Designing the Leveraged Organization

The easy days of the pure SBU are gone as the world continues to turn into a modular one of cross-unit synergies, outsourcing and strategic alliances. This rotation means more companies must perform a balancing act—breaking apart value chains while still making sure the new interfaces fit with the corporate strategy.

HATS OFF FOR A MOMENT as we honor the strategic business unit (SBU) in its original and purest form—an immensely convenient organizational device in its day. Much as a child's wooden block can serve as the building unit for an elaborate play castle, the SBU served as the fundamental unit for highly diversified companies, with the accompanying benefits of entrepreneurial control, clear accountability and efficient measurement.

And now hats back on—for we all know that the easy days of the pure or even semipure SBU are past. In the new modular world of today, what was once acceptable verticality is increasingly being sacrificed in the name of cross-unit synergies, radical outsourcing, the emergence of new businesses out of what had once been functions, and the pursuit of growth through strategic alliances at the same functional level.

A company such as Palm, which is assembled around only the most important parts of its value chain, while contracting out for nearly everything else, is no longer viewed as an exception but as an example. Companies such as DHL and UPS are remarketing their expertise, transforming what had once been strictly internal capabilities into everything from software solutions to consulting on logistics strategy. Meanwhile, other companies are cutting across or redefining traditional SBU boundaries in their own search for competitive advantage. As just one example, DSM, the Netherlands-based international chemicals firm, has recruited 250 new researchers into several small "innovation teams," grafting these teams like exotic cuttings onto the rootstock of its main organizational structure. The hope is that the new businesses will flourish more readily in an environment free from the responsibilities of a full-fledged SBU.

The evolution is such that many companies are in danger of being overwhelmed by the number of seemingly inviting opportunities for "synergy" or "leverage"—whether in the context of sharing activities or outsourcing them. Your brand manager wants to co-brand a new product range with another company. Your logistics manager wants to bundle your flow of goods with two other players to achieve better service levels at lower costs. Another manager has a chance to create a new business but needs capabilities too costly to develop in-house—so they'll have to be sourced from outside. The more diversified the company, the longer the list.

In and of itself, each opportunity is welcome. The problem comes with having to choose among so many. You could just leave individual decisions to the SBU managers, as in the old days. But as value chains are broken apart, there is the potential for havoc if the new interfaces and requirements don't fit with the corporate strategy (this is especially risky with external alliances), or if what benefits one business unit ends up harming another. For that matter, even the corporate strategy should be influenced by the opportunities available to the businesses—but this influence must be brought under at least some control, and not utterly ad hoc.

The SBU as the basic unit of the organization can't and needn't be abandoned—but the old model of the child's building block won't work either. Something more is needed to help make the right decisions.

What we propose here are practical guidelines—some particular analyses followed by a recipe—for the leveraged SBU, or if you like, SBU 2.0. The analysis will proceed from two directions: from the bottom up, by examining the leverage potential (whether for growth or for economies of scale) for each significant piece of each value chain. We also analyze from the top down, by synthesizing the data to judge how

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well a given opportunity aligns with the overall strategy and with the needs of the other SBUs. Combined with the recipe, this allows the organization to see and evaluate many opportunities, not just the obvious or the trendy, and to make the best trade-offs in deciding which to pursue and which to forgo.

New Responsibilities and Roles for SBUs and Corporate

By necessity, SBU 2.0 implies not only new responsibilities but also a new mindset. Business managers, for example, should no longer boast of managing tens of thousands of people, but rather of managing and developing their core business through a network of contracts providing the nonproprietary portions of their value chains.

