McKinsey on **Finance**

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Outsourcing grows up

Many outsourcing deals are tantamount to strategic divestitures and joint ventures. Executives should start treating them that way.

David Craig and Paul Willmott

When companies first started thinking about farming out nonstrategic functions—such as payroll, IT maintenance, facilities management, and logistics—their goal was to reduce costs. Today, however, these corporations regularly contemplate outsourcing core operations to third-party specialists in order to improve operational performance. Many such deals are big and strategic enough to qualify as "bet the company" arrangements involving a complex mix of people, processes, and assets. Indeed, almost 100 megadeals (contracts with values of greater than $1 billion) have taken place in the past ten years, with 15 in 2003 alone.[1]

Yet few companies have changed the way they make deals. Our research[2] found that most corporations still rely on a standard procurement approach, with contracts and agreements managed by individual departments—the way they make commodity purchases. This mind-set is underscored by the increasing use of third-party consultancies, which often reduce the bidding process to a commodity comparison of vendors that limits transparency and that uses price as the primary decision-making factor. Neither customers nor vendors are served well: the process limits ways to improve the economic value of a deal for both sides and creates large, unnecessary risks that vendors are expected to bear.

Not surprisingly, up to 50 percent of outsourcing arrangements fail to deliver the expected value (Exhibit 1). Poorly planned deals often have some of the same shortcomings as flawed divestitures and joint ventures: companies overestimate the economic benefits of the deal, fail to establish the right baseline for price negotiations and performance tracking, or are not fully prepared to manage the transition and postdeal situation. And outsourcing has some unique challenges as well. Companies sometimes accept a vendor's riskiest goals, establish strictures that reduce the vendor's ability to manage costs effectively, or put so much emphasis on getting rock-bottom prices that they lose essential performance guarantees and flexibility.

Given the size, the degree of complexity, and the importance of outsourcing deals to a company's overall portfolio strategy, we think senior executives would be wise to apply the same rigorous approach to these agreements as they would for mergers, divestitures, and joint ventures. Both the

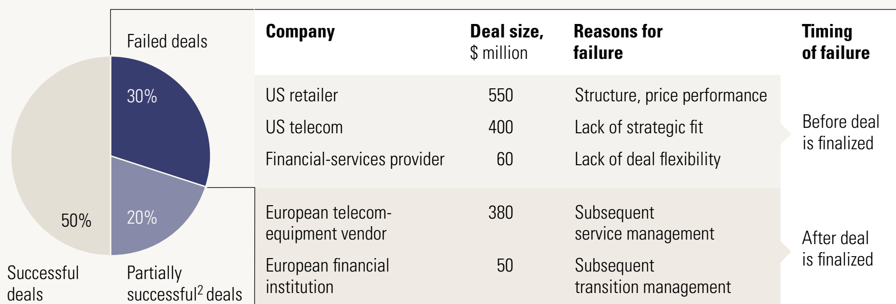
[1]Gartner.

[2]We studied 30 outsourcing deals, signed in the past four years and worth more than $20 billion in total contract value.

EXHIBIT 1

Around half of all deals come up short

Outsourcing-deal success rate[1]



Company	Deal size, $ million	Reasons for failure	Timing of failure
US retailer	550	Structure, price performance	Before deal is finalized
US telecom	400	Lack of strategic fit	
Financial-services provider	60	Lack of deal flexibility	
European telecom-equipment vendor	380	Subsequent service management	After deal is finalized
European financial institution	50	Subsequent transition management	

[1]For 30 outsourcing deals signed within past 4 years and worth >$20 billion in total contract value.
[2]Deals did not deliver planned benefits and/or were subsequently reduced in scope after problems with suppliers/customers arose.

customer and the vendor must find the relationship valuable over the longer term.

Applying M&A principles

When outsourcing deals were smaller and limited to noncore processes, executives could treat the transactions as fairly standardized, the strategic implications as limited, and the risks as well understood. Today, the executive team no longer has the luxury of easy decision making, and not merely because the average size of deals has grown. How a company develops its outsourcing relationships directly affects its core strategic planning: the shape and boundaries of its corporate portfolio and the focus of its executives. Some guidelines can increase the odds of outsourcing success.

Clarify deal strategy from the beginning

The strategic objective of an outsourcing deal must be explicit from the outset. The goal of some deals is simply to have a low-value job done more cheaply, to make the cost base more variable, or to leverage a provider's skills, expertise, technology, or processes. Many of today's arrangements go further, aspiring to improve operational performance and service levels or to free managers to focus on higher-value-added activities.

Once the objective of the deal is clear, the best way to structure it becomes clearer too. It often makes sense to go far beyond a traditional procurement-type contract. If the outsourced function or process is noncore, for example, and if cost cutting is the primary goal, then often an outright divestiture makes sense. Many of today's formalized outsourcing arrangements are effectively divestitures, even if managers don't think of them that way. Such arrangements transfer assets—including people, systems, intellectual property, and even buildings—to a vendor and create obstacles to bringing them back in-house. Companies also cede management control to vendors, since the contract governs the formal relationship. Unfortunately, most managers still think about their outsourcing contracts as if they can recover all their assets at the end of a deal. In fact, while many outsourcing agreements include provisions for the return of assets, the vendor often retains access to intellectual property and has already reassigned its best people to other contracts. As with any divestiture, companies should consider such a move only if the loss of flexibility won't hurt business performance.

One financial-services institution learned this lesson the hard way when it structured the outsourcing of its lending operations as a divestiture. The company relinquished control of its people and IT systems in return for guaranteed service but lost the flexibility to support new products. The managers who structured the deal had focused primarily on cost cutting without considering this crucial component. They discovered the flaw when the institution was unable to offer new forms of lending: it was precluded by contract from developing the product, and the vendor was unable to develop it.

On the other hand, if the goal is to improve the performance of a strategically important function or process, then managers should consider structuring the deal like a joint venture. Under this type of arrangement, both companies share ownership and control of assets, splitting the costs of new applications, technologies, and operating improvements. An approach that incorporates the best features of a joint venture—without necessarily creating one—can help align incentives for both parties to make the deal work and to create economic value. Specifically, it rewards the vendor's successes while allowing the buyer to retain flexibility and control.

One European company structured an outsourcing agreement as both a divestiture and a joint venture. It transferred ownership and control of its desktop and network IT assets to the vendor but shared a core-application platform critical for addressing changes in the marketplace. One year later, both companies are working together to improve the effectiveness of the applications and reduce costs. Meanwhile, the vendor has freed the company's management from the time-consuming task of redesigning and improving the desktop platform and network.

Assemble the right team

Companies typically rely on teams with a heavy concentration of IT managers to execute and oversee outsourcing relationships. Historically, IT functions were early targets for outsourcing, so these managers developed expertise in this area. Today's complex arrangements, however, require a deal-making team with a wide range of skills that go well beyond those of most IT experts.

Innacurate estimates of the total value of an agreement lead to incorrect revenue distribution between the buyer and the vendor.

As in any M&A deal, at least one team member should focus on the economics of the deal. In addition to handling the typical merger questions, this individual should be fluent in the process to be outsourced as well as the vendor's economics. We find that often companies accept a vendor's target prices or risky promises at face value. Other team members should be able to draw on that knowledge to determine appropriate service levels and transition plans and to manage supply and demand.

Such detailed knowledge is critical, since a key component of negotiating for shared value is setting the right baseline—the basic level of vendor support and its current cost. A pricing expert, organizational-change specialists, and experienced negotiators should also be included on the team. One company that sent its development of IT applications to India assembled a team of five technology experts and three human resources (HR) managers, along with representatives from each business unit, third-party consultants who understood offshore economics, and specialists in M&A, law, and tax. The team, led by the CIO, reported biweekly to the global executive committee. Over the course of its eight-month tenure, the team structured the scope and incentives of the deal, planned the transition, managed the economics, and selected and negotiated with the suppliers.

