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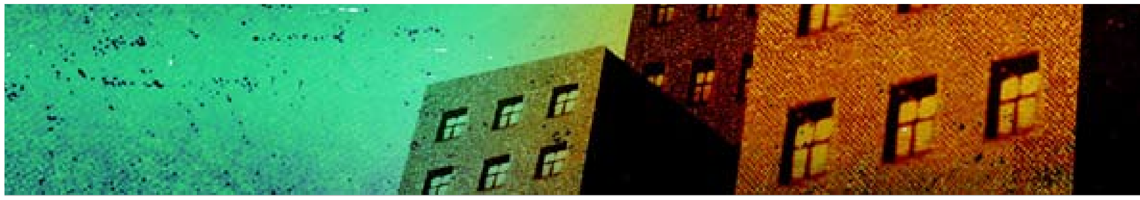


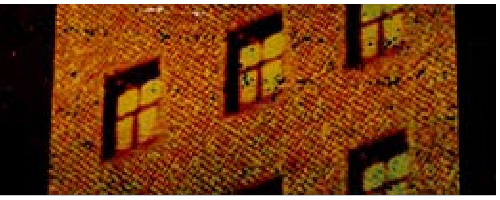
Organizing for **value**

The division structure can mask big differences in the performance of smaller units. A finer-grained approach can better show where value comes from.

Massimo Giordano and Felix Wenger

Organizing large corporations along a few divisional lines has long been an effective way to groom managers for top jobs and to limit the number of direct reports the CEO has to keep track of. But for value-minded executives, those bulky divisions can obscure the performance of smaller units where value is actually created. In a big, complex division, the division and function heads often become the de facto decision makers about whether and where to invest and how to make trade-offs between long-term growth opportunities and short-term demands. A head of research and development might spy a promising new technology investment, but just as quickly look away when the broader demands of complying with the budget of that function come into view.

This organizational blind spot, often combined with an excessive focus on short-term earnings, can produce unfortunate results, in our experience. Managers end up optimizing earnings goals at the expense of long-term growth and value creation. "We typically spend 80 percent of our time figuring out how to squeeze the economics, and only 20 percent on actual strategy, without numbers to back our decisions," says one executive. Some readily admit to cutting back on value-creating projects in order to meet short-term earnings targets. Others overlook or underfund value-creating strategies—such as investment in high-growth niches, entries into new markets, or new R&D projects—that don't fit into their short-term planning horizon. Many treat all units within a division as if they were creating value equally. A large European bank, for example, reduced staff after the subprime crisis hit its US operations. The uniform freeze across business units meant that even an alternative-investment unit delivering 60 percent earnings growth had to cut back its resources, negatively impacting future growth.



One way companies can compensate for the blunt tools of traditional planning is to take a finer-grained perspective on businesses within large divisions. By identifying and defining smaller units built around activities that create value by serving related customer needs, executives can better assess and manage performance by focusing on growth and value creation. These units, which we call "value cells," offer managers a more detailed, more tangible way of gauging business value and economic activity, allow CEOs to spend more time on in-depth strategy discussions, and make possible more finely tuned responses to the demands of balancing growth and short-term earnings. There is no guarantee that companies taking this approach will make the right investment decisions, of course. But in a number of companies across industries, we have found that it fosters transparency and a more strategic and longer-term perspective.

Simply recasting a company's view of its assets in this way is a largely no-regrets move, we believe. However, executives looking to make strategic decisions and measure performance using a value cells approach will face the challenges of rewriting metrics, redefining the performance-management process, and changing the mind-sets of top managers.

What are value cells?

Value cells are actually smaller business units, typically segments or geographical markets, along with their backbone functions, such as central production or operations. We think of them as "cells" because they stand apart from the traditional organizational-unit structure of most companies and often have surprisingly different economics. One large health care company, for instance, analyzed one of its divisions by the type of disease to be treated, rather than by the classic functional structure of research, development, sales, and production. This meant adding up all the products used to treat each disease, the specialized sales forces serving specialist professionals around the globe, and the development teams working on new medical devices. Additionally, parts of the production, supply chain, and overhead needed to be allocated.

