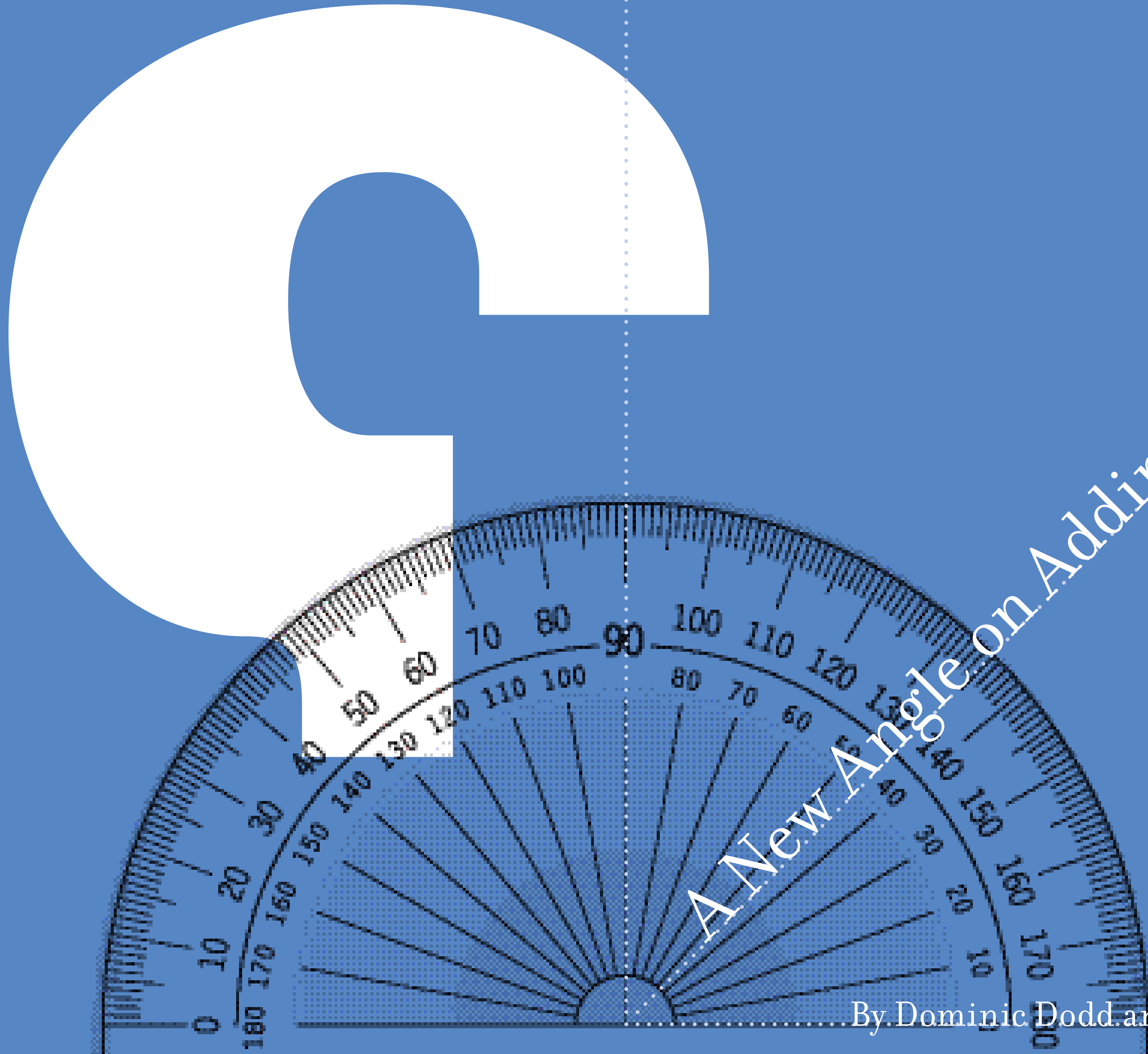


A New Angle on Adding Value

By Dominic Dodd and Ken Favaro

Most companies fail to add value to their business units. Typically, they end up choosing between improving performance vertically, by giving their business units greater autonomy, or doing so horizontally, by increasing centralization.

To achieve greater performance, managers should take a different angle on the challenge: They should focus on strengthening their company's diagonal value instead.

