

SDW Industry Discussion Paper

The Self-Sustaining Firm

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George Bernard Shaw said, *“any fool can start a love affair, but it takes a genius to end one successfully.”* In a similar vein, many have observed that it is far harder to build an enterprise that endures than to merely start a new business.

Existing models of growth fail to capture the variety of business development patterns that we observe. In fact, the path to sustainability must integrate the founder’s vision and the internal capabilities of the organization with a realistic assessment of the external environment, in which the firm operates.

Turning a fledgling enterprise into a self-sustaining business poses a difficult challenge for entrepreneurs. Of the hundreds of thousands of new businesses launched in the United States every year, many fail to attain a basic operational sustainability - they cannot function without the day-to-day intervention of their owners. Others show great early promise but then cannot cope with the problems of growth or the maturation of their markets. Few attain what one entrepreneur calls the "escape velocity to go into stable orbit after launch." And only the most exceptional ventures evolve into resilient institutions that can survive revolutionary external changes.

The failure to attain sustainability matters. Stress, burnout, or sickness can jeopardize the livelihoods of the many entrepreneurs whose businesses require their daily toil. The inability to sustain a promising start also represents an unhappy outcome. Conversely, success in building a self-sustaining business provides handsome rewards. An enterprise that is perceived to be self-sustaining can enter a virtuous cycle: expectations of longevity attract customers and other resources that further consolidate its position and open new opportunities. Entrepreneurs realize higher prices from the sale of businesses thought to be self-sustaining as well as the satisfaction of leaving a more permanent mark on the world.

The challenges of building sustainability also offer attractive opportunities for individuals with managerial skills and training. Often, ventures are launched by innovative or technically proficient individuals whose limited managerial capacities threaten the survival of the enterprise. Professional managers who can subsequently bring order to the chaos and help define sustainable strategies can enjoy considerable rewards financial and otherwise.

Building sustainability is also closely related to the problem of "managing growth." An enterprise has to grow in order to support the organizational infrastructure it needs to function without the day-to-day intervention of its founders. Growth may also be needed to attain sustainable advantages of market share and scale. And, attracting and retaining employees, customers, and other critical resources often requires the enterprise to keep expanding. Talented prospects are more likely to join (and key employees to stay) if they believe the firm has the growth potential to provide increasing responsibility and financial reward.

The problem, however we frame it, is complex. Building sustainability (or managing growth) requires progress along an "external" (or "market") front as well as an "internal" (or "organizational") front. The external dimension pertains to the sustainability of the firm's competitive position vis-à-vis rivals and substitutes as well

its access to capital and other resource markets. It derives from "structural" advantages such as patents, brand names, and customer switching costs and from the goodwill and trust the firm has established with its external constituencies. The internal dimension relates to the organization's (as opposed to the entrepreneur's) ability to serve customers profitably and to adapt to changing circumstances. It derives from the talents and training of the firm's members, its structures and systems, and its values and character (the "corporate culture").

Furthermore, the internal and external challenges are at least partially related. For example, an entrepreneur cannot delegate to poorly qualified or trained employees; but attracting and integrating quality personnel into the organization requires a profitable market franchise or easy access to capital. Conversely, long-run external sustainability depends on internal strengths. Patents expire, consumer tastes and wants change; renewing competitive strengths requires a fresh burst of organizational creativity and will.

Confronting these interconnected problems requires the principals of the enterprise deal with high-level, somewhat abstract questions as well as nitty gritty tasks. Thus on the one hand the principals must decide what business they are (or aspire to be) in, how they will compete, and the long-term "purpose" of the organization; on the other hand, they must also engage themselves in the minutiae of control systems and compensation. And all this must often be accomplished under changing, uncertain market conditions and serious constraints of time and cash. This is challenging managerial territory indeed! ¹

MANY DESTINATIONS AND PATHS

Some experts have proposed "stages of growth" or "life-cycle" models to describe the evolution of businesses. Just as humans pass through similar stages of physiological and psychological development from infancy to adulthood, these models posit that businesses evolve in predictable ways and encounter similar problems in their growth. And, managers of firms at different "stages of growth" have different tasks and priorities, just as parents of children of different ages face different challenges.

