Why Deal Makers Go Astray

by Ram Charan

What fatal flaw is shared by many of today's corporate fallen angels, from WorldCom Inc. to Tyco International Ltd. to media conglomerates like Vivendi Universal? At one time, each was a darling of Wall Street and the business press for its daring strategy of growth, largely by acquisition. Now the CEOs who led the charge are gone and the companies are beset with huge debt, accounting questions, tumbling stock prices, bankruptcies, and even criminal investigations. A single shared attribute led them astray: the deal maker's hubris.

Growth doesn't come easy. CEOs are under great pressure to produce results. To make a quick impact, many of them have articulated inspiring but impracticable visions, and have tried to achieve them by using acquisitions to juice up top-line growth. These leaders are deal junkies whose competencies include discovering clever ways of getting their deals done. Tyco's taxation expertise, for example, allowed its executives to outbid a rival to acquire the home-security firm ADT Ltd. through a complicated reverse merger that effectively relocated Tyco headquarters to Bermuda. Deal makers like these spend a lot of time cultivating relationships with key investment bankers and securities analysts, and have huge public relations machines, all in order to keep their stock prices artificially high. This garners glowing headlines, with CEOs heralded as godlike figures. But have they really created sustainable value?

More often than not, they haven't. Companies that pursue a growth-by-acquisition strategy commonly ignore the complex reality of adding operational value to the acquired companies. They see both revenue growth by acquisition and margin expansion by cost cutting as one-time events — believing the mergers, alone, equal success. Time after time, such companies fall apart when they don't earn back the merger premiums they paid, when they fall victim to crushing debt loads, or when their promises of revenue growth through operational synergies prove incorrect. Additionally, performance pressures create a temptation to skirt the rules of accounting and governance.

To be sure, acquisitions are an important part of a growth strategy. Corporations that balance acquisitions with organic growth, focus on the top and bottom lines, and use acquisitions to accelerate growth have had very positive long-term outcomes. This approach underlies the General Electric Capital Corporation's legendary growth. GE Capital has superb acquisition integration skills and uses integration teams drawn from multiple functions. A team's early actions are to identify and retain the best people in the acquired company, reach out to customers, and integrate growth-oriented assets such as the sales force — all of which must be done in 120 days. From the start, GE Capital works hard to cultivate its management discipline and values.

Contrast that with Tyco's growth-by-acquisition strategy in the late 1990s. Tyco used deals to power top-line growth and slashed costs to demonstrate profitability improvement for the short term. But it was not sustainable. Tyco bought companies that had little growth potential in the first place; it promised growth rates of 20 percent per year while buying businesses that were growing 5 percent per year. It simply cut costs and moved on to the next deal.

Then there are the new breed of deal makers — those who don't focus on cost cutting. Instead, they attempt to buy revenue growth through the convergence of disparate companies. Some media conglomerates were built this way. For example, Vivendi claimed that delivering content from Universal Studios and its myriad publishing groups through Canal+ and its other distribution channels would boost the conglomerate's revenues. But when the economy buckled, the fissures between the businesses became obvious. Now the Vivendi dream seems over, and some other media conglomerates are struggling under large debt loads, leaving their convergence promises unfulfilled.

By contrast, GE did not embark on the quixotic search for synergistic revenue growth when it acquired NBC in the mid-'80s. Rather, NBC became another business unit run just like the other dozen. GE brought in a management team of disciplined leaders and imposed its focused set of execution-related disciplines: planning sessions, reviews, informal dialogue, formal evaluation and development of people, and rigorous analytics. The result: NBC under GE has consistently outperformed competitors in terms of television ratings, return on capital, and revenues.

Every manager wants growth, but each should ask whether such growth is possible, let alone sustainable. Sustainable growth is both profitable and capital-efficient.

If those two conditions can't be met, and there is no room to grow in the market segment, then an M&A strategy is just a house of cards. And when it comes tumbling down, like WorldCom's bankruptcy under $32 billion of debt, it's not an act of God; it's the deal maker's hubris. ✚

The Art of Best Practice Transfer

by Paul F. Kocourek, Walter J. Mancini, and Matthew Calderone

Change programs designed to improve overall performance by promoting the highest standards in every unit of the organization can seem simple on paper but often fall apart once they hit the plant or office. Companies often have difficulty identifying good ideas and making them stick. As a recent front-page article in the *Wall Street Journal* said, "On factory floors, top workers hide secrets to success." The key is to design a

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change program that overcomes workers' natural resistance to committing three unnatural acts — sharing, collaborating, and using.

Workers resist sharing because they fear that efforts to make their company more efficient will mean fewer jobs, more work, and/or less overtime pay. They have difficulty collaborating to meet the challenge of documenting practices and determining which ones to implement across the company. And they often fight the use of best practices, succumbing to people's natural tendency to take a "not invented here" attitude toward adopting the ideas of others.

