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Rethinking The Business: Why CEOs Can't Avoid A Market-Based Strategy

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A large number of CEOs, executives and employees are dissatisfied with the way business is being conducted within their companies. They are finding that existing business thinking and management processes seem less and less pertinent to creating value in today's marketplace, and they don't know what to do to generate the results they desire. The problem, said Peter Drucker more than a decade ago, is an avowed commitment by CEOs to continue to manage with an outdated "theory of the business." What's required to succeed is an avowed commitment on the part of CEOs to strategic thinking and executive leadership; not wishful thinking.

Many companies that were experiencing moderate success just a few years ago are struggling in the current business environment to do better. Strategies seem more difficult to define, and where they exist, more difficult to achieve. Consumer desires are hard to pin down and likely to change quickly and unexpectedly, making product innovation risky. As a result, business leaders are tentative and uncertain about what to do next.

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Even when corporations think they are doing the right things, and doing them well, markets aren't responding and profits, if not revenues, are declining. Executives are finding that yesterday's road to success is crumbling quickly, and that new paths are required to attract and retain new customers in ways that are profitable to the business.

These symptoms are usually leading indicators that executives are managing to a business model that is no longer aligned to the values of the

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marketplace – or, as Peter Drucker put it, are operating to a *theory of the business* that is obsolete. Peter Drucker describes the situation this way:

"The assumptions on which the organization has been built and is being run no longer fit reality. These are the assumptions that shape any organization's behavior, dictate its decisions about what to do and what not to do, and define what the organization considers meaningful results. These assumptions are about markets. They are about identifying customers and competitors, their values and behavior. They are about technology and its dynamics, about a company's strengths and weaknesses. These assumptions are about what a company gets paid for. They are about what I call a company's *theory of the business*" (Peter Drucker, "The Theory of the Business," in *Managing In A Time of Great Change*, Truman Talley Books/Dutton, New York, 1995, p. 22; All Drucker quotes in this essay are from this source).

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In business as in life, reality is the ultimate arbitrator of what works, so when a manager's understanding of the world is misaligned with reality, he or she is unlikely to be doing the things that need to be done to make the business successful.

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For Drucker, the articulation of *a theory of the business* is primarily a marketing function that describes how the business makes money. It requires the difficult task of identifying and integrating the realities of the marketplace and operating environment and figuring out how best to apply the resources available to create customer and shareholder value.

Drucker wrote in 1994 that "what underlies the current malaise of so many large and successful organizations worldwide is that their theory of the business no longer works."

Two Typical Examples

Drucker identifies General Motors as an example of a successful theory of the business which he says worked well for seventy years and "combined in one seamless web assumptions about markets and customers with assumptions about core competencies and organizational structure." For the details you'll have to refer to the book cited above (p.p., 27-28), but the business model incorporated long-runs of mass produced cars to achieve lowest fixed cost per car, minimal model changes, segmentation by income groups, trade-in allowances to encourage upgrading to more expensive higher margin cars, and a structure of semi-autonomous divisions focused on income segments with overlapping price points to encourage upward mobility. All of this changed in the late 1970s when GM's "assumptions about the market and about production became invalid." New production techniques, technological innovation, and market segment fragmentation led to the onset of lean manufacturing, thereby significantly diminishing the economic advantage of long production runs and placing GM at a competitive disadvantage.

A second example is adapted from Booz Allen Hamilton's Dec. 2004 report, "State of U.S. Retailing" which is worth reading in full in relation to the topic of business models: http://www.boozallen.com:80/bahng/SilverDemo?PID=Home.html&contType=TABLE&dispType=HTML&Region=&Geography=&Taxonomy1=&Taxonomy2=&Taxonomy3=&SortBy=creation+date+DESC,title+ASC&GroupBy=-1&FORM_ACTION=FOCUS&style=item&ITID=455312.

K-Mart is a company that successfully transformed its business model in the early 1960s. In the late 1950s the company was known as the S.S. Kresge Company, and operated a mature variety retailing business in city and town cores in competition with F.W. Woolworth. Around this time, out-of-town discount stores began to emerge. The new post-war middle-class affluence allowed for increased car ownership, which, when combined with improved roads, made it worthwhile for consumers to spend time to travel greater distances for increased savings. The lower operating costs and economies of scale of these new stores resulted in significant consumer benefits as cost savings were passed on to consumers to attract their business.

