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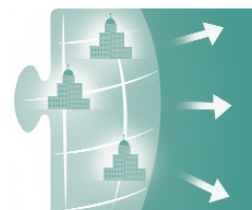


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## Mapping value growth in complex portfolios

*If you have lots of businesses, how do you unlock their latent value?*

By *Richard Balaban, Phyllis Rothschild, and Bill Stevenson*



**R**unning a large, multi-business company has never been harder than it is today. For one thing, investors tend to accord higher multiples to “pure play” firms, in part because they understand what they’re buying. One recent academic study, for example, finds that the shares of highly diversified firms traded, on average, for almost 10 percent less than those of focused firms during the 1980s and early 1990s.<sup>1</sup>

Multi-business firms also must contend with multiple challenges caused by repeated economic, social, and technological changes in their various markets. These changes frequently lead to shifts in who owns the profit zone in an industry, with value moving rapidly away from traditional players. With this kind of pressure applied simultaneously across multiple businesses in a complex portfolio, keeping track of risks and growth opportunities can seem overwhelming.

The problem is compounded by the fact that, over the past decade, the surest route to growth in many industries has been through acquisitions. Merger mania has created new behemoths: More than fifty public companies currently employ more than 100,000 workers; in the mid-1980s, only eighteen did.

Firms bent on consolidation in one industry often pick up new products or services through their acquisitions, as Nortel Networks and Kimberly-Clark have found. As a result, the typical CEO who might have had four or five businesses to manage ten years ago has twenty or more businesses today. Even many firms considered “pure plays” actually sell to multiple customer sets in multiple geographies, with multiple combinations of products and services. Each of these segments can have very different growth dynamics.

The challenge for senior managers running a multi-unit company is twofold:

- Optimizing the businesses you already have and want to keep.
- Identifying and building the best new businesses for the future, sooner than your competitors.

Some firms manage to surmount these problems by finding a jewel in their portfolio and diverting resources toward growing that fledgling business. In the mid-1980s, for example, fiber optics was a tiny portion of Corning’s portfolio. Today, it represents a dominant and growing part of Corning’s business and value. Corning made the right bets to adapt its technology to a new, rapidly expanding market.

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<sup>1</sup> Raghuram Rajan, Henri Servaes, and Luigi Zingales, “The Cost of Diversity: The Diversification Discount and Inefficient Investment,” National Bureau of Economic Research Working Paper No. 6368, 1998.

Similarly, in 1992, Nokia was a conglomerate producing everything from steel cable to diapers. The newly installed CEO, Jorma Ollila, bet the company on one of its smaller products, cell phones, launching Nokia on a period of unprecedented growth.

But not every company can find one business that grows so fast as to outweigh all the other missteps in the portfolio. And it's often difficult to sort out the right mix of business improvement and business reinvention. The complexity of the strategist's dilemma can be sensed by imagining the thoughts of a newly installed CEO at a large technology-based company.

"The company I'm running is really dozens of companies. We make packaging materials, electrical components, adhesive tape, auto parts, specialty chemicals, machine tools, and calibrating equipment. We sell to OEMs, corporate clients, wholesalers, and consumer retailers. We earn profits based on product offerings, distribution channels, financing plans, value-added services, and information management.

I'm getting business plans from my unit managers with customer segmentation, competitive intelligence, and investment proposals that all pay out. But I don't know which to back. And I don't know whether there's a whole set of other options that haven't been put on the table. How do I make sense of it all?"

In such firms, executives setting strategy and allocating finite resources are often overwhelmed by inconsistent information from the business units. The only common tools across units may be backward-looking financial metrics, which offer little help in choosing among hundreds of investment options presented in business reviews.

Moreover, when management cannot clearly articulate the strategy of how the pieces fit together, it's no wonder that investors find large companies opaque. Analysts can understand the risks in the historic drivers of profit far more easily than they can identify the future sources of growth. As a result, shareholder value growth tends to be low relative to more focused firms. For a large, complex company, investors need a clear understanding of the competitive position and a well-defined vision of the next moves.

So how can a CEO lead the organization to consistent growth performance across a diverse portfolio? How can a firm turn its participation in multiple markets with multiple business designs into a source of advantage? Senior managers in this situation must be able to answer several hard questions:

- Where is the true value of the current portfolio, and where will it be three and five years out?
- What are the real risks to that value?
- What are the threats in each unit's economic neighborhood, both from close competitors and from firms on the periphery of the radar screen?
- Who are the portfolio's leading customers and how are their priorities shifting?
- Which businesses need to be redesigned to maintain or create growth?
- What new opportunities, or "white spaces," are available, and which deserve the firm's backing?
- How is the firm taking advantage of the broad range of products and customers in its portfolio?

Answering those questions, and then putting the information to good use, requires an innovative yet disciplined approach to corporate portfolio strategy. The senior management team must systematically drive value growth through a wide range of diverse operations, recognizing the broad-scale opportunities and risks without losing sight of the crucial differences among businesses. This emerging discipline for driving portfolio growth departs from traditional portfolio thinking.

### Flaws in the traditional tools

The traditional approach to portfolio management has typically emphasized a role for the corporate center in active *financial management* or in driving *operational excellence* through corporate-run processes.

