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TO CENTRALIZE OR NOT TO CENTRALIZE?

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One of the biggest challenges facing large business organizations today is finding the right balance between centralization and decentralization.

Countervailing forces push in both directions. On the one hand, pressures to cut costs through economies of scale, drive stronger financial performance from the center, transform existing business models, and respond to new legal requirements for risk management or sustainability all seem to argue for more centralization. On the other, imperatives to reduce bureaucracy, foster local entrepreneurship, respond rapidly to local customer needs, and encourage adaptiveness and agility in the face of fast-changing markets seem to favor decentralization.

How senior executives choose to navigate these conflicting pressures will have major consequences: the approach they take will play a large part in determining the role, scope, and size of the corporate center. There is no easy answer. Slogans such as "think global, act local" and "create a lean but activist center" may sound good, but they don't provide much concrete guidance. And, while best practices abound, there is no single universal set of practices that can be applied like a recipe in any and all circumstances.

Rather, finding the right answer for your organization will require making strategic choices and designing optimal tradeoffs among competing objectives. The goal: to create a value-adding corporate center that follows a carefully customized parenting strategy that takes into account the needs of its business units and the strengths—but also weaknesses—of the organization's corporate capabilities. The Boston Consulting Group has identified four principles for achieving that goal.

Focus on Value

Most discussions about the corporate role focus on the benefits of performing certain activities centrally. Such benefits are important, but they are only part of the equation. In order to ensure that centralization adds value, its potential benefits must be weighed against its likely costs.

The direct costs of corporate functions and initiatives are highly visible line items that are subject to considerable scrutiny at most companies. But many organizations neglect the indirect costs imposed on the company's businesses. Centralization can add complexity, diffuse accountability, and slow responsiveness. And although managers in the corporate center commonly assume that they know what's best for the business, those managers are, in many cases, too far removed from real customer needs to make the best decisions.

It's necessary, therefore, to assess carefully the situations in which the center genuinely adds value and those in which it does not. What is the corporate center currently doing? What kinds of complexity and costs do these activities impose on the company's business units? Which activities hamper the development of individual businesses in the portfolio, and which enable that development? Does the current value delivered justify the cost? Bringing this value perspective to every activity that the center currently performs or may perform in the future is a critical discipline.

Emphasize Strategy over Structure

When management considers the design of the corporate center, its natural impulse is to start with structure—boxes, responsibilities, and reporting lines. But that is putting the cart before the horse. Instead, senior executives should start with a clear view of their target parenting strategy and use that to frame discussions about the most appropriate organization model and roles.

A parenting strategy defines a clear role for the corporate center on the basis of a specific understanding of how the center adds value. For example, does the center drive the business by overseeing financial governance, providing strategic direction, or achieving functional excellence through central resources?

BCG has identified six basic parenting-strategy archetypes that reflect the degree to which the corporate center is "hands off" or "hands on." (See the sidebar, "Six Parenting Strategies.") The six models not only provide a useful place to start, they also illustrate a fundamental point: there are many different ways to succeed.

Senior executives need to fight the natural tendency of corporate centers to continually expand their scope and take on additional functions. Instead of diluting the center's value by making its coverage too broad, they should be selective, focus on a limited number of value levers, and really excel at them. Doing less can be a great way for the center to add more value.

Another advantage of having an explicit parenting strategy is that it establishes clear guidelines and priorities for organization design and provides corporate managers with good arguments for why they are doing what they are doing. In large organizations, debates about who should do what are inevitable. Rather than being determined by politics, power, or ego, responsibilities and authority should be grounded in the clear logic of how the center creates value. Managers at the center who can make a case for activism that is grounded in fundamental strategic principles are more likely to earn buy-in from business unit managers and agreement about everyone's role.

Let the Business Drive the Center—Not Vice Versa

In his inaugural address, U.S. President John F. Kennedy declared, "Ask not what your country can do for you; ask what you can do for your country." When it comes to defining the role of the center, senior executives should follow a similar mantra. It's only natural to think about the center from the perspective of the corporate functions. But if corporate executives aren't careful, they will end up building a corporate center that serves itself—in effect, asking "what can the businesses do for us?"—rather than serving the businesses in which value is actually created.

SIX PARENTING STRATEGIES

BCG research has identified six basic parenting strategies with different models of engagement for the corporate center in the management of the company's portfolio of businesses. (For detailed descriptions of these strategies, see *First Do No Harm: How to Be a Good Corporate Parent,* BCG report, March 2012.)