Kresge executive Harry B. Cunningham observed and studied this new phenomenon, and devised a bold plan to transform the company from its five-and-dime store roots into a leading discount chain. The first K-Mart discount store opened in 1962, which, coincidentally, was the year that the first Wal-Mart and Target stores appeared. Over the next decade K-Mart stores expanded aggressively, attracting price-sensitive consumers from a wide area and benefiting from the economics of its advantageous operating structure.

The new stores generated strong financial returns, and the company stopped investing in traditional format five-and-dime stores. The success of K-Mart is reflected in the growth of the value of the business. In the period from 1965 to 1975, Kresge stock grew at an average annual rate of 25% as compared to almost zero growth of the Dow Jones index including reinvestment of dividends. Over the same period, rival Woolworths continued to do business as usual, betting on the existing business model while continuing to expand its network of stores. As a result, it generated an average annual return from 1965 to 1975 of -6%.

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While K-Mart survived the first fundamental retail shift at the expense of Woolworths, it failed to notice the second shift, which was very much an updated version of the first.

As time progressed, so did Wal-Mart. Sam Walton was relentless in identifying improvements that would lower costs for customers while maintaining profitability. Wal-Mart began to experiment with larger scale rural stores, creating even greater economies of scale while adding customer convenience by offering a broader range of products and categories *and* rewarding customers with lower prices.

As long as Wal-Mart and K-Mart operated in different markets, K-Mart was able to prosper. But as both continued to expand, they soon began to compete head-to-head with inevitable results. Wal-Mart's relentless pursuit of continuous innovation to drive cus-

tomer satisfaction and increasing revenues easily outperformed K-Mart. K-Mart's price-sensitive customers perceived that they were made better-off by shopping at Wal-Mart over K-Mart.

Wal-Mart's theory of the business combined a lower cost structure derived from choice of store format and location with the creation of an immensely efficient supply chain and ever-growing buying power to create rock-bottom retail prices for customers. K-Mart was forced to cede the low-price position and resorted to a more traditional and largely unsustainable "high-low" promotional pricing strategy in an attempt to hang on until a better competitive alternative – a better theory of the business – could be developed to gain and retain customers while remaining profitable over the longer term.

> A business succeeds to the extent that its resources are aligned to deliver something consumers will pay for at a price that exceeds the cost of all inputs.

K-Mart failed to find a viable new business model to attract customers and through a lengthy and painful retrenchment lasting thirty years finally closed its doors and declared bankruptcy in the late 1990s. (K-Mart was revitalized through venture capitalist funding in 2004 and has since acquired Sears Roebuck, creating the third largest U.S. retailer behind Wal-Mart and Home Depot.)

Both the GM and K-Mart examples provide supporting evidence to Drucker's observation that companies organize their resources to deliver value particular to a given time and place. A business succeeds to the extent that its resources are aligned to deliver something consumers perceive to be of value for which they are willing to pay a price to the company in excess of the cost of all inputs. But over time, consumer values change and evolve due to any number of influencing factors, be they personal, sociological, environmental, technological and/or political. It is incumbent upon executives to try to assess the changing values in the marketplace and keep the offering relevant and aligned to the fulfillment of those values.

> Instead of rethinking the fundamentals of the business, executives engage in wishful thinking and hope that yesterday's assumptions will continue to work going forward.

The executives of some companies are better able to do this than others, as demonstrated by their relative market share and financial performance. The misalignment between management's perception of what customers value and what they actually value arises when "the realities that each organization actually faces have changed quite dramatically from those that each assumes it lives with" (Drucker, p. 26).

Sometimes changes are such that the old successful way of doing business becomes outmoded and an entire new theory of the business is required.

Three Parts To The Theory

According to Drucker, a theory of the business consists of three components as follows:

1. Assumptions about the environment of the organization: society and its structure, the market, the customer, and technology (this defines what an organization is paid for);

2. Assumptions about the specific mission of the organization (this defines what an organization considers meaning-

ful results, i.e., how it envisions itself making a contribution to the economy and to society);

3. Assumptions about the core competences needed to accomplish the organization's mission (this defines where an organization must excel in order to remain a leader to its most critical stakeholders - consumers, shareholders, employees).

