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ROSS SCHOOL OF BUSINESS

Ross School of Business at the University of Michigan

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PROFESSOR **: Noel Tichy**

STUDENT **: Kurt A. Cummings**

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Diagnostic Growth Model

Kurt A. Cumming
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Global Fellow Paper Comments - Noel Tichy, Fall 1998

Name: Kurt Cumming

<u>Comments:</u>

The growth model developed in this paper represented a solid conceptual contribution to an emerging area of research, namely, how to assess the growth potential of an organization.

The categories in the model are sound. They cover most of the key areas of organizational performance.

What is missing are categories that deal with:

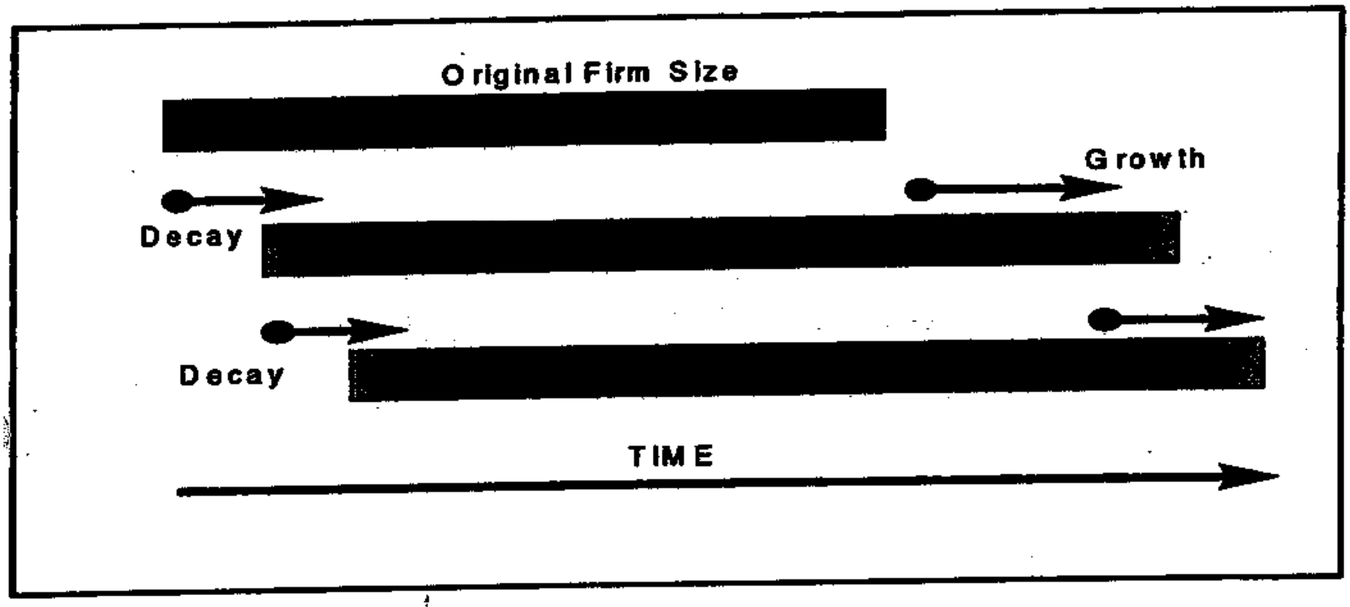
1. Social Networks of Ideas
2. Leadership and Operating Mechanisms

Finally, work is required in explaining to likely interrelationship of the variables.

Good, solid-start for empirical work in the next term.

Noel Tichy

Growth is imperative for companies wishing to survive as a going concern. Executives know that growing profits solely through cost cutting is neither sufficient nor sustainable. In order to be successful, firms must find ways to increase their revenue potential. This reinvention and growth is not simply expansion or growth for growth's sake alone, but rather high quality growth of capabilities, competencies, capital, opportunities, options, and revenue. The figure below illustrates this point. As you can see from the darkly shaded areas, the actual size of the firm might remain constant through the years, yet the area in which it is deployed is continually changing. "Growth" in our context does not mean that bigger is necessarily better, but that growth in capabilities and opportunities is crucial for continued life. Decay at the "tail end" of the business is all but inevitable; growth at the front end is the only way to combat that.



