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Strategic Bets

Sooner or later, most global business leaders will have to put their entire enterprise at risk. Here's how to do it successfully.

BY RAM CHARAN AND MICHAEL SISK

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by Ram Charan and Michael Sisk

The Dow Chemical Company bet its future on the acquisition of Rohm & Haas. Announced in July 2008, the deal was an audacious move; not only would it take all of Dow's financial resources to acquire this specialty chemicals maker, but it represented a fundamental shift in Dow's business model, one that challenged the prevailing assumptions of the industry. CEO Andrew Liveris used the word *transformational* to describe the US$18.8 billion all-cash deal: He said it would lower his company's reliance on low-margin, highly volatile, highly cyclical commodities and bring in specialty products whose differentiation offered global opportunities and higher margins.

This was not an ordinary M&A exercise; it was a dramatic strategic bet with life-or-death consequences for this venerable company founded in 1897. Many chief executives would have avoided this strategic bet, yet it was the kind of move that many companies must make in today's fast-changing business environment. Nonetheless, during the first few months after the announcement, it looked as if the deal might fall apart. Wall Street was dubious from the start, and financing was hard to come by. Dow had a long history as a dominant player in commodities. According to most industry analysts, the change in course was too great, the timing too abrupt, the chances of success too uncertain, and the price tag too high — even given Dow's solid balance sheet and industry prowess as the world leader in sales.

But Liveris had put together a meticulous plan over many months to pave the way for the deal. Now he met frequently with board members and institutional

Illustration by Peter Kraemer

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investors to win their support. They discussed how to finance the deal, what to divest, and whether the timing was right. There were setbacks. Several potential financial partners whom he sought as sources of capital turned him down. He persisted, and in December 2008, Dow signed a binding agreement for a joint venture with the Kuwaiti state-run Petrochemical Industries Company (PIC), which would infuse Dow with $9 billion to partly finance the Rohm & Haas acquisition and thus greatly reduce the risk involved.

The majority of large global corporations will probably have to make this sort of strategic bet sometime in the next 10 years. A number of companies are ahead of the curve, including some from emerging markets. Brazil's Vale, Mexico's Cemex, India's United Breweries, South Africa's SABMiller, and Luxembourg's ArcelorMittal have already become world leaders in their industries through strategic bets. Other companies, including major corporations from the U.S., Canada, Europe, and Japan, are facing big changes or maturity in their markets. They will, from time to time, find themselves forced into strategic bets as their best option for thriving in the future.

Some companies may have to make more than one strategic bet during the course of a decade — they may have to bet the company two or three times in succession. Their ability to recognize the need for a game-changing move, to seize the moment, and to execute the decision will be critical. To succeed, they will need to alter their whole framework for conceiving and shaping strategy. It behooves them to build the necessary mental and organizational resolve and fortitude in advance — and not wait until the moment of truth to find out whether they have it.

A Test of Leadership

As Andrew Liveris discovered, a chief executive embarking on a strategic bet should expect to face a series of harsh tests that might stretch over several years, severely straining the resolve and creativity of everyone closely involved. Those tests began for Dow Chemical on December 31, 2008, two days before the close of the deal with PIC, when the Kuwaiti government abruptly backed out, throwing all of Liveris's plans into jeopardy. "We were shocked by this news, and this was completely unexpected, given the approvals already received and the behavior, actions, and words from our partners," Liveris said at the time.

Once the financial foundation of the deal had been destroyed and the other critical building blocks were wobbling, most observers expected Dow Chemical to shut down the deal and retreat. But Liveris was in a corner. Retreat would be a defeat for him personally and could put Dow in a difficult legal situation. The contract with Rohm & Haas was airtight, and its leaders would not budge. It was also a cash deal, and a replacement for PIC's promised investment was not easily found in early 2009. Even in normal times, investors are often fearful to commit money to a strategic bet, but at that moment, as the capital markets were coping with the worst economic crisis in 65 years, and the world financial system was teetering, their fear was compounded. Both the debt markets and equity firms were paralyzed, and the stock market was in free fall, down 60 percent. Meanwhile, Dow's own stock, which had been at $30 per share when the Rohm & Haas deal was announced in the summer of 2008, plummeted to $7 by March 2009, and Andrew Liveris was facing the prospect of a serious debt downgrade to junk status by

Standard & Poor's and Moody's.

