 By Michael Useem and Neng Liang

Globalizing the company board:

Lessons from China's Lenovo

"The board of directors has the important role of overseeing management performance on behalf of shareholders"

The rise of the Indian and Chinese economies during the past decade is transforming how executives and directors think about company governance. In both countries, corporate boards had traditionally played a modest role in company decisions. And even when more actively involved, they had often pulled decisions toward objectives not entirely in keeping with governance ideals. If directors are in theory the eyes and ears of all company owners, in practice they sometimes favored family owners over others in India, and state holders over others in China.

The sustained growth of the Indian and Chinese economies, however, has forced regulators, shareholders, and companies in both countries to reexamine their governance practices for two reasons. First, international investors increasingly moved cash across country lines, and as they took greater ownership in publicly traded companies outside their home countries, they also brought home-country biases for independent, informed, and even-handed directors. Second, Indian and Chinese executives increasingly moved their operations across national boundaries, and as they entered demanding international markets, they also learned that independent, informed, and even-handed directors can constitute a source of company advantage.

The broader outlines of these trends are reasonably well known, but what is less understood is how companies remake their boards to reflect the emerging reality of global equity and operating markets. This article seeks to identify the process by which company leaders are restructuring their governance through investigation of how one of China's more prominent companies, Lenovo, transformed its board following acquisition of IBM's personal computer operation in 2005.

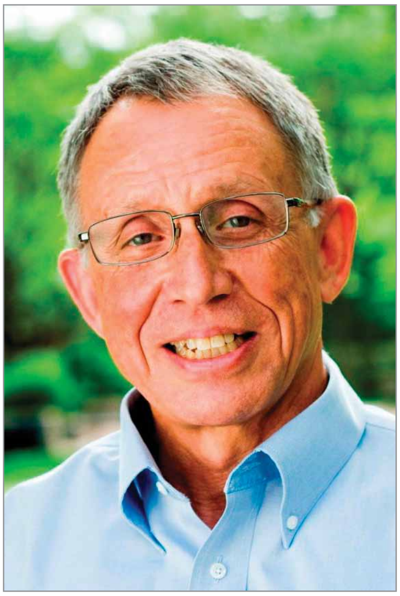
Founded in 1984, Lenovo had emerged two decades later as China's largest computer maker. It had captured 27 percent of China's rapidly expanding computer market, with annual revenue exceeding $3 billion. The company concluded, however, that its long-term growth depended on its becoming an international player, just as many American and European companies had concluded in years past. "In our world," explained executive chairman Yang Yuanqing, "a high growth rate is hard to sustain if you only try to maintain your position in the China market."

After thirteen months of negotiations, Lenovo and IBM announced that Lenovo would acquire IBM's Personal Computing Division for $1.75 billion. Founder Liu Chuanzhi declared that globalization had become a necessity, the company's only option for growth and survival. In the months that followed, Lenovo restructured its governing board as well, and we focus here on that change.

Two Conceptions of Corporate Governance

Before we enter the boardroom, it is useful to identify the major potential areas in which directors may make decisions. We are primarily concerned with directors' explicit involvement in company decisions and the criteria that they apply in reaching those decisions under varying market conditions. From prior research, theory, and experience we anticipate that directors engage in two areas of decision making, each with its own set of distinct criteria.

Monitoring Management: One well-established conception of the firm views directors as largely serving as the eyes and ears of the shareholders, ensuring that company executives conduct themselves properly on behalf of the owners. The decisions that directors take are therefore inferred or prescribed to be directed at monitoring the decisions that executives make. This is the formal view that big business sometimes even takes of its own boardrooms. "The board of directors has the important role of overseeing management performance on behalf of shareholders," declared the U.S. Business Roundtable, and "directors are diligent monitors, but not managers, of business operations." By way of illustration, directors often take decisions to ensure that their executives do not enrich themselves at the expenses of shareholders, nor that they enter into sweetheart deals with other companies controlled by the executives' families.



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Partnering with Management: A long-standing additional conception of corporate governance suggests that directors are decision partners with the top executives, joining with them in making the company's most important choices. Directors are seen as co-producers of the firm's strategic decisions. This is the informal view that business executives often take of themselves. The chief executive of a large financial-services firm, for instance, spoke for many in describing the decisions that directors reach in his boardroom. They are, he said, those that are "strategically impactful" and those that will "change the future." If a company's executives are seeking to integrate newly acquired international operations, for example, directors may collaborate with the executives in reaching key decisions on how to optimize the process.

