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frontier of analytics, Rosabeth Moss Kanter's
latest thinking, understanding customers,
and managing consultants

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Uncommon common sense

Global competition is intense and often thought to be for big multinationals only. Yet, **Bernd Venohr** and **Klaus Meyer** believe that mid-size firms can achieve global market leadership, as many German companies demonstrate. But, how do they do it?

German businesses present a paradox: on one hand, they face some of the highest labour costs in the world, an aging workforce and an overly regulated labour market. Yet, at the same time, they generate the largest manufacturing export surplus worldwide, ahead even of China and Japan. Key drivers of Germany's export success have been privately held small- and medium-sized companies. These "Mittelstand" companies, accounting for about 40 per cent of all German manufacturing exports, have been a source of much envy and mystery.

Many mid-size German companies have achieved global market leadership despite relative obscurity. They are mostly family-owned and based in provincial towns, yet they hold market shares of up to 90 per cent in worldwide market niches: Kronen (beverage bottling and packaging systems), Heidenhain (encoders for manufacturing equipment) or Dorma (door control hardware and systems; moveable walls) may not be household names, but they are leading global competitors in their respective industries. What are the secrets of success of these comparatively small, but globally competitive, firms?

Over a decade ago, Hermann Simon identified over 450 of these companies and coined them *Hidden Champions* (Harvard Business School Press, 1996). Based on a recent analysis of over 1,400 such

firms, we identified three common success factors: (1) their family ownership and governance help to build long-term relationships with stakeholders, (2) they focus on global niche markets that they can dominate with superior product quality and relentless customer orientation and (3) they implement their strategies with a persistent focus on operational effectiveness throughout the value chain.

Hidden champions: then and now

In his original study, Simon used a broad definition of *hidden champions* that combines medium size with qualitative criteria. We have revisited Simon's original firms almost 15 years later and found most of them still prospering in their global market niches. In addition, the number of such companies has vastly increased. By 2008, we identified about 1,400, mostly privately owned, companies that generate up to €1 billion annual revenues and occupy a top three position in their respective market segments worldwide or number one position in Europe. This increase in numbers provides a first indication of the vitality of this type of firm.

Yet, how have Simon's original hidden champions fared in the turbulent decade since the mid-1990s? Since detailed profitability data for most companies is still unavailable, we rely upon survival and revenue growth as key indicators of success. →

→ We have traced Simon's 450 companies from 1994 to 2004 and find them to outperform other businesses in Germany:

- They uncoupled themselves from the slow-growing German economy and grew on average by 8.4 per cent annually. This compares favourably to the 2.7 per cent average annual growth of German companies and of the 4.9 per cent achieved by DAX 30 companies.
- By our estimates, 82 per cent of the hidden champions have defended or even extended their worldwide leadership.
- Even among the 18 per cent of companies losing their leadership position, only a small number (about six per cent) experienced challenges leading to dissolution of the company.

Those who lost their leadership position experienced one of three challenges. First, some companies faced substantial structural change in their industry due to new low-cost competition, notably clothing and textile manufacturers and some textile machinery

unusual form of evidence of the sustainability of their strategies in the global economy. Comparing Simon's original findings with recent evidence based on our database and other studies done in this sector offers some fascinating insights.

Ownership and governance: "enlightened family capitalism"

Since private ownership was an important criterion to identify hidden champions in 1994, it is interesting to note that most of these companies stayed private through 2004. Only 15 per cent of firms changed hands from private to public or private-equity ownership, usually driven by generational change or substantial changes in financing conditions. These results are supported by our larger database: over 70 per cent of the 1,400 companies are privately owned; about 10 per cent are publicly listed and 10 per cent are owned by private-equity funds.

Private ownership shapes a firm's organizational culture and lays the basis for long-term development of business strategies. Potential advantages of

Family ownership with professional management may combine the best of two worlds.

suppliers. A second group could not cope with major technological and demand changes, mostly in IT-driven segments (including consumer electronics and IT-based B2B products). A third group made serious management mistakes, notably by pursuing overly ambitious growth strategies at a time of slow industry growth, for instance in the building products industry.

Yet success has been more common than failure. Some firms have grown so spectacularly that they are no longer hidden. Three companies stand out: SAP has become the undisputed world leader in business software; Fresenius developed into the world leader for dialysis care; Wuerth became the world market leader in direct selling of fixing and assembly materials. In 1994, Wuerth already had revenues of €1.8 billion and was one of the largest companies in Simon's sample. Simon included the company because it shares some of the key characteristics of the hidden champions. Wuerth achieved annual revenue growth of more than 25 per cent over more than 50 years despite operating mostly in mature industrial market segments. This growth can be attributed largely to its unique management model with more than 800 customer-focused profit centres.

