By Bill Spitz, Principal

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Monumental Failure

What do you consider the most iconic corporate brands in American history? How about Coca-Cola, Apple, McDonalds, Disney, and Nike for starters? Would you also include Eastman Kodak, Polaroid, Sears, Xerox, Woolworth, Compaq, Pan American Airways, and Blockbuster? **Every company on the second list is either bankrupt or a shadow of its former self.** Capitalism is by definition rough and tumble so corporate failures are a fact of life. Somewhere between four and eight hundred companies file for bankruptcy each year in the U.S., and nine of every ten companies that were included in the Fortune 500 in 1955 have gone bankrupt, merged, reorganized, or contracted. But, how could companies like Kodak, Xerox, and Sears fail? They were household names that were responsible for amazing innovation and their CEOs graced the covers of Fortune and Business Week. On a personal note, I clearly remember my youthful excitement when the Sears catalogue arrived; I would longingly pour over it for weeks.

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DIVERSIFIED TRUST

Having witnessed so much corporate destruction, I was curious as to whether there are consistent causes or patterns that could be identified. After doing a good deal of research, I found that most business commentators immediately jump to one of two simple explanations for decline and failure:

- The company failed to innovate and was passed by competitors with newer and better products or services.
- The company was a victim of changing consumer tastes and purchasing habits.

These were certainly present in many cases. However, they are subsumed by the root cause of corporate failure which is misguided strategy that is in turn attributable to poor management. A good way to begin this discussion is to review the poster child for management failure which is Eastman Kodak. While its decline has been chronicled in many places, I include a discussion here because it is remarkable that a one-hundred year old company that enjoyed 66% global market share as late as the 1990's entered bankruptcy in 2012. While Kodak emerged from bankruptcy and continues to operate in several product categories, its current revenue of $1.2 billion compares to $16 billion in 1996, and its current market value of $397 million is a mere 1.5% of the company's $28 billion capitalization in that year.

A KODAK MOMENT

George Eastman incorporated Kodak in 1892 putting a simple camera in the hands of consumers with the slogan "You press the button; we do the rest." Kodak employed the classic razor/ razor blade strategy by selling cameras at a low price (or even giving them away) in order to garner film sales as well as revenues from processing and printing. Importantly, despite the fact that the company operated in a number of different market segments, it really viewed itself as being in the film business which is hardly surprising given that its profit margin on film approached 80%. However, as we will see, this mindset turned out to be a critical factor in its ultimate failure. With U.S. film market share of 90%, revenues crossed $10 billion in 1981, and the company employed 120,000 people at the peak. (Today's headcount is 4,200)

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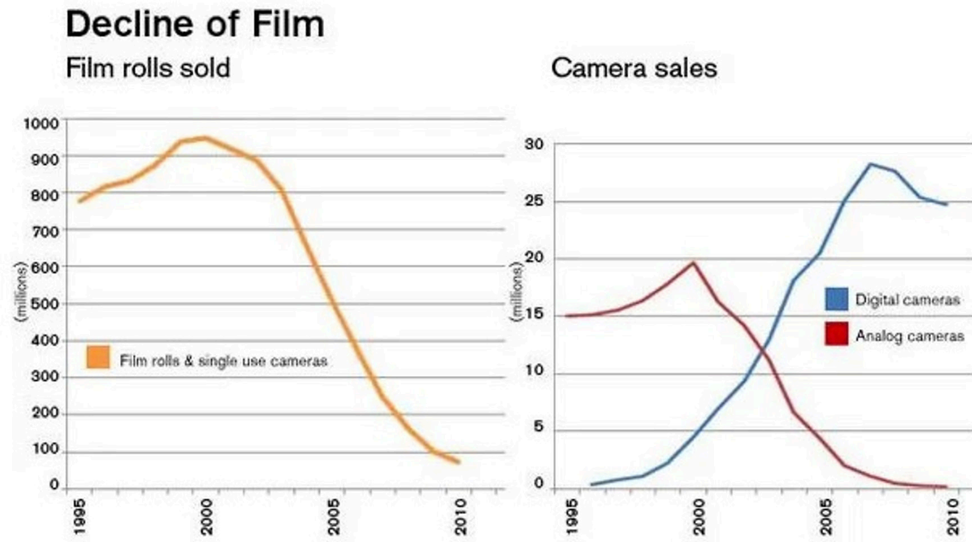
Given that digitalization ultimately led to its downfall, it is terribly ironic that the first digital camera was invented in 1975 by a Kodak engineer named Steve Sasson. He has said that management's response to his invention was "that's cute-but don't tell anyone about it." Sony launched the first commercial digital camera in 1981 leading a large retail photo finisher to ask Kodak for its views on whether the new technology posed a threat. In response, Kodak undertook a very detailed research project which concluded that digital photography did indeed have the potential to upend the film business. However, the study estimated that Kodak had at least a ten-year window in which to adapt and adjust. As it turns out, its forecast as to the timing was extremely accurate. The fact that the company had very realistic and accurate market intelligence is particularly damning because it largely squandered the ten-year grace period by tinkering around the edges as opposed to directly addressing the coming disruption. For example, it used its growing digital capability to improve the quality of film rather than to focus more broadly on digital photography. Under increasing market pressure, it launched a camera in 1996 called Advantix that still required film but allowed the user to preview her shots on a small screen and then order prints. In other words, it was a digital camera that still catered to the company's traditional film and paper business. The product totally flopped and the company wrote off its entire $500 million investment. Kodak also acquired a photo-sharing site called Ofoto in 2001. However, rather than focusing on the future which was photo storage and sharing (ala Instagram), the service was largely designed to stimulate users to print images. Similarly, the company installed thousands of Image Magic kiosks around the country that allowed customers to print images they had stored online. Unfortunately, this occurred just as competitors introduced low-cost photo printers that people could use at home.

