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WHY GOOD COMPANIES FAIL

It's not just weak organisations that spiral into decline and fail. Managerial arrogance and inflexibility can bring even great companies to their knees.

Back in 1991, the newly appointed CEO of a large multi-division company asked one of us the question that led to this research. The CEO had read Peters and Waterman's *In Search of Excellence* some years earlier, and believed strongly in its precepts. However, he found that many of the organisations held up by Peters and Waterman as exemplars (such as Xerox, IBM, Sears and Kodak) were struggling. Why were such iconic companies, which had long stood for the very best in US management, in such difficulties? Why, he asked, do good companies fail?

This heartfelt and insightful question launched us on a journey of discovery. We started by conducting archival research on companies that had failed during the past several decades, interviewed people from some of the failed companies directly, and eventually came to the conclusions presented here.

While it is commonly believed that institutions are (at least potentially) immortal while humans are mortal, we found that the average lifespan of corporations is declining, even as that of humans is rising. Others have come to similar conclusions.

The best-known work in this area is by Arie de Geus, who found that one-third of the companies listed in the 1970 *Fortune 500* had vanished by 1983, either acquired, merged or broken up (de Geus 1997). De Geus quoted a Dutch survey showing the average corporate life expectancy in Japan and Europe was 12.5 years. Another study found declining corporate life expectancy across the major European economies: from 45 to 18 years in Germany; from 13 to nine years in France; and from ten to four years in Great Britain (Seifert 2002).

Much of the decline in corporate life expectancy is a result of a heightened level of merger and acquisition activity in recent decades. However, most of this is due to distress selling rather than strategic buying, because so many companies are in trouble.

Succeeding by being there

Before delving into the question of what causes successful companies to fail, we wanted to understand what leads to success in the first place. What we discovered was that most successful companies became successful almost by accident. We call this the "Chauncy the Gardener" phenomenon, or

“success by being there”. Recall the 1979 Peter Sellers movie *Being There*, in which Chauncy, a simple, childlike gardener, is elevated to a position of power and wealth through a series of coincidences and misunderstandings. Chauncy’s simple statements about gardening are interpreted by listeners as profound political advice or economic predictions.

Likewise, most companies succeed by accident, rather than through careful or thorough planning. We found that most companies come into existence by being opportunistic. Quite simply, they succeed by being in the right market at an opportune time with the right offering. Corporate success is similar to human behaviour, a result of nature and nurture. But managers refuse to acknowledge that they were blessed from above, and tend to take all the credit for themselves. They continue to be successful as long as the environment does not change.

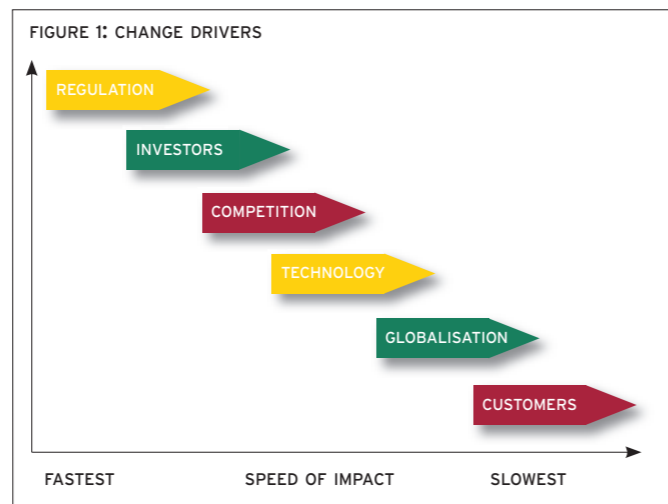
But success achieved in this manner comes with a built-in catch. Since the companies succeeded because of a combination of circumstances, they are likely to fail when the environment changes, especially if they are unable or unwilling to change their culture, processes, systems and structure. On the other hand, if they are able to transform themselves to adjust to their new realities, they could prosper indefinitely.

Consider the amazing success of Microsoft, as pure an example of succeeding by “being there” as we can think of. To a large extent, Microsoft owes its very existence and subsequent enormous success to a series of decisions made by IBM (some of which, ironically, were responsible for IBM’s own steep decline in the nineties). In 1980, IBM was looking for an operating system for its planned personal computer. It entered into negotiations with a company called Digital Research, whose founder Gary Kildall had written a simple operating system called CP/M. When the companies could not agree on terms, IBM approached Microsoft – a tiny Seattle company – only because the chairman of IBM and Bill Gates’ mother both served on the national board of the charity United Way. Microsoft had no operating system to offer IBM, but co-founder Paul Allen found a small company called Seattle Computer, which sold what it called QDOS, for Quick and Dirty Operating System. QDOS was virtually a clone of CP/M, and Microsoft acquired the rights to distribute it to an unlimited number of users – for the grand sum of \$25,000. Microsoft later paid an additional \$50,000 for all rights to the product, dropped the “Q” and proceeded to make billions by licensing DOS to not just IBM, but all PC makers, for \$40 a machine (Rivlin 1999). Microsoft’s astonishing success with DOS became the foundation on which the company’s subsequent successes were built.