Specifically, we suggest that business units do the following:

- Organize around the most crucial parts of the value chain
- Acquire a contract-oriented mindset toward noncrucial parts of the value chain and be able to articulate confidently under which conditions these will be sourced
- Prioritize the opportunities for leverage or growth such that they can readily be pursued, whether internally or externally

Corporate, meanwhile, will take on the following responsibilities:

- Actively manage the trade-offs and potential conflicts between serving the one business or the many in a multibusiness company
- Encourage an environment in which value chain interfaces can be measured and managed effectively, and parts of the value chain are routinely sourced
- Prioritize and create new functional businesses where relevant

Twisting Apart the Value Chain For Insights

What follows doesn't call for any unusual organizational model in the formal sense. The assumption is simply that the multibusiness leveraged corporation will contain resource-contracting SBUs, a select group of functional businesses, and a corporate center capable of making trade-offs between the two types. SBU boundaries might end up being redrawn from time to time as a result, but that goes with the mindset we discussed earlier.

We start at the SBU level with an analysis of the value chain. This might seem like nothing new, except that our analysis is quite focused: We want to develop three key insights about each significant activity or cluster of activities.

This can be accomplished by answering three questions: What are the optimization characteristics and potential of each part? What characteristics are key to value creation? What is the fit with strategy?

Although initially we do the analysis separately for each SBU, it is important to use common criteria—we like to call it a common language—to make it easier to view the collected insights from a corporate perspective. Seeing all the possibilities at once, we can then choose the optimal redesign for our value chains and our company based on a simple three-part recipe.

To demonstrate the process from start to finish, let us invent a hypothetical pan-European brewing company, EuroBrew. Our company is modeled in broad terms after such well-known names as Heineken, InBev! and Carlsberg, and has resulted from a whole series of acquisitions in both Western and Eastern Europe. These acquisitions have so far been grouped by country—mostly because beer market conditions vary significantly among countries. So, for that matter, do the positions of EuroBrew, our brewing company: It dominates in some countries, but is a distant third in others.

Please bear in mind that with this example we're not pretending to teach brewing industry experts a thing or two—nor should our conclusions be extrapolated to real life. We choose brewing only because the industry has such clear characteristics, making it easy to demonstrate how the corporate and SBU perspectives will play out. And of course, many people seem to find it easy to relate to the industry's products.

Let us now look at the questions we need to answer to analyze the value chain of any given SBU:

What are the optimization characteristics and potential of each part? Here we examine each major part of the value chain, seeking to determine any intrinsic horizontal synergies or cross-unit opportunities, as well as the potential for internal and external growth. From our example, figure 1 provides an overview of the characteristics and potential for sharing activities along the major parts of the value chain in the brewery industry.

Which parts are most important to creating new value? We determine how important the different value chain parts are for value creation. Not all parts are created equal, and those that are more important should have a bigger impact on the core design of our organization.

For our brewing company in particular, two pieces are crucial for value creation:

Facts Rather Than Opinions

One danger in making organizational design changes is that things will bog down in arguments over the ideal organizational model and how to get there: lots of theory, lots of examples pulled from this study or that, but no way for any given proponent to prove that anyone is right.

By contrast, the guidelines offered here are based on relevant, factual analyses and insights. For example, looking at the different value chain elements will reveal which functions should be shared across all business units versus those best left to the individual business that they serve. Another discovery might be that certain parts of the value chain would benefit from added size—and if that size can't be found internally, then external alliances can be sought. The effect is to force companies to articulate strategic priorities concretely in terms of actions that must be taken.

FIGURE 1

What can be leveraged in the brewery industry?