Lenovo Goes Global

During the late 1990s and early 2000s, Lenovo had attempted to diversify beyond its manufacturing and sale of personal computers in China, but that effort largely failed. In the meantime, its PC dominance within the Chinese market was coming under increasingly successful attack by Hewlett-Packard, Dell, and other foreign and domestic makers. In 1994, Lenovo held 4 percent of the Chinese PC market, and by 2000 its fraction had risen to 29 percent, but its market share then dropped back to 27 percent in 2003 and 26 percent in 2004. Top management concluded that for continued growth, international expansion had become essential. It also concluded that it would have to change its original name—Legend—to Lenovo, because the name of Legend was already used by other companies in other countries.

At the time, however, Lenovo had no foothold outside greater China. By coincidence, IBM approached Lenovo on the possibility of the Chinese company acquiring IBM's personal-computer division, and Lenovo's management swiftly embraced the offer, even though IBM's operation drew four times the revenue of Lenovo. But IBM was losing money on its personal-computer sales, and Lenovo's due diligence convinced management that it could turn the much larger IBM operation around. "We finally came to believe that in IBM's hands the PC division would continue to suffer annual losses," reported Liu Chuanzhi, then executive chairman of Lenovo, but he felt that in his own hands the IBM operation "could be profitable." That conclusion was partly based on analysis of overhead that the IBM parent allocated to its PC division. The division would have been profitable were it not for the high headquarters overhead imposed on it. And it could have been even more profitable had it adopted Lenovo's lean manufacturing methods. Assembling a PC in the United States at the time cost $24, compared with $4 in China.

Lenovo announced the IBM acquisition on December 7, 2004 at a Beijing news conference attended by some five hundred Chinese and Western journalists, and it completed the acquisition in April 2005. From a dominant but faltering place in the Chinese computer market, Lenovo became a substantial and rising force in the global computer market. The IBM acquisition moved Lenovo from the eighth to third largest computer maker worldwide after Dell and Hewlett-Packard. In the year after the acquisition, Lenovo doubled its workforce to twenty thousand and quadrupled its revenue to $12 billion.

To appreciate the governance impact of this transformation of a largely domestic Chinese manufacturer into a significant international maker, we interviewed the key decision makers in 2007–2008. They included Liu Chuanzhi, Lenovo's founder and executive chairman just prior to the IBM acquisition; Yang Yuanqing, Lenovo's chief executive before the acquisition and executive chairman afterward; William Amelio, Lenovo's second chief executive officer; Shan Weijian, a non-executive director of Lenovo representing one of its major private investors; and two other top executives at Lenovo.

Monitoring of Management

Lenovo's market and organizational remake brought a substantial remake of the governing board. In 2003, non-independent directors outnumbered the independent directors four to three. The post-acquisition board, by contrast, was divided between five executive and non-independent directors, three private-equity directors, and three independent directors. Prior to the acquisition, all seven of the directors were Chinese or of greater China origin. After the acquisition, four of the eleven directors were Americans. Before the acquisition, board meetings had always been conducted in Chinese; after the acquisition, because all but one director spoke English and several spoke no Chinese, English became the medium of expression. Going into the acquisition, the executive chairman and chief executive were both Chinese; coming out of the acquisition, the executive chairman was Chinese and the CEO American. Of the top management team in 2004, all were Chinese; of the eighteen members of the top management team in 2007, six were from greater China, one from Europe, and eleven from the United States. Ma Xuezheng, the company's CFO at the acquisition moment, declared at the time, "This is going to be very much an international company operated in an international fashion."

"All of this work requires an unprecedented degree of professionalism, dedication, and fine-grained knowledge on the part of today's board member"

Compared with publicly traded companies worldwide, Lenovo's post-acquisition governance reached international norms for director monitoring of management. To see this, we turn to Institutional Shareholder Services (ISS), which furnishes institutional investors with independent appraisals of company governance, drawing upon publicly available data sources. ISS gathered data on 236 governance features, ranging from board composition and executive compensation to takeover defenses and stock-option expensing. ISS provided an overall measure of a company's governance with its Corporate Governance Quotient (CGQ). The CGQ compares Lenovo's governance with that of publicly traded non-U.S. companies (those included in Morgan Stanley Capital International's EAFE index and the Financial Times' All Shares and World Developed indices). ISS also compared Lenovo with a subset of technology and hardware equipment makers outside the United States. ISS termed the first comparison a company's Index CGQ, and the second a company's Industry CGQ. The CGQ scores represent a company's percentile ranking, with a score of 50 implying that the company's governance ranks better than half the comparison firms and worse than half.

