Lessons from the most inexcusable business failures of the past 25 years.

Seven Ways to Fail Big

by Paul B. Carroll and Chunka Mui

Businesses rack up losses for lots of reasons—reasons not always under their control. The U.S. airlines can't be faulted for their grounding following the 9/11 attacks, to be sure. But in our recent study of 750 of the most significant U.S. business failures of the past quarter century, we found that nearly half could have been avoided. In most instances, the avoidable fiascoes resulted from flawed strategies—not inept execution, which is where most business literature plants the blame. These flameouts—involving significant investment write-offs, the shuttering of unprofitable lines of business, or bankruptcies—accounted for many hundreds of billions of dollars in losses. Moreover, had the executives in charge taken a look at history, they could have saved themselves and their investors a great deal of trouble. Again and again in our study, seven strategies accounted for failure, and evidence of their inadvisability was there for the asking.

Take adjacency moves. Frequently what appears to be an adjacent market turns out to be a different business altogether. Laidlaw, the largest school-bus operator in North America, bought heavily into the ambulance business in the 1990s, figuring its logistics expertise would carry over to that kind of enterprise. It turned out that operating ambulances isn't really a transportation business—it's part of the intricate and highly regulated medical business. Laidlaw struggled with negotiating contracts and collecting payments for its services, before selling off its ambulance units at a considerable loss.

The underlying business moves we discuss here aren't always bad ideas; they've generated a tremendous amount of wealth for some companies. But they are alluring in ways that can tempt executives to disregard danger signals. In this article we'll describe the seven risky strategies and offer advice on how to resist their charms.

The Synergy Mirage

Often a company seeks growth by joining forces with another firm that has complementary strengths. The whole isn't always greater than the sum of its parts, however. Look at the 1999 merger of disability insurers Unum and Provident, which operated in the group and individual markets, respectively. Executives thought that each company's salespeople would be able to sell the other's products, but the two businesses served entirely different customers through different models. Unum's sales reps called on corporations to sell group policies; Provident's crafted sales pitches for individuals. They had different skills and no particular desire to collaborate on cross-selling. Joining the two companies proved costly and complicated. The merger just ended up producing higher prices for everyone and an aggressive posture toward denying claims, which provoked a series of lawsuits that imperiled UnumProvident's reputation and finances. Unum eventually undid the merger, dropping the Provident name and exiting the individual market in 2007. Its stock price plummeted and is still less than half what it was in 1999, and the company continues to cope with class action suits from claimants.

Even when synergies do exist, excitement over them can lead a company astray. Quaker Oats overpaid horribly for Snapple, which it acquired to freshen up a dowdy brand and gain access to Snapple's direct-store-delivery system and network of independent distributors. At the time, analysts warned that the $1.7 billion price might be as much as $1 billion too high. Quaker never dug deep enough to understand Snapple's distributors, who fought efforts to push Gatorade and other Quaker products. Just three years after the acquisition, Quaker sold Snapple for $300 million. Synergies can prove problematic in more subtle ways, too, as when executives focus so much management time and energy on capturing them that they lose out on other, more fruitful opportunities. And clashes of culture, skills, or systems can make it impossible to achieve even synergies that seem easy and obvious.

Faulty Financial Engineering

Aggressive financial practices don't necessarily lead to fraud, but they can be dicey. The stakes are high—brands and reputations and even entire businesses can crumble as a consequence, and corporate officers may be exposed to massive fines and even prison.

If subprime mortgage lenders and the banks that supported them had paid attention to the story of Green Tree Financial, they might have realized how dangerous lending to unqualified buyers was. A darling of both Main Street and Wall Street in the 1990s, Green Tree made its fortunes by offering 30-year mortgages on trailer homes—which depreciate rapidly and can have a life span as short as 10 years. Three years after a $50,000 purchase, a home owner might be stuck with an asset worth $25,000 while owing more than $49,000 in principal. At that point, defaulting starts to look pretty attractive. All the while, Green Tree followed aggressive "gain on sale" accounting methods to record profits, basing its calculations on unrealistic assumptions about defaults and prepayments. With profits based on loan origination, there was also little incentive to qualify buyers.