Internal causes of failure

Before examining the changes in the external environment that can cause companies to fail, let us look at some internal factors that can lead to failure. For many companies, success breeds failure; they enjoy such enormous success in their early years that they become complacent and even arrogant. For example, General Motors and AT&T both enjoyed such huge dominance in their industries (GM held over 60 per cent of the US automobile market, and AT&T controlled over 90 per cent of the long-distance telephony market) that they failed to recognise their own vulnerabilities. Many companies practice “status quo” management, and become highly bureaucratized: their existing policies, procedures and culture create inertia for change. They accumulate costs during their growth phase that they are unable to reduce in tough times. They are often rife with internal conflicts: infighting among functional departments and business units creates a negative impact on customers and employees.

Another important cause of decline is the lack of a stakeholder orientation. Some companies fail because they become too focused on the interests of one or two stakeholders at the expense of the others. If a company becomes a unilateralist, focusing primarily on a single stakeholder, it inevitably begins to decline. The role of management is to ensure that a firm continues to satisfy the functional, as well as psychological, needs of all its primary (customers, employees, investors) and secondary (community, suppliers, business partners) stakeholders over time. One signal that a company is heading towards decline is the recognition that it has lost an emotional



Sheth and Sisodia identify six ways in which the external environment of a company can change. Some have a rapid impact; others manifest themselves more slowly.

connection with its stakeholders; it is no longer emotionally bonded with them. Stakeholders may continue doing business with the company, but they do it without heart – a sure indicator that the relationship is heading for trouble.

In our forthcoming book, *Firms of Endearment*, we show how companies that satisfy both the functional and emotional needs of all their stakeholders perform extremely well financially over the long run (Sheth et al 2006). They build a sustainable value creation engine that does not force them to squeeze certain stakeholders for the benefit of others. They can provide excellent pay and benefits to employees, excellent value to customers, treat their suppliers fairly and are a positive force in the community.

Changes in the environment

There are six ways in which the external environment of a company can change. When any of these external contexts changes radically and the company is either unable or unwilling to change, then failure is often the result.

As shown in Figure 1, some of these factors can have a very rapid impact on a company and its industry, while the effects of others manifest themselves more slowly. In our opinion, most people focus too much on technology and globalisation as the primary drivers of change. In fact, we have found that the fastest moving externalities are regulation, capital markets and competition, while the slowest moving ones are technology, globalisation and customers. Let’s examine these in the order of speed of change.

• **Regulation:** An industry can get restructured with the stroke of a pen, and many companies are simply unable to adapt. In the US telecommunications industry, AT&T’s decline can be traced to its inability to manage regulation at the state level against the “Baby Bells”, as well as the emergence of the non-regulated internet. In some industries, existing regulations present barriers to much-needed change. They may prevent the company from adapting rapidly enough to fast-changing environments. Companies in the telecommunications, defence and healthcare industries often face this issue. The deregulation of a regulated industry sometimes occurs too rapidly, leaving a company’s processes and people unprepared. For example, the “Big Bang” deregulation of the US airline industry overwhelmed the ability of many companies to adjust, leading to a rash of failures. Rapid economic liberalisation in countries such as India led to the collapse of many domestic companies, as they were unable to cope with foreign competitors.

Regulatory changes do not always mean deregulation; in many industries, the opposite may be the case. As a result

IN BRIEF

- The average business lifespan has become steadily shorter over the past few decades.
- It is not markets or customers that are responsible for this phenomenon; companies are sowing the seeds of their own downfall.
- Most companies succeed by accident, rather than through careful planning.
- Short-term success leads to myopic leadership.
- The long-term survivors are adaptable and can anticipate change.

of widespread abusive practices in the past, for example, the financial services industry in the US is going through a phase of significant re-regulation.

Since regulation is such a potent force, companies must learn how to anticipate, manage and respond to regulatory changes. Rather than viewing all regulation as inherently bad for business, they must work with their competitors to help craft forward-looking regulatory policies that help curb abuses within the industry, remove cross-subsidies and position the industry and its stakeholders for growth and prosperity.

