DARE TO DREAM: STRATEGICALLY! INNOVATIVELY

Strategic Innovators

Volume 1 Issue 1

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Competition and Co-opetition

Creating sustainable advantages and competencies

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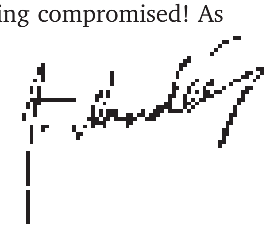
Competing to death!

Well, that's the heading for one of the benchmark research papers written in this issue of Strategic Innovators. As quoted in even other papers in this journal, the world is viewing a dramatic shift in competitive dynamics from straightforward competition to rampant co-opetition! The term co-opetition refers to a situation where diehard competitors start collaborating, legally of course, to maximise shareholders' value, profits, revenues etc, and to minimise consequent costs and expenses by optimal utilization of joint operations, products, services *et al*.

One of the most compelling reasons for competitors to turn co-opetitors is the focus on maximizing returns from core competencies. When two competitors realize that they are stuck in a "prisoner's dilemma" situation, where competing against each other actually ends up giving them lesser returns, a logical methodology of operating becomes co-opetition. Examples are in abundance. Instead of competing, Disney and Pixar Animation went the co-opetition way, where Pixar provided the graphics content for movies like Finding Nemo, Toy Story, Monsters Inc, The Incredibles, Bug's Life etc, while Disney went ahead and distributed these hugely successful films all over the globe. Or where companies like Hindustan Motors and Mahindra & Mahindra have supplied engines and other auto components to companies like General Motors and Ford (and now to Renault too). Where HLL still distributes the *Dalda* brand – that it sold off to top competitor Bunge – through its own channels. Where Honda of Japan would continue selling various automobiles through its joint venture with the Hero group in India, and at the same time, continue selling scooters through another arm unrelated to Hero, and generators through another.

Co-opetition, and not straightforward competition, is becoming the rule, especially in industries that have typically high competitive pressures, and – if one can mention – intelligent competitors. Perhaps the biggest, the most successful, and one of the oldest of all co-opetition examples can be found in OPEC, a cartel legally formed by oil producing countries ostensibly to ensure that there is no over supply of oil, as that would – again ostensibly – result in crashing of prices, consequently placing all oil producing countries in losses. Though the OPEC was initially unsuccessful, with time, countries accepted quotas for production, which contributed to the huge success of OPEC and its member countries; a fact that can be seen from the high and rising per capita incomes of the OPEC nations.

Truly so, infrastructure industries are perfect spaces for co-opetition to flourish. Steel is one such example. In recent news has been the ongoing hostile takeover bid by Mittal Steel (the world's largest steel producer) for Arcelor (the world's largest steel corporation in terms of revenues and profits). Whether the takeover bid goes through or not completely depends on the European Commission's approval; especially given the fact that the CEO of Arcelor, Guy Dolle, and the French & Luxembourg governments, have illogically shouted their throats hoarse about national security (and employment) being at stake! In the end, Mittal might have to churn out a price that is higher than the actual worth of Arcelor, just to cash in on the distribution channels, and high production quality of Arcelor steel. Could the answer to Mittal optimising his company's returns have been in co-opetition with Arcelor? Well, one just might actually see that happening in this takeover bid, if Mittal finally refuses to pay the higher price, or if the European Commission bends to fears of national security being compromised! As I mentioned, competing to death never was recommended; or was it?



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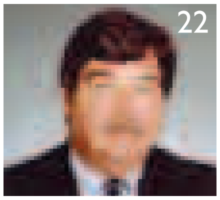

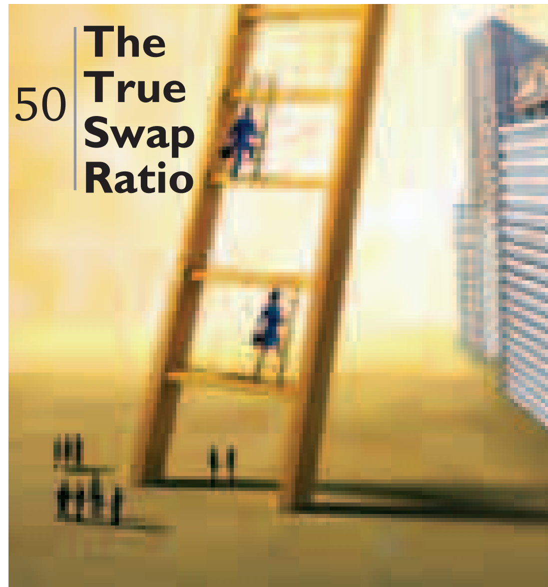


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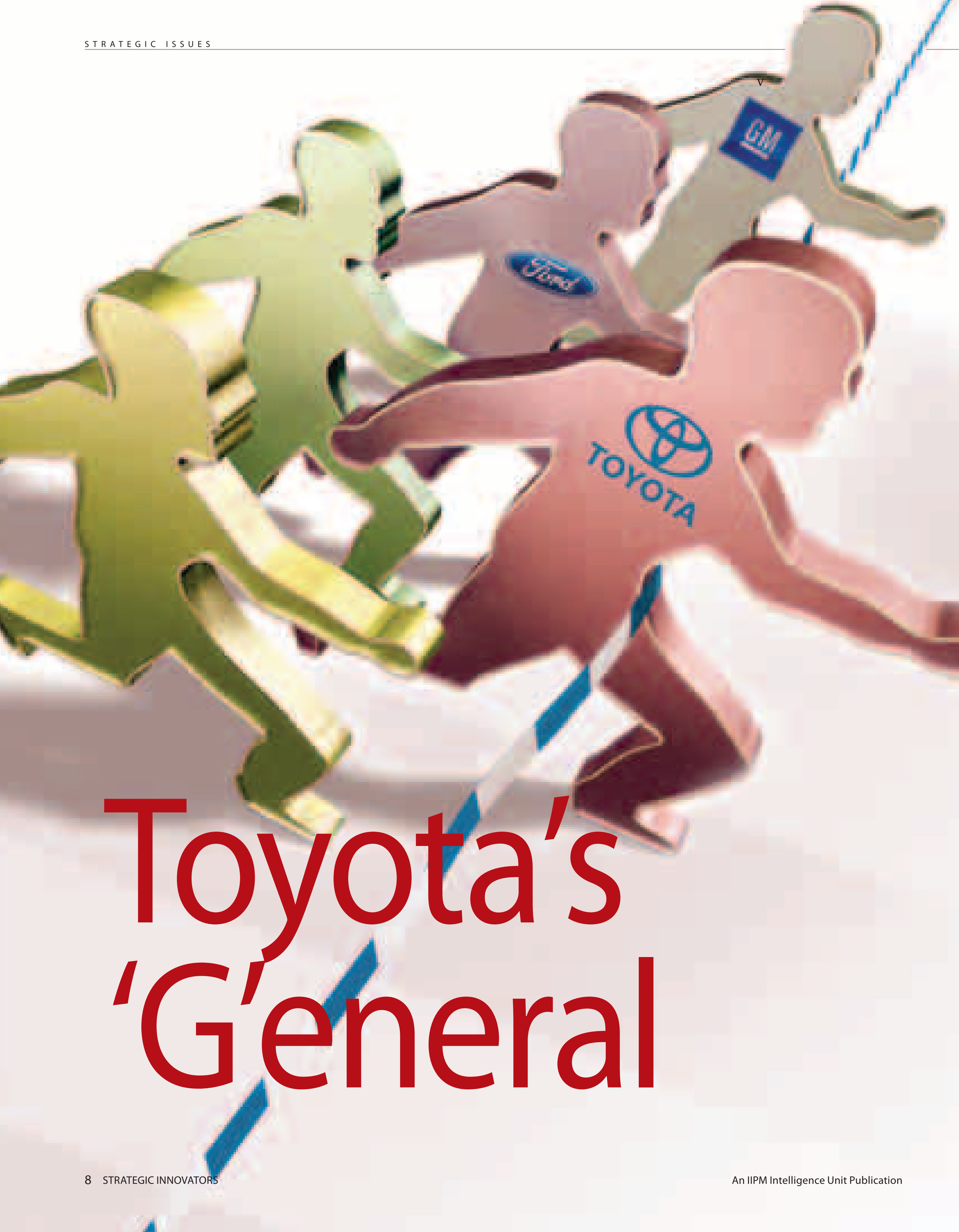


Toyota's 'G'eneral

In 1937, Sakichi Toyoda would have never thought that one day his local car company would be amidst the fiercest battle in the history of the industrial world. Toyota Motor Corporation, as it is known today, has come a long way since it started the production of 'model SA' way back in 1947. The company has raided Detroit with such an intense ferocity that there has been a scramble for cover among the big three. The seemingly immortal General Motor (GM) and Ford motor company are going through an almost irreversible depression, as their sales and market share are on a continuous down slide and a recovery looks bleak.

Detroit has tried to resist but to no avail, as the indomitable Toyota is just cruising along and in the process has already overtaken Ford and Daimler Chrysler. Now that Toyota is ensconced at the number two spot, it is at striking distance of the mother goose, GM, this year. The landmark earning of $11.4 billion in 2005 – more than the combined earning of all other automobile corporations – has been the crowning glory for the company, which seems all set to take the top position in some time sooner this year than later...

It was the year 2004 that was the turning point for the ailing GM that saw its sales plunge by 13% during the golden year for Toyota. A turnaround magic

Feasting on an ever increasing global market share, Toyota is about to beat General Motors hollow. Read more about the temerity of...

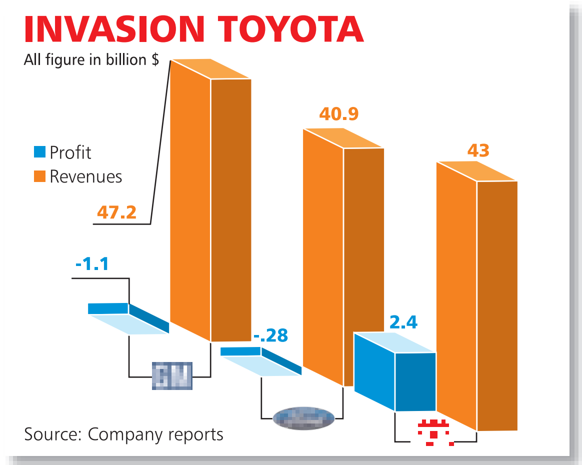
'M'arch

wand is now not easily accessible, in spite of the fact that the company was supposedly one of the biggest sustainers of the US economy.

Though the travails of GM could well be a litany of unforced errors. It has been reported that GM spends an equivalent of $2,000 per car on its pension liabilities – so much for competitiveness. Losing about a billion whopping dollars every year, analysts have questioned a plethora of GM strategies, right from production, to distribution and marketing. The company's market share slipped to 26% in its home market in 2005. Though seemingly huge, this market share contributed more to the losses of GM than ever.

It is believed that GM is still SUV dependent and continues to formulate its policies on it. These faulty business lines have done much damage to the corporation, as the demand for these fuel guzzling vehicles is fast drying up in the wake of the relentless rise of oil prices. In the market of United States itself, GM's SUV sales plummeted a whopping 20-30% in the first quarter of 2005. But the horrors of the experience comes from the fact that GM might just end up being bankrupt sooner than later (Fortune, February 2006).

Contrastingly, the Japanese conglomerate Toyota has tread carefully and has invested in all relevant technologies. Greater emphasis on fuel efficient lighter vehicles has been a wise step as the company correctly gauged the market trends towards fuel efficiency which is its strong hold. Detroit is feeling specially challenged by Toyota as it recently overtook Ford – which started the US automobile revolution back in 1901 with its 'model T' – and is now the No. 2 auto company of the world. Ford chairman Bill Ford Jr. was left helpless as Toyota strategically ate into its market share. In a most ironical role reversal, Bill Ford recently commented that his company's primary objective now was "to beat Toyota!"



Toyota has been quite innovative all these years and has maintained its efficiency by this virtue. The implementation of 'JUST IN TIME' strategy followed by a hallmark 'IMV' project involved improved production cycles and impressive capacity manpower utilizations. The IMV project in fact revolutionized outsourcing. Under its aegis, a particular car model is specifically produced in the target market with full localization content – this method reduces price and supply chain complications, which generally arise when production is not country specific. Due to these prolific initiatives, the introduction of thoroughly localised cars – such as the Yaris supermini, Fortuner and Innova apart from the world-class sedans Camry and the Corolla – has added stars to the company's profit tables. The company has always played the 'value for money' card to beat Detroit, even in segments that were previously considered top of the line (e.g. versus Lexus, Mercedes et al). Perhaps a bigger impetus has been obtained due to the 'fuel guzzler tax', that has ensured that Americans in general have become averse to their former beliefs, of big cars and big engines.

The key behind any company's success is understanding consumer taste and customer perception well and Toyota has scored really high on both accounts. The company knew customer insecurities with respect to oil prices well in advance, and therefore it left no stone unturned in cashing on this prejudice. Truly, Toyota's most successful world beater 'green factor' gamble has been the introduction of its hybrid car, the PRIUS.

The fact is that the gas-electric car, when launched in US in 2000, was considered by competitors to be rather beyond the requirement of the times. It was fuel efficient, and used technology that was way ahead from what the motoring world had ever seen, but had issues like relatively low acceleration power and the fact that the car could not many miles on the electric power component because of low battery power. But with innovation being of prime consideration to Toyota, the abovementioned problems were resolved to a considerable extent over time. And consequently the Prius did what no previous product could do for Toyota – catapult it to the top three in the world of automakers.

It is interesting to know that though the product was introduced just as a showpiece car to highlight the company's potential, Toyota not only holds 60% of the hybrid market today, but is also considered the most technologically innovative and affordable brand; a positioning combination that is almost impossible to achieve. As the concept of hybrid vehicles caught the whims

Toyota invests massive amounts of money in research and development and that shows

and fancies of car buyers in the developed world, other manufacturers tried to give Toyota some company but failed miserably. GM, which had just five years back scoffed at the hybrid concept as being not that usable, suddenly officially accepted last year that perhaps it had missed the hybrid bus. GM's Graphyte hybrid is still in concept stages; and the EV1 electric vehicle is considered impractical by industry analysts. Ford also could not move things as planned with its 'model U'. Now Toyota expects its hybrid range to contribute 10% to its total sales in this decade; of course, with electricity powered vehicles biting at its hybrid concept. So where does all this leave GM?

Theoretically, GM still has about $23 billion in cash reserves – a flamboyant asset that could be used while leveraging its equity ratios; but it should not be forgotten that GM is indebted to the tune of $30 billion. The amusing aspect is that the reasons for GM's travails are actually quite simple. When Toyota entered the US market, it hardly had any global presence, but what it did have was a range of cheap affordable cars which were extremely popular. After realising that Toyota was gaining ground, GM initially tried to kill Toyota at this game with the concept of 'economies of scale'. The logic of GM corporate strategists was that if the company produced large number of vehicles simultaneously, it would save costs and the company would be able to offer better value to the customers. But what they forgot was the fact that a large production cycle would require a large number of plants and – to maintain a continuum of production – a larger number of workers as well. Unfortunately for GM, this whole vicious cycle transformed into unmanageable liabilities.

GM never got away with this folly and eventually, demand could never really catch up with the supply side. Toyota, on the other hand, had a more conservative approach, as primarily it started with a plant in Japan and another one in Latin America. Toyota continued to take the import and assembly route until the 1980s when it strategically built ten highly efficient plants in North America, including the 4300 employee Princeton production facility that benchmarked labour efficiency ratios across the United States. Not only was this hugely cost effective, but also ended up saving a lot of money for Toyota at a time when competitors were bleeding badly. Another critical aspect of Toyota's ubelievable success has been that it has concentrated on product differentiation intensely. Comparatively, GM always has had a confused portfolio of brands, as cost-cutting measures hardly gave it a chance to maintain its brand identity consistently across products. The worst hit brands were the Chevrolet and Buick brands. Adding to this was the cost due to acquisition of Daewoo previously, and the billion dollar divorce payment GM had to pay to Fiat to pull out of a planned takeover of Fiat in 2005. Ford, the other big guy of the automotive world is no different than its half brother, GM. The company's brand portfolio does not represent a unified branding strategy. For example, the Volvo brand represents safety and technology, while on the other hand, the Jaguar and the Aston Martin brands represent style and speed. Further, The no nonsense Mondeo sedan and the outrageously powerful show car GT are further examples of brand extremes. These cars are really far apart in what they represent, but are still being sold on the same brand platforms.

Toyota has a single brand portfolio and hence encounters no brand prejudices

Toyota understood the concept of brand diversification rather well and bifurcated its luxury offerings early on, first with the CROWN brand and then the LEXUS. Interestingly the LS 400 sedan was received so well that Toyota had a solid foothold in the luxury segment overnight. The subsequent launch of the GS 300 forged Toyota's Lexus as a sought after brand. Lexus was often termed as a cheap Mercedes as it could do and offer anything the latter could at half the price. Cheap was, is and will be the mantra for Toyota, but not compromising on quality. Reaching these levels of refinement was only possible with Toyota's relentless struggle to be the "cheapest best" in industry. To break the mundane and price conscious outlook of the company, Toyota has now entered Formula 1 (F1). Ending the 2005 season in the top five teams has given the company a new found confidence and established the brand Toyota as "performance capable". Though Toyota was never starved of performance cars as the stable's CELICA sports car has always been an epitome, the success at F1 has added up to it. Though everything seems to be working now for the behemoth called Toyota, it has to now face up to other fast upcoming Japanese brands. Honda, with its 2006 eight generation Civic almost ready for launch is poised to take on the conservatively styled Toyota Corolla. Nissan, under Carlos Ghosn, has also turned over a new leaf with its French connection with Renault.

Toyota represents key learning for the corporate world in the strategy of forecasting global change, capitalising on that change through radical innovation, and ensuring that such innovation finally transforms itself into affordable and useful products. If global corporations were able to follow this strategy, the world would of course be a much better place for consumers. No doubt, in Fortune's March 2006 survey of The World's Most Admired Companies, Toyota came in 2nd. And where were GM & Ford? Not in the top fifty! ■

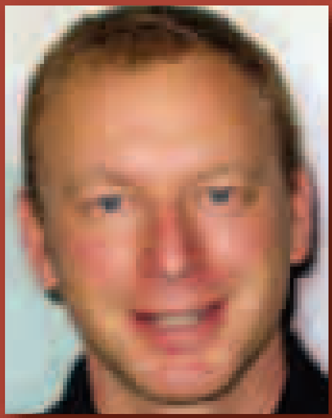
Edit bureau: Karan Mehrishi

Interview with
Dr. Tom Kirschmaier
Professor, London School of Economics

by Virat Bahri

"The story of CORPORATE GOVERNANCE starts here"

People should constantly & strongly ask questions before and after investing. Because the investor has the right to know what value he would get out of it.



Ques: *Is corporate governance only about maximizing shareholders' value? How does one protect a company's overall interests?*
Ans: Corporate governance is fundamentally about two dimensions; first, about protecting investors so that they feel secure about investing in somebody else's firm, and second about putting processes in place that ensure that a firm is managed and organized in the best possible way. Without protecting the suppliers of capital nobody would invest in another company. This means companies would not have the capital available to rationalize and automate their operations, and so would not be able to pay higher wages, nor would they have the capital available to grow their firms. As you can see, corporate governance is pretty fundamental.

You can look at corporate governance in another way. There are essentially two input factors into a firm, Capital and Labour. While Labour is represented through Unions, Capital is represented through the various corporate governance mechanisms. Ideally, one achieves a certain balance of power between unions and corporate governance.

Ques: *It is seen that the problem starts when one has to decide how to structure corporate governance, How does one do that?*
Ans: One thing that has to be kept in mind is of course that "maximization of shareholders' value" is about running and managing these firms well. It is nothing artifical. Investors provide capital and get competent people to work together for the benefit of all; that is, shareholders as well as the management and employees. This way, the balance of power is maintained.

Corporate governance is concerned about protection of all investors, shareholders as well as debt holders. But more emphasis is given to maximization of shareholders' wealth principally because shareholders are the people who carry most risk and have the least protection.

And of course, there is an important social dimension. Undercapitalised and small firms can't normally pay their employees well and have little chance to invest in new technology and grow the firms.

Therefore it is important that policy makers and lawmakers form a corporate governance framework and also see that it is properly implemented. And this is what corporate governance is really about. If firms are managed well, shareholders automatically get more value, and people get more interesting and better paid jobs.

Corporate governance is concerned with protection of all investors – shareholders as well as debt holders

Ques: *Dr. Kirshmaier, how can corporate governance be actually achieved?*
Ans: We've developed a set of institutions within the concept of an organization. These institutions not only include the board of directors, but also other in-

ternal and external corporate governance institutions like well structured incentive contracts, and even, as the nuclear option, hostile takeovers (in case an outsider thinks the company would perform better after being taken over). At the board level, there should be a distinct divison of labour between the Chairman, who is responsible for the governance of the firm, and the CEO who is in charge of running it (This differentiation between "governance" and "management" would ensure conflicts of interest are avoided; for example, where the CEO deliberately commits or omits something that is ethically questionable). Transparency, through such differentiation, is an important precondition for a well functioning governance system.

Ques: *Tell us why corporate governance is important and why it should be followed. Is it only about developing transparency?*

Ans: As I mentioned, corporate governance is important as in the end it ensures that firms are well capitalised and managed. Transparency is a necessary precondition, as without the right and reliable information, nobody can make a decision about whether or not to invest. When we look back in time, we see that corporate governance has improved considerably over the last 10 years. Everybody takes it more seriously, and the regulatory framework has improved considerably. There are of course still a number of problems, many of which are country specific. For example boards in the US have a very strong position as their decisions are very hard to challenge in-between any two annual general meetings. But if outsiders find boards aren't working, they have only very few – and normally very expensive – options, like hostile takeovers or proxy contests.

In UK, on the other hand, it is easy to challenge the board. If only 20% of the shareholders agree, then an Extraordinary Shareholder Meeting can be called, the threat of which is enough to discipline the board or the management. In Germany, for example, the board has 30-50% employee participation. These differences are a result of distinctly different economic and political developments.

This is also reflected in very different legal systems that have developed over time. Broadly speaking these are (1) case law system, as it is know in India and other countries with historic links to the Anglo-American system, and (2) codes based system, as it is known in France, Germany and Scandinavia.

The history of legal systems is very interesting, and nicely illustrate how circumstances shape systems, and how they affect present day structures. For example, in France, the King was weak and didn't trust his people. So codes were defined and executed, leaving most power with the centrally acting administration and giving judges very little leeway. Whereas in Britain, the monarch was all powerful and people had trust and faith in him; but more importantly, vice versa too. So, principles were developed, and many decisions were taken in a decentralized manner by judges in various districts. And this is one of the major questions that continental Europe faces with respect to corporate governance: Codes are easier to circumvent than principles. One can always hire expensive lawyers who find ways around these codes. From my point of view, it is therefore very important that we formulate very strong and clear principles – that can be implemented in a decentralised manner – and then develop strong enforcement mechanisms. Only then can a growth oriented organization develop and exist ethically.

> Previously, finance was not cheaply available through banks. The world changed when, in 1979, IBM defected from Morgan Stanley

Que: *What about minority shareholders' representation?*

Ans: Minority shareholder representation is important. However, concern for minority shareholder representation becomes obsolete if the board's outside directors are truly independent, competent and follow best corporate governance practices. Then the interests of minority shareholders are always taken care of.

Que: *What about India?*

Ans: It is a developing country. What we see here is like in many other developing countries – conglomerate structures (like Tata, Birla etc) have many firms working under one big roof. In the 1950s and 60s, the conglomerate structure was predominantly in America. These conglomerates were subsequently dismantled in the 1980s and 1990s, often through mergers and acquisitions. So why are there conglomerates in some countries, and not in others?

The answer to this lies in the availability of finance and good managers for smaller and medium seized firms. Let's take the US in the 1960s. At that time, business schools were not developed and skilled people like MBAs were not readily available. People had to be developed through rotating them throughout the firm. In addition, cheap capital was not readily available. In the

1960s, Wall Street was a cartel, and medium size companies were not important enough for the big Wall Street firms to be of interest to them. Finance was not easily and cheaply available through banks. The world changed when in 1979 IBM defected from Morgan Stanley. After that we saw a lot of competition and the entry of various smaller firms; and the services of investment banks were in reach of medium size firms. Capital was then available, and small firms did not necessarily need the large internal cash flow of conglomerates to have access to finance. This system was advantageous to investors also, as they could diversify over a larger number of individual firms, rather than a few conglomerates.

On top of it, conglomerates are difficult to manage and are facing problems of internal control. Conglomerates are often at a disadvantage when compared to stand-alone firms. Though conglomerates might be painted as the second best, they often are a necessary evil when operating in countries with underdeveloped capital or labour markets.

Que: *How do you get out of such a situation of conglomerates having a stranglehold?*

Ans: For India, it is therefore important to focus on developing an efficient capital market. This means establishing good capital market institutions, good corporate governance principles and an impartial and reliable enforcement mechanism.

Que: *How do you develop corporate governance in such a situation when (financial) conglomerates have great power to influence capital markets?*

Ans: Let me start by telling that most of the (financial) conglomerates are not listed because they are self-financed and are run by entrepreneurs (or by managers authorised by the foreign parent firm). Though this is ok, many of these firms might be better off tapping the external capital markets. The highest priority for India is to develop a liquid & reliable capital market, which can finance the build-up of India to one of the great economic powers, for which it has potential. One step that we will see along the way will be that conglomerates will be broken up into smaller focused firms.

The highest priority for India is to develop a liquid and reliable capital market

Sadly, presently we have a great number of conglomerates, some of which might feel that they are big enough to write their own laws. Much needs to be done in India in this field.

Que: *How would you compare India with countries like Japan?*

Ans: Japan has a different model. Also, firms that operate in sectors that are exposed to global competition and standards, like electronics and automobiles, are very successful. But in many other sectors where firms are not exposed to competition, things don't look that good. Overall, Japan provides only limited leaning for India.

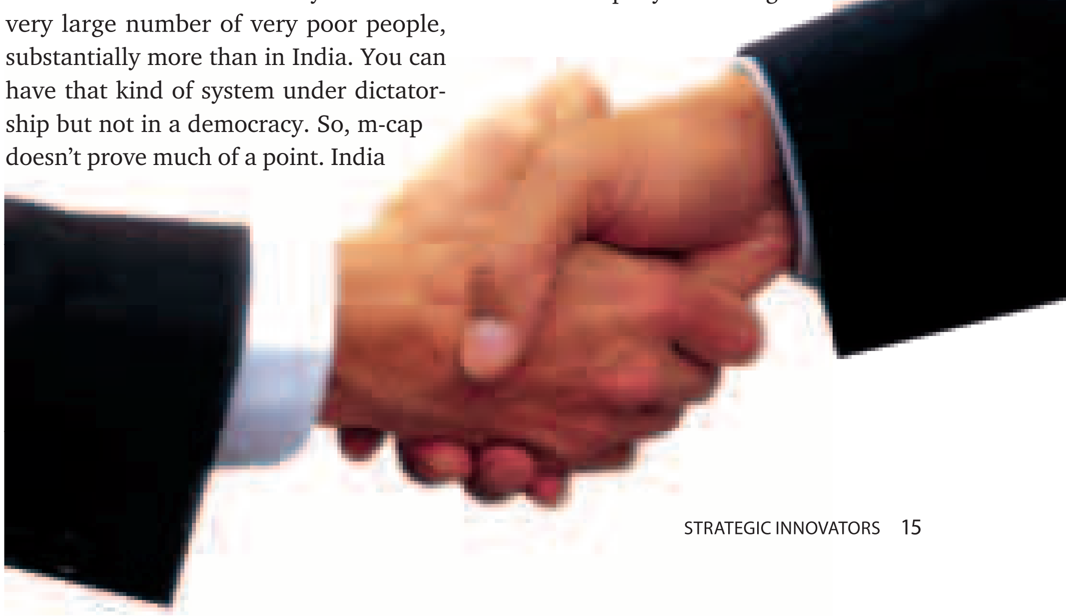
Que: *Recent research says that we have more market capitalisation (m-cap) than China; though they are very efficient. What have you to say about China as it is incredibly focused on production and India has not been able to match up with it?*

Ans: I think India is in a much better position than it thinks. China has a smaller middle class than India. They still have a very large number of very poor people, substantially more than in India. You can have that kind of system under dictatorship but not in a democracy. So, m-cap doesn't prove much of a point. India can't take up the Chinese economic model; it will not be able to sustain it. In India, the middle class is 500 million as compared to 100 million of China. China has a very narrow focused manufacturing system that exploits cheap labour. This is my advice to India – stand safe with your assets. You have many intelligent and well educated people, which will allow you to provide more services and other well paid services. But for that to develop, you need a well functioning financial market so that corporate governance can function properly.

Que: *Taking examples, Unilever globally and HLL (their subsidiary) in India have seen similar patterns driving their share prices down in the past 3 to 4 years. What is your perspective on such a situation when EPS is going down & shareholders are unhappy?*

Ans: Shareholders are unhappy as they perhaps understand they are not getting any substantial returns. Banga's retirement too was not a clear one. Not everything is working well; including the control mechanisms we mentioned previously. But on the other hand, five quarters are not much time if wish to question the growth rate in sectors like the ones Unilever (and HLL) operate in. Shareholders should give more time to test out performance.

At the same time, the corporate group should look into cost cutting as well. There comes a time to say goodbye but what is difficult is to find the time to say so. One important dimension is monitoring functions properly in India. One thing that is not proper is representation. If the question is about markets getting saturated and the company not seeing



growth, what should be done is that the company should be closed down and money given back to the owners. They should put it in other business or start a new venture.

And if the industry is one where current products or services go out of use very quickly, one should innovate. Money creates wealth and money comes from new innovations. All of it mingles. Corporate governance is a part of larger system. Germany is a good example where we can see that it focused on limited goods after 1920. All capital intensive sectors grew there at that time. They focused on technology & development and nurturing latest innovations; and the labour market also developed through strong labour unions & thus Germany additionally developed scale economies.

Que: *What do you think about issues of succession plans? Are companies realizing the importance or still ignoring?*

Ans: In US people are really aware now. In UK, as well as Germany, things have become much better.

Que: *Is there any link between corporate governance and performance?*

Ans: For a number of – mainly scientific – reasons it is hard to prove a clear link between corporate governance and performance, but it is intuitively clear that better managed firms should lead to better performance.

Que: *In today's Indian firms we are seeing a trend of acquisitions. Corporations are taking significantly high risks by practising the strategy of mergers and acquisitions. What are your advice points for the Indian industry? Are we mature enough for M&A?*

Ans: If you buy a firm, the advantages one gets are tangible in form of economies of scale. The disadvantages are intangible like labour problems, power and other infrastructural differences, to name a few.

If one looks at merger history starting from 1895, then one sees that on an average, these mergers didn't make any money. Some firms did do well but largely they failed, because the art of this game is to see who benefits most (Even research by various consulting firms like McKinsey proved that around 50% of mergers were rampant failures considering shareholders' value).

If one looks at merger history starting from 1895, one would see that on an average, these mergers didn't make any money

The first dimension is that for firms to do well, they should buy relatively smaller competitors. In this we have an example like BMW taking over Rover – which was 3 times BMW – where in the end, the exercise failed because BMW didn't have managerial experience to handle such a behemoth.

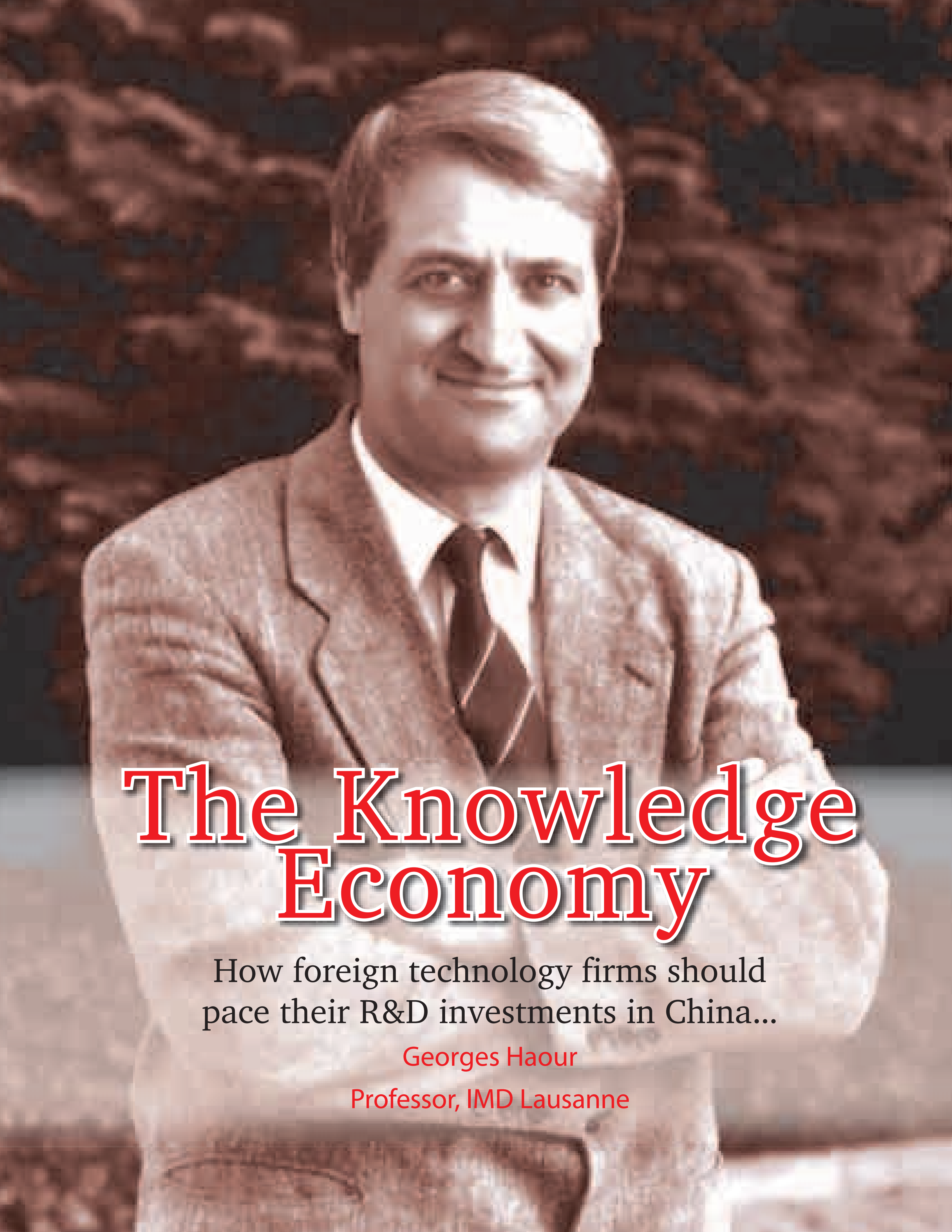
The second dimension is that one should be sure of what one wants out of the union. The goal should be achievable and it must be first kept in mind before deciding to go for the merger. This again is important because it helps in deciding who should one partner with. The merger would fail if it is not done with the right partner; it is similar to marriage.

Another thing one should have is a very good implementation plan in mind and a very clear vision. Consider for example the takeover of a company which is dependent on human capital, by a company which is based on technology. The merger between such kinds of industry based companies can never be good.

Furthermore, there should be commitment and communication when takeovers take place. Proper communication of facts and information among the people of both the companies is very essential for any further progress. Because when people don't understand what is happening, they start looking for jobs in other companies. These things prompt good experienced people to leave, and that is a great loss to both the companies. Another aspect is how one pays for the takeover. It can be either through paper (stock swap) and done in steps or it can be done in an all cash deal; though by putting in much cash, the company would have a shortage of money for other things.

