

BEST PRACTICE

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Alliances play a major role in almost every industry—from airlines to oil exploration, from pharmaceuticals to semiconductors. In fact, we've found that the typical corporation relies on alliances for 15% to 20% of its total revenues, assets, or income. While some alliances are highly successful—Airbus, Cingular, and Visa International, for instance—many have a less-than-stellar track record. The overall success rate of alliances hovers near 50%, and the average life span of a joint venture is just five to seven years. It's no wonder executives complain about their inherent instability. But, in fact, they've got it backward; most alliances are actually too stable for their own good.

Organizations tend to use alliances in uncertain circumstances—to enter an unfamiliar market or to develop a disruptive technology, for instance—or in maturing industries as a step toward consolidation. Because these ventures operate in the midst of change, they must continually evolve to succeed. Yet their corporate parents routinely fail to intervene to correct their performance problems or address

their exposure to risk. Some companies wait too long to expand successful ventures; others defer shutting down alliances that have served their purposes or have little hope of being successful under the current ownership structure.

Corporations are missing an enormous untapped opportunity: A 2004 McKinsey survey of 30-plus companies reveals that more than 70% of them have major alliances that are under-performing and in need of restructuring. Likewise, our research indicates that JVs that broaden or otherwise adjust their scope have a 79% success rate, versus 33% for ventures that remain essentially unchanged. In China, where most foreign investment has historically taken the form of joint ventures, our colleagues surveyed the alliance portfolios of 30 multinationals and discovered that top performers are twice as likely to have restructured their alliances as underperformers are. Companies that overhaul a single large alliance can generate an additional \$100 million to \$300 million in annual income.

It takes hard work to reap those benefits,

however. For a host of reasons, retooling an alliance is far more complicated than restructuring a wholly owned business unit. But our work with more than 20 major alliance restructurings and our interviews on the topic with more than 50 executives, including board members and CEOs of many of the largest JVs in the world, have revealed some best practices.

We define an alliance as an agreement between two or more separate companies in which there is shared risk, returns, and control, as well as some operational integration and mutual dependence. As such, “alliance” is an umbrella term for a vast array of corporate relationships that fall between arm’s-length deals and full mergers. The advice in this article is particularly relevant for large, equity joint ventures (where the partners each contribute resources to create a new company), complex nonequity alliances (where the partners may collaborate on marketing or development projects), and multiple-partner ventures; less so for straightforward contractual alliances.

Stifling Stability

Investors and regulators have put wholly owned businesses under the microscope in recent years, increasing transparency and accountability. And managers have taken vigorous action to improve performance by cutting costs, refining their pricing methods, closing plants, selling assets and businesses, and combining units for scale. But the story is fundamentally different for alliances. Many are weighed down by outdated strategies, are mired in governance conflicts between their parents, or suffer from a lack of consistent performance scrutiny. As a result, they perform much more poorly than they could.

Consider a multibillion-dollar joint venture in the metals industry. Formed in the 1970s, the JV was designed as a shared utility for its four corporate parents, each of which sold raw materials to and purchased finished products from the JV. By the late 1990s, the JV was operating one of the largest processing facilities in the world. But it was also stuck in a strategic and operational morass: The partners couldn’t agree on a series of operational improvements and expansions to plant capacity that offered more than \$1 billion in annual revenue increases. After several years of frustration and debate, the partners ultimately restructured

the JV—but not before hundreds of millions in profits were forgone.

Or consider a pharmaceutical alliance formed to market a blockbuster drug that produced more than \$1 billion in annual revenues. It was suffering from extensive operational inefficiencies, spending at least \$60 million a year on excess labor and external contracts. The alliance was also experiencing governance frictions—the partners couldn’t agree on how to pursue an adjacent \$1 billion market opportunity. Because the executives didn’t understand the extent of the costs and disagreed on the remedy, they didn’t address these problems for two and a half years.

Examples like these are not unusual. Companies routinely delay needed restructuring by 24 to 48 months, and sometimes longer. And three-quarters of the 50-odd business development executives we surveyed say their organizations don’t routinely evaluate the need for alliance restructuring or regularly intervene to address performance problems.