Liveris had to keep the board committed to the deal, find new sources of financing, and convince the capital markets that Dow's strategy had hit a bump, not a brick wall. Tackling these issues tested Liveris's leadership abilities. He needed to summon his own mental toughness and perseverance, and to project continued conviction about the merits of the move he had championed. He had to persuade board members, institutional investors, Wall Street analysts, and rating agency analysts that the course he'd chosen was still correct and viable. He also had to be resourceful and creative in finding solutions, including alternative sources of funding.

In the end, Liveris succeeded. He kept the directors on board, convinced the rating agencies to maintain the company's investment-grade rating, and lined up alternative financing from Warren Buffett and two members of the Rohm & Haas family. And the deal was in fact transformational; it set up the combined Dow–Rohm & Haas enterprise for better performance than either company might have expected alone. Today, specialty chemicals make up about two-thirds of Dow's revenue, up from 50 percent before the merger, and Liveris says he's aiming to tilt the mix toward 80 percent. The capital markets have warmed up accordingly. The deal closed in July 2009, and by January 2010 Dow's stock was above $29. Matthew Norris, a portfolio manager and equity-research director at the investment management firm Waddell & Reed, told *Barron's* in an interview that Dow's transition "means a faster-growing business that deserves a higher multiple." Liveris said at a New York City investor conference in December 2009 that Dow could return to record earnings levels of $4.50 per share by 2012.

As an example of strategic thinking, the Dow deal is of great significance. It represents the kind of challenge that more companies will find themselves facing in the future. Liveris and his board put their company on the line because they understood that the global environment affecting the chemicals industry was changing rapidly, and that they would be forced, sooner or later, to change too. They would be much better off if they could find a way to stay ahead of this inexorable change, even if it meant putting their entire enterprise at risk. It might not have taken a genius to see that commodity chemicals were going to become less profitable, given new entrants from emerging and resource-rich countries in the industry; the real genius was in moving quickly to a new business model and acquiring and deploying the necessary capabilities before competitors fully accepted or woke up to this reality.

The Dow Chemical example is instructive in another way; it shows the inherent uncertainty that leaders must navigate even after a strategic bet is made. Liveris had to execute the deal with Rohm & Haas under conditions neither he nor anyone else could have imagined — a global financial system turned upside down.

Preparing for Upheaval

Strategic bets were once a matter of choice, not necessity. In the 1980s, '90s, and early 2000s, though the business environment grew steadily more turbulent, large mainstream corporations could still survive through gradual change, honing core capabilities and creatively extending them to new markets. But pursuing incremental improvements is no longer a reliable path to success. No matter what a company's business model, at some point in the future, that model will become irrelevant or obsolete or will lose value against new competitors and new opportunities. That point can arrive abruptly, without clear advance signals.

There are several reasons for this. The first is the digital revolution. It has been in play for 20 years, but only now has it begun to routinely cause cross-industry disruptions. As Amazon and Apple have famously shown, a company with a new value proposition that takes advantage of digital media can change the game swiftly. Additionally, many innovations can become commoditized with unprecedented speed, because digital media makes it easier for other companies to learn about them and copy them.

Meanwhile, the extraordinary economic growth in China, India, and Brazil is elevating a billion people or more to higher levels of prosperity. Coupled with increasing demand for scarce resources in the Middle East and other emerging markets, this phenomenon will lead to seismic (and still unpredictable) political and economic change.

Perhaps the most significant and under-recognized force is the shift in global capital markets. They have become more volatile and less transparent, and trading has been hugely focused on the short term — even as regulators look to impose new long-term capital requirements and other constraints on trading in the wake of the Great Recession. Unpredictable movements in currency trading, often involving sudden shifts in currency value of 30 to 50 percent, add to this volatile environment. The comparative value of countries, industries,

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and companies can now change rapidly on any given day.

In this new business context, the power of the capital markets cannot be overstated. Capital today is more fluid, fickle, and abundant than ever; these traits exert a steady pressure on companies to either attract capital or risk seeing it flow to competitors — or, worse, flow to upstart predators that have not traditionally been in a company's competitive line of sight. No longer are the capital markets merely a tool to execute corporate strategy; they are integral to the way a company forms its corporate strategy.

Combined with the speed of the Internet and relentless commoditization, this means the market value of a particular asset — anything from a business operation to an oil well to a brand name — may decline sharply at any time against the intrinsic value of that asset. Factoring in the volatility of markets, leadership must pragmatically and unflinchingly evaluate the fundamental depreciation of its assets on a long-term basis, and react by making strategic bets about what to keep, what not to keep, what to buy, and what timing to use on any bet.