While the use of a third-party consultant can be beneficial to both sides in an outsourcing negotiation, its role often deteriorates into commodity procurement—to the detriment of customer and vendor alike. These firms usually position themselves as intermediaries, often precluding any direct contact between the customer and the vendor. As a result, negotiations become exercises in adherence to a proposal written without the creative input and experience of vendors. Furthermore, third-party consultants often discourage customers from discussing any alternative proposals from vendors, even if this step is in the interest of both companies.

Focus on value, not cost

Many companies with traditional outsourcing agreements have focused only on the embedded value of an agreement—the cost savings realized by the buyer or the new revenue streams created by the vendor. As a result, inaccurate estimates of the total value lead to incorrect revenue distribution between the buyer and the vendor or undermine the deal altogether. One financial-services company, for example, hoped to transform its

EXHIBIT 2

Shared value in negotiation

Typical M&A deal structure	Contribution to total deal value	
	Buyer	Supplier
Embedded value	• Provides assets (people, systems) and business volume over contract lifetime • Bears cost of setting up, managing contract	• Introduces new efficiencies, cost-structure benefits • Improves buyer's service levels/control, reduces buyer's management overhead, and thereby improves buyer's balance sheet • Reduces buyer's delivery risk
Option value	• Provides supplier with skills, capabilities to attract new customers • Contributes to cheaper service platform for new supplier's subsequent clients	• Gives buyer ability to absorb higher volumes, create new products, or make acquisitions
Liabilities	• N/A	• Bears transition risk • Reduces (or increases) buyer's operational risk
Exit cost	• Carries cost of transferring operations elsewhere or bringing them back in-house	• Carries cost of losing buyer's business

Typical deal focus

customer-service and back-office functions by outsourcing the development and operation of its new customer-service platform. The company spent three months negotiating solely on price, and while it ultimately got the lower price it had sought, it did so at a considerable cost: the supplier no longer guaranteed performance, shared the operating risk, or contributed staff. The deal changed from a partnership focused on business improvement to simple software procurement.

A more complete examination of the sources of value—a key principle of smart M&A—can help an executive team set a realistic and fair target price. Many outsourcing agreements also generate value through options including new business opportunities, such as the vendor's resale of deal-related software or the buyer's offering of new products to new markets. Other teams create value by changing the liability and risks their company faces.

The key is to consider all the components of value, along with the risks (Exhibit 2). What is valuable to the buyer may cost the vendor, and vice versa. Higher service levels can typically increase the vendor's cost base by requiring more resources, for example.

Similarly, retaining architectural control may feel more comfortable to the customer, but doing so eliminates one of the primary sources of value creation in an IT infrastructure: the centralization, consolidation, and standardization of applications and hardware. Even though a vendor may try to protect itself by extracting promises from customers to perform some of these transformations themselves, it often has little recourse if customers don't follow through.

Create transparency

Increasingly, the initial proposal is used as the baseline for the asset and labor pool that the outsourcer will handle, and vendors are not permitted to conduct their own due diligence before signing the deal. Furthermore, in many cases the contracts don't even contain the ability to verify the deal's assumptions—and thereby the price. This arrangement creates significant and unnecessary risks for vendors, since the structure and cost of a technical solution are critical to the amount and level of services a vendor must provide.

In extreme cases, the denial of due diligence is combined with a so-called sweep clause, which requires a vendor to assume all physical assets, labor resources, and services formerly provided by the customer's IT department—even if they were not included in the initial proposal or even in the contract's statement of work. Omissions in the proposal's baseline are often one-sided, however, since customers often are

EXHIBIT 3

Safeguarding the deal

Safeguard	Outsourcing approach	Examples
Earn-out: Links final acquisition price to future earnings	• Supplier fees linked to business volume • Bonus/penalty clauses linked to business performance	• Volume boundary for price is created (eg, 10–20% volume increase results in 5% price increase) • Bonus is awarded only if customer experience in call center improves • Repeated failure to meet agreed-upon service levels triggers termination clause
Representation, warranty: Links acquisition prices to original scope, assets, service-level assumptions	• Price reviews occur at predetermined times; price-review approach predetermined	• Contract renegotiation is triggered by periodic benchmarking • Mechanism is established to alter prices if inaccurate asset register is used during due diligence
3rd-party arbitration: Establishes neutral party to arbitrate conflicts	• Neutral auditors, consultants, other suppliers ensure price/service competitiveness	• Supplier and buyer name 3rd-party auditor to assess deal performance
Control change: Grants parties right to pull out of deal should ownership change hands	• Buyer and supplier have right to terminate contract should ownership change hands or key personnel leave	• Acquisition by 3rd party of supplier's organization triggers termination clause • Buyer holds veto power over supplier's appointment of key staff

not aware of their total existing assets, resources, or services. The resulting risks for vendors can be massive, potentially turning a seemingly attractive deal into a losing one.

Manage the risks

No matter how well structured a deal is, conditions can change to upset the value equation. These factors include management turnover, poor service delivery, major increases or decreases in business volume, and corporate activity such as mergers or acquisitions. M&A practitioners have devised a number of safeguards that companies can apply to outsourcing deals to protect their interests (Exhibit 3). These measures include earn-outs, which ensure that prices reflect fluctuations in the business environment; warranties and other mechanisms that periodically realign price and service levels; third-party arbitration to ensure a quick and fair resolution of any conflict; protection against unfavorable changes in management or key personnel; and exit clauses.

The aim of these safeguards is to protect both parties in an outsourcing deal from unforeseen or unfortunate developments. One vendor found inaccuracies in staff compensation and asset levels when it took over the IT-management function for a new customer. The problem was amicably resolved with a clause in the agreement that allowed for a price increase.

When ending a vendor relationship, the key is to manage exit and transfer costs. A company can accomplish this task by transferring only those skills or capabilities that can be easily returned, thereby ensuring that a vendor uses open, standard processes and equipment. In cases when this exchange isn't possible, the agreement should obligate the vendor to provide training for the buyer's staff alongside its own. One UK financial institution, for example, transferred all the intellectual property from the design of its trading systems to the provider. At the end of the contract, the company had to spend 12 months rehiring and training staff to lower its switching costs. In another case, a company protected itself with a clause that covered the cost of exit if the vendor's service declined to unacceptable levels.

Negotiate internally, then externally

A successful outsourcing deal involves both internal and external negotiations, which are often more complex than M&A talks, in part because many more internal stakeholders are involved. Outsourcing deals need approval from not only the board and executive team but also managers in operations, financial controllers, and technology experts. What's more, there is no standard protocol for appraising outsourcing deals, so it can be

difficult to gain consensus on their value and strategic implications. Last, suppliers frequently offer such a wide array of scope, service levels, and pricing options that comparing deals is difficult.

As a result, negotiating teams must work internally with the business managers who control the process to be outsourced, with employees and union representatives who will be affected by the move, and with the executive team. Internal stakeholders should agree on service levels, the degree of flexibility, the controls that the team will secure from a vendor, and acceptable transfer conditions (and their implications for staffing levels). Without alignment on these critical issues, the effective handoff of processes to external vendors will be difficult. The negotiating team must also agree with executives on pricing as well as compare the value of the deal against the next-best alternative, which is typically an internal-improvement plan.

These interactions within the company pave the way for successful vendor negotiations, in which services, procedures, assets, and total value are hammered out, along with pricing and the other mechanisms for sharing value.

The bargaining process is most effective when it is driven by a stand-alone negotiating team—one that is separate from the overall deal team and excludes the head of operations or the business managers who run the process to be outsourced. Operations managers tend to focus on liabilities and service and commitment levels instead of keeping in mind the total value of the deal. The head of operations at one company went forward with an outsourcing agreement without first consulting the executive team, which ultimately rejected the deal because they didn't fully understand its economics. The company had to start from scratch, which delayed the deal by six months—a time marked by major internal confusion and uncertainty among employees.

