WILEY CORPORATE F&A

THE CEO, STRATEGY, AND SHAREHOLDER VALUE

Making the Choices That Maximize Company Performance

The CEO, Strategy, and Shareholder Value

Making the Choices That Maximize Company Performance

PETER KONTES

WILEY
John Wiley & Sons, Inc.

Preface

THE DECISION TO WRITE this book was stimulated by a conversation with the CEO of one of the world's most admired companies in which he expressed his concern that "we are not very good at strategic planning." This statement struck me as remarkable because his company is the largest and, by nearly any measure, the most successful in its industry. The company has a history of formulating and executing very profitable strategies, with a record of tremendous innovation and bold competitive initiatives, and the company's shareholders have enjoyed spectacular increases in the value of their investment. Thus, even if it were true in a formal sense that the company was "not very good at strategic planning," that did not seem to have been much of a handicap.

The CEO understood this. What he was saying, I think, was that after delivering exceptional results for several decades, the company's embedded beliefs and practices were beginning to show signs of diminishing effectiveness. It was time to begin challenging some of the old precepts, to consider new ways of doing business, and to bring fresh thinking into the organization—all without destroying what was still good and effective from the old paradigm. This would be a tremendous task for any company, and his sense of urgency was no doubt justified. But this was not a task that could be addressed through the strategic planning process, which is at best a useful analytical exercise. The real task was to determine whether and how the company needed to change its approach to *strategic management*—to reexamine how the biggest choices affecting the company's future performance would need to be made.

This book presents a strategic management framework that has been developed through my consulting experience and my teaching at the Yale School of Management. It contains concepts and ideas that are new and some that are well known. My goal is to show how these ideas fit together into a pragmatic framework that can help CEOs lead their companies to significantly higher levels of performance.

A few words on the scope and timing of the book follow.

SCOPE

As with any book on management, there is a balance to be struck between the breadth and depth with which subjects are treated. The framework I wanted to present here is necessarily broad, focusing much more on the "what" than on the "how" of strategic management. It is about the responsibilities of the CEO and business unit leaders, defining the most important choices they are responsible for making, elaborating on those choices, and laying out general recommendations for addressing them. Some specifics pertaining to measurement and analytical techniques are included in the endnotes and appendices, but I have deliberately kept these to a minimum to avoid digressing into long and, for most readers, mind-numbing explications of various finance, accounting, and strategic methodologies.

The book is written from the perspective of a large, public, multibusiness company, with almost all examples and cases drawn from U.S. and European companies many readers will recognize. This perspective simply reflects my own experience in management consulting, as nearly all of my clients have been companies fitting this profile. However, I believe the principles and practices put forward here are equally valid for smaller companies and private companies, though their implementation might have to be modified to suit a more entrepreneurial environment.

TIMING

The book was written during 2009 and 2010, tumultuous times for the U.S. and world economies. Many companies have, of necessity, been focusing on their immediate survival and shorter-term liquidity issues. Reducing head counts, rationalizing product portfolios, consolidating production facilities, selling assets, deferring investments, and finding financing have been top priorities. Also during this time, at least in the United States, there has been massive government intervention in many of our most important industries including housing, banking, insurance, health care, automobiles, and energy, resulting in what may be permanent but as yet not fully predictable changes to the economics of these and related sectors.

So this was perhaps not the best time to be writing about long-term strategic management.

One very practical problem in writing a book during this time has been the rapidly changing situation at many companies I had intended to use as case examples. Some, like the Saturn division of General Motors, and as a practical matter General Motors itself, either ceased to exist or were so completely changed as to no longer serve my original purpose. Others, like the NBC/Universal unit of General Electric, became involved in ownership changes. There were many of these moving targets to contend with, and some no doubt will have changed yet again by the time the book is published and read. I have tried to select cases that will still resonate with readers in the coming years, but recognize that some may fade from relevancy sooner than I hoped.

In early 2010, the question remains as to whether CEOs are ready to turn their energies back to the longer-term strategic choices about which this book has been written, and on that score I am optimistic. As bad as the Great Recession has been, there are already signs that businesses are beginning to stabilize and start growing again. So long as the smothering and wasteful influences of state control can be minimized, the world's economies will resume their upward path of increasing wealth for all people. With that happy future in mind, I hope this book can play a role in improving the strategic management practices at many companies.