Their resonance with the biological world gives these models intuitive appeal. They also give entrepreneurs the comfort that an authoritative childrearing book can provide parents by, for example, telling them what to do and expect during their child's "terrible twos." Unfortunately, however, these models fail to adequately account for the great variety in the manner in which businesses grow and what they can grow into. For example, the evolution of a Sun Microsystems has little in common with its venture capital firm, Kleiner Perkins. Sun's installed base of workstations provides a sustainable competitive advantage. Organizationally, Sun has many talented employees and is not dependent on a few individuals for its success. Kleiner Perkins, although a preeminent venture capital firm, doesn't have the same external franchise or organizational capability. Its reputation may give them somewhat better access to new opportunities; but its returns largely depend on the quality of new investments. And, this quality depends on the skill of a handful of partners whose abilities represent - about all the organizational capability the firm has. Thus successful firms in different industries can grow up to be very different creatures.

We see differences not only in destinations, but also in the paths taken. Consider, for example, the leading microcomputer software firms in the 1980s. We cannot easily map the histories of Microsoft, Lotus, Word Perfect, or Intuit into a common evolutionary story. Rather, we see great differences in how these firms, competing in the same industry, developed their strategies and organization, and in the role of their founders. And, if we look at successful firms across a range of industries, the case for a one-size-fits-all model becomes even weaker.

Some successful businesses, we find, have an ambitious blueprint for establishing sustainable advantages when they are launched which they execute for a decade or more thereafter. For example, the basic elements of Federal Express's strategy-guaranteed overnight service, hub and spoke logistics, advertising to build a brand name - have been in place for over 20 years since the company was launched. Such an early "go-for-broke" commitment to a long-term competitive strategy, however, is rare. Entrepreneurs rarely start with the breakthrough concepts that can sustain an enterprise for so long or the credibility to muster the necessary resources if they do. More

¹ 1. Whether to emphasize sustainability or growth is therefore a matter of taste. I prefer to put sustainability first because it is more closely linked to the rewards and objectives entrepreneurs typically seek

commonly, entrepreneurs start with a marginal niche business, ride a popular wave, or exploit their personal, technical, or professional skills.

These more modest start-up approaches usually cannot sustain a long-lived business. A small niche player is vulnerable to attack from mainstream competitors who enjoy lower costs and better access to resources. Jumping onto a wave may be profitable and easy, but waves do eventually crest. Selling one's personal services does not constitute a business. Therefore, such enterprises have to change their initial strategies to survive. We observe great variance in how they do so.

In some cases changes are planned in advance. The entrepreneur has a long-term strategic vision at the time of launch but, lacking the resources to execute it, starts with something else - perhaps a short-term trade or consulting project to generate cash. Then, as soon as the resources can be mustered, the entrepreneur reverts to the original blueprint. In other cases, the entrepreneur does not have a viable long-term strategy in mind at the time of launch. Subsequently, the entrepreneur makes a deliberate effort to formulate one or, more likely, a strategy emerges from chance events - a core business grows out of a customer asking for an add-on product or a new employee suggests a new market.

Competitive forces help determine how quickly firms must adopt new strategies. In a mature, low overhead business, such as consulting, an entrepreneur may bob along, seemingly forever, without a strategy for building a sustainable franchise. But an entrepreneur who has jumped onto a wave, taking advantage of temporary market imbalances, must more urgently find a viable strategy. Luck matters as well - some ventures chance upon an attractive long-term formula quickly, while others encounter several false leads first.

