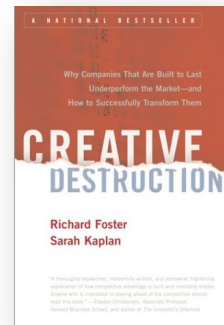


Creative Destruction Whips through Corporate America

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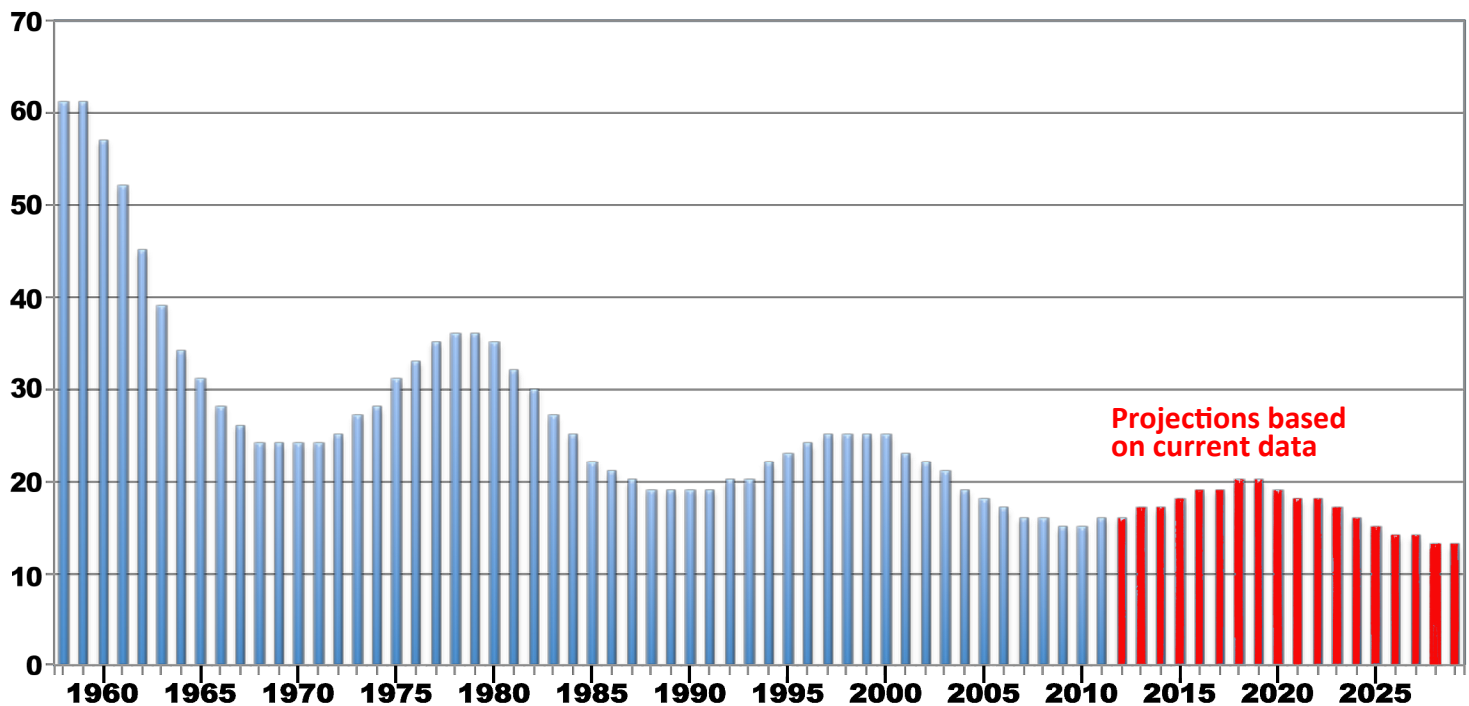
Executive Summary

Lifespans of top companies are shrinking, according to an Innosight study of the S&P 500 Index



- 61-year tenure for average firm in 1958 narrowed to 25 years in 1980—to 18 years now.
- A warning to execs: At current churn rate, 75% of the S&P 500 will be replaced by 2027.
- To survive and thrive, leaders must “create, operate, and trade”— build new divisions and trade mature ones at the pace and scale of the market without losing control of their company. Few companies have been able to do so over the longer term.
- Innosight Lead Director Richard N. Foster, co-author of Creative Destruction and author of Innovation: The Attacker’s Advantage, discusses his most recent analysis of the turnover of the S&P 500.

Average company lifespan on S&P 500 Index (in years)



Year (each data point represents a rolling 7-year average of average lifespan)

DATA: INNOSIGHT/Richard N. Foster/Standard & Poor's

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As 2011 came to a close, virtually every news outlet in the world made note of the fact that the value of the S&P 500 hardly changed—with the index dropping 0.4% for the year. Yet while the market's performance is always well known, what rarely gets reported is that the makeup of the index itself has been changing radically.

Over the past couple years, a number of iconic American companies—among them Eastman Kodak (2010), Radio Shack (2011) and The New York Times (2010)—were removed from the S&P 500 Index, the barometer list of companies with the largest U.S. stock market capitalizations.