All these things would be mirrored in the fall or rise of share prices of respective companies. All these factors, when separated, seem very simple; but when taken together they become incredibly complicated. But in reality, this also depends on what phase of the lifecycle a company is. In the infant stage, or the initial stage, it is easy and cheaper to buy a company; and the same becomes more difficult with each passing cycle.

In the end, with specific emphasis on corporate governance, I should like to say that stakeholders should constantly and strongly stand up and ask questions before and after investing. They should ask where are the things at present and where is the management taking them. Because clearly, the golden rule across the world is: The one who invests has the right to know what value one would get out of it. ■



The Knowledge Economy

How foreign technology firms should pace their R&D investments in China...

Georges Haour

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Overview

China's economy is expected to have grown at a rate of about 7% to 9% in 2005. Accomplishing massive transformations in its coastal regions, while remaining a developing country in its vast "hinterland", China is stepping up its transition towards the so-called "knowledge economy". This includes increased investments in R&D (Research and Development), estimated to be $60 billion in 2003.

Following Japan and Korea, China is using its dynamic manufacturing sector as the platform for stronger value-creating activities through product adaptation, and in due course, product innovation. By and large, China has already attained the latter stage in the telecommunications sector. Life sciences may well represent the next opportunity.

Attempting to exploit the potential of this huge market, foreign companies are making considerable investments in China, including R&D. However, in order to become an equal member of the world's R&D/ Innovation community, China's current applications of intellectual property laws must fully conform to OECD standards.

China's economy is fast climbing the value chain

Largely fuelled by a substantial flow of FDI (Foreign Direct Investment) of US$62 billion in 2003, compared to US$121 billion to the USA, China's economy elicits great interest. Having joined the World Trade Organization in 2001, China is currently making another round of decreasing its import tariffs: Taking the automotive sector as an example, the level of duties of 43.8% in 2001 will come down to 25% on July 1,2006.

Emulating Japan, where several decades ago engineers and marketers in Tokyo and Osaka designed, manufactured and sold products such as cars, cameras, walkmans, which would conquer the world markets, China's "world factory" is now moving to higher-value activities. In this trajectory of development, the manufacturing of products leads to product adaptation through R&D, which in turn creates product innovation.

As a result, China's investments in R&D, public and private, have roughly tripled between 1998 and 2003, according to best estimates. Widely ranging numbers are proposed for China's R&D investments: between US$14 and US$70 billion per year, depending upon the source. A more realistic figure may be US$60 billion, given by the Paris-based OECD (www.oecd.org). It is not clear how this estimate should be split between private firms and China's large public sector of SOEs, the State Owned Enterprises or government laboratories. This amount already represents a third of what the USA invests in R&D each year, but is still only 1% of China's Gross National Product, a level encountered in most developing countries. Taking the crude indicator of the yearly R&D investment per capita, the numbers are US$10 for China versus US$25 for Korea. As is particularly the case for R&D, input numbers are one thing, but what really matters is the effectiveness in transforming these investments into commercial successes.

Taking the example of electronics industries, it is anticipated that China will manufacture half of the entire world's output in this sector by 2008, or so. Chinese companies in this area include the PC maker Lenovo,with sales of US$3 billion in 2003. China's rapid ascension in this sector is illustrated by the US$2 billion Chinese firm TCL, which has become the world's first manufacturer of TV sets, following a deal with the French company Thomson Electronics in 2003. The resulting company now has a yearly production of 18 million units, far ahead of SONY and Philips, while currently China turns out a total of some 30 million sets each year. In chip making, recently established companies such as SMIC have aggressive growth targets. China thus challenges Taiwan's position in this area, occasionally even hiring Taiwanese managers to lead the growth of this industry.

> Attempting to exploit the potential of this huge market, foreign companies are making considerable investments in China, including in R&D

In the ICT's, Information and Communications Technologies, China has moved up the value chain aggressively. Bypassing fixed telephone lines, China is the world's largest market for mobile telephony, with 235 million subscribers in 2003. In this area, China is the world's most dynamic market for cellular phones, with yearly growth rates of 10-15% during the 2000-2003 period. China is using its muscle to impose its own preferred technical standards, thus pushing R&D activities and innovations specific to this market, but liable to diffuse to other countries. China's largest operator in this area, China Mobile, has a yearly turnover of close to US$13 billion, while telecommunications equipment maker Huawei, with sales of US$5.5 billion in 2004, recently secured a US$10 billion credit line from the China Development Bank in order to finance overseas expansion.

Non-Chinese firms and R&D investments in China

In recent years, Western technology firms have wanted to become players in this active scene. In particular, the Chinese ICT sector has seen considerable foreign R&D investments. In the recent past, close to 40% of these investments went to joint-venture firms, but the trend now is rather to invest in wholly-owned subsidiaries, whenever possible.

As an example, in early 2004, Motorola, one of the largest investors in China, had 1600 persons employed in the 19 centers of its China Research and Development Institute, which was established in Beijing in 1999. With five R&D units totalling 600 persons in China, Nokia is expanding its Product Creation Center in Beijing, while telecom equipment maker Ericsson is completing a plan to invest US$600 million in China between 2002 and 2005.

In the ICT area, investing in R&D in China is a necessity. To start doing it only now is already late. This is not only because of the sheer size and dynamism of this highly competitive sector, but also due to the fact that China has become the world's innovation driver in this sector.

The healthcare and medical sectors also represent considerable potential for growth. Again, the logic of the population size and economic growth makes it likely that by 2010 the Chinese market will grow from the present US$10 billion to become the fifth market in the world. Also, the country's pool of talent in life sciences is considerable. It is estimated that close to 200,000 researchers are currently involved in biotech R&D work in China. The country is leading in specific areas of gene therapy: An example is the anti-neck-and-head cancer drug Gendicine, commercialized in early 2004. A specific feature of China's scene is that public opinion in this area appears to show little reluctance to issues such as gene technologies, in contrast to US and European societies where occasionally heated and irrational fears hamper scientific work.

In all, many features make China a high-potential market in the healthcare area. As a result, Swiss drug-maker Roche opened an R&D unit in Shanghai in 2004. That same year, the Danish Novo established a collaboration with 60 staff at Beijing's Tsinghua University. Building on century-old traditions, the effects of Chinese herbal medicine are currently studied by various pharmaceutical companies, using genome research.

In the engineering sector, participating in the buoyant market encouraged companies such as elevator maker Schindler to set up R&D activities in Shanghai more than 15 years ago. In this way, the company was able to benefit from a situation where the dynamic building sector was less risk-adverse – as is the case in times of robust growth – hungry for novel features and prompting local innovative developments, which would eventually be used elsewhere in the world.

With similar logic, Bosch, following the rapidly growing car manufacturers General Motors and Volkswagen, who already are among China's largest foreign investors, plans to make R&D investments of 600 million Euros in the country within the next two years.

How should foreign technology firms pace their R&D investments in China?

Large non-Chinese firms have rushed in, to be in a position of some day profitably participating in this dynamic scene. When it comes to R&D/Innovation, a knowledge-intensive activity par excellence, there is, however, an additional attraction: China offers a considerable pool of talent, while having a general high esteem for technological or scientific pursuits.The country's university system counts some of the world's leading institutions. Each year, China graduates three times more engineers than the USA and 14,000 PhD degrees are given. In addition,there is a diaspora of 600,000 Chinese students abroad, with an increasing percentage of them returning to China soon after graduation in order to participate in growing opportunities, in a reverse "brain drain", just like Taiwan experienced in recent decades.

Trends on the national scientific scene look reasonably encouraging, if one is to believe the statistics on China as being one of the very few countries to have increased its share of the world's scientific publications:from 1% in 1995 to 3% in 2000. This should be compared with China's "rival" India, for which similar statistics indicate a slight decline from 2.1% to 1.9% in the same period.

Interestingly, the asset of access to technical talent was rarely invoked in the case of Japan in the "roaring 1980s". Then, the

For any industrial corporation, China's market size and spectacular economic growth are mesmerizing

rationale for foreign firms to do R&D in Japan was not so much to tap into the local talent, but rather to be able to adapt to this fast growing, quality-demanding market.

The presence of foreign organizations and management highlights the prospects of China catching up with the standards of the innovation process encountered in the world's most industrialized countries. Not surprisingly, managing R&D and technological innovation constitutes an area of growing interest. Most likely, China will soon innovate in the process of managing technical innovations, as well as contributing advances in the content of scientific and technological endeavours. A recent special issue on this topic in the Journal of R&D Management illustrates this interest. (www blackwellpublishing.com)

In all, it is estimated that more than 200 foreign firms currently have an R&D presence in China. The size of these units range from small "observation posts" to full fledged arrays of R&D laboratories employing several thousand staff. Townships and provinces actively compete to attract such investments. Tax incentives, infrastructure projects, administrative fast tracks are used to seduce investors. The country's business center of Shanghai is proclaiming itself a future world's hot-spot for life-science, competing with other cities such as Beijing, which, in addition to being close to government and leading universities, enjoys a somewhat less volatile manpower situation.

In the future, the pace at which companies will make R&D investments depends largely

on one set of issues around Intellectual Property (IP). This is indeed particularly valid for the life sciences.

Intellectual property in China

At different degrees depending on the sector, China has all the ingredients for robust value creation through technological innovation. But will the "mayonnaise take"? As China is closing the economic gap with the OECD countries, will the country attract foreign investments to help its transition from the "world's factory" to a "global fountainhead of innovation"?

Whether China becomes a world player in technological innovations crucially depends on the way it deals with Intellectual Property (IP) issues. China formally joined the World Trade Organization in December 2001, with the attendant IP regulations ofTRIPS -Trade Related Issues relating to Intellectual Property. China has ratified the corresponding treaties since the Paris Convention in 1984, but its familiarity with the IP area is recent, since its patent office was opened only in 1985.

It is estimated that more than 5% of world trade involve counterfeit goods, and this results in Japanese companies losing close to US$35 billion each year. In Asia, Singapore has been most determined to secure a solid IP framework, while relentlessly enforcing the law. China, on the other hand, is a major source of counterfeit products. In its 14 July, 2004, resolution 576, the US House of Representatives deplored "the continued existence of widespread IP rights violations in China". Chinese officials frequently underline how vital a solid intellectual property infrastructure is for their country. Indeed, China's legal framework for IP seems to be "state of the art", if one takes the industrialized Western practices as a standard. In particular, this concerns the 2000 Patent Law, with a "first to file" rule, the 2001 Copyright Law and the 2004 Regulation on Custom and Protection for IP. Crucially important, however, is the way this WTO-driven IP legal arsenal is actually put into practice. Most often,the various provincial courts handle patent litigations involving non-Chinese firms in ways that are rarely in favour of the latter. In the particularly IP-sensitive pharmaceutical sector, this is tantamount to turning ethical drugs into generics overnight for the potentially promising Chinese market. Recent cases, involving Pfizer and AstraZeneca, are not encouraging in this regard.

Conclusions

Primarily to serve this seemingly insatiable market, companies from higher-income countries will continue to massively invest in production in China, provided that qualified labour, materials, parts and stability are in adequate supply. China may thus become the paradox of a world flooded with goods, but possibly incapable of producing enough food for its inhabitants, since it is expected that in 2030 the world's population will require three times the current food production levels.

In parallel, China will increasingly benefit from "professional outsourcing", as the rest of the world taps into the considerable technical talent available there. India is another contender, with the well-known Bangalore-based, large IT companies Infosys and Wipro, as well as fast growing drug companies such as Ranbaxy and Dr. Reddy. India indeed presents the advantages of the English language and of a legal system highly compatible with the currently dominating Western way of doing business.

> China will increasingly benefit from professional outsourcing, because of technical talent

With regard to innovation, following the current period of consolidation of R&D investments in technology-intensive sectors, non-Chinese companies are expected to somewhat align the size of their R&D presence with their sales volumes, just like US multinational companies developed R&D units in Europe in the 1960s.This time, the shift may be more rapid, so that the prospect that R&D investments will level Europe and the USA, while growing at a healthy rate in large overseas markets such as China or India. This seems particularly to be the case in China's telecommunications sector.

The caveat is indeed the IP situation: If carrying out R&D in China results in substantial leaks of innovation-based competitive information, R&D investments will be channelled elsewhere. Technology firms must carefully monitor IP practices in the field, particularly in the life-sciences area. A key incentive for making the IP scene a "level playing field" is likely to come from domestic technology firms. The already mentioned Huawei company invests 10% of its sales in R&D each year. As it grows overseas, such Chinese technology companies will want comparable patent protection at home and abroad.

But overall, the combination of China's large, innovation-prone and fast-growing markets, together with the availability of its substantial pool of engineering talent, are likely to constitute too much of an attraction for non-Chinese technology firms to resist. ■

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www. innovationparadox. Com

Anti-dilution protection. Everyone has heard that phrase. Most people think they know what it means. But many first-time entrepreneurs don't and that can lead to huge mistakes. One of the problems is that "dilution" has several meanings when it comes to doing a deal. This is the first article from a series on various types of dilution definitions and significant factors associated with and affecting each one of them.

Percentage-based Dilution

If you own 60% of the equity of your company before an investment and 30% afterward, that's dilution. If an investor owns 40% of your company before a round of investment and 20% afterward, that's dilution. BUT that's NOT the kind of dilution that anti-dilution protection applies to. Let's look at some other options.

Share Price Dilution

Confused? Well, let's talk about the kind of dilution that investors do seek protection against. If an investor buys shares of stock in your business at $1.00 per share and the next round of investment is at $0.50 per share, that's dilution.

Back To Basics

Some basics about deals –

- Deals are negotiated with percentages, but are structured with shares.
- The value of a company is only known at the instant of a transaction when cash is being exchanged for equity.
- The value of a company is determined by multiplying the total number of common shares by the most recent share price.
- Pre-Financing Value + Investment = Post-Financing Value.
- Pre-Financing Value = Post-Financing Value *Less* Investment.
- Price per share = Amount of investment divided by shares purchased.

But the truth is that that's all pretty dry and boring gobblygook, unless it's your company and you're the one who is doing the deal.

The 1st Round (Fig. 1)

Let's translate this into an example:

- I offer to invest $400,000 in your company in exchange for 40% of it.
- Since you own all 600,000 shares of your company, I am offering to buy 400,000 "new" shares in order to acquire 40%.
- My investment of $400,000 divided by 400,000 shares that I'm buying yields a per share price of $1.00.
- Since you own 600,000 shares, that means the value of the stake in your

Learning to Destroy

All you wanted to know about dilution, but were afraid to ask!

Frank Demmler
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company is $600,000, which is the pre-financing value.

- Adding my $400,000 to that yields a post-financing value of $1,000,000.
- That is confirmed by taking the total number of outstanding shares, 1,000,000 (your 600,000 and my 400,000) and multiplying by the share price of $1.00.
- That also says that the post-financing value of your company is $1,000,000.

Everything is in balance. The world is good.

The Good Second Round: Share Price Increase (Fig. 2)

As time progresses, you and your company forge ahead and it's time to raise some money. Fortunately, you are in a business that venture capital investors are interested in. They are looking at you, and after a while you negotiate a deal with one of them.

- The new investor offers to invest $2,000,000 for 50% of your company.
- If 50% of the company is worth $2,000,000, the total worth must be $4,000,000.
- Since there are 1,000,000 shares outstanding today, and they will represent 50% of the company after the financing, then the new investor is buying 1,000,000 shares.
- The $2,000,000 investment divided by 1,000,000 shares yields a price of $2.00.
- Since I paid $1.00 per share, I'm happy. In fact, the 400,000 shares that I paid $400,000 for are now worth $800,000 (400,000 shares X $2.00 per share).
- The value of my investment has appreciated (grown in value).
- Even though the percent of the company I own has decreased (been diluted) from 40% to 20%, I'm happy.
- By the same reasoning, your equity stake is now worth $1.2 million, and you've got $2,000,000 of investor's money to pursue your dream!

Everything is in balance. The world is good.

The Not-so-good 2nd Round: Share Price Decrease (Fig. 3)

Alternatively, as time progresses, you and your company move forward. It's time to raise some more money. Unfortunately for you, you are in a business that venture capital investors shun. Only one expresses lukewarm interest. Finally, you extract a deal.

- The new investor offers to invest $500,000 for 50% of your company.
- If 50% of the company is worth $500,000, then the total company must be worth $1,000,000.
- Since there are 1,000,000 shares today & they will represent 50% of the firm after financing, then the new investor

Figure 1

	Invest-ment	Price per Share	Shares	%	Post Financing Value
You			600,000	60.0%	$600,000
Investor 1	$4,000,000	$1.00	400,000	40.0%	$400,000
Investor 2					
Subtotal			400,000	40.0%	$400,000
Total			1,000,000	100.0%	$1,000,00

Figure 2

	Invest-ment	Price per Share	Shares	%	Post Financing Value
You			600,000	30.0%	$1,200,000
Investor 1	$4,000,000	$1.00	400,000	20.0%	$800,000
Investor 2	$2,000,000	$2.00	1,000,000	50.0%	
Subtotal			1,400,000	40.0%	$2,800,000
Total			2,000,000	100.0%	$4,000,00

is buying 1,000,000 shares.

- The $500,000 investment for 1,000,000 shares yields a share price of $0.50.
- Since I paid $1.00 per share, I'm not happy. In fact, the 400,000 shares that I paid $400,000 for, are now actually worth $200,000 (400,000 shares X $0.50 per share).
- My investment value has been diluted.
- In addition, my holding has decreased (diluted) from 40% to 20%.
- By the same reasoning, your equity stake is now only worth $300,000, and you've only got $500,000 of investor's money to keep your business alive.

Everything is in balance. The world is not so good. I want protection against dilution.

It is critical to understand the context of dilution in deal making. An investor is most concerned about his investment. If a transaction will reduce the value of investment (a lower price per share than he paid), he will seek anti-dilution protection. An investor is concerned that the next round could be at a lower price per share than what he is paying now. Therefore, he will insist upon anti-dilution protection. If pressed for justification, the investor may explain that if the value of a company declines between rounds, management must be largely responsible. The investor maintains that he shouldn't be penalized for management's deficiencies. Two common types of anti-dilution protection are: Full Ratchet & Weighted Average.

Full Ratchet Anti-dilution Protection

As a practical matter (as compared to the legal language below), full ratchet anti-dilution protection gives the original investor rights to those number of shares of common stock the investor loses if he were to give up shares at the current round's lower price. Investors purchase preferred stock that is convertible into common stock. Initially the conversion is on a one-to-one basis, or at the same share price as that paid for the preferred stock. Anti-dilution protection is implemented by adjusting the conversion price.

In the event that the Company issues additional securities in the future at a purchase price less than the current (say, Series A) preferred conversion price, such conversion price shall be adjusted in accordance with the following formula: The conversion price will be reduced to the price at which the new shares are issued (*National Venture Capital Association*). Let's look at how this works.

Figure 3

	Investment	Price per Share	Shares	%	Post Financing Value
You			600,000	30.0%	$300,000
Investor 1	$400,000	–	400,000	20.0%	$200,000
Investor 2	$500,000	$0.50	1,000,000	50.0%	$500,000
Subtotal			1,400,000	70.0%	$700,000
Total			2,000,000	100.0%	$1,000,000

Figure 4

	Investment	Price per Share	Shares	%	Post Financing Value
You			600,000	60.0%	$600,000
Investor 1	$400,000	$1.0000	400,000	20.0%	$400,000
Anti-dilution protection			0	0.0%	–
Investor 1 Subtotal			400,000	40.0%	$400,000
Investor 2			0	0.0%	–
Investor 2 Subtotal			400,000	40.0%	$400,000
Total			1,000,000	100.0%	$1,000,000

Figure 5

	Investment	Price per Share	Shares	%	Post Financing Value
You			600,000	30.00%	$300,000
Investor 1	$400,000		400,000	20.00%	$200,000
Anti-dilution protection			0	0.00%	–
Investor 1 Subtotal			400,000	20.00%	$200,000
Investor 2	$500,000	$0.5000	1,000,000	50.00%	$500,000
Investor 2 Subtotal			1, 400,000	70.00%	$900,000
Total			2,000,000	100.00%	$1,200,000

The 1st Round (Fig. 4)

Reviewing the past example:

- I offer to invest $400,000 in your firm for 40% of stock.
- Since you own all 600,000 shares of your company, I am offering to buy 400,000 new shares to acquire 40%.
- My $400,000 divided by 400,000 shares yields a per share price of $1.00.
- Since you own 600,000 shares, the value of your stake is $600,000, which is 'pre-financing value'.
- Adding my $400,000 to that yields a post-financing value of $1,000,000.
- That is confirmed by multiplying the share price of $1.00 to total 1,000,000 outstanding shares (your 600,000 & my 400,000).
- That also says that the post-financing value of your company is $1,000,000.

There's one big difference now. The terms of this deal include full ratchet anti-dilution protection.

The Second Round (Fig. 5)

It's time to raise some more money. Unfortunately, the only investment offer you are able to attract is at a lower price per share than the prior round. Without anti-dilution protection, the deal would proceed:

- The new investor offers to invest $500,000 for 50% of your company.
- If 50% of the company is worth $500,000, then the total company must be worth $1,000,000.
- Since there are 1,000,000 shares outstanding today which will represent 50% of the firm after financing, the new investor is buying 1,000,000 shares.
- This $500,000 investment over 1,000,000 shares yields a $0.50 price.
- Since I paid $1.00 per share, I'm not happy. In fact, the 400,000 shares that I paid $400,000 for, are now worth $200,000 (400,000 shares X $0.50).
- My investment value stands diluted.
- In addition, my stake of the firm has been diluted from 40% to 20%.
- By the same reasoning, your equity stake is now only worth $300,000, and you've only got $500,000 of investor's money to keep your business alive.

But I do have anti-dilution protection, so the deal will have 'needs' to be adjusted.

The Adjustment – Step #1 (Fig. 6)

The deal with anti-dilution protection:

- The new investor offers to invest $500,000 for 50% of your company.

- If 50% of the company is worth $500,000, the total company is worth $1,000,000.
- Since there are 1,000,000 shares outstanding today & they represent 50% of the company after the financing, the new investor is buying 1,000,000 shares.
- The $500,000 investment over 1,000,000 shares yields a share price of $0.50.
- While I paid $1.00 per share, the new round will reduce that price to $0.50. So, in addition to the original 400,000 shares for which I paid $400,000, I will receive an additional 400,000 shares, bringing my total shares to 800,000 ($400,000 by $0.50 per share). Done? Nope.

By issuing an additional 400,000 shares, the total number of shares has increased as well. The new investor would only own 42% if we were to stop here, but we won't.

The Adjustment – Step #2 (Fig. 7)

Remember the first element of the deal:

- The new investor offers to invest $500,000 for 50% of your company.
- If 50% of the company is worth $500,000, the total firm's worth is $1,000,000.
- Since there are 1,400,000 shares outstanding, including those created by my anti-dilution protection, the new investor must buy 1,400,000 shares to purchase 50%.
- The $500,000 investment divided by 1,400,000 shares yields a share price of $0.36. Done? Nope.

The Adjustment – Step #3 (Fig. 8)

With the share price having dropped to $0.36, my anti-dilution protection needs to be recalculated.

- Since the price per share this round is $0.36, in addition to the original 400,000 shares for which I paid $400,000, I will receive an additional 720,000 shares, bringing my total shares to 1,120,000 ($400,000 divided by $0.36 per share). Done? Nope! But are you beginning to see a pattern?

The Adjustment – Step #4 (Fig. 9)

When I get additional shares from anti-dilution protection, the investor's ownership drops to less than 50%. The share price is reduced so that the investor is buying enough shares to own 50%. The lower price means I get more shares. That lowers the investor's share price. And on and on…

The Investor Outcome

The share price drops all the way to less than $0.17. The new investor buys 3,000,012 shares. I get 2,000,010 shares as a result of full ratchet anti-dilution protection.

Your Outcome

As you may have noticed, all of these adjustments have occurred to the investors' positions. What happens to you isn't pretty. As the number of shares ratchet higher, your number of shares remains at 600,000. Your share has fallen to 10%! Your shares' value has dropped to $100,000!

Reviewing The Basics

Let's look at relevant basics:

- Deals are negotiated with percentages, but are structured with shares.
- The value of a company is determined by multiplying the total common shares by the most recent share price.
- Price per share = Investment divided by the number of shares purchased.

As I've said before, these may appear to be pretty dry and boring gobblygook, but as we've seen, they can have very significant consequences. An investor in any given round of financing is concerned that the next round could be at a lower price per share than what he is paying this round.

Therefore, the investor will insist upon anti-dilution protection. Full ratchet anti-dilution protection is truly very friendly to the financial investor and very harsh to the original founder. ■

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Figure 6

	Investment	Price per Share	Shares	%	Post Financing Value
You			600,000	25.0%	$300,000
Investor 1	$400,000		400,000	16.67%	$200,000
Anti-dilution protection			400,000	16.67%	$200,000
Investor 1 Subtotal			800,000	33.33%	$400,000
Investor 2	$500,000	$0.5000	1,000,000	41.67%	$500,000
Investor 2 Subtotal			1, 800,000	75.00%	$900,000
Total			2,400,000	100.00%	$1,200,000

Figure 7

	Investment	Price per Share	Shares	%	Post Financing Value
You			600,000	21.43%	$214,286
Investor 1	$400,000		400,000	14.29%	$142,857
Anti-dilution protection			400,000	14.29%	$142,857
Investor 1 Subtotal			800,000	28.57%	$285,714
Investor 2	$500,000	$0.3571	1,400,000	50.00%	$500,000
Investor 2 Subtotal			2, 200,000	78.57%	$642,857
Total			2,800,000	100.00%	$857,143

Figure 8

	Investment	Price per Share	Shares	%	Post Financing Value
You			600,000	19.23%	$214,286
Investor 1	$400,000		400,000	12.82%	$142,857
Anti-dilution protection			720,000	23.08%	$257,143
Investor 1 Subtotal			1,120,000	35.90%	$400,000
Investor 2	$500,000	$0.3571	1,400,000	44.87%	$500,000
Investor 2 Subtotal			2, 520,000	80.77%	$900,000
Total			3,120,000	100.00%	$1,114,286

Figure 9

	Investment	Price per Share	Shares	%	Post Financing Value
You			600,000	10.00%	$100,000
Investor 1	$400,000		400,000	6.67%	$66,666
Anti-dilution protection			2,000,010	33.33%	$333,334
Investor 1 Subtotal			2,400,010	40.00%	$400,000
Investor 2	$500,000	$0.1667	3,000,012	50.00%	$500,000
Investor 2 Subtotal			5, 400,022	90.00%	$900,000
Total			6,000,022	100.00%	$1,000,000

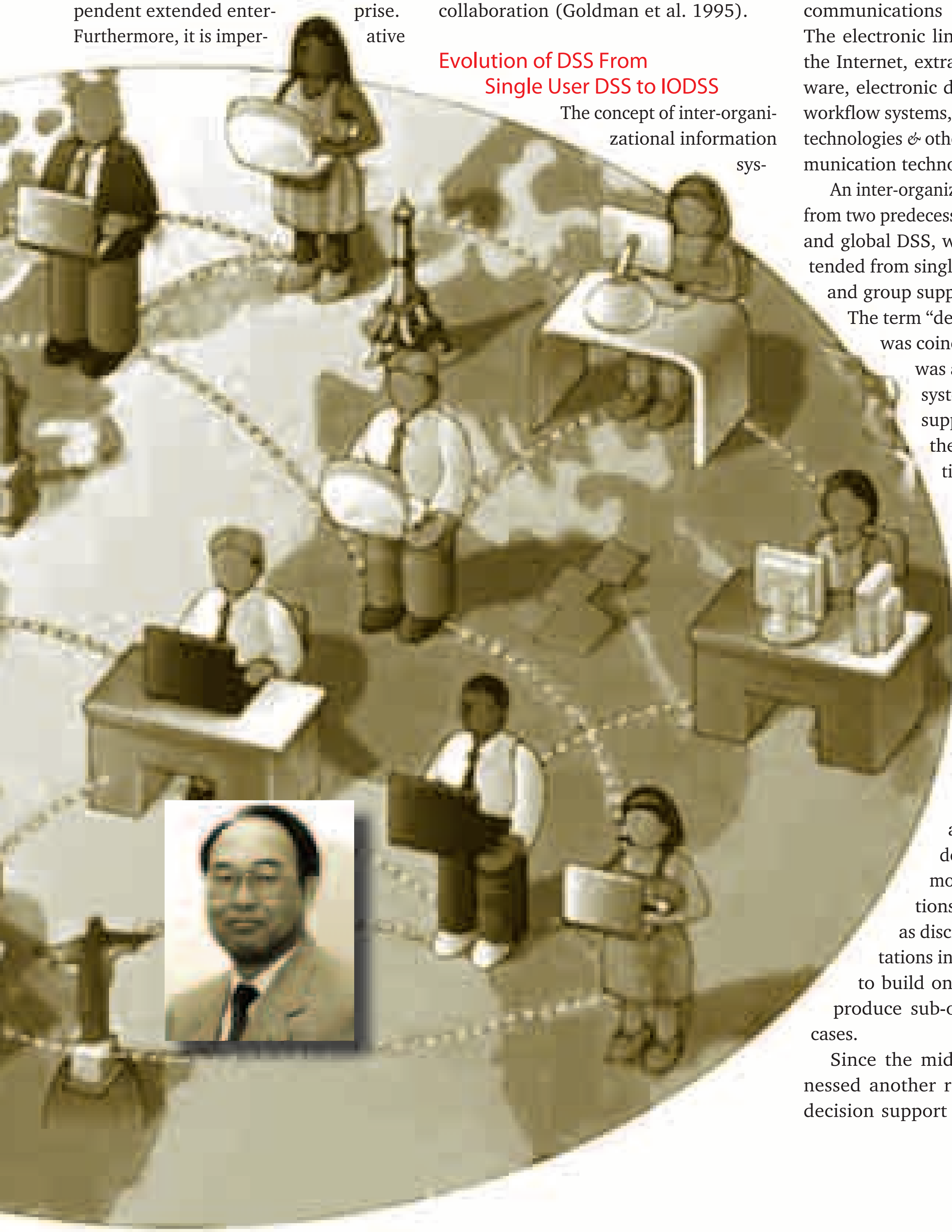
Inter-Organizational Decision Support Systems: An Emerging Tool for MANAGING THE DIGITAL FIRM in the Internet Age

Is decision making entering a new & more sophisticated stage?

Sean B. Eom
Southeast Missouri State University

Top management and policy makers in the twenty first century must be keenly aware of the most powerful phenomena of the new economy whose emergence poses new challenges. We have moved from an industrial economy based on coal, steel and smoke to an information-based economy. The new economy is characterized by several attributes – digitisation, knowledge/information, integration/internetworking, virtualization, and globalization (Tapscott 1995). Modern information systems are based on the digital computer which processes data represented in binary digits (bits) and communicated through digital networks at the speed of light. This is the basis of creating information/knowledge based economy. For that reason, the term 'information/knowledge based economy' is often used interchangeably with digital economy. It is built on the digital computers and ubiquitous and invisible communication infrastructures. The digital firm totally relies on digital networks and communication and information technologies in managing internal functional operations and linking business partners to facilitate intra and inter-organizational collaboration.

The digital economy today needs a different set of business strategies from – business process reengineering, just-in-time inventory management, optimization of internal production planning and control, flexible manufacturing systems deployment, and making effective human resources planning. These are necessary but not sufficient enough to win the global competition in the new economy. In addition to optimizing all internal functional management processes, those organizations with the ability and commitment of electronically linking business partners will be able to survive under the new economy in the twenty first century. Emerging from the digital economy is a new organizational paradigm that changes how an organization competes in the industry. The new paradigm shifts the focus away from looking at an organization as an individual autonomous entity to viewing it as part of an interdependent extended enterprise. Furthermore, it is imperative for top management and policy makers to be keenly aware of an emerging organizational paradigm, the smart organization. It is information/knowledge driven, internetworked, learning, and agile in exploiting opportunities created by the digital economy (Filos et al. 2001). To fully explore the new opportunity, smart-organizations should focus on customers, and commit to intra and inter-organizational collaboration (Goldman et al. 1995).



Evolution of DSS From Single User DSS to IODSS

The concept of inter-organizational information systems (IOIS) has emerged as a strategic tool for achieving competitive advantages in the Internet age (Eom 2005). An inter-organizational information system transcends organizational boundaries via electronic linkages with its trading partners to share data, information and business applications. It provides the capabilities of electronic transactions including buying and selling goods and services, and facilitates communications and decision making. The electronic linkage is established by the Internet, extranets, intranets, groupware, electronic data interchange (EDI), workflow systems, mobile communication technologies & other information and communication technologies.

An inter-organizational DSS has evolved from two predecessors, organizational DSS and global DSS, which, in turn, were extended from single user DSS, group DSS, and group support systems (Figure 1). The term "decision support systems" was coined in the early 1970s. It was argued that information systems should exist only to support decisions, and that the focus of the information systems development efforts should be shifted away from structured operational control to semi-structured/unstructured critical decisions in organizations. During the 1970s, most of DSS research focused on a DSS for supporting a discrete functional decision within a functional management area for an individual decision maker. Although most decisions in organizations cannot be considered as discrete, technological limitations in the 1970s permitted us to build only the system that can produce sub-optimal result in most cases.

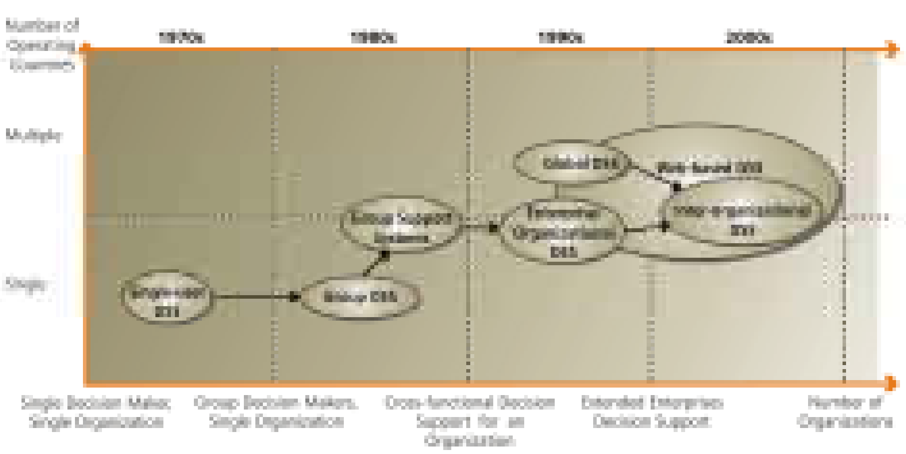
Since the mid-1980s, we have witnessed another research theme, group decision support systems (GDSS) for a set of decision makers working together as a group. GDSS are distinguishable from single user DSS in terms of number of decision makers/users. Research on computer based information systems to support group activities has been conducted under the titles of group decision support systems, computer supported cooperative work, group support systems (GSS), electronic meeting systems, and collaboration support systems. GDSS have focused on decision making/problem solving, while computer supported cooperative works are driven more by the communication needs of a group. There seems to be a consensus that GSS is a broad umbrella term referring to all information systems to support all group activities aforementioned.

During the 1990s, the focus of DSS research shifted from the optimization of functional decisions in an organizational unit to the optimization of an organizational task, activity, or decision that affects several organizational units. The best example of ODSS is enterprise resources management (ERM) systems/enterprise resource planning (ERP) systems. ERP systems integrate and optimize the entire organization's multiple functional units (marketing, human resources, production, etc.). The ERP systems support multi-plant, multi-location global corporations operating world-wide. The essence of ERP systems is the ability to tightly integrate the various functional units of an organization using a systems/process view of the organization. While production planning DSS in the 1970s could only produce production planning that cannot simultaneously consider its impact on the other functional areas of the organization, ERP systems produce production planning that results in the organization-wide optimization with the capability of analysing the overall impact on the organization (Eom 2002a; Eom 2002b).

