John Chambers, After the Deluge

How do you guide a legendary growth company through the worst slump in its history? That's the challenge that faces Cisco's CEO. In an in-depth interview, John Chambers explains how to slow down smart, why the Internet still matters, and what to do when your customers stop buying.

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John Chambers chooses his imagery with great care. So in a conference call with Wall Street analysts this spring, the CEO of Cisco Systems picked a phrase meant to convey both terror and hope. The Internet economy's all-out slump has been like "a 100-year flood," he declared. "It's something you don't expect to see in your lifetime. We never built models to anticipate something of this magnitude."

Think of such a flood, and immediately, snapshots of staggering destruction come to mind. But stay with those images a moment longer, and in your mind's eye, the waters start to recede. Rescue workers pump out the water and rebuild what was swept away. Homeowners and businesses return. Full recovery may take months or even years. Eventually, though, nature's sudden ravages are repaired, a little bit at a time. With plenty of hard work and patience, people reclaim what had briefly seemed lost forever.

That sort of gritty, stubborn recovery is what Chambers wants to set in motion for Cisco -- and perhaps for the entire technology sector -- over the next few quarters.

Just one year ago, everything seemed to be going Cisco's way. Chambers, 51, was both the market leader in the huge network-equipment business and the thought leader for the Internet economy. His vision of an Internet-centric world had captivated businesses, consumers, and governments, all of which figured that the new technology would help them work faster, more efficiently, and more enjoyably. In a supreme compliment from Wall Street, Cisco's stock-market value in March 2000 reached $555 billion, briefly making it the most valuable company on the face of the earth.

Then tough times arrived. Cisco's legendary sales growth began to stall last December in the face of a severe slump being suffered by many of its customers. That forced Chambers to announce layoffs of 8,500 workers, more than 17% of his workforce. And an enormous inventory pileup contributed to $3.4 billion in special charges this spring, making the company's worst-ever quarterly loss inevitable. Investors responded by slashing Cisco's stock price by more than 50% in the first three and a half months of this year, knocking it off of the list of the 10 U.S. companies with the highest market value.

For many fast-track executives, these sorts of setbacks could be paralyzing. But if Chambers was the visionary of the 1990s, he hopes to emerge as this decade's leading pragmatist. From earlier jobs at IBM and Wang Laboratories, he has learned how to manage smart in a slump -- and he knows what smart leaders should not do in response to a difficult business environment. In the long run, he says, the case for the Internet is stronger than ever. And in the short run, he wants to pull Cisco away from things that don't work so that he can redouble his bets on the most promising new opportunities.

In a recent conversation with Fast Company, Chambers spelled out his thoughts on how to redirect a company in tough times and on how to keep a growth culture alive. He also talked candidly about what happens when customers aren't as eager to buy as they once were -- and what to do about it.

The headlines are filled with nothing but bad news. In this kind of economy, what's still exciting? What makes you think, I can still get a lot of good things accomplished in the next six months?

Excellent question. All of us like periods of growth, but I learned a long time ago that you deal with the world the way it is, not the way you wish it was. This is where you develop character. It's exactly what my parents meant when they said that something was going to be a learning experience. That usually meant that something was not going to be fun, and that it was going to last longer than I wanted. Well, this is going to be a learning experience. It's not going to be fun. It's going to last longer than I want. But it is tremendously important in building great companies.

This is where you've got to help your whole team learn, especially the new managers who haven't been here before. Even some of the experienced ones forget what it's like. You have to listen very carefully, be as sure as possible that you've got the issues right, set the direction -- and get your whole team pulling toward that direction. Then it's all about leadership. You keep people very calm, very focused, and yet with a sense of urgency, because this is the chance really to gain market share.

You move from focusing on absolute revenue growth -- which has gotten a number of companies in trouble -- to focusing on profitability and earnings contribution, both short- and long-term. You say, I'm going to measure my team on how well they gain profitable market share, not on how big the numbers are. And you deal with reality the way it is in terms of what [customers'] capital spending will be and how to get a bigger piece of that. That makes a lot more sense than saying, Well, we aren't growing as fast as we were last year; isn't that terrible?

Based on your experience at Cisco, Wang, and IBM, what would you say are smart ways for leaders to manage in a slowdown? And what shouldn't you do?