At the extreme, financial management assumes the role of a holding company, involving a highly decentralized, non-interventionist style of management. The CEO and the senior management team take on the role of investors, buying and selling businesses based on their financial attractiveness using traditional investment ratios and metrics: ROI, revenue and margin growth, and so on. The operational excellence approach, by contrast, emphasizes improving divisional profit margins through quality programs, centralized services, reduction in overhead costs, and unified controls over budgeting, cash flow, and capital management.

Both approaches offer benefits, to be sure. Instituting across-the-board financial controls is often a necessary step, one that may yield a harvest of low-hanging fruit in the form of enhanced efficiencies, process simplification, and staff reductions. Margins are likely to improve.

However, our experience indicates that financial information typically provides a weak platform from which to map growth opportunities. Corporations developed on this basis tend to build a portfolio of high-share, high-volume growth businesses that are unrelated to one another. The result is a collection of business unit “silos” that do little to share their combined reach and customer knowledge. The basic leadership message is, “Give me 15 percent growth. I don’t care how you do it.”

The operational excellence model, for its part, can achieve incremental gains. But once those improvements are exhausted, this approach fails to provide a platform for future growth.

Both of these approaches, moreover, tend to be backward-looking, focusing on past financial performance rather than present and future customer and marketplace dynamics. They tend to direct your thinking inward, on what you do best, on the products you make, on reducing your costs, or building synergies across the businesses you already have. This inside-out perspective is ill-suited to help identify changing patterns of strategic risk, such as when business models are in danger of becoming obsolete. They also fail to identify the white spaces of opportunity. And by restricting the discussion to financial performance, they leave the CEO and senior management team without a vocabulary to articulate the common themes that unite the company’s many operations, making it very difficult to formulate and communicate a forward-looking strategic message about adaptation and growth.

To effectively manage strategic risk and define growth opportunities in rapidly changing markets, today’s executives need a more powerful, indeed strategic approach, with tools capable of sensing new shifts in the competitive landscape and anticipating where the next profit zones will be.

## Becoming business design architects

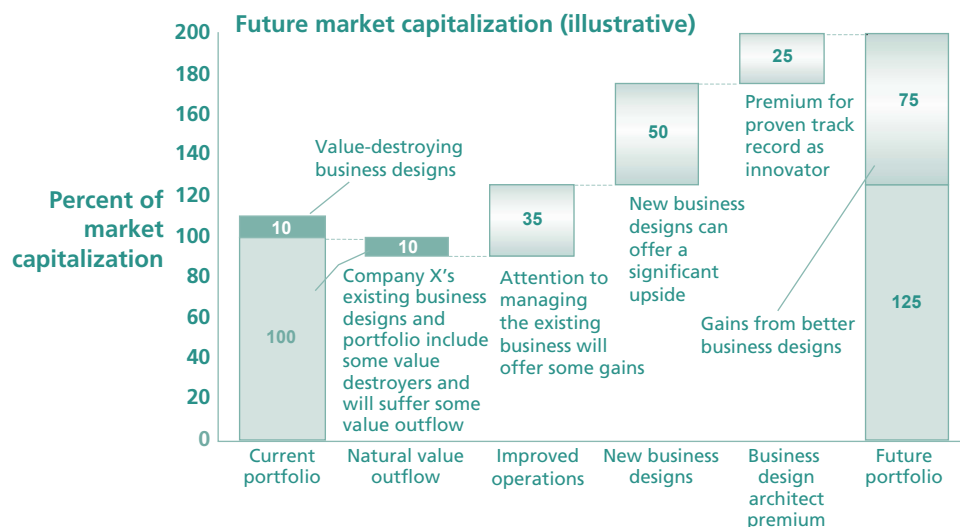
A far more effective approach is for the CEO and the strategic team to become business design architects. In this role, the team focuses on understanding the evolving priorities of its best customers, both current and potential, and the new business designs that promise to capture the profit zones in each of the firm's markets. By anticipating changes in the landscape, minimizing the risks and taking maximum advantage of the opportunities, the business design architect is in a better position than competitors to seize and hold the high ground.

By business design, we mean the discipline of making choices along several closely interrelated strategic dimensions: customer selection, the unique value propositions for those customers, the profit model, the scope of activities, the points of strategic control over profit streams, and the organizational architecture required. Great companies are characterized by insightful, mutually reinforcing responses in all six areas.

Companies managed by business design architects, who continuously enhance and evolve their business designs, have outperformed those that have employed traditional financial management tools. Williams Companies, for example, has moved from a focus on natural gas transmission to building new business designs in broadband using the firm's primary point of strategic control, rights-of-way through populated areas. LVMH moved from building a portfolio of luxury brands to going downstream into distribution channels as a way to better control the customer interface.

The stunning achievements of General Electric become more accessible when viewed through the lens of business design. At first glance, GE seems like a loosely connected collection of businesses ranging from aircraft engines, plastics, and appliances to finance, dynamos, and broadcasting. Many of GE's units, however, share a common "customer solution" business design. Over the past fifteen years, they have steadily broadened their value propositions from simply selling a product to financing the sale, providing maintenance and other downstream support services, and even guaranteeing equipment operations and uptime. GE is now rapidly moving to a set of new e-commerce offerings built around the customer's activity chain in using a product.