Plan for transition and delivery

As M&A practitioners know, effective post-deal management can mean the difference between success and failure. Yet this aspect of outsourcing is often given short shrift as the deal team becomes focused on the near-term objectives of evaluating and negotiating the deal. Before signing a contract, a company and its outsourcing vendor must clearly structure the new management organization, define the roles and responsibilities of each party, design and install reporting and control mechanisms, and plan hiring for new roles.

Uncertainty during an outsourcing transition also increases the risk of staff turnover, so companies should design a retention program that targets and retains key personnel. One hotel chain was able to keep its best employees by setting up performance-based bonuses for staying on through the transition. In another case, the vendor held one-on-one sessions with more than 100 employees of the customer company to articulate the value of staying with the new organization.

Outsourcing deals have become bigger, more complex, and more strategically important. By applying M&A deal principles rigorously, executives can avoid costly errors. **MoF**

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Finance 2.0: An interview with **Microsoft's CFO**

Microsoft is paying cash to shareholders, stressing transparency in its diverse businesses, and embracing Sarbanes-Oxley. CFO John Connors explains why.

Bertil E. Chappuis and Timothy M. Koller

When Microsoft announced, in July 2004, that it would tap its legendary cash reserves to return some $60 billion to shareholders, analysts immediately began scrambling to understand what the move might say about the software giant's strategy, its growth prospects, and the maturation of the entire high-technology sector.

For John Connors, Microsoft's chief financial officer, however, the decision to pay a onetime special dividend amounting to about $30 billion and to buy back as much as $30 billion of the company's own shares over the next four years was merely the latest in a series of financial moves that have positioned it at the cutting edge of financial innovation in the high-tech industry. In 2002 Connors helped reconfigure Microsoft's financial-reporting processes around seven clearly defined business units, each with its own CFO and profit-and-loss statement, to offer investors a greater degree of organizational stability and transparency. The following year, the company surprised many people by announcing that it would stop compensating employees with stock options and would instead issue stock awards.

Connors believes that this combination of initiatives has helped build a stronger value culture at Microsoft while permitting management to focus on performance in the company's increasingly diverse business lines. In an interview at Microsoft's headquarters, in Redmond, Washington, he talked with McKinsey's Bertil Chappuis and Tim Koller about the thinking behind Microsoft's finance moves, the company's plans for growth, and the role of finance in the next era at Microsoft.

McKinsey on Finance: The first dividends for Microsoft come out in December. What was the strategic rationale for how much cash Microsoft holds onto, disburses in dividends, and applies to share buybacks?

John Connors: The first thing was to keep enough cash on hand to give us flexibility to manage things like a severe short-term economic dislocation or investment opportunities. We haven't publicly said how much cash that will be, but it's probably fair to assume that, after the upcoming distribution, we will still have around $25 billion to $40 billion on hand.

Even holding that much back, we still have a lot of money to distribute. We also had a number of constituencies pushing us to do different things with it: growth investors wanted a very large-scale buyback; income-oriented investors were clamoring for an increase in the regular dividend; and some investors just wanted all the money back so that they could decide what to do with it. Of course, we also had our employees, who now have stock awards as well as options from our legacy program.

We concluded we had enough cash to do something substantial on all fronts, but we decided against a huge buyback. Not only would that have disappointed the

investors who simply wanted the cash but it would also have been a monumental undertaking. Our analysis also showed that if we had committed ourselves to a $60 billion share buyback, we could have ended up purchasing 5 to 8 percent of our stock every day that the Nasdaq allows us to buy our own shares for the next three years, and some of that inevitably would have been uneconomic. So we decided to take that $60 billion and use roughly half of it for a special onetime dividend, with the rest committed to a multiyear buyback. That's a pretty significant percentage of the enterprise value, and a fairly decent percentage of the shares.

We believe that this strategy will reward all of our investors. It will also increase growth in profits and cash flow, which are what drive our valuation and our return to shareholders.

McKinsey on Finance: Any rules of thumb about how much cash companies need to remain flexible?

John Connors: We have a relatively unique model, in that our business is not capital-intensive. What drove our approach is that Bill [Gates] and Steve [Ballmer] and the board are pretty conservative. We don't want to be in the position where we have to make decisions because of the balance sheet. And while we don't anticipate that we would ever have a year with expenses but no revenue, we'll probably keep at least one year of operating expenses and cost of goods sold in cash on hand—that's around $20 billion in cash and short-term investments.

We also want to have enough for acquisitions. We have made a series of acquisitions, some of them for cash. And while most of them have been fairly small, we also want to be able to make some game-changing investments if we so choose. Any large acquisition would likely be a combination of cash and equity.

McKinsey on Finance: The high-tech industry is seriously underleveraged. Are we seeing the beginning of a fundamental change in capital structure? Do you think the industry will take on more debt over the next couple of years in order to increase returns on equity?

John Connors: I don't think we have seen any large-scale move in that direction yet, primarily because tech companies still have high P/Es relative to most other industries. The growth rate assumption priced into tech companies' stock is that tech will continue to grow faster than other industries, although the differences in growth assumptions between tech and other industries have begun to narrow.

The real question would be whether the market starts assessing technology companies the way it measures companies

High-tech finance innovator

John G. Connors

Vital statistics

- Born February 6, 1959, in Miles City, Montana
- Married with 4 children

Education

- Graduated in 1984 with BA in accounting from University of Montana; is a certified public accountant

Career highlights

- Deloitte Haskins & Sells (1984–86)
  – Staff auditor
- Safeco (1986–87)
  – Staff accountant
- PIP Printing and Document Services (1988)
  – Corporate controller
- Microsoft (1989–present)
  – Various management positions (1989–94)
  – Corporate controller (1994–96)
  – Vice president of Information Technology Group, chief information officer (1996–98)
  – Vice president, Worldwide Enterprise Group (1999)
  – Senior vice president of finance and administration, chief financial officer (1999–present)

Fast facts

- Received Distinguished Alumni Award from University of Montana in 1997
- Serves on board of directors of Avanade, Bellevue High School Football Boosters, Nature Conservancy of Montana, and University of Montana Foundation
- Served as cochairman of Washington state finance committee for 2004 Bush/Cheney presidential campaign and for Dino Rossi gubernatorial campaign

in other industries. For start-ups, the last thing in the world a company like Google is worried about right now is whether or not it should have debt. While there will continue to be great start-up home runs, I don't see why the Wall Street analysis of midsize and large tech companies would be different from that of companies in other industries five or ten years from now. So if the market starts to measure technology in terms of returns on equity, capital, and assets, you will probably see more financial engineering of technology companies to bring them in line with companies in other industries.

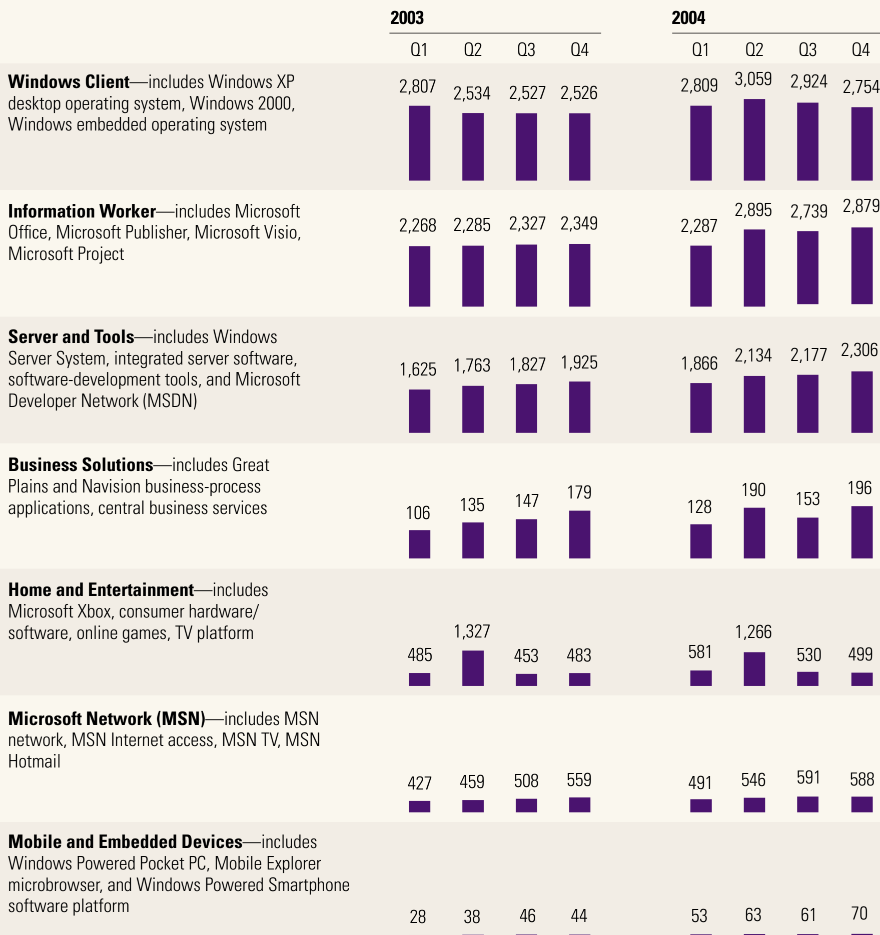
McKinsey on Finance: It has been a couple of years since Microsoft reorganized its financial reporting along business-unit lines. What has the impact been and has it lived up to expectations?

