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Getting the best out of teams

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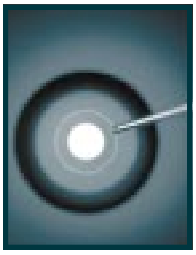
Performance measurement and customer privacy

Marketing practice is changing as the Internet evolves. Customer-centric marketing may bring about changes such as outsourcing of the marketing role or co-creation of new marketing approaches. The intention is to increase marketing performance, but how should this be measured ? So far, there is little agreement. Meanwhile, sharp practices on the Internet threaten customer privacy. In the drive for ever higher performance, can ethical behaviour and privacy be sustained ?



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The way in which organisations view their customers has evolved from a mass-market approach to segmentation, niche marketing, and now a focus on personalised attention to single customers.

This move towards treating each customer individually will, according to Sheth, Sisodia and Sharma[1], be the beginning of a more fundamental shift called *customer-centric marketing*, which will prevail in this century. In this approach, customers are treated as individuals. After individual assessment, customers may be served directly by the organisation or through a third party. Depending on their specific needs, they may receive a customised or a standard product and marketing approach.

The authors stated that 'the objective of customer centric marketing is to maximise both efficiency and effectiveness simultaneously, at a customer level'. As a result, the outcomes of the customer-centric approach will be 'non-intuitive'. The marketing function may become more closely involved in the following activities :

- *Supply management* : More diverse and possibly unpredictable customer demands will be satisfied most successfully by those who can quickly modify their supply to meet demand.
- *Outsourcing of customers* : Conventional marketing approaches are focused on customer acquisition and retention, whereas the customer-centric approach makes a more concerted effort to serve profitable customers. Instead of subsidising unprofitable customers, the organisation will need to consider outsourcing them to *competitor partners*, where they may become profitable within a new cost structure.
- *Co-creation marketing* : This is similar to personalisation, as discussed by Prahalad and Ramaswamy[2] and reviewed in the last article in this series[3]. The customers are involved in the specification, design and production of the products and services they eventually purchase.
- *Fixed-cost marketing* : Marketing should be treated as an investment and not an expense. Marketing will increasingly be interactive, involving a multitude of customer contacts, which will incur transactional costs. Thus organisations will need to invest in infrastructure and technology to minimise these costs.

The growth and interest in customer-centric marketing is, according to the authors, due to three factors :

- technological change and sophistication;
- the pressure on firms to improve marketing productivity and performance;
- the changing diversity and demography of markets.

The measurement of performance (or marketing metrics, as it is often called) is one of the key challenges facing marketing. This has been discussed not only by Sheth, Sisodia and Sharma, but also in a number of other journals in recent months. Day and Montgomery[4] have stated that the most important research priority is the development of 'metrics that might be used to help academics, managers, and governments judge the performance of marketing activities against absolute and relative standards'.

Performance

'The faithful, both practitioner and academic, consider marketing too obvious to need validation. Sceptics see it as extravagance, fine for consumer packaged goods but not applicable to their sectors.'[5]

Marketing performance has received more attention recently, but there is still a great deal of work to carry out in this area.

Clark[6] summarised the current status of performance measures used in marketing, and suggested that the discipline does not need more measurement but should refine the existing approaches and explore the interrelationships between them.

He identified four categories of measures :

1. *single financial output measures* : for example profit, sales revenue and growth;
2. *non-financial measures* : market share, customer satisfaction, loyalty, adaptability, brand equity, and so on;
3. *input measures* : marketing assets, market orientation, marketing implementation;
4. *multiple measures* : efficiency, effectiveness and multivariate analysis.

In charting the development of these measures, Clark noted that managers need to balance financial and non-financial approaches. He explained that financial approaches alone are not sufficient as measures of marketing performance.

Further, he was not convinced of the value of input measures of performance, but appreciated their contribution to the provision of a 'richer, deeper understanding of the marketing process'.

In the multidimensional category, he noted that these methods have been very useful for researchers, but have proved impossible for managers to implement, as they have none of the simplicity which makes comparable measures (such as the 'balanced scorecard') so appealing to practitioners.

Clark suggested that marketing scholars must similarly present management with a handful of measures 'that are simple enough to be usable but comprehensive enough to give an accurate performance assessment'.

He suggested a simple model, which is in need of further research and development, but that combines brand equity with customer satisfaction.

Service quality and profitability

Valerie Zeithaml, with A Parasuraman and L L Berry, has been a prominent contributor on service quality issues in the mid-1980s and beyond. She has entered into the performance debate, and discussed the links between 'service quality, profitability and the economic worth of customers'.

In a synthesis of previous research[7], she stated that some progress has been made towards measuring the effects of quality on profits. She noted, however, that there is still a need for a systematic method which is valid, reliable and applicable to the various classifications of services.

In her paper, she developed a model which shows the relationship between service quality and profits. There are two key components in this model :

- offensive marketing;
- defensive marketing.

Offensive marketing charts the relationships between service quality and market share, premium price, and reputation, and ultimately their effects on sales and profit.

Further research is required into offensive marketing in this context. Indeed, questions still need to be asked about

- the optimum level of spending on service in order to have an effect on reputation;
- the role of advertising support in offensive marketing;
- the methods that should be used to alert customers to the service levels.

Zeithaml also suggested a role for defensive marketing, which provides a link between service quality, customer retention, improved margins and profits. In this part of the model, the key factors that have an impact on profits are

- customer retention;
- repeat purchase.