The evidence of survival and growth of Simon's firms 10 years later adds weight to his prediction that their strategies would succeed. Revisiting the successful firms after 10 years also provides an

family-controlled firms include continuity, "embeddedness" in local communities, long-term relationships and flexibility arising from central command. Moreover, such companies use distinct governance and management processes (family capitalism) that contrast with publicly listed companies run by external managers in the interest of anonymous shareholders:

- The principal-agent problems typical for large public corporations do not arise if capital-majority and management are united either in one person or shared by family members. If external management is employed, in most cases the family keeps an important governance role.
- The organizational structure is typically based on flat hierarchies and informal channels of communication following the personal style of the owner. Management and employees cultivate a high degree of mutual trust and loyalty, leading to an implicit life-long contract.
- In consequence, the corporate culture tends to resemble an extended family with patriarchal features and strong internal cohesion.
- Owners are often emotionally attached to their firm, which is typically an integral part of their self-fulfilment and family tradition, rather than just a financial investment. Their *raison d'être* is thus not only to maximize profits but to secure the company's existence for the next generations.

The stability of ownership and the absence of short-term pressures from stock markets create a supportive environment for continuity of strategy. Profits are often not projected as the primary objective but are seen as the result of delivering superior products and services, which may in part be a culturally grounded phenomenon. The long-term perspective allows the development of unique skills and assets and establishes a clear identity with customers, channels and other stakeholders while strengthening the fit across the value chain.

However, family-owned companies face unique challenges, most notably with respect to inter-generational transfer of leadership within the family. A recent study by Nick Bloom and John van Reenen, "Measuring and explaining management practices across firms and countries" (www.aeaweb.org/annual_mtg_papers/2007/0107_1015_2001.pdf), finds that mid-sized German family firms are considerably more likely to employ outside professional managers in leadership positions than similar companies in the US, the UK and France. Our research confirms this pattern: 20 per cent of our mid-sized leaders employ only family members in leadership positions, 40 per cent have only external management, while 40 per cent have both. This governance practice has important implications for corporate performance. Bloom and van Reenen's study finds that companies managed only by family members, especially primogeniture family firms

offers differentiated products and services, appealing to a particular segment of customers and (b) the value chain that best serves the target segment is distinct from that of other industry segments.

Most of the companies have developed their specialization continuously, while some have restructured their portfolio to shift from domestic diversification to a global specialist strategy, a phenomenon known as *globalfocusing* (K.E. Meyer: "Globalfocusing: From domestic conglomerate to global specialist", *Journal of Management Studies*, 2006). The competitive pressures of market liberalization and foreign competition lead to a globalization of markets; diversified companies lose competitive edge in some of their activities and thus focus on what they are best at, yet on the global stage. In their niche, they can isolate themselves from competition by serving the special needs of a narrowly defined target segment. They may attain a temporary quasi-monopoly in a contestable market until substitute products become available or until new competitors find it profitable to enter the niche. Market leadership in such contestable niches thus requires both continuous improvement of differentiated products and services along with monitoring of the cost base to stay price-competitive and to deter entrants.

Globalization has enhanced the opportunities for global niche players: the opening of markets has led

Revisiting the successful firms after 10 years provides an unusual form of evidence of the sustainability of their strategies in the global economy.

(those led by the family's eldest son), are significantly less well-managed and financially less successful than those managed by the founder or by external professional managers.

Family ownership with professional management may thus combine the best of two worlds: family control ensures a long-term investment horizon and a balanced stakeholder philosophy while professional managers contribute state-of-the-art management practices.

Strategic positioning: dominating global niche markets

Family-owned companies may use the advantages of patient investors to pursue niche strategies that combine product specialization with geographic diversification. Such a strategy can lead to a competitive advantage and above-average returns vis-à-vis broadly based competitors if (a) the firm

to an increase in product variety while the historical disadvantages in terms of economies of scale can be overcome through global leveraging of costs across geographic markets. Moreover, the technological changes that fostered globalization create new opportunities for niche players in two ways. First, new technologies can substantially lower the costs and increase the speed and reliability of transportation. Second, innovations in telecommunication and information technology facilitate global transactions by reducing telecommunications cost to virtually zero, thereby enabling companies to manage geographically dispersed operations much more effectively.

Mid-sized market leaders are typically positioned as value leaders, combining superior quality of products and services with a careful attention to customer needs. They support this strategy with major resource commitments in R&D, sales and →

→ distribution, and many of them pioneer new products or create new market segments. Once technological leadership has been attained through a radical innovation, it is extended through continuous and gradual innovation. Our group of mid-sized leaders is typically active in high value-added manufacturing sectors like industrial machinery, components and medical instruments. In these sectors, technological breakthroughs are rare, making incremental innovation strategies viable. German mid-sized global leaders spend about five per cent of revenues on R&D, two to three times as much as their industry peers. Almost all of the companies hold a significant number of patents, on average about 40 per company.

