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Reshaping your company business model

Building for the future during the downturn

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EXECUTIVE SUMMARY

There is widespread recognition that the typical corporate cost-cutting initiatives will not suffice in the current business environment. To navigate the global downturn and even prosper in the process, corporate leaders must take a step back and consider how best to implement long-lasting and effective initiatives aimed at fundamentally improving the way their companies operate. Strategy&'s approach focuses on three strategic questions: What do we do? How do we do it, and where? How well do we do it? Our experience shows that companies too often neglect the relevant issues related to their business model ("How do we do it?"). Focused efforts in this area can result in structural improvements in efficiency and effectiveness.

This Perspective explores the commonly observed issues and derailers surrounding companies' business models in light of important questions they currently face: Have we built into our operation the flexibility and resilience necessary to survive this crisis? Is our business model appropriate for navigating and succeeding in this global downturn?

THE NEW CEO AGENDA

After a period of intense growth across almost all sectors and regions, the global downturn has rapidly shifted CEOs' agendas from strategies for growth to how to improve performance and tighten cost controls. Though the crisis started in the U.S. financial industry, it has quickly spread to virtually all industries and geographies.
All over the world, companies are postponing or canceling investment plans, reviewing their operating targets, reducing and sometimes even temporarily suspending production, announcing job cuts, terminating or reviewing contracts, implementing cost-cutting efforts, selling or thinking about selling assets, and more.

This sudden change poses a new challenge for CEOs, who find they must quickly readjust their mind-sets for a future that looks very different than it did only a few months ago. Current trends in major economic variables suggest that difficult times are ahead, at least in the coming months. Companies are already facing lower demand and are having increasing difficulty in finding capital.

The time has come to clean house. As a rule, when demand is increasing rapidly, as it was in recent years, companies must move fast to stay ahead of their competitors, which often leads to decisions being made and implemented without a thorough analysis of the structural impact on the organizational model. A typical outcome is the addition of people and positions without the benefit of a holistic view of the consequences. When the growth frenzy settles, companies should take a step back and reevaluate the way they work.

"Expanded restructuring actions are required to protect UTC profitability and are expected to position the company for resumed earnings growth in 2010."
— Louis Chenevert, CEO of United Technologies Corp. (March 2009)

In a recession, softening demand generally makes it difficult to deliver results by relying simply on revenue. Profitability is defended by increasing the focus on cost control and operating efficiency. However, while most companies are quick to start cutting costs, we argue that the outcome of most of these efforts—which may be necessary—tends to be marginal and short-lived. Despite the immediate results, cost reductions generally do not structurally change the way the company works, or how its executives think, so those costs eventually come back once the initial focus is lost.

The current economic crisis demands deeper reflection. The effects of this downturn are expected to last for quite some time, so companies should consider long-lasting initiatives, rather than temporary cost-cutting efforts. True transformational cost reduction opportunities need to break ingrained structures and behaviors throughout the company. Moreover, the downturn creates a window of opportunity for companies to rethink and review the way they operate. It is time to seek short-term savings while building the foundations for another growth period in the future. It is dangerous indeed to merely stand in the wings as a passive spectator, as this could create disadvantages vis-à-vis the competition or lead to increasing pressure from shareholders, analysts, or creditors. In other words, it is imperative that companies use the downturn to seize the future with their own hands, before a top-down mandate is imposed.

"As a consequence of the unprecedented crisis affecting the global economy, which also affects the air transportation industry, it has become inevitable for Embraer to implement a revision to its cost structure and workforce."
— Embraer statement announcing a 20% reduction in production and administrative personnel (February 2009)

Strategy&'s approach goes beyond traditional cost-cutting efforts, focusing on a set of three strategic questions *(see Exhibit 1)*.

What do we do? A strategic review of the company's portfolio of products and services, as well as the markets and customers targeted.

