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What Every CEO Should Know About Creating New Businesses

by David A. Garvin

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"Some problems," wrote Laurence J. Peter, the business humorist, "are so complex that you have to be highly intelligent and well informed just to be undecided about them." Top-line growth is one of those, especially when it comes to creating new businesses within large, complex companies. The challenges are vast, and it's difficult to know how, or even whether, to move forward. Most CEOs would benefit from having a few rules of the road.

Fortunately, scholars have studied the problem for decades. And whether they've called it "new business creation," "corporate venturing," "corporate entrepreneurship," "corporate innovation," or "intrapreneuring," their observations have been remarkably similar. Yet these findings have seldom been summarized or presented in an easily accessible form. Here, then, is a primer on the topic—the ten things every corporate venturer should know.

1. Ultimately, growth means starting new businesses. Most firms have no alternative. Sectors decline, as they did for Pullman's railroad cars and Singer's sewing machines. Technology renders products and services obsolete—the fate Polaroid suffered, as digital cameras decimated its instant photography franchise. Markets saturate, as Home Depot is now finding, after establishing more than a thousand stores nationwide.

2. Most new businesses fail. New businesses may be necessary for long-term growth, but successes are hard to pull off. The numbers are downright depressing. In the 1970s and 1980s, 60% of small-business start-ups failed in their first six years. Large companies did only a bit better. A study of sizable corporations during the same period, which included such household names as DuPont, Exxon, IBM, Procter & Gamble, Sara Lee, 3M, and Xerox, found that they divested or closed 44% of their internally generated start-ups and 50% of their joint ventures in the first six years.

3. Corporate culture is the biggest deterrent to business creation. New ventures flourish best in open, exploratory environments, but most large corporations are geared toward mature businesses and efficient, predictable operations. When a company's leaders recognize and support mavericks, encourage diverse perspectives, tolerate well-reasoned mistakes, and provide resources for exploratory ventures, employees are apt to embrace entrepreneurship. When leaders reward conformists and rule followers, insist on acceptance of the party line, demand error-free performance, and tightly ration resources, employees are likely to shun exploratory projects. New ventures whose operating sponsors are close to the action and know their businesses intimately tend to do better than those championed by the CEO alone.

4. Separate organizations don't work—or at least not for long. If new ventures require a new environment, the reasoning goes, they should be in a separate unit. Accordingly, from the 1960s through the 1980s, such companies as Boeing, Exxon, GE, Gillette, Levi Strauss, and Monsanto set up separate internal venture divisions. In the 1990s, companies like Bertelsmann, Chase, Intel, and UPS favored corporate venture funds that would act like Silicon Valley venture capitalists, nurturing nascent businesses by offering managerial oversight, funding in stages, and technical advice.

But allowing a different culture to flourish in either type of separate organization eventually leads to repeated power struggles and culture clashes, which members of the mainstream organization invariably win. Interest in the new ventures tends to be cyclical. Brief surges of enthusiasm, triggered by abundant resources and the desire to diversify, are followed by sharp declines. The life spans of both internal venture units and corporate venture capital funds, therefore, tend to be short—on average, only four to five years.

5. Starting a new business is essentially an experiment. New ventures can go wrong in so many ways. They can encounter customer failures (insufficient demand or unwillingness to pay for the product or service), technological failures (inability to deliver the promised functionality), operational failures (inability to deliver at the required cost or quality levels), regulatory failures (institutional barriers to doing what's desired), and competitive failures (a competitor's entry changes the rules of the game). These setbacks are unavoidable, and no amount of TQM or efficient management will anticipate them all. There's usually no alternative: A new venture simply has to prototype its initial concept, get it into the hands of users, assess their reactions, and then repeat the process until it comes up with an acceptable version. IBM calls these efforts "in-market experiments"; scholars call them "probe-and-learn processes."

It follows that perfectionist cultures (and planning-oriented managers) are in for a rude awakening, since it's seldom possible to figure out product designs or business models fully in advance. Repeated investments in rigorous, fact-based planning or quantitative research inevitably produce diminishing returns. Motorola found this out the hard way. In the mid-1970s, when cellular telephones were in their infancy, managers mailed out a survey to several hundred thousand potential users and then ranked the leading market segments; salespeople ranked 31, way down the list. Yet when prototypes were handed out, salespeople proved to be among the most devoted users, leading the adoption process and purchasing phones in large numbers.

The need for speedy feedback is not, however, an excuse for sloppiness. Managers must think hard about the design of their experiments. Scientists like to talk about an experiment's "discriminating power"—its ability to distinguish between two competing hypotheses. All too often, in-market experiments do not. Managers manipulate too many variables at a time: A computer manufacturer simultaneously changes a product's features, marketing, and pricing and then struggles to determine which was the critical success factor. Or they fail to build in controls: A retailer tries out four different store formats, in four different locations; because each location has a different socioeconomic profile, there's no baseline for comparing profitability from store to store. Or they fail to agree on the definition of success: A bank tries out a variety of branch layouts and finds that some increase traffic, others attract new customers, and still others increase the sales of more profitable services. Executives can't decide which layout to choose because they had not previously ranked the value of each outcome. Good experiments begin with clear, explicit objectives; they're designed to produce targeted insights and rapid feedback; and they generate measurable, actionable results.

