

Profitability or growth? Short term or long? Synergy or stand-alone unit performance? All companies struggle to reconcile these tensions. But in any given company, one is more important than the others – and that’s the one to manage.

by Dominic Dodd and Ken Favarro

Managing the Right Tension

Every leader and every company faces the problem of how to make progress on seemingly conflicting objectives at the same time. And of all the competing objectives, three pairs stand out: profitability versus growth, short term versus long term, and the whole organization versus the parts. In each case, more progress on one front usually comes at the expense of progress on another: Going for more growth damages profitability, and working toward higher profitability slows growth. Efforts to build for tomorrow distract everyone from producing results today, but when managers shift the focus to today’s results, they compromise the future strength of the company. Attempts to create companywide benefits hold back individual business units, then attempts to unleash the individual potential of the business units bar the way to capturing the benefits of being one company. It’s like squeezing a balloon in one place only to find that it expands elsewhere.

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Three years ago, we set out to examine these three tensions systematically. We wanted to understand how prevalent they were, how much they mattered to overall company performance, and what managers should do about them. We researched the 20-year performance of more than 1,000 companies worldwide, commissioned a survey of 200 senior executives, and conducted in-depth discussions with 20 chairmen and CEOs of large corporations – all wrestling with different tensions in different ways.

Our research shows that most companies struggle to succeed in managing the three tensions. Between 1983 and 2003, only 38% of the companies we studied achieved both positive profitability and real revenue growth in the same year more often than they failed to do so. On the short-term/long-term tension, the results were little better: In a typical year, only 44% of companies grew earnings over the previous year while also being on the path toward economic profit growth over the next five years. Finally, we found that fewer than 45% of companies were able to add value to their divisions and business units through both synergy and improving stand-alone performance at the same time.

The problem is not so much that managers don't recognize these tensions – they are all too familiar to anyone who has ever run a business. Rather it is that managers are often not focused on the tension that matters most to their company. Although companies have to manage all three tensions all of the time to some extent, at any point in time only one of them is critical to unlocking better performance. More often than not, executives pick the wrong tension as their priority. This is hardly surprising because the tensions often masquerade as one another. A business's apparent problem reconciling short term with long term, for example, may actually reflect a growth versus profitability issue.

Even if managers do identify the right tension, they usually make the mistake of designating a "lead" objective within it – for example, focusing on profitability over growth or vice versa. As a result, the company often ends up moving first in this direction, then in that direction, then back again, never quite resolving the tension. We found that the best-performing companies adopted a very different approach. Instead of setting a lead objective from which all decisions followed, they looked at how they could best strengthen the factor that unites the two sides of each tension. For the profitability/growth tension, that common bond is customer benefit. For the short-term/long-term tension, it is sustainable earnings. For whole and parts, the common bond is something we call

diagonal assets, particular organizational resources and capabilities that help the company act as both a single company and many different businesses at the same time.

In the following pages, we will describe how companies can select the right lead tension, and we will demonstrate the results that doing so can unlock. We will describe the traps that companies can fall into when they focus on one side of a tension over the other and show how they can escape these traps by managing with an eye to the common bond between the two objectives within each tension. First, though, let's take a look at how companies can determine how well they are currently managing the three tensions.

Calculating Your Batting Average

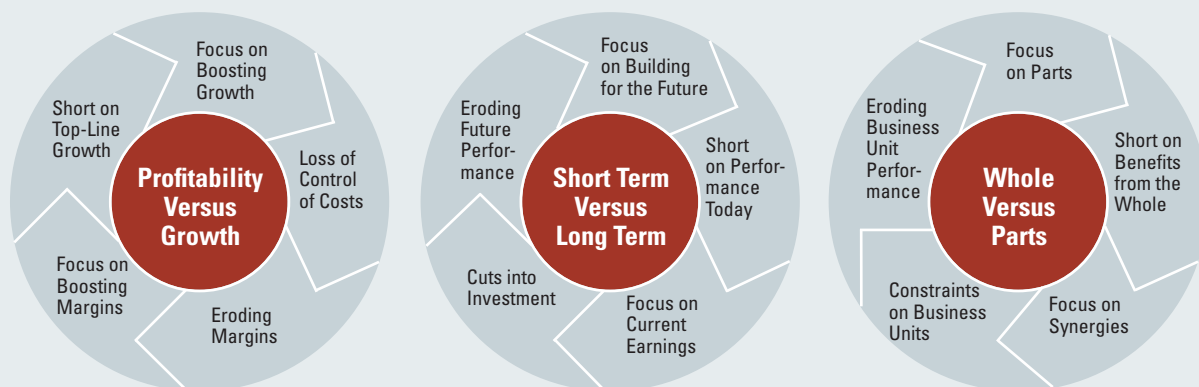
We borrow the baseball concept "batting average" to measure how often a company is able to succeed at two competing objectives at the same time in any given year. For example, between 1983 and 2003, General Motors achieved positive real growth in revenue and a positive economic profit margin during the same year only six times. In the other 14 years, the company either didn't grow in real terms, or was unprofitable, or failed on both fronts. GM's batting average on the profitability/growth tension was .300 – in essence, six hits in 20 at bats. In baseball, of course, a batting average of .300 is quite good, but in business, the bar is set much higher. (The exhibit "Batting Average: A Measure of Success in Overcoming Tensions" describes the calculations required to estimate the average for each of the three tensions.)