• **Investors:** At certain times, some industries and companies fall out of favour with investors. Despite its high margins and huge cash flow, for example, Microsoft is currently being shunned by investors. That can be attributed to the rise of Google. Another company that is out of favour is Wal-Mart, whose stock-market decline (the stock has gone nowhere for six years) can partly be attributed to investor sentiment in favour of Target, and partly to its declining reputation as an employer and business partner. Wal-Mart is now targeting Target, by trying to move somewhat upscale itself – a strategy that is likely to fail and leave the company in a weaker position. When investor sentiment toward a company changes, it does not have access to the equity market, and cannot therefore leverage its debt-to-equity ratio. It just flounders and a sense of malaise creeps in. Companies must continually assess their attractiveness to the investor community, treating investors as customers. They should determine what these customers are looking for in an investment and make changes accordingly.

• **Competition:** The key issue here is not rising competitive intensity, which is an incremental change of the kind that companies can often adjust to, but the entry of “non-traditional” competitors into the fray. Competition from non-traditional competitors has the potential to rapidly alter the rules of the game. For example, national cellular telephony companies in the US started treating all phone calls, local or long-distance,

as equivalent. This had a devastating impact on traditional land-based long-distance companies. The advent of telephony based on the internet protocol has the potential to upend the local telephony business.

The outsourcing of many business processes and back-office functions in recent years to locations such as India has brought a new type of competition into those industries. In the photography business, traditional film companies such as Kodak and Fuji face a rash of new competitors from the computing and consumer electronics industries. In software, Microsoft's near monopoly in many of its businesses is now being seriously challenged by the rise of Linux and other open source co-operative programming movements.

Non-traditional competitors often offer radically different (and usually superior) value propositions to customers. To continue to prosper in the face of such competition, companies have to be willing to make themselves obsolete. As the saying goes, "Your lunch is always on the table. It is better that you eat your own lunch, rather than let someone else come and eat it".

• **Technology:** Every industry is experiencing advances in technology. New technologies with superior performance-cost ratios provide better customer value. As discussed above, non-traditional competitors often enter an industry with new technology, though some may use the same technology that is widespread within the industry. Likewise, a firm's "traditional" competitors may gain a significant first-mover advantage by moving rapidly to embrace new technology. In the telecommunications industry, Northern Telecom gained a significant foothold in the market by being the first to embrace digital technology for switching and transmission, moving much faster than industry leader Lucent (then known as AT&T Network Systems).

• **Globalisation:** Industries inevitably go through a shakeout when they become globalised. The process is a gradual one, and companies must develop effective offensive as well as defensive strategies to survive. When the car tyre industry started to globalise in the seventies, for example, France's Michelin made the first foray into the US. In response, Goodyear moved to shore up its domestic market position as well as enter the European market. The big story in globalisation today is the opening up of vast new markets in developing countries such as China and India, as well as the entry of companies from those countries into the global arena. Chinese companies, for example, are moving aggressively into the computer and home appliance industries by seeking to acquire major Western brands. Companies can become passive victims of the globalisation process, or they can position themselves to take advantage of the many new opportunities it opens up.

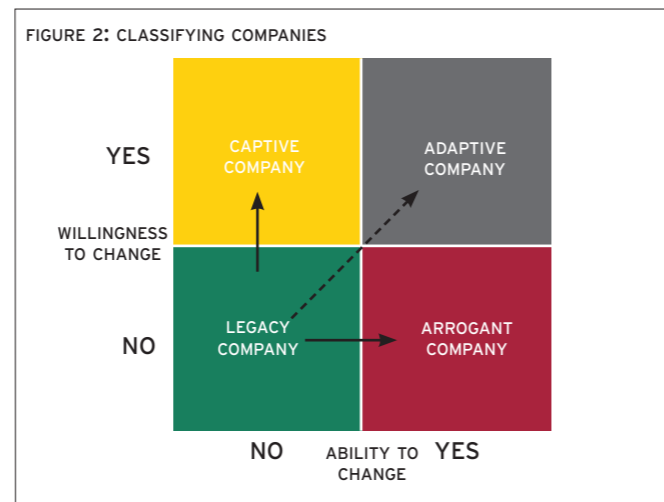
• **Customers:** Customers are constantly changing and evolving, albeit usually at a slow rate. Some shifts in customer tastes and preferences can be traced to demographic changes such as ageing, changing roles of women, greater polarisation of incomes and so on. Others are due to cultural changes that may, in turn, be triggered by technology. The explosion of the internet and wireless technologies, for instance, has impacted how many consumers, especially the younger ones, search for and purchase a multitude of products. Clearly, companies that fail to keep up with the changes their customers are going through will gradually lose them. Surprisingly, though, we have found that customers are often the last ones to abandon a company, much slower to do so than regulators or investors. Many companies have die-hard customers who remain loyal to the end.

