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Creative destruction

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How can corporations make themselves more like the market? An excerpt from the best-selling book.

The first Standard and Poor's index of 90 major US companies was created in the 1920s. The companies on that original list stayed there for an average of 65 years. By 1998, the average anticipated tenure of a company on the expanded S&P 500 was 10 years. If history is a guide, over the next quarter century no more than a third of today's major corporations will survive in an economically important way.

So conclude Richard Foster and Sarah Kaplan in the best-selling *Creative Destruction: Why Companies That Are Built to Last Underperform the Market—and How to Successfully Transform Them*.[1] Foster, a McKinsey director, and Kaplan, who worked at the Firm for many years as an expert on innovation, argue that an accelerating pace of change has ended an era of corporate development that lasted more than seven decades. Foster and Kaplan, using their research on the performance of more than 1,000 corporations in 15 industries over a 36-year period, show that the corporate equivalent of El Dorado—the golden company that continually outperforms the markets—has never existed. Managing for survival, even among the best and most revered corporations, doesn't guarantee long-term performance for shareholders.

In fact, the opposite is true: in the long run, the authors argue, markets always win. Management philosophies and control processes based on the assumption of continuity only deaden corporations to the vital and constant need to embrace the forces of what Joseph Schumpeter called "creative destruction" and to change at the pace and scale of capital markets. In the following excerpt, the authors explore the need to abandon assumptions of continuity and to tackle the cultural barriers that make it hard to change corporate cultures even in the face of clear market threats.

—The editors

When corporate culture kills

How can corporations make themselves more like the market? The general prescription is to increase the rate of creative destruction to the level of the market itself, without losing control of present operations. As sensible as this recommendation is, it has proved difficult to implement.

[1] New York: Currency/Doubleday, 2001.

Hundreds of managers from scores of US and European companies have told us that while they are satisfied with their operating prowess, they are dissatisfied with their ability to implement change. “How do the excellent innovators do it?” they ask, presuming that excellent innovators exist. “What drives an innovation breakthrough?” Others question how one expands a company beyond its core business. And most fundamental of all: “How do we find new ideas?”

The difficulties behind these questions arise from the inherent conflict between the need for corporations to control existing operations and the need to create the kind of environment that will permit new ideas to flourish—and old ones to die a timely death. This may require trading out traditional assets, challenging existing channels of distribution, or making dilutive acquisitions. But whatever the challenges, we believe that most corporations will find it impossible to match or outperform the market without abandoning the assumption of continuity. Author James Reston Jr., in his book *The Last Apocalypse: Europe at the Year 1000 A.D.*,[2] noted Europe’s fear that the first millennium would end in a fiery conclusion:

> When the millennium arrived the apocalypse did take place; a world did end, and a new world arose from the ruins. But the last apocalypse was a process rather than a cataclysm. It had the suddenness of 40 years.

The current apocalypse—the transition from a state of continuity to a state of discontinuity—has the same kind of suddenness. Never again will American business be as it once was. The rules have changed forever. Some companies have made the crossing. Under Jack Welch, General Electric has negotiated the apocalypse and has seen its performance benefit as a result. Johnson & Johnson is moving across the divide quickly. Corning has been successful in shedding its dependence on consumer durables and becoming a leader in high-tech optical fiber. In France, L’Oréal seems to be on the right track, having found a new way to organize itself and transfer beauty concepts from one economy to another. But these are the exceptions. Few have attempted the journey. Fewer still have made it to the other side successfully.

Cultural lock-in

For half a century, until Johnson & Johnson introduced Tylenol, Bayer Aspirin drove the growth of Sterling Drug. Out of fear of cannibalizing its Bayer Aspirin leadership, Sterling Drug refused to introduce its leading European nonaspirin pain reliever (Panadol) to the United States. Instead, it tried to expand its Bayer line overseas but failed. This failure ultimately led to its acquisition by Eastman Kodak. Sterling Drug had become immobilized, unable to change its half-century-old behavior out of fear. Its strong culture—its rules of thumb for decision making, its control processes, the information it used for decision making—blocked its progress and ultimately sealed its fate. It had locked itself into an ineffective approach to the marketplace despite clear signs that it needed to act in a new way.