You might expect batting averages to reflect what's going on in the industry environment, and that is true to some extent. Certain industries, by their very natures, present managers with stark choices between performance objectives, whereas others do not. For instance, companies in capital-intensive industries are forced to accept short-term losses for long-term gains to a greater extent than companies in low-capital industries are. The headroom to grow and be profitable at the same time is more limited in industries like automotive, oil, or steel.

But the batting averages of individual companies vary more *within* an industry than *across* industries. It is possible to have a high batting average in a very challenging industry. Conversely, companies can get stuck with low averages even in the most promising industries. Take the automotive industry: GM's performance was about average for the sector in terms of the profitability/growth tension: a batting average of .300, or 30%, for GM compared with a 34% industry average. German carmaker

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The Three Tensions Every Company Faces



Symptoms of Being Trapped by the Tension

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|---|---|---|
| <ul style="list-style-type: none"> > Swinging between a growth push and a productivity push > Giving priority to reducing costs in difficult times and to boosting growth in boom times > Low or falling share or price relative to competitors > Falling market growth > Reduction in volume per line; increasing complexity > High unit costs relative to competitors | <ul style="list-style-type: none"> > Swinging between a focus on strategy and a focus on execution > Increasing reliance on profitability rather than growth to achieve earnings growth, or vice versa > Difficulty in hitting earnings targets without delaying investments > Low or falling investment compared with competitors and relative to earnings growth > Investment following earnings; investing at same times and on same things as competitors | <ul style="list-style-type: none"> > Swinging between centralization and decentralization > Debates about accountability versus authority versus ownership > Few voluntary interactions among business units or between business units and the corporate center > Strong separate cultural identities across business units or functions > A culture of blame and finger-pointing |
|---|---|---|

BMW, in contrast, achieved both positive economic profitability and real revenue growth in ten years out of the 20—a batting average of 50%. At the other end of the scale, Japanese automotive company Daihatsu managed to achieve both at the same time in only five years: a batting average of 25%.

Why does your batting average matter? Performing well on different objectives at the same time is necessary to serve the competing interests of different stakeholders. For instance, a company that is growing will find that it is able to provide fulfilling jobs; and a company that is profitable will be able to pay higher wages and benefits; only a company that is growing *and* profitable will be able to serve both interests simultaneously. But are *shareholders* really better off when companies reconcile such objectives at the same time? Doesn't it make sense to grow, then consolidate and work on profitability, then go for the next phase of growth? Isn't accepting losses now part of creating profits later?

It turns out that there is a close positive relationship between batting average and total shareholder returns (TSR). We found that for each tension for which we could measure performance at all of our 1,000-plus companies, batting average is a better proxy for TSR than any other measure in common use today, such as earnings, earnings per share, EBITDA, economic profits, price-to-earnings multiple, or return on capital. For example, the differences we saw in batting average for the profitability/growth tension in the automotive industry line up with differences in TSR. BMW, with the highest batting average, earned the highest TSR at 14%; Daihatsu, with the lowest batting average, earned 4%; and GM stood in the middle with 8%.

As you move up the quartiles on batting average, TSR increases accordingly. In general, a 10% increase in batting average—hitting both objectives one additional year every ten years—equals about two percentage points more in annual TSR. This is a big amount lost in a small

number: An investment of \$1,000 made in 1983 in the average S&P 500 company was worth around \$5,600 20 years later; with a return two percentage points higher each year, that investment would have been worth more than \$8,000.

This result flies in the face of conventional thinking about company performance. A company's long-term market value fluctuates on the basis of changes in market expectations of profits. But batting average is a retrospective measure, and it does not account for the amount of profits expected. The fact that batting average correlates with TSR, despite these differences, suggests that a track record of avoiding compromises between performance objectives is much more important than at first might be imagined. If companies can achieve batting averages of above 50% – meeting both objectives at the same time *more often than not* – they will be likely to finish in the top quartile of their industry by TSR.

Why then do so many companies score such consistently low batting averages? The first explanation is that many leaders worry about the wrong tension.

Picking the Right Tension

The problem here is that the three tensions are not independent of each other. A low batting average on one can cause a low batting average on another. A company's failure to create synergies across the organization might result in duplication in back-office costs, which would reduce profitability and act as a drag on new growth projects. Thus a low batting average on the whole/parts tension can lead directly to a low batting average on the profitability/growth tension. Similarly, a culture of business-unit autonomy can act as a barrier to open interactions with the corporate center, making it difficult for the senior team to see how results are being generated and whether short-term earnings are coming at the expense of investment needed for long-term performance.

