Why Do Companies Fail, and How Can They Avoid It?

We all love business success stories. But failure is much more common. For example, in "*The Mortality of Companies*", Daepp et al identify a roughly constant hazard rate (likelihood of failure) of about 5.80% per year for public companies between 1950 and 2009.

Here's what Britten Coyne Partners has learned from our root cause analysis of corporate failure, both from research and from years of experience as corporate officers, directors, and consultants.

Typically, the proximate cause of failure is running out of liquidity, when operating cash flow is insufficient to meet a company's obligations, and cash can't be obtained from borrowing, asset sales, or a new equity issue.

But what causes liquidity to disappear? Usually a decline in business fundamentals beyond one or more tipping points, including shrinkage in the size of served markets, weakening of value propositions, and eroding business model profitability.

In turn, these adverse developments emerge from the complex and often non-linear interaction of four broad macro drivers, which tend to operate (with many feedback loops) in a roughly chronological cycle: Technology evolution gives rise to economic and environmental effects, then social and demographic consequences, and ultimately political and regulatory change.

Consider the case of ToysRUs. The most important technology changes that eventually led to existential threats to the company's survival included the birth of the internet, the development of online shopping businesses, the penetration of broadband, the arrival of advanced gaming consoles in 2001, Facebook in 2004, YouTube in 2005, smart phones in 2007, Instagram in 2010, and Snapchat in 2011.

Technology developments led to economic change, such as the shift in children's interest away from traditional toys and towards online entertainment, gaming, and social media that did not require a physical distribution network.

Technology changes also enabled the launch of new business models that sharply intensified competition in many industries, including toys.

With their margins under increasing downward pressure, many companies have had to continuously cut costs, which has left fewer employees with much more to do and less free time for non-work tasks.

Economic changes eventually produce social change. In the case of ToysRUs, critical social changes included time-short parents increasingly turning to online and superstore (e.g., Walmart and Target) shopping, where in one trip they could purchase both grocery and other items, including toys. This further increased the downward pressure on the margins at traditional toy retailers.

At the end of this causal chain comes political change – or in this case, its absence. In the case of ToysRUs, perhaps the most important was that for many years online sales were effectively tax free. This held down costs for economically stressed consumers, which created another incentive for them to avoid purchases at physical toy stores.

In order to be lethal, adverse external changes also require the presence of at least one of three potential organizational shortcomings: failure to anticipate risks to corporate survival, failure to accurately assess the potential threats they pose, and/or failure to adequately adapt to them in time.

Again, let us return to the ToysRUs case. The available evidence suggests that the company's management anticipated the new threats that it faced. The environment was providing strong signals, including the disruption of book selling by Amazon's arrival, increasing toy sales at Walmart and Target superstores, the closure of many independent toy retailers, and the bankruptcy of FAO Schwartz in 2003.

Whether ToysRUs managers accurately assessed the danger posed by these emerging threats is hard to say, as much of the evidence on this point is located in documents that remain company confidential. However, ToysRUs' online alliance with Amazon in 2000 suggests that management and the board appreciated the danger they faced.

Unfortunately, the history of organizational failure is filled with stories of timely anticipation of new threats and accurate assessments that came to naught because of inappropriate or poorly implemented adaptations, or initiatives that were too long delayed. The public record suggests that this may well have been the case at ToysRUs.

The Amazon alliance was not successful and in 2004 ToysRUs sued Amazon to force its termination. ToysRUs launched its own website in 2006, by which time Amazon's dominance and growing economies of scope were well-established. ToysRUs had also continued to maintain a relatively large number of traditional "big box" stores, often in malls in which many other retailers were failing (which decreased shopper visits).

While media coverage has focused on the firm's recent bankruptcy and impending liquidation, perhaps the most interesting chapter in the ToysRUs story played out earlier, in 2005 when the company was sold to a trio of private equity firms for $6.6 billion, an 8% premium over its stock price.

In our work with clients, we emphasize the importance of boards and management teams maintaining their situation awareness of evolving time dynamics – specifically, the relationship between the remaining time before an evolving strategic risk reaches one or more thresholds and becomes an existential threat, and the time still required to implement adequate adaptations to it.

Besides driving timely adaptation, another critical benefit of this approach is that enables boards to recognize situations in which no more "safety margin" is left, and it is clear that an evolving strategic risk has a high probability of becoming an existential danger before an adequate response can be implemented.

At this point, the rational choice for a board is to sell or merge the company to maximize its shareholder value. This approach can be very successful if it is undertaken while there is still considerable market uncertainty about future threats and opprtunities, and a wide range of beliefs about the potential effectiveness of various options for responding to them.

An even more vivid example of this occurred in May 1998, when Cor Boonstra, the CEO of Philips Electronics, sold Polygram, its music business, for $10.6 billion. Boonstra's actions were reportedly triggered by scattered reports that new software was being used to "rip" songs from CDs, encode them in the new MP3 digital format, and distribute them over the internet, which, for consumers, was still in its infancy (dial-up modem speed was just 56kbps). With the release of Napster in June 1999, this trend went exponential, and radically changed the music business.

To reach the deepest root cause of corporate failure, we must ask why organizational failures to anticipate, assess, and adapt to developing threats occur. Both experience and research suggest that three powerful forces are at work.

As individuals, we suffer from normal human biases that are as easy to identify as they are hard to change: We tend to be over-optimistic, overconfident (particularly about approaches that have been successful in the past), and to give more weight to information that supports our current beliefs and desired outcomes than to evidence that is at odds with them.

We are also intensely social beings; evolution has conditioned us to pay keen attention to our peers' thoughts, feelings, and actions, especially when uncertainty is high. As a result, we tend to conform to the majority opinion and suppress information that challenges it.

When groups combine into larger organizations that prize predictability, a cultural norm usually emerges that places greater emphasis on avoiding errors of commission ("false alarms") than errors of omission ("missed alarms"). And as organizations increase in size, their desire to minimize internal conflict in order to coordinate complicated collective action grows stronger.

When you consider this potent mix of interacting causal forces, the wonder isn't that so many companies fail; it is that some manage to survive for long periods of time.

The good news is that research by Eric Beinhocker, Doyne Farmer, Paul Ormerod and others repeatedly finds that in today's complex and deeply uncertain economy even a little bit of foresight advantage goes a very long way towards keeping failure at bay. In our experience, there are three reliable ways to increase these insights.

The first is ensuring a board has high quality non-executive directors, who do not shy away from questioning management's assumptions.

The second is management and board processes and systems that are deliberately designed to offset normal human biases. Here are two examples. The first is the "pre-mortem" technique developed by Gary Klein. Ask everyone on your team to assume it is five years in the future, and your strategy or plan has failed. Have them anonymously write down a short story about why this happened, including key

warning signs that were missed, and actions not taken. Collate the answers, and then discuss them as a team.

Alternatively, ask your colleagues to write their answers to this question: “What assumptions are so deeply embedded in our plans that they could lead to catastrophe if incorrect?” Again, combine and discuss the responses.

Finally, external advisors have an important role to play in avoiding corporate failure, not just as a source of new insights, but also as “Red Teams” that deliberately collect information which is at odds with management’s key assumptions.

In sum, corporate failure emerges from a complex mix of interacting environmental, organizational, and individual factors. Yet it is neither random nor inevitable. While difficult and at odds with some corporate cultures, there are steps that management teams and boards can take to shift the odds of survival in their favor.

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