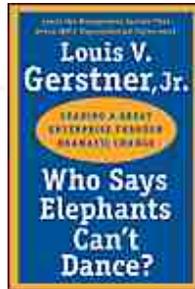


## Who Says Elephants Can't Dance?

Leading a Great Enterprise Through Dramatic Change



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### ■ About the Author



Louis Gerstner, Jr.

**Louis V. Gerstner, Jr.** was chairman of the board of *IBM Corporation* from April 1993 until his retirement in December 2002. He served as chief executive officer of IBM from 1993 until March 2002. In January 2003 he assumed the position of chairman of *The Carlyle Group*, a global private equity firm located in Washington, DC.

Prior to joining IBM, Mr. Gerstner served for four years as chairman and chief executive officer of *RJR Nabisco, Inc.* This was preceded by an 11-year career at *American Express Company*, where he was president of the parent company and chairman and CEO of its largest subsidiary, *American Express Travel Related Services Company*. Prior to that, Mr. Gerstner was a director of the management consulting firm of *McKinsey & Co., Inc.*, which he joined in 1965.

A native of Mineola, New York, Mr. Gerstner received a bachelor's degree in engineering from *Dartmouth College* in 1963 and an MBA from *Harvard Business School* in 1965. He is a member of the National Academy of Engineering, a Fellow of the American Academy of Arts and Sciences and has been awarded honorary doctorates from a number of U.S. universities.

Mr. Gerstner is a director of *Bristol-Myers Squibb Co.* and a member of the advisory boards of *DaimlerChrysler* and *Sony Corporation*. He is vice chairman of the board of *Memorial Sloan-Kettering Cancer Center*, a member of the board of the *Council on Foreign Relations*, a member of *The Business Council*, and a fellow of the *America-China Forum*.

### ■ The Big Idea

In the early 1990s, International Business Machines Corp. (IBM Corp.) was in a devastating slump. Stock prices had dropped from \$43 in 1987 to \$12 in 1992. System/390 mainframe sales were at an all time low. IBM Europe, Middle East and Africa (EMEA) reported a dismal gross profit margin of 38% in 1992, down from 56% in 1990.

In both print and TV, chroniclers heralded the eventual demise of this industry giant. Charles Morris and Charles Ferguson co-authored a book titled *Computer Wars*. In it was a statement allegedly quoting Bill Gates as saying that IBM "will fold in seven years." The *Wall Street Journal* said, "IBM will never again hold sway over the computer industry.

Then came Louis V. Gerstner, Jr. and IBM was never the same again.

## ■ The IBM Facts

IBM was created by Thomas J. Watson, Sr. in the early 20<sup>th</sup> century. Originally, IBM was simply a collection of small companies, with largely unrelated product lines dealing in everything from cheese cutters to typewriters. It must be noted, though, that even in its early stages of business, IBM had become known as a pioneer in computation.

In 1956, IBM's new CEO, Thomas Watson Jr., catapulted IBM into the future with the development of the System/360, IBM's collection of highly successful mainframes. Before the S/360, a company that made and sold computers based each system on proprietary technology. Each system had its own line of peripherals and wouldn't work with other systems, even those machines that were produced by the same company. As a result, if customers wanted to upgrade, they had to completely discard their old systems and purchase new ones. The S/360 was revolutionary, capitalizing on the integrated circuit (today's semiconductor chip). These circuits made the machines more powerful, reliable and less costly. It also allowed an entire family of computers to be built, each one capable of working with the other, including all peripherals.

The S/360 was an expensive undertaking, costing \$5 billion (in the 1960s!). IBM went into several new businesses, among them the semiconductor industry. Software tools, programming languages and operating systems had to be developed. The sales force required knowledgeable, technology-inclined members with the capacity to assist customers in reinventing business functions such as accounting, payroll and inventory management.

These were big risks but at its launch, customers ate the S/360 up. Revenues grew at a compound growth rate of 14% between 1965 and 1985. Gross profit margin was at 60%. So successful was the S/360 that the United States Department of Justice filed an antitrust suit against IBM in 1969. Business behavior changed and although the suit was dropped in the 1980s, IBM's success also became IBM's ruin. The "next big thing" had arrived.