**Exhibit 1** **Becoming a business design architect**  
Driving growth typically requires new business designs, not just improving current designs.



In each case, investors have endorsed the focus on business design as a firmer platform for growth than traditional portfolio approaches.

Business design architecture thus provides the critical structure for profitable growth of the portfolio (Exhibit 1). Looking at a complex portfolio of companies in terms of business design helps produce a perspective that faces outward, connecting with customers and markets. It looks ahead toward how the individual business units are likely to evolve, how risks can be managed, and how opportunities can be seized.

### Getting started: Portfolio Value Mapping

In our work with major corporations, the starting point to identify a company's current business designs and their future potential is a process called Portfolio Value Mapping. It uses four analytical lenses:

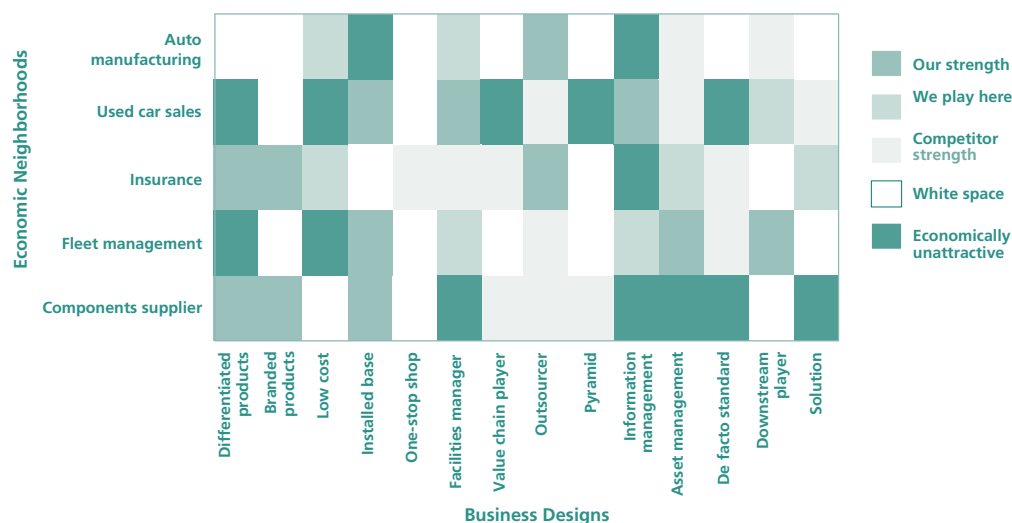
- *Financial.* Where is the profitability and value within our current portfolio? Is the portfolio worth more than the sum of its parts? What is the financial performance gap between what the markets expect and what we can deliver in terms of value growth?
- *Customer.* Who are our customers now and which ones will shape our future? How will digital technologies and other market shifts change who our customers might be, what their priorities are, and how we will reach them?
- *Economic neighborhood.* Broader than a market, an economic neighborhood is an array of markets that are related in the mind of the customer. In many industries today, the sale of a product accounts for a small portion of overall revenues. Providing services to customers is where the real money is. For example, the automotive economic neighborhood includes not only the new-car dealership market but also those for used cars, auto insurance, repairs, parts, financing, and warranties.

Managers analyzing their own company need to ask: How many economic neighborhoods do we participate in? Where do we play with strong positions, good customer relationships, and a relevant brand? What are the emerging spaces that we should be building in? What patterns are reshaping the neighborhoods, and which competitors should we monitor? And how does the Internet shift neighborhood boundaries?

- *Business design.* How many do we actually have? Can we cluster them by common profit models or around the five broad categories of strategic control points—assets, products, customers, reach, and knowledge? (See sidebar on page 9, “Securing strategic control.”) Which of the business designs at risk of being made obsolete by shifting value growth opportunities or by competitors' moves are in fundamentally attractive economic neighborhoods? And which represent opportunities to replicate across other neighborhoods?

The primary output of the process is a portfolio map, a single view of the company across customer needs, economic neighborhoods, and sources of strategic control. One dimension of the map tracks the economic neighborhoods in which the enterprise plays; the other dimension tracks the business designs that the firm employs (Exhibit 2).

## Exhibit 2 Restating the current business (illustrative auto industry example)



The map often reveals unexpected and enlightening patterns. For example, most large companies play in either a few economic neighborhoods served through many business designs, or in many neighborhoods and relatively few business designs. One CEO, after working through the process of developing a Portfolio Map for his diversified manufacturing company, commented:

“Now I understand what I am dealing with. Several of our businesses are based on the ‘innovation’ design, where we live and die by inventing new products. These businesses will be profitable to the extent that we support smart R&D and develop products that meet real customer needs and get them to market more quickly than our competitors. Other businesses we own use the ‘service’ design. The value-capture mechanism in these is our ability to keep customer processes running efficiently and with minimal interruption around the clock. But three of our businesses are built on the ‘brand’ design, where we are selling technology products into the general consumer marketplace in competition with companies like Sony. In that game, it’s necessary to spend tens of millions of dollars on advertising just to build and maintain mindshare. Frankly, as an engineering company, we aren’t comfortable with that kind of marketing spending, and we have no real idea how to do it right. That’s where the big downside risk is lurking in our portfolio.”

