Stumblers, and how to avoid them

Members Meeting

September 2021

We have continued to refine our view on stumblers

The stumblers research is based on a review of 55 major companies that stumbled

- **Market cap dropped by >25% and CEO left under a cloud**

Our original findings were published in a 2020 CMR article

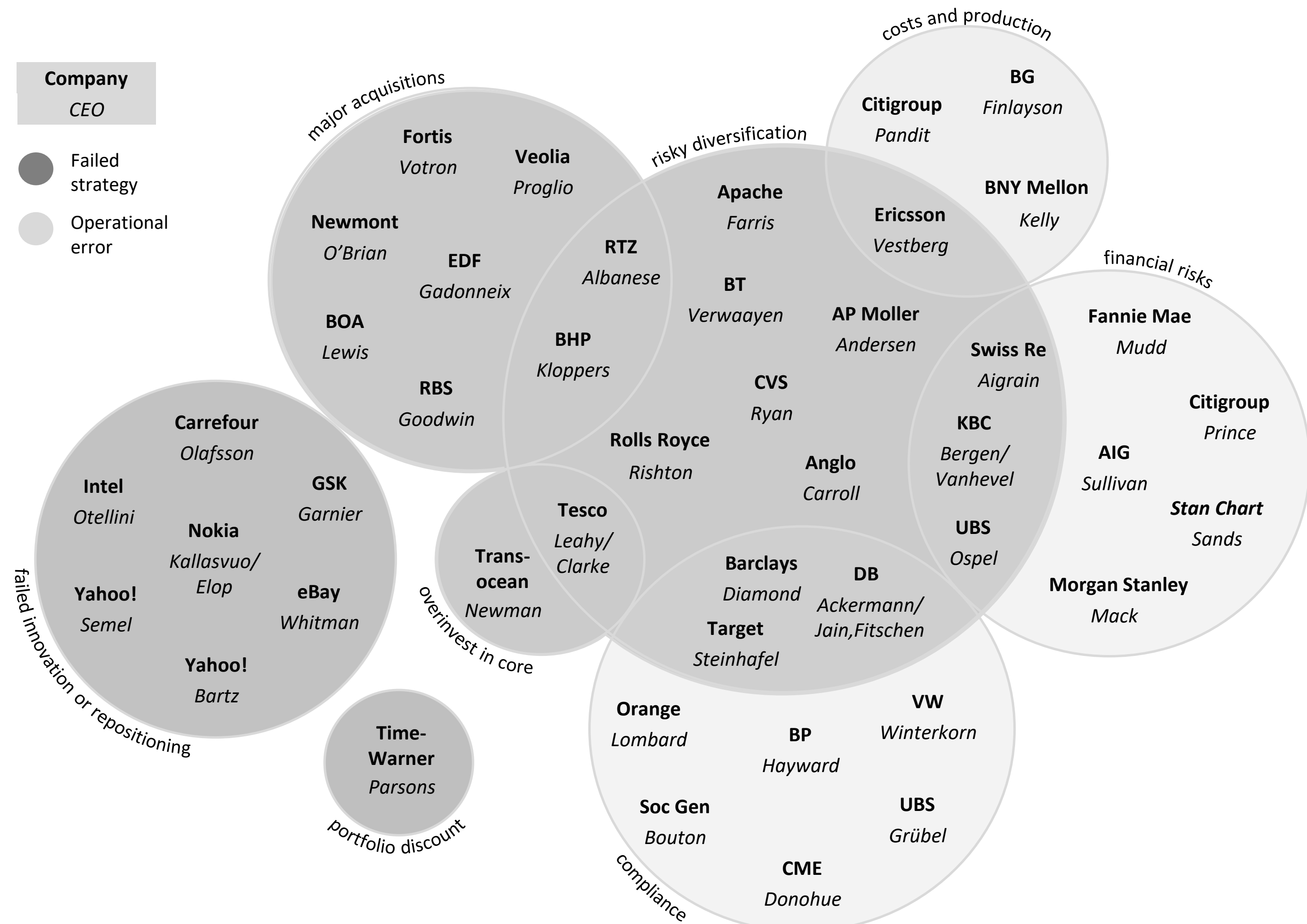
Over the last year we have been refining the key messages

- **Causes of stumbles**
- **What companies and corporate strategists can do to reduce the chances of a stumble**

We have also realized that historical ASMC research has touched on the broader topic of corporate failure

- **Good fit between stumblers research and other observations over the last 30 years of research**

In CMR we explored the causes of stumbles



Agenda

1. Review of the center’s historical insights on corporate failure

2. Review and update on recent “stumbler” research

3. Discussion of how to reduce the risk of stumbling

Over 30 years

Over 30 years the center has conducted many projects into corporate value creation

A flipside of this research has been many different lens on when, how and why corporates destroy value

Each lens provides different but complementary suggestions about interventions that corporates, and corporate strategists, might use to reduce the risk of value destruction

- **E.g., portfolio design, process changes, organisational design, executive selection, etc.**

We review these various lenses first, to provide some context

- **And, if you are not already aware of the research, highlight various materials that may be of interest for addressing particular reasons for stumbling**

Different research lenses suggest different ways tp reduce the risk of value destruction

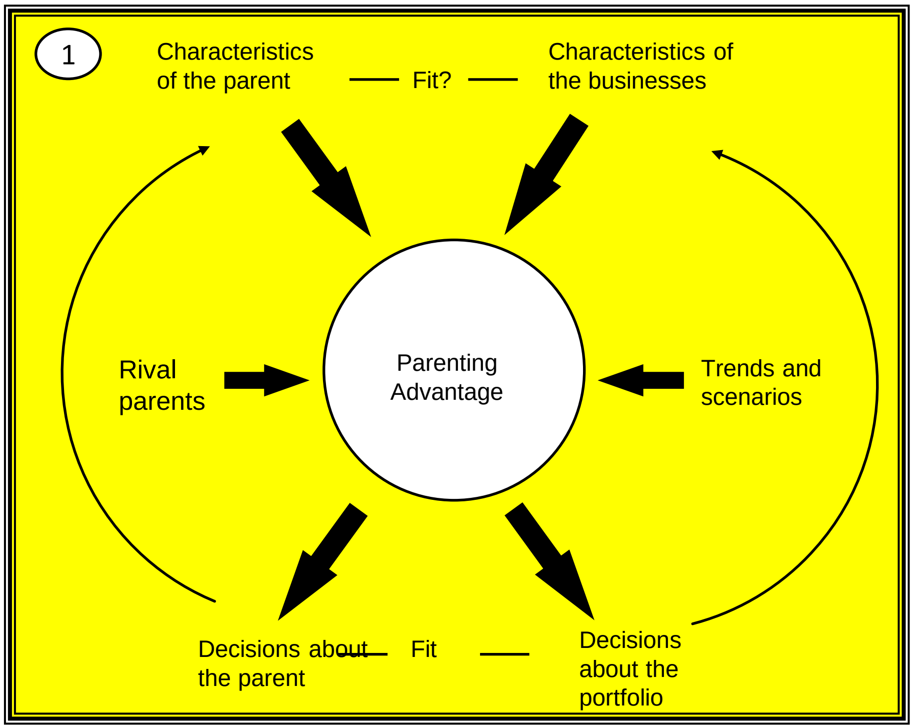
Lens	Ways to reduce the risk of value destruction

