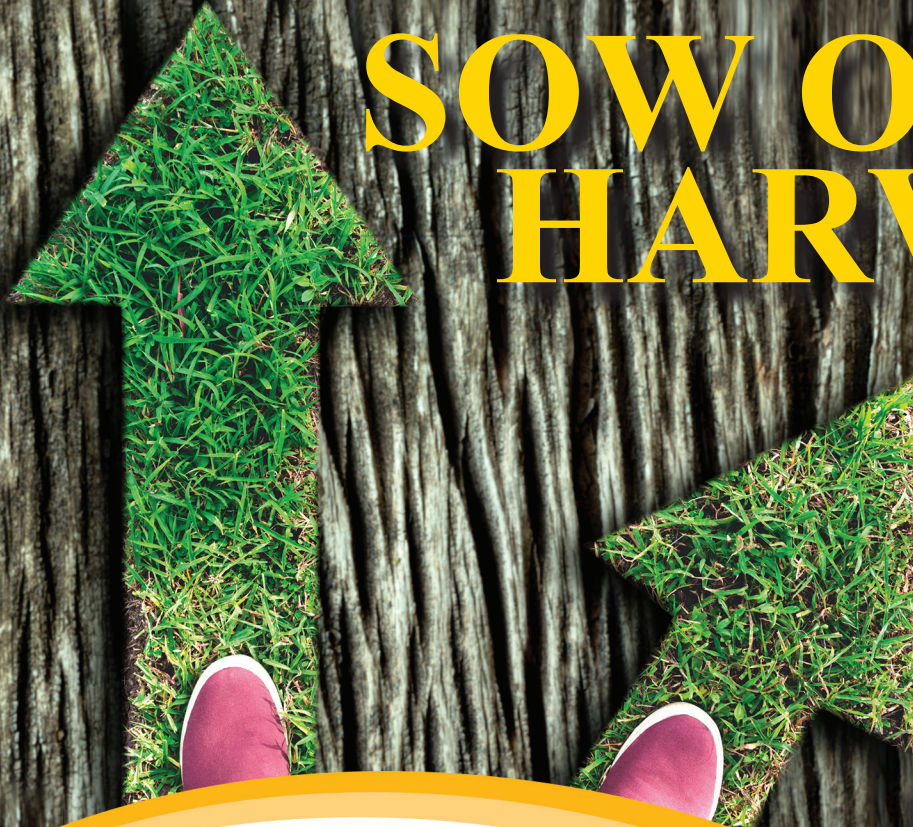


# A MANAGER'S DILEMMA:

## SOW OR HARVEST



*Vijay Govindarajan, Ashish Sood, Anup Srivastava, Luminita Enache, and Barry Mishra have found that companies must focus relentlessly on building long-term competencies, even if doing so reduces immediate profits. Nonetheless, it is vital to shift focus when your product or idea becomes unexpectedly successful, so that you can milk that opportunity's profits before it vanishes in the face of competition and technological progress.*

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“You got to know when to  
hold ’em  
Know when to fold ’em  
Know when to walk away  
And know when to run.”  
—“*The Gambler*”  
(Don Schlitz, songwriter)

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## Developing the dynamic capabilities that enable firms to accomplish both current and long-term objectives is neither easy nor cheap.

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**F**irms routinely face a vital dilemma: whether to continue to reap the profits of existing competencies or invest in new competencies which might produce future profits but reduce current ones. PepsiCo has to find a balance between the continuing income of sugar-laden products and shifting to healthy drinks and snacks which accommodate changing consumer needs. Ford Motor Company has to choose whether to go on milking its established internal combustion vehicle brands or reinvent itself for the emerging markets of electric automobiles, ride sharing, and self-driving cars. Developing the dynamic capabilities that enable firms to accomplish both current and long-term objectives is neither easy nor cheap. Firms struggle to optimally divide their scarce resources between sowing and harvesting and, all too often, end up vacillating between the two.

Should managers shift their focus back and forth, and if so, when? We examine this question by observing how the investors react to their firm’s shifts in focus. Investors can read these shifts in the firm’s selling, general, and administrative (SG&A) expenditure which includes investments that improve future profits like

strategy, brands, patents, innovation, customer relations, market intelligence, organizational technology, and human capital, as well as those that support current operations, such as product and sales support, sales commission, delivery costs, and advertising. These outlays, representing over a trillion dollars in the U.S. economy, can create both short- and long-term value.

Working from the assumption that stock market response is a good indicator of the long-term best interest of the firm, we examine the stock market’s reaction when firms shift their strategic focus from sowing to reaping, or vice versa, and the conditions under which market responses differ.<sup>1</sup> From this scrutiny we have drawn five important insights.

### 1. Focus Relentlessly on Value Creation

Although the popular press frequently bemoans shareholders’ obsession with immediate profits at the cost of long-term value, we have found that stock markets react negatively when companies shift suddenly from sowing to harvesting. This response indicates that investors believe such unexpected changes in strategy to be detrimental to the firm’s interests. Indeed, they are quite willing to postpone their profits as long as the firm continues to focus on creating value. Anecdotal evidence supports this proposition. In the face of operational losses, shareholders continue to back Tesla, Uber, and Twitter, with double- or even triple-digit billion-dollar valuations, because such companies continue to build future value.