It is an inconvenient truth every manager should bear in mind: The average company cannot justify its existence. In an analysis of 400 multi-divisional companies, we found that 55 percent earn economic profits that are lower than the sum of what their divisions ought to earn if they stood alone. Other studies have found that the majority of acquisitions turn into disposals within six years and that spin-offs perform better on average after leaving their corporate owners. Whichever way you look at it, companies have a poor record of fulfilling their central purpose to add value.

What causes this poor performance? Too few corporations have figured out how to maximize the parts and the whole of an organization at the same time. To understand this conundrum, and how to overcome it, we must start by identifying the two ways in which companies traditionally add value to their constituent parts: vertically and horizontally. Vertical value is performance added through better management of the company's business units. It relies only on the bilateral relationship between the unit and the corporate center, not on the existence of any other unit within the company. Different targets, a new management team, fresh priorities or a new incentive system are all possible ways to add value vertically. Horizontal value—often called synergy—is performance added through coordination across units. Pooling purchasing, sharing a corporate brand or coordinating sales to common customers are all ways of trying to add value horizontally. An organization adds value as a whole if the net effect of its efforts to add vertical value and horizontal value is positive. This is as true for the large multi-national as it is for the small firm with two sales offices.

The problem: vertical and horizontal assets tend to cancel each other out.

Companies that look to add value vertically—to sharpen the individual performance of each business unit—very often take the route of increasing business unit autonomy. This involves reaching for some familiar levers: splitting the company into many units; devolving to these units the functions that an autonomous entity would have and conferring on them substantial decision rights; setting up incentives that mirror the kind of rewards units might receive if they were stand-alone businesses; and removing bureaucratic interference by reducing the size of the head office. These actions make it easier to adapt companywide approaches according to the differences across its business units while creating an effective context for motivating performance improvement.

Companies have a poor record of fulfilling their central purpose to add value.

Naturally, the more company leaders free up the business units to act independently in pursuit of their own performance, the more business unit managers cite "accountability" as a defense against the perceived interference that achieving horizontal benefits requires. They are quick to equate accountability (being responsible for outputs) with authority (having decision rights over inputs) and to equate authority with possession (running their inputs themselves). Consequently, horizontal value becomes very difficult to create.

Conversely, companies who look to add value horizontally—through coordinating activities and customers that are shared across business units—tend to impose company-wide constraints on their business units. They often combine business units; centralize the main functional responsibilities into shared units to remove duplication; refocus the decision rights of the business units on local sales; adjust business unit rewards to account for their membership in a wider enterprise; and add in intermediate levels of oversight and coordination to manage sharing and collective benefits.

When vertical value is raised by increasing autonomy and horizontal value is enhanced by decreasing autonomy, you end up trapped in a tug-of-war between the parts and the whole.

But as the horizontal value of the company is strengthened, business unit managers start to argue that their own performance is too dependent on that of central functions for their businesses to be held accountable. Their motivation to perform better is weakened and the distance between where decisions are made and where the consequences are felt becomes too great. Efforts to increase coordination create more layers in the organization. Accountabilities blur and opportunities to customize each business unit to its market are lost.

Of course, most companies try to add value in both directions at the same time. This brings us to the heart of the issue. When vertical value is raised by increasing autonomy and horizontal value is enhanced by decreasing autonomy, you end up trapped in a tug-of-war between the parts and the whole. This explains why the average company operates at an economic profit discount to the sum of its parts and why so many others barely operate at a premium. Autonomy and constraint don't mix well.

This challenge makes another classic management dilemma very hard to resolve as well: achieving revenue growth and profitability at the same time. Often companies chasing revenue growth use the autonomy approach until profitability becomes more of a concern, at which point they cut costs and seek to gain economies of scale through centralization. Because autonomy and constraint do not mix well, neither do growth and profitability. This helps to explain why only 32% of companies manage to achieve growth and profitability at the same time more often than not. It also explains why so many companies find themselves caught in a vicious cycle that takes them from decentralization to centralization and back again.