Parenting and corporate strategy	• Develop and apply a clear parenting strategy for use in strategy processes, particularly growth strategy
	• Evaluate portfolio to sell/avoid investment if
	    • Weak industry attractiveness and/or competitive position
	    • Potential for value destruction by parent
	    • NPV of owning is less that price it could be sold at
	• Review and alter overall corporate design to reduce potential for value destruction e.g., corporate strategy, M&A processes, key appointments, function strategy, de-centralization contracts, etc.

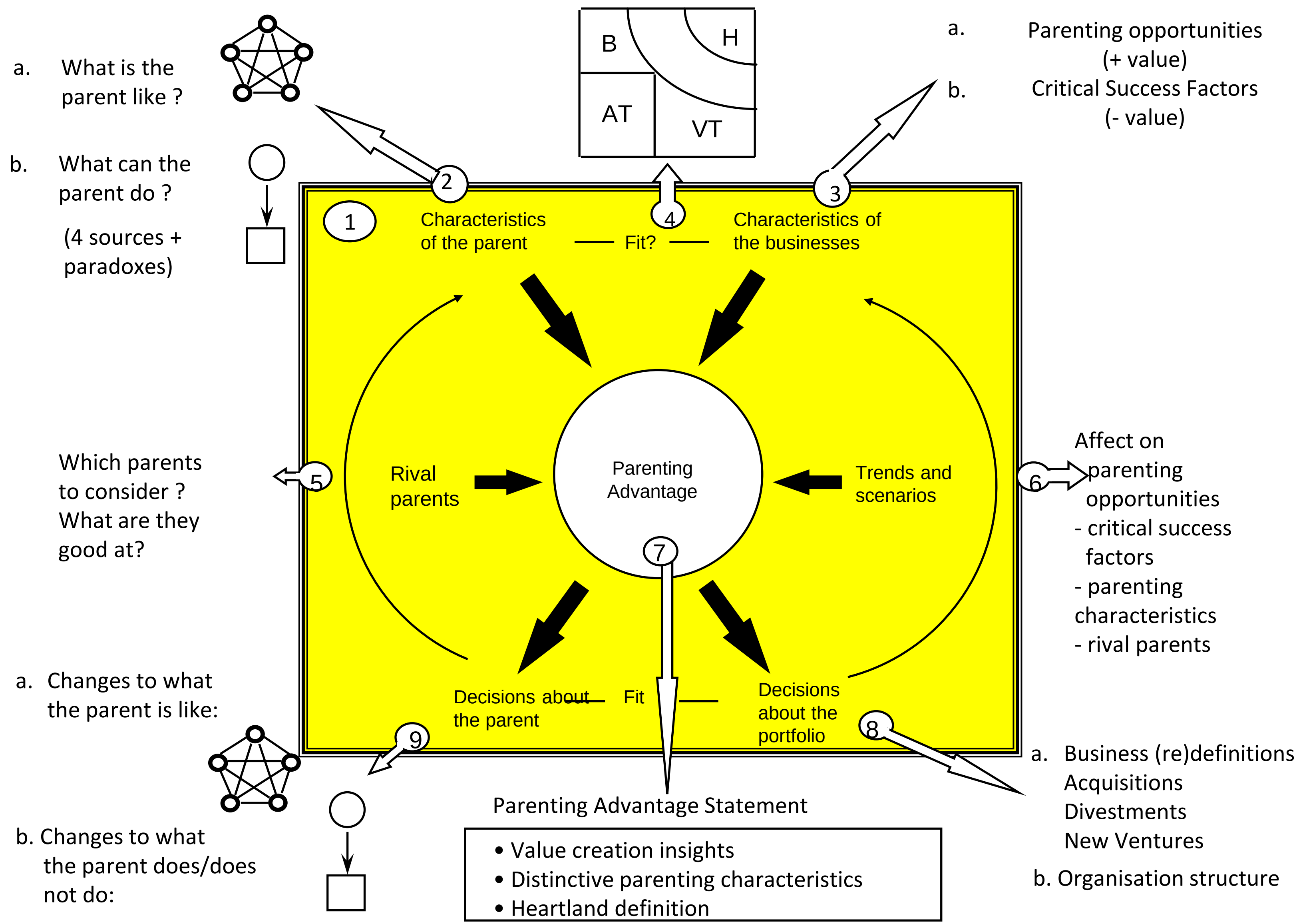
Growth	• Evaluate all acquisitions/major growth initiatves using portfolio strategy approach (see above)
	• Apply ”growth gamble’ traffic lights
	    • Evaluation of the quality of senior team leading the new BU,
	    • Threat to core business

Organisation	• Redesign corporate organization to address poor fit with the nine tests e.g., difficult links, specialist cultures
Biases	• Identify red flags and add safeguards to decision processes addressing major strategy challenges
Shareholder value	• Review and address aspects of the organization that discourage maximization of shareholder value
Head of Strategy	• Fill gaps in senior team capabilities required to take on current major strategic challenges
Stumblers (2020)	• Reinforce corporate and BU leadership teams e.g., people, culture/values/constructive dialogue, incentives • Apply “Emperor’s clothes” tests for major avoidable and unavoidable strategy challenges • When faced with a major challenge, do some combination of: Modify/shape the challenge, add safeguards, recover well