Moreover, companies often manage the tensions in lockstep. When the priority is today's earnings, managers tend to push for higher profitability rather than faster revenue growth because they are confident they can increase profitability more quickly and with less investment than they can influence revenue growth. Companies that give priority to revenue growth often seek it by freeing up the individual parts of the company to stimulate new ideas, more experimentation, and greater adaptation to local markets.

Because the three tensions interact in these ways, it is difficult to disentangle cause from effect and problem from symptom. But despite the close relationships among them, each tension raises different questions and prompts managers to take a different focus. The tension between profitability and growth focuses the leader on the company's *business model*: what it does for customers and how

it configures its costs to support that. In other words, it prompts questions of strategy. The tension between the short term and long term requires that leaders examine the company's *management model*: how the company manages performance and investment. It prompts managers to think about the company's targets, processes, and routines. The tension between the whole versus the parts steers leaders toward considering the company's *organizational model*: its structure, culture, and people.

This means that managers need to carefully think through their companies' problems to make a diagnosis. A good way to begin is to ask, "What is our batting average for each tension relative to our peers?" If, as is often the case, the company's batting average is low or falling for more than one tension, then the next step is to unravel whether the cause is related to the company's business, management, or organizational model. To illustrate, let's look at the case of Coca-Cola.

Most current assessments of Coca-Cola focus on the tension between today's performance and tomorrow's. The company's management has missed progressively lower targets for annual earnings growth. Its preoccupation, therefore, has been on restoring short-term earnings growth. But if you look more closely at Coca-Cola's performance, you will find that the company has also generated more of its earnings growth from profitability than from revenue growth, whereas archrival PepsiCo's earnings growth is generated to a greater extent from both. The more a company's earnings come from either profitability improvement or revenue growth but not both, the more likely it is that there is a fundamental strategy problem lurking behind the short-term earnings numbers.

Coca-Cola had a profitability/growth batting average of 91% between 1985 and 1995, achieving both objectives in all but one year (1987). Between 1996 and 2004, the company's batting average fell to just 11%. Although the earnings growth was healthy in 1996 and 1997, it stemmed from margin increases, not revenue growth. Coca-Cola's real problem, therefore, may be that its core business model for carbonated soft drinks is broken. The relative price of products in this category versus other categories may be an indicator: "Starbucks can charge \$2 for a cup of coffee, and [Coca-Cola] can barely sell a 12-pack of Coke for that amount," notes one commentator. Slow market growth in the carbonated drink category is perhaps another indicator, as could be mounting concerns about obesity. Coca-Cola remains reliant on soft drinks for 80% of its revenue, compared with around 20% for PepsiCo, and is not perceived as having adapted as much or as well to changes in consumer attitudes and concerns. The symptom of Coca-Cola's problem might be its struggle to reconcile performance today with performance tomorrow – a management model challenge. But the real issue for the company – which was apparent in the plummeting of the profitability/growth batting average several years

Batting Average: A Measure of Success in Overcoming Tensions

A company's batting average is a measure of how often a company is able to succeed at two competing objectives at the same time in any given year.

PROFITABILITY/GROWTH BATTING AVERAGE

The proportion of years in which a company achieves both positive real revenue growth and a positive economic profit margin. For example, a company that achieves both in three out of five years has a profitability/growth batting average of 60%.

SHORT-TERM/LONG-TERM BATTING AVERAGE

The proportion of years in which a company has positive single-year earnings growth and is on the path to positive multiyear economic profit growth. We use a period of five years to gauge multiyear performance because it is a planning horizon that many companies use (and not far off the six- to seven-year average tenure for CEOs of large companies).

WHOLE/PARTS BATTING AVERAGE

The proportion of years in which a company improves the performance of its business units irrespective of their relationships with the other units and creates net positive one-company benefits by coordinating across them. This is hard to measure from outside a company, so we look at the proportion of years in which a company trades at a higher value than the sum of its parts on a stand-alone basis. This overstates the batting average because for some companies a positive on one objective more than offsets a negative on the other, but otherwise we have found it to be a reasonable proxy.

before the short-term/long-term average faltered – may well be its business model.

Making an accurate diagnosis of the root cause of underperformance is a real problem for business leaders. But it is not insurmountable. Jim Kilts of Gillette and Lewis Campbell of Textron give us two examples of how shifting a company's focus from the wrong tension to the right one can deliver tremendous improvements in performance.

Focusing on the profitability/growth tension at Gillette. In February 2001, Jim Kilts took over as chairman and CEO of Gillette. The company's market value was \$34 billion. Four and a half years later, in October 2005, Procter & Gamble bought the company for \$57 billion. What was behind the surge in numbers? Kilts shifted the company's focus from worrying about the tension between short term and long term to worrying about the tension between profitability and growth.

Historically, Gillette's short-term/long-term batting average had been high – averaging 77% from the mid-1980s to the mid-1990s. But then the company started to struggle. By 2000, its annual earnings were falling and its multiyear economic profit trajectory turned negative. Consistent with a focus on managing to the short-term/long-term tension, executives were pulling levers within the company's management model: setting challenging earnings-per-share targets, managing the timing of investment to ensure the right earnings profile, tying cost disciplines to earnings outcomes, and so on.