Firms which imprudently believe the common misperception that the stock market punishes firms with a long-term focus can wind up damaging profitable investment strategies.

High-tech companies, such as those offering internet services, electronics, pharmaceuticals, and telecommunications, suffer the most from the market’s punishment of shifts towards a short-term focus. There are two possible reasons for the market’s particular disapproval. First, investors believe that continual innovation is essential to ensure long-term profitability. Second, and perhaps more important, investors also believe that, because the competition keeps innovating, investment is vital even to short-term survival. Recent research shows that, for technology companies, R&D is no longer a discretionary expenditure: it is a necessity of survival.<sup>2</sup> LinkedIn, for example, continually upgrades its proprietary systems for feature extraction, information retrieval, and matching to improve member searches by strengthening its data sets. If it failed to improve constantly, it would lose its market share in no time.

Investors’ beliefs could also reflect current economic realities. Creative destruction moves ever faster in the corporate sector while the life cycles of products are becoming shorter. Consider, for example, how often most of us replace our mobile phones now, compared with the nearly endless lifespans of rotary phones. In recent years, companies that failed to innovate saw their market shares usurped with shocking rapidity, from Yahoo’s mail service and Alavista’s search engine to Kodak’s films and cameras and Blackberry’s phone. And this phenomenon is not confined to technology companies; traditional businesses such as Macy’s, Borders, and Blockbuster have also suffered. Right now, decades-old health care giants like UnitedHealth Group Inc. are under attack from a joint venture by Amazon, Berkshire Hathaway Inc.,

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and JP Morgan Chase. Nonetheless, rapidly changing technological and market conditions make it increasingly difficult to forecast which specific action will lead to success, like pinpointing the molecule that will become the next blockbuster drug or determining which app will be the most appealing in 5G.

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**Firms need future-oriented investments not only as a route to future profits but also to defend their existing market share, rather like running against a moving sidewalk just to stay in place.**

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In short, today's incumbents have no choice but to keep innovating because of the ferocity of their competitors. Firms need future-oriented investments not only as a route to future profits but also to defend their existing market share, rather like running against a moving sidewalk just to stay in place. We therefore advise that, even when it requires them to sacrifice immediate profits, firms must focus constantly on building strategy, brands, patents, customer relations, market intelligence, organizational technology, and human capital. Stock market rewards will follow.

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**When an idea or product strikes gold, the company must immediately shift its efforts toward milking the profits from that lucky strike.**

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## **2. When Opportunity Knocks, Grab It**

Our second insight is that, by quickly shifting their focus from sowing to harvesting when opportunities arise, firms can maximize their returns. Shareholders reward firms which nimbly take advantage of a sudden success in product markets. Such opportunities come rarely and disappear quickly in today's fast-moving world. In the biotechnology industry, only one in 5,000 projects which reach the laboratory stage finds commercial success. Among thousands of social media startups, only a few manage to become Snapchat, Twitter, or Facebook. When a company's idea or product strikes gold, it must immediately shift its efforts toward milking the profits from that lucky strike. After all, the company had been investing its precious resources in creating just such a scenario and it won't be long before copycats and superior products arrive.

In the past, successful products required large investments in factories, warehouses, and supply chains. Today, high-technology and digital products can rapidly be marketed globally, thanks to technological production, marketing, and distribution that are faster than ever before. How much time or money does it take to produce one more copy of Microsoft Windows or deliver services to one more Facebook subscriber? Almost none. So firms get the most out of unexpected opportunities by changing their strategic focus rapidly, perhaps by immediately increasing production or poaching the best sales team from the competition so as to expand into new markets.

In short, when fortune strikes and a product succeeds unexpectedly, the firm must instantly shift to branding, positioning, producing, distributing, and securing

markets for that product. This prescription may seem obvious but shifting from sowing value to harvesting value when the moment strikes is a surprisingly underused tactic. Technological entrepreneurs are generally eager to invest in innovation and are careful to hire the best scientific and product-development teams. Yet the same entrepreneurs frequently fail to appreciate the value of hiring the best marketing minds who are essential to branding, advertising, and positioning their products in the right market and at the right price, and to getting the greatest profit out of a new product. While Yahoo was the most visited site on the web for a long time, it could never figure out how to turn that traffic into money.

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**When opportunity knocks, top management must divert its attention toward earning profits.**

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One probable reason that small companies don't tend to turn eagerly toward harvest is that, more and more commonly, their primary aim is to be purchased at a premium price by a larger company. They are less interested in growth, profits, and shareholder dividends. Google snapped up YouTube for \$1.7 billion, Facebook acquired Instagram and WhatsApp for \$1 billion and \$19 billion, respectively, Walmart acquired Jet.com for \$3.3 billion and FlipKart.com for \$16 billion, Salesforce bought Tableau for \$15.7 billion, and Microsoft acquired GitHub and LinkedIn for \$7.5 billion and \$26 billion. Most of these acquired companies had yet to show profits despite their established market leadership. Yet while earning profits may not be

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the main goal of modern startups it remains the principal means of creating value for shareholders. So when opportunity knocks, top management must divert its attention toward earning profits.

