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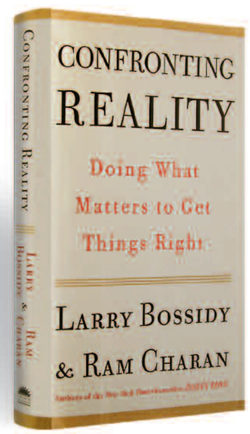

By Larry Bossidy and
Ram Charan

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Doing What Matters to Get Things Right

CONFRONTING REALITY

THE SUMMARY IN BRIEF

Any plan for a business has to answer three questions: What's the nature of the game? Where's it going? How do you make money in it? Yet, in many organizations today, they rarely get asked — much less answered — adequately.

It takes unflinching realism to get such answers, but the established methodologies for defining the purpose of a business have drifted steadily away from realism. Many people today are boxed in by dysfunctional practices and habits that more often than not obscure reality, rather than expose it. Fewer companies will succeed in the future because the business environment is becoming far less forgiving of mistakes.

In their previous book, Execution*, the authors focused on the gap between strategic plans and outcomes, pinpointing execution as the missing element. In* Confronting Reality *they explain that the gap originates with the nature of how people conceive the purpose and direction of their businesses.*

This summary reveals how organizational processes are flawed. People don't fully understand the game they're playing because they don't look at it hard enough. Specifically, they don't analyze and link the three fundamental components that determine a business's success or failure: the environment it operates in, the financial targets it needs to meet and the internal activities and capabilities it depends on to meet those targets.

In addition, you will learn:

✓ ***How to implement the business model the authors developed to achieve a robust, reality-based process for thinking about the specifics of your business in a holistic way.***

✓ ***How to use a process called "iteration" to debate and harmonize your external environment and financial targets with your internal capabilities.***

✓ ***How companies like EMC, Cisco, 3M and The Thomson Corporation used this business model to decide what they needed to change.***

✓ ***How you can anticipate future events, condition your culture for the changes required and develop leaders who can succeed in this tumultuous environment.***

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CONFRONTING REALITY

By Larry Bossidy and Ram Charan

— THE *COMPLETE* SUMMARY

When Reality Bites

The most widespread unrealistic behavior when the game changes drastically is to violate the First Law of Holes (when you're in one, stop digging). They often achieve heroic results — which are, alas, almost as often pointless, because they fail to confront the new realities.

To lead successfully in today's environment, you need to employ a business model based on the world's new reality. Such a business model answers the following questions:

- Is the "how" of making money in my business and industry changing?
- Who is winning in my industry, who is not winning and why?
- How, specifically, are winners making money?
- If my business is a winner, what do I need to do to stay on top?
- If I change my game, what, specifically, should I be doing?
- Am I in a growth industry or not? If not, and I want to continue playing in the game, how do I change or play it better than the competition?
- Is my organization moving quickly to spot and take advantage of growth opportunities generated by these changes?

The Six Habits of Highly Unrealistic Leaders

1. Filtered Information — They may get information only from people with the same point of view. Or the information may be distorted by people because of their own biases or agendas.

2. Selective Hearing — Leaders practice selective hearing for several reasons. The most common reason for this is preconceived notions or past experience, e.g., looking into the rearview mirror, the arrogance of success and refusal to confront a problem because they can't see a solution.

3. Wishful Thinking — This is the root of much selective hearing and seeing, e.g., the acquisition will work because we need it to. Information to the contrary doesn't make it through the screen. Wishful thinking can take the form of rhetorical statements based on experiences, such as "The market will come back — it always does."

4. Fear — Fear may be embarrassment over saying the wrong thing at a meeting, or a necessity in a culture of fear. Some tyrants fire people for disagreeing with them. More common and pernicious in companies that force-rank executives, people who make superiors uncomfortable risk being downgraded to a lower performance percentile.

5. Emotional Overinvestment — People can accomplish great things with deep commitment. The downside is that emotional investment in a project may blind them to its weaknesses. Some of the most poignant victims of emotional overinvestment are companies with great histories of innovation. Nobody has the courage to say that the splendid history is just that — history.