These measures, however, did little to solve the company's underlying problems. From the mid-1990s until Kilts's arrival, Gillette had allowed product lines to proliferate. By 2001, it was managing more than 25,000 stock keeping units, many with very low sales volume and poor profitability. Gillette had resorted to extensive use of price promotions and coupons to try to keep share and

BATTING AVERAGE VERSUS SLUGGING PERCENTAGE

Batting average measures the frequency of achieving two performance objectives within a tension at the same time but not the degree to which each objective is achieved. We refer to that as slugging percentage. Thus a company with a profitability/growth batting average of 50% but an average revenue growth of 5% and an average economic profit margin of 4% has a lower slugging percentage – is generating lower levels of economic profit – than a company with the same batting average but 10% revenue growth and an average economic profit margin of 8%. Clearly, slugging percentage matters to a company's total shareholder returns (TSR). But if that were all that mattered, we might expect to find no relationship between batting average and TSR. This is not the case. In fact, the correlation between TSR and total economic profit growth – a component of slugging percentage – was less than that between TSR and batting average for the profitability/growth tension and the short-term/long-term tension.

earnings up. When times got harder, the company resorted to trade loading—pushing hundreds of millions of dollars of stock onto retailers at one point—in an effort to hit its earnings targets. From 1996 to 2001, Gillette failed to generate both real growth in revenue and a positive economic profit in any year. Its profitability/growth batting average was 0%.

In 2001, Kilts and his team shifted focus away from relying on Gillette's management model to keep earnings going toward improving its business model to achieve high profitability and faster growth at the same time. EPS targets were jettisoned; Kilts stopped giving earnings guidance; spending on trade promotion was slashed as a proportion of total spending and in absolute terms; trade loading was prohibited on threat of immediate dismissal; and extending product lines became a cardinal sin.

Kilts's philosophy for upgrading the company's business model was this: "The way to have growth at a premium return is to grow productivity and brand value at the same time. The way we operate is to drive functional excellence to drive productivity growth to pay for innovation to drive brand value." According to Kilts, high brand value to Gillette meant "having a small number of relevant and differentiated benefits that in combination no other competitor can match."

Gillette began its functional excellence campaign by comparing the costs of each function with those at relevant peers. Kilts's team discovered, for example, that the company's finance function cost 30% to 40% more than comparable functions elsewhere and that its human resource department cost 15% to 20% more. The team also learned that Gillette was the fastest payer and the slowest collector of debts, one of the main reasons the company had a 36% working-capital-to-sales ratio at the end of the 1990s. (P&G had an equivalent ratio of 1%, and Colgate-Palmolive, 2.5%.) Next, Kilts set a standard for continuous productivity improvement. Overhead costs fell 4% within the first year. Pretax procurement costs were cut by some \$200 million. And further savings were found from closing seven manufacturing facilities, reducing inventory, and cutting working capital over four years.

Gillette retained some of those savings in the form of higher profitability and reinvested others. "As a rule, we reinvested 50 to 60 cents of every productivity dollar into growing brand value," says Peter Klein, former senior vice president of strategic planning and a longtime associate of Kilts. The priorities included getting new products quickly to market and outspending competitors on consumer brand marketing for core brands. For example, the company brought its M3Power razor to market earlier than planned; it became the top-selling razor in the United States in its first three months. Gillette had had the technology for putting a battery in a razor for a decade. Under the old management model, it had made more sense to "save it for later" for fear of disrupting the

earnings line and cannibalizing current brands. When Kilts first saw the product demo, he immediately asked that it be launched as fast as possible. Kilts accelerated other major product launches as well: an upgrade of the women's shaving brand Venus Divine, a battery-operated toothbrush, and the Hummingbird dental-flossing tool.

From 2002 to 2005, Gillette scored a batting average of 75% on the profitability/growth tension. It missed revenue growth only once, in Kilts's first full year, 2002, when the halt in trade loading hit sales. Since 2003, Gillette's aggregate performance has also been impressive: Revenue growth has picked up to double-digit levels and economic profit margins are nearly twice the company's long-term average. As a result, annual TSR, which between 1997 and 2001 had been ten percentage points below peers', outstripped competitors by five percentage points in the years between 2002 and 2005.

Focusing on the whole/parts tension at Textron. When Lewis Campbell became CEO at Textron in 1998, he could have been forgiven for bringing with him the assumption that the primary tension he needed to manage was between the short term and long term. Top managers at the \$10 billion conglomerate had the usual levers at their disposal to manage that tension: targets for annual earnings growth coupled with a traditional strategic-planning process for prioritizing investments for the long term. But the company was struggling to keep earnings growth going while finding the room for investment to build stronger positions in its most profitable markets. When the company's share price dropped by half between 1999 and 2003, Campbell and his team undertook a major transformation to shift the company to what proved to be a much more productive focus: overcoming the tension between the value of each individual business unit and that of the company as a whole.

