

# Introduction

## *Can Fatal Strategic Flaws Only Be Recognized in Hindsight?*

International Business Machines Corporation lore says that, in the early 1960s, CEO Tom Watson Jr. summoned to headquarters an executive who was responsible for a venture that lost \$10 million. Watson, whose fierce temper was legendary, asked the man if he knew why he'd been called in. The man said he assumed he was being fired. Watson responded: "Fired? Hell, I spent \$10 million educating you. I just want to be sure you learned the right lessons."

Corporate America has spent hundreds of billions of dollars producing educational failures in recent decades. But executives shudder at the very word "failure," so people rarely try to learn any lessons from them—unless that lesson is how to make sure someone else catches the blame. As we've seen with the subprime mortgage crisis in 2007 and 2008, which mimics earlier financial crises, businesses keep making similar mistakes, over and over again.

We propose to help executives and investors learn the lessons to be had from failure. Organizations involved in life-and-death situations—such as hospitals, airlines, and the military—routinely do after-action analyses that help them keep from repeating catastrophic errors. We think it's time managers did likewise. And executives need to learn not just from their own experiences, but from the lessons financed by others, as well. Why spend \$500 million, and a decade of your life, repeating someone else's mistake when you could learn to avoid it by spending a few hours with a \$26 book (less on Amazon)?

Business books routinely look at successes and suggest how readers can emulate them. But no one looks at failures and lays out methods for how *not* to emulate them. Imagine a sports team that decides it will only play offense and not play defense. It's time executives focused some of their attention on defense.

To glean the lessons from failure, we undertook an extensive research effort to examine the most significant business failures of the past quarter century. We defined failure as writing off major investments, shuttering unprofitable lines of business, or filing for bankruptcy. Working with leading information vendors, we built a comprehensive database of more than 2,500 such failures suffered by publicly traded companies in the United States. We did a literature search to look for failures that didn't show up in the vendors' databases—for instance, companies that sold themselves before having to account for a major problem. Then, using various screens, we narrowed the list to the 750 most meaningful. Aided by a team of researchers, we spent more than a year poring over the data.

The extent of the failures was stunning. Since 1981, 423 U.S. companies with assets of more than \$500 million filed for bankruptcy. Their combined assets at the time of their bankruptcy filings totaled more than \$1.5 trillion. Yes, that's *trillion*, with a *t*. Their combined annual revenue was almost \$830 billion. Some of these companies went into bankruptcy multiple times; in other words, they couldn't even learn from their own mistakes.

Over those twenty-five years, 258 publicly traded U.S. companies combined for more than \$380 billion in write-offs. Sixty-seven companies had combined losses from discontinued operations that totaled almost \$30 billion.

What caused all those flameouts? The current emphasis in business literature suggests that everything boils down to execution. Generals say a battle plan never survives the first contact with the enemy, and business executives have much the same attitude. They reason that they can only do so much planning. After that, they have to plunge ahead, hoping to execute better than the other guy and maybe catch a bit of luck. Yet, despite all the books written about how to improve performance by making individuals and companies more effective, we found that failures

often don't stem from lack of execution. Nor are they due to timing or luck. What we found, instead, is that many of the really big failures stemmed from bad strategies. Once launched, the strategies were doomed to fail, and these failures probably could not have been prevented by even spotless execution—unless the implementers were licensed to kill the strategy itself.

The situation is rather like the Charge of the Light Brigade. Faulty intelligence and vague orders contributed to the disastrous decision of the British to charge overwhelming Russian artillery in the Crimean War. Once the charge was set in motion, disaster was inevitable—“Into the valley of Death / Rode the six hundred,” as Alfred, Lord Tennyson put it.

With strategy often to blame, the next question is: Are doomed strategies avoidable? Or are the fatal flaws only recognizable in hindsight?

To answer this, we sifted through the database to eliminate cases where failure stemmed from poor execution or from environmental factors beyond management control. For instance, we didn't ding airlines for the plunge in traffic following the terrorist attacks on 9/11. Still, we found hundreds of cases where a strategy led directly to a major failure. We then did a root-cause analysis into those cases. We reviewed financial filings, business and popular press reports, and assessments from industry analysts to understand the failures. We used numerous techniques to avoid giving ourselves the benefits of hindsight—looking at what was written at the time, seeing whether everyone in an industry was making the same mistake or whether our failure case stood out, and so forth.

What we have found is that as many as 46 percent of the failures could have been avoided if companies had been more aware of the potential pitfalls. A significant percentage of the other failures, the ones that we didn't classify as avoidable, could have been mitigated if companies had seen warning signs and had proceeded more cautiously.

Looking at the avoidable failures, we identified repeating patterns, where failures across multiple industries were variations on a theme. We then drilled into the repeating patterns, or failure modes, to draw the lessons about the common problems and ways that those problems might be averted.

