

STRATEGY PRACTICE

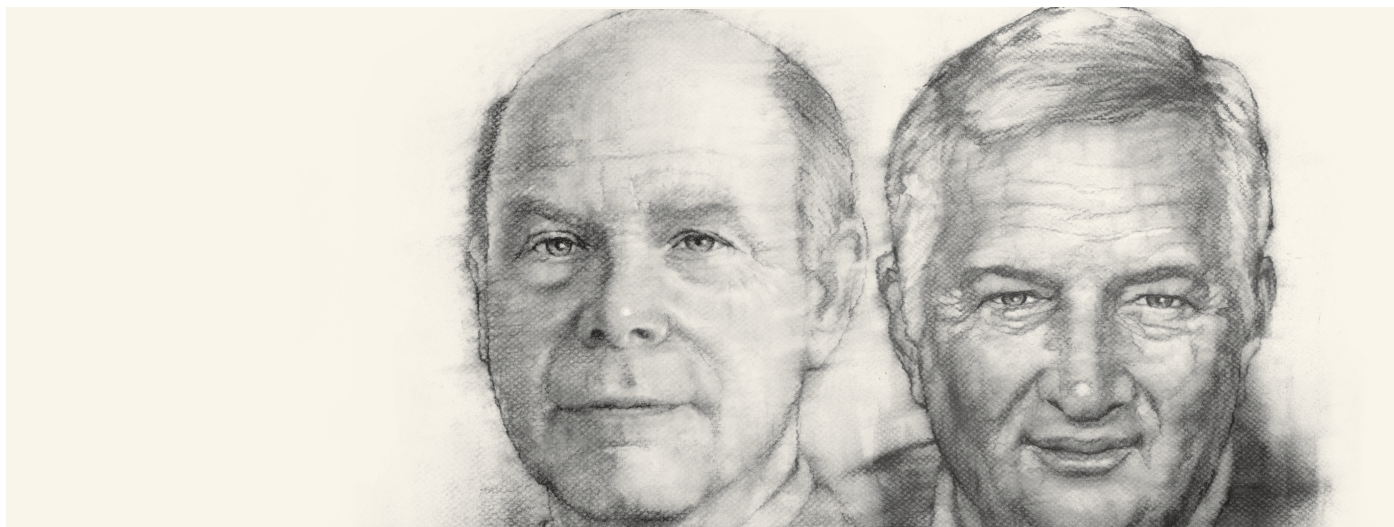
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Setting strategy in the new era:

A conversation with Lowell Bryan and Richard Rumelt

In this final installment of a three-part series, Professor Richard Rumelt and McKinsey's Lowell Bryan reflect on the strategic opportunities emerging as value shifts within and between economic sectors.

Allen P. Webb



This conversation is one of three installments summarizing Lowell Bryan and Richard Rumelt's reflections on the implications of the financial crisis. This third part explores what it means for corporate strategy today. The first examines the broad managerial implications of the crisis, and the second focuses on the public-policy response.

Rare is the time when the strategic environment for a great many companies and industries undergoes a rapid, fundamental, and universally perceptible change. UCLA's Richard Rumelt and McKinsey's Lowell Bryan argued in separate *McKinsey Quarterly* articles ("Strategy in a 'structural break'" and "Leading through uncertainty"), both published last December, that the financial crisis of 2008 was such a moment. Deleveraging, an expanding economic role for government, a reevaluation of imbalances in global trade and capital markets, and pervasive uncertainty, they suggested, were likely to upend business models and create unexpected opportunities. For Rumelt and Bryan alike, the ensuing months have confirmed the magnitude of the strategic change under way. In late April, they talked with the *Quarterly's* Allen Webb about the structural shifts to come in different economic sectors, the strong likelihood that the biggest opportunities will be surprisingly different from anything strategists expect today, and the resulting importance of building flexibility into a company's strategy.

The Quarterly: How would you characterize the strategic environment today?

Richard Rumelt: The level of uncertainty is as high as I've seen in my lifetime. Is the government spending program going to work? Is quantitative easing going to work? Is the dollar going to collapse? Is world trade going to come back? Is the consumer going to come back?

