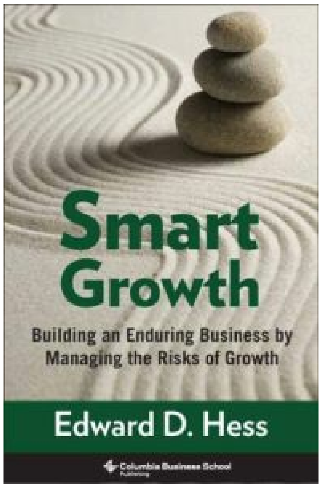

Book Smart Growth

Building an Enduring Business by Managing the Risks of Growth

Edward D. Hess
Columbia UP, 2010
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Recommendation

In this fervent academic treatise, Edward D. Hess applies more than a half dozen different strangleholds to bring the “Growth Mental Model” – also known as the “grow or die” corporate mind-set – to its knees. According to Hess, blind worship of growth causes companies to manage expectations by manipulating their earnings and to grow in ways that are downright irresponsible. Hess offers original research, case studies and academic rigor to convince you that there must be a better way – and there is. “Smart Growth” happens when companies flourish based on carefully managed plans, clear and reasonable parameters, and honest self-assessment. *BooksInShort* recommends this refreshing, alternative viewpoint to business leaders, managers at all levels, strategy consultants and the Wall Street types who insist on growth, year in and year out.

Take-Aways

- The “Growth Mental Model” drives the mind-set that impels companies to “grow or die.”
- As a result, corporations work to exhibit predictable, continuing growth – at all costs.
- Firms legally manage their earnings – through accounting methods or asset sales – to meet or beat Wall Street’s expectations.
- Winning the “Earnings Game” means short-term stock boosts, but potentially unhealthy long-term results.
- Growth for its own sake is not a guarantee of success, and firms do not achieve growth without introducing a degree of risk.
- During a 2007 blizzard, JetBlue learned that untrammeled growth can lead to disaster.
- Numerous business studies, along with evolving theories in economics and biology, prove that prolonged growth is largely unattainable.
- True corporate growth relies on incremental improvements, not manipulated income.
- “Authentic earnings” based on real sales and improved operations are the proper measurement of a company’s growth.
- “Smart Growth” is good for the customer, the business and the economy at large.

Summary

The Dangers of “The Growth Mental Model”

“Mental models” describe how individuals, alone or in groups, see and process the world around them. If a piece of information aligns with your mental models, you recognize its value and use it. If it doesn’t support or relate to your mental models, chances are your brain will discard it.

> “Growth should never be an assumed goal.”

The Growth Mental Model has attained iconic status in modern business; it drives many organizations with its underlying imperative that companies must "grow or die." The Growth Mental Model's narrative arc is simple: Growth is indisputably positive, and optimal growth is both predictable and continuing. Private companies often unquestioningly accept growth as their main objective. For public corporations, "Wall Street Rules" enforce rising quarterly earnings as the only measures of success. Investment banking analysts calculate those future quarterly earnings, and if your firm exceeds Wall Street's forecasts, your stock price gets a shot in the arm. But fail to meet the predictions – no matter how well your firm may have performed against other measures – and your stock price tumbles.

> "The Growth Mental Model necessitates the Earnings Game, which distorts corporate earnings and can stifle needed long-term investments."

To avoid that dire consequence, many companies play "the Earnings Game." With the help of attorneys, bankers and accountants, firms legally can massage quarterly figures by carefully timing income, changing credit terms, delaying expense recognition or selling assets. These are but a few of the "best practices" corporations employ to meet Wall Street's expectations and bolster their stock prices. Playing and winning the Earnings Game benefits – at least in the short term – executives, shareholders and those business consultants who are paid to boost earnings. But in the long run, the heights of growth Wall Street expects are ultimately unreachable, and they can undermine a company's health and the very integrity of financial markets.

> "In academic terms, the Growth Mental Model is severely limited. In practical terms, it is an unrealistic and a rarely achievable goal."