Lenovo's governance ranked at about the 25th percentile on both measures during the year of the acquisition (the first year ISS appraised Lenovo's governance). During the two years that followed, however, Lenovo had elevated its governance ranking above the 40th percentile compared with all companies, and above the 50th percentile compared with other firms in the technology hardware and equipment industry. By these measures, Lenovo had moved its outward features of governance for monitoring management into the middle ranking of company governance worldwide.

Partnering with Management

Our interview evidence also points toward a transformation of the Lenovo board to include a partnership with management. Company executives instigated the change in the immediate wake of the decision to expand rapidly outside of China through the acquisition of the personal computer division of IBM.

"The IBM PC acquisition is a watershed," observed Liu Chuanzhi. "Before that point," he said, "the board of directors did not play much role." The board had mainly been concerned with company audit and executive pay. The board played a modest monitoring function on behalf of non-state investors, but was otherwise little involved in the firm's strategic decisions. Lenovo has been listed on the Hong Kong stock exchange (and through an American Depository Receipt on the New York Stock Exchange), and in keeping with Hong Kong tradition, independent non-executive directors prior to the IBM acquisition were viewed by the company as largely present to protect minority stockholders—in this case, investors other than the Chinese Academy of Sciences. Liu and Yang reconstituted the board to go well beyond that focus, adding the international directors, improving board capacity to render guidance to the executive team, and, more generally, creating a governing body that is more globally informed and independent, important prerequisites for partnering with management rather just monitoring to management.

The decision to add international directors, for instance, was largely driven by the reported need for the board to bring global "vision" into the boardroom. "Now," said Yang, "internationalization is our key consideration as we are taking on international business." This in his view required directors who would bring fresh insight into how Lenovo could make inroads into the worldwide market share of its larger rivals—Dell Computer at 18 percent and Hewlett-Packard at 16 percent in 2005—and at the same time hold onto its market share against its smaller rivals, including Acer at 5 percent and Fujitsu at 4 percent in 2005.

Although Lenovo was still the biggest player in the Chinese market—the nearest rival, Founder Technology Group, held less than half its market share—domestic dominance provided no assurance of growth abroad. "If you have a highly successful business in one country," warned Amelio, "it does not mean that you will have a highly successful business in a global operation," and that is where the counsel of the non-executive directors would prove particularly valuable. And their counsel pointed toward equal footing for the Chinese and American operations. Non-executive director Shan Weijian explained, "We don't want people to have a feeling of takeover [by a] Chinese company of the American company. We want an integration process which doesn't involve which part takes which part. What we want is [to be] integrated into [a single] global operation."

The restructuring of the Lenovo board following the IBM purchase also brought the directors into direct guidance of the integration of Lenovo's and IBM's distinct operating styles. IBM had built up strong, enduring relations with its select corporate customers; Lenovo had by contrast created a largely "transactional" exchange with its many retail customers. Although large enterprise relations had been the staple of IBM's PC sales, management anticipated greater growth among small consumers. But identifying the optimal areas for growth outside of China and identifying effective ways of reaching them were uncertain and risky judgment calls, and in making them management sought director guidance.

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Facing many decisions of this kind in the wake of the acquisition, the company formed a strategy committee, charged with vetting the company's mid- and long-term decisions on behalf of the board. As a step toward internationalization, the company placed two Chinese directors—Yang Yuanqing and Liu Chuanzhi—on the strategy committee along with two Americans—James Coulter and William Grabe. The board met quarterly, but the strategy committee met monthly to focus on issues ranging from competitive strategy to cultural integration. Regarding the latter, for example, Yang viewed the non-executive directors as an "impartial third party" that would help prevent a "confrontation of two teams, two cultures, and two mentalities." With their own money invested in the company, the "third party" private-equity representatives would not be reluctant to resolve the differences, or for that matter to delve into other significant issues. "In order to build a world-class organization," said private-equity director representative Shan Weijian, "you really have to have world-class challenge." The directors were ready to provide it, and company executives sought it. In CEO William Amelio's words, the role of the directors on the strategy committee was to pick from an array of choices "the right idea that is going to maximize the core competence of the company."

