Building competitive advantage in a global economy
Special focus section
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We live in challenging times. Numerous unfolding — and sometimes contradictory — events are fueling uncertainty about the direction of the world economy, making it difficult for companies to know how to react. The global recovery is slower than expected. And, at the time of this writing, unemployment remains stubbornly high, housing markets are stagnant, and fiscal deficits are at unsustainable levels in the United States and Europe. Yet those factors no longer tell the entire story. Many Asian companies are benefiting from a robust economic recovery. Even in the United States and Europe, corporate profits are up and deal-making is accelerating. While the shape of the global economic recovery remains uncertain, companies in the United States and around the world are wasting no time charting new courses for sustainable growth and building a competitive advantage.

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companies are adapting to new circumstances, taking advantage of opportunities in global markets, leveraging technology, and recalibrating talent, as well as what part acquisitions may play in their growth plans.

Rebalancing of the global economy

The global economy is rebalancing, as nations change relative position. For example, in 2010 China surpassed Japan as the world’s second-largest economy. And while the US economy remains the largest, the demographics of countries such as China, India, Brazil, and Indonesia could change the mix yet again.

Many believe that over the long term the US economy will no longer be the main driver of economic growth, and that trade and investment patterns will consequently change. Those shifts will likely have a major influence on investing internationally, and on currency, regulatory, and reputational risk.
As a result of the global recession, governments around the world have intervened heavily in their markets and are changing policies and regulations governing the business environment. Today more than ever, government fiscal policies are shaping economic outcomes. Therefore, it is prudent to not only evaluate a country’s potential for growth but also its foreign investment environment before making investment decisions.

In Europe, governments have shifted fiscal policy toward austerity; accordingly, economic growth is projected to slow in 2011. In contrast, consumer demand is likely to remain steady or rise in China, Brazil, and Australia, where stimulus helped the private-sector economy gain traction. The strengthening of many emerging market currencies, in relation to the US dollar, has hurt the competitiveness of their exports and could limit the opportunities for sourcing in those markets.

Some governments, including Indonesia and Poland, are implementing policies to attract foreign investment through tax breaks for capital investments, subsidies for new businesses, or low-cost financing. Such governments view foreign investment as an important source of capital for their economies. On the other hand, some governments give the advantage to local businesses over outsiders. For instance, China has provided preferential loans to domestic players, while Russia has enacted policies that restrict foreign companies from investing in “strategic” sectors.

Additionally, brands and businesses that are perceived as “foreign” may also be subject to rising nationalist and anti-globalization sentiment. That may hinder a company’s ability to succeed in cross-border mergers and acquisitions, especially if the public perceives the company is gaining undue market share or control.

Marked differences in the speed that countries are recovering from the global economic slowdown are impacting exchange rates and rapidly shifting the costs of doing business abroad. The relatively faster growth, coupled with historically low interest rates and rising savings rates, has further intensified currency appreciation among emerging economies. In response, policy makers in these countries have turned toward currency management to protect manufacturers.

Policy makers in export-oriented emerging economies are particularly under pressure to act, as the appreciation of their currencies reduces the competitiveness of their exports. If those nations don’t
follow China’s lead and manage currency appreciation, they will fall further behind China as to the relative cost of their exports. But following China’s currency policy can be expensive. And so countries have been looking for alternative ways to slow the strengthening of their currencies. For instance, Brazil and Thailand have created and expanded taxes on capital inflows into credit markets.

Management should monitor exchange rate movements and policy changes that affect the company’s operations and discuss with the board how it will respond to related challenges. Management also should consider the strategic business implications of potentially significant and long-term currency shifts — perhaps most importantly from a rising yuan and yen and a falling dollar.

More regulatory risk
The credit crisis and resulting global recession prompted governments to rethink their role in the marketplace, with many policy makers taking the view that greater intervention is warranted. In most industrialized countries, the focus is on constraining risky and unregulated activities and restoring consumer and investor confidence. The Dodd-Frank Act is a prime example. Longer term, governments may be able to reduce their direct involvement as economies rebound.

