

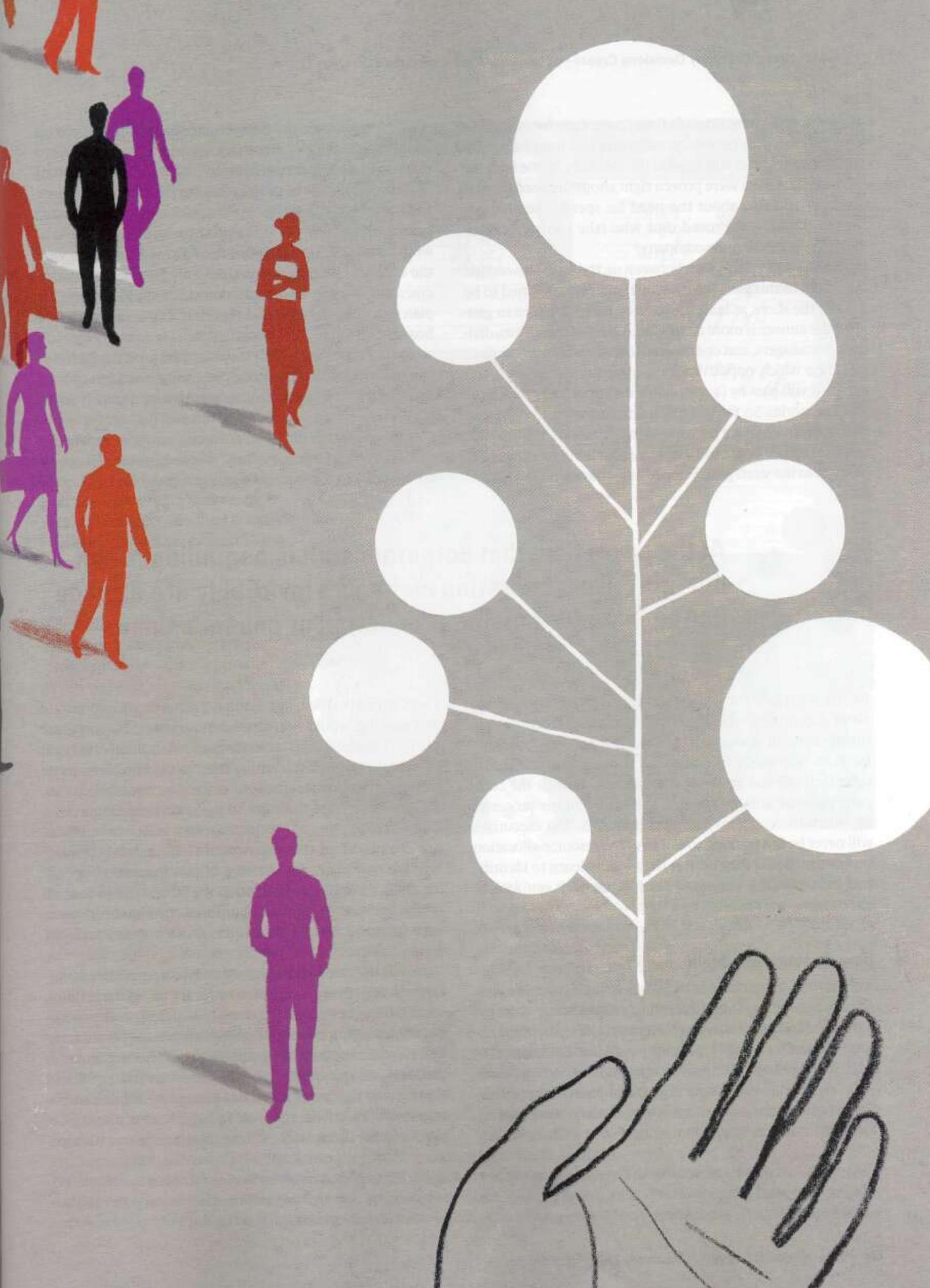
The cumulative impact of the allocation of resources by managers at any level has more real-world effect on strategy than any plans developed at headquarters.