Customers are likely to pay a premium and, through word of mouth communication, will act as advocates in the marketplace. This, in turn, can lead to internal marketing cost benefits, as less effort needs to be spent on acquiring new customers.

Here, too, there are some unresolved research questions, and Zeithaml asked the following questions :

- What is a loyal customer ?
- What levels of service are needed to retain customers ?

In many respects, her paper raised more questions than it resolved, but its contribution lay in the development of a framework that links quality with offensive marketing, and increased sales with defensive marketing. She also explained how these factors lead to improved margins and profits.

While the question of profitability has received more attention of late, a great deal of research is still needed to provide managers with the tools and techniques that they need to measure marketing performance with confidence.

In addition to the performance issues, Sheth, Sisodia and Sharma also suggested that one of the external factors that might affect customer-centric marketing is public policy.

Prominent in this debate is the use or misuse of the Internet. Their concern was that privacy laws comparable to those introduced in the European Union that restrict the use of customer data would prevent the customisation and personalisation of products and services, and might well impede the growth of customer-centric marketing.

Marketing, ethics and the Internet

The development or maintenance of an Internet presence is high on the agenda of most organisations, for example because of its value in

- developing relationships;
- facilitating customer contact;
- providing easy access to information;
- establishing a brand identity;
- acting as a direct distribution channel.

Less conspicuous is any significant research into the ethical issues raised by online marketing. Bush, Venable and Bush[8] highlighted the criticisms of online marketing with respect to

- privacy;
- financial security;
- information integrity;
- spam (junk email);
- pornography;
- fraud and organised crime.

Their study focused on 'how businesses perceive the ethical environment surrounding marketing on the internet'. They had in mind two key areas :

- issues of regulation
- the role of ethics in marketing.

While their hypotheses focused on these broader questions, the detail of their research concentrated on the following :

- *Regulation* : There is a fine balance between the perceived need for regulation and 'protection' of some groups in society (for instance children) and the freedom of the individual to use and access the information and facilities on the Internet.
- *Privacy* : The Internet is an ideal framework for many marketing activities. Marketing success builds on current trends in customisation and personalisation, coupled with the added benefit and value of information that websites can generate about customers. Some uncertainty in customers' minds is centred around privacy and security issues.
- *Codes of ethics* : Most organisations have a code of conduct or ethics. Should organisations develop a code of ethics specifically for the Internet ?

Bush, Venable and Bush found that the ethical issues that caused most concern were

- security of transactions;
- fraud;
- 'hacking';
- privacy;
- honesty.

Interestingly, the participants in their survey thought that the ethical issues when customers were managed online and when conventional approaches were used were very similar.

Over 50% of the participants in the survey were concerned about the lack of regulation and about ethical abuse, but there was a substantial discrepancy in their views on the imposition of regulatory controls.

The research showed that there was a tendency towards self-regulation, but 'an overwhelming majority (82 per cent) of the respondents indicated … that companies themselves should develop a code of ethics for internet marketing'.

In essence, the research found that ethical concerns affect the development of trust in relationships with online customers, and that the first course of action should be to develop an ethical approach at the organisational level. Bush, Venable and Bush considered that the 'ethical concerns that emerge from this study appear to indicate that many of the societal and industry issues surrounding internet marketing might begin to be solved at the *organizational* level'.

Privacy

The privacy debate has been rumbling on for a number of years with the development and increasing sophistication of direct and database marketing. The ability to personalise and target specific individuals has led to a number of concerns about possible 'invasion of privacy'.

This debate has increased with the growth of the Internet and recent publicity in the marketing and management press[9] about a scheme by DoubleClick (an Internet advertising company) to match anonymous information collected on the web with personal data obtained through its acquisition of Abacus Direct (a direct mail data list). Customers are becoming increasingly aware of a decline in their degree of privacy as information which was once anonymous and unattributable has become personal and identifiable.

Sheehan and Hoy[10] investigated the relationship between consumer behaviour and concern about privacy in an online context. In particular, they were eager to learn about the activities that consumers adopt to protect their privacy.

In their study, they explained that it is difficult to identify when privacy has been violated, as this varies according to the person and his or her role and situation. They distinguished between privacy in the public arena and privacy in the private domain, where they feel that 'violations of privacy' are clear. It is in the zone between these extremes that Sheehan and Hoy believed that most ambiguity lies. They stated that 'whether an individual determines that privacy is being invaded or not is likely to depend on the characteristics of the situation and on an individual's own judgement of a situation'.

In reality, consumers react in a number of ways to concern about privacy. They can do any of the following :

- *voice* their concern about privacy by having their names removed from mailing lists;
- take *private actions* using contacts in online newsgroups to inundate companies with emails to give them a taste of their own medicine;
- take *third party actions* using regulatory bodies to control privacy violations and develop blacklists to register Internet abuses and privacy infringements;
- engage in *withholding actions* by providing incomplete information when they consider the information requested to be too personal or simply not needed;
- *abstain* from using websites where registration is required prior to site access.

Sheehan and Hoy asked about the implications of these consumer reactions for advertisers. Will it affect the quality of the information that the advertisers are able to collect ? Will these concerns affect the quality of their relationships with their customers and their customers' customers ?