First of all, you should prepare people well ahead of time for disruptions in business cycles. These can happen in all kinds of ways, including not just turbulence in the overall economy but also switches from one product generation to another, or radical changes in what the customer views as added value. We constantly look for an inflection point -- good or bad -- and ask ourselves, How do we adjust? We make that part of the culture. We learn to look at those situations not as problems but as opportunities to break away from everyone else. All of us prefer fast growth, but you actually gain more market share during the tough times.

What we're seeing now is challenging in the short term, but in the long term, it's likely to be just a speed bump. It's important not to lose track of that. You always have your sky-is-falling people who say, "See, I told you." Well, what they don't realize is that as Cisco continues to gain in productivity, all kinds of other companies -- the GEs, the Fords, and some others -- are learning how to do it as well. Companies that don't do this simply will not survive and grow. As I travel around the world, it's interesting to see that government leaders and business leaders have got it. Take the CEOs of the two largest banks in China. Believe me, they appreciate what technology can do every bit as well as their U.S. counterparts.

As you hit speed bumps, there will be a tendency by some to want to change everything, which is obviously a terribly naive approach and which can get a company into real trouble. But there will be others saying, "Let's pull back our aggressiveness." You can't do that either. By the time the majority of the market realizes that something is clearly a good opportunity, it's way too late. We're moving quickly and early in areas such as content management, e-learning, and voice over Internet. As you keep taking risks, you will still misfire periodically on certain opportunities. But as long as it's a good business prospect, you don't want to slow that down at all, regardless of the economic situation.

What do you say to people who have started wondering whether the Internet is still mission critical?

It's more critical now than ever. It's moving at an even faster pace, and it's not just the IT people or the few enlightened CEOs who get it. Having said that, it's a fact that when people come under pressure, they often go back to traditional ways of handling it. That can mean big cuts in capital spending, because it's much more painful to cut people than it is to cut the capital budget.

One of the key elements to watch right now is broadband buildout. It's slowing. And if you don't have wide bandwidth to the home and small business, then you're not going to see applications grow as rapidly. I hope that our current government will take a person-on-the-moon type of approach here and say, We want to have broadband to every American home that wants it by the end of this decade. The number-one issue that will drive technology growth over this next decade is how quickly broadband gets built. That's true whether you're a chip manufacturer or a personal-computer player or a mainframe player or an application player. It's across the whole spectrum.

All you can do in this scenario is to share with business leaders your view of why continuing to focus on the Internet is the right thing to do. We share best practices, including our own, and we try to walk our own talk. But in the end, of course, the customer gets 100% of the votes.

When you're in the midst of difficult times, how do you still identify growth opportunities -- and get hundreds or thousands of your people working on them?

You need a willingness to take risk. This is something we have to be very careful to preserve. We listen very closely to our customers, and if we detect signs that something they want isn't yet on the market, we respond. Ideally, we prefer to move into a new market with ecosystem partners. But we are often well ahead of the market -- or else we've made a mistake. In either event, partners may not want to take the same business risks. So we will often develop the first products for a given market, knowing full well that longer term, we'll want to delegate that to partners who do mass production much more effectively than we do, at lower margins.

Our voice-over-Internet phone is an excellent example. We're making the handset ourselves, which is unusual and temporary. From nothing a year ago, we're now selling nearly 2,000 a day. We did this initially to jump-start the market and to ensure reliability, which is very important to customers. But we also did it because our peers were not in a position to move as quickly as we wanted. So we'll do the first wireless connection to the home, to really get the market going.

Can you live with being unprofitable or break-even as long as you're entering a promising market?

No. This is one of the things we have to learn: You always focus on profitable contribution. When you enter new markets, by definition, the initial profit contribution won't be what you'll want to see later, but you've got to keep your culture focused on profit growth. This is what got the dotcoms in trouble. It will get successful companies, including Cisco, in trouble too if people make the mistake of focusing on market-share gain and not on understanding profitability.

That's the old Penn Central Railroad case that we were taught in business school. [Penn Central's misguided expansion plans helped push it into bankruptcy in 1970.] It's amazing how industries repeat themselves again and again. Anytime we move into a new industry, we had better have a plan for boosting it to our normal profit level, or else we shouldn't be there.

