Introduction

Breaking with the Past

It's time to radically change the way you think about your business.

Any plan for a business has to answer three questions: What's the nature of the game we're in? Where is it going? How do we make money in it? These questions go to the heart of what business is all about; they are the fundamentals of business thinking. Yet–incredibly–in many organizations today they rarely get asked, much less answered, adequately.

It takes unflinching realism to get such answers. But the established methodologies for defining the purpose of a business and planning its future have drifted steadily away from realism. Many people in business today are boxed in by dysfunctional practices and habits that more often than not obscure reality, rather than expose it. Many have succeeded anyway in the past. Fewer will in the future, because–as we will see shortly–the business environment is becoming far less forgiving of mistakes.

When we wrote *Execution* almost three years ago, we focused on the gap between strategic plans and their outcomes, which so often fall short of the planners' ambitions. We pinpointed execution as the missing element, and explained how to link the strategy, operations and budgeting, and people processes to achieve effective results. This was a reality-based approach and we've been gratified by the number of people who've used its lessons to improve their businesses.

But it turns out that we'd only begun our journey. As we continued with the thinking we'd started, we dug deeper into the reasons for our own successes and failures along with those of others whom we'd known and observed. Eventually we found that the gap originates with the very nature of how people conceive the purpose and direction of their businesses.

In many organizations, large and small, the process is flawed. People don't fully understand the game they're playing because they don't look at it hard enough. They don't ask whether they can realistically make the money they hope to, and why. Specifically, they don't analyze and link the three fundamental components that determine a business's success or failure: the environment it operates in, the financial targets it needs to meet, and the internal activities and capabilities that it depends on in the given environment to meet the financial targets.

Why not? Because until now there hasn't been a specific discipline for understanding the game at this level. The traditional strategic planning process is an approximation, but it falls short because it doesn't force people to organize the fundamental components into a framework that links them rigorously.

Everyone needs to fully understand the realities of the world in which they do business, and they need a new way to mesh their business goals and actions with those realities. We show how to do this with a specific and unique method-

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ology using a concept that is widely misunderstood: the business model.

"Business model" is a new name for an ancient analytical tool. The people who succeed in business at any level, from shopkeepers in primitive third-world villages to entrepreneurs drawing up their first business plans to CEOs of global corporations, have always worked with business models, most of them intuitive. Today spreadsheets allow you to construct highly elaborate models, but the basic premise hasn't changed: a business model makes it possible for you to gain a comprehensive and realistic understanding of how to make money.

The version of the business model we have developed is a robust, reality-based process for thinking about the specifics of your business in a holistic way. It shows you how to tie together the financial targets you must meet, the external realities of your business and internal activities including strategy, operating activities, selection and development of people, and organizational processes and structure.

Our business model builds realism into the process of plotting your company's direction by enabling you to link specific facts about the external environment with your financial aims, organizational capabilities, and action plans. It tells you sooner rather than later when your fundamental business premise is under assault, where your best opportunities lie, and whether you need to change internal activities or the business model itself. It will be your central tool for confronting reality.

The fact is that the strategic plans of most companies don't work. A key reason why is that little time, if any, is spent harmonizing the facts of the external environment, the financial targets that are set and the internal capabilities of the business so that these discrete activities work together. Let's say, for example, that one of your financial targets is 12 percent sales growth, but that the overall growth of your served market is 5 percent. Without specific programs dedicated to meeting that top line objective—marketing, sales incentives, the right people in the right jobs, et cetera—the 12 percent goal is a chimera and the likelihood of the strategy working is close to zero.

Your business model is incomplete and ineffective unless you debate and harmonize your external environment and financial targets with your internal capabilities through a process we call "iteration." As we will show throughout the book, iteration is not a one-shot meeting that gathers up key people for a review, but a mentally challenging recurring activity to get things right. Once you start to practice it you've confronted reality and built a platform for profitability, growth, and prosperity in synch with what is going on in the world.

The process of iteration makes you confront the world the way it really is, not how you would like it to be. It is intimately tied to the idea of "business savvy." People often use the phrase to describe really astute business leaders, the kind of people who possess a shrewd, instinctual feel about how to make money. Business savvy distinguishes those who over time consistently make their businesses succeed from those who have the occasional stroke of genius or lucky break.

Our analysis of business savvy shows that its essence is the use, intuitively or explicitly, of the business model in choosing where and how to make money. People with business savvy have specific financial targets in their minds. These targets are the reference point for everything they do, from looking for opportunities and dangers in the external environment to designing the combination of strategies, operating practices, people, and organizational processes that will enable them to capitalize on the opportunities and avoid the dangers. And guess what? People with a well-developed sense of business savvy seldom have a strategy ahead of time. Instead, they devise their strategies as a means of meeting their financial targets, not the other way around. How they do this is a point we will develop at length and illustrate through analysis of companies in a wide range of businesses.

What kind of people are we talking about? Sam Walton, Michael Dell, Jack Welch, the successful proprietor of a shoe store in Bombay . . . and, would you believe Billy Beane, general manager of the Oakland A's?

In Major League Baseball, as everyone knows, the rich keep getting richer and the poor get poorer. Teams in big markets will always be able to outspend those in smaller ones because they have more revenues. Who can compete with Yankees' owner George Steinbrenner's vast treasure chest in hiring talent? The Yankees, along with teams in big metropolitan markets like the Boston Red Sox and the Los Angeles Dodgers, have framed a business model based on rich television and radio revenues that provide them with pots of money to bid for highly regarded players.

Oakland is a small-market team supposedly doomed to also-ran status. And yet with one of the lowest payrolls in baseball, Billy Beane defied conventional wisdom in one of the most tradition-bound of businesses and created one of the winningest records of the past several years.

