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Creative Destruction

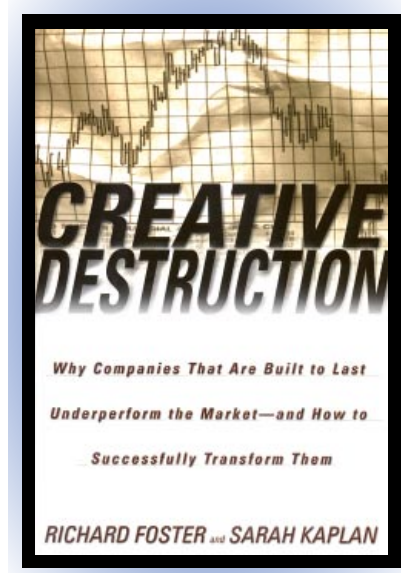
*Why Companies That Are Built to Last
Underperform the Market—and How to
Successfully Transform Them*

Richard N. Foster and Sarah Kaplan

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Reviewed by Susan Carr

Chapter One: Survival and Performance in the Era of Discontinuity

During the 20th century, highly revered and much-touted “built-to-last” corporations tended to underperform the market by a significant amount, while upstarts outperformed the market and their established competitors. The fact that there has never been a “golden company” that consistently beat the market is due to differing principles under which capital markets and corporations operate. Markets, built on the assumption of *discontinuity*, “enable, manage, and control the processes of creative destruction” by encouraging new entrants that produce superior results and value and by “remorselessly” replacing weak performers that consume wealth. This process has always been at the heart of capitalism, but the pace of change is accelerating, to the extent that we have entered what Peter Drucker calls the Age of Discontinuity.

Most corporations, however, continue to operate pursuant to an assumption of continuity that prevents them from keeping step with the dynamics of the market. Their quest for perpetuity is characterized by a blind

adherence to mental models that can impede, or even prevent, creativity. Moreover, as corporations grow and become more complex, they become weighed down by rules and procedures that discourage innovation. In order to keep pace with the markets, which are not plagued by such “cultural lock-in,” corporations must be redesigned from top to bottom. While companies have historically focused on operations, stressing continuity over evolution, they must now begin to embrace the assumption of discontinuity by generating or acquiring new businesses and ejecting marginal ones, while still maintaining control of operations.

Organizations seeking to succeed, not just survive, must learn to “act like the market” and adopt policies that will enable them to “change at the pace and scale of the market.” They must adjust their planning and control processes and rely on *divergent*, as well as *convergent*, thinking. This requires that they focus more on asking the right *questions* than on having the right *answers* and that they select, equip, and motivate the right employees, rather than control them.

Chapter Two: How Creative Destruction Works—the Fate of the East River Savings Bank

Originally founded in 1848, the East River Savings Bank became an innovative and seemingly invincible institution that continued to prosper throughout the Depression and beyond, largely due to strategic acquisitions. In the 1970s, however, East River sought to diversify by aggressively acquiring S&Ls and investing in real

estate but, by 1997, it had fallen victim to bad loans and new owners.

This is but one example of the creative destruction reflected by the changing composition of market indices, such as the S&P 500. Although companies have been added

“The right of any corporation to exist is not perpetual but has to be continuously earned.”

— Robert Simons

and deleted from this list since its inception, the turnover has been accelerating over the past 70 years, because new companies are generating higher shareholder returns. A comparison of changes and long-term performance in industries, individual companies, and the overall economy reveals that no companies, not even long-term survivors, have been able to outperform their industries for long periods of time.

Companies that do achieve returns that are above the industry average are likely to be new entrants that enjoy superior performance only for a limited time; they surprise analysts, whose historical models cannot adequately forecast their performance. And, they generate high investor return, only to inevitably fall into more normal patterns of corporate behavior and industry and market performance. Strong long-term performance can only be achieved by *mastering continual change*. Thus, companies within industries that experience a great deal of change seem to sustain higher performance levels, as do the industries themselves: They are adept at dealing with discontinuities that result from technological changes, government policies, and changing attitudes.