It’s easy to see why. All alliances involve at least two corporate parents, so a venture overhaul requires separate corporate actors—each with its own (often divergent) interests—to agree to the changes. Likewise, because alliances are defined by contracts, restructuring often involves renegotiating and redrafting legal agreements, a process that can be both messy and time-consuming because the contracts typically don’t anticipate future restructuring.

Restructuring an alliance also involves a broader set of issues than restructuring a wholly owned business does. A wholly owned business’s plan for retooling tends to focus on optimizing business-unit strategy, operations, organization, or finance. A joint venture must focus on those areas, too, but it must also contend with board-level governance issues and the challenges of balancing financial arrangements between the partners, beyond basic P&L and balance sheet issues. Moreover, because a parent company often has various business relationships—as supplier or customer—with a partner, it may fear that tugging at the loose string in an alliance will cause a different part of the relationship to unravel. A natural reaction, therefore, is to avoid the risk and do nothing.

Beyond these inherent challenges are man-made problems, such as a faulty deal structure or weak governance and management pro-

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cesses. Many joint ventures, for instance, lack an effective challenge process—that is, the mechanisms for managers to ask penetrating questions about performance, risks, and future prospects. Alliances, including billion-dollar JVs, often exist outside the parent companies' standard corporate planning and review processes, and many don't have an independent governance system to instill discipline. The complexity of alliance economics and the frequent lack of robust performance metrics make it much harder for management to discuss a joint venture's performance than a similarly sized business unit's. In addition, restructuring almost always requires senior executives in both companies to become involved. Yet these executives may not be on the venture's board, and it might not be obvious who owns the decision about when to restructure.

To see how these barriers can delay change, consider a billion-dollar industrial materials joint venture that was formed in the mid-1990s. The JV aimed to combine the research efforts of two global competitors in order to pursue growth opportunities in new materials for the electronics industry. Then the industry headed south, partly because of low-cost Asian competition and partly because of a technology shift. But back when the parents had set up the venture, they hadn't agreed on threshold levels of performance that would trigger a reassessment. So for three years, the JV delivered a return on assets of between 5% and 7%—well below the U.S. parent's 13% corporate hurdle rate.

The parents were aware of the venture's low returns, but they could not agree on the root causes or the solution. Quite simply, they lacked enough data to make an informed plan. One board partner favored a major downsizing of the business and a major shift in product market focus, which would mean writing off hundreds of millions of dollars to shutter high-cost plants. The other partner felt the venture could restore its margins through some belt-tightening and by improving its operations and marketing functions. It's normal to have differences of opinion, but someone eventually has to make the final decision—and, in this case, no one did. Ultimately, more than \$100 million in annual profit improvements were delayed for nearly two years while the parents debated, and the long-term viability of the business became more uncertain.

How to Restructure a Joint Venture

Executives who set up a joint venture have the luxury of being able to build in contingencies for restructuring. (See the sidebar “Building Flexibility into Alliances.”) Managers who are charged with revamping an existing venture don't have it so easy—but these four steps can help them overcome barriers to change and unlock value from underperforming alliances.

1. Launch the process. Why are so many underperforming alliances left to wallow for years? Inertia is probably the biggest reason. To successfully launch the restructuring pro-

Building Flexibility into Alliances

If you're creating an alliance—as opposed to trying to salvage one—you have a golden opportunity before you. It's extremely likely that the venture you set up now will need rethinking in several years' time, but you can ease the eventual pain of restructuring by taking action now.

For one thing, approach your exit provisions differently. Most alliances' exit clauses are all-or-nothing affairs—that is, they spell out the situations or circumstances that would trigger full termination of the venture but rarely specify what would trigger less dramatic changes. Managers (and their lawyers) should create provisions that prompt restructuring based on specific performance metrics or external conditions. For example, if the venture misses baseline financial performance targets for two consecutive years, then it automatically initiates a restructuring review by the parents. Or if the alliance surpasses certain revenue targets, then the structure will change from, say, a nonequity alliance to a JV with its own staff and P&L.