The portfolio value mapping process yields several specific and useful insights:

- *Business designs tend to repeat across your portfolio.* So making one set of moves has the potential to trigger growth or performance improvement across large sections of your company, not just in one place—if your organization can channel the learning.
- *The evolution of business designs tends to be predictable,* because patterns emerge that have already played out in other sectors, just not yet in yours. Divisions or units with common business designs tend to share the same risks and opportunities in their respective marketplaces. You can build “playbooks” and plan out your next moves with a higher chance of success.
- *Most portfolios tend to be relatively concentrated in business design terms,* with five or six designs usually accounting for up to 80 percent of a portfolio. You are no longer running twenty or fifty units, but five or ten business designs. The job just got easier because the vantage point got higher.

## Securing strategic control

Portfolios can be categorized by sources of strategic control. There are five broad categories:

- **Assets** you control: oil rights, mineral deposits, patents, or positions where you've got the right stuff in the right place (fiber near the mill, or gas near the market).
- **Products** with better performance or lower cost: a unique performance chemical or true low-cost manufacturing process for a standard product.
- **Customers** with whom you have a proprietary relationship: access, loyalty, or identification, such as the position American Express enjoys in credit cards.
- **Reach**, or the ability to be wherever your customers require you to be. VISA's universal credit card acceptance and UPS's package delivery are prime examples. The scalability of many Internet businesses also serve as potential sources of strategic control.

- **Knowledge** you can leverage or deploy to make money in new ways.

Few business designs will be based around just one sort of strategic control. Most will have a combination of several sources of control, for example, a competitive but not lowest-cost product targeted at specific customers with a known and well understood set of specific needs. But all designs will have a center of gravity that makes understanding where the leverage is, and where the future options lie, easier to grasp and control.

There is no hierarchy among these categories. The pressure for change and renewal to serve evolving customer needs is constant and unavoidable, so it is not uncommon to find that a business design moves from emphasizing one source of control to another. ❖

- *Some business designs are clearly more valuable than others.* This fact causes the perspective on opportunity to shift away from volume and revenue and toward value. Growing a big business is not always, or even usually, more valuable than growing an emerging business design. The perspective on risk changes as well. Testing new business designs is relatively low-risk, while not testing a new idea becomes high-risk.
- *White spaces and growth opportunities are abundant.* What's uncommon is the ability to think systematically about how to find them. If you are prepared to evolve your business designs, adapt someone else's to your neighborhood, or take your designs into a new neighborhood, then there are lots of games to play.

Portfolio value mapping thus helps senior managers identify the most fruitful businesses to be in. It can guide development of a sound differential investment policy for various businesses, transcending the traditional "peanut butter" approach in which money is spread equally throughout all parts of a portfolio, or the "pick the winner" approach, which rarely is able to find a true winner. It also helps managers identify specific strategic choices for each business unit. By recognizing the business design patterns at work in a portfolio, managers are able to manage complexity with far more assurance.

## Next step: the Business Design Playbook

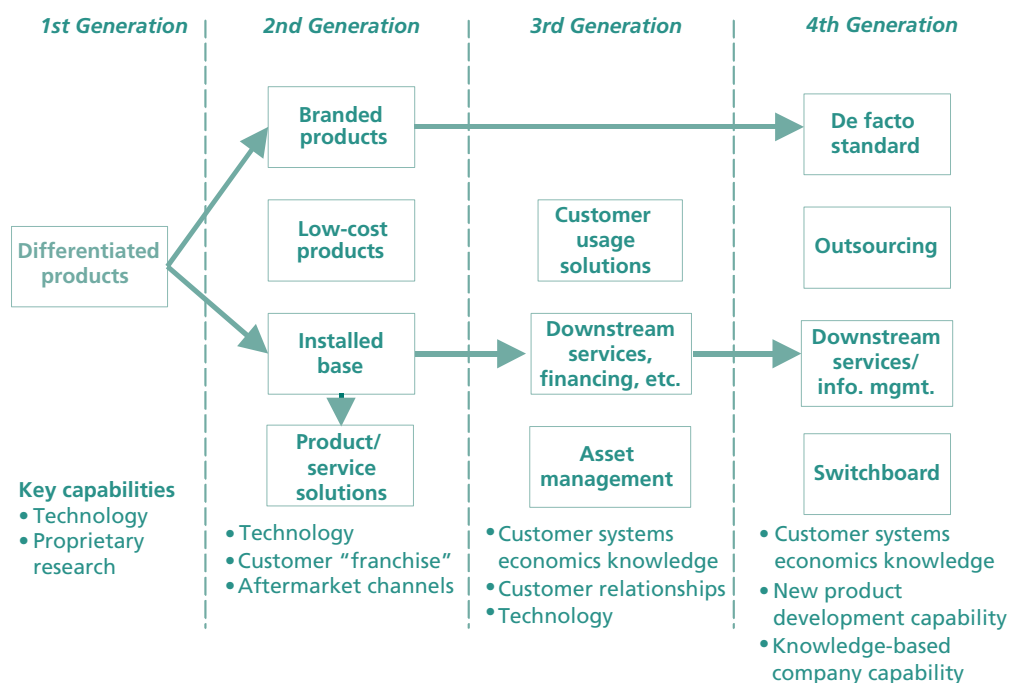
Once the portfolio value map is drawn, managers will be able to develop their own business design playbook—a guide to where the businesses are and where they should go next. Like the playbook used by the coach of an American football team, this playbook incorporates the experience and wisdom of dozens of other managers as to what works, when, and why.