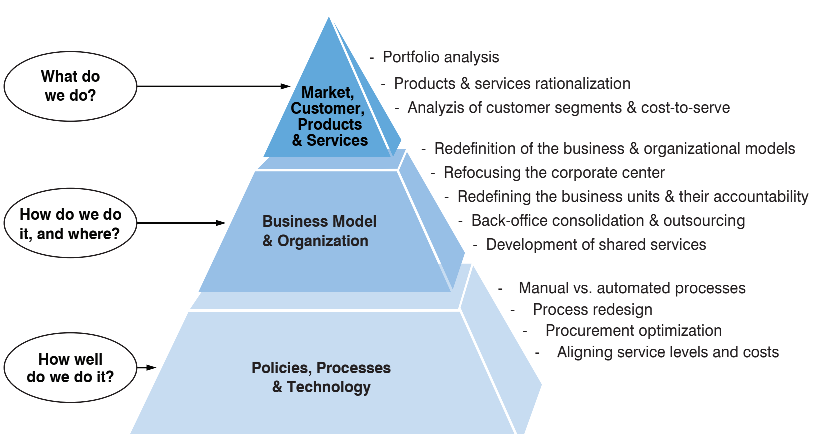
How do we do it, and where? An assessment and rethinking of the company's business and organizational model and in-house versus outsourcing (make or buy) choices.

How well do we do it? Performance assessments, identification of opportunities, and implementation of operational improvement initiatives.

While the first question is addressed in yearly strategic planning processes, and the third has to do with the tactical performance improvement levers mentioned earlier, companies tend to neglect relevant issues related to their business model ("How do we do it?"). Focused efforts in this area can result in structural improvements in efficiency and effectiveness.

The remainder of this Perspective focuses on issues surrounding the company Business Models by describing our view of these issues and commonly observed derailers.

Exhibit 1
Companies' Typical Performance Levers – Key Strategic Questions



Source: Strategy&

BUSINESS MODEL STRUCTURE

The activities performed in a business organization can be split into three blocks, or elements, according to their nature and their role in delivering results. Typically, the Corporate Center performs activities related to strategic leadership, Business Units house functions focused on the product or customer value creation, and Support Services provide internal client-driven services and manage outsourcing relationships *(see Exhibit 2)*.

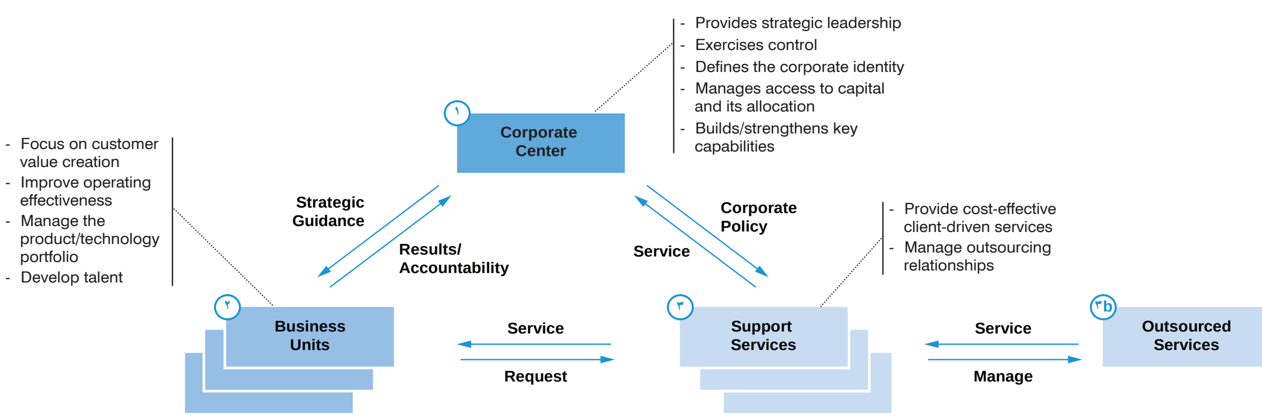
1. Corporate center. The corporate center holds the functions that provide strategic and financial guidance for the company. Its key role is to fulfill five fundamental missions: provide strategic leadership, control and monitor results, develop and promote a corporate identity, gain access to and allocate capital, and ensure that the required capabilities and talent are available.

2. Business units. These areas are responsible for activities directly related to providing services and products to customers and are usually structured into units that are accountable for results.

3. Support services. Support areas are focused on providing cost-effective client-driven functions that support the business units and the corporate center. Establishing an efficient and effective support area requires a clear definition of its operating model. Traditionally, these areas can be centralized at the corporate headquarters or decentralized to provide each business with a significant level of autonomy. In most cases, support areas can be consolidated in a shared services center, a model that defines new relationships between internal clients and service providers.

