

Why good companies go bad

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Management gurus exhort companies to go from good to great. Regrettably most move in the opposite direction. Recent examples of companies that have gone from good to bad include Sainsbury's, Parmalat, and Lego to name just a few prominent examples. Microsoft, for years the gold standard of corporate excellence, stands accused of slipping into mediocrity. A few of these fallen stars—IBM or Ericsson—regain their stride, but most—such as Xerox, KMart or Laura Ashley—hobble on as pale shadows of their former glory, or like NatWest and Andersen—disappear altogether.

Why do good companies go bad? Managers usually draw the blame. Common explanations include executives who are too thick to notice big changes in their market, freeze like deer in the headlights of an oncoming car when the market shifts, or simply plunder the corporate coffers. All plausible explanations. Unfortunately none fit the facts. Over the past decade, I have studied dozens of successful companies that have gone bad (as well as comparable firms that responded effectively to the vicissitudes of the market). In the majority of failures, senior executives saw market changes coming and responded aggressively. They were capable managers—indeed many led the companies to the top—trying to do the right thing.

If these familiar explanations don't account for corporate failure, what does? My research suggests that companies fall prey to *active inertia*—responding to even the most disruptive market shifts by accelerating activities that succeeded in the past. When the world changes, organizations trapped in active inertia do more of the same. A little faster perhaps or tweaked at the margin, but basically the same old same old. Managers often equate inertia with inaction, like the tendency of a billiard ball at rest to remain immobile. But executives in failing companies unleash a flurry of initiatives—indeed they typically work more frenetically than their counterparts at competitors which adapt more effectively. Organizations trapped in active inertia resemble a car with its back wheels stuck in a rut. Managers step on the gas. Rather than escape the rut, they only dig themselves in deeper.

The failure of success

What locks firms in a rut? The surprising answer is the very commitments that enabled a firm's initial success. Everyone knows that success breeds complacency and arrogance. But a more fundamental dynamic links early success to subsequent failure. Clear commitments are required for initial success, but these commitments

harden with time and ultimately constrain a firm's ability to adapt when its competitive environment shifts. This dynamic can lead good firms to go bad, even when executives avoid arrogance and complacency.

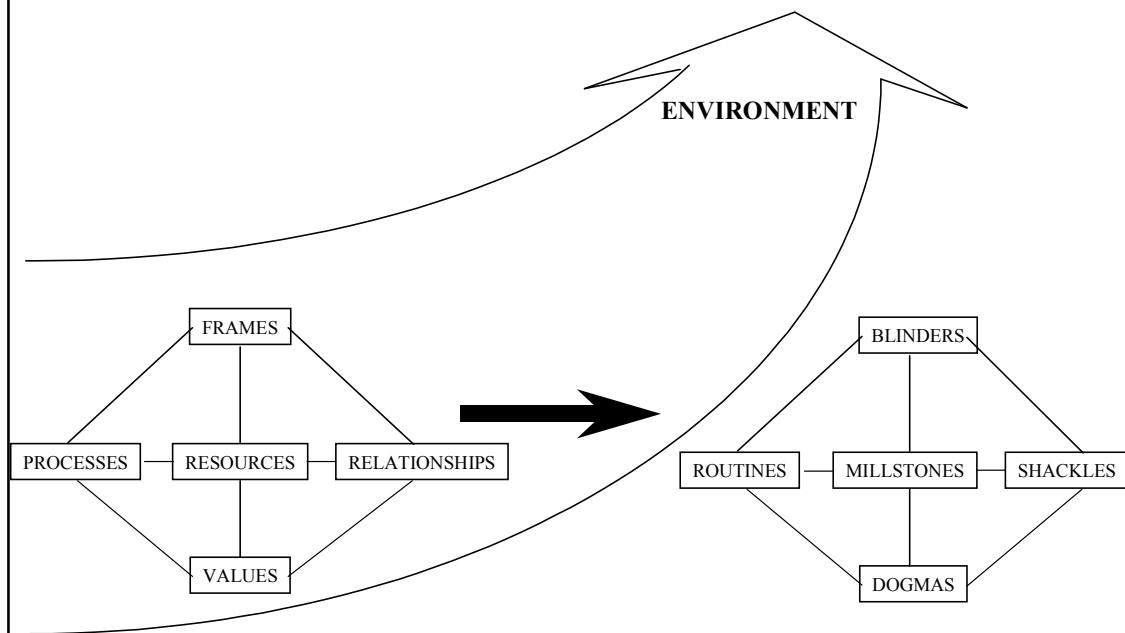
To win in the market, executives must make a set of commitments that together constitute the organization's success formula. A distinctive success formula focuses employees, confers efficiency, attracts resources, and differentiates the company from rivals. Five categories of commitments comprise the success formula:

