

CHAPTER ONE

THE CORPORATE CYCLE

*'tis wisdom to beware;
And better shun the bait, than struggle in the snare.*
JOHN DRYDEN, EPISTLE 13

Growth becomes the new imperative. The leaders of the company look to the future and set demanding goals for market share and new revenue. They know that they must invest and that long-term gain may mean some short-term pain for earnings. But “no change” is not an option. To grow, the company must take greater risks and encourage more experimentation. So the leaders push more authority down the organization. Central intervention in day-to-day management is reduced. They sharpen individual incentives for growth. The emphasis is on building: brands, new businesses, alliances. The company reaches out into new markets and adopts new ways of doing things. The watchwords of the day are ambition, innovation, initiative, change. It’s an exciting time to be around.

But the results are mixed. Revenue does grow, but margins fall. Large investments in the name of future potential haven’t translated into higher earnings today. The new energy that was unleashed within the organization seems to have ebbed. Duplication and complexity are widespread. People fear that the company has moved into areas too distant from its real skills. No one seems to have paid enough attention to the details, to the everyday tasks. Standards for investment approval and for financial discipline have slipped. There is “slack” in the system everywhere. The sense that things aren’t working comes to a head. Pressure for better results—now—is becoming intense.

A drive for efficiency follows. People start to say that what the company needs is “better execution, not more strategy.” Company leaders place a moratorium on new acquisitions and shelve some of the recent new ventures. They set goals for costs, margins, profitability. Budgets tighten. Peripheral businesses are sold. Some operations are centralized to reduce duplication and waste and to instill more control. Everyone recognizes the need to act as one well-coordinated company. Where before there was local initiative, now there is top-down guidance. The priorities are to standardize, share “best practice,” and avoid “reinventing the wheel.” The new words on everyone’s lips are discipline, coordination, standards, and “payback.” The going is tough, but there’s a new sense of realism. Determination is high.

Soon, however, it feels as if the company is backing itself into a corner. Earnings growth has started to become ever more reliant on delaying investments, cutting into costs that customers care about, pulling tactical levers. People start to worry that the company is starving the future to feed the present. The existing business doesn’t have enough headroom to secure future prosperity. Growth is as elusive as ever. The company has become too rigid, too distant from its customers, too inward focused, too obsessed with numbers. Everyone knows “we can’t shrink ourselves to greatness.” And so growth becomes the new imperative. . . .

THE THREE TENSIONS AND THE CORPORATE CYCLE THEY CREATE

A path of least resistance lies in front of every company. It’s not always easy to see that the path is turning inward in a circle. There’s one sure way to tell, though: more progress on one front always seems to come at the cost of less progress on another. More growth damages profitability, and more profitability slows growth. Efforts to build for tomorrow distract everyone from producing results today; but when managers shift focus to results for today, they compromise the future strength of the company. Attempts to create one-company benefits hold back individual business units; then attempts to unleash the individual potential of the business units bar the way to capturing the benefits of being one company. It’s like squeezing a balloon in one place only to find that it expands elsewhere.

These are the three tensions that act on every company: profitability vs. revenue growth; results today vs. results tomorrow; and the performance of the company as a whole vs. the performance of each part of the company. The tensions usually act in concert. When the priority is today's earnings, companies tend to push for higher profitability rather than faster revenue growth because they are confident they can increase profitability more quickly and with less investment than they can influence revenue growth. Companies that give greater priority to revenue growth often seek it by freeing up the individual parts of the company to stimulate new ideas, more experimentation, and greater adaptation to local markets. Conversely, a desire for improved profitability usually sits alongside greater emphasis on improving the performance of the company as a whole by coordinating across common activities to reduce costs.