As a rule of thumb, value cells have stand-alone economics and must be relatively "homogenous" in regard to their target market, business model, and peers—that is, they must have one target segment, one country or region, or one group of products. The trick is to create financial analyses, such as P&L statements, as if a value cell were a stand-alone business. This is normally not done in a classic divisional structure, where each division's financials are an amalgam of different products, markets, and costs relating to shared assets. A useful litmus test is determining whether a value cell could be sold and whether there would be a clear market price for it. Defining cells in this way also implies a value-minded bias for managerial action: some may need investment, some may need to increase their profits, and others should be wound down.

In our experience, a company of above $10 billion market capitalization should probably be managed at the level of 20 to 50 value cells, rather than the more typical three to five divisions.[1] Another European bank, with above €50 billion[2] in market cap, for example, identified more than 50 value cells, where it had once had nine divisions. Each cell was built around

[1] In our study of 400 very large companies, we found that, on average, they have three to five divisions, with the largest division making up 55 percent of revenues.

[2] About $80 billion.

related products, segments, or geographical boundaries. Examples of cells were consumer finance, asset management for institutional clients such as pension funds, or wealth management for wealthy individuals.

Value cells can easily coexist with the organizational structure of a division, which might need to take other factors into account, such as geographic proximity or economies of scale in common functions such as production plants, supply chain, or sales networks. As an overlay on an existing structure or a lens through which to view existing businesses, however, the cells facilitate strategic decision making. Their primary benefit is to improve reports to the corporate center by increasing the level of detail in data and differentiating between the performance of units previously buried in larger divisions—and the opportunities these units pose. The mere process of identifying value cells and discussing the strategic options around them creates transparency about the sources of value within divisions, making it clear whether, say, high-performing businesses have been cross-subsidizing weaker siblings. What typically emerges is a better baseline for portfolio decisions regarding which value cells managers should keep, which require more investment, and which they should divest altogether. Senior executives—the CEO and the CFO—will need to insist on detailed economic and strategic data from business managers in each value cell before allocating the company's resources. In the case of the bank described previously, the CEO did so by requiring a 50-page "value report" on all cells before making investment decisions. The CEO used the report, which included business drivers, economic profit, and valuation data, to monitor and challenge the businesses in the company's portfolio systematically. The report also served as a basis for longer-term growth and investment plans, something that was not possible using the traditional three-year-earnings approach to planning.

While managing so many value cells might appear to increase the CEO's workload, the reverse is often true. Focusing more on single cells actually reduces complexity because managers find it much easier to identify and monitor the two or three operational metrics that truly drive performance, as well as to make decisions in a more straightforward way. In essence, the CEO can use value cells to take out a "disintermediation layer" between actual business decisions and the corporate planning process. Instead of aggregating strategies and economics into complex divisions and then spending lots of time understanding the overall strategy and performance, the CEO can take a larger number of more rapid, more specific, and more radical decisions at the value cell level.

A secondary benefit of a value cells approach is its emphasis on a company's performance and longer-term prospects. In today's typical command-and-control, budget-driven organization, most managers focus on ensuring that their units meet short-term earnings targets. With value cells, CEOs and CFOs have better information for taking a more active role in managing a company's long-term development rather than the shorter-term focus of the divisions. The more detailed information they get from value cells, the less likely they will be to tolerate continual underperformance or to forgo investment opportunities.

At a global technology company, for example, R&D was managed broadly as a percentage of divisional revenues. When the CEO exerted pressure to meet short-term earnings targets, R&D spending was squeezed. One of the divisions did make investments in a breakthrough renewable-energy technology—but did not want to commit more than a certain percentage of its R&D budget. Once the company redefined the technology and its application as a value cell, its R&D costs were linked to its long-term revenue potential. The investment returns were risky, but potentially very high. Strategically, the company found it was already losing ground to competitors and spending significantly less on R&D than they were. As a result, the company decided to increase R&D spending and accelerate the commercialization of the technology, even though this meant sacrificing some short-term profit margins.

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It's worth noting that a value cells approach is meaningful only if a company has the courage to follow up on decisions to invest or divest. Managers must regularly scrutinize cells that destroy value and divest them if turnaround plans don't materialize. They must nurture high-potential businesses aggressively and continuously. If competitors devote far more resources to a given business, for example, the real choice is exiting it or doubling down on the investment—not adapting marginally.