John Connors: One of the most positive outcomes is the transparency the reorganization created. Prior to 2000, Microsoft was viewed largely as a two-product company or a desktop company with phenomenal success in Windows and Office. But in the mid-1990s, we had expanded into gaming and mobile devices and into business applications for small to midsize companies. By 2001 people were not really certain which businesses we were involved in. Today the outside world can easily see Microsoft's business units and how well they are doing against their competitors. Now investors can answer the following questions every quarter: How is our Home and Entertainment Division competing against Sony? MSN against Yahoo! and Google? Our server and tools business against IBM and Oracle? How are we competing with Nokia in mobile devices? Investors can also easily track the performance of Windows and Office as well as the company's growth beyond those two products.

The P&L focus also forced some improvements in resource allocation. One of the big challenges we faced in 2001 was that, because of the company's orientation toward long-term investment, our research and development efforts had created a broad range of new products that often outpaced our capacity to sell and support them. Complicated products like the BizTalk server created a great opportunity to automate many business processes, but

EXHIBIT

Investors can see clearly now



Source: Microsoft Web site

in order for our customers to earn the best returns on the purchase of our products they also needed specialist salespeople who understood the supply chain, data warehouses, and financial flows. In some rapidly growing categories, we also lacked a coherent worldwide brand proposition for certain unique products, compared with our brand proposition for the company as a whole. In the end, we had to decide what areas required continued investment—and what areas did not.

As the bubble collapsed and technology spending slowed, it became very clear that we could not continue to invest at the same levels. Today we all know how much money we have to invest, and we all have to agree on how much will go into R&D, sales, marketing, and tactical initiatives.

The restructuring also forced a degree of organizational stability and continuity. Historically, Microsoft had a major reorganization once a year that coincided with our budgeting in the spring. This process worked very well when we were smaller, had fewer units in fewer geographies, and weren't invested in so many segments. But as the company got larger and more complicated, we heard from customers and partners that Microsoft was hard to keep track of. So once we organized around these seven business groups and reported along those lines, customers and partners believed we were serious about them.

McKinsey on Finance: Did anything about the move surprise you?

John Connors: It was surprising how many people within the company didn't really understand how intensely analysts, investors, and the press would follow each of these seven businesses. A lot of our businesses had flown under the radar, and while we would talk about their long-term opportunities in a way that investors appreciated, after a while they also wanted to see how those investments were performing. Now there's a quarterly scorecard that reports—both relatively and absolutely—how we are doing.

Second, it was surprising how difficult it was to synchronize what we called the "rhythm of the business" between our field organization and the business groups. Traditionally, our field, or geographic, organizations could move both people and marketing around to take advantage of opportunities and to adjust to changing market conditions. While the P&Ls of our field organizations still matter today, and they still have a revenue quota, the business groups now have the ultimate financial accountability and make the final resource allocation decisions. The field is secondary in authority. That was a big shift, and if you look at companies that have had collapses in financial performance, it often has to do with the shifting of financial reporting from product to geography or vice versa. So we took a relatively measured step over a two-year period.

McKinsey on Finance: What about the impact of the restructuring on the finance function specifically?

John Connors: It has allowed us to push much harder on performance because the finance folks in those groups report solid line into the business, dotted line back to the finance function in the center of the company. And it's much easier now for the center of the company to push on financial performance.

It's also helpful that this model can easily accommodate growth. When we want to do

a deal, it's very clear that the CFO and the business-unit leader are on point for that deal. If we want to add new businesses, we have a model that will scale.

Last, the restructuring has allowed us to talk about the role of finance in the next generation of Microsoft, which is quite different from its traditional role.

McKinsey on Finance: How will finance at Microsoft differ in the next generation?

John Connors: When we restructured, we decided very early on to designate as CFO the lead finance person in each of our seven businesses. This model is fundamentally different from the one Microsoft had in the past.

Historically, the top position outside the center of the company was a controller, whose role was to control and measure. But today the finance function must do more. For example, if you look at the incredible diversity of the company now—the number of businesses, the different models, and the economics of some of the new businesses—Microsoft today requires much stronger strategy and business-development functions. Business units like MSN and Home and Entertainment are entering into multibillion-dollar contracts and alliances over long periods of time. Our mobile-devices business requires a very different alliance model with handset carriers and telecom operators than any we have had. Add the requirements of the Sarbanes-Oxley legislation and you find that the control and risk-modeling function has to be at a much higher level than it was three or four years ago.

In practical terms, that means we have a greater number of senior business leaders in finance than we had prior to 2002. Of 125 corporate vice presidents, for example, 9 are now from finance, whereas before there would have been 2 or 3. And corporate-finance leaders at that level also have different requirements: they have to be able to nurture other great business leaders, who then move into marketing, services, and sales, and they have to be articulate spokespeople for the company at technology conferences and industry events.

McKinsey on Finance: What's the most value-added role a CFO can play in a high-tech company?

John Connors: We are in an era today when technology isn't really different from any other industry. In the 1990s it was just growing a heck of a lot faster than GDP. In the late 1990s the dot-com and telecom meltdown made it pretty clear that such growth had been part of a bubble. It's unrealistic to expect that an industry this large will grow substantially faster than GDP.

So a technology company's CFO must be good at both top- and bottom-line growth. The skills that a CFO has at Wal-Mart or GE or Johnson & Johnson are much closer to what will be expected at technology companies now.

Technology also resembles other industries in that its consolidation focuses mostly on cost synergies rather than growth synergies. At least in the near term, Sarbanes-Oxley requires CFOs of companies in every industry to spend a significant amount of time on how a company's ethical or business-integrity tone emanates across the organization. How does its internal-control structure operate? How does its disclosure-control process operate? And is it being really, really clear with investors in its SEC

filings and press releases? Sarbanes-Oxley tends to make CFOs focus on similar tasks regardless of the industry.

McKinsey on Finance: Speaking of Sarbanes-Oxley, what are the costs versus the benefits when it comes to implementing Section 404, for example?[1]

John Connors: Publicly traded US companies have historically had a premium on the equity side and a discount on the debt side relative to other markets because of the value of transparency and trust that investors had in US markets. That trust and transparency got violated, and we all have to bear the cost of earning it back. Microsoft accepts that.

Of course, there are negatives in Sarbanes-Oxley. For example, there isn't much guidance on what is material for public-company financial statements—not in the legislation itself or in the regulations or rules yet—nor is there any case law defining this. There are far too many areas where companies could take a reasonable risk with good business judgment but still be subject to litigation.

