Strategic Management Centre
Members Meeting

30th September 2021

Minutes of Meeting

In attendance

Nicola Adams	BP
Paul Barrett	Babcock
Jiri Beca	D S Smith
Mark Cruickshank	D S Smith
Ananth Gopalakrishnan	Shell
Yitzchak Grant	D S Smith
Gavin Jackson	Babcock
Alex Manisty	D S Smith

From Ashridge Strategic Management Centre

Stephen Bungay
Neil Monnery
Jo Whitehead

Neil Monnery and Jo Whitehead: Avoiding Corporate Stumbles

Research carried out by Felix and Jo of 268 companies in the top 100 of US and European indices over a 10-year period showed that 55 of them - about 20% - suffered a 'stumble' leading to their value dropping to at least 25% below the local index and the loss of the CEO.

The frequency was surprising and worrying. The overall conclusions were published in the California Management Review in February 2020, and since then Jo and Neil have been analysing the causes of 'stumbles' and thinking through some possible remedies.

Jo began by placing this research in the context of the history of ASMC research. Much of it has directly or indirectly explored the causes of value destruction and ways in which it can be avoided.

The early focus of ASMC work was the role of the centre. '*Corporate Level Strategy*' appeared in 1994 and introduced parenting theory. Its best known model was the 'Ashridge matrix', the dimensions of which are the chances of the centre being able to add value and, strikingly, the risk of its destroying value. These two dimensions define the 'value added logic' of parenting. Parents more likely to avoid stumbles have strong risk management capabilities in the centre, and run businesses they understand well.

The 2014 update of parenting theory in '*Strategy for the Corporate Level*' introduced two more logics – 'business logic', which adds the attractiveness of the businesses in the portfolio; and 'capital markets logic', which is about buying at fair value. Only one company in Jo's dataset, Time Warner, stumbled because of a fair value failure. On the other hand, behavioural characteristics did play a role. Even before Deepwater Horizon, BP was strengthening its safety systems, but it failed to extend them to sub-contractors and the head of upstream kept himself at a distance from the centre, making oversight difficult.

Another major ASMC publication, '*Designing Effective Organisations'*, which appeared in 2002, points to another factor at play in Deepwater Horizon. Organisational structure is not a prominent cause of stumbles, but one of the tests of good design it identifies, the 'difficult links' test, did play a role in BP's stumble. As BP were operating a rig owned by a subcontractor, it had thereby created a difficult link, but did not fully address the problems that caused.

Another ASMC study, '*The Growth Gamble'* (2005) addresses one of the major factors in stumbles. The book introduced the 'traffic lights' model to evaluate growth prospects in general and M&A in particular. It identified four dimensions which can be evaluated from the most positive (green) to the most negative (red). One of these dimensions is leadership and sponsorship, covering the relative quality of the team leadership, their personal insights into the business and the status of the sponsor within the parent, all of which play a role in stumbles. The book's rule of thumb 'only go on green' is one which a majority of stumblers have ignored.

Finally, '*Think Again'*, published in 2009, addressed a major factor: decision-making biases. This was complemented by some later work on the role of the head of strategy which highlighted the fact that the nature of the challenges faced by the senior team is constantly changing at a higher rate than the makeup of the team. This can create dangerous gaps between the needs of the business and their capabilities.

In summary, the risk of stumbling can be increased by inadequate parenting, a weak corporate portfolio, gaps in the skills and experience of the executive team, or the team in charge of a critical business unit, inappropriate biases and vulnerabilities in the wider organisation.

After Jo's review of past work, Neil took us through a number of features of the stumbler dataset that were surprising.

