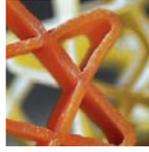


# Perspectives



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# Perspectives

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## Foreword

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The formula for writing BCG Perspectives was established many years ago, and it's a good one: keep them short; be provocative rather than exhaustive; begin a conversation, don't end it. One of our officers, Anthony Miles, once wrote, "The writer should think of the reader as one of his smarter clients. You don't want the reader to necessarily agree with everything you have to say. You want the reader to get hold of you and talk the thing out with you."

So if you are getting this collection of the ten Perspectives BCG published last year, consider it a compliment! And an invitation to some discussions this year. You may have received these essays individually during the course of 2005, but we thought it might be useful to bundle them together for some two-hour plane ride in your future or a short weekend read.

Insight—real and valuable insight—is elusive. We hope that you find these Perspectives worth reading or reading again.



# Don't Be a Schwinn

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When I was a young boy growing up in the 1960s in New York, what I really wanted was a Schwinn bicycle—first the Black Phantom, then the Sting Ray, then the Varsity. Any kid in the neighborhood was proud to have a Schwinn. No other bike manufacturer came close.

At its peak, Schwinn employed more than 2,000 people, produced hundreds of thousands of bikes a year in five factories, and owned almost 20 percent of the U.S. market. The Schwinn name stood for cutting-edge innovation and unmatched quality. Today, however, Schwinn no longer exists as an operating company. There are no Schwinn plants and no Schwinn employees in the United States. The company that was founded in 1895 declared bankruptcy in 1992 and closed its last factory in 1993. The Schwinn name is now owned by Pacific Cycle, which in turn is owned by Dorel Industries, a consumer-products company based in Canada. All of Pacific Cycle's bikes are manufactured in Asia. And the only thing the Schwinn bicycles currently for sale at Wal-Mart have in common with Schwinn's of old is the brand.

What happened? Did Schwinn's management think that its long history of designing, building, marketing, and selling some of the world's best bikes would keep the company on top? Did executives fail to see that the economics of the

industry were changing? Did they miscalculate their response to those changes? For instance, a poorly executed attempt to source low-cost bicycles from Taiwan helped create one of Schwinn's biggest competitors. There are different stories that might account for the company's demise, but the facts are that Schwinn went bankrupt and its brand was sold.

And today the fact is that many well-known companies—not just in the United States but in Europe and Asia as well—are facing a situation similar to the one Schwinn confronted. Yet the course of events is not predetermined. You don't have to lose control of your destiny. You don't have to be a Schwinn.

### **What Could Have Been: Two Alternatives**

Schwinn's story could have been different. Indeed, the company could have taken several different pathways to success. There are two potential alternative scenarios.

**Alternative Reality One: Aim High.** In this scenario, Schwinn decided not to embark on a path that would send almost every unit of its production to Asia. Instead, it tailored plans for each segment of its product line. For a short time, low-end bicycles were sourced from contract manufacturers in China and Taiwan, but Schwinn soon left that segment entirely to low-cost players. Meanwhile, for midrange and premium models, Schwinn determined that it could substantially decrease costs by turning to

low-cost partners for labor-intensive parts. The company investigated and interviewed hundreds of potential suppliers and locked the best ones into long-term contracts. Schwinn then reconfigured its operations to perform final assembly and inspection in the United States, saving on logistics costs and ensuring that quality was maintained.

Still, the changes forced Schwinn to make some gut-wrenching choices. Almost 30 percent of the company's work force was laid off in the process. However, the moves allowed Schwinn to produce bikes at half their previous cost, which allowed it to maintain a significant position in midrange bicycles while leveraging its product-development and manufacturing capabilities—as well as its brand—to build a very strong position in the high-end market. For instance, Schwinn was able to develop new mountain bikes—and new brands—because it had the cash flow to take risks and compete in new product areas. As a result, Schwinn is now extremely competitive in the United States and is a major exporter of premium bicycles to China and Europe. Today even the Dutch ride Schwinn. And because of its growth, Schwinn currently employs twice as many people in the United States as it did before the outsourcing began.

**Alternative Reality Two: If You Can't Beat Them, Join Them.** In this scenario, Schwinn went on the offensive. Rather than send most of its production volume to contract manufac-

turers, the company moved as quickly as possible to open its own factory in China. This move allowed Schwinn to make bikes at one-third their former cost. The company could actually have made its bikes for as little as one-sixth the cost. But by investing in building its own factory, Schwinn was able to bring in its own manufacturing techniques and train workers itself, helping it maintain quality. Indeed, the company was able to achieve high quality at a much lower cost.

The decision meant cutting more than 70 percent of Schwinn's U.S. jobs. However, Schwinn kept expanding operations in China, and it soon started selling its bicycles in the Chinese domestic market—not only in the low-end segment but also, by leveraging the cachet of its history in the United States, in the high-end, luxury segment. In addition, Schwinn used its position to expand into other products sourced in low-cost countries, and it began to export first throughout Asia and then globally. As a result, Schwinn is the top-selling bicycle company in the world today, with new factories in Eastern Europe and Brazil in addition to China. All told, the company has now sold more than half a billion bikes in new markets—more than it did in its first 100 years combined. This success has helped the Schwinn family rise to near the top of the *Fortune* 500 list of wealthiest families, and the company now employs more people in the United States than it did before deciding to expand abroad.

## Options and Opportunity

Competing against low-cost rivals does not mean giving up. It means carefully working through what can be done and what the options are. First, understand the threat. Consider how low-cost competitors might attack. Are they going to cut price to gain volume or are they going to acquire brands to achieve a price premium? Where are you strongest?

Then answer these questions: Is doing nothing survivable? If not, how do you evolve? Does it mean going to the “other side” and sourcing in, say, China or even selling your company to the Chinese? Or does it mean finding ways to reduce your costs, manage your brand, and build a stronger competitive position? It is usually critical to understand your existing supply chain—and potential supply chains of the future—in detail if you want to identify where advantage can be gained and disadvantages offset.

Finally, act quickly. The threat is real: acting slowly can put you out of business. But so, too, is the opportunity: acting quickly may strengthen your position against both low-cost and traditional competitors. Sometimes making the choices that require layoffs or other hard measures is the best way to preserve jobs in the long run.

Many years ago, I worked with a pulp-and-paper company that was struggling to survive in a small Wisconsin town. The pulp mill,

which employed 500 people, was high cost; but the paper mill, which employed 1,000, was cost effective. By shutting down the pulp mill, even though it was extremely painful for the town, the company was able to save the paper mill. In other words, the company cut 500 jobs in order to save 1,000. The paper mill has thrived, and today more than 1,500 people work there. By jettisoning the pulp mill, the company freed up the paper mill not just to survive but to grow.

Had Schwinn taken a similar course, it might have done the same. It might now boast even more jobs in the United States than it did when I was a child; or it might look quite different from the company of my childhood but still be alive and profitable. Of course, hindsight is always 20/20, but that just means there is no excuse for making the same mistakes and losing control of your own destiny. Denial is not a winning strategy.

Harold L. Sirkin

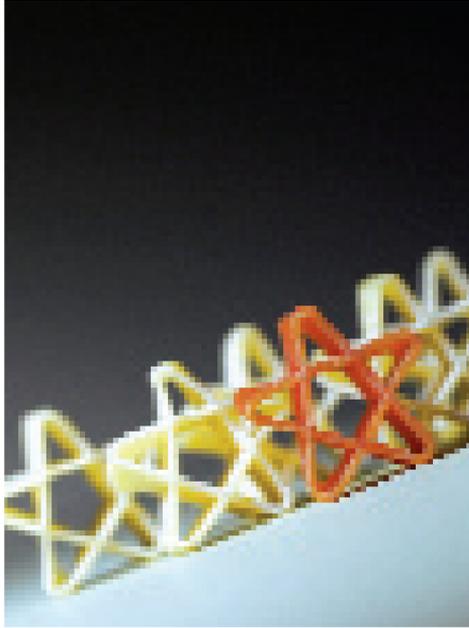
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## More than Talent

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The economic exuberance of the 1990s brought with it an almost elitist exaltation of the high-performing individual. For companies seeking to achieve superior corporate performance, the only thing that seemed to matter was to get, motivate, and keep “talent.” The standard scenario went something like this:

**Problem:** Organizational complexity is causing poor performance. There is not enough personal accountability and capability.

**Approach:** Aggressively simplify the organization and add personal performance disciplines, frequently in the form of targeted earnings numbers and linked financial incentives. To help managers take the strain, train them in leadership and “personal mastery.”

**Solution:** An “atomized” organization with small business units, empowered business-unit heads, and “born again,” socially competent managers able to establish effective personal networks whatever the hierarchical structure.

It wasn’t a bad idea, but it was just one idea. Focused solutions such as this one often ignore second-order effects and can be counterproductive. If making the numbers is all that performance is about, and if personal pressure and rewards are high, then managers may find

ways to cheat the system to make those numbers. They may focus on their personal advantage, even if doing so destroys value for the company. In fact, there is good evidence that this is exactly what some managers did.

Putting better controls in place doesn't really help, because there is a more basic problem. You cannot get "there"—to higher performance that creates value for the organization's stakeholders—by working only through individuals.

Companies that have no particular ability to add value to talent, but that go ahead and hire top talent anyway, simply end up paying their employees a lot without creating superior profit. Senior executives need to build platforms and interactions that enhance and combine employees' talents in order to create and capture corporate value.

### **Platforms and Interactions**

An organization can leverage human capabilities in two basic ways: by the way it interacts with its employees and potential employees (human resources processes and internal communications) and by the way it sets up the platforms for interactions among employees and between employees, customers, and suppliers (organization design).