Parenting advantage argued that the wrong style of owner would have problems



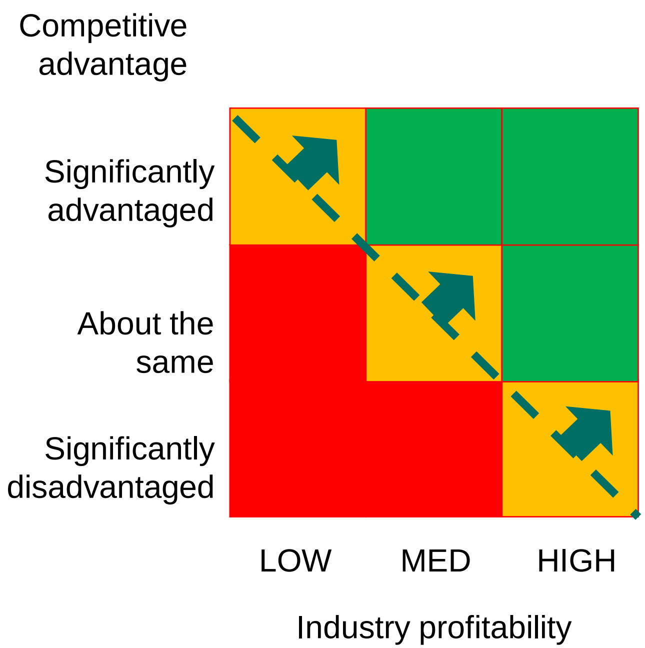
Source: Corporate Strategy



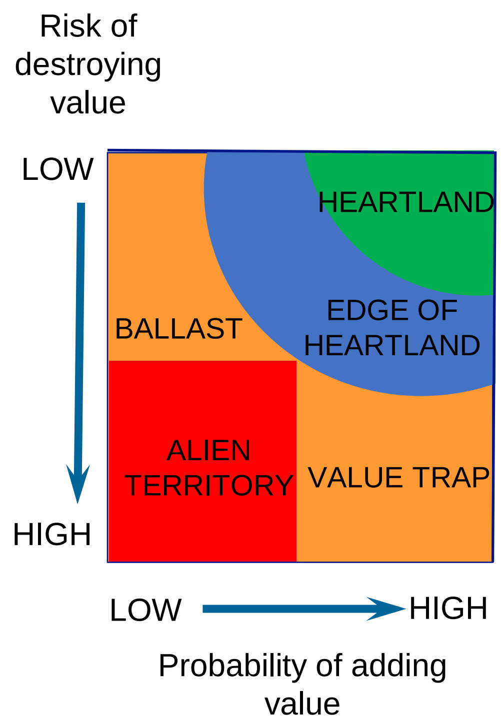
a. What is the parent like ?
b. What can the parent do ?
(4 sources + paradoxes)
B
H
AT
VT
a. Parenting opportunities (+ value)
b. Critical Success Factors (- value)
1
2
3
4
Characteristics of the parent
Fit?
Characteristics of the businesses
Which parents to consider ? What are they good at?
5
Rival parents
Parenting Advantage
Trends and scenarios
6
Affect on parenting opportunities
- critical success factors
- parenting characteristics
- rival parents
7
Decisions about the parent
Fit
Decisions about the portfolio
8
9
a. Changes to what the parent is like:
b. Changes to what the parent does/does not do:
Parenting Advantage Statement
• Value creation insights
• Distinctive parenting characteristics
• Heartland definition
a. Business (re)definitions
Acquisitions
Divestments
New Ventures
b. Organisation structure

Different logics should be used to evaluate the portfolio

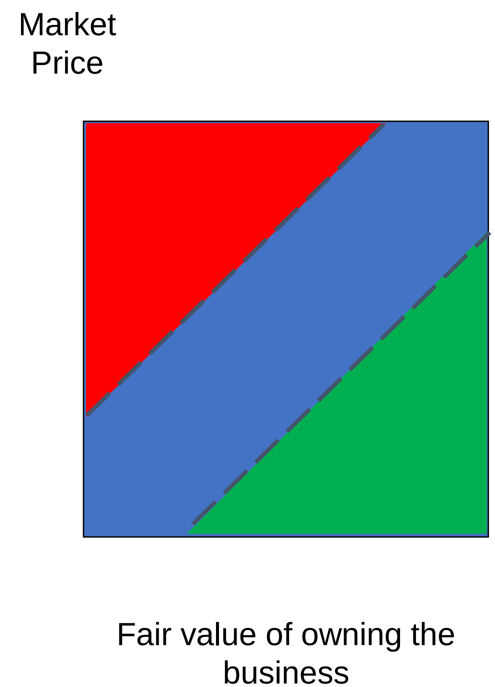
“Business logic”



“Value added logic”