- *Strategic frames*: What we see when we look at the world, including definition of industry, relevant competitors and how to create value.
- *Processes*: How we do things around here entailing both informal and formal routines.
- *Resources*: Tangible and intangible assets that we control which help us compete, such as brand, technology, real estate, expertise, etc.
- *Relationships*: Established links with external stakeholders including investors, technology partners or distributors
- *Values*: Beliefs that inspire, unify and identify us.

Although commitments are essential for initial success, they tend to harden over time. Initial success reinforces management's belief that they should fortify their success formula. With time and repetition, people stop considering alternatives to their commitments, and take them for granted. The individual components of the success formula grow less flexible: Strategic frames become blinders, resources harden into millstones hanging around a company's neck, processes settle into routines, relationships become shackles, and values ossify into dogmas.

An ossified success formula is just fine, as long as the context remains stable. When the environment shifts, however, a gap can grow between what the market demands and what the firm does. Managers see the gap, often at an early stage, and respond aggressively to close it. But their hardened commitments channel their responses into well-worn ruts. The harder they work, the wider the gap becomes. The result is active inertia (see figure "active inertia").

Figure 2:2
The Dynamics of Standing Still



Frames Become Blinders

Strategic frames provide focus and fit new information into a broader pattern. By continually focusing on the same aspects, frames can constrict managers' peripheral vision, blinding them to novel opportunities and threats. As their strategic frames grow more rigid, managers often shoe-horn surprising information into existing frames or ignore it altogether.

Consider NatWest Bank (National Westminster until 1995). At its foundation, National Westminster's executives committed to a clear set of strategic frames--retail banking is stagnant and UK suffering irreversible decline. The bank diversified into the US, Europe, Far East and Soviet Union and expanded into new financial services. When the Big Bang deregulation heightened competition, rivals such as Lloyds TSB refocused on their domestic retail business. NatWest, in contrast, responded by accelerating geographic and product diversification. Critics blasted NatWest throughout the 1990s for waiting too long to divest money-losing distractions until RBS acquired NatWest in 2000.

Processes Lapse into Routines

Established processes confer efficiency and facilitate coordination across functional and geographic units. Over time, these routines resist change. With repetition, processes become second nature; people stop thinking of them as a means to an end, if they think of them at all. When the environment shifts, managers' commitments to existing processes trigger an actively inert response.

Consider Compaq, which grew to sales of \$3.6 billion in its first eight years based on processes that consistently produced high quality products. Manufacturing routines made quality the first priority (and cost a distant fifth) while the product development process sacrificed speed and thrift to get the product specs 100% right every time. Compaq's quality-at-any-price processes served the company well in the early days of the PC industry when customers worried about the product's usability and low-cost alternatives were rare. As PCs became commodities and nimble rivals like Dell rose to the fore, competition shifted to value for money. Compaq relied on its well-honed processes to churn out gold-plated products priced to gather dust on dealers' shelves.

Resources Harden into Millstones

Specialized resources build competitive advantage that rivals cannot easily replicate. Shifts in the competitive environment, however, can devalue established resources. Major airlines historically competed on the strength of their hub-and-spoke systems in which the carriers controlled valuable real estate at hub airports and a fleet optimized for this business model. The rise of low-cost upstarts such as Southwest and Ryan Air depressed industry pricing and poached customers. Traditional carriers could not easily redeploy their hubs and planes to compete cost-effectively against new entrants.

