

When Things Change

By Russell Redenbaugh and Natalia Davis

Clayton Christensen's remarkable book, *The Innovator's Dilemma*, examines "why outstanding companies that had their competitive antennae up, listened astutely to customers, and invested aggressively in new technologies *still* lost their market leadership..."¹ Christensen's work produces a profound insight and a great place to examine the question, "If we are a great company, or are invested in great companies, is enough being done to maintain greatness?" Digital Equipment, IBM, Compaq, Sears, Xerox, Polaroid, Lucent, Nortel and Kodak were great companies. Most of these companies failed suddenly and they failed because they listened to their best customers and ignored what happens when things change.

To make Christensen's insights a valuable tool for investors, executives and strategic consultants, an understanding of investment, economics and corporate behavior are imperative. In this article we introduce methods for anticipating and responding in time to what happens when things change.

Anomalies Can Kill

Looking back it always seems obvious. Kodak and Polaroid were killed by digital photography. The PC destroyed DEC and damaged IBM. Dell then destroyed nearly everyone else. All of these seem obvious now, but by the time they were apparent it was too late for executives to save themselves or their companies. Moreover, investors were unable to avoid the great destruction of wealth.

Trends, although they tend to stay in force, are always self-terminating. If this were not the case, the best strategists and the richest investors would be those with rulers. The mechanism of free markets is that they seek to disrupt and terminate the trends that show the accumulation of power and monopoly rents by others. These trend busters are like rust; they never rest! Sometimes they are two or three engineers in a garage, (as in Apple computers) or perhaps they are backed by venture capitalists; once in a while they are your smallest competitors; occasionally, the threat comes from outside your industry from an innovation seeking a new market (as in the case of the transistor killing the vacuum tube or the compact disc eliminating the vinyl record).

If you are a company leading your industry, collecting monopoly rents, with high barriers of entry for your competitors and high barriers to exit for your customers, you can add "your customers" to your list of potential trend busters. For example, if you make something like high performance, highly engineered capital equipment for a power plant, a four color printing facility or the process tools for a semiconductor fab, it is very likely that your customers are in "resentful bondage." By "resentful bondage," we mean that your customers are begging your competitors to beat you. They are eager to have choices. They are encouraging and possibly financing your competitors. They are plotting the demise of your profitability.

Economics: A New Common Sense

Trends are the footprints of the accumulation of power or, on the gloomy path, the loss of power. Trends shout! They trumpet their success. A Microsoft and an Intel are obvious examples of monopoly rents. Although trends shout, the little anomalies that signal the beginning of a new trend or the ending of an old trend only whisper. In fact, most anomalies are just that, a

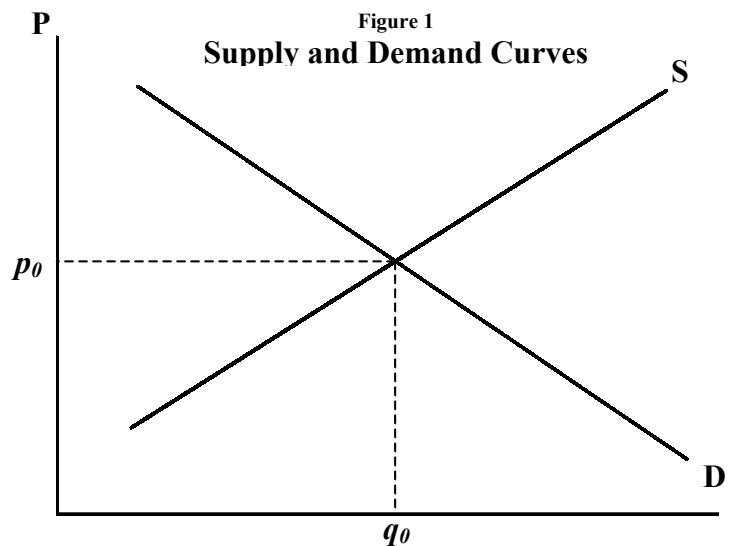
momentary whisper that disappears and is never heard from again. A few anomalies do grow and start a new trend crowding out the “old.” These anomalies then become disruptive.