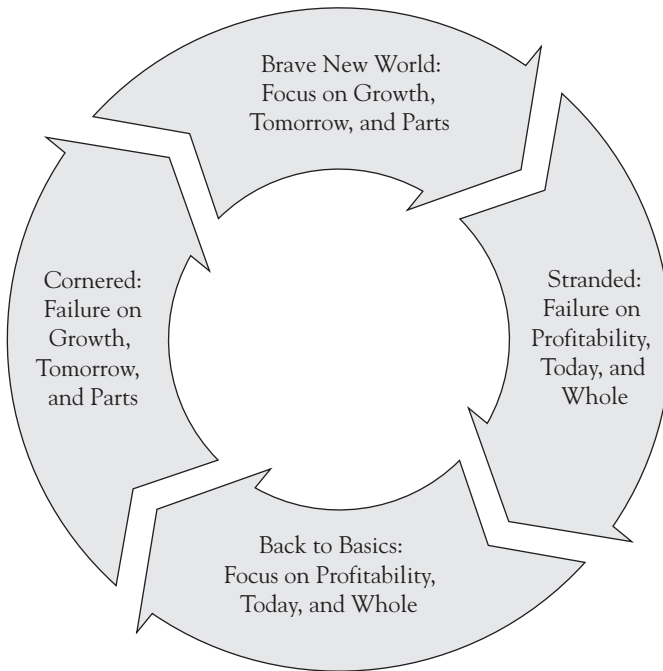
Because of these affinities, priority and performance on some objectives sit more comfortably together than priority and performance on others. On the one side sits growth, tomorrow's performance, and the individual parts; on the other sits profitability, today's earnings, and benefits across the whole. Together they create the corporate cycle: an interaction of the three tensions that causes companies to cycle between two phases: the "Brave New World" phase, where the focus is on growth, long term and parts; and a "Back to Basics" phase, where the focus is on profitability, the short term and the whole (Figure 1.1). In between these two phases, the company attempts to deal with its failure to achieve adequate performance on the other three objectives. The completion of each phase is quite often marked by the decision of the chief executive to spend more time with his family.

It isn't hard to find companies that have been caught in the corporate cycle—swinging back and forth between seeking their brave new world and going back to basics. The history of General Motors (GM) over the last twenty years is as good an example as any.

General Motors, 1983–2003

In the 1980s, the company went on an \$80 billion spending spree to build for the future. It took a 50 percent stake in Saab to expand its international presence and pushed into new markets by buying Electronic Data Systems and

FIGURE 1.1. THE CORPORATE CYCLE.



Hughes Aircraft. GM formed a car-manufacturing joint venture with Toyota to experiment with Japanese production techniques. The company launched its Saturn car division as a “greenfield” operation. Between 1984 and 1990, GM’s revenue grew at an average annual rate of 6–7 percent.

But by 1991, its profitability had suffered. GM’s economic profit margin fell from 1.2 percent to –7.4 percent. (Economic profit margin is net profit after tax and a notional charge for capital, expressed as a percentage of revenue. We use it here and elsewhere as our measure for profitability because it includes all costs, operating and capital.) In 1992, the company came within forty minutes of bankruptcy. A boardroom coup put a new CEO in charge. He closed plants, cut the workforce, sold poor-performing component operations, centralized purchasing, and combined engineering operations across the company’s car brands. He sold off noncore divisions, including National Car Rental and the recently acquired EDS. By 1999, GM’s economic profit margins were up again to 2.5 percent.

But revenue growth in the years between 1991 and 1999 had slowed to an average annual rate of 4 percent, with GM's share of the world automobile market continuing to fall. And its earlier layoffs had saddled GM with nearly three retirees for every active worker. By the turn of the century, their generous pensions and health care terms had generated "legacy costs" amounting to over \$1,000 a car, a cost that many of its foreign competitors didn't have. The company responded in 1999 and 2000 by redoubling its efforts to increase volumes to cover these fixed costs, launching aggressive marketing and discounting programs. It also bought the part of Saab it didn't own, acquired stakes in Fiat and Fuji Heavy Industries, and expanded its commercial finance business. Annual revenue growth returned to a healthier 6.5 percent in 1999–2000.

But by 2001, GM's economic profit margin turned negative again to -1.4 percent. With market share in its car business still sliding, the company embarked on a new phase of belt tightening to get costs in line with volume. GM cut a further thirty thousand jobs and identified ten plants for closure. It jettisoned another round of businesses, such as the defense and locomotive divisions. Its European subsidiaries centralized functions to reduce costs.

The current CEO, Rick Wagoner, is now in the uncomfortable position of walking the tightrope between keeping volumes up to cover GM's enormous legacy costs and trying to maneuver those costs down to lessen the need to chase volume at whatever price.