When they discuss the exit provisions, the alliance partners will necessarily have to consider and talk about their desired endgame for the venture. Such a conversation can help the players create a tailored approach to venture management that's better than the classic buy-sell exit provision, in which one partner names a price and the other must buy or sell.

Companies should also put in place

the people and systems to create robust performance data and an effective challenge process. To help companies improve oversight of their major alliances, we have developed JV Governance Guidelines, a set of governance minimums similar in spirit to the guidelines used by the California Public Employees' Retirement System. For example, we recommend that JV boards establish performance-review and challenge processes equal to those of similar-sized business units. The board should include at least one outside director (even if the director has limited voting rights) to inject objective performance discipline and to ask the tough questions. And each corporate parent should designate a nonexecutive chairman or “lead director” to spend 20 to 30 days a year on the venture and to act as a counselor and performance coach to the CEO.

Finally, companies should look at ways to institutionalize alliance restructuring. One approach is to conduct an audit every year or two to assess three to 15 crucial alliances in the corporate portfolio and rapidly identify a few prime restructuring candidates. One U.S. industrial company annually assesses alliances against two dimensions: strategic fit and financial performance. The company has restructured two large alliances as a result of its scans. Similar audits have been used successfully in oil and gas, consumer products, and electronics firms.

cess, executives from the initiating company need to formally choose how and when to start. Most companies wait until the venture is in the midst of a performance crisis or there's a major change in the business environment. But our research and experience show that the odds of successfully turning around a venture are much higher when the process starts early, before the problems lead to deeply entrenched positions, prolonged underperformance, or a cycle of mistrust. Some firms identify candidates for restructuring by auditing the major alliances in their portfolios every 12 to 18 months, testing them for financial performance and strategic fit. That practice can be a powerful complement to regular dialogues between the venture board and its management team.

Another tactical decision relates to the scope of the change. Ideally, the company should think as broadly as possible about restructuring solutions. But if there are clear boundaries—for instance, if one parent will not consider making major investments or selling out—it is critical to get these parameters on the table as soon as possible.

Additionally, the parent company that's

initiating the move toward restructuring needs to decide when its partner (or partners) should become involved in the process. As a general rule, sooner is almost always better. The obvious exception is if the probable outcome of the assessment is termination of the joint venture. In this scenario, the partners would be better off making their own evaluations before triggering the contentious, often zero-sum, discussions.

Executives also need to decide who will be on the restructuring team. It's important to have a senior sponsor, often a CEO or a division head from a parent, who can push the process along and make decisions on the future shape of the venture. The rest of the team can be composed of venture managers, parent company executives, outsiders or all three, depending on the nature of the problem. If the JV wants to, say, improve its internal operations, the team should include primarily venture managers, with some participation by the parent companies and possibly some outsiders. But if the JV is considering major changes in scope, structure, or management, then much of the core team should come from outside of the venture.

Four Steps for Restructuring Your Alliance

1. Launch the process

These steps are usually conducted alone, without input from partners.

- Scan your major alliances to determine which, if any, need restructuring.
- Determine how to approach your partners: who, when, how to broach the topic.
- Designate an initial restructuring team, define the scope of change, and set a time line.

2. Diagnose performance

- Assess the venture's strategic fit with the parents' businesses and determine the attractiveness of continuing the venture's operations in light of future competitive requirements.
- Assess the venture's financial performance compared with targets, parents' hurdle rates, and so on.
- Evaluate total venture economics.
- Evaluate operating performance relative to

competitors and industry benchmarks.

- Evaluate the fitness of the venture's governance structure, including decision speed, efficiency, transparency, and level of trust.
- Assess the quality and depth of the venture's talent and the JV's ability to attract, evaluate, and motivate employees.
- Estimate dollar amounts for each of the root causes of the venture's problems.
- *If there is limited need or value to be gained from restructuring, disengage from the process.*

3. Generate restructuring options

- Decide whether to fix, grow, or exit the alliance.
- Develop a robust list of restructuring options for all levers: strategy, financials, operations, governance, and organization and talent.
- Prioritize the list on the basis of the overall value and workability of the ideas.

- Assemble three or four packages of restructuring options.
- Test shareholder buy-in for different options.
- Get parent companies' initial approval, find champions for the change effort, and develop a detailed plan.