Lenovo's board also became directly engaged in decisions on executive succession, an arena that had also not previously been its prerogative. Two non-executive directors from the private-equity groups in 2005, for instance, played a pivotal role in replacing the first CEO after the acquisition. At the time of the purchase, the IBM executive responsible for the PC division, Stephen Ward, had been the logical candidate for the role of chief executive, with Yang to serve as executive chairman. Their dual appointment was largely an executive decision, but within months it became evident to the board's strategy committee that the former IBM executive was not the right person to lead the combined enterprise given the specific challenges it faced, topped by the need for greater supply-chain efficiencies. Yang and Liu worried, however, that an unexpected exit of the top American executive so soon after the acquisition would cast a shadow over their effort to internationalize the firm. Neither knew the international computer industry well enough to identify a strong replacement, and it was American non-executive directors James Coulter and William Grabe who identified several candidates for succession, including William Amelio, then head of Dell Computer's Asian operations, who eventually became the successor. Nor were Yang and Liu familiar with the process of replacing an American chief executive, but the private-equity directors on the Lenovo board represented firms that had often done so. Said one of the private-equity directors, "we have done this repeatedly, and we are familiar with the U.S. market and the practice over there, the environment, and how to do it."

Private-equity firms generally seek direct engagement in company decision making through service on the governing board. Texas Pacific Group and General Atlantic were no exception, and both were already well familiar with the IBM operation. TPG had hoped itself to buy out the IBM PC division, and had conducted its own due diligence. GA had been asked by Liu Chuanzhi to advise him on whether to buy the IBM division, and it too had gathered detailed data on the IBM operation. Though other bidders emerged, Lenovo and TPG became the two finalists, and IBM notified Lenovo that it had won and TPG that it had lost just thirty minutes apart. Consequently, James Coulter of TPG and William Grabe of GA were already well versed in the personal computer business when they joined the Lenovo board and its strategy committee. Executives as a result treated them like partners rather than minority investors, reported Coulter. Vince Feng, a GA partner who managed its investments in China and East Asia, affirmed the same, reporting that "our influence comes less from ownership than having been trusted advisors for Lenovo's key decision makers for a long time."

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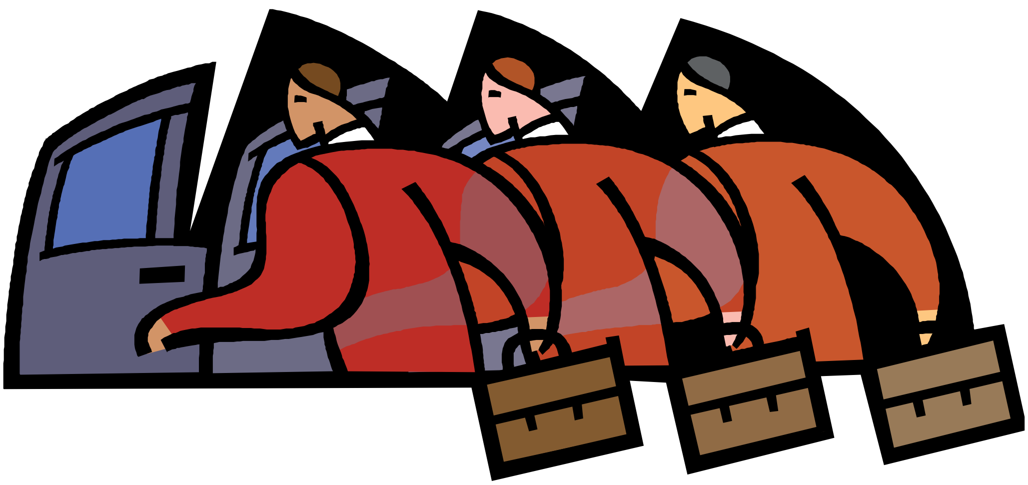

Similarly, the criteria for bringing specific non-executive directors onto the board after the IBM acquisition reflected a preference for directors who would partner with management more than monitor or defer to management. The selection standards for the new board members, reported Yang, included their industry experience, "strategic vision," personal reputation, and functional expertise in such areas as finance, strategy, and marketing. For example, in the case of the appointment of John Barter, who had served as Allied Signal's chief financial officer and president of its thirty-five-thousand-employee automotive division, Yang and his colleagues had identified more than twenty candidates, narrowed the list to four finalists, and then selected Barter because of his "very solid background" in finance and management with publicly traded American companies. Equally important was his extensive experience on the boards of American companies—including NYSE-listed BMC Software—because he would bring an understanding of best practices in American corporate governance to the Lenovo board. "As we are going international," said Yang, "we'd like to learn from American companies. That's why we invited people like John Barter to join us."