In traditional manufacturing businesses, plant and equipment provide a standardized physical

platform for interactions among employees. Process flows constrain organization design and vice versa. The same is true in simple services, where information and communications technologies often take the place of plant and equipment in setting bounds on employee interactions.

In sophisticated services, knowledge businesses, and the upper echelons of large corporations, platforms for employee interactions are crucial, but interactions are not standardized and not bounded by process flows. What is at stake in these interactions is not only doing things right (effective execution) but also doing the right things (relevant strategy) by deriving an adequate knowledge of the competitive battlefield from the series of weak signals emerging from the marketplace. Indeed, an organization's ability to move from *information* (piecemeal, fuzzy, contradictory) to *knowledge* (sense making, direction setting, or even just problem raising) depends on interaction.

Only interactions among information holders will connect the bits and bites and ensure proper detection, transmission, and interpretation for action. Employees have substantial autonomy in how they interact. But they are not totally at liberty. If the corporation is completely "atomized," you might as well break it up, because the whole is worth no more than the sum of its parts. Organizational hierar-

chies, internal markets, and networks provide resources, set constraints, and define the possibilities and probabilities for interactions. At their best, they create an organizational context that makes value-adding cooperation in pursuit of company strategy a solution for employees, rather than just an additional constraint on top of their “normal” duties.

Loosely structured interactions mean, of course, that management’s job becomes more complex and that there is no longer the luxury, even in addressing operations issues, of focusing simply on individuals and how to motivate and control them. Instead of trying to convince people that they should behave differently, it may be more effective to adjust the context for individual behavior and the platforms for collaboration. Senior managers need to understand the organizational dynamics—the actors and their objectives, resources, and constraints (such as their dependence on other functions that fail to cooperate). When they do, they can reset the pulse of information and decision-making flows so that loosely structured processes can perform without management’s having to intervene constantly to motivate and police individuals.

### **A New Scenario for Improvement**

So where does this put us today in our search for a theory of performance improvement? Still imperfect but less simplistic, the scenario looks like this:

**Problem:** Poor organizational performance in a large, complex enterprise for reasons not fully understood.

**Approach:** Companies are human systems—people and interactions, not just people and not just interactions. Understand whether you have the needed talent, but also understand the quality of the underlying HR processes, employee engagement, and organizational dynamics. If people are the problem, make sure to improve HR processes as well as find new talent. Otherwise, the problem will repeat itself and the fix will be expensive. Remember that employees, as people, have their own objectives—and these are not just financial objectives. To engage employees, the company must meet its objectives in a way that also meets its employees' objectives. If company and employee objectives are not aligned, find a way to align them by changing the organizational context, the communication, or the employees; don't expect to do it by changing deep-rooted employee psychology. The simplest organization is not always the best. Teaming across the organization raises complexity and imposes constraints on employees, but it also can add great value.

**Solution:** An adaptive organization that interprets and acts on new signals coming from the marketplace. An organization that attracts and builds talent, and doesn't simply buy it, and that engages employees for results by combin-

ing performance disciplines with personal motivators. A collaborative organization that provides employees considerable freedom of action but also hard-wires effective teaming into the structure, incentives, and communication platforms. An organization on the move that engages, teams, and performs.

Obviously, this task is not easy or straightforward. But it is a task well worth pursuing.

Felix Barber  
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## Trusting Transactions

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*This article is the second in a series of Perspectives on network capital and transaction costs. The first, "Richer Sourcing," was published in September 2004.*

"Materials handling" was never a traditional category in cost accounting. But when, in the 1980s, manufacturers discovered the surprising fact that 20 to 30 percent of their cost-added was simply from moving stuff around, that concentrated the managerial mind. It proved one of the insights motivating the revolution called business process reengineering. Well, here's another surprising piece of nonstandard cost accounting to consider: more than 60 percent of the costs-added incurred by businesses and their customers are *transaction costs*. That ugly fact also concentrates the mind and may drive another revolution in management.

Transaction costs can be defined as the costs that would go away if you were dealing only with yourself. They apply to market transactions but also to transactions within organizations. "Cash" transaction costs comprise the costs of searching for, negotiating, monitoring, and enforcing agreements. Legal, cost accounting, sales, merchandising, purchasing, financing, auditing, and mediation by the boss are all cash transaction costs. If you built your own house instead of buying it, you would still need to buy the wood and the nails (direct production costs), but you wouldn't need to pay the

fees for the real estate broker, title insurer, or lawyer (direct transaction costs). But the direct production costs themselves include the indirect transaction costs incurred upstream. The transaction cost embedded in the price of the nails, for example, itself includes almost the entire cost-added of the retailer, since merchandising, advertising, displaying, sales help, and billing would all disappear if you “sold them to yourself.” Transaction costs are thus the price we quite sensibly pay for the benefits of division of labor: we incur transaction costs in order to lower production costs.<sup>1</sup>

In the aggregate, we spend more on negotiating and enforcing agreements than on fulfilling them. And as the exhibit on page 19 shows, transaction costs are not only surprisingly large but also rising. This may be counterintuitive, since we can all think of examples where technology has dramatically lowered transaction costs—for example, the efficiencies of e-procurement or the substitution of electronic payments for paper. What has happened is that the cheaper unit costs of transacting have more than proportionately increased the number of transactions, so the total cost of transacting has

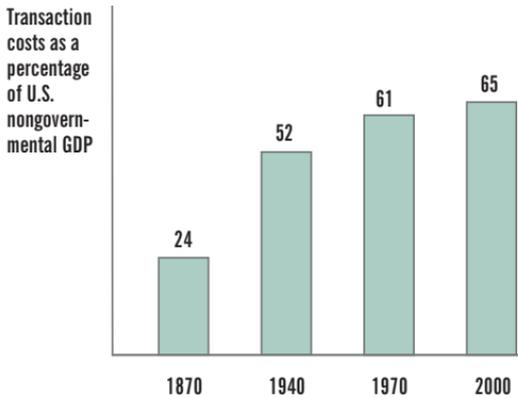
1. There is a second important kind of transaction cost: the “opportunity cost” of mutually beneficial agreements forgone. This is the value lost because the parties could not find each other or did not trust each other sufficiently to make a deal, or to make the best deal. “Cash” transaction costs and “opportunity” transaction costs tend to substitute for each other: in most cases, the more cash the parties spend on search, negotiation, monitoring, and enforcement, the nearer they approach an “efficient” transaction in which no opportunity costs are forgone.

gone up, not down. As the division of labor deepens and integrated value chains “deconstruct,” production costs fall, transactions proliferate, and transaction costs preponderate.

### Putting the Brakes on Innovation

In a sense, of course, this is just a cost of doing business. But transaction costs have not been

#### TRANSACTION COSTS ACCOUNT FOR A GROWING SHARE OF GDP IN THE NONGOVERNMENTAL SECTOR



**SOURCE:** BCG analysis, based on national income data using the estimation method developed by John J. Wallis and Douglass C. North, “Measuring the Transaction Sector in the American Economy: 1870 to 1970,” in *Long-Term Factors in American Economic Growth*, ed. Stanley L. Engerman and Robert E. Gallman (University of Chicago Press, 1986).

**NOTE:** Transaction costs are measured as the value-added of sectors whose output is a transaction expenditure by the remainder of the economy (for example, retailing, finance, insurance, real estate, brokerage) plus the transaction functions (such as purchasing and legal) incurred within the remainder of the economy. Since the statistics are based on national income data, they are only approximations.

the focus of systematic managerial attention. Like materials-handling costs a generation ago, they have crept up on us in part because they do not fit into conventional paradigms of good management.

Just about every information system, organizational structure, and managerial doctrine subordinates transaction costs to other considerations. Decades of managerial effort have been applied to minimizing production costs, often driving transaction costs up in the process. Arm's-length, aggressively negotiated outsourcing is the obvious example, as we discussed in our previous Perspective. Efforts by business leaders to increase accountability, ownership, and direct reward for value creation may have served as the motivation for individual initiative, but they have placed a transaction tax on internal collaboration. Escalating accountabilities and incentives within the corporation make every team meeting a negotiation for credit; technology owners enmesh each other in thickets of patents; digital rights management technologies extend copyright and curtail the simplest forms of idea sharing.

This is not a matter of bad or negligent management: the individual executive protesting divisional cost allocations and the individual company protecting its intellectual property are both behaving entirely rationally. But for the system as a whole, there is not one iota of economic logic that dictates that, on the margin, higher incentives create more value than

lower transaction costs would. It's just an assumption.

The most insidious aspect of transaction costs is that they tax transactions, especially small ones with uncertain outcomes. And especially transactions involving the transfer of ideas as opposed to things, since it is difficult to proffer an idea without, by that very act, giving it away. But it is in the multitudinous exchanges of small ideas of uncertain value that innovation occurs. In a very wide range of contexts, transaction costs are not *a* but *the* fundamental brake on innovation, both within companies and among them. As business leaders turn their attention from cost to growth, and from efficiency to innovation, so must they turn their attention from the more visible production costs to the less visible transaction costs.

But how?

### **The Benefits of Trust**

A countervailing force, critical to lowering transaction costs, is trust. Trust substitutes for search, negotiation, monitoring, and enforcement; it substitutes for hierarchical control internally and for the legalisms of contracts externally. The core elements of trust are threefold: *reciprocity* (the understanding that the parties will deal with each other repeatedly), *reputation* (the understanding that other potential parties are watching), and a *common semantic* (a shared language through which the

parties can sort through ambiguities and arrive at mutual understandings). Reciprocity and reputation align motives, and a common semantic aligns perceptions.

We tend to think of trust and its three elements as qualities of the individual or the small team: domestic virtues, nice to have, but hardly control variables in the management of a large-scale enterprise. That view is obsolete. With the right managerial context and IT platform, trust can scale. And broadly distributed trust drives down transaction costs in radical ways.