Critically, the best examples of ODSS have been ERP and ERM systems

The distinction between global DSS and organizational DSS is based on the number of operating countries (see Figure 1). Nowadays, the distinction becomes blurred because very few pure domestic corporations exist. Global management support systems have indeed become a real world technology to deal with the real world managerial complexities of global corporations. Federal Express Corporation has developed an integrated decision support and information system, the Global Operations Control Center (GOCC) system. The system uses the World Wide Web and intranets to support critical decision making concerning future operations of the 2,500 trucks, 252 jet transports, and 200 feeder aircraft, as well as to keep track of what is happening in the far flung courier and freight operation. The GOCC system will be a strategic decision making tool to quickly and accurately evaluate the impact of operational, tactical, and strategic management decisions (Ott 1992).

Figure 1. Evolution of Decision Support Systems



Inter-Organizational DSS

As noted by Lambert and Cooper (Lambert et al. 2000, p. 65), "One of the most significant paradigm shift of modern business management is that individual businesses no longer compete as solely autonomous entities, but rather as supply chains". To exploit the challenges and opportunities created by the paradigm shift, inter-organizational DSS has emerged as a strategic tool for achieving competitive advantages in the global marketplace. Inter-Organizational DSS is primarily built on the extranets which can be executed over the Web to provide information, communication, and decision support (modelling and analysis) tools in order to create and sustain the competitive advantages of all consortium members of industrial networks. The critical element of IODSS is an integrated decision support modelling and analysis tool to handle the uncertainties in estimating demand, sales, lead time, supplier reliabilities, etc. Industrial networks (extended enterprise or integrated industry-wide system) electronically link multiple organizations in the same industry vertically (manufacturers, suppliers, and suppliers' supplier). It is also possible to link horizontally (linking competing firms in an industry).

Extended supply chain management is the best example of inter-organizational DSS applications. The supply chain is a series of physical entities associated in the process beginning with procurement of raw materials through several multiple-tiers suppliers (upstream supply chain), and internal manufacturing processes used by an organization (internal supply chain), and ending with the delivery of the finished goods to the customers, distributors of finished products, and retail outlets (downward stream supply chain). Its management requires inter-organizational collaborations between organization and its business partners.

Today's supply chain management software aims at improving Collaborative Planning, Forecasting, and Replenishment (CPFR) among companies in an extended supply chain. CPFR is not a specific information system. Rather it is a business practice (or general reference model) well adopted in the retail, hard goods, apparel and consumer packaged goods, and chemical industries. Readers are referred to http://www.cpfr.com for a good introduction to voluntary inter-industry commerce standards CPFR model. Based on reference models such as CPFR, there are several well known examples of specific IODSS in the USA. The Asset Management Tool (AMT) of IBM Personal Systems Group and other divisions is a notable example (Lin et al. 2000). The AMT system consists of enterprise database, advanced modeling, graphical user interface, simulation, and optimization capabilities for quantitative analysis of multi-echelon inventory systems. There are a host of other companies world wide who have implemented the CPFR model based IODSS including Ace Hardware, Federated Department Stores, Proctor & Gamble (P&G), Warner-Lambert, Wal-Mart, Kmart, and Target in the USA and Dansk, Sainsbury, Tesco, and Superdrug in Europe.

The essence of the CPFR model is sharing data/information and business models among business partners and implementing a collaborative co-managed planning process. The success of this model critically hinges on sales forecasts made by a retailer, supplier, manufacturer, etc. Warner-Lambert Co., a division of Pfizer Inc., linked its planning DSS to Wal-Mart's internal sales forecasting DSS, as well as to K-mart's forecasting systems. These links allow both K-mart and Wal-Mart to order and automatically replenish several product items from Warner-Lambert. ERP systems of companies in an extended supply chain are interlinked together and the collaborative planning layer (subsystem) is integrated as an essential part of IODSS.

Table 1. Evolution of Supply Chain Management Software

	Phase I (1995-2000)	Phase II (2000-2005)	Phase III (2005-2010)
Leading Software Models	ERP	Collaborative Planning/ Forecasting	Smart Networks
	Supply Chain Execution	Real-time messaging systems	Point-to-point delivery of customized SCM applications
Characteristics	Bulky applications designed to run on corporate networks	Lighter, faster applications designed for the Web	Real time total supply chain visualization
	Internal Data Center Managed applications	Suites of Supply chain applications hosted by 3rd party application service providers (ASP)	Mergers of ASPs into Telco Network Providers
	Focus on Corporate Transactions	Focus on joint operational agility between companies in a shared supply chain	Virtual supply chains, reconfigurable on the fly

Source: (Boyson et at. 2002)

Another example is the case of Ace hardware and its suppliers. Ace created an extranet so that manufactures can access its sales and forecasting data stored on the company's database server. An extranet is an extended or expanded corporate intranet, operating over the Internet for a wide range of applications by building bridges between the public Internet and private intranets. An extranet is created if an organization opens part of its intranet to others to improve coordination with trading partners in virtually all functional areas.

Extranets allow partners to gain access to collaborative networks

A secured extranet allows trading partners to gain limited (controlled) access to a collaborative network to increase profitability and competitive advantages through managing important organizational activities in the most timely and cost effective manner (Riggins et al. 1998). The CPFR model brings companies together to slash inventories, increase sales, and cut product cycle times. There are numerous success stories. One notable example includes IBM personal systems group that reported over $750 million in material costs and price-protection expenses saved in 1998(Lin et al. 2000). Schachtman (2000) also reported the following:

As a result of these forays, cycle time has improved by 12% to 20%. Out-of-stock items have also dropped because P&G has immediate access to its retail customer's sales data and promotional plans, and can take action before a marketing campaign kicks into high gear – and before a retailer runs out of products. In a recent promotion for Pringles potato chips, an English retailer was able to sell an extra $585,000 because P&G spotted a potential out-of-stock problem before it happened.

Future of IODSS

Having discussed the various types of DSS that can optimize the organizational planning and decision making and inter-organizational collaborative decision making, the next important question is: what comes within the next several years? According to Thomas Davenport, Director of Anderson Consulting Institute for Strategic Change, several broad-scale dominating trends are looming. They are globalization, rapid "sense and respond" business models, overcapacity and corporate realignment, the growth of virtual organizations, and accelerating product innovation (Davenport 2000). I will discuss only two trends – virtual organization and rapid "sense and respond" business models.

In the age of digital economy in which everything moves at the speed of light, a smart organization needs to be extremely flexible to respond to changing market demand, customer taste, government regulations, etc. The need for flexibility has attracted more interest in virtual organizations. Virtual enterprises are the fluid, flexible, and temporary inter-organizational systems to exploit business opportunities, focusing on core competencies and relying on other companies to perform the rest.

As the new opportunities come and go, virtual organizations are assembled and disassembled. In the future, it has been widely predicted that an increasing number of companies will be able to provide the capabilities to rapidly "sense and respond" to the changes in the business environments (changing demand and customer tastes, etc.) via forming virtual organizations as the opportunities and needs arise. Many organizations are responding to these types of changes by using internal organizational information systems with little collaboration with business partners in the form of "lean production" or "mass customization".

Smart organizations will be equipped with "smart networks" that are self adjusting (Boyson et al. 2002). According to Boyson of Supply Chain Management Centre at the University of Maryland, the future of supply chain management software is characterized by what he calls "smart networks" with very high bandwidth self-adjusting networks. In phase III (2005-2010) of the evolution, leading supply chain management software will be capable of creating "point to point delivery" of customized supply chain applications over smart networks.

Companies will use "virtual orgnaizations" to respond dynamically

Future supply chain management software will be primarily hosted by 3rd party application service providers (ASPs), and it will support virtual supply chains, reconfigurable on the fly. In conclusion, inter-organizational DSS will be able to effectively manage ever-changing organization's need for flexibility in responding to fast changes in the global market environment. To do so, future IODSS will be built on "smart networks" and support on-demand supply chains (virtual supply chains).

Conclusion

Top management and policy makers in the twenty first century must be keenly aware of the most powerful phenomena in the twenty-first century which poses new challenges to them -- emergence of the global economy, knowledge/information-based economies, the digital firm and industrial networks. To deal with such changes in the global business environment, management theorists point to the need to respond to the digital economy by creating a smart organization. A smart organization is the digital organization which is information/knowledge driven, inter-networked, learning, & agile in exploiting unprecedented opportunities.

Reengineering business processes, optimizing production planning & control systems, integrating functional subsystems into enterprise-wide organizational systems are necessary, but may not be sufficient to win the global competition in the Internet age.

Those organizations with the ability & commitment of electronically linking business partners will be able to survive in the Internet age. IODSS is an essential element of being a smart organization in the digital economy. ■

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Planman's Meta SBU Analysis Constructs

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The Planman Wealth Payback Sculpt helps organizations optimally utilize their capabilities for overall wealth development. This is the first in a series of articles...

How does one choose a good business from a bad one? How does one prioritize investments in various ventures? How does one come to know whether a business endeavour would turn out to be smash-hit or a box office flop of the future? For example, how could Thomas Watson, Chairman of IBM in the 1940s, have at that time known whether IBM's computer business was to be supported or not (Watson had purportedly said at one time that the world had a future market of only five computers)? In a nutshell, how could a person like Leo Burnett know whether to continue creating 'good' ads; or changeover to the more profitable profession of writing ransom notes?

Metasbu Analysis Constructs Generic Portfolio Models

Portfolio models are so known because they are able to provide a summary view about the various businesses of any corporation, generally utilizing diagrams and charts (and mostly matrices). Generic portfolio models are those that can be applied across various corporations and businesses. These models are 'generic' in nature as they provide standard, general and broad guidelines and strategies for the 'portfolios' of businesses that corporations might have.

Some of the better known portfolio models are the Arthur D. Little Model, Shell Directional-Policy Model, Boston Consulting Group's Growth-Share Matrix and the General Electric Portfolio Model. The Planman Wealth Payback Sculpt and Planman m-PIPE Matrix are some of the models that have been technically ranked superior to various portfolio models globally.

Planman Wealth Payback Sculpt (WPS)

Due to the fact that this article might not be enough to get into the various mathematical calculations that go into developing any Wealth Payback Sculpt and the MetaSBU Possibilities & Internal Potential Exploitation Matrix for a corporation or MetaSBU, we have provided a live reference guide on our all our web sites for our current international clients and other interested researchers & students.

Organizations requiring documentation kits and process manuals for WPS and m-PIPE constructs can directly write to our Global Opportunities and Threats Analysis Programme Cell.

The genesis of Wealth Payback Sculpt (WPS) lies in the realization that however much portfolio models tried to develop strategic orientations of businesses, the most critical aspect of wealth payback to the shareholders was strangely not included in the plethora of models available to management professionals. There was an urgent requirement of developing a portfolio model that could not only factor in this primary issue of returns to shareholders, but could also represent strategies that were understood by & justifiable to shareholders. There was also this problem that portfolio models worldwide were becoming more of slick presentation techniques rather than intelligent supports to strategy development.

> The biggest advantage of WPS is that it calculates wealth of individual divisions too

When the Wealth Payback Sculpt & m-PIPE constructs were initially developed internally in the 90s by a select team of Planman consultants that was working with the General Electric group on human resource consulting assignments, the objective was more to develop a model that could be truly used for conclusive strategy development. But it took till the latter half of the 90s decade for various technical issues in the WPS methodology to be adjusted after many practical tests on homogenous mix of companies globally.

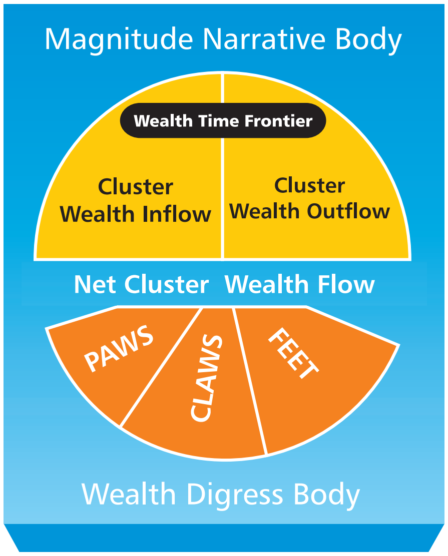
One presentation difference between these constructs and other portfolio models is that while other portfolio models attempt to chart all businesses of an organization on the same matrix, WPS & m-PIPE constructs analyze MetaSBUs or business units one at a time.

The Wealth Payback Sculpt is a rebuilt perspective of any business (or of any Meta SBU as we have described businesses) that views businesses as wealth creating or wealth destroying entities rather than as just being competitors in an industry. The m-PIPE Matrix utilizes this rebuilt perspective of a MetaSBU and infers the strategies that should be utilized after having placed the MetaSBU on a relative quadrant that allows the management and shareholders to understand whether the MetaSBU is providing the necessary returns on their investment. Thus, the Wealth Payback Sculpt focuses on providing a globally standardized profile for any business and the m-PIPE Matrix capitulates on this profile to fit it into relevant payback quadrants. The biggest advantages of the WPS and m-PIPE constructs are that these help in calculating the wealth index of not only corporations, but also of individual value chains, departments, divisions and other marketable business units of any organization. Thus corporations wanting to understand the wealth power of their warehousing department can use these two models and compare this with the wealth capability of say their transportation departments.

Requirement of Presence of TC (Transformation Capability) Units

WPS & m-PIPE Matrix are made in conjunction with various possibility scenarios. However, the 'most possible' scenarios are the ones that have to be analyzed time and again. See the discussion on forecasting given later on in this chapter to understand

Wealth Payback Sculpt



modern techniques advised by Planman to reach the most possible scenarios. It is of the utmost importance that the development of these constructs and the consequent strategy devolvement is undertaken by dedicated Transformation Capability Units rather than the management itself.

The TC Units, being independent by their very own definition, would be able to provide a spot on picture without conflicts of interest. The TC Units would be able to tread the border line between management's and shareholders' sentiments, researching the huge number of factors that go into gaining market competence, analyzing industry attractiveness, calculating various success & failure probability scenarios, deciding on the actual costs of capital, estimating essentially required rates of return etc and suggesting strategies thereon.

As is the case with other portfolio models, these two constructs also use inputs from external sources. But the inputs obtained are from sources across 360o of the business unit & the industry, rather than just from the management. A relevant question might be asked, "Doesn't this kind of intensive research by the TC Units lead to a lot of effort and time being invested?" The answer to this question focuses on the fact that decision making is no longer a one-man or one-division prerogative. Strategic decisions are not and should never be taken on gut-feel; or after analyzing situations with a short-term focus. Strategies have to be deduced after undertaking relevant fundamental & technical analysis of available & forecasted data. In this age of advanced computing and most modern enterprise resource planning solutions being available, it becomes much easier & faster to analyze complex and gargantuan masses of data. Even for smaller organizations, standalone packages for analyzing huge masses of data have made the process extremely unproblematic. These advanced constructs were initially developed by Planman while collaborating with the Indian Institute of Planning & Management In one of the consulting projects being initiated with Ford Motor Corporation USA under the guidance of Harvard Business School professors. The complexity of the exercise itself justifies development of industry specific, company specific and MetaSBU specific quantitative and qualitative equations that can provide the necessary data.

WPS Description

As shown in the exhibit, Wealth Payback Sculpt represents any Corporation, SBU or MetaSBU in the form of a circle (as has been prevalent in various other portfolio models. However, most of the similarities end here. Some more similarities would be described later on). WPS consolidates the wealth situation of the company, SBU or MetaSBU by calculating the present value of not only future & current wealth flows, but also past wealth additions, updations and negations.

WPS is made up of two straightforward main bodies: Magnitude Narrative Body (discussed in this issue) and Wealth Digree Body (discussed in the next issue).

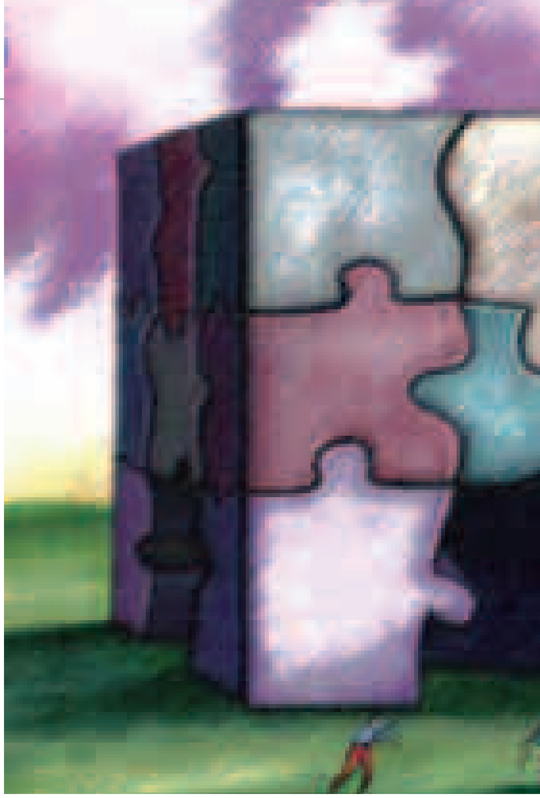
Wealth Payback Sculpt is made up of two clear bodies: Magnitude Narrative and Wealth Digress

1. Magnitude Narrative Body

This portion breaks up the status of the current period's wealth inflows (referred to as Cluster Wealth Inflows or CWI) and outflows (Cluster Wealth Outflows or CWO) to give Net Cluster Wealth Flows (NCWF). Pertinently, in most of the cases, corporations use the Magnitude Narrative Body to simply give pointers to annexures that describe the magnitude of Cluster Wealth Inflows and Outflows more clearly. The question arises, what constitutes Cluster Wealth Inflows or Cluster Wealth Outflows? CWI & CWO are calculated by critically analyzing the balance sheet, profit & loss, cash flow statements and various other environmental parameters (internal and external) to calculate the wealth position of any business unit. There are currently 118 adjustments that have to be made to the various financial statements to reach the exact figures of CWI & CWO on a period to period basis. These 118 adjustments are extremely critical for the exactness in various calculations. The tradeoff is that these calculations sometimes become really cumbersome. However, Planman has identified between 4 to 12 critical adjustments that can more or less suffice to provide a very good approximation of the true Cluster Wealth Flows. Thus, even those managers who do not have access to financial management details can calculate the wealth figures by using these limited and easy-to-understand adjustments and use the same to decide on strategies.

Cluster Wealth Inflow in Magnitude Narrative Body

CWI is a parameter that increases the total wealth potential of a business unit any time positive wealth gets added on to the corporation. For example, sales (whether



cash sales or credit sales) increase the CWI (and thus increase the total wealth potential). Similar other operational revenues increase the CWI. CWI also increases when a corporation takes a loan, goes in for equity capital or sells of a long term capital asset.

Cluster Wealth Outflow in Magnitude Narrative Body

CWO is a parameter that decreases the total wealth potential of a business unit. CWO items eat into the wealth of the corporation. For example, expenses (whether cash expenditure or credit) increase the CWO (and thus decrease the total wealth potential). Similar other operational expenses increase the CWO. Mirroring the previous case, CWO also increases when a corporation gives away loans, buyback of equity capital or purchases long term capital assets.

Net Cluster Wealth Flow (NCWF) =
Cluster Wealth Inflow (CWI) –
Cluster Wealth Ouflow (CWO)

Critics have argued in the past that corporations can easily increase wealth status under these constructs by rampantly taking loans, getting equity capital, selling asset equipment, or increasing the amount of credit sales. Further, wealth status of corporations also might be wrongly decreased due to increased capital asset purchases, equity buybacks or even dividend payments. Even thought the Net Cluster Wealth Flow figure of every period would show only the actual wealth flows (that might have been wrongly manipulated by the management), the Wealth Digress Body of the WPS captures such deviations exceptionally effectively.

Please see the paragraph on 'Wealth Digress Body' in the next issue to understand how these constructs capture such attempts by calculating present values of future effects on wealth due to current and past wealth increasing and decreasing measures.

Shareholder Differentiation in Magnitude Narrative Body

CWI & CWO are extremely important to shareholders because while CWI displays how much equity is being brought in every year, CWO shows how much returns are being targeted for each block of shareholders. How does this make any difference? If you remember, we had mentioned that many a time, corporations use the area of CWI & CWO to point out annexures that contain the complete details. These annexures are typically useful because as a rule, the Wealth Payback Sculpt does not allow combining new equity with the past existing equity.

Even the past existing equity has to be broken up and divided into blocks that represent different groups of shareholders who were invited to subscribe to the company's shares at different times. Let's take an example of a company with paid-up equity capital of Rs.100 crores that had initially acquired Rs. 30 crores during startup through private placements (when, say, costs of capital were very high) and then had acquired Rs. 70 crores after two years through a public offer (when, say, costs of capital had become very low). When this company uses the WPS construct, it has to specifically show these two equity inflows separately. But of vital importance is the fact that WPS forces the management to disclose on paper the future planned dividend payout for these two blocks of shareholders separately.

Even though legally (as per corporate laws in most countries), management is not allowed to provide different dividend to different blocks of shareholders, this differentiation of shareholders allows the

TIME VALUE OF MONEY (PAWS, CLAWS, FEET) IN WEALTH DIGRESS BODY

A wealth inflow of Rs.100 today is not equal to a wealth inflow of Rs.100 say in the next year. The amount of Rs.100 that we might receive after one year is actually equal to a lesser amount today; 'how much lesser' is found out by discounting the next year's amount of Rs.100 with an interest rate that is equal to the required rate of return. If we use 10% as the discounting rate, then the amount of Rs.100 that we receive after one year is today actually equal only to Rs.100 divided by 110%. That is, equal to Rs.90.90 of today. In other words, if we had Rs.90.90 today and if we were to invest this amount in an activity (or say, bank deposits) that could get us 10% returns, then this amount of Rs.90.90 would have become Rs.100 after one year. If we discount tomorrow's Rs.100 with a lesser interest rate (say 5%), then the same amount is equivalent today to an amount of Rs.100 divided by 105%; that is, Rs.95.23. In other words, lower the discounting rate, higher the present value of future wealth flows; higher the discounting rate, lower the present value of future wealth flows. This is the concept of time value of money with respect to the Wealth Digress Body. This would be discussed in further detail in the next issue.

WPS becomes an outstanding tool to make management responsible towards different shareholders

management and shareholders to clearly calculate whether the management has returned particular groups of shareholders' initial investments with adequate profitable margins or not.

Thus WPS becomes an outstanding tool to make management responsible towards different blocks of shareholders. In our example, the management might have made enough dividend payments to the initial Rs. 30 crore group of shareholders (whose costs of capital had been very high as per our description above) to cover their initial investment alongwith the required profit margins. This realization would actually make them stronger while facing this first group of shareholders as management would have actually justified the investments of this particular group. This allows the management the freedom to focus on the second group of Rs. 70 crore shareholders (whose costs of capital had been very low), thereby actually lessening the burden on the management's shoulders; at the same time justifying this shift in focus to the first group of shareholders by using the WPS. The first group of shareholders would not mind the management shift of focus because the management would be able to logically prove to them how their initial investments have been paid back with adequate profit margins. Again, as per our example, due to the fact that the second group of shareholders had invested money into the company by borrowing at much lower rates than the first group of shareholders, the management would not have to focus on ensuring returns at the previously high costs of capital.

Wealth Time Frontier (WTF) & WTF Tally in Magnitude Narrative Body

The Wealth Time Frontier (WTF) stands for the number of remaining periods that it would take for a particular shareholder group's wealth to be paid back with returns. The WTF Tally figure provides the remaining amount for every shareholder group. The WTF Tally for each group is increased every period by the Augment Interest Rate in order to provide the true present value figure of investments.

WTF for each group of equity investors is written alongside the relevant category in the WPS annexures. WTF follows the nomenclature of WTF (-n) where 'n' is the number of periods remaining for payback. Thus if the management, using the Wealth Payback Sculpt, were to assign a WTF (-9) schedule to a particular group of shareholders, it would mean that that specific shareholder groups would get back their investments (the AIR rate of business return) in 9 periods from the present.

On the other hand, once the payback has been made, then the management starts assigning positive Wealth Time Frontiers to the shareholder groups. For example, in case a group of equity investors has been assigned a WTF (+3) schedule, that would mean their investments plus the business return has been paid back to them 3 periods previously and any extra dividend they might be getting are the true bonuses for undertaking the business risk.

It is highly advisable to develop separate Wealth Time Frontiers for each group of equity investments. The objective is to ensure that each group of equity investors is provided with real-time information on the status of their investments. As mentioned previously, the Wealth Payback Sculpt simply mentions the numerical figures of total Cluster Wealth Inflows & Outflows. Annexures and detailed descriptive material should be necessarily provided by the management to show the breakup of these Net Cluster Wealth Flows and the Wealth Time Frontiers attached with various groups of shareholders. Very interestingly, the WTF & WTF Tally assigning system should also be inevitably used for entities giving loans to the business unit. When a particular loan giving entity or financial institution is assigned a WTF schedule, it allows the financial institution to easily understand repayment schedules. It might seem that financial institutions are not too worried about the WTF schedules as in most cases the institutions work out the schedules much before giving the loan.

That is not the case at all. Modern financial loan transactions have started involving various cash flow components where such financial institutions demand a share of revenues or cash flows as a part of the repayment schedule. The Wealth Payback Sculpt allows financial institutions to understand the repayment schedules of not only their loans, but also the loans of other financial institutions and other wealth outflows (like dividend payments) being incurred by the corporation. From the shareholders' perspectives, it becomes very important for the shareholders to know in straightforward terms how various loans are eating into the wealth of the business. For the shareholders, having a WTF benchmark becomes very important when they wish to analyze the timeliness of their dividends compared with other Cluster Wealth Outflows like interest repayments on loans. ■

(As mentioned, the Wealth Digress Body will be discussed in the next issue...)

Application to India

Contrarian Investment Strategies:

Despite all the hype, contrarian strategies remain as promising as they are risky. Should Indian investors "Go Contra"?

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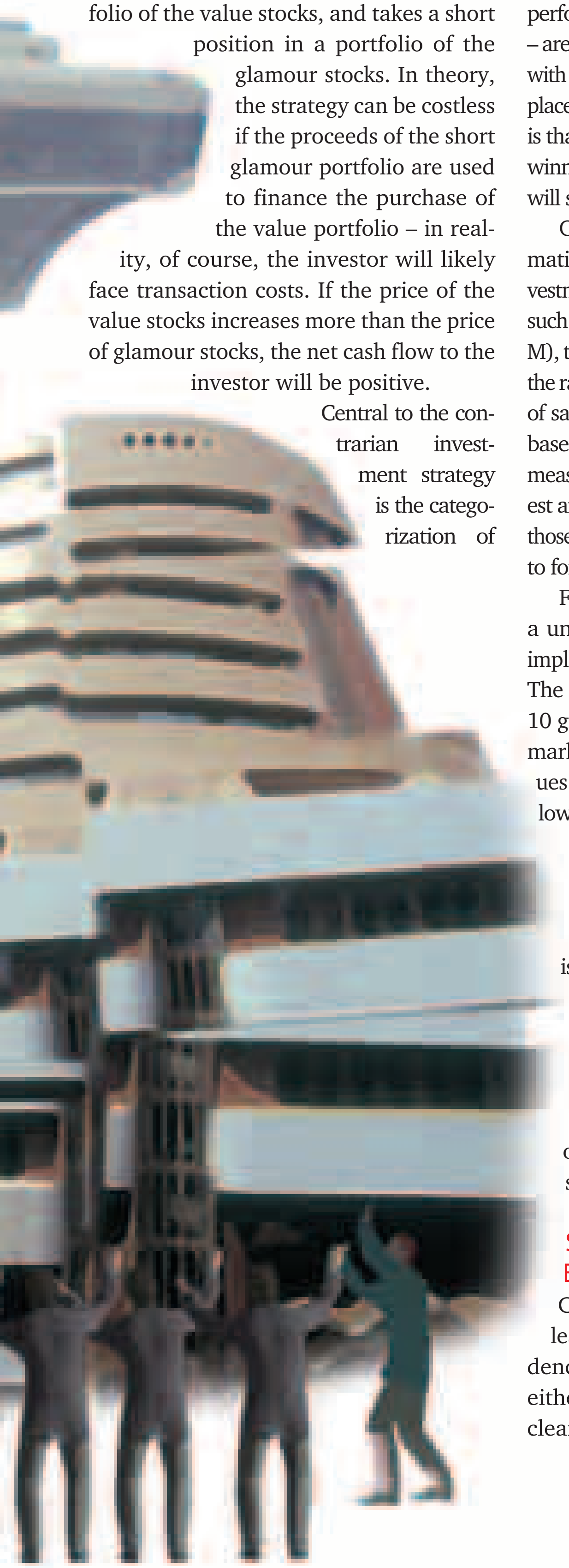
Contrarian investing refers to the strategy of investing in stocks that are "underpriced" while selling (shorting) stocks that are "overpriced." Stocks are classified as underpriced or overpriced through analyzing prior stock returns or accounting data. Investment professionals have long advocated contrarian investment strategies, arguing that such strategies can "beat the market." But many investors are highly skeptical, due to their natural suspicion of any investment strategy that claims to lead to consistently superior returns. Is it really possible to use publicly available accounting and return data to beat the market?

Surprisingly, the answer is that contrarian investment strategies may, indeed, lead to consistently superior returns. Academic finance researchers – individuals typically cynical about any "beat the market" strategy – have rigorously analyzed historical stock market returns. Using statistically sound analytical methods, they repeatedly find that contrarian strategies work. This unexpected finding has lead to a heated debate among academics: Some believe that contrarian strategies succeed because they are riskier – and argue that on a risk-adjusted basis such strategies cannot "beat the market." But others argue that contrarian strategies allow the intelligent investor to take advantage of quirks in the financial markets that are caused by naïve investors. Let's explore contrarian strategies in more detail – and consider the applicability to Indian investors.

Implementation of Contrarian Investment Strategies

Fundamentally, contrarian investment strategies require the investor to categorize some stocks as underpriced and others as overpriced, using methods that will be described shortly. Underpriced stocks are perceived as "value" stocks, which will eventually increase in price, while overpriced stocks are perceived as "glamour" stocks, which will eventually decline in price. Once the value and glamour stocks are identified, the investor invests in a portfolio of the value stocks, and takes a short position in a portfolio of the glamour stocks. In theory, the strategy can be costless if the proceeds of the short glamour portfolio are used to finance the purchase of the value portfolio – in reality, of course, the investor will likely face transaction costs. If the price of the value stocks increases more than the price of glamour stocks, the net cash flow to the investor will be positive.



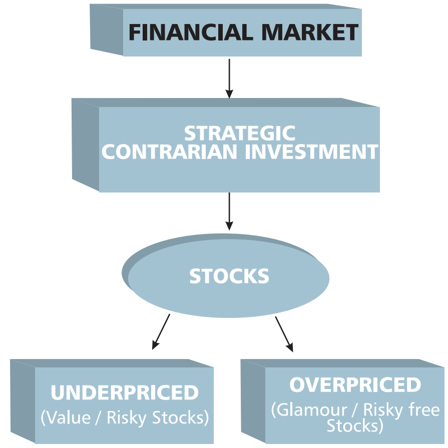
Central to the contrarian investment strategy is the categorization of stocks as underpriced (value) or overpriced (glamour). Broadly, categorization can be based on prior returns, or based on publicly reported accounting information. Categorization based on prior return can be as straightforward as ranking stocks on the basis of their historical return over some period. Those that perform most poorly in the past – the losers – are placed in the value portfolio, while those with the highest past returns – the winners – are place in the glamour portfolio. The expectation is that the portfolio of past losers will become winners in the future, while the past winners will start losing.

Categorization based on accounting information involved, ranking potential stock investments on the basis of accounting measures such as ratio of book value to market value (B/M), the ratio of earnings to market price (E/P), the ratio of cashflow to price (C/P), and growth of sales, among many others. Using rankings based on either one or multiple accounting measures, those stocks whose ratios are weakest are used to form the value portfolio, while those stocks whose ratios are strongest are used to form the glamour portfolio.

For example, consider an investor with a universe of 1,000 stocks from which to implement a contrarian investment strategy. The investor places these stocks into one of 10 groups on the basis of the B/M (book to market) ratio. The higher the market values the stock, relative to its book value, the lower the B/M ratio – and the more likely the stock is overpriced. Hence, the lowest B/M group, consisting of 100 stocks, is categorized as glamour and the highest B/M group, also consisting of 100 stocks, is categorized as value. Through investing in the value portfolio and shorting the glamour portfolio, the investor has implemented a contrarian investing strategy. Glamour & value portfolios can similarly be formed on the basis of multiple accounting measures at the same time.

Superior Performance: Evidence and Explanations

Can contrarian investment strategies lead to superior performance? The evidence for contrarian strategies that use either prior returns or accounting data clearly suggests they do. For example,



one group of researches formed value and glamour portfolios based on individual and multiple accounting measures. Using New York Stock Exchange and American Stock Exchange return data, and repeatedly testing the strategy between 1968 through 1989, they found that value portfolios outperformed the glamour portfolios for each of the subsequent five years by very large amounts. And the evidence is not limited to U.S. stock exchanges: Contrarian strategies have been proven to work in many other countries, both in developed and developing countries.

The intriguing question is: How can this possibly be? After all, one widely accepted (though frequently challenged) characteristic of financial markets is that they satisfy the Efficient Market Hypothesis, which is the idea that market prices already incorporate all available information. Given that prior return and accounting data is publicly available and widely disseminated, how is it sensible that an investor can strategically form portfolios that beat the market? Finance researchers provide several explanations for the success of contrarian investment strategies. Let's explore two common themes: The "behavioral" and "risk" explanations.

Proponents of the behavioral explanation argue that the overpricing associated with glamour stocks occurs due to existence of naïve market participants. These naïve market participants make their buy and sell decisions for spurious reasons, instead of basing their decisions on a rational assessment of the fundamental value of the stock – the present value of the expected cash flow flowing from of the stock – as do sophisticated market participants. With such participants in the market, stocks perceived as "winners" tend to become overpriced, while "losers" tend to be underpriced. These mispricings represent diversions from the fundamental value of the stock – and the trading activity of sophisticated investors will force stock prices to their fundamental value. However, due to the presence of naïve investors, the reversion to fundamental value takes some time. The success of contrarian strategies, therefore, is due to these short-term diversions from fundamental value caused by naïve investors.

Proponents of the risk explanation argue that the overpricing associated with glamour stocks is unrelated to any behavioral explanation. Instead, they argue that the value portfolio has superior performance because it is composed of riskier stocks – though this risk is difficult to estimate using traditional measures of risk. Indeed, proponents of the risk explanation argue, the very measures used to form the accounting-data-based portfolios that underlie the contrarian strategies proxy unobservable risk factors. Hence the performance of the value portfolio is not truly "superior" after adjusting for the additional risk burden.

As with any great debate, there is strong statistical evidence, using historical returns and accounting data, for both positions. What is clear, however, is that contrarian investment strategies work – though proponents of the risk explanation go to great pains to demonstrate that any benefits disappear once risk is fully controlled. While one explanation may eventually be proven unquestionably accurate, I suspect that the true explanation is likely a combination of both. The debate continues.

Application to India

Can contrarian strategies work for portfolios of stocks that trade on Indian stock markets? The evidence is sparse, and future research is required before we can conclusively state whether contrarian strategies can succeed in India. But in my opinion, the extensive evidence from the stock markets of other countries suggests that such strategies should be profitable in India. However, one should note that the performance of contrarian strategies in India can differ from their performance in large markets, such as those in the U.S., due to characteristics specific to Indian markets.

How do market characteristics influence contrarian strategies? The answer lies in the relation between the influence of naïve investors and market competitiveness and liquidity. According to the behavioral explanation of the success of contrarian strategies, naïve investors cause prices to divert from their fundamental value – but prices sooner or later reach their fundamental values. However, some argue that when a market is less competitive, or when the market is more illiquid, reversion to fundamental value takes longer. For example, one study found that contrarian investment strategies using stocks from the small New Zealand Stock Exchange are only profitable in the second year following portfolio formation, unlike U.S. studies which find such strategies profitable in the first year.