Attracted by Green Tree's rapid growth, Conseco, an Indiana-based life and health insurer, bought the firm for $6.5 billion in 1998 in the hope of creating a broader financial services company, only to find itself stuck with a house of cards. Conseco ultimately took almost $3 billion in write-offs and special charges related to Green Tree, essentially erasing all profits earned by the unit between 1994 and 2001. CEO Steve Hilbert resigned in April 2000, and Conseco filed for Chapter 11 bankruptcy protection in 2002—reportedly the third-largest bankruptcy in U.S. history at the time.

The rise and fall of Green Tree and its ensnarling of Conseco illuminate two problems with financial engineering strategies: First, they can produce flawed products, such as easy-credit mortgages, that attract customers in the short term but expose both buyer and seller to excessive risk over time. Second, they encourage further hopelessly optimistic borrowing to finance more investment. Green Tree's model was elegant in that the firm could borrow short-term funds at low rates and lend at much higher rates—but at the same time preposterous, because the machine seized up as soon as the flaws in the underlying mortgage product became apparent.

Overly clever financial reporting is also risky, especially when it involves cutting corners to increase profits and deliver better bonuses. Such techniques tend to veer toward

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fraud, even when outside auditors have blessed them. Like other aggressive practices, they're powerfully addictive: Investors reward increased profits, which leads the company to scramble for even greater creativity.

Stubbornly Staying the Course

Redoubling your investment in your current strategy in response to market signals is a strategy in itself, and it can lead to disaster. Executives too often kid themselves into thinking that a problem isn't so severe or delay any reaction until it is too late. Eastman Kodak stuck to its core in the face of a blatant danger: digital photography. Company executives had made a detailed analysis of the threats posed by digital technology as far back as 1981 (when Sony introduced the first commercial electronic camera, the Mavica) but couldn't shake their attachment to prints and traditional processing. The margins were hard to pass up as well—60% on film, chemicals, and processing, versus 15% on digital products. Digital technology also eliminated the huge recurring revenue stream that came from film and reprints (though some companies—HP and Epson—now profit from recurring revenues from ink cartridges for printers).

This is a common reason companies don't change course: The economics of the new model don't measure up to the economics of the old. Companies also falter because they don't consider all the options. Kodak's executives couldn't fathom a world in which images were evanescent and never printed. The company fought only a rear-guard action against digital cameras and didn't make a big move into the space until the early 2000s. It now has a share of the online photo-posting market, but its hesitation was costly: Over the past decade, Kodak has lost 75% of its stock market value. As of 2007, the company had fewer than a third of the number of employees it had 10 years earlier.

Pager company Mobile Media had even less of an excuse to stand by its strategy, because pagers were essentially a fad that lasted only several years. They were a status symbol in the mid-1990s, when cell phones were still bulky and calls expensive. But even as cellular technology followed Moore's law, Mobile Media acquired other pager companies and focused on designing new-generation technologies that nobody wanted. Following a purge of senior executives, Mobile Media filed for bankruptcy in January 1997. But the brunt of the decline in paging was borne by Arch Communications, which bought Mobile Media in 1999.

It isn't just fast-moving technology companies that fatally ignore new threats. Pillowtex was an old-line company that manufactured pillows, comforters, and towels. It grew steadily for decades—largely through acquisition—and by 1995 reached annual sales of almost half a billion dollars. In 1994, however, the United States began to phase out quotas on imports. Other companies immediately began outsourcing production to developing countries so they could compete with low-price imports, but Pillowtex redoubled its acquisition efforts, hoping that efficiencies from scale would give it an edge. The company's SEC filings from the late 1990s barely mention outsourcing as an option, instead highlighting the $240 million that Pillowtex spent on new, efficient machinery for its U.S. plants in 1998 alone. Two bankruptcies later, the company shut down in 2003 and was liquidated. Although part of the company's rationale for keeping manufacturing in the United States was to protect American workers, 6,450 lost their jobs. The layoff was the largest in the history of the U.S. textile industry.