"[A]ll of this sounds deceptively simple," writes Drucker, and yet "it usually takes years of hard work, thinking, and experimenting to reach a clear consistent, and valid theory of the business. Yet to be successful, every organization must work one out" (p.30). All of these assumptions about markets, customers, core competencies and organizational structure must form the framework of elements to be combined in a manner that allocates corporate resources to create consumer and shareholder value.

> If what the business does isn't desired or required anymore by consumers, then the business has to find a way to provide something else that consumers do want.

Unfortunately theories of business rarely last very long. "Eventually," writes Drucker, "every theory of the business becomes obsolete and then invalid" (p. 31). Drucker cites the examples of IBM, GM, AT&T, Deutsche Bank, Sears and others where management failed to adequately adapt to a competitive business environment in constant flux. More recent examples could easily be added to the list: Sony vs. Apple; Barnes & Noble vs. Amazon; Bell and AT&T vs. Skype and Vonage; Cineplex vs. Blockbuster; Ford vs. Nissan; Toys'R'Us vs. Wal-Mart; etc. Others can be found daily in the business headlines.

Drucker notes that management of most companies react defensively as their theory of the business begins to demonstrate misalignment with the realities of the marketplace. It's not that they don't see what is happening, it is that they don't believe it, or don't want to believe it due to fear of the implications, so they don't take appropriate action.

Instead of reassessing and rethinking the fundamentals of the business, executives resort to patchwork. They engage in wishful thinking and hope that the marketplace will come back into alignment with the assumptions that drove all of yesterday's hard work so that the effort going forward can be minimized.

GM resorted to patchwork, says Drucker: "It maintained the existing divisions based on income segmentation, but each division now offered a 'car for every purse.' It tried to compete with lean manufacturing's economics of small scale by automating the large-scale, long-run mass production (losing some $30 billion in the process). Contrary to popular belief, GM patched things over with prodigious energy, hard work, and lavish investments of time and money. But patching only confused the customer, the dealer, and the employees and management of GM itself. In the meantime, GM neglected its *real* growth market, where it had leadership and would have been almost unbeatable: light trucks and mini-vans" (p.28).

Patchwork never works, says Drucker. Instead, he professes, "when a theory shows the first signs of becoming obsolete, it's time to start thinking again, to ask again which assumptions about the environment, mission, and core competencies reflect reality most accurately - with the clear premise that our historically transmitted assumptions, those

with which all of us grew up, no longer suffice" (p. 32).

The fact is that as all of the myriad variables change, the business model will become obsolete. If the business is stagnating, if what it "does" or provides isn't desired or required anymore by consumers, then the business has to find a way to do something else or provide something else that consumers *do* want.

The CEO Can't Avoid A Market-Based Strategy

In the end, developing and implementing a successful theory of the business is what business strategy formulation is about. Strategic planning is the process by which the guiding members of an organization envision the organization's future and develop the necessary procedures and operations to achieve that future.

Many executives profess the importance of a strategic orientation aligned to an understanding of marketplace dynamics, but their actions belie their professed values.

Yet business strategy formulation is currently out of vogue because it demands commitment to the achievement of a longer-term vision and mission in a world dominated by short-term incentives and goals. You can tell what people really value by the investment of effort they make to achieve those values. Many executives profess the importance of a strategic orientation aligned to an understanding of marketplace dynamics, but their actions belie their professed values. Too many executives spend most of their time managing in the present to solve short-term operational problems and apply and devote very little brain-power and time to developing an effective theory of the business and strategic plan by which to operationalize it.

In general, too few executives are operating to the fullness of their capability and at the level of work that is required to fulfill their executive obligations, i.e., lead the business and manage its resources in a manner that attracts and retains customers and earns acceptable investment returns over the long-term.