THE SOLUTION: STRONG DIAGONAL ASSETS

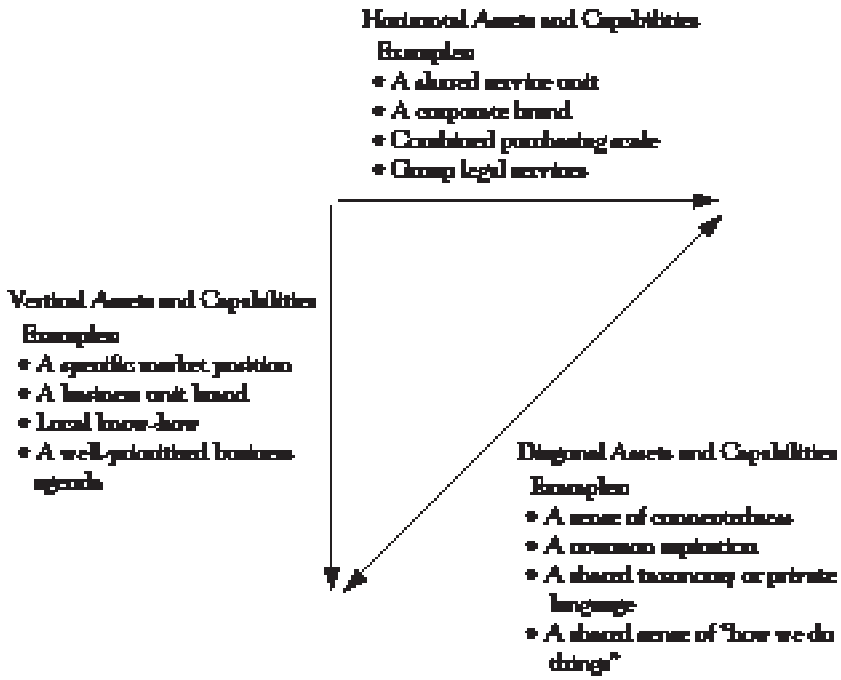
A different approach is needed to solve the problem. Think of a company's assets dividing up vertically and horizontally: They either support an individual business or happen to be shared by two or more businesses. A particular patent or technology in a business unit might be in the first category. In the second might be central payroll processing, shared logistics or the corporate brand. As we have seen, actions that nurture one type of asset often damage the other type more. But with appropriate management, the two types of assets can be mutually reinforcing. And that means paying attention to a third kind of organizational asset—diagonal assets.

Diagonal assets are special types of resources and capabilities that help a company act as both one single organization and many different businesses at the same time.

Diagonal assets are special types of resources and capabilities that help a company act as both one single organization and many different businesses at the same time. They can be tangible (a shared IT network, for instance), but the most powerful are usually intangible such as a common language or common values that underpin a company culture.

Unless companies have strong diagonal assets, efforts to create value horizontally and vertically will cancel each other out. For example, suppose you planned to add value horizontally by centralizing logistics. In theory, that should reduce logistics costs and also give business unit managers more time to focus on other customer-centric activities where the units can add more value. But if the corporate center charges back the costs of logistics through an opaque transfer-pricing mechanism, or if the businesses suspect that the head of logistics is slacking on his job, then any benefit of a sharper business unit focus from centralization will be swallowed up in argument and mistrust. Shared logistics might well be a source of new horizontal value. A sharper management focus could be a source of new vertical value. However, it takes diagonal assets in the form of trust and transparency to realize both types of value at the same time.

THREE TYPES OF ORGANIZATIONAL ASSETS



Companies often overlook the assets and capabilities that help them convert horizontal value into vertical value and vice versa. But it is these diagonal assets that are central to the ability of a company to meet the challenge of being more than simply the sum of its parts.

PRACTICAL STEPS TO STRENGTHEN YOUR COMPANY'S DIAGONAL

1 **Emphasize that every manager wears two hats.** Rather than cultivate a culture of autonomy, companies should foster a culture of "wearing two hats" —where every manager is accountable for the performance of her own individual unit and also for her personal contribution to the performance of the company as a whole. There should be clear consequences for an individual's performance in striving to add value vertically and horizontally at the same time. When he was CEO of Gillette, Jim Kilts instituted a grading system designed to give feedback to his top managers on how well they were fulfilling both roles. At the end of the year, the executive team graded the quality of its decision making and its overall performance as a team. All team members graded themselves and each team member graded each of the other team members.