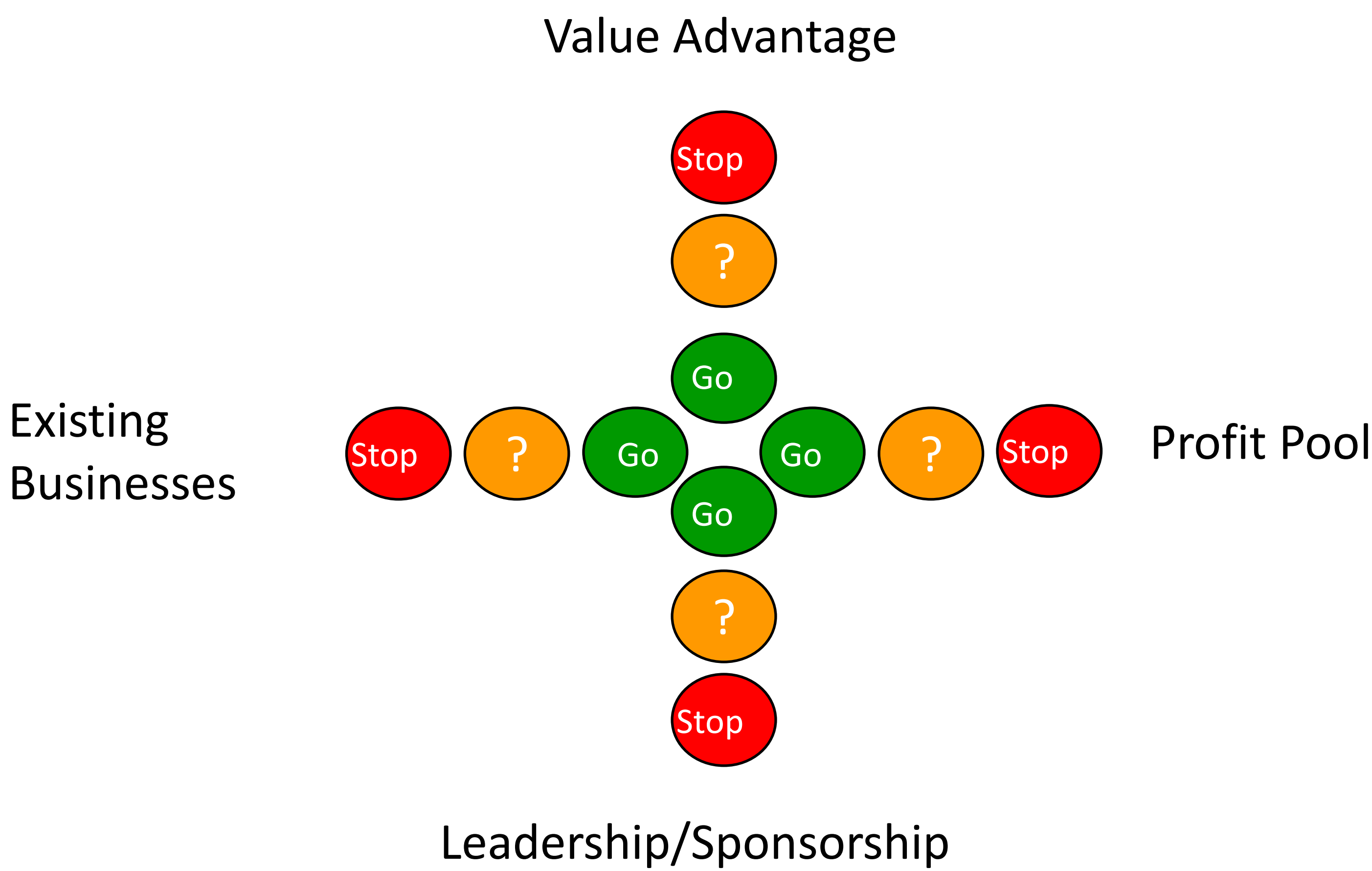


“Capital markets logic”



Source: Strategy for the Corporate Level

The “New Businesses Traffic Lights” added two organisational factors to consider



Source: The Growth Gamble

The New Businesses Traffic Lights

- **Value Advantage**
  - our unique contribution (at operating and parenting levels)
  - less % of our contribution that is tradable
  - less unique contribution of competitors
  - less cost of learning the new business (at operating and parenting levels)

- **Profit Pool Potential**
  - business model potential for high margins (value relative to cost, break even as % of market
  - industry structure potential for high margins (5-forces taking account of likely growth rates)
  - opportunity for us to be a leader in this market
  - cost of trying relative to size of profit pool (taking account of time to commercialisation)
  - business model vulnerability (number of enablers, sensitivity to key variables)

- **Leadership/Sponsorship Quality**
  - relative quality of MD/leadership team of the unit
  - significance of MD/leadership's personal insights about the business
  - status of sponsor within main parent

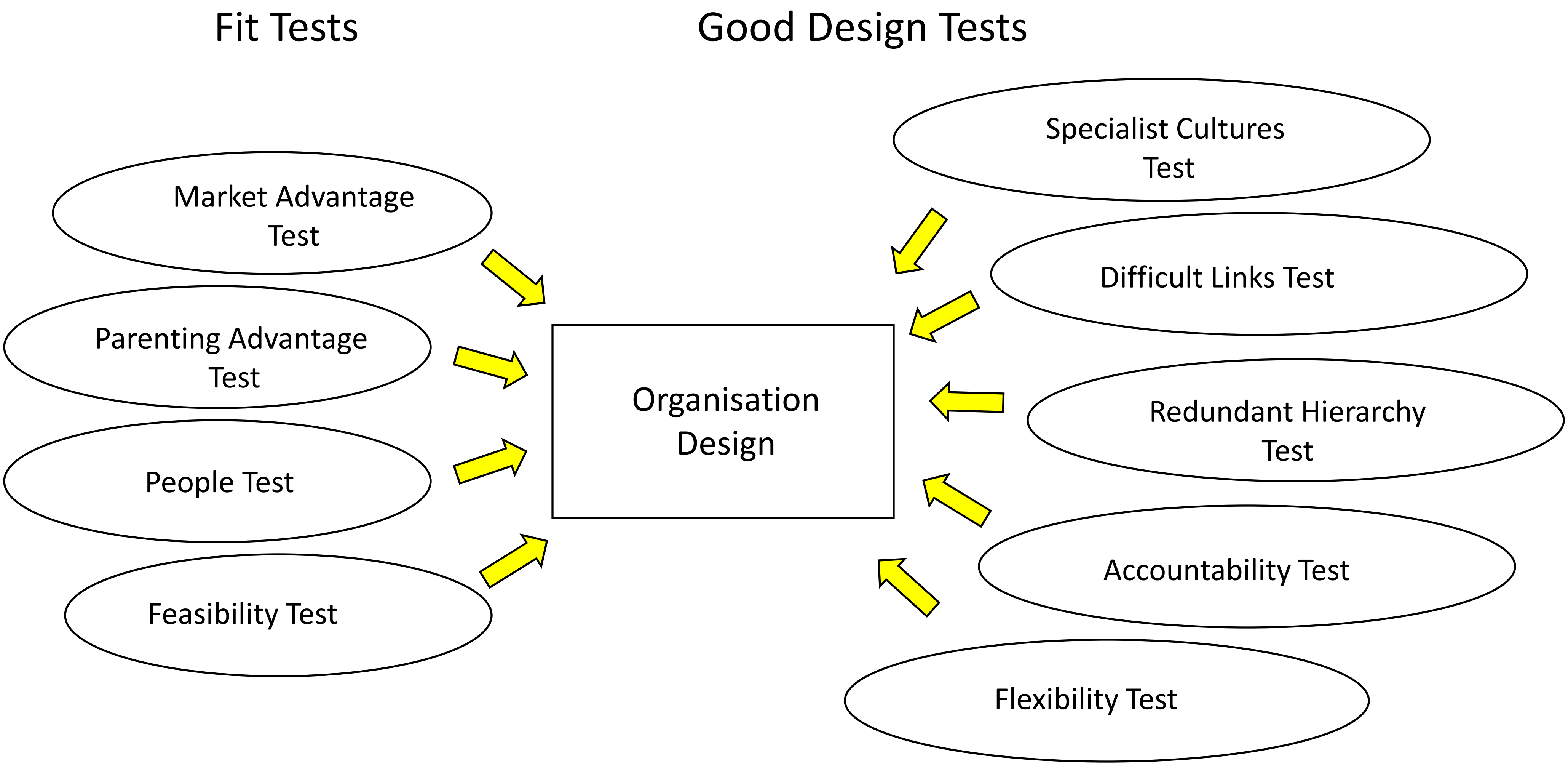
- **Impact on Existing Businesses**
  - size of positive or negative synergies
  - risk of distraction costs