It is an inherent aspect of the role of an executive to understand current events and trends and assess the opportunities and threats they create for the business, and figure out what they are going to do about it and how they are going to do it. Then they must lead the organization in getting it done. The dominating concept that forms the theory of the business needs to be constructed, communicated and propagated "through the minds of the whole hierarchy of subordinate leaders to animate the entire command and to concentrate its actions before the [competition] can place a counter concept in operation" (adopted and quoted from Gen. W.E. DePuy, U.S. Army Retired, cited in E. Jaques and S.D. Clement, *Executive Leadership,* Blackwell Publishers, 1991, P. xxiii).

When a CEO and his or her executive team fails to establish a dominating theory of the business appropriate to the mission and the unique circumstances they face, the opportunity to do so is ceded to their competitors. Whatever other qualities of leadership the CEO and his team may possess, they become irrelevant when applied in pursuit of an ineffective theory of the business.

A Moral Imperative For Critical Thought

To adjust to a new reality as an existing *theory of the business* becomes obsolete, executives needs to think critically and creatively

and to "take effective action in order to change policies and practices, bringing the organization's behavior in line with the new realities of its environment, with a new definition of its mission, and with new core competencies to be developed and acquired" (Drucker, p. 32).

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With corporate executives already feeling over-extended, and everybody already busy managing more projects than is prudent, no one wants to make the time and effort to redefine the strategic framework of the business and realign the assets to deliver a different, unproven, value proposition. But there is no way around it. If executives are not up to committing the effort required, they can, and should, either find another vocation, or seek help from strategic consulting professionals who can provide guidance and assistance.

One imperative that executives cannot legitimately evade because it is inherent in their managerial responsibilities is that of applying critical thinking skills within the context of sound business principles. This is a fundamental skill required to move any company from ongoing decline to renewal.

> Neither hope nor a burgeoning bank account is a viable business strategy when it is generated by the willingness of business leaders to sacrifice the long-term viability of the business.

We live today, and forevermore, in a knowledge economy that recognizes the importance of the human mind and it's use of reason as the primary asset for wealth creation. Any manager that makes it to the executive ranks of a listed company and fails to apply critical thinking skills and a passion for discovery and innovation to the specific problems of one's business every day, is committing a moral and fiduciary breach against the board, the shareholders, and their own integrity.

Executives who aren't committed to enhancing the value that the company delivers to customers and shareholders are responsible for introducing an opportunity cost that detracts from the value of the business (and you can probably multiply that negative impact by at least the number of subordinates reporting up to them).

Paradigms rarely shift suddenly or unexpectedly. Those managers who are conscientious and paying attention to their customers, competitors, and overall market forces in the context of their business strategy will notice the signals of impending changes sooner than others operating without such conscientiousness. The question is whether they will spend enough time proactively considering and weighing the implications of the changes, and thinking through new ways to deliver value to the marketplace ahead of, or at least on par with, the known or contemplated competition. In the words of futurist Joel Arthur Barker: when the paradigm shifts, everything goes back to zero. Zero is not a good place to be if you're heavily invested in the old paradigm and you're operating on the expectation that yesterday's investment in hard and soft assets will make a valuable contribution to your future.

Hope is not a viable business strategy, nor is a burgeoning bank account when it is generated by the willingness of business leaders to sacrifice the long-term viability of the business in exchange for the false comfort of the pursuit of day-by-day preservation.

Preventative Measures

To prevent sudden awareness that your theory of the business has collapsed along with the perceived strength of your balance sheet, Drucker provides some sage advice by way of two preventative measures.

The first preventative measure is to adopt a policy of *abandonment*. Every three years an organization should challenge every product, service, policy and distribution channel – every major aspect of the business value chain – with the question: If we were not in it already, would we be in it now? This forces the business managers to test implicit assumptions about policies and routines, and forces the organization to think about its theory of value creation. Given the rapid pace of change in most industries, it would be more prudent to review every two years, if not every year.

The organization should look critically at how it utilized resources and ask probing questions about its current activities and whether they are really delivering the results they were supposed to deliver when they were initially justified and funded. Was the analysis faulty? Were the wrong things done in the execution? Or were the right things done but they didn't work? What does this analysis tell us about our *theory of the business*? How should we use these new insights and new information?