Each of these change drivers represents a potential opportunity as well as a threat to companies. Companies that survive in the long run are those that are able to dynamically adapt to their changing circumstances.

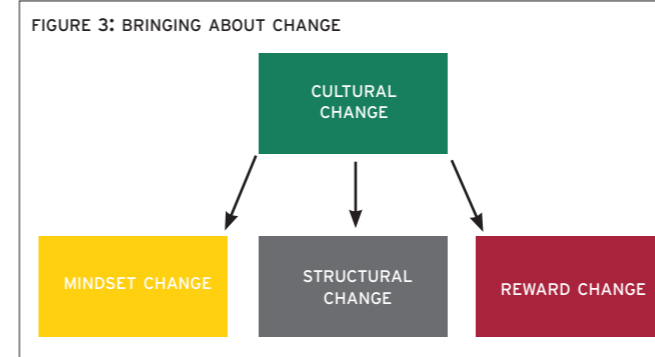
The ability to adapt

What happens when these changes occur? Companies clearly need to make changes of their own to adjust to the new realities. Why are company managers and executives not able to adapt? Unfortunately, we have found that most companies are either unwilling or unable to change.

The primary reason that many companies are unwilling to change in the face of new realities is that they become locked into certain orthodoxies and therefore do not take



The majority of companies are either unwilling or unable to change and are therefore doomed to failure. The long-term survivors are the adaptive companies, who take charge of their own destinies.



The authors liken change management to a three-legged stool but believe that most organisations focus on only one of the three elements.

charge of their own destinies fast enough (Tichy 1992). We have found that when people or organisations succeed by accident, they often become very rigid about their belief system, much more than before they became successful. In a way, they become superstitious. They end up believing what they do will succeed forever, and then they become resistant to change. They get locked into one paradigm or one way of thinking. Consider Digital Equipment Corporation, for example. The founder, Ken Olsen, created a world-class company that competed very successfully with IBM. The company's mini-computers were more versatile and offered better price performance than mainframe computers. However, when personal computers came along in the eighties, Olsen refused to acknowledge that they had many advantages of their own and might pose a threat to the continued success of mini-computers. He held on to that belief even when PCs became the standard, and destroyed the company in the process. Similarly, many airlines failed after rapid deregulation in the late seventies because they could not change fast enough to meet or resist competition. Examples include Pan Am, TWA and Eastern Airlines.

Companies must continually identify and battle their own orthodoxies, which are often disguised as strengths but are, in fact, vulnerabilities. Take Apple, for instance. Its primary orthodoxy over the years has been its tendency towards being highly proprietary in virtually everything it does. In the view of many observers, this has relegated Apple to a niche position in an industry that it could have dominated. Coke's orthodoxy appears to be its belief that its brand is so strong that it can overcome the emerging reality that carbonated beverages are a declining product category.

An organisation's unwillingness to change comes from the myopia of its leadership. An inability to change, on the other hand, comes from its processes. IBM, for example, recognised

that it had to change in the nineties, as it had lost its leadership in PCs and the mainframe business was in decline. However, the company's leaders simply could not get the huge, bureaucratic company to alter its ways. The larger the company and the longer its history, the more likely it is to exhibit this trait.

As Figure 2 shows, companies can be classified according to these two dimensions. Captive companies are those that are willing but not able to change. Arrogant companies have the ability to change, but are unwilling to do so. Legacy companies are neither willing nor able to change, and are therefore doomed to obsolescence. The companies that will survive and thrive in the long run are the adaptive companies, who are willing and able to change as needed.