Yet there are real benefits to Sarbanes-Oxley. In our case, we knew what our key controls were, we knew what our materiality threshold was, we had tight budgeting and close processes and strong internal and external audits, but we didn't document everything in the way that Sarbanes-Oxley legislation requires. So we have done a complete business-process map of every transaction flow that affects the financials. In so doing, we have improved our revenue and procurement processes, and we can use controls to run the company in a more disciplined way. So we have gotten real business value out of all that process documentation.

Sarbanes-Oxley also really forces you to evaluate the policies that are in place and whether they make sense. One of its requirements is that if a company has a written management policy, people are expected to follow it—whether or not it has a financial impact. For example, how much can people discount contracts? Even if a company can record that contract exactly right from a GAAP[2] perspective and the financials are correct, are people following the discount policy? At Microsoft, we have taken a really fresh and invigorating look at our management policy.

McKinsey on Finance: Apart from the accounting issues, what was behind the decision to give employees restricted stock rather than options? What effect has the decision had?

John Connors: The options program was originally designed to give employees enough money for retirement or a vacation home or to pay for their kids' education—goals that usually take 15 or 20 or 25 years to achieve. Yet because of the stock performance, people were making enough money to send 3,000 kids to college or build 30 vacation homes. Then the bubble burst, our stock declined by half, and roughly half our employees had loads of money but were sitting in the same offices and doing the same jobs as the other half, who would likely earn nothing from their options.

It was the worst of all possible worlds. At the same time, we were diluting the heck out of shareholders, who were telling us loud and clear that we should rethink the long-term value proposition of our options program. Of course, shareholders hadn't paid much attention to that dilution when it was outstripped by growth, but when growth lags behind and

[1] Section 404 of the Sarbanes-Oxley Act of 2002 requires all public companies to give the Securities and Exchange Commission (SEC) an annual assessment of the effectiveness of their internal controls. In addition, the independent auditors of a corporation are required to review its management's internal-control processes, with the same scrutiny as its financial statements.

[2] Generally accepted accounting principles.

expectations change, that dilution looks a lot different.

In the end, we wanted a program that aligned employee and shareholder interests over the long term. So we came up with the stock award program, and we were very clear with employees about how many shares they would get, how the stock would have to perform for them to be worse off, and how the program would work over a multiyear period.

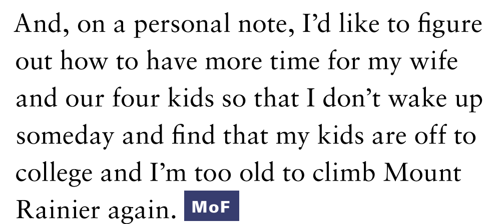
The reaction has been pretty positive, and I think we have a good model. We will have been wrong if Microsoft really outperforms the market and the market performs extraordinarily well over the next seven years—then a number of employees would have been better off with options. That was a bet we were willing to make. If you look at the market in the 14 months since we made the announcement, and the predictions of most market prognosticators, the bet is pretty good so far.

McKinsey on Finance: Having tackled such an ambitious agenda in your tenure, what challenges are next for you?

John Connors: The big challenge is probably institutionalizing the finance function and the finance 2.0 model we have been developing. And I feel the company is in a good place right now; if I got hit by a bus, got fired, or decided not to work here anymore, someone could step in and he or she would be really successful. That's important to me because I will have worked here for 16 years in January, and I believe people should leave a job in better condition than it was when they started.

Second, while it's essential to be viewed as a leader in investor relations, treasury, tax, and corporate reporting, it's also rewarding to be viewed as a leader in creating great finance talent. Keith Sherin from GE was here last week, and that corporation is just a machine for producing great talent. In the Puget Sound area alone, the CFO at Amazon is from GE; the CFO at Washington Mutual is from GE. The company takes good people and makes them great, and its ability to export these business leaders is phenomenal.

I'm happy to say that we have also had some success along these lines. In the past six months, two of our business-unit CFOs have left for CFO positions at other corporations. It's tough to lose good people, but what a great thing it is for people who are five or six years into their careers here to be able to say, "I can become a CFO—either at Microsoft or somewhere else. I can be a business leader."



And, on a personal note, I'd like to figure out how to have more time for my wife and our four kids so that I don't wake up someday and find that my kids are off to college and I'm too old to climb Mount Rainier again. MoF

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The **hidden costs** of operational **risk**

The impact of an operational-risk crisis far exceeds the actual loss. Companies can protect their shareholder value by preparing in advance.

Robert S. Dunnett, Cindy B. Levy, and Antonio P. Simoes

Many companies regard the funds they allocate to meet the regulatory requirements concerning operational controls as money well spent. Avoiding operational risks—either dramatic (embezzlement and loan fraud, for example) or mundane (such as regulatory compliance)—can prevent sizable losses from damages, fines, and sullied reputations.

Yet few companies think strategically about operational controls. In our experience, executives typically view paying a fine, for example, or reaching a settlement in a court case as merely the cost of staying in the game. They approach operational-risk measures not as exemplary management practice but as regulatory requirements that should be dispatched with a minimum of fuss.

Perhaps they should think again. Many companies underestimate the long-term effect of these events on their market value. Indeed, recent McKinsey research shows that a company's loss from such a crisis pales beside the eventual loss to shareholders. And it's not necessarily the biggest missteps that deliver the biggest blows; share prices can plummet as a result of even the smallest events.

Corporations *can* take a better-informed and more systematic approach to preventing operational-risk crises—and to protecting shareholder value when they do occur. Certain organizational changes and processes will promote a more rapid and candid response and reinforce measures to prevent similar events from recurring.

Operational crises in financial institutions

The experience of the financial-services industry yields useful insights into the long-term effects of operational risk. Financial institutions are particularly vulnerable to events that make them appear risky in the eyes of their customers. Moreover, they typically have a wealth of data to call on as well as strict reporting standards. In general, these companies base their risk calculations and allocate their capital on the probability that a particular incident will occur and the size of the resulting financial loss—the sum pocketed by an embezzler, for instance, or the fine for breaking a rule. At present, few banks factor potential market losses into their operational-risk-management plans or capital allocations, for example.

We analyzed more than 350 operational-risk incidents[1] at financial institutions in Europe and North America and found that as news of a crisis reached the market, the initial declines were limited to levels in line with the actual fines, settlements, and monetary losses. Yet over the next 120 working days, the total returns to shareholders (TRS) of our sample declined by a whopping $278 billion,[2] more than 12 times the total actual loss of $23 billion (Exhibit 1).

Moreover, we found that the size of the loss varied with the kind of operational crisis that caused it.[3] First, we organized the 350-plus incidents in our sample into a number of categories. We then analyzed those categories[4] that included more than 20 incidents—

[1] Fitch Risk Management's OpVar Loss database provided our sample of events for this study.

[2] The combined market value of the institutions was $15 trillion.

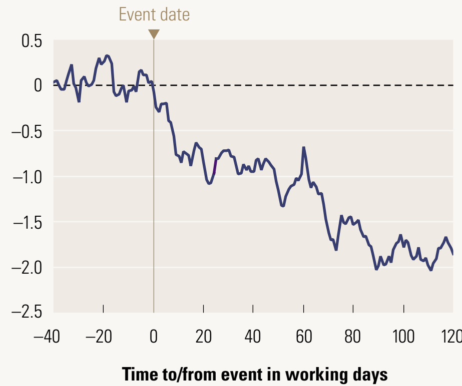
[3] We segmented our sample by using the level-3 classification scheme of the Bank for International Settlements (BIS) for actual losses stemming from operational-risk events.

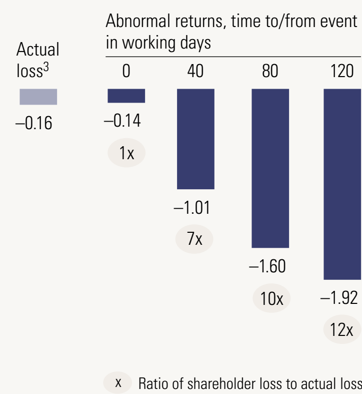
[4] Defined using the BIS level-3 classification, which is more discriminating than the commonly used level-1 classification.