How Managers' Everyday Decisions Create or Destroy Your Company's Strategy

by Joseph L Bower and Clark G. Gilbert

OUR FAVORITE STORY about how strategy really gets made comes from a visit one of us - the lead author-made to a large company's headquarters. The company controller was concerned and confused about a capital project proposal he'd recently received from one of the company's most important divisions: a request for a large chimney. *Just* a chimney. Curious, the controller flew out to visit the division and discovered that division managers had built a whole plant (minus the chimney) using work orders that did not require corporate approval. The chimney was the only portion of the plant that could not be broken down into small enough chunks to escape corporate scrutiny.

The division managers, it seemed, were eager to get on with building a new business and had despaired of getting corporate



approval within a reasonable time frame. Convinced that the new capacity was necessary, managers had found a way to build the plant but still needed the chimney. In the end, the division managers were proven right about the need for new capacity and also about the need for speed. The chimney was, ultimately, approved. But who (the controller wondered) was running the company?

We've spent many years, between us, trying to answer that question. In this case, the divisional managers seemed to be calling the shots, at least for their own division. But in general, the answer is more complicated: Senior executives, divisional managers, and operational managers all play a role in deciding which opportunities a company will pursue and which it will "pass by (a reasonable definition of "strategy" in the real world). So, for that matter, do customers and the capital markets. What we have found in one research study after another is that how business *really* gets done has little connection to the strategy developed at corporate headquarters.

At the same time that corporate staff is beginning to roll out initiatives, operating managers invariably are already acting in ways that either undercut or enhance them.

Rather, strategy is crafted, step by step, as managers at all levels of a company - be it a small firm or a large multinational-commit resources to policies, programs, people, and facilities. Because this is true, senior management might consider focusing less attention on thinking through the company's formal strategy and more attention on the processes by which the company allocates resources. Top executives will never be in a position to call all of the resource-allocation shots-nor should they be. But they should learn to identify, and influence, the managers at all levels who can forever alter a company's future.

How Strategy Gets Made, and Why

A somewhat longer case story will help illuminate the connection between resource allocation and corporate strategy. It involves Lou Hughes, who took over as chairman of the executive board of Opel, General Motors' large European subsidiary, in April 1989. Just seven months later, in November 1989, the Berlin Wall came down, and shortly thereafter, Volkswagen, Germany's number one automobile producer to Opel's number two, announced a deal with East Ger-

many's state automotive directorate to lock up all of that country's automotive manufacturing capacity and to introduce an East German car in 1994.

A corporate view of strategy making in response to the tectonic crash of the Berlin Wall would have Hughes's staff gather information to be relayed to corporate staff, who would then develop a plan that fit GM's overseas strategy. (At the time, this strategy was to make cars in large, modern, focused factories in low-wage countries such as Spain). The plan would be debated and then possibly approved by the board of directors. The process might take a year-especially since very little concrete data was available on the East German market, and East Germany was still a sovereign country with its own laws and currency guarded by 400,000 Soviet soldiers.

Instead, Hughes did as an energetic, entrepreneurial manager running a large subsidiary in a foreign country would do: He worked vigorously to secure a place for Opel in the

East German market, in ways that did not fit with corporate strategy and would not have been approved by corporate planners. Rather than waiting to gather data, he created new facts. Acting on an introduction from an Opel union member to the management team of one of the directorate's factories, Hughes negotiated the right to build new capacity in East Germany. He allowed the local factory leader to publicize the deal, induced then-chancellor Helmut Kohl to subsidize the new plant, and drew on talents from other operating divisions of GM to ensure that the facility would be state of the art. GM Europe and corporate headquarters were kept informed, but local decisions drove a steady series of commitments.

As was the case in the chimney story, corporate headquarters was effectively preempted by local management doing what it thought best for the corporation. Despite the apparent contradiction between Opel's plans and corporate strategy, Hughes proposed the commitment of resources, and his proposal was approved first by the European Strategy Board and then by the corporation. Top management (over corporate staff's objections) endorsed Lou Hughes's bottom-up action-and his vision for the future-because he was the local

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manager, because he had a good track record, and because he was thought to have good judgment. It was more an endorsement of Hughes than of his plan per se.

Does the Opel case demonstrate how resource commitments shape strategy, or is it just an example of an organization out of control? Traditionally minded strategy planners may assume the latter. In fact, the Opel story highlights what we have found to be near universal aspects of the way strategic commitments get made. These fall into two categories.