All these fundamental uncertainties mean that it's very hard to do strategy. Everybody who isn't in a death spiral would like to know how to take advantage of the downturn. But I don't really see that much strategic activity. I see people biding their time and husbanding their resources. There's a wise caution about jumping the gun. This high level of uncertainty means that you can really make a wrong move, and the end of easy credit means that you can no longer get cheap, easy money for a big leverage deal. So that kind of strategic move is more difficult.

Lowell Bryan: Almost everybody went into the bunker for the last several months. But I see some signs that people are saying, "Maybe I need to go out and find some food and water." I'm seeing people really beginning to engage in uncertainty and scenario planning seriously, in a way that they weren't willing to do, say, six months or a year ago. What would it mean if globalization goes in reverse or if we have high inflation in two or three years—or if, in fact, this is not a temporary loss of high US consumption levels but a more permanent loss? People are now beginning to engage in asking those questions. How do they start getting prepared to be resilient and flexible no matter how this environment comes out? People are willing to think about changing their models and changing their strategy.

Richard Rumelt: I agree with that. Companies are now beginning to ask deeper questions. It's a good bet, I think—a good 60, 70 percent chance—that consumers are going to hold onto their money because they are going to be worried about their health care, their savings, and their pension funds. If consumer spending doesn't come back for years, then what? That's strategic thinking at a simple level.

At the second level is the change in sectoral balances. One of the things a structural break like this is signaling is that we need to do less *A* and more *B*. Most of economic development or economic growth or economic value comes from this constant churning of doing less *A* and more *B*, whatever it is. In China, for example, look at the enormous wealth they created by having people stop doing rice farming and start doing manufacturing.

The puzzle for everyone is what's *A* and what's *B*? Here in the US, we have a reasonably clear idea of what *A* is. We probably have enough shopping malls for a while. And we probably have enough investment bankers for a while. And we certainly have enough houses in Orange County for a while. But what's *B*? What should we be doing instead? That's, of course, the brilliance of a decentralized economy—it does get figured out. But it doesn't just flash like a neon sign in everyone's face instantly.

Lowell Bryan: Take an area like health care, which at first blush is less affected by the crisis than other industries might be. But then you actually look at it, and the payer–providers are undergoing incredible challenges because the value of the investments on their balance sheets is way down. The hospitals' other big issue is bad debt: large numbers of people without health insurance use emergency-room services, who are unable to pay their bills. Then you've got the entire health care system facing a massive, ongoing fiscal issue from an aging population and the way the US government's benefits programs work. So we know that there are bound to be wholesale changes in how we spend on health care, how value's created, how profits are made, who gets what share of what pie, and so forth, in this enormous sector. But no one quite knows how it's going to turn out, including the would-be architects in Washington.

What I find interesting, coming out of this economic shock that Richard described, is that all the industry structures and rules and value chains and customer segments in industry after industry are in flux. And no one's yet figured out how you make money at it. That's the opportunity.

Richard Rumelt: Lowell's exactly right. The structural shifts in the economy are where the real opportunity is here. Pinning them down and seeing the second-order effects—the second wave in each one of them—is the strategist's job. It's fairly easy to see the first wave. Everybody can see that the government's going to spend money on health care. And as Lowell points out, you just don't go out and buy a health care company. That isn't acting strategically.

Because if you look ahead a bit, you can see that the health care system we have, if we extend it to a larger group in the population—to everybody, let's say—is going to bankrupt us. So something's going to give. The strategist is someone who has an idea about what's going to give or about reshaping it. That's how you're going to create value. You don't create value by jumping in on Day One.

Remember when AT&T was deregulated and everybody could see that telecommunications and computers were going to converge? That was the big word of the day. AT&T got deregulated and it bought a computer company, and IBM bought a telecommunications company, and both of these two giants were going to battle it out. Well, that isn't what happened. That was the initial vision, and the initial vision was shattered by the birth of microcomputers and microprocessing and the Internet.