EXHIBIT 1

It gets worse

Impact of operational-risk event on market returns[1]





[1]For 350 operational crises experienced by financial institutions in Europe and North America.
[2]Abnormal returns for each stock calculated daily as difference between actual and expected returns, adjusted for movements in broad market index; unweighted average of daily abnormal returns calculated across all operational-risk events to prevent "noise" of particular stocks from distorting overall results.
[3]As share of total market capitalization.

Source: Fitch Ratings; Thomson; McKinsey analysis

enough to yield reliable, in-depth results. Five types of crises led to the harshest responses from the market (Exhibit 2):

1. Embezzlement. This type of internal fraud appears to have a contradictory effect on corporate market valuations: a net gain around the date when the event is first revealed but an eventual 3.5 percent loss in market value.

2. Loan fraud. The market value of companies reporting losses from borrowers that fraudulently obtained credit and later defaulted declined by 3.5 percent of TRS.

3. Deceptive sales practices and concealment. The market reacts negatively to penalties—such as those resulting from misleading equity research or from miscalculated pension annuities—handed down by regulatory bodies or civil courts. Recovery, if it occurs at all, is short-lived, and companies can lose as much as 5.5 percent of their TRS over the next 120 working days.

4. Antitrust. Settlements are negotiated in suits brought against companies for price-fixing in, for example, commodity, credit card, or equities markets. The companies involved in such events lost 3.5 percent of their market value in the month following a settlement. Most of them subsequently recovered their losses, however.

5. Compliance. Imminent fines for various forms of malpractice can generate losses even before they take effect. The market reaction after a fine can shave an additional 5.5 percent off shareholder value—though there can be some recovery after three months.

The way companies communicate information about such events to investors can delay or exacerbate the market's response. European markets tend to overreact at first, perhaps in the absence of readily available information, and assume the worst until contrary evidence emerges; in contrast, the immediate response of US investors is commensurate with the actual loss. As more information emerges, the market continues to respond (Exhibit 3). Investors in both Europe and the United States assume that the losses exceed the amounts reported, perhaps in the belief that such events signify general mismanagement and herald further losses (possibly too small to report) that will affect the company's future ability to create value. This negative reaction levels out at some point, as investors either forget the event or come to believe that the problem has been corrected.

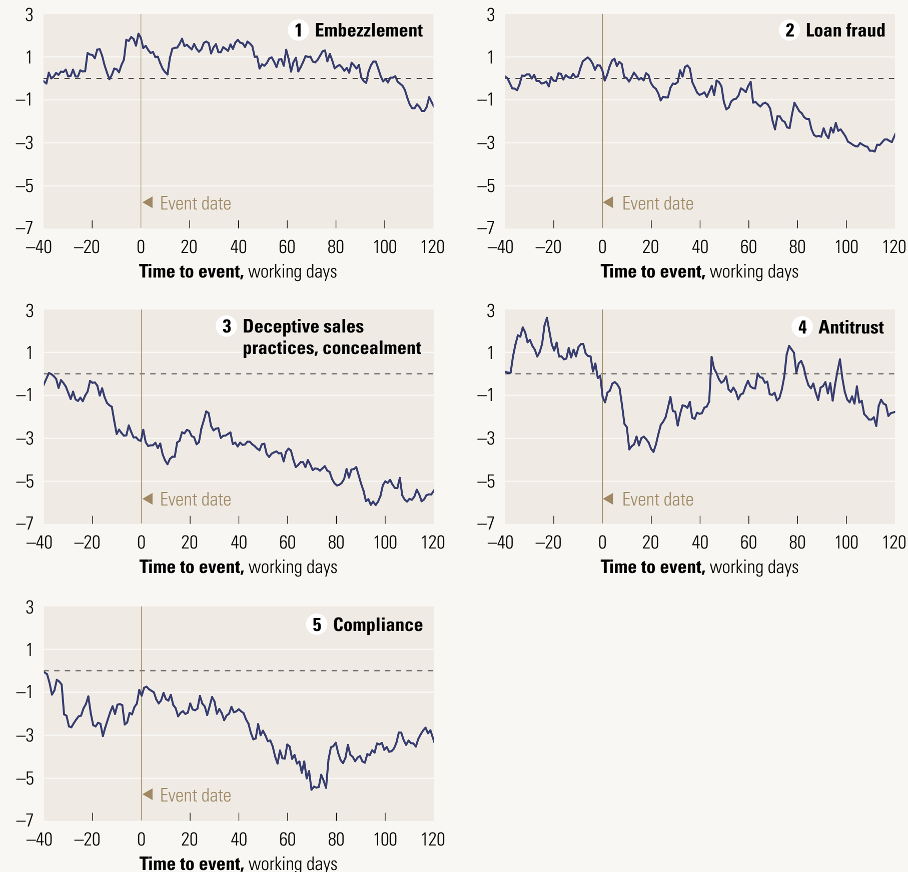
A shareholder value approach to managing operational risk

These results suggest that CFOs and their executive teams can protect and even improve

EXHIBIT 2

Five deadly sins

Overall cumulative average of abnormal returns,[1] %



[1] Abnormal returns for each stock calculated daily as difference between actual and expected returns, adjusted for movements in broad market index; unweighted average of daily abnormal returns calculated across all operational-risk events to prevent "noise" of particular stocks from distorting overall results.

Source: Fitch Ratings; Thomson; McKinsey analysis

returns to shareholders by understanding and managing operational risk more systematically. While most institutions have already carried out some elements of an operational-risk program, an effort to place a premium on preserving shareholder value will create additional responsibilities.

The critical task for executive teams is to establish an operational-risk policy and the guidelines for implementing it. This process can be a challenge for employees who don't understand the risk categories; if risks aren't clearly defined and understood, efforts to measure and monitor them—let alone rank them by cost—will likely prove ineffective.

Intuitive as this approach may seem, many companies remain ill prepared to deal with an operational-risk crisis. While they may attempt to be as forthcoming as possible with investors, at times they find it impossible to provide full details. When one European bank, for example, attempted to communicate the extent of its loss from unauthorized trading, it couldn't provide an accurate estimate. As losses mounted, any credibility the company may have gained from its initial candor evaporated because investors began to suspect that it was hiding something or that another upward revision was yet to come.

We believe an effective risk-management policy should have the following elements.

A common language and understanding of operational risk. Many European financial institutions are using the definitions in the Bank for International Settlements' Basel II accord as a starting point, and companies in other industries could do the same.

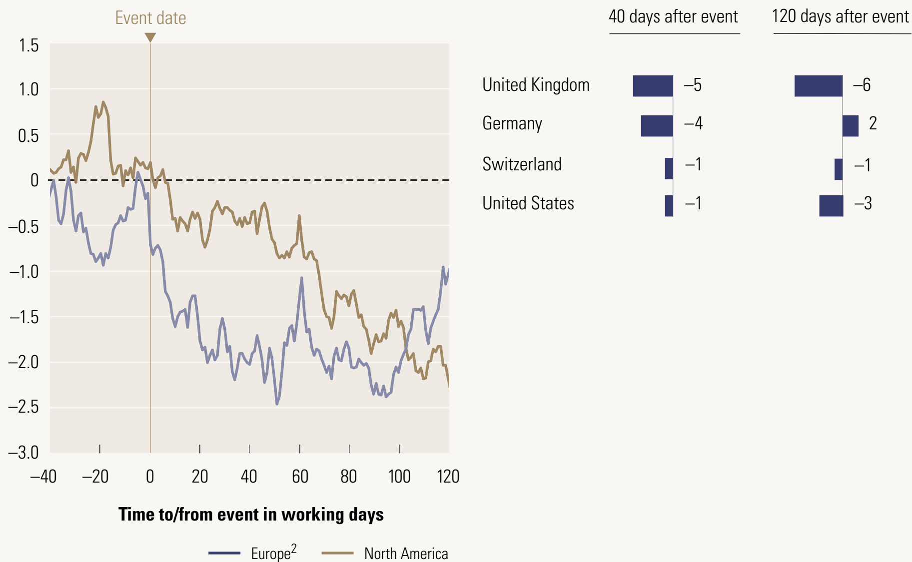
A shared approach to assessing risks. Agreeing on how to predict the frequency of events and calculate their severity is one example. Some Web-enabled tools can quickly collate the data needed to conduct easy, accurate risk assessments, which can then be updated frequently.