The trends in excess profits or monopoly rents can be thought of as trends of power. Stock price changes are influenced very little by earnings, instead they track shifts in power, also thought of as future earnings. Power is defined as a differential in an organization’s capacity for action. Power is always a zero sum game. For example, if a company or industry is gaining power it is at the expense of other factors in the market: power relative to competitors, vendors, employees, customers, etc. Remember when the “new economy” was, for a time, gaining power at the expense of the “old economy”? Of course, the resentful “old economy” fought back. (See “Good Vibrations” Sept/Oct 2001 Shareholder Value Magazine)

The key to identifying future excess profitability or monopoly rents is not in the demand curve (Figure 1). Most investors and executives have the wrong common sense around this. They are drawn to high growth markets believing that high growth in demand will lead to high profitability. Great business leaders, like Jack Welch, know that high demand growth may only encourage high supply growth. Welch understood that power is not merely high growth but the interaction of supply and demand. This is indicated by the shape or slope of the supply curve.

For example, a flat or horizontal supply curve means that any change in demand will be accommodated by a change in quantity supplied, not a change in price. Investors hate these flat supply curves. Somebody else supplies all the increase in demand and profitability remains

marginal. On the other hand, a steep supply curve means that an increase in demand will lead to an increase in price and an increase in profitability. The world hates a vertical supply curve and will do everything to kill it because a vertical curve indicates an incredibly powerful monopolistic firm.



Are we in Trouble?

How can we know in time and what are the anomalies that will quietly announce a trend? A trend that transfers power from the “old” to the “new,” keeping in mind that the “new” may be outside the “old” industry, over the horizon and under your radar. Below is a partial list of signals or anomalies that may indicate that the trend busters are at work.

- Relative stock price declines (Your stock price relative to your competitors).
- Relative profitability declines (Your profitability relative to your competitors).
- Your smaller customers “make the mistake” of buying the competitor’s “inferior” product.
- Market share declines or you redefine the market to show that you are actually gaining market share.

Relative stock price declines

Chart your stock versus each of your competitor's, especially, the upstarts. A sustained decline may reveal a loss of power as well as shareholder wealth. Start the investigation.

Relative profitability

This is the relative profitability to your competitors and other companies. This is a critical indicator as it measures your company against other investment options. You are in competition with other companies for shareholder dollars.

Customers make the mistake of buying the competitor's "inferior" product

Your sales people report that the "dumb" customers are making the mistake of buying the competitor's "inferior" product and to counter we need either a price cut or more features or both. This is further evidence that the point of competition or the value proposition (what the customers will pay for) is shifting. This has implications for product design, as you may be making the product not only too costly but you may be "overshooting the market."ⁱⁱ This also implies that your business processes, organizational design, staffing and strategy are tuned to support an offer that is no longer valuable. This doesn't mean that customers don't want the product. They are just unwilling to pay all of your costs and a monopoly profit for it. In short, the cost of great engineering, customization or highly featured products has moved from the customer's income statement to yours. Often this triggers a cost-cutting, supply management initiative focused on squeezing your suppliers. Though this is a necessary housekeeping initiative, it will never be enough. The problems usually lie with the design and delivery of a product that your customers used to be willing to pay for.

Market share declines or you show that you are actually gaining market share

Market share declines or is maintained by redefining the market. Explaining that you do not compete in that low margin but growing part of the market may indicate trouble. Remember it was Kodak and Polaroid who proudly announced that they didn't compete in that low quality digital photography part of the market.

This is a partial list of the characteristics of companies under attack from what Christensen calls, "disruptive technologies." It is a useful tool in evaluating a company's current situation. The next step is to prepare for change and take action.