The power of a playbook derives from the fact that many businesses go through a similar evolution of business designs, as customer needs and the competitive environment change. Just as particular ecosystems (say, pine forests) tend to evolve in predictable ways over time, so business environments and the companies that compete within them tend to shift in predictable directions.

Thus, differentiated product businesses often become installed base businesses or branded businesses—Gillette razors and blades, for example. In the next phase, installed base businesses often evolve into financing and asset management businesses, as in many of GE’s industrial businesses. Similarly, the source of strategic control in an industry tends to evolve from the product to the distribution channels to the customer relationship to leveraging knowledge about customers, as at UPM-Kymmene, where this evolution has created a stronger, better performing, more valuable paper company. Many firms with strong product manufacturing capabilities have found new revenues and profits in downstream service markets such as financing, technical support, or even distribution, as the Swedish-based Atlas-Copco has done in air compressors (Exhibit 3).

A company’s unique playbook represents the cumulative learning of the entire organization about how business models in its economic neighborhoods are evolving. It allows the firm to develop its capabilities around business design architecture and identify moves in each successive generation. Updated regularly and used intelligently, it can enable you to anticipate the next moves by your competitors and act first to outflank them. And investors are keeping score.

Exhibit 3 Business Design “Playbook” (illustrative)



## Creating organizational capability

Portfolio value mapping allows CEOs and senior managers to organize and prioritize “too many” growth opportunities. It helps them lead the organization to sustained value growth in the face of an increasingly complex environment. For senior managers in Japan who are at the helm of a *keiretsu*, or in China or Latin America running a group of “family companies,” this approach can help define a path forward into global capital markets. And it creates a measurement and control system that improves the tools available to the finance function and senior management team for getting early warning signals on profitability issues and more effectively directing resources toward high-profit opportunities.

This approach thus serves as a strategic shortcut to identify and manage the real strategic risks and the emerging opportunities in the portfolio. But effectively using portfolio value mapping and a business design playbook depends on disseminating the approach and the tools throughout much of the organization (see sidebar on page 14, “The Strategic Enterprise”). Senior managers must make sure that the staff have the means to support a value growth process. They need to provide:

- *A common language* for defining and describing businesses in many different markets, revealing their underlying similarities and making it easier to share insights and ideas across a range of economic neighborhoods.
- *Meaningful metrics and incentives* for divisions and companies based on their current business design status, rather than applying uniform or arbitrary rules of limited relevance.
- *A clear brand image* for the corporation based on shared business design strategies, transcending the usual sense of a diversified enterprise as a hodge-podge of businesses with little common direction. This enables the senior team to send a clear message to investors, customers, and employees.
- *Institutionalized learnings* across businesses and their leaders, enabling continuous, systemic growth.

At the division level, managers can use this approach to reinvent current business designs or create new ones. At the front line, the process should help sharpen the message about what is being emphasized in the portfolio. That supports day-to-day decision making, and streamlines the process of winnowing business-level investments.

However, acting on the opportunities identified with these portfolio tools will inevitably require new skill sets and new capabilities to support the new business designs. Buying these capabilities through acquisitions, and setting them out as defined targets for the firm’s talent strategy, may be key initiatives for determining the firm’s future success.

Great moves look simple when executed well. But a global company is a complex team. A CEO can lead the team in developing a common understanding of the current business designs, and create an active dialogue around the forward-looking playbook. This increases the likelihood of choosing the right play and executing it well. While any team’s success will always depend on the initiative of the individual players, these tools create an opportunity to lead the team to sustainable success in shareholder value growth. ❖

## Portfolio redesign at Royal Dutch/Shell



**Roxanne Decyk**

Headquartered in the Netherlands and the United Kingdom, Royal Dutch/Shell reported adjusted net income of \$13.1 billion in 2000 on revenues of \$191.5 billion. **Roxanne Decyk**, the firm's vice president for corporate strategy, spoke recently with Mercer about the evolution of portfolio thinking at Royal Dutch/Shell.

**Q. What was Shell's traditional approach to portfolio strategy, and how have you been changing it?**

A. We look at our portfolio in terms of the global business descriptions that had been adopted over the past five years or so—our upstream business, our downstream business, our chemicals business, our renewables business, and so on. It's a classic industry structure, which we still use, in part because this is how the analyst community thinks about it. Analysts can compare our performance in each segment against competitors.

But for internal purposes, around 1998 we became concerned that this traditional view was preventing us from seeing common problems that would cut across those businesses. There might be issues common to a class of customer that exist in all the businesses, or around organizational capabilities across those businesses. In a classically defined portfolio, we wouldn't see them as common issues.

Another concern was that because the traditional portfolio approach starts with the assets we own, our expectations about the future were grounded in how those assets had performed in the past. Yet the evidence shows that future performance for asset-based companies is highly unpredictable. Many companies have faced significant discontinuities because a projection of historical perfor-

mance of assets or products was completely disrupted by changes in customer expectation, or other environmental factors, that couldn't even be isolated or identified based on the way portfolios were defined and performance was tracked. The concept of starting with the customer and working back, as opposed to working forward from assets, was intuitively appealing.