Chapter Three: Cultural Lock-In

Mental models reflect a corporation’s core beliefs, and are used to “edit” the world and facilitate operations by simplifying complex situations and permitting distributed decision making. While mental models can provide a distinct competitive advantage, they can also be oversimplified, improperly used, inaccurate, and are rarely subject to any control or assessment. Thus, mental models often present the single most important barrier to change. Although mental models cannot, and should not, be avoided, they must be reexamined and adapted to reflect discontinuity and new opportunities.

Primarily, mental models have an impact on a corporation’s information systems, decision making,

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executorial capabilities, and control processes, which together form the corporate architecture, or MIDAS (Models, Information, Decisions, Actions, and Systems of control). This architecture evolves as the corporation matures, and if not managed correctly, will progress to cultural lock-in, virtually paralyzing the corporation with fear of cannibalizing its own products, competing with its customers, and diluting earnings. This is the final stage in the evolution of an industry, which begins with the “attack” stage, in which mental models are still fluid, organizations are driven by passion and commitment, and the emphasis is on day-to-day operations. While operational excellence will always be a key component in competition, it is not

“By 2020, more than three quarters of the S&P 500 will consist of companies we don’t know today—new companies drawn into the maelstrom of economic activity from the periphery, springing from insights unrecognized today.”

the only factor. Corporations can no longer rely on mental models based on traditional assumptions. They must also learn to overcome natural denial and confirmation biases, in order to prosper, and cannot succumb to fears that do not affect the market.

Chapter Four: Operating vs. Creating—the Case of Storage Technology Corporation

Founded by IBM employees, convinced they could produce cheaper disk and tape drives, Storage Technology Corporation quickly established itself by selling quality products at a significant discount. Success led to expansion into mainframes (in an attempt to compete head-to-head with IBM) and a resultant loss of control in operations. After rushing new drives to market, with faulty parts from substandard suppliers, the company labored to repair the defective drives and its tainted reputation, while IBM recaptured market share. Left with a large inventory of drives, Storage Technology filed bankruptcy and replaced its CEO. Under new leadership, the company downsized and refocused on drives and, although it recovered for awhile, it again suffered from an imbalance between operations and innovations, as well as a failure to perceive the market shift to personal computers. Despite the fact that Storage Technology is still the dominant player in its sector, mainframe tape storage is a limited market that does not offer much of a future.

In order to avoid Storage Technology’s fate, corporations must maintain operational excellence as they pursue innovative strategies. Entities wishing to initiate change must first evaluate how their own corporate architecture defines their response to discontinuous events and then accurately assess and effectively manage the level of innovation. Incremental innovations are actually closer to operational excellence than creative destruction; they aren’t particularly new, have minimal impact, affect only current strategy, and are easily implemented—often by frontline personnel.

At the other end of the spectrum, transformational innovations are very new, create enormous wealth, are usually “competency destroying” (by outplaying the competition), and so violate traditional corporate concepts and operational systems that they are rarely initiated by existing companies.

These types of changes must be instituted and led by senior management.

Substantial innovations are often second-generation changes that follow and continue the attack originated by transformational innovations. More extensive and far-reaching than incremental changes, but less sweeping than transformational changes, they may offer a significant competitive advantage (by reinforcing and augmenting the original innovations) and often lead to subsequent innovations, or *positive returns*. Implementation might require outside expertise as well as the expertise of senior management, but probably in an advisory role.

Regardless of type, however, all innovation is founded in creativity, which requires both convergent and divergent thinking. Rarely practiced in the corporate arena, divergent thinking is characterized by three phases: *search* (in which the thinker seeks inconsistencies and anomalies often overlooked by management); *incubation* (in which data simmers until answers are clarified); and *collision* (the end of incubation, when good ideas are generated). Convergent thinking is more rational and deductive, with people focusing on the details of the current situation and using a two-step process of decision and trial in order to screen potential solutions. While divergent thinking deconstructs a problem into smaller pieces, convergent thinking “reassembles” it and reduces it to its essential core.

