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STRATEGY LETTER

A slow and balmy death

or
The aging company

N° 50

To get there. Together.

A slow and balmy death

The aging company

"Every man desires to live long, but no man wishes to be old." (Jonathan Swift)

Large diversified companies are an essential base of our Western economy. For many of them, the fundamental problem is no longer how to handle rapid growth but rather managing their large size. There is a fine line between competent maturity on the one hand, and senility on the other; ossification lurks and the worrying symptoms of the aging company often jump out for the external observer.

As you read the text below, which is meant to be simple, you may call to mind groups which have ceased to be (Allis-Chalmers, Montedison, AEG-Telefunken, British Leyland/MG Rover, A & P, Boussac), been taken over by other groups (Westinghouse, Nedlloyd, Norton, Washington Mutual, Merrill Lynch), been saved by vigorous new management (General Motors, Siemens, Fiat, Tarkett), survived only through very radical changes to the scale of the business or even a break-up (KarstadtQuelle, Motorola, ITT), or are barely surviving thanks to Chapter 11 or similarly artificial protection (Armstrong, Mitsubishi Motors, Abitibi/Bowater, Congoleum).

From cash cow to lean cows

A diversified and mature group generally has a portfolio of businesses consisting of a few quite large cash cows, and a relatively large number of small activities. The elephants live alongside little rabbits.

Usually, the group has developed around a historic business. The mindset and decision-making approach of top management have been steeped in the obligatory cult of the founder of the business, his values, quirks and all. This core business remains at the heart of the company and is the best career path to top management (for several decades, the CEO of GE always came from the Lighting Division). A "way we do business here" has emerged. Unsurprisingly, one tends to overinvest in the cash cow, which seriously hobbles the resources that should be selectively reinvested in the growth businesses. The virtuous portfolio cash cycle is hampered from square one.

Attempts at diversification are nevertheless undertaken, if only to look good and please analysts. Unfortunately, these attempts often end in failure: diversification activities, even if they are well chosen in growth segments, do not receive enough funding from the reluctant cash-cow to succeed in the face of more combative competition. Reflexes developed in mature activities are applied to a growth business, which is expected to immediately meet profitability standards comparable to the old core business. It all ends in blood and tears and irreversible loss of treasure with severe collateral human damage.

Too much caution prevails where aggressive competition is needed. These phenomena are powerfully reinforced where the success of the management is itself linked only to short-term results (in the US, Lever Brothers was for a long time subject to a deliberate liquidation of market share by a management team incentivized only on this year's profit objective, easily met no matter what if you simply cut advertising). Attempts at diversification thus result in mediocre competitive positions, leading to financial black holes and annual reports peppered with wishful oratory. Siemens and Alcatel lionize their cell phone businesses for a while until one suddenly shifts to the next shiny object.

Financial policies are prudent, with low debt and a high dividend (which further limits the possibilities for growth). A high level of liquidity is maintained, assets are under-utilized and the P/E is often low, as diversification attempts have not managed to change the company's overall image. Were it not for its size, it would become a perfect target for a raider, and it sometimes does, as the barbarians sneak up to the gate.

Companies like to pose as the Rolls Royce of their industry, and they prefer to price high based on their laurels and good reputation rather than fight it out based on a lower cost level. Competitors who win market share through price cuts are regarded as unfair competition and responded to with contempt, proliferating unnecessary SKU's (desperately fumbling for "niches") and, whenever possible, entreaties for government protection (the US steel industry was once a case in point). This begins a process of systematic liquidation of the Company's best competitive positions, including the hallowed but declining cash-cows.

However, life at the head office remains pleasant and deteriorates only slowly, with an in-house culture that has become soft. Spartan rigor is forgotten, Athenian babbling prevails. Decisions are not made. Net cash generation keeps wilting until it progressively becomes negative.

Reassuringly, the firm's size is regarded as a right to survive and a guarantee of invulnerability ("too big to fail"). Past successes are glorified and their patterns of thought and action are revered. Routine settles in; change and innovation become suspect. Responsibilities are diluted, meeting mania takes root and administrative procedures proliferate, inflating overheads and thereby considerably slowing down effective decision-making. One Harvard Business School professor once went so far as to say that the only real skill left at General Motors was the art of very accurately counting its losses. Soon the company is surprised not to be able to sign on brilliant young recruits and to have to accept lower caliber candidates, which only accentuates its mental and physical aging to the point of insidious ossification.