Value chain part	Characteristics and leverage potential
Local brand equity	As the name suggests, brand equity is local in nature. The footprint of some beer brands is even restricted to individual cities in Germany, for example. Therefore, finding synergies among existing local brands is usually limited to within individual countries.
Global brand equity	Our company has two brands that can be considered global and that enjoy premium prices outside the countries of origin. Here we have substantial growth potential—for example, by acquiring local brewing companies or by forging distribution alliances in countries where EuroBrew is not yet present.
Distribution	Distribution is so local in nature that it benefits only from increased volume locally—for example, by selling more beer—or by broadening its scope to sell mineral water, sodas and fruit juice in addition to beer.
Sales and marketing	Sales and marketing is leverageable primarily at the country level—although best practices can be employed universally.
Filling and packaging	Because it is so capital intensive, this piece benefits from horizontal synergies and leveraged growth opportunities. Scale optimization (within the realistic boundaries of what it takes to ship beer) can make a material contribution not only to cost advantage but also by providing more packaging flexibility to support promotions, retail-specific offerings and more product variety. Obviously, the global premium brands can travel further.
Brewing	By comparison, the brewing process is less capital intensive and so does not benefit from economies of scale.
Ingredients	Purchasing the main ingredients (hops, wheat, yeast, bottles, cans and equipment) can benefit from economies of scale.
Research and development	Brewing companies spend relatively little on R&D, so optimization is not so much about size but more about sharing innovations across the different countries.
Support functions	Support functions enjoy substantial scale advantages at the country level and across countries. Pursuing these will help build a platform for leveraging other parts of the chain.

Source: A.T. Kearney

brand equity and access to distribution. Say that the organization acquires a competitor in a neighboring country. One choice would be to consolidate brewing plants, closing some of them down in the name of savings. Very often, however, more value can be created by exploiting one of the company's existing global brands through the newfound access to distribution.

What parts of the chain are most important for strategy? Finally, we identify the value chain requirements necessary to drive competitive strategies. For example, EuroBrew might seek advantage through the ability to provide retailers with highly flexible promotional support and specific packaging formats. It might also seek advantage through the ongoing creation of custom formulations of its beers, such as seasonal beers, football championship specials or beers with unique tastes or packaging. Either of these differentiators will demand great flexibility from certain parts of the company's value chain. For example, it will be vital to be able to tap into horizontal

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synergies for filling and packaging, even to the extent of involving third parties.

On the other hand, if our company aims for competitive advantage through the consistently excellent quality of its beer, it will favor large batches produced in a controlled environment. This would require a value chain with a fundamentally different configuration. Either way, the resulting requirements will determine to a great extent the conditions under which the company will feel comfortable either contracting for or sharing specific services. In a multibusiness environment, this extends to the willingness to partner with other businesses as a means of tapping scale advantages.

A Recipe for the Leveraged Organization

We should now understand what activities could be put forth as candidates for horizontal synergy or leveraged growth. We should also have an idea as to which leverage opportunities are more important than others, based on their relative contribution to overall business results. Finally, we should have a clear understanding of how our company's strategy bears on all of these opportunities, pro and con. Armed with our insights, it's time to construct an organizational design that not only chooses the most appropriate opportunities but also firmly anchors control and coordination. Although it sounds forebodingly complicated, the essential recipe has only three steps:

Focus on the most important parts. The most important parts of the value chain—those that contribute the most to overall value creation—must be served first in our organizational design. In other words, these should have the biggest influence on such organizational dimensions as geography, applications, products and technologies. The result will be that the managers involved will have control over the most important parts of their businesses, and within the right setting.

Back to our brewing company. Having looked at global brands, local brands and distribution, EuroBrew will likely come to a number of conclusions. First, it's clear that local brands have different managerial needs from global brands: The former want local optimization and distribution, whereas the latter want access to and management of global distribution. So it makes sense to sharpen management focus by creating a like-minded organizational distinction—by having one SBU for local brands and distribution, and another SBU for global brands and global distribution. Second, it's also clear that various geographic regions have different characteristics.

