scale (high, medium, low) according to how critical they are to our ability to maintain operations in a pandemic. For example, we might rank the manufacturer of an essential pharmaceutical ingredient higher than a company that provides market data services. On the basis of this ranking, we prioritize our approach to suppliers and engage in one-on-one dialogues to ensure that each vendor has a thorough understanding of what we expect from them in a pandemic. During the conversations, we ask our suppliers about their ability to maintain operations and continue to meet our needs during a pandemic.

Consider incorporating pandemic response into contractual agreements with vendors. Such contracts could be especially important for companies that share vendors with several of their competitors. In a workshop Roche cosponsored for hospital leaders, much discussion focused on the importance of contractual agreements to ensure that, in the event of a pandemic, suppliers would not favor one customer over another. While this is a chief concern of hospitals that will care for massive numbers of patients in a pandemic, it also applies directly to other types of businesses.

Work with local government officials to gauge how their actions might affect your supply chain or the delivery of your product. Roche maintains communication with local officials in areas where we do business to keep abreast of local governments’ anticipated actions during each stage of a pandemic, to share information, and to coordinate plans. For example, if we learn that a state might close certain roads during a pandemic, we will work with our transportation vendors to plan delivery alternatives for customers in the affected area. We encourage our suppliers to foster such relationships with their local governments.

Make pandemic planning a C-suite priority. In addition to hosting company-to-company meetings with suppliers, we engage with them through peer-to-peer outreach. Members of our operating committee, myself included, reach out to our counterparts at partner companies on an ongoing basis to discuss the potential impact of a pandemic on their businesses. We are exploring what their information needs are, where potential vulnerabilities lie, and most important, how we can work together to address them. Besides helping to ensure business continuity in a pandemic or any disaster, we’ve found, engaging suppliers in this planning has improved supply chain efficiency and our ability to service customers in times of relative normalcy.

George Abercrombie (george.abercrombie@roche.com) is the president and CEO of Hoffmann-La Roche, the U.S. prescription drug unit of the Roche Group, in Nutley, NJ.

Reprint F0712B

GLOBAL PARTNERS

Mao’s Pervasive Influence on Chinese CEOs

by Shaomin Li and Kuang S. Yeh

Executives of multinationals partnering with Chinese firms can benefit by being alert to Mao Zedong’s lingering influence on some of the country’s most successful executives. One leadership tactic, in particular, can undermine a joint venture.

Our research on the practices and attitudes of Chinese CEOs offers abundant evidence that Mao’s principles continue to influence top executives: All but one of 15 CEOs we interviewed told us they often turned to Mao’s teachings for management ideas. Consider the manner in which Mao wielded power: by keeping the country in a state of chaotic flux, often playing one group against another. To make a change in the political landscape, Mao would orchestrate a movement that sucked in the entire population, such as the campaign against Liu Shaoqi (the number two leader in the Chinese Communist Party) and his allies, then resort to a mixture of agitation, networking, and rallying to mobilize people at the grass roots to denounce certain cadres, or senior officials. Most of the cadres would be forced out of their jobs, and Mao would rehabilitate a few. Deng Xiaoping was denounced in this manner, rehabilitated, and denounced again.

In our study, conducted with Garry D. Bruton of Texas Christian University in Fort Worth, we found several Chinese chief executives who employ a business version of that tactic: They cement their authority by keeping even senior managers in a constant state of uncertainty, sometimes mobilizing lower-level employees to criticize and pressure mid- and upper-level executives.

A wireless-paging company we studied offers an example. Rather than directly fire some of her middle managers, the CEO mobilized lower-level employees to defy them, leaving them with no choice but to resign (the CEOs we spoke to did not want their names used). In another instance, a former general manager of a call center told us she had to quit after her subordinates were directly mobilized by the parent company’s CEO to circumvent her orders and pressure her to resign.

High-profile Chinese business leaders who have used this and other Mao-style tactics to dominate their managers include Zong Qinghou, the founder and former CEO of Wahaha, the French-Chinese beverage joint venture. Zong recently circumvented the formal organizational procedures during a dispute and mobilized Wahaha employees to publicly denounce the French management.
As of this writing, no settlement of the dispute was in sight.