What we found is that failures tended to be associated with one of

seven types of strategy. Failures could certainly happen for other reasons, but if a company followed one of these seven strategies it was far more likely to flop. Those seven strategies are:

- **Synergy.** This “whole is greater than the sum of the parts” approach often led companies to overestimate the benefits from a merger. Synergy fades in and out of vogue, even though studies have found that companies have only about a one-in-three chance of reaching their goals for revenue gains driven by synergy. We found dozens of major examples—from the granddaddy of them all, AOL Time Warner, on down—that let us identify the warning signs that a given synergy strategy is based on smoke and mirrors.
- **Financial engineering.** We don’t mean fraud. We’re talking about legitimate, albeit aggressive, ways of using accounting or financing mechanisms. The aggressive approaches did sometimes lead to fraud because they were addictive. Once companies started, they couldn’t stop. They had to keep increasing the aggressiveness until they crossed the line into illegality. But even companies that thought they were merely being aggressive sometimes found they were constructing a fairy tale—such as the major lender that generated a huge amount of business by offering thirty-year loans on assets with a useful life of only ten to fifteen years.
- **Rollups.** Much to our surprise, we didn’t just find tons of examples of companies that had run into problems while trying to “roll up” an industry, buying dozens or even hundreds or thousands of local businesses and turning them into a regional or national behemoth. We found that many of these failed attempts ended in fraud. We also found it hard to uncover successful rollups. Even companies that are sometimes cited as successes, such as Waste Management Incorporated or AutoNation Incorporated, went through horrific problems along the way and had to back off much of their initial rollup strategies.

- ***Staying the course.*** This may seem like inertia, not a strategy. But, in the face of a clear threat to the heart of a business, staying the course was often a conscious, strategic decision—and a bad one. Eastman Kodak Company, for instance, was aware as far back as 1981 of the significant threat that digital photography posed to its century-old film, paper, and chemicals business. Yet Kodak never reoriented itself to allow for the fact that the world would go as thoroughly digital as it has—and we have a long way to go. Kodak thought it could use digital technology to “enhance” its traditional business and kept investing heavily in that business. The result was a betwixt-and-between strategy that, among other things, produced a digital camera that required film. Not a big seller.
- ***Adjacencies.*** While moving into an adjacent market could be a great way for a company to stretch itself, adjacency moves also turned out to be perilous. Some of these strategies would have been amusing if they hadn’t cost investors so much money. In some cases, the “adjacencies” were only semantic, not real. For instance, a big cement company went into bankruptcy proceedings after moving into a series of new markets, including lawn mowers. The company’s rationale was that its cement was used in homes, and homes have lawns, so it should start selling lawn mowers. Nope.
- ***Riding technology.*** This can be great, as eBay Incorporated and others have shown. But managers sometimes trick themselves into riding the wrong technology. We’re not talking Betamax, which had a legit chance of beating out VHS as the standard for videocassette recorders. We’re talking Zapmail, which cost FedEx Corporation hundreds of millions of dollars in write-downs in the mid-1980s because FedEx executives didn’t allow for the fact that faxes would keep getting cheaper while improving in quality.
- ***Consolidation.*** As an industry matures, and the number of companies in it is shrinking because of a diminishing pool of profits,

executives sometimes make mistakes. They may buy up competing companies that have more problems than they think. Or they may make an even more basic mistake: deciding to be the consolidator when they should actually sell out and let someone else deal with the pressures of consolidation. An example: the paging companies that were buying up other paging companies to consolidate that industry in the late 1990s, right before cell phones wiped out a vast chunk of that business.

To be clear: We aren't saying that these seven strategies are doomed to failure. Far from it. In the right circumstances, all of these strategies can succeed splendidly. All we're saying is that these strategies are danger zones. If you're pursuing one of these strategies, you need to be extremely alert to what can go wrong, and ready to react before your business is flirting with disaster.

To help you be more careful, we begin part 1 of the book with a chapter on each of these failures. We draw on dozens of examples, plus others' research, to tease out of each strategy the three or four reasons it may fail. We end each chapter with a list of tough questions that you can ask yourself before proceeding with the type of strategy covered in that chapter, to minimize the chance that you'll fall victim to one of the common problems.

We conclude part 1 with a coda that lays out some broad principles about failure. The coda summarizes the problems we've listed in the first seven chapters and lays out general mistakes that companies make. For instance, looking at problems with several strategies, we found that companies that fail often do so because they overestimate the loyalty of customers. We may care deeply about our customers, but the feeling often isn't reciprocal. We're an afterthought to them. They may not even know that a particular utility supplies their electricity. They certainly aren't going to buy insurance from that utility because they're so enamored of the brand name—as more than one utility learned the hard way.