6. Unrealistic Expectations of Capital Markets — It's vital to create value for shareholders. The downside: Many leaders become captive to unrealistic performance expectations, notably the pressure for steady, predictable quarterly improvements. They respond by making unrealistic promises, which often they can keep only by bending their businesses totally out of shape. ■

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Upended: Why the World Is Changing

Virtually every business is now a player on the global stage. Understanding how the world business environment affects you starts with distinguishing between cyclical and structural change.

While cyclical changes are a part of business life's normal ups and downs, structural changes are fundamental, long-term alterations in the basics of making money. Structural changes are usually hard to differentiate from cyclical ones in their early stages — when you really need to see them. By the time they're obvious, your odds of adjusting well to them are sharply lower.

Three structural changes drive today's explosion of intensifying worldwide competition:

1. **Increasing integration of business activity across borders, accelerated by the Internet.**
2. **Worldwide overinvestment, fueled by a vast credit expansion and immense free flow of risk capital.**
3. **A global buyer's market that has shifted power from owners and managers of capital to consumers and giant retailers.**

Also, beware of the wild card: Government regulators around the world are getting more aggressive and coming at different issues without coordination or rationalization of their policies.

Why Don't Companies See These Things Coming?

Planners typically put their time into studying strengths and weaknesses of important rivals, which are usually traditional competitors in their home markets, and seeking ways to beat them. This is far too narrow a focus and may allow other players to set the direction of the game. You are dealing with something very close to the hypothetical butterfly of chaos theory, whose beating wings in China can ultimately generate a tornado in Iowa.

The challenges of a changing environment inferred by the butterfly beg the questions:

- Can you see growth in your industry?
- Is it profitable?
- Are supply and demand in balance?
- How far are the products of your industry from being commoditized?
- Is it structurally defective or heading that way?
- How do you stand in relation to your competitors?
- Where is the technology going? Can you foresee making breakthroughs with either one product or a series of products or a division?
- How does your talent compare with that of your competitor, and is it equal to what the customer needs?
- Do you have legacy costs that can sabotage your competitive advantage? ■

Redefining the Basics of Management

Rising competitive intensity forces a return to basics, but in a far more fundamental way than the operationally focused 1980s. Getting down to basics today means focusing on how you can create intrinsic or fundamental value for your business.

Fundamental value is a combination of real profit, real return on investment, appropriate cash generation and growth that is sustainable based on continuing differentiation of your products in the marketplace. Your ability to create fundamental value rests on how good you are at finding the right balance between your external and internal realities and your financial aspiration — how skillfully you develop and use your business model.

Leaders hoping to grow their way to success through mergers and acquisitions had better think again. Studies repeatedly show that companies that grow mainly through acquisitions are less successful than those that earn most of their growth organically. Consolidation cannot return an industry's dynamics to "normal" if the player's business models have been overtaken by structural change. The only good reason for an acquisition is to enhance the fundamental value of an enterprise. In other words, it must complement and strengthen the business model.

Another old practice ready for the scrap heap is that 1990s holdover, maximizing shareholder value in the short run. As the dot-com phenomenon made clear, market valuations aren't necessarily connected to the fundamental value of a company. ■

The New Model for Confronting Reality

The business model proposed in this book offers an organized, rigorous way of looking at the health and profitability of a business, now and in the future. It is a statement of your current reality and its probable — as opposed to hoped for — future direction. It is also an early warning system for real-world changes that pose threats or provide glimpses of opportunities. Finally, the model is a blueprint for taking action. By using it to test the actions you want to put in place, you gain a better understanding of what will and won't work.

How Does a Business Model Work?

The model starts with a logical breakdown of many elements that make up a business, from its markets to

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The New Model for Confronting Reality

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income statement to leadership development programs. These group into three components: the environment you business lives in; your financial targets; and business activities.

The Financial Targets

As you search to determine the right relationship between each component of the model, you develop a basis for adjusting financial targets to reality. The purpose of these targets is not to strive for precision over, say, three years, but to recognize that the changes in the external environment, as well as most changes in internal activities, have consequences that must be recognized in the financials.