Consider some examples:

- EBay pioneered the application of technology to the creation of trust. About 50 million active buyers and sellers have the opportunity to rate each other, one transaction at a time. These ratings are visible to all, openly documented, and disputable through open arbitration mechanisms (such as SquareTrade). They are represented as icons: a newbie gets a , and someone with 100 feedback results that are more than 98 percent positive becomes a  **Power Seller**. The value of a good track record is measurably a seller's premium of 5 to 10 percent. The system is not foolproof, of course, but it permits small transactions (often under \$10) between distant parties who would otherwise have no mutual recourse—a “currency” of reputation that lowers transaction costs below the

threshold needed to make the transaction possible.

- Amazon allows its readers to post reviews, including intemperately bad ones. No single review is reliable (despite an eBay-type rating system for reviewers), but people learn to filter and to aggregate. Aggregated reviews by readers influence sales more than those by professional journalists because people have a high measure of confidence in their own ability to interpret “weak signals.” And the ironic result of posting negative reviews is that Amazon sells more books: it gains more from reducing uncertainty (a transaction cost) than it loses from broadcasting negative signals. Contrary to the nostrums of consumer marketing, transactions are better facilitated by unbiased noise than by biased clarity. All that is needed is lots of signals and simple technology to add the noise up, thus allowing most of it to cancel out.
- Google pushes this same logic even further. The fact that one Web site chooses to link to another is a weak, uncertain, and easily manipulated endorsement. Google’s PageRank algorithm measures all the links to a site but weights them by the PageRank of each endorsing site. This recursive principle (technically a measure called “eigenvector centrality”) harnesses the collective choices of millions in the direct or indirect evaluation of any one site. Most businesspeople would

agree that searching Google is not only more comprehensive but also more relevant than using their own company's internal knowledge-management systems! Search technology extracts superior semantic meaning from the topology of the network itself.

- More generally, aspects of the open Internet architecture (such as public key-encryption and site certificates) allow one site to authenticate another, validate a specific item of information, or confirm that an avowed policy is being followed. Most banks, for instance, carry this icon on their Web pages: . This makes trust “transitive.” (Someone I trust trusts you, so I trust you in turn.) Friendster and LinkedIn do this for individuals. Next-generation service-oriented architectures, based on XML, Web services, and the concepts of the semantic Web, will all exploit the transitivity of trust by building validation into the content itself, thus underwriting scalable and self-organizing networks of trusting relationships.

### A New Set of Levers

Such trust-generating mechanisms are not panaceas: indeed, information technology makes possible new kinds of fraud as well. But they do address an old problem in new ways, and they are the thin end of a very large wedge. They exploit the facts that in a networked world, information channels are dirt cheap and massively redundant, the distribution of infor-

mation is inherently more symmetrical, and simple technology can expose network patterns to casual inspection. On those premises, reciprocity between individual transactors “scales” into reputation within an open community. Digital certification permits the lossless propagation of trust through very large networks. Search technologies allow the extraction of new and shared semantic meaning from the collective behavior of the network in which they operate. And all these mechanisms enjoy increasing returns: their power is at least proportional to the size of the network within which they are embedded.

Technology merely liberates network-centered trust from the traditional constraints of richness and reach, enabling it to achieve critical mass for the first time.<sup>2</sup> And once increasing returns set in, these mechanisms reduce many transaction costs far below what could be achieved in traditionally organized markets or hierarchies.

It has long been understood that transaction costs determine the competitive advantage of markets and hierarchies, and thus the boundaries of the corporation. But to stop there is to treat them as a given, a mere “fact of life.” The transformation of networks by technology opens a new and exciting possibility: that transaction

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2. For more on richness and reach, see Philip Evans and Thomas S. Wurster, *Blown to Bits: How the New Economics of Information Transforms Strategy* (Harvard Business School Press, 1999).

costs can be managed, both internally and externally, through newly scalable mechanisms.

Nobody knows how far these mechanisms will extend or how effectively they will bring transaction costs under control. But we do know that the need is pressing, the potential real, and the concept applicable both inside the corporation (organizationally) as well as outside it (strategically). The pioneers in both domains, like the pioneers in reengineering, will be the ones who reap the competitive advantage.

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# The Dilemma of the Successful CEO

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The cover of *Fortune* recently featured 21 men and women whom the magazine hailed as “business superstars.” They were asked to relate the best advice they ever got. One good piece of advice that they *should* have gotten, given recent events, is “Don’t let yourself become a business superstar. If you do, there could well be trouble ahead.” The ancient Greeks spelled out the problem in such tragic dramas as *Oedipus Rex* and *Antigone*: *hubris* (pride) leads to *ate* (an act of arrogance offensive to the gods), which results in *nemesis* (infamy and death). A more contemporary formula is, of course, “Pride goes before the fall.” The admonition should have been made to the swelling ranks of once-powerful business executives now facing trials or prison sentences for fraud. But it applies to all successful CEOs and to successful businesspeople in general.

To explore the problem of arrogance and fraud, I examined the 25 largest cases worldwide involving allegations of corporate fraud that surfaced since accounting irregularities at Sunbeam became public in 1998. I studied each company’s incentive system for top management, the CEO’s reputation, growth targets, analysts’ expectations, and rules for corporate governance. I looked for evidence of overvalu-

ation and examined price movements around the time that problems with each company's books were discovered. All the cases—including such well-known examples as Enron, WorldCom, Adelphia Communications, Ahold, and Parmalat—involved publicly traded companies whose top management was directly or indirectly implicated in the accounting troubles. The companies (21 of which were American, interestingly) made the top-25 list on the basis of the absolute amount of fraud alleged, the amount of fraud relative to company size, and the company's size itself. Together, they accounted for \$25 billion of corporate malfeasance.

Surprisingly, the story that emerges from the research is not about bad corporate governance per se, since the 25 companies scored the same on corporate governance issues, on average, as the set of companies I used as a control group. The story turns out, instead, to be about the dilemma of the successful CEO.

### **What Went Wrong?**

Companies and, in particular, their shareholders look desperately for successful leaders. The danger starts as soon as one is found. The new CEO gets increasingly wealthy because of huge stock options and bonuses. In 2000 the CEOs of the companies that would later be accused of fraud had eight times higher stock pay (the sum of exercisable and nonexercis-

able stock options, plus stock holdings, at year-end) than their peers in the control group: \$1.2 billion, on average, compared with \$150 million.

Along with big checks come big reputations. Indeed, some CEOs acquire icon status and celebrity chic. The heads of the companies in which fraud was alleged were cited, on average, three and a half times more often in the business and popular press than their counterparts in the control group. Some, like Kenneth Lay of Enron and Bernard Ebbers of WorldCom, were quoted over ten times more often.

Before long, tens and sometimes hundreds of millions of dollars of incentive pay as well as oversize reputations are at stake. And some of the most successful CEOs are at great risk of losing it all because they have committed themselves to unrealistic targets.

Precisely because they are so successful, these CEOs set increasingly high goals. They do so for two reasons. First, to remain successful in the stock market and protect their immense stock holdings, they must increase profits by 12 to 20 percent a year, since those are the targets needed to outperform the market. Second, they start to believe in their own hype. Ebbers, now facing up to 85 years in prison for his role in the WorldCom fraud case, developed “a little bit of a God syndrome,” said one vice president at the company.

The superstars become untouchable as they become more and more powerful. Having committed themselves to unrealistic annual growth targets (on average 18 percent, or the equivalent of nearly 130 percent growth every five years, in the 25 companies in my study—compared with 7 percent annual growth, or 40 percent growth every five years, in the control group), they sometimes feel as though they have no choice but to start fiddling with the numbers and cooking the books. But eventually they fall, and when they do, investors lose their money, employees lose their pensions, and the public loses trust in the corporate world.

Many studies (including those conducted by Manfred Kets de Vries, a psychiatrist and management professor at the INSEAD business school) have shown that narcissism is an occupational hazard for successful leaders, especially in the case of charismatic CEOs. Narcissism is at the same time an addictive drug and an important ingredient for success. Narcissism leads to hubris. Successful narcissistic leaders are tempted to surround themselves with mirrors, in the form of yes men. Such leaders lose touch with reality and tolerate no contradiction. The success of the CEO is the very proof that he or she is always right. Hubris strikes, and Icarus, who has tried to fly to the sun, falls into the sea.

The mechanisms that create success and the mechanisms that are, in turn, created by suc-

cess (staggering compensation, iconic reputation, unrealistic targets) also stimulate hubris and can cause catastrophe. Ambition and self-confidence—two characteristics necessary to becoming a successful leader and to climbing to the very top—are also inherently dangerous. Ambition can be very close to hubris, and there is a thin line separating self-confidence from narcissism.

The fall from grace comes suddenly, but not as suddenly as it may appear. On the day the allegations of fraud became public in the 25 companies I studied, 26 percent of the value, on average, vanished into thin air: \$73 billion was lost. But savvy investors had anticipated these negative effects well in advance: in the year before the news of each scandal, 40 percent of the market value of the 25 companies, relative to the market index, had vanished. Tens of thousands of investors had read the signs.

### **What Can Be Done?**

What can companies do to prevent irresponsible, value-destroying decisions and fraud—or at least to lessen the chances of their occurrence? Systemic changes are needed in the following areas:

- *Incentive Compensation.* Stop paying excessive sums; base CEOs' options and bonuses on their performance relative to their counterparts.

