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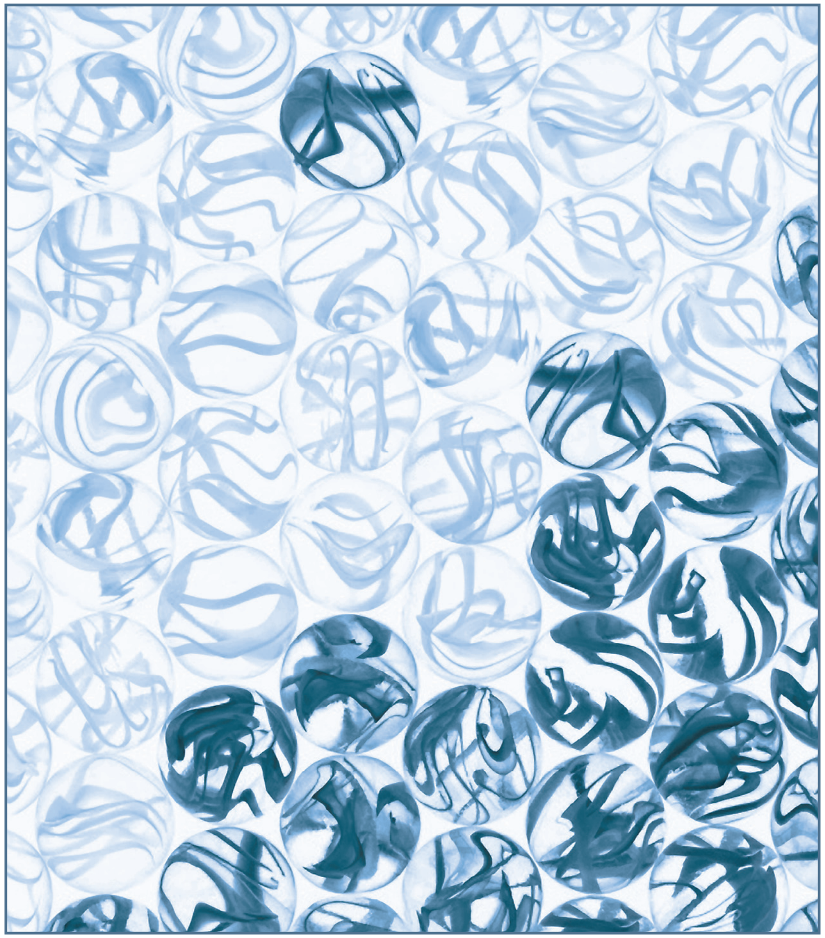
The Game Changers

Findings from the BusinessWeek/PRTM Global CEO Survey on Operational Strategy



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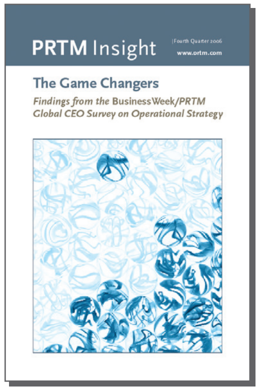

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Executive View

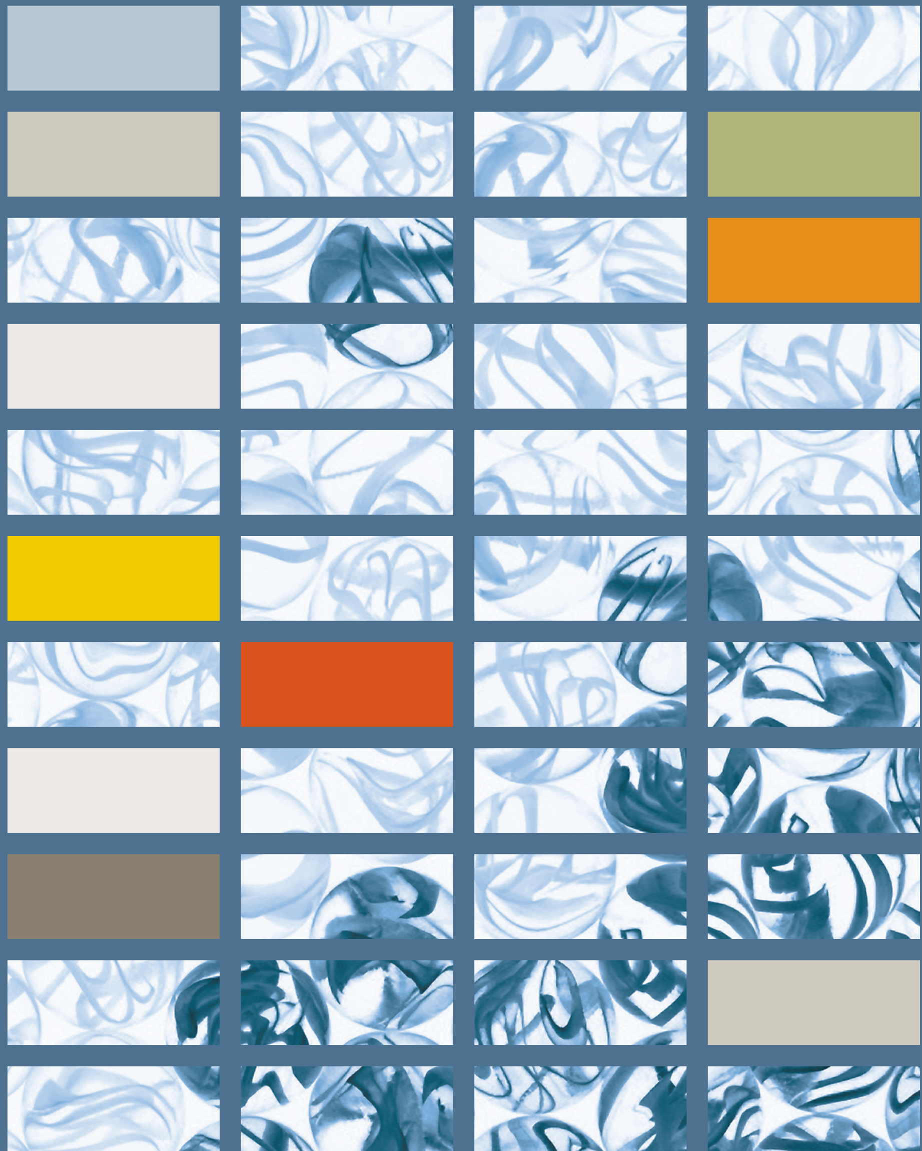
Is Best in Class a Bad Investment?

Geoffrey Moore, author of *Crossing the Chasm*, wrote in his blog that investing to move from adequate to best in class is essentially a low-return strategy. He asserts that differentiation is the source of superior returns and "requires you to be unique in class or 'beyond the class.'" Our lead article this quarter looks at what over 300 C-level executives worldwide think of this notion. We've quantified what many of you have known in your gut for some time: that someone, somewhere, is going beyond best-in-class performance and redefining how the game is played in your industry.

This is a new era for leadership in the corporate world. The survey confirmed what our clients have been telling us of late: The war for talent is more critical than ever; the CEO position and the definition of strategy are becoming more operational; misalignments in the C-suite are more paralyzing than ever; and innovation—in particular, operational innovation—is the lifeblood of competitiveness.

I suspect for some of you the articles in this issue will provide depth; for others they may change your frame of reference. I hope you find them insightful regardless.