"Without systematic and purposeful abandonment," writes Drucker, "an organization will be overtaken by events. It will squander its best resources on things it should never have been doing or should no longer do. As a result, it will lack the resources, especially capable people, needed to exploit the opportunities that arise when markets, technologies, and core competencies change. In other words, it will be unable to respond constructively to the opportunities that are created when its theory of the business becomes obsolete" (p. 33).

> A business can suffer from too much customer focus, for example, when very high customer satisfaction scores are combined with declining market share.

The second preventative measure put forth by Drucker is to study what goes on outside of the business, and especially to study *non-customers*. Executives should be engaged in an ongoing assessment of all aspects of the external environment that influence and create some meaningful impact on business success, and must take action to influence that environment in favour of the business.

With regards to customers, consider that there is considerable focus today on utilizing CRM technology to enhance revenue per customer and customer lifetime value. This trend is based on the premise that existing customers have an affinity to your brand and therefore, if you understand their needs and build a "relationship" with them, they will be receptive to additional offers.

Managers have bought into research that shows that it is less expensive and more profitable to attract additional revenues from existing customers than from new customers. For many, this has become an excuse to ignore non-customers.

This can lead to *too much* customer focus. Here's one sure symptom: very high customer satisfaction scores combined with declining market share. The problem here is success at providing value to a narrowing market segment. This is strong signal of an outmoded theory of the business. Non-customers always outnumber customers, so while it may be less expensive to acquire incremental sales from existing customers, it is a huge mistake to ignore the enormous untapped potential that resides in converting non-customers into customers. Drucker, as usual, sums up the lesson nicely: "The department stores learned the hard way that although being customer driven is vital, it is not enough. An organization must be market driven too" (Drucker, p.34).

* * *

One of the things I most admire about Peter Drucker that is absent from most management and business writers is his understanding of how much hard work is required to succeed in business, and that hard thinking must proceed purposive action if that effort is to result in meaningful results.

Sluggishness, complacency, arrogance, bureaucracy, are all symptoms of trouble for Drucker, not primary causes of business crises. Rejuvenation of business through the development of a renewed theory of the business requires higher level strategic thinking, not ongoing trial and error over a prolonged period of time in a race against insolvency. A search for miracle workers and magic wands isn't going to transform an ailing organization into a success, says Drucker. What is required in the executive suite "is not genius; it is hard work. It is not being clever, it is being conscientious. It is what CEOs are paid for" (Drucker, p. 37).

Rejuvenation of business requires higher level strategic thinking, not ongoing trial and error over a prolonged period of time in a race against insolvency.

CEOs in deep beyond their capabilities may pray for mystical or divine intervention if they are so inclined, but what separates the efficacious from the poseurs, according to those who succeed, is that "they start out with diagnosis and analysis. They accept that attaining objectives and rapid growth demand a serious rethinking of the theory of the business. They do not dismiss unexpected failure as the result of a subordinate's incompetence or as an accident but treat it as a symptom of 'systems failure.' They do not take credit for unexpected success but treat it as a challenge to their assumptions.

"They accept that a theory's obsolescence is a degenerative and, indeed, life-threatening disease. And they know and accept the surgeon's time-tested principle, the oldest principle of effective decision making: A degenerative disease will not be cured by procrastination. It requires decisive action" (Drucker, P.p. 37-38).

Strategic market thinking and decisive action: that's what is required of business leaders, every day.

About

The Strategic Planning Group

The Strategic Planning Group (T.S.P.G.) is a full service consulting firm that can provide organizations with a wide range of advice, business tools and solutions. At T.S.P.G. our focus is on helping our clients solve their complex issues to realize their ultimate business potential, whether we are helping to set the overall strategy for the organization or assisting in a particular functional area. Our practical-results-oriented approach to solving business problems, combined with our personal commitment and dedication to providing great value for our clients, makes us the consultants of choice to blue-chip executives across North America.

We aspire to be more than just consultants. For us to be successful in helping you we need to understand how you operate and what challenges you are currently facing. We want to help you achieve your goals and your ultimate business potential. To accomplish this we must be trusted and objective advisors by contributing our knowledge, experience and thinking in ways that have a positive impact. We want to be *your* consultants of choice – as we are for other senior executives – for all of your strategic business needs.

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