Creativity is difficult to manage; in fact, many managers find it difficult even to relate to creativity because it does not fit into corporate “operating disciplines of decision making, measurement, and control.” Although creative and operating personalities differ, corporations should search for individuals with a blend of operating and creative expertise, since they are singularly equipped to lead creative destruction efforts while maintaining operational excellence.

Chapter Five: The Gales of Destruction

Destruction is the means by which markets “maintain freshness by eliminating those elements that are no longer needed.” New, efficient corporations put pressure on existing companies that often are unable to change quickly enough to compete successfully. Although destruction signifies “the end of the economically useful life,” it does not necessarily mean death; it could just as easily result in a spin-off.

Like innovation, destruction comes in three levels: incremental (a normal part of operations that does not impact the corporate mental models and can be executed by the organization’s front line); substantial (necessary when key functions need to be replaced or overhauled and require senior management intervention); and transformational (which “irreversibly changes the course of the corporation” and is often driven by market events). All three types of destruction are necessary in order to keep a corporation fresh.

Chapter Six: Balancing Destruction and Creation

In order to keep up with the market, companies must simultaneously *create and destroy at the scale and pace of the market*. Destruction is just as essential as innovation to maintain freshness and continue prosperity, but is more complex because it requires overcoming the natural bias built into the corporate structure. It also requires management to demonstrate confidence in the corporate vision, to possess advanced executional abilities, be willing to destroy current business, and be determined to “build the skills to produce new revenue streams.” The balance between creation and destruction is delicate, and “extraordinarily difficult” to maintain, but necessary

to keep a corporation from being the victim of market housecleaning.

Chapter Seven: Designed to Change

Any entity seeking to succeed in a discontinuing environment must be more than an efficient operator; it must mimic the market by becoming a “creator, operator, and trader of assets.” This requires a new corporate architecture that supports multiple mental models (similar to those present in the market), an increased rate of change, open decision making, and relaxed controls. In a creative environment, where there is less definitive information and more need for flexibility, *thinking* right is just as important as *doing* right; thus, permission is more conducive to desirable outcomes than control.

Thus far, private equity companies offer the best example of architectures that foster creation, operation, and trading. Both venture capital and principal investing firms (or LBO associations) share features which enable them to “ride the gales of creative destruction,” and their “create-operate-trade” models have been extremely effective in providing above-market returns for their investors. They

“No amount of experience in the operating environment can prepare one to perform well in the creative environment, and vice versa. The skills, for the most part, are in opposition to one another.”

both make intermediate, *limited-life investments* and do not invest at all unless they have a clear plan about how and when to divest. This is unlike corporations that are more concerned with near-term and long-term results and tend to hold on to units as long as they meet minimal performance criteria. Also, unlike corporations, private equity firms maintain a minimal corporate staff and use contracts and incentives as a means of control, rather than rigid, across-the-board control systems. In fact, private equity firms do not take an interest in day-to-day operations at all, preferring to “control what they must when they must, not what they can.” Finally, private equity firms take the notion of decentralization to an extreme: Each company in which they invest remains a separate entity.

Chapter Eight: Leading Creative Destruction

In corporations operating under the assumption of continuity, management committees (the executive/senior management team) see their primary role as ensuring operational excellence. Consequently, they spend a lot

of time in routine “presentation and response” meetings, making decisions in accordance with designated options, with little dialogue or outside-the-box thinking. While management committees certainly are responsible for the operating health of the corporation, they also must concern themselves with change management and can only be effective at the latter if they understand the environment well enough to spot opportunities and potential problems. Further, while they may be capable of managing incremental changes, large-scale changes that exceed corporate mental models often pose difficulty.