In a number of emerging markets, however, increased state intervention appears to reject basic free-market principles. US companies operating in these markets may find their competitiveness threatened by state-owned enterprises and domestic companies that benefit from government policies. If such anti-free market policies continue to be adopted, foreign companies may also face increasingly intrusive partnership, licensing, and technology transfer requirements, as well as environmental, health, and safety standards that are not as rigorously enforced for local companies. Companies may also face different risks and opportunities as governments seek to increase their countries’ competitiveness and reorient their economies toward more sustainable drivers of growth — as with proposed labor market changes in Chile and tax reform in India.

More complex reputational risk
Doing business in emerging markets, which often have lower environmental, health, and safety standards, also exposes companies to reputational risk. Advances in communications, including social networking, enable criticism about the company’s behavior in its foreign operations to spread more widely and quickly than in the past.

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Innovation as a strategic imperative

The emergence of these global trends, including global rebalancing, will likely create new competitors from different corners of the world. For companies to sustain growth and build competitive advantage, innovation must become a strategic imperative. Companies remain committed to the operational efficiencies they’ve achieved during the economic crisis. But that cost discipline may stifle innovation, which is vital to grow in a competitive world market. If your company isn’t bringing new ideas to market, your competitors will.

Innovation is meaningful only if the new products or different processes create value. Innovation is not only about how much your company spends on R&D or the number of patents it registers, but also about developing a culture that encourages employees to think about what’s next and what could work.

Companies innovate in two ways. The first involves incremental changes that help reduce waste or increase efficiency in existing operations. These changes are generally modest in nature. Having employees on the lookout for these opportunities is important, but such changes will only rarely move the needle in a big way.

The game-changing ideas usually come instead from the “innovation lab.” As R&D focuses on the next generation of products or services, many of its ideas won’t succeed. Indeed, failure rates typically range between 70% and 90%. Managers who grew up in companies where failure is not tolerated often have a difficult time making the leap to risk such a high failure rate. So what factors support innovation?

- An environment that expects and tolerates a certain level of failure as the team tries out new ideas. It doesn’t hide failure but instead shares lessons learned. It avoids demoting or otherwise punishing individuals whose ideas don’t work. And it’s suspicious of repeated success, as that could mean the team isn’t stretching.

- Support to advance ideas past initial stages. That doesn’t mean the company needs to provide a great deal of funding. But it does mean the funding needs to be available at the right times, so the team can either reach important milestones, or discover quickly if an idea doesn’t work and move on to other ideas.

- The right measures. Some companies track what is moving through their development pipeline — how many products are at the various stages from incubation through acceleration and scaling. Some set goals for the percentage of revenue from products they didn’t have a few years earlier, as a measurement overall of how well they are innovating. They also tie these measures to the performance goals set for employees.

The ultimate goal is competitive advantage: bringing a unique good or service to market that your competitors can’t easily replicate.
**Leveraging IT**

Information technology, once relegated exclusively to operations, is emerging as a strategic business function. It has become a potential source of competitive advantage and, therefore, directors will want to understand the opportunities for and possible risks of technology to their company. Among the most important technology developments is cloud computing.

Companies still spend the lion’s share of their IT operating budgets — by some estimates, upward of two-thirds — on ongoing maintenance, leaving relatively little for innovation. Demands on existing infrastructure have increased sharply in recent years. Companies are generating enormous amounts of information and sharing it in ways and at speeds that were unthinkable a few years ago. Cloud computing holds the promise of being a true solution to meeting these many demands.

Cloud computing allows computing services to be supplied over the internet without the need for companies to provide their own internal hardware or platform support. The cloud provides the servers, switches, and storage needed to build an application environment. Cloud computing provides clear cost advantages to companies that can lease computing and data storage capacity from web-based providers. How? By reducing companies’ capital investments in equipment and software, and lowering operational maintenance costs. In addition, cloud computing is scalable, with an on-demand model that lets companies pay as they go.

Momentum for cloud computing and its supporting technologies has been considerable. But companies are only starting to feel the real impact. Cloud computing can play a strategic role for all companies, not just those in the technology or services industries. By doing away with typical IT constraints — limited resources, consuming maintenance, and incompatible systems — cloud computing frees a company to pursue growth and innovation. Companies should be viewing cloud computing developments as a source of competitive advantage with great potential, instead of as an incremental improvement in information technology. Directors will want to understand how management is leveraging the opportunities cloud computing brings.