- *Target Setting.* Adopt sustainable strategies and set realistic targets; if necessary, just say no to Wall Street.
- *Image Control.* Prevent CEOs from becoming “sun kings”; just say no to journalists.
- *Market Watching.* Carefully follow and read the stock market and your (relative) stock price to watch for early signs of trouble.
- *Real Corporate Governance.* Recognize that governance is essentially about the control of power; understand that there are limits and dangers to the CEO model and that it is vital to have an independent and strong chair and CFO.
- *Corporate Culture.* Recognize also that good governance is not about rules and regulations; instead, it is about instilling and nurturing a healthy and ethical corporate culture.

Corporate fraud and the misguided leadership of narcissistic sun kings are much more widespread problems than is often assumed. And their cost is much higher, too. From 1978 through 2002, according to a study of the U.S. market by Jonathan M. Karpoff of the University of Washington and two other researchers, federal regulators initiated 585 enforcement actions for financial misrepresentation by publicly traded companies, naming 2,310 individuals and 657 companies as poten-

tially liable parties. The legal penalties imposed were substantial. For example, individuals were assessed \$15.9 billion in fines and civil penalties, and 190 managers received jail sentences for financial-reporting violations. Companies were assessed an additional \$8.4 billion in fines and damages through class-action lawsuits. Beyond the cost in dollars, the damage to reputations is severe: the Karpoff study puts it at 12 times the amount of penalties imposed through legal and regulatory processes. This evidence belies a widespread view that financial misrepresentation is only lightly disciplined.

But punishment is not a remedy, and good governance—at least as it is measured in corporate governance codes, codes of conduct, and legislation like Sarbanes-Oxley—is not a solution. Corporate culture is. “In the end, corporate governance is indeed about corporate culture,” Gerard Kleisterlee, the CEO of Royal Philips Electronics, said in my discussion with him about the problems caused by the sun kings. “Once a sun king has made it to the top, nobody or nothing—not even corporate culture—can stop him anymore. It’s too late. But what corporate culture should and can do is to keep narcissistic leaders from climbing through the ranks and becoming CEOs in the first place.”

Most of us read these stories of fraud and arrogance and think that we would never succumb

to the pressures and temptations. But recognize how strong these pressures and temptations are and how little others will do to help you resist them.

Kees Cools

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“Icarus” from the illustrated book *Jazz*, by Henri Matisse, 1947. © 2005 Succession H. Matisse, Paris / Artists Rights Society (ARS), New York.





## The Forgotten Half of Change

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*This article is adapted from the author's new book, The Forgotten Half of Change: Achieving Greater Creativity Through Changes in Perception (Dearborn Trade Publishing, 2005).*

In the country, I had a dog that used to take sly pleasure in jumping over the garden fence and escaping into the neighboring fields. So one day I decided to remove the ugly wire netting, which no longer served any useful purpose. Imagine my surprise the next day when I saw my dog jumping up at the exact point where that fence had been—and with the same sly pleasure.

But before you laugh at him, think a moment. Maybe he's laughing at us—incapable of getting out of the boxes that we make for ourselves, squatting inside fences that disappeared long ago, and shut inside imaginary walls.

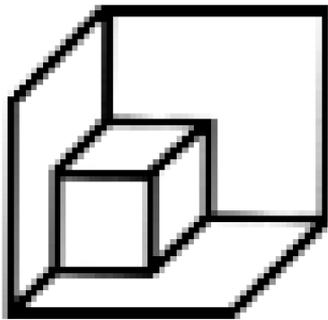
There is a clear lesson here for business leaders: Sometimes, in order to lead, you need to change perceptions, not reality. Indeed, your business is one thing, but the way you look at it is another—and too many people forget this sometimes crucial second half of the change process.

Consider the couple who always arrive late. They could use an appointment book or wake up earlier or schedule more time between meetings. But change is not just a matter of bet-

ter organization. If they limit their change to action only, they will arrive late again within weeks, back to their old bad habits. To make a permanent change, they need to change the way they look at punctuality.

In fact, they will need to change *twice*. And that is a task faced by many business leaders. Running a company is a task that straddles two distinct dimensions. There is, of course, the daily management role, which entails making decisions to improve processes and the like. This is where the CEO *acts* for the benefit of the company. But there is another dimension that is parallel to this one and just as essential. This is where the CEO imagines change, seeks out new ideas, invents the future. This is where the CEO *thinks* for the benefit of the company. In the end, successful companies evolve up a steady slope and a stepped staircase, both at the same time.

You can visualize this continuous and discontinuous evolution with the help of the geometric metaphor below. Slowly turn the drawing upside down. When the rotation is modest,



your perception of the drawing doesn't change. But turn it a little more, and what you see is totally different—even though the “reality” of the drawing hasn't changed at all.

Now, back to the slope and the staircase. The trick is to know when the staircase needs more of your attention, to anticipate the day when strategic vision is exhausted and contributes less and less to keeping things moving. This is the moment at which to turn from innovation to creativity. (To understand the key differences between the two, see the exhibit below.)

### Navigating a Different World

Being creative isn't easy. It requires more than a quick course in “thinking,” because our minds insist on seeing the world as it was. Yet for most

#### CHANGE COMES IN TWO WAYS: THROUGH INNOVATION AND CREATIVITY

##### Innovation Changes Reality

Innovation requires *action*  
It is a challenge for a team  
The process is continuous  
It takes a long time  
It delivers something new to the system  
Its impact is measurable  
Project management is required  
The fuel is practical ideas and useful suggestions  
The role of a consultant is to cause action

##### Creativity Changes Perception

Creativity requires *thinking*  
It is a challenge for an individual  
The process is discontinuous  
It takes an instant  
It envisions a new system  
Its impact cannot be measured  
Brainstorming is required  
The fuel is questions, surprises, and strange and incomplete ideas  
The role of a consultant is to encourage reflection

**SOURCE:** Luc de Brabandere, *The Forgotten Half of Change: Achieving Greater Creativity Through Changes in Perception* (Dearborn Trade Publishing, 2005).

of us, the world that existed when we were born, and that shaped us, has changed completely. The fences are down. Can you still trace the borderline between professional and private life? Where do cosmetics stop in the drugstore and start in the pharmacy?

The disappearance of barriers is just one of many changes. Another is what Michelangelo might have called *non finito*. Many of Michelangelo's statues are unfinished. The four naked *Slaves*, for example, give the impression that the figures are emerging from the marble. The heads and torsos have been drawn out, as if to allow the statues to breathe, while the rest of the body is trapped within the marble, waiting.

The idea of *non finito* is strangely modern. It's an attitude that consists of just being ready, since we no longer know how to make forecasts. It is in opposition to the sinister approach that says, "We don't move so long as we don't know where we're going." Instead, *non finito* would say, "Let's in any case do what has to be done," even if it can't be finished. *Non finito* is humility in the face of one sole certainty: we don't know what's going to happen. *Non finito* is the will to act while leaving the future open, the habit of writing in pencil rather than ink, of actively participating in a world that is becoming, without knowing what it's going to become. In the end, *non finito* is respect for others and the liberty we grant them to finish in their own way.

Leaders will need to ask many more people in their organizations to be *non finito*. Creativity was once defined as a revolution in the way we look at things. But this revolution should not be limited to future Nobel Prize winners; the insurrection has to appeal to everyone, because every individual's eye can contribute to the imagination of us all. You have to be the scientist of your own life and be astonished four times: at what is, what always has been, what once was, and what could be.

### Creating a New Strategic Vision

But how can we ask people in our organizations to be *non finito* in a world that increasingly demands and extols flawless execution? How can we ask them not only to execute but also to think and, when necessary, to transform? What does this mean for the leader who must change minds as well as matters? It means coming to grips with the challenge of creating a new strategic vision. Here are some points to remember:

1. Developing a strategic vision is above all an intellectual process. It is located in the world of thought and not in the world of action. Its objective is to change the way we see things and not the things themselves.
2. All reflection is based on a system of values that we construct from what we believe is desirable. It is essential to express these val-

ues clearly. Sticking to them is a sine qua non for strategic vision.

3. Thought has its own laws. If we want to create a strategic vision, we have to defer to it. As ideas develop more like a stepped staircase than a steady slope, a new vision implies that there is a break with the old one. What is broken is a stereotype—at least one—that supported the previous vision.
4. A strategic vision has to be easy to understand and coherent. At its start, it must not contain any contradictions or ambiguities; if it does, it is doomed to confuse people and fail.
5. The first challenge the vision will have to face is that of credibility. Whoever develops the vision will immediately have to be able to show that it is feasible—in particular, through a clear demonstration of what the available resources are.
6. A strategic vision exists only if it can be shared among those it concerns. It exists only if they take ownership of it. It has to motivate. It gives everyone involved room to be creative and space for personal development.
7. Good communication is essential; a strategic vision has to appeal to the emotions. So why don't you put it in pictures and communicate with both sides of the brain?

8. A strategic vision has to be visible from the outside—to clients, suppliers, and the public, among other constituencies—and it has to provide information on the specific characteristics of the company, on the project itself, and on the difference it will make. It can be crystallized in a strong phrase, but the temptation to create a slogan must be resisted.
9. A strategic vision is limited in space and time. It is defined by limits that are set down in advance, and it “knows” it is not eternal and that—just like its predecessor—it is based on a certain number of hypotheses that will one day no longer be verifiable. In short, it knows that it, too, will end with a break.
10. A strategic vision contains qualitative elements that can’t be tracked with traditional metrics. There are no figures that allow us to evaluate how things are progressing. Nonquantifiable objectives should therefore be accompanied by criteria, if they are not to become wishful thinking. These criteria will allow permanent comparison of what *is* with what *was* supposed to be.
11. Growing uncertainty is a fact, so strategic vision is necessarily incomplete. Because the unknown cannot be taken into account, it will be fitted out with correction mechanisms. While we can “preview” what is certain, we can “prepare” for the uncertain.

