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CHAPTER 1

The First Cycle: Why Success Breeds Failure

LIFECYCLES FOLLOW THE WAY PEOPLE THINK

The history of business is paved with companies where roaring success was followed by steep decline: Digital Equipment Corporation, MG-Rover, and Upjohn, just to mention a few. Steep decline followed decades of prosperous growth and industry leadership. It seems as though a virus was allowed to enter into the once-healthy businesses. The virus gradually spread without management or staff really bothering or even knowing what happened. Alarm signals were overheard or neglected for years. Management continued to act as if the company was successful, even at a point where the emerging disaster was obvious to outsiders.

That's how a company's lifecycle usually goes: It begins with a period of struggle before the business takes off. Then, there is a period of rapid and prosperous growth with frequent new product introductions, growing market shares, and high customer satisfaction. After this growth period, a period of stagnation often follows, in which management is under increasing pressure. Consultants are brought in and management is changed,

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followed by painful downsizings that temporarily restore profitability. Mergers and acquisitions are used to create new growth and profits through cost savings from elimination of double functions.

But the capability of the business to continue the former organic growth seems to have disappeared. Despite apparent financial success, the lifecycle is about to turn into a death cycle. Additional management changes, additional downsizings, and additional mergers fail to address the key issue: The company has lost the innovative capability, the focus, and the energy that originally made it successful. Subsequent downsizings lead to corporate anorexia: The organization becomes leaner and weaker.

Companies die from this process, either from being taken over by others or simply by going out of business. The first lifecycle becomes the last. The lifecycle becomes a death cycle.

This book is about breaking the stagnation or downturn of the first cycle and turning it into a second cycle. It helps you understand if you are actually in danger of being caught in the downward cycle. It suggests how you can create a new platform for a second cycle and how you can move the existing organization from the first into the second cycle.

Cycles are determined by the way people in general, and managers in particular, think. To understand why, you need to look upon the way people think.

Imagine you are driving your car on the way to an important meeting. You take an alternative route with very little traffic to play it safe. You have enough time, but not too much. Suddenly, there is a smell from something obviously burned or at least very hot. Within a split second, your brain builds what is called a mental model of the situation, building upon your experience from previous situations and your current situation. How far do you still have to go? How much time do you have? What happened last time you had a burned smell from your car? Where can you get a taxi?

Your mental model of the situation is built on very limited actual information: the smell of something burned. But you add all sorts of other information from past experience to provide you with the relevant framework to analyze the situation and to act. You have

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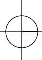

stopped thinking about what you will say at the upcoming meeting. Not even 10 percent of your mental energy is devoted to that any more. You have changed your mental model 100 percent, from thinking about today's meeting to dealing with the smell issue. After a few minutes of driving, you stop the car. Very cautiously, you open the hood to find out how serious the trouble is. Will the motor catch fire?

After a little search, you realize that the smell comes from a few leaves that somehow have entered the motor at a hot spot. The leaves are almost burned and there seems nothing left to be concerned about.

Now your *mental model* immediately switches back to the situation before you discovered the smell: You now think of the meeting, the people you will talk to, and the contract you hope to land. A new mental model has entered once again based on very limited information, but drawing on vast reservoirs of knowledge from your brain. Again, this new mental model doesn't share the attention of your mind 80 percent or so. One mental model at a time dominates your thinking 100 percent.

Mental models determine the way people think and act. They enable us to switch very quickly from one situation to the other. We don't need to gather detailed information about the actual situation because the brain simply chooses a mental model, downloads it, and starts to use it.

Despite quick access, mental models have been built over long periods of time. The more times you have faced a specific type of situation, the more you have developed your relevant mental model.

Organizations have mental models, too, especially successful organizations. Organizations tend to remember their successes and failures. The more successes they experience, the more aspects and nuances they add to their mental model. They remember the development of a very successful product and how they surprised competition with a unique marketing concept. They remember how a group of engineers came up with a new technology that boosted performance of the company's product, and they don't forget the managers that came from another industry

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thinking they could change this industry without fully understanding it.

Organizational memory is the foundation for their mental model. It defines their success formula, such as "The H-P Way," and it determines their reactions to problems and opportunities. It guides their thinking and defines their horizon. The more successful the organization is, the stronger its mental model becomes.