The diagnostic model presented below examines the pre-cursors of growth. It consists of three main categories and eight sub-categories. Each of these is highly interdependent, and must be viewed together as a system, rather than piecemeal. Together they paint a picture of the company with great potential to be a leader in the marketplace. This is graphically represented in Appendix 1. This model is not meant to be exhaustive, but rather is a survey of a few areas that I believe are central to the question of growth potential.

CULTURE

The culture of an organization is one of the most critical ingredients for growth. Its impact is often overlooked in the rush to quantify all decisions in financial terms, yet it can be the biggest obstacle to, or contributor towards, successful growth. It is like a healthy body, in that while it works we might not pay much attention to it, but if it is sick we know it with every painful movement

Communication . ,

One of the main roles of communication is to ensure that there is clarity of goals and purpose throughout the organization. An organization that doesn't have clean and clear communications channels in all directions will be disjointed and inefficient. Effective communication is the lubricant in the engine of the firm, assisting everything to move in concert with unity of purpose. When missing the engine might still run, but will be lacking in power.

Rewards and Motivations .

Everyone works for some type of reward. In many cases the reward is monetary or physical. Often as important are the intangible sources of motivation; the need for recognition, appreciation, promotion a challenging task in the face of great odds. It is interesting to ask why are people promoted and recognized - for not screwing up, or for taking action and risks to further the business. Ascertain what management values: Action? Starting a project? Finishing well? Perfection? Imagination? . .

In growing firms the incentive schemes must be properly aligned to mitigate the fear of failure and the fear of taking risks. One key learning out of the interviews so far is that it is more important to "just get going" than to plan everything to the n* degree. Organizations that value those employees who don't rock the boat will be left behind by those that value entrepreneurial nsk taking, action, and the courage to stand put.

Zeitgeist

The last sub category under culture describes the "spirit of the times" in the organization. Specifically we want to discover the personality of the firm and its collective imagination.

- What is the prevailing managerial view of employees in the firm - expendable resources or partners? Would the managing directors consider them an asset that must be protected, or a variable cost and liability that can be pared as needed.
- Is there a widespread belief in the product, the firm, and the future?
- What are the history, training, vision, courage, and personal ethos of the leadership team? Assess whether they are committed participants or merely contributors. If you will pardon a silly yet accurate word picture, a chicken is a contributor to the bacon and egg breakfast, but the pig is committed. Are the leaders committed?

CAPABILITIES & COMPETENCIES

These are the foundations for action in a company. Firms structure their strategy around them, and thus must have an accurate picture of their strengths and weaknesses. When a weakness is assessed, a firm must have a way to acquire the requisite capability. Once obtained, the firm must use it wisely, and finally they must have means to renew and refresh the capability over time.

Capability Acquisition

One of the biggest traps in capability acquisition is myopia, in terms of both existing capabilities (i.e., the competency trap) and market opportunities. Management needs to work hard to widen the bandwidth of information entering their insular universe. The consultant should examine the beliefs and assumptions implicit in the organization, and help management "enlarge their pond" (Tichy and Charan).

Every firm needs some fashion of an idea generation machine; a process by which the collective imagination is stimulated and the output is mined. It is here that culture and communication play such a vital role. Risk averse employees and managers will fail in this step as they are paralyzed by their fear of possible failure.

Recruiting and Retention is another critical aspect of capability acquisition management. When corporate assets walk on two legs special care must be taken to attract and retain the best, lest the competition do the same.

Competency Use

Implementation issues such as speed, flexibility, decisiveness become important once the competencies are acquired. How quickly does the firm act? In addition, inappropriate staffing and asset deployment can quickly squelch any advantage gained by having great personnel and ideas.

Does the business Value Proposition make the most of existing competencies? Does the firm strive to align competencies with the market driven value proposition or do they try and convince the market to buy what the firm wants to produce? All of these questions can help assess the potential for wise capability use in the pursuit of growth.