We also see that strategic change can be more or less radical. In some cases we see a complete change in direction - completely new markets, products, and sources of competitive advantage. In other cases we find refinements and extensions - for example, geographic expansion, adding related products or services, or forward or backward integration.

Patterns of organizational or internal development display the same variety as the patterns in strategic or external evolution. In some ventures, well-funded startups with a clear strategy to achieve competitive advantage organizational development follow a systematic plan. An experienced founding team provides the nucleus. The founders then quickly delegate many of their responsibilities to talented employees who are recruited for specific, well-defined positions. Formal control and other systems are established well before they are necessary - investment in organizational infrastructure is made before it's needed.

Such orderly development however is unusual. Often the founders lack the experience, interest, or resources to build their organizations in a systematic way. For a considerable period after launch they provide most of the crucial skills and make all the critical decisions. They do not, or cannot, hire talented employees into specific organizational slots. Rather, they recruit whomever they can for tasks they are too stretched to perform themselves. Ad hoc judgments and informal systems rather than formal procedures and policies are pervasive and investment in organizational overhead and infrastructure is minimal. The purpose of the organization is primarily to survive. To attain sustainability, the capabilities of the firm (as opposed to those of the entrepreneur) have to be somehow broadened and deepened. More qualified personnel have to be added, the specialization of functions increased, decision-making decentralized, systems to cope with a larger and more complex organization instituted, and the employees oriented towards a common long-term purpose.

But, it is just as difficult to find a single process for successful organizational development as it is for strategy reformulation. If the principal impediment is the lack of resources, organizational transformations are likely to be executed after the firm acquires the financial wherewithal to upgrade its personnel and systems. But where the barrier lies in the founders' lack of interest in organizational matters, a crisis may be required to galvanize change.

We see differences in the extent of personnel change. Some organizations hire a few top managers who so change the structures and systems that all the old employees are transformed. Other firms give up on the warm bodies that they had initially hired off the street and replace them with new cadre of professionally trained employees. The rate of change varies - in some cases, particularly where there is a crisis, the organization has to be reshaped quickly. In other cases changes have to be more gradual because the old order still generates the cash that the firm needs in its period of transition.

Some firms develop strong cultures and values which distinguish their employees' attitudes and behavior, right from the beginning. Other firms develop their characters and personalities more slowly, while some never establish much distinctiveness. In some cases, the founders actively seek to build a certain culture by, for example, articulating norms and values, hiring individuals who they expect will adhere to the norms and terminating those who don't. More often, however, culture building does not represent a priority in the early days. Consequently, employees are hired for their technical skills and qualifications more than for their values. And subsequently, the mix of personalities that happens to gain the most influence shapes whatever organizational culture that eventually emerges.

Founders play quite different roles in the organizational and strategic development of their firms. Most start with broad responsibilities, thereafter, some change but little - the founding partner of a venture capital firm may perform many of the same tasks ten years after starting the business. Others quickly put in place an extensive organizational infrastructure and involve themselves mainly in broad policy making. And yet others, like Bill Gates of Microsoft, establish the organizational infrastructure but continue to play an important day-to-day role, monitoring the progress of programming and product management teams. Some founders lead organizational transformation themselves; others have such attachments to the initial employees and approaches that they bring in a strong outsider to clean house.

UNDERSTANDING THE FULL SITUATION

The observation that successful firms develop external and internal strengths following their own unique circumstances rather than some standard growth model has several implications for entrepreneurs (and managers brought into a fledgling enterprise).

Any actions entrepreneurs contemplate should be informed by the opportunities offered and constraints posed by the overall situation rather than by the firm's "stage of growth."

Evaluating the firm's external sustainability represents an important component of the situation analysis: What's the magnitude of the firm's cost or price advantages? Can the advantages be scaled up to larger or different markets or are they limited to a small niche? Are they controlled by the firm or by a few of its employees? Does the firm have a large, diversified base of customers? How likely are they to switch easily? Could the firm's advantages be undermined by changes in upstream or downstream technologies, standards, channels, or regulations? How likely are such changes? How confident are investors and other resource providers about the firm's prospects? Under what terms, if any, are they prepared to back the firm?