The key point is that the company was so fearful of damaging its core film and print business that it was blind to the changing market dynamics that are pictured below. Sales of film rolls fell by more than 90% between 1998 and 2010. Similarly, sales of analog cameras declined from an annual rate of 20 million to essentially zero. At the same time, sales of digital cameras exploded to 28 million units by 2007.



Continuing with the theme of disruption, the proliferation of smartphones has contributed to an 87% decline in sales of stand-alone digital cameras since 2010.

Kodak shot itself in the foot in several other ways. First, it acquired Sterling Drug for $5.1 billion in 1988 based on the premise that both it and Sterling were essentially chemical companies that would enjoy a great deal of synergy. Kodak quickly discovered that the two companies were in very different businesses and eventually sold off Sterling piecemeal realizing roughly one-half of its original investment.

Second, Kodak bungled the process of CEO succession. The retirement of a long-time CEO in 1989 led to a horserace between two candidates: one with significant digital experience, and the other who had spent his entire career in the film business. The Board chose the latter who promptly announced that Kodak would stay closer to its core businesses of film and photographic chemicals. He lasted only three years and was followed over the next decade by three additional CEOs, each of whom promised to transform the organization into a digital powerhouse. None of them was particularly successful and it was probably too late in any case.

In their book **Billion-Dollar Lessons-What You Can Learn from the Most Inexcusable Business Failures of the Last 25 Years**, authors Paul Carroll and Chunka Mui conducted a post-mortem on Kodak that pointed to the following examples of poor strategy and leadership:

- The company saw the future as a variant of the present and failed to assess the risks associated with disruptive technology.
- In the face of new technology, the company tinkered with its existing business rather than making substantive changes.
- The company was blinded and paralyzed by the profitability of the core film business.
- The management team was insular and suffered from complacency and hubris.
- The organization lacked agility.
- The Company made unwise acquisitions in a desperate attempt to restore growth and profitability.

Each of these and a number of other factors are discussed in the following sections that address the common causes and patterns of corporate failure.

IT'S ALL ABOUT STRATEGY AND MANAGEMENT

There are many proximate causes of business failure including excessive debt, a lack of liquidity, poor execution, timing, environmental factors, and just plain bad luck. However, as stated above, all of these are ultimately associated with misguided strategy and poor management. In preparation for this paper, I read several books, dozens of articles in the financial media, and scholarly works in academic journals and the Harvard Business Review. I was able to distill the management failures identified by their authors into five broad categories. This synthesis is mine and would not necessarily correspond to the framework that other observers of the corporate scene might employ.