Growth for its own sake is not a guarantee of success, and firms do not achieve growth without introducing a degree of risk. Due to the pervasive Growth Mental Model, companies often chase growth without fully assessing its potential consequences – or worse still, in spite of its potential consequences. The pursuit of growth at all costs warps the very notion of what it means to expand and excel. Firms need to find better ways to do business – more productive means to manufacture or sell their products and services – in order to create nonmanipulated, "authentic earnings."

JetBlue: A Case of Too Fast, Too Soon

JetBlue Airways burst onto the US passenger aviation scene in 2000. The upstart airline achieved great success almost from the start; it grew rapidly, increasing the number of its routes and its aircraft. But in February 2007, that all changed when a massive snowstorm hit the US East Coast, grounding flights and closing airports. Though the inclement weather affected all airlines, JetBlue suffered the most: Its "communications and reticketing systems problems, in addition to crew management and rerouting problems," left passengers stranded on 10 JetBlue planes at JFK airport in New York. Travelers on one packed JetBlue flight "spent 11 long hours trapped on the tarmac."

> "Growth is a complex process, and this process does not fit into a deterministic, linear, mechanistic equilibrium world as mathematically modeled by neoclassical economics."

In the storm's wake, chief executive officer and founder David Neeleman blamed the airline's disastrous performance on "weak management and a shoestring communications system" that clearly did not keep up with the company's expansion in routes and flights. JetBlue's blazing growth blinded executives to the need for the "right people, processes and procedures" that could have handled contingencies, even one as predictable as a blizzard in the northeast US in February. Neeleman quickly replaced his chief operating officer and his head of the firm's JFK operations, but that was only the beginning: A few months later, JetBlue's board of directors fired Neeleman as CEO.

Nails in the Coffin

Multiple studies and interdisciplinary approaches show that the Growth Mental Model is not only flawed and unrealistic but an inaccurate description of actual business performance. Note these six studies and their results:

1. **"The McGrath Study"** – Only a small number of firms in this survey demonstrated "continuous growth" rates of 5% over five years. More than 90% of those firms used acquisitions to fuel their growth.
2. **The "Lipton" study** – Of 3,700 companies, just 3.3% consistently improved their profitability, and only 1% of those firms grew predictably.
3. **"The McKinsey Study"** – Research showed that companies that achieved continuous, consistent growth were mostly corporations in "high-growth industries."
4. **"Corporate Executive Board Study"** – Almost 90% of *Fortune* 100 firms from 1955 to 2006 experienced "growth plateaus" that interrupted linear revenue increases.
5. **"Hess's Organic Growth Index Study"** – No more than 11% of companies in this study – which focused only on authentic, nonmanipulated earnings – achieved smooth, repetitive growth.
6. **"Wiggins and Ruefli Study"** – Its long-term findings called "sustained superior economic performance" a "rarity" and questioned growth as a corporate objective.

> "A key missing variable in the Growth Mental Model is one that includes human beings who bring unpredictability, irrationality and personal relationship dynamics into play."

Yet capital markets, underpinned by widely accepted economic principles, still penalize companies that cannot deliver "smooth and continuous growth." The Growth Mental Model continues to drive companies despite bearing no resemblance to the way businesses actually function. Neoclassical economic models, which rely on mathematics and theory to simulate real financial activities, continue to support this dominant mental model.

> "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."

But more modern theorists question the model's relevance. Industrial economists note that the correlation between growth and profits is much lower than you might think, challenging the traditional view that "growth equals profits." Economist Edith Penrose posited that management's ambitions, abilities and attention determine the rate of a corporation's progress. Researchers in the field of complexity economics view the world as "dynamic, interactive, adaptive, evolving and unpredictable." They reject the linearity of the Growth Mental Model and consider growth as messy rather than smooth. These economists propose that companies should aim for constant improvement, learning and sharing as their corporate milestones, which don't necessarily relate to profit or asset growth. "Ecological steady-state economics" cites the Earth's limited resources as a natural brake on unlimited progress, and behavioral economists trace the herky-jerky nature of growth to humans' inherent irrationality and inefficiency.

> "Smart Growth believes that improvement is more important than growth."