4. Execute the changes

- Assign accountability for executing the changes, and put incentives in place.
- Build support through one-on-one conversations between members of the restructuring team and high-level executives in the JV and parent companies.
- Embark on communication efforts to build alignment and momentum at all levels of the organization.
- Review performance, and make mid-course corrections as necessary.

Finally, a time line needs to be set by the CEO or other senior executives championing the effort—and it should be short. Diagnosing the venture's performance, framing a set of options, and gaining agreement should take the team no more than two to three months, even for the largest JVs.

2. Diagnose performance. To diagnose venture performance, the team has to determine what needs to be fixed, how much value will be created, and what it might take to realize the full value. Again, this should be kept brief: Even for a billion-dollar joint venture, such a diagnostic should rarely take a team more than three or four weeks.

To promote buy-in and objectivity, an independent board member or outside adviser should work with the team to help drive the restructuring process. The team can use a short, anonymous survey of those involved in the alliance (for instance, the venture's top management team, its board members, and parent executives shaping decisions or spending more than 20% of their time on venture issues) to develop a fact base, gain quick agreement on sensitive issues, and build momentum for change. The survey can take as little as 20 minutes for respondents to answer and should include questions about overall venture performance; the effectiveness of specific elements of the governance system (such as time spent on approving the budget or responding to the parents' reporting requirements); and the degree of difficulty in and potential impact of implementing changes.

Whether the team uses a survey or not, it should evaluate the venture on the following performance dimensions: strategy, financials, operations, governance, and organization and talent. A broad-based diagnostic is critical given the structural complexities of alliances, the unlikelihood of having solid performance data, and the probable differences of opinion among key decision makers as to what is wrong with the venture.

On the strategic dimension, the diagnostic should answer such questions as: Is the alliance meeting each parent's strategic objectives? Given changes in the business environment, how should the original objectives for the venture be altered? Are the parents' strategies for the alliance sufficiently aligned to continue the venture, and is the venture still viable? And has the JV achieved its own strategic goals,

such as target market share?

On financial performance, the team should ask the obvious business questions: Is the alliance meeting its baseline financial targets and performing above the parents' own corporate financial hurdle rates? The team also needs to assess "total venture economics," including profits from transfer pricing and other commercial arrangements between the parent companies and the joint venture.

In the realm of operations, the team should compare the alliance's performance with that of competitors and comparable internal business units on such metrics as per-unit production or sales costs, levels of product quality, and the degree of annual performance improvement.

Governance and organization questions to ask should include: Does the governance setup enable fast and solid decision making? For example, how long does the JV take to make capital expenditure or strategy decisions? How does that compare to similarly sized business units within the parent companies? Has the JV board approved a single set of objectives and a clear performance contract that provides incentives for top management? Is there an effective challenge process in place? Can the venture attract top talent from outside or from the parents?

When all the performance dimensions are factored in, the restructuring team should have a clear overview of the venture's problems. For instance, one natural-resource-processing JV was generating about \$500 million in annual profits for its parents. These returns were largely the result of well-timed investments in capacity and a favorable shift in world commodity markets. Below its glowing financials, however, the JV was suffering from serious operating problems. Its plant experienced severe bottlenecks, and its production levels were well below baseline targets. The JV's governance system was off-kilter, and mistrust had built up between the partners, who battled continually over transfer-pricing arrangements. The partners also couldn't agree on important capital-improvement investments.

The parents wanted to determine if the venture could survive as it was or if it needed a fundamental change in ownership and control—through one partner buying out the other or through spinning off the business as an independent, or partially public, company.

Corporate parents routinely fail to intervene to correct alliance performance problems or address their exposure to risk.

The restructuring team started by identifying the venture's sources of value and linking them to the underlying problems. There was a lot of friction among the partners and the JV's management because of poor governance, but the performance shortfall—which had cost the venture more than \$100 million a year in income for the past several years—was caused by a small set of issues.