According to Campbell, "The issue all companies face is that the corporate center wants every business unit to be the same, but every business unit wants to be different. I want to keep every business unit focused on customers and to be state-of-the-art on common processes: payroll, health care, talent development, IT, receivables, accounts payable. This can be done either by centralizing or through 'commonizing'—adopting the same language, textbook, tools, and so on, without actually creating a central function." Campbell believed that every business has "core" and "context" processes and activities. Context processes are common across all the businesses, like getting the paychecks out on time. Core processes are specific to the customer value-added equation in each business and drive the value of that business. "I look for the group to add value to the context processes by either centralizing them or commonizing them and to focus the business units on becoming customer satisfaction machines."

Textron centralized a number of context functions, such as payroll processing and employee benefits, taking



all responsibility for them away from the business units. This has allowed the company to reduce costs significantly—for example, by reducing the number of data centers from 88 internally operated centers to two, which are now operated by a third party, and by cutting the number of health insurance plans from 154 to just one.

In other areas, such as manufacturing, Textron takes the other approach. Rather than creating a central function, it boosts performance by applying well-known enterprise management processes such as six sigma, lean manufacturing, and integrated supply chain management. The aim here is to build what Textron calls a “networked enterprise”: a portfolio of businesses that do not share customers, costs, or competitors, but do shared enterprise management processes. Says Campbell: “We’re now at a stage where we can take specialists in many of our enterprise management processes out of any business and drop them into another business and they can be immediately effective.”

Campbell reinforces the new focus by aligning pay with the whole/parts tension. “We now split bonuses into a per-

sonal performance rating and a company performance rating, and these are multiplied. So if Textron does really well, and if a manager has done something on behalf of other businesses that helped them and possibly hurt his business, that manager can get a big bonus even if it wasn’t a great year for his business.” Campbell is using the new organizational model to shape M&A strategy as well. Textron guides its acquisitions by concentrating on its capability of continuously improving manufacturing. “The ability to ‘commonize’ some processes, centralize others, and focus the businesses on their core processes gives you the basis for tangible benefits from making acquisitions. So instead of being woolly about ‘synergies,’ we can be specific about how we, Textron, will add value to the company we are acquiring. If you have businesses that have the same operational characteristics in terms of customers to be served, products to be made, employees to be paid, and receivables to be managed, you have the potential to manage the tension between whole and parts.”

Investors have been well rewarded under Textron’s new focus: Its annual TSRs of 54% from March 2003 to March

2006 are more than double the World Diversified Index (25%) after falling short of this same index by 12 percentage points, annually, in the prior four years.

The Dangers of Picking Lead Objectives

When leaders have identified the tension that is most important to unlocking better performance, the question becomes how to manage it. A proverb tells us that if we chase two rabbits, both will escape. Much intuition about management reinforces the belief that it is next to impossible to succeed at both competing objectives within a tension at the same time. Our survey confirmed that most companies choose a lead objective within each tension: Of the executives we surveyed, 60% said their company

tently on customers. You do this by increasing the difference between your company's products and services and those of competitors; tailoring products and services to reflect differences across customers; finding new and different marketing and sales approaches to increase the appeal and reach of your offerings; splitting the company into smaller autonomous businesses closer to their customers; and entering new and fast-growing customer segments. Revenue growth responds. But these actions create side effects that make it harder to increase profitability at the same time: They lead to a proliferation of lines and increased complexity and reduced volume per line; they tempt you into discounting, price promotion, and "push" sales techniques; they cause duplication and overlap across units; and they lure you into occupying weak positions in apparently attractive markets.

The common factor behind the bad numbers is that managers tend to use effective management tools to focus on only one side of a tension.

chooses to prioritize either growth over profitability or the reverse, rather than place equal emphasis on both; for short-term/long-term, 70% prioritize one objective or the other; and for the whole/parts tension, the figure is 72%.

The trouble is that managing to objectives in this way can very easily lure companies into traps where improvement in one objective ultimately comes at the expense of another.

The tying-costs-to-earnings trap. If your lead objective is to improve profitability, you set your cost budget with earnings in mind and tie pricing decisions to margin requirements. But engineering costs to hit target earnings soon blurs the distinction between costs that are important for growth and those that are not. In particular, it encourages you to manage costs more closely in bad times than in good times. Then in the good times, you tolerate cost increases because they are more than covered by revenue increases and because overall earnings growth meets target. But this allows costs not needed for growth to rise unchecked and become locked in. Such costs eventually become an anchor on growth. The funds available for growth are lower than they could be, and the sales volumes at which new investments start to be justified are higher than they could be. When the bad times come, as they inevitably do, the imperative is to cut costs across the board—including the costs needed for growth.

The customer-focus trap. When your lead objective is more growth, a first port of call is often to focus more in-

The annual-earnings-growth trap. When short-term performance is the priority, you deliberately set a stretch target for annual earnings growth. You link company incentives to it, sharpen budgeting disciplines, work on creating a culture of "execution excellence," and institute the standard of a fast payback on new investments. Collectively, this builds a powerful engine for meeting your target for annual earnings growth. But this system doesn't dictate how numbers are to be hit and how they are not to be hit. After the low-hanging fruit has been plucked, pressure mounts to delay important investments for the long term, cut into the quality of customer service, push stock onto customers, and raise prices to improve short-term earnings. Doing this generates the desired short-term numbers but undermines the company's ability to grow earnings in the future. In our survey, we found that 77% of executives said they would often or sometimes be prepared to delay a project to meet a short-term earnings target, even if the project would be profitable in the long term.

