by Randall Rothenberg

Photograph by Mark Katzman

Ram Charan: The Thought Leader Interview

The celebrated CEO coach says leaders must learn to confront reality.

Perhaps no term was more abused during the Internet mania of the late 1990s than *business model*. To most participants in the era's economic game, *business model* was synonymous with *strategy*, and strategy, in turn, was equated with new-to-the-world products or services. Investors poured billions of dollars into start-up companies that were little more than speculative sketches dressed in the fancifulness of that two-word phrase.

No wonder they failed, say Ram Charan and Larry Bossidy. They refused to confront reality.

Hence their latest book. *Confronting Reality: Doing What Matters to Get Things Right* (Crown Business, October 2004) is a no-nonsense template for driving business-model-based transformation in an organization. In their latest collaboration, the noted management consultant and the former chairman and chief executive of Honeywell Inc. demystify the process of devising and implementing profitable change in companies — and doing it over and over again.

Although a follow-up to *Execu-*

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tion: The Discipline of Getting Things Done (Crown Business, 2002) — a *strategy+business* pick as one of the best business books of 2002 — *Confronting Reality* is effectively a prequel to the earlier work. It hews to the same nuts-and-bolts style that has kept *Execution* on U.S. bestseller lists for two years, providing templates by which business leaders can cycle through the three elements — financial targets, the external environment, and internal activities — that a complete business model must address. Even more striking, the authors provide concrete examples (from Dell, the Thomson Corporation, Cisco Systems, Home Depot, and other companies) of how successful leaders implement change by shaping four components of the organization: strategy, operations, people, and processes. *Confronting Reality* is probably the most comprehensive "how-to" guide available to CEOs … and those who aspire to the position.

The book is infused with the famous candor of coauthor Mr. Bossidy, but even more, it bears the imprint of Ram Charan's deep, diversified, and worldwide experience. The 65-year-old former Harvard professor is among the world's foremost leadership consultants; his clients over a 35-year career include GE, DuPont, Novartis, Thomson, The Home Depot, KLM Cargo, and Verizon. On the road 365 days a year, according to *Fast Company* magazine, Dr. Charan "does not own a home — or even rent one — has no nuclear family or significant material possessions, and he has his assistants FedEx his clean clothes to him." He is a veritable Baedeker of the leader's life; the 10 books he has written or coauthored (including 2004's *Profitable Growth Is Everyone's Business: 10 Tools You Can Use Monday Morning*, also published by Crown) all follow the same, thoroughly accessible guidebook format.

Dr. Charan visited with *strategy+business* in a conference room at the journal's Park Avenue headquarters in Manhattan, where, over turkey sandwiches and Diet Coke, he explained how to inject reality into companies that have drifted from it.

S+B: Most books about business strategy seek to tell readers how to locate a single point of competitive advantage that will last them for years. *Confronting Reality* is quite different: It's an argument about the necessity of continual business transformation. At what point did business become so unstable that companies required that kind of capability?

CHARAN: The need has always been there, but it hasn't really been recognized. The general tradition is, most corporate strategists and consultants look at the environment and at their core capabilities, and ask, What's the fit with their strategy? Or a CEO will say, "Get me a brilliant strategy," and someone will come in with a high-level strategic idea, work out a five-year spreadsheet, and say, "I will make it happen."

But that's the *wrong way*. All my life I have been working with the Bossidys, the Welches; I was exposed to Sam Walton, people like that. And I saw these guys — because I have access privately to them, and how they think — they don't go this way. So I talked to Larry Bossidy about it. And he said, "You're right, this is not the way successful leaders think or act." There's a lot of superficiality in conventional approaches to strategy.

But there is an opposite way of thinking, one that's followed by the most successful leaders. They ask, What is the *how* of money making in this business? How does that *how* fit with the shifting environment? Is there a misfit? Are you expecting a misfit?

S+B: Once you begin to answer those questions, how do you act on them?

CHARAN: There are four component questions to ask about your organization: How should your strategy transform? How should your operating activities transform, whether or not you have a shift in strategy? To accomplish a transformation, what shift in people and leadership is necessary? And what shift in organization processes must you facilitate?

These are the four components of how to make money: strategy, operating activities, people, and processes. When you confront reality, you may have to make changes in one of the four, two of the four, three of the four, or all four. To confront reality, you start with the selection of the mix of financial targets. You see how they link to the external environment. If those targets are not being met, you ask the question, "What's going on in here?" A leader has to determine when not to change, when to change, and to what extent to change. Then you determine which of the four internal organizational components have to be changed, and in what sequence, to meet those goals.

Wall Street Wiles

S+B: Just as *Execution* implied in its title that senior executives had somehow forgotten how to execute, *Confronting Reality* by implication says people lost their business savvy. What happened?

CHARAN: One factor was Wall Street. There's an excess supply of capital available to fund just about any project. You prepared your plan, you got the funding. A lot of capital was coming into and from a variety of channels, such as private equity. And there was another factor: The banks figured out how to dump the risk taking into a big ocean. So when these things went sour, the banks didn't really suffer. There was a shift in the responsibilities assumed for risk.

