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Michael Porter about a Strategy for Romania

Introduction

Professor Michael E. Porter needs no introduction as the business strategy expert worldwide. He visited Romania in November 2007, and his conference was a great opportunity for us, Romanians, to listen to him talking live about strategy, and about Romania as seen from the Institute for Strategy and Competitiveness at the Harvard Business School.

We decided to cover this event in this paper, because we believe that Michael Porter's ideas deserve proper leverage in Romania, a country with plenty of resources and with no strategy. "This country desperately needs a strategy, and I don't see one" he said. The question is "how we build a world class Romanian corporation".

It is Easy to be a Manager of a Successful Business

Michael Porter believed that Romania is a country at a good location, which faced enormous growth and prosperity improvement. In a boom time, which he also described as "exciting" and "vibrant", the forces that have driven growth in Romania ended their job. "That is just about over in Romania" he said. Now, the boom, with its economic unbalances is over. "The easy part is over, it's going to be harder, and you have to raise the standard of productivity, companies will not going to be successful in the same way".

Michael Porter also warned that there is "not enough action from the government", and that it is "easy to be a manager in a successful business".

We at Brainbond could testify that this is true. Managing a successful business is not a big deal. The challenge is to recover a business from the vicious spiral or "death spiral" as Bill Gates called it. Lee Iacocca would not have made such a great manager if Chrysler were on the peaks of success. A manager is like an airplane pilot. In a smooth horizontal flight, with a functional airplane, and in perfect weather, all pilots are good pilots. Only in a storm, with a missing engine and in a dive, you can tell apart the really good pilots from the crowd.

Now, Romania is going to need a real pilot, and the country is going to need a real strategy.

The Worst Error in Strategy is to Compete with Rivals on the Same Dimensions

Competing to be the best is the obsession of many corporate managers, and Michael Porter said this is the wrong way to put it. "Competing to be unique" is the true strategic goal. A unique strategy position means how to create something different, a unique competitive advantage.

Strategy is often taken for something else than pure competitive advantage. Flawed concepts of strategy were presented by Professor Porter:

- strategy as action: internationalize, consolidate the industry, outsource; strategy is not about a particular step to take

- strategy as aspiration: "our strategy is to be #1", "to grow", "to be the world leader"

- strategy as vision: "meet our customers' needs", "offer superior products"

The lesson for Romania is "don't copy just what you see in other countries". Secure a unique competitive advantage.

The Goal is Growth - a Common Mistake

The corporate goals should be listed and addressed in the following strict order:

1. The first goal is *profitability*: get a good ROIC (Return on Invested Capital), or add economic value, so the cost of capital is covered by the returns.

2. The second goal is *growth*.

"Reversing these two is the source of a lot of mistakes" said Michael Porter. "Be profitable and get bigger - not just grow, it is easy to grow, but growth is not good if it does not create sustainable profitability" he added.

Michael Porter warned against putting growth first, but he did not clearly state why this generalized urgency to grow in corporations worldwide? In our opinion, this bias towards growth comes from the corporate governance need for a raise. Everybody wants a raise. If you were a well-paid CEO of a stable and profitable corporation, how could you ask the shareholders for a raise? Only a bigger corporation would "justify" a bigger salary. In this way, our world is a world of huge corporations and huge executive salaries and benefits.

Professor Porter also mentioned that "scale is overrated". When you outsource almost everything, there is no more magic in the "economy of scale", and subsequently, the need to grow in order to achieve economy of scale is less important now than probably two decades ago.

Returning to profitability, Professor Porter indicated that it is equally important to know where it comes from: the industry in which you are competing in, or the position you occupy in your industry. "It is important for a manager to pull these two apart" said Michael Porter, calling this "Disaggregating Economic Performance".

The average profitability (represented by ROIC) of US industries over a 15 years period is 14.9%, ranging from about 6% in airlines, catalog and mail-order houses, 12% hotels, and up to 33% pharmaceuticals, 38% soft drinks and prepackaged software, and 43% security brokers and dealers.