These challenges can be overcome. We have worked with a number of clients that have realized dramatic results through a structured approach that is inclusive, but does not encourage "letting a thousand flowers bloom." The challenge is to extract the maximum value from the minimum number of change initiatives with speed, precision, and certainty. Here's how:

1. Prioritize, locate, and analyze. It is management's job to choose the areas with the highest potential, identify the high performers within them, and document their potential best practices. Ideas must come from the workforce, but many workers lack the skills, initiative, or knowledge to both record their processes and compare them with similar ones from their peers. Data collection and analysis must be done rigorously.

2. Seed and manage debate. Engage a cross section of skilled workers in a structured process to determine which practices should be put into place across the organization. Challenge these "experts" to apply their cumulative knowledge and choose solutions that will provide the maximum value.

Combine longer-term process changes with quick hits that can be rapidly implemented and standardized.

3. Create and communicate incentives for change. Tell employees from the start what's in it for them. Often, nonmonetary benefits are the most compelling to workers; schedule changes, investments in labor-enhancing technology, and recognition from management can be much more powerful than a $100 quarterly bonus. Tie compensation to participation and impose sanctions for noncompliance.

4. Appoint influential field leaders. People whose opinions and actions carry the most weight should be involved early on to facilitate a smooth implementation of the change agenda. Clearly define roles for these local leaders, make them accountable for results, and rely on them in the best practice transfer stage. Transfer is almost always more labor-intensive than people believe; a network of people on the ground who understand the program is essential.

5. Back the program. Show that the company is willing to invest in promising ideas and provide the necessary physical resources and human capital to support knowledge transfer. Workers know when a corporate initiative has power, or when they can wait for it to blow over. Employees who take the risk of sharing their expertise need to be taken seriously. Those who are on the fence, or are resistant, must understand that change is coming, and that they need to either get on board or get out of the way!

6. Look for quick wins. Combine best practice initiatives that require longer-term process changes with quick hits that can be rapidly implemented and standardized. With quick hits, management and workers can test the change process, build trust, get immediate results, and celebrate success.

Knowledge transfer is tricky because it requires clear documentation, hands-on training and direction, a mechanism for ongoing tracking and performance measurement, and sustained support. Management must know what is negotiable and nonnegotiable before it kicks off a program, and be willing to stick to its guns. It may take months of conference calls and repeat visits, but if you declare success too early, desired changes will never be institutionalized.

Companies that effectively share best practices have boosted their bottom lines by as much as 20 percent. In a world where the competition is ever increasing, an effective best practice program can prove to be a powerful tool for driving world-class performance. +

The "Dos" and "Don'ts" of Options Grants

by Paul Oyer

Stock-option compensation plans have been at the center of public debate recently, but most discussions fail to consider a hidden value of options. While much of the attention has focused on how companies account for senior executives' princely stock-option packages, a more fundamental question is which workers should get options grants and why.

Stock-option grants are an important resource to help companies manage their compensation costs and retain employees at all levels. The classic justification for offering options is that doing so provides incentives that align employee and shareholder interests. For senior executives and employees of startup companies, the economics from stock options can be attractive, and thus serve as effective motivators. But the incentives built into most employee packages appear less than compelling. Indeed, the options held by a typical middle manager of a firm with 1,000 employees might represent a 0.01 percent stake in the company. Suppose those options induce him or her to frequently spend nights or weekends working. If that hard work created (an optimistic total of) $1 million of shareholder value over the course of a year, it would net the manager $100. That's not much of an incentive.

But just because options grants are unlikely to affect the on-the-job behavior of the rank and file doesn't mean options should be abandoned. An important and underappreciated benefit of stock options is that they can keep compensation in line with changes in market wages. In the late 1990s, for example, Silicon Valley engineers were in high demand, so their total compensation (in cash and options) rose dramatically. If those engineers had been compensated entirely in cash, their salaries would have been exorbitantly high. But large stock-option grants in a booming industry meant those engineers' salaries could be kept lower while their options became valuable. When the recession hit the region, engineering jobs became less plentiful. Likewise, the engineers' options became less valuable, and total compensation dropped. So while the boom and bust made dramatic swings in total compensation necessary, the use of options allowed companies to keep salaries relatively stable. Options fluidly adjust overall compensation, both upward and downward, in connection with the firm's and the industry's prospects, and thus can be an efficient mechanism to retain employees.

Which firms can benefit from this natural pay-adjustment process, and to which workers should they be issuing options? The best compensation strategy may be defined differently among different geographic regions, even for the same types of employees.

Consider two software companies — one in Palo Alto and the other in Chicago — each trying to balance cash salaries with stock-option grants for its accountants. Demand for accountants in the Palo Alto area is high when the technology sector is doing well. In this environment, the software firm should offer accountants higher options and lower wages. With stock options becoming more valuable in such boom times, these individuals would be less likely to move to another Silicon Valley firm. And the increasing value of the options gives the firm the flexibility to moderate salary levels and still retain talent that is in great demand. If the tech sector busts, the accountants' options would be worth less, but there also would be fewer opportunities for them to job hop.

Employee stock plans aren't always effective motivators, but they can still help companies manage compensation costs.