While the competitiveness and liquidity of Indian markets compare favorably against other emerging markets, they are weaker than markets of large developed countries such as the U.S. and Japan. Hence, if the behavioral explanation is accurate, we should expect contrarian strategies in India to take longer amounts of time following portfolio formation to become profitable.

This also suggests that an investor attempting to implement a contrarian strategy in India should not form portfolios based on current information, but on information from earlier periods. However, the deficit of research into contrarian investment strategies in the Indian markets makes any specific prescription speculative.

Concluding Remarks

I'll conclude with the following caveat: Our understanding of contrarian investment strategies remains primitive. Additional research is required to fully explore the applicability of contrarian investment strategies, particularly in the context of transaction costs and illiquidity, and particularly in India. As well, evidence that an investment strategy has been successful in the past is no proof that it will work in the future. Finally, contrarian investment strategies may be "successful" due to the additional risk the investor accepts, as we have discussed.

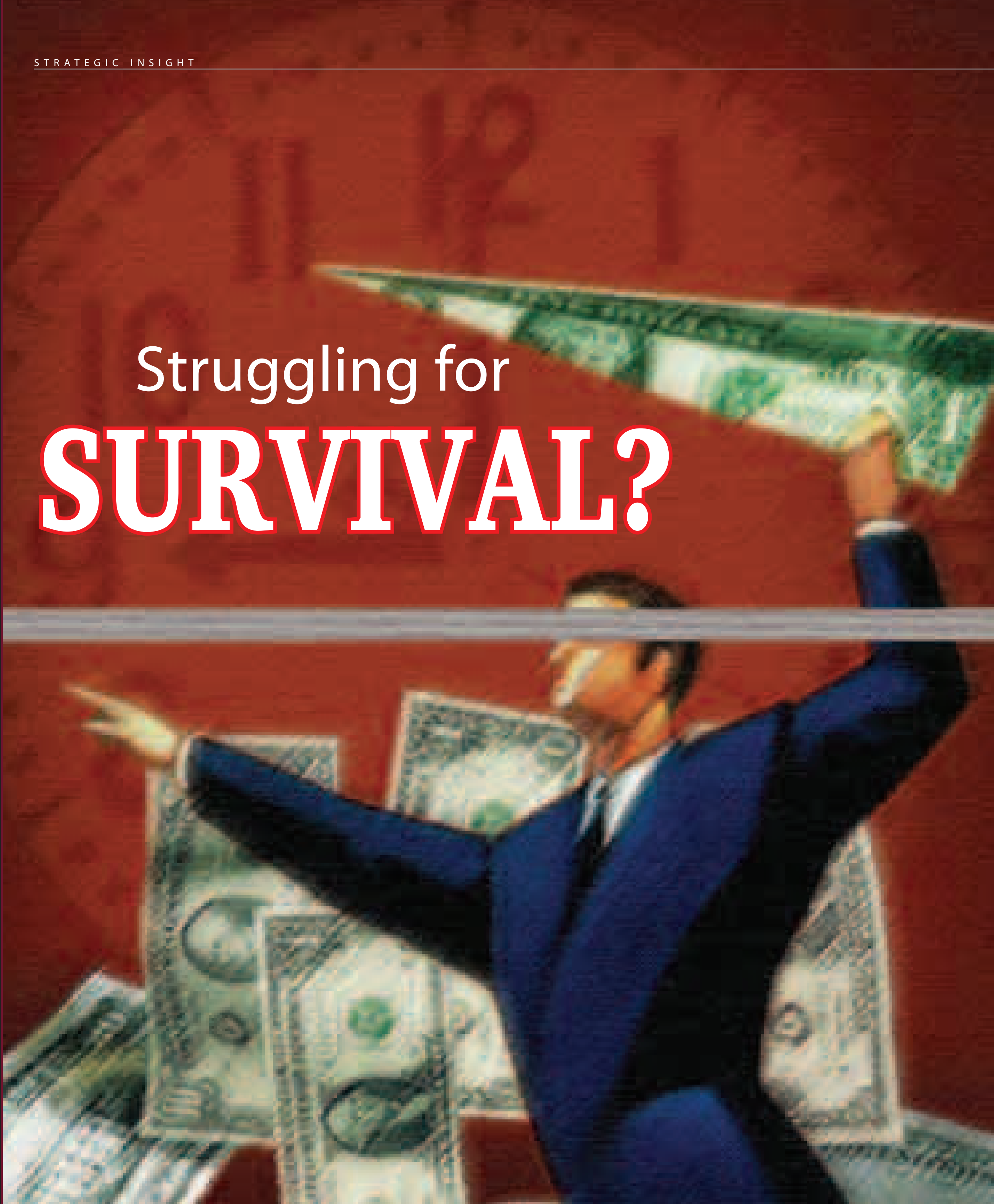
Hence, please remain a skeptic about contrarian investment strategies, and, of course, make sure to consult with an investment professional before making any investment decisions. At the same time, I hope I've convinced you that contrarian investing should not be rejected completely either. Simply put, the evidence is too strong – and the potential for profit is too great – to ignore. ■

Contextually Contradicting Contrarian Concepts

Contrarian strategy historically has worked in some cases, but in many it has not. In context to Indian stock market contrarian strategy has been working, with people investing and taking risk in the bullish market since past one year. A recent example is of Infosys. In the first quarter this year, it delivered results which were disappointing though the long term prospects remained benign. Everybody sold and the stock price fell to Rs 1,900. Investors who kept their heads and bought at Rs 1,900 soon saw the price shooting back to Rs 2,650. Another example is that of Bharti Televentures Ltd, which had huge start up costs and capital outlay, offered windfall gains to those who recognized its intrinsic value. The stock traded below Rs 50 in 2003 but as of today it is priced at over Rs 300.

With the market scaling new heights contrarian investments is gaining popularity. Even many new sectors are coming in the foray, like the mutual fund industry is eager to employ this strategy. Kotak MF and Tata MF have recently launched contra funds.

Internationally, the strategy has also worked well. In Wall Street the contrarian strategy has seen a huge amount of investments with people picking up stocks which they would have otherwise not. Some of the examples of contrarian investing stocks in the last one year have been like Time Warner, Enron, Pfizer and Merck. Telecom in USA remains a favorite sector among the contrarian set, like stakes in Verizon, BellSouth and SBC Communications. At last it is one's outlook and approach whether or not to embrace this investment, though it is debatable but well accepted.



Struggling for SURVIVAL?

A primer on the various strategic techniques that could be utilised by corporations that fall in the vicious trap of cutting costs to become profitable; and thus losing their core strengths

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It seems there are very few sectors right now where most firms are not struggling to survive. Conventional efforts to protect profitability, such as down-sizing and expenditure cuts, cause substantial damage to the core business, and often leave firms substantially weakened – having cut back once, they just find themselves still less able to cope, and have to cut again. It need not be like this.

Case example

A high-value financial service firm I worked with a few years ago; the stock market crash had killed their investment returns, and fee income was on the floor. They had built many investment products during the confidence of the late 1990s, and professional staff to support them. Naturally, the combination of falling income and higher costs left them in trouble, and they reckoned they needed to take out at least 15% of their cost base – some £3m.

All the usual suspects had been looked at – deferring the long-needed upgrade to their information systems (which would increase efficiency and cut costs, but only too late), cutting back-office staff, economising on the car scheme, pension contributions and on business-class travel! Problem was, this didn't add up to anything like enough savings, and the year ahead promised still-worse trouble.

The new HR director, the Finance Director and the CEO were not too happy with this unsatisfactory answer, so asked their senior team to take a look at the business to see if there was something fundamental needing to be done.

A new look at the problem

The strategic architecture of these financial service firms is not too complex. Clients invest money, buying products that are developed and managed by the firm's professional staff. The capital is invested in stocks and bonds, and any investment gains are added to the funds. The back-office staff and systems ensure that transactions are dealt with accurately and efficiently, though there was at the time some manual processing too.

The basic resources of the firm, then, are clients, investment funds, products, professional and other staff, plus the many independent financial advisors through whom the firm reached their ultimate clients. In addition, they were concerned to sustain three critical 'intangibles' – their reputation with clients and the advisors, the motivation of their staff, and the strong investment capability they had built up over recent years. The team was especially worried about these soft factors, since crude redundancies would cause serious damage to all of them, risking a serious melt-down from an already serious position.

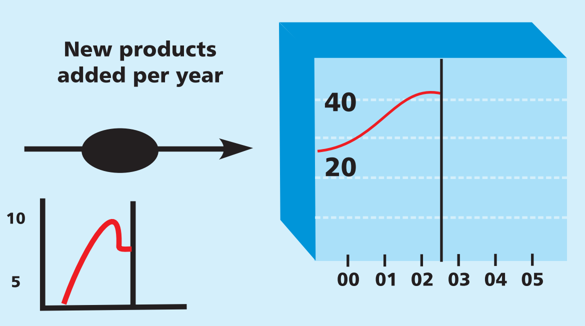
The optimism of the investment boom had encouraged people to launch numerous attractive new products, sell to many new clients, and develop more channels for selling these products to investors – all of which had entailed fighting hard in the market for the few skilled professionals who could do these sophisticated tasks. Figure 1 shows the product range as a 'bathtub' into which new products had been 'pumped' rapidly through the pipe entering from the left.

Trouble under the surface

Apart from the people, though, the team found that most of these resources were in rather poor shape. Most of the investment products were performing badly, there were many small clients who cost more to serve than they were worth, and lots of intermediaries with rather dubious acces to the market were causing still more work. Three more things surprised the team.

- The quality of these resources had been bad for a long time – well back into the boom period. Indeed, many products and clients had never been worthwhile. This problem had been hidden, though, while the core business made money.
- The growth of these resources had all been mutually reinforcing. As new products were added, they needed new people to support them, who then wanted to

Figure 1 : Rapid expansion of production in the boom



launch still more products. Moreover, with established clients fully provided with the investment products they wanted, still more clients had to be found to take up the extra offerings!

- Not only were the resources (products, clients, intermediaries) themselves in bad shape, the performance outcomes had been poor for some time too. Uptake for each new product had been declining, so average product holdings by clients had been low for many quarters. Client-acquisition and new relationships with advisors was proving very poor for the amount of effort that had gone into it. Nor did the problems stop there. All these marginal products, clients and relationships were generating a complex range of administrative and transaction-processing tasks, which put a disproportionate burden on the firm's systems and back-office staff.

This sounds alarming, but may be disturbingly familiar. Very many firms face their own version of such difficulties, to a lesser or (more often) greater degree. But in this case, as in most others, it turned out that a solid core business remained, on which recovery could be built.

A healthy core architecture

The firm's core products were still performing as well as any in the market, and were widely held by clients. Many of the most marginal clients had already disinvested. Amongst the rest, many valuable clients remained, accessed either directly, or through good advisors. Good professionals remained, sustaining the firm's capabilities in product and client management. Reassuringly, the firm's reputation was holding up & morale was remarkably buoyant, thanks to great leadership. Better still, when the team looked into the architecture, they found that the best quality resources were tightly coupled – best people were looking after best clients, holding best products, managed by more of the best people.

Consolidating back

This good news made it possible for the team to devise a comprehensive program of rationalisation back towards a solid core of business that they were confident would function well. This would provide a platform for renewed growth, whenever more favourable conditions returned. (They hoped this would be during 2003, but it looks increasingly unlikely!)

It would be crucial, though, to get everything properly balanced and timed – what to do, when and how much, with what likely impact on the rest of the system? And, of course, it had to protect staff motivation and the firm's reputation in the market! The plan went as follows:

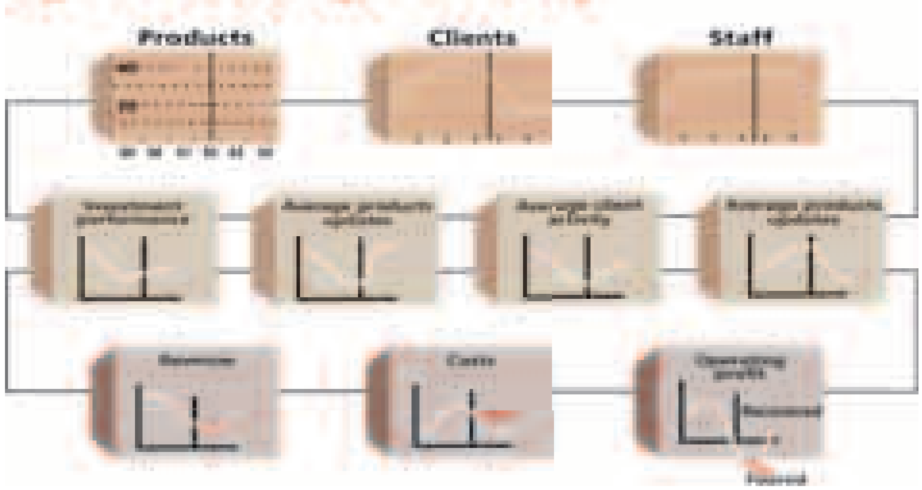
- "Identify useless products & remove them!!!" This was easier said than done! You can't just discontinue investment products without managing investments onto alternatives; so migration had to be planned in too.
- This would of course require fewer professionals, but to protect morale, the plan included the transfer of some products along with the associated staff to rival providers who were known to be more successful.
- Marginal clients had to be rationalised too, and of course, some went with the marginal products. For the rest, rather than simply cut them off, efforts were made to find ways to make at least some more worthwhile, e.g. consolidating several small investments into one & offering service that required less support.

Figure 2 shows some of the key components of this recovery. On the left are the resources, being rationalised by the right amount, at the right rate, in the right order. If changes happened too fast in one part of the organisation, other parts would not be ready in time to cope. Conversely, if certain changes were too slow, costs would continue to arise with no business to support them. If the team could just get the timing and scale of change right, they could get back to levels and qualities that were strong in their own right, and strongly supportive of each other. In the middle of Figure 2 are some of the internal performance improvements, and on the right the expected financial outcomes.

Important side-benefits of this rationalisation were spotted immediately. Simply removing the complexity would actually cut error-rates and delays, and actually improve service. This alone would boost the firm's reputation with clients and advisors. In addition, the product rationalisation was turned into a reputation advantage, by telling the customers how it was actually in their interests – investment performance would be protected and costs reduced. There was also a significant simplification of the support and transactional activity in the business, so that back-office costs could be reduced, but only after the business had been safely simplified.

The architecture that the team worked with was naturally more complex than Figure 2, and included three important additional features. First, the changes to resource-levels at left arise through actions to 'pump' them out of the business, and the confidence in the sustainable levels resulted from a strong, and quantitative managerial appreciation of how they had supported each other back in the days be-

Figure 2: Strategic Recovery



fore the complexity had been added. Secondly, the intermediate consequences and financial outcomes were worked through in detail, not merely guessed. Lastly, the team's architecture included thoroughly thought-through estimates of what would likely happen to the softer factors too.

In addition, the team were able to use the architecture as a living 'control-panel', on which they could track each month's progress towards their better future, making adjustments if things worked out better or worse than expected. Like many firms today, they already employed a balanced score-card system to track many of these factors – data that could be dropped straight onto the architecture.

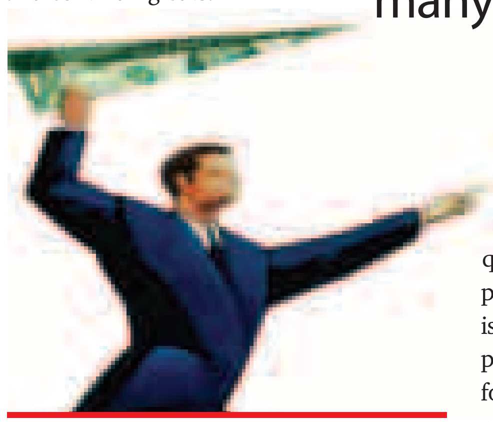
Lessons for strategic recovery

Many features of this situation are to be found in firms struggling to survive current troubles. Most can expect to discover the roots of their difficulties in historical developments undertaken in a very different trading environment. Fortunately, this very history may leave them with the chance of strategic recovery.

First, as firms scrambled not to miss the boat as markets boomed, a headlong rush ensued to capture every conceivable piece of new business. In the process, much poor business was signed up, which only became apparent when the bottom fell out of the market. You may well find suchsludge in the bottom of your tank. Problem is, it's a tough call to shut down business at exactly the time when you seem to need every piece of it you can get. That's why it has to be linked to a coherent plan for improving other resources in parallel. While sales were booming, almost anything seemed to sell, especially if it was 'new'. An explosion of novel products mushroomed, faster than anyone could really have time to check if the last great idea was working. This too left companies in market after market with slow-moving products, and rationalising these provides the second opportunity.

Regrettably, of course, the corollary of bringing business back to a sustainable core is a reduction in the staff needed to run a slimmer business. But as in our example, efforts can be made to find more secure futures for people, such as by passing products or customer-segments to other firms who can make better use of them. Furthermore, by not acting, everyone else is put at risk – and a strategically sound re-basing of the business is going to be substantially less troubling than the unfortunately common practice of indiscriminate and continuing cuts.

> Regrettably, the corollary of bringing business back to sustainability is the throwing out of staff; many of them talented



Manage expectations better than during the boom

The over-expansion of products and customers that led up to today's troubles was exacerbated by inevitable side-effects on managerial and professional mind-sets. Because everything was going so well, taking on people and spending lots of cash to build products and customers still faster was obviously the right thing to do. This was compounded by irresponsible hype from many quarters about the 'new economy' in which all the old rules would no longer apply.

Unfortunately, the old rules about providing goods and services people wanted, at a price they could afford and at which you could make a margin, never did go away. It has now bitten back, and the pain has not gone away. A further unfortunate pressure on management during the boom arose from ill-informed investor pressure.

Because everyone else was growing like crazy, anyone who didn't was criticised for poor leadership and bullied into following the herd – Marconi springs to mind. In cases where real growth was not available, phantom earnings growth was often pursued by damaging, rather than over building resources. Marks & Spencer is one of the best-known examples.

The recovery of our case-example, though, should provide some reassurance. A sound, fact-based picture of the business architecture, building in the quantities and qualities of relevant resources, shows why performance is heading in the direction it is. The clear, quantitative and unambiguous picture that emerges gives a team a sound foundation on which they can work through possible rescue plans. Except in the most dire situations, it is likely that a sound (if smaller) core of quality resources can be consolidated into a newly sustainable business model.

An important trick now will be to show investors that you actually do know what you are doing, and that they are not likely to better-guess what you should be doing. There is a risk that they will see some alarming signs – serious cuts in business and in revenues, for example – but their ultimate interest is in sustainable future earnings, and crude topline financials tell them (and you!) very little about that; and an optimistic note to end on.

Once this rescue is achieved, further opportunities become apparent. Less skilled rivals will be in trouble, and you can save them the heartache of struggling on, either by acquiring them, or else taking on any quality resources they do possess – good customers and staff, for example, and finish them off.

As a newly-robust business, enjoying the foundation of a sound underlying architecture, you will be amongst the strongest players left on the field when markets recover, able to deploy some of the new cash-flows from that recovery into building new products and markets for the future – but do take care to build quality, not just quantity, next time! ■

Unfortunately, in today's corporate world, managers have forgotten that innovation can't "just happen." Of most critical importance are processes and structures...

Where's my Innovation?

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This article develops an analytical framework for bounding innovation that captures not only inventions that make it to the patent office, but also occur on the shop floor. It hypothesizes that innovation is occurring all around us and that those are managerial behavior and processes that make the difference in capturing and harnessing it to obtain competitive advantage.

To identify and measure innovation, focus must be placed within the microcosms where it occurs within organizations, rather than to larger, more translatable frameworks. Managerial concentration should be on the recognition of the existing innovation, already occurring around them, rather than techniques designed to generate increased levels of creativity.

What are we looking for?

As the competitive environment stiffens, managers increasingly look to innovation to boost productivity and contribute to a corporate competitive advantage. Managers try to stimulate innovation and maximize ways which they can capitalize upon it. However, in order to maximize the utility reaped from innovation organizations must be specific in determining exactly what is being sought.

While we have an intuitive sense of what it means within our organization, further analysis of the concept proves that the devil is in the details. The central difficulty in analyzing innovation is in the way it is measured. There are few concepts that are specific and objective enough to lend themselves to academic study and pragmatic implementation for quantification. Traditional measures of innovation, such as patents, research and development expenditures or literature citations fall short of examining the innovation that occurs around us every day. Process measures such as productivity gains or industry leadership, are difficult to critically isolate.

Much of our attention in seeking innovation has been focused in the wrong direction. It's like the joke about the man looking for his lost keys under a streetlight one night. When a passerby offers to help in his search, he asks, "Where do you think you dropped them?" The man responds "About 100 meters down the street." "Then why are we looking here?" the passerby asks. The man responds, "Because the light is better here." As managers, our attention is drawn to the measures that we can easily quantify and compare but that leads us away from where our attention should be focused.

> Of the 1405 firms reporting an innovation in the past three years, only 34% launched innovations that were new to the general market

New to whom?

The key issue in the identification of innovation lies in the managerial significance of the interpretation of novelty. Classically, when we think of innovation, we think of invention. It is an interpretation rooted in historical precedent and western legal tradition dating from the earliest days of the 17th century scientific and industrial revolution. In this sense of novelty, an invention contributes to the overall global knowledge base in some way.

An organization, too, has a knowledge base. It is composed of the collective experience, education and history embodied in its people and processes. These assets accumulated over time are finite. While this organizational knowledge base may have great depth in certain areas, it remains a subset of the greater knowledge base. In some areas, an organization may possess unique proprietary knowledge that has not been shared outside the organization and is inherently unique and obviously different. But how do these differences impact our concepts of innovation?

In an organization, innovation is a localized phenomenon, defined within very specific contextual boundaries. This makes it difficult to establish a generalizable framework that can be abstracted and applied to other environments. An interesting statistic reported by Hipp and Grupp (2005) from the 1999 Mannheim Innovation Panel of German firms, reflects the localized nature of much innovation. Of the 1405 firms reporting an innovation in the past 3 years, 34% launched innovations that were new to the market and 57% produced innovations which were only new to the firm. This disparity in the level of novelty was even more pronounced in the services sectors. From the 1080 services sector firms with an innovation in the past 3 years, 16% created an innovation new to the market, while 77% produced an innovation new to the firm.

While the aspects of intellectual property are significant, the more pragmatic benefits of cost reduction, value addition to existing products or new product introduction are the more tangible benefits that 21st century managers seek. The yardstick that innovation is measured by is the net benefit that it brings to the organization. An innovation must increase competitive advantage. This results in a much less rigorous standard of novelty for the desired innovations than is found in many of the more common metrics.

R&D

R&D is a systematic way to advance and explore an innovative insight, but not necessarily to originate them. Survey data reflects that even in the largest firms, R&D serves as the source of only a fraction of the innovation output of the firm. A study of successful and unsuccessful R&D innovations at Exxon Chemical over 40 years revealed that despite the company's substantial R&D activities, only 2 major breakthroughs were achieved. The majority of R&D products were mostly smaller, lower value process innovations (Canner & Mass, 2005). R&D's ability to generate innovations, let alone reflect a measure of organizational innovation is increasingly in doubt.

Innovation measurement and the linkages to R&D as a metric are even more difficult to establish in the services sector,where it is rarely linked to traditional concepts of R&D but more unsystematic and organizationally diffused investigations. Hipp and Grupp (2005) empirically confirm the work of Dosi (1988) using German service sector statistics on innovation.

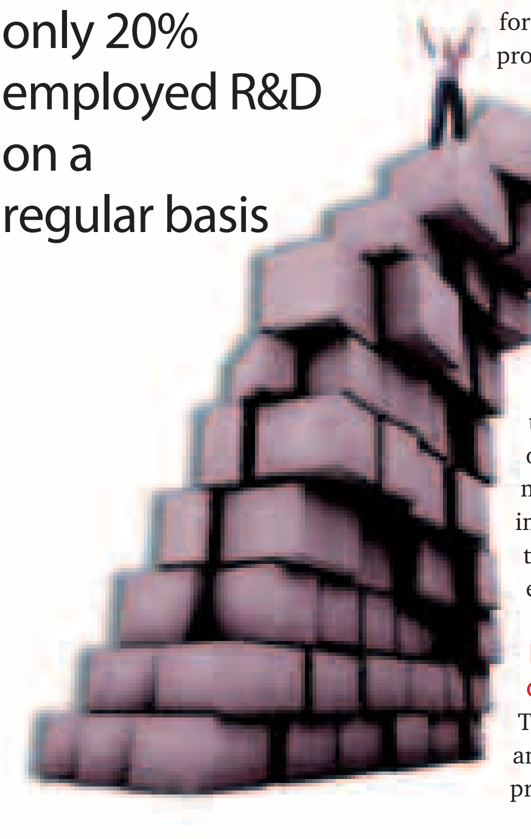
Based upon the 1999 CIS survey data from German services sector firms, 55% created a product innovation and 50% created a process innovation in the three preceding years. Of the firms innovating a new service offering or innovating in the delivery of an existing service, only 30% engaged in any R&D with 20% employing R&D on a regular basis.

There is no indication of the percentage of innovations that were generated by the R&D activities conducted by services firms. However, based upon the fractional nature of raw statistics, internal R&D plays at best only a minor role in services sector innovation.

Employee Suggestion Programs

Employee suggestion programs have a history of capturing significant innovation that other frameworks have not. The Employee Involvement Association reports survey data on 2004 annual suggestion program statistics from 41 of its U.S. member organizations (EIA, 2005). From this limited sample, a total of over $811 million in savings and other benefits were realized as a result of their employee suggestion programs. While all of these suggestions may not be innovations, they do conform to the ideas that they are novel when compared to a localized knowledge base and have utility when measured by the values defined by the firm. Most of these innovations will never be patented nor published outside the organization. These statistics demonstrate the power and managerial significance of the search for contextually defined ways to identify efficient innovation.

Of the firms innovating a new service offering, only 30% engaged in any R&D, and only 20% employed R&D on a regular basis

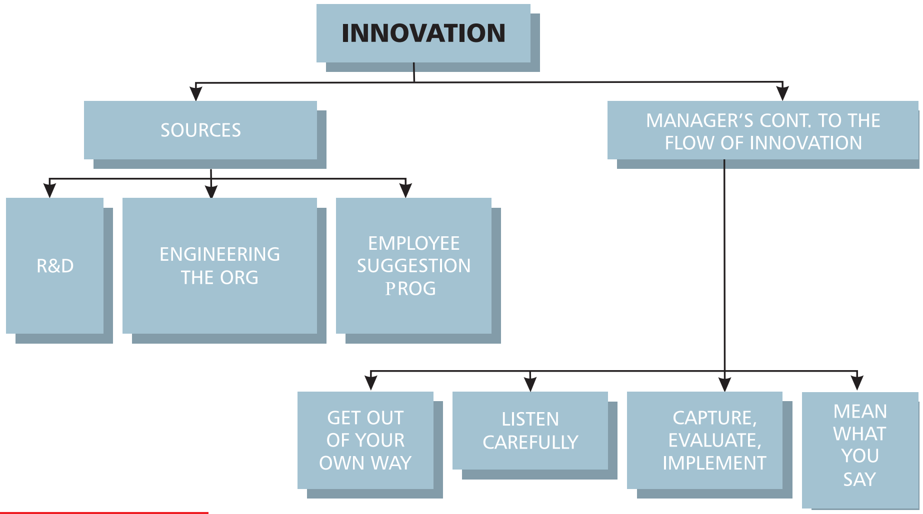


Employee involvement programs have been successful in generating innovation across national and cultural boundaries. Khanna, Mitra and Gupta (2005) describe a very similar program for the identification and capture of shop floor innovation at Tata Steel. Tata's approach, called Aspire Knowledge Manthan, uses an IT supported focus group discussion format to elicit tacit knowledge and to extract innovative technical or procedural innovations and capture them in an explicit form. Validation of these initiatives is provided by technical experts and idea champions. This has resulted in 300 implementable innovations in the first year of the process.

It may be that the success of suggestion programs lies in their effectiveness as a parallel communications channel for ideas. The achievement of these processes may be the very fact that they circumvent more conventional organizational communications channels thus reducing opportunities for innovations being stifled by inattention, personal agendas or parochial evaluations.

Engineering the organizational environment

The academic literature of the 1980s and 1990s is replete with organization prescriptions for encouraging innova-



tion. Most of these focused on encouraging a nurturing, participative environment to elicit and develop ideas into innovation. Studies on the implementation of these innovation generation methods have been tepid, at best. On the other hand, the somewhat disturbing data from organizational creativity studies has found that many times innovations from the shop floor find their birth in anger, frustration and desperation. Canner & Mass' (2005) contend that innovation is motivated by desperate acts needed to keep operations running rather than by a creative environment and desperation reduces the risk of perceiving an idea negatively. This motivates innovators to share their insights. More significantly, desperation may change the perspective of managers making them more receptive and attentive to innovative solutions being presented to them.

The ability to capture and capitalize on innovation has a great deal to do with managerial behavior

Whether you believe that creativity giving birth to innovation is best served by a supportive, nurturing environment or by struggle against adversity, valuable nuggets of insight can be picked from both. A common theme of the studies of successful innovations is that managers are carefully looking for it. Regardless of the circumstances that cause the managerial focus, when we listen without preconceived notions or bureaucratic concentration on processes, we find innovation.

Look to ourselves

The ability to capture and capitalize on innovation has a great deal to do with managerial behavior. The ability of management to carefully listen and focus on the ideas in their environment increases an organization's ability to generate and incorporate innovations. While most management schemes for enhancing innovation in a firm focus on idea generation, it is much more practical and efficient to focus on techniques to capture and incorporate the ideas swirling around us every day that come from the shop floor, competitors and customers.

The amount of innovation that comes from these sources is dramatic. While most managers are good at accepting and acting on the formal channels of innovation in the organization, such as R&D and structured employee suggestion programs, they are not very aware of the innovations that are delivered through informal channels. While managers attempt to be supportive facilitators the remnants of Taylorism still exist in their overall behavior. There are creativity theorists who believe that any structure stifles innovation and propose creativity and innovative ideas can only flow in the most unfettered and free organizational environments.

They point to the freewheeling environment in small technological startups that many times serve as hotbed of innovations. It is also clear from several studies that these environments are difficult to preserve and the fountain of innovation that they produce is temporary due to many reasons. Operationally, it is difficult to preserve such an environment as the organization grows and specialization of roles becomes more distinct. Furthermore, idea champions get distracted by other activities as the organization evolves. The cause of lack of innovation may be as simple as fatigue or staff changes.

In any case, it is not clear that issues of managerial choice or design can impact this type of environment in anything other than the short run.

How then can managers best contribute to the flow of innovation?

Managers should only create those processes for identification, evaluation and development of innovations that are independent of the idea source..Whether the innovative insight comes from the R&D department, the shop floor, a supplier's sales rep, or the package deliveryman, innovation development measures must focus on a transparent and consistent method of evaluation and development. The management processes must focus on a source neutral technique for incorporating the values and goals of the organization into the selection and development steps.

1. Get out of your own way.

As a manager, trying to promote creativity is beyond your reach. The best you can hope for is to eliminate the organizational impediments that stifle innovation before it can surface which is a monumental task. Management is about control based upon the establishment and

Aspects of Innovation

Since managers' influence on creativity is limited, managerial focus should be to capture, evaluate and implement innovations. Models of the evolutionary structural changes behind innovation focus on a three step process; variation, selection and feedback (Saviotti, 1996; Metcalfe,1998, 2001; Consoli, 2005).

This model is also effective for innovation management. It serves to accent the aspects of effective listening that lead to innovation capture, and transparent methods of innovation evaluation and implementation aligned with the organization's value system. These are all phases of the innovation implementation processes where managerial attention can be effective.

Creating a failure-tolerant environment for innovation hypothesis testing and experimentation does not do as much to guide the behavior of an employee with an insight as it does to remind us that all ideas have value. The most significant aspect of managing for innovation is to listen carefully regardless of the source. It is important not to create processes or structures which preclude a particular source of mode of contribution and also that it does not preclude the flow from another. A common theme of the studies of successful innovations is that managers are carefully looking for it. Regardless of the circumstances that cause the managerial focus, when we listen without preconceived notions or bureaucratic concentration on processes, we find innovation.

(*The reader is also encouraged to read the related Exnovation article in the previous issues of Strategic Innovators and 4Ps*)

execution of the processes, procedures and employee behavior that create our organization's wealth. Six Sigma and process control techniques are intended to discipline managers to avoid variance and correct them.

2. Listen carefully

The most significant aspect of managing for innovation is to listen carefully regardless of the source. It is important not to create processes or structures which preclude a particular source of mode of contribution and also that it does not preclude the flow from another.

There are many examples and cases that show the effectiveness of listening effectively to customers for innovation ideas. 3M has raised the techniques of listening to customers for innovative insights to a high art. By taking customer focus groups through carefully guided brainstorming sessions, new product opportunities as well as existing product enhancement for development are identified.

3M has raised the techniques of listening to customers to a high art

Leiponen (2005) found that service innovation in knowledge based organizations is more directly a function of interactions from customers and competitors than from the R&D intensity of the firm, firm size or education level of the general corporate workforce.

In case after case, the measures that are most effective in capitalizing on innovation are those that reflect sincere efforts on the part of managers to listen to and consider innovative ideas by subordinates. Though specific implementation details vary from situation to situation, it is the consistent thread through all typically successful programs.

An example from the factory floor of a poorly performing plant of the Isola Group brought managers offices down to the factory floor into a "project office". Through daily team meeting and providing feedback on a real-time basis, workers were able to understand productivity problems. As they gained confidence in the sincerity and availability of their managers, workers reported problems quicker and stopped by to offer informal suggestions. The workers were involved in the "re-invention" of their own plant and offered several process innovations. Moral increased quickly and the effect gained momentum allowing the plants to reverse its losses (Gnamm & Neuhaus, 2005).

3. Capture evaluation and implementation

Since managers' influence on creativity is limited, managerial focus should be to capture, evaluate and implement innovations. Models of the evolutionary structural changes behind innovation focus on a three step process; variation, selection and feedback (Saviotti, 1996; Metcalfe,1998, 2001; Consoli, 2005).

This model is also effective for innovation management. It serves to accent the aspects of effective listening that lead to innovation capture, and transparent methods of innovation evaluation and implementation aligned with the organization's value system. These are all phases of the innovation implementation processes where managerial attention can be effective to the maximum.

4. Mean what you say

The transparency and sincerity of the processes for evaluating and developing innovation can only be effective when it is aligned with the other components of the organization's system of incentives and penalties.

Without the alignment of employee incentives with innovation products and the removal of penalties, significant worker insights will never see the light of day. Indeed, many employees are deterred from sharing their production process innovations. They fear that management will use this knowledge against them by expecting more productivity per worker or in directly reducing the number of employees required.

Case studies from highly unionized firms, like John Deere (Sprinkle & Williamson, 2004) and empirical studies (Jimenez-Jimenez & Sanz-Valle, 2005, Jackson, et.al., 1989, Damanpour, 1991) support the requirement for alignment of these practices and their importance for innovation output.

There is some evidence that anonymous methods of contributing ideas in an organization may enhance participation and contribution levels. By reducing the perceived risk to participants of offering ideas which might be seen negatively, anonymity increases their willingness to participate. Valacich, et.al. (1994) found this effect when studying electronic brainstorming techniques. The anonymity offered by the technology reduced their perceived risk and increased their willingness to participate. Creating a failure-tolerant environment for innovation hypothesis testing and experimentation does not do as much to guide the behavior of an employee with an insight as it does to remind us that all ideas have value.