**Q. How does this play out in one line of business?**

A. Chemicals is a good example. There had been a steady effort over part of the decade to improve results by doing a lot of aggressive portfolio management, especially to get rid of underperforming units. When we began to identify what might be the portfolio of business designs in the chemicals business, as opposed to the portfolio of products, it became clear that the strategies adopted to improve performance were necessary but not sufficient to give us strategic advantage in the long run.

In some cases, we honed in on the "collapse of the middle" problem, where at the low end value is based on price, at the high end on delivering solutions, and sometimes Shell was in the middle, which is untenable. Understanding the implications of those business designs, and some of the threats, caused our managers to consider different actions to improve our position.

**Q. What other insights does the business design perspective provide?**

A. In our portfolio, not surprisingly, we have many more asset-based business designs than knowledge-based business designs. Now we're better able to understand which of the asset-based designs have real promise to evolve. We can think about creating value out of the set of skills, capabilities, and technologies around that asset-based business, and build a knowledge game on top of it.

**Q. Is a knowledge-based business design potentially more valuable than an asset-based business design, or just a different way to create value?**

A. It depends. We do have very high value asset-based business designs, which will be part of our portfolio for a long time. But knowledge-based business designs tend to be attractive in two ways.

First, capital discipline is important to Shell, so we need to find ways to grow value outside of capital-intensive areas. In the oil industry, we know

the good years are always followed by bad years, and the oil price goes up and down. During the down years, capital is scarce. But investors increasingly expect great companies to grow value on a consistent basis that isn't completely tied to oil price. As a result, we're now forming competencies around the question, "How can we add a layer of value that doesn't require proportional capital?"

The second appealing characteristic of businesses based on knowledge is that they might have different growth rates than the underlying businesses. Energy industry growth rates are largely tied to projections on energy demand, which are for the most part low single-digit projections. We want to find maximum value from the value chains in which we currently operate.

**Q. Does the business design approach change how you think about competition? Do you see new companies coming onto your radar screen?**

A. In some cases, we're looking at acknowledged competitors and we hypothesize additional explanations for moves they're making. In other cases, we're looking at emerging competitors who came from nowhere, such as the asset-less digital companies that suddenly appeared and were threatening the traditional customer relationship.

**Q. What about investment allocations and new opportunities—how does business design thinking help you define those?**

A. Now that capital discipline is part of how we think about growth, the challenge becomes identifying the incremental or new business designs that can be funded in a way that they aren't eating into the capital budget, which we need for core businesses.

Consider Shell's consumer base. We touch hundreds of millions of people around the world. We've interacted with them through our petrol stations and through motor-related products. How do we enrich and enlarge the relationship we have with this customer base in ways that are less asset-intensive than just building more petrol stations? We have, in some of our regions, introduced additional services to motoring customers that go into different realms of their daily experience.

In Holland, for example, we offer a variety of different services ranging from Internet access to credit cards. These businesses build on the fact that we have a relationship with the customer and that the customer trusts our brand. They aren't businesses that require significant asset investment to grow.

**Q. Internet access doesn't immediately strike me as a logical extension of the Shell brand.**

A. We partnered with a provider to allow Internet access to our customer base and distribution network without featuring the Shell brand itself. But we have found that the Shell brand has a fair amount of permissive space, especially in countries where we have a long history. Much of what we do is partner with firms that have great credibility for a particular product, but don't have our brand.

For example, in Europe, we are offering insurance products in partnership with Axa. We bring the brand and the customer base, and they bring the credibility in their sector. We are approached regularly by a variety of companies (and, of course, we approach others), from financial services companies to content providers. They recognize that the Shell brand and global reach can be extremely valuable for expanding their regional or highly focused offerings. Some of those partnerships will become evident over the coming months as we roll out new products and services, particularly to consumers.

**Q. How far into the organization does this thinking reach?**

A. We have 90,000 employees, and a fraction of them actually know about this—the senior business leaders, the people who support them in creating strategies, and a growing network of people who are in business development positions. We do workshops around business design thinking, but an awful lot of it is more like apprenticeship. Somebody hears about it, and they go to work on a project with somebody who knows about it, and they start picking it up. Then they look for one of our internal workshops to get some more systematic training. ❖

# The strategic enterprise

## A new organizational architecture for complex companies

By David A. Nadler and Mark B. Nadler

As large, multi-unit companies seek ways to create and add value in today's fluid business environment, one thing is clear: The tried-and-true organizational models simply can't get the job done. Senior managers within these firms are wrestling with fundamental questions on the organizational front:

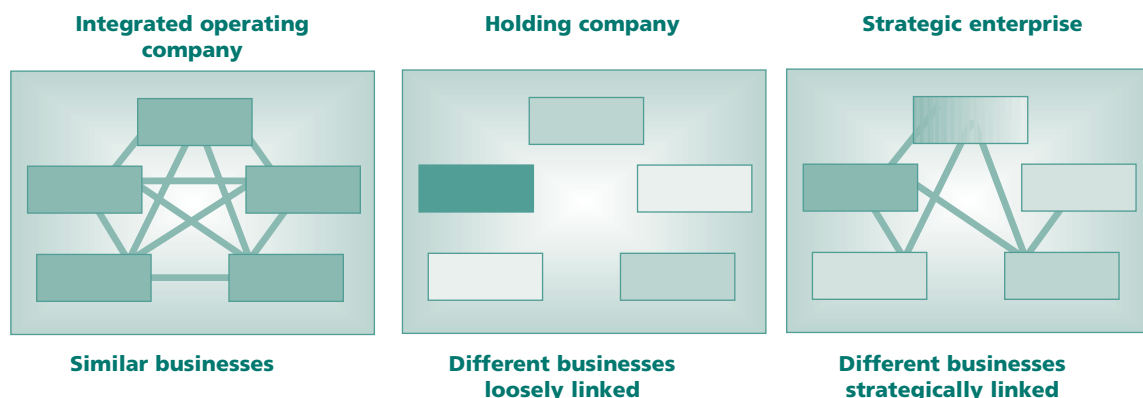
- How do we maintain cohesion and overall direction in a company that embraces a broad spectrum of subcultures, business designs, and organization designs—including some that may be in direct conflict with one another?
- Is it possible, within a single corporate entity, to incubate and integrate radically new technologies, offerings, and distribution channels, including those employing disruptive technologies that could potentially destroy the core offering? Is there an alternative solution to the “innovator's dilemma” that doesn't force companies to risk corporate suicide by spinning off their most promising new businesses and innovations?
- How can we slash the time required for decision-making, strategic shifts, technological innovation, and time to market?
- As the traditional and digital economies converge, is there a way to combine companies from both sides of the divide in ways that will actually create greater value than either would have enjoyed under separate ownership?

The solution to these issues lies in an emerging model of organization we call the strategic enterprise. In contrast with earlier models, such as the integrated operating company and the conglomerate holding company, the strategic enterprise combines strategically aligned businesses employing a wide variety of business designs, linked closely where there are opportunities to create value by leveraging shared capabilities but only loosely where the greater value lies in differentiated focus (Exhibit 1). The strategic enterprise is not in itself an organizational structure, but rather is a powerful conceptual framework that sets the stage for designing a structure in detail.

The strategic enterprise aims to achieve both focus and leverage. It can encompass a variety of business units, each with a different internal value chain or business design, and selectively links those value chains only where it makes sense—or not at all, where there's little value to be gained. The goal is to derive the maximum benefit from leveraging shared resources and capabilities while keeping those links to a minimum in order to maintain focus in a sharply fragmented marketplace.

In broad terms, the value chain offers three ways to achieve leverage: through the front end, the organization's go-to-market capabilities; the back end, the organization's processes for developing technological innovation; or the middle, the organization's infrastructure, management

Exhibit 1 The evolution of organizational architecture



processes, and production capabilities (Exhibit 2). Managers must determine where the added value of leverage would outweigh the potential costs of management overhead and diminished focus. Let's examine each form of leverage:

### Going to market

When properly linked, the front ends of the various businesses within a single enterprise can become a powerful network of distribution channels, customer relationships, and market intelligence.

Leveraging the front end is tricky, however. Thanks in large part to the Internet, companies are employing hybrid distribution channels to meet widely divergent demands for the same core product or service in terms of pricing, options, sales and service support, speed of delivery, and customization. In complex organizations, this variability can provoke intense and debilitating internal conflict.

This conflict is most apparent in consumer businesses employing multiple channels. The leaders of Charles Schwab had to overcome substantial resistance from their own brokers before launching the online discount brokerage, Schwab.com. General Motors and Ford have had only limited success in expanding their distribution channels; both automakers faced resentment from dealers over plans to step up the companies' consumer Web sites and had to guarantee dealers that they will be involved in any Internet selling strategies.

In such cases, companies have to embrace new distribution channels that might divert, or even dry up, the revenue streams of their core businesses. The more farsighted companies are linking

these various channels in ways that encourage customers to use and combine the best features of each—a worthy strategy, but one that requires deft management of internal conflict.

### Designing for innovation

A second source of value creation lies in leveraging the research and innovation capabilities that reside within the various internal value chains. Theoretically, the sizeable research capabilities of large corporations should offer technical, intellectual, and financial economies of scale.

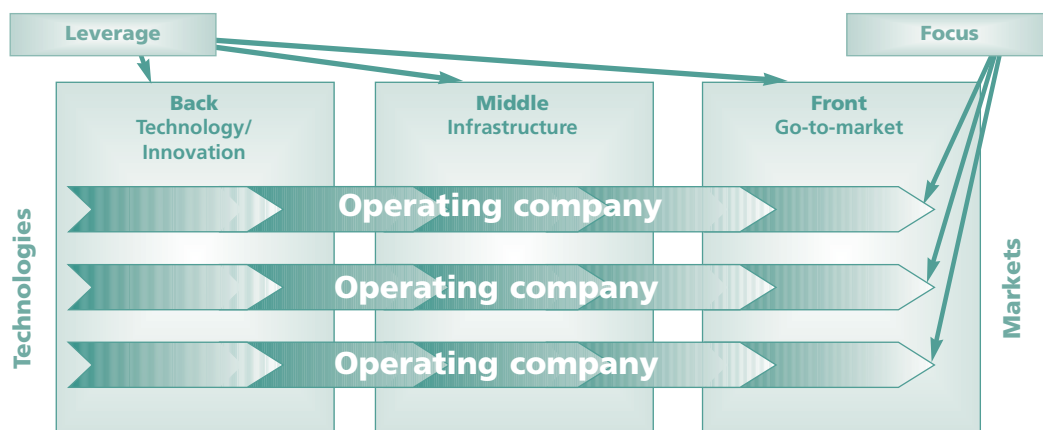
Clearly, spinning a host of products from the same technology isn't a new idea; for years, 3M has been translating basic research on adhesives into products ranging from medical instruments and the ubiquitous "Post-It" pads to reflective strips used on highways and road signs.