Acknowledgments

OVER A CAREER OF advising several dozen chief executives, I find each has added to my own knowledge of the special demands of that role and the ways in which CEOs can, for better or worse, affect the performance of their companies. Two giants who deserve special mention are Roberto Goizueta (The Coca-Cola Company, 1981–1997) and Sir Brian Pitman (Lloyds TSB, 1983–1997), each of whom led his company to perform at levels seldom matched among large public corporations. Roberto was an early adopter of some of the basic tenets described in this book, and he showed as much as any CEO how powerful these ideas can be in revitalizing an organization, raising it from modest to exemplary performance. Brian Pitman was also an early adopter in the UK and Europe, showing the way for many other companies through the spectacular rise of Lloyds TSB from a second-tier UK bank to one of the most valuable financial institutions in the world. Sadly, neither of these great leaders is still with us, but perhaps a small part of their legacies can be found in these pages.

Among the many colleagues who have influenced my thinking over the years, the late Dr. William Alberts stands apart for the enormous intellectual contributions he made to his two beloved institutions, the University of Washington and Marakon Associates. Bill, more than anyone, started me on the journey that led to writing this book. I also wish to acknowledge Deans Sharon Oster and Stan Garstka of the Yale School of Management for allowing me the time off to write, and professors Rick Antle, Jake Thomas, and Nick Barberis, who graciously responded to some of my decidedly unscholarly questions.

Special thanks are due to my three "readers," Andy Bryant, David Coulter, and Peter Mulford, who did me the great favor of providing their reactions and suggestions to the late stage drafts. They were encouraging, as I hoped they would be, and challenging, as I knew they would be. My gratitude goes also to

David Pugh of John Wiley & Sons, who was most helpful in improving the clarity and flow of ideas throughout the book.

Other friends and colleagues who made important contributions and deserve recognition are Alan Hamilton, Michael Mankins, James Mossman, and Greg Rotz.

I was fortunate to be joined in this effort by three associates without whom it would have been impossible to complete the job. Sarah Gross and Noel Bottjer were my resourceful researchers, overcoming fickle databases and a sometimes fickle author to carry out the necessary searches and analyses. My longtime assistant Mary Jo Amato made sure I had the uninterrupted time I needed to write, produced many of the graphics, and generally would not let me off the hook until the book was done. To all three, my deepest thanks.

Finally, the responsibility for any errors or omissions rests with the author.

Introduction

MANAGEMENT HAS A DUTY to produce goods and services with real and growing value for both customers *and* shareholders. Companies that provide customer value without earning adequate returns for shareholders do not last long. Or, like General Motors, they simply bump along in corporate intensive care awaiting an ignominious takeover by a competitor or a government. Even shorter life expectancies await companies that try to fool investors into thinking they are providing customer value when they really are not, becoming the failures we know as Enron or the hundreds of now defunct "dot-coms" from the late 1990s.

All great companies focus intently on their customers' needs and work constantly to add more customer value to their offer, as well as more customers who value their offer. Customer feedback, in the form of changing market share, changing prices, or requirements for new or different product attributes, is constant, challenging all competitors to adjust their strategies in ways that, at a minimum, can sustain good revenue growth year in and year out.

But there are myriad ways that companies can drive revenue growth, and not all are equal: Some create a great deal of shareholder value, some result in adequate but not exceptional increases in shareholder value, and some, unfortunately, actually destroy shareholder value. If increasing customer satisfaction and revenue growth were the sole objectives of business, formulating at least adequate strategies would be relatively easy. It is the duty to increase value for both customers and shareholders that makes formulating great strategies interesting, and hard.

Much has been written about accounting and financial market metrics that management should employ when evaluating investments and strategic options. Most of this literature is technical, tedious, and extremely difficult to relate to high-level strategic decision making. This book is about management, not measurement, but a solid economic underpinning is essential to successful strategic thinking and action. When it comes to financial metrics, choices are

EXHIBIT I.1 Economic Profit Illustrated

The General Electric Company (2007)	
Earnings	$22.5 billion
Equity	$112.3 billion
Cost of equity	× 10%
Capital charge	–$11.2 billion
ECONOMIC PROFIT	$11.3 billion

Source: Datastream.

not without controversy, including the three that will be mentioned most frequently: economic profit, equity value, and total shareholder returns.