GM'S BATTING AVERAGE

Between 1983 and 2003, GM achieved both positive real growth in revenue *and* a positive economic profit margin in only six years. In the other fourteen years, the company either didn't grow in real terms, was unprofitable, or failed on both fronts. To use a baseball analogy, a batter who gets six hits in twenty at bats would have a batting average of .300. GM's batting average on the tension between profitability and growth was .300, or 30 percent. (In this book, we use batting average as a measure of how frequently a company achieves two competing objectives at the same time.)

GM's performance on the tension between results today and results tomorrow painted a similar picture. In five of the years between 1983 and 1999, the company achieved higher earnings than the previous year and at the same time was on the path toward positive economic profit growth over the *next* five years. (Because economic profit includes a charge for the capital invested in the business, it is more relevant to judging long-term performance than earnings.) In the other years, either single-year earnings fell, or the company was on the path to negative economic profits over the next five years,

or both. This gave GM a batting average on the today vs. tomorrow tension of five out of fifteen, or 33 percent.

These two batting averages are indicators of the degree to which a company is trapped in the corporate cycle. Companies that have broken out of the cycle will tend to achieve both objectives within each tension at the same time—at least more often than not. Companies trapped within the cycle usually achieve one objective at the expense of the other, or achieve neither. With performance of 30 percent and 33 percent, respectively, GM was clearly trapped within the cycle over the final two decades of the last century.

HOW PREVALENT IS THE CORPORATE CYCLE?

It is tempting to think of companies like GM as rarities. But it isn't only such famously difficult-to-manage companies that behave this way. In a survey we conducted with the Economist Intelligence Unit of two hundred business executives in the United States, Europe, and Asia, 52 percent said that their company swings between objectives within at least one of the three tensions. One in four said they swing between a focus on profitability and a focus on growth. One in three reported swinging between a focus on short-term earnings and a focus on long-term investment. And one in three said that they swing between focusing on the stand-alone performance of the parts and focusing on benefits across the company as a whole.

The evidence is all over the business news. Companies go for scale, often through acquisition and diversification, and then they retrench, divest “noncore” assets, and manage down their costs. They make large “strategic” investments for the future and then cut back to concentrate on improving “execution” in the current business and squeezing out earnings today. They organize to stimulate local initiative and then they reorganize to achieve “one-company” benefits. Many management teams swing between pushing for one objective in each tension and then pushing for the other. The amount of time over which these changes occur, whether they are dramatic or evolutionary and whether in coordination or isolation, differs from company to company. But few companies can justly claim to be free from any trace of the influence of the corporate cycle.

Batting Average

Batting average is a measure of how often a business achieves both of the two objectives in a tension at the same time. It indicates whether and how much a company is overcoming the tension. Together, batting averages on the three tensions tell you how much a company is succeeding in breaking away from the corporate cycle.

Profitability vs. Growth Batting Average

The proportion of years that a company achieves *both* positive real revenue growth *and* a positive economic profit margin. For example, a company that achieves both positive revenue growth and a positive profit margin in three out of five years has a profitability vs. growth batting average of 60 percent.

Today vs. Tomorrow Batting Average

The proportion of years that a company has positive single-year earnings growth *and* is on the path to positive multiyear economic profits growth. We use five years for multiyear performance because it is a planning horizon for many companies. It is also not far off the average tenure for chief executives of large public companies.¹

Whole vs. Parts Batting Average

The proportion of years that a company improves the performance of each part of the company irrespective of its relationship with the other parts *and* creates net positive one-company benefits from coordinating across them. For reasons we cover in Chapter Four, this batting average is very hard to measure from the outside. So for our thousand-company analysis, we have looked at the first two types of batting average instead. In Chapter Four we estimate batting averages for whole vs. parts by looking at the performance of a smaller set of five hundred companies.

See Appendixes A and B for more details.

In fact, many companies are as trapped in the corporate cycle as GM has been. We looked at the performance of all one thousand companies in our database over the twenty years between 1983 and 2003. In the same way as for GM, we calculated batting averages for each company. The batting average on profitability vs. growth across the sample was 38 percent. The batting average on earnings today vs. economic profits tomorrow was 44 percent. On both tensions, most companies hit the two objectives at the same time only two years in every five.

The probabilities of achieving both, either, or neither objective in each of the two tensions are shown in Figure 1.2. The average company is much more likely to achieve either or neither objective in each tension than it is to achieve both at the same time. At any point in time, at least three in every five companies are trapped somewhere in the corporate cycle by one or more of the three tensions.