You've always made the point that Cisco doesn't just sell networking equipment -- it lives on the Internet. That's supposed to make Cisco extra quick and lean when it comes to everything from filing expense accounts to closing your financial books every night online. Sounds great. But how did you end up with excess inventories and an oversized payroll this past winter?

Well, first, in terms of the system, I'd evaluate its quality and performance as an A+. In hindsight, I wish I'd been a little bit more conservative in certain areas. In the first week of

December, the biggest issue facing my customers -- and the biggest issue in their levels of satisfaction -- was that I just could not deliver product to them fast enough. So in an effort to meet our customers' expectations, we continued to increase our inventory and our supply capacities, and to keep up with our rising demand.

Then we had five days in the second week of December where orders were 10% off normal. All of a sudden, we were going from 65% growth to flat or negative growth. No company in history that I'm aware of has ever faced that quick a turndown.

By December 15, we had already met as a senior management team. We said that for the next 45 to 60 days, we would cut back on all hiring and refocus on discretionary spending. From that point onward, we've been managing with an eye on the state of the economy.

In April, we announced a more than $2 billion charge against excess inventory -- a charge that reflects the recent significant and unexpected drop in customer demand. Yes, we took a conscious risk with our run rate being as aggressive as it was. Would I take that risk again? Absolutely. Cisco won't change. We will always take risks. When you see us not taking risks, that's when you ought to tell your readers to sell.

Let's look at a risk that paid off for Cisco. You managed to grow your business in Japan from almost nothing in the early 1990s to nearly $1 billion a year today. And you did it with no help from the underlying Japanese economy. What did you do right, and what kind of lessons can other people draw from that?

We realized that if we went in alone -- as American or European companies traditionally did -- we'd get the same result, which is a much lower market share in Japan than anywhere else. So we linked up with 14 Japanese partners, with the full support of the Japanese government. That was our first move anywhere toward operating in an ecosystem. We learned that you acquire small companies; you partner with large companies. And then we earned the right to share our thinking with business and government leaders. We told them what they had to do differently. Even in areas where we had some healthy disagreement, we turned out to be pretty accurate. People might not follow your recommendations the first time, but they will listen the second time.

Finally, we didn't withdraw from the market during the slowdowns. We actually increased our commitment and used it as a chance to pull away. The faster our competitors withdrew, the more aggressive we got.

As Cisco has grown, you've redefined people's jobs in a very unusual way. Instead of letting managers build up ever-larger empires, you've constantly split up their duties, in what Cisco calls "divide and grow." Why do you do that?

It's one of the hardest things to grasp, but the more successful a group is, the more you ought to split it up. In sales, that allows a more focused approach to the customer. It forces you to cover each of the bases in order to achieve your overall goals. If you have multiple accounts, you can let opportunities slip away and still have what looks like a good year. But then you're leaving room to make your competitors strong. The same thing is true with R&D or other groups.

Now, this sort of approach only works if you can empower the people who work for you. If your style is top-down and centralized, you'll get very consistent performance, but you'll also limit growth. If you're talking about keeping up with growth across as many areas as we are, you really have no choice but to empower. That's not only part of our culture. We also have the applications, the network, and the data design to let that occur.

And yet we have a healthy paranoia that makes [Intel chairman] Andy Grove look relaxed. Any company that thinks it's utterly unbeatable is already beaten. So when I begin to think we're getting a little bit too confident, you'll see me emphasizing the paranoia side. And then when I feel that there's a little bit too much fear and apprehension, I'll just jump back to the other side. My job is to keep those scales perfectly balanced.

How does Cisco's share price fit into this? For a long time, your stock was on such an amazing run that if you sneezed, 200 CEOs would come to San Jose to learn to sneeze like John Chambers. Now everyone's stock has taken a pounding -- including Cisco's. How much does that change the cachet of the whole company?

Well, there's a huge difference between the short-term stock performance and the overall strategy. And it's important to understand that. Our story of how we've evolved Cisco and how we continue to evolve it has never been stronger. In fact, I would say that if we do this right, you'll be writing an article 6 months from now, or 12 months from now -- whenever the economy turns around -- about how Cisco handled this in classic Cisco style and broke away again. It wouldn't be the first time we've done this. We did it in 1991, we did it in 1994, we did it in 1997, and we hope to do it in 2000-2001.