Public firms can take a cue from private equity firms that constantly reevaluate their worldview and its consequences and have developed expertise in evaluating future opportunities and businesses. The first step in meeting the challenge is to understand the difference

“It is no longer good enough simply to operate well. Corporations have to operate and manage creative destruction at the pace and scale of the market, without losing control, or they will falter and fade.”

between *technical* (“expert” work, done pursuant to authority) and *adaptive* work (exploratory, often creative, endeavors). Senior management must provide more than the authoritative “direction, protection and order” technical work requires; they must also provide *leadership* for the adaptive work for which there is no precedent or history. They must learn “to ask expert questions rather than to fall into the more familiar pattern of providing expert answers.” This is a sticky task, because most upper level managers attained their position based on excellent performance in some phase of operations. They must learn to change their mind-set, however, and break down adaptive work into manageable modules and turn ideas into action plans, thereby, reducing the complexities of adaptive work to the more familiar territory of technical work.

Shifting from an authoritative mind-set to a leadership one is *the* prime test faced by management committees. It is imperative that management engage in dialogue about, and prepare for, the corporation’s future by designing new models of performance to nurture adaptive work, without losing control of operations. Management must also encourage divergent, as well as convergent, thinking and allow ample time for alternative mental models to be conceived, opposition to be advanced and examined, and new solutions to be formulated. Finally, management must oversee implementation of this course to ensure that

it reaches its potential without jeopardizing operational control or creating undue stress and conflict.

Chapter Nine: Increasing Creation by Tenfold

Markets produce substantial and transformational innovations at ten times the rate of established corporations, primarily because traditional “innovative” processes relied on by corporations, such as strategic planning, research and development, and corporate development, have not afforded the results needed to keep up with the market.

The traditional processes do not need to be abandoned, however, just updated to incorporate discontinuity, divergent thinking, and creative destruction. The first step is to realize that major changes come from *outside* the corporation, specifically the *periphery* of the industry, where the newest ideas are developed. It is crucial that

senior management understand the periphery--particularly the companies on the periphery, the unmet needs they seek to fulfill,

and how these needs can be met. Management must be careful to distinguish the actual versus the theoretical edge of capability; however, they must understand the gap between ideas in the early stage of development and those mature enough to attract funding. And, they must begin to restructure strategic planning, R&D, and venture capital efforts around the “evolution of the periphery (and the substantial and transformational innovations that thrive there) and the potential implications of that evolution for wealth generation.”

Strategic planning must become an ongoing dialogue, and corporations must foster divergent thinking by picking the right people, allowing adequate preparation (or incubation) time, setting high aspirations, supplying adequate resources, allowing flexibility within deadlines, and providing senior-level leadership. The entire planning process must be redesigned, starting with giving participants the opportunity to “gain a firsthand understanding of the periphery” perhaps by visiting lead customers, or through the use of “retail laboratories” (such as NikeTown stores). There should be no detailed agenda or other “constraints” on actual planning sessions, other than clear objectives, but meetings should be facilitated by a well-prepared leader who uses effective techniques to encourage creative thought and dialogue. Finally, the dialogue leader should summarize each session for senior management, who

should announce their decisions within a few weeks. This dialogue process can be repeated as often as necessary, for different issues and with different leaders, but should follow the same pattern.

Likewise, the scope of R&D needs to be reevaluated, since the goal should really be business creation. Research is certainly a valid way to acquire information needed for expansion, but corporations must extend their efforts to include the licensing of desired technologies and the acquisition of other companies through corporate development efforts.

Venture cap activities should parallel those of private firms and receive endorsement at the corporate level rather than through an operating unit. Organizations can also step out of the corporate venture capital mode by sponsoring “business plan contests” that encourage employees (who often know more about the market and customer needs than the upper echelons) to submit ideas.

Chapter Ten: Control, Permission, and Risk

Corporations cannot balance continuity and discontinuity and divergent and convergent thinking unless they also effectively balance control and permission—a delicate and complicated proposition. Control is an outgrowth of convergent thinking, manifested by formal and informal systems throughout the organization. These control systems may conflict with each other, are subject to manipulation, and may hinder performance by distorting information, overplaying the wrong issues, discouraging creativity, and generating a false sense of security.

