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Smart Growth

BUILDING AN ENDURING COMPANY BY MANAGING THE RISKS OF GROWTH

ONE ONLY HAS to look at the recent financial crisis in the United States to see that good companies can self-destruct or self-inflict serious wounds by pursuing poor quality growth or by failing to manage the risks of growth. Examples are Merrill Lynch, Citicorp, AIG, Washington Mutual, and Lehman Brothers. Outside the financial services industry, one can also find good companies that have created serious problems for the same reasons.

In this book, I challenge some commonly held business beliefs about growth. First, I challenge the commonly held business beliefs (“Growth Mental Model”) that

1. businesses must continuously grow or they will die;
2. growth is always good;
3. public company growth should occur continuously and smoothly; and
4. quarterly earnings should be a primary measure of public company success.

These beliefs drive short-term business behaviors that in too many cases defer or destroy long-term value creation, decrease competitiveness, and can lead to premature corporate demise. Adherence to these beliefs can also result in the creation and manufacture of earnings that have no business purpose other than to help companies meet quarterly earnings estimates. These earnings neither are evidence of a company’s future earning power nor provide meaningful information regarding a company’s economic and strategic health and competitiveness.

Unfortunately, the Growth Mental Model reigns and permeates the public markets as well as private businesses. Many privately owned businesses believe that they must grow or they will die and that all growth is good. In reality, for both public and private companies, growth can be good or growth can be bad. In many cases, it is just as likely that growth can harm a business as it is likely that growth can enhance its survivability.

For U.S. public companies, the Growth Mental Model has been operationalized by what I refer to as “Wall Street Rules” that measure compliance. The Wall Street Rules dictate that public companies should grow continuously and smoothly. Furthermore, according to the Wall Street Rules, the best way to measure growth and predict the future prospects of corporate health is the metric of quarterly earnings. This focus on quarterly earnings is not merely retrospective. Predictions of future earnings growth is a banner waved to all investors. To get such predictions, financial analysts, with the input of management, create and announce quarterly earnings estimates. Companies are generally rewarded with increased stock prices for meeting or exceeding those consensus estimates. So powerful are these estimates of future growth that even strong companies who can report growth but fail to meet the estimates can be penalized by declining stock prices.

Making sure Wall Street Rules are met has given rise to a large and profitable fee business involving accountants, investment bankers, and lawyers who are paid well to help companies legally produce earnings that comply with Wall Street Rules, which I shall call the “Earnings Game.” Those earnings are qualitatively different from real, authentic earnings that arise from a company selling more products/services to more customers in arm’s-length transactions or from operating more efficiently or productively (“Authentic Earnings”). The arsenal of methods companies can use to play the Earnings Game includes accounting elections, valuations, judgments, reserves, elections, channel stuffing, liberalizing credit policies, structured finance transactions, financial engineering, related party transactions, investment transactions, and serial acquisitions. These noncore, nonoperating earnings help companies meet Wall Street Rules, which supports stock prices for investors and, as importantly, the value of managements’ stock options. The creation of earnings through accounting rules and the manufacture of earnings through nonoperating or non-arm’s-length transactions are the Earnings Game.

The challenge for investors and others wanting to evaluate a company’s underlying strength is that the Earnings Game is not clearly transparent, and studying a company’s quarterly or annual reports may not suffice. As a result, in most cases investors cannot determine whether a company’s earn-

ings were the result of Authentic Earnings or the Earnings Game. An unfortunate outcome of the Wall Street Rules is that the Earnings Game can mask or hide business sickness. Another unfortunate outcome is that corporate decisions are often made solely to meet the current quarter's earnings estimate.

The primacy of the Growth Mental Model has been accepted for decades. As far back as 1954, *Time* magazine, in an article, stated "Grow or Die Is the Chief Axiom of US Business." Although pervasive, there has been remarkably little systemic evaluation of the viability of the Growth Mental Model as a robust and useful approach to guiding business behavior or assessing business strength. As Chapter 1 shows, the origins and the basis of the Growth Mental Model are mysteriously hard to find. It appears that it has reached axiom status without rigor or empirical data as its foundation. Furthermore, it has permeated MBA programs, Wall Street, the business press, strategy and management consulting, and the investment community, resulting in a nearly maniacal focus on the Wall Street Rules and short-term earnings results.

The Growth Mental Model assumes that all growth is good and makes growth the key objective of a business. This results in people just assuming or accepting the assumption that every business must grow or it will die. This focus on growth fuels an insatiable drive for more—more stores, more markets, and more growth—often without adequate focus on the risks of such growth.

Smart Growth

Smart Growth as a concept rejects the Growth Mental Model because it is not based on science and does not represent reality. There is no justification in business, economics, or other disciplines for its dominance. Smart Growth rejects Wall Street's edicts that growth must be continuous and smooth, occurring each quarter, because there is no scientific or business basis for those rules. In fact, the research contradicts the likelihood of achieving that outcome. Smart Growth rejects the Earnings Game and believes business health should be measured solely by Authentic Earnings, which can include strategic acquisitions.

