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Manage Resource Allocation to Craft Strategy

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Abstract

Research from a set of studies conducted over 35 years shows that actual strategy rather than words on paper at corporate is crafted step by step as company resources are committed to policies, programs, people, and facilities. In turn the process of allocating resources is distributed across all levels of the company. Those activities go on simultaneously. As a consequence, the way in which the structure divides up responsibility and the way the processes of the organization distribute information have vital consequences. *Senior managers often have less control over their strategy than they think* while middle managers and operating managers can have a much greater role on strategy than is generally recognized either those managers or by top management: But the complexity of the resource allocation process only increases the need for leadership at the top. This requires a more complete understanding of the processes of the company from a strategic perspective. That understanding implies that systems cannot substitute for management in the resource allocation process.

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The concept of corporate strategy entered the curriculum at Harvard Business School in the early 1960's as part of the work Professors Kenneth Andrews and Roland Christensen embarked on to redevelop the Business Policy course. Using what we now call a SWAT framework for analysis of a company's environment and resources, the concept proved a remarkably powerful way to organize thinking about the process of giving direction to a company's activities. Many cases and industry studies were published that helped faculty and managers to see how these ideas could be used to explain the success of some companies and the failure of others. Over the next decade faculty, corporate staffs and consulting companies embraced the ideas and elaborated them with ideas such as growth share matrices and the five forces in order to drive companies. Strategy was everywhere. But how was it managed?

At the same time the concept was developed, we began to study how strategy was made. The story was at least as important but was a lot harder to understand. The simplest way to state what we found is to relate one of our early research experiences. One day in 1964 while visiting a large company headquartered in NYC, we ran into the very distracted company controller. Asked what the problem was, he told us that he had received a capital project proposal for a large chimney from one of the important divisions. Not clear how a chimney could function independently, he had flown to visit the division and discovered they had built a plant using work orders that did not require corporate approval. "The chimney is the only thing that was too big. Now I don't know what we should do!"

It turned out that the division management was eager to get on with the building of a new business and despaired of getting corporate approval in a reasonable time frame. Sure that they needed the new capacity, they had built the plant but needed the chimney. In the end, after things were sorted out, it developed that the division managers were right. But who was running the company?

What we saw then and have seen again in one research study after another is that actual strategy rather than words on paper at corporate is crafted step by step as company resources are committed to policies, programs, people, and facilities¹. A far more dramatic example from 35 years later comes from one of our favorite case studies. It involves Lou Hughes who took over as chairman of the Vorstand of Opel, GM's large European subsidiary in April 1989. Having grown up in Cleveland, attended General Motors Institute and Harvard Business School, he joined the finance staff of GM headed up by Jack Smith. The real excitement began in November 1989 when the Berlin wall came down and shortly thereafter Volkswagen, Germany's number 1 producer, to which Opel was always number 2, announced a deal to lock up the entirety of East Germany's

¹ The thirty five years of research embodied in this article is developed in the authors' book, *From Resource Allocation to Strategy*, Oxford University Press, 2006

manufacturing capacity, with a new east German car to be introduced in 1994. The phone rings and Jack Smith asks what Hughes is going to do about East Germany.

A conventional view of strategy making would have Hughes' staff gather information for corporate, which would then prepare studies, and develop a plan that fit GM overseas strategy that conceived the proper approach to Europe to be large modern focused factories based in low wage countries such as Spain. The paperwork would be debated and approved by the Board. The process might take a year, especially since very little concrete data was available to support analysis of the East German market, which in any event was still in a sovereign country with its own laws and currency guarded by 400,000 Soviet troops.

In fact, as would be the case with most managers running large subsidiaries in a foreign country, Hughes' initiatives as he pursued the opportunity with some vigor, began to create facts on the ground locally that were inconceivable to corporate planners. Acting on an introduction by Opel union members to a part of the East German automotive combine that was eventually carved out by Opel, Hughes negotiated an opening in the combine that permitted building a new factory, allowed the local leader to publicize it and induced Helmut Kohl to subsidize it, while drawing on talents from other operating divisions of GM to insure that it would be state of the art. The bottom up vision framed in the German context defined the strategic response that was funded primarily because GM top management endorsed the initiative of its general manager for Germany despite the objections of corporate staff.

As with the chimney story, corporate was preempted by local management doing what it thought best for the corporation. Eventually Opel would build a state of the art manufacturing facility in East Germany. But unlike the chimney story, the commitment of resources would be proposed by Hughes, approved at the European Strategy Board and then again by the corporation, despite the apparent contradiction between the Opel's plans and corporate strategy. From the perspective of GM strategy, it would be critical to know what the next step would be in order to know whether this was an aberration tolerated because of a local need, or whether it signaled a shift in corporate direction. It would be the next resource commitment, not the words on paper that would tell the story.

