The Multinational as an Engine of Value

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Large multinational corporations whose names are well known, and whose credit ratings are strong, are not all creating as much value as they can. Instead of continuing to operate as if their strengths were the same as they have been in the past, they need to tailor their structures of production, investment, and management to suit the new, specialized roles they are best suited to play. Spectacular growth and excellent profit performance will be the reward for those global firms that redirect their emphasis.

The first step they must take is to rethink the role they can most constructively perform in the business environment that now exists. New strengths have emerged for the multinationals, and their advantages are actually stronger than before. At the same time, many of their traditional strengths have faded or disappeared altogether. The implications of this shift affect the range of activities these firms should engage in, how they should be organized, how their managers should be motivated and rewarded, how their internal communications systems should be set up, and how they should handle their relationships with suppliers, customers, and the financial markets.

Strengths Contrasted with Self-Image

Multinational companies have relied on communications intensively since first appearing in the Middle Ages. Early trading firms that handled long-distance trade in goods needed up-to-date bulletins about market conditions, so they used couriers, carrier pigeons, and secret codes in a top-priority effort to stay abreast of events. Multinationals were among the earliest and heaviest users of the telegraph, the telephone, and the modem, and they are today as communications-intensive as ever. Their transaction-based financial reporting systems operate in real time; internal cash management and treasury management systems operate around the clock, with the "book" being passed from one regional headquarters to the next as the workday ends in one time zone and begins in another; they have leased lines, dedicated circuits, and conference calls; and they are the largest users of video-conferencing services.

> *It's time to realize that global firms must pay attention to their role of creating value through financial markets.*

Finance has also figured heavily throughout the history of global firms: moving gold, handling bills of exchange, opening letters of credit, giving guarantees. Multinational corporations were among the first issuers of stocks and bonds. Today they move money across boundaries as they trade foreign exchange. They swap it, lend it, borrow it, and bounce it off satellites.

Multinational firms have also been able to organize and manage far-flung activities. Excelling at logistic coordination, they procure in one country, process in another, and market to final users in all three. They have been able to set up vertically integrated businesses and keep all the installations operating close to capacity, with a minimum of slack.

Surprisingly, though, most multinationals do not see themselves as information managers, financial intermediaries, or masters of logistics. Instead, they see themselves as manufacturing firms, marketers, or technology implementers. Information gathering and processing activities, financial transactions, and logistics management are seen as subordinate to the main activity, which the firm itself has defined as its core business competence: to develop, produce, and deliver the product line.

The Mix of Activities Changes, Dragging the Self-Image Along Behind

For most large multinationals, the organizational self-image has changed more slowly than its pattern of actions. Companies' statements about themselves reveal glimpses of the transformation but lag behind the day-to-day changes. The financial press has caricatured the modern large corporation as "hollow" or "virtual," well on the way to becoming a mere shadow of its former self, and still obsessed with remaking itself. The financial press has used dieting as the metaphor; firms are "slimming down," or "shedding" all sorts of things: layers of management, factories, whole divisions. They are flattening the organization to bring the top closer to the market and make it more agile.

The words betray a lack of understanding and a veiled criticism that large corporations have abdicated the social role they used to play. That role, which is now outmoded, was to strengthen the economy of the nation in which they happened to be headquartered. Multinational corporations of today are less imposing than their muscular, fully integrated, megalithic ancestors of the 1950s. A company that is "hollow" or "virtual" has put distance between itself and its earlier, very solid and tangible incarnation, when it was a protean creator of jobs, generator and harnesser of new technologies, and builder of sprawling industrial complexes.

Conventional wisdom still links the fortunes of a multinational firm too closely to the economic strength of its home country. In times past the two were closely linked, even to the extent of seeming to be alternate manifestations of each other. Years ago it would have been absurd to dissociate the German economy from German chemical companies, the Japanese economy from Japanese trading firms, or the U.S. economy from General Motors and IBM. The corporations were multinational but still tightly associated with their nationalities in the popular imagination.

But that conventional wisdom was behind the times. Ownership of the large multinationals had already spread across national boundaries, as investors in many countries bought up the shares, and the corporations had begun to diverge from their national economies, becoming more global and less national.