When we create an internal climate that encourages individual creativity and openness, the group most affected might not be our employees, but ourselves. When such approaches are successful it is because we are hearing the stream of ideas already flowing from our employees. The real innovation payoff is that it is predicated on managers taking the time and mental focus to actually hear and act on those suggestions. Increases in the innovation output may be caused more by changes to the organizational receiver rather than the sender. ■

Creating a failure-tolerant environment for innovation & experimentation does not do as much to guide the behaviour of an employee as it does to tell us that ideas have value

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The True Swap

Inorganic growth strategy and alliances have become a generic strategy for many companies. Today 501 large multi-nationals, as an outcome of multiple acquisitions, drive the global economy and control around 25 per cent of total U.S. corporate assets. Various studies done on wide range of performance parameters, industries and countries has shown that in excess of 50% of M&As, JVs and alliances have failed till date. Above all, it has also indicated that rate of failure has been increasing since last three decades. Not only the mergers, but also the collaboration and alliances with the suppliers, customers, consultants, and job workers too have many intricacies and nuances in dealing with each other.

For instance, in 2003 the value of M&A business in the US was worth $510.86 billion which when compared with the value of merged and acquired business in 1998, amounted to $1.2 trillion showing a huge difference. Though success rate is estimated to be between 30 to 40%.

The aim of this article is to analyze successes and failures of inorganic growth/ Strategic alliances using Friction Zone Identification Model (2 X 2 Matrix). Initially when we started researching, we had predisposed assumptions that failures of M&As, JVs, Collaborative alliances etcetera are mainly due to the factor of 'employee friction'. But when we started to dig deeper, we found that neither all the failures were due to employee friction, nor all the success were due to cultural cohesiveness. Success and failures are also because of other factors such as business, markets, financial, legal and others. This paves a platform for analyzing the successes and failures of M&As and JVs from different perspectives. But one common thing is that the top management plays the most important role in the success and failure of M&As, alliances and JVs.

Frictional Zone Identification Model (FZIM):

This model helps us in analyzing successes and failures of inorganic growth strategies by classifying them using 2 X 2 matrices. In the first few paragraphs, we shall attempt to describe the definitions of various terminologies being used; and then move on to the actual analysis of the usage. So initiating the definition parts, there are three variants of FZIM:

1. The first represents focus – Goal Congruence & Cultural Cohesiveness Matrix.
2. The second represents physical properties of the system – Tensile and Impact Strength Matrix.
3. The third, organization's societal nature – Egoism & Productivity Matrix.

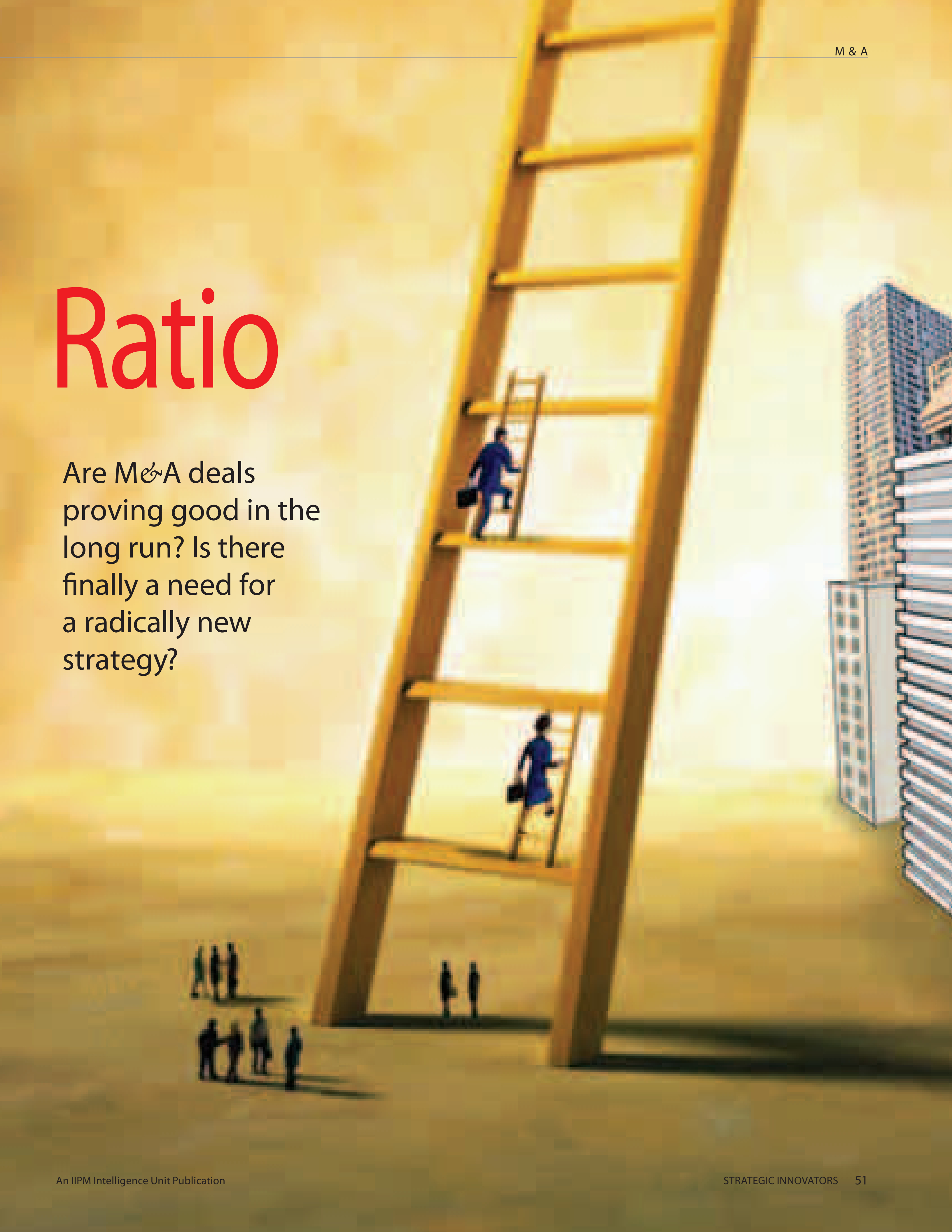
In this article, inorganic growth and technical collaborations between only those organizations that occupy similar positions in the value chain are considered for the study encompassing collaborations/mergers/acquisitions/JVs/alliances. Comparisons between organizations that hold different positions in the value chain are not considered. For instance:

- Companies having alliances with suppliers or distributors are not considered for the study. For example, ITC forming alliances with farmers for the supply of Soya is not considered for the study.
- Companies forming alliances for outsourcing their jobs are not considered for the study. For instance, ABN AMRO's alliance with Infosys and TCS for outsourcing its IT operations is not taken for the study; or LG's alliance with Chinese local manufacturers for outsourcing its production operation is not considered for the study.

> Various studies have shown how in excess of 50% of M&A deals have actually failed till date (considering shareholders' net worth and value)

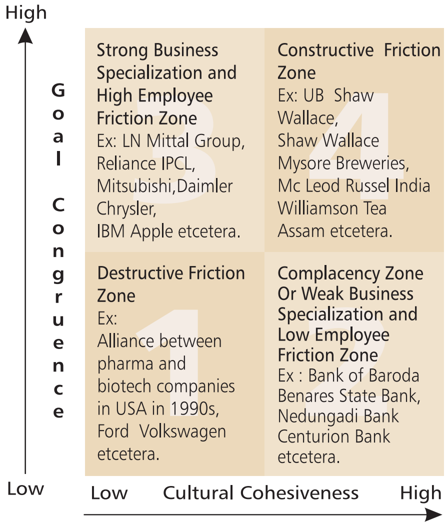
Goal Congruence Versus Cultural Cohesiveness

- **Goal Congruence:** It refers to the goal which is mutually beneficial and acceptable to both the partners. At the same time the goal must have a perfect execution plan. It also refers to the extent of business specialization in the post merger scenario for the corporations involved.
- **Cultural Cohesiveness:** Here, culture refers to the organizational culture and not the national culture. It is because inorganic growth can also happen between the companies belonging to the same country. For instance, as would be obvious to even non-researchers, culture varies from one company to another. One straightforward example could be



Ratio

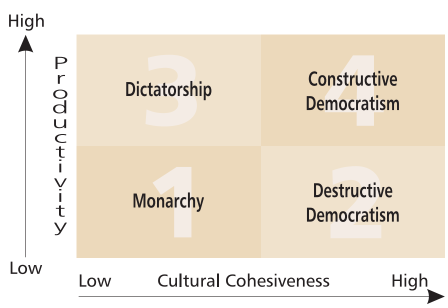
Are M&A deals proving good in the long run? Is there finally a need for a radically new strategy?

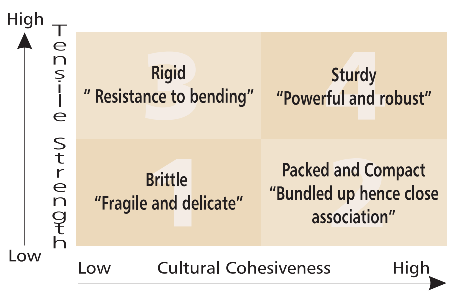


the cultural differences between public sector (employee oriented) and private sector (production oriented) companies. The abovementioned example may also be compared to another factor of 'Hire and Fire' (as has been practised by MNCs) and permanent retention (as is culturally expected by Indians of their wives – pun intended – and of government companies); or to the example of appraisal based versus seniority based pay increase .

2. Physical properties of the system

The physical properties are well explained by impact and tensile strength of the system. This is similar to the first variant of





FZIM i.e. Goal Congruence and Cultural Cohesiveness.

- 'Impact Strength' means "the maximum and sudden force that the system can withstand." It refers to the extent to which employees can be forced to follow the work culture of your company. Sudden and excess force may lead to a culture shock. Examples: Some organizations welcome open expressions whereas others may not.
- 'Tensile Strength' means "the extent to which a system can be stretched." It examines the efficiency of the system. To delineate it further from 'impact strength', we can say that companies which have strong competence in respective sectors will have higher tensile strengths whereas companies that have work culture cohesiveness will have high impact strength.

3. Leadership, Productivity and the Societal Nature of the System

In this part, we shall define various terminologies related to individual and group leadership behaviour.

Monarchy: When each partner wants to be a monarchist, a situation might arise that displays overall poor leadership (with respect to inorganic growth strategies and collaborations) as leadership conflicts may arise even at the start.

Dictatorship: In such cases, contrary to assumptions, a strong leadership base may develop; one that results in more productivity, and that too irrespective of low cultural cohesiveness.

Destructive Democratism: In this case, each partner is allowed to do anything. This subsequently results in poor leadership and poorer productivity.

Constructive Democratism: This is surely a utopian state where none of the partners display egoism. There is evident significant high goal orientation, combined with high productivity

Frictional Zone Identification Model (FZIM):

There are different zones that occur within the partnering organizations that are entering into the said merger or alliance or JV et al. These zones are described below:

1. Destructive Friction Zone.
2. Strong Biz Specialization And High Employee Friction Zone.
3. Complacency Zone (Or) Weak Business Specialization And Low Employee Friction Zone.
4. Constructive Friction Zone.

1. Destructive Friction Zone (This zone displays Low Impact Strength – Low Tensile Strength):

With respect to the work culture, the system as such is brittle (because of both low tensile and impact strengths). This is the zone where exists strong cultural differences coupled with weak goal and objective congruence.

Example 1

Let us take the pharmaceutical or biotech industry in USA. In the 1990s, industry consolidation had failed to solve the problem of diminishing research productivity. One option that companies were pursuing with evidence of vision was to enter into collaborative R&D alliances. Hundreds of collaborative research alliances were signed in 1997 involving academic, biotech and global pharma participants. But sadly, nearly one-third of alliances were unsuccessful and finished half way after the completion of four to five years.

In this milieu, one should note that collaborative R&D involves a large number of scientists from different companies who are high in knowledge base; and at the same time are highly individualistic (egoistic) in nature. Secondly, one should also note that such 'high intellect, high ego' scientists usually don't want to share their research findings (read 'hard-found secrets') regarding formulations, and this eventually results in the lack of team work, and hence affects the team work. Moreover, these researchers lack goal congruence (we are tempted to attribute this to the fact that a majority of such researchers are non-MBAs) and are more oriented towards the typical Maslowian 'self-actualization' benefit.

Example 2:

A reported example from which we can

learn is the joint venture between Ford and Volkswagen to manufacture, sell and service luxury vans in Portugal. But due to subsequent lack of goal congruence and cultural cohesiveness, Ford decided to manufacture, sell and service the vans directly without Volkswagen. Ford and Volkswagen could never work out a win–win situation; which is, though clichéd, a must for team work. Ford withdrew, leaving Volkswagen with virtually no return on its investment.

Collaborative work between high-intellect individuals can also lead to non-cohesive 'team spirit'

2. Complacency Zone
(High Impact – Low Tensile):
This is the zone where the impact (work force cohesiveness) is higher but tensile is lower.

The post merger scenario is splattered with high cultural cohesiveness but with low productivity. These kinds of mergers usually take place between public sector companies for consolidation purpose and to cut costs.

Examples:
Some examples of such public sector mergers could be the Bank of Baroda merger with Benares State Bank, and the merger between two private sector banks, Nedungadi Bank and Centurion Bank (now Centurion bank has been merged with Bank of Punjab too).

Though not quantitatively proven, complacency factor may creep into such mergers, ultimately resulting in decreased productivity. There are other cases where these kinds of mergers and acquisitions happen when a company acquires another company perceiving that ROI is much higher. If the company lacks business specialization, then it may lead to an ultimate failure.

For example: ICI had – and still has – strong business specialization in pharmaceutical and polymer sectors. ICI's investors forced the top management to come out of low ROI businesses and forced the top management to enter into businesses where ROI was more. As a result, ICI bought the debt-ridden businesses of Mayflower, a corporation that was into the high-ROI cosmetics industry. Initially, ICI's – and Mayflower's – share prices sky rocketed and everybody applauded the marriage. But after a few months, ICI ended up incurring huge losses when it decided to takeover the management of Mayflower, despite the fact that ICI originally had very less understanding of the cosmetics industry.

3. Strong Biz Specialization And High Employee Friction Zone
(High Tensile – Low Impact)
The following example would surely grab every one's attention.

Mittal Steel has become the world's largest steel manufacturer with a turnover of $30 billion and capacity of 70 million tonnes. The special facet of Mittal's rise has been that he turned the steel industry's crisis in 2001-04 (because of a global economic slowdown) into a big opportunity for himself. He bought ailing plants in Romania (2001), Algeria (2001), South Africa (2002), Czech Republic (2003) and Poland (2004) in Eastern Europe at virtually throw away prices, turned them around, and became the steel king of the world.

Here the LNM group – as L. N. Mittal's companies have now come to be known as – scores high in tensile strength; that is, it has proved its core competency in the steel sector. But if we consider impact strength, the same seems to be weaker. So what? It is quite lucid from LNM Group example that under certain conditions, strong business specialization and core competence have upper edges over presence of (or lack of) cultural cohesiveness. Another example would be Reliance Industries acquiring IPCL. RIL has excellent business specialization in the polymer arena. But they struggled a lot in amalgamating the work force of IPCL (a public sector firm).

4. Constructive Friction Zone (High Tensile Strength – High Impact Strength):
This, perhaps, is the most desirable zone and the most reliable one too. Newly formed companies have higher chances of success since they possess similar culture and core competencies in the related business areas; this also would refer to personnel competencies.

Examples:
Business baron, Vijay Mallya's United Breweries, which comprises McDowell, Phipson Distillery, United Spirits and others, has acquired controlling stake in Shaw Wallace – which belonged to the Jumbo group – for a value of Rs.16.2 billion. McLeod Russel, a tea major which is a part of B. M. Khaitan group, acquired Williamson Tea Assam. Disney Corporation is just about to acquire Pixar, a company providing all the special effects for various Disney movies. In all these cases, cultural cohesiveness and business competence prevails, resulting in higher tensile and impact strength.

Conclusion

FZIM is a powerful tool by which any organization entering into inorganic growth can understand whether the growth will be 'profitable' or not. They can also use this tool to study various cases by which, in case of mergers and acquisitions, they can fine-tune the post-M&A integration. ■

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Competing to Death

By Adrian Slywotzky and Charlie Hoban

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A rethinking is necessary on the basic foundations of collaboration and competition

Earlier this year, the business press eagerly reported a surprising story: General Motors and Toyota had begun exchanging information about the development of hydrogen fuel cells. News of the talks came just months after GM and DaimlerChrysler had announced plans to work together to design a hybrid power train for large cars and sport-utility vehicles. And it followed earlier agreements by Ford and Nissan to use Toyota's hybrid technology in their own engines. Five of the world's largest automakers, in other words, had begun collaborating on the technological underpinnings of next-generation vehicles.

If this multi-party collaboration does happen, we hope it is the first of many such moves for the auto makers. Ever since California tightened restrictions on car emissions in 1990, many of the major car companies have been investing aggressively to develop successors to the traditional internal combustion engine. Technologically complex, the R&D efforts have been extraordinarily expensive and risky, with each company having to duplicate much of the research of its rivals. If the auto makers had collaborated from the outset, instead of waiting 15 years, they could literally have saved billions of dollars in redundant investments and expenses.

The entire industry would have been considerably more profitable, and GM and Ford might not find themselves in such dire straits today. More than that, by collaborating on basic engine technology, which is, after all, invisible to most car buyers, the auto makers would have been able to focus their innovation efforts on areas that have real impact on the decisions of customers, such as product design or the dealership experience. They would have been able to compete where it counts.

Vigorous competition is, of course, the lifeblood of modern economies. It spurs creativity, rejuvenates markets, keeps companies agile, and guarantees consumers better products and lower prices. But as the experience of the auto makers reveals, competition can be bad as well as good. In dynamic economies, value is constantly migrating from outmoded business models to those that are better calibrated to satisfy critical customer priorities. As the game changes, certain aspects of competition become outdated and irrelevant, and companies have to revisit the scope of activities they engage in.

When companies fight over things that hold little value to customers or offer little potential for competitive differentiation, they are engaging in competition that's destructive rather than constructive. They are throwing away shareholders' money, wasting valuable time and energy, and reducing resources available for innovation, thereby reducing the chance for profitability tomorrow – not only their own profitability but also that of their entire industry.

Much of the competition in business today has become outmoded. Indeed, the prevalence of destructive competition is one reason why a wide array of industries – from music to airlines to consumer electronics – has experienced a steady and seemingly inexorable erosion in profitability.

Globalization is already putting pressures on corporate profits. Even in industries that enjoy comfortable margins today – like pharmaceuticals and movies – the persistence of misdirected competition raises the odds of severe margin compression in the future. Global sources of supply contribute to overcapacity in many industries that enjoy such comfortable margins today, and the persistence of typically misdirected competition raises the odds of severe margin compression in the future.

At the same time, global sources of supply contribute to overcapacity in industries such as plastics and automotive. New competitors with structurally lower costs become more commonplace in every industry; new competitors that have not only lower costs but also innovative business models proliferate as well. And as companies outsource more product development activities to third-party providers in Taiwan and other development centers, the role of new science becomes even more prominent as a way to differentiate oneself from competitors. Science, with its long odds and high costs, is exactly the type of activity that lends itself to industry-wide collaboration.

Strategic Collaboration

By joining forces to carry out common and largely undifferentiated functions or processes, companies can avoid redundant expenditures and capitalize on economies of scale and shared expertise. Strategic collaboration can take place at any stage of an industry's value chain. Some companies may find it in their best interest to cooperate in producing a standard input required to manufacture their products or deliver their services. Others may set up a joint center for basic research, partner to produce a software application, set up a distribution channel, jointly collect and sell information, operate a repair or returns facility, or set up a factory and sales force in a new geography.

There have been examples of these types of strategic collaboration among companies in the past. But they've been rare, and they've tended to be launched too late, usually in the face of impending disaster or under government pressure. Most firms shun opportunities for collaboration, if they even recognize them in the first place.

Think about your own company. What percentage of its effort and investment goes toward trouncing its rivals, and what percentage goes toward cooperating with them? What, in other words, is your firm's compete/collaborate ratio? If your business is typical, you may do a little collaboration here and there – but your compete/collaborate ratio would be probably somewhere between 90:10 and 100:0. Typical firms compete pretty much everywhere, all the time (than collaborate).

Mutually Assured Destruction

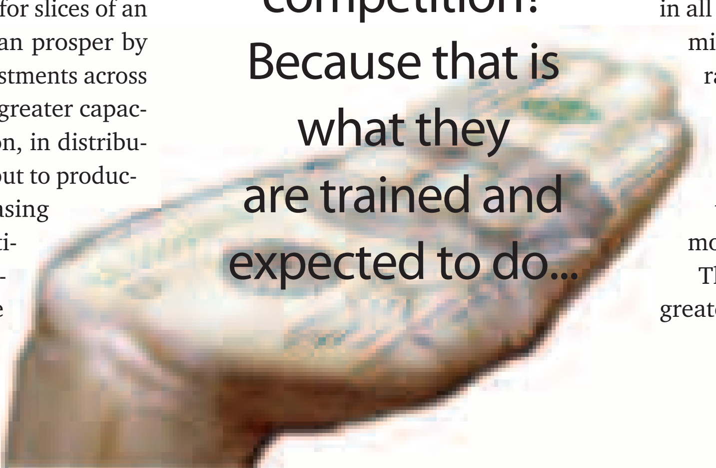
All-out warfare can make sense in rapidly growing industries with buoyant profits. If companies are competing for slices of an ever expanding pie, they can prosper by matching one another's investments across the entire value chain. The greater capacity – in supply, in production, in distribution, in marketing – can be put to productive use in fulfilling increasing demand. And broad competition can also boost productivity in every function, while providing different competitors with new opportunities for differentiation.

But at some point, economic logic reaches a crossover point. When an industry matures or its margins otherwise get squeezed, undisciplined competition becomes a form of mutually assured destruction. It leads to overcapacity, high costs, weak capital efficiency, a lower innovation rate, and precious little competitive differentiation.

Why do managers persist in destructive competition? Because that's what they're trained and expected to do. The idea of setting aside the sword and working shoulder to shoulder with rivals on some part of the business is anathema to most executives. Just look at the music business. For years, it's been clear that the digitization of songs would shake up the traditional distribution model. When Shawn Fanning invented Napster in 1999 and turned the illegal downloading of music into a mass hobby, the threat to the big music labels could hardly have been clearer or more dire.

Yet instead of joining together to pioneer a legal alternative to digital distribution, the labels continued to bicker and battle. They ended up launching separate, competing services. Universal and Sony organized a joint venture called Pressplay, while Time Warner, Bertelsmann, and EMI set up MusicNet. Because the two services refused to license their songs to each other, they were shunned by customers, who wanted one-stop shopping. That provided an opening for Apple Computer to launch its comprehensive iTunes store and bring a new form of value to the customer.

> Why do managers keep persisting in destructive competition? Because that is what they are trained and expected to do...



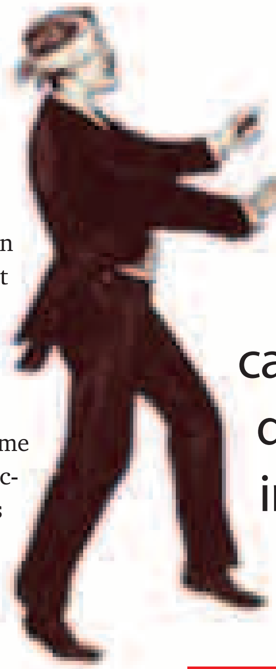
That's not to say that companies haven't tried to temper the ill effects of undisciplined competition in other ways. Three methods are, in fact, commonplace. The first is acquisition – merging businesses to reduce duplicate functions and combine customer bases. The second is outsourcing – offloading non-strategic activities to third-party specialists that can achieve greater scale, lower costs, or deeper expertise. The third is standards-setting – agreeing on shared technologies or protocols to avoid a proliferation of incompatible products or components. All of these approaches can provide great value under the right circumstances, although some have shortcomings as well.

M&A, for example, is a blunt instrument. It forces companies to combine all aspects of their operations, not just those that will benefit from consolidation. Such broad integration is devilishly difficult to pull off, which is why mergers destroy value more often than create it. M&A also perpetuates the destructive type of competitive behavior, just with larger stakes among consolidated players.

Strategic collaboration avoids these problems. Unlike M&A, it's precise. Companies only have to join forces in well-defined activities or processes – those that offer the greatest immediate payoffs from consolidation and rationalization. Unlike outsourcing, it doesn't entail a loss of control. Existing competitors are able to share directly in the benefits of economies of scale and pooled talent.

And in contrast to standards-setting, it can take place throughout the value chain, in all areas except those, like pricing, that might lead to unfair competition and raise antitrust concerns. Strategic collaboration also tends to promote, rather than dampen, constructive competition, which inevitably leads to greater innovation in those fields most valued by customers.

There have, of course, been calls for greater business cooperation before. But most of the existing literature on cooperation, such as the book Co-opetition by Adam Brandenburger and Barry Nalebuff, focuses on complementary efforts – on businesses doing different things that complement each other in a way that creates added value. Strategic collaboration involves working together on the same things – on key shared activities within an industry's value chain.



Close collaboration is not only possible, but it can also dramatically improve profitability of industries

It is about collaborating in exactly those places where competition has been the rule. As such, it offers the possibility of fundamentally changing the economics of an existing industry in a way that benefits all players.

Given the harsh realities of business today, it's time for managers to rid themselves of their anti-collaboration bias. Companies need to take a fresh, objective look at their compete/collaborate ratios and begin shifting them toward a more productive balance – before it's too late.

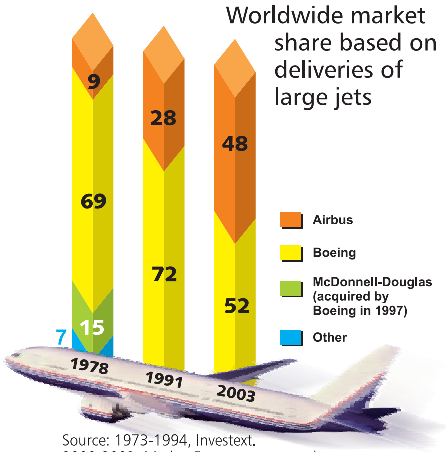
We'll examine some compelling examples of how strategic collaboration has strengthened, or even saved, entire industries while boosting the profits of individual firms. We'll describe opportunities that may be available to third parties in creating a collaboration platform, as Apple did with iTunes, or in serving as a collaboration catalyst for an industry. And we'll provide some practical advice for sorting through collaboration options and targeting the right ones for your business. The success of your company is too important to be competed away.

Save Money, Then Reinvest To Create New Value

In the 1960s, airplane manufacturing in Europe appeared doomed. U.S. companies, particularly Boeing and McDonnell-Douglas, had become the dominant players in the increasingly capital-intensive industry. The smaller European manufacturers, scattered across the continent and fighting fiercely with one another as well as with their international rivals, lacked the scale and the capital to compete effectively against their U.S. counterparts in building big, modern passenger jets. By the end of the 1960s, the Europeans' combined share of the global aircraft market had dwindled to just 10%, despite the fact that 25% of planes were being purchased by European airlines.

Then, in 1970, four of the leading European manufacturers – France's Aerospatiale, Germany's Daimler-Benz Aerospace, Spain's Casa, and U.K.'s British Aerospace – did something radical. They formed the joint venture Airbus, pooling their resources to design, produce, and sell jet aircraft. Not only did the venture provide operating economies and temper financial risks, but the combination of capital and talent also led to a surge of innovation.

Exhibit 1 Airbus ascending



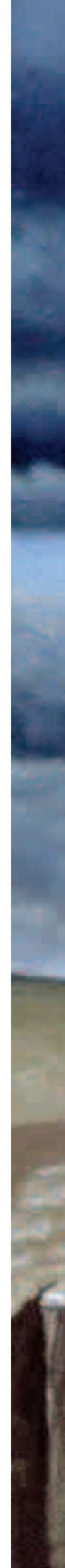
Source: 1973-1994, Investext. 2000-2003, Market Forecast, www.eads.net

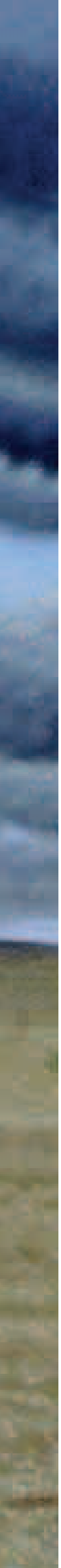
Despite early managerial conflicts, Airbus successfully pioneered new approaches to aircraft design, including fly-by-wire control technology and the introduction of a common cockpit across the entire fleet. Between 1984 and 1994, the joint venture launched three technologically advanced, highly efficient planes that proved attractive to a large number of airlines.

The collaboration didn't just provide temporary life support for the aircraft makers; it has allowed them to thrive. Although Airbus's first customers were European airlines, the venture began penetrating the American market by 1980, and in the 1990s its clientele expanded to include such U.S. giants as United Airlines, US Airways, and Northwest Airlines. Not only had European aircraft manufacturing survived, but Airbus had become in essence the only rival to Boeing (which in 1997 had acquired McDonnell-Douglas).

As shown in Exhibit 1, Airbus has grown rapidly over the past two decades, to the point where it now often beats its American archrival in annual deliveries of new jets. In 2000, the European partners strengthened and extended their collaboration, consolidating Airbus's management and operations at a centralized facility in Toulouse, France. While charges of unfair government subsidies from both sides surface periodically, the important business lesson is the greater efficiency and innovation made possible by the Airbus partnership.

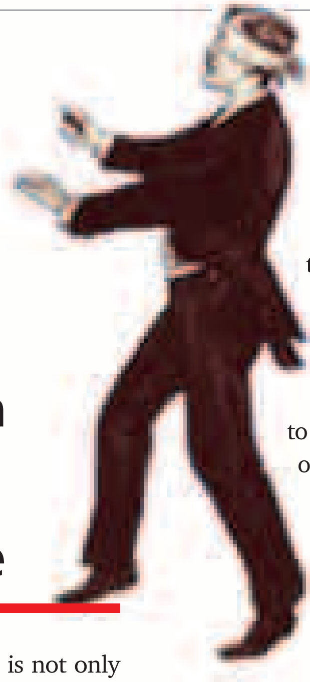
In a similar way, collaboration set the stage for a turnaround in the once-beleaguered U.S. semiconductor industry. During the 1980s, American chip manufacturers were being trounced by low-cost Japanese rivals. Between 1980 and 1986, the U.S. semiconductor industry saw its profits shrink by more than \$2 billion and its payrolls contract by more than 27,000 workers. The sector's ongoing collapse caused grave concerns among U.S. policymakers, for national security as well as economic reasons. Half the chips used in the country's F16 fighter jet, for example, were being supplied by Japanese manufacturers.





In response, the U.S. Department of Defense spearheaded an effort to create a research consortium to stem the industry's losses. Fourteen semiconductor manufacturers, representing 85% of the industry, joined together in 1987 to form SEMATECH in order "to solve common manufacturing problems by leveraging resources and sharing risks." Each of the participants, along with the U.S. government, invested $100 million in the effort, and in return they were all granted the right to share in the resulting technologies. SEMATECH's research initiative, launched from dedicated facilities in Austin, Texas, succeeded in strengthening the entire U.S. semiconductor supply chain while spurring rapid advances in chip miniaturization and speed. The joint effort played a crucial role in the industry's resurgence during the ensuing decade.

> The examples also reveal something interesting: Collaboration usually takes place too late



These two stories show that close collaboration among competitors is not only possible – and legal – but also that it can dramatically improve the profitability of industries and individual companies, particularly in maturing businesses that are undergoing margin erosion. Collaboration allows firms to capture the benefits of superior scale, rationalized assets, and combined talent in those areas of the value chain that offer little potential for strategic differentiation. And it frees up cash to invest in those areas that do offer the potential to generate competitive advantage.

Proactive Moves

The examples also reveal something else: Collaboration usually takes place too late. The European aircraft manufacturers and the U.S. chip makers began to collaborate only after their businesses had deteriorated severely, and in

Collaboration Platforms, Collaboration Catalysts

In addition to improving their performance by collaborating with competitors, some companies may be able to create entirely new businesses by helping spur collaboration among their customers or their suppliers.

In the automotive arena, Johnson Controls Inc. (JCI) has profited by offering to auto makers a collaboration platform – a business set up by a third party that creates the means and incentives for industry collaboration. Over the past ten years, JCI has built five state-of-the-art technology centers – two in the U.S., two in Europe, and one in Japan – to work with auto companies in researching and designing integrated, modular vehicle interiors. These labs have become, in effect, the means through which auto makers around the world can share in creating expensive but non-differentiating components, such as seats and heating systems, rather than duplicating one another's efforts as they formerly did. Acting as a collaboration platform has been extremely lucrative for JCI.

Establishing a collaboration platform can be a particularly powerful business model for two simple reasons. First, the legacy of hypercompeti-tion often makes it difficult for competitors themselves to take the first step toward collaboration. Second, collaboration can unlock so much economic value that both the platform operator and the existing competitors can reap added profits – a collaboration platform enlarges the pie rather than just re-slicing it. For both these reasons, competitors in an industry often have strong incentives to embrace a third party's platform.

A savvy outsider may also have an opportunity to act as a catalyst that spurs industry competitors to begin collaborating. The catalyst may, for example, be a supplier to the industry that can strengthen its existing business by helping its customers work together to solve common problems.

That's what Cardinal Health has done in the prescription drug business through its ArcLight Systems venture. Cardinal convinced pharmacy competitors CVS, Albertson's, Wal-Mart, Kmart, and five regional drug store chains to form a consortium to collect and market real-time drug sales data. ArcLight delivers the data and trends online to paid subscribers, such as pharmaceutical firms, that want to track the effectiveness of marketing campaigns, the impact of new product launches, and the introduction of generic drugs.

The catalyst may also be a customer of the industry. Wal-Mart, for example, is playing the role of catalyst in getting its suppliers – the world's leading consumer packaged goods companies – to collaborate in adopting radio-frequency identification (RFID) technology to better track products as they move through the supply chain. Wal-Mart knows that if the new technology enhances the productivity of the entire retail supply chain, a good portion of the gains will flow to its own bottom line. Without pressure from Wal-Mart, the consumer goods companies would have been much slower to invest in the risky new technology, basic research would been delayed, and a proliferation of incompatible standards would likely have raised development costs and undermined productivity gains.

both cases governmental encouragement and financial assistance were required to get the cooperative ventures off the ground.

There have been some notable exceptions to the collaboration-as-last-resort rule. A group of 25 small hardware stores banded together to form a cooperative for joint purchasing and advertising back in 1948 – well before they were threatened by big-box retailers such as Home Depot. The cooperative, now called True Value, has grown to encompass more than 6,200 hardware, gardening, and equipment-rental stores in 54 countries, with total sales of more than $2 billion. The organization allows its members, mainly entrepreneur-owners, to enjoy big company scale economies without sacrificing their independence.

On the product side, True Value provides members a wide selection of private-label merchandise under such popular brand names as True Value, Master Mechanic, Green Thumb, and Master Plumber. Goods are shipped from the cooperative's 12 regional distribution centers, assuring fast replenishment and responsive service. On the marketing front, in addition to shared advertising campaigns and sales flyers, True Value allows members to tap into a joint customer loyalty program, True Value Rewards, that not only strengthens local customer relationships but provides in-depth market data that would be prohibitively expensive for stores to assemble on their own. The cooperative also allows members to share best practices through "marketing toolkits" that include detailed instructions and templates for proven promotional and public relations activities.

Big companies, too, have on occasion launched proactive collaboration initiatives. Early in the history of the credit card business, for instance, card-issuing banks realized that cooperation would provide two critical benefits. First, it would allow them to develop a national (and later international) network of merchants that would accept their cards. Second, it would dramatically reduce their transaction-processing, technology, and brand-building costs, allowing them to focus their investments and attention on the kind of service programs that can provide real differentiation.

Is Collaboration Legal?