The present-value trap. You want to build for long-term profits. You set up the objective of maximizing net present value—that is, following whatever path of investment and earnings will deliver the highest cash flow for the company. But when you ask your managers to give you plans that maximize net present value, they all come back with the same familiar investment profile: one that requires a lot of up-front investment and promises a lot of return later—the "J-curve" or "hockey stick." Although

the plans are sincere and sometimes warranted, no CEO wants to have all the company's options for investment generating profits only in the distant future—and you are no exception. You risk investing behind an ever-receding promise of future earnings. Your difficulty is compounded by the fact that most of your managers will move on before their long-range forecasts come home to roost. In trying to set high standards for long-term performance, you have let people off the hook for today's results.

The centralization trap. You see the benefit of acting more as one company. You decide that the most important task is to increase synergies across the organization. You emphasize collective benefits over business unit autonomy. You combine units. You centralize the main functional responsibilities into shared units to remove duplication and create advantages of scope (such as in hiring talent); you refocus the decision rights of the business units and adjust their rewards to account for their membership in a wider enterprise; and you add in intermediate levels of oversight and coordination to manage sharing and collective benefits. But your business unit managers start to argue that their own performance is too dependent on that of central units for their businesses to be held accountable. Their motivation to perform better is weakened. The distance between where decisions are made and where the consequences are felt becomes too great. Efforts to increase coordination create more layers in the organization. Accountabilities blur. Benefits of customizing each business unit to its market are lost.

The autonomy trap. Your priority is to sharpen the individual performance of your business units. You reach for some familiar levers: You split the company into as many stand-alone units as is viable. You devolve to these units the functions that an autonomous entity would have and confer on them substantial decision rights. You set up incentives that mirror the kind of rewards they would receive if they were stand-alone businesses. You remove bureaucratic interference by reducing layers between the units and the corporate parent and by reducing the size of the head office. These tools shine a spotlight on the differences between the business units. They improve the ability to adapt companywide approaches according to those differences. And they create an effective context for motivating performance improvement. But the more you free up the parts to act independently in pursuit of their own performance, the more your business unit managers cite “accountability” as a defense against the “interference” that managing synergy requires. They are quick to equate accountability (being responsible for outputs) with authority (having decision rights over inputs) and to equate authority with possession (running their inputs themselves).

These six traps are the unintended side effects of sensible management practices. They are as prevalent as the practices that give rise to them, and their prevalence ex-

plains why the batting averages are so low for most companies across the three tensions. The common factor behind the bad numbers is that managers tend to use effective management tools to focus on only one side of a tension, and, as we've seen, creating better performance for one objective creates collateral damage to a company's ability to perform on other objectives. So what should companies do instead? Rather than use these tools to manage one or the other objective in a tension, the answer is to focus on the common bond that can unite the competing objectives.

Strengthening the Common Bond

If the common bond underlying a tension is ignored, good performance on one objective will inevitably lead to poor performance on the other. But if it is nurtured, then both objectives within a tension can be achieved at the same time.

Customer benefit: The common bond between profitability and growth. Customer benefit is the reward that customers receive through their experience of a product or service. It varies by customer and by context. The primary benefit of a mobile phone for one person might be feeling secure in the event of a breakdown; for another, it might be more akin to that of a fashion accessory. If a product has high customer benefit, customers will be willing to share a greater burden of making it profitable for the company. They are likely to consent to a high price for a high benefit; they will be happy to do some of the marketing and advertising to new customers for you through word-of-mouth recommendation; you will not need to persuade them so aggressively to keep buying. High customer benefit usually means higher market share, which in turn brings greater opportunities for capturing economies of scale. Without high or increasing customer benefit, the only way to acquire and retain new customers is for the company to keep paying all such costs itself. Growth based on customer benefit is clearly more likely to be compatible with profitability. What's more, reducing the costs that are unnecessary for improving customer benefit—“bad costs”—will deliver higher profitability without damaging growth.

Different leaders have adopted different tactics to keep their companies' focus squarely on customer benefit. After the 2003 acquisition of the Adams confectionery business, Cadbury Schweppes CEO Todd Stitzer asked the team to give him a strategy to grow the market rather than just the company's market share. Thinking about share makes you look to competitors; asking about market growth makes you look to the fundamental customer benefit of the category. Cadbury used this approach in the U.S. chewing gum market to develop a product development and marketing strategy that would deliver new consumer benefits beyond breath freshening, for example,

teeth whitening, stain prevention, and cavity repair. It also stretched the market by introducing new fruit flavors that offered benefits more akin to other confectionery categories. This has boosted market innovation and growth rates, with higher consumption and higher price points—a combination indicating more consumer benefit. Meanwhile, Cadbury's share has grown five percentage points.