Gordon Stewart, PRTM Managing Director, gstewart@prtm.com, +1 781.434.1200



The Game Changers

Findings from the BusinessWeek*/PRTM Global CEO Survey on Operational Strategy*

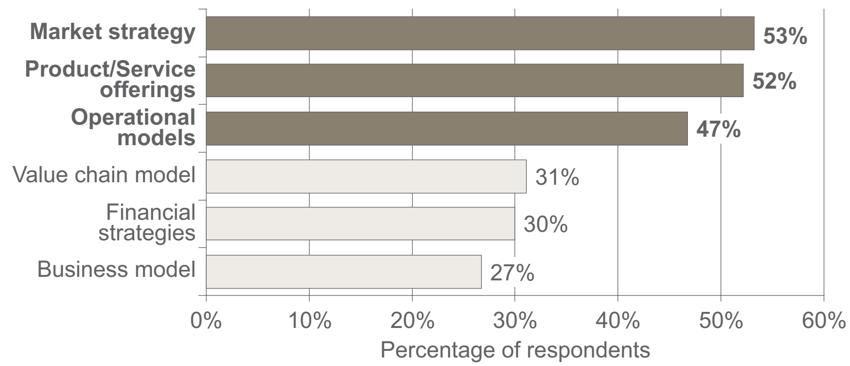
By Tom Godward and Anil Khurana

This survey of over 300 C-level executives reveals that operational strategy today is critical to profitability and growth. Nearly 25% of respondents said they're aiming for no less than breakthrough performance. An effective operational strategy requires a coordinated approach across the many different components of the business, and can be a powerful source of innovation. The CEO needs to drive operational strategy, but a traditional view of operations and misalignments in the C-suite can pose major barriers to execution.

The C-suite recognizes today that *operational strategy* is critical to business performance. It is now one of the top three strategic weapons senior executives will deploy to improve profitability and revenue growth—even more important than financial restructuring and business-model transformation (Figure 1). Over 300 C-level executives[1] from North America, Europe, and Asia expressed these views in a comprehensive survey jointly conducted by PRTM and *BusinessWeek* (see sidebar for survey methodology).

Figure 1: Strategic Weapons for Performance*

Areas that respondents said they would change significantly to drive business performance during the next three years



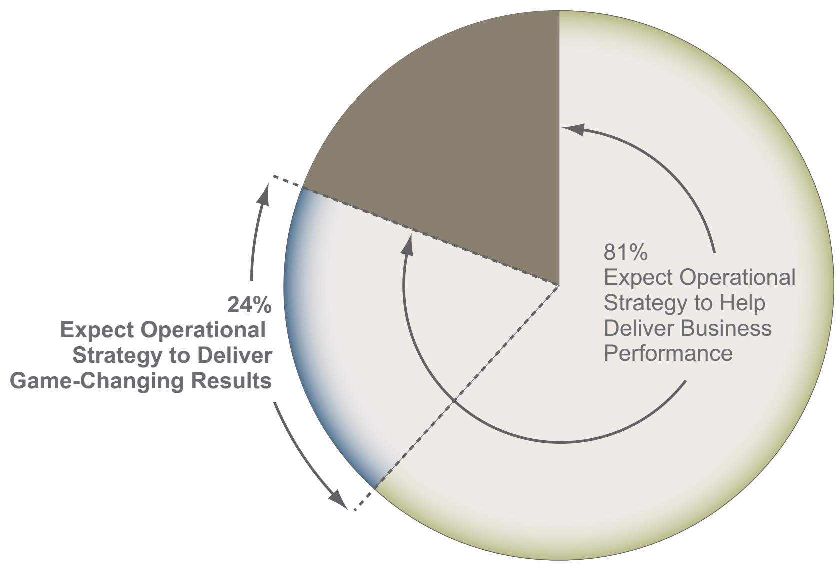
*Respondents could select up to three options, so the percentage numbers total over 100.

[1] C-suite survey participants comprised the full range of executive management, including board members. References to executive positions such as CEO are based on specific responses.

Over 80% of the executives who took part in our survey are expecting operational strategy to drive business performance in their company. Their level of ambition varies: Some are seeking functional improvements, while others hope to attain operational excellence through best practices. But 30% of the executives focusing on operational strategy—that is, nearly 25% of the total survey population—aim for no less than game-changing results in their industry (Figure 2). Given the fact that this survey covered all key industries in leading and emerging markets worldwide, this finding should be of concern to the companies not aiming as high.

Figure 2: Goals for Operational Strategy

Nearly 25% of respondents said they are looking for game-changing results



Why is operational strategy moving into the C-suite as a competitive weapon? Is it because companies like Toyota, Tesco, and Southwest Airlines have demonstrated its potential? That's clearly a factor, but it's only part of the story. Our survey respondents say increasingly demanding customers, globalization, ever-increasing market velocity, and pressure for new sources of innovation are their chief reasons for turning to operational strategy. This represents a substantive shift in top management's focus in the face of dramatic changes in global competition, economics, and demographics underpinning today's business environment. Operational strategy is becoming a key way to turn global challenges into competitive differentiation.

A Broader View of Operations

Operational strategy, defined as finding new ways to structure business operations and business economics for competitive advantage, is no longer confined to traditional operations (e.g., manufacturing and distribution for product companies or provisioning and billing for services companies). C-suite executives see operational strategy as a coordinated approach across the customer, product, delivery, technology, regulatory, and financial components of the business. Two key insights emerged from the study: (1) all components of what a business does are viewed in an operational context, and (2) these components must be coordinated to achieve breakthrough performance. In fact, the more aggressive the respondents' market goals, the more components of the business they expect to change and coordinate to achieve their operational strategy objective.

Top Operational Strategy Components*

The three components respondents said are most important to their company's operational strategy:

- **Customer acquisition and retention — 70% of respondents**
- **Product development — 58%**
- **Supply chain — 40%**

*Respondents could select up to three options, so the percentage numbers total over 100.

Regardless of industry, geography, or competitive strategy, our respondents overwhelmingly indicated that customer acquisition and retention is the number one operational strategy component. The components in the number two and three positions depend on the industry. For product businesses, the number two and three spots are held by product development and supply chain, while for services businesses, they're held by service development and regulatory compliance. Other notable differences emerged from the survey as well. Alliance management, for example, is frequently cited as an important component of operational strategy in electronics and communications/media companies. These findings imply that industry dynamics will dictate which operational strategy levers are available to the C-suite.

HP's turnaround over the past couple of years exemplifies how an effective operational strategy can create game-changing performance. For more than a decade, HP's competitive position in most of its product categories was undermined by more focused competitors: Dell (PCs and laptops), Cisco and EMC (servers and storage), and Nokia (PDAs and mobile solutions). In 2003, these markets contributed approximately 50% of HP's revenue and -1% of profit. Notably, HP treated operational domains like product development, supply chain, alliances, and marketing as centers of process excellence during this performance period.

The printer and imaging division was the exception, contributing 31% of revenues and 72% of profit. HP's market leadership and innovation in this product category is well known. Not coincidentally, the printer division deployed an operational strategy that was quite different from the rest of the business and several years ahead of HP's competitors. This strategy included a number of coordinated components: designing printers to minimize supply chain costs and complexity; global high-quality sourcing for key components; a global distribution footprint that allows HP to postpone printer assembly while minimizing inventories; and a multi-channel retail strategy that succeeded where others had failed.