Strategies, Operating Activities, People and Organization

Only when you've crystallized the realities of the external environment and linked them with your chosen set of financial targets can you think about strategies, operating activities, selection and development of people and organizational processes and structure.

Questions to ask when thinking about strategy in the context of a business model:

- If your industry is delivering financially attractive results and you aren't, what are the reasons?
- If the industry is underperforming, is there something you can do to overcome the root causes?
- How can you develop flexible plans that provide directions rather than specifics? Many strategic plans are rigidly linked to fixed projected numbers for three to five years. Instead, you have to plan directionally: What mix of actions do you plan to take, and what's the range in which your resource allocation will take place? When any variable changes, you have the flexibility to respond.
- What productivity initiatives, such as enterprise resource planning (ERP) systems or outsourcing, will make you more competitive by lowering your costs?
- Do you have the resources to finance the strategies and initiatives you identified?
- How good are your operating activities? Do they ensure that your strategy provides distinctive experience to your customers and delivers one or more financial targets?
- Do you have the right people to pull off the introduction of new initiatives? Are they properly deployed?
- What obstacles in your business stand in the way of reaching your goals?
- Are you focusing on the right initiatives for growth? To grow at a faster rate than your industry, you need some edge — a cost advantage that enables you to sell at a lower price, new and better distribution channels, serving parts of the world not yet served, a breakthrough technology, better knowledge of the customer, a more effective organization.

Iterating the Model

As you work through the external environment and your internal activities, your financial targets will change according to the realities you've identified. Each iteration depends on understanding what you can and cannot reasonably expect to accomplish. You identify areas where you may be able to improve your performance — or ones you thought held promise but which, under scrutiny, do not after all. You learn whether of not all the moving parts of the plan mesh with each other. Each of these discoveries is a new iteration of the business model.

The iteration process is where you make tradeoffs. ■

Assessing External Realities

The four elements of making a realistic assessment are the following:

✓ **The broad business environment:** existing and potential competitors; economic, demographic and technological trends; regulatory issues; and structural and cyclical changes

✓ **Financial history of your industry and its players:** the attractiveness of your industry

✓ **Your customer base:** arguably your most precious asset

✓ **Root-cause analysis:** underlying causes of trends and issues you've identified.

Getting to Reality

When Michael Wisbrun was appointed head of KLM Air Cargo in 2000, its management team foresaw that companies would develop more and more worldwide networks and supply chains. The team wanted to position Air Cargo as a leader in this emerging trend. But Wisbrun had serious reservations about the business model he inherited.

When he examined financial targets, he saw that the division had flat revenues and was barely breaking even. Cash flow was negative and the return on investment was approaching zero — not a great foundation for a bold, unproven strategy.

Worse, his external analysis of the new model turned up a major flaw in the vision. Large integrators such as

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Getting to Reality

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FedEx and UPS were already serving the market; not many customers were looking for similar service from an airline, and those who were didn't seem willing to pay for it. "The business model clearly wasn't anchored in reality; its parts didn't mesh," says Wisbrun.

Modeling the Solution for KLM

External Realities: The marketplace was not ready for the logistic services the strategic planners hoped to offer. But there was opportunity in the core air cargo business, where some of KLM's competitors were making money.

Financial Targets: Cash flow was negative and return on capital close to zero, revenues were flat and the division was barely breaking even on margins.

Internal Activities: The idea people who were advancing the strategy lacked operating skills and didn't pay enough attention to their financial targets. Their huge, long-term logistics project was consuming resources without generating growth.

Iteration: Searching for the right mix of elements in the three components, Wisbrun pinpointed flaws in the existing strategy: It was out of step with current market realities and imposed a prolonged drain on financial resources.

In his first iteration he assessed prospects for a new strategy — return to the core business — and focused on people, creating a new management team to help him determine requisite changes in people and operations. He and his team then established realistic financial targets and revisited the model every six weeks.