6. New businesses proceed through distinct stages, each requiring a different man-

The Right Questions

New businesses go through three main stages, and in each, the critical questions executives need to answer are very different.

Experimentation Stage

- What products or services should we offer?
- Are they technically and economically feasible?
- Can we make money?

Expansion Stage

- How rapidly should we expand the business?
- How should we grow? By expanding into new offerings? New customers? New geographical areas?
- What financial and human resources are required?
- How will they be obtained?
- How should the new business be organized and managed to ensure short-term success?

Integration Stage

- How do we link the new business to the old processes?
- How do we ensure continued growth and profitability?
- How should the business be organized and managed for the long term?

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agement approach. Experimentation is only the first step in an extended, multistage process of business development. Each stage introduces a different set of questions and challenges. (See the exhibit "The Right Questions.")

Each stage also demands different talents and perspectives, and new leaders usually have to be brought in as businesses progress. The visionary who is well suited to leading a new business through its early experimental stages is often poorly equipped to guide the venture through the expansion and integration stages, when sales and organizational skills become more important than bold thinking and creativity. Nor can performance measures remain immutable. Because new businesses are seldom profitable in their early, formative years, financial metrics make little sense as a starting point for evaluation. Instead, milestones of various sorts—the number of prototypes in customers' hands; the number of times analysts mention a hot, new technology; the number of salespeople bringing in leads—are more useful indicators of early progress. During expansion, measures of market penetration and market share become important; as the business becomes established, traditional financial measures can be installed.

7. New business creation takes time—a lot of time. In most cases, the three stages of business creation take years to unfold. Experimentation, in particular, is extremely time-consuming. New concepts are difficult to validate, and customers' first reactions are not always good predictors of long-term sustainability. Home Depot opened its first Expo Design Center in 1991, built seven additional stores over the next few years to explore different formats and layouts, and didn't roll the concept out on a large scale until late in 1998. Managers hoping for quick returns are certain to be disappointed. The best study on the subject, which examined nearly 70 corporate ventures in the 1960s and 1970s, found that new businesses took an average of seven years to become profitable. None of the businesses had a positive cash flow in its first two years.

8. New businesses need help fitting in with established systems and structures. Probably the greatest concern of new-business leaders is that they and their ventures will become organizational orphans. Especially when they combine offerings from several divisions or target markets that fall into the white spaces of the organization chart, ventures find it difficult to secure an organizational home. They frequently find themselves shunted from one division head to another, as reporting relationships constantly change. The trick, says one experienced venturer, is "to achieve the right balance between identity and integration." Too much independence, and the business will be an orphan; too tight a link to established divisions, and the business will fail to differentiate itself.

On other occasions, support fails to materialize because of a perception that the new business will never become big enough to "move the needle" and make a substantial contribution to revenues or profits. The problem is, financial predictions are tricky because of high levels of uncertainty. Large forecast errors are common—in one study, first-year sales forecasts were off 80% and first-year profit forecasts were off 116%—making new businesses easy targets for critics. Go/no-go decisions should seldom be based on whether a new business has large initial returns or has met its budget targets.

9. The best predictors of success are market knowledge and demand-driven products and services. When you launch a new venture, pick a product or service close to the ones you already offer. Success rates rise substantially when new businesses target familiar customers and are staffed by people well acquainted with the market. New businesses launched simply to commercialize research findings rather than meet market needs are best avoided. Unfortunately, most engineers prefer working on the latest and greatest technology. It's therefore wise to ask: "What's the pain point for customers, and how does our offering overcome that pain?" Without such discipline, new ventures are likely to end up as solutions looking for problems.

10. An open mind is hard to find. The biggest hurdle for new businesses is mental—the way senior managers think about products, services, technologies, customers, and competitors. Every established company is based on an implicit theory—a largely unstated view of how the business works and money is made.

Polaroid is a telling example. As my Harvard colleagues Mary Tripsas and Giovanni Gavetti have reported, its powerful business model was based on the concept of razors and blades. Cameras (the razors) were viewed as a necessary evil; the real money came from sales of film (the blades). Digital cameras looked like razors. Senior managers kept asking, "Where's the film? There's no film?" recalls an employee in Polaroid's electronic-imaging division. "So what we had was a constant fight with the senior executive management in Polaroid for five years."

Sadly, many executives view all new businesses through the same filters and judge them on how well they conform. But few new businesses can meet that test—nor should they. If they do, every new business will look just like the old.

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