"We can't team up with competitors – it will get us into anti-trust trouble." That may be a convenient excuse, but it's usually not true. Companies must, of course, think through the legal ramifications of any cooperative venture. They have to avoid working together in areas that would involve the sharing of pricing information or entail other actions that might harm customers. And they can't team up in a way that gives them cartel-like power over a critical distribution system or over some other component of a market's shared critical infrastructure.

But the goal of antitrust laws is not to prevent cooperation. Rather, it's to block business activities that damage public interest by reducing the efficiency of markets, slowing innovation, or obstructing productive competition. Because strategic collaboration actually enhances market efficiency, spurs innovation, and intensifies productive competition, it benefits the public and thus is unlikely to be a target of government action (Indeed, past examples of industry collaboration often involved direct governmental encouragement and assistance). Companies launching a collaboration initiative may need to educate policymakers and the general public about the scope and benefits of the effort, but that shouldn't be a deterrent to cooperation. The potential gains – for customers as well as companies – are too great.

To capture these benefits, the banks formed two member-owned agencies, which evolved into today's Visa and MasterCard organizations. There are now more than 1.5 billion Visa and MasterCard cards in circulation, accepted at more than 20 million merchant locations worldwide and used for nearly $4 trillion worth of purchases annually. The credit-card agencies have created value for all parties. Consumers have been given more credit and payment options – the agencies pioneered debit cards, among other innovations. The agencies themselves generate strong revenues through fees for basic and value-added services. And member banks have dramatically reduced their costs and risks. The cost savings provide members with an advantage over American Express (although American Express has other advantages) and a daunting barrier to new entrants.

> Proactive collaboration remains distressingly rare and is casting deep shadows on healthy businesses

Too Little, Too Late

Proactive collaboration remains, however, distressingly rare and is casting shadows on currently healthy businesses. Consider the pharmaceutical industry, where many companies continue to enjoy enviable profit margins as they reap the rewards of drugs developed years ago. But their future margins are under threat from the explosion in drug development costs. In 1975, it cost drug makers an average of $138 million to bring a new therapy to market. By 2000, the cost had reached $802 million.

But pharmaceutical firms continue to compete broadly, each pursuing separate development or licensing initiatives for similar compounds. They often refuse to share even basic clinical information, such as data on liver toxicity, clinging to the belief that it will provide them with a competitive advantage. If the drug makers continue to ignore opportunities for strategic collaboration, they seem fated to endure the kind of margin erosion we've seen in the automotive, airline and other sectors.

What's particularly striking is that in all these industries there have been instances of competitors collaborating in the past and reaping important benefits as a result. The Big Three car makers, for example, launched the U.S. Consortium for Automotive Research (USCAR) in 1992 to undertake studies in such areas as safety and emissions. Most major pharmaceutical companies use sophisticated licensing partnerships to reduce costs and spread risks. Yet despite their own positive experiences with cooperation, they continue to shun broader opportunities for strategic collaboration. Their compete/collaborate ratios remain overwhelmingly biased toward competition.

Improving The Compete/ Collaborate Ratio

Shifting those ratios requires, first and foremost, a change in managerial mindset. It also requires a practical, objective process for thinking through collaboration opportunities. In this area, few companies have in place either the expertise or the analytical frameworks required to make smart decisions.

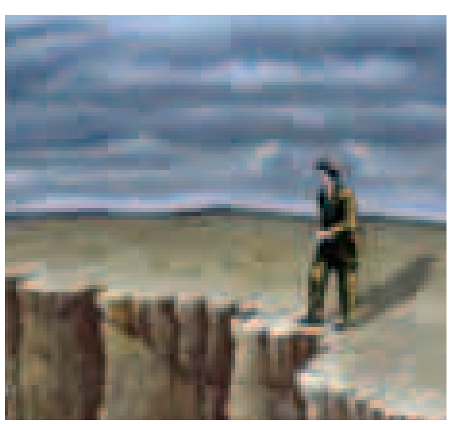
Every company will have to weigh different factors in plotting its collaboration strategy, depending on its industry's economics and structure and its own competitive positioning, but all companies need to answer four crucial questions: Where in our industry's value chain are the greatest collaboration gains likely to be found? What types of collaboration will allow us to best achieve those gains? Whom should we partner? How do we overcome the "mortal enemies" objection?

Where in our industry's value chain are the greatest collaboration gains likely to be found?

Collaboration can unlock value in different ways in different areas of an industry's economic system. At the back end, for example, it can change the economics of innovation and discovery, allowing companies to reduce redundant investments in solving common problems, tackle larger problems by aggregating their resources, and find more creative solutions by tapping into a larger and more diverse pool of talent. In operations, it can change the economics of manufacturing by enhancing scale, spreading risk, aggregating purchases, and speeding the journey through the experience curve.

And, at the front end of the curve, companies may have opportunities to enhance customer satisfaction by more tightly integrating the components of a solution or to reduce costs by consolidating low-value sales or service activities. Start by assessing your industry's current performance in value creation along dimensions such as customer satisfaction, profitability, asset efficiency, and volatility. Different competitors will have different scores, but you'll be able to see the general trends and spot the bottlenecks that limit industry performance.

Then move to the value chain itself. Exhibit 2 shows the key activities of an illustrative company and lists some of the categories to gauge collaboration opportunities in each segment. In general, firms should try to identify activities that provide little opportunity for achieving competitive differentiation or influencing customers' perceptions of value, and that offer strong opportunities to enhance scale economies, asset efficiency, labor productivity, or innovation through the aggregation of resources from different companies. These activities are those that typically represent the strongest opportunities for collaboration.



What types of collaboration will allow us to best achieve those gains?

Collaboration can take many forms, ranging from informal cooperation to formal partnership. And the right forms of collaboration will change over time, as you fulfill prior objectives and as customer preferences change. In industries that have little experience with collaboration, it may be wise to begin with modest efforts, in order to build trust, learning, and momentum.

You might partner on a narrowly defined project with a small number of companies with whom you have existing relationships. Timken works with competitors such as bearing manufacturer SKF to share logistics and e-business activities. In aerospace, Northrop Grumman has teamed up with BAE North America to develop an integrated microwave assembly for a joint striker fighter.

Or you might want to spearhead an industry-wide exploratory committee to evaluate collaboration opportunities and develop initial plans. For example, several mobile phone network operators in developing countries decided that the best way to promote adoption of mobile phones is to reduce the cost of the handset. So they joined together to aggregate their buying power; & Motorola has agreed to supply up to six million handsets for less than $40 each. Such modest efforts provide a way to create a collaboration infrastructure, develop best practices & build relevant skills.

Whom should we partner with?

Choosing the right collaboration partners is a balancing act. Linking up with many competitors through a consortium can bring greater scale advantages than collaborating with a smaller group, but operational conflicts and complexity also tend to increase as more partners are brought into an effort. And collaborating with companies that are similar to your own – in size, culture, and heritage – can reduce managerial and operational conflicts, but will also tend to decrease diversity, making it harder to think outside the box.

In choosing partners, therefore, you

should carefully weigh both the project's goals and the characteristics of potential collaborators, asking such questions as:

- How tightly integrated will partner organizations need to be, given the project's scope, goals, and accountability arrangements?
- How similar are the potential partners' strategies and operating environments?
- Do they exhibit wide variations in performance on key measures related to the project goals, or is performance fairly uniform throughout the industry?
- What shared knowledge base or history exists among the potential partners? If the industry is tightly knit, will existing or past relationships help or hinder efforts?
- How much "common ground" do the potential collaborators have? Is there enough diversity in the collaborative design? Are there other potential partners, from within or outside the industry, that could inject new perspectives?
- Would there be benefits to bringing suppliers or customers into the group?

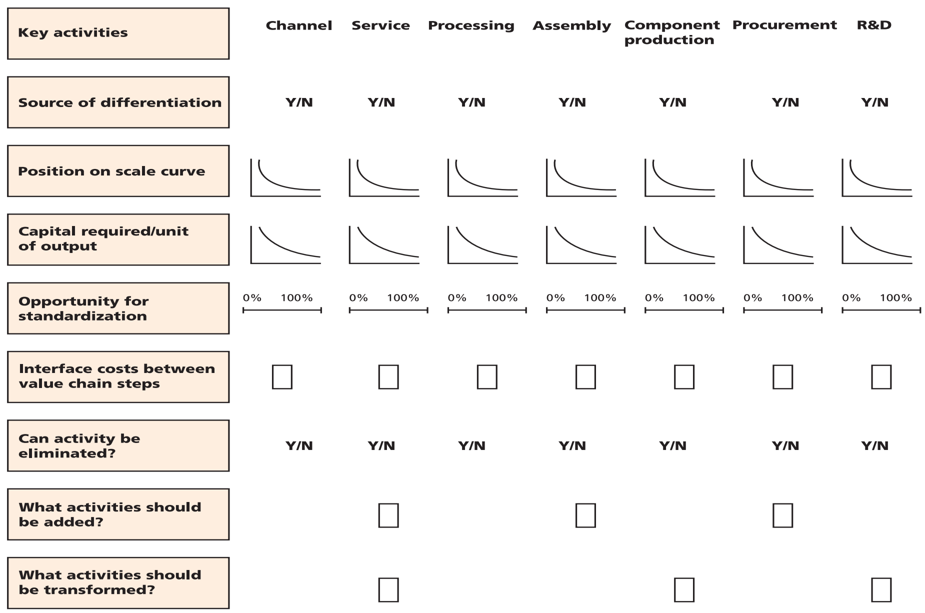
How do we overcome the "mortal enemies" objection?

There is a powerful psychological barrier to collaboration: "We can't collaborate with our mortal enemies." But a quick look at the historical record suggests that this is not always the reality.

Hewlett-Packard (HP) and Canon are rivals in the printer business, yet they've worked very effectively in collaborative arrangements, such as HP sourcing printer engines from Canon. WPP and Paris-based Havas are fierce rivals in the advertising business, yet they have worked closely together in media purchasing. Sony and Samsung are global rivals in the consumer electronics world, yet both have begun collaborating on several fronts:

- Jointly investing $2 billion in a factory in South Korea to produce liquid-crystal displays
- Sharing 24,000 basic patents that cover a range of components & production processes
- Participating in a consortium that is trying to establish the standard for the next generation of digital video discs and players

Exhibit 2 Value chain analysis



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Crafting an effective collaboration is never easy, especially when the participants are intensely competitive. But the record shows that profitable collaboration can be achieved in ways that bring enormous economic benefits to the partners and their customers.

The Competition Paradox

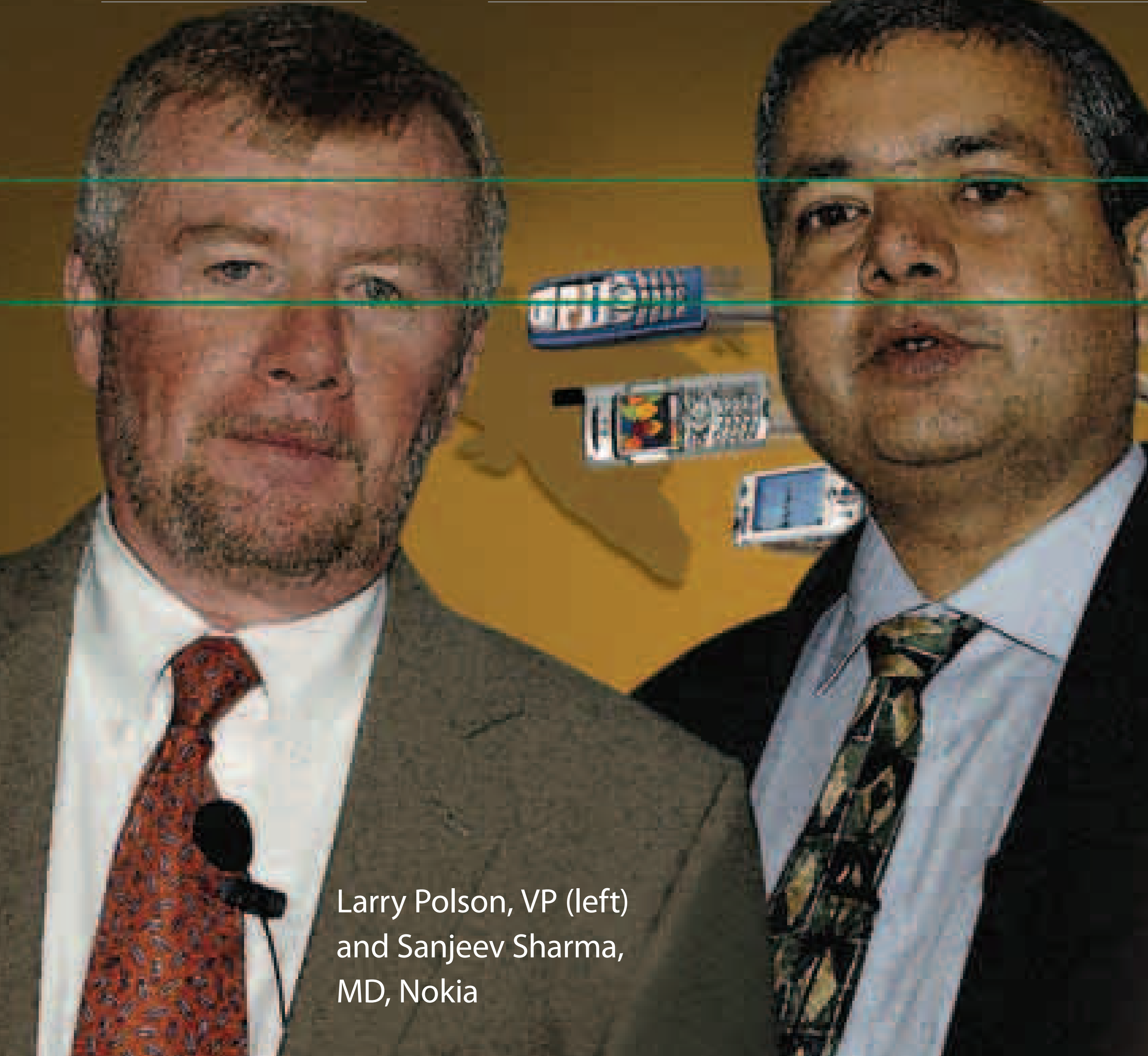
In 1776, Adam Smith published his great defense of free market capitalism, An Inquiry into the Nature and Causes of the Wealth of Nations. By showing how competition lifts living standards throughout society, Smith successfully countered calls for increased regulation of commerce, and set the stage for the great gains of Industrial Revolution. More than 150 years later, the economist Joseph Schumpeter added a memorable gloss to Smith's ideas, when he described how competition creates a cycle of "creative destruction" that continually brings new and better products into the competitive marketplace.

Smith, Schumpeter, and the other great capitalist philosophers provide the intellectual bedrock for our faith and trust in the benefits of vigorous competition. But over the past 50 years, we have come to distort their teachings by using them to justify a blind and sometimes fanatical devotion to competition. Some business executives and pundits have promoted a view of business as a form of warfare or sport – a game of "hardball" that can be won only through fierce and unrelenting conflict.

That's a simplistic and dangerous view of business. Adam Smith and his followers understood that in some cases (of competition in markets that are not perfect) unbridled competition may cause great harm – that mindless competition can bring not creative destruction but just destruction. Given how easily global pressures can devastate the profitability of industries, we need to return to a more balanced view of competition – and a greater appreciation of the role of collaboration in engendering and sustaining healthy economies.

When companies compete too broadly – battling in areas that create little value for customers – they end up wasting enormous amounts of money and weakening the very structure of their industry. By refocusing competition on areas that really matter, strategic collaboration promotes the kinds of robust rivalry that engender better products, lower prices, and stronger industries and economies.

That's the great paradox of competition: By reducing it in some areas, you strengthen it in the places that provide the most benefits to the most people. ■



Larry Polson, VP (left) and Sanjeev Sharma, MD, Nokia

Connecting *II*

From a paper mill, to the world's leading GSM handsets manufacturer, Nokia has powered its leadership through aggressive, but most logical strategies...

Chandra Sharma was a worried man. After many excruciating trials, he had finally managed to expand his fruit business beyond the boundaries of New Delhi. But his growing business was creating new problems for him, as he was finding it difficult to be in touch with his suppliers, agents and customers simultaneously. His best friend Amitesh, who owned a grocery store, advised that buying a mobile phone was the best option for him if he really wanted to get things in order. However, Sharma was scared of exorbitant prices of handsets and tried to work out options. When nothing worked out, Sharma finally walked into a multi-brand cellular handset showroom near his office to get into the cellular freeway. Surprisingly, almost all the attractive – and affordable – handset pieces that were shown to him by the dealer belonged to a brand he had heard many times before of, Nokia; a brand almost all his friends and associates currently used. Wondering whether the dealer was trying to push the Nokia brand through, Sharma checked out other handset dealers around town. But the story remained the same; whichever dealer, whichever locality, whichever budget, the brand Nokia was over-empowering throughout. With extreme conviction after this thorough a market survey, Sharma decided to go for the brand that seemed most convincing, not only in innovation, but in ease of use and post purchase servicing options – of course, the brand of Nokia. And Sharma's total cost? An amazingly little Rs.2,500! "Connecting People" has now got a new meaning for people like Chandra Sharma; and for hundreds and thousands of Indians across geographies.

Welcome to the world of Nokia

Nokia is the largest manufacturer of mobile phones worldwide. In terms of market share, arch rival Motorola has been left behind not only in Asia and Europe but even in its home market, America. In 2005, Nokia was recognized as the 'Brand of the Year' by Confederation of Indian Industry (CII). In 2005, a consumer study carried out by "Indicus Consumer Tracker" declared Nokia as "the most preferred brand", in mobile phones with 75% in aggregate preferences, followed by Samsung with 7%. Nokia also had the highest brand recall in its category.

Way back in 1995, all this was a distant dream for a late entrant in the Indian market. But Nokia went on to become the market leader; and how! Seven out of ten mobile handsets sold, carry the Nokia name! The key to this huge success is Nokia's presence across all price ranges.

NDIA

Nokia – yesterday and today

Nokia has a 140 year long history, but its presence in the telecommunications industry spans 40 years only. Founded by Fredrick Idestam, the Finnish corporation shares its name with the river Nokia in Finland and came to existence in the year 1865 as a paper manufacturing company. It further diversified into rubber business with the establishment of Finnish Rubber Works in 1898. Nokia then tested waters with other businesses as diverse as chemicals and cable manufacturing (Finnish Cable Works).

The present day corporation evolved in 1960 after the merger of the original Nokia Company, Finnish Rubber Works Ltd and Finnish Cable Works. The company that was once hit by the idea of making coloured rubber shoes created its impact in the telecommunication world in 1963 by developing a radio telephone that year and data modem in 1965, innovating far ahead for that time. Nokia became the first company to introduce the NMT (international cellular mobile telephone network) based hand portable phone – the Nokia Cityman – in 1987. A year later, when Jorima Ollila – the enthusiastic Assistant Vice President Finance – took charge, Nokia started developing its GSM network. It developed its first GSM network in 1989 and went ahead to develop the predecessors of its entire GSM phone range including the Nokia 1011 in 1992. The company is also credited with the developed world's first GSM PTT phone, the Nokia 5140.

NOKIA's Firsts... For India

- On August 15, 1998, India's 51st year of Independence, Nokia launched a special 'Saare Jahan Se Achcha' ring tone
- In 1999, Nokia introduced 3210 with user interface menu in local languages
- In 2002, for the first time, users could send text messages in Hindi with the model Nokia 3610
- Nokia innovated and developed localized games for the Indian market like Makhan Chor and Swayamwar.

The mobile major has established itself as a market leader within ten years of entering India. In April 2005, Nokia opened its first manufacturing facility in India at Chennai in order to use India's strategic location for tapping the potential of the Asia-Pacific market. This $100-150 million venture with over 2,000 employees is expected to offer great returns. The decision for the directive has been in the wake of rising revenues in the country. By the end of financial year 2004, India's share was 4.6% in the company's total revenue, making India its fifth largest market, after the US and China. Its 10 year operations in India witnessed a paragon growth pattern, leaving its major competitors Samsung and Motorola far behind. According to RNCOS's market research report 'India Mobile Handset Market (2005)' Nokia leads with a market share of 59%, followed by Samsung at 13% and Motorola at 7%. In June 2005, there were 45 million GSM subscribers in India. Notably, the mobile phone market has been growing by over 50% in the past few years.

It defies the rules

Defying the well established management norm of the early bird taking the worm, Nokia has grown phenomenally in the Indian market. Fighting against odds like high entry cost, lack of government support, customer perception and developed supply chain network of the competitors, Nokia turned out to be a winner. It has been able to do so because of its proper timing and understanding of consumer behaviour along with a well planned marketing strategy. Nokia has proved the Abigail Adams saying, "Great necessities call forth great leaders" right because of the following three straightforward strategies:

1."Made for India": Nokia

The essence of a brand must be felt in each and everything that moves from the brand and reaches the customer, for the company to make an impact. For any company, its interaction with customers is through the product it offers. The Indian success story of Nokia must be attributed to its superior product portfolio across varied segments. Every brand, which is a late entrant in the market, faces the challenge of changing customer perception in its favour and making consumers comfortable with its products. Nokia was no exception. The earlier entrants in the Indian mobile handset industry had come at a time when mobile telecommunication was a status symbol and the market was just developing. The handsets of those days were clumsy, utilitarian black boxes, but Nokia changed it all. Since then, over the years, Nokia has added more and more handsets, as well as features, to localize its global products and cater to Indian preferences. Nokia did not adopt the mundane theory of mass customisation, rather it entrapped the consumers by customising its product categories suited for different groups of people. Moving beyond the horizon of smaller localization initiatives, efforts have always been made to identify specific customer needs. Considering the warm and humid weather of India, all Nokia phones have been made with a texture which is easy to hold. All the Nokia models have been made with a solid basic body, which allows an easy grip and are dust resistant. The second most selling brand for Nokia is the 1100 series, the "Made for India" phone. It was launched in 2003 and has features like dust free key pad, a built in torch and an anti-slip grip. One of the other finest examples of customization is probably the introduction of *Saral Mobile Sandesh* in the year 2004, where Nokia came up with the 1100, 1108 and 2300 series – phones that were Hindi SMS compatible. This was an addition to the list of localized features like the Hindi ring tone '*Sare Jahan Se Achha*' launched in 1998 and the revolutionary Hindi menu in the 3210 & 3610 models. These features have made Nokia one of the most sought after brands in the country.

The latest feature of talking alarms in Nokia 1110 and 1600 has surpassed all previous localization experiments, as the feature comes in Tamil, Bengali, Marathi and Gujarati as well. This really has added a star to Nokia's localized product range. According to an ORG-GFK 2005 study, Nokia is the leader in the Indian GSM mobile handset market and its models Nokia 1100, 3315 and 2300 occupy the top three positions, followed by Samsung's C100, Nokia's 1108 and 3310.

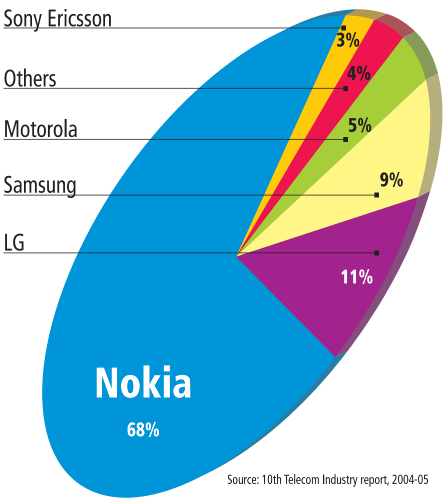
The dedication of Nokia towards providing better services to the Indian customers can be understood in the words of Sanjay Behl, Head of Marketing, Nokia India, "Nokia is committed to bringing ease of use to the Indian audience. This initiative combines product innovation with a wide array of applications and services to deliver

The CDMA no-show

Nokia's current market share is 68% and it is the number one player in GSM and color handsets. Nokia's market share has come down considerably since 1997, mainly because it did not give attention to the CDMA segment, thus helping its rival from Korea (LG) in gaining the top slot in the CDMA segment. Currently, LG has a CDMA market share of 42% as compared to the 23% market share of Nokia. The main reason for Nokia lagging behind in this segment was not paying enough attention to its technical requirements and using the same technology which they had used for GSM phones i.e. implementing the antennas designed for GSM phones on their CDMA models – a tactic which proved unsuccessful and led to Nokia's decline in CDMA from 1997 onwards. Also problematic is its inability to develop a reliable CDMA chipset -- the brains of the phone – given continuing royalty fights with Qualcomm, the inventor of CDMA

'Made for India' supremacy

Nokia rules the roost



Source: 10th Telecom Industry report, 2004-05

a mobile experience that is unparalleled in its relevance to a large section of Indian consumers."

2.Mobile for all

Nokia has got the strongest presence in the market across all segments, irrespective of whether it is in terms of units sold or in terms of value. The most important reason for this is perhaps the mass marketing strategy that it has followed. Indian populace is sensitive to pricing and the company has rightly played on this tune, leaving behind its competitors in GSM markets; Nokia is not far behind even in the CDMA market (it has over 20% of the CDMA market where LG is the undisputed leader).

From being a class symbol, the mobile phone is now treated as a necessity for around 60 million people in India and the service providers' growth has come as an added benefit for the handsets industry. Nokia handsets start at Rs.2,500; this has allowed the lower middle class segment to own a mobile phone. With its aim of winning the volume game, Nokia has stepped up its operations in India. Considering the fact that even today, India has only 10% market penetration, this logic seems to be very rational. With an aim of tapping the customer at every level of various SECs (Social and Economic Classes) by providing multiple options of up-gradation, the company has surely done well in India. Its collaboration with Reliance Infocomm and Tata-Indicom in India has also

"...Whether it was the high-end segment, or the low-end market, Nokia has always sold the concept first..."

helped in tapping a wider array of customers; specifically, in reaching the lower economic segments and increasing its numbers. With the economies of scale that it has achieved, it has been able to give higher margins to its distributors, enabling itself to increase its network far and wide. The presence at each level has proved fruitful for its flanking strategy. Again, offering low priced phones goes perfectly well with the lower spectrum of mobile usage and helps the company tap other untouched markets in India.

3. Promotional and distribution efficiency

India has more than a billion people, more than 250 million homes and consistently rising disposable income. But the mobile coverage is less then one mobile phone per home. Most of the mobile sales are in the urban areas with concentration on metro and 'A' grade cities. The rural market is still to be covered and India is still a vast unexplored market for Nokia. It has focused on its distribution and advertising to capture a major chunk of growth that has been prevalent in the Indian mobile market.

Whether it is the high-end segment now, or the low-end segment earlier, Nokia has always tried to sell the concept first. When the concept of mobile phones was relatively new to India, Nokia tried to sell the product. Now with the acceptance of the product, it has shifted its focus on selling the different product categories. But in the wake of all these changes in the promotional projects at Nokia, one thing has not changed – Nokia is still the single largest spender in terms of telecom advertising in India.

In terms of spending on the ads in print and audiovisual media, Nokia has spent around four times more than Motorola and seven times higher than Sony Ericsson, (see table) its close competitors in India. And it has spent it all well. With its primary focus on mass marketing and more sales in the entry and mid-level segment, it has planned for more ads in that area. Over the years, it has concentrated more on models which it wanted to sell more. In 2004, it spent the maximum on advertising for Nokia 1100

The Nokia arsenal for all classes

Presence of models in various segments has ensured the top position

Range/Level**	Nokia phones	No. of Nokia sub-brands
Entry level (Rs.3000-Rs.6,999)	1100, 1108, 1110, 1600, 2300, 2600, 2650, 3100, 3120, 6030, 6100, 2112, 2280, 3105	14
Mid-level (Rs.7,000-Rs.14,999)	N Gage QD, N Gage QD(with game card) 3200, 3220, 6020, 6021, 6030, 6100, 6101, 6220, 6600, 6610(i), 6820, 7250, 7260, 6585, 6225, 3205, 6235, 6255	20
High end (Rs.15,000-Rs.24,999)	3230, 6170, 6230, 6230(i), 6630, 6670, 6680, 6681, 7270, 7600, 7710	11
Techno (Rs.25,000 and above)	N70, N90, 9500, 9300, 8800, 7600	6

Source: Nokia * The phones given here are currently present in the market including CDMA. As on November,2005 ** The prices at MRP

Lasting impact

Nokia has been one of the highest advertisment spenders

(in Rs.lacs)

Advertiser	2001		2002		2003		2004		2005*	
	TV	Print	TV	Print	TV	Print	TV	Print	TV	Print
Alcatel Telecom	30	15		0		43		101		20
Benq						49	1,605	416		86
Ericsson	143	47		0						
Haier									857	71
LG Electronics India Ltd				25	1,759	1,007	7,170	2,122	3,410	2,246
Motorola		42	1,333	56	386	1,679	4,576	2,052	4,233	612
Nokia Corporation	1297	689	4,622	290	9,885	3,242	13,449	3,424	24,921	4,288
Philips Electronics India Ltd	6	44		0	15	29	97	117	504	24
Samsung India Electronics Ltd	878	484	2,410	300	2,987	1,559	8,902	2,443	3,663	867
Siemens Ltd	0	116	84	92	195	246	22	386		
Sony Ericsson (India)			195	24	1,329	694	2385	827	3,399	470

Source: NRS (National Readership Survey, 2005), MAPS *Till October2005

in order to boost its sales in the market. But for the year 2005, Nokia 2600 colour phones took most of its spending with the product category of colour phones growing in India. This strategy has been different to the one followed by other competitors who have generally not focused with such narrow attention on key models.

Besides advertisement, Nokia has also developed in other forms of promotion. Like the campaign to promote *Mera Nokia*, a Hindi portal. This portal provides access to a host of Hindi language content including *Samachar* (News), *Suvichar* (Thought for the Day), *Chutkale* (Jokes), *Jyotshi* (Astrology), Wall papers and Ringtones.

As part of its distribution strategy, Nokia has ensured that it has a presence in all 2,000 cities and towns that have cellular coverage. Nokia's distribution network of over 30,000 outlets is roughly double that of its rivals, according to industry sources. It has developed a complex form of distribution with its dealers in all the major cities, touching over 25,000 of them, making it the leader in terms of distribution in India. Nokia has attained such huge numbers by employing a kind of sales force, comprising individuals who have distributed FMCG, durables and automobiles earlier. With 4-5% wholesale margins, it has been successful in alluring numerous dealers, who eventually became Nokia Priority dealers. Like FMCG goods, mobile handsets and airtime services have started to become accessible to almost every consumer and Nokia has understood this potential, as it developed its hegemony on the distribution channel. Now it has started focusing on rural and smaller towns, where non-traditional distribution channels are required to reach the end customer.

Other than this, Nokia has come up with "concept stores" in New Delhi in 2005 as pilot projects for starting a new type of retail outlet which would showcase and provide first hand experience of Nokia products. This kind of innovation in the distribution channel has helped it sustain in the market as the leader for around 10 years.

4.Giving technology the human face

Worldwide, Nokia has always tried to position itself as 'technology with a human face'. All its advertisement campaigns try to depict the humanized technology that the company presents. Each hand set made by Nokia tries to depict an individual (that personifies its target market) and it has thus been able to add a personality to its brand, rather than just giving the brand a name. This perhaps is the Unique Selling Proposition (USP) that Nokia has carved out for itself. For any prospective customer, an electronic gadget is as good as the first ease of use. The product makes a good impression only if it is user friendly or easy to operate. Nokia has got this equation right; and that is the reason why Nokia handsets are rated the highest by various research reports on the factor of user-friendliness.

The "Made for India" campaign was a marvellous positioning tactic that communicated to the Indian target market how Nokia mobiles were not just innovative, but were also localised to regional conditions. Their large screens, with 65,356 pixels, make content viewing a delight. The scroll buttons are larger for easy operation with standard signs in all sets; the menu buttons are similarly easy to access. Along with these, features added over to basic communications like easy call management and SMS management have also made it more useful. Interestingly, Nokia was the first to provide the T9 dictionary for SMS compiling – an intelligent key tab recognition software that forecasts the word one is about to type.

Nokia has worked relentlessly in all the markets that it has entered, India is a crowning glory for its success. The world has much to learn from this behemoth, most importantly being their customer orientation. Nokia remains, the leader, connecting people... ■

Edit bureau: Niharika Singh

Panache Pantal

A critical documentation of the Pantaloon saga; from retail to food, from single outlets to multiple ones, from outsourcing supply to insourcing production, Kishore Biyani is rocking!

oon

Pantaloon Retail (India) Ltd

It's an early October evening and the mood at Knowledge House, the headquarters in Mumbai of Pantaloon Retail (India) Limited – India's largest retailer – is boisterous as the employees come to know that their CEO Kishore Biyani has just been chosen 'Retail Face of the Year' by Images Retail. In choosing the name, a nationwide poll decided the verdict with performance assessment by Global Retail Consultants KSA Technopak, Knowledge Systems and a jury chaired by McKinsey & Co. Biyani beat a veritable who's who of Indian Retail – B. S. Nagesh (CEO of Shoppers Stop), Raghu Pillai (CEO of RPG Group) and other lumniaries being among those who were nominated. The achievement highlights Biyani's rise as the super retailer in India (or the '*Rajah* of retail' if you will, as a business magazine recently called him on its cover) and at the same time, the wheels seem to have turned a full circle.

Nobody took the man and his methods seriously when he started off in 1997 at cracking the puzzle of organized retail in India. He may not have had the flamboyance, panache or glitter of the more illustrious competitors, but more than made up for it with his performance. Today, he leads the pack in turnover (and profits) and is the fastest growing to boot. He wants to be the 'Sam Walton of India'. But he still has a long way to go (for starters, he doesn't sell cars in his stores yet) before getting that epithet.

And the reason is that there are various issues relating to expansion, consolidation and competition that he needs to address. But how did one man, trusting his gut-feel and knowledge of customers, eschew all conventional methods to build a business that turned the Indian retailscape upside down? It surely makes for a fascinating tale.

The Tale is Retail

Retail is the biggest industry in the world with sales crossing $7 trillion annually. And India has almost 12 million retail stores. Anyone with even passing awareness about the Indian market can spot the potential here.

Or so it seems. Because, astonishingly, organized retail has not even grazed the proverbial tip of the iceberg of this Rs.9,300 billion market. Organized retail stands at only 2% of the total market in India compared to 85% in the US, 55% in Malaysia and 20% in China. The business scape is oddly barren. But thanks to several players aggressively trying to expand, the number is growing steadily especially after liberalization. The boom in organized retail is but inevitable given the fact that reforms and liberalization policies have led to more favorable income distribution and increased consumption expenditure.

The K. Raheja group promoted Shopper's Stop can be heralded as the pioneer in kicking off the organized retail push with their first store in Mumbai in 1992. The model was that of a departmental store. As the chain of stores – run by a smart bunch of professionals led by B. S. Nagesh, a graduate from the Indian Institute of Management Bangalore – turned profitable, the Great Indian Retail Potential story had started unraveling. But India was as yet a nascent market and critical doubts loomed. What formats would work? Can western models be replicated? What about scale? And most crucially, is there money to be made? Somebody had to seek the answers. But that would entail a load of experimenting and humongous risks. Somebody had to bear those and be brave enough to plunge headlong into the untested waters. Kishore Biyani was that somebody.

The First Few Steps

Biyani, the son of a Mumbai based Textile merchant, graduated in Commerce from HR College, Mumbai in 1981 and initially joined his father's business. He hailed from a conservative Marwari business family and his father was an old school conventional businessman. Being a cloth trader, he could never associate fabrics with fashion.

Soon, Biyani began to tire of the business and chose to start a yarn manufacturing unit, which in those days offered high margins. Of the Rs.700,000 he needed, he put in Rs.200,000 saved from his trading deals and the rest he financed with borrowings from family. In 1987, he incorporated Pantaloon as Manz Wear Pvt. Ltd. That initially made trousers, which were sold to shops stocking multi brand clothes. There were not many exclusive retailers around those days and the response was decent though not overwhelming.