Within a year, cash flow and margins improved. By early 2004, KLM Cargo was a leading player in the industry and gaining market share. Improved financial performance allowed it to acquire new and more efficient freighters to further increase market share and improve margins, asset utilization and cash flow. Because the management team practices the business model drill regularly, all of its members are not merely masters of their functional silos but well versed in the totality of the business. ■

What to Change and What Not to Change

There is no one-size-fits-all plan of action. The ability to zero in on precisely the parts of the business that need attention and leave the rest alone is just as much a sign of great leadership as is reinventing the business model when radical action is needed. The business model brings rationality to the issue of change. Use it to identify and anticipate external realities and make realistic, positive change.

Facing Crisis: What EMC and Cisco Did That Sun Didn't

All three companies were successful during the tech boom. Then EMC and Sun found themselves facing structural change in their external environment. While EMC chief Joseph Tucci faced facts and reinvented his business model, Sun's Scott McNealy struggled to keep his old course. Cisco's John Chambers realized that his problem was not structural but cyclical and operational. He put his company through profound change, but his business model remained intact.

Modeling the Solution for EMC

External Realities: After the tech crash, purchasers of storage systems cut back on expenditures and switched from EMC's high-cost products to cheaper ones. Competitors were also developing machines for the high end, at lower cost.

Financial Targets: Revenues, margins, profits, cash flow and ROI were all falling precipitously.

Internal Activities: EMC was geared toward producing premium-priced products with proprietary software and high margins. Its technologists strove to design and build highly sophisticated machines and its salespeople, operating as loners, were aggressive because they had the most desirable products on the market.

Iteration: Tucci's external analysis showed that the old strategy was obsolete because market changes were structural. Financial targets could not recover without a new business model. He started with a new strategy: Recapture and expand the customer base by selling lower-cost hardware, software — open, not proprietary — and solutions.

He and his management team met often to iterate in the search for solutions. The first iteration left too much high-end product to meet targets for costs, margins and products, leading to further efforts to produce for middle and lower markets. Subsequent iterations revealed the need to replace people who couldn't adapt to new conditions and to restructure the organization. Financial targets were revised upward as the action plan produced results.

Modeling the Solution for Cisco Systems

External Realities: Demand plunged as customers cut back on purchases and confronted mounting industry overcapacity. But Cisco's cutting-edge products were still desirable.

Financial Targets: Revenue growth stalled, margins shrank and cash generation slowed.

Internal Activities: Cisco's operations and organizational processes were designed for high growth. Product prolif-

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What to Change and What Not to Change

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eration and controlling costs were not a high priority.

Iteration: Chambers correctly analyzed the market downturn for Cisco; it was cyclical, not structural. He kept financial targets and strategy intact and modeled ways to align them with new and future marketplace realities.

After establishing the likely volume of sales, he searched repeatedly for ways to lower costs and get his desired margins. In subsequent iterations, Chambers saw opportunities to get into new markets and segments vacated by fallen competitors; with plenty of cash, he moved to exploit them.

Modeling the Solution for Sun Microsystems

External Realities: As with EMC, Sun's customers deserted its high-priced, high-performance products after the bubble burst, seeking cheaper alternatives.

Financial Targets: Revenues plunged and margins collapsed. Cash generation slowed drastically.

Internal Activities: Sun maintained its technological leadership with intense R&D efforts. Its people and organizational processes were geared to selling unique and demonstrably superior products.

Iteration: Judging the market change as cyclical, McNealy at first stuck to his original strategy and focused on cutting costs. As it became apparent that changes were structural, he went through many iterations to find other ways to meet the targets, including broadening his market with lower-priced models, pooling his resources with other technology suppliers and moving toward open architecture in some product lines.

Simultaneously, he continued his traditional course, spending heavily on R&D to develop dazzling new technologies.

