



# A Market-Based Approach to Organization Renewal

## *Positioning Your Entrepreneurs for What Lies Ahead*



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## EXECUTIVE SUMMARY

*No matter how efficient a company's operations, it cannot succeed if its business units are not properly aligned with the marketplace. Structural misalignment often creeps in as companies mature or when their markets morph. The current recessionary environment in many industries is exacerbating this problem and dragging companies further from their entrepreneurial roots—at a time when they need to be more focused and responsive than ever before.*

*Typically, structural misalignment with markets causes poor overall performance. Its consequences can also surface in subtler ways, such as slow decision making, confused accountability, and low levels of employee satisfaction and motivation. When such misalignments exist, incremental changes are rarely the answer. What is needed is a systematic, clean-sheet review of the organization in the context of the company's markets and strategies. Such a review entails three basic steps: returning to entrepreneurial roots by identifying the market-based natural businesses within the company, thinking objectively about the economic and market implications of cross-business-unit synergies, and establishing a more strategic and market-driven role for the corporate core.*

*Market-based organizational renewal is an important element of establishing a company's essential advantage in tough and turbulent business environments. Leaders who can rise above the day-to-day pressures and chart a market-based course for organizational renewal will be best prepared to deliver superior performance in the months and years to come.*

# LEANER, BUT NO LONGER MEANER

Companies drift away from their entrepreneurial roots. Sometimes markets evolve and companies forget to respond: New competitors and technologies emerge or a shock such as a recession occurs. Sometimes companies evolve away from the market: Executives misread or lose touch with the pulse of their customers; personnel considerations—retirements, retention strategies, succession planning—drive structural alterations; or change is pursued for its own sake. No matter the reasons, when organizational structures become misaligned with markets, corporate performance and results inevitably suffer.

The current market environment, with its dramatic declines in demand,

dearth of easy credit, and intensifying competitive dynamics, is exacerbating the structural misalignment of many companies with their markets. Leaders are struggling to make their companies lean; they are cutting, centralizing, outsourcing, consolidating, and divesting. But what about their organizational structures, and the cultures and capabilities that those structures support? The companies may be lean, but are they focused and nimble? Market-based organizational designs are as essential to competing and winning in tough and turbulent business environments as competitive cost structures.

Leaders must first recognize the symptoms of structural misalignment (*see Exhibit 1*). Proactively addressing the root causes and charting a corresponding course for organizational renewal may prove far more important in the coming months and years than all the cost-side actions combined.

Generally speaking, executives should be seeking structures that

hark back to the gold standard for organizational effectiveness—the entrepreneurial startup. The classic startup is highly responsive to market challenges and opportunities, a characteristic that is essential in today's harsh global economy.

In entrepreneurial startups, the executive team has a clear view of its customers and competitors, the capabilities required to drive value in the market, and the overall potential of the market. The team controls all the levers necessary to create value, and there is a closed loop between market feedback and organizational response. All team members know which decisions each is empowered to make, and they have the data and the tools needed to support that mandate. Further, executive performance is easily discerned and thus highly accountable. The entrepreneurial startup has clear and focused P&Ls with limited or no allocations. And finally, by necessity, these organizations are typically very lean, although they are never efficient at the expense of market effectiveness.

## *Exhibit 1* *Common Symptoms of Misalignment*

PERFORMANCE	DECISIONS	METRICS & MOTIVATORS	PEOPLE
<ul style="list-style-type: none"><li>- Competitors are quicker to the punch</li><li>- Revenue growth lags behind market growth</li><li>- Profits and margins lag behind competitors'</li><li>- Existing business gets more attention than new markets</li><li>- Costs are out of line; synergies are unexploited</li></ul>	<ul style="list-style-type: none"><li>- Most decisions are made at the top or by committee</li><li>- No one is accountable for results</li><li>- Decisions aren't acted on or must be repeatedly revisited</li></ul>	<ul style="list-style-type: none"><li>- Accounting allocations obscure business unit performance</li><li>- Metrics and financials do not fully reflect business unit performance</li><li>- Functions have more control over costs than business units</li><li>- Measures are not aligned with performance levers</li></ul>	<ul style="list-style-type: none"><li>- Frustration and high turnover among employees</li><li>- No bench strength, particularly at the executive level</li><li>- No sense of empowerment at lower levels</li></ul>

Source: Booz & Company

## LET THE MARKET DEFINE THE MODEL

Strategy and organization design go hand in hand, but while most executives would not think of creating a strategy without reference to their markets, they often design or realign their organizations without the same discipline. Like strategic planning, structural design initiatives must be built on the recognition that companies exist to serve markets and therefore should be defined by external market realities, not internal considerations. The goal is to design a structure that is aligned to corporate strategy and supports and enhances the creation of market value.