3b. Outsourced services. Outsourcing services is another relevant theme for companies, especially during downturns, when a reduction in costs is necessary. Outsourcing can be extremely efficient and effective, but it must be carefully planned and executed. Many executives believe that outsourcing is an easy move to cut costs by reducing the activities currently executed in-house, benefiting from the outsourcer's economies of scale and its focus on core functions. A classic mistake is outsourcing to "make the problems go away." But evidence shows that most of the promised benefits are not captured.

Exhibit 2
Business Model Structure



Source: Strategy&

TYPICAL BUSINESS MODEL DERAILERS

We would argue that the main goal for corporate leaders, especially during times of high uncertainty and expected downturn, is to develop a robust business model with flexible and accountable operations, efficient and agile support functions, and a lean corporate center focused on setting the strategic guidelines while controlling the results through an appropriate set of indicators. However, in many companies, the roles and responsibilities of each element of the business model (corporate center, business units, support services, and outsourced services) and the interfaces between them are not clearly defined, which leads to duplicated or misaligned activities, unclear strategic guidance, and ultimately poor performance. We find that many companies face difficulties in their operations that can be directly traced to this lack of clarity. The downturn merely makes these problems more apparent. Improving the business model starts with a precise diagnostic of each element, and follows with targeted quick wins that will produce savings that can then fund the remaining restructuring that needs to take place *(see "Kick-Starting a Business Model Diagnostic")*.

Kick-Starting a Business Model Diagnostic

Strategy& has developed a methodology for reviewing issues related to the business model that allows for a precise diagnostic and enables focused efforts on a company's critical issues. In addition, our methodology entails the identification and implementation of quick wins early in the effort in order to maximize the needed savings and fund the rest of the program.

Although every company has its own realities, a set of key questions helps to kick-start the diagnostic *(see Exhibit A)*.

Exhibit A
Key Questions on Business Model

Corporate Center	- What **roles** should the corporate center play? - Given these roles, what is the best **organizational structure**? - What should be the **decision rights of the corporate center and the business units**?
Business Units	- What is the best way to **organize the business units**? - How can we **align business units with the company's strategy**? - **How should we push accountability** and how can the business units be held accountable?
Support Services	- Which services should be **centralized vs. decentralized**? - How can we ensure that support functions provide the **right level of service** for the business? - **Is shared services the most adequate construct**? If so, **for what functions**? How should shared services be governed? - **Which services should be outsourced**? What are the expected savings/effectiveness gains? - How can we ensure the **appropriate management** of outsourced services and vendor relations?
Overarching Topics	- **How many people do we need** to perform the activities? - **How many and what work levels** should there be in the organization? - What is the adequate **number of layers and spans of control**? - What are the **gaps in skills and qualifications**?

Source: Strategy&

Building a More Effective Corporate Center

Large corporate centers have earned their bad reputations, so it is little wonder that they are often the first target of many corporate restructurings. Years of bureaucratic "Big Brother behavior," glacial decision making, and opaque overhead allocations have not won corporate headquarters many allies among the P&L-bearing business units and newly streamlined support functions. Consequently, in recent years the best practice in sizing the corporate core has been to shrink it and cut its costs.

The irony is that there is no evidence that streamlining the corporate core contributes much incremental value to a company. In fact, our analyses show no correlation between the efficiency of the core (as measured by the size of its staff relative to revenues) and shareholder returns (as measured by stock price growth).

This calls into question the single-minded devotion to cutting costs in the corporate core. If big is not necessarily bad, what constitutes good?