The points set out here say nothing about the quality of the vision being created. There comes a time for validation. Is it ethically acceptable, practically feasible, economically tenable? Moreover, quite simply, is this the right moment? A positive response leads to a decision to “freeze” the vision, and that decision leads to action.

To make a long story short, a strategic vision is a representation—an ambitious image of a future state that is radically preferable to the current state. It becomes a reference and thereby provides a set of concepts that allow all employees to approach their work thoughtfully and effectively.

If you keep this definition in mind, the forgotten half of change will be forgotten no more.

Luc de Brabandere

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## As Simple as Possible

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The toughest job for top management may be keeping a business as simple as possible. Time and again, organizations get in their own way by inserting complexity in areas that don't need it. Solving this problem by keeping things simple is a tremendous source of potential value.

Complexity is found in countless variations of custom pricing, contracting terms, product offerings, supplier networks, manufacturing lines, organization structures, and business processes. Some of it is justified because it adds value and increases revenue. But a lot of it isn't. More often, complexity destroys value by adding people costs, lengthening cycle times, and frustrating both customers and employees. At one company, we estimated that fully one-quarter of the work force—accounting for well over \$1 billion of annual costs—existed solely for the purpose of “handling” complexity. And this cost didn't include the lost revenue from frustrated customers.

### **Warning Sign Number 1: “We Have 1,000 Ways of Discounting \$100 to \$98.”**

What causes unneeded complexity? The question really is *who* causes it? And the answer is well-intentioned people in your organization, at all levels, who say *and* rather than *or* and who won't make the choices that good strategy and management demand. To be more specific, here are some of the problems:

**Misguided Attempts to Respond to Customers.**

Ironically, the movement to be more “customer responsive” has created much of the mess. Many organizations have translated *responsive* to mean “customized—any way you want it.” But this approach often proves to be *less* responsive when it spawns manual processes, errors, and confusing options. In the pursuit of a good goal, this approach makes the problem worse.

**Creeping Economics.** The cost of adding “one unit” of complexity is near zero. As a result, there is little reluctance to add it. But the cumulative cost of many of these added units is very high. And because few people take that into account, complexity costs creep up.

**Technology Hubris.** Too many companies have the naïve belief that IT will “automate away” the complexity problem. After all, what are computers for if not to process large numbers of complex tasks? The problem is that complexity grows faster than IT’s ability to respond. And IT never catches up. Even worse, this naïve belief gives us the false confidence to continue adding complexity.

**What Goes Up Does Not Easily Come Down.** As with many things in life—prices, your weight, your children’s allowance—what goes up tends to stay there. The same is true for complexity. Adding a new discounting method or product code is fairly straightforward, but taking it out or migrating a customer from an old code to a new one is not at all easy.

The truth is that most complexity just sneaks in—and it is costly for everyone.

### **Warning Sign Number 2: “Our Customers Hire Outsiders to Check for Errors in Our Bills.”**

So how do you reduce complexity and simplify your business? Success involves five principles.

1. *Start at the source.* At some point you will need to turn your attention to business processes and technology, but do so only *after* you have addressed the inputs to complexity themselves—for example, variations in custom pricing, nonstandard contract terms, and low-volume product codes. Run the numbers on how many pricing methods, contract terms, and product codes you have, how much revenue they “account for,” how much cost they consume (direct and indirect), and, most important, how much they impede your ability to respond to customer demand. Protect the high-value variations and attack the numerous low-value, nonstandard variations. You may be surprised at how well your existing processes and technology systems work once you have done that.
2. *Eliminate, accommodate, and separate.* Not all complexity is created equal. Categorize your existing complexity with a view to three types of actions:
  - *Eliminate.* Just get rid of it. Migrate low-volume custom variations to high-volume standard variations. You will need a heavy dose

of paring and persuasion for such an effort to succeed.

- *Accommodate.* Standardize and automate high-volume variations through a factory-like process. Don't try to push low-value or low-volume variations through the factory: they will clog it up.
  - *Separate.* Put high-value or low-volume variations through a job shop process. Don't worry about automating: the volumes are low enough and the value is high enough to justify manual processing. Just make sure to keep the volume low and the job shop and the factory separate.
3. *Play the full team.* Taking complexity out of a business is a companywide endeavor. Each move will have first- and second-order consequences across the organization. Just as the consequences are cross-functional, so too should be the way the complexity reduction effort is staffed and managed.
  4. *Beware of the statistics trap: track outcomes.* Reducing complexity is only a means to tangible outcomes—lower costs, improved responsiveness, higher revenues. Measure those outcomes directly to be sure your effort is having an impact. Avoid the trap of declaring victory after measuring only reductions in complexity statistics (for example, fewer product codes) rather than the outcomes themselves.

5. *Make change “safe.”* Many employees will view taking on the complexity problem as personally risky. After all, it is much safer to let complexity go unchallenged. “No one ever got fired for leaving in a low-volume product code,” one product manager told us. “But I will be blamed the first time someone asks for the odd code that I eliminated.” Senior executives must be visibly involved and supportive. And they must back up their people anytime someone looks for that discontinued variation.

### **Warning Sign Number 3: “Eighty Percent of Our Product Codes Generate Just 5 Percent of Revenues but 20 Percent of Costs.”**

Reducing complexity is not just about making the business as simple as possible; it is about *keeping* it as simple as possible. This is a dynamic process, not a one-time cleanup. It requires managing complexity throughout a product’s life cycle and across an entire portfolio, drawing out commonalities rather than spawning unnecessary “one-offs.” And it requires managing complexity across the entire sales process. Simply put, keeping it simple is not an event in time but rather a capability that is built into an organization.

This capability depends on people, systems, and hard and soft feedback loops. Ask yourself the following questions about your own capability:

- Does our organization have an operational definition of complexity?

- Do we know how much complexity we have—quantitatively, not anecdotally?
- Do we know how much value and cost the low-volume, nonstandard variations generate? Are they a source of profit or a sinkhole? Are they constraining our ability to be responsive?
- Do we have checks and balances to keep complexity under control? Are they set up in a segmented fashion—eliminate, accommodate, and separate? Is there an explicit feedback process or are decisions made in a one-off fashion?

If you are not satisfied with your answers, you are looking at a real opportunity.

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## Greed Is Not Good

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Only where love and need are one,  
And the work is play for mortal stakes,  
Is the deed ever really done  
For Heaven and the future's sakes.

—from Robert Frost,  
“Two Tramps in Mud Time”

How do you create a hunger for performance in your organization without also creating a greed for reward? Too often, in the pursuit of growth and entrepreneurship, we strike a dangerous bargain. We start with a promise: “I’ll pay you whatever it takes to meet these goals.” Then we delude ourselves into thinking that we can control the inevitable and spreading greed by installing tighter governance. But greed out-smarts governance. With bonuses at stake and promotions on the line, games get played and figures are faked. Not just accounting figures but also sales, delivery, and return figures.

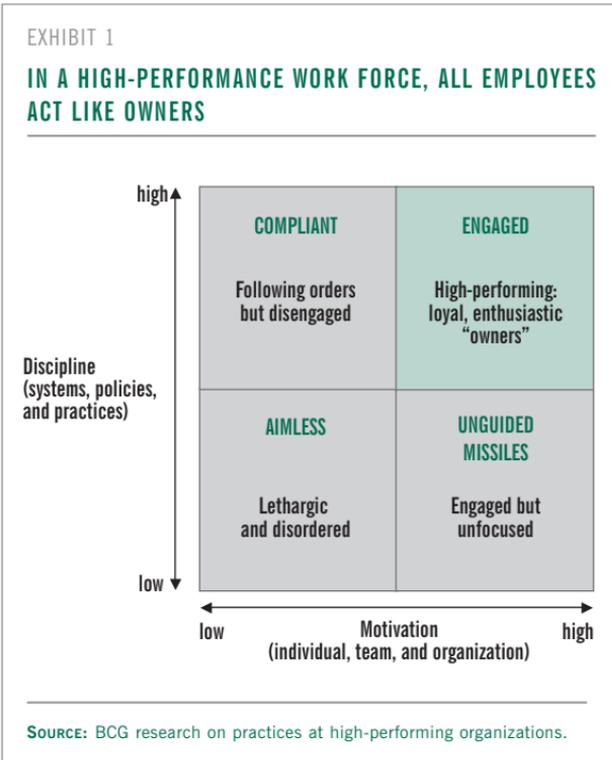
We propose a different approach: discipline and motivation. Not discipline *versus* motivation but discipline *and* motivation, working together to produce a chemistry of engagement and achievement. (See Exhibit 1, page 58.)

### Raising Accountability

By *discipline*, we do not mean hierarchy or autocracy but rather the systems, policies, and practices that raise accountability. This disci-

pline is built around strategy and clarity about goals and performance, not around accounting and quotas.

By *motivation*, we don't mean tossing money at people but rather creating an environment in which employees want to go beyond the call of duty in the service of corporate goals—out of a desire to make a difference, not because of obligation. Employees throw themselves into their work because work matters to them—professionally *and* personally. It is no surprise that employees feel better about themselves



when they are motivated, yet too often motivation is missing. Walk down the hallway of many corporations, and the lethargy is palpable. The same person who is staring blankly at the computer screen in his cubicle will be an engaged and energized soccer coach in a few hours. Many of your employees are motivated and engaged individuals—just not on the job. They apply their talents doing voluntary work. They leave their leadership at home because they don't think what they do for your company is important and they sense that you don't value their contributions.

*Discipline + motivation = engagement.* This is the state of grace in which the goals and values of the individual and the organization are aligned and performance is at a peak. This is not a dream but an achievable goal. We have seen it happen. To be sure, there are no quick fixes. It takes years, not months, and it requires dedicated leaders who understand and manage the challenge rather than guess at it.