The research found that when consumers are concerned about privacy issues, they are less likely to register on a website at all, and consider this to be an efficient method of protecting themselves. Sheehan and Hoy also asked people whether they would be likely to falsify the information that they provided, but interestingly the results were negative. Customers were more likely to provide incomplete information in more than half of their online registrations.

Customers tend to avoid contacting the advertiser directly to express their concerns, and turn instead to their Internet service provider to complain about unsolicited emails and privacy infringements.

Overall, it seems that concern about privacy does affect behaviour. Avoidance and withholding behaviour by customers affects the quality of information collected by advertisers, and the data may not be reliable. Advertisers thus need to be proactive and to develop relationships with online customers if only to ensure that the data they collect is clean and from reliable sources.

Privacy is a thorny issue, and while some consider privacy a right, others think of it as a luxury which may not be sustainable. In the meantime, organisations need to consider their policies on customer privacy, as DoubleClick has been obliged to do in recent months. It has recently announced a privacy initiative, and stated that '… until there is an agreement between the government and industry on privacy standards we will not link personally identifiable information to anonymous user activity across websites'[11].

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Getting the best out of teams

Getting the best out of teams has never been more important. Today, successful organisations are flatter, more flexible and dynamic, and they rely greatly on teams. If they are to perform really well, teams have to be carefully set up and managed. This article reviews key factors such as the organisational preconditions for team success, the team's diversity of membership and the appropriate skills, the most suitable type of leadership, and the nature of the team's task.

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Teams have become one of the key building blocks of the modern organisation. Flatter, more decentralised organisations now tend to be built around groups, which hold the promise of more effective performance, greater integration and a richer source of ideas. Cross-functional teams routinely manage the new product development process, for example. Diversity in team membership is increasingly sought as an inevitable consequence of an increasingly diverse workforce.

As the performance of teams is critical to the achievement of competitive advantage, how can an organisation maximise the performance of its teams, and especially diverse teams ? The following are particular issues :

- How should these teams be led ?
- How can the learning derived from these teams be applied by the whole organisation ?
- What are the nature and consequences of conflict in teams ?

Effective new product team leaders

Jassawalla and Sashittal[1] have argued that the impact of cross-functional teams in new product development is strongly influenced by their leadership. They studied the process by which effective leaders transform both themselves and their teams.

All of the less effective team leaders in the study were R&D appointees who tended to view team leadership as a part-time job; their main loyalty was to R&D rather than to the team. In this situation, other members of the team can lose interest and lack commitment.

The authors also identified strategies that effective leaders use to manage their teams and the new product task environment :

- *Ensure commitment* : Ensure that every participant commits to the inputs in the team, and takes personal responsibility for team outputs.
- *Build information-intensive environments* : Encourage high levels of information exchange, for example through meetings, and support openness and integrative thinking.
- *Facilitate play* : Use play techniques to build teams, rather than rewarding the high-profile 'hero'. Select a team with a good mix of talents, and help them to develop their personal skills.
- *Focus on human interaction* : Concentrate on people issues, and on developing intrapersonal, interpersonal and team skills, in addition to focusing on technical matters.
- *Focus on learning* : Develop levels of flexibility and creativity. Focus, in particular, on the process of learning, create opportunities for new learning to emerge, challenge assumptions, and promote experimentation and risk taking.

In addition to an internal role, the effective leader has a role outside the team in developing relationships with all departmental heads in order to avoid possible split loyalties, and in shielding team members from unnecessary bureaucracy.

The development of effective leaders requires careful selection, development and an appropriate culture. Effective leaders are more likely to emerge in cultures that look favourably on change and view product innovation as a high priority in the organisation.

Leaders should be selected for their interpersonal skills. Once chosen, they should undergo considerable training in the areas of managing change, conflict and teamwork. Team members also need continual training and development, especially in human relations skills.

Radical innovation versus the dissemination of learning

Forrester[2] studied innovation and learning in teams in two automotive companies, one American and one Japanese. In spite of sharing the objective of cost reduction, the companies adopted different approaches to product development.

The key features of the Japanese approach were the following :

- a 'bottom up' approach to strategy;
- a predetermined procedure for innovation;
- a set procedure for collecting and implementing ideas;
- tight timescales and a focus on achieving targets;
- idea generation and idea implementation carried out by same team;
- prescribed team leadership, with membership from specific areas;
- a set process for team facilitation by the leader;
- a largely internal input to the innovation process.

The Japanese organisation utilised many teams, and these were often short-lived. It was more inward looking and risk averse than the US firm, more rigid in its approach, and more constrained by rules. This rigidity restricted the range of ideas put forward and limited their scope.

At the same time, innovation was part of the culture, and part of everyone's role, whatever their level in the organisation. The focus of the company was on the dissemination of innovation, and the involvement of all employees in new ideas. This helped to facilitate change and reduce resistance to new concepts.

The main features of the US firm's approach were as follows :

- a 'top down' approach to strategy;
- innovation conducted with no adherence to a formal process;
- informal dissemination of ideas based on informal networks;
- more flexible timescales;
- ideas generated by one team passed to others to implement;
- flexible composition of teams, with membership selected by the 'idea champion';
- facilitation of the team by the team leader in the wider organisation;
- input from suppliers, customers and experts to the innovation process.

The members of the teams in the US firm were drawn from all areas of the business. They seemed to be less constrained by rules, procedures were more informal, and they felt empowered to challenge suggestions and take risks.

