity), *platform-as-a-service* (the leasing of computers ready for software development), and *software-as-a-service* (the hosting of applications for users). Arguing that CEOs and senior managers need to take the lead on the shift to the cloud, he then outlines how companies can get started.

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INTERNATIONAL BUSINESS

KFC's Radical Approach to China

David E. Bell and Mary L. Shelman | page 137



Global companies face a crucial question when they enter emerging markets: How far should they go to localize their offerings? Typically they try to sell core products or services pretty much as they've been sold in Europe or the United States, with headquarters calling all the shots—and usually with disappointing results.

The authors, both of Harvard Business School, examined why KFC China has been able to find fertile ground in a market that is notoriously challenging for Western fast-food chains. KFC's executives believed that the dominant logic behind the chain's growth in the U.S.—a limited menu, small stores, and an emphasis on takeout—wouldn't produce the kind of success they were looking for in China. KFC China offers important lessons for global executives seeking guidance in determining how much of their existing business model to keep in emerging markets—and how much to throw away.

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How I Did It

LEADERSHIP

Office Depot's President on How "Mystery Shopping" Helped Spark a Turnaround

Kevin Peters | page 47



When Peters became president of Office Depot's North American operations, in 2010, its customer service scores (as graded by a third-party mystery-shopping firm) were soaring—but sales were falling.

To understand why, he went undercover, quietly visiting 70 stores in more than 15 states. He talked to customers and observed their behavior. What struck him most was how often they walked out of the store empty-handed. It turned out that Office Depot's customer service scores depended on factors that shoppers didn't really care about—such as the cleanliness of floors and bathrooms. And its employees were offered incentives to focus on the wrong things. (In fact, the company learned that some of its associates preferred interacting with stock over interacting with people.) Peters's conversations with customers gave him three insights: The chain needed to offer smaller stores, dramatically improve the in-store experience, and add value with services such as shipping and copying. Office Depot has since rolled out 30 pilot stores, retrained associates, and begun to see the first signs of improvement.

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Managing Yourself

Fire, Snowball, Mask, Movie: How Leaders Spark and Sustain Change

Peter Fuda and Richard Badham | page 145

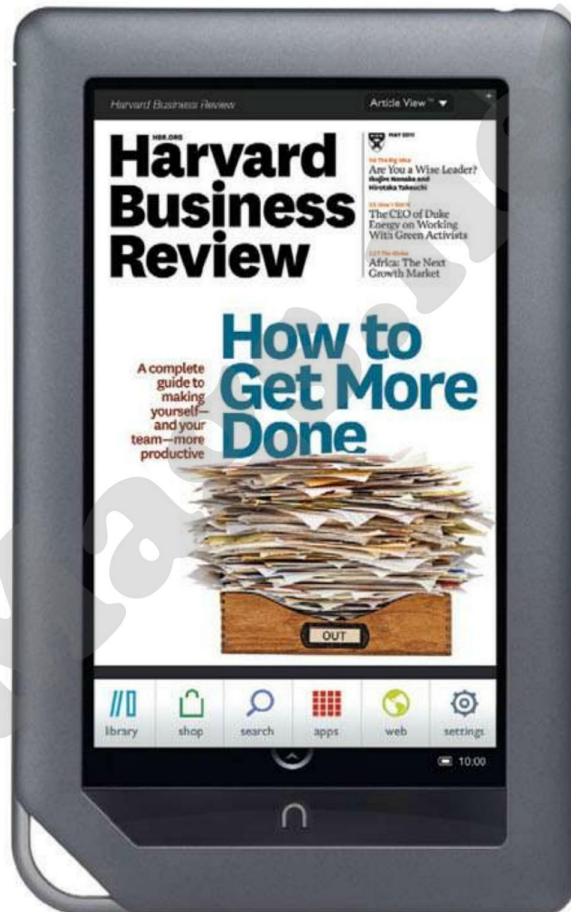


What does it take for an average manager to become a highly effective leader? There are countless books, models, and formulas for success. But the truth is that leadership transformation is deeply dependent on circumstances. The key

for those who seek it is to absorb the insights that can be drawn from the successful experiences of others. During their in-depth study of seven CEOs, Fuda and Badham uncovered seven interdependent metaphors, which they went on to test with more than 10,000 managers on four continents. The authors discuss four of those metaphors—fire, snowball, mask, and movie—here, in the context of individual managers' experiences.