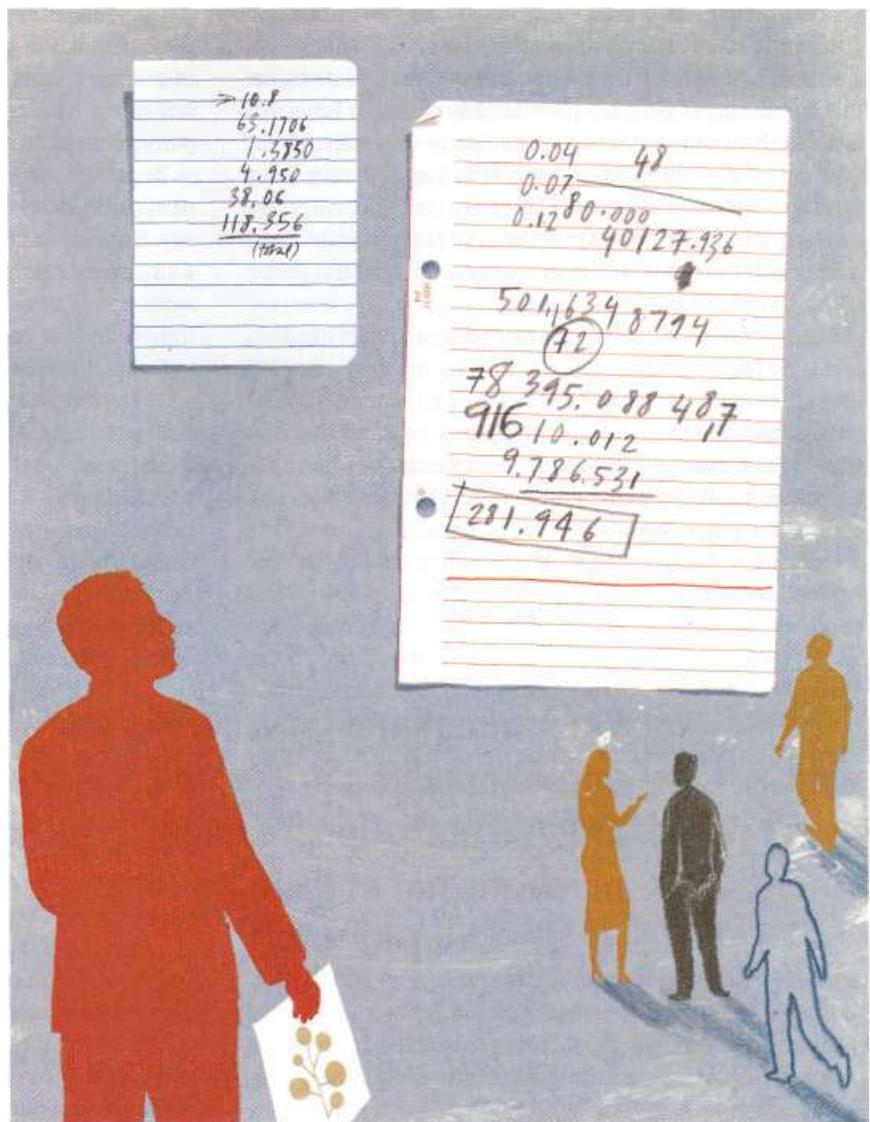
Organizational structure. The fact that, at any company, responsibility is divided up among various individuals and units has vital consequences for how strategy gets made.

Knowledge is dispersed. For any given strategic question (such as how Opel should enter the East German market), relevant expertise resides in scattered, sometimes unexpected parts of a corporation. When the wall tumbled, managers in the West understood almost nothing about the East German market. The first GM managers to develop any useful knowledge, not surprisingly, were the ones on the spot: Opel's marketing staff. Meanwhile, the GM employees with deep knowledge about lean manufacturing techniques, which would

be needed for the new venture, were in California and Canada. Those with the deepest knowledge of overseas strategy and profitability overall were in Detroit, Michigan-but European strategy was developed in Zurich, Switzerland.

Power is dispersed. Lou Hughes's formal authority was limited. He could fund studies and negotiate with East German counterparts, but he could not command his manufacturing director to work with California, nor insist that California work with Opel. The right to approve a plant in a new country lay with the board of GM. For permission to present to the board, Hughes would need to go through GM Europe; in addition, financial and other corporate staff could (and would) provide evaluations of their own. Nonetheless, Hughes's negotiations with the local factory manager and Helmut Kohl could virtually commit GM.