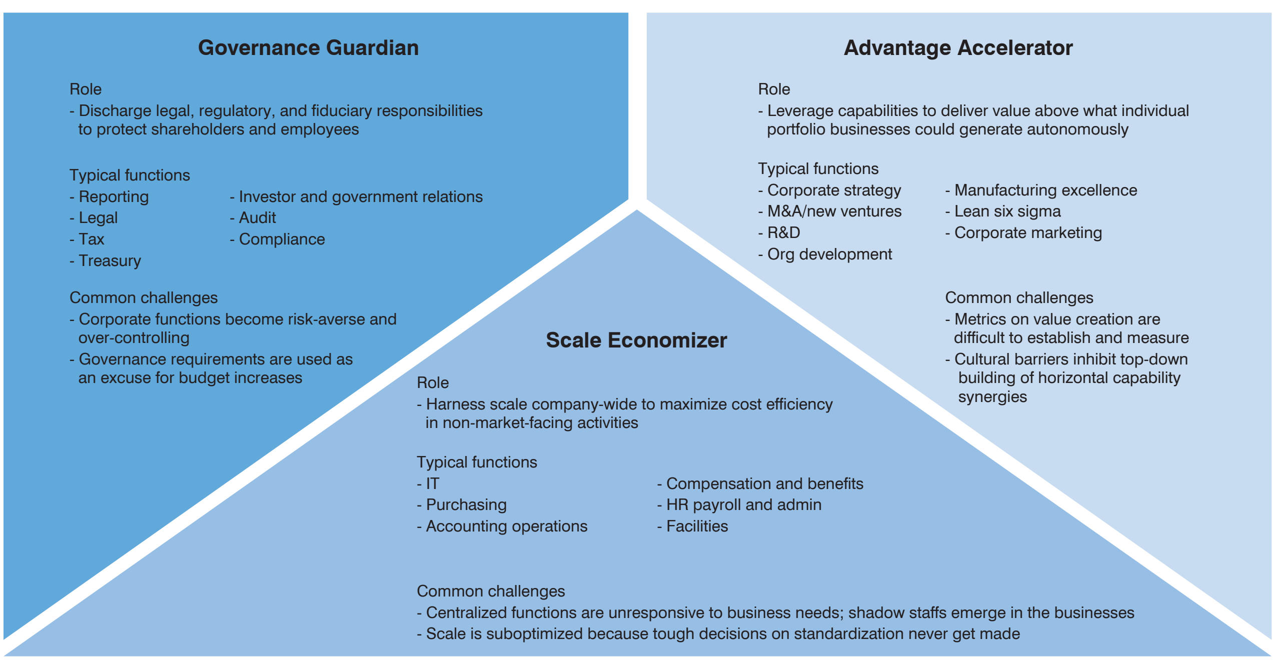
First, companies need to recognize that the optimal size of the corporate center is not simply a function of efficiency, but also one of effectiveness. Corporate centers must strike the right balance. But how do you assess the effectiveness of the corporate core? Over the past few years, Strategy& has collected more than 50,000 individual responses from around the world and created an organizational diagnostic tool that we have posted online. According to our findings, companies with strong execution (those that quickly translate important strategic and operational decisions into action) are significantly more likely to have a corporate staff that supports rather than "audits" the business units.

Unfortunately, most companies are not strong execution companies. Not surprisingly, the corporate staff in companies with weak execution tends to "audit" more than support the business units, resulting in unnecessary bureaucracy, hindering decision making and adding cost.

It's a bit of a chicken-and-egg dilemma. Does the deadweight of the corporate core contribute to a weak performance culture, or does a weak performance culture disable the corporate core? Regardless of the answer, we believe that half the battle is in setting explicitly clear roles and expectations for the corporate core.

Ultimately, the right size of the corporate core is a function of the role the company expects it to play, whether it is (1) governance guardian, (2) advantage accelerator, or (3) scale economizer *(see Exhibit 3)*.

Exhibit 3
Corporate Core Roles



Source: Strategy&

Governance guardian. There is no opting out of this role, which encompasses all the legal, compliance, and finance activities needed to abide by corporate governance standards and regulatory requirements. Although the added value contributed is limited, this role is not a significant drain on resources either, as economies of scale are easily leveraged and head count needs are low. In our experience, a company of about 10,000 employees can comfortably handle governance activities with a staff of about 30.

Advantage accelerator. This is where the corporate core makes the leap from "auditing" the business units to releasing the value trapped within and between them. In the advantage accelerator role, the core can create considerable incremental wealth if it does its job right.

The advantage accelerator concentrates on the sources of competitive advantage identified in a company's strategy, whether they are innovation, leadership development, consumer marketing, manufacturing excellence, or any other critical capabilities. By allocating resources to the development and sharing of these winning capabilities, the corporate core makes explicit choices about where an advantage matters most in a company's market.