[2] New York: Doubleday, 1998

"Cultural lock-in"—the inability to change the corporate culture even in the face of clear market threats—explains why corporations find it difficult to respond to the messages of the marketplace. Cultural lock-in results from the gradual stiffening of the invisible architecture of the corporation and the ossification of its decision-making abilities, control systems, and mental models. It dampens a company's ability to innovate or to shed operations with a less exciting future. Moreover, it signals the corporation's inexorable decline into inferior performance. Often, as in the case of Sterling Drug, cultural lock-in manifests itself in three general fears—the fear of cannibalization of an important product line, the fear of channel conflict with important customers, and the fear of earnings dilution that might result from a strategic acquisition. As reasonable as all these fears seem to be to established companies, they are not fears that are felt in the market. And so the market moves where the corporation dares not.

Cultural lock-in is the last in a series of "emotional" phases in a corporation's life, a series that mirrors, remarkably, that of human beings. In the early years of a corporation, just after its founding, the dominant emotion is passion—the sheer energy to make things happen. When passion rules, information and analysis are ignored in the name of vision: "We know the right answer; we do not need analysis."

As the corporation ages, the bureaucracy begins to settle in. Passions cool and are replaced by "rational decision making," often simply the codification of what has worked in the past. Data are gathered, analysis is performed, alternatives are postulated, and scenarios are developed. Attempts are made to avoid the game of information sculpting. Only when rational decision making is in vogue does all the relevant information flow to the right decision maker, at the right time, and in the right form to be easily analyzed and interpreted. Rational decision making is triumphant, at least for a while. This stage is often pictured as the normal state of the corporation, although in our experience, particularly as the pace of change increases, rarely does this ideal state accurately describe how the company actually operates.

Eventually, rational decision making reveals that the future potential of the business is limited. Often, at this point, threatened by the prospect of a bleak future, the corporation falls back on defensive routines to protect the organization from its fate, just as defensive emotions emerge in our lives when we sense impending trauma. Management now sees the future filled more with trouble than with promise. Decisions are made to protect existing businesses. The fear of discarding the old for the new (product cannibalization), the fear of channel conflict, and the fear of earnings dilution through acquisition paralyze acts of creative destruction and often effectively shield the corporation from the perception of future trouble—as well as the need to act—for a long time. Cultural lock-in is established, thwarting the emergence of a leader or team that might save the day.

The causes of cultural lock-in

Why does cultural lock-in occur? The heart of the problem is the formation of hidden sets of rules, or mental models, that once formed are extremely difficult to change. Mental models are the core concepts of the corporation, the beliefs and assumptions, the cause-and-effect relationships, the guidelines for interpreting language and signals, the stories repeated within the corporate walls. Charlie Munger, a longtime friend of and co-investor with Warren Buffett and vice chairman of Berkshire Hathaway, calls mental models the “theoretical frameworks that help investors better understand the world.”

Mental models are invisible in the corporation. They are neither explicit nor examined, but they are pervasive. When well crafted, mental models allow management to anticipate the future and solve problems. But once constructed, mental models become self-reinforcing, self-sustaining, and self-limiting. And when mental models are out of sync with reality, they cause management to make forecasting errors and poor decisions. The assumption of continuity, in fact, is precisely the kind of disconnect with reality that leads corporations into flawed forecasting and poor decisions.

Mental models manifest themselves in corporate-control systems. These systems are designed to ensure the predictable achievement of goals, whether cost control, the control of capital expenditures, or the control of the deployment of key personnel. Effective control means that an informed manager can be reasonably confident that unpleasant surprises will not occur.

Unfortunately, control systems can also create “defensive routines” in organizations, including the failure to challenge the status quo, the failure to encourage a diversity of opinions, the failure to disagree with superiors (thereby displeasing them), communicating in ambiguous and inconsistent ways, and making these failures, even when known, “undiscussable.” Change becomes impossible.

Corporate-control systems also undermine the ability of the organization to innovate at the pace and scale of the market. Under the assumption of continuity, for example, the arguments for building a new business can be turned back, since its probable success cannot be proved in advance. Under these circumstances, it is more likely that ideas based on the incremental growth of current capabilities and mental models will be encouraged.

Corporate-control systems limit creativity through their dependence on *convergent thinking*. Convergent thinking focuses on clear problems and provides well-known solutions quickly. It thrives on focus. Order, simplicity, routine, clear responsibilities, unambiguous measurement systems, and predictability are the bedrock of convergent thinking. Convergent thinking is tailor-made for the assumption of continuity. Convergent thinking can be effective at handling small, incremental changes and differences, but transformational changes completely flummox the system.