Although shocking through the discrepancies between industries, the slide presented by Michael Porter is not so surprising at a closer look, but maybe some additional explanations are needed. Why wouldn't all airlines and hotel chains sell everything and start again with soft drinks or financial services? The discrepancies in our opinion are in fact between the capital intensive industries and those which need less expensive assets to operate. The fleets of airliners and the chains of hotels are multibillion assets, whereas the brokers and dealers only need a laptop and a phone. The pharmaceutical companies need labs and fabrication lines, inexpensive when compared to the turnover of the major world players. Soft drinks companies need no assets except the brands and the recipes, while the bottling is externalized. When it comes to prepackaged software, here we just need computers and an office space. Thus, when the profitability ratio used is ROIC, the value of the fixed assets involved is one of the factors to explain the discrepancies between industries.

The profitability of an industry is revealed by the well-known Five Forces model:

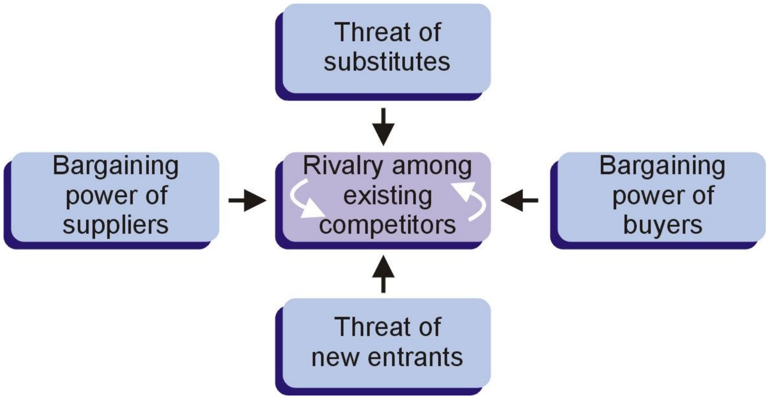

Figure 1 - The Five Forces Profitability Analysis Model (Michael Porter)

Michael Porter illustrated this with a brilliant example: Paccar. The truck industry in the US is not a profitable one (ROIC around 10%, well under the average 15%), because customers with truck fleets have a lot of bargaining power that pushes down the truck industry profits. Thus, the rivalry between truck manufacturers is based on price, the truck are not differentiated. Paccar understood their industry very well. A lot of powerful buyers, how to avoid them? What about the owner operators? These are self-employed truck drivers; they drive long distances, often sleeping in the truck. This is their home and their office, with bed, TV, microwave. Also these people care about image, paint, features, sleeping, and comfort. Paccar built their strategy to sell to these individual business owners what they wanted: a customized truck with a high standard of comfort inside, a lot of service points and warehouses for parts distributed all over the country. When a truck belonging to a large fleet broke down, a replacement was made available, but an individual truck owner had to repair it, so he felt on the safe side with lots of service points around. These customers did not care much about price if they could find the truck that met all their needs. Thus Paccar managed to create a very strong competitive advantage and sustainable profitability of 30% ROIC as compared to the 10% of the truck manufacturing industry.

Turning now to Romania, the fundamental question we should also ask ourselves is how can we be unique?

Superior Relative Performance

The relative performance of each competitor depends on his strategy, and superiority may be achieved in two ways: either by driving up the prices, or by driving down the costs:

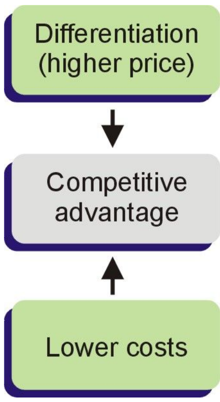

Figure 2 - Generic Strategies to Increase Relative Profitability

Many people believe that the best for their business is to achieve operational effectiveness by assimilating, attaining and extending the best practices, or even by creating new best practices. "That is only half of the job" said Professor Porter. "Very hard to have an advantage... They are going to copy whatever you do". Strategic positioning is a better choice, by creating a unique and sustainable competitive advantage. "Choose to run a different race".

Democracy or How to Please the Shareholders

This chapter is particularly relevant, and it quotes the entire reply of Michael Porter to a question from the audience.

Strategy is not about democracy. "There will be no majority of vote here. Strategy is a clear choice what is this company going to do. It takes strong leadership and it is the job of the CEO to lead the process."

"The CEO has to communicate his strategy to the financial markets. Trying to please the shareholders is a mistake. Tell them what makes them to support your strategy instead. Recruit new shareholders who understand the future instead of trying to please the old ones."

