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Preface

Although it took some time for me to realize it, the origins of this book go back some twenty years. The text draws mainly from my diverse experiences as a financial economist, a university professor, a consultant on public policy, antitrust issues, and mergers and acquisitions, a financial valuation consultant, and a director and member of the audit committee of a public corporation.

The book was born of an unusual request: Could a client claim tax write-offs of a substantial premium it had paid to acquire the deposits of a failed bank? No precedent, in banking or elsewhere, existed. Thus began a long journey of investigation into the intangible sources of value in corporate enterprises. In time, it became clear that:

- Most market transactions involve buyers and sellers who maintain continuing relationships, often over long periods of time.
- The primary objective of competition in the marketplace is not simply to generate transitory transactions but to establish long-term market relationships.
- Once established, market relationships typically have substantial value, representing the future recovery of the investment in their development.
- Tax considerations aside, the very existence of relationship values requires their analysis in mergers and acquisitions.
- Essentially the same relationship principles apply within an enterprise as apply to its external relationships with customers and suppliers.
- A business enterprise seeking maximum shareholder value re-

quires management that fully understands the sources of that value, including relationship values.

Many of these points first emerged in the context of banking, in major part because of the large number of acquisitions in banking in the 1970s and 1980s. Clearly, however, these types of relationship values permeate virtually all economic activity.

The material in this book evolved through a series of articles that appeared primarily in banking journals. Next came the publication of my *Foundations of Relationship Banking: Structuring Decisions to Build Enterprise Value,* in 1994. I am indebted to Lafferty Publications Ltd., Dublin, Ireland, for recognizing the potential importance of the concept of relationship capital. It has also graciously granted permission to adapt some of the material in *Foundations* to the present work, for which I am further grateful. *Foundations,* of course, contains a good deal of material specific to financial services that is of little interest otherwise.

Publication of a book such as this one represents no more than a rest stop—it can never really be complete. New ideas persist in bubbling to the surface and perspectives keep changing as new facts emerge. I confess to a certain degree of happenstance in what relevant materials have or have not come to my attention. For whatever I have overlooked that is important and relevant, I can only apologize. To pursue each line of inquiry to a point that would satisfy the academic community would be never to complete the book. I also apologize to the extent that the book's many factual generalizations have not sufficiently recognized that virtually all have important exceptions.

In addition to thanking my wife, friends, and colleagues who have lent support to this project, I must particularly thank my literary agent, Ruth Wreschner. Her exceptional perseverance saw this book through, as she put it, an unusually difficult pregnancy. I am also grateful to my publisher, John Boyd, and his organization for recognizing the potential significance of the book and for bringing it to fruition. I also owe an expression of thanks to individuals who made a point of bringing relevant material to my attention at various times. In addition to the above, they include Dorsey Baskin of Arthur Andersen & Co., John Bailey of Wellington Management, Gerry Ballinger of MMM Direct, and Frank Wickersham of Falcon Group Worldwide and The Senior Professional Foundation. In addition, my involvement with The Professional Group, Inc., at George Mason University was helpful in focusing on internal corporate relationships. I also am indebted to

some financial institutions, which must remain anonymous, for sharing their views of outside management consultants. Finally, I must acknowledge my debt to my late colleague, Joe White, who worked with me in the early days of developing procedures for valuing relationship assets.

Contents

Introduction: Trapped Inside the Box

> The ideas which are here expressed so laboriously are extremely simple and should be obvious. The difficulty lies, not in new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.
>
> John Maynard Keynes, *The General Theory of Employment, Interest and Money* (1935)

THE PURSUIT OF PROSPERITY

Consider *prosperity* to be the sense of well-being that society extracts from economic activity. In contrast to instant gratification, it has a future dimension that extends at least through present lifetimes and probably to future generations. A relentless pursuit of prosperity is necessary simply to maintain it. Most societies seek to add to it. Nations seek to increase prosperity, primarily their own, but occasionally that of less advantaged nations as well. Organizations, and particularly business enterprises, pursue prosperity on behalf of their constituents or owners. Households and individuals devote most of their time and effort to that pursuit. Of course, its full achievement is elusive, as aspirations and expectations always exceed its current levels.

How to increase prosperity appeared rather simple a few generations ago, as it seemed to depend on the accumulation of more physical tools of production—transportation systems, factories and other structures for producing and distributing goods and services, machinery, equipment, and housing. In time, however, it became clear that even in the Industrial Age, prosperity requires much more than accumulating physical plant and equipment. Understanding that point has become ever more critical as more manufacturing moves abroad and nonmanufacturing activities assume dominance in the most advanced economies. Yet Industrial Age concepts continue to guide economic policies and business strategies and decisions.

With a broader view of its sources, the pursuit of prosperity still means accumulating more wealth, ultimately in the form of capacity to produce goods and services. The measure of that success is the *value* that society assigns to the productive resources providing that capacity. Achieving prosperity thus means building value, and particularly the value embedded in business enterprises. For a corporation, its value to shareholders represents its capacity to create prosperity.

With the ascendance of nonphysical forms of productive resources, today's economy requires new approaches to pursuing prosperity. However much that pursuit may be a national or international objective, it depends mostly on how private enterprise defines its goals, the strategies it adopts to pursue them, and the criteria guiding business decisions. As becomes clear in exploring this subject, the business principles, conventions, and practices that currently guide most corporate enterprises are flawed. They unconsciously and unnecessarily impede the growth of prosperity by systematically squandering productive resources.

What follows is thus intended for, and indeed dedicated to, all members of society who seek a more prosperous future. In the corporate context, it is for all those members of the business and financial communities who seek ways to do a better job for shareholders.