He took the company public in 1991, changing its name to Pantaloon's Fashions (India) Limited and then finally to Pantaloon Retail (India) Limited [PRIL] in 1999. He advertised his trouser brand – Pantaloon – heavily (he initially had an ad budget of Rs.1.7 million on a turnover of Rs.7 million) and considered taking it national, positioning it in the office and casual wear segment. He expanded his product portfolio and introduced two more brands – John Miller (office formals) and Bare (mostly Jeans) and sold them through outlets called 'Pantaloon shoppe' using a franchisee model nationwide. But it was in 1997 that he fired his first dramatic salvo into the Indian retail canvas.

The 'Fast Mover' Advantage

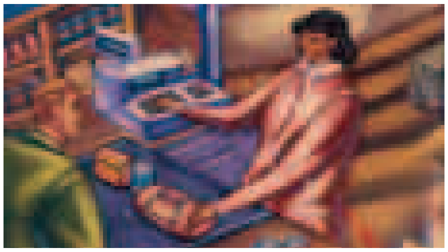
Back in 1997, his products were good but struggling despite competitive pricing due to high distribution costs involved in maintaining the franchisee model. That's when he felt driven to set up his own store to retail his brands. He invested Rs.50 million in the first Pantaloon store in Kolkata including a Rs.4 million promotional campaign – a radical step for a retailer one store strong!

Biyani had been hoping the Kolkata store to do about Rs.70 million worth of business in the first year. It did Rs.100 million! The upshot: Biyani realized that the Indian market was under-retailed and suddenly got into a hurry to expand. Within 6 months of the Kolkata launch, he had rolled out stores in Hyderabad and Nagpur, investing a further Rs.50 million in an untested format. But then, the quintessential intrepid entrepreneur that he is, Biyani was no stranger to risk. In June 2000, he opened in Chennai and by the end of the year had expanded his footprint to New Delhi, Bangalore, Ahmedabad, Indore and Jaipur. He had earmarked Rs.140 million as projected capital expenditure and Rs.100 million towards media spend.

The reason why he preferred to push the exclusive retail format as opposed to the franchisee model was the expanded product portfolio that he now boasted of. From being a men's wear company, Pantaloon added several lines of branded ladies and kids wear (all of them their own private labels). During that time, Mr. Biyani wanted to be the 'largest ready-made garment retail chain in India'. But those plans would soon change in favor of something even more mega at the turn of the century.

Insight Inside

PRIL's real success story started in late 2001 when the value retailing format – Big Bazaar, a hypermarket was rolled out. Shoppers Stop was deep in the red then ; Delhi based Nanz (a food retailer) had closed down and the stark reality of uncertainties in the retail business was hitting the players. Most existing players were grappling with figuring out the USP for the Indian market. What, then, did Biyani see that others didn't?



The reason why Biyani preferred to push the exclusive retail format as opposed to the franchisee model was the expanded product portfolio

On the face of it, there isn't anything outstanding about Pantaloon's retail business model. Early consulting reports on the sector had indicated that there are enough models out there in the developed part of the world that will find acceptance here, even though they may find some modifications to suit local needs better. The challenge, really, is in the re-invention. And that is where Pantaloon scored with a combination of Biyani's old fashioned entrepreneurial abilities (like being able to read the mind of the consumer, taking big risks etc) and excellent networking swinging its fortunes.

While many competitors were blindly trying to apply the western merchandising and retailing models in the Indian market place, Pantaloon zeroed in on one attribute: The average Indian consumer's obsession with bargains. Biyani wagered that the in-store ambience per se doesn't matter if there is enough discounting happening. Thus he built his value businesses, Food Bazaar and Big Bazaar, based on that premise. Big Bazaar was a discount hypermarket that stocked more than 2,00,000 stock keeping units and offers discounts ranging from 6 to 60%.

The company was the first in India to venture into the discount hypermarket business. Food Bazaar, on the other hand was the company's food and grocery retailing arm. Conceived initially, as a part of Big Bazaar, Food Bazaar filled the vacuum that existed within the food and grocery-retailing sector in India. In these stores he could get away with stockpiling everything from plastic containers to loose rice in gunny bags reducing the aisle to just about fit a cart since the prices were so profoundly marked down compared to others.

Biyani has always focused on the family as the customer and not the individual. As is evident from his insights, he has built his strategies trying to position himself for the entire family. For example, the trademark of his stores were the winding, U and C shaped aisles that created corners for families to consult about purchases. Why? Because he believes, "Indians like to shop in groups and find straight aisles insipid." But that wasn't all. The man, who has publicly admitted that he attaches little value to MBAs, also shunned the traditional segmentation approach.

His approach, as mentioned in media: "Within a family, people were…acting very differently, which is why I believe studying Indian consumers by demographics and psychographics is a waste of time. We should look at communities: Techies, metrosexuals etc." According to Biyani speak, the inspiration for Big Bazaar's hyper market format came from a simple and ubiquitous source – the neighborhood markets that looked pretty much the same everywhere in India. Each had a trader (a mom and pop general grocery store), a dry cleaner, a chemist and so on. "We knew we would have to create that same mix in whatever format we evolved," Biyani postulated to a magazine. He believes that Food Bazaar also succeeded because it was modelled on the *mandi* (a typical Indian produce market) where the consumer can touch, feel and choose products.

Armed with these insights, he followed a two pronged strategy: Rapid expansion and engineering low prices at the same time. And those were his finances that needed the most attention, if this venture were to succeed.

Money Lines

A company that was trading at Rs.51 per share (PE ratio 8 x FY03 earnings) on the Bombay Stock exchange in mid 2003 and now quotes Rs.850 (PE ratio 85 x FY04 earnings) must surely be doing something right. Growth has been tremendous (a topline growth of 65% over the last 10 years) and an integral part of the strategy.

"The retail business is like mounting a bicycle. You cannot stop riding. If you stop, you fall... In retail, size matters. It is a business that revolves around volume," Biyani was quoted as mentioning recently. Even the company's annual report exhorts that it wants to emerge as a 'Godzilla' in the Indian retail industry in the next three years. In 2001, when the second Big Bazaar was rolled out in Mumbai, Biyani almost pushed himself to financial brink. The topline stood at Rs.1.8 billion and they needed financing to expand. But with profits of just Rs.40 million and the share price at Rs.18, the options of internal accrual or raising money at the bourses were ruled out. Biyani took on a loan of Rs.1.2 billion that pushed the debt exposure to as high as 1.5. It was almost do or die but the store clicked. It recorded footfalls of almost 100,000 and did business worth Rs.10 million – in the first week itself!

Having survived his sternest test yet, Biyani finally began to blip on the investors' radars and new investments started coming in. Initially, investors were put off by the idea of him behaving like a maverick and doing most things by himself. Once he had famously remarked, "I use people as hands and legs. I prefer to do the thinking around here." Hardly words that inspire confidence. But once it became apparent that his successes were not as serendipitous as they seemed, and with not many other growth stories in Indian retail, investors were willing to bear with him.

Incidentally, Biyani also yielded territory as new investors suggested him to delegate more and hired a whole new management team putting together a pack of top profession-

als handpicked from the industry. Ved Prakash Arya formerly at Globus (an apparel retail chain promoted by the Rajan Raheja group) handles operations; Kush Medhora from Westside (retail chain of the TATAs) looks after new store rollouts and the list goes on.

The results quickly translated into balance sheet improvement. The year 2004 was the critical year when revenues moved up to Rs.6.5 billion (FY04), up from Rs.4.5 billion in 2003 and the target for Rs.10 billion looks well within reach. Rapid scaling up is the key. The organized retailing market is expected to increase to Rs.1,040 billion in the next 5 years up from Rs.280 billion, according to a study by global rating agency Fitch. And Biyani is ready for it with a kitty of Rs.2.5 billion earmarked for capital expenditure over the next 3 years. Of that, Rs.320 million has been raised through a convertible debenture offer made in late 2003 and another Rs.600 million is being financed by debt. The rest, keeping in mind Pantaloon's balance sheet, could be ploughed back from profits.

The reason for that being the fact that the company's topline growth has not come at the cost of profitability. Even four years back, in 2002, while sales grew at an impressive 58%, net profit grew almost 10% with a healthy operating margin of 8%. Moreover, expansion has helped them reap economies of scale. Expansion ensures that incremental capital employed per square feet decreases whereas the incremental sales increase strengthening the efficiency of capital employed. Given the low margin nature of this industry, retailers are seeing the need to invest in efficient sourcing and supply chain management to bring down costs. PRIL is already doing it.

The Step Backward

The company is integrating backwards into the in-house manufacture of apparel, a move that allows less dependence on intermediaries and competitive advantage in value cost and convenience. It has a captive trouser manufacturing unit in Tarapur, a denim plant in Mumbai, shirt manufacturing facility in Bangalore and knits manufacturing facility in Gurgaon.

But these moves are not just limited to apparel. PRIL is aiming to do the same in the food business as well. The Ahmedabad Food Bazaar has a full scale dairy set up in place with a capacity of 1000 liters a day. It makes its own paneer and pasteurized milk. They even intend to add spice grinders and *atta chakkis* (flour mills). It is part of a backward integration strategy that Biyani has elegantly titled 'Farm to Plate'. And even this is driven by a simple insight of his into the business of food retailing in India: Indians prize freshness above all in their food items.

The other trend in the Industry is private labels for margin enhancement. Private labels are brands created by retailers. Products sold under these brands are comparable in quality to the available branded products. But they are priced lower (for example Food Bazaar retails its own brand of Ketchup which costs Rs.38 a bottle as opposed to Rs.58 for a branded one) and offer better margins.

PRIL has been a seasoned player in this arena boasting of 45 odd private labels (from Knighthood in shirts to Premium Harvest in *basmati* rice) [See exhibit for a comprehensive listing] that straddle all sorts of product categories. The vertically integrated structure brings freshness in the food segment and reduces the time to market in the apparel segment (which helps them track trends fast and refurbish clothing lines accordingly). "Our own brands will not only provide us with better margins, but also give us better bargaining deals with FMCG companies," asserted Biyani in one particular news article. After all, it was internal brands that kick started the idea of organized retail for PRIL.

Steep Growth Ahead?

Seven years on and the words 'mega expansion' and PRIL seem inseparable. The company has 42 stores, in 17 cities straddling a mammoth 1.1 million square feet of retail space. The business is divided into two major retail formats; Lifestyle retailing and Value retailing. Value retailing consists of Big Bazaar and Food Bazaar [see exhibit for details]. Lifestyle retailing comprises Pantaloon, the departmental store, and Central, the 'seamless mall'.

The latest buzz has been around the Central 'seamless mall' concept and whether this new format would get off the ground like the others. The design of the mall does away with in-between walls and shop-in-shops thus offering customers unobstructed and pure shopping experience. The revenue model is based around the concept of space utilization. Brands pay certain fixed charges based on the amount of space they occupy, additionally; they are also required to pay a certain percentage of monthly sales. The revenue parameters allow the company to have a de-risked model, which insures that the downside is protected.

At the same time, the company benefits from the sales recorded by each brand. In addition to stocking some of the most well known national and global brands, Central also provides the company with a platform to showcase the ever-increasing number of its in-house labels. Central tries to marry the efficiency of a departmental store to the ambience of a mall. It carries lots of brands under one roof and has unified billing (like a departmental store), but also has eating joints, cafes and play areas (like a mall). The uniqueness being that the partners are responsible for their stocks and PRIL has no valuable working capital stuck in the inventory. The first Central opened in Bangalore in May 2004 and two more have already come up in Hyderabad and Pune. It is part of the expansion blueprint that the company has developed. The target is to touch Rs.90 billion in sales by 2010 and straddle an astonishing 3 million square feet of retail space. The expansion will see a focus primarily on 'B' cities (non metros) of Gujarat, Maharastra, Karnataka, Andhra Pradesh, Punjab and West Bengal.

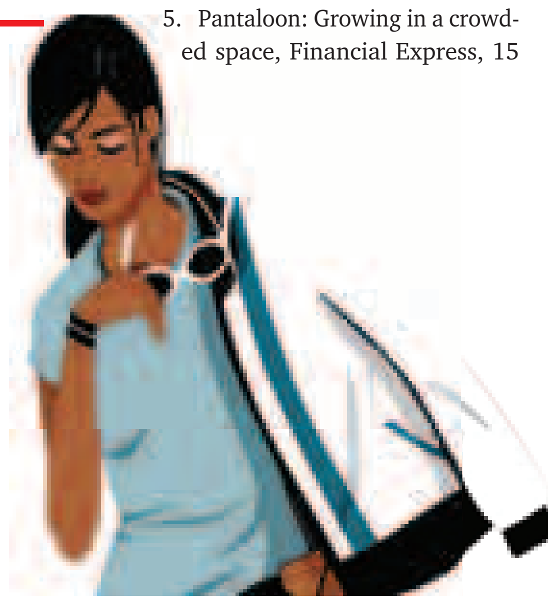
Most of the new stores are likely to be Big Bazaars followed by Pantaloons and Central malls. But competition is lurking in close vicinity as the Indian retail space gets increasingly competitive and will become cutthroat with foreign direct investment almost certain to be allowed in the sector. Points out Ireena Vittal, Partner at McKinsey and Co. in a press statement: "Retailers need to not only understand and roll out successful formats, but also constantly replenish them with newer formats." But Biyani, ever the contrarian, had responded consequently, "I will no longer try out newer formats. My focus will be to consolidate our operations."

Pantaloon's strength perhaps lies in the fact that it has got region specific knowledge and in the next three years it hopes to create a size that will be difficult for newcomers to match quickly. But does that mean that PRIL has cracked the Indian retail Puzzle? PRIL has four major competitors: Shoppers' Stop, Piramyd, Lifestyle and Globus. Moreover, players like Giant, Trent & Reliance are also enter retailing. Can PRIL sustain its scorching pace?

The award Biyani got – mentioned at the start of this paper – must feel great for Biyani. Knowing him, he might probably be rather labeled the 'Retail face of the Decade' or better still 'Retail face of the Century'. But for that to happen, a lot will ride on how his expansion and consolidation plans pan out. And with the FDI in retail almost finalized, it's only a matter of time before Walmart and the other biggies like Tesco and Carrefour make their appearance.

Only three years back, Biyani had almost risked it all trying to fuel his first expansion wave. He must ask himself: is PRIL growing too big, too fast? And are they ready for the second wave? And most important of all, can he fund his own growth trajectory or does he need foreign collaboration? ■

The target is to touch Rs.90 billion in sales by 2010 and straddle an astonishing 3 million square feet of retail space



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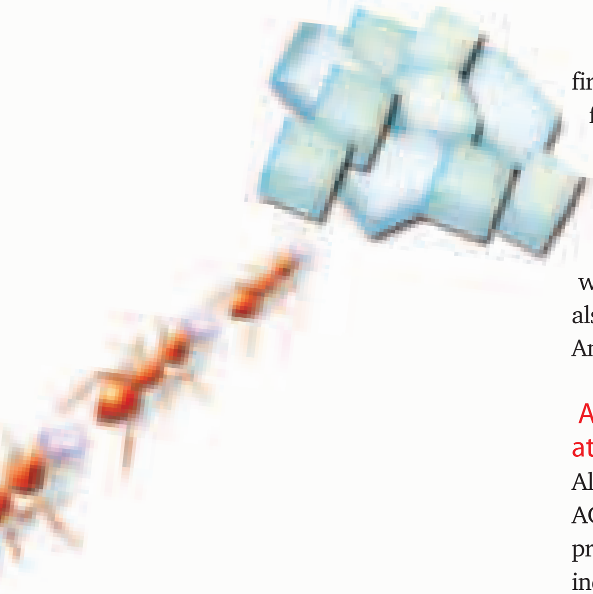
This case has been prepared by Tareque Laskar, Professor at The Indian Institute of Planning & Management, Bangalore. The case has solely been developed for class discussion. Cases are not intended to serve as endorsements, sources of primary data or illustrations of effective or ineffective management or administration. All statements mentioned are either media quotes, or from third party sources. ■

The Logic of Logistics... and SCM

Poul V. Jensen

A case of how BASF implemented an efficient & environmentally friendly system

Jayant Chopra



Background of BASF

BASF is one of the world's leading chemical companies. Founded by Friedrich Engelhorn in 1865 in Mannheim, Germany, BASF was originally known as Badische Anilin-und-Soda-Fabrik (Baden Aniline and Soda Factory). The group has its presence in Europe, Asia, North America and South America with headquarters in Ludwigshafenam Rhein (Rhineland-Palatinate, Germany). BASF produces a wide range of chemicals like solvents, amines, resins, glues, electronic-grade chemicals, industrial gases, basic petrochemicals and inorganic chemicals.

Problem at BASF

In the 1990s, BASF's top management decided that the company needed to take the following steps in order to improve and address the following issues:

- Cost reduction in all areas of logistics and transport
- Lasting quality improvement
- An increase in the percentage of the rail transport within the modal split

TransCare hired

TransCare was hired by BASF in the year 1996 for the improvement in the area of Logistics. It is one of the areas in which sustainability plays a central role to BASF.

History of TransCare

TransCare, founded by Ralf Jahncke in 1993 in Germany, is an international consulting firm with expertise in logistics and transportation. TransCare has helped its customers in every aspect of their business activities. The firm won the European Innovation Award for Intermodal Transport in 1996. It has done countless projects like developing the traffic and transportation concepts for the German Soccer Association's application for the FIFA World Championship which will be held in 2006. TransCare is also present in Netherlands, Russia, South America and India.

Addressing the logistic issues at BASF

Along with logistic consultants TransCare AG, BASF decided to initiate a long term project, emphasising on the following four individually important modules:

1. Development of alternatives for the existing off-site rail freight transport, including the establishment of a private rail company.
2. Construction of an intermodal transport terminal with public access within the BASF site, including integration of a certified container depot for dangerous goods.
3. Integration of the internal site logistics into the transportation process, pre-carriage optimisation for intermodal transport with respect to loading point control in production and in the depots.
4. Consolidation of the depot logistics and relocation of the central depot to the immediate vicinity of the rail activities.

> All measures till now have produced far better results than predicted

Implementing the modules:

By introdcing an extra logistical services in the newly constructed BASF terminal, and by employing intelligent pricing it was successful in:

- Breaking up the commercial fragmentation that had previously dominated
- Integration of the Site Logistics in the Transportation Process
- Significant reduction in the truck waiting times in the BASF production's loading areas by implementation of and adherence to exact depot delivery times
- Smoothing out the peaks and troughs in the usage of the intermodal transport units and more consistent usage of the loading personnel
- Reducing unaccompanied loading facilities leading to extended loading times
- Reduction of external drivers

Depot/Warehouse Logistics

Lower damage quota (damaged palettes/cartons) because of reduced number of handlings

- Round the clock access to depot stock
- Reduction in loading times
- Increase in turnover speed of up to 20% to guarantee the same delivery capability despite reduced depot stocks

Success in solving the problem

Changes in the Modal Split – All measures undertaken produced far better results than predicted. Reductions in costs have been remarkable – the private rail freight has in some cases reached savings of over 30% and in pre-carriage and post-carriage to intermodal transport terminals reductions of up to 50% were obtained.

Whilst the conventional rail freight transport has remained constant at 1.6 mn. tons per annum equalling 27% of the modal split, the intermodal transport had increased to 900,000 tons per annum by 2004. It is expected to continue rising by a further 300,000 tons by 2006. This increase of close to 1.2 mn. tons by 2006 is also the result of the early completion of the second stage of intermodal transport terminal in Ludwigshafen. At the same time the transport of freight by road has been reduced by 1.1 mn. tons.

In comparison, the intermodal transport market share of BASF's transports is expected to increase from 10% in 1995 to 21% in 2006. Looking closely, a trend reversal can be observed – the growth in the share of road transports has not only been stopped, it has in effect been reversed.

This clearly shows that the TransCare approach with integrated transportation concepts leads to a successful increase in rail transport.

The Development of the Intermodal Transport Terminal

The most important step in achieving the positive development in the modal split described was the realisation of the intermodal transport terminal. One factor central to the success of the terminal was the integration of the terminal into the BASF site area in Ludwigshafen, Germany. It has direct connections to the national road and rail network and other BASF sites. The first stage terminal with a capacity of 150,000 moves per year was opened in 2000. At the beginning of the project it was estimated that the second stage of expansion should be opened at the earliest in 2006.

However the increase in demand for intermodal transport ensured that the second stage came much earlier. By 2003 the terminal was already working above its predicted handling capacity limit of 150,000 moves per year. Struggling to cope with the demand, the additional 15,000 moves per year encouraged the project management team to begin immediately with the second stage, which was completed by the end of 2004. The terminal's capacity of 280,000 moves is expected to be reached once again by 2006 (see figure 1).

Cost Efficiency

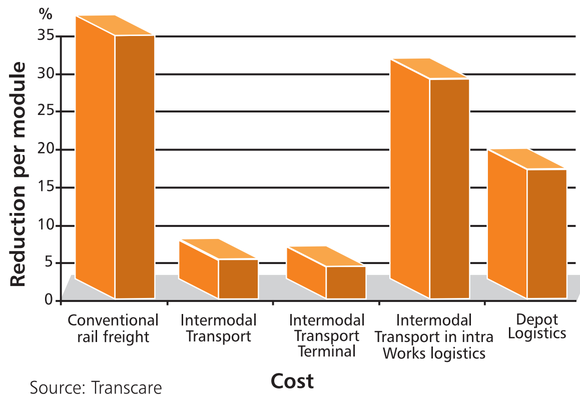
Significant cost reductions were achieved during the whole project. It would however be a distortion of the truth to claim that each individual module would have achieved the same level of savings, had they been implemented individually. Had this been the case, then the reduction of 4% achieved in the intermodal terminal module would have to be valued negatively in comparison to the other modules. However, without the expansion of the intermodal transport terminal within the BASF site neither the process optimised site logistics nor the immense increase in intermodal transport and the related reductions connected to the road transport would have been possible. The following reductions were achieved in various modules in combination with the other modules:

- Conventional rail freight: 25% cost reduction
- Intermodal transport: 5% cost reduction
- Intermodal transport terminal: 4% cost reduction
- Intermodal transport in intra-works logistics: 29% cost reduction
- Depot logistics: 17% cost reduction

These reductions apply to the current process costs compared to the original costs generated by the transport and logistic operations. Whilst the reductions in the areas of conventional rail freight and depot logistics relate to the same amount of goods, the absolute reductions in intermodal transport have also been positively influenced by additional quantities transported.

Cost Reduction: Results Per module

Broken up over different logistics systems



Source: Transcare

Quality Improvement

An important part of the project controlling was the improvement in quality. The following was achieved in the individual modules:

Private Rail Company

- Improvement in reliability (max. 60 min. delay) from under 60% to 83%
- Consolidation of conventional and intermodal transport with an increase in train frequency and lower interim storage time in the wagons
- Significant reduction in the time needed to process transportation requests and transportation itself

Intermodal Transport Terminal

- Reduction in the truck turnaround times as a direct result of the terminal's immediate vicinity to the loading areas and an optimised process within the terminal itself
- Shorter train operation times as a result of making shunting operations redundant, resulting in extended loading time for carriers, optimised loading processes as a result of tracks equalling the length of the train, gravity optimised shunting and the prioritised use of complete load shuttle concepts
- Adaptable shunting time, added Value Services from one Supplier, i.e. the site internal train company
- Additional services for the customer (repair services, agents, storage space, dangerous goods depot etc…) offered by private terminal operator

Figure 1: The BASF Intermodal Transport Terminal – before and after construction

Easing the Environmental Burden. Regionally: BASF's decision to strengthen an alternative mode of transport to the road through the construction of their own intermodal transport terminal has led to wide reaching changes both in the region and to long distance transport flows. The cities of Mannheim and Ludwigshafen have benefited tremendously from this decision. The shift from road to rail by the BASF alone meant cutting approx. 61,000 truck trips per year (220 trips per day) through the two cities as the pre-carriage and post-carriage trips now only occur internally. In 2006 the reduction is expected to total 81,000 trips within these two cities alone.

The construction of the central logistics centre reduced the number of palette moves between the de-central depots and warehouses and the consolidation centre within the BASF sites by 330,000. This in turn meant a reduction of approx. 50,000 truck trips per year. As the average trip distance was 15km, a further 0.75 mn. Km's of truck trips were avoided.

Supra-Regionally

In 1995, 30,000 consignments were shipped by intermodal transport, in 2004 it was 46,000 consignments, and in 2006 it is expected to be about 62,000 consignments with BASF goods being shipped by intermodal transport. The average transportation distance of these goods is approx. 680 km by rail. When considering the goods transported by intermodal transport before the terminal was operational, the project implementation in effect means that over 21 mn. kms are avoided each year.

These are mainly km's that would have occurred on the national highways. These calculations however do not include empty return trips which are now also avoided and would sum up to several million kms. When taken all together, BASF has reduced the distance driven by trucks by over 25 million km per year! Of this, 1.75 mn. would have been within the cities of Mannheim and Ludwigshafen with the remainder being on the national highways.

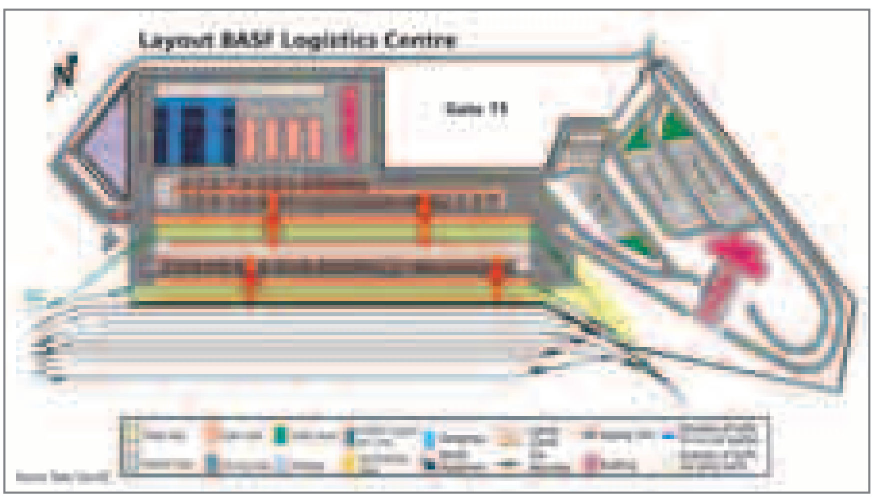


Figure 2: BASF Intermodal Transport Terminal – Technical Layout

Interaction of the Modules

- Without the on-site intermodal transport terminal with a low economic effect, the high savings in the site logistics would not have been possible
- Without the new rail company and the cost reduction in rail freight, the positive shift in modal split for intermodal transport could not have been achieved
- Despite the central depot as a standalone project being economically successful, through it's vicinity to the terminal a large increase in the goods transported can be seen

Furthermore partners involved in the supply chain, explicitly logistic partners and carriers, other industrial companies, have used the services of the private rail company, Rail4Chem. This meant that approx. 50% of the services in the terminal were for third parties. Furthermore, if considered alone, Rail4Chem actually provided more than 75% of their transport services for third parties!

Conclusion

Over the past ten years, the scope of the above project has constantly evolved and TransCare has intensively supported BASF in the modules described always with an integrative view and emphasis on the total success. The strategic decision to place the responsibility for the project with the logistics management assured that together with TransCare, sensible innovations, unconventional but effective contracts as well as completely new technologies and their use could be investigated and quickly implemented.

The sum of these measures has led to almost unbelievable success. As earlier mentioned, in all areas substantial savings were achieved. This cost reduction along the whole supply chain has proven the success of the project. With the support of TransCare the criteria for sustainability have been satisfied, but that is not all. The 70s and 80s trend of continuously increasing road transport has not only been stopped but also turned around.

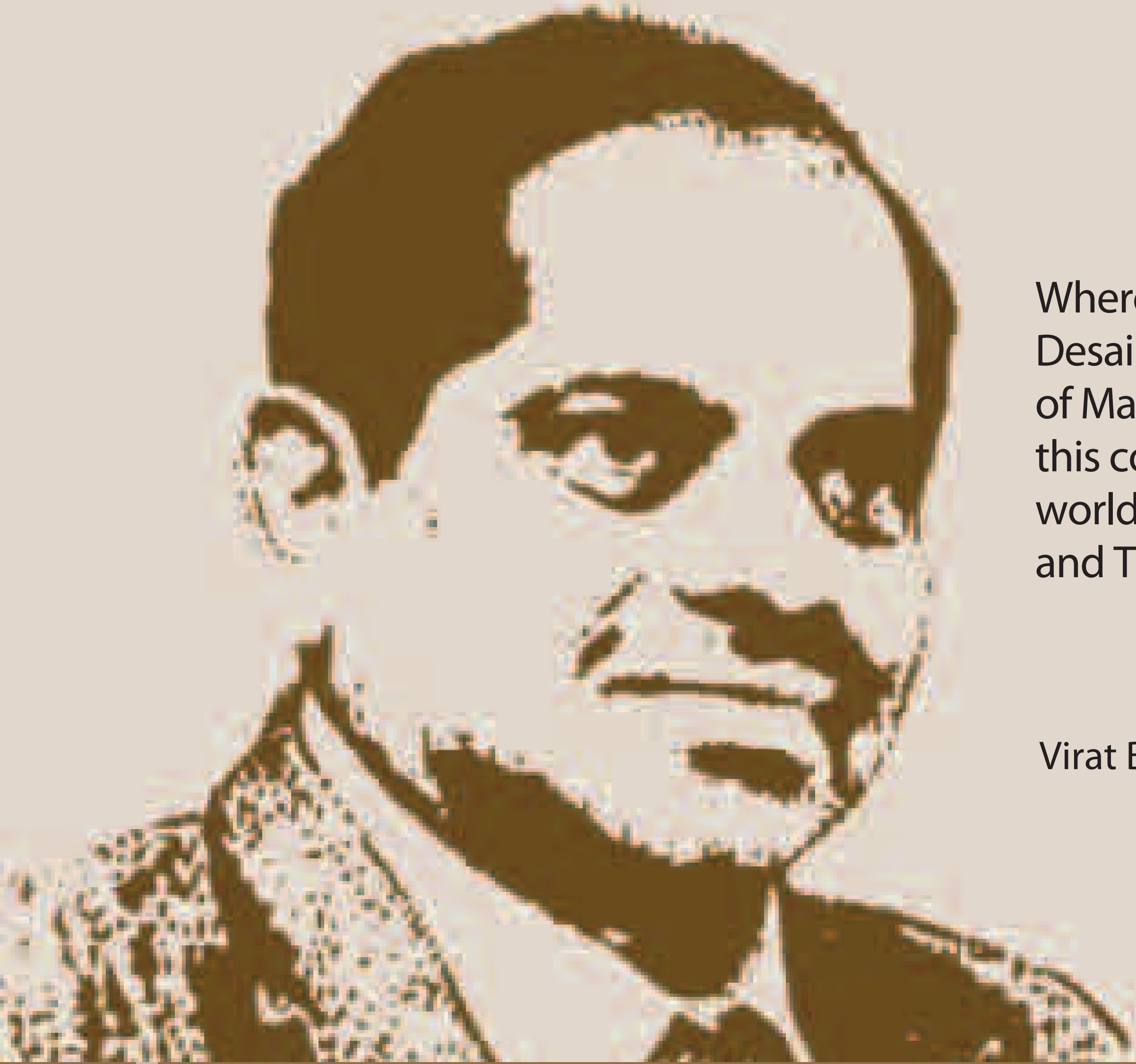
The rail sector is in fact regaining market share. Supporting this is the significantly increased quality in all areas of the material flow and transport, the higher level of transparency in the process controlling via the successive development of modular and integrative software solutions, and finally, the increase in the intermodal transport of 100% (600,000 tons) together with a reduction in the amount transported by road.

Only with the consistently employed backwards integration, from the macro logistics to the micro logistics, accompanied by continuous process control has it been possible to achieve the sustainability targets of BASF.

The concepts developed by TransCare and realised along with BASF have not only achieved this, but have also ensured significant cost savings and helped secure the production location in Ludwigshafen in the high income country Germany.

The success of this project has led to many further projects between TransCare and the BASF. And as Poul V. Jensen (Executive Director, TransCare Logistics India) and Ralf Jahncke (CEO, TransCare AG) agree, this type of project can be initialised and implemented in most industrial sectors in any large industrial or trading company.

In small and medium sized companies projects of this kind can also be implemented, however with a much more segmented approach with several projects which are designed to build upon one another. ■



Where does Ashank Desai – the founder of Mastek – stand in this competitive world of the Wipros and TCSs?

Virat Bahri explores...

The balance scorecard?

Desai believes in the theory "Do to your employees, what you want them to do to your customers"

Whenever one brings up the topic of the Indian IT revolution in a discussion, one often brings up the names of the behemoths like Wipro, Tata Consultancy Services and Infosys; which are no doubt stories of exemplary achievements. In this hype however, one definitely cannot ignore companies like Mastek, which started around the same time in adverse circumstances against these software giants, and have made their mark, albeit in a more niche space, with a highly specialised suite of software solutions.

For Mastek founder and Chairman Ashank Desai, memories bring back a deep sense of satisfaction. The company was started by him with the help of a few friends who opted to start a business back in 1982, a time when software was a novelty. The first big break he recalls was with Procter & Gamble, which came to them with an inventory management problem; and they solved it. Since then, Mastek has been on a consistent growth trajectory.

Desai adds that "for the first ten years we concentrated only on the domestic market". This strategic decision taken by Mastek has been decisive with respect to how they stand today. Desai points out one major benefit of this decision – that it allowed Mastek to design its DNA. The name Mastek is an acronym for Management & Software Technologies, which actually stands for software solutions to handle management problems. But the drawback that Desai admits is that Mastek put exports on the back seat. If Mastek would have concentrated on exports as well since the beginning, Desai believes that Mastek would be at least "four times bigger" than it is today. Excellence in a few niche segments is Desai's model for growth.

He concurs that we want "to be a company admired by the customers in terms of integrity and flexibility and satisfaction." Perhaps it is this focus that has seen Mastek successfully deliver on one of its major projects till date – the London Congestion Charging (LCC) initiative by Transport for London (TfL) Street Management, which as claimed by Mastek is the largest Microsoft ".Net" project in the world. The project is aimed at reducing congestion of traffic in central London. Mastek was contracted by Capita Group Plc as one of the vendors for this project to support the development of bespoke applications and the integration of key business applications as well as the integration of key external service providers. The implementation of the project has led to significant improvement in several parameters of traffic performance in central London.

Desai is a proponent of well balanced growth with a strong motivated employee base. He believes in the theory "Do to your employees what you want them to do to your customers." He has developed Mastek as an organisation based on seven well defined principles:

1) Open atmosphere – They are a completely democratic organization and no one with an ego can work here. This kind of environment leads to a lot of creativity.

2) Team work – The first IT team in the world to get People CNN (certification) assessment, "We always work in teams. If somebody can't answer something in a meeting the other will help!"

3) Respect for individuals – There is a

The 'future of IT' or the 'tried hard'?

system in which the company chooses one employee and puts personal facts about her/him on the website, which would help other people in the organisation know her/him better. Later that employee also receives an email from Desai.

4) Pride in whatever they do – Mastek claims to be the first company to go public with a premium pricing for their shares, "When Manmohan Singh opened the economy we were priced at Rs. 70, at that time when others were at only Rs.10. It was successful. 100% ESOP!"

5) Customer intimacy – They always undertake customer satisfaction surveys and strive for excellence continuously.

6) Give results – Desai ruminates, "One example is that during Mumbai floods, one of our employees waded through water for 5 km to give important information to the customers, even though no taxi was available. We also got a message of thanks from the customer. When the whole of Mumbai was closed, we were open!"

7) Long term relationship – The company focuses on looking for long term relationships.

The early period of Desai's life was of tremendous struggle. Desai belongs to a family of Goan freedom fighters. His father died when he was only two years old. The family situation forced him to study in an "*adivasi*" school and live a very difficult childhood. When asked about whether it is important to face hardships to be successful, he asserts, "Hardships give you a better perspective towards life. I can relate more to an employee and understand what it is like for a poor employee to teach his children." He introspects that although hardships temper you, they are not an essential ingredient of success.