Roles determine perspectives. Miles's Law - the notion that where you stand is a function of where you sit-is cen-



tral to how strategy gets made in practice. All the managers who would need to cooperate to make an East German initiative possible had different sets of responsibilities for resources and outcomes (like specific levels of sales by model and in total) that shaped their perspectives about what success in a new, eastern European market would look like and what it would be possible to achieve. They all considered a different set of facts, usually those most pertinent to success in their individual operating roles. Hughes's triumph was to convince a group of managers with limited authority that they could deliver on a radical idea.

Decision-making processes. Just as important, the way decisions are made throughout an organization has vital consequences for strategy.

Processes span multiple levels; activities proceed on parallel, independent tracks. The notion of a top-down strategic process depends upon central control of all steps in that

process. That level of control almost never exists in a large organization—quite the reverse: At the same time that corporate staff is beginning to plan for and roll out initiatives, operating managers invariably are already acting in ways that either undercut or enhance them. Hughes was developing a strong relationship with Helmut Kohl and obtaining funding for a new East German plant even as GM's corporate staff was looking over sales forecasts and planning GM's next moves in Europe: focused factories in countries that probably would not include East Germany.

Processes are iterative. Crafting strategy is an iterative, real-time process; commitments must be made, then either revised or stepped up as new realities emerge. GM's first commitment came when Hughes took part in a factory worker vote that committed the East German spin-out to Opel; this public act made it hard for GM to back out, especially as Hughes was already lobbying with Helmut Kohl for subsidies. A second level of commitment was obtained when GM funded a facility to assemble 10,000 cars, and

its total sales. Intel's lower-level managers had already exited the business. What Intel *hadn't* done was shut down the flow of research funding into memory (which was still eating up one-third of all research expenditures). Nor had the company announced its exit to the outside world.

Because knowledge and power span organizational levels, managers at each level are likely to have an impact on strategy. External forces can also have a strong effect on how resources are allocated, and, in turn, how strategy evolves. The most powerful of these forces are the company's best customers and the capital markets.

General managers. Strategic decisions are critically affected not just by senior corporate managers, but also by midlevel general managers, their teams, and the operating managers who report to them. These intermediate-level general managers run the fundamental processes that make multibusiness, multinational companies feasible. They are general managers who report to other general managers. Their jobs involve translating broad corporate objectives

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those cars were presented to German consumers with massive publicity. Soon after, a third stage was reached when a major manufacturing facility was built. GM's strategy for East Germany was revised at each step along the way. How the automaker's European strategy developed after that would turn on events to come, particularly the movement of currencies and labor costs and developments in GM leadership assignments.

Who's in Control?

A leader can announce a strategy to become global, change core technologies, or open new markets, but that strategy will only be realized if it's in line with the pattern of resource allocation decisions made at every level of the organization. Another well-known business story - Intel's exit from the memory business - illustrates this point. Legend has it that Andy Grove and Gordon Moore were talking about what business Intel should be in. Grove asked Moore what they would do if Intel were a company that they had just acquired. When Moore answered, "Get out of memory," Grove suggested that they do just that. It turned out, though, that Intel's revenues from memory were by this time only 4% of

such as earnings and growth into specifics that operating managers can understand and execute on. They provide corporate management with an integrated picture of what their businesses can accomplish today and might achieve in the future by determining the package of plans, programs, and activities that should drive the strategy for that business.

One of the most obvious ways that these managers in the middle affect strategy is through their decisions about which proposals to send upward for corporate review. One top executive we interviewed communicated his surprised realization of this role: "One fascinating moment came as I met with a key midlevel manager. I had mapped out on a piece of paper the resource allocation process and its effect on the intended and emergent strategies. As we talked, this manager proudly told me that he was the one who set the strategy, not the CEO or board of directors. According to him, he owned the resource allocation process because his boss, who was president of the largest business unit, would not approve anything without his recommendation."

Operational managers. Most strategy analysts ignore the role operating managers have on strategy outcomes, assuming that these managers are too tied to the operational requirements of the business to think strategically. Senior execu-

utives overlook the very real impact of operating managers at their peril. For example, in 2000, Toyota launched the Echo, a no-frills vehicle designed partly to protect Toyota from low-cost competition. But deep inside that organization sat salespeople in local retail operations. Because margins (and, more important, sales commissions) were higher on other Toyota vehicles, customers were repeatedly steered toward higher-priced models. Even though the corporate office placed a high priority on the new product, the day-to-day operating decisions of the organization directed the realized strategy of the firm elsewhere.