However, while the teams were able to achieve more radical and higher levels of innovation, implementation was sometimes more difficult to achieve, perhaps because the innovation was restricted to a smaller group. The incremental approach of the Japanese, and their focus on dissemination, may achieve longer term success by creating a positive acceptance of ideas.

Forrester questioned whether it was possible for an organisation to both achieve radical innovation and involve everyone. A balance between innovation and dissemination can be achieved in a number of ways.

At the individual level, ensure that employees have the following attributes :

- appropriate knowledge and expertise;
- an acceptance of their responsibility to innovate;
- openness to new ideas;
- a concern to improve and learn.

At the team level, ensure that the following exist :

- good relationships within and outside the team;
- good internal intra-team and inter-team communication;
- a team involvement in generating and developing ideas, with only a few involved with implementation;

- team freedom to select external inputs to bring new ideas into action;
- support from the leader;
- active management of the interface with the rest of the organisation, especially at the political level.

At the organisation level, ensure that the following are in place :

- clear goals for teams;
- acceptance by everyone of making change work;
- openness of teams to individual inputs;
- policies to support teams, including training and rewards;
- formal dissemination of ideas to create a climate for innovation and change.

Introducing teams

If work teams are a potential source of competitive advantage, how can they best be introduced ?

Eby *et al.*[3] argued that for a change effort to be successful, an organisation must support and reinforce a climate that is conducive to change. It must consider both general factors relating to change and factors specific to the type of change planned.

The authors studied the introduction of team-based selling, and found that the main factors indicating readiness for this change were

- a preference for working in teams;
- trust in peers.

On a more general level, whether employees thought that the organisation policies and procedures could cope with the change was highly significant.

The implications for organisations are that systems and policies require realignment prior to organisational change. An organisation should also consider promoting support, participation and trust through open communication, and skills training.

Hybrid team cultures in transnational teams

A key principle of group formation seems to be that group attachments are based upon perceived similarities in personal characteristics.

Nationality appears to be a particularly important characteristic. This is a significant issue in the formation of teams with multinational membership, especially given that such teams are becoming more common with increasing globalisation.

Early and Mosakowski[4] examined the effects of heterogeneity in transnational teams. They identified three levels of heterogeneity, which were based on whether members saw themselves as sharing key characteristics.

Effective teams need a strong team culture (a set of rules, norms, expectations, and roles shared by team members). This culture may be derived either from pre-existing characteristics, or from team member interaction. Heterogeneous teams do not begin with a shared culture, but successful teams create a strong hybrid team culture. This emergent culture provides a common, group-specific sense of identity, facilitating team interaction and high performance.

The study demonstrated that the processes underlying team development are complex. Initially, heterogeneity had a detrimental effect on team functioning. However, the performance of the heterogeneous teams improved over time, while those of the homogeneous or moderately heterogeneous teams stayed relatively constant. After developing ways to interact and communicate, highly heterogeneous teams may create a common identity. In contrast, moderately heterogeneous teams showed many communication problems, relational conflict and low levels of team identity, possibly because in such teams individual and team identities are balanced, and members are not motivated to adjust this balance.

Why differences make a difference

Another perspective on the impact of diversity has been provided by Jehn, Northcroft and Neale[5], who studied the effects of various types of diversity on workgroup outcomes.

Three specific types of diversity were identified :

1. *informational diversity* : differences in the knowledge and perspectives that members bring to the group;
2. *social category diversity* : explicit differences between group members in terms of social category membership such as race, gender and ethnicity;

3. *value diversity* : differences between what members of a workgroup think that the group's real task, goal or mission should be.

Their findings demonstrated that, for most measures of performance, low value diversity among members is critical. Value diversity may become more important as a predictor of performance, and more noticeable over time, as other more readily apparent diversity characteristics such as age and gender become less relevant.

Value diversity rather than social category diversity causes the biggest problems in relation to performance, and it also has the greatest potential for enhancing both workgroup performance and morale.

The authors identified the types of diversity associated with various types of performance :

- *Effectiveness* : This requires high information diversity and low value diversity.
- *Efficiency* : This requires low value diversity.
- *High morale* : High morale (high satisfaction, intent to remain and commitment) and perceived effectiveness require low value diversity.

The important finding here is that diversity itself is not enough to ensure innovation. The nature of the diversity is critical. For innovative performance to be facilitated, it seems to be necessary for group members to have similar values.

Managing task and emotional conflict issues

Janssen, Van De Vliert and Veenstra[6] have argued that conflict in the decision making process in top management teams results from both task-oriented and person-oriented issues.

Some CEOs may try to improve the performance of the top team by increasing competition between the members. At the extreme, this amounts to a 'divide and rule' approach that may backfire if it causes person-directed conflict.

A better approach for effective decision making is to recognise that conflicts have both task-related and person-related aspects, and to create or emphasise positive goal interdependence. When person and task conflict are present, team members need to have perceptions of positive interdependence in order for them to stick together and for the potentially harmful effects of person-oriented animosity to be minimised.

Simons and Peterson[7] argued that trust is a key to gaining the benefits of task conflict without suffering the costs of relationship conflict.

Team structure, tasks and performance

Stewart and Barrick[8] considered the effect on performance of two aspects of team structure :

- *interdependence* : co-operative and interactive working;
- *autonomy* : the extent to which the team has the authority and freedom to lead itself without supervision.