2 **Standardize rather than centralize.** Textron's CEO Lewis Campbell has said, "The issue all companies face is that the corporate center wants every business unit to be the same, but every business unit wants to be different. I want to keep every business unit focused on customers and to be state-of-the-art on common processes: payroll, health care, talent development, IT, receivables, accounts payable. This can be done either by centralizing or through 'commonizing'—adopting the same language, textbook, tools, and so on, without actually creating a central function." Textron centralized some activities, such as payroll processing and employee benefits, removing responsibility from the business units. But in other areas, Textron takes the standardize approach to adding value horizontally. Rather than creating a central function, it boosts performance by creating and sticking to a Textron "playbook" for enterprise management processes, for example, in manufacturing and supply chain management. Says Campbell: "We're now at a stage where we can take specialists in many of our enterprise management processes out of any business and drop them into another business and they can be immediately effective." Textron aims to build a "networked enterprise" — a portfolio of businesses that do not share customers, costs, or competitors, but do share a common way of getting things done.

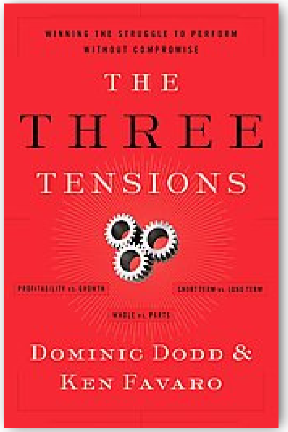
3 **Centralize when you decentralize.** In our experience, the most successful decentralization efforts we have seen have been those with a lot of concurrent centralization—for example, decentralizing authority but at the same time centralizing goals, culture, leadership development, and company standards for how strategies are developed and approved. Financial services group BBVA recently sought to empower its regional businesses in Europe and the Americas, and decided, at the same time, to strengthen the group's central control. According to José Ignacio Goirigolzarri, president and chief operating officer, "We come from a past of acting within a single harmonized model for going to market. There arrives a moment when you realize that increasing diversity will improve performance." But today, two things make BBVA more than just the sum of the parts. The first is its ability to recreate revenue synergies across the group by leveraging the company's brand and knowledge-sharing processes. The second is its ability to derive cost synergies from four shared services: compliance and procedures, funding, IT, and people. "We will, if anything, be increasing our grip in these areas. The local CEO receives support and needs to be aligned with the group on these. To make decentralization work, very strong leadership from the center is needed."

4 **Work hard on fostering a "connectedness" that doesn't rely on formal structure.** A shared belief in a higher-order purpose can be an important diagonal asset that connects the business units without the constraints of formal structure. According to Andrew Cosslett, CEO of InterContinental Hotels, "People need to know why we are here and how we are going to win. Asking them to be motivated by financial goals just doesn't cut it. They need a higher-order quest. Without a compelling story, leadership becomes exhortation." Sometimes simple physical proximity is all that's needed to create a diagonal asset. Dow Jones's chairman, Peter Kann, recalls: "When I became publisher for the *Wall Street Journal Asia* early in my career, it was very siloed: News, production, ad sales and circulation never talked to each other, even though everything they did had an effect on each other. I was the first to bring together all of these into one room of a warehouse in Asia. It worked, and I brought this model back with me to the United States."

A NEW ANGLE ON ADDING VALUE

The typical company is plagued by the low value-added, intractable tension between growth and profitability and oscillation between centralization and decentralization. Companies that want to overcome this should avoid prioritizing one direction—vertical or horizontal—over the other. Instead, they should work to strengthen those assets and capabilities that allow a company to add value in both directions at the same time. This means nurturing diagonal assets such as connectedness, cultural norms, and common aspirations for performance. With a strong diagonal, a company has higher odds of adding real value.

info



BUY THE BOOK
Get more details or buy a copy of Dodd and Favaro's *The Three Tensions*.

ABOUT THE AUTHOR

Dominic Dodd (ddodd@marakon.com) is a director of Marakon Associates, an international management consulting firm headquartered in New York and London. Ken Favaro (kfavaro@marakon.com) is Marakon's co-chairman and former chief executive. They are the authors of *The Three Tensions: Winning the Struggle to Perform Without Compromise* (Jossey-Bass, January 2007).

SEND THIS

Pass along a copy of this manifesto to others.

SUBSCRIBE

Sign up for our free e-newsletter to learn about our latest manifestos as soon as they are available.

BORN ON DATE

This document was created on June 6, 2007 and is based on the best information available at that time. Check here for updates.

ABOUT CHANGETHIS

ChangeThis is a vehicle, not a publisher. We make it easy for big ideas to spread. While the authors we work with are responsible for their own work, they don't necessarily agree with everything available in ChangeThis format. But you knew that already.

ChangeThis is supported by the love and tender care of 800-CEO-READ. Visit us at 800-CEO-READ or at our daily blog.