An Emerging Global Village

The marketplace is shrinking in the sense that time and space impose ever fewer limits on production and distribution. Globalization is but a manifestation of a much more profound trend. Primarily, it is the ascendancy of a relationship economy—an economy representing a symbiosis of services and new information and communications technologies. Today's business environment is in a growing number of respects analogous to a village economy, although on a vastly larger scale.

One would expect economic upheaval such as is now occurring to provide a rich array of new opportunities; it does. It also injects substantial new complexities into the business environment. Communication, and the relationships facilitating it, become horizontal as well as vertical, both internally and between the enterprise and the outside world. The new economic village is not necessarily a cozy place.

Many corporate enterprises have had difficulty coping with the change, mainly due to their inability to comprehend it. Instead of seizing new opportunities, many have become defensive and dysfunctional, with a loss of meaningful strategic direction. A process of disengagement among and across organizational levels has become widespread. Employees no longer pretend to unreciprocated loyalty, nor can they have confidence in or respect for employers displaying no leadership. The consequences include an enormous waste of productive resources—real capital—within the corporate community and by society at large.

Such problems do not arise simply because of unawareness of the importance of economic relationships to a business. Ideas about strengthening customer and employee loyalty, for example, are hardly new. The problems lie, rather, in failing to recognize that traditional criteria for business decisions are inconsistent with the significance of those relationships. The prospects for addressing these shortcomings are not good for the near future. The tools actually are at hand, as the following chapters will demonstrate. What is likely to remain missing is sufficient commitment to address them—a commitment that requires breaking away from a comfortably familiar conceptual *status quo*.

In many respects, the new economic environment poses more challenges for larger enterprises, particularly for those producing and distributing retail goods and services. Correspondingly, the difficulties are probably less apparent for many smaller businesses, particularly for smaller manufacturers in the supply chain. The chief executives of small companies may themselves be the focal point of the entire enterprise communications network, internally and externally. In those cases, perhaps intuition and common sense are adequate substitutes for the more rigorous decision requirements that larger enterprises require.

The Best of Times, the Worst of Times

No matter how seemingly progressive, most corporations remain unconsciously hostage to obsolete business principles and practices. This condition perhaps matters little for the entrepreneurial members of the corporate community, at least for the present, but it can have devastating effects on more mature enterprises. A revolution in the economic order has displaced the environment from which those traditional principles and practices emerged. If they once seemed to work tolerably well, they no longer do so. Today they substantially and systematically subvert the most fundamental and essential corporate objective—the value of a corporate enterprise to its shareholders. They do so by applying short-term criteria to decisions having long-term consequences.

Ways of reversing this pattern to develop corporate enterprise values more fully are not inherently difficult to identify and adopt. With modest adjustments, they become well established and even familiar. Nevertheless, a decision framework to develop shareholder value directly first requires recognizing that many enterprises are performing well below their potential. Most companies are captives of conventions and assumptions that lacked adequate foundation from the outset. Whatever legitimacy those business conventions may once have had is vanishing. Too many corporate directors and chief executives seem to have difficulty comprehending and adjusting to what is, indeed, an economic revolution.

Why do so many leading corporations seem to disappear? According to one account, only about a third of the 500 largest U.S. corporations in 1970 remain in business today.[1] Why are corporate restructurings necessitated by disappointments with previous restructurings? Why do companies persist in engaging management consultants who, in promoting the latest fads in management theory, provide only quick fixes that quickly fail? Among the answers:

- Conventional business principles and practices have shallow roots on muddy hillsides. To endure, they need a solid foundation in fundamental social scientific principles—a true, comprehensive theory of enterprise management.
- Too many of the "solutions" for addressing the new business climate are conceptually shallow, retrogressive, narrowly focused, and out of touch with modern realities. An analogy is looking through the wrong end of a telescope.
- Insufficient accountability to shareholders allows some chief executives to sacrifice shareholders' long-term objectives in favor of their personal, shorter-term goals.

[1]John Mickelthwait and Adrian Wooldridge, *The Witch Doctors: Making Sense of the Management Gurus* (New York: Times Business, 1996), p. 7. Further references to this work appear in later chapters.

- A widespread absence of corporate strategic direction results both from an inability to comprehend the new economic environment and from too little focus on long-term objectives.
- Corporate directors and executives are in any event often slow to recognize needs for remedial action, tending to avoid it until too late for it to be effective.

A continual process of rolling out newer and sexier management fads impedes rather than facilitates the alignment of business principles with the changing marketplace. Corporate enterprises instead need a unified framework for pulling together the legitimate elements of disparate theories into something sensible and useful.

Corporate leaders today are off balance because they face an economy very different from that of a generation or two ago. One consequence is fertile ground for charlatanism. Exactly what has changed nevertheless often eludes description. Economic change is at least as much qualitative as quantitative. A historical comparison is the nineteenth-century transformation from an agricultural to an industrial economy. Now, as then, altogether new economic patterns have displaced once familiar ones. *The new economic order is a relationship economy dominated by services in combination with new information and communications technologies.*

Why is it so clear that the present economic transformation is widely misperceived and poorly understood? Consider evidence of failures to adapt:

- Most corporate executives continue to rely on inadequate and increasingly archaic and misleading measures of business condition and performance in formulating business strategies.
- Many corporate restructurings and mergers reportedly fail because of disregard for important *internal* elements of enterprise value, including experience, creativity, and corporate culture.
- Many also may fail because of disregard for important *external* components of enterprise value, particularly customer relationships.
- Many, and perhaps most, corporate mergers and acquisitions seem to yield disappointing results as measured, for example, by subsequent share prices.
- Management consultants are earning enormous fees to undo or