From the Toyota example, one might conclude that operating managers (salespeople, in this case) constrain innovation because they are not aligned with the strategy of the firm. However, operating managers can redirect and improve strategy in very innovative ways. At Intel, the exit from memory took place over time, because the managers in manufacturing responded to a directive from finance: Allocate plant space so as to maximize gross margin per wafer square inch. Memory and microprocessors used the same silicon wafers, so as competitive conditions worsened in memory, the rule took Intel right out of the business.

Customers. Customer decisions can play a huge role in real strategy formation, particularly in businesses with a few very powerful customers. Companies that stay close to their best customers give them a virtual veto on product development and distribution. By the mid-1990s, Tony Ridder at Knight Ridder recognized that the Internet was going to have a dramatic effect on his newspaper company. Accordingly, he redirected corporate strategy to focus on the Internet, presented annual reports that discussed plans for new media, and moved the headquarters from Miami to San Jose. Despite these bold efforts to change the corporate strategy, the realized strategy continued to be largely controlled by existing advertising customers in the newspaper business. Every day, sales reps had the choice of selling a \$40,000 print display ad to their existing print customers or promoting a \$2,000 online ad that was unfamiliar, even uninteresting, to these same advertisers. And every day, the sales reps made the logical choice to sell traditional print ads. Despite the explosive growth in online advertising, Knight Ridder and other newspaper companies were largely unsuccessful at tapping into this new and evolving revenue stream. Through their influence on the sales force, the print advertising customers effectively captured the newspapers' resource allocation process and, in effect, its strategy.

Capital markets. Most observers understand that capital markets influence management performance. That they can dramatically reshape strategy is less well documented, but equally true. Earnings pressure can cause a company to exit a market too soon; a dip in stock price can cause a company to scramble to improve short-term performance. One of the clearest cases of this phenomenon comes from a natural experiment in the U.S. telephony market that one of our doc-

toral students examined. BellSouth and U.S. West were two Baby Bells that formed when AT&T was broken up. Both were born with the same technology, patents, and planning models. Despite their similarities, the capital markets determined that U.S. West's growth prospects were inferior to those of its sibling. In the face of the consequent pressure on earnings, U.S. West's CEO chose to diversify by moving away from regulated telephony and to set high earnings objectives. To meet those objectives, the managers of the cellular business (the general managers in the middle) adopted a strategy of skimming, that is, seeking high margins on the low-volume top end of the market.

Facing less-intense short-term pressure from the capital markets, BellSouth chose to treat cellular as an opportunity with earning potential equal to that of its wire line business and with much better growth prospects. Managers pursued a strategy of broad market penetration.

BellSouth's and U.S. West's strategic objectives were reflected in the performance measures that were set for the two businesses. Despite similar early performance, the different measures led the two companies to reach very different conclusions about the cellular market. U.S. West was disappointed by results that failed to reach the high financial targets it had set. BellSouth was pleased with the positive first steps and made further investments. U.S. West ultimately divested its business, while BellSouth became one of the leading cellular providers.

Manage It Anyway!

If divisional, middle, and operating managers—as well as customers and capital markets—have such a powerful impact on the resource allocation process and, in turn, on the realized strategy of the firm, what does that imply for the role of corporate leaders? Is the process of strategy formation entirely out of their hands? Of course not. We believe that the complexity of the resource allocation process only increases the need for leadership at the top. But senior leaders have to understand what is happening and adjust their management styles accordingly. Here are six ways that senior managers can direct the strategy of their firm by better understanding the resource allocation process.