THE ROAD TO DECLINE AND FAILURE

Route 1 - Mergers and Acquisitions

Unfortunately, between **70% and 90%** *of all acquisitions fail according to the Harvard Business Review.*

Companies engage in M&A activity for many reasons including the potential to accelerate growth, access to new technology or markets, achievement of scale, acquisition of talent, and the benefits of operating synergies that lower costs. A more cynical view is that managements are motivated to acquire by virtue of the fact that executive compensation is at least partially tied to the size of the enterprise. Unfortunately, between 70% and 90% of all acquisitions fail according to the Harvard Business Review. They fail for many reasons including a lack of strategic fit, overestimation of synergies, poor internal communication, brand dilution, and customer attrition. The potentially fatal impact of failed acquisitions includes:

- Poor morale, employee conflict, and loss of key talent.
- Highly distracting integration problems, particularly for systems.
- A loss of focus on the core business.
- Financial strain attributable to the fact that companies tend to overpay for acquisitions and often assume heavy debt loads.

In addition to Kodak's ill-fated combination with Sterling Drug, two other candidates for the acquisition Hall of Shame are Quaker Oat's purchase of Snapple in 1994 and AOL's merger with Time Warner in 2000. Both immediately ran into operating difficulties, cultural clashes, and declining sales. Snapple was sold for $300 million just three years after it was purchased for $1.7 billion. AOL-Time Warner was unwound through a series of transactions over many years realizing a small fraction of its value at the time of the merger.

Route 2 - Poor Financial Management/ Creative Accounting

Companies frequently run into classic financial squeezes due to a lack of liquidity, an asset/liability mismatch, poor cash flow, or excessive leverage. However, there is a more subtle and insidious source of trouble which is aggressive and creative accounting. Many companies push the limit on their accounting practices but the problem comes when they cross the line between "aggressive" accounting and what Warren Buffett calls "alchemy." Some companies engage in aggressive practices in order to get through a

rough patch with the expectation of returning to the middle of the road at some point. The problem is that these practices become addictive; they create high expectations and pressure to continue to generate outsized results. The best-known example of the use of creative accounting is General Electric which employed a wide variety of techniques to deliver forty uninterrupted quarters of earnings that met or exceeded Wall Street estimates. However, GE has since paid several large fines to settle SEC charges of misleading investors and its current stock price is roughly 65% below its 2000 peak. While GE's practices were "edgy", WorldCom, Tyco and Enron crossed the line into outright fraud resulting in prison time for executives.

Route 3 - Inertia

This category combines a number of management failures that stem from complacency, hubris, and inward focus. It includes poor talent development, inadequate focus on the customer, analysis paralysis, insufficient attention to the competition, management that does not value different and challenging points of view, inadequate risk assessment, poor strategic thinking, an absence of creativity, and a general lack of urgency. This is also the area in which poor governance shows up given that the primary role of the Board of Directors is to guide management on all of these issues.

Once again, Kodak was guilty of many of these sins. Another example is Blockbuster which entered bankruptcy in 2010. Blockbuster failed to adjust to on-line streaming of video. Instead, it maintained a business model based on high-cost physical stores that were not competitive with lower cost Redbox kiosks and generally provided poor customer service with limited inventory and unpopular late fees.

Route 4 - Failed Innovation

While failure to innovate has certainly led to the demise of many companies, an equally dangerous path is to back the wrong technology, products, or markets. And, as was the case with Kodak, a third problem can arise when companies do innovate but fail to translate their R&D into commercially viable products or services. Here are examples of each.

Nokia dominated the mobile phone industry with market share in 2008 of 38%. However, the company failed to innovate by sticking with its outdated operating system resulting in devices that were not competitive with Apple and Android in terms of user experience, app ecosystem, and design. The company was also slow to employ touchscreens that became

the defining feature of smartphones. By 2012, its market share had fallen to 3.1% and the company suffered a €1.3 billion annual loss. Microsoft bought Nokia's mobile phone business in 2013 for $7 billion only to sell it three years later for $350 million.

A great example of backing the wrong technology is the introduction by Federal Express of its ZapMail product in 1984. Here is how it worked. A courier would pick up a document from the customer's location, take it to a FedEx office where it would be faxed over a proprietary network to another office. From there, it would be delivered by courier to the recipient-all within two hours. What FedEx failed to anticipate was that fax machines would decline rapidly in price making it economical for users to purchase their own devices and operate them over public networks. The service was discontinued in 1986 resulting in a write-off of $320 million.