In each of these industry transformations, whether it's airline deregulation or the rise of the microprocessor, what you see over and over again is that the initial sense of what's going to happen is wrong. The money is made in the second-order effect. The money is made on the rebound from that initial proposition.

When microcomputers started to push into business firms, a company like Compaq said, "We need a sales network. We need a sales force." So they bought Digital. And then they got blindsided by Dell, which didn't have a sales force. You have to think through not just stage one but stage two. That's strategic thinking. And that's why I said in my previous article about strategy in a structural break—that times of structural change are the time when strategy comes to the forefront.¹

Lowell Bryan: One thing about this new environment that hasn't been found out yet is where the real opportunities to make money are. No one is smart enough to have figured out how this complex, adaptive economy is going to play out. What you can do is the kind of strategic thinking Richard was talking about and come up with a really good initiative that tries to find a way to make money. But you don't need just one initiative. You need eight or ten or more. You need a portfolio of initiatives. And you need to be continually pruning them, adding to them. You do less of *A* and more of *B*. It's not different than what venture capitalists or exploration and production people in oil have done for a long time. It really is a whole set of initiatives that help you discover, over time, new ways of making money.

You need to start with doing the kind of analysis and strategic thinking that Richard was talking about. But that's just the start, because you learn so much by doing. So often, you wander through the woods and you come out in a direction you never had any intention of going to. To some extent, you're planning on being lucky. Fortune favors the prepared mind. I think that's what companies need to do—much more than saying, "I see the future, I'm a visionary, I'm going to make the future happen." In this environment, I think you've got to be a little foolhardy to think you can see the future.

Richard Rumelt: I fully agree with that. Someone in the introduction of their book wrote that if you don't have a clear vision of the future ten years hence, you're not managing. I couldn't disagree more. I think if you have a clear vision of the future ten years hence, you're psychotic.

Lowell Bryan: It's a hallucination, it's not a vision.

Richard Rumelt: It's a hallucination, that's right. Good strategy is more like surfing a wave than having this clear vision of the future. You've got to find a wave of change. The way we make money in business, typically—if we're not sitting on a stable brand—is we find a wave of change that we can exploit. And we ride it with skill. It's not about having a lockstep plan. It's about figuring out which forces we can harness or ride to our benefit.

The Quarterly: What other sectors strike you as intriguing candidates for structural shifts? Let's not focus on health care, which you've discussed, or on financial services and energy, which are already getting a lot of attention.

¹See Richard Rumelt, "Strategy in a 'structural break,'" mckinseyquarterly.com, December, 2008.

Lowell Bryan: Those are three pretty big ones! But you may also get something in consumer electronics or high tech because of the change of consumer behavior. More than ever, people want more value for less cost. Another is obviously the whole residential- and commercial-construction industries. They're obviously deeply affected by the financial crisis. And if we're going to act seriously about trying to change carbon footprints, I don't see how we do that without massive new ways of doing things that are yet to be discovered. Because otherwise, it's going to be an economic disaster.

Richard Rumelt: I would add that my guess is that the dollar's going to devalue, and that's going to have an impact on a whole lot of international operations.

Lowell Bryan: It will basically cause reinvigoration of US exports.

Richard Rumelt: We are going to be exporting things that we—

Lowell Bryan: —We've been importing. It will affect offshoring.

The Quarterly: What is the smartest thing that you've seen a corporate strategist do recently?

Richard Rumelt: The single smartest move I've seen is a medium-sized, private firm that went out and purchased a small company that had 15 or 20 years of skill at government contracting. Because it was failing, they got it for a song. So now they have a staff of people that know how to administer government contracts—which they feel is going to be a scarce resource in the next year or two.

Lowell Bryan: A lot of it, though, is not so much being smart as recognizing what's going on. I've seen people creating situation rooms, getting on top of business intelligence, consciously building flexibility into their plans, beginning to look for the right kind of opportunities—as Richard said earlier, doing more of what's working well and less of what's not working. *Q*

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Allen Webb is a member of *The McKinsey Quarterly's* board of editors.

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