While the temptation might be to read just one chapter on a specific strategy or to head straight to the coda, we think it's important to read through at least a significant part of part 1 because it runs counter to what business executives typically think about failure. They tend to assume

that failures are due to circumstances beyond management control, that failures are unique in some way that limits generalization, that failures generally happen to companies out of the mainstream, or that the principals were (to put it mildly) idiots. Executives convince themselves that a catastrophic failure couldn't possibly happen to them. After all, they're brilliant, they've gone to the best schools, they've had nothing but success their whole careers, they're . . . You get the idea. Our research shows, however, that many of those who fail were brilliant, went to the best schools, had never had anything but success their whole careers, and all the rest. Similarly, many failures occur at companies that were long established. Many were considered to be well managed, didn't seem to be taking excessive risks, and weren't undone by widespread fraud.

Our findings should be, as a result, all the scarier. They can't be dismissed as anachronistic or as extraneous data points. As Alfred Hitchcock said, the scariest villains aren't the ones who arrive on camera wearing black hats and accompanied by eerie music; the scariest are those who seem like normal, even nice, people and only gradually reveal themselves to be evil at the core.

We hope the scariness in part 1 will be enough to provoke study and raise awareness.

In part 2, however, we argue that awareness isn't sufficient. Based on what we saw in our research, it isn't enough to just know where the pitfalls lie. We found plenty of companies where senior people knew that a strategy was flawed yet still failed to head it off. People have known in general terms about certain pitfalls for years—for instance, in synergy strategies—yet still fall into them. Companies have paid investment bankers and consulting firms billions of dollars to help them be more careful. Yet companies continue to have an iffy record with the strategies we investigated.

So we begin part 2 with a chapter that looks at individual psychological issues that make it likely that businesses will, from time to time, come up with strategies that are clunkers. We cite research such as Stanley Milgram's work that shows just how much people are inclined to conform, rather than stand up, even when they know something is wildly wrong. Milgram is the person in the 1960s who got numerous subjects to "teach" others by administering electric shocks when

they gave a wrong answer, gradually increasing the shocks until they went beyond what those running the experiment had told subjects might be a lethal dose. (There were, of course, no shocks being administered, but the subjects of the experiment didn't know that.) We supplement the discussion of psychological impediments with a quick review of an anthropological study that shows that these impediments are universal to all cultures. The point is to underscore that the issues are so deep that we can't avoid them just by trying a little harder.

The second chapter in part 2 extends the argument that awareness isn't enough. This chapter looks at organizational issues that hurt corporate decision making—along the lines of Friedrich Nietzsche's statement that "madness is rare in individuals, but in groups . . . it is the rule."

While business seems to outsiders to be rational, it is, in fact, very emotional and, as a result, subject to irrational behavior. Strategy formulation in particular is as much a social process as it is an analytical one. Armies of bright young people go to business school so they can learn strategic frameworks, regression analysis, and other arcana. Yet most analysis goes to support a decision that's already been made, rather than to see whether it's really a good idea in the first place. A CEO sees that all his major competitors are pursuing a certain idea and decides over his morning newspaper that he can't be left behind. Maybe he decides he has to have a story to tell when he confronts securities analysts on the quarterly earnings call. Maybe he reads the latest *Harvard Business Review* and falls for some surefire template for success. Maybe he falls in love with a tale told by his investment bankers (who get their fees anytime a company completes a transaction, regardless of whether it succeeds—and who get paid again when they're hired to unwind transactions they proposed in the first place). Maybe he believes that he needs to set a potentially unattainable goal to rouse the organization out of its inertia. Whatever the reason for the CEO's initiative, most managers in the organization understand that it's death to get in the way. The reality is, unfortunately, often not unlike this cartoon:



"All those in favor say 'Aye.'"

"Aye."

"Aye."

"Aye."

"Aye."

"Aye."

This chapter also looks at more subtle issues, such as the fact that risk is often poorly understood within companies and that commonly used analytical tools, such as net present value, can lead companies to misunderstand their situations and come up with bad strategies.

The final two chapters in part 2 are the book's real payoff. Based on what we've seen in our research and in our work over the past two decades, the only way to avoid the kinds of bad strategies we chronicle is to add one or more processes that will build disagreement into the formulation of strategies. We explain how to do that in these final two chapters, 10 and 11.

Chapter 10 introduces the concept of devil's advocacy as a powerful tool for deliberating strategy, and it offers several relatively low-key, everyday ways to increase contention. For instance, we explain how to set up alarm systems so you know when your competitive environment has changed enough that assumptions that are crucial for your strategy are in danger of becoming untrue.

Chapter 11 lays out the formal process that we call the devil's advocate review, which we feel any company should use whenever it is about to embark on a major strategy. We borrow the name from the Catholic Church, which for centuries appointed a "devil's advocate" to challenge the credentials of anyone being seriously considered for canonization as a saint.