A multinational partner of a Chinese firm should recognize Mao’s tactics and regard their use as an indication that the company is dealing with an authoritarian leader who tends to be secretive (secretiveness was a characteristic of many of the CEOs we studied) and who is likely to bypass formal decision-making processes. Such companies often have vague organizational structures and CEOs who can easily nullify any of the company’s agreements, hampering the JV’s attempts to implement official strategy.

Recognizing a CEO’s penchant for Mao-style tactics isn’t easy, but the chief executive’s age is often revealing. Mao left an indelible imprint on the thinking of Chinese people who are now in their forties or older. Another indicator is a firm’s inability to select a second in command or successor (one analyst has wryly noted that Ren Zhengfei of the telecom equipment company Huawei has “more than 100 second in commands”).

A multinational that chooses to work with a CEO who uses those tactics needs to have effective procedures – both formal and informal – in place for monitoring the Chinese leadership. A JV should create a standing executive committee with members from both companies that meets frequently and monitors the CEO and the decision-making process. At the same time, the foreign partner should take note of small details: For example, one way to anticipate management reshuffles is to pay attention to clues such as who sits where at receptions and who gets invited to play golf with whom. A former senior executive of Procter & Gamble in China described successfully following similar procedures during his P&G tenure.

Additionally, a multinational should always be ready with a contingency plan to thwart the Chinese leader’s attempts to get around organizational procedures. Had Wahaha’s French managers anticipated Zong’s tactic, they might have been able to defuse it by providing rank-and-file workers with objective information on the dispute.

Kuang S. Yeh (kuangyeh@gmail.com) is the chair of the Department of Business Management and EMBA director at National Sun Yat-Sen University in Kaohsiung, Taiwan.

Shaomin Li (sli@odu.edu), a professor of management and international business at Old Dominion University in Norfolk, Virginia, was the founding CEO of a Hong Kong–based IT firm with subsidiaries in China.

INVESTING

The Truth About Private Equity Performance

by Oliver Gottschalg and Ludovic Phalippou

Rising credit costs have already taken the bloom off private equity’s rose, but some funds (and some investors) are due for another shock. Our research shows that the way PE fund performance is most often reported overstates the truth.

Here’s the problem: Private equity returns are often reported as the internal rate of return (IRR) – the annual yield on an investment – of the underlying cash flows. This implicitly assumes that cash proceeds have been reinvested at the IRR over the entire investment period – that if, for example, a PE fund reports a 50% IRR and has returned cash early in its life, the cash was put to work again at a 50% annual return. In reality, investors are unlikely to find such an investment opportunity every time cash is distributed.

Finance 101 teaches us a simple solution to this problem: the so-called modified IRR (M-IRR). This measure is similar to the regular IRR, but rather than assuming reinvestments at the IRR, it specifies a fixed rate of return for investing and borrowing. We looked at this measure in a study of 1,184 private equity funds raised from 1980 to 1995, considering all investments and corresponding cash flows through 2004. The highest IRR in our sample was an impressive 464% per year; when we applied the M-IRR measure to that fund and specified 12% per annum for borrowing and investing, we got an M-IRR of 31%: a far cry from 464%, and certainly a better representation of the fund’s true return.

Doing the same for all funds in our sample, we found that the top 25% as ranked by IRR had an average net-of-fees IRR of 35.32%. However, the top 25% as ranked by M-IRR (assuming borrowing and investing at 12%) had an average M-IRR of only 18.56% – much more in line with other investment opportunities.

In addition to skewing the apparent performance of “star” funds, IRR calculations can mislead investors who are trying to compare the returns of different fund managers. We ranked the funds in our sample according to IRR and M-IRR and found immediately that the top two according to M-IRR don’t even appear in the list of the top 10 according to IRR. As the table shows, the top 10 IRR funds in our sample shift dramatically when ranked by M-IRR. What’s more, the astronomical returns suggested by IRR calculations plummet to earth when an M-IRR calculation is applied.

Overstated private equity performance may partially explain why investors continue to allocate substantial capital...