Entrepreneurs should also evaluate their firms' internal or organizational sustainability: Does the firm depend on a few individuals or do its capabilities derive from the skills and knowledge of a large number of its staff? Do most decisions and conflicts flow to the top for resolution or just the most important ones? Is the firm a collection of independent agents or do many employees cooperate to get the job done? Do employees have a shared understanding of the firm's goals and do they identify with these goals? Does the organization have the confidence and the resourcefulness to overcome unexpected adversities and crises?

Entrepreneurs should examine their personal goals. For some entrepreneurs building a self-sustaining firm is important because they wish to build an institution that will live beyond them or because they wish to sell out. For some others, however, the desire for self-sustainability may be tempered by the satisfaction they derive from doing the day-to-day work, lack of interest in selling out, or an unwillingness to share control. To the extent that it involves extra effort and risk, the entrepreneur should really want to build an independent, on-going firm rather than sell out to someone else who does or engage in a series of lucrative deals. Entrepreneurs should also examine their personal capabilities and contributions: in what roles do they represent an asset to the firm and where do they constitute a liability?

Wishful thinking about the situation - which entrepreneurs are often prone to - may be avoided by examining objective facts. Price competition and deteriorating gross margins, for instance, provide evidence of a weakening competitive position. Onerous terms for equity demanded by investors suggest a deteriorating confidence in the firm's management or prospects. Uncollected receivables, cash shortages, executive fatigue, protracted conflicts, and personnel turnover points to a potentially malfunctioning organization.

An honest analysis can help decision-makers identify the main obstacles to the realization of their goals for longevity and growth. In some cases, the analysis may show that the bottlenecks lie in its competitive strategy. Or, the firm may have a sound strategy but cannot fund the investments it needs to achieve competitive advantage because it lacks the confidence of the capital markets. The firm may also fail to realize the full benefits of its competitive strategy because of weaknesses in the organization or the unwillingness of the principals to let go.

Besides identifying the areas of vulnerability, the analysis may also reveal new opportunities. For example, the decision-makers may determine that the organization has matured and that it could in fact support a more aggressive strategy to gain market share. Or, that a record of profitability through a difficult initial period has gained the firm the credibility needed to fund a new technology. Or, that the technology has gained the reputation to attract new talent to the organization.

MULTIDIMENSIONAL OPTIONS

Just as entrepreneurs should understand the whole situation, they should also consider a broad menu of alternatives, not just a progressive decentralization or "letting go".

To address external issues and opportunities, the decision-maker should consider changes ranging from minor modification in tactics to a fundamental redefinition of goals and strategies. On the incremental end of the scale, changes might cover pricing, product features, the elimination of undesirable customers, or the conversion of a line of credit into a term loan. More extensive changes could include geographic expansion, forward or backward integration, continuous flow instead of job shop production, the introduction of related products, entering new channels of distribution, building a sales force, forming alliances or joint ventures, acquiring rivals, issuing new equity or going public. And, as an extreme measure, the principals may consider serving entirely new markets with entirely new products or even selling the firm.

On the internal or organizational front, incremental or radical changes may be contemplated in firm personnel or staff, structures and reporting relationships, incentive and control systems, and in the culture of the firm. Staff changes may entail changes in the qualifications of entry-level personnel, bringing in outsiders at senior positions instead of promoting from within, or eliminating the old-timers who cannot perform. Structural changes may involve adding (or reducing) levels of hierarchy, the establishment of staff functions, decentralization or changing the locus of decision making, or adopting a divisional or matrix form of organization instead of a functional form. Incentive and control systems may be made more or less formal, applied to different units and levels of the organization, or used to track or reward different variables. The firm's culture may be changed by articulating and promoting certain norms (say of cooperation rather than conflict), hiring employees who believe in these norms and punishing violators.