This result was consistent with another finding from our survey (Figure 1.3). We asked executives to rate their company's capabilities on the three tensions. For each, fewer than one in four said their company was good at both objectives. Three-quarters said their companies were better at one than the other or were good at neither. Most companies have great difficulty in mastering the conflicts within the three tensions. Our conclusion is that the corporate cycle is not some curiosity that is relevant to a few aberrant companies. Most companies are trapped somewhere within it.

THE ECONOMIC AND POLITICAL FORCES BEHIND THE CORPORATE CYCLE

None of this is surprising. For all three tensions, the economic forces that act on companies serve to divide performance on one objective from performance on the other. Growth invites competition by imitation or substitution, leading to pressure on prices, costs, and therefore profitability. High profitability attracts new entrants, depressing market shares, prices, and therefore growth. Because competitors relentlessly introduce new products and services, what determines today's performance will be different from what determines tomorrow's performance. And good long-term

FIGURE 1.2. PROBABILITIES OF ACHIEVING NEITHER, EITHER, OR BOTH OBJECTIVES.

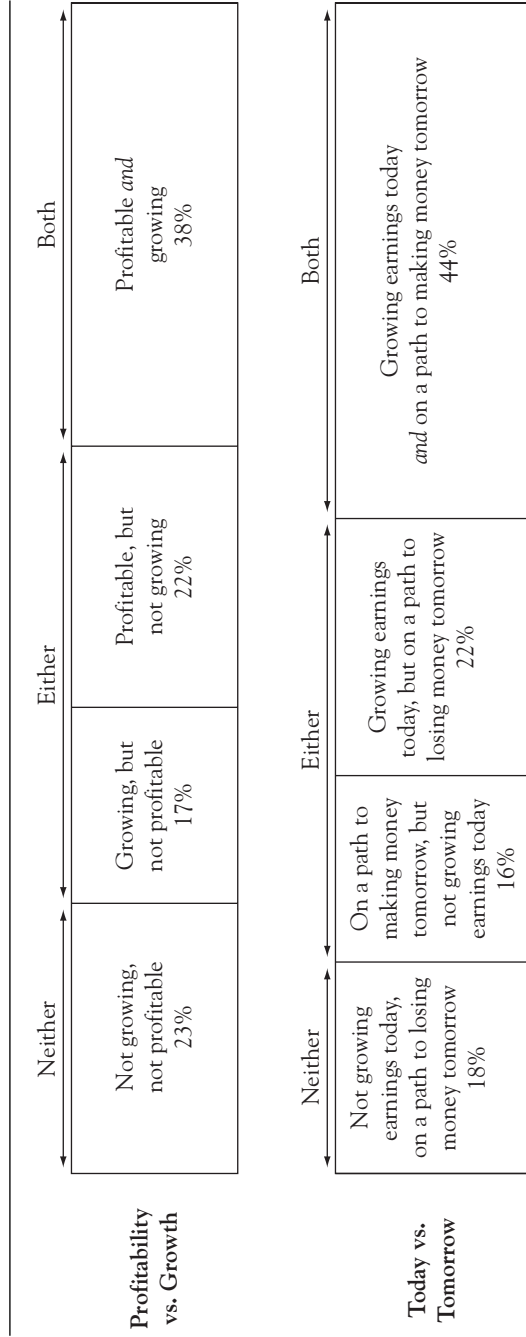
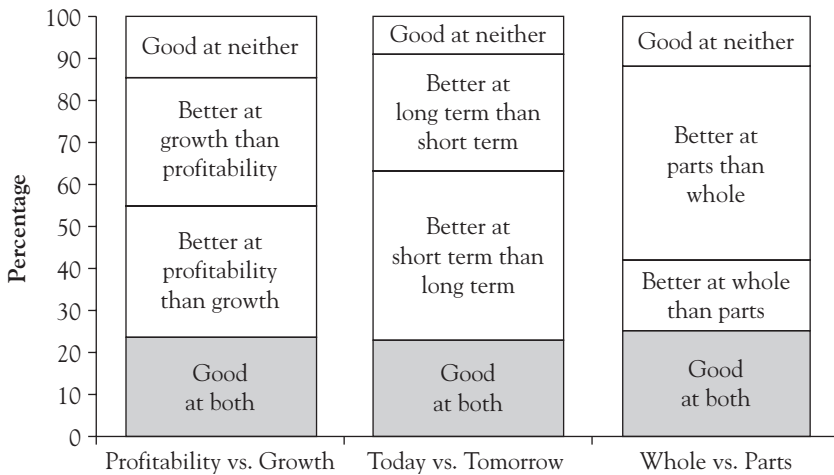