Typically, however, companies tend to be designed from the inside out, based on available assets and people, or from the bottom up, based on the dictates of functional processes. Even worse, the struggle for personal power can sometimes determine structure; turf wars and other games of ambition are usually not grounded in market realities.

Instead, like entrepreneurial startups, companies should be designed from the market back. A market-back, or market-based, structure ensures that business units are tightly aligned to customers, the corporate core is supporting—not inhibiting—growth, and the drive for synergies enables, rather than conflicts with, effective action. The first step in creating such a structure is a clean-sheet redesign that does the following:

- Identifies and structures natural business units, which serve as the building blocks of a market-back design
- Establishes a strategic, empowering, and market-based role for the corporate function
- Integrates market requirements with the drive for scale and synergies

# RESTRUCTURING AROUND MARKET-BASED NATURAL BUSINESSES

Most companies are too big to be organized into a single entrepreneurial entity, so a key design question arises: How can the total size and scope of the enterprise be deconstructed and reorganized into discrete business units that can behave in an entrepreneurial fashion? We call such units “natural businesses” because each covers a distinct market and leverages distinct operating models and capabilities that enable it to best serve that market. There are several ways to identify a natural business unit (NBU):

- There is competition from independent companies or freestanding divisions of larger companies with the same market scope as the business unit.
- The business unit could be taken public or sold “as is” to a private-equity firm.
- The business unit has unique products with discrete customer segments, channels, or markets.
- The business unit has its own operations in key functions, such as manufacturing, distribution,

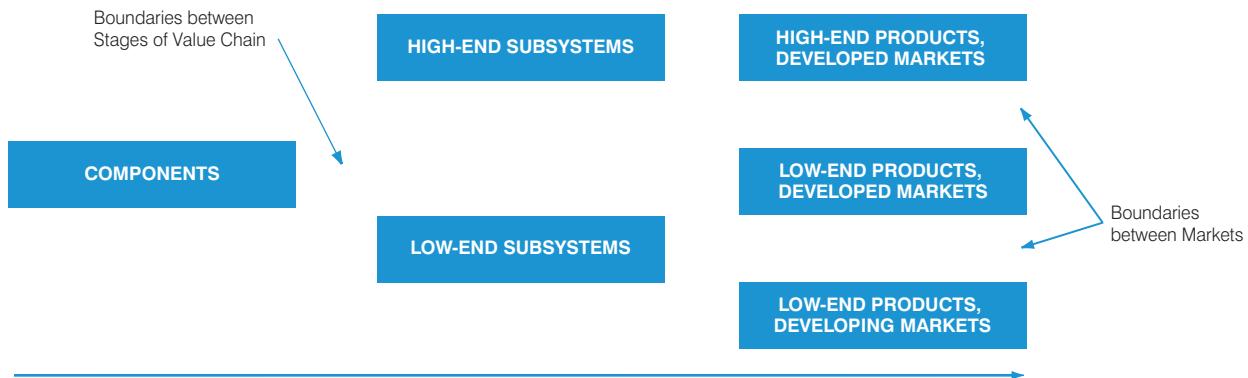
product development, and marketing and sales.

- The unit is responsible for a step in the value chain or a service that could be carved out as a “supplier” to other parts of the company.
- Basic accounting measures—income statement, balance sheet, etc.—accurately reflect the business unit’s financial condition and performance, without significant allocations required.

The boundaries of natural businesses are typically in one of two places: They exist between stages of the value chain, or they exist between markets—geographies, channels, and customer segments (*see Exhibit 2*).

When a company is properly structured into NBUs, each unit aligns with a discrete external market and its unique customer requirements. Day-to-day decision making within the unit can flow naturally with clear accountabilities and measures. And the business unit is positioned head-to-head against the right set of competitors on a daily basis.

*Exhibit 2*  
*Natural Business Unit Boundaries in a Typical Global Manufacturer*



