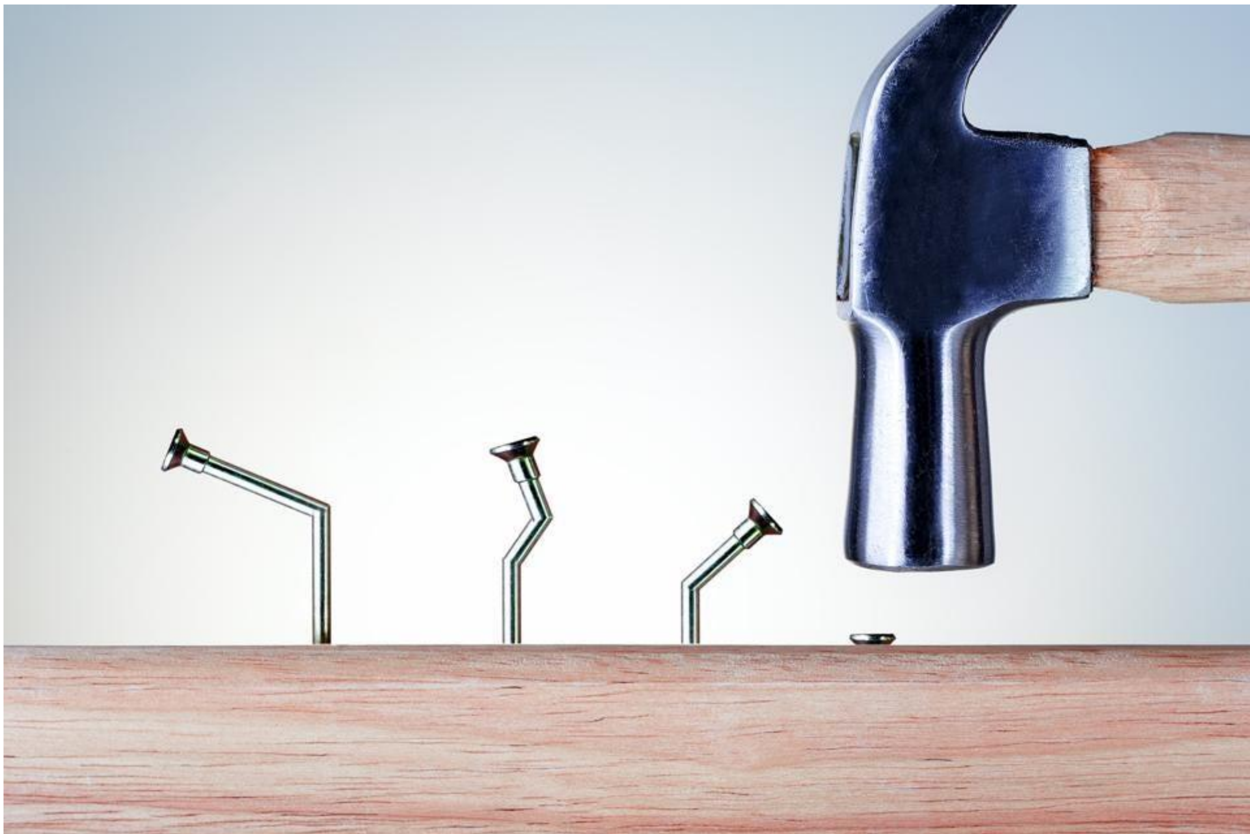
The Unsung Benefit of Failure

By Gregory Milano



Based on my own analysis of S&P's Capital IQ data, there are 389 companies in the S&P 500 that have been public since the turn of the century, and the management of these large public companies appear to have, in aggregate, improved profitability at the expense of growth over the past decade.

Using pre-pandemic data, their collective earnings before interest, tax, depreciation and amortization as a percent of sales, or EBITDA margin, over the 10 years through 2019 increased 3.5% versus the prior 10 years. Over the same timeframe, annualized aggregate revenue growth fell 3%.

These numbers will be applauded by many, particularly those who value short-term profit more than growth. But one important indicator — the market — views value differently. One finding that struck me is that companies with above-median revenue growth delivered a total shareholder return (known as TSR) that was 3.9% higher per year than those with below-median growth.

To what can the revenue growth be attributed? I believe the answer is innovation. Regrettably, despite the best of intentions, many company cultures have increasingly focused on cost efficiency and capital productivity, and the unintended outcome is employees who avoid the risk and uncertainty — and occasional failure — that drives innovation. Whether focused on improving products and services, supply chain and delivery processes, or overall business models, innovation is critically important to success, revenue growth and value creation for all stakeholders.

A heightened emphasis on risk management is sensible after witnessing corporate fiascos. But the aggregate value lost across companies due to a decline in prudent risk-taking, and therefore innovation, is a far bigger drain on the economy than infamous, but isolated, incidents seen in the past.

I believe part of the problem is that many companies face difficulty evolving toward a growth focus, especially large public companies. They find their growth initiatives don't stack up well, at least in the near-term, against financial performance measures like profit margin and return on capital. And the strong historical performance on these measures effectively raises the bar for new initiatives. Indeed, even high-value growth investments are likely to bring down the average return on capital once it is very high.

On the other hand, the common mistake is to say, "We don't need to worry as much about margins and returns as long as we deliver more growth." But as many companies have learned, "growth for growth's sake" often doesn't end well. What organizations should do instead is pivot gradually toward growth while also fostering discipline around cost efficiency and capital productivity. Then, as the organizational culture embraces the growth mindset, the transition can continue at a measured pace. The outcome will more likely be a business that supports transparency, engagement and innovation — and, thus, more growth.

Through my years of experience guiding companies in these very measures, I have identified three key actions that can increase the likelihood of successful innovation for any company, especially large, diversified businesses.

1. Shift away from a balanced scorecard. This is a collection of different measures that are liable to confuse decision-making and lead to analysis paralysis. Instead, focus on improving a single, more complete measure, such as one of the many forms of economic profit (or EP) that are used by management teams and investors. As one CFO recently said to me during an online roundtable, EP measures "make meetings shorter" since the implications of decisions are so clear.

2. Stop measuring performance against budgets. This amounts to paying managers and employees to plan for mediocrity. When performance is rigidly assessed versus plans, it is normal behavior to avoid uncertainty — to play it safe and deviate minimally from what worked in the past. Unfortunately, "business as usual" has become a formidable obstacle to innovation, and the accelerating pace of disruption and industry turnover have only served to compound the ill effects of such risk aversion. The way around it is to create an environment that celebrates cumulative improvement. To do so effectively, leaders should *always* measure performance versus the prior year, not against budgets. As discussed above, this requires a reliable value creation metric, like EP.

3. Be mindful that this is not a business process change as much as it is a cultural change. Communication, training and coaching are required to be successful in such change management efforts. It might seem simple, but old habits die hard. Executives must visibly support the culture change through their actions and pass their experience and validation on to others. Experimenting with new ways of doing things should be encouraged. Praise them when they admit failure, and make sure they feel safe doing so. Above all, steer employees to learn from the process of failure, and apply these lessons as they formulate new, innovative ideas.

For most companies, embracing a culture of innovation requires a cognitive and behavioral shift in how they approach and evaluate decisions. It will take time, but eventually innovation will increase, the balance of growth and return will improve and more value will be created for all stakeholders.

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