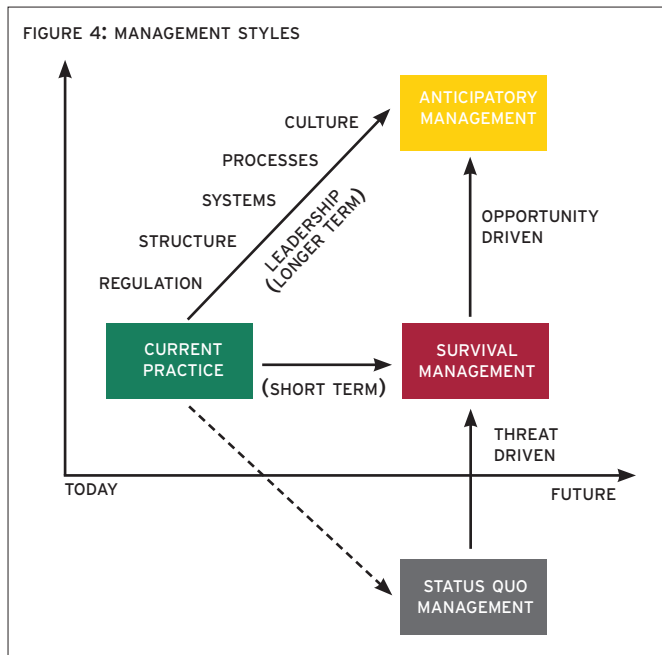
Bringing about change

As shown in Figure 3, change management is like a three-legged stool. The first dimension is mindset change. Companies usually try to accomplish this through training initiatives, such as the famous "workout" programme at General Electric. The second is some form of structural change. This includes eliminating or restructuring leadership's responsibilities and restructuring the organisation. In terms of reorganisation, the biggest change is in terms of where a company houses its profit centres. The most common forms of reorganisation are to go from a functional organisation to a product organisation, or from a geographic organisation to a customer organisation. Finally, the most critical change is the reward system. Most companies are reluctant to tamper with the reward system, yet this is the most effective change lever at their disposal. They should use both negative and positive incentives. Positive incentives induce behaviour in the direction the company wants to go, while negative incentives discourage behaviour that perpetuates the status quo.

Most companies only focus on one of the three elements of culture change, or go through these steps sequentially. Many believe that communication and education will be sufficient. Some attempt reorganisation as a starting place, hoping that new leadership will create culture change. Very few focus on the reward system, though this is generally the most effective in bringing about rapid culture change. However, for truly successful change management, companies must co-ordinate and execute all three dimensions of change in parallel.

The fastest way to bring change is to recruit an outsider as the CEO. Most companies in crisis do that. For example, it took Lou Gerstner, coming in from the outside, to get IBM to make the changes that were clearly needed. Of course, having an outsider is no guarantee of success. There are as many examples of failures by outside leaders as there are of successes.

Why good companies fail



Anticipatory management gives organisations a major competitive advantage over those that continue to practice the status quo.

Outsiders who come in as saviours or crusaders are rarely successful. So the key question is how change has to be brought about, not necessarily who is responsible for it. Here are some strategies that we have found work well:

1. Some companies try to identify a young executive who is a few levels below the CEO - a smart, fast-rising leader capable of making tough decisions who is then rapidly moved around within the company as preparation for assuming the top job. This is how Jack Welch was selected at General Electric and David Whitwam at Whirlpool Corporation.
2. Appoint as CEO an outside board member who is already a CEO at another company. This is what Boeing has done with W James McNerney Jr, who was the CEO of 3M, and what Eli Lilly did with Randall Tobias, who was vice-chairman of AT&T.
3. Take the company private via a leveraged buyout. The private equity firm appoints a team to fix the problem, after which the company is often taken public again.

Needed: anticipatory management

Consider the performance of General Electric under Jack Welch. When Welch became CEO in the early eighties, analysts regarded GE as a solid but staid performer, growing at the same rate as the gross national product. Welch disagreed, and soon threw GE into turmoil by declaring it had to radically transform itself. He launched a major effort to restructure GE

under a strategy called "No 1, No 2". The strategy called for GE to "fix, close or sell" every business that was not first or second in worldwide market share, and which did not offer major global growth opportunities. In implementing this strategy, GE eventually sold 400 businesses and product lines - including housewares and mining operations - worth \$15bn and acquired 600 others worth \$26bn. By 1988, GE was organised into 14 major high-tech or service businesses that Welch believed had tremendous global growth potential.

GE is a prime practitioner of anticipatory management, a proactive approach to controlling one's destiny in a changing market. Anticipatory management is most needed and works best when the external environment is undergoing rapid and discontinuous change. Anticipatory management gives organisations a major competitive advantage. Trends that are anticipated can be planned for, and competitive advantage accrues to firms that do so better and earlier than their competitors.

As shown in Figure 4, if the environment changes yet the company continues to practice "status quo" management, it goes on a slippery downward spiral. The company continues to look inside-out rather than outside-in. Such companies slowly die, similar to dying from a chronic disease.

If the company confronts a sudden threat, it goes into crisis management as a survival necessity. The sudden loss of important employees or customers, for example, may cause a professional services company like an ad agency or an investment bank to institute urgently needed changes. Such threat-driven changes can prolong the survival of the company, but it cannot ensure long-term growth or prosperity in the long run.

Leaders must try to anticipate environmental changes and proactively position the company to be even more successful under those altered conditions than it has been under the status quo. They must pay close attention to regulation, structure, systems, processes and culture - otherwise they'll be hearing their last rites.

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