All the leaders we spoke to emphasized the importance of excising bad costs, such as those identified by Gillette, on a continuous basis. When he was chief executive of Barclays, Matt Barrett (now chairman) would ask a business to disaggregate its economic profits by product line, customer group, channel, and geography. He would also request more granular detail within each of those dimensions until managers found areas in which the company was losing money. "The problem was, when I first saw the numbers, everything looked profitable. The charts came back with everything over the line. So I told them to keep going until they found something negative. We found some real opportunities that way."

Sustainable earnings: The common bond between short and long term. Given the external pressures for immediate results and the internal pressures for project funding and investment spending, the short-term/long-term tension accounted for the majority of "share of voice" in our discussions with CEOs. The way to resolve this tension, we found, is to focus on sustainable earnings. Sustainable earnings are not borrowed from the future by cutting necessary long-term investment or borrowed from the past by exploiting a business model that is past its time or loaned to the future in the form of excess investment. They are repeatable. If the management of results for today and investment for tomorrow is designed to grow sustainable earnings, then companies will be much more likely to avoid unnecessary choices between the short and long term.

In a cyclical industry with one of the lowest short-term/long-term batting averages (28%), oil giant BP has scored 40%. Consistent with that, since 1995, its 13% average annual TSR has beaten the sector by four percentage points, a huge number when applied to the scale of its industry and the companies that compete in it. According to CEO John Browne, "The first thing we think about is the overall value generation of all investments. Having considered that, we then move on to the timing of investments. It would be value destroying to start with the timing." BP uses a "control matrix" in its effort to avoid under- and overinvestment across the cycle. Browne amplifies: "We look at gross margin, operating expenditure, spending on safety and integrity, revenue expenditure, overhead, and capital expenditures down the side [of the matrix] and different control mechanisms across the top, including oil prices. This gives us the set of oil prices and refining margins we should consider along with our overall capacity for investment."

As a result, BP has largely ducked a common tendency of large businesses to overinvest during good times and underinvest during bad times. For most oil companies, capital expenditure tracks current oil prices. But when the price of oil fell to \$10 a barrel in the mid-1990s and many expected it to fall further, BP massively increased capital expenditures on exploration and production. Now, with money from high oil prices pouring in, Browne has maintained a steady pace of capital expenditure and is continuing to put pressure on costs. BP's judgment has not been perfect. It assumed – incorrectly, as it turned out – that refining would be an unattractive business and therefore invested less than competitors did. But BP's discipline is the impressive point.

Another way to reduce tension between the short term and the long is to spend more time considering what separates them: the medium term. Barclays chairman Matt Barrett and its CEO, John Varley, replaced the traditional single-year and five-year planning horizons with three time frames: long-term direction, short-term priorities, and medium-term themes. According to Varley, "The short term focuses minds on the results that will build a track record with investors and the long term on where you want to participate and the portfolio options you are prepared to defend. It turned out that the medium-term themes for us centered on creating value for customers – sustaining franchise health."

Several leaders felt that companies can easily lose sight of sustainable earnings due to the targets they set for themselves. According to Gillette's Jim Kilts, "If you achieve just above median performance year in and year out, you will be number one over five to ten years. If you seek to be number one year in and year out, you will do things that wreck the business. People get this wrong all the time."

Diagonal assets: The common bond between whole and parts. A company's diagonal assets are resources and capabilities that help the company act as both a single company and many different businesses at the same time. Diagonal assets can be tangible – a shared IT network, for instance – but the most powerful are usually intangible: for example, a sense of shared purpose and values that underpin a company culture. These assets foster a sense of connectedness between people in different parts of the organization, which is essential if any company is to be more than the sum of its parts. Lewis Campbell's new focus for Textron has been to prioritize three diagonal assets for the company: standardized business processes, a shared language and approach for making and executing strategic decisions, and a new pay system that values individual and collective performance.

Unless companies can build strong diagonal assets, efforts to create value through synergy will inevitably go awry. Suppose you planned to capture synergies by centralizing logistics. In theory, that should reduce those costs and also give business unit managers more time to focus

The Three Common Bonds

For each of the three tensions, there is a necessary ingredient that must be nurtured in order for the two objectives to act as complements rather than as rival forces. If this element is ignored, good performance on one objective will inevitably lead to poor performance on the other.