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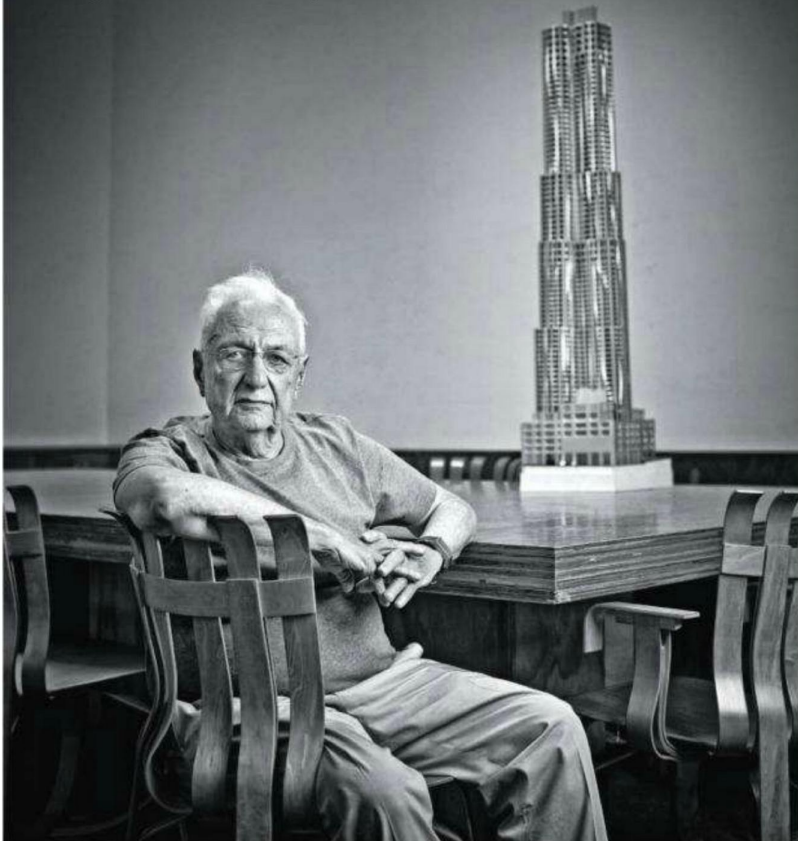
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Frank Gehry is, at 82, America's most celebrated living architect. His designs, including the Guggenheim Bilbao and Disney Hall in Los Angeles, are all technically challenging and unmistakably his. Gehry's creative process famously borrows from artists; less well known is his fierce commitment to budgeting and the architect's role as project manager. *Interviewed by Katherine Bell*



HBR: Tell me about starting your own firm.

Gehry: I'm not a businessman, but the business model I set for the office turned out to be a good one. It's simple: Don't borrow money. Pay everybody. Nobody works for free, ever. It was difficult financially for the first few years. At the beginning I had to do all the work myself. And then it was hard to get experienced people. They had families; they didn't want to work with a struggling young architect. So I couldn't get the technical help we needed, and we suffered for it. Buildings leak when you don't have enough construction experience.

You've said that one of the reasons the Guggenheim Bilbao is a great building is that you had a great client. What makes a client great?

It's a collaboration. I'd say it's 50/50. The client has got to be willing to talk to you. Imagine you get a job

with IBM, you're working with an executive vice president, and he shows the model to the president, and the guy says, "What the f--- is that? That won't work with my work." So I only accept jobs where I work with the decision maker.

How do you balance your clients' desires against other concerns?

The client hires you, so the client is the priority. But you can't just build a building based on what the clients say, because their vision is based on what's normal. How do you get out of the normal? You've got to question everything. Spend time with the user group. Glean all the information you can. And then throw it all away and begin to play.

How do you go about solving design problems?

I'm like a pussycat with a ball of twine. It goes over there, and he jumps over there. It falls on the floor, and he goes there. I'm opportunistic. Once I understand the problems, I try things. I see what works and what doesn't, and then I try again. When it looks like something I've done before, I abandon it. I have learned to trust my intuition.

I've heard you have unusually strong feelings about budgeting and project management.

Cost control is a big deal for me. In the construction industry, 30% of the money spent is wasted. That's why it's important to value engineer as you design. It's easy to do now—we use software that's precise to seven decimal points, so there's no chance of a mistake. You can get a good sense of how much a building will cost and whether the budget is real. And once you've set a real budget, it behooves you to stay there. You have to manage the information and the relationships with the construction people. You have to control the project through to the end, really control the goddamned thing, because it's your design. Nobody else knows how to do it.

What's your succession plan?

When I reached my sixties, I separated my fee from the office fee so the office would grow up with a culture of working within a normal fee range. Now we've got this well-honed machine. Six or seven young people in the office are good enough to take over. We talk about it a lot. My guess is some will splinter off and the rest will figure out how to use the well-honed machine in their own way. ♣

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