While Tucci, Chambers and McNealy responded differently to the industry shakeup they faced, there are common lessons to be learned from their experience:

- In times of crisis, it's essential to understand the environment as it has become and is likely to be, rather than what it has been.
- Thoroughly refresh your understanding of your customer base before you decide what actions to take.
- Ruthlessly assess your organization.
- Be rigorous in measuring the progress of your turnaround, keeping an eye out for any sign of slippage from the chosen path.
- Approach any crisis without preconceptions. This is the time when relying on the past or on conventional wisdom can lead you rapidly to disaster. ■

Innovating for Growth: The New 3M

When Jim McNerney became CEO of 3M in 2000, the company had been ambling along with unremarkable earnings, little revenue growth and a lethargic stock price. As a transplant, he could have brought in a prepackaged solution, raising financial targets and driving people to meet them. But he was a master of business-model thinking, so he took a different course.

3M had a basically sound model. McNerney recognized it would be important not to damage a strong culture built on innovation that did many things well. Defining the situation as "a build rather than a teardown," he concentrated on the third component of the

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Rebuilding the Foundation: Home Depot

Home Depot roared its way through the 1990s, but then the rocket fizzled out. In 2000, same-store sales declined, the company issued a profit warning and the stock plunged. Robert Nardelli was brought in to straighten out the company.

Nardelli used the business model as his mental framework, scrutinizing each of the three components. The external environment didn't seem problematic, but the financial component was badly out of balance. Home Depot had relentlessly pursued top-line growth to make its earnings-per-share targets. But cash was getting soaked up by inventories and capital expenditures, and sales at stores open more than a year had begun to decline. Expanding beyond 200 store openings a year, he concluded, was not realistic unless cash and recruiting of qualified store managers could keep pace.

Connections between financial targets and internal activities gave Nardelli much to ponder. Home Depot was an operational free-for-all. The company needed leadership development. As Nardelli iterated the model, connections between internal activities and financial targets became clearer. He rapidly and massively accelerated investment in information technology. Once he had the right kind of people in place, he made bold moves in operations.

Changes were anything but smooth. Between May 2001 and early 2003 the stock price fell from $52 to $22. Acknowledging that he'd made some mistakes, Nardelli stuck to his business-model targets. By spring 2004, people were finally noticing his accomplishments. In three years, annual sales, net earnings and cash had grown. The stock price had climbed back to the $30s.

Innovating for Growth: The New 3M
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business model to uncover weaknesses in operations — the people and organization processes that kept the company from realizing its full potential.

Modeling the Solution for 3M

External Realities: Markets in general were growing well, and there were no dramatic threats on the horizon.

Financial Targets: 3M was meeting all of them, but they were modest and well below the company's potential.

Internal Activities: Talented people made the company an innovation machine. But new product development was disconnected from customers and took too long. Operations lacked discipline.

Iteration: During six months of meetings with senior management, McNerney searched for ways to improve financial results without damaging 3M's culture of innovation. He repeatedly iterated his approach to change until he was satisfied that he had the right mix and sequence of actions.

He then set higher financial targets, transparent both inside and outside the company, and began to change organizational processes, combining many businesses and centralizing things like purchasing. After conditioning his people for change by introducing a Six Sigma initiative, he overhauled the innovation processes to speed them up and connect them more closely with the marketplace.

The results have been clear: 3M shortened the new product introduction cycle by a year and a half. Revenues grew by $1.5 billion from 2000 to 2003, and operating margins rose several percentage points during that period, just shy of the goal McNerney originally set. The stock price has nearly doubled since he took over. McNerney is admired both inside and outside the company. ■

Seizing Opportunity: How the Thomson Corporation Transformed Itself

The Thomson Corporation didn't appear in need of transformation when Richard Harrington took over as CEO in 1997. The U.S. $8.8 billion business had enjoyed an almost legendary status for its empire of newspapers and professional publications. It also owned a travel and resort business in the U.K. Overall, revenues were growing about 8 percent a year, compounded.

But Harrington's central question was whether a model dependent on regional newspapers would run out of gas no matter what new strategy might be conceived and executed. His analysis exposed a simple but crucial question: If the model is not adequate for the future, what fundamentally needs to change? What arena can we play in where the business model will create long-term value?

Modeling the Solution for Thomson

External Realities: The newspaper and travel businesses were currently profitable, but the future looked less promising. By contrast, Thomson's smaller professional publishing business appeared to have enormous growth potential.