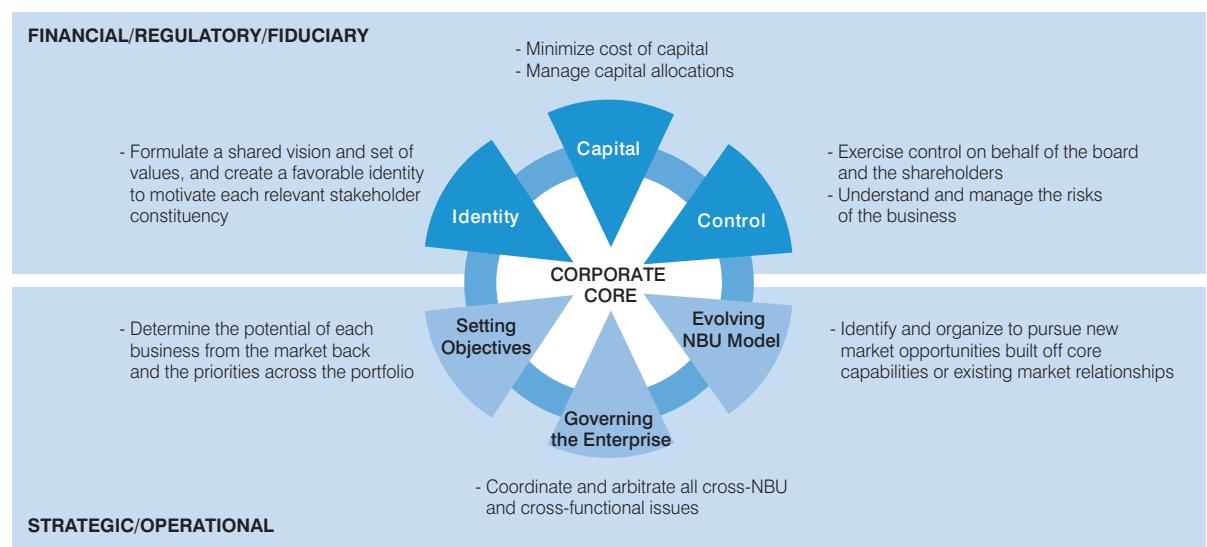
Source: Booz & Company

## A MORE STRATEGIC AND MARKET-BASED ROLE FOR CORPORATE

An organizational structure redesigned around NBUs requires the corporate core to play both traditional and new roles (*see Exhibit 3*). As before, corporate will establish and maintain the company's identity, mission, and values; allocate capital among the business units; and manage both the company's

finances and its responsibilities vis-à-vis shareholders and other stakeholders. In addition, corporate will need to adopt three strategic and operational roles aimed at ensuring the overall integration and interplay of the NBUs: setting objectives from the market back, governing the enterprise, and managing the ongoing

*Exhibit 3*  
*Corporate's Role in a Natural Business Unit (NBU) Structure*



Source: Booz & Company

evolution of the organizational structure in response to market challenges.

*Setting objectives:* In an NBU structure, corporate defines market-based objectives and incentives for each business unit. These objectives, which will differ for each unit, direct and encourage the NBU as it seeks to serve its market in a way that makes it superior to its competitors (as measured by market share and profitability) and exceeds investor requirements (as measured by return on invested capital and return on earnings). The objectives should be based on market potential, not just incremental annual progress or conservative hurdle rates. In performing this function, corporate

will need to maintain a view of the market and competitive environment that is complementary to, but independent of, the company's business units.

*Governing the enterprise:* In an NBU structure, corporate is responsible for overseeing all interactions among business units, including handling exceptions, arbitrating disputes, overseeing the development and monitoring of service-level agreements, and administering the transfer pricing process. The corporate office will also need to identify the potential synergies and capabilities that cross the boundaries between business units, and design and adjust measures and incentives to encourage the business units to pursue

them. This requires that corporate have a strong financial capability to develop insight into the economics of its business unit operations, as well as to execute more traditional reporting, tax, and treasury functions.

*Managing the evolution:* Corporate must also look beyond the new NBU structure to discover opportunities to continually improve the company's structural alignment with its markets. This function requires corporate managers to anticipate where market boundaries are shifting and determine when further realignment is warranted. To fulfill this role, corporate should either establish an internal business development team or engage an external team of focused experts.

*In an NBU structure, corporate defines market-based objectives and incentives for each business unit, oversees interactions among BUs, and identifies synergies that cross BU boundaries.*

# THE ECONOMICS OF SYNERGY

If the deconstruction of companies into NBUs and the alignment of those units to their markets was all that was needed to succeed in business, then every company could be structured into a holding company, such as Berkshire Hathaway. But holding companies that combine unrelated businesses in a single portfolio generally miss the benefits of cross-business synergy.

Conversely, large companies can overvalue the benefits from synergies. For example, the cost benefits of scale are obvious, but the associated costs of complexity or slower decision making are often overlooked or poorly understood. Similarly, one face to the market can seem like an efficient interface with customers, but it can also help the customer

arbitrage across business units. When leaders assign too much value to synergies, they can end up running a more complicated, less nimble, and larger business when they should be deconstructing the business into smaller units that are more focused, responsive, and manageable.