Similar to Kodak's failure to commercialize its digital camera invention, Xerox was a R&D powerhouse that lost out to competitors who were quicker to bring new technologies to market. Xerox invented the graphical user interface and mouse, both of which became critical to the growth of the personal computer industry. However, the company did not commercialize them and instead allowed Apple and Microsoft to adopt these technologies. Xerox was also slow to embrace digital technology in its document management products which allowed competitors such as Canon, Ricoh, and Hewlett Packard to offer more innovative products. While Xerox still exists, its current stock price of $15.85 compares with the all-time high of $103 in 1999, a decline of 85%.

Route 5 - The quest for growth at all costs

Growth is certainly a prerequisite for a healthy enterprise but problems arise when a company does not have sufficient management bandwidth, infrastructure, or capital to rapidly pursue scale. Additionally, the desire for growth can easily lead to lemming behavior in which a company pursues strategies or markets in imitation of others. A particularly seductive strategy is to pursue what are known as adjacencies which are products or markets that superficially seem related to the company's existing business. Many of these attempts fail because the company actually lacks expertise in the "adjacent" business.

The classic example of unwise and uncontrolled expansion was Webvan which was founded in 1998 to deliver groceries to customers' homes within a 30-minute window of their choosing. Webvan raised $396 million in venture capital funding and an additional

$375 million in a 1999 IPO. The company's strategy was to acquire a fleet of vans and develop very large and complex distribution centers in four initial sites quickly growing to ten. Webvan's aggressive longer-term plan called for operation in 26 cities. Each center had five miles of conveyer belts that were operated by computers using very complex algorithms. The centers were designed to deliver 10,000 product bundles per day and each required a $50 million initial capital outlay. In 2000, the company achieved sales of $178 million but expenses totaled $525 million. With cumulative operating losses of more than $800 million, it filed for bankruptcy in 2001.

DEATH SPIRAL

Good to Great is a classic management book that describes how companies transition to greatness. Its author, Jim Collins, thought it would be interesting to study the other side of the coin, those companies that fail. The result was his book **How the Mighty Fall And Why Some Companies Never Give In**. Using the vast trove of data he compiled when doing research for Good to Great, Collins was able to identify what he called the Five Stages of Decline. The examples that I used to illustrate strategy and management failures were not described in great detail. Nevertheless, I believe you will be able to identify the Five Stages of Decline in many of them.

- **Stage 1 - Hubris Born of Success**: In this stage, management loses sight of what created success in the first place and largely limits its focus to internal processes rather than to customers, markets, competitors, and emerging risks.
- **Stage 2 - Undisciplined Pursuit of More**: Management focuses on more scale, more growth, and more recognition while frequently making undisciplined leaps into areas outside of the company's core competency. Frequently, the company outgrows its talent pool.
- **Stage 3 - Denial of Risk and Peril**: Managers ignore growing warning signs stating that emerging problems are cyclical or temporary. A particularly dangerous and common practice is to blame the company's emerging problems on external factors.

- **Stage 4 -Grasping for Salvation**: As the enterprise falls into decline, management looks for quick fixes rather than returning to the fundamentals that led to early success. Quick fixes include the selection of a charismatic leader, acquisitions, a radical restructuring, and the launch of a "blockbuster" product.
- **Stage 5 - Capitulation to Irrelevance or Death**: Financial strength erodes rapidly leading to poor morale, atrophy, outright sale, or even bankruptcy.

Importantly, Collins points out that a number of companies such as Apple, IBM, Marvel, and Starbucks have managed to recover from a near death experience and return to greatness. He provides a number of steps that increase the likelihood of redemption. They include:

- Formulate recovery strategies based on extensive analysis and data rather than on a bold, untested leap. Avoid "silver bullets."
- Avoid the temptation to engage in M&A unless the combination plays to proven strengths.
- Focus on clear performance metrics that are incremental rather than transformative. Create momentum with small wins.
- Gain clarity on, and re-emphasize, the company's core competencies.
- Search for a disciplined executive rather than a charismatic savior.

PERSPECTIVE

I did not write this piece to harshly criticize the managements of distressed companies although I do object to some of the severance packages that failed executives receive. As stated at the outset, creative destruction is a reality so running a large enterprise is a constant challenge in the best of circumstances. Instead, my goal was to provide information that might be useful to either an investor or corporate manager in recognizing and averting a coming storm. It has been said that the true measure of greatness is not the absence of difficulty but the ability to recover from setbacks.

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