Although theories suggest that stable growth should be possible, reality says that it is not. "Hypercompetition" in a global, technological business world has changed the game for growth. Research shows that traditional ideas about long-term competitive advantages for companies are giving way to short-term competitive advantages or even "relative" competitive advantages that lead more naturally to sporadic and intermittent growth spurts.

> "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."

Biology also contradicts the prevailing grow-or-die model. In fact, for some species, to grow is to die: Predators often opt for larger prey. If it is to thrive, an organism must continually adapt and change, but not always in an orderly, stable fashion. More and more, it's becoming clear that serving the Growth Mental Model while playing the Earnings Game requires a blatant disregard for reality.

Do It Right

Companies that oppose the grow-at-all-costs trend to generate authentic earnings have plenty in common: They follow "disciplined, focused strategies." Their managers are "humble, passionate operators" who maximize their employees' capabilities. These firms are not necessarily the most innovative companies, but they execute consistently and progress incrementally. They stress internal alignment among people, strategy, policy and rewards. And they exercise the nine-step "Growth Progression":

1. They start by growing their operations geographically.
2. They expand their product range to their current clients.
3. They extend their sales into new markets.
4. They add value to their current product offerings.
5. They "focus on cost efficiencies."
6. They drive "technological productivity" with their suppliers and manufacturers.
7. They strategically make "small scale" product or client acquisitions.
8. They evolve from selling discrete products to "selling solutions."
9. They return to step 1, all the while enhancing their procedures.

> "Growth can occur without improvement. And improvement can occur without growth. Growth by itself will not prevent a company's death."

This step-by-step, often experimental, approach – and the results that spring from it – rarely unfolds in a "smooth and continuous" manner. The course of actual progress, in other words, is rarely that of the Growth Mental Model.

Toward "Smart Growth"

The bottom line, in nature and in business, is that growth should be organic, planned and nurtured. Smart growth allows a business to add value to its constituencies. Your company should grow because it is committed to "authentic growth" and willing to accept the risks growth brings. Authentic growth produces real earnings that originate through "arm's length transactions" and improved operations. Unlike massaged earnings that provide a quick, short-term boost, authentic growth earnings reflect a company that serves a different set of masters – not Wall Street, but customers, employees and stakeholders.

> "Growth can stress a business's leadership, culture and employees; its quality and financial controls; and its execution processes."

Is your company improving? Is it doing a great job of meeting its customers' needs? Then growth might be a good option – but only if the company is able to manage it properly. Growth is change, and change is difficult on cultures, people and processes. Companies can expand only to the extent that their employees can handle everything that comes with growth. Growth can push a company onto a playing field on which the firm is not yet ready to compete, either because its management team is not prepared or because a more fleet-footed competitor is already there. Crucially, bigger is not better; only better is better.

> "Good strategies are not good unless people can execute them...people can only change so much, so fast and so often, and any change will generate mistakes."

Never grow just for the sake of growth. Before committing to growth, ask a series of hard questions – and be willing to provide honest answers. You need to know, for example, the "why" behind your decision. You also need to consider the "preconditions for growth": Are your people equipped to grow? Can your corporate culture withstand the impact? Will your growth attract a new competitor? How will you know if growth is really working?

> "What should replace the grow or die axiom? It should be replaced by 'improve to stay competitive'."

If your company is private, you have other factors to consider as well. With fewer resources than a public company, a "growth mistake" that might cause a mere ripple in a public company could result in massive disruption in your organization. Common growth mistakes for private companies include:

- Becoming significantly larger without planning for the challenges ahead.
- Failing to "manage the pace of growth."
- Changing the working dynamics among people, structures and processes.

- Outgrowing previously important, long-standing employees.
- Growing beyond the firm’s resources.

> “I think it is in our national interests to systematically promote and enable the building of enduring Smart Growth companies.”

Improper or reckless growth guarantees you will have problems. Paradoxically, though, you cannot stand still; not improving is not an option. So replace the obsessive grow-or-die attitude with a mentality that improves products and services, executes more effectively and adds value for your customers. Growth that is not smart growth is not just bad for business – it’s bad for the entire economy.

About the Author

Edward D. Hess, a professor at the Darden School of Business at the University of Virginia, has written eight books and his work has appeared in more than 100 media outlets.