About the Research

Our research focused on the most significant business failures among U.S. public companies from 1981 through 2005, because reporting requirements ensured uniformity and access to data, while the universe of companies was large enough for us to generalize results. We defined "failure" as a significant investment write-off, a shutdown of an unprofitable line of business, or a bankruptcy.

Working with leading information vendors, including Reuters, Thomson Financial, and Bankruptcy.com, we built a database of more than 2,500 failures. We also did a literature search to find failures that didn't show up in databases—for instance, companies that sold themselves before having to account for a major problem. Aided by researchers from Diamond Management & Technology Consultants, we narrowed the field to the 750 most meaningful cases: bankruptcies of companies with at least $500 million in assets in the last quarter before bankruptcy and write-offs and discontinued operations greater than $100 million (excluding write-offs for in-process research and development). Our analysis revealed that strategy had been the key factor behind failure in 355. To identify the red flags that might have alerted management to impending failure, we also turned to personal interviews, court documents, local newspaper coverage, and business-school cases.

Pseudo-Adjacencies

Adjacent-market strategies attempt to build on core organizational strengths to expand into a related business—by, say, selling new products to existing customers, or existing products to new customers or through new channels. Such strategies are often sensible; they fueled much of General Electric's growth under Jack Welch. But in our research we found many cases where ill-conceived adjacencies brought down even storied firms. Oglebay Norton, a regional steel provider, is just one example. After 143 years the Cleveland-based company was looking to diversify because steel was in decline. Limestone seemed like a logical choice because Oglebay's shipping business was already hauling it for its steel mills. Limestone is used in steel production to separate impurities, which are removed before molten iron is turned into steel. It has many other industrial uses, especially in production.

Oglebay began buying up limestone quarries, but it lacked a fundamental understanding of the limestone business. For one , iron ore was shipped on the Great L...s, mostly on 1,000-footers, but limestone often needed to be transported on rivers to get closer to customers. That required much smaller vessels, which Oglebay didn't have in its fleet. The company filed for bankruptcy on February 23, 2004, with $440 million of debt, most of which was incurred as part of the push into limestone. It would emerge from bankruptcy but never recover its footing. After selling off its fleet piecemeal to retire its debt, it was acquired by Carmeuse North America.

Four patterns emerged among the failed adjacency moves in our research. The first was that a change in the company's core business, rather than some great opportunity in the adjacent market, drove the move—witness Oglebay Norton's desperation to reduce its reliance on steel. A second was that the company lacked expertise in the adjacent markets, leading it to misjudge acquisitions and mismanage competitive challenges. Avon made this mistake with a move into health

Avoiding Disasters: The Devil's Advocate

Devising a new strategy is heady stuff, and decision makers can quickly lose their objectivity. Even companies that have strong internal safeguards against failure can overlook the questions that might uncover unfounded assumptions, unattainable forecasts, untreated deal fever, or otherwise flawed thinking. Steve Hilbert, the Conseco CEO who acquired Green Tree Financial, had a rigorous acquisition process and a crack team, both honed by dozens of deals over almost two decades. Yet he paid an exorbitant premium for a company that was clearly imperiled, in spite of outright skepticism from investors and analysts. Any internal doubts were either muffled or unheeded, which just underscores how hard it is to tell a CEO that his rousing vision (in Hilbert's case, creating a financial services Wal-Mart) is flawed.

That's why we recommend that companies institute a formal review by a devil's advocate who is truly separate from the strategy-development process and has explicit license to ask tough questions. The deal process of Pitney Bowes, the mail management company that has acquired more than 80 companies since 2000, includes two reviews by people who were not personally involved in the early planning. (See the sidebar, "Questions Every Company Should Ask," for the type of queries that can produce useful insights.) Of course, CEOs often encourage questions merely for the sake of appearances and may strike back at naysayers, so the internal devil's advocate model has its limits.