| Tension | Common Bond | Questions Managers Should Ask to Nurture Bonds |
|------------------------------------|---|--|
| Profitability versus growth | Customer benefit: The reward customers receive through their experience of choosing and using a product or service | <p>What are the customer benefits of our products and services?</p> <p>How is this project or investment intended to grow customer benefit?</p> <p>What could we do to grow market size rather than just market share?</p> <p>Are we as tough on growing productivity in the good times as in the bad times?</p> <p>For which of our costs are our customers (most) willing to pay?</p> <p>Where are there bad costs and low customer benefits in our business?</p> <p>How does our scale generate customer benefits?</p> <p>How do our acquisitions create new or more customer benefits?</p> |
| Short term versus long term | Sustainable earnings: Earnings that are not influenced by borrowing from the future (cutting long-term investment) or lending between time frames | <p>What proportion of our current earnings are sustainable?</p> <p>What is our long-term outlook on the key variable in our industry?</p> <p>Do we think of our business boundaries by benefits or products?</p> <p>Does the corporate center have visibility into sustainable versus transitory earnings across the business units?</p> <p>Are we giving a clear line of sight to investors on sustainable earnings?</p> <p>What are our medium-term priorities—and how do they link to our shorter- and longer-term priorities?</p> <p>What level of earnings growth is just above median?</p> |
| Whole versus parts | Diagonal assets: Capabilities and resources that help companies improve stand-alone business-unit performance and create corporate synergy at the same time | <p>What are our diagonal assets, and what are we doing to strengthen them?</p> <p>Where could we standardize rather than centralize?</p> <p>What behavioral norms define our identity as a company?</p> <p>Do we have a compelling story about how we are going to win as a company?</p> <p>Can we better pair decentralization with centralization?</p> <p>What companywide processes should be cultivated?</p> <p>Can we use physical proximity as a diagonal asset?</p> |

on other activities for improving customer benefits where the units can add more value. But if the corporate center charges back the costs of logistics through an opaque transfer-pricing mechanism, or if the businesses suspect that the head of logistics is slacking on his job, then any benefit of a sharper business unit focus from centralization will be swallowed up in argument and mistrust. Shared logistics might well be a source of new synergy value. A

sharper management focus, trained on the more important points of leverage for the business unit, could be a source of new stand-alone value. However, it takes diagonal assets in the form of trust and transparency to realize both types of value at the same time. The same is true for other kinds of synergy. A shared belief in a higher-order purpose can be an important diagonal asset. According to Andrew Cosslett, CEO of InterContinental Hotels, “People

need to know why we are here and how we are going to win. Asking them to be motivated by financial goals just doesn't cut it. They need a higher-order quest. Without a compelling story, leadership becomes exhortation."

Fostering diagonal assets allows companies to pair decentralization with centralization rather than choose one over the other. Companies might, for example, decentralize decision authority but at the same time centralize goals, culture, leadership development, and enterprise-wide standards for things like how strategies are developed and what "good" means with respect to strategies, execution, and performance. Carefully constructed, this can result in a common understanding of "how we do things around here" and a common sense of mission. Financial services group BBVA has recently looked to empower its regional businesses in Europe and the Americas and has decided, at the same time, to strengthen the group's central control in certain areas. According to José Ignacio Goirigolzarri, president and chief operating officer, "We come from a past of acting within a single harmonized model for going to market. There arrives a moment when you realize that increasing diversity will improve

Sometimes simple physical proximity is all that's needed to create a diagonal asset. Dow Jones's chairman, Peter Kann, recalls: "When I became publisher for the *Wall Street Journal Asia* early in my career, it was very siloed: News, production, ad sales, circulation never talked to each other, even though everything they did had an effect on each other. I was the first to bring together all of these into one room of a warehouse in Asia. It worked, and I brought this model back with me to the United States."

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It is natural to want to focus on certain performance objectives rather than others, depending on how well a company is currently performing – growth over profitability, for example, or current earnings over long-term health. Yet our research tells us that emphasizing one performance objective at the expense of another – except in special cases such as start-ups, exits, or performance crises – is not the route to better performance. Good performance on one objective does not automatically result in good performance on others. If anything, the odds are in the other direction: It is easier to end up with "either" or "neither" than with "both." Furthermore, by prioritizing

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performance." But today, two things make BBVA more than just the sum of the parts: its ability to recreate revenue synergies across the group by leveraging the company's brand and knowledge-sharing processes and its ability to derive cost synergies from four shared services: compliance and procedures, funding, IT, and people. "We will, if anything, be increasing our grip in these areas. The local CEO receives support and needs to be aligned with the Group on these. To make decentralization work, very strong leadership from the center is needed."

In a similar way, the U.S. health care company Cardinal Health complements the more traditional bottom-up planning process – whereby the company's plan is largely the sum of its business units' plans – with a top-down process that sets strategic direction for the company as a whole. The executive committee identifies a series of issues and opportunities that cross or transcend the business units, calling them "horizontals." For instance, generic products are an ongoing focal point for companywide (top-down) activities that complement and reinforce the efforts of any business within Cardinal for which generics are important.

between objectives, many companies end up swinging back and forth between them: 52% of executives in our survey said their companies swing from one objective to the other within at least one of the three tensions.

Our advice, therefore, is not to prioritize between *objectives* but to prioritize between *tensions*. Leadership teams should debate and carefully pick the right lead tension for their company. Then they should focus their organization's energies on strengthening the common bond that unites the two sides.

This is no easy task. The decision of which tension should be the lead is as much a matter of judgment as of analysis. And the three common bonds are hard to measure. You can't touch or feel them. What's more, apparently sensible management practices can weaken performance on the three common bonds. But no matter how difficult it is to do, working hard to strengthen the common bond in your company's lead tension is the only truly reliable route to improving performance for all your stakeholders. ▢

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