S+B: You term the result of this *mal-investment*.

CHARAN: The global dispersion of risk and faster, global, larger flows of capital — together, these trends promote commoditization and continuing excess capacity. That's the difference.

S+B: One of the underlying themes of your book is that each company must find its own sweet spots on the spectrum from commoditization to differentiation, almost for each customer. For example, you talk in the book about Thomson Financial. Part of Thomson's success was developing seven integrated solutions packages that could be tailored for each customer.

CHARAN: It's very important. The key is you cannot rest on the laurels of your current differentiation. The whole history of business is about bringing things to people at cheaper prices. That's commoditization. So you have to have the leadership, the organization, the processes, and people inside to allow differentiation to continue in the face of commoditization.

S+B: Which creates a need for continual change, because companies have increasingly limited pricing power.

CHARAN: Very limited.

S+B: It creates a terrible spiral for so many industries.

CHARAN: Airlines, autos, paper.

S+B: You'd think that almost any business leader would want to throw up his or her hands and say, "Leave somebody else with the problem."

CHARAN: But there are always profitable segments! There's always a way to discern something from something else. Even in commodities. You'll have to work very hard, you'll have to fight for every inch of market space. But if there were no way to discern opportunities, why wouldn't there always be equal market shares? There are always advantages to be gained: service, point of contact, delivery.

S+B: You and Larry Bossidy say that the business model enables a leader to define and confront reality. It comes from simultaneous and tenacious iterations of three elements: external shifts, financial targets, and internal operating activities.

CHARAN: That was one of Jack Welch's strengths. His mind was always experimenting. He was always asking, What is the business model?

S+B: How important are breakthrough products or services in this conception of strategy?

CHARAN: Michael Dell personally told Larry that he didn't have a vision: He was driven to it. His singular goal was survival. That was it. "How do I survive against these big guys?" And out of that came a philosophy, a concept. But that meant a huge amount of transformation involving the whole supply chain, which his competitors didn't get. He wasn't starting with a "strategy." Operating activities were forcing the

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strategy. He’s saying, “I’m a mass guy; I’m going to sell direct and be the lowest cost.” But saying it does not get him anywhere. He needed to transform the operating activities — the supply chain.

S+B: **In the new environment, what capabilities does a company need now that it might not have needed 10 years ago?**

CHARAN: While we say you’re going to have to change more often — and make deeper change — you still have to have a resilient core gut of your business model. That’s what makes a Wal-Mart, a Dell, a Toyota, a P&G, a GE so special; they understand their core underlying business model.

Leaders need to have intellectual honesty to see that what worked in the past either might not be relevant in the future, or might no longer differentiate them, because competitors have caught up.

Take, for example, Joe Tucci of EMC. He quickly recognized that a single-trick pony — the high-technology, high-priced, high-margin business model — had become obsolete and was no longer differentiated after the bubble burst in 2001. He tenaciously iterated many times the three components of his business model and changed all four pieces of EMC’s internal activities. Results are impressive.

When you understand your core business model, you can determine where there needs to be and where there doesn’t need to be wholesale change. For most companies, the key processes are not going to go through major change. They are not adaptable. No matter what Dell does, the supply chain will still be needed. Now matter what Wal-Mart does in its business model, the linkage with suppliers will always remain a core competency.

S+B: **I was very much intrigued by the story you tell in the book about James McNerney, who left GE to become CEO of 3M, because that story is largely about focusing on internal activity — not strategy — as the fundamental component for change. 3M had a great innovation capability, but it was too slow.**

CHARAN: Jim is a very accomplished leader who’s mastered the three pieces of the business model. He recognized that the P&L and balance sheet were OK. The company had bright people around the world. He focused on taking performance to a higher level, concentrating on organization processes as a driver to make the change impactful. In most other cases, a new leader comes in and focuses on changing top people and strategy. Jim focused on the lever that mattered most.

Start with Consumers

S+B: **The message that “not everything has to change” seems almost counterintuitive for a book *about* change. How do you distinguish temporary swings from truly significant environmental disruptions?**

CHARAN: Always start with the end consumer, and see if there are shifts in behavior, and if the shifts are structural or cyclical. And then ask if this change really took place, how badly could it affect us?

S+B: **You talk about customer mapping and demand-chain mapping. How does that work in practice?**

CHARAN: Analysis and observation. Visiting stores. Being in the field. This is a lost art. Most cost-cutting companies don’t value the people who are good at this. Call five business schools on the phone. Talk to the marketing professors of first-year courses. And ask the question, What kind of fieldwork is required during the term?

Fieldwork is only part of what is sorely missing in the teaching. We teach management, we teach leadership; we do not teach business acumen. Political people have political acumen. We have to find a way to teach business acumen. Business acumen is the missing element in the whole leadership and management arena.

S+B: Can it be taught?
CHARAN: Yes.

S+B: So it's not something that has to be innate.
CHARAN: I coach, I teach. It can be learned.