FIGURE 1.3. PERCENTAGE OF EXECUTIVES SAYING THEIR COMPANY IS . . .



performance relies on investments that inescapably depress short-term performance. The better a company is at making each of its constituent parts a specialist in its own field, the greater the attraction for competitors to provide a generalist “all-under-one-roof” offer across the whole. And vice versa. For each of the three tensions, trade-offs between objectives are unavoidable. They almost seem to be part of the “invisible hand” of competitive markets.

These factors alone would make the corporate cycle hard enough to escape. The overall cycle of the economy makes the challenge even more arduous. Periods of economic prosperity create the funds for investing in long-term growth, which can lead to overcapacity, which depresses profitability, which reduces long-term investment. And so on.

Moreover, the typical life cycle of a business conspires against those who would score a high batting average on each tension. As they move from birth to maturity, individual businesses and whole industries naturally have growth stages and profitability stages. They move from investing for their future to harvesting and reaping the rewards in the here and now. Particularly at each end of the business life cycle—start-up and close-down—achieving both

short-term and long-term results and both profitability and growth is just not possible.

What is more, different types of people are suited to different tasks. The manager suited to the task of finding growth is different from the manager suited to boosting profitability; explorers of the future are made differently from exploiters of the present; autonomous entrepreneurs are fundamentally different from those who want to belong to a larger corporate whole. Company cultures find it hard to embrace such different types of manager with equal warmth at the same time, hence the difficulty in achieving many performance objectives concurrently. A culture of risk taking and experimentation does not sit well alongside a culture of standardization and best practice; a culture of execution sits unhappily with a culture of vision; and a culture of autonomy does not fit well with a culture of working in teams.

The political behaviors inside companies push and pull across the tensions as well. What has been termed “the institutional imperative”² to protect and increase the scope and scale of the activities in your ambit or empire competes with the pressures to produce profits. The desire for new resources leads managers to promise future performance in exchange for permission to forgo earnings today. The suspicion that managers are “sandbagging” their resource requests—asking for more than they know to be necessary—leads their bosses to insist on a rapid return from those investments. Managers value their independence and freedom from interference, but their bosses feel they cannot justify the existence of the company as a whole or their roles in it without adding something beyond the summation of parts. And it is only human nature for new leaders to assert themselves by swinging the pendulum in the opposite direction from the last guy. The laws of politics are just as effective in dividing one objective from the other as are the laws of economics.

The pull of the corporate cycle will always be strong, some may argue. It is the natural rhythm of business. And it’s not at all clear that making choices between objectives is always a bad thing. Good performance on one objective will be worth more than good performance on the other. It makes sense to grow and then consolidate and work on profitability, and then go for the next phase of growth. Accepting losses now is part of creating profits later. There

is a time for giving priority to the performance of the parts, and a time for putting first the performance of the whole. Such choices, it is argued, are vital to the natural development of high-performing companies.

Furthermore, choice gives you that most precious of management commodities: focus. With a clear focus on growth, for example, managers can shape measures, targets, remuneration, structure, vision, processes, culture, and all the other tools at their disposal in a common direction. Choices between performance objectives are not just inevitable. The right choices are good business. Good management is all about making the right choices. Right?

THE LINK BETWEEN BATTING AVERAGE AND TOTAL SHAREHOLDER RETURNS

Well, perhaps not. A test of good management is what happens to the performance of the company on the capital markets over time: what happens to total returns to shareholders (the change in the value of investors' money through share price appreciation with dividends reinvested). If making choices between performance objectives were good business, you might expect there to be no correlation between batting averages—a measure of how often such choices are sidestepped—and total shareholder returns (TSR).

But, in fact, what you see is the opposite. Our main finding from our research is that *there is a close positive relationship between batting average and TSR*. The higher a company's batting average, the higher its TSR. The lower the batting average, the lower the returns. This is true for both of the tensions we can measure directly: profitability vs. growth and today vs. tomorrow (Figure 1.4).³

In fact, we found that batting average is a better proxy for TSR than revenue growth, economic profit margin, short-term earnings growth, long-term growth in economic profits, earnings-per-share growth, price-to-earnings (P/E) multiple, return on capital, or any other single measure of performance you might care to mention.