They also looked at two different types of team :

- those performing manual production tasks;
- those performing thinking or conceptual tasks, such as planning, deciding or negotiating.

The authors found that the levels of interdependence and autonomy do seem to influence team performance. Teams performing thinking tasks perform better when interdependence is either very high or very low, when autonomy is high, and when there is open communication and less conflict between team members. By contrast, manual teams perform best with only moderate interdependence and autonomy. This is the opposite of the conditions creating good performance for thinking or conceptual tasks.

The implications for managers seem to be that they must consider various factors in order to get the best out of teams. The organisation's culture, policies and procedures have to be conducive to the use of teams in the first place, particularly in change situations. The composition of teams is also important, in terms of members' diversity, skills and knowledge. Finally, the tasks given to teams need to be related to the type of leadership that they are going to have.

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Co-evolution

How can a business get the balance right between exploitation of the here and now and exploration of future opportunities ? To support this balance, when should collaboration between divisions be built into the structure, and when should linkages be more temporary ? What difference does it make if the business environment is relatively stable or if it is very fast moving ? Should top managers be rewarded for collaborating internally or for individual success ?

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This article reviews some recent contributions on the concept of co-evolution. Co-evolution is an idea which is derived from the complexity sciences and the study of species in the natural world, and it can be viewed at a number of levels.

Co-evolution at the macro level

Lewin, Long and Carroll have reviewed the literature on co-evolution at a macro level (see reference 1, pp 535–550).

Here, the concern is not only with how organisations adapt to changes in the environment, but also how the environment adapts to pressures from organisations changing their behaviour and their strategies.

The authors proposed a new model of wealth creation. Their model supposes that, for an organisation to survive in the long run, a balance is needed between exploration and exploitation.

Exploitation adaptations are essentially refinements of the existing model : improving productivity and responsiveness, reducing costs, and so on. Exploration adaptations are about experimenting with new forms, models and strategies.

The long run survival of the organisation will be a function of its ability to 'engage in enough *exploitation* to ensure the organization's current viability and engage in enough *exploration* to ensure its future viability' (see reference 1, p 537).

The glue which binds the two processes of exploitation adaptation and exploration adaptation is the company's 'legacy'. Legacy is a broad, but useful, concept which includes such things as

- reputation;
- brand equity;
- economies of scale;
- core competencies;
- human capital;
- assets;
- inertia.

The cumulative effect of past exploitation and exploration adaptations are naturally reflected in any company's legacy. Legacy also operates at the level of the industry, reflecting such things as

- the size of the market;
- competition;
- institutional constraints.

Legacy has less impact on wealth creation in very highly competitive industries than in more stable, oligopolistic ones.

The model assumes that organisations for the most part prefer exploitation strategies, as these involve less risk and are more familiar. However, returns from exploitation adaptation are unlikely to be sustainably high. Thus exploration strategies are necessary if new opportunities with higher and more sustainable profits are to be sought.

The three elements of exploitation strategies, exploration strategies and legacy are mediated by a filter which includes the following :

- *Slack* (*or redundant*) *resources* : This is a concept that is derived from organisation behaviour. For an organisation to be able to adapt successfully, there needs to be some space for individuals to create new recipes.
- *Absorptive capacity* : This refers to the ability of an organisation to assimilate, process and distribute new knowledge.
- *Path dependence* : This is a term that is derived from complexity theory. It refers to the notion that a company's options are constrained and shaped by how it got to where it currently is. This is, incidentally, not unlike the legacy concept.
- *Strategic intent*.

Lewin, Long and Carroll went on to suggest how companies would perform in certain conditions, for example

- fast moving markets or different institutional systems;
- Anglo-Saxon versus Japanese environments.

They thought, for example, that in times of turbulent or fast moving market conditions, the amount of exploration adaptations would be likely to increase.

Co-evolution from within

Eisenhardt and Galunic have taken a decidedly more hard-nosed view (see reference 2, pp 91–101). Eisenhardt and Galunic were interested in the concept of co-evolution as a new form of collaboration between and among business units within multidivisional companies.

Their starting point was that the traditional concept of cross-business collaboration involving 'frozen links amongst static businesses' and a mixture of individual and group incentives would be unlikely to generate the levels of adaptability required to compete in fast moving markets.

The Velcro organisation

Eisenhardt and Galunic put forward the notion of the Velcro organisation. Forms of collaboration between separate divisions are not fixed. Alliances and linkages are set up on a temporary basis for specific purposes and are taken apart when they are no longer useful.

In this model, it is the role of top management to set the context within which various parts of the business can co-evolve without trying to force collaboration down from the top. This is not to say, however, that Eisenhardt and Galunic saw no role for corporate executives in stimulating cross-divisional collaboration. They advocated the setting up of multi-business teams, and outlined rules to ensure that the teams met regularly and discussed issues of real value to the company.

> *Without the team, individual business managers have difficulty finding collaborative links, developing social relationships with other business heads that facilitate collaboration and even conceptualizing a collective strategy*. (reference 2, p 96)

Moreover, the authors saw an important role for corporate executives in acting as cross-pollinators, moving from one business unit to another, transferring ideas and simulating new thinking.

Eisenhardt and Galunic contended that companies should not try to constrain competition between business units. Given the rapidity with which technology changes in the new economy, parallel tracking is likely to be inevitable and a certain amount of internal competition may, in any case, be desirable.