The concept of economic profit is so central to the framework proposed here that it deserves special mention at the outset. Most executives have had some experience with economic profit, which is simply a measure of earnings minus a charge for the equity capital employed to generate that income. A simple calculation of economic profit is illustrated in Exhibit I.1.

The significance of economic profit, its measurement, applications, and its advantages will be developed more fully in Chapter 2. Here, it is not being argued that economic profit is a new idea, or that it is the holy grail of business management, or that it is the best measure of economic benefit in every circumstance, or that its measurement and application cannot be manipulated by executives who are intent on doing so.

The principle argument is that economic profit, both as a single- and a multiperiod measure, offers executives substantial pragmatic advantages for the purposes of generating insights, formulating options, and making strategic decisions. In particular, three recurring themes of this book—the role of the CEO, the choices that shape strategy, and the creation of shareholder value—can each be described in economic profit terms, allowing them to be integrated into the overall strategic management framework, which is described in Chapter 1.

For readers skeptical of the validity or usefulness of economic profit and the other financial measures to which it will be related, try not to put the book down quite yet. As the broader framework unfolds, perhaps their conceptual and practical utility will prove greater than you might imagine, and greater too than any of the alternatives.

Contents

Preface xi

Acknowledgments xv

Introduction xvii

Chapter 1: Foundations 1

The Purpose of Strategy 2
The Role of the CEO 4
Five Choices That Shape Strategy 6
A Strategic Management Framework 9

Chapter 2: The Economics of Strategic Management 11

Economic Profit 11
Economic Profit and Strategy Valuation 13
The Financial Drivers of Economic Profit and Equity Value 15
The Strategic Drivers of Economic Profit and Equity Value 17
Dealing with Mythology 23
Chapter Summary 29

Chapter 3: Choosing the Right Performance Objectives 31

Aspirations 32
Business Unit Objectives 34
Company Objectives 39
The Tyranny of Top-Down Targets 39
Chapter Summary 46

Chapter 4: Making the Right Participation Choices 49

General Considerations 50
Assessing Participation Opportunities 51

Offering Choices 63
Geographic Market Choices 67
Customer Segment Choices 72
Corporate Participation Choices 75
Chapter Summary 82

Chapter 5: Making the Right Positioning Choices 85

Positioning Choices and Competitive Advantage 86
Business Models 88
Execution Capabilities 107
Corporate Positioning Choices 111
Chapter Summary 122

Chapter 6: Making the Right Organizational Choices 125

The Institutional Imperative 126
Governance Practices 128
Executive Processes 134
Executive Capabilities 151
Chapter Summary 155

Chapter 7: Making the Right Risk Management Choices 157

Clarifying "Risk" 158
Setting Risk Thresholds 160
Portfolio Choices 162
Balance Sheet Choices 166
Ethical Choices 174
Chapter Summary 181

Chapter 8: Making It Work 183

Conditions Conducive to Success 183
Priorities for Change 189
The Prize 195
Chapter Summary 198

Appendix I: Economic Profit Growth, Earnings Growth, and Total Shareholder Returns 201

The Data 201
The Analysis 202
Discussion of the Results 204

Appendix II: Economic Profit and Equity Value **207**

Valuation Models 207
Maximizing Economic Profit Growth versus Maximizing Equity Value 209
Valuation Issues 210

Appendix III: Economic Profit and Equity Value: Illustration **213**

Appendix IV: Reconsidering the Corporate Center **215**

The Need for Change 215
Creating a New Model of the Center 217
Conclusion 221

Appendix V: CEO Pay Practices: An Alternative **223**

Typical Package 224
An Alternative Approach 224
Illustrative Compensation Plan 226
Alerting The Board Early and Often 229

Notes **231**

Index **239**

CHAPTER ONE

Foundations

THIS BOOK IS ABOUT strategic management, the process by which the chief executive shapes a company's strategies and drives its financial performance over time. Strategic management is not strategic planning, or strategy formulation, or setting the strategic direction of the company, though these activities may be part of it. It is a broader concept, encompassing all of the CEO's major decisions and their ultimate impact on the quality of a company's strategies and the height of its economic success.