The interests of individuals increasingly diverge from those of the company as a whole: distinct profit centers become silos, individual incentives typically become biased in favor of short-term profits, thus promoting personal career games at the expense of the corporate future. Internal politics develop and conflicts flourish between groups and individuals.

This leads to situations that often make the headlines in the financial press: extreme sensitivity of results to the economic climate (fixed costs too high) or plant-shuttering problems, all due to loss of market share, deadwood overheads and a lack of rigor in selecting investments. The past is jettisoned without preparing the future. The company as a whole (and no longer just the diversification activities) becomes a financial black hole and a loose cannon for the country. The CEO is feckless: why be bothered anyway when the money is so good and retirement so close?

Fortunately, few companies are affected by all these symptoms at the same time, but with the slowdown in the growth of the economy, a myriad fresh examples have sprouted up, be it say in Detroit, Wall Street and even Silicon Valley, not to mention Europe (Italy's Montedison is one case where all symptoms did unfold at the same time).

Timely action

The inertia, the tone-deaf denial seeing right through the elephant in the room inexorably lead up to crunch time: cash insolvency. At that point, the only options open are very costly and traumatic. Some go under (Arthur D. Little, Polaroid), some struggle (Armstrong, Citibank, Kodak), some are taken over by competitors (Chrysler, Lucent) or private equity funds (Bausch & Lomb), often only to be sold off piecemeal.

Weaknesses which, if tackled in time, could have been resolved internally, tend to unnecessarily become political on the state or national stage. Had the same situation been analyzed objectively a few years earlier, in its proper competitive context, it would probably have been possible to fix the company (beginning with asset deployment) and avoid serious damage.

The contrast between Ford and General Motors is striking here. Even during the major crisis of 2008-2010, Ford never had to ask for federal government aid. In a company that had never fallen asleep at the wheel, the CEO, Alan Mullahy, kept listening to the market and the competition: this enabled it to keep quality high, comparable to the best of the Japanese; the company kept a good price/quality ratio by offering a third as many models for sale, thereby lengthening the production runs.

In contrast, GM fell into a complacent slumber, and gave up trying to understand why a stable market share of nearly 50% in the 1970s had dropped to around 15%, why GM Europe was constantly haemorrhaging cash, and why the Saturn small car project was costing billions of dollars but taking forever to complete. Without the federal government's emergency rescue package, GM's slow and balmy decadence would have ended in grim torturous death and massive layoffs. The top management team had lost all sense of customers, competition, rapid decision making and profitability; it was estranged from reality to the point of believing it could not be replaced.

Business History will probably remember the arrival of this self-complacent team in Washington, DC, by private plane at the taxpayer's expense. Historians will probably underscore the first bail-out nationalization in the U.S., and the astonishing spectacle of an American President firing the (bewildered) CEO of a private business on the spot.

Finally, good managers will remember that where there's a will there's a way and that one can make a great comeback from the edge of the precipice by taking the proper bold steps while there's still time (and sometimes after). Examples are fairly numerous: Boeing (in the 1980's), Gucci, Nissan, Fiat.

We may also remember a small French business which, not long ago, was so tired at the ripe old age of ninety that with paltry sales of $ 10 million, it managed to lose $ 4 million.

Along came professional new managers with unwavering dedication to an ambitious growth strategy, and today the business is one of the most profitable and admired worldwide: Louis Vuitton. The small workshop in an unglamorous Paris suburb has eventually made its owner, Bernard Arnault, the fourth richest man in the world.

Only a determined CEO, supported by a strong board of directors, can impose draconian measures on a slumbering organization. It goes without saying that this CEO is typically new and often put in place by a new shareholder, businessman or private equity fund.

The new demands of the shareholders or governance, swift action by alert global competitors, governments under the gun themselves, the spectacular rise of private equity… all tend to curtail the frequency of outburst of the doze-off disease, or to correct it much further upstream and thereby make it less painful to eradicate.

The time is no longer when the former CEO of a major truck manufacturer could say proudly in public: “I’ve done a great job: the losses are so high and there are so many employees that the State cannot but bail out the company”. Slow comfy deaths and lionized incompetence are hopefully receding.

The most optimistic would even say that, if Peter Löscher managed to turn Siemens around and Sergio Marchionne saved Fiat, there is everything to hope for, as long as the right CEO is put at the helm, preferably before the iceberg has been hit.

Maurice Marchand-Tonel

“ Of all the things that happen to a man, old age is the only one that takes him by surprise ”

(Leon Trotsky)