Figure 1
Traditional Organizational Chart

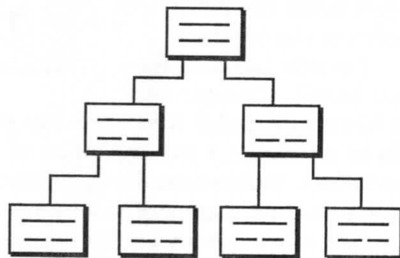
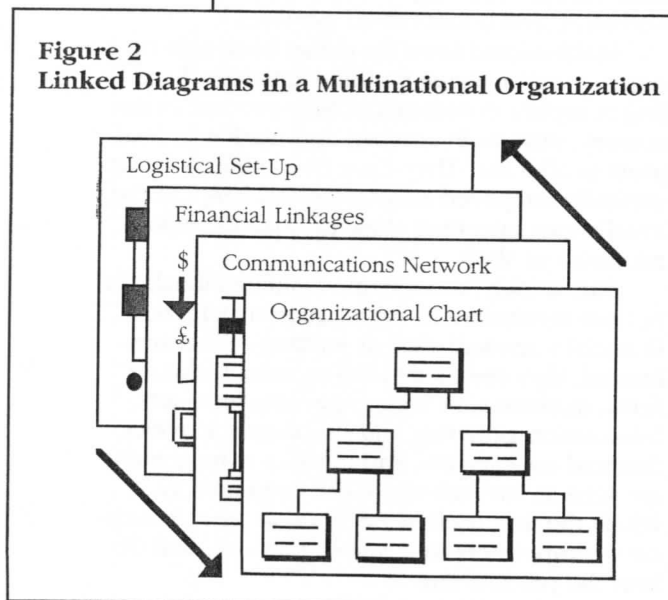


Figure 2
Linked Diagrams in a Multinational Organization



The Global Anorexic Takes the Driver's Seat

The caricature of the slimmed-down firm, striving to become yet leaner, has a grain of truth to it. Multinationals are indeed remaking themselves—not to lose weight, but to reposition themselves into activities where they have advantages that are getting stronger. As the modern large multinational corporation transforms itself into an ever smaller core, with more activities pushed toward the periphery, it becomes more powerful and influential in the domain of abstractions, even as it becomes more difficult to isolate in the domain of tangible reality. It ceases being the brawny machine of production and international commerce, and evolves into a ghostly force in the network, a neural net of commercial intelligence perched atop an eminence of information, organization, and financial clout.

The new corporate form creates more value than the old one. Its securities are worth more in financial markets. Condemning it or caricaturing it does not help understand it. What follows is an attempt to describe the new corporate form, and to show how companies can actively move toward achieving and implementing it.

Nodes, Not Business Units

Most large companies are described using block diagrams. The labels inside the blocks might be factories, controlled corporations, affiliates, suppliers, or distributors. If the block diagram is an organization chart, such as in **Figure 1**, the labels

are job titles and the names of the people who hold those jobs. If the block diagram is intended to represent strategy, the blocks may contain the names of business units, or the links in the chain of value. These block diagrams are useful, but three more diagrams are needed (**Figure 2**). The first depicts the firm's communications network, the second shows its financial linkages, and the third is its logistic setup.

The communications diagram has to show each node, the directions of communication, the sources of information, the processing points, and the targets. It should show the density of communication, and if possible should provide approximate error rates. The discussion accompanying the diagram should include an assessment of the reliability of the commercial intelligence the firm collects, describing how decision makers in the firm use that information and how they can cross-validate the information they receive.

The diagram of the company's financial linkages should present much more than the consolidated financial position of the entire multinational. It should group the firm's total financial resources by country, line of business, currency, and trading bloc. It should show the finances of each legal entity in the group as a stand-alone; how much money the organization has moved from each node, or from each bank account; the locally granted lines of credit each national office has available; the assets each subsidiary has available as collateral; an estimate of the market value of every investment one company in the group has made in another; and the stock market value of each affiliate that has a public listing on any national stock market.