As far as work life balance is concerned, Desai feels that "everyone should do what they like to do." Desai was ready to sacrifice his personal life to reach the pinnacle of success in his career. On the other hand, he gave us the instance of one of his friends from college who has the philosophy of leaving office by 6:30, whether or not there is work. Desai quips, "No point telling him that if you don't do that, you will become the MD of the company!" So for Desai, it is a matter of individual responsibility to set priorities straight. For him, the bottom line is providing value in the workplace as well as in the personal sphere. Value, which he asserts, "should be physically present; not in one's imagination. I am adding value to customers, bankers, suppliers, shareholders, employees as well as my family." If there is lack of value in even one, you will lose that part. And the constant pursuit of value is Desai's mantra for success.

Desai is a Founder Member of NASSCOM (National Association of Software and Service Companies) and has had stints as NASSCOM President and Vice President of ASOCIO (Asian-Oceanian Computing Industry Organisation). He was part of the group of IT business leaders that met with British Prime Minister Tony Blair, when Blair was visiting India during the Indo-EU business summit on September 7, 2005. Faster movement of people across borders is cited by Desai as one of the major constraints faced by Indian IT companies, which was one of the agendas for discussion with Blair. If the hassles with visa restrictions are relaxed, it becomes easier for Indian companies to send their workforce abroad. Also the Indian government should get more work done from Indian IT companies, as Desai projects the Government to be a major centre for IT.

The other most important discussion with Blair was how Indian IT companies could come up in system integration. With respect to break up of revenues for Indian IT companies, Desai adds, "A large part comes from system application, we have 10% of the whole world but we lack in terms of system integration. This is only 1% of the total market. System integration means taking up the ownership of the projects." It is one area where Desai feels that British companies could help the Indian firms in a big way.

Mastek has made significant strides in CSR initiatives as well. The Mastek foundation is one initiative that has the mission to "inspire global communities and institutions associated with social development issues to make a difference through informed giving and responsible receiving." So there is a lot of focus on sensitising corporate India on issues related to environment and backward classes. Mastek has a unique initiative called "Magic Bus" in which volunteers from Mastek pick up children from slum areas and take them to the Mhape centre of Mastek, where they are introduced to basics of computers. The foundation organises courses for corporates that seek to encourage corporates to engage in active participation in the social cause that they are most passionate about.

Mastek is attempting what leading corporations now understand; profits cannot be at the cost of society. One has to be responsible and give back to society, what society has provided as profits. Mastek remains, the value based benchmark... ■

It is a matter of individual responsibility to set priorities straight. For Desai, the bottom line is providing value in the workplace as well as in the personal sphere

MAKE WEALTH WHILE OTHERS THINK OF IT

NEED THE DOUGH?

" If a man is proud of his wealth, he should not be praised until it is known how he employs it "

— Socrates

SPECIAL ISSUE
MUTUAL FUND

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The rudimentary *oracle!*

Larry Ellison: A profile

Oracle! A word that has the literal meaning of a prophet, a soothsayer, a futurist – in short, a true visionairy – perhaps words that typify what Larry Ellison is, and will always remain to the world around. But yes, media has oft flagrantly provided additional embellishments of his being a millionaire playboy, a Don Juan, sports fanatic, top-notch sailboat racer and an outstanding jet pilot; but then, that is a collateral damage one profits from, if one is the charismatic and sometimes volatile CEO of Oracle, the world's third-largest software company and the leading supplier of database software. Lawrence Joseph Ellison, popularly known as Larry Ellison, is definitely not a commonplace businessman. In fact, he is one of the most controversial figures in the brilliant world of Silicon Valley celebrities.

Oracle has made Ellison one of the richest men in America. With a personal worth of $18.4 billion, he is the ninth in the list of world's richest men. Born to Florence Spellman, a 19-year-old unwed mother in the Bronx, New York, on August 17, 1944, he was raised by his mother's great uncle (Louis Ellison) and aunt (Lillian Ellison). He came from a lower-middle-class family living in a Jewish ghetto on the South Side of Chicago. Though he shared a warm and loving relationship with his mother, Ellison had a very complex relationship with his adoptive father. Ellison believed that his desire for success and recognition was rooted in his father's lack of trust in his son's ability. Though he was a brilliant student of science and mathematics

– he was the science student of the year at the University of Illinois – he still dropped out of university twice. Ellison learnt the basics of computers from University of Chicago – but he is largely a self-taught computer programmer. After two failed attempts at finishing college, Ellison moved to California to turn a new leaf in his life.

He kept moving for eight years from one job to another, till he landed a job with Ampex. He was hired as a Vice President of research and development. While working in Ampex, he worked on a database project for CIA, which was named Oracle. Only while working there did he realize that he could do a better job of running a technology company. This was just the starting for the thirty three year old man. Ellison, Robert N. Minerhis. (Larry's then supervisor at Ampex) and Edward Oates (another close colleague) teamed up to start a new company. Originally, the company was visualised as a technology consulting business. But the three men soon decided to go into the new budding software business.

They incorporated the company called Software Development Labs (*SDL*) in California in June 1977, with a meager amount of $2,000. The business demand for prepackaged software applications seemed to be growing, and they wanted to develop an application that could be sold repetitively to different companies. The idea was to come up with the right product. Ellison found potential in the idea of creating Structured Query language (*SQL*) – a paper written by an IBM researcher, Dr.Edgar Codd. Ellison's interest in relational theory changed the software industry forever as he saw the great business potential in database software. Ellison was willing to take the risk in effort to produce the world's first viable relationship database.

Larry promised features in his product which were never there; and then he demanded his developers to deliver those features in the software products

In any case, a young upstart company had nothing to lose in terms of reputation and market share. Ellison used SQL to create a database which was compatible with mainframes as well as desktops; and the finished product was called Oracle. This was the time when they got their first customers: Wright Patterson Air Force Base and the CIA. In 1978 the company was renamed Relational Software Incorporated (*RSI*).

In 1979, Oracle v2 was released publicly. This was a big feat for the company and a punch to IBM as the market share of IBM was around 80% that time. The year 1980 was a huge landmark in Oracle's history as it was the year of the official birth of Oracle Systems Corporation; now Oracle Corporation in Redwood, California.

This was the time when Ellison developed one of his many skills – his ability to envision the future of IT industry. He captivated and dazzled his clients by the power of persuasion. Ellison was so completely focused in gaining market share for his product that he was willing to take

A family and a society man

Thrice-divorced Ellison is one of the most colourful characters of Silicon Valley, and enjoys a reputation of a flamboyant playboy. Marriage and business have surley not mixed well for the tech-titan. His past colourful marriages – or divorces, whichever way you put it – have been to Adda Quinn (1967 to 1974), Nancy Wheeler (1977 to 1978) and Barbara Boothe (she divorced him in 1986). Though he has moved from one woman to another, he is often believed to be still the most eligible bachelor in the Silicon Valley. The latest in the string of Mrs. Larry Ellisons is Melanie Craft – a romance novelist, whom Ellison married in 2003 after after eight years of courtship. Ellison has 5 children – two from his previous marriage to Barbara Boothe and three from his current wife Melanie Craft. Ellison not only oozes of wealth and power but also of sophistication and charm. He is noted for his aesthetic sense of dressing up well in expensive suits (see box above). Ellison has always been portrayed as a pursuer of good things in life and has been named the "playboy of the wired world." Ellison has been known for his flashy lifestyle and aggressive business mannerisms but very few people are aware that Ellison is a philanthropist who is also interested in life sciences. In fact, Ellison sometimes takes off from work to work with Josh Lederberg, a Nobel laureate, in his molecular biology lab. He is helping an institution called Ellison Medical Foundation to provide vaccines to fight infectious diseases and blood cell disorders in third world countries. He also has majority ownership – of 70% – of a research firm called Quark Biotech, Inc., a gene-based drug developer focusing on cancer research. Ellison also supports efforts to protect gorillas.

incredible risks. He promised features in his product which were never there and then he demanded out of his developers to deliver those features in the products

Owing to his remarkable foresight, the company was doing pretty well. But in the late 80s, Larry was accused – perhaps wrongly so – of destroying his company because of recklessness and arrogance. As an oft quoted example, in the year 1988, Ellison released Oracle version 6 without testing properly; this proved disastrous for Oracle's reputation and credibility. What aggravated the matter further was Oracle's aggressive sales strategy; to an extent of offering huge discounts just to close the deal. Apart from all this, disorganized accounting systems and worse financial controls led to such a situation that by 1990, Oracle had lost control of its finances and declared losses worth $36 million.

What Oracle needed was an entrepreneurial spirit and visionary brilliance to re-engineer itself! And what it got was exactly that in Larry Ellison, who changed track, perhaps just on time, to drive the company to its heights, backed by brilliant new-found business acumen. The circumstances made Ellison refocus on Oracle and its strategy. For a start, he personally took the reins of management of the company in his own hands and recruited highly trained & skilled people. With the new management team, and a flurry of launch of new products, Oracle, by 1994, was again dominating the database market. But despite its success, Oracle was still a small player in the technological arena. It had a long way to go.

A futurist that he is, Ellison envisaged the impact of internet on Information Technology. And from that day onwards, Ellison focused his business strategy on the Internet. Larry took blatant and appropriate advantage of the dot-com boom, which made it one of Silicon Valley's most powerful companies. Though even companies like Microsoft were slow to recognize the significance of Internet, it was perceived to be a high risk strategy for Oracle; "If the Internet turns out not to be the future of computing, we're toast. But if it is, we're golden," once said Ellison. He worried that this internet move had the risk of alienating clients as people were unprepared for such a dramatic change. To his credit, Ellison has always been able to anticipate the next trend and how it would benefit his company. This time, Ellison's ever striving strategy was not only to gain market share, but also to overtake the PC pope Bill Gates, whom Larry hated astoundingly badly.

But sadly, his ambitious plans also had a harsh impact on his management team. After Ellison took over charge, his unwillingness to share power with his team led to the resignation of top executives. The shocker of a resignation of Oracle's President Ray Lane (under whom Oracle trebled profits in four years) in June 2000 – which Lane claimed was because of Larry monopolising power – saw Ellison consolidating his hold even further. Larry realised that to add shareholder value dramatically, he needed Oracle to monopolise the enterprise solutions market. For this, he went aggressively into the mergers and acquisitions route, targeting top-notch corporations like Peoplesoft and J D Edwards, to finally become the largest enterprise solutions corporations in the world (and overall the third largest software corporation). Interestingly, it took Larry a legal war with the US Department of Justice to takeover Peoplesoft.

The Larry Ellison saga is one of the benchmark cases in corporate history for understanding "impatient management"; because that is what Ellison – a non-MBA – has practised within his organization. At the cost of antagonising his management team, Larry has focussed wholly on maximising shareholder value. A complex yet highly valued visionary leader, Larry has been an exceptionally flamboyant avant-grade thinker and an outspoken & brilliant business man – described, and despised, by some as a hotheaded egomaniac.

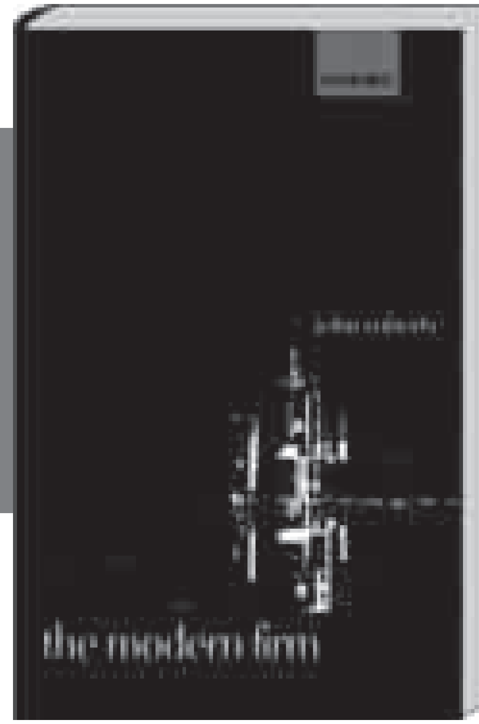
Feared as a merciless and fearsome rival, Ellison has ensured that the world would surely see many upheavals in the information technology space; many of them led by Oracle. His has been the true 'American dream' story of traveling from a most modest background to a most immodest foreground. Larry always remains the man, the leader, the philosopher, the futurist, whom the world continues to christen, the rudimentary Oracle...

Larry – razor tongue – Ellison

Ellison is the most sophisticatedly attired person in the world of mavericks. He is often compared to Giorgio Armani. But this sharply dressed good looking rich is also compared to John McEnroe, the impudent tennis star, because of his regular seat-of-the-pants statements. For example, Larry has been quoted calling America Online "ridiculous" and ridiculing it further as "Club Med on the web." Nathan Myhrvold of the Bill Gates camp was labeled with panache as an "Idiot". It is said that even friends are not spared of this verbal castigation. Perhaps the most pompous statement ever made by Ellison was when he said, "IBM is the past, Microsoft is the present, Oracle is the future." Larry's latest obsession – or should one say obfuscation – is Bill Gates, whom he has addressed as "a man with a greasy crown of hair and ill-fitting sweaters!" Larry's hatred for Bill Gates has been made quite evident, what with his regular diatribes against the man who also has no love lost for Larry; but then, does anybody?

Oracle took advantage of the dot-com boom, which made it one of Silicon Valley's most powerful technology firms

Firmly in the Saddle



Free enterprise turns the eye inwards to survive in a globalised world

By Kalyan Chatterjee

Though the demise of the Soviet Union was accompanied by a great deal of drama (and cheering on the Western side of the fence), few truly grasped at that point of time the import of what had really happened. There was much talk about whether the world would now be a uni-polar one with the United States of America as the lone power with a capital 'P', or a multi-polar one. The passage of a decade-and-a-half has provided some answers, though not the expected ones.

The world has been forced to take a closer look at the exercise of power – an issue that had till then been viewed exclusively through the lenses of the Cold War. Nations and governments have struggled to come to terms with the new distribution of political and economic power. The bickering over the reconstitution of the UN Security Council is merely an expression of this struggle.

But if private business had hoped that the 'victory' of their free market over Communism meant that their future paths would be paved with flowers, they were in for a rude shock. As businesses began to expand across political boundaries and capital became truly globalised, it was discovered to the dismay of champions of the free market that many of their own merits – that they had flaunted at the "Evil Empire" – were not so meritorious after all. A number of top companies began to flounder and many others began a frantic search for ways to survive in what was turning out to be a bad new world.

Managers, business leaders and economists began to recognize that many features of private business itself were responsible for inefficiencies that had begun to rear their ugly heads as soon as scales were expanded. Before this, most people following in the footsteps of neo-classical economist, Paul A. Samuelson, were firmly convinced that while looking at an economy, it was not at all necessary to examine the internal workings of that great institution called the private firm. Those economists who ventured to analyse hierarchies and power play within the firm were dismissed as radical prattlers. In other words, the private firm remained a 'black box' as it were. What happened inside this box was a mere technicality and had no economic relevance.

All that came loose in a world minus the Soviet Union and one in which globalisation was the mantra. What happened inside the 'black box' suddenly assumed importance as a number of prominent companies like British Petroleum pulled back from the brink of disaster merely by redesigning themselves. 'The Modern Firm' by John Roberts, an economist, is an attempt to show that rather than the free markets, it is the firm which is the fulcrum that performs the task of allocating resources efficiently. Therefore, it is very important to concentrate on the structure of the firm to make it and the economy, as a whole, function better. Roberts attributes to the firm the functions that had been believed by neo-classical economists as the function of the free market viz. to coordinate and motivate people's economic activity. The focus, in Roberts's view, should be on designing the structure of a firm and through it to implement strategies selected in accordance with the environmental requirements. Transaction costs whose origin can be traced to the hierarchies and power structure of a firm must be kept in mind while designing its structure.

'The Modern Firm' may be part of the movement of neo-classical economists towards the viewpoint of their counterparts in the socialist mould; but it is definitely a major step towards saving capitalists from themselves. ■

EXECUTIVE SUMMARIES

STRATEGIC ISSUES

Toyota's 'G'eneral 'M'arch 08

Toyota appears to be doing all the right things, whether in making money or launching successful models. The company has already overtaken Ford Motor Corporation and Daimler Chrysler and could be soon on its way to overtake GM as well. Except for some minor coherent faults such as the rigid consolidation policy, Toyota has been a winner all the way because of its innovative ways. The implementation of the 'JUST IN TIME' strategy followed by the 'IMV' project involved improved production cycles and successful capacity manpower utilizations. Along with these prolific initiatives, the introduction of cars such as the Yaris super mini, Fortuner and Innova have added stars to the company's profit tables, which were already set ablaze by class toppers like the Camry and the Corolla sedans. The company has always played the value for money card to beat Detroit (which had so far ignored the need for fuel efficiency). With the introduction of Prius, the hybrid car, late last decade, Toyota has innovated in a business space that will become the future of automobile technology.

The Story of Corporate Governance 12

How efficient are corporations today in developing and implementing orientations in corporate governance norms and in safeguarding the interests of shareholders? The paper provides dramatic insights into methodologies for developing such norms and procedures. Creditably, the interview based concept note also sheds light on cross-country comparisons of various internal institutions that control and regulate management in corporations; and the intensity and efficacy of such controls. The paper also traces the legacy of orientations towards corporate governance through various decades, emphasizing on how in recent times such governance measures have become more accepted and legally enforced.

The Knowledge Economy 18

This research attempts to encapsulate on the reasons why China is the country to watch at present and in future too. With the economy growing at the rate between 7 to 9%, it's a golden opportunity for any company wanting to establish itself there. China is stepping up its transition towards the 'knowledge economy'. With this new door having been opened, foreign companies are making considerable investments in China, including in R&D – giving evidence to the correctness of the claim of why foreign technology firms should increase their speed of R&D investments with the growing Chinese economy. China offers a considerable pool of talent, while having an extremely high orientation

STRATEGIC INSIGHT

Learning to Destroy 22

towards technological and scientific pursuits.

Dilution - a lucid word with a crispy concept – depends completely on how the cookie is cooked; in other words, on how calculations are extremely important in understanding the concept of how to maximize shareholder value. Relating the concept with investor attraction, Frank Demmler provides the reader basics of dilution, as well as various anti-dilution techniques. The paper provides concepts on why anti-dilution sometimes provides a win-win situation for all parties involved in dilution; though the author also covers other situations. Pertinently perhaps, and ironically, the paper's core concepts deal with understanding how to crumble a cookie, than how to build it!

Managing the Digital Firm 26

As we head towards an information based economy from an industrial economy, businesses in the new economy face fresh challenges. The digital economy needs different sets of strategies for better results, other than the established ones of implementation of Business Process Re-engineering solutions, Just In Time inventory management techniques and the likes. Inter-organizational information systems augmented this growth quite approporiately through the evolutions of the concept of Decision Support Systems (DSS), which are a class of computerized information system that support decision-making activities. The abovementioned shift in business paradigms has called for realignment of challenges that are expected by keeping in line with changing customer preferences and market dynamics. This research paper is nothing but a compelling commentary on the dire need for corporations to evolve their cliched information technology systems from legacy structures to post-modern parametres.

Planman's Meta SBU Analysis Constructs 31

Portfolio models are important for any company to get an overview of the businesses they are into. There are many such known models that exist as of today; like Boston Consulting Group's Growth-Share Matrix and the General Electric Portfolio Model. However, many of these models have their individual drawbacks, due to which analysis done solely on the basis of these models often comes out to be faulty and misprespresented. Two contemporary models developed by Planman Consulting, that is, the Planman Wealth Payback Sculpt and Planman m-PIPE Matrix, have attempted to overcome these drawbacks in order to have a most optimal structure of portfolio analysis. Though truly speaking, even these models have their own weaknesses, which the author has documented. This paper is the first in a series of research documentaries that covers the initial fundamentals of the above mentioned models.

Contrarian Investment Strategies 36

Finance without jargons is like an ocean without water. 'Contrarian Investing', a term making ripples in the global stock market, is worth paying heed to. Investments in today's world do not only need technical and fundamental analyses, but also an openness to the existence of imperfect markets and inefficient transactions, despite complete transparency in knowledge, data and information transfer. The author deliberates on why contrarian investment techniques, though being criticised by various analysts globally, still cannot be ignored just rudimentarily. Additionally, the author also considers the Indian context of investment management and the level of predictability (or unpredictability) that is typical of the Indian stock market.

Struggling for Survival 40

The norm for today's businesses is constant change. Unfamiliar circumstances with diverse environmental conditions call for tackling the same. Taking the example of a high value financial firm, Kim Warren narrates his typical experiences and structures them in this benchmark paper. Warren elucidates how a singular focus on varied investment products did not quite help one particular firm to tackle the problem of rising costs and decreasing income. In fact, the very basis of attempting to solve one of the cost control related problems ended up in creating further problems for the firm as progressive retrenchment measures (to control costs) ended up in productive and efficient people being kicked out. Warren propounds with the above mentioned example that a comprehensive consolidation would probably have had a better impact to the firm's market orientation. A thrillling preview on the perspectives that can be built up to resolve issues, and the regressive ramifications of such perspectives

Where's my Innovation? 44

Innovations are not synonymous with inventions; they also include radical improvements that take place on the shop floor. Innovations need not be restricted to formal channels but can also take place around us in daily lives. It is a myth that only structured R&D efforts lead to innovations; surveys reveal that in many large firms, such R&D efforts lead to only a miniscule percentage of innovations. Employees and customers do form strong informal channels from where ideas could be taken, which could lead to profitable innovations. Managers should stress on encouraging innovation, rather than being narrow minded about the source from where the ideas are generated. As the author emphasises, it is not possible to promote creativity, but it is always good to create an environment where ideas can flow freely. Incentive linked innovation schemes have been the latest in a series of new found strategies in global corporations.

The True Swap Ratio 50

Digging deep into the matter of success and failures of joint ventures, mergers and acquisitions, where it has been often said that culture collisions have been a major factor for success or failure of these inorganic growth strategies, the author finds out that culture and employee friction is not necessarily the predominant factor in deciding such success or failure. There are a lot of factors, namely, business oriented, financial and legal, which act vehemently too. Despite all these factors and their respective roles, it is perhaps the top management that plays the leading role as the protagonist of the strategic drama. To conclude, an organization entering into inorganic growth could appropriately utilise the FZIM tool for further improvements, and also devise better strategies in the future to go in for further collaborations – that is, JVs, mergers, acquisitions, and the likes.

BEST PRACTICE

Competing to Death 54

In one statement, there are times when bitter rivals should team up. Vigorous competition among companies for customers, talent, and capital serves everyone well, for the most part. But competition can be harmful as well, when companies fight over things that hold little value to customers or that offer little potential for differentiation. Rethinking and changing the compete/ collaborate ratio offers a way out that benefits all players. By joining forces to carry out common and largely undifferentiated functions or processes, companies can avoid redundant expenditures and capitalize on economies of scale and shared expertise. Strategic collaboration can take place at any stage of an industry's value chain. It can take many other forms, consistent with anti-trust laws, including the sharing of back-office functions, factory production, R&D efforts, marketing and distribution, and repair or return facilities. Even bitter rivals have sometimes joined forces to achieve common goals and solve common problems. Notable examples are the Airbus consortium of European aircraft manufacturers, the Sematech consortium of US semiconductor manufacturers, banks working together to launch Visa and Mastercard, and small hardware stores using the True Value organization for cooperative marketing, purchasing, and loyalty programs.

CASE STUDY

Connecting India 62

This case covers the growth of Nokia in India. Today, we associate Nokia's name with mobile phones, but it actually started off 140 years ago as a tree cutting company and a paper mill. Nokia has been successful worldwide and is currently leading the GSM handsets market. It was a late entrant in the Indian market but subsequently emerged as a market leader, leaving its competitors far behind. Its four pronged strategic approach of customisation, providing a well diversified product portfolio, having an extensive distribution network, and continuously innovating according to customer preferences has helped it establish itself as a market leader here. Nokia has been able to change the concept of mobile phones from being a luxury purchase in past days to

Panache Pantaloon 68

The review covers Pantaloon (PRIL) and their success in retailing, the industry of the future in India. The industry views everybody else far behind the Biyanis who own the Pantaloon outlets. Pantaloon began garment retailing in 1987 in an organized fashion by opening up franchisee outlets. They coupled the global best retailing practices and suitably modified the same to suit Indian conditions. Hence, many industry analysts have called the knowledge base on retailing and sharp consumer insights of the Biyanis being unparalleled in the industry. Moreover, foraying into domestic "fast food" with a "humble samosa" and "garam chai", PRIL can only get richer with the strong backing of the Biyanis. The Biyanis could well be the Indian version of the Waltons.

The Logic of Logistics... and Supply Chain Management 74

Logistics is an important area for any company. It plays a vital role in bringing down your overall costs, making it less time consuming and most importantly increasing your efficiency. This case study of BASF tells us how this company has been been restructured with the help of TransCare, a logistics company. The case covers the whole process that TransCare used for the world's leading chemical company. The cost reduction along the whole supply chain has proven the success of the project. The concepts developed by TransCare – and realised along with BASF – have not only achieved this, but have also ensured significant cost savings and helped secure the production location in Ludwigshafen in Germany.

CEO PROFILE

Ashank Desai – Mastek 78

Profiling Ashank Desai, the founder and Chairman of Mastek, this review questions whether Desai has been successful in bringing Mastek in the league of Infosys, Wipro, Tata Consultancy Services et al. To his credit, from nowhere, Desai has brought his company to a time when everyone recognises Mastek. Desai takes the reader back to the past at a time when the IT revolution in India started with players like Wipro, TCS and Infosys coming into picture. Desai also comments and gives insights on the adverse conditions that surrounded Mastek when it was being started. Aiming at niche markets, the company has now become successful with adopting value based strategies and is now well known even for their corporate social responsibility initiatives.

PATH BREAKERS

Larry Ellison 82

Larry Ellison is a man of eccentric choices. Born to an unwed mother, he was brought up by his mother's great uncle and aunt. Though he went to college, he dropped out three times. He worked for a few years before starting Oracle. Being the founder of Oracle, he is the primary reason for Oracle's success saga. Not to forget, he is also the person to be blamed for the problems Oracle has faced over time. But true to his nature, he brought back the company to its old position once again. The Peoplesoft takeover episode also forms an important phase for Oracle. On the personal front, Larry Ellison has walked down the altar four times. He is also known for his blunt tongue, which lashes at nearly everybody; the biggest sufferer perhaps being Bill Gates.

BOOK REVIEW

The Modern Firm 86

The reviewed book, The Modern Firm, covers how a business can fail without the existence of communism. It all started when with the fall of Soviet Union, the world took a new direction. The book reviews and looks very closely at the exercise of power, especially on private businesses, through the eyes of cold war. The author suspects that nations and governments have not yet perhaps come to terms with distribution of political and economic power. Doing private business has not been as easy as one would have thought, given the promises of a free capitalistic world. But the author also cleverly reaffirms that one shouldn't blame it on the so-called "free market," but should see the other aspect which is the weak link, that is, one's own firm. The Modern Firm also enunciates on strategies to utilise and implement when faced with politically adverse conditions.

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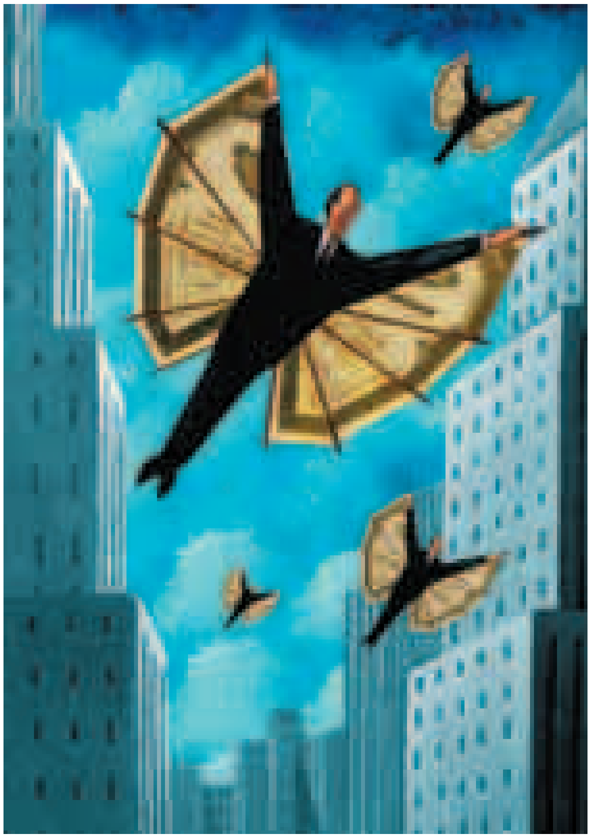

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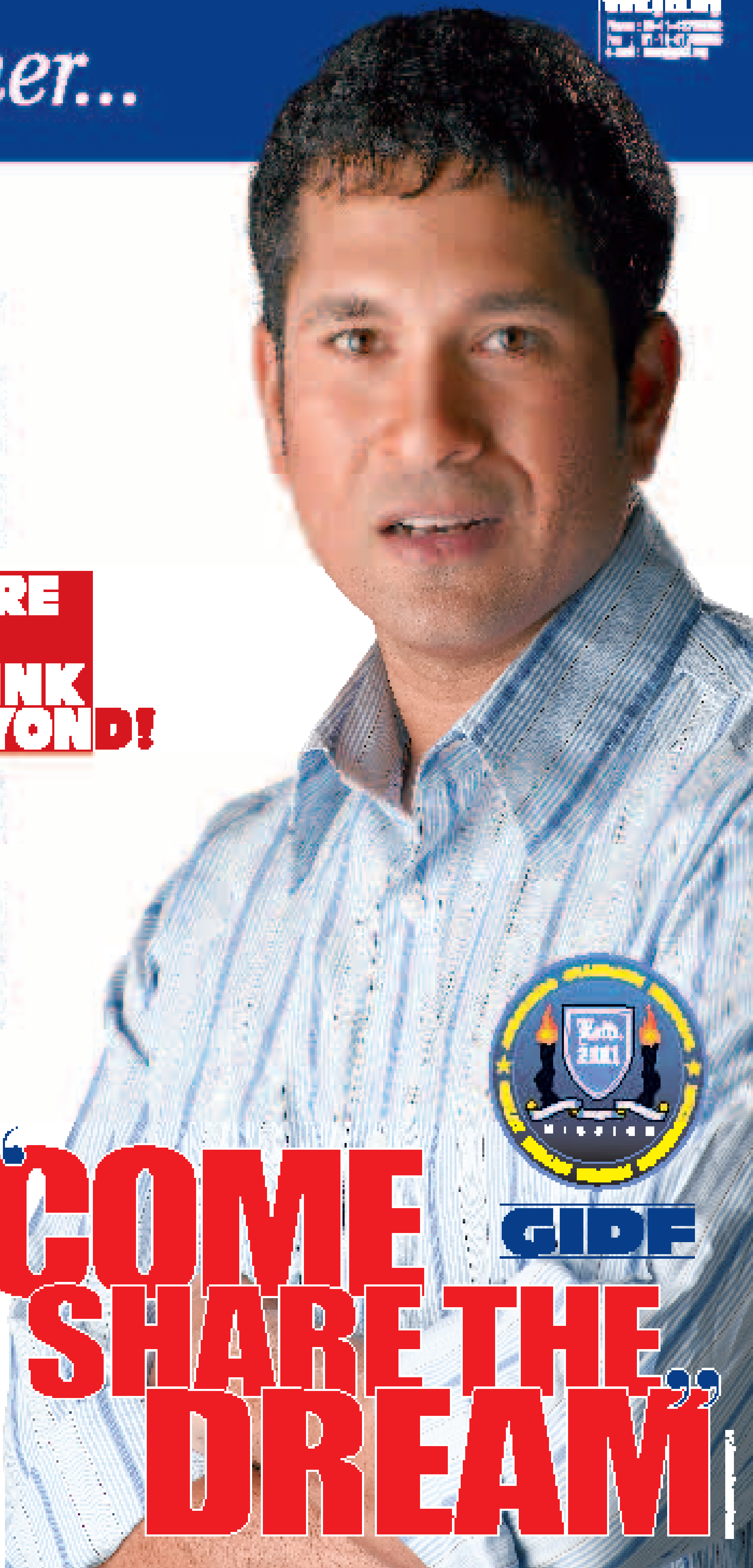

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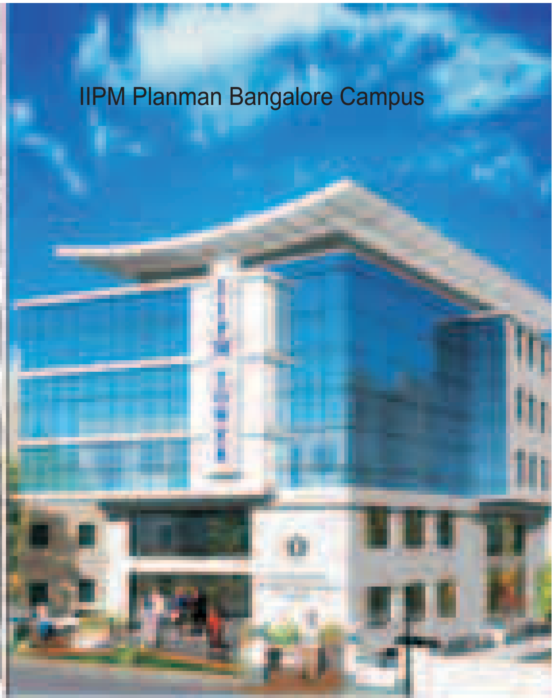
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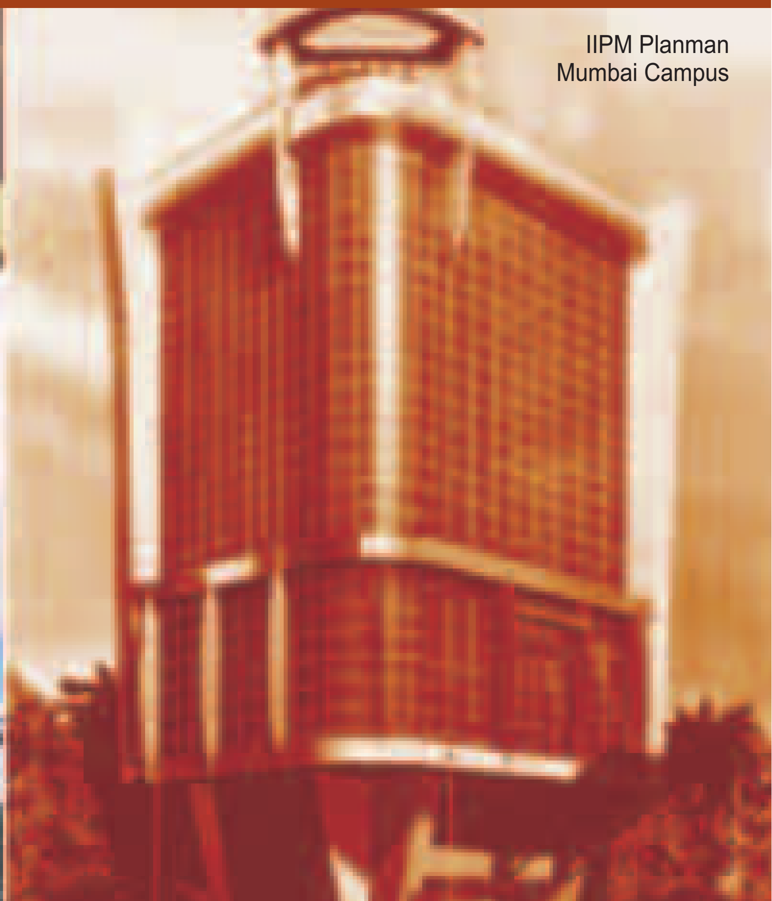
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