> **The Importance of Operational Innovation**
> (Total = 100 percent)
>
> - **Forty percent of respondents said operational innovation will be "absolutely essential" over the next two to three years**

Enter Mark Hurd. Upon taking the helm in 2005, he applied the printer division's winning operational strategy to the rest of the company. PCs and digital cameras are now designed with capital, distribution, and retail needs in mind. Server and storage solutions and IT services have been reorganized to connect design, sales, and delivery. And mobile solutions integrate alliance partners into the solution-development process. Overall, HP's business groups have become more integrated, innovative, efficient, and accountable. The result? HP's non-printer product categories now comprise 53% of revenue and 35% of profit.

Many of the executives we surveyed likely feel as Mark Hurd must have felt on his first day at HP. Nearly 70% of respondents think their operational strategy is less than very effective and nearly the same percentage report significant gaps in execution against their business strategy. Like Hurd, they see opportunity in a more effective operational strategy.

A Powerful Source of Innovation

Notably, 40% of C-suite executives believe an essential form of innovation over the next two to three years will be *operational innovation*, the restructuring of the operational model to achieve breakthroughs that redefine the basis of competition in a particular industry. In fact, these executives think operational innovation is as important for supporting revenue growth and profitability as more traditional forms of product, service, and technology innovation.

> ***Apple's leading position in digital music is due to its unique operational strategy***

The one-quarter of the respondents who expect their operational strategy to deliver game-changing performance are 50% more likely than the rest of the survey population to use multiple sources of innovation to achieve that performance. Technology is no longer the only focus of innovation efforts. Clearly, the executives who demand the most out of their operational strategy are expecting innovation along multiple dimensions to drive future performance.

So what precisely does it mean to innovate operationally across multiple dimensions? Take the example of Apple Computer.

From its earliest days, Apple has brought simplicity to complex, computer-based devices. Its commanding lead in portable digital music players and the resurgence in popularity of its computing hardware products are well documented. All of its product and service innovations, from electronic storefronts to software, are designed to achieve one objective: sales of more hardware, iPods in particular, because Apple's economics are built on profitable hardware sales.

Apple's leading position in digital music is due to its unique operational strategy. For starters, Apple manufactures its products in low-cost countries and has strategic sourcing agreements that provide not only cost-competitive components but also first-mover advantage for new technologies. Just as strategically, Apple kept its key application development in-house—in particular, the proprietary methods and libraries that make its software so easy to use.

But to ensure broad market appeal, Apple also had to broadly disseminate content while securing copyright protection of digital media. The solution was to develop a proprietary digital format (AAC) and digital rights management system (Fairplay). To promote and defend its position, Apple gives away the AAC codec but refuses to license Fairplay. The end result is that any music player can play a song encoded in AAC, but any song bought from Apple with the Fairplay DRM system can only be played on an iPod.

Apple also needed to enter a new business, services—something product companies generally find difficult to do well. Cleverly enough, Apple extended its core capability in software to the web, building an online music store that seamlessly integrates with its iPods—not coincidentally, the only devices that can play music from this site. Apple makes little if any profit from this online store. The profit is in the iPods, which are the only way to access the richest commercial music library available today.

Apple's operational strategy bore real fruit. The company was first to go to market with the a small hard drive player, first to contract with major labels to sell music online, and first to develop a comprehensive music encoding and delivery system that, at least to competitors, isn't really fair play.

What did Apple achieve? Competitive differentiation and high customer loyalty—not surprisingly, the top two benefits of operational innovation, according to our respondents.

CEO Responsibilities and Challenges

> **The Leaders of Operational Strategy***
>
> *The people respondents said are the top three drivers of operational strategy at their company:*
>
> - **CEO — 78% of respondents**
> - **Board of Directors — 43%**
> - **COO — 29%**
>
> *Respondents could select up to three options, so the percentage numbers total over 100.

Operational strategy is the responsibility of the CEO. Regardless of industry, geography, or competitive strategy, C-suite respondents—including CEOs themselves—said that leadership of operational strategy comes from the top. This is a profound recognition of the strategic opportunities and organizational challenges that successful operational strategy presents. Our survey showed that operational strategy is clearly on the CEO agenda, that the CEOs themselves recognize its importance and their leadership role, and that they are not confused between "operational strategy" and "managing operations better." Simply put, the CEO needs to be operational, but this does not mean that the CEO needs to be managing operations.

C-suite executives overwhelmingly indicated that talent, culture, and leadership are critical to successful execution of operational strategy—far more critical than management systems, business process models, and enterprise technology systems. CEOs were much more likely to identify with the primacy of "talent, culture, and leadership" than were non-CEOs. Clearly, finding, developing, and retaining the right talent in the C-suite and in operational leadership roles are a critical priority for the CEO.

> ***Subtle misalignments in the C-suite may translate into ineffectual execution of operational strategy***

An important implication is that talent, culture, and leadership now are at the epicenter in the operational realm of business. All three are needed to innovate operationally in individual functional domains and coordinate with colleagues across those domains. Top talent today must be 100% aligned on the financial and operational goals of the business, and must earn the right to be engaged in the deepest strategic decisions CEOs must make.

Barriers: Traditional, Complacent, and Misaligned Perspectives

Our respondents indicated that they experience a number of barriers to effectively devising, innovating, and executing game-changing operational strategy. "A traditional view of operations" was overwhelmingly cited as a major barrier, followed closely by "complacency with the status quo." This suggests organizations are not effectively leveraging their talent to drive operational innovation.

A barrier which was communicated more subtly—but which is nevertheless important—is a lack of alignment in the C-suite. When asked to prioritize performance metrics, priorities, enablers, and barriers, CEOs expressed greater interest in changing their operational models than did non-CEOs. In addition, compared with other C-level executives, a significant percentage of the CFO respondents see their company's operational strategy as less than effective. The importance of alignment on strategic priorities, managerial effectiveness, and financial results cannot be understated. CEOs should beware the enemy within: subtle but meaningful misalignments in the C-suite may translate into ineffectual execution of operational strategy.

CONTINUED ON P. 14

Regional Comparisons

The key findings of this study—the focus on game-changing operational models, the emerging broader view of operations, the imperative for operational innovation, and misalignments in the C-suite—apply across industries and geographies. But there are some important differences worth noting.

EUROPE:

Focus on Products and Services

Most of our European C-level respondents hailed from industrial and manufacturing industries; the percentage of financial services respondents was smaller than that of our North American contingent. The top European performance goal is profitability.

European C-level executives believe globalization is the key factor driving operational strategy. Product development is a consistent focus: A majority of European respondents describe product leadership as their basis for competition, product/service offerings as their number one performance lever, and product development as the most important element of operational strategy.

Our European respondents see alliance management as one of their weak spots. Our experience suggests that European companies are well acquainted with the complexities of global alliances—how, for example, a sales alliance in the U.S. could be quite different from an R&D alliance in India. The importance of globalization, product leadership, and alliances highlights how European companies plan to use operational strategy to drive profitability.

NORTH AMERICA:

Focus on Customers

Our North American respondents came from a wide range of industries, with a significantly higher proportion of financial services and a lower percentage of automotive and industrial respondents than Europe. North American respondents focus on both revenue growth and profitability as top performance goals.

The greatest driver for operational strategy for the C-suite in North America is increasingly demanding customers, followed by globalization and market velocity. The customer is consistently the central focus: North American respondents regard customer experience as their key basis for competition, customer service as the most important area of innovation, and customer loyalty as the greatest benefit operational strategy has to offer.