Go

Maybe

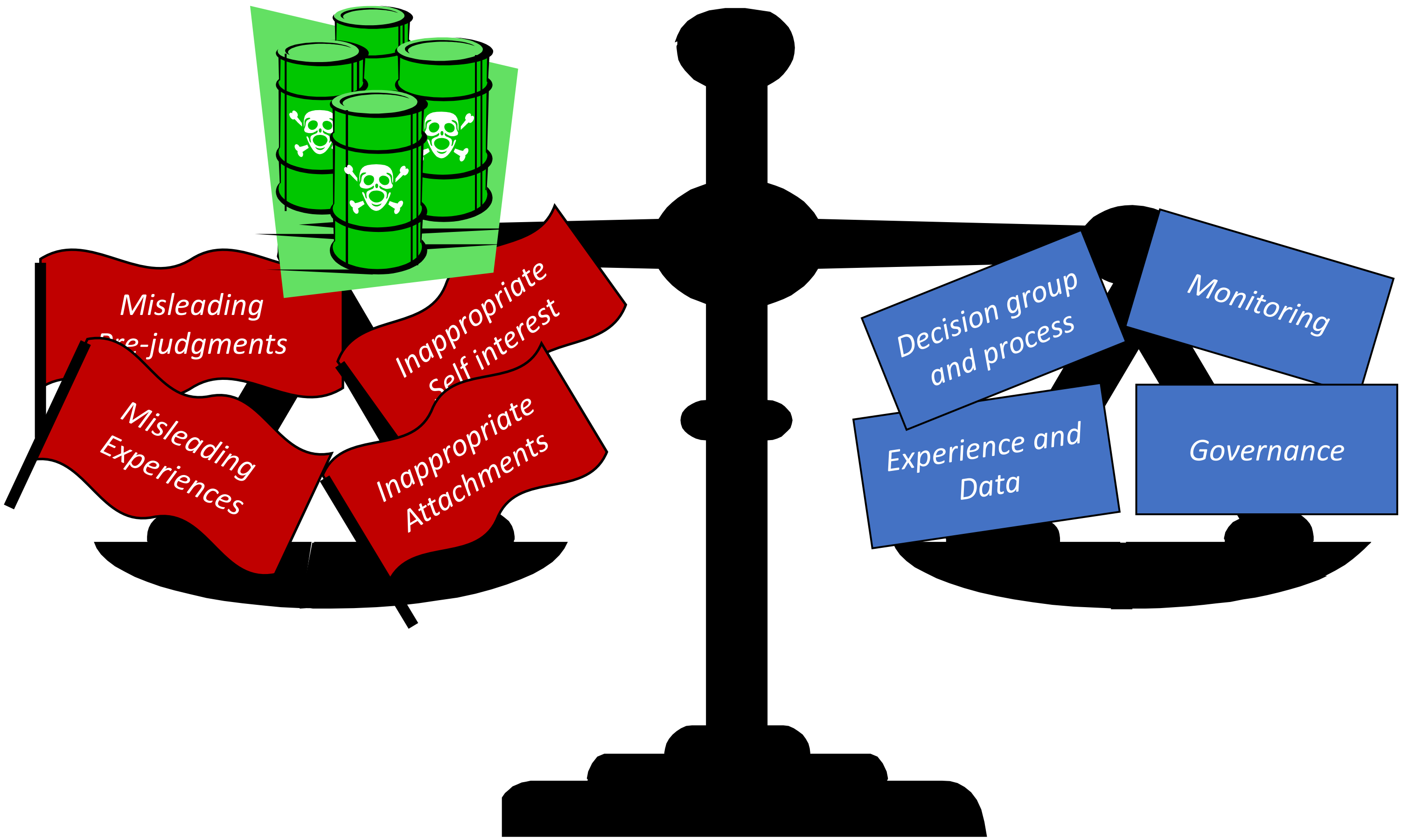
Stop

Nine Tests of Organisation Design



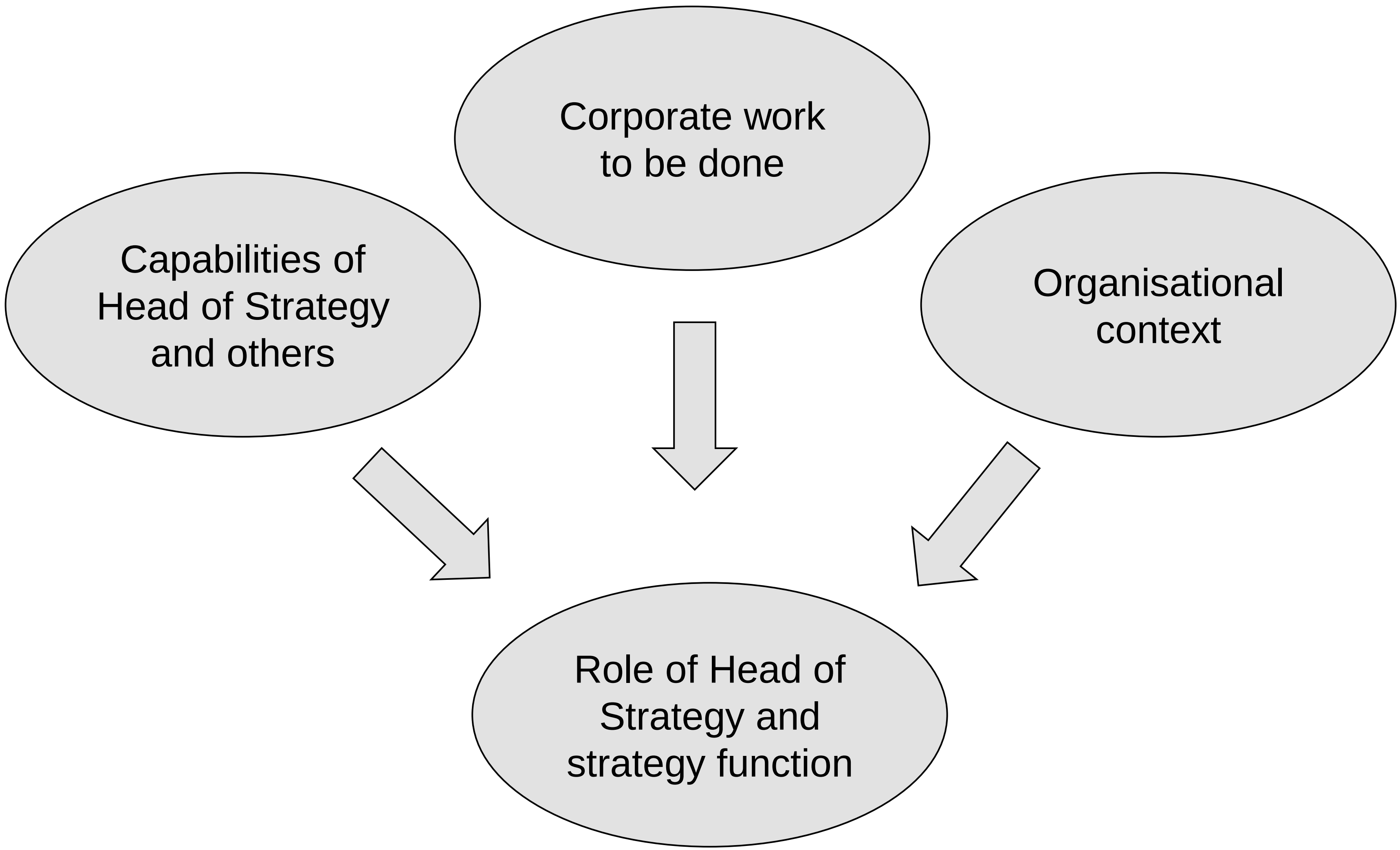
Source: Designing Effective Organisations