Smart Growth rejects the assumption that every business must grow or it will die. Smart Growth's objective is to create enduring businesses, which continue to meet the needs of their customers, employees, owners, and the

communities in which they operate. Smart Growth is not antigrowth. Smart Growth believes that improvement is more important than growth. And if a company continuously improves in ways that meet customers' needs faster, better, or cheaper than the competition, then growth may occur if the business makes the decision to grow. Smart Growth believes that growth should be a rigorous conscious decision rather than an assumption. And Smart Growth rejects the belief that all growth is good.

Smart Growth believes that growth creates business risks that need to be managed and that being better is more important than being bigger. If not properly managed, growth can stress a company's culture, its customer value proposition, its people, its execution processes, and its quality and financial controls. Growth is change. Growth changes businesses and people. Growth is a complex dynamic process that rarely happens smoothly or predictably without mistakes, bumps in the road, or detours.

Displacing the Growth Mental Model is not an easy task. However, supplanting the Growth Mental Model with a concept that is more realistic and is a better gauge of corporate health is a goal worth pursuing. Using research on growth theory from the fields of economics, strategy, organizational design, biology, and systems theory, I concurrently challenge the Growth Mental Model and ground Smart Growth in both science and business reality.

In addition, based on my research, I present case stories illuminating the key concepts of Smart Growth: building an enduring company by constant improvement that utilizes an internal growth system that includes an experimental growth/innovation model, a rigorous growth decision process, a growth risks audit, and a growth risks management process, which results in authentic growth.

At a very basic level, it is important to acknowledge that growth can be good or growth can be bad for a company depending on the circumstances. Growth is a complex change process that changes an organization, the people in it, and the myriad relationships both within a company and in its business environment. Growth should never be an assumed goal. Growth should be a conscious and rigorous management decision made only after weighing its pros and cons and developing both a growth strategy and a plan to manage the risks created by growth.

Organizational managers and leaders need to understand the circumstances in which growth can be bad:

- Growth can outstrip the capabilities and competencies of a company and its management team.

- Growth can stress quality and financial controls and destroy or dilute one's culture.
- Growth can dilute one's customer value proposition, weakening one's competitive position.
- Growth can take management's focus off of operational excellence, weakening existing business.
- Growth can put a business in a different competitive space, facing tougher, bigger, well-capitalized competitors.

When faced with the decision about whether or when to grow a company, I submit that business leaders and managers should continuously ask themselves the following questions:

1. Why should we grow?
2. How much should we grow?
3. Are we ready to grow?
4. What are the best ways for us to grow?
5. What are the risks of growth?
6. How can we manage those risks?

This book is written for business leaders and managers, strategy and management consultants, policy makers, accountants, investment bankers, and business students to provide an alternative way to think about and manage growth, which would replace the Growth Mental Model. Smart Growth is based on the notion that it is not only possible but also often desirable to limit or manage the rate of growth in order to be a successful company. Determining whether to grow, when to grow, and how to grow require important and complex decisions that need to be made objectively and not by blindly following the Growth Mental Model that equates success with growth.

Organization of the Book

Chapter 1: Defining the Growth Mental Model sets forth the pervasiveness of the Growth Mental Model and the lack of specificity of not only its origins but also its basis or justifications. Chapter 1 concludes with a case story about Tiffany & Co. that for years has espoused its strategy as "Growth Without Compromise" in an attempt to grow smartly. Tiffany has been a

Smart Growth company. The case questions whether public market pressures are now challenging its strategy.

Chapter 2: Smooth and Continuous Company Growth—The Exception Not the Rule challenges the belief that growth should be continuous and smooth by examining six research studies that show how difficult it is for public companies to grow continuously and smoothly for periods of time. Continuous growth is revealed to be the exception not the rule. In academic terms, the Growth Mental Model is severely flawed; in practitioner terms, it is unrealistic. Chapter 2 concludes with the Sysco story that illuminates how Sysco has built an internal self-reinforcing growth system that has made it a growth leader for years—one of the exceptions. Sysco is a Smart Growth company that understands that growth is more than a strategy. Sysco is a constant improvement execution champion.

Chapter 3: Economics—Theories of Growth looks at the works of leading economists in the Neoclassical, New Growth, Industrial, Behavioral, and Complexity schools of economics to test the Growth Mental Model along with the work of Edith Penrose and Joseph Schumpeter. The only support for continuous smooth growth in the field of economics is the theoretical ability to create a linear production mathematical formula that a leading economist describes as not what we see in reality. A scientific model that does not reliably reflect or predict real-world behavior is generally discarded. So should be the Growth Mental Model. Economics states that corporate growth rates are hard to predict and are nearly random. Chapter 3 concludes with McDonald's growth story that illustrates the fact that growth is not continuous in good companies and discusses McDonald's strategic focus on being better, not bigger. McDonald's is another example of a Smart Growth company.