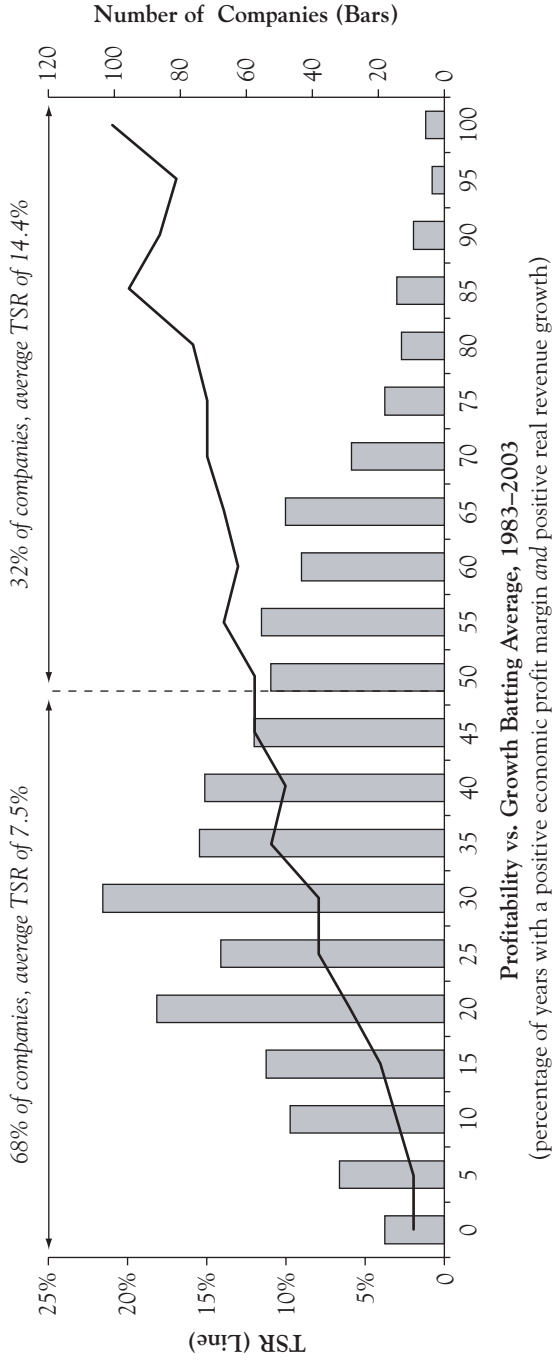
Companies with batting averages below 50 percent have lower economic profitability (c. -1 percent vs. c. +3 percent) and slower revenue growth (c. 6 percent vs. c. 11 percent) than companies with batting averages above 50 percent. And companies that bat less than 50 percent generate half the TSR of companies that bat over 50 percent.