Strategic management comprises five high-level choices every CEO must make:

1. *Performance objective choices*—deciding what the company will define as success
2. *Participation choices*—deciding where the company will compete to achieve its performance objectives
3. *Positioning choices*—deciding how the company will compete to achieve its performance objectives
4. *Organizational choices*—deciding how to build an institution that can sustain high performance over time
5. *Risk management choices*—deciding how the company will protect its performance from catastrophic setbacks

Companies vary enormously in how, and how well, they make these choices. Many factors can influence these choices, including a company's history, industry practices, its understanding of customers, its competitive situation, its embedded resource allocation processes, the quality of information available to its executives, and the effects of its reward systems. These and others factors combine in unique ways that predispose one company to make certain strategic management choices one way, while other companies facing similar choices tend to make them in entirely different ways.

The fundamental question for the CEO, and for all executives, is: How do we make the right choices?

The ability to make the "right" strategic management choices is based on two governing principles, one relating to the purpose of strategy itself and the second relating to the role of the CEO. These governing principles and their impact on how companies should address each of the five choices are the foundations of superior strategic management.

THE PURPOSE OF STRATEGY

As a first principle, the purpose of business strategy is to maximize the growth of economic profit over time. It is not to do anything else. If a new strategy will increase economic profit over time, it is better than the old strategy. If a new strategy would reduce economic profit over time, it is inferior to the old strategy regardless of other benefits it might bring. Specifically, it is not the purpose of strategy to achieve competitive advantage as measured by indicators such as having the largest market share, having the most satisfied customers, or being the low-cost producer. For some businesses, achieving these goals will increase economic profit growth, but in other cases, achieving some or all of these goals will reduce economic profit growth. As the following chapters will show, pursuing these and other commonly accepted strategic objectives is simply not a reliable path to improving, let alone maximizing, the economic performance of a business.

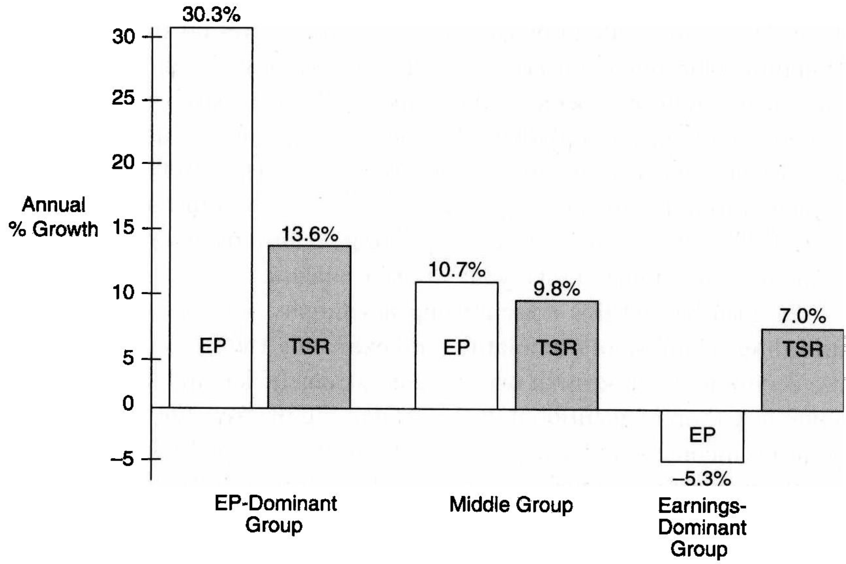
There will be a chorus of objections to this principle. One curious objection is that the principle is "obvious," as though that somehow diminishes its validity. As obvious as it may be, few companies or CEOs have actually embedded this principle at the core of their strategic management processes, nor is it even mentioned in most of the strategy literature. Another objection is that strategy is about much more than mere financial results and cannot be reduced to a simple financial metric. Well, certainly formulating and executing great strategies requires capabilities far beyond measuring financial outcomes, but the greatness of a strategy is not determined by the skill or cleverness with which it is constructed but by the concrete economic results that it produces. Yet another objection to the principle is that maximizing shareholder value, not economic profit growth per se, is the purpose of business strategy. This is a fair objection, but not a particularly useful one in the conduct of everyday strategic management. As will be shown, maximizing economic profit growth is an excellent proxy for maximizing value under most circumstances, not only theoretically but in the observed results of top performing companies, and it is much easier to employ in everyday decision making.