This kind of churn happens regularly. Kodak was replaced by a cloud computing firm, while the NY Times Co. was replaced by an

oil and gas extraction firm. If removal from the S&P 500 is not due to an acquisition, it can be a jolt that emphasizes the urgency of a turnaround effort (as with the Times) or it can be a prelude to delisting and the threat of bankruptcy (as with Kodak.) The removal in 2003 of American Airlines parent AMR from the S&P 500 was a prelude to the delisting of AMR on the eve of its Chapter 11 declaration.

S&P 500 Churn Over the Past Decade

Sample companies that have entered and exited the index since 2002

Entered the index:



Exited the index:



In 2011, a total of 23 companies were removed from the list, either due to declines in market value (for instance, Radio Shack's stock no longer qualified as of June) or through an acquisition (for instance, National Semiconductor was bought by Texas Instruments in September).

On average, an S&P 500 company is now being replaced about once every two weeks. And the churn rate of companies has been accelerating over time.

According to the Innosight study of almost a century's worth of market data, corporations in the S&P 500 in 1958 lasted in the index for 61 years, on average. By 1980, the average tenure had shrunk to about 25 years. Today, it stands at just 18 years based on seven year rolling averages.

The Trajectory of Creative Destruction

The term "creative destruction" is widely credited to the Austrian-American economist Joseph Schumpeter (1883-1950). Schumpeter studied the formation and bankruptcy of companies in Europe and the United States. He concluded that "economic progress, in capitalist society, means turmoil." Richard Foster, in his 2001 book *Creative Destruction*, applied Schumpeter's theory to the modern practices of management and innovation.

According to Foster, the life span of a corporation is determined by balancing three management imperatives: 1) running operations effectively, 2) creating new businesses which meet customer needs, and 3) shedding business that once might have been core but now no longer meet company standards for growth and return.

The problem is that the innovation that is needed to create significant new businesses can often directly conflict with the operational effectiveness of the current business. Under these circumstances large companies slowly fall behind the pace of

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change of the economy. Most companies end up succumbing to the siren call of continuing on their current course rather than managing for long term evolution of their product lines to keep pace with the overall changes in the economy.

Ultimately, the challenge faced by all companies is to grow at or above the pace of their industry without losing control of their operations. The Innosight study shows that very few companies achieve this goal. Most corporations fade, meaning that most firms see their performance and their stock price wither as new technologies and startups with new business models enter the economy. As Kodak and others illustrate, fade is very difficult for management to fight. Yet it is worth the time and effort of corporate leadership to understand how to fight the fade that will eventually lead to a firm's demise.

Over the past decade, about half of the S&P 500 has been replaced. This chart on page 3 shows sample corporations that have entered the index and others that have exited due to a drop in market value or via an acquisition or private equity buyout.

How to Create, Operate + Trade at the Pace and Scale of the Market

The takeaway lesson is that companies must apply market principles to itself. In other words, the only way to fight fade is to embrace “creative destruction” at your company, before the market does it for you. “Markets outperform companies—they always have, with only occasional exceptions,” says Foster. “And you want to be one of the exceptions.”

The first step in the process of embracing creative destruction is to envision the corporation as if it is a market itself: one that must “create, operate and trade” its assets without losing control of its operations. This must be done at the pace and scale of the overall market.