The survey revealed some other interesting differences between European and North American C-level executives. Proportionately more North American CEOs emphasized the need for hands-on operational management by their senior executives. They also think there's a greater need for operational strategy and operational innovation. European and Asian respondents seem to be more concerned with the lack of talent in their companies.

ASIA:

Focus on Global Capabilities

Our Asian sample was small, representing less than 10% of the total. Asian respondents came mostly from low-cost countries, and from industrial, communications, and software companies. Like the Europeans, Asian respondents see profitability as their top goal.

Despite the small Asian sample, three key themes emerged. First, Asian C-level executives are seeking to achieve either product leadership or customer excellence. Consistent with this emphasis, their operational strategy is largely driven by increasingly demanding customers and market velocity.

Second, the Asian respondents are very concerned about their global capabilities. They believe their companies' supply chain, value chain, and product offerings are the most important performance levers, and that these need to be enhanced significantly. Interestingly, they place a much higher importance on financial strategies as a performance lever than either our North American or European respondents, possibly reflecting the high cost of capital in much of Asia.

Third, our Asian respondents acknowledged that their operational strategy and execution capabilities could be strengthened through operational improvements. They are not placing as much emphasis on operational innovations and operational strategies as European and North American companies.

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If not addressed, these internal challenges—the inability to fully tap the organization for operational innovation, and subtle but fundamental misalignments in the C-suite—could undermine the power of operational strategy as a key competitive weapon.

The CEO's Choice

The survey findings make two points patently clear:

1. Operational strategy is one of the top-three strategic weapons deployed by the C-suite, whether in North America, Europe, or Asia.
2. One in four of executives surveyed are looking to operational strategy to achieve game-changing competitive performance.

In addition, the survey provides guidance on the definition, scope, and challenges of a successful operational strategy, as well as insight into the competitive reasons CEOs should be devoting time and energy to it now. However, these points are in themselves insufficient reason to take immediate action.

Action, by definition, is an allocation of scarce intellectual and financial resources to a course. Determining where operational strategy fits into a company's competitive strategy is an executive decision equal in importance to market and acquisition strategies.

Companies like Southwest, Tesco, and Toyota have demonstrated that first-mover advantage applies to operational strategy. Followers too can be successful, but the results are mixed. For every HP there is a Song, Delta's unsuccessful response to Southwest. Since game-changing operational strategy often requires fundamentally restructuring relations with suppliers, partners, customers, and employees, it stands to reason that first movers have greater flexibility and more options than followers.

What are the signs to alert CEOs that their operational strategy may need another look? We see three in particular:

- *Industry Triggers*. Broadly speaking, these are leading indicators to act. For instance, has your industry (or perhaps your company) experienced a series of mergers, carve-outs, or consolidations? Is the leadership in your industry changing (e.g., many of your competitors are now led by executives from outside your industry)? Are sources of supply and customer expectations changing in a way and at a pace different from the past?
- *Global Levers*. These are untapped opportunities to turn competitive threats into competitive advantage. Low-cost country competitors can become partners or source companies that give your company an unbeatable cost structure or service capability. Shifting markets can bring either an erosion of your current markets or an opportunity to grow into vast new ones. For every global threat, there's an operational strategy response.
- *Internal Drivers*. These are lagging indicators to act. For example, are there fundamental changes to the economics of your business that suggest profitability is structurally unsustainable? Do you find yourself wondering if the nature of your revenues and profits will be the same next year? It may not be too late to react to these drivers, but there may not be a lot of time to do so.

These are the questions to ask. The answers, ultimately, are the responsibility of the CEO.

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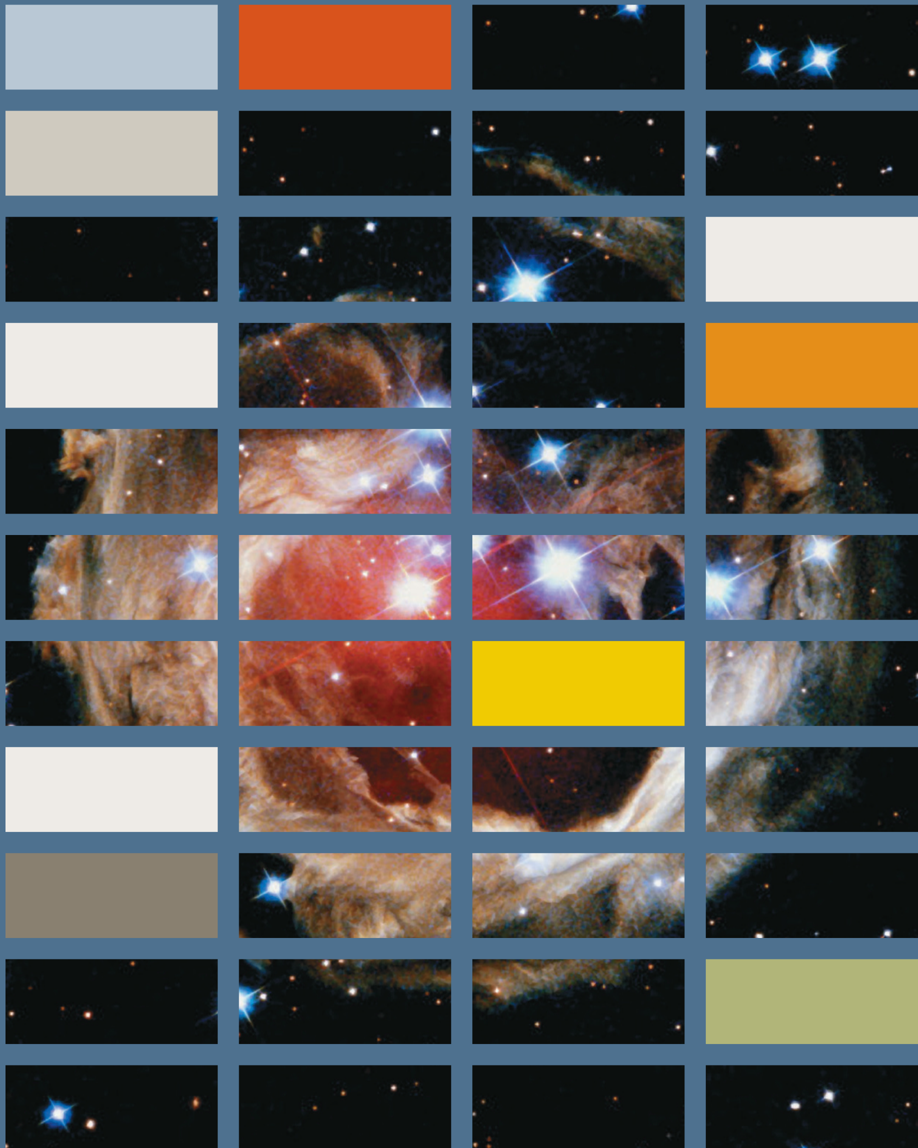
RESEARCH METHODOLOGY

In May 2006, BusinessWeek Research Services and PRTM conducted a study to explore operational strategy among CXOs at large companies. A total of 323 qualified respondents participated. All qualified respondents are "CXOs" (CEO, President, Managing Director/COO, CFO, CIO, Owner/Partner, Chairman of the Board, Board Member). We focused only on large companies: 25% of the companies had more than 50,000 employees; 20% had 10,000 to 50,000; all companies had at least 1,000 employees.