### **Installing Systems and Strategy**

You don't need to pursue both discipline and motivation at once, at least in the short term. Usually, discipline should precede motivation. Before any bottom-up collaboration takes place, you will have to install basic organizational systems and strategy—the vegetables *before* the ice cream. It's similar to structure and creativity. Leave creativity unbounded and it will bound off the tracks.

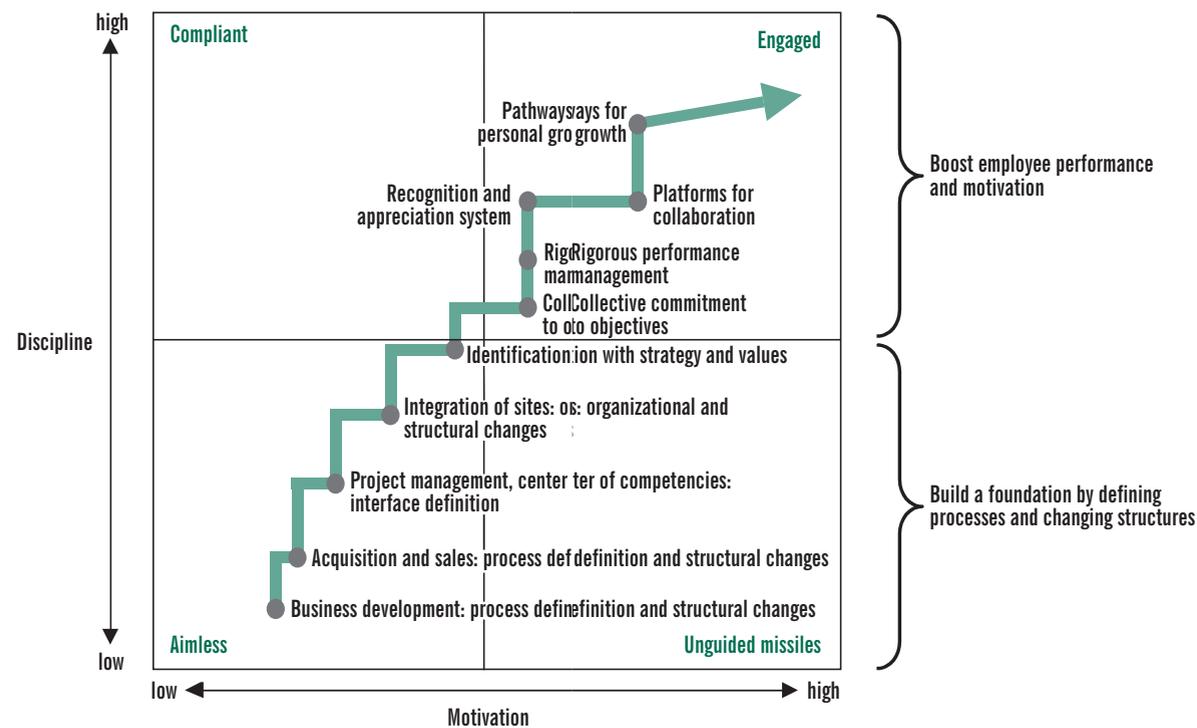
Not everyone agrees. Some would rather start motivating the troops before addressing discipline. Consider Jack Welch's early days as chief executive of General Electric, when the company achieved huge gains through discipline. Welch's formula was clear: define roles and decision-making authority, and measure, monitor, and assess performance. Those who favor starting with motivation counter that too much of an initial emphasis on discipline is likely to

make people feel exploited. It wasn't until GE began focusing on motivation, they say, that productivity jumped from 2 percent a year to 5 and 6 percent. But that argument doesn't hold, because you can't do a controlled experiment.

There is no right answer. You will need a mix of efforts aimed at improving discipline *and* motivation. Exhibit 2 illustrates one company's journey through a variety of interventions. They

EXHIBIT 2

**A PATHWAY TO ENGAGEMENT REQUIRES MANY STEPS TO BOOST DISCIPLINE AND MOTIVATION**



Source: BCG casework.

included rigorous performance management (to improve discipline) and efforts to foster collaboration (to spur motivation).

### Getting in Touch

So how do you know when to do what? First, recognize that you may be out of touch with many of your employees. For the reasons described above, most of them are probably less motivated and disciplined, at least while on the job, than you would like. You may once have known the people who work in the cubicles or on the factory floor, but you don't anymore. Get the facts and put them into a guiding framework. Focus on five fundamentals:

- building a foundation
- raising accountability
- achieving results
- working together
- developing skills

For each of them, ask yourself and your senior team a pair of questions about discipline and motivation. For building a foundation, ask whether you have a clear strategy and set of objectives *and* whether you have articulated your aspirations and values. For raising accountability, ask if your structure makes your strategy possible *and* if your people are behaving as expected and desired.

You see the point. Facts should be gathered through the lens of discipline and the lens of motivation. For achieving results, ask if your performance management system is robust *and* if individuals receive proper rewards and recognition. For working together, ask if the structures and processes for collaboration add value *and* if your people cooperate in a way that helps achieve results. Finally, for developing skills, ask if you have the right people in the right jobs *and* if you are adequately supporting their development.

There are reliable ways to get good answers to these questions. But before you start using surveys and tools, you need to be committed to the belief that you can break the compromise between disciplined performance and performance motivated by money.

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## The Knocking on the Window

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We have both returned to India after a few years abroad, the CEO of one of India's largest companies and I. "What change do we see?" we asked each other one evening. "The knocking on the window," he said.

There had always been poor people on the streets, and beggars. But you could ignore them if you chose to. Now they knock hard on the windows of cars at traffic lights, and it is not easy to chase them away. The cars have changed, too. Ten years back, clunky Ambassadors and Padminis chugged alongside the Marutis in city traffic. They are almost gone. Now many new models—Hyundais, Fords, Hondas, Opels, and Mitsubishis—swarm the roads. People drive in air-conditioned comfort. And the beggars knock on the windows.

In India, as everywhere, corporate leaders must shoulder a greater responsibility for answering the knocking on the window. Governments are being asked to downsize, to stop running businesses, and to hand over the operation of public services to private managers. Government leaders consult with business leaders more closely, and it is even fashionable for heads of government to call themselves CEOs.

But prevalent models of business leadership cannot provide a sufficient response to the

knocking, which will get louder. Business leaders must instead discover new solutions that address broad social issues while also meeting the increasing demands of shareholders.

### **A New Way to Do Well by Doing Good**

People want money to buy food, clothes, and shelter. And to buy toiletries, consumer durables, and the other good things that corporations hope they will buy. Poor people must earn this money somehow. Putting them on the bloated rolls of government departments and state-run corporations is not a sustainable solution. Even private Indian companies have to improve their productivity substantially, and many need to shed employees, not take on more.

Conventional wisdom says that, over time, increases in productivity in the public and private sectors will make the economy more vibrant and generate higher incomes, with the benefits ultimately trickling down to the poor. However, the interim will be uncomfortable for CEOs. It will not only be morally uncomfortable, because of the knocking on the window. It will also make CEOs feel strategically insecure, because it is not clear how long the political system can hold to its course of privatization and downsizing if it does not demonstrate the benefits of this course to the poor.

Business leaders can overcome their moral discomfort by donating money to social causes. Better still, they can offer their managers' time

to help community efforts. Several Indian companies are doing exemplary work of this type. Yet those initiatives may be insufficient to address the fundamental challenge—namely, the need for the incomes of poor people to rise quickly, along with those of the companies that the new economic policies are assisting.

Therefore, we need a new model of business enterprise, with new approaches to production and distribution. Under this model, big companies would engage poor people in large numbers as free agents rather than as employees. The poor would work *with* those companies, rather than *for* them, in some sort of independent contracting relationship to provide a variety of goods and services. This arrangement would not only greatly increase the income of the poor but also allow them to become bigger consumers and thus contribute to corporate growth.

To work, though, this model must address several major organizational issues that confront business leaders:

- How, exactly, can they engage millions of people without putting them on their payroll?
- How will these people acquire the skills and money they need to act as free agents?
- How can managers ensure that these people will do their work diligently to meet the

needs of the enterprise without a hierarchical edifice to coordinate their activities?

- How will business processes be redesigned so that a new form of networked enterprise can span existing boundaries?
- Who will set the minimum critical rules that all members of such an enterprise must abide by if the organization is to function coherently?
- How will the new value that is created be equitably shared among the many independent participants?

### **A Different Way to Organize and Govern**

The answers to these questions are emerging. Advances in information and communication technologies—highlighted, of course, by the Internet—have completely changed the way information is exchanged and activities are coordinated. It is no longer necessary to have a central coordinator to whom all information is passed for processing and who then sends back instructions. People can coordinate with one another directly. Until very recently, it was believed that people would need PCs in order to participate in such networks, and therefore that poor people in India would have to be excluded. But the continuing ferment of technologies, as well as innovations in business models, are making it possible to provide access to people who do not own communication devices.

Relationships among the many parties in these Weblike networks can function along commercial lines rather than as a charity. The poor will honor their debts so long as the terms of their contracts are fair. Indeed, underprivileged women and children have shown themselves to be very reliable business partners. The success of Grameen Bank in microlending to women in rural Bangladesh is well known. Less known is the success of a lending effort to street children by a Mumbai businessman. These children, who do not even have an address, are taught a trade and then lent money to start up a microventure such as selling flowers. The only security the child is required to provide is a photograph and a surety from two friends, who are invariably also homeless Mumbai street children. Remarkably, the recovery rate of these loans, to the poorest of the poor, has been more than 75 percent.