For example, consider what occurred in the materials sector starting in the early 2000s. China's consistent double-digit GDP growth reached a tipping point; that nation's economy started sucking up natural resources at a prodigious rate, and it had ripple effects across the globe. In response, BHP Billiton Ltd., an Australian mining company that had been formed by a merger in 2001, made a strategic bet to become a dominant player in China. It purchased Anglo Potash, Intercor, and WMC Resources and steadily cemented ties with China — even winning the honor of producing the medals for the 2008 Beijing Olympics.

BHP's CEO, Marius Kloppers, has said he believes that the industry will consolidate further. In late 2009, BHP set aside a $10 billion war chest to prepare itself to pounce on opportunities and make acquisitions. The capital markets rewarded Kloppers by pushing up BHP's stock price. By early 2010, the stock had grown 250 percent over five years, well ahead of peers such as Rio Tinto and Alcoa. Vale and ArcelorMittal made similar strategic bets before the financial meltdown, and the market also rewarded them with higher P/E ratios. All three now enjoy great influence over prices and control over resources, particularly iron ore, upon which China dearly depends for its growth. In a testimony to this foresight, the price of iron ore went up 95 percent between 2008 and 2009.

To stay ahead of trends like this, corporate leaders must embrace the idea of strategic bets and prepare for the moment when such a bet will be necessary. This means becoming acutely aware of changes in the external environment and anticipating new realities before others do. It means being willing, when necessary, to strike out in new directions with dramatic changes in capabilities, even if the organization lacks experience. Corporate leaders will also have to prepare critical stakeholders for the kinds of dramatic strategic bets that will be necessary.

Anatomy of a Strategic Bet

A strategic bet is a big, bold move made either to transform a company and create a new growth trajectory or to create a totally new enterprise. Almost all strategic bets are potential game changers for the company, its industry, and sometimes adjacent industries; indeed, strategic bets are so comprehensive that they tend to alter most of the company's staff, processes, and practices. Such bets require serious commitment from leaders and boards. In almost all cases, especially if the strategic bet involves a highly visible action, such as a large acquisition, there will be concerns about how the market, the analysts, and the rating agencies will react. Nonetheless, strategic bets work only if management and boards have the confidence and stamina to sustain themselves until the outside world sees the merit of their decision — a period that could last five or 10 years.

There are at least three basic reasons for making a strategic bet:

1. To acquire a controlling interest in, or even a stranglehold over, critical resources or competencies. For example, in late 2010, several strategic bets were under way in the mining and metals industry. They were driven by competition among Chinese and Indian companies for the kinds of rare elements needed for new technologies — such as lithium, a metal expected to be in greater demand for the next generation of car batteries.

2. To escape a declining industry before others see its demise. Typically, this approach is taken when a company's leadership recognizes that part of the business is being commoditized or for some other reason is about to lose value and pricing power. Instead of riding the industry down, the company sells the business to cut its losses and puts its efforts into something with more promise.

In 1996, Allied Signal CEO Lawrence A. Bossidy made exactly that sort of clear-eyed assessment of the company's auto parts business, which was responsible for almost 15 percent of its total sales. The company sold off the lion's share of its car parts business for $2.1 billion, moving instead to concentrate on aerospace and chemical products. Two years later, Bossidy led the purchase of Honeywell, which was about half the size of Allied Signal, for a stock swap worth approximately $14 billion, creating a Goliath in the global aerospace and chemical products markets.

The strategic bet to escape a declining industry must not be confused with selling a business to simply rationalize operations. For example, many companies sell divisions with the assumption that the acquiring company will run them more efficiently, and to gain some cash in the process. Such divestitures are worthwhile, but unless the fate of the company is riding on their completion, they are not strategic bets.

3. To practice a form of large-scale entrepreneurship. This typically means acquiring companies, technologies, or core competencies needed to be successful in an emerging form of enterprise. For example, consider Bharti Airtel Ltd. It is the largest cellular service provider in India, with more than 120 million subscribers. Its global expansion strategy has been based on scale and efficiency: that is, acquiring customers with very low asset intensity (requiring little capital per dollar of revenue). This type of expansion can be risky, because it often requires extensive investment to move rapidly to gain first-mover advantage.