Not surprisingly, the advantage accelerator role is the most challenging of the three. To be effective, the corporate core must not only add value to the business units but add more value than the businesses could generate on their own—and more value than any other corporate parent could provide. It must focus on capabilities that are truly differentiating: those where the company must be the best to win and where it has the skills to be the best.

Take a look at the Global Fortune 500 today, and you will see every variation on the advantage accelerator theme. Procter & Gamble and 3M, for example, have invested heavily in corporate R&D and have enjoyed big new-product payoffs as a result. Dow Chemical and General Electric, on the other hand, have focused on building a strong multi-business manufacturing function to encourage manufacturing excellence at the individual business unit level, as well as across businesses. BP has pushed hard to create a high-performance HR culture in its corporate core, which oversees the setting of stretch targets and personal performance contracts.

Scale economizer. Beyond observing minimum fiduciary obligations and cultivating strategic competitive advantages, the corporate core is basically overhead. Think of all the functions that are sensitive to economies of scale, scope, and specialization (IT, purchasing, accounting, facilities, payroll), and you will have a good sense of what overhead encompasses. It cannot be eliminated, but it certainly can be optimized, and that is the third role of the corporate core: the creation of common processes, standards, and consolidated pools of expertise. More often than not, this takes the form of shared-service operations, either housed in corporate headquarters and reporting to a corporate functional head such as the CIO, CFO, or CHRO; established as organizationally distinct centers under a shared-services leader; or outsourced/offshored. The corporate core is still ultimately responsible for optimizing the efficiency and effectiveness of certain back-office or overhead functions, which is its most critical role.

The most common derailer related to the corporate center, therefore, is not size but the lack of a clear definition or dissemination of its role. This, in turn, leads to a number of other symptoms such as inadequate capabilities, excessive number of highly paid executives second-guessing the business unit heads, and lots of questions about value addition.

Moving to Business-Driven Support Services

In working with and talking to more than 50 organizations about their support services in the past decade (and mostly in the last five years), we have observed three predominant models—all of which are in use today *(see Exhibit 4)*. The choice of model combined with excellence in implementation is what drives the large difference in results.

Stage 1: Organizational Consolidation

The objective of many of the early models (and even some recent ones) was to capture scale efficiencies within the organization. However, because the solution selected focused primarily on organizational aggregation, it generally delivered limited sustainable benefits. Usually an executive was appointed to implement the new model, and once the structure was in place, the head began negotiations with business units about the services that would be consolidated and sold back. The focus was on consolidation, rather than fundamentally changing the way services were delivered.

Business managers found this a very alienating process. They had built up significant autonomy over the years, which was now about to be taken away in return for "centralization." They were being asked to relinquish control.

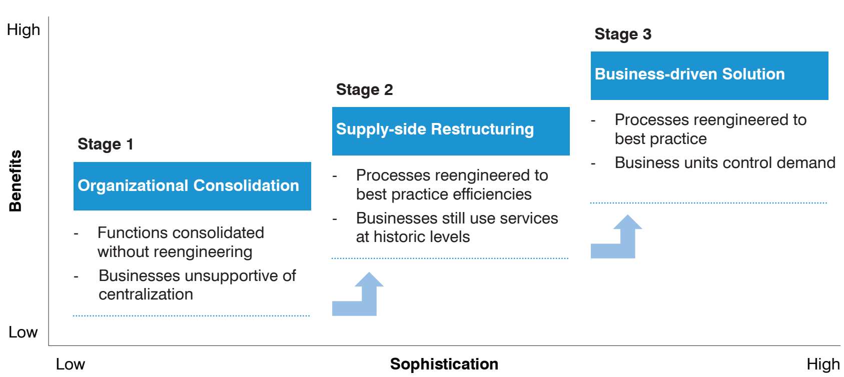
In this environment, support service managers were confronted with major problems in selling the concept. In the absence of restructuring, it was often not possible to reduce costs. This resulted in a service organization with few of the benefits but many more of the headaches of implementation.