Capability & Competency Renewal

Lastly, is there a process by which the competencies of the firm are continually reinvented? To borrow an analogy from Steven Covey, the firm must find a way to "sharpen the saw," in order to remain at peak capability. What is the investment in education and training, in innovation and creativity? This is closely related to the concept of creative destruction, or avoiding the trap of past success. Rom a resource perspective it is easier to reinvent and reconfigure while the firm is in a position of leadership. Unfortunately the very presence of success is a powerful opiate, and can lull even the most aggressive manager into a sense that past success virtually guarantees future earnings.

If in fact an organization accepts the fact that they must change, does the learning come from all levels of the organization? Top managers often don't realize how much they are a product of their experiences and often try and treat current situations from historic paradigms. Younger employees often have fresh perspectives on the issues in the marketplace, and their lesser degree of imprinting from the firm culture might prove helpful to provide direction.

Capital

Questions to ask about capital include its availability and cost It is important in a growth firm that everyone understand the cash flow implications of any plan, and that the Pro Forma statements are properly risk adjusted, and show the best case, worst case, and most likely outcomes. Everyone needs to have a deep understanding of the entire business, the drivers of value and the uses of cash. Surprisingly, both people that I have interviewed thus far stressed that often times the unavailability of capital is a powerful motivation for growth. Companies that throw cash at projects indiscriminately raise inefficient and sluggish management, trained to be unable to act in the absence of cash.

Ratio analysis can be helpful in ascertaining the potential for growth. The Selden Model, which ranks companies relative to return on assets and revenue growth is a good predictor of quality growth. The Sloan ratio, calculated by subtracting cash flow from operations from net income and

then dividing by total assets, helps asses the quality of earnings that compares report, and separtfes out accounting games from true earnings growth potential. The DuPont fonnula which disaggregates profitability, efficiency, and leverage is also a window into the financial workings of the firm.

COMPETITIVE ENVIRONMENT

The last key to assessing the growth potential for a firm is to analyze, the competitive environment in which the firm operates. One helpful model for framing tins analysis is Porter's Five Forces. Particular care should be paid to the core competencies of competitors as they can drastically affect the marketplace and the company's actions to capture the market Can the firm accurately explain the competitor's Value Proposition?

Another factor in analyzing the industry is current state of the art in Research and Engineering, Production and Manufacturing, and Marketing and Distribution. The company should be careful to be investing in those technologies with the greatest likelihood of success.