The governance of networked enterprises of small and large businesses, and the management of monolithic and hierarchical companies, require different concepts and skills. In the former, stakeholders are far more diffuse than in the latter, and the power of ownership and positional authority cannot be wielded to obtain control. Yet the core curriculum of management education and practice is focused on traditional corporations. This curriculum has shaped the lenses that managers use to distinguish interesting opportunities from those that

they consider pie in the sky. After all, the assessment of opportunity is greatly influenced by the experience managers have in making certain types of things happen.

To answer that knocking on the window, and to empower the poor as well as turn them into bigger consumers, business leaders in India and elsewhere will need to write a new management textbook. The Indian leaders in particular will be those who experiment and discover pathways for engaging more people who are eager to earn. Some promising pathways have already been found, such as the “e-choupal” model of ITC, the Indian conglomerate. By employing information and communication technologies, along with insights into social structures in India’s rural areas, ITC is developing new channels for the procurement of agricultural products from remote parts of the country and for selling consumer goods there to farmers and their families. (Under this model, ITC provides computers with Internet access to farming villages. *Choupal* means “gathering place” in Hindi, and e-choupals function as both a social nexus and a hub for e-commerce.)

\* \* \*

The knocking on the window is a warning, but it is also an opportunity to grow—an opportunity that companies might not see if they keep looking through traditional management lenses. By changing ingrained concepts of business

management and by developing innovative ways of organizing, companies will discover new pathways to the future, with profits for both the business sector and the poor.

Arun Maira

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# Advantage, Returns, and Growth—in That Order

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*This article is the first in a series of Perspectives on strategy and value creation.*

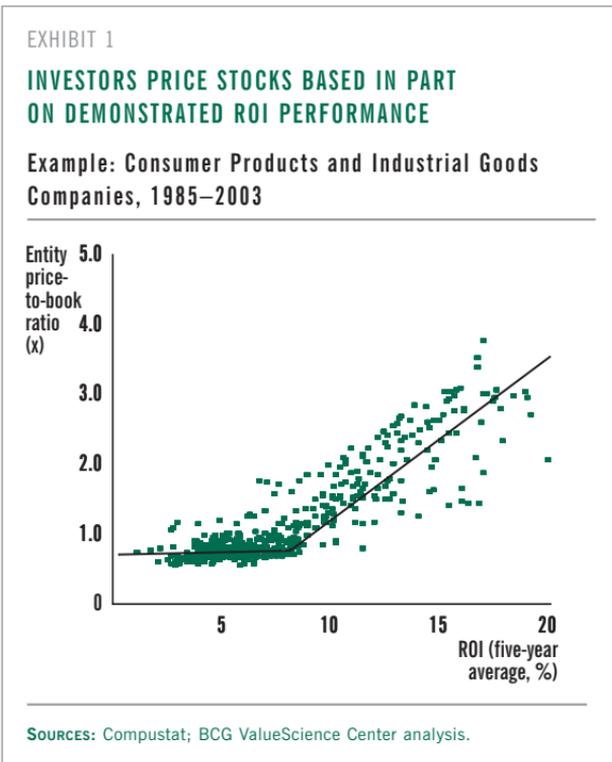
Short-term market pressures make it tempting for managers to play a game of growing volume, beating plan, or exceeding analysts' estimates for the quarter. But sustained value creation requires disciplined portfolio choices that drive performance along three critical dimensions: competitive advantage, returns (on capital), and growth. The sequence is important: without advantage, returns decrease; and without adequate returns, growth destroys value. Although these principles sound deceptively simple, the wishful funding of me-too strategies and chasing after growth in low-return business positions annually extinguish immense amounts of shareholder value.

## **Market Valuations: Providing a Feedback Loop on Performance Priorities**

Exhibit 1, on page 74, compares how investors value businesses with different returns on capital. Each dot shows a particular company's valuation multiple, or entity price-to-book ratio, versus the profitability of the business, measured as the five-year-average after-tax return on gross invested capital (ROI), excluding goodwill. The exhibit indicates an overall positive relationship

between ROI and the valuation multiple. One dollar of cash flow reinvested in a high-return business creates \$1 of new book capital and often \$2 or \$3 of net present value, while the same dollar reinvested in a low-return business will usually be worth less than \$1.

Looking more closely at the left-hand side of the exhibit, we see dots representing 75-cents-on-the-dollar businesses. These businesses earn ROIs of less than 8 percent (roughly at or below the cost of capital), and their valuation multiples cluster between 0.7x and 0.9x. There is a



small but steady upward drift in the valuation multiple as ROI increases from left to right.

These businesses on the left are usually low-margin and asset intensive, with little competitive advantage. And the market values these low-return companies on the basis of assets (not earnings): the flat slope of the trend line suggests that there is a relatively weak link between valuation and current period profits. These companies consistently trade at a discount to book value because the capital reinvested to sustain the assets doesn't earn back the cost of capital. In other words, each \$1 reinvested and on the books is worth only about 75 cents.

As ROI increases above the cost of capital, investors seem to price companies differently. An upward "kink" in the exhibit's trend line indicates that the slope of the relationship between ROI and the valuation multiple becomes much steeper. The story behind this steeper slope is *competitive advantage*: high ROIs reflect competitive advantage, and higher ROIs signal more advantage. Investors, in short, are willing to pay a premium for advantaged assets.

At the same time, however, the goodness of fit seems to decrease for these high-ROI businesses. Turning again to the exhibit, we can see that the vertical scatter in the valuation multiples increases with increasing ROI. Competitive advantage, then, doesn't tell the whole story. A key variable is missing, and that additional variable is growth. High-ROI businesses with more

growth potential are above the trend line, and high-ROI businesses with low growth potential are below the trend line.

### **Portfolio Priorities: Differentiating Goals and Skewing Capital Allocation**

So what does all this mean for managing the corporate portfolio?

First, senior managers must frame decisions about portfolio choices at the business level—not just at the project level. That may sound simple, but many companies destroy value through a bottom-up process of funding all “good” projects as they appear or setting one-size-fits-all performance goals across all units (such as increasing volume growth, market share, or operating income margins). Managers of low-return businesses constantly fund incremental investments whose high (forecast) project-level returns fail to raise the business as a whole to attractive levels.

Portfolio choices do not emerge magically from a mechanical review of historical returns. But the business economics are simple: if you don’t understand and address the underlying competitive realities that are causing sustained low ROIs, you should expect investments in those businesses to continue to return 75 cents on the reinvested dollar. Often, these value-destroying investments are funded or subsidized with cash flows from higher-ROI sister units. Such cross-subsidies destroy value and are a common cause

of the so-called conglomerate discount. Despite the name, such a discount can plague any company that averages reinvestment across a mix of high- and low-return business positions. Even focused companies, such as single-format restaurant chains or retailers, can earn a conglomerate discount by deploying cash flow from their high-ROI legacy locations to fund the opening of marginal new locations.

Second, senior managers need to segment the portfolio and adopt business-specific goals across competing performance priorities. Each company—each dot in the exhibit—is in fact an aggregation of underlying business positions with different competitive positions and business economics. A one-size-fits-all goal-setting approach treats businesses with different starting positions as if they had the same value-creation priorities. But they don't. In framing the relative merits of investing for growth, focusing on raising returns, or decapitalizing the business, managers need to start with a fact-based review of the long-term return patterns in the peer group of each business unit.

- Are long-term industry returns attractive overall? In other words, are ROIs above the cost of capital?
- Which companies earn high returns and what is their source of competitive advantage? Does that advantage show up in relative cost, relative price (and mix), or relative asset intensity?

- How do your businesses and business subsegments perform relative to industry leaders in terms of ROI level and consistency?

By segmenting the portfolio in this way, you will usually uncover three groups of businesses: those with low returns, those with high returns, and those with erratic returns.

For businesses with sustained low returns and therefore little competitive advantage, you must probe to discover root causes and think as an owner would. “Value” investors who specialize in making money from low-return assets focus their efforts on the restructuring (not growth) implications of low returns:

- If there is a structural problem with the industry—for example, depressed returns for all participants—can you consolidate (either as a seller or as a buyer) to improve industry returns?
- If the strategy is misguided, can you identify the segments and activities that would provide customer value and profits? And can you refocus your efforts, and shrink or exit the remaining segments and activities?
- If the issue is one of bad execution, how quickly can you prioritize the problem areas and close the gaps?
- In all cases, how does the return from selling the business compare with the value, risk, and achievability of the “keep and fix” program?

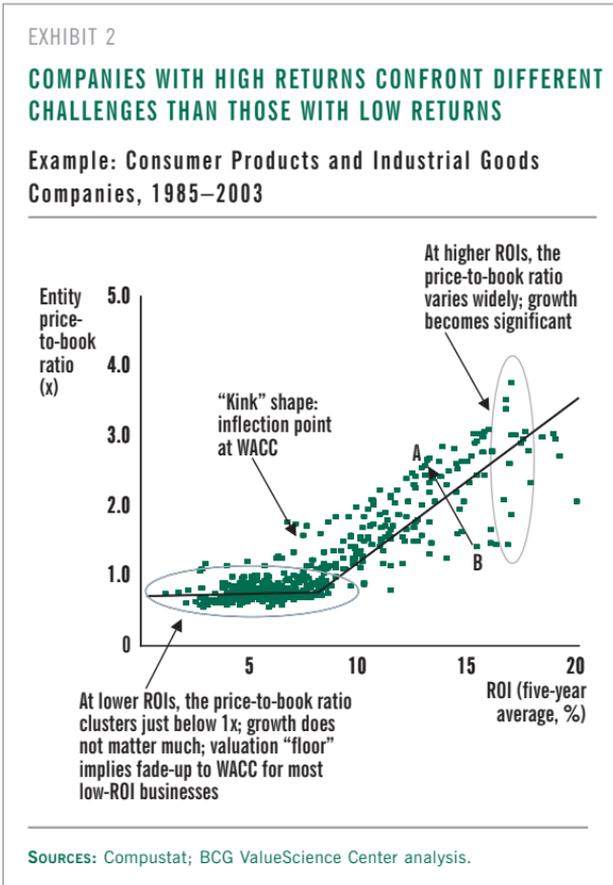
For businesses with sustained high returns, and therefore meaningful competitive advantage, growth is the obvious priority. Paradoxically, the portfolio management choices can become substantially trickier when you begin from such a strong position:

- An easy choice, if you are lucky enough to be presented with it, is to fund a high-return business facing growth opportunities that reinforce the core business and preserve or raise relative market share.
- A more common—and difficult—challenge is to assess growth investments in a high-return business with few close-in growth opportunities (those to the right and below the trend line in Exhibit 2, on page 80). Growing successful but mature positions often entails taking a leap to new business models or constructing a bridge to “adjacent” markets, where the company’s current capabilities and drivers of advantage often apply weakly or not at all. But if the economic linkages between adjacent markets and the core are real, such incremental investment can create significant new businesses, raise the sustainable growth rate, and trigger a positive rerating. (See B→A in the exhibit.)
- In either case, growing through acquisition can be rewarding but requires the discipline to pay a reasonable price and capture substantial net synergies after the acquisition. You will

pay market value (plus a control premium) for the assets, resetting the ROI equation.