Our interviews revealed that a host of other major issues—how long to retain the IBM logo, what acquisitions to make, which "adjacencies" such as servers to consider, and whether to build devices that bridge laptops and telephones—now came to the directors for vetting and decision making. Before the acquisition, the board's decision domain had been largely limited to audit and reporting issues. "The board of directors during that period," said Liu, was "mainly to ensure transparency" and played little "role in business or strategy decisions." But after the acquisition, the board frequently engaged in both business and strategy decisions. Lenovo subsequently considered acquiring personal-computer makers Packard

Bell, for instance, and the directors took an active role in deciding on whether to proceed and what to pay. "Everybody was involved," reported non-executive director Shan Weijian, "because this is a large issue for the entire company." Lenovo decided to back off—another PC maker, Gateway, was later acquired by Taiwan PC maker Acer—and the board's deliberations proved critical in reaching that decision.

By way of illustration of the value of independent director "opinions on strategy," consider Lenovo's focus on operational efficiency in the wake of the IBM purchase. Lenovo found that certain points in the chain inherited from IBM enhanced value while others reduced value, and Lenovo believed that the key to turning the IBM operations from money-losing to moneymaking was the effective "worldsourcing" of its supply chain. "We have been relentless in trying to squeeze every penny out of this process," observed non-executive director Shan Weijian, for "making sure the process is as efficient as possible."

Although the American Business Roundtable had warned that directors should be "monitors, not managers," Lenovo drew its directors directly into decisions on worldwide sourcing. "We need thinkers that are on the board that can help us make sure that we are in the process of maximizing this concept of Worldsourcing," affirmed Amelio. Whatever the optimal way to produce computers, you have to "gravitate to it rapidly in order for you to have the most competitive offerings for your customers," he added, and that pointed to engaging directors directly in decisions on manufacturing operations. When Lenovo looked at the recruitment of new directors, pragmatic operational experience proved an important criterion. The preferred expertise could range from knowing the pitfalls of SAP software implementation to identifying the best foreign suppliers of computer components and best foreign sources of computer engineers.

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Conclusion

We have seen a sharp divide in Lenovo's boardroom between the company's governance before and after its decision to build out globally through the IBM purchase. Prior to the acquisition, the board had operated without a strategy committee or performance review. Now it had both. Director decisions had been largely limited to proper audit for protecting small shareholders. Now their decisions ranged from branding to sourcing. Executive succession and director selection had been the prerogatives of management. Now they were shared decisions with directors. The boardroom norms had been high in formality and low in content. Now they were the opposite. A limited form of director monitoring and management control had been superseded by director partnering in reaching the company's major decisions.

If the board is to serve as a strategic partner, it requires an investment of time well beyond that necessitated by a legitimating board or a board controlled by management. Informed directors who trust one another and have faith in their executives constitute an essential platform, and Lenovo management worked to build it. The company adopted a rule, for instance, that all directors must attend all board meetings, which are rotated around the world, or send a pre-designated alternate. Liu Chuanzhi frequently flew to the U.S. to meet with the American directors, especially when the board faced contentious issues.

ßCompany leadership and governance have long been conceived as distinct domains. With the exception of the chief executive, executives and directors have often been seen as constituting different sets of people with distinct imperatives. Executives led. Directors monitored—or sometimes not even that. We have found at Lenovo, however, that its directors came to play more of a leadership role in the wake of the international acquisition, advising and guiding executives in major company decisions and representing the company to major owners. They also played a leadership role in facilitating cross-cultural integration after the acquisition.

If Lenovo's experience is symptomatic of what other Asian companies are likely to face as they globalize their operations and ownership, and we believe that it is, we can anticipate that company governance at other firms will also move toward greater engagement of directors in collaborative decision making with management. Executives and directors will ask, as one academic observer of Chinese enterprise has recently suggested, whether they "have a plan for corporate governance that will focus the firm on national competitive advantage and ultimately global advantage rather than short-term profitability in local markets." As they consider or adopt such a plan, that in turn will point toward an evolving skill set for directors, with greater emphasis on director capacity to work with executives at critical choice points. It will also point toward a changing skill set for executives, with a stronger ability to work with directors expected at major decision moments and less inclination to hold directors at arm's length. Institutional investors and other major holders will be more likely as well to look for directors and executives who can collaboratively engage in the firm's most important decisions. ■