A clear process. Companies should outline at what level of the company business-risk assessments will be conducted and how the approach to them will be integrated with the requirements of the Federal Deposit Insurance Corporation Improvement

EXHIBIT 3

Responding to risk

Impact of operational-risk event on market returns[1]



[1] For 350 operational crises experienced by financial institutions in Europe and North America; abnormal returns for each stock calculated daily as difference between actual and expected returns, adjusted for movements in broad market index; unweighted average of daily abnormal returns calculated across all operational-risk events to prevent "noise" of particular stocks from distorting overall results.
[2] Includes Germany, Switzerland, and United Kingdom.

Source: Fitch Ratings; Thomson; McKinsey analysis

Act (FDICIA) and the Sarbanes-Oxley accounting rules.

A loss database. Tracking internal operational losses can help a company make forecasts and agree on key risk indicators. A database can also integrate the reporting and analysis functions and thus alert managers of significant trends.

With the foregoing elements in place, a company can calculate its capital against the Basel II requirements, rank its risks, analyze their causes, and mitigate the damage, thereby focusing effort on the most serious risks. But the process will also reveal numerous small and frequent errors in everyday processes as well as some large and infrequent events that can become major problems. Companies can reduce the number of small errors across their operations by using tools such as the Six Sigma approach or failure-mode analysis. But to reduce the number of larger errors, they will need to review and strengthen their business practices, compliance and risk-management culture, business-continuity planning, and corporate-insurance programs.

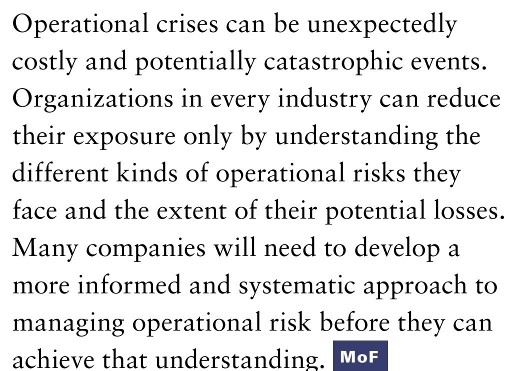
Create a governance structure for managing operational risk. In the past, many good efforts to control risk lacked centralized executive oversight. In financial-services institutions, for example, the responsibility for managing operational risk is often unclear and dispersed. Even companies that have a chief risk officer usually emphasize strategic areas, such as credit or market risk. As a result, most companies don't have a comprehensive view of the operational risk they face; nor does any single person or group ensure that messages to the markets are clear, accurate, and consistent.

In our opinion, best practice starts with defining the organizational and governance responsibility for dealing with operational risk throughout the institution as a whole. In this way, the roles and responsibilities for managing corporate and business-unit risk are complementary, and their links to auditing, compliance, operations, and technology are clear.

Increase transparency during a crisis. The knee-jerk reaction to a crisis is to clam up immediately—perhaps in the expectation that it can be minimized or that investors won't find out. This approach is precisely wrong. If news of a crisis leaks to the market before a company comes forward on its own, the shareholders' response is much worse. When efforts to prevent a crisis

don’t succeed, the company should make its communications with investors more transparent. Even where the size of the loss is quite significant, a company is better off disclosing everything up front.

To see whether different approaches to shareholder communications had different effects on the size of the market loss, we analyzed the strategies adopted by comparable companies that suffered crises of similar magnitude. We found clear differences in the time needed for the share prices of different companies to recover. Consider two cases of major unauthorized trading that led to losses of several hundred million dollars each. One institution released a series of negative statements, including numerous upward revisions of the amount of the loss and various related resignations and reorganizations. The market penalized the company heavily during the six months following the crisis. The other institution was candid from the outset and provided lots of details. Just as important, it issued no further bad news related to the event. This company suffered no long-term damage to its market value, and within six months its TRS had returned nearly to its predicted market-adjusted level had the event not occurred.



Operational crises can be unexpectedly costly and potentially catastrophic events. Organizations in every industry can reduce their exposure only by understanding the different kinds of operational risks they face and the extent of their potential losses. Many companies will need to develop a more informed and systematic approach to managing operational risk before they can achieve that understanding. MoF

The authors would like to thank Professor Ron Anderson, of the London School of Economics, for his contribution to the research.

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The right passage to **India**

Companies attracted to the country's potential must do more than merely transplant products and systems that have succeeded elsewhere.

Kuldeep P. Jain, Nigel A. S. Manson, and Shirish Sankhe

India, for some time now the focal point of the global trend toward strategic offshoring, has simultaneously become appealing as a market in its own right. With GDP growth more than double that of the United States and the United Kingdom during the past decade, and with forecast continued real annual growth of almost 7 percent,[1] India is one of the world's most promising and fastest-growing economies, and multinational companies are eagerly investing there.

Yet the performance of the multinationals that have tried to exploit this opportunity has been decidedly mixed. Many of those notable for their strong performance elsewhere have yet to achieve significant market positions (or even average industry profitability) in India, despite a significant investment of time and capital in its industries.[2] Why? Perhaps because the market entry strategies that have worked so well for these companies elsewhere—bringing in tried and tested products and business models from other countries, leveraging capabilities and skills from core markets, and forming joint ventures to tap into local expertise and share start-up costs—are less successful in India. Our research[3] suggests that the most successful multinationals in India have been those that did not merely tailor their existing strategy to an intriguing local market but instead cut a strategy from whole cloth. In short, they have resisted the instinct to transplant the best of what they do elsewhere, even going so far as to treat India as a bottom-up development opportunity.

With less of a focus on the initial entry and with a longer-term view of what a thriving Indian business would look like, the more successful companies have invested time and resources to understand local consumers and business conditions: tailoring product offers to the entire market, from the high-end to the middle and lower-end segments; reengineering supply chains; and even skipping the joint-venture route. The reward for this effort? Of the 50-plus multinational companies with a significant presence in India, the 9 market leaders, including British American Tobacco (BAT), Hyundai Motor, Suzuki Motor, and Unilever, have an average return on capital employed of around 48 percent. Even the next 26 have an average ROCE of 36 percent (exhibit).

Getting local in India

India's per capita income is half of China's and one-fourth of Brazil's, and as much as 80 percent of Indian demand for any industry's products will be in the middle or lower segments. As a result, multinationals must resist the temptation merely to replicate their global product offerings; the products and price points that are competitive in India are often considerably different from those that work well in other countries. In particular, in India companies must reach into the middle and lower-end segments or they may end up as niche high-end players, with insignificant revenues and profits.

Multinationals that understand the Indian consumer's expectations and price sensitivities can tap into what is often

[1] The Economist Intelligence Unit forecasts 6.9 percent real GDP growth from 2003 to 2008.