Two-thirds of the respondents hold positions in the United States, nearly 20% in Europe, 7% in low-cost economies, and the remaining 5% in the Far East and South America. The respondents represented a broad industry mix—58% product based and 42% services with 26% industrial/automotive, 12% electronics/computing, 14% consumer goods, 19% financial services, 12% communications and media, and 12% software/energy/government.



Aligning the Stars

Using alliance capability to build a constellation of partnerships that deliver

By Mark Deck, Gene Slowinski, and Matthew Sagal

For global companies that rely on innovation for profitability and growth, alliance capability is key. This involves more than striking one-off deals. Building alliance capability that will provide sustainable access to sources of innovation requires a long-term approach. In particular, it's important to use an operational strategy to guide alliance choices, build alignment and skills within the organization, and take the steps needed to become a partner of choice.

Roche Pharma Partnering[1] is known worldwide as a master of alliances, and for good reason. As the race to bring innovative medicines to patients accelerates, this department at Roche has cultivated a constellation of partnerships. Roche forms alliances with biotech, pharma, and medical equipment companies around the world to introduce innovation across the entire value chain (Figure 1). Its R&D partnerships—with companies ranging from early-stage biotech firms like Maxygen to mammoth companies like GE Healthcare—provide first-mover access to new technologies and can accelerate technology commercialization. Roche also forges alliances with suppliers, third-party manufacturers, and licensees. And partnerships expand the company's presence in important markets: The alliance with Japanese biotech Chugai makes Roche the largest foreign player in the world's second largest pharmaceutical market.

Figure 1: Roche's Many Alliances

[1] All discussion of Roche in this article is based on references found in the public domain.

Roche's alliances numbered more than 50 at last count. The results speak for themselves. Since 2001, when Roche launched its dedicated alliance function, no partnership has failed due to relationship concerns.

Key to Roche's success is *alliance capability*—a competency at creating, managing, and growing alliances to realize strategic goals. Alliance capability provides access to new sources of innovation across a company's entire value chain to deliver breakthrough results.

What does it take to develop alliance capability? Three C-suite actions are essential: ensuring an operational strategy is in place to guide alliance choices; building the internal alignment and skills needed to create and manage those alliances; and positioning the organization as a partner of choice.

Using Operational Strategy to Guide Alliance Choices

Since alliances can add enormous strategic value, some argue that companies should develop alliance strategies. But this approach confuses strategy with tactics. In reality, alliances are a tool to carry out strategy, not a strategy in themselves. Successful companies start with a clear understanding of their underlying strategic objectives and ask, "What is our operational strategy—that is, how do we structure our business operations and business economics for competitive advantage—and where do alliances figure in that strategy?" Beginning with operational strategy is crucial for getting the full value from partnerships—seeing how they can help change your operational business model and lead to new sources of competitive advantage.

Roche knows the value of this firsthand. To further its core competency in innovation, the company developed an operational strategy that combines strong internal R&D, majority stakes in Chugai and leading biotech Genentech, and a broad range of alliances with universities and biotech companies. As a way of supporting this innovation model, Roche made a conscious decision to change its philosophy around alliances. Instead of executing one-product deals on an opportunistic basis, Roche began developing long-term, collaborative partnerships to uncover new sources of advantage in its R&D, supply chain, and marketing functions.

Alliance capability is not limited to the pharmaceuticals sector. Consider global consumer products leader Procter and Gamble, which uses a network of alliances to gain quick access to a wide range of technology and supplier alternatives, then applies its own R&D, manufacturing, marketing, and purchasing capabilities to produce better products faster. In just two years, P&G has developed 100 new products with the help of alliances, while reducing R&D spending as a percentage of sales by nearly 30%.

Leading alliance makers understand that strategically valuable alliances are possible on every link of a company's operational value chain

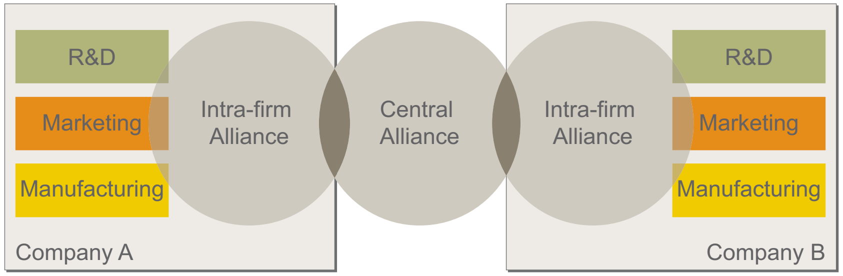
Leading alliance makers understand that strategically valuable alliances are possible on every link of a company's operational value chain. It's on those less-used links, in fact, where some of the greatest potential lies. P&G Pharmaceuticals developed Actonel® to treat osteoporosis but didn't have the specialized marketing and sales capability needed to penetrate the market. So P&G formed an alliance with Hoechst Marion Roussel (known today, after various mergers and acquisitions, as Sanofi-Aventis), and Actonel soon became a billion-dollar blockbuster. This is not an isolated case. Today, many of the most profitable alliances occur in the marketing and sales arena.

Building Organizational Alignment and Skills

Determining the role alliances play in operational strategy is only part of the equation. To translate that role into revenues, the C-suite must give proper attention to the organizational dimension. That means embedding alignment and the requisite expertise deep in the organization so the firm can respond to the best alliance opportunities when they arise and manage them to success.

Three alliances in one. Building alignment in alliances is a complex affair. Every alliance actually consists of three different alliances, the central alliance formed by the two firms and the two intra-firm alliances (Figure 2). While the central alliance usually gets the most attention, the intra-firm alliances are just as critical to success.

Figure 2: How Alliances Work



Adapted from Gene Slowinski, *Reinventing Corporate Growth* (Alliance Management Group, Inc., 2005).

To ensure these intra-firm alliances function optimally, each must be in complete alignment with the corresponding central alliance. That means that inside each firm, the different business units or functional groups (e.g., engineering, marketing, and sales) that are to provide resources to the central alliance must be in agreement on how the alliance supports their strategic priorities, and what their specific responsibilities are to achieve alliance success.

There also needs to be alignment on a broader organizational level—in the firm's culture, rewards, and operating practices. C-suite executives must encourage employees to develop an external innovation mindset by encouraging people to access external resources. We've often found this to be a problem. At one client firm, the reward system encouraged internal innovation. R&D managers instinctively responded with "not invented here," rejecting alliance opportunities whenever they came up. At another client, a manager who did not appreciate the value of alliances told his overloaded subordinate to handle her alliance responsibilities as her "Sunday job." Then there was the general counsel who, when reviewing a prospective alliance agreement, maintained his company needed to own all intellectual property that was jointly developed—even though the firm only needed rights to use the technology.

To change attitudes like these, top management should develop organizational structures and processes dedicated to making alliances work. One technique we've found especially effective is to make the business unit leadership that's most closely associated with a particular alliance accountable for the success of that alliance.

It's also effective to establish a cross-disciplinary group whose mission is to oversee every partnership from formation to marketplace success. Roche's Pharma Partnering group includes physicians, pharmacologists, chemists, biologists, lawyers, and financial analysts. This global 80-person group has the clear support of senior management, and the global head of Roche Pharma Partnering has a seat on both the Pharma Executive Committee and the Enlarged Corporate Executive Committee for Roche (J.R. Minkel, "A Drug for Discovery," *Drug Discovery and Development,* 2004).