Setting up a final line of defense—a rigorous "last chance" hearing by an objective, independent panel—will counter that problem. It's best to convene the panel toward the end of the strategy-formulation process, to keep it separate from that process, but before it's too late to turn back. Some companies successfully use a devil's advocate review earlier to build consensus or even use it after an acquisition to identify potential problems. Our research uncovered some guiding principles that ensure constructive discourse, no matter when the review takes place.

Make the process transparent to the board—with limits. CEOs may resist this approach on the grounds that it invites directors to meddle with their authority. Transparency is usually more palatable to CEOs, however, if everyone involved understands the distinction between governance and management. As long as boards don't attempt to take over the management of the business, they have every right to understand and react to CEOs' decisions. Some CEOs have even used the independent review as a tool for getting the board's buy-in to an otherwise controversial strategy.

Establish a limited charter and clear ground rules. The company should define explicit parameters for the scope and conduct of the panel and the ultimate use of its findings, to keep the discussion from ranging too far and uncomfortable findings from being buried. Ground rules will also discourage panel members from coming in with their own agendas.

Panelists should set aside their own preconceptions of the "right" answer and should stay in the real world, rather than compare strategies with some model of perfection, because almost no strategy could bear up to such scrutiny. The goal is to figure out whether the strategy is the best alternative, warts and all.

care in the early 1980s, including the acquisition of medical-equipment-rental businesses and substance-abuse centers—a strategy justified by its "culture of caring." But these acquisitions did nothing to build on Avon's core asset, its door-to-door sales force, and overlooked the regulatory realities, in which it had no expertise. Avon took a bath. After significant losses, it took a total charge of $545 million for dismantling its health care business in 1988.

The third recipe for disaster was overestimating the strength or importance of the capabilities in a core business. Successful companies are particularly prone to this; their ability to achieve in their own market makes them overly optimistic about their prospects in others. Laidlaw, the school-bus operator, fell victim to this type of thinking when it figured it could leverage its considerable expertise in logistics in the ambulance services business and went on a buying spree. The company suffered big losses in the ambulance business, taking a $1.8 billion write-down on it in 2000.

Finally, adjacency strategies tended to flop when a company overestimated its hold on customers. Just because people buy one service from you doesn't mean they'll buy others. Several utilities seeking to expand in the mid-1980s fell prey to this kind of thinking. When regulators began threatening to cut rates, utilities looked for opportunities in other industries. Some made a classic mistake: They jumped into high-growth markets without having any idea about whether they were qualified to operate in them. They thought they could simply leverage their customer bases and sell them products like life insurance, but they found few buyers.

Bets on the Wrong Technology

The huge rewards for breakthrough products and services understandably inspire many companies to search relentlessly for the next Google or eBay or iPod. Still, in our research we discovered that many technology-dependent strategies were ill-conceived from the get-go. No amount of luck or sophisticated

The conduct of the review itself should be restrained. The devil's advocate is not an inquisition, and the managers who designed the strategy will feel defensive as it is. The review should explore facts, not feelings, intuition, or emotion, and should focus on aspects of the strategy that are pivotal to its success, not on minor defects.

Organize for success. The credibility and effectiveness of the review hinge on the credibility and position of the review's leader, who should be outside the management hierarchy directly associated with the proposed strategy and have no stake in the outcome of the review. A corporate executive or manager from a different unit might lead a business-unit-level devil's advocate review. An independent board member or some other seasoned outsider familiar with the organization, such as a retired executive with no ax to grind, might lead a corporate-level review.

Panel members should provide a fresh point of view, not replicate existing expertise—the panel is not a smarter set of experts. Good panelists must be able to ask broad and open questions that tease out the systems-level assumptions, issues, and consequences of any strategy. Two personality types often make poor panelists: people who come to quick conclusions and then advocate their own position (the greater the expertise, the greater tendency to fit this profile); and overly empathetic people, who may identify quickly with the managers responsible for the plan and readily accept their assumptions.