As an illustration, let us go back and take a look at how the mental model of my former company, Oticon, emerged in the 1970s and 1980s.[1]

HOW OTICON BECAME DEAF

In the 1960s, Oticon was a small local hearing aid manufacturer serving primarily local and regional markets with Denmark as its home base. Denmark, however, had a unique combination of three factors that were found nowhere else in the world:

- Research within the field of sound had reached a world-leading level at the Technical University of Denmark.
- Ear, nose, and throat (ENT) doctors at Danish hospitals were highly focused on better hearing care to their patients in addition to cost-effective care. This was unlike doctors in other countries, such as the United Kingdom, that focused almost entirely on cost reduction within hearing care. In other words, Denmark's doctors went for greater value, whereas most others went for cost reduction.
- The Danish government was willing to publicly subsidize treatment for hearing loss at Danish hospitals—unlike any other country in the world at that time.

The three small Danish hearing aid manufacturers were quick to take advantage of this situation and competed fiercely to develop higher performing and more reliable products to serve the needs of

[1] You can find the full Oticon case study in the appendix at the end of this book. It includes both the growth and decline parts of the first cycle and the subsequent turn-around that led to Oticon's second cycle.

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the Danish hearing care service, whereas hundreds of manufacturers in the rest of the world were mainly focused on cost reduction.

Within two decades, the three Danish manufacturers—and Oticon in particular—had won positions on the list of the 10 largest manufacturers in the world, enjoying a combined market share of more than 30 percent of the world market.

Oticon was the most successful of the three, and company sales and profits skyrocketed. The company grew to more than 1,000 employees in about 10 countries. The four directors were seen as gurus, and salaries, pension schemes, offices, and company cars reached a level that was perceived as suitable for a world-leading business. The first cycle was at its steep growing stage.

It was in this period that Oticon's mental model emerged. Oticon's mental model perceived hearing aids as standard hardware products to be manufactured in large series in their highly automated plants. It looked upon users as patients with little choice, which was the reality those days. The choice of hearing aid was a professional one, made by audiologists and hearing aid dispensers, not by consumers. Oticon's mental model rightly perceived acoustical performance as the key criterion for choosing one hearing aid over the other.

Oticon was the master that took the lead in moving hearing aids from the pocket to behind the ear—a great achievement, marketing-wise and technologically. The behind-the-ear mental model of the 1970s was indeed a winning formula for Oticon.

But customers wanted to move to the next stage: They wanted hearing aids to move into the ear and the ear canal, a distance of less than an inch. However, this move was difficult from two points of view: Space in the ear was much smaller than behind the ear and worse, the shape of ear canals differed tremendously from person to person. That required the behind-the-ear mass-produced product to become a customized one. The market moved from mass production to mass customization.

Oticon stuck to its mental model despite the apparent change in the marketplace. Oticon honestly thought that consumers were wrong. Consumers didn't understand what was good for them. And

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professionals seemed to be so hungry for business that they accepted the demand for inferior in-the-ear products.

Oticon started to lose business. In Oticon's mental model, there was only one logical response: to develop even more superior behind-the-ear products so that the acoustical quality difference would be so obvious that nobody would choose an in-the-ear hearing aid any more. Oticon started to refine and improve its outdated mental and business model. It defended its current mental model by prescribing more of the same. More of what it was good at: high performance, behind-the-ear hearing aids.

More and more salespeople were unhappy. They reported back reactions from dissatisfied audiologists that threatened to stop doing business with Oticon if Oticon did not enter the in-the-ear segment. They perceived Oticon to be arrogant. Oticon management fought back by ordering the salespeople not to waste their time talking like competitors. They should instead go out and sell the Oticon advantage to audiologists.

Oticon continued to defend and improve its irrelevant mental model for almost 10 years. And when the headwind became too strong, Oticon's entrance into in-the-ear hearing aids was only half-hearted.

Even at the time when custom-built in-the-ear products had captured half of the world market, Oticon maintained that the market was wrong and the whole thing would blow over.

It didn't.

Finally, Oticon's response was to develop a mass-produced, standard, in-the-ear product that needed no customization—that is, a behind-the-ear product to be clicked directly on to the ear mold. Sound was fine, but it looked nothing but terrible and the market completely rejected it and bought the customized products instead.