Tools too are critical. Proven methods such as the Alliance Framework® provide guidance for planning, structuring, and negotiating alliances, while companies with multiple partnerships, like Roche, P&G, and Eli Lilly, develop their own sets of tools from their previous alliance experience (Gene Slowinski and Matthew W. Sagal, *Strongest Link: Forging a Profitable and Enduring Corporate Alliance,* 2003).

Alliance competencies. While alignment is important, your organization must also develop specific alliance competencies. Your business development function must be proficient in communicating with alliance partners and crafting alliance terms that accommodate both partners' strategies. At the same time, your financial group must be adept at creating financial structures that control the risks and benefits. And your legal department must be skilled in drafting intellectual property provisions that meet the marketplace needs of both partners.

Where do these skills come from? The answer is often experience. But without an intentional effort to grow these skills, they can dissipate with each new alliance and set of players. Training, both formal and informal, makes all the difference. There are many options to choose from. HP, for example, holds a two-day course on alliance management, while at Eli Lilly alliance managers meet weekly to share their experiences.

Becoming the Partner of Choice

Knowing when and how to employ alliances is important, but how will you ensure access to the right alliances, the ones that will provide first-mover advantage? In this global business environment, the company that waits on the sideline can be shut out of the action. Key to winning the game is becoming what's known as a *partner of choice*—the reputation as the best company in your industry to partner with. Then external firms will approach your company first with their new technologies, business models, and market opportunities.

Table 1: The Four Stages of the Alliance Lifecycle

	Want	Find	Get	Manage
Activities to help you find and keep right partners	Determine what resources are needed from other companies	Identify and locate companies with the right resources	Structure and negotiate contracts with partners	Work closely with partner to reach milestones
Activities to help right partners find you	Ensure your company has the resources other companies need	Demonstrate your company treats its partners well and gets results	Move quickly on decisions	Take into account partner's needs as well as your own needs

Companies that have landed the "partner of choice" designation focus on acquiring the right partners and, equally important, making themselves attractive to potential partners. To this end, they pursue certain activities during the four different stages of the alliance lifecycle: *Want, Find, Get,* and *Manage* (Table 1).

Want. In the first stage of the alliance lifecycle, the partner of choice determines what external resources it needs from other companies. At the same time, it ensures it has the capabilities that other top companies are looking for. In this sense, it's like product development, where the goal is to create offerings with features that will draw the right customers.

Roche, for example, has cross-functional disease-area strategy teams for each of the company's therapeutic areas—oncology, virology, and so on. Roche also emphasizes that it has what other companies are looking for. Beyond its expertise in development, manufacturing, and commercialization, Roche is willing to share its knowledge, has an open mind to other ways of doing things, and can customize partnerships to meet the needs of its partners.

Find. During the second stage of the alliance lifecycle, the partner of choice locates the resources it needs from other companies. Roche's disease-area strategy teams rely on "finders," well-trained individuals who have a deep knowledge of disease areas, high internal credibility, and who are closely connected with the company's research organization. These "finders" identify opportunities for new treatments—more than 1500 each year. A larger cross-functional team then analyzes each opportunity to see if it is scientifically and commercially viable and aligned with the company's overall strategy.

While partners of choice expend great effort to find the right companies, they also want to be "found" by others. How? By demonstrating that they have the right kinds of expertise, treat their partners well, and are effective at getting results. Word gets around—it's that simple.

Companies that have landed the "partner of choice" designation focus on acquiring the right partners and, equally important, making themselves attractive to potential partners

Get. After locating that external resource, how do companies land the alliance that will give them access to it? In the third stage of the alliance lifecycle, when contractual agreements are planned, structured, and negotiated, the partner of choice is distinguished by its ability to move quickly on decisions. Roche is known for its speed, with the ability to strike a deal in six months and sometimes as little as six weeks—significantly better than the industry average of 12 to 18 months.

Manage. During the fourth stage of the alliance lifecycle, the collaborating firms "manage" their alliance relationship to ensure that as the business environment changes, the alliance continues to support their operational strategies. Partners of choice continuously work with their alliance partners as the relationship progresses to successfully reach pre-determined milestones. As part of the evaluation process, P&G asks its alliances' managers to complete a scorecard on each alliance, while Eli Lilly distributes a survey to everyone who participated in the alliance, not only from Lilly but also from the partner company. For Roche, alliance management is key to the evolution of the partnership and takes into account environmental factors. These factors include the partners' corporate needs and strategies alongside the needs of the compound or product in question. This often includes the expansion of an existing relationship, as it did recently with GlaxoSmithKline, when the companies agreed to co-promote Xenical®, a weight-loss drug. The underscoring aim through all of Roche's partnerships is to develop innovative medicines that make a difference in patient's lives, and Roche has recognized that alliance management is one of the determining factors for success.

The partner of choice chair is empty in most industries, but that situation is temporary. Firms realize that this designation is key to competitive differentiation and are taking positive steps to achieve partner of choice status.

How do you know if you have alliance capability? Ask a simple set of questions: What key alliances do we have today; who owns them; why are we in them; and are we getting the results we expected? How are alliances changing our operating model? Does the organization embrace alliances or avoid them? What do our partners think of us? Who is accountable for alliance success, and who is accountable for building alliance management skills? This basic audit is a good way to understand not only whether you have capable alliances, but also whether you have alliance capability.

When the time comes to write the next history of business, an important chapter will describe the advantage that comes from treating the world as a resource base and creating collaborative innovation from the best players available. The C-suite has the ability to tap this source of advantage and change the way the industry competes. As is the case with developing any core capability, building alliance capability is not easy. But the rewards—stronger revenues, profits, and market share—are well worth the effort.

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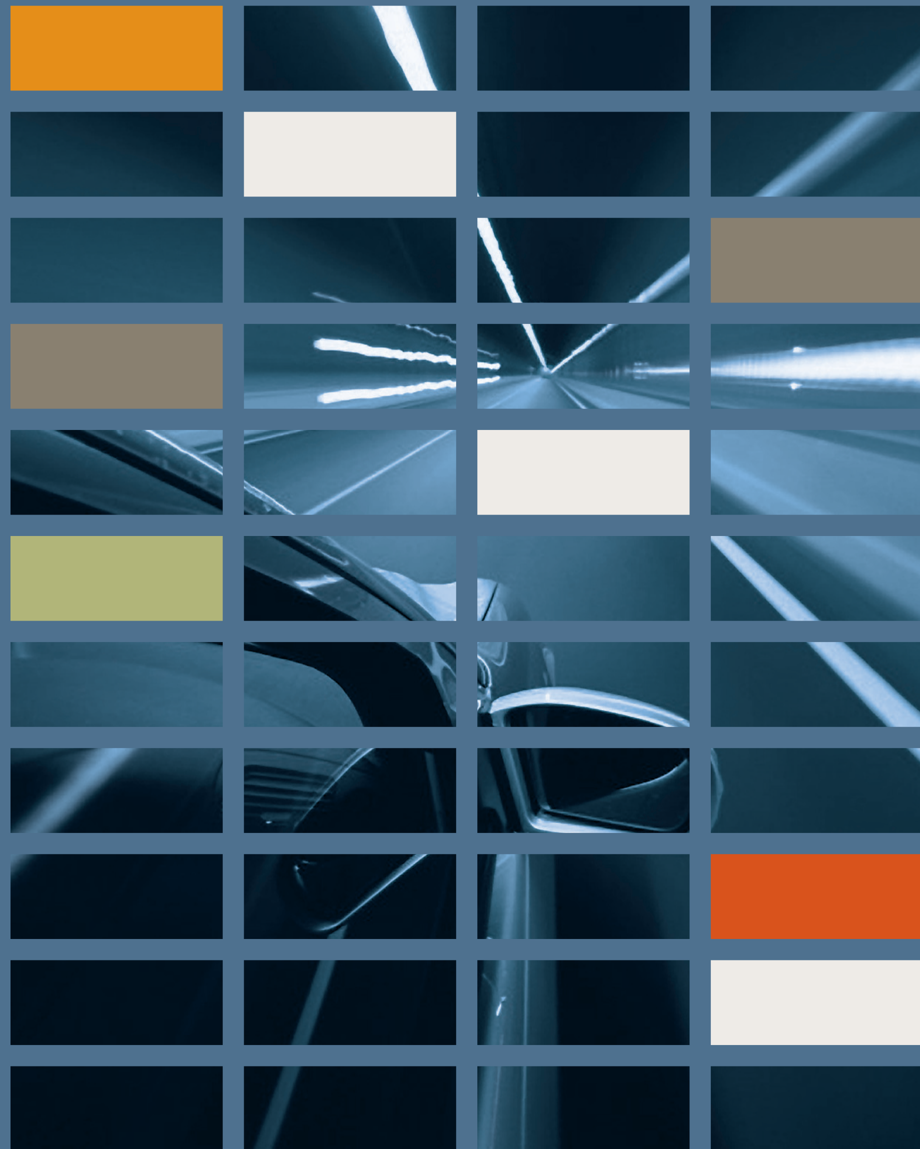