Hands-Off Owner. At one end of the spectrum, which ranges from relatively light to relatively heavy engagement, a hands-off owner assembles a portfolio of largely autonomous and self-contained businesses and then adds value through a very lean center with extremely active board control. Berkshire Hathaway is a classic example of such an owner. The company manages its holdings by means of board control and an activist-investor mind-set. Berkshire's corporate office consists of only about 25 people.

Financial Sponsor. A financial sponsor provides funding and systematic financial governance to drive performance in its businesses. This is the traditional model of many private-equity firms, but some public companies use this approach as well. For instance, Wesfarmers, a successful Australian diversified conglomerate, drives value in its autonomous divisions through strong financial governance and controls.

Family Builder. A family builder puts together a synergistic portfolio and concentrates on providing the right context for cooperation and sharing best practices across business units. Johnson & Johnson, for example, has pharmaceutical and medical-technology businesses that serve similar markets. The two businesses are independent and autonomous, but they aim to exploit synergies in selling to local health-care systems. Many consumer-goods companies and Asian business groups also use the family builder approach.

Strategic Guide. A strategic guide sets strategy across the entire portfolio of business units and drives key initiatives and M&A. At Airbus Group, a European aerospace and defense company, for instance, the center is responsible for defining the role of the company's aircraft-manufacturing, defense, and helicopter business units in the overall corporate strategy. It's the responsibility of the units to implement that strategy. Acquisitions are managed from the center and linked to the overall group strategy.

Functional Leader. A functional leader creates value by leveraging its scale in corporate functions to drive business performance. Procter & Gamble, for example, uses standardization throughout the company to drive down costs and achieve world-class functional excellence. A central global-business-service organization creates value by providing low-cost transactional services in critical functions, such as accounting, HR, and procurement.

Hands-On Manager. At the other end of the engagement spectrum, a hands-on manager actively guides operations with the help of detailed plans and controls, as well as corporate initiatives on the operational level. For example, Apple's large corporate center consists of roughly 37,000 of the company's total employment of about 80,000. The corporate center comprises all business activities except for production (which is outsourced) and distribution (which is organized in regional business units).

Instead, management must make sure that the role of the center is shaped around the specific needs of the company's businesses. Rather than benchmarking corporate functions against those of corporate centers at other companies, management should benchmark them against an objective assessment of what the company's own businesses need and how best to support them.

To be sure, there will be some activities that naturally fall to the corporate center—for instance, certain key governance tasks, such as internal auditing and key investment monitoring. But for all other functions or activities, management should determine whether it is really necessary to centralize these tasks. As a general rule of thumb, it's best to put the burden of proof on the champions of more centralization, not the other way around. Some companies even take an approach akin to zero-based budgeting—regularly reevaluating central activities to make sure that they continue to add value.

Be Self-Critical About Central Capabilities

Even when there is a clear and compelling business need, it's important to critically evaluate the existing capabilities of the corporate center and whether they can effectively and efficiently address that need.

Just because a company has identified a critical unmet need doesn't necessarily mean that the capability to address that need must be located at the corporate center. Perhaps it would be better to have a business unit take responsibility for building that capability for the entire company. Or maybe it makes more sense to locate the new capability in a shared-service center that is organized to deliver basic services at low cost and that is benchmarked against the most efficient external providers of the service.

Management should guard against overconfidence about what the center can deliver, systematically assessing corporate capabilities by answering three critical questions:

- Is there potential for this activity to create significant value?
- Is the risk of value destruction from this activity sufficiently small?
- Is the risk of implementation also limited?

One especially effective way to develop an objective understanding of the center's capabilities is to ask the business units to evaluate them. A bracingly honest assessment of the center's strengths and weaknesses from a company's business-unit leaders can be very helpful in understanding precisely when it makes sense for the center to take the lead and when it does not.

In some situations, the potential value added by a central function might be integral to the company's chosen parenting strategy. If that function doesn't yet exist, it will be necessary to invest in creating it. A prominent recent example is the effort by many companies to drive the creation of digital platforms from the center. But if in doubt, don't centralize. Sometimes, it is simply better to let the businesses develop the capabilities they need on their own.

These four management principles will help executives strike the right balance between centralization and decentralization: focus on value, set an explicit parenting strategy, define the center's role around the needs of the company's business units, and critically assess corporate capabilities.

Having struck that balance, however, managers should be prepared to revisit—and perhaps revise—their choices as circumstances change. Just as a company's corporate strategy evolves over time, so should its parenting strategy and its corporate center. Executives should be ready to routinely challenge current assumptions about the role, size, and organization of the center and to make changes when necessary by continually applying these four principles.

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