Preparing for Change: Corporate Behavior and the Davis 10/10 Rule

Corporate change is extremely difficult and is possible only when there is a clear threat to survival. To explain this, let us look to nature. All organisms, at the cellular level, at the level of the individual and at the level of the organization, resist change. This "conservation of adaptation," as biologists call it, can be seen clearly at the cellular level. Homeostasis is the term that describes the elaborate set of systems that any living organism uses to maintain temperature, pH and chemical balances in very narrow ranges. The corporate biology or culture is also very resistant to change. Davis postulates a 10/10 rule, that is, if you ask for greater than a 10 percent change in behavior there had better be at least a 10-fold advantage, AND the advantage must benefit those who are asked to change. Said another way, the incidence and burden, or, the cost of change and the benefit of change, must be aligned and occur in the same group. For example, we cannot ask manufacturing to bear the burden or cost of a dramatic change if all that benefit is captured in sales or in service and warranty.

In our work with companies we never ask for more than a 10 percent change. We believe that most successful companies are doing at least 90 percent of things right. We tweak the remaining 5-10 percent to “steepen” the supply curve, to extend the trend of monopoly rents and hold off the competition. Quite frankly, we don’t ask for much change because we know that change is difficult. Adaptation in nature is usually based on survival. We find it to be the same in corporate organizations. Their very survival, not only profitability and stock price, needs to be at risk in order to bring about significant change in many companies. Often, they move too late. As with nature, only the fittest survive.

Once you have a company’s attention and you have gone through the strenuous task of aligning incidence and burden, or costs and rewards, to each initiative and program, there is still the arduous task of implementation ahead. Have any of you tried to learn a new language, embark on a new diet or master a martial art? It’s quite difficult isn’t it? One starts out clumsy. Well, that’s how it is for companies. Few go on to succeed with these new endeavors. Just as many of us have never taken the time, nor endured the embarrassment, of learning a new language, losing those last few pounds or mastering karate.

Taking Action: Ready, Aim, Fire Vs. Fire, Ready, Aim

As an executive, if you find your company suffering from market share declines or declining margins it’s necessary to diagnose the problem correctly and quickly. Competitors are always looking to break monopolies. One must take decisive action to combat trend busters.

- If you are in trouble with a sustained decline in relative stock price and margin pressure coming from suppliers and competitors, make two critical assessments:
 1. Have things changed?
 2. Can they be fixed?Insiders have a very difficult time answering these two questions with a ruthless honesty.
- Rediscover what customers’ value and pay for, not what they want. Has the point of competition changed? If so, what organizational design, structure and staffing would be the ideal to support that kind of business?
- Make a focused, simple diagnosis.
- Design for minimal change. Remember the Davis 10/10 rule
- Align incidence and burden. Remember incentives.
- Measure and reward for results

Lastly, let us say that good leadership is key to success. As investors we look for CEOs who see the world in the way that we have described. They don’t over promise. They are realistic dreamers. Some of our favorites in the past have included David Pottruck and Charles Schwab of the Charles Schwab Corporation, Richard Fairbank of Capital One and, of course, the inimitable Jack Welch formerly of GE. All have brought exceptional returns to their shareholders in the past.

Rather than predict the next great leaders and companies, we have given a partial list of their characteristics in previous Shareholder Value articles. In summary, great business leaders will

focus on power rather than current reported earnings. They will work continuously to steepen the slope of the supply curve. They will be more than paranoid regarding the threat from trend busters. They will live in and for the concerns of the customers. They will design strategies that customers will value and that mere mortals can implement. They will incent and reward their employees. They will have a deep respect for how hard it is to fix something by the time it is really broken. Accordingly, they will work for continuous improvement in the things that really matter.

ⁱ Clayton Christensen, *Innovator's Dilemma*, Harvard Business School Press, 1997.

ⁱⁱ *Ibid.*