Financial Targets: Thomson was currently meeting its long-run targets. But with the newspaper business, that would not necessarily be the long-term case.

Internal Activities: People, operations and organizational processes were well harmonized for existing businesses.

Iteration: Harrington recognized that structural changes would erode the newspapers' profitability. He and his board agreed that Thomson should create an entirely new business model that would achieve desirable financial targets by publishing information for professionals such as financial services people and lawyers. Harrington first modeled the relationships between different sale prices for businesses to be sold and investment required to build professional publishing. Arriving at a balance that would not require heavy borrowing, he proceeded with the plan. Moving forward required continual changes in people and organizational processes, with results weighed constantly against the progress on financial targets.

Over its transformation period, Thomson grew its total revenues at a compounded annual rate of 7.4 percent and organic revenues at about 5 percent. Thomson was listed on the NYSE in 2002 with an initial market capitalization of $19.5 billion; in May 2004 it stood at $21 billion. It is widely recognized as the industry leader in transforming itself into a provider of value-added electronic solutions. ■

How to Prepare for Change

Succeeding in today's business world requires skills and abilities that haven't been given much weight in the past. Acute radar is one: You need to "look around corners" and discern parts of the external environment that will affect the future of your business.

In most businesses, people put most of their time into studying the strengths and weaknesses of major rivals. They look for ways to beat competitors.

But you constantly have to ask bigger questions:

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How to Prepare for Change

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- Can you see profitable growth in the industry?
- What could commoditize it?
- Can you foresee a technology change that could alter the rules of engagement?
- Who else might become a competitor?
- What government policies are brewing that could affect you for worse or better?
- Is the industry structurally defective, or heading that way?
- Most important, what do your customers think?

To know and anticipate these things, you must take information gathering to the next level. It must be a real-time process: a social mechanism with frequency and consistency.

If you do it just during the planning session, it's too late. It has to inform the business model and all the daily decisions people make about their direction and processes. Mostly you need to converse proactively by asking questions, listening and keeping your mind open about answers. You do it not just in routine meetings, but when you're meeting with people from different parts of the business or at a trade show or at lunch with a supplier. ■

Getting Ready: How to Condition Your Culture for Reality

The more change your organization can handle, the more freedom you have in adjusting your business model. The readily available tool for conditioning your organization to change is the initiative — a specific, high-impact project that requires cooperation across the entire organization, such as enterprise resource planning, Six Sigma or digitization.

How to Lead an Initiative

If an initiative is important enough to launch, it cannot be allowed to fail. The leader's follow-through keeps the initiative alive and encodes it into the organization's DNA. Before you start, ask yourself:

- Do you understand the initiative well enough to develop metrics to evaluate its implementation?
- Are you willing to commit necessary resources for education?
- Do you have the focus and discipline to drive it through the organization?
- Do you have the stamina to repeatedly convey the importance of the initiative through your actions as well as your words?
- Do you have the courage to confront those who are standing in the way?
- Is cynicism changing over to excitement? ■

Leading for Reality

Companies are full of talented, hardworking people whose time-honored leadership qualities have taken them to the top but aren't adequate for the task now at hand. Two leadership qualities have become absolutely indispensable:

Business savvy — People with business savvy know how to make money. They have business models in their minds and understand all three components and their relationships. They have a gut feel for the external environment.

A need to know — Leaders relentlessly pursue critical information that can make all the difference to their business prospects.

Identifying and Developing the Right Kind of Leaders

The processes most companies use to spot potential leaders aren't geared to finding those with the qualities needed most today. In addition to business savvy and intense curiosity, these include flexibility of mind, perpetual adaptability, willingness to change and courage to risk failure.

What does the person you're watching talk about in meetings? What sparks her curiosity? How broad is her scope? Does she have a natural tendency to search for root causes? Does she shape a set of options before doing anything? You can learn a lot about a person by watching how he solves problems. Does he diagnose a situation based on what's worked in the past, resorting to familiar solutions, or search for new and creative approaches?

Are the people you're looking at broad thinkers? Listen to the options they propose and notice whether they sit or act on them. ■