Think Again provided tools to reduce the risk of biases leading to a bad decision



Source: Think Again: Why Good Leaders Make Bad Decisions and How to Keep it From Happening to You

Study of the role of the Head of Strategy highlighted the capabilities of the senior team



Summary of factors that ASMC research suggests might increase the risk of stumbling

1. Inadequate parenting/corporate advantage
2. Weak corporate portfolio
3. Gaps in the skills and experience required to address current corporate challenges
   - Particularly in the corporate team, including the Head of Strategy, and the senior team of critical business units
4. Inappropriate biases that compromise the ability to deal successfully with current corporate challenges
5. Vulnerabilities in the wider organization (with a focus on formal and informal design)

These were all confirmed by our more recent stumblers research

Agenda

1. **Review of the center's historical insights on corporate failure**

2. ***Review and update on recent "stumbler" research***

3. **Discussion of how to reduce the risk of stumbling**

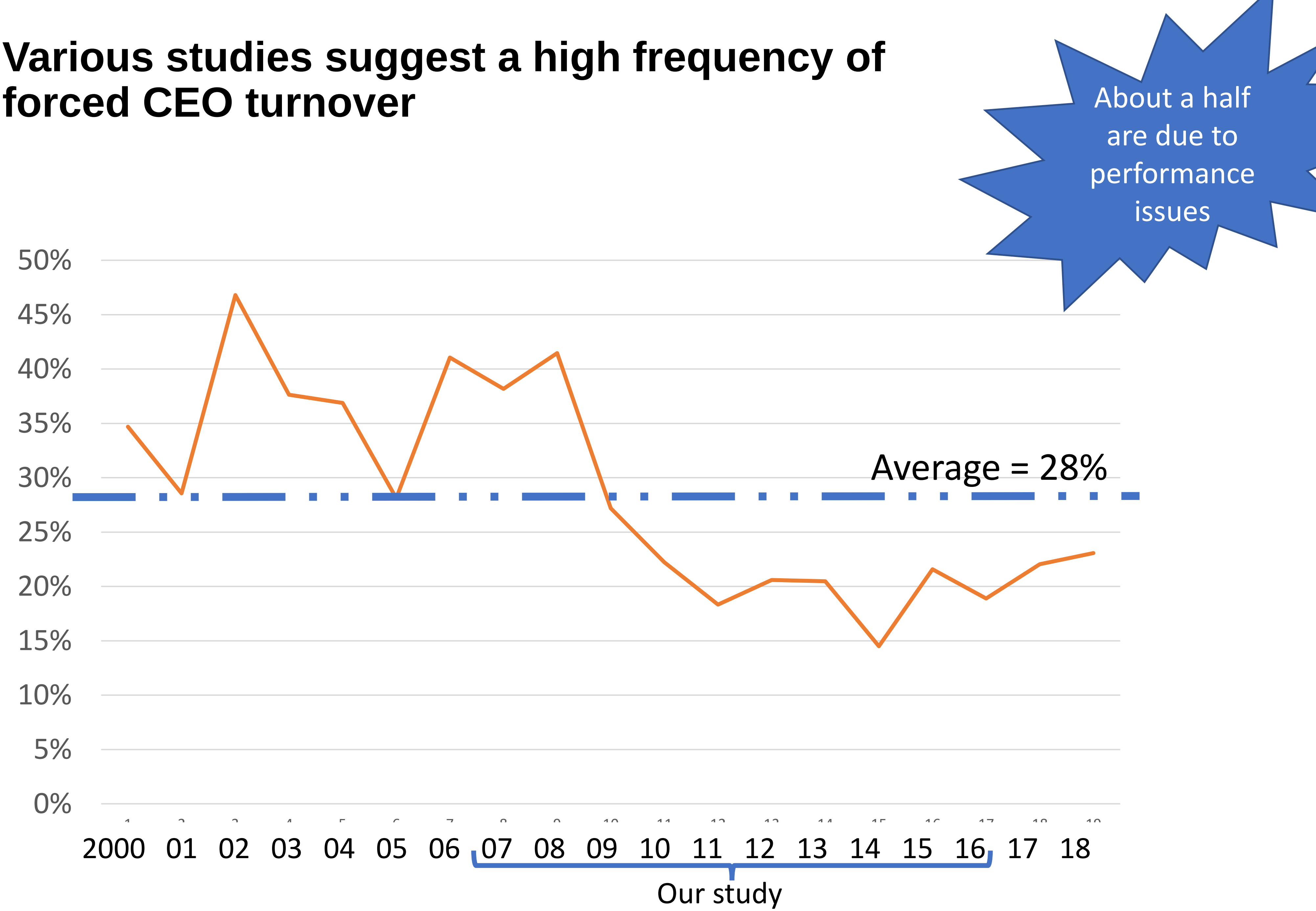
Members Meeting Update: Stumblers

Several surprising observations about stumblers

- **Stumbling is unexpectedly frequent**
- **There is little explicit focus on avoiding stumbles**
- **Most stumbles are not caused by BAU**
- **Only a minority of stumbles are unavoidable**
- **The majority of challenges were self-induced**
- **The difficulty of the challenge was often amplified by predictable factors**
- **Stumbles mostly caused by the leadership team not doing what they should know needs to get done**
- **The main reasons why leadership teams fall short in reducing the risks of stumbling are information, competence, bias and (resistable) pressures to take on difficult challenges**

- **We propose two main types of remedy that could prevent stumbles**
  - **Some ongoing work can be done to increase an organizations defences against stumbles**
  - **And extra mitigation can be deployed when a specific challenge arises**

Various studies suggest a high frequency of forced CEO turnover



Source: https://www.strategyand.pwc.com/gx/en/insights/ceo-success.html

Surprise 1: Stumbling is unexpectedly frequent

We evaluated 268 companies over a 10 year period

- **All those in the top 100 in Europe or the US between 2006 and 2016**

A stumble was defined as

- **>25% drop in share price relative to the local index over one or two years, AND..**
- **CEO left under a cloud (excl those in post for < 2 years)**

20% companies stumbled in the decade examined

- **So ~60% of executives will experience a stumble over a 40-year career**
- **Not enough to build an anti-stumble skill-set, but frequent enough for most executives to suffer a stumble**