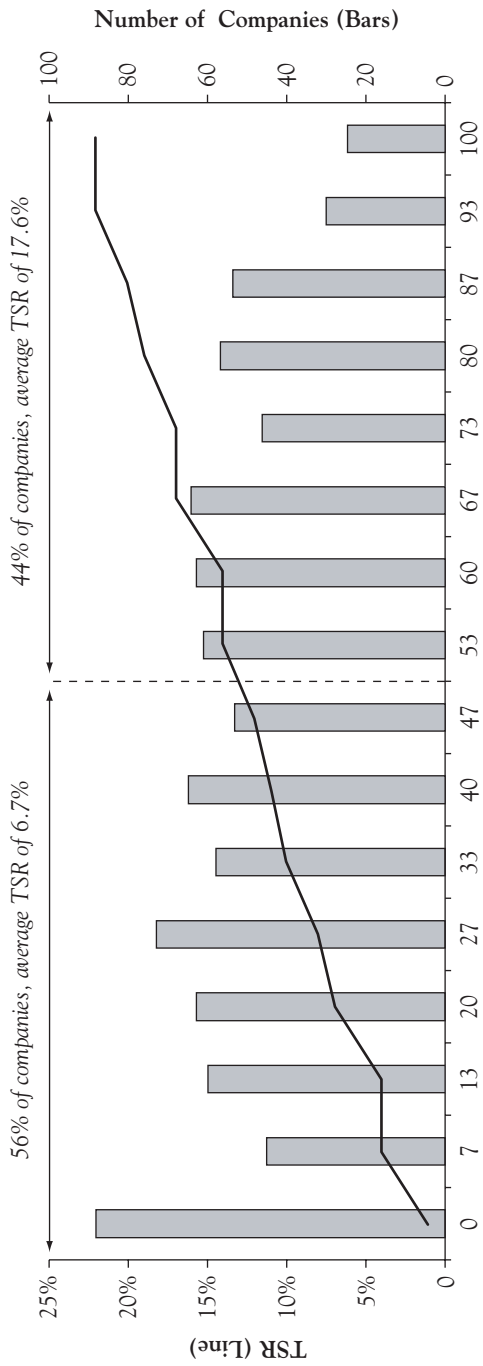
This is a strange result, on the face of it. Students of capital markets generally agree that over the long run, the market value of a company gravitates toward its economic value: the sum, in today's money, of all future cash flows or, equivalently, of all future economic profits plus current capital.⁴ Movements in a company's share price reflect changes in market expectations of *prospective* profits. But batting average is a *retrospective* measure, and it does not take account of the *amount* of profits expected over time.

That batting average correlates with TSR, despite these differences, suggests that a track record of avoiding performance compromises is much more important to the assessment of a company's future profit potential than at first would be imagined. Perhaps this should not be so surprising. After all, the two objectives in each of the three tensions are not independent of each other: poor performance on one objective will drag down performance on the other. Growth without profitability eventually stalls because it cuts off the reinvestment needed to keep growing. Profitability without growth eventually undermines profitability because it denies managers the scope and scale needed to fuel further efficiencies. Earnings in the short term eventually dry up without investment to keep them going into the long term. And long-term viability and health can be undermined by poor performance in the short term. The ability to get the most out of each part of the business ultimately relies on the ability to share and coordinate learning and talent across the whole; the ability to benefit from coordination across the whole relies on having high-performing parts with which to share.

The opposite is true as well. With the appropriate management, the better the performance you achieve on one objective, the better the performance you can achieve on the other. Higher growth brings with it the potential for using the benefits of scale to improve profitability; higher profitability increases the funds for

FIGURE I.4. THE LINK BETWEEN BATTING AVERAGE AND TOTAL SHAREHOLDER RETURNS.





Today vs. Tomorrow Batting Average, 1983–1998
 (percentage of years with higher earnings than previous year and positive cumulative economic profits over the next five years)

new growth investments and lowers the sales volumes at which those investments start to be justified—and therefore pursued. Better short-term performance increases the investment available for the long term; a business that is in better shape for the long term will have more opportunities for better short-term performance. Better-performing parts of the company create more opportunities across the company as a whole because there are more strengths to share. Good performance on one objective naturally creates opportunities for good performance on the other.

This interdependence may well explain why we observe this very clear positive relationship between batting average and TSR. What the capital markets prize the most are companies that provide evidence of *sustainable* performance. Investors will judge good performance on one objective as more likely to last if it is accompanied by good performance on the other. The capital markets just don't believe that good performance on any one objective will last if it is accompanied by poor performance on another.

By implication, management should not be considered just a science of making the right choices among many performance objectives. It should also be the art of avoiding the need to choose in the first place.

HOW BATTING AVERAGES VARY BY INDUSTRY

Which companies manage to achieve high batting averages? Surely they must be in industries that are profitable and growing, that are attractive, stable, and not prone to cyclicity. In other words, they must be in *industries* with high batting averages. Well, the answer is not what you might expect.

Some industries do indeed have higher batting averages than others. For instance, the batting averages in the natural resources sector are much lower than those in the pharmaceuticals sector. But high- and low-batting-average companies can be found in all industries. For example, between 1985 and 2000 Nucor Steel scored a batting average on profitability vs. growth of 50 percent—double the 25 percent long-term average of the natural resources sector. Nucor's performance was considerably better than pharmaceutical firm Aventis, which scored only 25 percent in an indus-

try that averages 53 percent. In fact, in every industry and on both measures, there is a bigger difference between the performance of the worst company and the best company than there is between the performance of the worst industry and the best industry (Table 1.1). When it comes to batting average, differences *within* industry dominate over differences *across* industry.

