Feeding the Flames

What every manager needs to know about creative destruction. An interview with McKinsey's Richard Foster.

Russ Mitchell 05/01/2001 issue

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Plenty of management quacks have written shelves of buzzwordy books containing nary a lick of research to back up their pontifications. Richard Foster is not one of them. A well-schooled engineer and scientist (he has two patents related to plasma catalysis), he bases most of his management theories on a database of more than 1,000 companies in 15 industries tracked over almost four decades.

Richard Foster: Dare to destroy. Photo: Seth Kushner

Known as the McKinsey Corporate Performance Database, it follows the performance of mostly U.S.-based companies and the stock markets. Foster, a longtime senior partner and director with consultancy McKinsey & Co., says the database "mimics the real economy with exceptional fidelity."

He reveals his findings in a new book. The title is a lengthy one: Creative Destruction: Why Companies That Are Built to Last Underperform the Market-And How to Successfully Transform Them. Thankfully, the prose is concise and the message is clear: Companies need to get a lot better at innovating, and they've got to get a lot more committed to destroying what doesn't work to clear the ground for the stuff that does. The book owes its inspiration to the late, great, but relatively unknown economist Joseph Schumpeter, who described the inevitable process of entrepreneurial capitalism as "the gales of creative destruction."

Readers with some gray in their hair might remember Foster for his classic 1986 book, Innovation: The Attacker's Advantage. Young fans of Harvard Business School Professor Clayton M. Christensen's widely acclaimed The Innovator's Dilemma would benefit from reading Foster's earlier book, too, which holds up 15 years later. In Creative Destruction, which he co-authored with former McKinsey consultant Sarah Kaplan, Foster demonstrates that no long-term surviving companies covered in the database were able to beat the Standard & Poor's 500 index over an extended period. The research also revealed to what extent the markets chew up and spit out companies that can't make the grade.

In 1926, the S&P 500 had a turnover rate of about 1.5 percent. Back then a company stayed on the list an average of 67 years-theoretically you, your parents, and your children could have worked for the same company for your entire working lives. Now the turnover is 8 percent to 10 percent, meaning the average company life cycle on the S&P index is 10 to 12 years. No longer could your parents and your children work for the same company all their working lives and expect it to remain on the S&P list-you couldn't.

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According to Foster, companies truly concerned about performing at the level of the capital market indexes and not mere survival-and just about any publicly traded company has been forced into that category these days-must "change at the pace and scale of the markets." And they must engage in creative destruction to do so. Focusing on operational excellence is a prerequisite to high performance, but it is not sufficient.

We spent a recent afternoon in Los Angeles talking with Foster about his book, and followed up with some email dialogue. Here's Foster:

If a company wants to achieve high performance over the long term, it has to perform at the level of the capital markets. That means providing return for investors at the same level as the overall capital markets. To do that, companies have to change at the pace and scale of the capital markets. And they don't.

The capital markets are remorseless. They encourage creation of corporations and then rapidly and remorselessly remove them when they don't perform. Stock indexes like Standard & Poor's 500 are not static; the index is based on performance. Companies are added, companies are dropped from the list. Of the 500 companies that made up the S&P 500 in 1957, only 74 remained on the list through 1997. Of those 74, only 12 outperformed the S&P index itself over the 1957-1998 period.

The management philosophy of corporations is based on the assumption of continuity, with a focus on operations. They are not able to change at the pace and scale of the markets. So, in the long term, they don't create value at the pace and scale of the markets. Capital markets are built on the assumption of discontinuity. Their focus is not on operations, but on creation and destruction.

To perform closer to the pace of the markets, companies will have to become masters of creative destruction-built for discontinuity, remade like the market. The great Austrian-American economist Joseph Schumpeter anticipated this transformation more than half a century ago when he wrote: "The problem that is usually visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them." The prescription is to increase the rate of creative destruction to the level of the market itself, without losing control of present operations. This has proven exceptionally difficult to implement.

Companies tend to move from early passion to "rational analysis" and then into the trap of denial. A few notable corporations have attempted to break out of this pattern-General Electric, Johnson & Johnson, Corning (GLW, info), Enron (EXG, info), for example.