In business situations, the devil's advocate would "argue the 'no' side," to use the phrasing of one CEO, who lost his job after he failed to have someone do just that.

That doesn't mean kicking the strategy back to the group that produced it and asking them to list everything that might go wrong. Finding a devil's advocate doesn't mean asking for an analysis by your investment banker, who will put up a nice façade but has no incentive to talk you out of a deal that will generate millions of dollars in fees for his bank. It may mean turning to an independent board member. It may mean assigning a trusted senior executive. It may mean hiring an outsider.

The process is simply designed to bring all possible objections to the surface, given that strategy-setting processes often smooth over objections. Note that the devil's advocate process isn't designed to override the top executives of a business. We'll say that again: The devil's advocate process isn't designed to override the top executives of a business. Despite the profusion of failures that we detail in this book, we aren't saying that every venture is doomed to fail. This isn't *Hamlet* we're writing here. Not everybody needs to die in the end. So we have no interest in helping those who would, for whatever reason, stand in the way of good ideas.

The process is designed to prompt executives to think about certain things, but decision making still rests with them. They're the ones in the best position to evaluate what strategy is best. Note also that the process doesn't present alternatives to a strategy that is being evaluated. That gets too messy and introduces too much ego into the process. This can't become a game of "I'm smarter than you are." Considering alternatives would also slow the process too much. We're not trying to stifle innovation—much of our work for the past decade has been about encouraging innovation. We're just trying to stop the bad ideas before it's too late. The good strategies will still sail on through.

We think about it this way: The process isn't designed to produce the best answers; it's designed to produce the best questions. After all, business isn't physics. Business isn't about finding the exact right answer, but rather is about avoiding the wrong answers and then executing as hard and as well as possible the answers that might be right.

In general, we think of the book as offering failure insurance. Though we aren't providing insurance in the strict sense of the word, anytime you have a major discussion about strategy you will be able to see if you're taking the same approach that tripped up others. If so, you'll need to ask yourself how your effort differs from the failures identified in our research. This extra round of well-informed due diligence will at least let you mitigate your risks; you might still lose money, but at least you'll lose a lot less. Better yet, you may kill doomed efforts before they get started, saving yourself and your investors a ton of money.

The book is, obviously, written primarily for business practitioners, but we mean that in the broadest sense. If you're a middle manager, you clearly don't have to decide whether to make a multibillion-dollar acquisition in the name of synergy, but you do produce more limited strategies and can benefit from the methods we lay out to bring possible problems to the surface and to use disagreement in a constructive way. You can use this book to gather information you wouldn't otherwise see. You can do a limited devil's advocate review, either relying on an outspoken subordinate or, perhaps, a peer.

We also hope you can use this book as a sort of career coach, maneuvering your way into projects that have a better chance of being winners by dodging projects that have a good chance of being doomed. As careers play out, there's nothing sadder than watching talented people paint themselves into a corner by being associated with a string of corporate failures. So, in a world where powerful senior executives aren't omniscient, we hope to help managers in the trenches figure out how to do the independent thinking that can help prevent them from burning up years on a project headed nowhere.

In many ways, this book is more about human nature than strategy—how we humans are flawed, how those flaws show up in the business world, and how to keep those flaws from leading to bad decisions. Those lessons apply at every level of a business.

Beyond what it tells day-to-day practitioners, the book holds a lot of value for independent board members and for savvy investors.

Outside board members are often outgunned when it comes to assessing a complex strategy advocated by management. The directors aren't immersed in the industry or the operational details of the company in the same way that management is. Outside directors can ask a few questions, but anything more requires, in essence, a vote of no-confidence in management. Our research gives you outside directors good reason to call for thorough, open-minded, and independent due diligence. The book also provides a template for conducting that due diligence, in an unobtrusive way that can improve the governance of a business while not interfering with its management.

Serious investors have, perhaps, the most to gain from our book because, while lacking the inside information that executives have, investors still must constantly size up which corporate strategies will succeed and which will fail. If you can analyze a corporate announcement and see one of our failure patterns, you can avoid a stock or identify a short-sale candidate and reap the appropriate rewards.

As you'll see, there have been many situations, especially with rollups, where what we classify as a failure actually were spectacularly successful projects for those who got in on the ground floor, then sold before the problems became apparent. Those sorts of "failures" will surely continue until investors learn to shun them.

Now, we're not saying that we're going to be able to identify and head off every mistake. Business is a contact sport. Companies win. Companies lose. That won't change. We cannot guarantee success. Our goal, instead, is to help avoid failure. Because, at the least, executives need to find new mistakes to make; there's no excuse for making the same ones that people have been making for decades.