



STRATEGY

# How to Hedge Your Strategic Bets

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To cope with growing uncertainty and volatility, most companies try to improve their forecasting and increase their agility. While important, both tactics have limitations. In times of rapid change, forecasts become obsolete almost as soon as the ink dries on them. And though responding quickly to market shifts is crucial, “perfect” flexibility and agility are costly to achieve—if not impossible.

A complementary—and potentially more effective—approach for established companies is to use “strategic options” as a hedge against uncertainty. Just as financial options can shield investors from risk and help them profit from fluctuations in securities and commodity markets, strategic options can protect companies and allow them to thrive in the face of the unexpected: moves by competitors, disruptive advances in technology, the rise of new markets, sudden swings in demand, and other surprises. By using strategic options, companies can test the waters, conserve capital, and delay final decisions until the tea leaves become clearer.

Some strategic options—such as buying an option for mineral rights or locking in a delivery slot for a new airliner—have long been widely used. Others, however, are much less familiar or are underexploited, including three that we’ll focus on in this article: temporary organizations, exploratory acquisitions, and disposable factories.

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## FURTHER READING

All strategic options are small-enough bets that a company can walk away from them. But they do incur monetary costs, which in the short term may be high. That explains why they aren’t employed more frequently: Many executives see them



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core. But if an opportunity or threat is uncertain, building a separate permanent organization around it can be hard to justify. One solution is to create a temporary organization—with a management team staffed by a mix of contract workers and consultants. This approach makes it possible to hit the ground running and avoid massive layoffs if the new venture fails. If the venture succeeds, permanent staff can be hired.

A temporary organization can help a company test a response to a competitive threat, evaluate a new strategy or concept, explore a joint venture, or capitalize on a fleeting opportunity without disrupting the operations of the existing business. It can be an attractive choice if, say, there are conflicting priorities or when an unexpected competitor emerges, making rapid market penetration critical.

## Temporary organizations let you avoid massive layoffs if the new venture fails.

Orbitz, the online travel agency, was launched in this fashion. (Full disclosure: The Boston Consulting Group was involved in the start-up of Orbitz and has relationships with the other companies featured in this article.) In late 1999 and early 2000, during a period of slow growth for airlines, five major U.S. carriers—Delta, United, Northwest, Continental, and American—joined forces to create the travel site. Unlike Expedia and other online services that charged airlines a fee for favorable placement of their flights, Orbitz planned to list in an unbiased order all available flights (with the exception of those of Southwest, which did not share information with third parties). The airlines believed that value proposition would appeal to customers and would be difficult for rival online travel services to match, since their sites were designed to display only the most common flights between cities.

Orbitz had a good strategy, but its success was far from assured. A new IT system, including the core search algorithm, had to be built. The website had to be user-friendly and easy to navigate. Both would require a major investment of time and money. What's more, to compete with Travelocity and Expedia, Orbitz had to grow rapidly, leaving little time to test the concept with customers. If the new business failed, the partners would be stuck with costly assets that they'd have to sell at a loss and people they'd have to jettison.

Because they were competitors, the partners ruled out incubating the venture inside one of their own organizations. They also realized that a traditional start-up approach—building the business one employee at a time—would take far too long.

as wasteful, risky, and ambiguous. Often executives want to “get it right the first time” rather than experiment.

But because they tie up less capital and are easy to unwind if trends prove unfavorable, strategic options can save money in the long run. Equally important, they help companies learn and build their experience, positioning them to capture valuable opportunities they otherwise might miss.

## Temporary Organizations

Some opportunities can't be pursued within the structure of the core business. They may require completely different capabilities or a business model that could cannibalize the

So they created a temporary organization staffed largely with contract employees and managers from professional services firms, who cost about two to four times more than permanent employees (excluding full-time benefits). Orbitz started with five managers from BCG, who oversaw operations, finance, IT, corporate development, and HR, and eventually grew to 60 workers, including lawyers, accountants, engineers, IT developers, and human resource experts. Once it was clear, three months into the launch, that the site was a success, Orbitz began replacing the contractors with permanent hires, a process that took half a year.

The temporary organization paid big dividends. The total cost to build and fund Orbitz until it reached self-sustaining profitability was about \$250 million. In 2004, Cendant bought the company for \$1.25 billion, netting the partners \$1 billion in profits.

## Exploratory Acquisitions

Companies seeking to diversify through acquisitions face a lot of risks and unknowns. Although acquisitions can be a quick way to gain market entry and new customers, technical expertise, and lines of business, they typically involve enormous integration challenges and have notoriously high failure rates. This is particularly true with large deals in noncore markets.