They also counselled against trying to maintain too many linkages. As they rightly pointed out, a cost is attached to collaboration, and all collaborations have to be viewed on a 'return for effort investment' basis. This is one reason why they believed that it is not a good idea for corporate executives to determine what forms of collaboration will exist because, typically, they overestimate the value and underestimate the cost of collaboration.

More controversially, perhaps, Eisenhardt and Galunic also came down very firmly in favour of individual rewards and incentives rather than group-based or mixed incentive schemes. They claimed that business unit managers who co-evolve their businesses are rewarded not for collaboration but for self-interest, the notion here being that each individual will identify an interest in collaborating, which, in turn, should generate value which will be rewarded by the company.

This, they believed, is a more powerful approach than trying to introduce incentives for collaboration. This is probably true, but there is a risk that some opportunities for collaboration which could be extremely beneficial for the corporation as a whole will not be exploited because the return on effort for a particular business unit will not be regarded as being sufficient.

It must be possible to devise mechanisms for rewarding individuals in one business unit on the basis of results elsewhere in the corporation to which they have contributed.

Making sure one hand washes the other

If any company should know something about how to realise synergies across business divisions, it is the Walt Disney Company, which has developed a massive business empire on the back of exploiting the characters in its films.

One of the keystones to this new success has been the rapid roll-out of its products and their exploitation for purposes of merchandising.

In a recent interview, Michael Eisner, CEO and chairman, talked about how to ensure that 'one hand washes the other'[3]. In Eisner's view, the key to ensuring that innovations are exploited throughout the corporation seems to be training.

Two or three times a year, the company holds a training session (the so-called Disney Dimensions) for 25 senior people from each division of the company worldwide. Eisner described it as a 'synergy boot-camp'. It is designed to give the participants a crash course in all the activities within the corporation. These include the core businesses, such as Disneyland and Disney Video, and also the various functions within company headquarters.

> *They learn what it's like to work in* 100 *degree heat and* 100 *degree humidity, to clean bathrooms, cut hedges, check out guests and soothe tired children. They start at* 7.00 *in the morning and work until* 11.00 *every night for eight straight days. There are no phone calls and they are not allowed to do any regular business.*

Eisner's point was that, with this type of intensive 'real-life' experience, not only do the participants get a better insight into the workings of the diverse activities within the Disney empire, but they also are able to bond more effectively with their opposite numbers.

> *When you want the stores to promote Tarzan, instead of the Head of Animation for Tarzan calling me, me calling the Head of the Disney Stores, what happens is that the Head of Tarzan calls the Head of the stores directly*. (reference 3, p 121)

Unlike Eisenhardt and Galunic, however, Eisner maintains that synergy will not happen within a multidivisional organisation unless there is constant, relentless pressure from the top.

Moreover, the Walt Disney Company does not eschew the more conventional and traditional methods of co-ordinating activities within large multinational activities. For example, they have introduced a matrix-type organisational structure in their international business so that the heads of subsidiaries around the world report not only into their line of business but also to a local country head who is there to ensure that synergies at a local level take place.

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Risk and value

Risk affects shareholder value because it has an impact on cash flows and the cost of capital. Risk management is usually concerned with reducing the impact of risks, but it can also be used to improve competitive advantage. Some companies have recently taken most imaginative approaches to managing risks. However, what extra return should investors expect from risky investments ? How large is the ‘risk premium’ ? This may not be as large as used to be thought.

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Risk has long been recognised as having an important impact on value. Typically, within a value calculation, risk is viewed as having a significant potential impact on cash flows and the cost of capital.

Specific risks relating to an investment are often investigated by undertaking sensitivity analysis, and sometimes probability analysis, on the cash flows. Market-related risk, by contrast, is frequently factored into this analysis through changes being made to the cost of capital.

However accounted for, such risk analysis does not necessarily reflect how risk management might be turned into a competitive advantage. The first topic reviewed below is how risk management can be taken beyond just risk reduction, and instead used to make the firm a more effective competitor.

The second subject considered is the notion of risk, with particular reference to its link with the cost of capital and capital structure. In short, the proposal is to broaden attention away from the weighted average cost of capital (WACC) to a total average cost of capital (TACC) that recognises on-balance-sheet and off-balance-sheet financing.

Third, the impact of capital structure decisions is considered with reference to developments in continental Europe and Asia. Illustrations are provided of the impact of capital structure decisions upon the cost of capital and value.

Last, but by no means least, the results of recent studies of the equity risk premium are reviewed. As indicated in previous articles in this series, the equity risk premium has been the source of a great deal of controversy because of widely differing estimates ranging from 0% to 8%. There now seems to be greater consensus on this important topic.

Turning risk management into competitive advantage

Strongin and Petsch of Goldman Sachs have made the case that many companies seem to have either rejected or reduced the size of their risk programmes because they do not believe that the market will reward them sufficiently for the consequent reduction in earnings volatility[1]. The authors argued that this stance takes a much too limited view of risk management, and that it can be used proactively to help in the creation of shareholder value. The way this is achieved is by ‘adding the right risks’.