Discontinuity, on the other hand, thrives on a different kind of thinking, *divergent thinking*. Divergent thinking focuses on broadening—diverging—the context of decision making. It is initially more concerned with questions than with getting to the answer in the fastest possible way. Divergent thinking places enormous value on getting the questions right and then relinquishes control to conventional convergent-thinking processes.

Divergent thinking thrives as much on the broad search as on the focused search. It focuses as much on careful observation of the facts as on interpretation of the facts. It focuses as much on the skills of reflection (which requires time away from the problem) as on the skills of swift decision making (which seeks to avoid delay). We refer to these three skills—conversation, observation, and reflection—as the COR skills of divergent thinking. Unfortunately, conventional corporate-control systems, built on the assumption of continuity, stifle the COR skills of divergent thinking or kill it outright.

When mental models are out of sync with reality, corporations lose their early-warning system. Leaders with genuine vision are suppressed. As Ronald Heifetz, codirector of the Center for Public Leadership at the Kennedy School of Government at Harvard, observed: "People who lead frequently bear scars from their efforts to bring about adaptive change. Often they are silenced. On occasion, they are killed."[3]

Abbott Laboratories, for example, flush with the success of its strategy to build strong positions in the medical diagnostic- and test-equipment business, was anxious to avoid the shocks to the pharmaceutical industry posed by the emergence of Medicare and Medicaid, which generated serious pricing pressures. Yet the company found itself with an incumbent chief executive officer who squelched three potential successors seeking to change strategy.

Once cultural lock-in guides a company's decisions, in the absence of some great external shock, the corporation's fate is sealed.

How the markets enable change

Markets, on the other hand, lacking culture, leadership, and emotion, do not experience the bursts of desperation, depression, denial, and hope that corporations face. The market has no lingering memories or remorse. It has no mental models. The market does not fear cannibalization, customer channel conflict, or dilution. It simply waits for the forces at play to work out—for new companies to be created and for acquisitions to clear the field.

The markets silently allow weaker companies to be put up for sale and leave it to the new owners to shape them up or shut them down. Actions are taken quickly on early signs of weakness. Only when governments are brought in, as with a bailout, does the market mimic a probable corporate response. Most of the time, the market simply removes the weak players and, in removing them, improves overall returns.

Lacking production-oriented control systems, markets create more surprise and innovation than do corporations. They operate on the assumption of discontinuity and accommodate continuity. Corporations, on the other hand, assume continuity and attempt to accommodate discontinuity. The difference is profound.

[3] *Leadership Without Easy Answers*, Cambridge, Massachusetts: Belknap Press, 1994.

Redesigning the corporation for discontinuity

> *The right of any corporation to exist is not perpetual but has to be continuously earned.*
> —Robert Simons[4]

The market has pointed the way to a solution. In response to the tension that builds between the potential for improved performance and the actual performance of large businesses in an era of increasingly fast economic change, there are certain kinds of firms—particularly private equity firms—that have demonstrated the ability to change at the pace and scale of the market, and they have earned sustained superior returns for doing so. The two kinds of private equity firms—principal investing firms and venture capitalists—are quite different from each other, but each looks somewhat like the holding companies of the late 19th century. It is possible to imagine that private equity firms will form the seeds of the industrial giants of the 21st century.

These newly important firms have been able to outperform the markets for the last two to three decades, longer than any other kind of company we know of. The difference between these partnerships and the conventional corporation is their approach to organizational design. These financial partnerships have discovered how to operate at high levels of efficiency and scale while engaging in creative destruction at the pace of the market, exactly as Joseph Schumpeter envisioned. Created around the fundamental assumption of discontinuity, they have then determined how best to incorporate or fold in the requirements of continuity.

These firms never buy any company to hold forever. Rather, they focus on intermediate (three- to five-year) value creation. Corporations, in contrast, concentrate on the very short term (less than 18 months) for operations and the very long term (greater than eight years) for research.

Private equity firms make as much money by expanding the future potential of their properties as they do by increasing the properties' operating income. When a private equity firm invests in a company or buys all of the equity, the firm buys it with a "take-out" strategy in mind: management knows what it must do in the next three to five years to build the property so that it has long-term value for the next buyer.

Finally, private equity companies think of their business as a revolving portfolio of companies in various stages of development. They realize that they will sell some of their properties each year and buy others. They keep the pipeline full of new properties at the front end and supplied with buyers at the back end, cultivating both simultaneously (a skill at which they excel).