But most companies eventually find themselves in a cul-de-sac of mediocrity. One way companies try to deal with that is to revitalize themselves by attempting to create transformational innovation-but without changing themselves to any degree. This is usually unsuccessful. A second option is "cashing out"- liquidating the corporation through a sale of assets to another corporation. This rewards current shareholders, but clearly leaves the company moribund in the long run-a target for acquisition.

A third approach is to tackle creative destruction on a substantial scale. Corning did this-it moved from cookware and glass products into fiber optics. Enron did it-moving from a natural gas pipeline company to a trader of natural gas and other commodities. Both companies sought not only to destroy their existing business, but to use their skills to create new businesses and new revenue streams. While they destroyed their current business, they knew their new business was there and that they could survive the crossing.

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Creation

Companies rarely distinguish between different kinds of innovation, and they get into trouble as a result. You can think of innovation on three levels.

The first is "transformational." This is in line with Schumpeter's concept of a "historic and irreversible change in the way of doing things." The second is "substantial," less in surprise and scope than transformational innovation, but still something that upsets the conventional order. The third is "incremental," which I've said is the everyday engine of change for most companies. We believe the scale of innovation is logarithmic. In other words, a substantial change is often 10 times greater than the change resulting from incremental innovation. And transformational innovation is 10 times greater than that. Transformational innovations tear at the social fabric and economic markets far more than incremental innovations do.

Managing innovation is impossible without understanding which layer of innovation one is dealing with. Storage Technologies got into trouble this way. Among other errors, the company tried to compete against EMC in RAID storage (a fast, high-end storage system) but used the same processes that delivered incremental innovation for this transformational effort. They were inadequate to the task.

The National Science Foundation provides annual industry statistics on the percentage of products that are new in the past five years. For the high-tech industries, the rates are 40, 50, 60 percent, something like that. But if you look close at what the companies include in their definitions of new products, and I've been able to do that in a few corporations, the companies themselves would classify 80 percent of the changes as incremental, not substantial or transformational.

Well, you don't get on the S&P 500 because you're doing something incrementally different from the companies that are already on there, because if that's all your business is, you get murdered along the way. You've got to produce substantial or transformational innovations if your company is going to get on that list. Things like the new process for steel-making Nucor launched in the 1970s; laparoscopic "keyhole" surgery, developed by Johnson & Johnson in the 1980s; MCI's "Friends & Family" long-distance service; Enron's creation of a natural gas trading market.

Destruction

When we say change at the pace and scale of the market, I think many people would assume that means creating new things at the pace and scale of the market. That's one of the two things I'm talking about, but the other one is trading out-whether through asset sales, stock spinoffs, layoffs, the shutdown of a project. There is a lot more viscosity around trading out than there is around creating.

There are few things more emotionally upsetting to people than the thought of shutting down a company or a division, or of firing a large group of people. Intel (INTC, info)'s decision to exit the DRAM business in the 1980s to focus on microprocessors is an important example of a company that was willing to go through the transformational pain of trading out a business that had been fundamental to its current strategy.

Talk of destruction triggers fear and foreboding, as do thoughts of Al "Chainsaw" Dunlop, whose performance as CEO of Scott Paper and Sunbeam made his name synonymous with destruction.

I want to be clear that by destruction I don't mean death as in the Judeo-Christian tradition, but rather a transformation as in the Hindu tradition. Looked at that way, destroy really means something much closer to trade than obliterate. It clears the ground for new creation, to allow for an increase in the "freshness" of a corporation: DRAM chips traded out for microprocessors.

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Trading out includes dramatic decisions like selling or shutting down a project or a group. A spinoff is a milder form of trading out. This kind of destruction is not the same as a corporate restructuring: Restructuring is a normal operational responsibility for a corporation. You can restructure to increase growth or profit, but the intent is to continue to actively manage the existing enterprise-not to spin it out to increase the capacity for creation.