Potential external and internal changes should also force reconsideration of the principals' roles. A change in role does not necessarily entail doing less or making fewer decisions. Rather, it may involve an emphasis on different tasks and issues focusing more effort on formulating marketing strategies and less on personal selling; negotiating and reviewing budgets rather than the direct supervision of day-to-day work; designing incentive plans rather than making judgments about the compensation of individual employees; negotiating acquisitions of companies rather than of office supplies; or, developing a common purpose and norms rather than getting the product out of the door.

The consideration of a wide-ranging change does not imply that the principals must turn everything upside down. If the firm merely faces normal growing pains, the situation may call for little more than a tightening of the operations by installing better inventory or cash management systems. Moreover, even if desirable, implementing new policies on every front may be unrealistic. Decision-makers in a fledgling enterprise must be more willing to consider radical changes than their counterparts in large and stable organizations.

Compared to mature firms, the fledgling enterprise often faces a more dynamic and uncertain environment - indeed external change typically creates the opportunity for start-ups. And, unlike established companies with market power, the young enterprise cannot easily shape its markets; it must adapt its competitive strategies to its changing environment. Attention to seemingly innocuous organizational routines is more important in a firm's

formative years as well because ad-hoc practices can easily harden into long-term policies. At the same time, young firms have more room to maneuver and change. They don't have to cope with vast fixed assets committed to a specialized use; consequently, a fledgling firm can more easily redefine its core business than say a General Motors. The number of employees who have to be turned around and the implicit and explicit contracts redrawn is also relatively small.

MAKING IT HAPPEN

Compared to the start-up phase, when many entrepreneurs seize opportunities without great forethought, building a sustainable business does require greater deliberation and planning. Good analysis of the situation or alternatives isn't enough. Given a reasonable concept, competitive advantages are typically determined by the quality of execution. As often as not, several entrepreneurs start the same kind of business at about the same time; the successful survivors have more audacity and imagination and the right balance of vision and pragmatism, not superior analytical abilities.

AUDACITY

When they launch a venture, entrepreneurs are often quite willing to step off the beaten track. They believe they have little to lose because they bootstrap the start-up or rely mainly on other peoples' money. After the enterprise has achieved some success, however, entrepreneurs can become nervous about undertaking new investments and changes in strategy that they fear will put their now valuable stake at risk. But maintaining the status quo, especially when competitors and customers aren't standing still, can increase the risks of eventual failure. Long-term success may require the entrepreneur to apparently "bet the company." For example, to build a brand name an enterprise that has relied on word of mouth awareness may have to invest in an advertising campaign. A company that tailored products for a specialized niche may have to adopt strategies to gain cost advantages. Or, an assembler of purchased components may have to build an integrated plant. And, these investments may require the entrepreneur to risk their wealth by plowing back cash-flows, taking on new equity partners, or signing personal guarantees for debt.

Organizational development, too, entails risky investment. Building systems and staff functions and other types of administrative infrastructure requires incurring expenses for intangible long-term payoffs. To improve the skills and confidence of subordinates, the entrepreneur must be willing to let others make mistakes and tolerate sub-optimal decisions. Similarly, employees who impair organizational growth may have to be let go, even if they are contributing to current profits.

IMAGINATION

Envisioning and communicating what the future will look like is another critical skill. There are a myriad ways to design the structure, systems, and culture of a new organization and there is no proven method for picking the best combination. At the same time, ad hoc or incremental approaches often lead to dysfunctional and difficult-to-reverse policies. Entrepreneurs who develop a consistent long-term view of organizational design can more easily provide the predictability that attracts people to the organization and minimize traumatic changes in direction.