With smaller acquisitions, the cost of failure is lower and integration goes more quickly. While lots of companies use small deals to expand into new geographies, we haven't seen many use them as a low-risk way to explore new businesses. The best approach is to focus on complementary markets where a company can leverage its current strengths and capabilities.

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### FURTHER READING

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MANAGING UNCERTAINTY MAGAZINE ARTICLE by Martin Reeves and Mike Deimler

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businesses and become the market leader.

If an acquisition is small and is viewed as a highly targeted trial run with specific objectives, it's better able to avoid the pitfalls of mergers. It affords an opportunity for learning—for walking before running. And it can be disposed of relatively painlessly if it doesn't deliver value. However, if the acquisition succeeds in helping the parent company get a foothold in a new area, it provides a foundation and framework for the parent to acquire more complementary

This was the path taken by Brooks Automation, based in Chelmsford, Massachusetts. Brooks was a leading producer of precision-materials-handling equipment, environmental controls, instruments, and subsystem components used in semiconductor manufacturing. In the early 2000s, industry growth began to slow and the business became more cyclical. In response, Brooks began to consider diversifying into areas with more potential. Mindful of the challenges and poor outcomes of many large-scale diversification efforts—especially those that involved mergers and acquisitions—the management team chose an options-based approach.

After inventorying its capabilities, Brooks determined that its ability to move materials in scientific cryogenic environmental chambers while precisely controlling atmosphere and temperature could be applied to the growing life-sciences industry—particularly pharmaceuticals and biotech. At that time, industry researchers were storing formulations and tissue samples in the equivalent of dormitory refrigerators, with lax controls that allowed temperature swings that could interfere with cell activity. Materials transport, storage, and record keeping were all done manually. Pharma and biotech researchers were unhappy with this state of affairs. Besides being automated, Brooks's equipment

kept digital records of the movement and placement of all formulations and sample tests—a critical benefit given the emphasis that regulators such as the U.S. Food and Drug Administration were placing on the “traceability” of materials.

Brooks's management team recognized that while the life-sciences market seemed promising, it was very different from the semiconductor industry. The latter was highly consolidated among a handful of manufacturers and equipment suppliers that were concentrated geographically. Brooks had been working very closely with a relatively small number of customers and often based its service people onsite at key accounts to minimize equipment downtime—and help chip makers maintain the high volume and low costs they required. The buyers and other decision makers tended to be engineers centrally located in semiconductor factories. The chip makers also planned capital investments far in advance and involved Brooks in those discussions, giving the company a clear window into future demand.

By contrast, the life-sciences industry was fragmented. Equipment manufacturers had thousands of customers—who typically were researchers and doctors, not engineers. Instead of being centralized, the buyers and other decision makers were distributed across the supply chain and included funders and regulatory agencies. Equipment purchases tended to be less predictable and involved shorter decision cycles, which made capacity planning more difficult.

Deciding it needed to get a jump on other likely competitors and that developing full-blown operations from scratch would take too long, Brooks made two exploratory acquisitions. In 2011 it paid \$3 million to buy RTS Life Sciences, a small British company with a contract to handle medical samples for the UK's National Health Service; and about \$80 million for Nexus, a 100-person company in the same line of work. Nexus had materials-handling equipment, but even more important to Brooks was the company's experience with customers in life sciences. Brooks expanded that capability, invested in further developing the Nexus product line, and worked to bring large-company discipline to both acquisitions.

As it won more materials-handling contracts in life sciences, Brooks gained confidence. Over the next four years it bought all or part of four more companies for a total of \$156 million. In the process it acquired a new capability (-150 degrees Celsius cryogenics) and grew its offerings to include new services and consumables such as storage containers.

Today, Brooks is the market leader in materials handling for life sciences, which now accounts for about 20% of its revenues of \$500 million. The company intends to follow the same approach in other markets: identify opportunities where it can apply its capabilities, acquire small companies to test the waters, improve and extend the product and service offerings by transferring its technical skills, and then buy more companies that complement and grow its market position.

## Disposable Factories

When building factories, companies often strive to use scale and automation to lower the per-unit cost of production. But big state-of-the art plants are expensive and time-consuming to construct—and typically they can add capacity only in large amounts. When demand is volatile or uncertain, these facilities may become albatrosses.

In businesses where profit margins are high, first movers seize the advantage, or the cost of stock-outs is large, relatively small “disposable” factories are a good alternative. They can offer a better way to deal with the unknowns of a new market and provide early data on costs, capacity, and product mix that informs the design of permanent factories (should the company decide it needs them).