"Do not defend what you did in the past. How could we make it better in the future? We need to keep optimistic, positive, and self-critical. Strategy focuses on the future."

Five Tests of a Good Strategy

If you think you have a strategy for your business, or for your country, put it to this test with five counts:

1. What is your unique value proposition?

2. Is your value chain different?

3. What are your strategic trade-offs?

4. Are your activities mutually reinforced?

5. Is there a strategic continuity?

1. Defining a clear value proposition is the starting point of any strategy, and it may be illustrated by the answers to the following key questions:

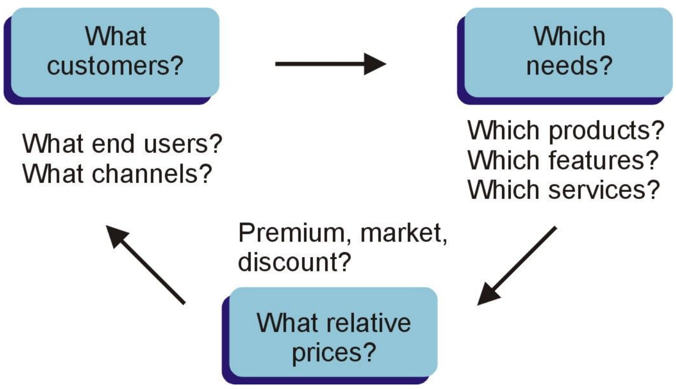

Figure 3 - Value Proposition Key Questions

Professor Porter warned against trying to address every need in every customer: "You will get killed when you will have to compete". Our experience with the business administration students confirms that this is a quasi-general mistake. They dream about the ideal business, pleasing every customer, offering everything for prices which float magically a little below each buyers' sensitivity barrier. The choice of customers (also known as segmentation) is particularly difficult to beginners. They would love to have them all. However, the successful corporations focus on a customer segment and forget about the rest. It is like the sharpness of a knife. If you focus on a clearly defined and relevant segment is like cutting through the market salami with a sharp knife. If you want all the customers, it is like cutting through the market with a balloon. Narrowing your scope is equivalent to sharpening your knife.

Michael Porter's example here is particularly relevant for Romania: IKEA. With a very clear value proposition, IKEA made history in Romania in less than one year of operations, taking the market by storm. What is the IKEA value proposition? Nice style compact furniture, for price sensitive young people, usually with their first house, Quality OK, but not fine wood, not the most durable stuff. It doesn't last for 30 years. The furniture is sold disassembled, in compact packs, easy to transport in a car. Young people save the transport money and also the assembly money. With clear instructions, they may do the assembly themselves. Not the kind of fun for the older generations.

"Is IKEA the best furniture?" asked Professor Porter. "Wrong question. There is no best furniture!" The correct question is whether the value proposition is clear and unique, with a good correlation between the customers segment, the needs and the prices.

2. The value chain has to be different, matching the value proposition through the warehousing, service, way of operating. For instance, Professor Porter took a Brazilian airline. They started with a value proposition for the people who normally take the bus: low prices, direct and immediate boarding, night hours, no thrills service on-board. They were very successful and grew enough to take over the national airline.

3. All good strategies involve trade-offs, or unequivocal choices of what NOT to do. What are you sacrificing in order to achieve something? If you are not prepared to sacrifice anything, your strategy is wrong. IKEA sacrifices rich middle-aged and old customers, who appreciate impressive furniture, in a wide range of fine wood finish. These are not going to buy from IKEA. Paccar sacrifices the large fleet customers, even though these make the most of the market share.

4. The activities are mutually reinforced in a company with a good strategy in place. Professor Porter used the example of Zara. "Is Zara the best clothing company? No. But this is the wrong question." Zara's value proposition is a quick freshening of the lines in the stores, every two weeks. For this reason, Zara does not source clothing in Asia, it is hard to coordinate the design, and the boat would take 2 to 3 weeks. Zara makes it in the EU instead. Purchasing, manufacturing and transport, all match the speed that they need. All other competitors fight each other in design, with changes two to four times a year. Zara is not about design though. Zara is about frequent changing, offering their customers every occasion to look new and fresh, with every visit. The windows of the stores advertise by themselves, always with the new lines. Women use to buy a lot of clothes, but every time they feel the need for something new. It is an instinctual need to change the look in women, and Zara is effectively addressing it. Everything they do (locating the stores, advertising, sourcing, operating) serves their strategy.