FIGURE 2

A brewing company applies the three-step recipe

STEP 1: Focus on the most important parts

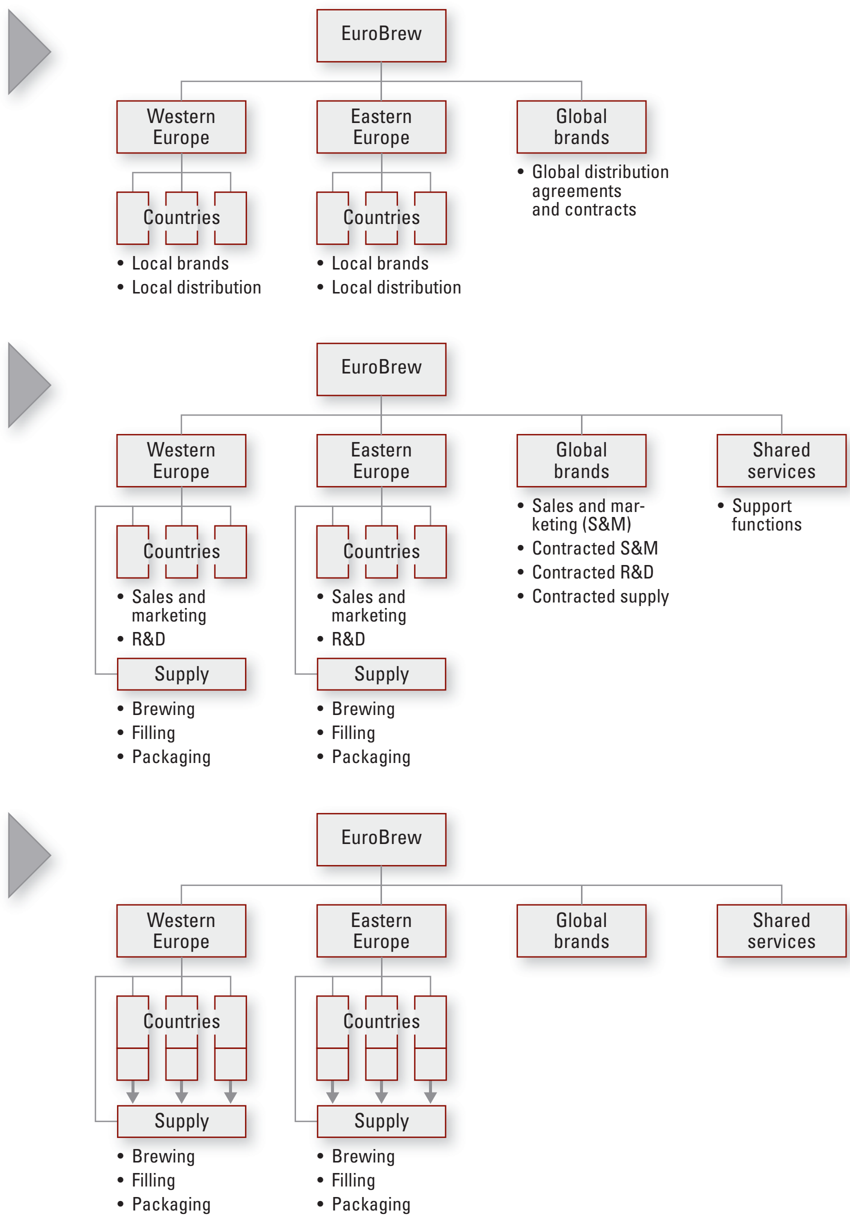
The needs of global brands, local brands and (access to) distribution

STEP 2: Be prepared to leverage the rest

The needs of sales and marketing, brewing, filling and packaging, R&D and support functions

STEP 3: Unless there is a good reason not to

Threats to the vertical integrity of the company have to be mitigated during the transition



Source: A.T. Kearney

For example, there's a big difference in price levels between Western and Eastern Europe. The organizational response to this knowledge might well be the creation of two regionally focused SBUs for local brands and distribution. Figure 2 offers an illustration.

Even this first step reveals a crucial difference between the design process for a leveraged organization and a more traditional one. As discussed in the sidebar, *Facts Rather Than Opinions*, on page 8, our design is driven by the optimization requirements of the most

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important parts of the company's value chain, thus ensuring that they are served optimally—not by haggling over the virtues of one formal model versus another, such as centralized versus decentralized.