## How to Thrive in Turbulent Markets

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Disposable factories inevitably have higher per-unit production costs than full-scale facilities do. That—and the reluctance to “throw away” a factory—is why many executives are hesitant to resort to them. But the added costs usually are more than offset by benefits such as a lower up-front investment, faster time to market, and greater ability to match supply and demand.

Of course, companies can also use outsourcing to achieve production flexibility. Firms can even buy an option to increase the amount that a contract manufacturer produces. But when a company has a proprietary production technology or process that can give it a competitive advantage, a disposable factory is the way to go.

Disposable factories typically have 5% to 10% of the capacity of a permanent facility and can be built in months versus the usual years. Because they’re smaller, they can be placed closer to centers of demand, which allows companies to better serve local tastes and to decrease transportation costs—an underappreciated benefit, given that logistics costs exceed manufacturing costs (minus purchased materials) by wide margins in many businesses.

Chinese companies are using low-tech disposable factories to compete in the pharmaceuticals industry, as some of our colleagues found during an assignment for a major U.S. drug company. The U.S. firm’s Chinese factory was highly automated and engineered for large-scale, flexible, low-cost production, but it had an inflexible cost structure with a 30-year life. In sharp contrast, the Chinese competitors’ plants were small, simple, manual, and dedicated. Instead of using computer-controlled process-monitoring equipment, for instance, the Chinese relied on repeated visual inspections. In other words, they threw people at the process to get it on spec. If demand did not materialize, it was no big deal to the Chinese. They could swap the inexpensive equipment out or tear down the cheaply built plant and move on.

Disposable factories can be placed closer to demand, reducing logistics costs.

Modular factories are a variant on this theme, though they’re usually not intended to be disposed of. In some cases, they are preassembled in special plants, which dramatically cuts the time required to get them up and running. Another advantage is their mobility. They can be dispatched to match output with near-term demand—but if local sociopolitical conditions deteriorate, they can be moved to a more stable location. If and when enough demand materializes, modular plants can be replaced with a global-scale facility.

Procter & Gamble is now using modular factories to make some products. One is surfactants, an ingredient in detergent, fabric softener, hair conditioner, shampoo, and toothpaste. Surfactants had long been produced in large centralized factories, using a decades-old technology, but a new greener technology now allows them to be made in distributed factories, shortening the supply chain and response time and lowering transportation costs and investment risks.

## The Challenges of Execution

While there won’t be strategic options for every situation, our experience suggests that they’re powerful tools and could be used far more often. But in most organizations they’re easier to identify and design than to implement—mainly because of management resistance. Three factors explain this foot dragging.

First, higher near-term costs are easier to calculate than long-term benefits. Without equal clarity on long-term benefits, how can a company justify pursuing an option? A review of past investments may help executives overcome this reaction. How far off were previous estimates of demand? What were the costs of underestimating—and being unable to meet—demand? What were the capital costs of overestimating demand? If the costs of inaccurate forecasts were high, management will probably feel more comfortable moving ahead.

Second, strategic options often require capabilities an organization lacks—and the task of building those new skills can be daunting. Brooks, for example, had to learn the art of acquisitions: how to identify targets with the right technologies and skills, evaluate candidates, and do deals, as well as integrate and manage the acquired businesses. With disposable and modular factories, engineers who have long focused on building low-cost facilities with global scale have to learn to think and design in different ways.

Finally, a forecasting culture is hard to move beyond. Forecasting is embedded deeply into the way that managers operate. Most organizations plan for uncertainty by creating scenarios with high, medium, and low probabilities. Then, all too often, they take the middle course. While we're certainly not advocating an end to forecasting, we are suggesting that companies should recognize its limitations. The strategic options approach enables management to spend less time and resources on trying to foresee an unpredictable future and more time on understanding upside opportunities and downside risks and how they can be mitigated. If organizations can begin to imagine how high-, medium-, and low-probability outcomes could be accommodated with a single approach (such as disposable or modular factories), strategic options will become more popular.

The three factors bias companies toward inaction or a “wait and see” approach that may not be in their best long-term interests. In many situations, companies that find lower-risk ways to gain experience and market intelligence and build relationships will be able to outmaneuver their more cautious and less creative rivals.

But the transition to an organization that can take initiative despite uncertainty requires action on multiple fronts. Leaders have to introduce options into their regular strategic dialogues with business unit and functional heads. The assessment of critical unknowns and the development of responses to them need an organizational home and must be integrated into strategy development. There should be rewards for the artful use of strategic options—and executives and engineers who fail to embrace them may need to be replaced or transferred to other roles.

We are often asked, When should a company *not* consider strategic options? Our response is that management teams should carefully take them into account whenever they're contemplating *any* investment for which the payoff is far in the future and uncertainty is high. Given today's competitive and volatile environment, strategic options are often the best choice.

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