In 2009, Bharti Airtel's management negotiated for months to acquire MTN Group Ltd., a South Africa–based multinational mobile telecommunications company operating in many Middle East and African countries. The Bharti Airtel–MTN deal was an enormous strategic bet; it was championed by Bharti Airtel Chairman Sunil Mittal, but investors and analysts opposed it, in part because of the debt financing involved. Mittal eventually called off negotiations, in the autumn of 2009, but only when the South African government withheld support for the deal.

Nonetheless, Mittal was undaunted by his critics. In June 2010, Bharti Airtel acquired Zain Africa for $10.7 billion. This branch of the Kuwaiti telecommunications company Zain had operations in 15 African counties; Mittal thus gained the foothold on that continent that he had missed with MTN. At about the same time, Bharti Airtel announced a deal to purchase 70 percent of Warid Telecom International Ltd. of Bangladesh. Analysts threw cold water on the plans, pressuring management and the board to abandon the strategy. But Mittal has resisted the pressure to withdraw; he has assembled a top-notch team of managers to go into the Middle East and Africa, and Bharti Airtel is clearly in it for the long term. Tellingly, bankers have competed aggressively to finance the deals.

Facing Up to Uncertainty

As Bharti Airtel's negotiations with MTN show, a strategic bet's outcome cannot be certain; indeed, that is one of the things that make it a bet. Bharti Airtel was fortunate that other acquisitions were available in its target area. The failure to acquire MTN was only a minor setback.

Sometimes, however, poor timing or external forces can produce grave consequences for a strategic bet — and threaten the life of the company. When the Federal-Mogul Corporation, a U.S. automotive parts supplier, purchased British manufacturer Turner & Newall in 1998, it inadvertently assumed an enormous asbestos liability that forced it into U.S. bankruptcy in 2001; it did not emerge until 2007. Similarly, in mid-2008, the Royal Bank of Scotland (RBS) Group's joint acquisition of the Dutch bank ABN Amro (with Fortis and Banco Santander) was a strategic bet to build a position on the European continent. But the bidding war with Barclays PLC over the deal left RBS too financially exposed to weather the credit crisis that arrived soon thereafter.

Keeping perspective is critical with strategic bets. They are so dramatic and compelling that there is always the chance of a misstep. Consider former Bank of America CEO Ken Lewis. His decision to acquire Merrill Lynch during the panicky days following the Lehman Brothers collapse was a bold strategic bet to quickly acquire a new capability. It is likely to prove to be farsighted and rewarding for the bank and its investors, but it will take more time and suasion to realize the potential that Lewis saw at the time. He was ultimately undone by a detail of the deal — not the overall decision, but the disclosure of bonuses. Lewis was eventually forced to resign, which shows just how high the stakes are when managing these bets.

Some executives might blanch at the fate of Federal-Mogul, RBS, and Ken Lewis — and decide that making a strategic bet is just too risky. When facing uncertainty, people have a psychological reluctance to taking on big strategic bets. This holds back many managements and boards. It is comforting, and often defensible, to continue with business as usual, especially if making a strategic bet would mean putting pressure on the board and the organization and having to convince them of a grand vision for corporate change.

Indeed, sometimes it is right to pull back from the brink of a poor strategic bet. In 2005, Johnson & Johnson abandoned its $24 billion bid for the Guidant Corporation, a maker of pacemakers, defibrillators, and stents, after safety issues cropped up. The Boston Scientific Corporation stretched to buy the company instead and eventually had to cope with a huge legal liability. Shortly after the acquisition, *Fortune* magazine called it the second-worst acquisition of all time, after the AOL–Time Warner merger. The stock price sank, and the founders are now selling their holdings.

But *not* making a strategic bet is often a worse move — and, in some cases, fatal. A passive failure to act may not look like a move at all, but it is a bet just the same — a bet of omission. The consequences are potentially dire. Hesitation and a missed opportunity can quickly turn a company into an acquisition target. Executives who make bets of omission are in effect putting the fate of their company in the hands of outsiders: a government regulator, competitors, or private equity investors and hedge funds.

Take, for instance, AOL's decision not to build a search engine. In the mid-1990s, AOL was the dominant Internet player, ahead of Yahoo and a bevy of now extinct portals and search engines. AOL's decision eventually put its fate in the hands of a couple of brainy kids from Stanford whose creation, Google, ultimately relegated the Time Warner portal to also-ran status. Today, AOL CEO Tim Armstrong, formerly of Google, is making a new strategic bet: realigning the company into a content provider through a series of acquisitions, partnerships, and organic growth initiatives. AOL's acquisition of the Huffington Post in February 2011 was a very visible component of this bet, with widely observed risks and many potential rewards.