Stage 2: Supply-Side Restructuring

By the mid-1990s, many organizations understood that in order to capture much of the promise, fundamental restructuring of support services, in addition to consolidation, was required. In general, the decision to implement was made at a very senior level and the functional heads (or a head of shared services) were held accountable for delivering the savings. The best implementations then involved a major functional reengineering effort to eliminate work and simplify processes. The focus of the support service managers was clearly on making the supply side as efficient as possible.

On balance, the results of this type of implementation have been very positive. Overall costs are generally reduced by 15 to 20 percent initially, and if implementation is closely managed, this level of performance is maintained through the transition. However, not all organizations have succeeded, even with this model in mind. The shortcomings are generally twofold. First, some support service managers are too aggressive in outsourcing activities such as finance and information technology without fully understanding how to manage external relationships, resulting in failure to address inefficiencies. In effect, they pass on the inefficiencies to the outside vendor with no program in place to improve operations. The second major shortcoming is business managers who are not fully engaged in the process and still view it as an initiative to take away control. The result can be a very contentious relationship—almost legalistic in nature—between the support service unit and the business. Evidence of this relationship can be seen in very long service-level agreements, some covering more than 20 pages. Unless the two sides work together to further drive down costs, the potential of the new operation is necessarily capped.

Exhibit 4
Evolution of Support Services Models



Source: Strategy&

Stage 3: Business-Driven Solution

The new wave of successful implementations shows that some 40 percent of the total benefit of implementing shared services comes from demand management: shared service managers working with the businesses to achieve a cultural change in how they regard support services. The goal is for business managers to think of support costs as controllable rather than as a head office allocation. Clearly, all of the supply-side restructuring and reengineering is still necessary, but successful demand management requires that business unit managers rethink their support requirements and be actively involved in the design and delivery of those services.

The focus of shared service managers has shifted from providing functional excellence to users to providing functional adequacy in which the businesses determine what their needs are and the level of service they can afford. To achieve this cultural shift, many organizations have adopted governance mechanisms and processes that involve key business and functional representatives in the ongoing decision-making process. Generally, a shared services board and shared service buying committees are the primary decision-making bodies.

With the successful implementation of both demand- and supply-side initiatives, companies using a business-driven solution have been able to sustain cost savings of more than 30 percent.

As for support services, the main derailer is a company's failure to establish the internal service provider relationship that the business-driven solution entails. The lack of an internal market often leads to a reality (or at least a perception) of high costs and low service levels. In some cases the business units rebuild their own service organizations, leading to a phenomenon we call "shadow staff," in which support functions are replicated within the organization.

Treating Business Units as Businesses

The concept of the business unit is straightforward. Businesses are built around what they do best. Rather than starting from the inside and looking out, a business unit is organized from the outside—in other words, from the perspective of the customers in the market, without regard for entrenched organizational lines, titles, or personnel.

Once identified, business units are treated as real businesses. Line managers are given the accountability and authority to run the business and make decisions based on their unique market requirements. They are empowered to make strategic, financial, and personnel decisions as required by the business.

In its purest form, a business unit would be structured and managed as if it were an independent entity with outsourced services. Its effectiveness would be measured by the marketplace rather than by its relationship to the rest of the company.

The business unit model benefits customers through greater value in terms of price (lower cost), speed, and customization to their needs. The corporation provides the line managers with the financial, intellectual, and human capital they need to succeed and lets them make the strategic and operating decisions necessary to drive the business.

Organized and managed this way, business units can leverage their capabilities to deliver a superior value proposition. Decisions are made closer to the customer. Business units not only are able to meet the demands of today but also can anticipate and shape the customer needs of tomorrow. They justify their existence in competition with the best the marketplace has to offer.

There are two main derailers related to business units. The first has to do with choosing an inappropriate option for how the business unit is organized. In practice, there are six main options, in their "pure" form *(see Exhibit 5)*.

Each of these options presents advantages and challenges. For example, functional alignment encourages the development of highly specialized skills, leading to efficient work within business units, but it may result in an overly internal focus ("silos") restricting cross-functional coordination and bottom-line accountability. On the other hand, while customer segment alignment allows increased focus on customer segment needs and delivery stream integration, it can lead to a higher cost structure and lower levels of coordination within functions to ensure a consistent approach to the market.