1 in 8 CEOs stumbled, often with devasting personal consequences

- **55 of 476 CEOs who left their post after serving for at least 2 years**

N.B. 37 stumbles in Europe versus 18 in US. 21% of CEOs stumbled in Europe versus 15% in US
Shorter CEO period in office in Europe; smaller average company size

Surprise 2: Little explicit focus on avoiding stumbles

Stumbling is no fun

- **CEO departs**
- **Shareholders lose out**
  - **A total cost of about $1 trillion in lost value**
  - **40% average TSR underperformance in stumbling CEOs last 2 years in office**
- **Business often in turmoil**

Would expect more senior management focus on avoiding a 20% chance of a very significant setback

- **Frequency and impact much higher than many risk register or strategic plan items**

Also relatively limited research on the interaction of factors that lead to stumbling

The objective of the research is to

- **<u>Understand why stumbles occur</u>**
- **<u>Propose what can be done to reduce the risk</u>**

Surprise 3: Most stumbles not caused from BAU

Of the 55 examples only 2 were due to a failure at executing BAU

- **A BAU stumble is defined as when an organization stumbles when seeking to address a challenge that is the result of the historic (BAU) strategy**
- **Both Societe General under Bouton and UBS under Grubel stumbled due to rogue traders, despite these trading activities being within the boundaries of the historic strategy**
- **BAU failures contributed at other stumblers, but were not the major reasons**

The vast majority are the result of taking on a new strategic challenge

- **Major M&A, diversifications, self-imposed growth targets, new competitors etc**
- **Stumbles were sometimes triggered by operational failures – but this was due to the new challenging stretching the organization beyond what it had historically being required to do**

This greatly narrows where companies need to be alert to a potential stumble, and guard against it

- **Best place to look for potential stumbles is in the new challenges that a company takes on**
- **Best group to focus on is the "leadership team" who drive strategy creation and execution,**
- **e.g., CEO, Kitchen cabinet, Executive team CEO/Chairman/COO, Executive+Board**

Surprise 4: Only a minority of stumbles are unavoidable

- **Many previous studies claim that it is a change in the external environment that causes corporate failure (stumbles)**
  - Competitor or technological or market change
  - Inadequate response
  - Underperformance

- **We have classified the challenge faced by some of our 55 stumbles as unavoidable, for example**
  - Carrefour’s rejuvenation of its base business
  - Nokia’s response to the rise of the iPhone
  - BP organizing for profits and safety

- **Only about a quarter (27%) of our stumbles were unavoidable:**
  - And some of these are just performing poorly in the ore (e.g., Carrefour)
  - But still worth checking for dangerous changes in the environment
  - Just not the main source of stumbles

Surprise 5: The majority of challenges were self-induced

70% of the 55 examples were driven by taking on a challenge that did not need to be taken on

- **Tesco's push into the US**
- **Internationalisation and diversification by BT**
- **Ambitious growth target set by VW**

These are decisions taken by the leadership team

Leadership team frequently has control over whether such future challenges are taken-on

- **Ex-ante one option is for companies to avoid self-induced challenges e.g., targets, potential acquisitions, diversifications**
- **Once assumed, or if unavoidable (e.g., due to market changes, competitor actions) , the challenge must be addressed, but**
  - **might be structured in a way to reduce the risk of failure e.g., BT could have forensically monitored early contracts**
  - **Can sometimes be backed out of e.g., investment in financial assets**
- **In most cases, other companies in the same environment avoided stumbling**
  - **Either avoided the challenge or dealt with it differently and more successfully**
  - **(Only exception; commodity companies)**

Surprise 6: Often the challenge is amplified by predictable factors

Sometimes the underlying problem turns into a stumble because of an amplifying factor

- **Alone the problem would not have created a stumble (as defined)**

The most frequent amplifier was not accounting and planning for cyclicality in cyclical businesses, thereby turning some problems into stumbles

- **Example: All the mining companies made investments that were then exposed when commodity price crashes**

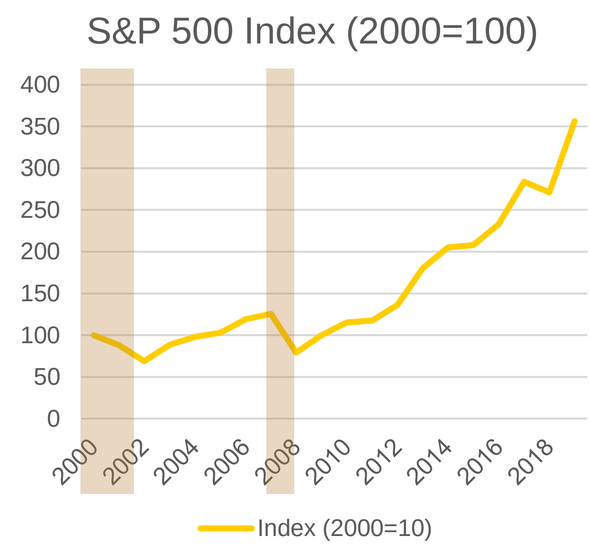
Other external amplifiers, which may be overlooked when evaluating the challenge

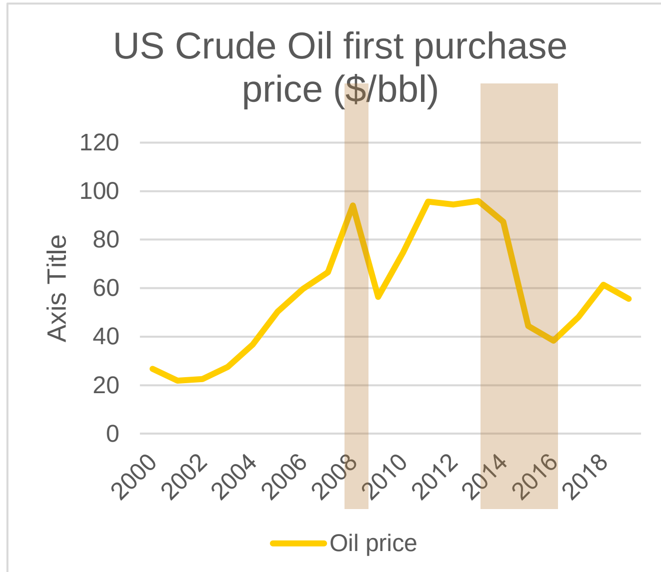
- **Constraints from having a weak market position**
- **Changes in the drivers of competitive advantage**