The Structure and Process of Strategy

Does the Opel case demonstrate how resource commitments shape strategy or is this just an organization out of control? Many of our more traditionally minded strategy planners assume the latter. Yet, over thirty years of research on the resource allocation process repeatedly reveal a set of structural and process characteristics that look like Opel. The complex pattern of bottom up and top down processes interacting appears to be robust across organizations.

In fact, Opel highlights what we have found to be near universal aspects of the way strategy is made. First, the way in which the structure divides up responsibility has vital consequences.

- Knowledge is dispersed across multiple levels of the organization. As the wall tumbled, there was little known about the East German market and what was known was gathered by Opel marketing staff. GM's mastery of lean

manufacturing technology resided in California and Canada. While European strategy was developed in Zurich. The fact that Opel had a director for manufacturing did not mean that he knew anything about the process technology in California.

- Power is dispersed across multiple levels of the organization. Lou Hughes could fund studies with his budgets and negotiate with East German counter-parts. But he could not command his manufacturing director to work with California nor insist that California worked with Opel. The right to approve a plant in a new country lay with the Board of GM. Approval to get to the Board would include GM Europe and the head of GM Overseas activity, and the financial and other staffs could provide evaluations of their own. Nonetheless, Hughes' negotiations could virtually commit GM.
- Roles are narrowly defined. Miles' Law states that where you stand is a function of where you sit. In fact, the scope of each of the many executive was specified and many roles were narrow. As a general manager of Opel, Hughes had extensive responsibility, but depended entirely on the cooperation of his functional officers who possessed needed expertise and years of experience at Opel, as well as those in other parts of GM to help out. Hughes ability to move fast depended on their engagement. Roles become lenses through which the nature of problems are perceived. If we do not see how we can execute on a plan, we are likely to perceive it as infeasible. Hughes' triumph was to persuade them to imagine that they could deliver on a radical idea.

Just as important, the way the processes of the organization distribute information has vital consequences.

- Processes span multiple levels. What this means is that when Hughes was developing his proposed new factory, staff at GM's corporate headquarters might be using for input to their financial calculations sales forecasts prepared by Opel sales staff. These individuals might or might not know about competitor's plans, about GM's plans in other markets, or GM's views on the world economy.
- Activities of all sorts proceed simultaneously. At the same time that Hughes was taking steps to obtain funding for a new plant in East Germany, the European and corporate staffs were proceeding with plans to locate production in focused factories based in low labor cost countries – not necessarily East Germany after monetary and political unification. In North America, GM managers were planning plant closures.
- Processes are iterative. Once Hughes took part publicly in a factory worker vote that committed the East German spin-out to Opel, it would be hard for them to back out, especially as Hughes was already lobbying with West Germany's prime-minister Helmut Kohl for subsidies. A second level of commitment was obtained when GM funded a facility to assemble 10,000 cars, and those cars were presented to the German public with massive publicity. At that point, in principle, the third stage would be reached when a major manufacturing facility was built. GM strategy for East Germany was revised at each step. How GM's European strategy would develop would depend on whether the movement of currencies and labor costs would make East Germany an exception to the established policy,

and in that case, whether it would be a sole aberration or followed by other nationally focused manufacturing facilities. Further iterations would tell.

Who Controls Your Strategy?

When one reads a list like the one above, it is easy to say, “that’s interesting” and go on. But the proper response is to ask something like, “if power and information are spread out, and processes are simultaneous, who controls our strategy?” To which the proper answer is “many people – not just the top team.” Intel’s exit from the memory business, one of the most repeated stories in management is exemplary. The legend tells how Andy Grove and Gordon Moore had a discussion about the business in which Grove asked Moore what they would do if they had just acquired Intel. When the answer was, “get out of memory, Grove suggested that they do just that. But when they made that “decision,” Intel’s revenues from memory were 4% of its total business. Intel’s organization had already exited. What it hadn’t done is shut down research on memories that were controlled from the top or announced to the outside world that the exit was underway.

What CEOs say and what the firm does may be very different. Leaders of an organization can announce a strategy to become global, change core technologies, or open new markets, but whether or not that strategy is related to what the organization is doing depends in a very significant way on the pattern of resource allocation decisions that are made at every level of the organization. *Senior managers often have less control over their strategy than they think.* Middle managers and operating managers can have a much greater role on strategy than is generally recognized either those managers or by top management: .