What builds good teams is found in how you handle stress. It's painful, but it's very good in terms of developing the character of an individual or a company. We want to show that we increased our investment in e-applications during this time period and used it as a chance to break away even faster.

Within Cisco, that makes a lot of sense. But surely some customers' appetite for working with Cisco goes up and down with your stock price, no?

Some CEOs will very definitely follow our main messages about the Internet. GE is an example. Others will say, "John, you don't understand. I've been CEO for two to three years already. The average life expectancy of a CEO is less than five years. If I don't make my profit target the next year, I've got a bigger issue." So I have to learn how to balance both of those perspectives.

We can't change how people behave. And we ought to listen to constructive criticism, because there are areas that we need to improve in. That said, we focus on customers who really believe that this is the future and who are willing to invest the time with us. We have 75 engagements with GE right now, for example. Others will say, "You know, I'm going to put this on the back burner." All you can do at that time is educate them and get them to realize that they are making a very conscious decision not to pay attention to the Internet.

When customers decide, for whatever reason, to change their spending behavior, we don't pack up our bags and go home. We stay closely related. They may come back to us later, either when the economy improves or when their perspective on the future changes. Over time, that's absolutely the right way to run your business.

How do you protect the Cisco brand in a downturn this severe? You've got an inventory overhang, fierce competition at the high end from Juniper, and a lot of speculation that there will be a price war whether you want one or not. What can you do to prevent brand erosion -- and market erosion?

What we're seeing in our industry is a rapid consolidation, where I believe the strong will get stronger and the weak may get eliminated. This is especially evident among companies such as alternate service providers, where I think brand will be more important than ever. I believe that during times of consolidation, Cisco is one of the best brands. Our market cap is greater than that of our eight largest competitors combined. We have $17 billion in cash, and we have balance among our product families, geographies, and lines of business, which will help us emerge stronger in the future. Brand is critical, and in the long run, it will be key to survival.

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Sidebar: What to Do When the Customer Isn't Buying

John Chambers has always listened to customers, even when the message hasn't been what he hoped to hear. Here are three reasons why CEOs are having second thoughts about the Internet -- and the responses that Chambers hopes will carry the day.

I'm a big believer in the Internet, but the people who work for me say our initiatives aren't paying off. They're cynical about the Web -- and I can't afford to get too far ahead of my organization.

"First, the CEO has to really determine whether he or she believes in survival. If the answer is yes, you've got to move. Second, by the time the majority of your staff gets it, it's too late. That's true here at Cisco. I wish I could tell you that when we move, I've got 99% compliance among my group, but the fact is, if I get up to 75% to 80%, that's as good as it gets."

I've got to listen to my shareholders, and right now, Wall Street hates anything Web related.

"I disagree. Wall Street gets it right in the long term. During periods of uncertainty, there is a tremendous focus on this quarter's earnings. So if you're investing in something with a payback in 6 to 18 months out, you've got to keep expectations in mind. Having said that, I think companies have an opportunity to reinvent themselves in a way they haven't done before. The dotcoms will be back. They'll be better funded and will have a better path to profitability. What we've got now is a reprieve for many companies in which they can use the Internet to gain even more competitive advantage. If they make the mistake of putting it on the back burner for 6 to 18 months, they will face both traditional and new competitors in a way that I think will shock people."

When I look at my customers, only 3% to 4% really use the Web site -- and 96% don't. I've got to spend more time on my pre-Web world.

"It's important to realize where different industries are in terms of acceptance of technology. You can't control all of that, but you can control how your employees function. So the place to start with an Internet initiative is internal. It's also important to make sure that the first few applications are quick paybacks that have high odds of success. Otherwise, you're fighting against naysayers.

"After that, you want to get your timing right in terms of your customers and suppliers. You can have influence over how quickly your suppliers come in line. We told suppliers nearly four years ago that if they didn't convert over to the Internet, they would not be a supplier to Cisco long-term. It was a very firm nudge, but it gave them a sufficient time frame to make the switch."