Once the team determined what those were, it became clear the problems could be solved without a radical restructuring. The main drivers of the JV's weak operating performance were a shortage of senior plant-level operating managers and an unwieldy capital-planning process, which was delaying a few crucial investments that would dramatically reduce bottlenecks at the plant. Also, the parents needed to agree on performance metrics so that the board and the JV management team could have a productive dialogue.

When creating a diagnosis, the team should take pains to separate the symptoms (poor operating performance, for example) from the root causes (skill shortages and cumbersome approval and reporting processes, for instance). Doing so provides a taxonomy for

managers to talk about the issues and keeps them focused on what matters.

The diagnosis can generate a long list of problems, more than can reasonably be addressed. To ensure that it's tackling the most important issues, the assessment team should attach dollar amounts to each of the problems identified. It should ask, for example, How much is poor operating performance costing us per year? What is the attributable cost of slow decisions? Are there instances where a 12- or 18-month delay in capital-expenditure approval can be linked to missed revenue opportunities or forgone savings? The answers to these questions can help CEOs and other decision makers focus on the most important problems instead of on the irritants that can be tolerated. They also help build a powerful case for change.

3. Generate restructuring options. Generating restructuring ideas and options for JVs is, in many ways, similar to determining how to restructure a wholly owned business: Executives will evaluate three macro options—fix, grow, or exit. Assuming the answer is fix or grow, the restructuring team needs to determine whether fundamental or incremental

Which Levers to Pull

Once you've decided to retool your joint venture, probe these five broad areas to generate concrete plans for improving performance.

Sample JV Restructuring Activities

Strategy

- Redefine the scope of the JV's business; for instance, bring activities such as manufacturing and sales into the JV.
- Bring in additional partners with access to different markets, skill sets, and so on.
- Change exclusivity provisions; for instance, allow the JV to enter some of the parents' markets to pursue growth opportunities.
- Change the JV's market focus; for instance, stop making commodity products and focus on high-end ones.

Ownership and financials

- Alter the JV's ownership stakes in exchange for additional capital infusion or other contributions from one parent.
- Sell a stake in the JV to investors or the public to raise capital and increase transparency and market discipline.

- Renegotiate the JV's long-term supply contracts or transfer-pricing agreements with the parents for services, products, or raw materials.
- Revise the terms of licensing, royalty, or commission structures with the parents.

Operations

- Close facilities.
- Relocate the venture's manufacturing facilities to low-cost labor markets.
- Redesign the venture's operating processes to improve quality, reliability, and innovation.
- Redesign the venture's supply chain.
- Streamline manufacturing to increase throughput.

Governance

- Change the JV board's composition; for instance, reduce numbers or bring in outsiders.

- Designate one partner as "operator" and others as nonoperating partners to speed decisions.
- Streamline approval processes inside the parent companies.
- Standardize parents' reporting requirements.

Organization and talent

- Bring in an outside CEO to increase independence.
- Change the organizational structure to better reflect the JV's business so it can separate itself from its parents' legacies.
- Develop a performance-based contract for the CEO to create alignment and accountability.
- Redefine policies for rotating staff members into the JV to increase the level of talent.
- Increase alignment by having the JV CEO hire, fire, and conduct reviews for all employees.

change is needed and then evaluate five levers that might improve the business. (For more details, see the exhibit “Which Levers to Pull.”)

Two of these levers—strategy and operations—would also be addressed in the turnaround of a wholly owned unit (along with some aspects of organization and talent). But JVs in particular must address the categories of governance and ownership and financial arrangements. Governance changes might include pushing more authority down from the JV’s board to its CEO, streamlining the parents’ reporting requirements or approval processes, or changing the fundamental operating model of the JV—for instance, shifting from a quasi-independent venture to one that is either very independent from the parents (think Dow Corning) or essentially run by one partner (think Verizon Wireless).

Changes to the financial or ownership arrangements could include a redrawing of the terms of the alliance, such as the percentage of equity ownership, or a redesign of the venture’s overall approach to profit sharing.

It is easy to generate ideas that could help reduce friction among the players; the real challenge at this stage is orchestrating a process that gets to a solution the parents can agree on. It is helpful to use the result of the diagnostic-phase work that assigned dollars to the problems; with those numbers, executives can pinpoint which restructuring ideas have the most potential.

