Supplementary Reading for

<u>Chapter 10 How Jack Welch Runs GE</u>

The Welch Legacy: the Creative Destruction

By Richard Foster

Whole institutions may one day be built just to preserve and dissect the leadership lessons of Jack Welch, who stepped down as chairman and CEO of General Electric on Friday. But the key to understanding Mr. Welch's astonishing legacy of shareholder return – a 23% compounded annual growth rate over his 20-year tenure, versus 15% for the S&P 500 – lies in what Joseph Schumpeter, the great Austrian-American economist of the 1930s and '40s, called “the gales of creative destruction.” In the latter part of his helmsmanship, Mr. Welch updated this mantra for a while by urging the managers of his business units to “destroyyourbusiness.com,” embracing the emerging capabilities of the Internet.

What Mr. Welch recognized is that destroying one's own businesses – or knowing when to let go of them and move in a different direction – is a far surer way to generate value and outperform the market than to buckle down and try to protect what you've built, regardless of how grand. Despite all the deserving accolades bestowed on Mr. Welch, and GE's willingness to share its philosophies and methods with others, GE's long-term performance remains a rare exception in corporate America.

For the past several decades we have celebrated the big corporate survivors, praising their excellence and their longevity. The general assumption is that these are the bedrock companies of the American economy, attracting legions of patient investors with the expectation of being rewarded richly at the end of a lifetime. If only this were true.

Of the 500 companies making up the S&P 500 when it was introduced in 1957, only 74 remained on the list through 1997. And of these 74, only 12 outperformed the S&P 500 index itself over the 1957-1998 period. Of these 12, only two were not part of industries which themselves outperformed the index: General Electric and Johnson & Johnson. If today's S&P 500 were made up only of those companies that were on the list when it was formed, the overall performance of the S&P would have been 20% less per year than it actually has been. Investors patiently investing in corporate survivors will substantially lag investors who merely invest in market index funds.

Why is this? Capital markets, and the indices that reflect them, encourage the creation of corporations, support their efficient operations (so long as they remain competitive), and then rapidly – and remorselessly – remove them when they lose their ability to perform. Corporations that assume continuity and longevity in their businesses are unable to change at the pace and scale of the market. Superior performance, at least for a time, usually appears among relatively new entrants in the economy – companies like Intel, Amgen and Cisco. Mr. Welch's brilliance was in never losing sight of the close parallels that should exist between corporations and capital markets in assessing investments, and in ensuring that GE changed at the pace of the market. As he wrote in GE's 2000 annual report: “We've long believed that when the rate of change inside an institution becomes slower than the rate of change outside, the end is in sight. The only question is when.”

How can corporations change internally at the same rate as the external markets? Corporations are built on the assumption of continuity; hence their focus is on operations. Capital markets are built on the assumption of discontinuity; their focus is on creation and destruction. This is the central contradiction of the life of a corporation: It cannot succeed without excellent operations, but it will fail if it focuses primarily on operations. Corporations are afflicted with the survivor's curse: Most are unable to earn above-average or even average shareholder returns over the long term. Their control processes – the very processes that help them survive for the long haul – deaden them to the need for change. Mr. Welch's mastery of creative destruction was rooted in his ability to decentralize operating responsibilities and make creative destruction the responsibility of senior management. This is a very difficult balancing act.

Within four years of taking over as CEO at GE, Mr. Welch divested 117 business units – from mines to Light N'Easy irons – totaling one-fifth of GE's 1981 $21 billion asset base. He was determined to shake up GE's staid, outmoded view of itself by creating, operating and ultimately selling divisions. Mr. Welch's “new” GE would be a high-tech provider of large-ticket products and essential services, ranging from mutual funds to jet engines, credit card processing, medical imaging, and network television programming. By aggressively moving to sell prime symbols of the “old” GE, Mr. Welch advanced his case by years, if not decades. He demonstrated early in his tenure that “nothing is sacred,” “change will be accepted as the rule, rather than the exception,” and “paradox is a way of life.”

Even apparently big setbacks, like the ruling by European regulators against GE's bid for Honeywell, seem like an acceptable blip in the company's progress. As Mr. Welch told *The Wall Street Journal* in a 1999 interview, every acquisition GE makes has “a perfect plan, but we know 20 or 30 percent will blow up in our face. A small company can only afford to make one or two bets or they go out of business. But we can afford to make lots more mistakes, and, in fact, we have to throw more things at the walls. The big companies that get into trouble are those that try to manage their size instead of experiment with it.” This is similar to the private equity model of create, operate, trade.

Other companies, including Enron and Johnson & Johnson, have followed the create, operate, trade mantra with positive results. In the 1920s and 1930s, the turnover rate in the old S&P 90 Index was about 1.5%, which meant that, on average, a company on the list could expect to remain on it for more than 65 years. Because of the accelerating forces of creative destruction, led by the mergers and acquisitions boom begun in the 1980s, McKinsey & Company estimates that by the end of the year 2020 the average lifetime of a corporation on the S&P will have been shortened to about 10 years. Will GE still be among the “survivors,” and continue to be a rare example of long-term market performance? No one really knows, but the challenge will be more difficult than Mr. Welch faced if long-term historic trends of market change continue.

When Mr. Welch took over at GE in 1981, much of GE's management philosophy was based on the idea of defend first, attack if you must. Mr. Welch's greatest contribution to GE employees and shareholders has been to turn this rule on its head, into attack first, defend when necessary. Under Mr. Welch, GE found a way to effectively integrate the functions of creation, operation, and trading close to the pace and scale of the market. While mirroring GE's success will not be easy, Mr. Welch's legacy shows that accelerating change can be accomplished in public companies, and that the capital markets will reward the companies that can do it.

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Questions for discussion:

1. What is Mr. Welch's astonishing legacy described in the opening paragraph of the article?
2. Does the author of this business review regard GE's long-term performance during Welch’s tenure as a common example of corporate America?
3. What is the general assumption about the big American corporations that have been celebrated for their longevity?
4. Did General Electric outperform the S&P 500 index over the 1957-1998 period or not?
5. Why was Mr. Welch keen on the parallels that should exist between corporations and capital markets? What was his philosophy of change?
6. Is it true that public companies and capital markets are supposed to focus on the same functions?
7. How does the author define the central contradiction of the life of a corporation?
8. How does the author illustrate his point that Mr. Welch was a mastery of creative destruction?
9. What attitude or conceptions should a big company break away with if it intends to continue to succeed in the competing business world today?
10. How did Welch succeed in implementation of his management philosophy?