Oticon lost market share, but continued to blame the competition and the customers. It was only when the company lost about half of its equity in one year (1987) that the board finally realized that something radical had to be done. The upward part of Oticon's first

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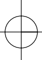


lifecycle had lasted about 75 years. The downward part, or death cycle, had lasted almost 10 years. During the first eight or nine years of the death cycle, management still had the illusion that the company was on the upward trend. It had no idea that below the surface of success, Oticon was heading directly into bankruptcy and extinction.

The board of directors' diagnosis was that the company needed a strong leader that could reduce costs and restore profitability. It prescribed more power and authority.

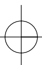
There is no question that Oticon needed power and authority, but the real issue was different: how to reinstall hearing into a deaf company. In other words, how to make a conservative company innovative and flexible, how to carry through a paradigm shift, and how to break the first cycle and build a platform for a possible second cycle.

Oticon was an extreme example. It should have been obvious to management that something was fundamentally wrong. But even in such an extreme case, Oticon management—then the dream team of the industry—did not realize that its mental model was becoming irrelevant.

Reflect for a moment. Could your organization be in the middle of exactly the same development without management having a clue? Hopefully, your organization has not progressed too far into the phases of decay so that you have time to take the necessary steps; and hopefully, this book can inspire you to find out where you are. Remember that it is not only managers of the hearing-aid businesses who lose their hearing; the mechanism is the same and the need to challenge your mental model is no less important for any industry.

THREE FACTORS THAT TURN THE LIFECYCLE CURVE

Companies are caught by the cycle on their way up, not on the way down. It is when success is celebrated that the virus of arrogance enters the body. When a CEO speaks enthusiastically about "The Company Way" or "Our Recipe for Success," he or she opens the company up for a virus that may be fatal five or 10 years later.



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That is the virus that turns the direction of the organizational lifecycle.

Three basic factors eventually turn the lifecycle curve for organizations into a death cycle: size, age, and success. Table 1-1 shows how the mechanism functions.

Table 1-1 How Organizations Get on the Downward Track

Success:	Leads to more:	With the consequence that:	But the organization continues to blame others:	…Which in the end leads to decline and:
Successful growth over time involves three basic factors:	Management layers. Departments.	Management loses touch with customers and grassroots.	Competition that has become much more intense this year.	Less action. Slower action.
■ Size. ■ Age. ■ Success.	Formalized procedures. Long-range planning.	Information gets delayed and filtered.	Customers that have changed preferences to much cheaper products.	More of the same action—that is, less innovation.
	Budgeting. Reports. Meetings. Coordination. Suboptimization.	Arrogance prevents management from taking challenges seriously.	The rise or fall of the U.S. dollar. The emergence of low-cost suppliers from Asia. Unions that demand higher wages and expensive health schemes.	
	Traditions. “Our way” mentality. Internal friction. Intrigue.			

Before we go into each of the driving forces, think for a moment about your own organization:

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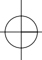

- Where do you think your organization is on its lifecycle curve?
- Have you ever heard management discuss this question?
- Are the employees as satisfied as management with the current state of affairs?
- Do customers feel that your organization is as service minded and flexible as management thinks it is?

If your answers to these questions indicate that your organization might need a wake-up call, you are not alone. My experience is that most organizations need it, in particular, those that have grown beyond 100 employees, those that are more than 10 years of age, and those that have been reasonably successful with what they do.

SIZE

As organizations grow, they tend to become more fragmented. They need more management levels, more specialized departments, more middle managers, more executives, more staff functions, more assistants and support functions, and larger corporate headquarters.

This fragmentation introduces filters between decision makers and where the action is. In small businesses, the owners and leaders know every single customer, small and large. They hear about every single complaint and they also meet satisfied customers that tell them what the customers like about the company. They know every single employee and probably their families. They are close to where the rubber meets the road.

In a larger business, there are departments that take care of every aspect of customer relations: marketing and sales, delivery, customer service, finance, and communication. And most top managers consider their primary role to be managing the whole company rather than interfering with any specific department. Customers become statistics or numbers. Satisfied customers show up as percentages in surveys. Dissatisfied customers are counted as quality costs. Customers' ideas for product modifications or innovations may be picked up by salespeople, but rarely make their way out of the sales department.

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All of this leads to a longer distance between the places of the "real business," where the company meets the customer, and management. Information from the market does not reach management at all, or may only reach management in a refined form—for example, in statistics. In the filtering and refinement process, the essence of information is often lost. In particular, this is because those that do the filtering and processing tend to convey that part of the original information that they believe management wants to hear or see.