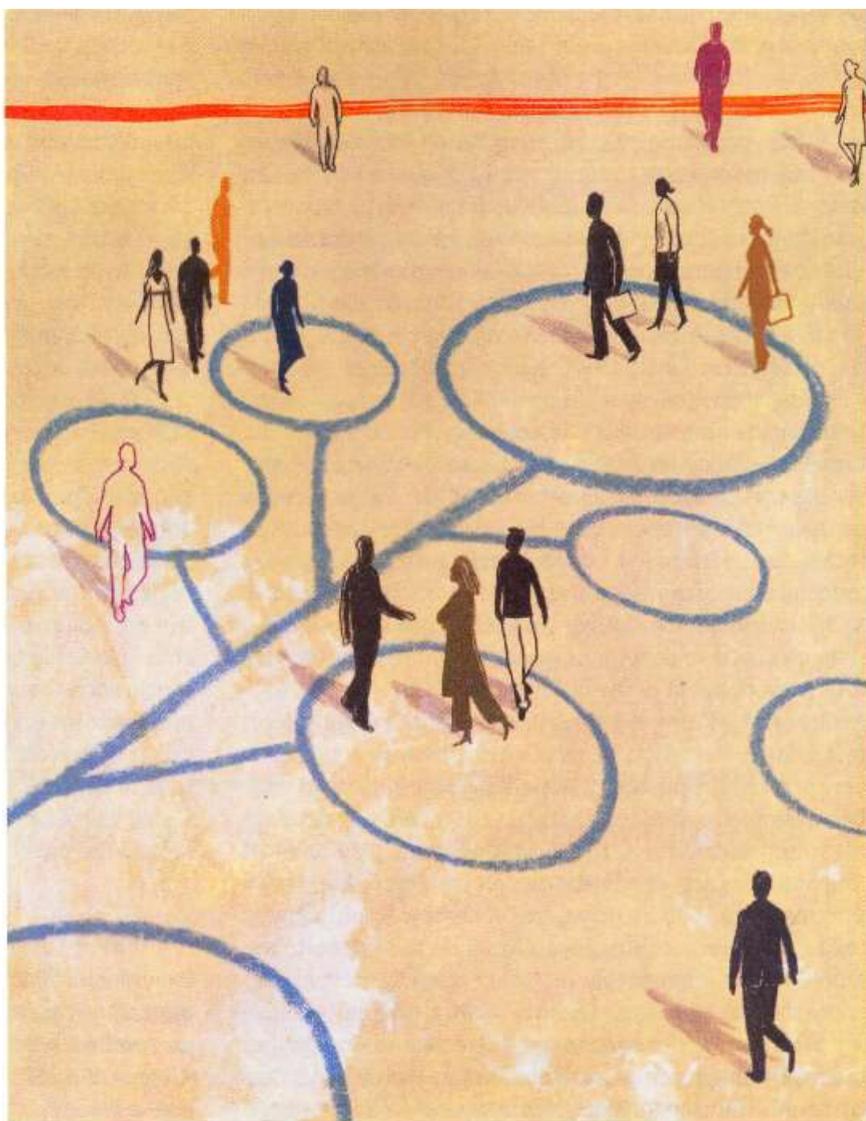
Understand the people whose names are on the proposals you read. When you read a proposal to commit scarce people or capital, you should calibrate what you are reading against the track record of the executive who signed the document. If the signing executive has a near-perfect record of proposals implemented, then you know that there is probably little downside in what you are reading, but the upside may be significantly underexploited. Requests for resources are based on stories about the future. Those stories may be summarized with numbers, but they represent judgments about uncertain developments. Very often, your managers' judgment - and your capacity to judge their judgment! - is

more important than the actual numbers presented. This reality will kill your finance staff, because they are good at crunching numbers, not at gauging what managers understand and what they don't.

Recognize the strategic issue, and make sure it is addressed.

Almost always, requests for resources require making two decisions: *Should we support this business idea?* and *Is this proposal the right way to go about it?* Most capital budgeting processes are set up to vet projects (in other words, they're aimed at the second question, not the first). It is usually possible to carry out fairly rigorous quantitative analysis comparing the plan of action in a proposal with alternatives. It is important that this analysis be done - and it is often done ad nauseam. But our research shows that the first question, the *business* question, is more important and far more difficult to answer - and it is often ignored. It is easy to invest money in cost-saving projects that will earn precisely the returns forecast in businesses that are losing money overall. After the project, they just lose less. One of our studies showed that companies and their industries poured new money into old technology at the same time that they were investing in facilities based on new technology that made the first set of investments obsolete. Managing resource allocation to build sound strategy requires that the proposal evaluation process begin with the "should we?" question. Should we put a plant in East Germany? In the end, you may decide to back managers rather than their logic, because you want to support them. But do it with your eyes open and controls in place.