He began with the frequency. 20% is conservative, as the criteria employed excluded some companies (like Yahoo) protected by investments (in their case Alibaba) that appreciated enough to cover up value destruction in the base business, and some near-misses (like Vestas). The definition of a 'stumble' includes the departure of the CEO under a cloud, because this indicates some culpability on their part, rather than a decline in share price in a cyclical downturn. For example, the German utility RWE suffered a severe decline in its share price, but that was as a result of government policy which was deemed outside its control, and the CEO kept his job. Therefore RWE does not count as a stumble. Over the 10-year period the 55 companies were led by 476 CEO's meaning that 7.5% of CEO's were involved in a stumble. Other studies over the same 10-year period covered by the data show high CEO turnover, with as many as 28% being forced out or pressured to leave for a wide range of reasons (not just stumbles).

In light of this, the second surprise is that there is little explicit focus on avoiding stumbles. This is perhaps because although stumbling is frequent enough to be worrying it is too infrequent for most executives to experience more than one and learn from it. The causes of a stumble are not simply the inverse of doing what it takes to be successful, but are quite specific.

One member asked if the high rate is simply an indication that market expectations are too high. Expectations do indeed play a role in that management teams are severely punished for nasty surprises. There are heavy penalties for issuing a performance forecast and missing it. People clearly should not push so hard, but they often do as a result of pressure. For example, when commodity prices were high, mining companies were expected to grow aggressively. After they did so prices fell, as they usually do, and they were caught out.

The overall findings suggest that although there were usually multiple compounding immediate causes, in only two cases was a stumble the result of a failure in business as usual. The majority were a consequence of taking on a major strategic challenge, whether in the core or in a new business. A failed growth strategy was the prime or a major contributory cause in large proportion of cases. Even when it was not the immediate cause, a quest for growth often created the problem leading to a stumble. For example, VW decided to become as big as Toyota which meant aggressive expansion in the US and this ultimately led to the pressures behind the emissions scandal.

Furthermore, only 30% of stumbles were unavoidable, such as Nokia's need to respond to the iPhone. The remaining 70% were self-induced, the result of deliberate choices made by senior executives, such as Tesco's expansion in the US or the internationalisation and diversification path chosen by BT.

They usually involved a company finding itself under pressure to take on a difficult, complex challenge and choose an ambitious strategy with a bias to growth which involved taking on significant unfamiliar risks. The organisation lacked the capability to deal with them, making it overstretched and vulnerable, and subsequent events exposed its weaknesses, resulting in failure.

This suggests that a Board paper on avoiding stumbles should focus on new challenges. These should be more carefully evaluated than they commonly are. If the challenges have to be taken on, they should be structured to avoid the most serious risks and contain a backout plan, with warning signs taken very seriously. For example, BT could have forensically monitored its early contracts. In most cases, other companies in a similar environment did not take on the risks and so did not stumble.

One member asked about 'slow motion stumbles'. Their company is facing major changes in the core business, so it needs to innovate in the core and is being pushed to take risk. They have been lucky in the past. They got into e-commerce early, and at first it looked like a misjudgement, but it is paying off now. However, the CEO spends 99% of his time on business as usual, and it is sounding as if he should be persuaded to spend more time worrying about the new things that are happening. Some fundamental shifts are taking place. For example, one reason their core business of cardboard packaging is attractive is that paper can be easily recycled. However, cardboard production is carbon intensive. Now things are shifting from recycling to the overall carbon footprint and plastic is beginning to look more of a threat. They sold a plastic packing subsidiary just before lockdown. That looked like a good move. Perhaps it was, but it looks different now.

Neil observed that a steady build-up of pressure was typical of the pre-history of a stumble. The trend towards internet retailing was clear for years. Not responding would lead to underperformance. However, responding in a way that leads the company away from its core would risk a stumble. Avoiding underperformance and avoiding a stumble are not the same thing.

The risks entailed by an ambitious growth challenge were often amplified by predictable factors, the most common of which was not taking into account the cyclical nature of some businesses, as in the case of mining companies. Other external amplifiers are the constraints imposed by having a weak market position and changes in the drivers of competitive advantage. Internal amplifiers exacerbate things further. They include ignoring the effects of the decision on the balance-sheet, taking on several challenges at the same time, ignoring the execution difficulties posed by organisational complexity or ignoring known functional issues. These can all be tested through scenario planning and by stress-testing decisions.