Finally, for businesses with erratic (not just cyclical) returns, one of two things is likely going on:

- There may be a temporary industry instability, usually related to competitive or technological dislocation. In these cases, it's especially use-



ful to think creatively about the future—who is likely to win and why.

- The sources of competitive advantage (and returns) may be inherently fleeting or unstable. These businesses are usually not very good candidates as significant portfolio positions for publicly owned companies.

\* \* \*

Portfolio strategy can be a huge lever in driving sustained shareholder value. But managers need to pull up from a purely executional focus and skew their goal setting and capital bets aggressively, finding and funding strategies with competitive advantage and high returns, and fixing or disinvesting disadvantaged businesses. Growth without advantage buys size but creates no value. And beating plan and making the quarter are not enough.

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## The Hotel Clerk

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What a piece of work is a man! How noble in reason! How infinite in faculty! In form and moving how express and admirable!

—from William Shakespeare, *Hamlet*

“She was the problem, the clerk. Despite all the training, despite all the incentives, she refused to sell all the rooms, even though there was plenty of demand. Why didn’t she understand our strategy?”

If you are searching for a New Year’s resolution, promise yourself that you will never say, “Our people failed to change.” It is much better and more honest to say, “They didn’t change, because we failed to create an organization in which the new behavior would be individually useful to people.”

The failure of many transformation efforts is caused not so much by people’s resistance to change or by the details of “implementation” as by a deficient understanding of the interplay between organization and behavior. Consider these widely held beliefs:

- More rules always improve control, but at the expense of individual freedom
- Improving interpersonal relationships always promotes greater cooperation and enhanced performance

- Behaviors can be measured, and ought to be, to make change happen
- Designing the proper incentives and improving task-related skills will lead to proper behavior

The first interesting feature of these statements is their centrality in change management. Their second, even more interesting, feature is that they are all wrong. To change behavior, you must start with two principles.

### **Principle 1: People Act Rationally**

Behaviors are the solutions people find to deal with their problems, given their resources and constraints. Treat with suspicion any explanations alluding to people's irrationality or to their "mentality." These are tautological explanations at best. What is necessary is to understand the problems (operational challenges, personal goals or aspirations), resources (skills, power, interpersonal network), and constraints (dependence on others, rules to abide by) from the employee's perspective.

Some of these elements don't work in a linear way. Take rules. Beyond a certain threshold, adding rules actually decreases rather than increases control over the people to whom they apply. Consider how people in some professions go on strike: they work strictly by the rules, which causes everything to stop. The more rules within a system, the more the sys-

tem depends on the willingness of its members to find the spirit beyond the letter. Efforts to ensure performance through complete sets of rules are always disappointing. Not because they constrain employees' freedom but because they create "freedom" in a system designed to avoid it—in a system thus unable to transform it into goodwill.

Another example of nonlinearity is the effect of interpersonal feelings on cooperation. To be sure, bad feelings create conflicts and deter cooperation. But beyond a certain threshold of good interpersonal feelings, you don't have cooperation, either. Cooperation between individuals with distinct responsibilities always requires them to find a compromise—to put the cursor somewhere between what is ideal for either. A group of people get along all the better when they can avoid dealing with their divergences—and thus not have to negotiate implicitly or explicitly where the cursor will end up. How do they make adjustments, then? Either by making others bear the consequences (the "cost of adjustments" is externalized to third parties, such as colleagues or customers) or by compensating with extra resources that basically remove interdependencies and thus the need to cooperate (think of how comfortable it is to have two TVs in a household).

"Bonding" is far from a panacea. The surface can look good—there are plenty of good feelings

among the staff—but the level of cooperation may be poor. Indeed, cooperation—one of the most valuable behaviors at work—cannot be measured. We can measure the output (combined performance) but not the individual input (who did what). Whenever you cooperate, part of your effort manifests itself only when it is incorporated into the work of others. It is then impossible to fully disentangle each contribution. When it *is* possible, it is because there was no real cooperation, just addition. Metrics meant to measure individual contributions to teamwork only deter cooperation or cause suffering due to unrecognized (nonmeasurable) efforts.

## **Principle 2: An Organization Is a Human System**

An organization is a human system, not the sum of the characteristics and behavior of its members. To understand an organization's situation (such as its rate of innovation or productivity), you need to understand behaviors and the way they combine to produce the situation. You should not jump to conclusions about the behavior and intentions of individuals by observing an organization's results. It doesn't automatically follow, for example, that if a company is weak at customer service, its employees don't care about customers. Nor should you jump to conclusions about an organization's overall results on the basis of what you know about individuals' behaviors or attitudes. In this regard, a group of very committed and loyal employees may exhibit

a high turnover rate. Whenever what people do depends on the behavior of others, interaction dynamics emerge that you need to understand and tackle as such, beyond individual attitudes.

That, in essence, is the first half of the challenge of what academics call “change management.”

Some hotel-chain managers become exasperated when, even after they have provided training and financial incentives to the reception staff, the receptionists don’t sell available rooms to last-minute customers. A frequent explanation is their “mentality” and lack of commitment, which the high turnover rate among young receptionists seems to indicate in many cases. But these managers forget or do not realize that the front desk staff are a lightning rod. Their main goal is to avoid conflicts with unhappy guests. At the same time, they are fully dependent on “back office” functions such as maintenance and housekeeping to determine customer satisfaction. Given this constraint, their main defense when customers complain is to offer them another room. To keep rooms in reserve—a key resource for them—they avoid fully booking the hotel, despite financial incentives based on the occupancy rate. Dependency relationships put obstacles in the way of behaviors that are out of reach of incentives.

Training front desk staff (in “customer dialogue,” as we have observed in some cases) may actually exacerbate the problem when no other

levers are applied to solve it, reducing the hotel's revenue in new ways. Thanks to this training, clerks become more at ease at explaining the division of roles between themselves and the back office to customers who complain, say, about a defective heater in their room. Because these discussions rarely satisfy customers, the desk staff then try to defuse tensions by applying their new skills to negotiating rebates.

In various instances, younger recruits, strongly committed and full of energy but not yet equipped with such skills, compensate for deficient back-office functions by running up and down the halls, looking for an empty room with a working TV remote control to replace the one that is missing from an occupied room. By the time they get back to the front desk, a line of angry patrons has formed, waiting to check in. After three months of such a regime, the new desk clerks often leave, exhausted. The turnover is not a reflection of poor commitment among the young recruits. On the contrary. If the recruits didn't care, they would stay much longer. It is the combined effect of their commitment and the weak cooperation of back office functions that produces the high turnover.

To change organizations, we must first understand their reality—the behaviors and interactions at the most operational level. Such an investigation must go beyond symptoms, which include what people say in interviews or on questionnaires. Reality is not the average of per-

ceptions held about it. A fruitful investigation must also go beyond the surface of structures and procedures—what people are supposed to do. It must uncover what sociological analysis calls the problems, resources, and constraints of behaviors—why people do what they actually do.

### **Bringing Strategy to Life**

The second half of the challenge of change management is creating a system that brings strategy to life—specifically, changing the context that shapes behaviors and interactions. There are many change levers: differentiation or integration of responsibilities, new reporting lines, processes, metrics, incentives, and training, among others. But what levers will produce behaviors that are in line with strategic requirements? That build buy-in? That make improvement permanent? The answer does not depend on the levers themselves; it depends on how they change the problems, resources, and constraints that shape behaviors. Understanding these effects is often the missing link.

Operational effectiveness rose by 20 percent in less than two years after a hotel chain was able to select its change levers on the basis of its knowledge of such effects. It designed new work processes, roles, and career paths that intrinsically, without extra control or pressure, exposed people to the consequences of their actions, good or bad. The feedback loop was built into the work processes themselves to make back office functions cooperate among

themselves and with the front desk. Cooperation always improves, again without added metrics or incentives, when poor cooperation becomes a constraint for those who do not cooperate—when they cannot externalize the consequences of poor cooperation to third parties (the front desk or the customers in that instance). And engagement always improves when better performance becomes a means, or a resource, to attain one’s own goals and aspirations.

\* \* \*

Too often, management has been asked to accept compromises between what is possible (the techno-economic side) and what people are willing to do (the “human” side). You “negotiate a solution” that reaches some middle zone of performance. That is a cop-out. By understanding work force dynamics, you can construct a system to change those dynamics, raise operational effectiveness, *and* improve satisfaction at work.

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