The Road to Good Fortune

Advice from top-performing automotive suppliers on how to capture the greatest cost savings in China

By Andreas Mai and Steve Pillsbury

As the pressure to reduce costs intensifies, sourcing commodities in China and other low-cost countries has become essential for automotive suppliers. But a recent benchmarking study by the Original Equipment Suppliers Association and PRTM reveals that many auto-parts companies have failed to realize the benefits of such procurement efforts. Top-performing automotive suppliers companies treat China sourcing as a piece of a larger, global commodity management strategy. In addition to setting up a local operation in China, they are careful to select the right commodities to source and engage the right partners.

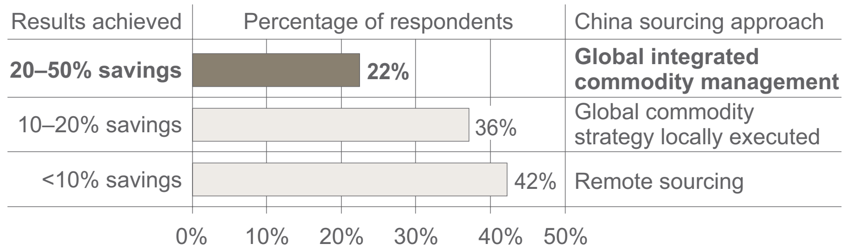
"The China price." These words strike fear in the heart of many an automotive supplier executive—and reflect one of the major challenges globalization has created for the sector as a whole. The proliferation of competitors in low-cost countries like China has become a serious threat, intensifying the pressure many suppliers are already feeling from customers like Ford and General Motors to keep prices low. That pressure shows no sign of letting up anytime soon. According to Bo Anderson, General Motors' vice president of global purchasing and supply chain, GM has increased the share of parts it sources in low-cost countries from 20% in 2003 to 30% in 2005 and expects that number to grow even more going forward.

The strategic imperative is inescapable. Automotive suppliers must establish new sources in China for the commodities they need to manufacture their products. "We've realized that China sourcing is not just a good idea to capture some cost savings," one purchasing officer acknowledged. "It's going to be critical to our very survival."

It's also critical for the Chinese suppliers providing the commodities. Keen to capture fast-growing markets in China and overseas, these companies do not simply want to be a low-cost source for commodities in China. They want to become a trusted partner sought out by global customers for long-term relationships.

Yet many auto-parts companies have realized only a fraction of the benefits of sourcing from China, according to "Lessons Learned in China Sourcing," a benchmarking study conducted in 2006 by the Original Equipment Suppliers Association (OESA) and PRTM (see sidebar). Over half of the companies surveyed achieved less than 40% of their cost-saving targets. Top-performing companies, by contrast, are capable of realizing cost savings of at least 20%, and as high as 50% (Figure 1). But it has taken them anywhere from six to 10 years to achieve sustainable cost savings across multiple commodities.

Figure 1: Savings from Sourcing in China, 2002-2005



Source: "Lessons Learned in China Sourcing," OESA/PRTM, 2006.

What does it take to make sourcing in China a winning proposition? Our findings indicate that leading companies employ a global commodity management strategy that relies on local Chinese purchasing representatives with responsibilities spanning the entire sourcing process. Less-successful companies, by contrast, often regard China sourcing as a quick route to short-term cost reductions. They tend to conduct operations from their home office and struggle to find the resources needed to manage the sourcing process. These companies are also most likely to abandon the effort as the coordination costs and hours begin to mount.

Laying the Groundwork

Companies that have been successful at procurement know that the decision to source in China, or any other low-cost country, is not one to be taken lightly. A winning sourcing initiative requires commitment in the form of strong executive support and a local operation in China.

Executive commitment. Because setting up a successful sourcing operation in China can be a long and arduous process, often the home organization believes it isn't really feasible, and is reluctant to lend its support. An executive mandate is essential for overcoming this mindset. Nearly 80% of the top-performing companies in the OESA/PRTM study ranked China sourcing a top CEO priority, as compared with only 30% of low performers. Executives at these successful companies were directly involved in the sourcing effort, investing adequate resources, insisting on results, and closely monitoring those results.

Top-performing automotive suppliers build and empower their own procurement offices in China

Local offices. Top-performing automotive suppliers also build and empower their own procurement offices in China. To make this investment pay off, they spend at least $10 million on commodity purchases and generate 15% in savings. They also hire local Chinese employees and trust them to make the right decisions. One leading supplier learned this lesson the hard way. "We started with the traditional approach of sending a team of ex-pats to China," he noted. "We soon realized we had simply exported poor practices to an unfamiliar place. Only when we finally trusted our locally hired staff to undertake higher-value purchasing activities did we begin to realize the importance of local insight and customs."

Making Smart Decisions

Once this foundation is in place, it's important to be smart about the decisions that have the greatest impact on success. According to our survey, leading companies are careful to select the right set of commodities and engage the right partners. They also keep their eyes open to the total costs and value proposition.

The right commodities. Given the long distances involved and the appreciable differences in engineering and manufacturing capabilities, it's advisable to source parts that are low on the complexity scale. High-complexity parts are more likely to require frequent engineering changes or sensitive manufacturing processes and consume substantial engineering resources.

Similarly, it's a good idea to source parts that can be transported easily. Relatively longer shelf lives and lower inventory costs are also a plus. Even when Chinese vendors agree to maintain inventory in North America, the buyer ultimately absorbs the true supply chain costs.

Labor costs. China is well known for its labor cost advantage. As a general rule, any part with a labor cost content greater than 10% of the total cost is worth considering. Many parts offer a cumulative cost-savings advantage: Sub-components, raw materials, and related processes such as machining can frequently be acquired at lower costs through the Chinese suppliers' suppliers.