Even though there is no "ideal" option per se, our experience shows that some are much more adequate for a given company reality.

Exhibit 5
Business Unit Alignment Options

OPTION	DESCRIPTION
Functional	- Aligned around functions (departments) - Enables scale benefits and typically provides the lowest cost position
Geographic	- Aligned around geographic regions - Enables the organization to effectively deliver on regional differences in customer demands
Product	- Aligned around products - Enables the organization to rapidly innovate new products
Customer Segment	- Aligned around customer segments served - Enables the organization to focus on the unique needs of each customer segment
Channel	- Aligned around distribution channels - Enables the organization to optimize delivery through each unique distribution channel
Process	- Aligned around critical high-level activities - Enables the organization to effectively operate where processes are complex or where a high level of cross-functional integration is required

Source: Strategy&

The second derailer has to do with accountability. As stated before, the whole purpose of business units is to empower their managers to view them as real businesses, calling the shots on strategic, financial, and resourcing decisions. However, the level of responsibility is often curtailed by limiting the managers' decision rights or not holding managers accountable for bottom-line results.

In fact, in a large number of situations, it is hard even to measure bottom-line results, as costs are not properly allocated. The whole purpose of setting up business units may end up watered down in a misalignment of expectations.

Common Business Model Derailers

We have identified certain, common business model derailers and their implications as perceived by managers *(see Exhibit 6)*.

The reasons for these derailers are typically related to the fact that each entity within the organization has a life of its own and may not be adequately connected to the rest of the firm, leading to suboptimization. Stand-alone efforts for specific areas and business units without a holistic approach tend to neglect cross-functional synergies and underestimate the complexity of the interfaces between functions and areas *(see Exhibit 7)*.

Exhibit 6
Business Model Derailers and Implications

BUSINESS MODEL DERAILERS	COMMONLY OBSERVED IMPLICATIONS
Roles and responsibilities of the corporate center not clearly defined	- Lack of clarity on how the corporate center adds value - Excessive interference in business unit operations - Excessive number of positions
Business units not organized adequately or not accountable for results	- Inappropriate organizational definitions for business units - Unclear decision rights leading to lack of agility - Lack of accountability for results - Inadequate cost allocations leading to lack of transparency in performance - Misalignment among the business unit's metrics, goals, and incentives
Lack of internal market for support services	- Areas consistently operating at a high cost, below benchmark levels - Low service levels and high level of complaints - Support functions replicated within the organization (shadow staff)

Source: Strategy&

Exhibit 7
Client Example: Utilities Company

OBSERVED "SYMPTOMS"	IDENTIFIED ISSUES	PROPOSED ACTIONS
- Slow decision-making processes, with long lead time to react to customer demands and competitors' moves - Low level of accountability: business units theoretically responsible for the full P&L, but in fact only measured by top-line growth - Corporate center staff duplicated at the business unit level (shadow staff) - Poor service levels by support functions - High cost of support services: above market benchmarks - Deteriorating financial performance	- Corporate goals not clearly defined or properly cascaded to business units - Business units organized by geography, with limited focus on different client segments - Top management too engaged in nonstrategic activities: excessive span of control - Absence of adequate control mechanisms - Functional areas operating in silos, with limited integration and cooperation - Lack of support policies and process standardization across the organization	- Redesign of the company's business model, reconfiguring the business units to be primarily aligned around customer segments, but still able to take into account regional specificities - Comprehensive review of how top management is organized, enabling it to refocus on strategic functions, reducing span of control - Assessment of the key business processes, defining decision rights, roles, and responsibilities for each area - Centralization and standardization of support services; creation of a shared services center - Design and implementation of a control panel with key metrics and targets for the business

Source: Strategy&

CONCLUSION

The current global downturn has defined a new CEO agenda, in which greater efficiency and effectiveness are key themes. Companies need to focus simultaneously on short-term actions that capture immediate savings and on restructuring efforts that will catapult the company to a new, sustainable level of performance. By adopting a thorough approach to reviewing and improving their business models, companies can benefit from long-lasting savings and build solid foundations for growth once the downturn effects cease. Doing it while simultaneously contending with myriad other short-term concerns related to managing through this crisis is no small task. But there will never be a better time.

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