Relationships Become Shackles

Managers commit to external relationships by investing in specialized facilities to serve a key customer, for example, or writing long-term service contracts. These relationships can make or break a company—think of Microsoft and Intel or Wal-Mart and Procter & Gamble. Over time, however, established relationships can turn into shackles that limit flexibility.

Recall the Daewoo Group, which at its peak approached \$20 billion in revenues and employed two hundred thousand worldwide before falling into bankruptcy. Daewoo owed much of its growth to cosy relationships with South Korea's General Park, who ruled the country with an iron fist for nearly two decades. Park supported Daewoo and other favored conglomerates with financing and tariffs. In exchange, Daewoo invested in industries targeted for expansion. When subsequent governments ended policies that favored the conglomerates, Daewoo's Chairman Kim tightened links with remaining friendly Korean politicians, and forged bonds with politicians in emerging markets such as Vietnam, the Sudan and Uzbekistan to replicate cosy relationships at home.

Values Ossify into Dogmas

Strong values can elicit fierce loyalty from employees, strengthen the bonds between a company and its customers, attract like-minded partners, and hold together a company's far-flung operations. As companies mature, however, their values often harden into outdated dogmas, that oppress rather than inspire.

Consider Laura Ashley who founded her company to defend traditional values under siege from miniskirts. Frilly frocks embodying Laura Ashley's commitment to traditional values of modesty initially appealed to many women but lost their attraction as more women entered the workforce. The company, however, continued to pursue the outdated designs that embodied an ossified view of its core values.

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Managers who understand why good companies go bad are better equipped to monitor existing commitments and keep them supple as markets shift.

Box: Warning signals of active inertia

Add one point for each risk factor that applies to your company. One is fine, two or three get nervous, three or more and your firm is at risk for active inertia.

Your CEO appears on the cover of a major business magazine. Praise from the business press reinforces attachment to the success formula. By the time a firm has attracted critical acclaim, managers should be rethinking their success formula.

Management gurus praise your company. Few companies survive guru praise for long. Consider the fall of most *In Search of Excellence* firms. The problem is not sloppy research. Rather guru praise reinforces confidence in the success formula.

Your CEO writes a book on the secret of your firm's success. A book publicly links a CEO to a success formula's, making it harder for him to later change those commitments.

You build a grand new headquarters. Managers often build grand monuments to commemorate their triumph. They are rarely in the state of mind to question the commitments that led to victory. (Bonus point for indoor waterfalls, heliports or architectural awards).

You name a stadium. CEOs sometimes name rather than build monuments, as did Enron, United, cmgi, American Airlines, PSINet, Compaq and Conseco did. Not every company falls prey—consider Pepsi or Staples—but it is another red flag.

Your competitors share your postal code. Detroit's automakers, Sheffield's steelmakers and Route 128 microcomputer firms all went bad. Clustered firms often make similar commitments and reinforce one another's success formula.

Your top executives are clones. Homogenous top executives generally rose through the ranks by reinforcing a success formula and know little else.

4. Why? Often assumed that problem is paralysis but.. fact differs as, Studies: little evidence of paralysis Contrary: Companies do recognize the threat early and respond. 5. Problem? Not the inability to take action but an inability to take APPROPRIATE action. You just clipped your first slide! Clipping is a handy way to collect important slides you want to go back to later. Now customize the name of a clipboard to store your clips. Name*. So why should non-founding employees of startups care? You still own your stock, and you can leave and join another startup. Small cap companies have never been worse investments. Any company worth its salt doesn't go public until it's a midcap these days. Savvy investors should look overseas for worthwhile investments because a unicorn is just a geriatric horse with a spike on its forehead. LikeLike. Why do good companies go bad? It's often assumed that the problem is paralysis. Confronted with a disruption in business conditions, companies freeze; they're caught like the proverbial deer in the headlights. Donald N. Sull is an assistant professor of strategic and international management at London Business School. ...Article Outline " Why Bad Multiples Happen to Good Companies The article suggests that rather than focusing too much on having the highest multiples with regards to the companies' performance, managers and executives will be better off focusing on the amount of value they create with regards to growth margins and capital productivity.