- Middle managers can have a powerful impact on strategy. If resource allocation is structured such that knowledge, power, and roles span levels of the organization, then managers at *each* level of the organization are likely to have an impact on strategy. This clearly happens when middle managers make decisions as to which proposals to sponsor and send upward for corporate review. One senior executive communicated his surprised realization of this role: “One of the fascinating moments came as I met with one of the key midlevel managers of our firm. I mapped out your framework on a piece of paper showing the resource allocation process and its effect on the intended and emergent strategies. As we talked, this midlevel manager proudly told me that he was the one who set the strategy at our company, not the CEO or Board of Directors. According to him, he owned the resource allocation process because his boss, who was president of the largest business unit, would not approve anything without his recommendation.”
- Operating managers can have a powerful impact on strategy. Most strategy analysts completely ignore the role operating managers have on strategy outcomes, concluding that these managers are either too tied to the operational requirements of the business to think strategically or too narrow in their scope to see the big picture. Failure to recognize this can have important implications for senior executives as they manage strategy.

For example, Toyota recently launched the Echo, a no frills, low cost vehicle designed partly to protect Toyota from low cost competition. But deep inside of that organization sits a salesperson in a local retail operation. Because margins (and more importantly sales commissions) are higher on other Toyota vehicles, customers are repeatedly steered to higher priced models. Even if the corporate office places a high priority on the new product, the day to day operating decisions of the organization act to direct the realized strategy of the firm elsewhere.

One reaction to this the situation at Toyota is that operating managers (salespeople) are constraining innovation because they are not aligned with the strategy of the firm. However, operating managers can also redirect strategy in very innovative ways. In the situation at Intel described above, the exit from memory took place over time, because the manufacturing management responded to a powerful directive from finance: allocate plant space so as to maximize gross margin per wafer square inch. Since memory and microprocessors used the same silicon wafers, as competitive conditions worsened the rule took Intel right out of memory.

External forces can also have a powerful rule on how resources are allocated, and in turn, how strategy evolves. The most powerful of these forces are the suppliers of capital – the capital markets, and the customers for the company’s products – especially the important ones..

- Customers can have a powerful effect on strategy. Toward the mid-1990s, Tony Ridder at Knight Ridder Corporation had recognized that the internet was going to have a dramatic effect on his newspaper company. Accordingly, he redirected his corporate strategy to focus on the internet, presented annual reports that discussed plans for new media, and moved his corporate headquarters from Miami to San Jose in an effort to locate the company in the center of Silicon Valley and the changes happening with the internet. However, despite these bold efforts to change the corporate strategy of the firm, the realized strategy continued to be largely controlled by existing advertising customers in the newspaper business. Every day as sales reps came into work they had the choice of selling a \$40,000 print display ad to their existing print customers or promoting a \$2,000 online ad that was unfamiliar, even uninteresting to these same advertisers. And every day, these sales reps made the logical conclusion to prioritize their time and effort to selling traditional print ads to their existing advertising customers. Despite the explosive growth in online advertising, Knight Ridder and other newspaper companies struggles to find new streams of revenue that were tied to an evolving online advertising client. Through their influence on the sales force, the existing print advertising customers effectively captured the newspapers’ resource allocation process. That sales force determined Knight Ridder’s strategy.
- Capital markets can have a powerful impact on strategy. That capital markets have a powerful impact on management performance is well understood. That this can dramatically reshape strategy is less well documented, but equally true.

On of the most clear cases of this phenomenon comes from a “natural experiment” in the U.S. telephony market that one of our doctoral students was able to study. Bell South and U.S. West were two “baby bells” that were formed when AT&T was broken-up. Both were born with the same technology, patents, and planning models required to establish a cellular phone business. Despite their similarities, the capital markets determined the growth prospects of US West to be inferior to those of its siblings. In the face of the consequent pressure for earnings growth, US West’s CEO chose to set high earnings objectives and diversify away from regulated telephony wired or wireless. To meet the imposed earnings objectives, the managers of U.S. West’s cellular business adopted a strategy of “skimming” – seeking high margins on the low volume top end of the market.

With lower short-term capital market pressure, Bell South chose to treat cellular as an opportunity that could earn as well as its wireline business, and could grow far better. Bell South was able to pursue a strategy of broad market penetration.

The strategic objectives were reflected in measures for the business that led the two companies to reach very different conclusions on the basis of very similar early performance. US West was disappointed by results that failed to reach the high financial targets they had set. Bell South was pleased with the positive first steps and made further investments. US West ultimately divested its business, while Bell South became one of the leading cellular providers.

Questions Managers Should Ask when Managing the Resource Allocation Process

If division and operating managers, customers, and capital markets have such a powerful impact on the resource allocation process, and in turn, the realized strategy of the firm, what does that imply for the role of corporate leaders? Does this mean that the process entirely out of their hands? Of course not. In fact, we believe that the complexity of the resource allocation process only increases the need for leadership at the top. But you have to understand what is happening and adjust your management. Here are six ways that senior managers can direct the strategy of their firm by better understanding the resource allocation process.