At Corning, the technology that was used to develop packaging for pump lasers and photonic devices drew upon the same technology the company had used for years to produce ceramic substrates for automotive catalytic converters.

Yet leveraging innovation is much harder in practice than in theory. Most companies devise a single design for R&D and then replicate it within each unit and at every level of the enterprise. That creates huge problems in complex corporations that have to compete simultaneously in both the present and the future—a critical requirement for players in the digital economy.

Varied strategies and business designs require a range of R&D approaches and behavior. In a mature business, for example, the emphasis is on finding the perfect solution, a priority that lends

Exhibit 2 The strategic enterprise



itself to a highly structured process with strict priorities, deadlines, and resource allocations. Businesses operating in emerging markets, on the other hand, face the dual imperatives of speed and flexibility, which calls for R&D processes that can respond swiftly to unexpected demands and opportunities.

Consequently, the strategic enterprise demands research processes that can maximize the value of pooled innovation while promoting distinctly different “innovation streams,” or processes for turning research into marketable products and services. R&D should not be placed in a straitjacket of uniform patterns throughout the enterprise.

### Designing for process management

In contrast with the conglomerates and holding companies of the past, the strategic enterprise creates value by leveraging shared processes, capabilities, and competencies. At the very least, the enterprise creates economies of scale through common management of businesses that are strategically linked by business design. Beyond that, by developing superior process management skills and applying them, where appropriate, to each of its business units, the enterprise drives performance at each unit to higher levels than any of them could have enjoyed under separate ownership and management.

Consider The Limited Inc., a collection of retail businesses selling products ranging from casual clothing (The Limited, Express, Structure) to intimate wear (Victoria's Secret) to personal care products (Bath & Body Works). The Limited engineered a significant turnaround in the late 1990s by creating an activist corporate center. On one hand, the company sought efficiencies by leveraging its businesses' shared capabilities in areas such as logistics, real estate management, and information technology. The Limited went beyond that, however, centralizing certain value-creating functions, such as product design, that were crucial to its strategy for growing the brands.

Leaders intent on leveraging the middle should start by selecting the appropriate role for their corporate center. The next step is to identify those activities and processes that hold the greatest potential for leverage. At that point, the critical design concept is “asymmetric application.” In other words, the corporate center might play a dominant role in managing certain functions or processes at some business units but not at others.

The enterprise's traditional business units likely should be operated with an eye toward maximizing assets to provide predictable growth while avoiding major risk. On the other hand, the start-up businesses involve minimal assets, big bets, high risks, and an explicit willingness to walk away from unsuccessful ventures—a business model involving dramatically different budget cycles, staffing requirements, and technology demands.

### Managing the dynamic balance

To build a successful strategic enterprise, senior managers will have to educate their staff about what this looks like, why it's necessary, and how it will affect them.

Staff must understand the concept of asymmetry and why the idea that “everybody should play by the same rules” is a blueprint for disaster.

As quickly as possible, leaders should clarify specific roles and rules of engagement. It's also important at the outset to promote explicit processes for managing conflict, which will appear early and often. Inevitably, there will be intense disputes between businesses employing different distribution channels to reach the same customers; between businesses making competing demands upon the limited research and development resources; and between the conflicting values and priorities of traditional businesses and their start-up partners. Unless senior leaders spell out a process for dealing with conflicts in a swift, constructive way, those conflicts will paralyze the enterprise. Successful leaders, often schooled in building consensus, will have to recognize that their real goal is cohesion, not harmony.

The complex balancing act implicit in the design of the strategic enterprise will place unprecedented demands on leaders at both the enterprise and operating unit levels of the organization. For many individuals, these changes will be difficult, perhaps even impossible, but for complex organizations, they will be essential. ❖

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**As you consider redesigning your portfolio, ask yourself the following questions:**

- How complex is our business portfolio in terms of operating units, economic neighborhoods, and business models?
- Do we have clear performance expectations for our portfolio based on market-based metrics?
- Do we have a clear process for prioritizing investments and divestments?
- Is our portfolio well positioned to take advantage of future growth opportunities?
- Do we understand the main sources of risk and volatility in our portfolio?
- Can senior managers clearly articulate our portfolio strategy to employees, investors, and customers?

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As one of the world's premier corporate strategy firms, Mercer Management Consulting helps leading enterprises achieve sustained shareholder value growth through the development and implementation of innovative business designs. Mercer's proprietary business design techniques, combined with its specialized industry knowledge and global reach, enable companies to anticipate changes in customer priorities and the competitive environment, and then design their businesses to seize opportunities created by those changes. The firm serves clients from 22 offices in the Americas, Europe, and Asia.

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