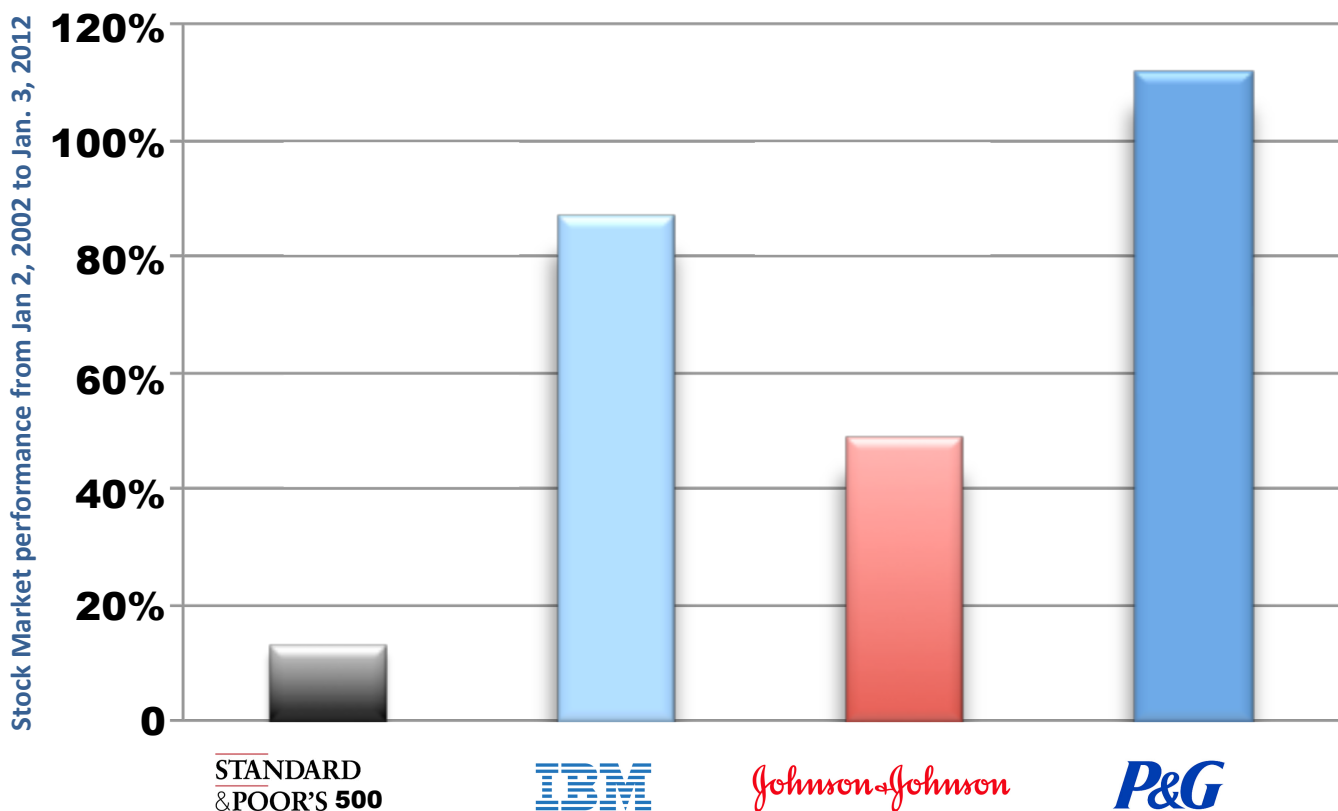
An example of one of the few companies

that is harnessing creative destruction through both creation and trading is Procter & Gamble. P&G’s ability to innovate is well known. Less well known is that the consumer products giant decided in the early part of the last decade to divest, or trade, its food product brands—for instance selling Jif, Crisco and Folgers to the J.M. Smucker Co. In 2011, it sold the Pringles brand for \$1.5 billion to Diamond Foods Inc.

The \$82 billion company has been deploying its freed up capital and resources to innovate its core personal care and household brands, as well as enter new areas of business. All this is happening while P&G maintains a very tight control of its margins and its capital. This strategy of “create, operate, trade” has helped P&G grow and outpace rivals in its industry.

Improving Performance via Create, Operate & Trade

Since 2002, three large companies that have embraced the model of “create, operate & trade without losing control” have not only survived but have outpaced the S&P 500 Index by a wide margin



Note: J&J and P&G have been clients of Innosight at various stages over the past 10 years.

Other companies that have embraced the “create, operate, and trade without losing control” strategy include IBM, GE and Johnson & Johnson. Each of these companies create, often by buying smaller companies in the market that are poorly positioned to expand their products internationally. They also free up capital by divesting business units at the same time—all while maintaining control of their margins and returns.

Foster recommends that companies use the market as their benchmark: If the S&P is turning over 5% of its companies in a given year, a corporation should seek to add 5% to its sales from new businesses while also undertaking the even more difficult task of shedding 5% of its current sales through divestiture.

The Innosight study shows that such companies not only survive longer, but they can also outpace the growth of the market for an extended period of time.

Drawing lessons from these market leaders, Foster suggests that the CEO and Executive Committee ask themselves three questions:

- 1). “Are our operations world class?” If not, the first order of business is to bring current operations to world class levels. Undertaking the more demanding tasks of creating and trading before operational excellence is established is a fool’s errand.
- 2). “How fast do we have to change to maintain our position within our industry?” The pace of change varies by industry. That said, if one’s industry is changing more slowly than the pace of change in the economy, that industry itself will experience gradual “fade” and often replacement by lower cost international competitors. Doubters only have to think about the steel, auto or paper businesses to find examples.
- 3). “Do our control systems work effectively?”

“Markets outperform companies—they always have, with only occasional exceptions,” says Dick Foster. “And you want to be one of the exceptions.”

“Control” does not only mean financial control. It also means operational controls—such as manufacturing and sales as well as “social” control, the standards by which business is done. Companies that lose these standards almost never come back from the brink of trouble.

The Outlook for 2012 and Beyond

The Innosight study suggests that the pace of creative destruction will accelerate further as the economic recovery picks up steam, especially if the stock market performs better than it did in 2011. That’s because mergers and acquisitions tend to increase when the economy is growing, leading to higher returns on equity.

When the market for deals and IPOs is depressed, as it has been for several years, demand for creative destruction builds up. This pent-up entrepreneurial energy and demand for deals typically gets unleashed when the economy is stronger. In addition, these phenomena do not only take place within the United States but globally.

As we head into a time of stronger growth coupled with increased technological change, the message for senior executives is clear: if you aim to maintain control of your corporation and deliver value to shareholders and customers, you must embrace creative destruction rather than wait to become a victim of this unstoppable force.

For more information on this study, or to interview Richard Foster on the results, please visit <https://www.innosight.com> or contact: colofson@innosight.com