Heroic Leadership

When senior management begins plotting a strategic bet, whether to combat the decline in the long-term value of an asset, to compete for natural resources, or for any other reason, the boardroom is often psychologically unprepared for such an audacious move. Even when the business case is compelling, the board or senior management team might resist — particularly if those groups are dominated by cautious people or people with little or no experience with strategic bets. We have seen board members, gripped by anxiety, break the momentum of a strategic bet with the assertion "Most acquisitions don't work, so we shouldn't do it." Typically, directors fear the stock price will go down, the rating will be cut, or the adverse publicity will be too severe for the company and their own individual reputations.

Ultimately, it's the leader's job to get the board to face up to the risks of not making a decision. For companies the size of Siemens AG or Procter & Gamble Company, the risks may not be as great as for smaller companies. Traders can create negative press, but they cannot turn Siemens or P&G into takeover targets. The issue is trickier for companies already on the radar as acquisition targets. At such times, a frank boardroom discussion might convince directors that a takeover is inevitable if the company doesn't make the strategic bet. By choosing to take the bet, leadership could propel the company to the next level.

Given the high stakes and uncertainty of a strategic bet, what is the difference between a leader who makes a strategic bet and a gambler who goes "all-in" at the poker table? From a strictly analytical point of view, the gambler's calculations are easier.

Whether the game is poker or roulette or baccarat, a gambler deals with concrete probabilities. Business leaders don't have the same controlled and stable context for their strategic bets. Each play for the leader is unique. The timing is different and the context is different, and this puts extraordinary demands on leaders. In earlier years, the emphasis for strategic decision making was on analytics — which subtly de-emphasized the role of leadership. But analytics can carry a company's executive team (and its board) just so far in their deliberations of whether to make a strategic bet. Indeed, gauging the odds of a strategic bet's success by looking at past successes can be fallacious, because the economic landscape is likely to have changed.

In making a strategic bet, the leader's conviction should be grounded, first and foremost, in a clear understanding of the future potential of the company. This understanding should be bolstered by quantitative forms of due diligence and analysis, alongside a careful qualitative approach that examines the bet through a variety of lenses and possible scenarios. This type of large-scale entrepreneurial judgment is a habit of mind that must be nurtured; it cannot be developed quickly. In an age of strategic bets, identifying and reinforcing that judgment will be the central task of leadership development.

The need to make strategic bets, and be prepared for them, will ultimately change the way many business leaders regard strategy. In addition to their existing concerns — their company's functional strengths, arrangement of business units, and portfolio — there will now be the presumption of a more dynamic, ambiguous, and difficult business environment. The only way to manage this environment, in a collected and capable manner, is to think in terms of external strategy, to continually cultivate an outside-in view of the company in which strategic bets are not automatically resisted, but are instead dispassionately evaluated.

The level of risk a strategic bet carries with it will feel uncomfortable to many. Indeed, if it feels thoroughly comfortable, it's probably not enough of a bet. But business, by definition, involves discomfort. You never have the control you want; you only have opportunities. You must be willing to step forward and risk your enterprise, boldly but thoughtfully, for the sake of its future. Andrew Liveris may not deliver a return on acquisition as quickly as Wall Street wants, and his strategic bet may be criticized for some time, but it has positioned Dow to capture growth on a worldwide basis. The market is just beginning to see what he saw years ago. He will be ready in a few years to make his next big move. That is leadership. +

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Resources

Greg Farrell, *Crash of the Titans: Greed, Hubris, the Fall of Merrill Lynch, and the Near-Collapse of Bank of America* (Crown Business, 2010): A *Financial Times* reporter tells the dramatic story of one of the strategic bets mentioned in this article.

A.G. Lafley and Ram Charan, *The Game-Changer: How You Can Drive Revenue and Profit Growth with Innovation* (Crown Business, 2008): Procter & Gamble's great strategic bet began when Lafley became CEO.

Paul Leinwand and Cesare Mainardi, *The Essential Advantage: How to Win with a Capabilities-Driven Strategy* (Harvard Business Review Press, 2011): Why pursuing an effective strategy often means making a strategic bet by cutting away those parts of your business that are incoherent.

Bob Rice, *Three Moves Ahead: What Chess Can Teach You about Business (Even if You've Never Played)* (Jossey-Bass, 2008): Chapter 8 covers the "exchange sacrifice," in which you trade something that seems valuable now for a better advantage.

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