The right partners. It's also important to choose the right partners, though this involves a lot of up-front research. There are more than 5,000 registered and 15,000 non-registered automotive supplier enterprises geographically dispersed across China. But only a small number of Chinese suppliers have the global management capabilities and experience needed for dealing directly with global car makers and Tier 1 suppliers. And there's a lot of competition for their products. One-third supplies two-thirds of the auto-parts market.

Traits to Look for in Chinese Partners

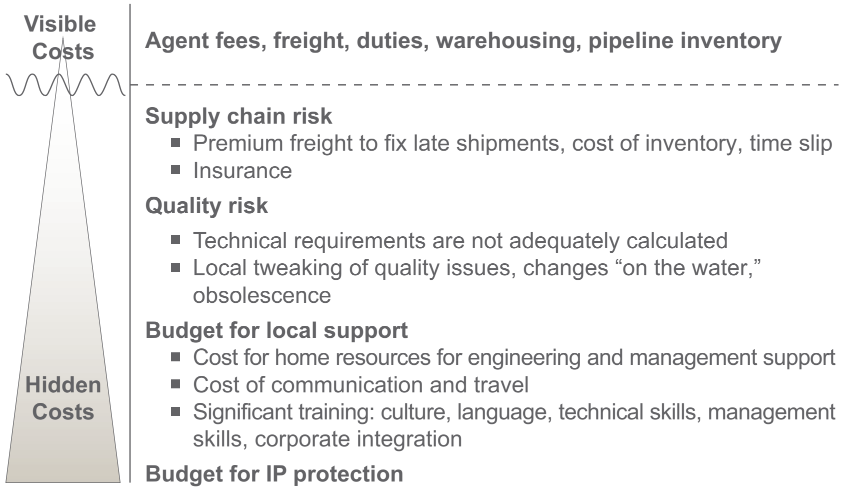
- **Management integrity/ transparency**
- **Robust quality system**
- **Communication ability**
- **Product development capability**
- **Engineering presence in customer's time zone**
- **Logistics ability**

To ensure success, be sure to conduct due diligence of many facets of your potential partners' operations. This means thoroughly investigating the quality, ownership structure, and financial standing of potential partners to foresee difficulties in managing the business. It's also important to make sure that mass production can maintain the same quality as the sample. And assess the specific site where the component is going to be produced by talking to managers, verifying the quality of workers, and reviewing supply chain logistics.

Failure to take these precautions can have dire results. "Just as soon as we finished patting ourselves on the back for securing low-cost components with high quality and a commitment to establish a local warehouse for inventory buffers we realized that the supplier did not know how to control the local warehouse," noted one automotive supplier executive. "We practically lost all our benefits due to service disruptions and increased management costs on our end."

Total costs approach. Surprisingly, although cost savings are usually what lead automotive suppliers to source in China, only a handful of companies use an integrated total-cost model. More typically, the various functions—purchasing, engineering, logistics, and quality—conduct their cost calculations independently based on worst-case expectations. This approach can end up concealing some important costs (Figure 2). Without a clear valuation of the opportunity, the executive suite is prone to delay decisions or make the wrong one. The situation is further complicated by the fact that Chinese vendors often lack the tools to provide accurate cost-breakdown data.

Figure 2: Choosing the Right Partners



To avoid this problem, it's essential to ensure that the various functions involved are aligned on an integrated total-cost model and that Chinese suppliers are provided with specific instructions on each component they are to design. Technical requirements must also be carefully validated so they are fully accounted for in the quoted price. It's even worth pointing out the critical issues in the technical specifications—this helps avoid surprises later on.

Managing Risks Proactively

The challenges of sourcing in China do not end with the signing of the contract. A successful outcome requires continuous involvement and support of vendors throughout the relationship. "Not long after we achieved steady volume delivery we started to see a gradual degradation in quality and less competitive pricing as we moved other products over to the same vendor," noted one automotive supplier. "Shame on us for assuming traditional on-going supplier development processes would suffice." Clearly, managing even the

top suppliers in China requires a high degree of dedication. Top-performing companies employ a comprehensive risk management strategy to deal with the different problems that can arise.

Quality. This is repeatedly cited as the number one concern, often because drawings and technical specifications are not clear or accurate. To allay this problem while ramping up operations in China, leading companies provide significant on-site support. They then conduct three or four quality audits per year, hold monthly online performance reviews, and even help their suppliers implement continual improvement programs. The increased complexity of the supply chain demands this type of commitment. "Lead time can be fixed with inventory buffers, but there is no easy quality fix," one supplier remarked. "You can quickly find yourself with a frozen pipeline over a 7,000 mile distance."

Transport. The transport of goods from Chinese suppliers is also fraught with risk. The inland transport infrastructure in China isn't well developed, and transport by ship can take up to 10 weeks. To make matters worse, the U.S. port and port-to-rail infrastructure is close to capacity. As a result, products sourced in China entail twice the inventory, three times the number of late deliveries, and five times the air freight costs as do products sourced in North America. Top-performing companies, however, have cut these added costs by as much as 50% more than their peers by testing the inbound logistics process, building buffer inventories in North America, and conducting frequent direct reviews of production plans with suppliers.

Intellectual property. As the number of IP lawsuits across all industries grows by some 40% every year, IP protection has become essential. It would be hard to exaggerate the importance of certain basic measures: Avoid IP-sensitive commodities, protect IP associated with product integration by sourcing components and phases of assembly across multiple suppliers, and prosecute offenders relentlessly.

As auto manufacturers expand production and sales in China and other low-cost countries, the number of local suppliers will likely continue to grow, reshaping the global automotive supply footprint over the next decade. A low-cost country procurement operation is now a core competitive capability for this industry. But sourcing in China should not be mistaken as a way to meet short-term cost-reduction targets. It is an essential piece in a global supply chain strategy, requiring a significant investment of planning, capital, and time. By treating sourcing there as a serious long-term commitment, automotive suppliers can secure the low-cost supply relationships they need to make their global sourcing capabilities a success.

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SURVEY METHODOLOGY

The OESA/PRTM joint study examined the performance of automotive suppliers that procured commodity goods from China. Conducted from October 2005 through March 2006, it consisted of a survey and in-depth interviews with purchasing and supply chain executives from more than 50 international auto-parts suppliers with locations in North America. These companies ranged from small, focused Tier 2 and Tier 3 suppliers to multi-billion dollar, multi-national Tier 1's.

Respondents fell into three categories. Leading companies, constituting the top 22% of respondents, repeatedly realized over 20% cost savings from China sourcing operations. These companies treat China sourcing as a piece of a larger, integrated global commodity management strategy. The second category, 36% of respondents, typically achieve 10% to 20% cost savings from China sourcing. The companies in this category tend to rely on local Chinese purchasing offices for tactical support while managing the overall sourcing process from North America. The third category, the lowest group of performers, comprising 42% of survey participants, realized less than 10% savings from China procurement. They conduct nearly all of their sourcing activities from their home office, without establishing a presence in China.

PARTING THOUGHTS

The world is changing very fast. Big will not beat small anymore. It will be the fast beating the slow.

Rupert Murdoch, Chairman and Managing Director, News Corporation

Beware of the tyranny of making small changes to small things. Rather, make big changes to big things.

Roger Enrico, former chairman, Pepsico

Successful innovation sustains and propels the growth of companies faced with intense competition.

Alex Gorsky, Chief Operating Officer, Novartis