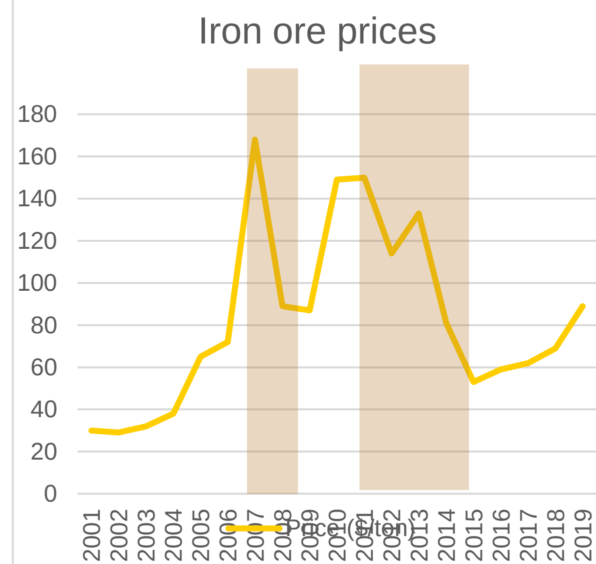
Internally created amplifiers make things even worse

- **Leverage and off-balance sheet liabilities**
- **Taking on multiple challenges, especially if they result in conflicting demands**
- **Challenges managed within complex/difficult organisational or governance structures**
- **Ignoring known functional issues**

”Only when the tide goes out do you discover who's been swimming naked” – Warren Buffett







2007: Citigroup
2008: RBS, UBS, Ageas (Fortis), BT, Fannie Mae, AIG
2009: EdF, Swedbank, KBC, Swiss Re, Morgan Stanley
2010: BOA

2015: Transocean, Apache
2016: Moeller Maersk

2013: Anglo, Rio Tinto, BHP

Avoidable stumbles often associated with ”the tide going out”

Surprise 7: Stumbles mostly caused by the leadership team not doing what they should know needs to get done

Adopting a new challenge (self-induced or unavoidable) gives rise to a new and different required market position and organization

This creates a gap between this existing and required position and organization

- **Ranging from minor to extensive levels of required change**

Stumbles occur because this gap is not closed

Usually the gap, and what needs to be done to close it, is known or knowable

- **Few stumbles caused by unexpected factors**

This points to the cause of stumbles being a failure of the leadership team

- **Changing market position and organization to meet the challenge is a key responsibility of leadership management**
- **The examples of comparable companies and subsequent leadership teams suggests that in most cases a different team could have done better…**
- **…even in cases where the gap might have been too big to have closed completely e.g., Nokia, Yahoo**

Surprise 8: Why leadership teams fall short in their efforts to reduce the risk of stumbling

Information: A lack of knowledge and understanding

- **If the leadership team lack the required knowledge then this may be enough to result in a stumble**
- **Ignorance comes from a mix of the team members knowledge and the information that they do (or don't) receive**

Missing capabilities: Lack of capability to understand and deal with the challenge

- **A mixture of the innate abilities, education and experience of the team**

Bias: Lack of objectivity in acknowledging risk. Two main biases:

- **Hubris/overconfidence**
- **A bias to growth**

Frequently compounded by pressures that cajole leaders into taking on more risk

Pressures on senior team can also contribute to them taking on potentially inappropriate challenges

- **External factors**
  - Core market stagnation or market share max out e.g., BT
  - A tough unavoidable challenge in the core business e.g., Ericsson diversified because it faced margin pressures in its core
  - Aggressive competitors, putting pressure on for a strong response e.g., VW potentially pressurized by Toyota's target for increased global market share
  - Attractive adjacent markets e.g., mining commodities expanded outside of their core markets because commodity prices rose together; CVS attracted by vertical integration that proved attractive in the long run (but only after CVS stumbled due to flawed execution)

- **Internal factors**
  - Past successes, leading to hubris and/or a pressure to keep growing e.g., BG Group, AIG
  - A beguiling strategy for the core business e.g., VW's goal of global scale implied an increase in US market share; UBS wanted to add investment banking and asset management to strengthen its private banking position
  - Influential stakeholders or advisers

Discussion

- ***If you think about what you are doing as a business that might increase the risk of a stumble, is the framework helpful in suggesting where to focus?***

- **Largely the result of taking on a new strategic challenge (rather than BAU)**
- **Often the result of taking on a challenge that could have been avoided i.e., Major M&A, internationalisation, diversification, ambitious growth target**
- **May be amplified by a range of factors, e.g.,**
  - External (cyclicality, constraints from having a weak market position, changes in the drivers of competitive advantage)
  - Internal (Leverage and off-balance sheet liabilities, taking on multiple challenges, especially if they result in conflicting demands, challenges managed within complex/difficult organisational or governance structures, ignoring known functional issues)
- **Typically due to a mix of problems in the senior team:**
  - Lack of required information, missing capabilities, biases
  - External or internal pressures to take on inappropriate challenges

Agenda

1. **Review of the center's historical insights on corporate failure**

2. **Review and update on recent "stumbler" research**

3. ***Discussion of how to reduce the risk of stumbling***

Reducing the risk of a stumble a mix of adapting to specific events having built some longer-term muscle

As we have seen stumbles occur when companies make big changes but fail to adapt appropriately

- **Possible stumbles are not hard to see**

Key to assess and manage the risk of a specific event to reduce the risk of a stumble

- Vital to initiate that thinking whilst the company is considering a major change

This is most easily done if the approach is debated and agreed prior to a specific decision

An ex-ante debate can also identify where structural risk lies

- **Helping to shape actions to more closely fit with existing and emerging capabilities**

Processes can be adapted or strengthened

	Step	Use/tweak existing process	Add new process safeguards
Ongoing decision "infrastructure:	1. Identify general challenges with potential to lead to stumbles	Adapt risk register to include possible stumbles Inc list in LT plan Strategy days/ Board strategy discussion	Ad-hoc informal discussions NED interviews Annual 'stumbles' paper
	2. Identify amplifiers (update in light of specific event)		
	3. Identify general causes of poor decisions (information, competence, bias, pressures)		
Event specific safeguards	4. Diagnose gap between existing and required position and organization created by challenge	Increase focus on description of gap in business case	Separate business case and gap management team
	5. Modify/ shape challenge to better suit current position and model (iterate)	Include alternative options based on key gaps in business case	
	6. Create plan to close key gaps	Gap identification and plan	Require gap plan sign-off
	7. Identify potential stumble triggers	Strategy scenarios Sensitivities	Trigger audit: Bias audit, Competence audit, Information audit, Pressures audit
	8. Execute plan to close gap and respond quickly/approriately	Steering committee Progress reports	Stumble/trigger reviews

Discussion

- ***Working in groups, review the list of potential interventions on the previous page***
  - Which of these are currently most important in reducing the risk of a stumble
  - What else is important
  - What interventions would you like to add?
  - How would you mix formal and informal approaches?