Focus on the strategy, not the process. The goal isn't to check that all the right steps were taken. At the end of the day, the strategy will stand on its own, or not.

Reviewers should ask for a detailed written description of the strategy—not spreadsheets and slides. The latter make it easy to gloss over the details and leave much to reader interpretation. Bruce Nolop, Pitney Bowes's former CFO, observed in this magazine, "I've been amazed at how many elements of a deal that seemed clear in PowerPoint can fall apart when they're subjected to prose. In bullet-point format, the rationale for a deal might be summed up in a phrase, such as 'cross-selling.' But a memorandum demands clarity about exactly who is cross-selling to whom—and how and why." (See "Rules to Acquire By," September 2007.)

Next examine and test the strategy's underlying assumptions. One such technique is the Strategic Assumptions Surfacing and Testing process, designed by Ian Mitroff, Richard Mason, and Jim Emshoff (and taught to us by Vince Barabba). In it participants organize into groups with divergent experiences and perspectives and go through a process of debate and role-playing that identifies areas where the strategy may be vulnerable.

Deliver questions, not answers. The purpose of the review is not to suggest alternative approaches. The review team might well leave the patient chopped up on the table, if that is warranted. While this might sound harsh, it's important to head off any attempt to replicate the strategy process to provide "better" answers. That's just not possible in the short window of the review. The product of the review should be a report that summarizes and synthesizes the team's discussions and findings.

Come to closure. More than once we've seen leaders exercise the equivalent of a "pocket veto" of a review team's findings. The final call belongs to management, but at the very least, some type of formal response to the work of the team should be built into the process.

Questions Every Company Should Ask

Had they tested their strategies by asking a few tough questions, most of the companies in our study could have stopped themselves from making ill-fated moves. These are the issues that devil's advocates, internal and external, should explore.

Is this a realistic strategy for long-term success? One of the companies we studied, Green Tree Financial, prospered in the 1990s by selling 30-year mortgages to unqualified buyers on trailer homes, which depreciate rapidly and may have a life span as short as 10 years. Did anyone ask, Is that a sustainable model? Green Tree sold itself at a bloated price to Conseco, which later filed for Chapter 11.

A strategy must be able to stand up to the sunshine: How would it look on the front page of the *Wall Street Journal*? Such a question might have prevented some cases of fraud or even close calls. Tyco, for instance, probably wouldn't have used such aggressive accounting methods for acquisitions if it had realized they'd be scrutinized by the media. The strategy must also be able to weather storms. Loewen Group attracted numerous investors during its funeral-home acquisition spree but crashed when the death rate tapered off a bit.

What can we learn from history? A thoughtful review of the past might have prevented a number of the failures we explored. When insurer Unum merged with Provident in 1999 in an attempt at synergy—the companies were in the group and individual disability markets, respectively—the move flopped. In their fervor to complete the deal, Unum's executives overlooked the fact that, not long before the merger, Unum had exited the very line of business that Provident was bringing to the table. A devil's advocate might have asked, Why did we get out of the business? Might we draw some lessons about the ability to cross-sell between individual and group disability customers?

A superficial look back can be counterproductive, however. One client we worked with suffered a high-profile failure thanks to an ill-conceived joint venture. For almost a decade afterward, most of its managers immediately rejected any potential partnership. They were looking at history but without nuance and context.

Do vital information and dissenting views about strategies reach decision makers? Our research showed that usually someone in the organization recognized that a strategy was doomed; the information just didn't reach the right person. Plenty of people at Unum had firsthand knowledge of how tough it would be to make a go of it in the personal disability market, yet their concerns either didn't reach or didn't influence strategy makers. And in the late 1980s and early 1990s, many IBM employees knew that OS/2 didn't stand a chance against Windows, yet their convictions didn't get to the top brass. In the end, IBM lost some $2 billion on its OS/2 effort.