Another pillar of their focus strategy is the

A global niche strategy thus allows mid-sized companies to build and exploit their industry-specific resources worldwide. They can enhance industry-specific capabilities through global scale of production, global supply chains, global reach of distribution and tapping into innovation clusters worldwide. At the same time, global niche market leadership based on technology-driven products and global sales and service networks allows leveraging these capabilities worldwide.

Operational effectiveness: firing on all cylinders

Dominating a global niche is an ambitious strategy for a comparatively small firm. Yet, many of the mid-size market leaders have protected their leadership

Due to high labour costs at home, German firms have to be particularly concerned with labour productivity in their operations.

commitment to customer needs. Firms in our sample typically sell their products and provide customer service and training through wholly owned distribution channels. Rather than contracting out, these companies typically operate networks themselves to ensure both quality of service and close customer contact. This control over the value chain allows them to feed knowledge from customers into organizational learning processes that generate a continuous stream of innovations; this innovation strategy requires a deep knowledge of customer needs, which is generated through direct customer contact.

Wholly owned sales and service subsidiaries are not only a vital source for innovations but an essential element of a strong and reliable service network. As product complexity increases, customers may require more support in operating and maintaining the products. For many mid-sized global leaders, personalized customer support services have become an important part of their value proposition.

The competencies supporting these niche strategies are often specific to an industry but transferable worldwide. Business customers worldwide have similar needs, and similar technologies may help develop solutions for them. Knowledge of particular needs of a customer in one part of the world may help to develop solutions for another customer in the same industry in another part of the world. Such global knowledge transfer is especially relevant for business-to-business markets in which customer needs are more similar across locations.

position with a persistent focus on enhancing operations by continuous improvement of products and processes. They developed strategies in close interaction with R&D and customers and typically implemented them in many small steps, yet with a long-term perspective. Few firms engaged in large acquisitions or other risky game-changing strategic moves; instead they more typically relied on:

International sales and distribution networks Many of the original hidden champions were by definition early “globalists”. Yet, they did not rest on their position and aggressively pursued newly opening markets, especially in emerging economies. Our research suggests that, on average, they have more than doubled the number of their foreign sales and distribution subsidiaries over 10 years: from six (as originally reported by Simon) to 13 in 2007, a number again confirmed by our broader dataset. This is a remarkable degree of internationalization considering the firms’ small size but reflects their global leadership ambitions. In addition, many of them use agents to serve smaller markets, such that their products and services are typically available in over 60 countries.

Aggressive cost management including selective offshoring Mid-sized global leaders may be quasi-monopolists, yet even so, their market power is limited. New entry is always a threat, forcing companies to be not only innovative but also cost-competitive. A key element to ensuring cost competitiveness is the constant improvement of

their cost position through selective offshoring of lower value-added activities. The original hidden champions have doubled the number of foreign manufacturing subsidiaries in the last decade to seven, with a main focus on low-cost countries. In 2007, they had a global footprint with, on average, three production plants in emerging economies (Eastern Europe and China have overtaken India and Brazil as main locations).

However, offshoring is only part of the success story and, in fact, would not explain Germany's persistent export surplus to which these companies substantially contribute. Due to high labour costs at home, German firms have to be particularly concerned with labour productivity in their domestic operations. Bloom and van Reenen found that German companies are particularly strong in shop floor operations with state-of-the-art lean manufacturing practices and in target setting and performance management. Thus, successful mid-sized global leaders are improving operational effectiveness by assimilating, attaining and extending best practices in key processes while making best use of the opportunities of a global supply chain.

Uncommon common-sense management

While businesses have, for good reasons, focused on the new players such as India and China, there is still life in old powerhouses such as Germany. We

have studied a particularly interesting group of German companies, mid-sized companies with global market leadership positions. With some simplification, we can summarize their management model as follows: *they concentrate their limited resources on a market niche they can dominate worldwide by investing heavily in R&D and by creating worldwide service and sales networks*. This strategic position is underpinned by a relentless focus on improving operational performance. Private ownership facilitates these long-term strategies; in particular, these companies excel in their relationships with employees, suppliers and local communities – relationships that are grounded in mutual trust rather than short-term profit opportunities.

Authors such as Simon argue that those practices represent “common sense”. In an increasingly short-term-oriented business environment, this may be a misnomer. The constant pursuit of such sound management principles with little change over the years may have become *uncommon sense*. Yet, rather than pursuing the latest management fads, it is time to revisit the enduring management practices of globally successful German mid-sized companies. Especially given the fact that these mid-sized companies are based in a high-cost country, they provide useful lessons about how others can succeed in the fiercely competitive global environment. ■

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