While IT innovations bear promise, directors should also be aware of some of the associated risks.

- Cloud computing entails data security risk, particularly in moving company data to a third party for storage, processing, or support. These data integration and ownership concerns need to be addressed to protect intellectual property as well as to safeguard employee, customer, and counterparty information.

- It’s easier now for employees to adopt unapproved external solutions when the IT department isn’t meeting their
needs quickly enough. But such “shadow IT” solutions won’t necessarily be reliable, interface with the company’s existing systems, or meet the company’s data security and privacy standards. Management needs to establish adequate controls to monitor the prevalence of such applications, determine whether they pose significant risk, and ensure the company is properly protected.

- Because we take technology for granted, employees could inadvertently disclose sensitive data on social networks or leave the company’s networks vulnerable to attack through their online actions. To reduce such risks, management can increase training available to employees and focus resources on protecting data that is most at risk, instead of trying to lock down everything.

**Successful companies manage human capital and talent as strategic assets.**

This is a trend that many American workers are well aware of. They are being challenged to learn new skills and deliver higher productivity in a tough labor market. In fact, new skills needed to succeed in today’s business environment include greater risk awareness, change management, and the ability to work across diverse cultures and respond to new consumer demands. Many companies that downsized aggressively — and US companies were at the forefront of global retrenchment — could soon face a shortage of skills suited to the new global economy.

Successful companies manage human capital and talent as strategic assets. They continually strive to align their workforces with company objectives through providing distinctive work environments, benefits and incentives. In fact, our 2010 annual Global CEO Survey found that about a third of US CEOs are changing their people strategy — with respect to training and development as well as staff morale and employee engagement programs. And a fifth say they are taking a fresh look at pension and healthcare arrangements.

**Recalibrating the workforce**

Structural shifts from the rebalancing of the global economy are being felt as much inside companies as outside. As one CEO observed: “Even though we’ve had a 9–10% reduction in terms of staffing, we’ve also had increases. We see a lot more people, for example, on the digital side being added to our talent base.”

Increased workloads, job reductions, and overall economic and employment uncertainty have strained employee morale, and as welcome as the recovery is, it adds even
greater challenges in workforce management. Human resources’ role may need to focus more on finding and motivating the right talent. To do so, human resources needs to understand the business strategy and identify the talent required to support that strategy.

**Growing through acquisitions**

Not all growth is organic. As companies emerge from the recession, many have accumulated significant cash reserves and are considering acquisitions. It’s important for management to be able to predict the earnings impact from possible acquisitions, but it is challenging to do this reliably.

In assessing a potential acquisition, companies typically estimate the fair value of intangible assets so they can project the expected amortization expense, which can be a significant factor in future earnings. Historically, these estimates were driven by “benchmarks,” which were based on the percentage of purchase price allocated to amortizable assets in past transactions. Benchmarking can be useful, but it has limitations. A 2009 change to acquisition accounting for certain items (such as earn-outs and in-process research and development) means that benchmarks based on transactions that closed prior to 2009 won’t factor into the earnings impact of such items. Management needs to adjust the estimation and expectation for such factors to avoid post-acquisition earnings surprises.

How can management avoid these surprises? By taking more time in pre-merger negotiations, using more sophisticated valuation techniques, and drawing on valuation and acquisition accounting expertise, as needed. If management can more accurately estimate the earnings impact of potential acquisitions, the board is able to make better-informed decisions.

**Directors’ actions**

- Understand how global developments are affecting both existing operations and investment opportunities.
- Discuss with management how it plans to further pursue and promote innovation as a key element to support growth.
- Discuss with management the value that cloud computing can bring to the company and how it can exploit the strategic opportunities while managing the risks.
- Understand how management is reshaping the skills and size of the company’s workforce in light of its strategy and today’s economic conditions.
- Discuss with management the level of analysis performed to support acquisition-related earnings guidance used in decision making.