Regular communication channels may quash any message challenging the strategy, so companies need to create a system that gets unfiltered opinions straight to the top. Microsoft routinely conducts surveys asking team members for their anonymous predictions about when a product will be delivered. Group leaders know that such surveys can happen at any time, which tends to keep them honest. The surveys don't help Microsoft avoid product delays, but they do give management an accurate picture.

Have we assessed the true advantages—and liabilities—that come with scale? Companies often overestimate the power of scale—it doesn't necessarily deliver presumed advantages, like greater purchasing power—and routinely underestimate the complexities. When they double in size, companies aren't just doing the same thing, twice as often. USAir's acquisitions tripled the company's size in just one year—1987—and completely brought down its information systems.

Have we considered all our options? This question is especially important for companies that stay the course. Kodak, for instance, could have sold itself in the 1980s or 1990s at a far higher valuation than it now has, or it could have moved faster into the digital world, capturing a greater share of sales of cameras and printers and, perhaps, the revenue from picture websites and cell phone cameras. Its principal competitors in film and paper, Agfa and Fuji, made such moves.

Would we bet on it? Gordon Bell, a prominent investor who funds start-ups, is very blunt with executives of firms in his portfolio. For instance, when someone makes predictions for company performance, Bell will zero in on one number and ask the CEO, "Wanna bet? A side bet, you and me, for $1,000." If the CEO gulps, Bell knows he or she has doubts. At least once, when an underperforming CEO didn't take the bet, Bell had him fired. You can take this notion up a notch to engage in prediction markets, set up like a stock market, where people can buy and sell shares reflecting their honest assessment of how a particular plan will play out.

execution could have saved them. To keep pursuing the strategies that produced these failures—some quite spectacular—companies had to go to great lengths to deceive themselves.

Motorola's Iridium satellite-telephone unit—a $5 billion venture that filed for Chapter 11 less than a year after the phone system went live—is widely cited as a failure of execution or marketing. In fact, the failure stemmed from a misguided captivation with technology. The project began in the 1980s to solve a legitimate problem: Cell phones were expensive and lacked global connectivity, and existing satellite alternatives were cumbersome and unreliable. But as Motorola pursued its development plans, it ignored its own engineers' warnings that the ultimate product would share the limitations of early 1980s cellular technology even as cell phones got better and cheaper with every passing year. Motorola was so enamored with its technology that its market research amounted to little more than marketing. For instance, when it asked if customers would like a global portable phone for a "reasonable price," it didn't define "reasonable" as an initial outlay of about $3,000, plus monthly charges and pricey minutes; and its description of a phone that would "fit in your pocket" assumed that your pocket would hold a brick.

Federal Express made a similar mistake in the mid-1980s with Zapmail, a service whereby couriers would pick up paper documents and deliver them to a nearby processing center, where they would be faxed to another processing center, close to the destination, and delivered by courier to the recipient, all within two hours. The price was $35 for up to five pages, with a discount and faster delivery if the customer brought the documents into a FedEx office. At the time, few companies owned fax machines, because they were expensive and transmission quality was often poor. As prices fell and the technology improved rapidly, fax machines proliferated; soon it seemed silly to use FedEx as an intermediary. In 1986, FedEx shut Zapmail down, taking a $340 million pretax write-off after losing $317 million during its two years of service.

Rushing to Consolidate

As industries mature, the number of companies in them diminishes. Holdouts have an incentive to combine and reduce capacity and overhead and gain purchasing and pricing power. Our research shows that it is sometimes better to sit back and let others fumble through consolidation. Though there's more glory in being the buyer, it may be wiser to sell and pocket the cash before industry conditions deteriorate.