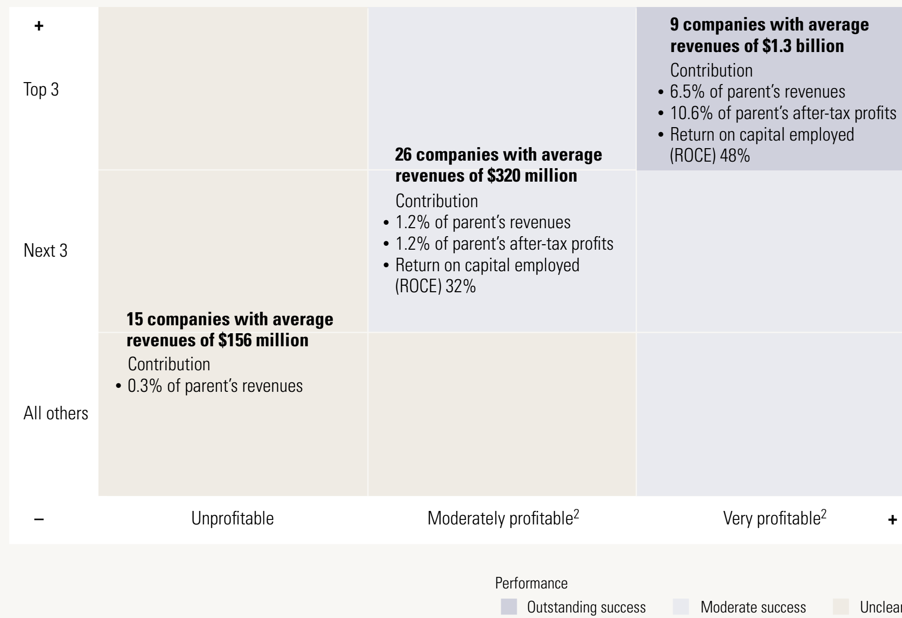
[2] Based on McKinsey analysis of the Centre for Monitoring Indian Economy's Prowess financial database for average industry profitability. The database is highly normalized, built on CMIE's understanding of disclosures in India on around 8,000 companies.

[3] We reviewed the performance in India of more than 100 multinationals, conducting detailed case studies of 15 that have had varying degrees of success and interviewing 30 experts, company managers, analysts, and current or retired CEOs of leading multinationals.

EXHIBIT

A mixed bag

Market share of multinational companies in India, by industry[1]



[1]Includes multinational companies with revenues over $100 million in industries where there is significant or moderate participation by multinational companies.
[2]Moderately profitable = net profit margin lower than industry average; very profitable = net profit margin higher than industry average.

a large and promising market, but they shouldn't assume that the lowest price tag will always lead it. Indian consumers, even in the lower-end segments, will pay a premium if the value of superior features and quality is seen to far outweigh their cost. LG Electronics, for example, reengineered its TV product specifications in order to develop three offerings specifically for India, including a no-frills one to expand the market at the low end and a premium 21-inch flat TV for the middle segment. By keeping the price of the latter offering to within 10 percent of the price of TVs with conventional screens, LGE persuaded many consumers to buy it. These innovations have led the company to a top-three position in the country's consumer durable-goods and electronics market in a little over three years, with revenues of nearly a billion dollars in India. And Toyota Motor captured nearly a third of the multi-utility-vehicle (MUV) market by offering a significantly superior product at a limited price premium.

Very often, however, companies need to develop completely new products to compete at target price points set by local competitors, as Hindustan Lever Limited (HLL), a part of the multinational Unilever, did with its low-priced detergent brand, Wheel. Responding to local competition, HLL lowered the active detergent content of its existing product, decreased the oil-to-water ratio, and then launched the new detergent at a 30 percent discount to the price points of the company's more traditional detergents. Today Wheel accounts for 45 percent of HLL's detergent business in India and for 8 percent of total HLL sales.

In other cases, companies must significantly localize their product offerings to meet Indian consumer preferences. Hyundai, for example, spent several months customizing its small-car offering, Santro. Because Indian consumers attach significant importance to lifetime ownership costs, Hyundai reduced the engine output of the Santro to keep its fuel efficiency high, priced its spare parts reasonably, and made more than a dozen changes to the product specifications to suit Indian market conditions. In contrast, other global automakers entered the market with vehicles that had low gas mileage and high repair rates and after-sales service costs.

Companies can bolster their profitability by reengineering their supply chains. Hyundai, for instance—in contrast to other global auto manufacturers in India, which source

only about 60 to 70 percent[4] of their components locally—buys 90 percent of its components from cheaper Indian suppliers rather than importing more expensive parts from its usual suppliers elsewhere. Multinational pharmaceutical companies outsource a large share of their production to third-party manufacturers within India— an uncommon practice for major pharma companies elsewhere in the world. And both Hyundai and LGE have built global-scale manufacturing facilities to capture economies, making India a global manufacturing hub that can serve other markets as the local market develops.

Using extensive third-party distribution also helps. In India, organized retail distribution systems reach less than 2 percent of the market, so there is considerable pressure to find innovative ways of reaching retail consumers. This third-party distribution system is crucial to capturing demand created by the superior price-to-value offerings available in smaller cities and rural areas, which make up a large share of the Indian market. In fact, successful multinationals such as Castrol (acquired by BP in 2000), LG Electronics, and Unilever have built deep third-party distribution networks that serve second-tier cities and villages. Here again, a local strategy is crucial. One multinational company, for instance, used to own its entire worldwide distribution infrastructure, including warehouses and trucks. Applying that business system in India, where large companies face high labor and overhead costs, made it impossible to attain nationwide reach. Moving to a third-party distribution system employing a network of dealers and agents proved very successful.

Finally, in contrast to companies that rotate expatriate managers in and out of the country every two or three years—often a recipe for failure—most successful multinationals, such as Citibank, GlaxoSmithKline, and Unilever, have an Indian CEO in their local operations. Given the need to tailor products, supply chains, and distribution systems to local markets, local managers tend to be more effective. If the CEO is an expatriate, combining longer postings with a strong local second in command, as in the case of the South Korean giant Hyundai, seems to be crucial to success. In addition, multinationals such as Castrol have benefited from strong local boards to counsel, challenge, and help local operations.

Skipping the joint venture

Multinationals entering new markets have traditionally struck up joint ventures with local partners for a variety of reasons, including their ability to influence public policy, to bring into the venture existing products as well as marketing and sales capabilities, and to comply with regulatory requirements when foreign participation was restricted to less than 50 percent of a business.

While joint ventures are still crucial to gaining access to privileged assets in some industries—metals and mining, for example, and oil and gas—our research shows that, where possible, multinationals are better off going it alone. Of the 25 major joint ventures established from 1993 to 2003, only 3 survive. Most foundered because the local partner couldn't invest enough resources to enlarge the business as quickly as the multinational had hoped. As a result, most of the multinationals that initially entered the market through joint ventures have exited them and pursued independent operations. Multinationals, such as Hyundai and LGE, that have achieved real success in India have bypassed joint ventures entirely,

[4] The Automotive Components Manufacturers Association (ACMA) of India.

and newcomers are increasingly entering the market on their own. Even when a joint venture is unavoidable, successful multinationals ensure from the outset that they retain management control and have a clear path to eventual full ownership.

Participating in the regulatory process

Multinationals in deregulating industries often need to be flexible and patient during the natural process of regulatory evolution. Regulations governing the mobile-telephony sector, for example, have been amended several times since 1994 as it has grown; it had two licensed operators per region back then and now has as many as six. Although most multinationals left the sector when the regulations governing it changed, Hutchison Whampoa continued to invest in India. Ten years later, Hutchison Essar is one of the top three telcos in the country (as reckoned by market share), and interviews with industry experts suggest that the company enjoys strong profitability.[5]

If regulations are a crucial factor for an industry, the CEO needs to spend a lot of time managing them. The most successful multinationals haven't relied on third-party legislation managers or joint-venture partners to address regulatory issues; instead they have invested much time and energy to identify and understand the key policy makers, to formulate robust positions for investment, and even to suggest regulatory changes. In addition, these companies have garnered support from constituencies such as state governments, which compete for investments, and industry associations that lobby for similar regulatory changes.

Clearly, any entry into a new market requires a certain degree of tailoring to its specific needs and conditions. But for some companies, the entry into India has forced a fundamental rethinking of product offers, cost structures, distribution systems, and management teams. Companies that successfully tap into the promising Indian market often ignore conventional wisdom, including the need for joint ventures. MoF

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[5] Since it is unlisted, actual numbers aren't available.

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