Getting started

Using value cells to emphasize value management requires some obvious implementation challenges—creating better data, exerting pressure to collaborate, adopting incentives that reflect the value created per cell. The real change of culture and mind-set requires even more: instilling business managers with the feeling that the new process gives them more freedom and more resources for good ideas.

Overcoming resistance

Some managers have a certain antipathy toward greater transparency, often because they have typically been rewarded for a division's overall short-term performance. As long as that performance depends on a few aggregated numbers, they have enough flexibility to let the strong performance of one unit make up for the weak performance of another, or to favor a unit that generates more revenues today over one that promises more growth for tomorrow.

In order to overcome that resistance, CEOs and CFOs will need to explain the benefits of the value cells approach clearly, and the rewards of managing for higher growth. On the one hand, this means adapting reward programs, so that managers will be rewarded for creating long-term value, even if this means investing, or riding out market cycles—things that can't be done if everything is melded into the usual division-level reports. One appropriate model for this can be found in many private-equity firms and hedge funds, which compensate managers according to their return on investment, offering them a share of the returns as they materialize. As a first step, many companies are moving away from absolute profit as the key metric towards return on invested capital (ROIC), or economic profit after cost of capital invested.

On the other hand, it also means stressing the greater opportunities for personal growth. The value cell approach requires business leaders at all levels to be entrepreneurs as well as managers. Instead of just delivering short-term earnings, business managers have more incentive to become opportunity scouts; business-development strategists; and investment managers who are expected to discover profitable opportunities in high-growth niches, entry into new markets, or R&D above and beyond current projects. As strategists, they need to weigh opportunities to drive long-term value. As managers of value, they constantly need to optimize all elements of the value equation, such as short-term earnings, long-term growth, and capital requirements. A practical first step here can be to devote more time in the corporate-planning process to discussing strategic options, and ask business managers to come up with investment cases that can be considered and challenged. This approach can require changing performance metrics and the incentives linked to them.

Beefing up the corporate staff

CEOs and CFOs face new challenges when managing with a value cells approach. Those who have made the transition have often found it difficult to strike a balance between tangible short-term earnings and accounting metrics and much less tangible long-term-investment and value ones. Ensuring that measures of value and returns are correct and consistent and that projections and investment cases are comparable, some have found, requires substantial valuation skills and a fairly detailed knowledge of the economics of various businesses. Many have found it useful to benchmark performance against external indicators (such as product market share, client churn rates, and productivity per sales point) and to establish an "educated" dialogue with business units. In our view, this requires that CEOs and CFOs first ask the corporate finance and strategy staffs to define value cells and to calculate their economics and value using consistent assumptions, for example, on allocations of overhead or valuation parameters such as cost of capital. Then they must test these analyses with the business managers (divisional and below), inviting them to comment on the key metrics that drive the value of cells and to present investment cases on how they could increase the value of cells—for example by investing in distribution or reducing capital absorbed. Once the best cases have been approved, there must also be an ongoing process of challenging the performance of cells relative to the initial plans and external benchmarks.

To meet these challenges, most CEOs will need to train and develop—or hire—a staff that can conduct such analyses, brief them on the findings, and coach them during discussions with business managers. The number of these employees can be modest, however. Companies should bear in mind that many comparably sized private-equity firms, which operate in a similar fashion, need only a handful of analysts to monitor the value of their portfolio companies and to brief their executives effectively on what questions to ask and what to challenge.

Beefing up the managerial bench

Many business managers are not immediately up to their new role when the value cell approach is adopted. One large European financial institution found it hard to fulfill one of the primary tasks of this approach: identifying profitable and creative ways to invest more money—other than, in some cases, buying a competitor. It turned out that the existing management bench was much more oriented towards fine-tuning short term revenues and costs, often at the expense of growth.

In some cases, companies will be able to train and develop existing talent. In the institution just mentioned, it took business managers one to two years to build the skills they needed to generate high-quality investment ideas above and beyond their current scope. Once that change was in place, their role became much more entrepreneurial and strategic, and they proposed more and better-developed investment plans than they had before and distinguished more clearly between growth and mature businesses.

Focusing corporate and divisional decision processes on value and growth isn't simple, particularly when the activities that create value are embedded in large divisions. Companies that adopt a finer-grained, granular approach can better identify and manage their value-creating assets. MoF

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