Because organizations bound by rigid controls find it difficult to deal with change, they must begin to look to capital markets, which control entry and exit, but not operations, and set standards without seeking to control results. Control must be offset by permission for managers to explore, pursue their goals, take risks, and seek outside resources for projects not underwritten by the organization. Permission does not imply a lack of responsibility; in fact, control should only be relinquished to those who are worthy of increased accountability. In order to be effective, permission must also be accompanied by adequate resources.

Inextricably linked to the issue of control is the balance between risk and reward. Decision makers use *expected value* in order to evaluate risk. Because the ultimate solution

will be the one closest to the decision maker’s *target return*, managers can influence decisions by “adjusting the risk/reward parameters to fit expectations.”

In choosing alternatives that involve risk, decision makers must always confront fear. Using the market, rather than internal assumptions, as their model, they should minimize control by taking a critical look and simplifying *necessary* control systems at each level—corporate, business unit, functional, project, and financial (“control what you must, not what you can”). They should update information systems to make them more flexible and encourage exploration and experimentation. They should change the incentive system by adjusting rewards and expand the accepted range of risk and tolerance of failure. And, they should ensure ongoing support from, and interaction by, senior management, in order to encourage creativity, risk taking, and divergent thinking in the lower ranks.

Chapter Eleven: Setting the Pace and Scale of Change

Johnson & Johnson found a way to manage the pace and scale of change through its FrameworkS process. The process began in 1993 with a meeting of the Executive Committee to design ways to change the company’s mental models. An agenda was set based on the most pressing and potentially dangerous issues the company would face within the next five years, with the EC mandated not to define answers, but to raise questions and “think about multiple frameworks for the future” (hence the name FrameworkS with the “S” underscoring the plurality of perspectives). In a loosely structured session, executives

“The periphery provides an external market benchmark for the pace of change in the economy. Appropriate use of this benchmark can help focus strategic planning or research efforts so that they do not become too abstract or narrowly focused.”

formulated objectives for the process, agreed to have a “conversation” about each issue, developed a template for the sessions, and planned the next meeting.

These issue-oriented dialogues included participants selected from throughout the organization on the basis of their “ability to contribute” (positions and levels were not considered). The process also included time for discovery, as well as a “forcing event” (the “collision” of divergent thinking), and provided opportunities for postmeeting

synthesis, wherein the knowledge obtained during the meeting was put into practice. FrameworkS became a catalyst for creating new mental models and diverse

“A corporation cannot declare itself in favor of decentralization and then refuse to give up control. It will not work.”

solutions and permeated the corporation’s management structure. J&J now views FrameworkS as “an open-ended, ongoing process” that has changed the way it does business, affected employees’ opinions and the way they relate to one another, and increased confidence and commitment. On a tangible level, the company was able to shave more than \$2 billion in costs from its bottom line and create new, profitable lines of business. Moreover, the process continues to support change, encourage risk, increase learning and communication, and incorporate reality into the decision-making process.

Several factors contributed to this success. First, the commitment and support of the senior-most executives insulated the process from premature evaluation and fatal opposition. Also, by “going to the source” (preparing for the meetings by making site visits and holding the sessions on location), senior management made issues more real and emotional. Finally, the entire organization was involved (through videoconferencing, newsletters, speeches, individual discussions, and the incorporation of insights into the management process).

Chapter Twelve: The Ubiquity of Creative Destruction

The principles of creative destruction were originated by Joseph Schumpeter in the 1930s, but were so ill-suited for Depression-era realities that they readily succumbed to Keynesian economics. The world is, however, quite a different place today. This is especially true of America, which is particularly receptive to the assumption of discontinuity, largely due to the visibility and maturity of its capital markets, trade policies that expose domestic companies to global competition, and a variety of government policies and laws that promote investment and protect intellectual property. Conversely, countries that try to control access to capital, protect themselves from outside competition, overemphasize continuity, or have an inadequate knowledge base, see their economies falter.