When Schumpeter wrote about "gales of creative destruction," he was describing about the fate of collections of companies, old companies being replaced by new ones. Schumpeter, I am sure, would have anticipated that even companies in new industries that have lost their edge over time would be eliminated. As we say in the book: "The future will tell whether the junior executives at Intel, those who aggressively fixed the DRAM dilemma, will now be able to muster the courage to overcome the cultural lock-in regarding the personal computer industry that now sits on the edge of the campfire."

Cultural lock-in

There is this phenomenon that we describe in the book as cultural lock-in, where, when you get started as a new company, it's all passion. It's a lot more passion than rationality. Any rational person wouldn't have done it, and there are a lot of the so-called dot-bombs now that would tell you that's the case.

Some of them have luck and wisdom and they grow into a large company, and the rationality comes in. And they're still very accepting of information and good analysis. And pretty soon, if you make it through that phase, and you get big and grand and great, you begin to really think that you know what you're doing, which in the markets is always a very dangerous assumption to make. And consequently, you start rejecting information, and denial comes in as the dominant kind of emotional state of the organization.

At that point the difficulty of change has skyrocketed. The prescription is not to get into that state, though that's where most corporations end up. But you can avoid that state. And one of the ways to avoid it is to focus on this trading-out function. So you get a fresh supply of people, a fresh supply of businesses, and you keep the overall freshness of the corporation at ever-greater levels.

You can almost see a corporation that's kind of getting into incipient trouble if the average age of the population is going up year by year. You can absolutely watch it happen. And you won't find it in some of these companies that are trading out faster.

Divergent thinking

Most corporations that are focused on operational excellence have become very good at answering a standard set of problems in a very efficient way. It's almost like, "What number problem do we have? Oh, it's 897, go to the book on Page 897, it'll tell you the 10 steps to take." Call it convergent thinking. They're tapping routines that we know, that have already been there. Convergent thinking is essential to operating a company. But for high performance, it's not enough.

The opposite of convergent thinking is divergent thinking. Divergent thinking doesn't start with a well-characterized problem. The first step is to figure out the problem. And that's much more characteristic of the creative process, whether it be in art or science or whatever.

The greatest scientists spend a lot of time figuring out what problem they're going to take on before they take it on. Often if you have a very tough problem, the problem and solution emerge simultaneously.

All of a sudden one day you have that so-called eureka phenomenon, the aha business. That's because you've seen both the problem in its clarity and the solution. That's a totally different process.

Problem-solving requires an incubation period. Often there are so many things going on in your mind, you might get the great idea this afternoon or two years from this afternoon. That kind of process, divergent thinking, does not lend itself to the same kind of expertise as operations does. It's just totally different.

Consequently, that kind of process takes place outside the corporation. It can take place in universities. Or with unemployed individuals. It can take place with consultants who go home at night with their pals and try to figure out how to start their own business.

It can take place in the corporation, but more easily within the markets themselves. Then when you've got one of those good ideas, you run to your local venture capitalist or the bank or whoever they happen to go to, and get money. And that's where the new ideas come from. I think the challenge for the existing operational company is to combine convergent and divergent thinking.

Middle managers

Our message is not only for CEOs and top strategists. I think there are lots of messages in here for middle management. First, this is the economic system in which you compete. So you want to be doing this in your organization. There's no level too low. You can do it in your daily life if you so choose. So it can operate on any level.

Second, if you think this isn't occurring in your division, start raising the issues with your senior managers. Talk to them about it and don't let go until somebody convinces you that either the ideas are wrong or the adequate action program is in place.

Admittedly, a CEO who risks billions on behalf of his company, but has a long-term contract, is not risking as much as the lower level project manager who may lose his job if the project fails.

Renewal Some people say, "God, this creative destruction stuff is a depressing thing," but I don't think so. First of all, it's real. I think reality may be depressing, though it's unlikely to be inherently depressing. But I think it's very energizing because it's arguing for the necessity of a higher rate of renewal for all of us.

I'm not trying to suggest this is a panacea for everybody. There are problems in this as there are in any other system. Admittedly, there are some people who won't be able to do it, or not want to do it, and we've got to be sure we take care of them in some way.

But for most people, I think it can be very energizing, very exciting.

Russ Mitchell is Editor in Chief for *Business 2.0*.

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