Traditionally, financial risk management has tended to focus upon eliminating or reducing financial risk, whereas Strongin and Petsch made the case for using hedging as an affirmative business tool. In this respect, the goal is not to eliminate risk, but to add as much high-return/high-quality business risk per unit of shareholder equity as possible. However, this has to be achieved without increasing the risk of future shareholder dilution; instead, the intention is to maximise the benefit to shareholders. In other words, a distinction is made between near-term, cash flow risk generated by short-term fluctuations in commodity prices or foreign exchange, and deeper longer-term business risks. The latter arise as the firm makes real investments requiring the longer-term provision of capital, which are far more likely to offer above-normal returns on shareholder equity.

The key to the Strongin and Petsch case is the focus of attention upon increasing returns rather than reducing financial risk. In practical terms, they see increasing returns in the form of improvements in the return on equity from

- improving the efficiency of access to the capital markets;
- using equity capital more aggressively;
- avoiding low return activities.

Improving efficiency of access to capital markets

In essence, the objective is to use hedging to create a good match between cash flow generated and cash flow needed. The consequence of this is that, on average, the firm should need to raise less capital, and will be able to raise what capital it needs under more favourable conditions.

According to this kind of thinking, there should be a direct link with the cost of capital, since an effective hedging policy should reduce the volatility in cash flows, and help the current shareholders keep more of the value that is created.

Using equity capital more aggressively

By improving the match between realised cash flows and cash need, it should be possible to free up capital to pursue business opportunities, thereby improving the efficiency of the use of capital within the firm.

This approach should enable the firm to take advantage of the circumstances in which it has substantial excess cash flow relative to business and financial needs. The firm can shift these excess cash flows into periods when they have greater value to the firm.

Avoiding low return activities

It is argued that hedging allows the firm to de-couple risks that are proprietary to the firm, and provide high returns from those that are less rewarding. The authors argued that often those risks that generate the higher return on equity are proprietary to the firm and cannot be hedged, for example exploitation risk in new oil fields or the opening of new mining areas. By comparison, the continuing exploration of these opportunities often involves taking on substantial short-term commodity price risk, which does not offer the firm comparable rates of return or the necessary equity risk capital.

The key point is that even if capital is held constant, it can add on more high-return/ high-quality business risk by decreasing short-term cash flow risk. The capital costs of a project vary with the level of equity capital. If the cash flow risk can be decreased, financing by a greater proportion of debt allows the remaining equity capital to generate higher returns for the shareholder.

Hedging

The authors recognised that some aspects of the gains from hedging, such as improved timing on accessing the markets, are difficult to quantify, while others, such as the reduction of capital reserves, are much easier to measure. However, they presented a model that can be used to determine the optimal hedge ratio which relies upon trading off the cost of hedging against the value of the capital freed up by hedging.

A basic proposition of shareholder value is that value is only created when the return on invested capital (ROIC) exceeds the cost of capital (COC). The focus of attention of Strongin and Petsch was upon enabling the firm to add as much value as possible using as little shareholder capital as possible. It is not how big the firm grows that matters – it is how much it grows per cost of equity capital used.

This was a useful review of the potential application of risk management techniques in discussing shareholder value. It captured an issue that has been relatively unexplored within the shareholder value literature.

Outsourcing capital

The importance of the capital used has attracted attention in another context. Pick up any finance text, and you will find extensive references to the weighted average cost of capital[2]. However, a short article has highlighted an issue that is likely to attract increasing attention : outsourcing capital[3]. This article illustrated how a tiny Canadian firm, United Grain Growers (UGG), substituted a large chunk of its own equity with that of the world's second largest reinsurer, Swiss Re.

The underpinnings and rationale for the action by UGG and Swiss Re have some important linkages with the work in reference 2. The link with risk-related issues is as follows. UGG's business is to trade grain grown by western Canadian farmers, thereby exposing the company to big risks in relation to its profits should there be a fall in grain volumes. To counteract shortfalls in profit, UGG traditionally maintains reserves as a buffer. However, risk capital has a cost in the form of the return that lenders or shareholders require for providing committed funding. By all accounts, in UGG's case, the cost of this capital has been high because of earnings volatility, and it has been realised insofar as investors have discounted the company's share price.

Why should Swiss Re have been interested in UGG ? First, UGG's main risk from a drop in grain volumes has no correlation with many of its other risks, such as fire. Second, and equally importantly, UGG's risks have little or no correlation with the millions of risks that Swiss Re faces around the world.

The idea of diversifying and bundling risks is not new, but the notion that transferring the risks changes the firm's structure and cost of capital is relatively novel. Within a conventional WACC calculation, it is normal to include only 'paid up' capital and not 'contingent capital', such as insurance, letters of credit, and financial derivatives. However, in my experience, those charged with the task of estimating WACC do recognise the importance of contingent capital, and do try to capture its effect, though this is typically very difficult.

The case for including contingent capital is that it can be argued that its economic effect upon the cost of capital is the same as for 'paid up' capital. For example, a firm can achieve similar protection against fire either by buying insurance or by issuing bonds and keeping cash in anticipation of damages. In the first case, the insurance forms part of the operating expenses, whereas in the second it represents an interest payment and a part of the cost of debt.

Apparently, the Swiss Re view is that the difference in treatment is absurd, and that all forms of financial capital should be treated in the same way. The impact of this treatment is on the total average cost of capital (TACC). According to TACC thinking, the focus of attention should move away from the debt/equity ratios to the question 'how much capital does the company need, and how much should be on and off the balance sheet to minimise its total cost ?'.