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As related in Michael Lewis's book *Moneyball,* Beane discovered the reality that more than a century of conventional wisdom about the basics of the baseball business was wrong. He questioned traditional criteria used to judge the value of players such as batting average, runs batted in, and home runs. They didn't correlate, he observed, with the actual value of the contributions players made to teams. Beane began using new criteria for measuring the skills of ballplayers. For example, the ability to get on base turned out to be a crucial component of scoring runs. The ability of a batter to take a deep ball-and-strike count—that is, handle the bat with enough skill to keep the pitcher throwing as many pitches as possible—both raised the chance of getting on base and helped wear the pitcher down.

Scouting players using the new fact-based criteria, Beane was able to assemble a team of affordable players undervalued by traditional measures.

In business terms, Beane had the business savvy to recognize that structural change in the baseball industry had put his organization at a disadvantage. Instead of entering a losing battle by trying to figure out different strategies for success using players selected on the old criteria, as other small-market teams were doing, he rethought the very basis of success. In essence, he designed a new business model that created fundamental value for the Oakland franchise.

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LIKE OTHER PEOPLE with business savvy, Billy Beane confronted the reality of his situation. To confront reality is to recognize the world as it is, not as you wish it to be, and

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have the courage to do what must be done, not what you'd like to do.

It never has been easy to face reality; there are a plethora of psychological reasons why people in all areas of life, not just business, shrink from it. But the price of unrealistic business thinking is rapidly heading upward, because the game is going into uncharted territory.

Everyone senses that business conditions are different from those of a few years ago, yet few grasp just how fundamental the changes are and how swiftly they are overtaking businesses of all kinds. The business environment has changed by an order of magnitude.

The economy appeared back on growth track as we went to press. More and more businesses were looking for ways to grow, innovate, and generally become bolder. The recovery could get derailed, of course, but let's assume it's still rolling at the time you're reading our book. The fact remains that any good times from now on won't look like the good times of years past.

Globalization is now a force that touches all businesses, even those that once seemed too specific, local, or small to worry about it. One reason is the Internet, which speeds decision making and the flow of ideas radically, linking all areas of the world into a real-time network. Another is the vast credit expansion of the recent past. Immense and highly mobile flows of capital have created worldwide overinvestment, along with overcapacity in industries from autos to consumer electronics to software. Together, these forces have helped to create a global buyer's market. The result is one of the biggest changes in business history: an unprecedented shift of power from the owners and managers of capital to consumers and intermediaries, including especially giant retailers such as Wal-Mart.

Global cost parity is becoming everybody's benchmark. New and unexpected competition can come from anywhere. New products become commodities almost overnight. Lack of pricing power and relentless pressure on profit margins will continue to haunt businesses, regardless of whether the economy is weak or strong.

These changes have the potential to obliterate your business—or to take it to an entirely new level. Which will it be? That largely depends on how realistically you understand your position in the ever-shifting business environment and translate that understanding into your financial goals and action plans.

Regardless of whether you are being hit by these changes today or in the longer term, the imperative is to recognize the position of your business and take action. Acting in anticipation of what is on the horizon can bring enormous rewards; waiting too long to initiate action eliminates many of your options.

Leaders with business savvy confront reality as a matter of course. It's often said that business savvy is inherent; it's part of a person's genetic makeup. Some people are indeed born with it (we know a number of them personally). But we believe it can be developed by just about any good businessperson.

Business savvy is the art of understanding the fundamentals driving your business and the connections among them. This is precisely what our business model enables you to do. It gives you a new way to develop an integrated picture of your business reality, calculated at the very beginning of any

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effort to plan your course and recalculated regularly as circumstances change. The picture of reality will enable you to answer the following questions:

- Is the how of making money in my business and industry changing?
- Who is winning in my industry, who is not winning, and why?
- How, specifically, are the winners making money?
- If my business is a winner, what do I need to do to stay on top?
- Conversely, if I need to change my game, what, specifically, should I be doing?
- Am I in a growth industry or not? If not, and I want to continue playing in the game, how do I change it or play it better than the competition?
- Is my organization moving quickly to spot and take advantage of growth opportunities generated by these changes?

Some people try to fend off disruptive forces of change by denouncing or ignoring them. But in this new environment, confronting reality has to become a leadership priority of the highest order—a nonnegotiable behavior for everyone at all levels of an organization.

Plenty of savvy businesspeople around the world *are* willing to try something different. As a result, we predict, most businesses will be required to change more and more often in the coming decade than they have in their previous histories. And if they stick with their old practices and behaviors, a great many won't be able to handle the changes.

That doesn't mean that everybody will have to be

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changing everything all the time. We don't agree with the gurus who insist that revolution and reinvention have to be part of the daily leadership agenda. Knowing what to change and what *not* to change will be another important challenge in this turbulent era. This you can know only by confronting reality with a rigorous business model.

We start in Part I, "Why Confront Reality," by explaining the forces of change that are permanently altering many industries. Part II, "Confronting Reality with the Business Model," explains the workings of our business model and illustrates how business-savvy leaders have used its principles.

Part III, "What to Change and What Not to Change," shows how EMC, Cisco, Home Depot, 3M, and The Thomson Corporation used the business model framework to decide what they needed to change–and what could be left alone. And Part IV, "How to Prepare for Change," provides insight into how you should anticipate future events, how to condition your culture for the changes required and, most important, how to develop the leaders who can succeed in this tumultuous environment. We conclude with a letter to our friend Jane, a business unit manager facing both danger and opportunity, with some ideas about how she and her team can better meet the challenge of structural change.

Now go forth and confront reality.