Using a thoughtful, market-based NBU model, a company can both preserve entrepreneurial power and capture the real synergies that exist across business units. These synergies typically fall into three categories: creating efficiencies, improving effectiveness, and building capabilities (see *Exhibit 4*).

*Creating efficiencies:* Because the pursuit of efficiency-related synergies can dilute the entrepreneurial

*Exhibit 4*  
*The Sources of Cross-Business Synergy*

	DESCRIPTION	EXAMPLES
<b>Creating Efficiencies</b>	<ul style="list-style-type: none"><li>- Scale and utilization of people and assets</li><li>- Leverage in negotiating better agreements with external providers</li></ul>	<ul style="list-style-type: none"><li>- Common IT infrastructure; shared legal team; shared services for transactional activities; shared facilities</li><li>- Indirect purchasing; outsourcing agreements</li></ul>
<b>Improving Effectiveness</b>	<ul style="list-style-type: none"><li>- Access to unique knowledge or expertise</li><li>- Sharing of best practices and learning across operations and in new markets</li><li>- Market management (i.e., common branding and avoiding internal competition)</li></ul>	<ul style="list-style-type: none"><li>- One face to local governments</li><li>- Key account managers</li><li>- Managing cross-BU competition</li><li>- Personnel rotation and career development opportunities</li></ul>
<b>Building Capabilities</b>	<ul style="list-style-type: none"><li>- Cross-BU combination of people, processes, and tools that serve market needs</li><li>- Differentiating activities to drive advantage across the NBUs' markets</li></ul>	<ul style="list-style-type: none"><li>- Product or service innovation</li><li>- Value pricing</li><li>- Operational best practices</li><li>- Exploring adjacencies and new business opportunities</li></ul>

Source: Booz & Company

control over a natural business and its markets, the effort should not be undertaken lightly. However, when efficiency initiatives are accepted by business units and offer a potential return on the level of an acquisition premium, they can often capture both the focus of the entrepreneur and the scale and power of the corporate whole.

Companies can improve the odds of successfully capturing cross-business efficiencies by raising performance expectations and using the right contractual mechanisms to encourage the NBUs to seek the synergies. For example, when pursuing efficiencies in support functions, such as finance, HR, and IT, a service center model governed by service-level agreements is a proven mechanism.

*Improving effectiveness:* Inevitably, NBUs come into contact with one another in the marketplace. Here, too, corporate must ensure that the pursuit of individual gains does not create internal conflict or compromise

the larger enterprise. For example, two NBUs selling to the same customer might undercut each other, as might multiple business units negotiating with the same union or dealing with a national government.

The key to managing cross-business effectiveness is to determine whether the contact is an exception or represents an evolutionary shift in the boundaries of the NBUs. For instance, if the products of two business units have become inherently linked in the customer's mind, there may be only one natural business. Or if interaction with China's government is critical to the success of both businesses, it may be that a stand-alone China-based business that cuts across two or more seemingly global businesses is warranted.

If the need for cooperation across the natural businesses represents an evolutionary shift in markets, there are a variety of options. Sometimes one unit (usually the one with the most at stake) can be

assigned the lead in handling the interface on behalf of the entire enterprise. Sometimes an executive position can be created in corporate to manage and be accountable for the interaction. Examples include corporate labor relations or global account management that functions across business units. In all cases, successfully managing interfaces across business units is dependent on clear roles, responsibilities, decision rights, and measures.

*Building capabilities:* Finally, each NBU will have a set of core capabilities that if fully developed can create an advantaged position in the market. To the extent that these capabilities are common across business units, it is clearly in the corporate interest to hone them and distribute them across the company. The key is to identify only a few critical cross-enterprise capabilities and avoid a proliferation of less essential capabilities that will compete for resources and dilute the corporate focus on what really matters.

## DON'T WASTE A GOOD CRISIS

Although the value of a market-based organizational structure is widely understood, many companies do not act on that knowledge. Some bend to market pressures or decide to pursue scale at the expense of focus. Some are convinced that resources should be shared and, therefore, weaken the influence or control of their internal entrepreneurs. Some are just uncomfortable with the relegation of corporate to oversight or simply succumb to politics and empire

building. Finally, some are occupied with battling short-term conditions and see structural transformation as a distraction rather than as a necessity and an opportunity.

But if there has ever been a time to create a market-back structure, it is now. Leaders who align their organizations with market principles and structure their business units to mirror the marketplace will capture the focus and responsiveness of the entrepreneur along with the strengths of the full enterprise's scale and scope. Both moves will be essential if companies are to deliver superior performance in the months and years to come.

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