Take the demise of Ames Department Stores. The company pioneered the concept of discount retailing in rural areas four years before Sam Walton got into the game. But it got reckless in its attempts to build a national presence. In its zeal to compete with Wal-Mart, Ames made a series of acquisitions, without adequately considering what it would take to win that battle. The moves didn't build on its core strength—merchandising—and exacerbated its greatest weaknesses: back-office systems like accounting. For instance, after Ames acquired discount chain G.C. Murphy in 1985, it suffered an enormous amount of shrinkage (industry speak for theft) because it had no system for checking inventory. Disgruntled Murphy's employees were reportedly stealing goods off delivery trucks and then logging complete shipments into stores. In 1987, Ames lost $20 million worth of merchandise and couldn't tell why. Even as the company struggled to integrate G.C. Murphy, Ames's managers went for another, bigger, takeover—Zayre, for which it paid $800 million, a glaring overpayment. The company filed for bankruptcy in 1990 but recovered, only to make the same mistake again. After struggling with the disastrous acquisition of Hills Department Stores, Ames again filed for bankruptcy in 2000 and was liquidated in 2002.

Consolidation plays are subject to several kinds of errors. For one thing, you may be buying problems along with assets. Ames repeatedly overlooked the fact that many of the stores it bought were damaged goods. For another, increased complexity may lead to diseconomies of scale. Systems that work well for a business of a certain size may break as a company grows. USAir bought Pacific Southwest Air for $385 million in 1987 to expand into the West and then bought archrival Piedmont for $1.6 billion. The company almost tripled in size in a bit more than a year, and its information systems couldn't handle the load. Service suffered, computers repeatedly broke down on payday, and crews were taxed to the limit by their new schedules. Before the merger, USAir and Piedmont had operating profits six to seven percentage points higher than the industry average; after the merger operating profits were 2.6 points below the industry average.

Furthermore, companies may not be able to hold on to customers of a company they buy, especially if they change the value proposition. And last, other options may be preferable to being the industry's consolidator. Ames didn't have to go toe-to-toe with Wal-Mart. It was doing nicely as a regional retailer with a far more limited product line. As far as we can tell, Ames never considered holding on to its position and potentially selling out to Wal-Mart down the line.

Roll-Ups of Almost Any Kind

The notion behind roll-ups is to take dozens, hundreds, or even thousands of small businesses and combine them into a large one with increased purchasing power, greater brand recognition, lower capital costs, and more effective advertising. But research shows that more than two-thirds of roll-ups have failed to create any value for investors.

We were interested to find that many roll-ups were afflicted by fraud—among them, MCI WorldCom, Philip Services, Westar Energy, and Tyco—but we won't focus on those in this article because for the most part the lesson is simply, "Don't do it." Instead, let's look at the fortunes of Loewen Group. Based in Canada, it grew quickly by buying up funeral homes in the U.S. and Canada in the 1970s and 1980s. By 1989, Loewen owned 131 funeral homes; it acquired 135 more the next year. Earnings mounted, and analysts were enthusiastic about the company's prospects given the coming "golden era of death"—the demise of baby boomers.

Yet there wasn't much to be gained from achieving scale. Loewen could realize some efficiencies in areas like embalming, hearses, and receptionists, but only within fairly small geographic proximities. The heavy regulation of the funeral industry also limited economies of scale: Knowing how to comply with the rules in Biloxi doesn't help much in Butte. A national brand has little value, because bereaved customers make choices based on referrals or previous experience, and being perceived as a local neighborhood business is actually an advantage. In fact, Loewen often hid its ownership. And it damaged whatever reputation it did have with its methods of shaming the bereaved into buying more expensive products and services (such as naming its low-end casket the "Welfare Casket").

Nor did increased size improve the company's cost of capital. Funeral homes are steady, low-risk businesses, so they already borrow at low rates. The cost of acquiring and integrating the homes far outweighed the slight scale gains. What's more, the increase in the death rate that Loewen had banked on when buying up companies never happened. Fast-forward several years and the company filed for bankruptcy, after rejecting an attractive bid. (Relaunched under the name Alderwoods, Loewen was sold to the same suitor for about a quarter of the previous offer.)