Ranked seventeenth, the automotive sector is trapped in the corporate cycle more than most. GM's performance was actually about average for the sector on both batting averages (30 percent vs. 34 percent for profitability vs. growth; 33 percent vs. 28 percent for today vs. tomorrow). Here too, the differences within the industry are striking. For instance, German carmaker BMW achieved both positive economic profitability and real revenue growth in ten years out of the twenty—a batting average of 50 percent. On the other end of the scale, Japanese automotive company Daihatsu managed to achieve both at the same time in only half as many years: a batting average of 25 percent. These differences in batting average line up with the differences in TSR: BMW earned the highest TSR returns at 14 percent, Daihatsu earned 4 percent, and GM stood in the middle with annual average returns of 8 percent.

Despite some important industry differences, batting average is much more tied to individual companies than to the industries in which they operate. There are companies that are able to escape the corporate cycle in the industries you would least expect it to be possible, and there are companies in the most promising industries that score very low batting averages.

ESCAPING THE CORPORATE CYCLE

The corporate cycle is the result of economic and political forces and management practices that make it difficult for a company to achieve many performance objectives at the same time. Batting average is our measure for how trapped a company is in the cycle. By this measure, around three-fifths of companies are somewhere in the corporate cycle at any point in time.

Yet escape is the path to superior performance. Our finding is that batting averages correlate with TSR. TSR reflects how far a

TABLE 1.1. BATTING AVERAGES BY INDUSTRY.

<i>Industry</i>	<i>Rank Order</i>	<i>Profitability vs. Growth</i>		<i>Today vs. Tomorrow</i>	
		<i>Industry Average (%)</i>	<i>Industry Range (%)</i>	<i>Industry Average (%)</i>	<i>Industry Range (%)</i>
Pharmaceutical and biotech	1	53	15–85	65	13–100
Retail	2	52	0–100	57	0–100
Business support	3	46	15–75	61	33–100
Health care	4	52	25–85	54	0–93
Consumer goods	5	43	5–100	60	0–100
Publishing, printing, and photo	6	43	5–70	55	0–87
Banks	7	46	0–100	51	0–100
Utilities	8	36	10–75	56	7–93
Other financial services	9	42	0–85	48	0–100
Insurance	10	42	0–90	45	0–93
Telecom	11	40	10–85	43	7–87
Construction and property	12	38	0–85	41	0–87
Electrical equipment	13	34	0–70	43	0–100
Manufacturing	14	34	0–80	40	0–100
Chemicals	15	31	5–85	43	0–100
Diversified industrials	16	32	0–95	40	0–100
Automotive	17	34	0–80	28	0–100
Oil and gas	18	33	0–60	28	0–73
Entertainment	19	30	0–90	27	0–93
Transport	20	26	5–65	27	0–87
Computing	21	29	0–70	22	0–87
Natural resources (not oil and gas)	22	25	5–50	25	0–73
All 1,000 companies		38		44	
Difference across industries		28		43	
Difference within industry			76		91

Note: Rank order is based on both batting averages.

company manages to break free of the three tensions that set the corporate cycle in motion.

To be sure, many of the forces that make the cycle so powerful are outside of management's control. They come from how markets and economies work and from human nature itself. The cycle will always be difficult to escape; its gravity will always work to pull you in. The cycle and the tensions that form it are shaped by powerful forces to which no company is immune.

But companies in the same industry share the same environment, the same external competitive forces, the same phase of industry life stage, and the same basic struggles of human nature within their organizations. Yet differences in batting averages *within* industry dominate over differences *across* industry. There are companies who are able to escape the corporate cycle in all industries. If general economic and political forces are so dominant in explaining the cycle, why is it that different companies in the same industry achieve such markedly different performance?

The only explanation is that some of the forces that trap companies in the corporate cycle are avoidable. Some companies are falling into traps of their own making; others are managing to step around them.

In the next three chapters, we consider each of the three tensions that form the corporate cycle. For each, we identify what can make compatible the pair of objectives within each tension—the common bond. We look at the traps that managers can fall into that break these bonds and what leadership teams can do to sidestep these traps. If leaders remain unaware of both those common bonds and those traps, their companies are unlikely to be able to break out of the snare of the corporate cycle. Struggling will only make it worse.