## ■ Grabbing Hold

Lou Gerstner Jr. began his IBM career on April 1, 1993. By then, IBM was in the red and many thought it would take a miracle to reverse IBM's state of finances. That miracle was Lou.

### Early Priorities

Lou's 90-day priorities included:

- Stop hemorrhaging cash.

- Make sure that IBM is profitable in 1994 to send the message to the world and the workforce that IBM was stable.

- Develop and implement a key customer strategy for 1993 and 1994.

- Finish right-sizing by the beginning of the third quarter.

Develop an intermediate-term business strategy.

During the first few weeks of his tenure, Lou concentrated on conducting several meetings with the workforce, senior executives and shareholders. The shareholders were understandably angry. Share prices had dropped more than half the original price of \$43 in 1987. Both industry experts and the media had no faith in Lou Gerstner's capabilities. Something had to be done.

### **Saving the Mainframe**

Lou's first meetings included a discussion with Nick Donofrio, who then ran the S/390 business. A major point of concern was that the S/390 had lost its significant market share to the likes of Hitachi, Fujitsu and Amdahl. IBM mainframes were easily 30-40% more expensive than its competitors. The S/390 was being milked for all it was worth.

Lou's first decision was to stop the milking. The second decision was to change the architectural structure of the S/390: change from bipolar to CMOS technology and cut costs without sacrificing profit. It was an enormously complex project but one where the technical wizards of IBM succeeded at. A \$1 billion investment in the early 1990s produced enormous returns from 1997 forward -- \$19 billion at the end of 2001.

### **Operation Bear Hug**

Lou launched "Operation Bear Hug" in an attempt to restore customer faith in IBM. It was the first of many cultural changes Lou was going to introduce for the duration of his IBM career. He required each of his 50 senior managers to visit at least five customers and obtain feedback about the machines they were currently using. If a problem was present, a one- to two-page report was sent to Lou and anybody else who could solve the problem. The customers needed to know that they were the most important considerations for the development of any IBM product.

### **The Death of the Management Committee**

Perhaps the second cultural change was the abolishment of what was called the Management Committee. The "MC," as it is known to IBMers, was the ultimate seat of power in IBM and consisted of six members who made all the major decisions within the company. Lou believed in taking responsibility for one's own actions and felt that the committee negated that belief. In April 1993, the Management Committee died.

## **Stop the Bleeding (and Hold the Vision)**

Lou's first one hundred days came and went. *USA Today* marked the day with a non-flattering lead story. He had brought significant change to the company but clearly, no one thought it was enough. It was time to make major decisions and act on them.

### **Keeping the Company Together**

In the mid-1980s, the trend was for one company to specialize in just one or two areas of information technology. If you made databases, then you made only databases. If you made operating systems, you stuck with it. This offered the customer a cheaper alternative to purchasing complete systems and allowed all companies a slice of the pie. IBM, being a huge corporation that spanned several continents, was under pressure to join the bandwagon, so much so that new names had been created for its "printer division" and its "storage division."

Lou, however, believed that amidst all these computer-parts suppliers, there was still going to be a need for someone to do all the integration, making sure that all the pieces could be put together to make something useful out of them. He firmly believed that IBM was in the perfect position to be that "someone." In what may have been the most important decision in his entire business career, Lou chose to keep IBM together as one single company.

### **Saving and Raising Cash in the Billions**

CFO Jerry York and his team discovered that it took IBM 42 cents to produce a dollar while their competitors only needed 31 cents. Multiplied against the total revenue of the company, IBM had a \$7 billion expense problem!

A massive program of expense-reduction was begun. Every change was called a "reengineering." Each of the 24 business unit had its own systems for inventory, accounting, distribution and the like. Now, IBM has only one Chief Information Officer. Data centers were cut down from 155 to 16. Thirty one communications networks were consolidated into one. Acres of land were sold, including buildings and offices that were not being used or were being used inefficiently. In all, a total of \$9.5 billion in savings was declared between 1994 and 1998.