S+B: Sometimes executives won't confront reality; at other times, they leap headlong into illusory realities. Imagine this situation: A CEO comes to you and says, "We have this complicated supply chain. There's a lot of money embedded in it. My leadership team is saying, 'I've got to start thinking of China for manufacturing, India for knowledge work.'" How could she apply your business model framework to this situation?
CHARAN: The world today has become more competitive partly because of globalization, the Internet, and better factor costs in places like China and India. Iterating all three pieces of the business model should indicate what's the reality for any given company.

Take, for example, a customer of your industrial business. He's already moving to China. In five years, he'll start product development there. And he's beginning to search for Chinese suppliers. Your iteration of the model should demonstrate that you cannot meet your financial targets without being there, or in an equivalent market.

But this is an intellectual exercise. It won't help you confront reality unless people who really know China are part of the exercise.

S+B: Would you say the majority of companies engage in full appraisals of their CEOs, or is that still a rarity?
CHARAN: Some do, but most, not yet. It's really hard for directors to do full-scale evaluations. Most will do selective evaluations. This is evolving. This is the finest of fine judgments. In addition to ethics and integrity, you've got to start backward from the fundamentals and the results. Not just the annual goals, but the fundamentals that drive the situation of the company and its success. You have to look at the quality of the different areas.

S+B: An alarmingly high percentage of companies don't assess talent at all.
CHARAN: They go through the motions and process. But getting to the precise substance requires leadership skills.

S+B: What's hard about it?
CHARAN: Many leaders have come from staff functions, consulting firms, and business schools and are "quant jocks." They've never really experienced sustained leadership over time, in which they learned the hard lessons of selecting, calibrating, and retaining great talent. The business schools really do not teach how to select people.

"Organizational DNA"

S+B: You mention a company's "DNA," its "genetic code," several times in *Confronting Reality*. Is this just a metaphor?
CHARAN: It's real. I can even define it for you. There are two simple components. One is the innate methodology of decision making — what information is valued, what criteria are used, what risks are assumed. The way a domestic auto company makes decisions on product portfolio selections is different from Toyota's way. So I, at 22 years of age, come into a company, I'm bright and ambitious, I learn this.

S+B: What's the other one?
CHARAN: The second one is the people and organizational equation. How people get selected, retained, and made to exit. And the political/analytical process in allocating resources.

S+B: Is a company's DNA fixed and unchanging?
CHARAN: Jack Welch changed the DNA of GE. Nobody could get into the top 600 people who could not execute. None! Not so before him. With Jeff Immelt, that code is already given — he's not altering that. But now, people in the top 600 will not move on unless they show in their makeup how to grow a busi-

ness. And he's going to make the change. You will see that gene pool changing.

Change Initiatives

S+B: You believe that "initiatives" are important catalysts to large-scale transformation. What is an initiative, and why is it so significant?

CHARAN: Powerful leaders don't procrastinate. After you've articulated your business model, and you understand which of the four components of the company need to change, and you've determined the sequence by which you are going to take the company to the next level — whatever that next level is — you need a way to make the change real for the whole company, not just a single piece. An initiative is a large program that aims at that objective.

For example, let's say you've determined that your strategy will involve making the company more customer focused. How do I get this strategy in the DNA of the company? We ought to first change the reviews of the strategy and the budgets and the people. In the strategy reviews, you say, "We're going to have a whole day for each unit, but you're only allowed to have five pages for the presentation. And the questions will be limited to customers and segmentation."

We did this at a company. The first guys were surprised that we actually did what we said. Within two weeks, the guys in the next division already knew what we were going to do. Then we did the same thing in budgeting. Now we are in the second round, and we have seen how the company has changed. Resource allocation has changed, costs went down, people selection changed. In some divisions, profitable growth has gone from single digits to double digits. It's now getting into DNA, in only three years. The energy went right through the roof. So these initiatives then expand the capacity of the organization for change. They see the success, they see the procedure, they see the benefits.

But, the CEO has to be the one involved, engaged, measuring, rewarding.

S+B: Why?

CHARAN: Because it is his leadership job to change the working of the whole social system. It is his initiative to make the organization flexible for change.

S+B: I can imagine a lot of chief executives saying, "Hey, I don't have time for that. I'm dealing with the board. I'm dealing with our customers. I'm dealing with our suppliers. I'm answering to Wall Street. I don't have time to be den mother for 10,000 people."

CHARAN: Then he needs to rethink his job, appoint a COO, and restructure his job.

S+B: In *Confronting Reality*, you mention some of the iconic business figures of past eras, people who were absolutely right for their times. Would you be willing to venture a guess about who the iconic management figure for this era might be?

CHARAN: It's too early to tell.

S+B: What are the qualities a successful leader needs today?

CHARAN: The first one is sorting out complexity.

S+B: Why is that different from the past?

CHARAN: Because of the nature and number of variables and the structural changes in business.

S+B: Others?

CHARAN: The second is managing external constituencies. And the third is you must be a social architect. You have to have those three. And of course, there's a fourth: tenaciously mastering the business model.

S+B: You use a lovely Indian phrase in describing an affliction suffered by successful leaders: "divine discontent."

CHARAN: Never satisfied. You'll never reach that inner, ultimate nirvana. +

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