Creative destruction has become one of the major drivers of economic growth and its significance will

surely increase. It provides multiple benefits, including the potential for low inflation, low unemployment, and budget surpluses, while its major downside is the social costs experienced by the people who are left in its wake. If avenues for sufficient change are not provided, failure will inevitably ensue, not only of national economies, markets, and organizations, but of individuals, as well. There are two choices: play the game (and play it well) or be eliminated.

Appendix A: List of Companies

Appendix B: Managerial Approach of Principal Investors

Appendix C: Dynamic Performance Analysis (DPA)

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Bibliographic notes, by chapter, and a subject index are provided.

Remarks

Foster and Kaplan base their conclusions on the McKinsey Corporate Performance Database (which tracked the performance of over 1,000 companies in 15 Old and New Economy industries over nearly four decades), supplemented by in-depth case studies and their own experience as consultants. Their basic premise is not as “radical” or “revolutionary” as the dust jacket would have us believe, however. The concept of creative destruction, after all, had its origins in the 1930s and has been revisited from time to time since, most notably by Clayton Christensen (in *The Innovator’s Dilemma*) who argued that companies fail because they bypass opportunities by neglecting to create new markets and find new customers. Nonetheless, as Foster and Kaplan demonstrate, creative destruction is an important issue in an economy where discontinuity reigns and, thus, must be examined from as many perspectives as possible until it becomes conventional wisdom. From their perspective, discontinuity demands that companies stop blindly adhering to rigid mental

models and release themselves from the controls and procedures that impede innovation and creativity. **Creative Destruction** is noteworthy for its comprehensive empirical evidence that substantiates the current relevance of this position.

This is a thoughtful, well-documented, well-written, and timely work, and Foster and Kaplan are to be commended for their dedication, tenacity, and thoroughness. They are eminently qualified to evaluate and effect corporate performance and make convincing arguments for the need for corporations to reinvent themselves on a continuing basis. They also do an excellent job of depicting the obstacles and pitfalls and offer sound (fairly granular) advice to help organizations maintain the necessary, but precarious, balance between discontinuities and continuity, change and stability, and permission and control. The book contains an enormous wealth of information (particularly for senior managers, executives, directors, entrepreneurs, and individual and professional investors), but it resides within a *slightly* obscurant haze of redundancy, graphs, and statistics that might discourage many readers.

Despite the obstacles (which are far from fatal), this book should not be ignored or discounted by anyone wishing to stay competitive. The authors provide exhaustive amounts of data to support their conclusions concerning market performance, leaving no doubt that long-term survivors are not necessarily long-term performers, and support a slate of recommendations with absorbing anecdotes and well-reasoned analysis. Kaplan and Foster have done their homework—and yours, too, to produce a comprehensive textbook for corporate excellence. **Creative Destruction** provides a “cheat sheet” for anyone wishing to beat the market in the 21st century.

Reading Suggestions

Reading Time: 9 to 11 hours, 378 Pages in Book

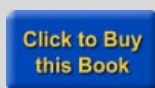
We found it difficult to assign a reading time for this work, as it will vary widely from individual to individual, depending on how deep one wants to go. You will certainly need more than the designated time to examine the many charts and graphs, or to truly absorb, much less analyze, the statistics and case studies. While business students

or new graduates would be well advised to pore over the details, many executives, entrepreneurs, and investors are apt to be discouraged, or perhaps overwhelmed, by the intensity and sheer volume of information, given their particular time constraints.

We recommend that everyone read the first chapter, as it is essentially an “executive summary” that covers the significant points, as well as chapter 11, which gives an in-depth and easily adaptable analysis of Johnson & Johnson’s FrameworkS process. Readers who have more time, or particular interests, can scan the table of contents and chapter introductions to detect other sections that may have relevance to their own concerns and environment. Additionally, anyone intrigued by statistics will also want to read the introduction (which details the composition of the database and has some interesting and curious revelations) and Appendix C, which justifies the authors’ analysis of the underlying dynamics of companies, industries, and capital markets.

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