It wasn't enough to just save cash; it was also important to raise it. It was necessary to sell off most of IBM's unproductive assets. Most of the corporate airplane fleet was sold, as were expensive training centers and an impressive fine-art collection. Loral Corporation bought IBM's Federal Systems Company, a unit that transacted business with the United States government, for \$1.5 billion. By 1996, IBM had been right-sized.

### **Holding the Vision**

On July 27, 1993, a press conference was conducted to communicate the state of IBM's future. During the conference, Lou stated what would be one of his most memorable statements: There's been a lot of speculation as to when I'm going to deliver a vision of IBM, and what I'd like to say to all of you is that the last thing IBM needs right now is a vision. The newspaper reporters had a field day.

The truth of the matter was that IBM did have vision. What it needed was action. Fundamental strategic decisions had to be made and focus had to be given to the stabilization of the company while seeking growth strategies that would build on IBM's unique position in the industry.

### **Creating the Leadership Team**

To rebuild and sustain a company as large as IBM, the proper leaders had to be put in

the proper positions.

The Management Committee was disbanded and in its place, the Corporate Executive Committee was created. The committee was meant to work together in running the collection of companies that made up IBM. What it decidedly would not do was accept delegation of problem solving. At the same time, a Worldwide Management Council was established to encourage communication among the various IBM businesses around the globe.

A new Board of Directors was also created. Prior to Lou's arrival, there were 18 members with 4 insiders. In 1993, the Board was reduced to 12 members to be made more manageable. More outsiders were also brought in to broaden the corporate perspective. The new members included Chuck Knight, chairman and CEO of Emerson Electric Co., Chuck Vest, president of MIT, and Alex Trotman, chairman and CEO of Ford Motor Co. Several others followed, all of them presidents, chairmen or CEOs of various companies.

At the same time that IBM was recreating its board and senior management system, Lou also opened up lines of communication with IBM employees. The voice of IBM's people had to be heard. Lou utilized the power of IBM's internal messaging system and used it to communicate with just about everyone. These correspondences were galvanizing. IBM was ready to move forward.

### Creating the Global Enterprise

IBM is a huge company with a staggering \$86 billion in sales in 2001. Operating in over 160 countries, it was nearly impossible to attain any semblance of order within the various units. There were powerful geographic units and powerful product division scattered all over the globe. Each unit guarded its turf zealously, producing machines and systems according to what the unit wanted, not necessarily what the customers needed. Local management in the Asia-Pacific was different from that in the United States. The same disorder could be found amongst the various IBM products. Products in the United States weren't always available in other parts of the world.

Ned Lautenbach, then head of all non-United States sales organizations, undertook the task of building a global customer-oriented organization. Eleven industries taken from the existing customer base were assigned accounts. Each unit was to take care of its account, no matter where in the world it was. This idea of a global organization took root slowly and was fully accepted only after three years of hard work.

### Reviving the Brand

Abby Kohnstamm, hired by Lou in June 1993 as head of Corporate Marketing, conducted a study to determine where the IBM brand stood. It was found that in spite of its problems, customers still believed that when they bought an IBM product, it was a quality piece of technology. It was time to market the brand further.

To send out a clear message to the world, the message had to come from a unified

IBM. Individual business units had their advertising budgets cut off, including personal agencies and the discretion to come up with an ad any time they wanted to. All of IBM's global advertising was assigned to Ogilvy & Mather, an agency with solid worldwide expertise and experience. Both O&M and IBM had parallel objectives: IBM was betting its future on O&M's abilities, O&M was staking its future on IBM's.

### Resetting the Corporate Compensation Philosophy

Tom Watson, Jr. had a fixed mind about compensation: all compensation consisted mostly of a salary; there very little variance in the salaries; and emphasis was placed on benefits. It represented a paternalistic view of IBM's culture, sending the message that sharing and equality were more important than performance. This drove the employees to be satisfied with mediocrity; no matter how badly or well they performed, they were all paid in the same manner.