1. Understand the people whose names are on the proposals you read. When you read a proposal, it is normal to look first at the author (and then at how much money is involved). If you haven’t cultivated the habit, you should calibrate what you are reading against the track record of the executives(s) who sign the document. If the signing executive has a near perfect record of proposals implemented, then you know that there is probably little downside in what you are reading, but the upside may be significantly underexploited. Requests for resources are based on stories about the future. Those stories may be summarized with numbers but they represent judgments about uncertain developments. This reality will kill your finance staff because they are good at crunching numbers, not calibrating what line managements understand and what they don’t.

2. Recognize the strategic issue and make sure it is addressed. Almost always requests for resources involve two decisions: should we support this business idea? Is this proposal the right way to go about it? The latter question is the “how to?” question. Most capital budgeting processes are set up to vet projects. It is usually possible to carry out fairly rigorous quantitative analysis comparing the plan of action in a proposal with alternatives. It is important that this analysis be done - and it will often be done ad nauseam - but our research shows that the *business* question is more important and far more difficult and often ignored. It is easy to invest money in cost saving projects that will earn precisely the returns forecast in businesses that overall are losing money. After the project, they just lose less. One of our studies showed that companies and their industry poured new money into old technology at the same time that they were investing in facilities based on new technology that made the first set of investments obsolete. Managing resource allocation to build sound strategy involves the “should we?” question. Should we put a plant in East Germany? In the end, you may decide to back a management team rather than their logic, because you want to support them. But do it with your eyes open and controls in place.
3. When a debate reflects fundamental differences about the strategy, intervene. As noted above, the formal process will often miss the big issue and focus on project details. The “should we” question inevitably involves basic issues as to how the company wants to compete. It will almost always involve different views as to the best way to compete that reflect the positions of the executives in question. Lou Hughes thought that he could use a new East German facility to drive change at Opel’s main plant. Some at GM corporate thought it more important to continue expansion at low cost sights in southern Europe and in Latin America. Good resource allocation uses the opportunity of investments like East Germany to trigger strategic discussion that crosses organizational perspective, that gets executives with different kinds of knowledge in the same room to discuss the evolution of strategy, not the details of a project proposal. Intel’s Andy Grove calls this “getting knowledge power and position power in the same room at the same time.” Top management almost always has to convene that meeting and pay attention to who is invited. It will also have to work hard to create a collaborative environment.
4. Barons defend their turf; operators serve customers. When top management believes that the right way to serve a market involves two or more divisions cooperating, there is an immediate problem. The bottom up process will not naturally develop a proposal because inevitably the division heads that see their ox being gored and they serve as gatekeepers. This is another case where top management must intervene. If freed from divisional measurement and compensation, operating talent can be engaged by the opportunity to serve customers better. It won’t happen automatically, but we have numerous cases where cross divisional teams assembled and supported by top leadership have been able to work issues successfully that were resisted by their superiors. The virtual companies created by the marketing services giant WPP to focus on markets such as health care or retail are examples. Note: be careful during staffing that kind of team. The easiest way for a division to undermine such a

- project is to deny it the right people. This recommendation means you have to be concerned that the right questions are not being filtered out, and the right people are made available to work those questions.
5. The leadership has to connect the dots. This is a related point. Understand that bottom up processes do not add up to a corporate view. Research shows that top management may have to lay out the big picture when more than one division is or ought to be involved in the question before the company. When bottom up processes are at work, conflicting divisional perspectives tend to work themselves out on the basis of power, or compromises that share resources “fairly.” Worst, there may be an agreement – explicit or tacit – not to challenge a sister division’s proposals in return for the same treatment. In many companies that is the norm. It will be an accident if this result is what the company could achieve if the corporate resources were pulling together. Especially when large sums are involved under great uncertainty, top management needs to get involved and frame questions that reflect the corporate perspective. What’s best for the company?
 6. Create a new context that will free up thinking and talent when you need to circumvent the regular resource allocation process. Most out of the box or disruptive ideas are badly handled by bottom up resource allocation process. It is top management that has to ask, “Is there a technology under development that looks inferior today, but will undermine our business from beneath once it is properly developed?” Windows NT had this impact on UNIX applications, as did internet applications in a host of industries. It takes a very well informed paranoia to ask this question early enough to keep a strong company in the lead.

The implication of these six recommendations is really a meta-recommendation. Once you realize that resource allocation decisions make your strategy, then you know you can’t rely on a system for managing the resource allocation process. No planning or capital budgeting procedures can substitute for the involvement of the best leaders in the company. No system of incentives will align objectives so that new opportunities will be studied correctly with the corporate interest in mind. Because of its impact on strategy, the corporate general management has to engage itself – selectively to be sure – in the debates that mark inflections in the process.