Entrepreneurs who can convincingly describe the evolution of a new market enhance their prospects of building competitive advantages therein. The future of a new market—the technologies that will succeed, the key factors for success, the size and nature of customer demand, and so on—cannot be predicted by extrapolating the past or applying first principles. And, in this uncertain climate, the skepticism of customers, investors, and potential employees represents a difficult hurdle for start-ups. The entrepreneurs who succeed are the ones who can tell a compelling story about how the market will evolve and why their strategy will win. Expressions of agnosticism or uncertainty, however well-founded from an objective point of view, rarely will turn skeptics into believers.

Lacking reliable deductive methods to model the future of their organizations or industries, successful entrepreneurs often imaginatively adapt examples from other fields and periods. For example, the Cleveland law

firm of Jones, Day served as the organizational model for Marvin Bower's efforts to build the consulting firm of McKinsey & Company. Bill Gates reportedly has studied Alfred Sloan's tenure as CEO of General Motors from 1923 to 1946, when General Motors came to dominate the automobile industry, to inform his long-term vision for Microsoft. But, because a law firm cannot serve as the perfect model for a consulting firm nor an automobile company for a software empire, entrepreneurs have to use intuition and imagination to select what elements of a model should be adopted and sometimes have to mix and match different models.

VISIONARY AND PRAGMATIC LEADERSHIP

Making it happen is not exclusively about boldness and drawing imaginative pictures of the future. Building a long-lived enterprise requires balancing between what might be termed as visionary and pragmatic roles.

As visionaries, entrepreneurs have to break free of the constraints imposed by others' perceptions. The strategic and organizational options available to a fledgling enterprise often depend on the beliefs of potential customers, investors, and other providers of resources: if they expect the enterprise to succeed, they provide the support that allows the enterprise to meet their expectations. But if they are skeptical and withhold support, the enterprise will have difficulty in rising above their expectations. Therefore, entrepreneurs must strive to change the perceptions that determine their reality by sketching a vision of the success that their enterprise is bound to enjoy. At the same time entrepreneurs must, as pragmatists, live with what is feasible. As they seek to raise serious capital and make the sale to a strategic customer, they have to keep their expenses below their meager cash inflows. While they try to project the image of a well established company, they have to manage as if they were on the verge of going under.

As visionaries, entrepreneurs set long-term goals and help shape the underlying values of the firm. They have to formulate disciplined strategies, defining what business the firm will compete in and forgoing opportunities that don't build sustainable competitive advantages. As pragmatists, the same entrepreneurs must demand immediate bottom line results and monitor day-to-day operating performance. And, their dedication to disciplined strategies must be tempered by an appreciation for the cash that short-term opportunities can generate and the risks of premature focus or commitment—the best long-term strategy often isn't the one initially deemed the most attractive.

As visionaries, entrepreneurs take a holistic view. They base the feasibility and attractiveness of their competitive strategies not just on an industry analysis but also take into account their organization's capacity for execution, access to capital, their own management styles and goals, and so on. As pragmatists, entrepreneurs must also pay close attention to tactics and sequence. Even if a holistic analysis suggests the need for comprehensive change, they focus their attention on a few critical areas. While they may regard the coordinated development of external strategy and organizational development to be a worthwhile long-term goal, they may push ahead aggressively into new products or technologies without waiting to put in the right organizational structures or systems.

Visionaries try to recruit subordinates more capable than themselves. They coach others, tolerate mistakes, and prefer to develop consensus rather than impose their own views. As pragmatists, entrepreneurs have to prune their organizations, terminating employees who don't fit and reducing the responsibilities of those who can't handle them. They must be prepared to do as well as delegate and make decisions that others aren't prepared to.

As with the other tasks involved in sustaining a business, balancing vision and pragmatism is difficult. There is no formula. Entrepreneurs must develop, through practice and observation, a somewhat crude personal theory to guide their actions. And, the emotional drain of playing complex, fluid roles leads many to not even try. These very difficulties, however, allow the few who can build a lasting business exceptional satisfaction and financial reward.

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