5. Continuity means that you will have to persistently pursue your strategy. If you change it every year, this indicates that you don't have one. "In Romania there is no emergency, the market is growing, but sometime in the next 3 to 5 years, you are going to face more competition. What do you do more than to assimilate best

practices?" The English language is probably the most euphemistic language in the world.

Romania Now

The accession to the EU was a process driven by others, but now Romania is on its own, and this generates a post-EU vacuum. The business environment is poor: the roads infrastructure, the property rights, and the legal system. The tax system is inefficient. The public administration does not show strong professionalism, the enforcement of rules is ineffective. There are issues of corruptions at many levels, lack of transparency, and there is too much government interference in the economy. The hardware is in place, the software is working ineffectively.

Michael Porter made an unequivocal statement: "the government is not doing his job in Romania". He was not talking about the current government in particular, but about all governments since 1989. Efficiency of the government would be to the benefit of all, whereas a few people benefit from inefficiency.

"Too many things that are going on in Romania are unsustainable: escalation in [real estate] property value is unsustainable, rate of consumption is unsustainable, and loans are unsustainable."

The Romanian "consumption bubble" will eventually blow. You are safe if you are out of the core economy. The real estate and the luxury goods are considered particularly vulnerable by Michael Porter.

Romania ranks 150th in the world in complexity of employment, 130th in taxation system and 130th in registering property. These World Bank data speak for themselves.

Everybody is busy in Romania, but everybody is competing against each other individual. "I can see the strategies of Ireland, Finland, China, Denmark, and India. About Romania - I am not sure. It is unclear, even for me, who work with strategies for such a long time."

A Strategy for Romania

Professor Porter hopes for "new government leaders to emerge; time for the private sector to take the leadership. I do not see it coming naturally from the government anytime soon, the private sector has to do it."

Romania needs more productive capacity which creates wealth: skills and technology have to be used to produce for export.

Michael Porter believes in a world class business group functioning as a think-tank for Romania. This would be a respected source of knowledge, and the new government would need to implement a strategy generated by this group.

There are similar emerging countries which did much better in terms of strategy. Professor Porter chose the example of Estonia.

Estonia catalogued its strengths and found one to build a strategy on: the IT skills of the young population. The following steps were taken:

1. Estonia opened 5 new universities specialized in IT, with 1000 graduates per year.

2. The government offered the first orders by its statement to be the most aggressive user of IT. They turned to computer-based processing in every operational area. These provided the start-up orders for the new industry.

3. The government advanced market laws friendly to electronic banking.

4. The physical infrastructure was built by the government: 5 fiber optic cables crossing the country.

This was the long-term choice of Estonia. Strategy is long term integrated thinking. "In Japan, everybody is thinking 10 years from now. In Romania, everybody is asking: will I be flexible enough to adapt?" (This indicates that Michael Porter has solid knowledge of Romanian way of thinking.)

Another idea is to boost professionalism of the public administration, like in Singapore, where civil service is a highly prestigious place to work. Only the best graduates can work for the government in Singapore, for market salaries, all on merit. This offers a professional public administration, and continuity in the civil service. It is easy to introduce meritocracy in the government if you really need performance. Singapore is a very small island with no resources, and the GDP per capita is over $40,000. Meritocracy in the government and a strategy based on location, probably the only strong point of this country, did this magic to Singapore. Michael Porter mentioned location as a strong point for Romania, as well.

Conclusions

In November 2007, Michael Porter made some crucial statements in Romania about a country strategy. After reading the weak reactions of the Romanian media to this event, and after seeing that the official presentation material left out any remark about our country, we decided to gather those powerful ideas that we strongly believe in.

Coincidence or not, in all the country strategy examples given by Professor Porter (Singapore, Estonia, and Japan), there was an education factor: universities, graduates. We strongly believe in a strategy based on education for Romania. A competitive education system could be easily achieved in two steps: 1. breaking the current protectionist barriers, which prevent both the schools and the professors to compete and to perform better; for instance, professors get lifetime contracts and in practice the candidate is never contested in the so-called "contests"; 2. Making a national priority to remove corruption and plagiarism from the education system.

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