The idea behind this principle appears simple, but appearances can be misleading. The task of formulating and executing the strategies that maximize economic profit growth over time is extremely demanding, much more demanding than conventional goals like gaining market share or increasing operating income, earnings, or even return on investment (perhaps this is why the principle is admired more in the breach than in the observance). A first step toward understanding, and then accepting and utilizing the principle is to examine the explicit linkages between strategic decisions and financial outcomes. A framework describing these key linkages is the subject of Chapter 2.

Principles are fine, but is there good evidence that maximizing economic profit growth over time has real consequences? Do companies that achieve higher economic profit growth also achieve higher valuations and returns for their shareholders over time? The answer, with appropriate qualifications, is yes, they do. Exhibit 1.1 shows the results of an analysis of S&P 500 companies comparing their 10-year economic profit growth and total shareholder return performance.

The results here show the EP-dominant group (companies that grew economic profits per share faster than they grew earnings per share) generated far higher total shareholder returns than the earnings-dominant group (companies that grew earnings per share faster than they grew economic profit per share). The nearly 7 percent annual compound difference in total shareholder returns between these two groups is enormous, and the nearly four percentage point difference between the EP-dominant and middle groups is also significant. These results, which are explained more fully in Appendix I, offer compelling evidence of a strong link between companies' longer-term economic profit growth and their total shareholder returns, reinforcing the proposition that maximizing economic profit growth is both the purpose and the result of good strategic management.

EXHIBIT 1.1 Economic Profit (EP) Growth and Total Shareholder Returns (TSR)



Notes:
EP-Dominant: Companies where 10-year annualized EP growth rate exceeds earnings growth rate by five percentage points or more.
Middle: Companies where 10-year annualized EP and earnings growth rates are within five percentage points of each other.
Earnings-Dominant: Companies where 10-year annualized earnings growth rate exceeds EP growth rate by 5 percentage points or more.
Analysis covers S&P 500 companies during the time period of 1998 to 2007. A more complete discussion of methodology and results is in Appendix I.

THE ROLE OF THE CEO

The primary job of the CEO is to determine the proper level and disposition of a company's resources. Whether adding a new product line, making an acquisition, entering a new market, increasing research and development, promoting a key executive, or divesting a business, the CEO is constantly reshaping the configuration of the company's human and capital resources. For major resource commitments, the CEO may make the decisions directly, or with other executives, with support or authority from the board. For the many other decisions made by management at all levels, the CEO's influence on the level and disposition of resources will be indirect, though powerful, through the people, performance standards, and approval processes he or she has put into place.

The majority of a company's resources are committed through strategic decisions about how, and how fast, to grow (or shrink) lines of business or business units. Some investments may be evaluated on a stand-alone project basis, but a company's chosen business strategies will ultimately determine the nature and magnitude of its total resource commitments. These strategies will also determine the rate of economic profit growth the company is able to sustain over time.

Therefore, the second principle of strategic management can be stated more precisely:

> The paramount role of the CEO is to ensure that all resources of the company are committed to strategies that maximize the growth of economic profits over time.

The role defined here is "paramount" because although there certainly are other tasks a CEO must perform, none is more important to the long-term strategic and financial health of the company. Enforcing the company's values, meeting with employees and key customers and suppliers, maintaining good community relations, or responding to a sudden crisis might all be legitimate demands on a CEO's time, but consistently directing resources to achieve superior economic profit growth is the *sine qua non* of the CEO's leadership role. The benefits from doing other tasks well would pale in comparison to the costs to all of the company's stakeholders if the CEO performs this supreme task poorly.

Looking at the definition in more detail, "all resources" means all of the human, technological, and financial resources the company can bring to bear on the strategies that will increase economic profit. The company's inventory of resources is not assumed to be fixed; if more resources can be invested to meet the objective, they should be added; if fewer resources are needed, they should be reduced. In addition, and of critical importance, is the implied corollary to this principle, which is that the CEO has a responsibility to ensure that *none* of the company's resources are committed to strategies that diminish economic profit growth.

The term "strategies" refers to both business unit and corporate center strategies. The CEO of a multibusiness company obviously cannot formulate individual business unit strategies personally; that is the job of the business unit leaders. But at the end of the day, the CEO must approve each of the business unit strategies, together with the commitment of resources needed to support those strategies. This approval should be subject to a number of tests designed