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**In reaping the rewards of a successful product, managers must focus not only on creating its ideal market but also on securing that market.**

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### **3. Don't Forget to Lock the Door Behind You When You Are Busy Harvesting Value**

Right now, iPhone is facing a threat from Huawei. Despite having produced one of the most successful products ever and having a phenomenal strategy for exploiting that success, Apple left itself vulnerable, ignoring the price-conscious segment of the market. This is the fastest growing group in emerging economies such as China, India, and various African nations. In reaping the rewards of a successful product, managers must focus not only on creating its ideal market but also on securing that market. They must ensure that their product becomes the de facto industry standard, cultivating relationships up and down the value chain and establishing proprietary ecosystems and networks. By building these walls, they can increase the switching costs for locked-in customers and value-chain partners, delaying their fall from market leadership when competitors arrive. When Microsoft established its operating system, it was quick to create an implicit, exclusive partnership with Intel that kept cheaper and often superior alternatives at bay.

And firms must keep enhancing their products, as well as their ancillary features, while they promote them. By so doing they increase customer lock-in. Instagram and WhatsApp are both extensions that have strengthened, or at least maintained, Facebook's grip on its customers. Attention to this area is particularly important when the market structure creates winner-take-all profits, leaving nothing for the runners up. Internet-based product markets can generally accommodate just one or a very few large leaders globally, and do not have the scope to accommodate a range of regional players coexisting peacefully in their own areas. For example, social media, a new market, is controlled by Facebook, while utilities, an old market, are distributed among numerous small regional players. Firms must be sure to encourage managers to defend market shares as well as, or even at the cost of, pursuing profits.

### **4. Communicate Regularly with Investors About the Firm's Strategic Focus and Its Change.**

Over time, effective communication with investors has become ever more important, both when the firm invests in ways that reduce immediate profits and when it shifts from sowing to harvesting. In 2019, Tesla CEO Elon Musk said: "It's hard to be profitable with that level of growth.... We could slow it down, but then that would not be good for sustainability and the cause of electric vehicles." This sort of communication is especially important since the rise of activist investors in the 1990s. While activist investors generally add value by subjecting corporate strategies to market-based checks and balances, they can also be disruptive when a firm fails to adequately explain its strategy. Without enough information, activist

investors can force firms to curtail investments such as R&D, even though doing so destroys long-term value.

The market penalty for shifting suddenly from sowing to harvesting has decreased over time. Markets no longer perceive sudden changes in a firm's strategic emphasis as negatively as they once did. Outside shareholders may be coming to realize that managers have access to private information which would damage the firm's opportunities if it were revealed. Nonetheless, the penalties for unexpectedly reporting losses remain severe, so firms should be prepared to explain changes in strategy during calls with analysts or in the management, discussion, and analysis sections of their financial statements.

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**Whatever the reason, the optimal strategy differs by industry and context.**

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### **5. Determine the Best Strategy According to Your Industry and Circumstances**

While providing clear general guidance, our study offers no one-size-fits-all prescription. High-technology industries suffer most from negative stock market reaction when they shift unexpectedly from sowing to harvesting. Yet, these same industries reap the greatest benefits from a well-timed change in strategy. By contrast, low-technology industries such as forestry, agriculture, and restaurants may see a positive market response when they realign from sowing to reaping, perhaps because investors do not expect huge payoffs from these diminishing industries and actually prefer to focus on immediate profits. Whatever the reason, the optimal strategy differs by industry and context.

Through this study we have revealed new insights which can guide firms on when to focus on sowing and when on harvesting as well as on the circumstances in which they should shift that focus.

### Conclusion

Through this study we have revealed new insights which can guide firms on when to focus on sowing and when on harvesting as well as on the circumstances in which they should shift that focus. Managers can also adopt our measures on sowing, harvesting, and shifts in strategic focus to establish a more data-driven approach to developing new products, marketing, and investment strategies. Solid metrics enhance the power of analytics, optimizing their results by allowing firms to invest in creating value at appropriate times and to enjoy the higher returns that result from shrewd shifts in strategy. ■



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### Endnotes

1. To divide SG&A expenses into sowing and harvesting outlays, we follow L. Enache and A. Srivastava (2017), "Should Intangible Investments Be Reported Separately or Commingled with Operating Expenses? New Evidence," *Management Science* 64(7): 3446-3468. Further information on the technical details of our research methods may be found in an online Appendix (<https://haskayne.ucalgary.ca/sites/default/files/Faculty/Online%20Appendix.pdf>).
2. See, for example, V. Govindarajan, S. Rajgopal, A. Srivastava, and L. Enache (2019), "It's Time to Stop Treating R&D as a Discretionary Expenditure," *Harvard Business Review* (January 29).