AGE

As organizations grow older, they develop traditions. It is not only that they conduct the New Year's reception exactly like last year, which is highly visible. But organizations also develop their specific ways of communicating internally, a culture of conflict handling or avoiding, and a tradition for dealing with new ideas that may be much less visible. Many such traditions are not even recognized as specific to the company—they are just the natural ways we do things around here.

Traditions may be very important, despite the fact that they are invisible. If there is a tradition for lack of communication between the sales department and research and development, one day products will tend to meet the engineers' needs rather than the customers' needs. Age gives tradition preference over innovation. And the older the company gets, the stronger the preference for tradition gets.

SUCCESS

Success is the most dangerous factor, however, because success inevitably leads to self-satisfaction. The more successful organizations become, the happier they are with the way they currently do things. "The H-P Way" or the "Siemens Spirit" reflects pride and happiness with the way things are. They are mental models that once were successful, but are not necessarily successful any more.

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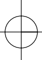

Only rarely do organizations know concretely the true source of their current success. Customer surveys may indicate that superb product design is a strong factor, but in reality, formulas of success are more often a combination of multiple factors that don't show up in surveys. In particular, soft factors very rarely come up—for example, management style, fundamental company values and their interpretation, or a unique interplay within a group of key people. And long after that unique point has gone away, the organization continues to believe that it possesses the secret key to success. The organization continues to perceive that it is still on the upward part of the lifecycle curve, and it often takes a dramatic crisis to uncover the reality.

Such companies may well show growing sales and profits, but rarely through the dramatic organic growth that once created their success. Mature businesses often enjoy massive positive cash flow from their original (cash cow) core business. These cash flows tend to be spent outside of the core business with the result that the core business is milked to a degree that leaves too little for the ongoing renewal and regeneration of it. Therefore, growth in mature businesses often comes from mergers and acquisitions, and profit goes up because of savings, often following large layoffs. On the surface, companies may look to be successful and healthy even at times when their culture and capabilities are in decay. First generation management that had a passion for products and customers is substituted with a different type of manager that is more financially oriented. In the short term, this may result in higher growth and profits, but long-term sustained growth seldom comes from clever financial management. When finance enters the CEO's office, passion goes out.

Success always builds on one or more unique advantages for the company: a uniquely valuable or cost-effective product, a unique relation to or control over distribution, or some other factor that creates a type of temporary monopoly.

The company that has enjoyed such a monopoly for some time may make several mistakes without those mistakes having serious consequences. The monopoly has a built-in inertia as long as it

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continues to be a monopoly. But when the monopoly is lost, which may happen quickly, the consequences of past mistakes add up to rapid decline, which at this point is very difficult to stop. The apparent upward part of the corporate lifecycle therefore usually takes much longer than the downward part, the death cycle.

DEAFNESS

There are two main components in the ear that allow hearing:

1. The three bones that transmit sound from the tympanic membrane in the outer ear to the cochlea, which is the sensing organ in the inner ear.
2. The hair cells in the cochlea and the hearing center of the brain, which processes and interprets the sounds.

When the following happens, impairment occurs:

If the ear bones lose connection, the sound is not transmitted and the cochlea gets a poor signal. If hair cells break and the brain forgets its natural routine in interpreting what it hears, even a good signal is perceived as noise.

The organizational structure and the traditions are like the bones of the ear. If they don't function properly, management gets a poor signal. Culture and misperceptions of the reasons for success are like the brain. If they don't work properly, management misinterprets whatever signal it gets.

The process of being caught in the lifecycle is similar to the process of losing one's hearing: For many years, the hearing may actually deteriorate without the person noticing it. And when she actually realizes that she doesn't hear well any more, she most likely rejects the problem for a decade and blames others for not speaking clearly and loudly enough.

When people lose their hearing, an early stage reaction is to guess what was probably said and answer accordingly. Ask one question and answer another. And when the problem gets more serious, the hearing impaired will listen less and talk all the time.

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Companies behave similarly. They think they know what the problem is and they act accordingly. Or they simply stop listening and do more of the things they know best.

Neither strategy works.

In addition, organizations seldom take responsibility for what happens. They tend to blame others for it: competition, currencies, customers, and globalization.