Be prepared to leverage the rest. Once the core organizational dimensions have been determined, we can assess the fit of the remaining parts of the value chain. If a given function or activity is easily handled by a business, and has no further synergy or leverage potential outside that limited role, it should stay within that SBU. However, if the fit is bad, or if there are sufficient opportunities to build synergies or exploit leverage potential, then we take it further. We enable that leverage or synergy by anchoring it appropriately, perhaps through establishing a separate service unit. If the potential extends not just across business units but outside the company, other forms of organization can be considered, such as outsourcing, insourcing or pooling. We're not likely to pursue all such opportunities—but based on our assessment, we can now prioritize them.

Our brewing company is likely to come to several conclusions:

- For the most part, sales and marketing can stay local by country to accommodate market differences, the exception being the group looking after global brands. Corporate will still push for the use of best practices and standards.
- For R&D, a similar reasoning, but with even stronger central guidance, will apply.
- Brewing, filling and packaging can't be left to local countries. There's simply too much to be gained from horizontal synergies and opportunities for external leverage. This applies to both a cost and a performance perspective. One implication is that a supply company should be considered at the subregional level or perhaps even firmwide.
- Support functions enjoy generic leverage and are prime candidates for centralization.

Don't leverage when there is good reason not to. In our experience, so many companies are coming from a mindset of vertical integration that asking which processes or functions should be leveraged often brings things to a standstill—you're likely to get 1,001 seemingly plausible reasons as to why one thing after another can't be. An alternative is to proceed in reverse, as we've done in this recipe: Once we've settled on what's most important—and obviously not everything can be most important—we assume that everything else should be leveraged until proven otherwise.

That said, however, there are many good reasons why certain things should indeed not be broken out of the value chain, and why it would be folly to do so even in a leveraged organization. For example, there might be vertical process interdependencies that preclude breaking up a particular value chain unless certain strict conditions are applied. Similarly, there might be learning curves or shared investments linking parts of the value chain together. Another good reason is that the organization doesn't have the manpower or management attention to handle all leverage opportunities at the same time.

Our brewing company, for example, might be afraid, and rightly so, that creating a pan-European supply company (or two—one for east and one for west) might put the local brands in the various countries at risk if the resulting interface couldn't be managed effectively. This is not an unrealistic fear if the various acquisitions in recent years haven't been fully digested yet. In such a case, supply optimization would risk wiping out more value in the market than it could create in savings. This doesn't absolutely preclude pursuing such leverage, but it does signal a need to take appropriate measures first, and in the process slow down the transformation.

As Flexible As You Need It to Be

Our brewing company made a useful guinea pig because it was relatively intuitive—so much so that you might now be wondering if the recipe isn't overkill. Wouldn't a model be simpler? No. Because SBU 2.0 *is* a recipe, it's more flexible: Once you've learned it, you can quickly adapt it to cases ranging from the simple to the complex. It is especially valuable when diving in great detail into the value chain, for example, or when resolving very complicated business mixes, such as those typically found in true multibusiness environments. We've even found it helpful in structuring individual departments to align them with the company strategy.

There are other advantages to be discovered as well. One CEO we worked with explained that he liked not only the results of the recipe but also the process it fostered among his people. "We have fact-based, strategy-driven discussions that naturally encourage consensus rather than standoffs based on 'gut feel,'" he told us. Another plus for him was the easy balancing of opportunities versus market needs.

Finally, because the recipe aligns your entire organization to your strategic priorities, they become that much easier to implement throughout the organization. In other words, SBU 2.0 isn't just an organizational design tool, it's a strategy deployment tool. Try *that* with a model.

Consulting Author

GILLIS JONK is a partner in A.T. Kearney's strategy practice and chairs the firm's Knowledge and Innovation Council. Based in Amsterdam, he can be reached at gillis.jonk@atkearney.com.