Under Lou's guidance, the compensation systems at IBM were changed. Emphasis was given to performance if you didn't perform, you simply didn't get paid as much as other better-performing co-workers. Stock options, a big no-no during Tom Watson's time, were offered. Stock-based compensation became the biggest element of executives' salaries. Executives were not allowed to own stock unless they put in their own money, a plan that was calculated to strengthen the over-all idea that IBM's success or downfall affected everyone, not just the company itself.

### ■ Strategy

By the end of 1993, IBM's first big war, right-sizing the company, had been won. In 1994, the company made two bets. The first was that customers would increasingly value companies that offered solutions. These solutions included the integration of thousands of pieces of technology the market had to offer and transforming them into usable systems to run various enterprises. IBM believed that in the following years, the main thrust of information technology would be services-led, not technology-led. The second bet would be the networked model of computing, a model not limited to just individual PCs. The Internet was not yet known as the largest network in IT but the most creative minds had begun to talk about this "information highway," a broadband network that connected home, workplace and school.

It was time to see if these two bets would be won.

### Building the World's Already Biggest Software Business

Microsoft was always seen as the biggest software-provider when in truth, IBM sold more software than Microsoft did in 1993. This misconception probably springs from the fact that IBM never really saw itself as a software company. IBM had concentrated on hardware sales. Each piece of hardware would need an operating system to get it running and IBM simply built it in or sold it as an added feature.

IBM's second war, building up its software business, was headed by John

Thompson, who was then running IBM's Server Group. John's task was a sizable one. He had to integrate all of IBM's software into a manageable program. A new, highly-skilled sales force had to be put to work. IBM's 4000 different kinds of software had to be sorted and consolidated to form just several brands with distinct capabilities. Substantial amounts of money had to be redirected to software marketing and sales.

IBM decided that it would take the position of "middleman," the provider of databases, software management systems and the like. At the base was Microsoft who owned the largest market share for operating systems. At the top were companies like SAP and PeopleSoft who provided user applications. Lou foresaw that an integrator, a company who could bridge the gap between these two very different sets of software, was going to be a vital source of growth. By 1995 and in the years that followed, IBM was working on re-writing all of its software, allowing it not only to be network-enabled but also compatible with other systems such as Sun, Hewlett Packard and Microsoft. Proprietary software was out!

In mid-1995, Lotus Development Corp was acquired by IBM. Lotus's Notes filled a hole in IBM's middleware portfolio and started the trend for collaborative computing. Tivoli Systems was also acquired nine months later. These acquisitions helped IBM attain its position today as the number one software company.

### Opening the Company Store

IBM's Research Division was given focus. IBM was noted for having one of the best scientific research laboratories in the world but they were unable to transform developments into something that was marketable and profitable. The answer lay largely in IBM's inability to work with other industry suppliers or take apart its mainframe, then still the biggest source of revenues for the company. Most of IBM's databases were still proprietary to only IBM. This had to change.

To get started, IBM started licensing its technology to third parties. No sale was actually involved but it allowed a larger part of the market, the OEM group, to access IBM's technologies. This move has been largely successful, earning an income of \$500 million in 1994. From licensing, IBM then began to sell individual technology components to other computer companies. This allowed IBM to get its foot through the door of the technology component marketplace, a feast-or-famine business but one that let customers know that IBM was serious about providing supplies in a reliable manner. Microelectronics then became the big trend, those specially designed microchips that powered billions of devices and appliances. IBM now stood to gain from the success of businesses outside the computer industry.

### Unstacking the Stack and Focusing the Portfolio

IBM just couldn't be everything to everybody. The decision to cut-back on developing application software was made. SAP, JD Edwards and PeopleSoft could potentially provide increased hardware sales for IBM if IBM stopped competing with them and worked instead on making their applications usable on IBM hardware. This rode on the general idea that most customers simply bought the software and then asked

providers which machines to run them in.

IBM signed several partnerships with software manufacturers, the first being Siebel Systems. Over the next few years, 180 other partnerships were made, pushing IBM to the lead in its strategy to be an integrator. Lou also gave up IBM's data network, selling it off to telecommunications giant AT&T for \$5 billion, an industry he never believed IBM was going to conquer. IBM gave up selling individual PCs to consumers in retail stores and sold them instead through telesales and their website.