The resulting organizational deafness leads to a behavior that seems to be independent of industry and country:

- Organizations react more slowly to both problems and opportunities.
- Organizations tend to respond by doing more of the same rather than doing something different from what they are used to.
- Organizations maintain a self-perception of success long after success has gone away.
- Organizations reject ideas and solutions that were not invented within their organization's walls. They consider competitors and customers inferior to themselves. They know better.
- Organizations and their top management develop an increasingly arrogant approach to criticism. Long after they have lost the battle, they continue to act as if they own the world.
- Whatever may be left of entrepreneurial management is substituted by "professional" or financially based management, which believes that key financial figures are its most important tool to run the business.
- Focus shifts from long-term value creation to short-term bottom line. Downsizing, mergers, and acquisitions become the dominating responses to demands for better financial performance.
- The company team spirit changes into a culture of internal competition and friction. Ever more detailed internal accounting systems are introduced to improve financial accountability.

In short, innovation often goes out as financial management moves in. Examples are numerous. Exceptions are few. Think of some from your part of the world and answer the questions in the

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Food for Thought section at the end of this chapter for each of them. You may also want to perform the more comprehensive self-assessment in Chapter 7, "The Toolbox."

THE FIRST CYCLE BECOMES A DEATH CYCLE

The first growth curve of a company may last from five to 50 years or sometimes even longer. Initial business model and product, marketing, or service concepts may be so unique that they last for generations with minor adjustments only. At least this was the situation 20 or 50 years ago.

At some point in time, the upward trend reverts. The question is not *whether* this turn occurs, but *when* it occurs. The downward trend is the second half of the first cycle—that is, the death cycle. It took Oticon about 10 years to lose everything the company had gained in the first 75 years of its lifetime. During this period of decay, both management and investors may well continue to perceive success: Downsizing improves short-term profits. Mergers or acquisitions may boost both top-line and bottom-line growth. Ambitious management goals may lift share prices and hit news headlines.

It is in this period of internal decay with increasingly short-term financially focused management that the company needs the second cycle the most. And it is probably also the time when the company most lacks the capability to create a second cycle.

This is not a new discovery, but it is a discovery that has become much more important. The reason is that change happens faster than before, and the nature of change is different: Companies don't primarily lose ground just because they are slow to adapt to a new situation. They lose because they don't realize that the new situation may be fundamentally new, thus requiring a fundamentally different approach instead of just a modified approach. They are so happy with their current mental model that they simply cannot imagine a radically different one.

Fundamentally, new situations occur more often than before because products and services contain much more knowledge

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than before—including new technologies and radically new materials. Moreover, buying habits move quickly—for example, from a specialized store to a hypermarket or from a physical store to the Internet.

Products as varied as eggs, cars, and banking services were once almost commodities. But now, you may buy eggs from different types of hens that have been fed and kept differently—for example, organically. Cars often come customized in every respect, and banks are no longer just banks.

Firms unable to anticipate or react very quickly to changing needs simply fall back. Hearing and reading the signs of the market has become ever more essential. Sticking to an outdated mental model can be fatal.

The choice is simple, but difficult to realize: You may either continue the first cycle downward or break it by fundamentally questioning its basis—that is, your mental model. If you dare do so, you have started to create the basis for your organization's second cycle.

FOOD FOR THOUGHT

Think of the current mental model of your organization:

- How does the company look upon customers, suppliers, employees, competitors, and the local community?
- What was the situation in which these views were formed?
- Which fundamental changes have occurred since these views were formed?

Do you want to analyze your organization's mental model further? Look at Chapter 7.

Here is a short checklist to help you determine whether your organization is about to get caught in the cycle:

- Does your organization anticipate or react to problems and opportunities as quickly today as it did when it was younger?

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- When your organization faces a problem, does it consider responding in ways that are completely new to you?
- Are you aware of any competitor products, technologies, systems, or marketing concepts that are clearly superior to your organization's?
- Does your organization's current organic growth match the growth it had when it was younger?
- Will the CEO of your company think you are a great employee if you tell him or her that you honestly believe the company's business model is outdated?
- Judging from what your company actually *does*, is it more important that the company create long-term value than meet the budget?
- Are you and your fellow employees more empowered to make decisions than you were 10 years ago?

If you answered "no" to two or more of these questions, you should consider performing the self-assessment discussed in Chapter 7. You might be surprised!