Cyclicality affects paper a great deal. Cardboard boxes are typically made from 20% virgin paper and 80% re-cycled. Our member's company had been pushing re-cycled paper for years, but because of capacity constraints bought a virgin paper producer at the top of the market. It caused a problem at the time, but with capacity constraints severe again, it now looks good. Luck seems to play a role, though stumblers are usually caught out by downturns outside the core.

Neil quoted Warren Buffet’s saying that it is only when the tide goes out that you find out who has been swimming naked, and observed that avoidable stumbles are usually a result of the tide going out. One member added that the mix of stumbles has changed. With such volatile energy prices in the UK, hedging now looks clever. The one thing that is predictable is unpredictability.

Neil elaborated on naked swimmers. Amplification takes place because the leadership know they are swimming naked but do not in fact do what they know they ought to do. Taking on a new, large challenge creates a gap between the existing and the required capabilities of the organisation. In most cases, both the gap and what needed to be done to close it were readily apparent but not addressed. Few stumbles are ultimately caused by something totally unexpected. This suggests that a different leadership team could have done better.

Teams fall short for three main reasons: a lack of information or understanding; a gap in the skills of the team which renders them unable to deal with the challenge; and bias in assessing the risk, especially a bias to growth and overconfidence, either in themselves or the company or both. These three were often compounded by pressures on the leadership team to take on the challenge. Common pressures are stagnation in the core business, aggressive competitors and the existence of attractive adjacent markets which appear to be similar to their core - though in fact they are not. Pressure is often succumbed to because of the hubris that results from past success or shareholders and advisers encouraging the management to be bold and take on the risk.

Ways to Reduce the Risk of Stumbling

It is not hard to see the possibility of a stumble ahead. It is vital to initiate the thinking while the company is considering a major change and not wait till it happens. Avoiding stumbles entails both adapting to specific events and building longer-term muscle.

Jo and Neil identified three main ways of muscle building:

1. To identify the general challenges which court the danger of a stumble, given the capabilities of the company
2. To identify amplifiers
3. To openly discuss the main causes of poor decisions – information, competence, bias and pressure

Addressing these may involve modifying existing processes such as adjusting the risk register or having a debate during strategy away-days, or adding new safeguards such as interviews with NEDs and external experts, or actually producing an annual ‘stumbles paper’.

They then listed five ways of adapting to specific events:

4. To diagnose the gap between the existing and required position and organisation created by the challenge
5. To modify or shape the challenge to better suit the current position and model
6. To create a plan to close the gap
7. To identify potential stumble triggers
8. And to execute the plan to close the gap and respond quickly.

Existing processes can be modified to explicitly include the gap and alternative options in the business case, run scenarios and to set up a steering committee to review progress reports. Additional measures could include setting up a separate team devoted to gap management, require the sign off of the gap closure plan, conducting audits of biases, competence, information and pressures and holding trigger and stumble reviews.

One Member commented that in a known environment the team would be culpable, but in high uncertainty it is hard. The energy transition is huge, with vast ramifications. The oil majors are in a position rather like Nokia – they have no choice but to change, but the risk of stumbling is high. The key question is whether you can identify the triggers early enough and adapt. Another Member involved in the energy transition added that their organisation would need to be re-purposed. The gaps can be audited, but biases would remain. Tackling those would be difficult.

Another Member explained that they had always focussed on their core business and had avoided a stumble, but they also avoided progress. Now there is no choice but to innovate and thereby take on more risk. They could go wrong in scaling up innovations. This could set up the business for a stumble it is compelled to avoid by identifying the capability gap to be filled. They have also found it very productive to introduce the organisation to fundamentally different ways of thinking by partnering with the Ellen MacArther Foundation, a charity devoted to promoting the idea of a circular economy. This is one way of stimulating innovation and countering biases.

Future meetings

The next meeting will once again be virtual, though we hope to return to face to face meetings next year.

It will take place from 14:00 – 16:30 on 18th November, and will be led by Stephen Bungay, who will review the subject of agile strategy.