Because the company's logistic setup is multidimensional, it should be presented in a relational database rather than a diagram. Only two-dimensional "views" of it will be easy to show on sheets of paper. It should depict the company's physical movement of goods from different points of view, allowing the user to look at the company's entire world system or zoom in for closer views of regions, provinces, or cities. For example, one image should show the amount of freight shipped from each point to each other point, with the width of the lines varying according to tonnage moved between points. Another view of that image would show the dollar value moved from point to point. Additional views would show the frequency of shipments, with heavier lines representing greater frequency; the mode of transportation (trucks, ships, planes); the perishability or time-sensitivity of the merchandise being moved; and the movement of goods according to the stages of production: raw materials, work in process, final goods.

These diagrams would not be reported to shareholders. They would be used internally to show the managers of the multinational company what its capabilities are in three areas: (1) its ability to collect, filter, organize, and transmit information, then to take profitable actions based on it; (2) its ability to raise money, move it, and allocate it to profitable activities; and (3) its ability to gather goods, move them to points of production, and then move them to markets. Managers are already familiar with their corporations' product lines, customers, organizational structures, legal entities, and buildings. The diagrams would give them new and useful ways of seeing the corporation, which they would then be able to turn into new sources of profit.

Pressure Points in the Chain of Value

For most multinationals, a key issue is how much of an industry sector, or what stages of a production process, it has to control to make a high and enduring rate of profit. Centuries ago, maritime empires seized monopoly control over production and marketing of spices, tobacco, and sugar. Later came attempts to lock up the supplies of diamonds, quinine, rubber, bananas, nitrates, and a lengthy list of other goods that commanded high scarcity value. The quest for market power and commercial dominance continues. Nowadays it is R&D spending, or marketing, or horizontal and vertical integration that give—or at least are thought to give—high returns.

Some attempts to acquire market power and high returns cost more than they are worth. Others scarcely recover their costs. A few are successful, and make high enough profits to have been worth the risk.

The evidence from statistics tracking returns on investment by industry sector reveals a surprising fact: Most new investment in plants and equipment in the traditional industrialized countries produces mediocre returns. This is especially true when the return is adjusted to remove the effects of accelerated depreciation and subsidized financing. Exceptions to this pattern are plant and equipment investments in such skill-intensive industries as computer software, pharmaceuticals, financial services, and semiconductors. Part of the superior returns in these industry sectors should be attributed to the human capital these companies employ, so the published rates of return overstate the returns to the plant and equipment.

U.S. mutual fund data report the following 10-year total returns (*Barrons* 1994):

• Health/biotechnology funds	466.7%
• Financial services funds	357.1%
• Average for all mutual funds investing in equities	248.5%
• DJIA	220.1%
• S&P 500	190.0%

For comparison, international equity funds yielded 337.1% for the same time period, and Pacific region funds yielded 425.8%. The extra return these funds earned over the DJIA or the S&P 500 is probably because of greater diversification and the decline of the dollar. International funds were also invested primarily in a broad mix of industrial shares in countries that are for the most part already industrialized. The cited returns for U.S.-based mutual funds support the assertion that if a multinational company is to earn more than 12 percent per year on average for its shareholders, it will not consistently be able to do so by investing in plants and equipment.

Looking Harder for Pressure Points in the Chain of Value

Where will multinationals consistently find investments that yield high and stable returns? A position of advantage in an industry sector is becoming more difficult to maintain. To earn high and enduring profits from a product, it is now less necessary than ever to control and monopolize every step of production and marketing. Vertical and horizontal integration continue to be strategic objectives, but in most industrial sectors they are tempered by other objectives. Nowadays other producers can be allowed to gain entry to the market because they can be kept from doing damage to the market. To effectively control an industry sector, it may be enough to have an advantage in market share, technology, or access to shelf space in retail outlets.

Brand leadership and technological leadership are harder to keep. Business advantage in an industrial sector has always diminished with time. Imitators and substitutes always encroach, and the high profits always fade into mediocre returns. The only question is what, if anything, can be done to postpone the inevitable.

The classic strategy was to keep investing in improvements to the design, the production process, the packaging, the positioning, and the distribution. This involved large expenditures in production facilities and on large work groups that included designers and marketers. Such a product-focused strategy prolonged the high-profit phase of the life cycle, but it did so by raising fixed costs and reducing flexibility. There was also the tendency to keep on making new investments in the same lines of business after the high-profit phase had already ended.