The team should then start assembling three or four packages of restructuring options, which should range from minor tweaking of the venture to major surgery. One telecom JV, for instance, came up with the following options: a simple renegotiating of transfer prices on about a dozen administrative shared services; a redrawing of the organization to put more functions and power in the hands of the JV’s CEO and management team; and a sale of the business to a third party, with some long-term access agreements granted to one of the parents.

Once the team has a menu of options, it needs to test shareholder buy-in for each one. A senior champion from each shareholder can ensure participation from his or her company. An independent process manager, such as an outside board member, is the best choice to gather reactions from each of the partners. And when presenting the options, the team

should be ready to unbundle them to explain which restructuring levers each option rests on and to test for the partners’ agreement on the details of each option.

For an example of a successful option-generation process, consider a global transport and logistics alliance. Its many members had very different operating styles, strategies, and initial opinions on how much restructuring was appropriate. But the following actions helped keep them on track.

First, the CEO of each parent company agreed to be directly involved in the effort to revitalize the venture’s governance. Second, the team created several viable options, both in terms of the organizational structure of the alliance and the process for setting strategy and getting the partners to commit to (or opt out of) specific strategic initiatives. The companies convened group discussions to regain alignment on the definitions of “success” for the alliance and for its governance system. Then, on the basis of input from the stakeholders, the restructuring team developed a composite set of recommendations that could be accepted by all of the partners. The actions included streamlining the organization and involving the venture board more in shaping strategy for the alliance.

4. Execute the changes. How does a team move from making recommendations to setting the venture on a new path? The most critical component of the journey is widespread and consistent vetting and communication of ideas. As a general rule, restructuring an alliance requires two to three times the communications efforts that restructuring an internal business unit would, for obvious reasons: No single decision maker has final say; partners often are suspicious of one another’s hidden interests; and the decision-making process frequently requires back-corridor conversations because the ultimate decision makers are outside the alliance’s formal governance system. The more partners involved, the greater the need for communication.

The members of the team that restructured the transport and logistics alliance started building buy-in from the start. After the team created an initial set of options, it held one-on-one discussions about each with crucial stakeholders in the parent organizations. That step took three weeks and entailed more than 50 conversations. Many of the parent executives

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that the restructuring team spoke to were outside the venture's formal governance structure, but the functions they led worked closely with the alliance. This vetting process also involved the CEOs of the partners—first individually to help frame the solution and then collectively to get approval for the recommendations and to hold the organizations accountable for implementing the changes.

A restructuring team should think hard about the sequence of the changes it proposes. For instance, one cross-border industrial JV's corporate parents agreed to restructure because the team was explicit about the order in which changes would unfold. Instead of starting with the time-consuming and contentious issue of renegotiating certain supply agreements between the parents, the team decided to first fix the decision-making and reporting processes that had gummed up the system. Once these changes were made, other issues could be tackled more easily.

The restructuring team should also consider making certain changes contingent on early successes. For instance, the parents of one industrial JV agreed that the CEO's sign-off authority should be raised from \$1 million to \$25 million, but the CEO would earn this authority only after improving operating earnings by \$50 million over 12 months.

Finally, because of their complicated decision-making structures and their parents' di-

vergent corporate interests, alliances and joint ventures are prone to getting stuck in the middle of restructuring or defaulting to incremental, least-common-denominator changes. To avoid this, the venture's leaders and parents must affirm the need for change. The venture board also needs to escalate its role temporarily and define who is accountable for making which changes happen.

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We hear a lot of grumbling these days about the frenetic pace of change. Last year's computer model is already obsolete; your home mortgage has been transferred to yet another servicer. It's true that change is rarely comfortable or easy. But too much stability can also be a bad thing. Evolution is necessary for success—not just in alliances but also in most relationships and other endeavors. Indeed, we are reminded of something Orson Welles said in *The Third Man*: "In Italy, for 30 years under the Borgias, they had warfare, terror, murder, and bloodshed, but they produced Michelangelo, Leonardo da Vinci, and the Renaissance. In Switzerland, they had brotherly love. They had 500 years of democracy and peace, and what did that produce? The cuckoo clock."

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