Chapter 4: Organizational Design and Strategy—Theories of Growth examines research dealing with corporate half-truths, sustainable competitive advantage, hypercompetition, and growth progression, all of which challenge the validity of the Growth Mental Model. This research is the basis for many of the assumptions underlying Smart Growth. In addition, I introduce the Darden Growth/Innovation Model and the concept of an Enabling Internal Growth System. Chapter 4 concludes with a discussion of another Smart Growth company, Best Buy, and examines how it executed a major change in its business model by creating a new internal growth system.

Chapter 5: Biology—Theories of Growth ventures into the field of biology to look for support or challenge to the Growth Mental Model. This chapter cites work on nonlinear growth, how fast growth and size increases

predator risk, and findings in complex adaptive systems, all of which challenge the Growth Mental Model. This chapter concludes with two stories: the Procter & Gamble Company's (P&G) twenty-plus-year story of growth spurts, CEO changes, restructurings, product management reorganizations, and alternating top-line and bottom-line focuses, and private company Defender Direct's story of personal and business model evolution.

Chapter 6: Smart Growth—Authentic Growth exhorts the need for the investment community, boards of directors, and business leaders to reward the production of Authentic Earnings as contrasted with earnings created by the Earnings Game. The Earnings Game may enable the creation of inferior quality earnings that are legal, but they are qualitatively different from earnings created by Authentic Growth. Unfortunately, no one has studied the magnitude of this issue despite significant consensus that it exists. My concern is that the Earnings Game may create an earnings bubble supporting unsupportable stock valuations, which challenges the financial integrity of our financial markets. This chapter concludes with the Coca-Cola case, which looks at the various ways Coca-Cola has historically created its earnings.

Chapter 7: Managing the Risks of Growth—Public Companies looks at how growth can stress an organization's culture, people, customer value proposition, execution and quality control processes, and financial controls. I discuss Starbucks, Harley-Davidson, and JetBlue and introduce two more growth tools: the Growth Decision Process and the Growth Risks Audit. This chapter also discusses the Home Depot story and examines how its growth strategy diluted its culture and customer value proposition.

Chapter 8: Managing the Risks of Growth—Private Companies looks at the findings of my recent research dealing with the challenges of managing growth in fifty-four high-growth private companies located in twenty-three different states and in different industries. This research illuminates the complexity of growth, the human dynamics of growth, and the need to manage the pace of growth so as not to outstrip capabilities or lose the essence of the business. This chapter concludes with the story of Room & Board, a successful private Smart Growth company that rejected the Growth Mental Model.

Chapter 9: It Is Time for Smart Growth advocates changing the unrealistic, myopic view of corporate growth contained in the Growth Mental Model and replacing it with the Smart Growth concept. Smart Growth rejects the Growth Mental Model, the Wall Street Rules, and the Earnings Game as well as the assumptions that all growth is good and that bigger is better. To do this requires systemic change.

I suggest that we should replace “grow or die” as the gold standard of success with a different objective: being a high-quality, enduring company that continues to deliver compelling customer value propositions while creating value for shareholders, employees, and communities. As a country, we need less premature economic destruction, dislocation, job insecurity, and community instability. It is time for the business world to take back control of business from Wall Street and those who earn their living from volatility and transactions.

Chapter 9 discusses two more stories of Smart Growth companies: Costco and UPS. Costco has resisted Wall Street pressure to change its employee wage policy and its mark-up policy to protect its business model, and UPS has built an internal people-centric high-accountability growth system.

My research and consulting have exposed me to many cases where business leaders who blindly followed the Growth Mental Model ultimately destroyed good businesses and jobs and hurt many families and communities. I began my corporate growth research in 2002 having worked professionally in investment banking, private equity, and strategy consulting. In those careers, I had accepted the Growth Mental Model without critically thinking about its biases and limitations. I made my living helping finance and create growth companies. When I launched my research on corporate growth, I had no intention of challenging the Growth Mental Model, which had served me so well. Rather, I wanted to gain a better understanding of why so few companies were able to grow successfully over long periods of time. What I discovered surprised me and led to further research, which led me to develop this alternative model. The results of my research, consulting, and teaching are found in this book.

This book is not anti-growth; this book is about the reality of growth. Growth is a complex process, and this process does not fit into a deterministic, linear, mechanistic equilibrium world as mathematically modeled by neoclassical economics. My research and real-world experience have taught me that business growth is the result of a complex interrelationship of business and its environment, and it depends upon many human beings, with their cognitive limitations, being able to perceive and process information and communicate with each other in a manner that results in learning and adaptation to constantly evolving situations. This dependence of business growth on human behavior makes smoothness, prediction, and continuity difficult. The one-size-fits-all approach of the Growth Mental Model should not continue to dominate business thinking and behavior. The research and analysis presented here in support of the Smart Growth concept dem-

onstrates it is a better concept for understanding and guiding business growth.

Growth can be good and growth can be bad. It depends. Growth should not be assumed; rather growth should be a conscious decision made only after evaluating the risks of not growing versus the risks of growth and devising ways to mitigate the risks of the chosen path.