These firms differ from conventional corporations not only in their divergent thinking but also in the depth and speed of their research activities. Moreover, private equity firms allow each of the companies they buy to retain its own control systems. This allows the private equity firm to concentrate on creation and destruction to a far greater extent than do traditional corporations and even to a greater extent than a private equity firm's own wholly or partially owned subsidiaries do.

[4] *Levers of Control: How Managers Use Innovative Control Systems to Drive Strategic Renewal*, Boston: Harvard Business School Press, 1995.

The road ahead

Long-term corporate performance has not matched the performance of the markets, because corporations do not adapt as fast as the markets do. This is due to the way corporations evolve, not because of the way they accomplish their day-to-day work. For historical reasons, as we have discussed above, corporations have been designed to operate—to produce goods and services—rather than to evolve. In order to evolve at the pace of the markets, they have to get better at creation and destruction—the two key elements of evolution that are missing.

Redesigning the corporation to evolve quickly rather than to operate well requires more than simple adjustments; the fundamental concepts of operational excellence are inappropriate for a corporation seeking to evolve at the pace and scale of the markets. One cannot just “add on” creation and destruction; one has to design them in. And only if the corporation is redesigned to evolve at the pace and scale of the markets will long-term performance improve. Markets perform better than corporations because markets allow new companies to enter more freely, and they force the elimination of those companies without competitive prospects more ruthlessly than corporations do. Moreover, markets do these things faster and on a larger scale than do corporations.

We believe that corporations must be redesigned, from top to bottom, on the assumption of discontinuity. Management must stimulate the rate of creative destruction through the generation or acquisition of new firms and the elimination of marginal performers—without losing control of operations. If operations are healthy, the rate of creative destruction within the corporation will determine the continued long-term competitiveness and performance of the company. Today’s financial partnerships give us confidence that this realignment can actually work. They also suggest a way to do it.

To create new businesses at a faster rate, corporations also need to ponder the details of divergent thinking. Divergent thinking is a prelude to creativity. Many divergent thinkers possess apparently opposing traits: they may be passionate and objective or proud and humble; they may be both extroverted and introverted; in negotiations they may be flexible and unyielding, attentive and wandering. They possess what Mihaly Csikszentmihalyi, one of today’s leading thinkers on creativity and the author of *Creativity: Flow and the Psychology of Discovery and Invention*,[5] has called “a sunny pessimism.” F. Scott Fitzgerald described it this way:

> The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function. One should, for example, be able to see that things are hopeless and yet be determined to make them otherwise.[6]

Managing for divergent thinking—that is, managing to ensure that the proper questions are addressed early enough to allow them to be handled in an astute way—requires establishing a “rich context” of information as a stimulus to posing the right questions. It requires control through the selection and motivation of employees rather than through control of people’s actions; ample resources, including time, to achieve results; knowing what to measure and when to measure it; and genuine respect for others’ capabilities and potential. It also

[5] New York: HarperCollins, 1997.

[6] *The Crack-Up*, New York: New Directions Publishing, 1945.

requires the willingness to remove people from responsibility when it becomes clear they cannot perform up to standard. In the end, both divergent and convergent thinking must successfully coexist.

Next, to improve long-term performance, the overall planning and control processes of the corporation need to be rethought. The conventional strategic-planning process has failed most corporations. As practiced, it stifles the very dialogue it is meant to stimulate. New ways of conducting a dialogue and conversation among the leaders of the corporation and their inheritors are needed.

Finally, corporate-control systems must be built that can manage both to control operations and to increase the rate of creative destruction. Control what you must, not what you can; control when you must, not when you can. If a control procedure is not essential, eliminate it. Measure less; shorten the time, and the number of intermediaries, between measurement and action, and increase the speed with which you receive feedback.

The point is to let the market control wherever possible. Be suspicious of control mechanisms if they stifle more than they control. Let those who run a business determine the best mix of controls for their business (they know the system best), and shift the burden of integration to the corporate level rather than designing uniform systems that have to be implemented, throughout a corporation, independent of the business. When such changes are implemented, the focus of the corporation will shift from minimizing risk, and thereby inadvertently stifling creativity, to facilitating creativity—and that is what is needed to strengthen long-term performance. □

This article is adapted from Richard Foster and Sarah Kaplan, *Creative Destruction: Why Companies That Are Built to Last Underperform the Market—and How to Successfully Transform Them*, New York, NY: Currency/Doubleday, 2001. A longer version of this article also appeared in *McKinsey Quarterly* 2001, Number 3.

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