Europe discovers corporate debt

While the notion of ignoring the debt/equity ratio and focusing upon TACC is an interesting proposition, it is important to recognise that many companies in continental Europe are only just discovering the importance of debt, often as part of the shareholder value movement.

A significant drive to take on more corporate debt has occurred in the wake of the introduction of the euro (see reference 4, pp 30–49). The pressure to provide shareholder value has forced European companies to leverage up at a time when banks facing exactly the same shareholder pressure are less keen to lend.

The recognition of the importance of corporate debt has focused increasing attention upon the very kind of WACC calculation that was perceived as being outdated in reference 3. Reference 4 (p 32) illustrated this focus well with its description of the work of Paul Gibbs, head of mergers and acquisitions research at JP Morgan. For those interested in understanding how to calculate WACC from a practitioner's perspective, this example is very useful.

Capital structure recognition : a global phenomenon

It is not only in Europe that debt recognition has come of age. Instances of this can be found in many parts of the world.

One good example is the PSA Corporation in Singapore[5]. The PSA Corporation is a port operator that is unlisted. By Singaporean standards, the corporation is relatively large; it is reckoned that if it were listed, it might rank as one of the five biggest companies by market capitalisation.

What is interesting about PSA is that it announced publicly its preparedness to raise as much as £3 billion to optimise its capital structure ahead of an eventual listing on the Singapore stock exchange. While the port operator does not need cash, it wants to carry a certain amount of debt on its books to raise the value of the company so as to increase returns on shareholders' equity.

This is a good illustration of an initiative that can be linked to the shareholder value movement. The press reported as follows :

… being cash-rich and debt-free do not come without cost.

A huge build-up in free cash-flow from operations depresses ROE and economic value added (EVA). Unless cash can be put to good use, leaving it in the bank to draw a meagre 1–2 per cent interest is a drag on EVA.

Equity risk premium

Risk has also been the subject of considerable recent debate with respect to the equity risk premium.

The equity risk premium represents the excess return above the risk-free rate that investors demand for holding risky securities. The risk premium in the capital asset pricing model is the premium above the risk-free rate on a portfolio assumed to have a beta equal to 1.0. There are, in fact, two perspectives for its estimation :

- historical, or ex post;
- forward-looking.

In calculating a historical equity risk premium, actual returns earned on stocks over a long time period are estimated and compared with the actual returns earned on a default-free (usually government) security. The difference, on an annual basis, between the two returns is computed, and this represents the historical risk premium. Reference to well respected corporate finance texts shows that rates of 8–9% have been accepted, at least until recently.

Recently published research[6] by Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School in association with ABN–Amro has revealed that the performance of UK equities back to the 1900s differs from that reported in previous work. According to this research, previous studies overstated equity returns, particularly in the first half of the 20th century. As a consequence, the equity risk premium is lower than was thought, and the authors concluded that real returns over the 20th century have been much lower than the 8% that they were previously thought to be.

The reason for the returns being lower than was assumed is that the London Business School company sample was broader than that in the main previous source of financial market statistics for the 20th century : the *Barclays Capital Equity/Gilt Study*. This source used only 30 stocks in its early period. By contrast, the source used by the London Business School team drew upon early issues of the *Financial Times* and the London Stock Exchange official yearbook to find the 100 largest stocks in any given year. These shares have tended to make up more than half of the market in any year.

A number of other factors also caused the Barclays capital study (which was originally prepared in the 1950s) to give an upward bias to returns. The two most important were hindsight bias and the choice of starting date. The hindsight bias arose because the Barclays figures, although they started from 1918, were based on the composition of the FT 30 index in 1935. The index therefore missed out many of the under-performing companies of the 1918–35 period. The decision to start in 1918 (as opposed to 1900, where the London Business School study started) meant that the First World War and the poor period for equity returns in the early years of the 20th century were not included. By all accounts, this factor alone imposed an upward bias on real returns of 2.6% a year.

The London Business School study thus effectively divided the 20th century into two. The implication is that previous studies have tended to focus upon the more prosperous and the later of these two periods to measure equity returns, and, indeed, the equity risk premium. In fact, the London Business School study found that the average risk premium for the 20th century was 4.5%, which is far lower than the 8% ex post figure that is often quoted.

Interestingly, this conclusion concurs with that of another recent study[7] by John Okunev and Patrick Wilson, who used a forward-looking approach. They adopted a simple technique that allowed the expected risk premium implied in the share price to be estimated. According to them, estimates of the risk premium using this approach are far less volatile when compared with the ex post risk premium. They estimated the average risk premium for the USA for the period 1871–1995 to be 4.46%, a finding similar to that calculated on an ex post basis from the 1970s onward.

In summary, we are starting to see a greater consensus on estimates between the two main methods of measuring the equity risk premium. However, not all controversy has disappeared.

As one good example, Glassman and Hassett of the American Enterprise Institute have argued that there is no equity risk premium[8] ! The basis for this is that equities have nearly always outperformed bonds (so that for long-term investors there is no risk). This is an interesting proposition, but it is not unchallenged !

Chancellor[9] offered good reasons for some equity risk premium being necessary. For example, the premium is a reward for uncertainty, because future economic performance may not be so good; investors need to be rewarded for the risk that they bear. Second, shares are more volatile than bonds over short time periods.

The debate continues.

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