Often roll-ups cannot sustain their fast rate of acquisition. In the beginning, all that matters is growth—buying a company or two or four a month, with all the cultural and operational issues that accompany a takeover. Investors know that profitability is hard to decipher at this point, so they focus on revenue, and executives know that they don't have to worry about consistent profitability until the roll-up reaches a relatively steady state. Operating costs frequently balloon as a result. Worse, knowing that the company is in buying mode, sellers demand steeper prices. Loewen overpaid for many of its properties. In another case, as Gillett Holdings and others tried to roll up the market for local television stations in the 1980s, the stations began demanding prices equal to 15 times their cash flow. Gillett, which bought 12 stations in 12 months and then acquired a company that owned six more, filed for bankruptcy protection in 1991.

Finally, roll-up strategies often fail to account for tough times, which are inevitable. A roll-up is a financial high-wire act. If companies are purchased with stock, the share price must stay up to keep the acquisitions going. If they're purchased with cash, debt piles up. All it took to finish off Loewen was a small decline in the death rate. For Gillett, it was an unexpected TV ad slump. When you go into a roll-up, you need to know exactly how big a hit you can withstand. If you're financing with debt, what will happen if you have a 10%—or 20% or 50%—decline in cash flow for two years? If you're buying with stock, what if the stock price drops by 50%?

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The vast majority of business research focuses on successful companies, in an effort to generalize from their traits, tactics, or strategies. Executives scrutinize healthy businesses for best practices they might be able to imitate. Our research looks at the data that others tend to ignore: companies that tried to do the same thing as the winners and failed. We know that companies are capable of learning from failure, given the right incentives. Airlines have a better-than-average record on preventing disaster because their own personnel go down with customers. Perhaps that's an overly dramatic example, but we do believe that enormous value lies in learning from companies that have lost millions, if not billions, in pursuit of fundamentally flawed strategies.

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When Bruce Nolop was an investment banker, he saw only the glamorous side of acquisitions. Since becoming executive vice president and chief financial officer of Pitney Bowes, however, he's learned how hard it is to pull them off. In this article, he shares the lessons his organization has learned throughout its successful six-year acquisition campaign, which comprised more than 70 deals: Stick to adjacent spaces, take a portfolio approach, have a business sponsor, know how to judge an acquisition, and don't shop when you're hungry. Pitney Bowes's management and board of directors now use these five basic rules to chart the company's growth course. For example, when evaluating a potential acquisition, Pitney Bowes distinguishes between "platform" and "bolt-on" acquisitions to set expectations and guide integration efforts; the company applies different criteria, depending on the type. According to Nolop, any company can improve its acquisition track record if it is able to learn from experience, and he suspects that Pitney Bowes's rules apply just as well to other organizations. Buying a company should be treated like any other business process, he maintains. It should be approached deliberately and reviewed and improved constantly. That means mapping a complex chain of actions; paying attention to what can go right or wrong at different stages; and using standard, constantly honed approaches and tools.

Finding Your Next Core Business
by Chris Zook
Harvard Business Review
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How do you know when your core needs to change? And how do you determine what should replace it? From an in-depth study of 25 companies, strategy consultant Zook has discovered that it's possible to measure the vitality of a business's core. If it needs reinvention, he says, the best course is to mine hidden assets. Some of the 25 companies were in deep crisis when they began the process of redefining themselves. But, says Zook, management teams can learn to recognize early signs of erosion. He offers five diagnostic questions with which to evaluate the customers, key sources of differentiation, profit pools, capabilities, and organizational culture of your core business. The next step is strategic regeneration. In four-fifths of the companies Zook examined, a hidden asset was the centerpiece of the new strategy. He provides a map for identifying the hidden assets in your midst, which tend to fall into three categories: undervalued business platforms, untapped insights into customers, and underexploited capabilities. For example, the Swedish company Dometic was manufacturing small absorption refrigerators for boats and RVs when it discovered a hidden asset: its understanding of, and access to, customers in the RV market. The company took advantage of a boom in that market to refocus on complete systems for live-in vehicles. Your next core business is not likely to announce itself with fanfare. Use the author's tools to conduct an internal audit of possibilities and pinpoint your new focus.