When a debate reflects fundamental differences about the strategy, intervene. The "should we" question inevitably focuses on basic issues about how the company wants to compete. It almost always involves evaluating different views that reflect the positions of the executives in question. Lou Hughes thought that he could use a new East German facility to drive change at Opel's main plant. Some at GM headquarters thought it more important to continue expansion at low-cost sites in southern Europe and Latin America. Smart executives use resource allocation opportunities like a new



Opel plant in East Germany to trigger strategic discussions that cross organizational perspectives. They bring together managers with different kinds of knowledge to discuss the evolution of strategy, not the details of a project proposal. Andy Grove calls this "getting knowledge power and position power in the same room at the same time." Top executives will almost always have to convene that meeting and pay attention to who is invited. They will also have to work hard to create a collaborative environment.

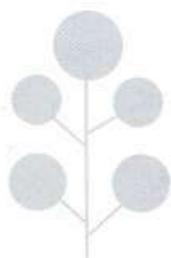
Use operational managers to get work done across divisional lines. When top managers believe that the right way to serve a market will require two or more divisions to cooperate, they face an immediate problem. Divisional managers obsess about the prospects for their own businesses. A bottom-up approach does not naturally foster cooperation because these managers view the resource allocation process as a way to protect their turf. (They also come at the

same strategy question from quite different perspectives - Miles's Law!) Because of this, executives need to reach down to operational managers if they want divisions to cooperate. If freed from divisional measurement and compensation systems, operating talent can be engaged by the opportunity to serve customers better. It won't happen automatically, but we have seen numerous cases in which cross-divisional teams that were assembled and supported by top leadership have been able to work together, even when their divisional superiors resisted the project. For example, marketing services giant WPP successfully created virtual companies, made up of staff from various units, to focus on retail and health care markets. While some division heads saw this as an encroachment on their mandate in these areas, the operating managers reveled in their ability to collectively solve client problems. Of course, the easiest way for a division head to undermine such a project is to deny it the right people.

source allocation process. It is top management that has to ask, "Is there a technology under development that looks inferior or uncertain today but will undermine our business from beneath once it is properly developed?" Windows NT had this impact on UNIX applications, for example, as did Internet applications on a host of industries. It takes a very well-informed paranoia to ask this question early enough to keep a strong company in the lead. A decision to pursue out-of-the-box ideas often requires a new box: a separate organizational unit with a new location, milestone-type measures instead of annual budgets, and short reporting lines to the top.

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The implication of these six recommendations is really a meta-recommendation. Once you realize that resource allocation decisions make your strategy, then you know you can't rely on a system to manage the resource allocation



Division managers view the resource allocation process as a way to protect their turf. Executives need to reach down to operational managers if they want units to cooperate.

Top managers must make sure that the right questions are asked and that the right people are made available to work on those questions.

The leadership has to connect the dots. Understand that bottom-up resource allocation processes do not add up to a corporate view. Top management may have to lay out the big picture when more than one division is (or ought to be) involved in a strategy question. When bottom-up processes are at work, several problems can occur. Conflicting divisional perspectives tend to resolve themselves on the basis of which unit has the most power. Or, divisional managers make compromises that share resources in ways that seem fair on paper but are not the best approach strategically. Worse, a division may agree-explicitly or tacitly-not to challenge another division's proposals in return for the same treatment. In many companies, that is the norm. It will be sheer coincidence if the result of this system is what the company could achieve if the divisions were working together with a coherent plan. Top management needs to step in and frame questions that reflect the corporate perspective, especially when large sums of money are involved and conditions are highly uncertain. They must get divisions to ask, "What's best for the company?"

Create a new context that allows leadership to circumvent the regular resource allocation process. Most out-of-the-box or disruptive ideas are badly handled by a bottom-up re-

process. No planning or capital-budgeting procedure can substitute for the best leaders in the company making considered judgments about how to allocate resources. No system of incentives will align divisional objectives so that new opportunities will be studied with the corporate interest in mind. Because of its impact on strategy, the corporate senior management has to engage itself-selectively, to be sure - in the debates that mark inflection points in the process.

This is where top-down process is vital. If you're part of the leadership, you can't delegate responsibility for your company's direction. At Intel and Opel, divisional managers took the right action. But that is often not the case. The management of the mining or semiconductor divisions at GE didn't tell Jack Welch to divest. The management of the television set businesses did not tell Frank Dangedard to shift Thomson into digital postproduction. Quite the contrary, those divisional managers were generating proposals to grow their businesses. The leadership challenge is to give coherent direction to how resources are allocated and, by doing so, align the bottom-up processes with top-down objectives. That's how you drive strategy in a big organization.

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