Investors feared the high costs would go on longer than the high profits. Having heard those fears, top managers responded by restructuring, when a more active reexamination of the sources of high profits would have indicated the need for a sweeping reorientation. The sources of high profit no longer constitute control over geography or raw materials. Now they consist of control of information in the form of technology, patents, or proprietary processes; commercial contacts, brand name recognition, or knowledge of consumer tastes; financial advantages in the form of cash, low cost of capital, or the ability to mobilize cash in different places to achieve an objective; logistical advantages in the form of warehouses, shipping capabilities, freight forwarders, knowledge of customs regulations, and fleets of delivery vans. In short, the sources of high profit are exactly what the multinationals have had all along.

The Hierarchy of Production Units

Multinationals can gain the biggest advantage from their distinctive competencies by acting as catalysts. In other words, they should place the keystone in the arch, not build the whole arch. Their contribution to a deal or to a production and distribution process should be only to put in the ingredients that smaller, lesser-known collaborators cannot. Global firms should not own assets or have employees unless they are critical to maintaining a dominant position in the hierarchy.

The hierarchy is as follows, expressed in terms of the credit ratings of the participants in a coordinated production arrangement:

Entity	*Credit Rating*
Multinational	• Credit rating 'A' • Known worldwide
Local prime contractor	• Local credit rating good
Local subcontractor	• No local credit rating • Small firm; low overhead

This separation of entities in the production and distribution process follows the pattern of the Japanese *keiretsu*, but is set up internationally instead of being all within one country. The chain of production is controlled from the top, but the local contractors and subcontractors have the land, buildings, machinery, warehouses, and production-line employees. The multinational controls the whole chain by contracts, as well as through market intelligence, data base design, and superior telecommunications.

Managing in Virtual Reality: Complete Autonomy with Strictly Controlled Risk

Firms that accomplish vertical integration through contracts tie up less capital, have fewer direct employees, are potentially more flexible, and wield less control over production and distribution. Although they are physically smaller, they

are financially stronger because their assets are composed of relatively high amounts of accounts receivable, inventories, and cash equivalents, and relatively low amounts of plant and equipment. For that reason their asset turnover will be faster, so they will be able to reposition assets more quickly. They will also have higher debt capacity because they will be able to keep their cash flow more stable than if they owned fixed assets that are susceptible to cyclical downturns.

Managing by contracts instead of by owning facilities means that the firm operates more in the commercial sphere and less as a technology creator or implementer. To operate in that style requires a corps of managers to originate, monitor, maintain, and renew or discontinue the contracts. These people are like foreign exchange traders or bond dealers, but they deal with goods and services. Like foreign exchange traders, they are assigned a trading limit that is tracked carefully and raised or lowered according to their performance.

Treasury Management and Product Management

Managers who handle contracts with suppliers are like foreign exchange traders in another way: They work sitting in front of several computer screens and talking on several telephones. They manage the real part of the business—the part that involves sourcing, producing, and delivering goods and services.

Another group of managers is the treasury managers, who track cash collections and disbursements, foreign exchange risk, capital structure, cash flow by business unit by currency, and the market prices of the firm's securities. Treasury managers enter into swap deals to smooth the wrinkles in the firm's underlying cash flow, which will continue to be more erratic than the financial markets want it to be.

The management challenge comes when a product manager has a profitable deal lined up and the treasury managers do not want to allow it. That's because it would take the firm's asset and liability mix away from the configuration they consider most desirable, or increase the firm's risk profile more than the potential profits from the deal would justify. These conflicts can be frequent, because all decisions and proposed deals are entered into a database so everyone in the company can adjust to the changing mix of activities on a continuing basis. Treasury managers, in fact, know about every deal involving goods and services even before it is approved.

Multinational companies have been roundly condemned in the press for paying too much attention to their stock prices while ignoring aspects of their business that, according to conventional wisdom, are more pivotal in determining future profitability. But this presumes that their role as value creators through financial markets is subordinate to their role as value creators through technology implementation. The alternate view—namely, that they have been paying too *much* attention to their core business and not enough to their power to create value through financial markets—is emerging as the triumphant view. Indeed, the core business of a multinational firm is to be an engine of value through financial markets. It is positioned to be more effective in that role, and the time has come to recognize that. ❐

References

"Lipper Mutual Performance Averages, Cumulative Total Reinvestment Performance, 6/30/84–6/30/94," *Barrons*, July 11, 1994, p. MW77.

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