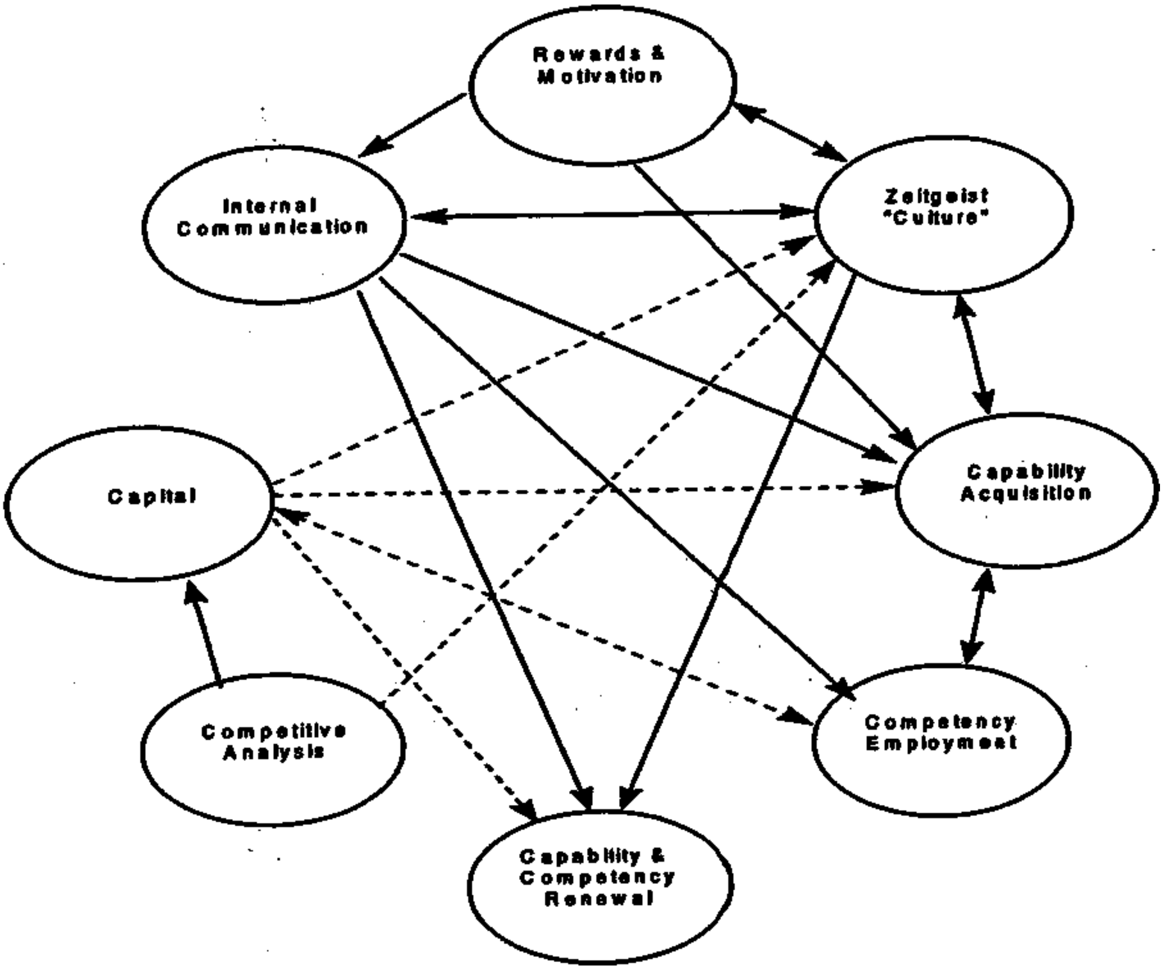
Macro Trend Analysis should also be done to try and predict where the needs of societywill be. I am not supporting "pie in the sky" scenario planning, but rather the valid projection of trends m

Alliances and Joint Ventures could be valid options forgrowth firms.The synergies gained are not without costs however, especially as two distinct cultures meld. Grow plans relying too heavily on the synergies gained from joint ventures should be carefully scrutinized.

CONCLUSION

Virtually no model can bring together every factor responsible for growth in a firm. However, I believe that this model helps paint a picture of a firm that is able to creatively invent new products, customers, and markets, and exploit these advantages.

APPENDIX 1 - The Growth Model



In the diagram above the solid lines represent a strong interrelationship, while the dashed lines represent a weaker relationship. The arrows indicate the direction of primary causality. For example, we see that internal communication has a direct effect on the firm's ability to renew its capabilities and competencies.

The purpose of this diagram is to help show the complexity of a growth company, and iUustrate the many levers for change available to company managers and consultants. On the following page is a list of specific sub-variables.

APPENDIX 2 - Categories and Variables

CULTURE

Communication

- Goal and Role clarity
- Learning from all levels
- Knowledge sharing

Rewards and Punishment

- Why are people promoted ?
- For what are people recognized and appreciated ?
- What do employees fear?

Zeitgeist

- Role of human resources; Fixed Cost or Variable Cost
- Firm Personality
- Widespread belief in self, product, firm, future?

CAPABILITIES & COMPETENCIES

Acquisition

- Information filters - beliefs, assumptions
- Idea generation machine
- Recruiting and Retention

Implementation

- Speed
- Flexibility
- Decisiveness

Renewal

- Constant reinvention
- Learning at and from all levels of the organization
- Creativity
- Leadership team qualifications

CAPITAL

- Availability and access
- Hurdle rates
- Project risk adjusted or common throughout company?
- Understanding of the importance of cash flow throughout the organization
- Realistic Pro Formas
- Ratio Analysis

COMPETITIVE ENVIRONMENT

- "State of the art" analysis
- Competitor value proposition analysis
- Porter industry analysis
- Mega trend analysis