All these shifted focus to IBM's strategy: they were going to be integrators.

### The Emergence of E-Business

IBM then created the term “e-business” to signify that the Internet was a place where real work could be done. As a provider of middleware, IBM was in the perfect position to develop the capacity for networked applications on the Net. Web hosting was also developed, as well as a campaign to increase consumer awareness of the Net's real value. IBM considers the \$5 billion investment it spent in marketing e-business money well spent; returns to IBM's brand and market positioning have been incalculable.

### ■ Culture

Think IBM and you'll think of blue suits and white shirts. Tom Watson, Sr. immortalized three basic beliefs in IBM: 1. Excellence in everything we do; 2. Superior customer service; and 3. Respect for the individual. Certainly, during his time, these beliefs were enough. But as enterprises and corporations change with time, it was necessary to change to change the focus on culture as well. Lou knew that this cultural transformation was going to be one of his biggest challenges.

Much of the work went into making IBMers believe in their capabilities again. Apart from this, Lou wanted a focus on customers and the marketplace, not on internal grand-standing. Categories were abolished and press releases were banned. Teamwork was given new emphasis, as well as accountability and responsibility. The IBM lingo was changed to include more understandable and customer-friendly terms. Leadership was revived and leaders and executives were reviewed for possessing what Lou gathered as IBM Leadership Competencies.

IBM's basic beliefs were supplemented by the following principles:

1. The marketplace is the driving force behind everything we do.
2. At our core, we are a technology company with an overriding commitment to quality.
3. Our two primary measures of success are customer satisfaction and shareholder value.
4. We operate as an entrepreneurial organization with a minimum of bureaucracy and a never-ending focus on productivity.
5. We never lose sight of our strategic vision.

6. We think and act with a sense of urgency.
7. Outstanding, dedicated people make it all happen, particularly when they work together as a team.
8. We are sensitive to the needs of all employees and to the communities in which we operate.

## ■ Lessons Learned

### On Focus

The ordinary day-by-day world of business doesn't produce miracles. Successful enterprises and executives always have the following characteristics:

1. They are focused.
2. They are superb at execution.
3. They abound with personal leadership.

A lack of focus is most often the cause of corporate mediocrity. Any company always has advantages in its base business. Losing focus leads to losing those advantages. This focus must also be the basis for forming business strategies and carrying them out to execution.

A good strategy comes from honest competitive analysis. Good strategies are long on detail and resources must be applied to the most important parts of the strategy.

### On Execution

Getting the task done is the most unappreciated skill of an effective leader, but it is also the critical part of a good strategy. Strategies that are not acted upon are useless.

Expectations are different from inspections. People respect only what a leader inspects. If you want a good strategy to work, make sure you inspect every aspect of its execution.

Effective execution is built on three attributes of an institution: world-class processes, strategic clarity and high-performance culture.

### On Leadership

Great institutions are not managed; they are led. They are driven to ever-increasing levels of accomplishment by individuals who are passionate about winning. The best leaders create high-performance cultures. They set demanding goals, measure results and hold subordinates accountable for their actions and decisions. They are visible in all areas of the company, rolling up their sleeves and tackling problems personally.

Leadership is all about passion, including but not limited to: passion for the job, passion for the customers, and passion for the products.

A leader inspires passion among his people. Managers, customers, researchers and all other people within the institution must see this passion in order for them to become passionate about their work themselves.

A leader must be of unquestionable integrity.

### ▪ *Elephants Can Dance*

Much has been said about small companies being better than big ones. It is said that smaller companies are more responsive, more effective. IBM's turnaround is the perfect negation of this idea. It isn't a matter of whether or not ants rule over elephants. If an elephant can dance, ants had better get out of the way.

There is still a lot of work left for IBM to cover as more and more developments come up with each passing day. Lou Gerstner's successor has his work cut out for him. For now, though, IBM is safe.