On the other hand, in the Chicago area, where the supply of accountants is large but high-tech firms are a relatively small employer, the software firm would be better off paying higher wages with lower options grants. If the Chicago firm issues options and pays less cash to its accountants, the accountants might become wealthy when the technology sector is doing well, even though the demand for their services would be unchanged. Significantly, however, if the technology sector and the firm perform poorly, the firm's accountants would suddenly find their cash compensation inadequate, and, with their options under water, many would leave the firm for other companies in Chicago.

Times have changed in the labor market, and firms should review their options-granting policies, not just their accounting policies. An employer that needs wage flexibility, and that has a market value related to its workers' market wages, should consider issuing stock options broadly. But remember that these options are not great for motivating recipients; the options are used to manage and smooth compensation costs as labor markets change. ✚

Global Warming: Perception Is Reality

by Robert Lukefahr and Tim Donohue

There are still skeptics, including many executives in corporate America, who roll their eyes with each fresh bit of news about global warming. But what they should be thinking is, "perception is reality."

In tracking the public debate over global warming, we've discovered a clear trend: Mainstream media coverage globally is both increasing and becoming more cataclysmic in its tone. Consider these recent high-profile stories: In March, MSNBC used dire language to describe the sudden collapse of two huge ice shelves in Antarctica ("Staggering End to Antarctic Ice Shelf"); in June, the BBC declared the severe African dry spell of the early 1990s a consequence of global warming ("West's Pollution 'Led to African Droughts'"); and in July, Reuters warned that if the Northern Hemisphere's glaciers continued to thaw, serious flooding could occur in cities like Miami ("Melting Alaskan Glaciers Raise Sea Level").

Still other accounts have said that because of global warming, an endemic dry spell may be in the offing, which could force the U.S. to import food. A skin cancer epidemic is another possibility.

Whether science ultimately produces hard evidence to support these stories is irrelevant. What should be of paramount concern to corporate executives is the power of this news to heighten public fears that the planet is heating up and that there will be frightening and unpredictable consequences.

Most corporate planners assume public opinion will evolve slowly. But one incident can catalyze a call for change.

If (or more likely *when*) these worries begin to have a decisive effect on public opinion, then people will likely begin to demand that companies take immediate steps to diminish global warming. Although there are no quick fixes to this problem, the economic impact on corporations could be swift and lasting.

Some companies are already preparing for this shift in public attitudes. Ford Motor Company will commercially launch a less polluting and more fuel-efficient version of its popular Escape SUV with a hybrid electric/gasoline engine by 2003. The Mitsubishi Motors Corporation recently purchased carbon dioxide credits from the Royal Dutch/Shell Group of Companies, a strong signal that Mitsubishi, like other corporations, is betting that the Kyoto Protocol requirements for reducing emissions will have to be taken seriously by businesses worldwide.

Many other organizations, however, will be caught flat-footed if global warming suddenly became a hot button. Most corporate and government planners assume that opinions will evolve slowly and their companies will have ample time to react and adjust. To see how shortsighted this notion is, corporate executives need only look back to the accident at Pennsylvania's Three Mile Island nuclear plant (TMI) in 1979, which had the nation on edge for weeks and effectively scuttled nuclear energy's rise as a dominant form of power generation. Most scientists concluded that the TMI incident had minimal short- and long-term environmental impact, and that U.S. nuclear plants had a better public safety record than any other sector of the energy business. But after the accident, nuclear power was viewed as unsafe — even though it wasn't. The nuclear industry has paid the price ever since.

Energy companies, part of a multitrillion-dollar industry that touches almost every aspect of the economy, would be the most vulnerable if global warming were suddenly on the front burner, primarily because carbon dioxide from fossil fuel (oil, gas, and coal) combustion is the chief source of human-caused greenhouse gases. If global warming were considered a clear and present danger, the public would demand alternative energy sources.

How significant would this be? Consider that a 30 percent drop in oil demand would make development of reserves outside the Middle East — that is, practically all the reserves held by public companies — uneconomical. Or that a 10 percent decline in U.S. gasoline demand would significantly reduce refining margins. The value of coal and coal-fired electricity generators — the largest source of carbon dioxide emissions — would fall even more abruptly.

But not every energy company would be hurt. BP, for example, could benefit because it is the world's largest manufacturer of solar-power devices and its portfolio is heavily weighted toward natural gas, which has the lowest greenhouse gas content among fossil fuels.

Corporate executives have a critical role to play in planning now for growing public concern about global warming. CEOs in every industry need to evaluate the impact that strict global warming regulations would have on their business performance, and should make plans to minimize the damage, or even to profit from the winds of public opinion. But before companies can have the confidence to make strategic bets on cleaner energy, governments must act. Even basic regulatory building blocks, like common definitions for carbon credits or clean electricity certificates, are not yet in place, let alone the financing or long-term incentives that companies need to ensure that environmentally friendly business investments achieve an acceptable return.

The widely broadcast dramatic satellite photos of Antarctica's Larsen B ice shelf disappearing into the sea should be a wake-up call that an economic shock due to global warming is not fantasy. It doesn't matter whether it's getting hotter on Earth; CEOs need to plan as if it is. ✚