CRACKING THE Value Code

Based on a three-year, 10,000 - company study

CRACKING THE Value Code

How successful businesses are creating wealth in the New Economy

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CRACKING THE
Value Code

For Fiona, Honor, and Fraser
with my love.
—RB

To my sons, who taught me how to CARE,
and to my wife, who taught me how to love.
—BL

For my parents,
who cracked the code
of instilling values.
Thank you.
—SS

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INTRODUCTION
What is Value?

"The real voyage
of discovery
consists . . .
in seeing with
new eyes."

—Marcel Proust[1]

Q How much does the New Economy weigh?

Answer: A lot less than you might think. U.S. Federal Reserve Chairman Alan Greenspan posed that question in a speech in Dallas, Texas. His conclusion: The country's economy is proportionally lighter, in a literal sense, than at any time in this half-century.[2]

By conventional measures, he noted, the U.S. gross domestic product is five times what it was 50 years ago, but its physical weight has grown only slightly. That is because the smokestack industries of the past produced tangible goods. Today, a significant part of the country's economic output is intangible, and that part is growing at exponential rates.

A newspaper available on-line in digital form, for example, weighs nothing compared with the physical product, and it can be transported via the Internet at a cost of next to nothing. A software program weighs no more than a few ounces. Music is no longer weighted down by packaging at all, as listeners download it from the Internet into their computers or MP-3 players.

Greenspan put it succinctly when he said that "virtually unimaginable a half-century ago was the extent to which concepts and ideas would substitute for physical resources and human brawn in the production of goods and services."

What does all of this mean for you and your organization? It means that the New Economy is not just hype and high-flying stocks, that it represents a new reality that no company can afford to ignore. It means that you and your business are going to have to embrace a new model of how to create value.

Why? Because today's economy—built as it is on a foundation of new technologies, globalization, a new generation of people entering the workplace, and the increased importance of intangible assets—is different from anything any of us have encountered before.

In the words of *Fast Company* magazine, "a global revolution is changing business, and that business is changing the world. New rules of business, and a new breed of company [that] will challenge the corporate status quo. No part of business will be immune. The structure of the company is changing; relationships between companies are changing; the nature of work is changing; and the definition of success is changing. The result will be a new world order representing unparalleled opportunity and unprecedented uncertainty." [3]

Organizations are creating value in totally new ways, using assets and combinations of assets heretofore unrecognized under traditional accounting systems—and certainly unmeasured. The realization of the enormous economic value of people, for instance, has sparked a no-holds-barred war for talent, often at the expense of traditional attitudes about work itself and old ways of recognizing and rewarding employees. In such a milieu, old methods of managing and measuring are simply not up to the task.

To ignore the significance of the changes afoot in business today is to ignore reality itself as the page turns on a new millennium. And what organization can thrive, or even survive, in a world of illusion? None.

Those changes are manifest in every day's headlines: When it turns out, for example, that almost every new member of the *Forbes* list of 400 wealthiest individuals in 1999 built his or her fortune on technology; when an upstart Internet company like America Online, Inc., could seek to acquire the Time Warner, Inc. media empire; when Microsoft Corporation achieved a market value exceeding the combined value of eight giant U.S. corporations (Boeing, Caterpillar, Ford, General Motors, Kellogg, Eastman Kodak Company, J.P. Morgan & Company and Sears, Roebuck). As the millennium began, Microsoft's market value stood at $602.4 billion—built almost entirely on intangibles.

This book examines how successful businesses like these are creating value in the New Economy. And we draw a key distinction between value creation and value realization. Value creation—that is, future value captured in the form of increased market capitalization—is how successful businesses are creating value in the New Economy. Value realization—that is, value captured in the form of past and current earnings or cash flows—is what underlies both traditional accounting and most of today's management information systems (including EVA). It necessarily means that many organizations take a short-term view, ignoring the drivers of value creation today, especially intangible assets.

In the pages that follow, you will find a new set of tools that we have developed to help you create value in the New Economy. It is called Value Dynamics, and it is based, in part, on an intensive three-year, 10,000-company research project by professionals at Arthur Andersen. It speaks directly to the four realities of the New Economy.

! New business models are emerging.

Businesses are their assets, all of their assets—tangible and intangible, owned and unowned. But in the New Economy, it is intangible assets such as relationships, knowledge, people, brands, and systems that are taking center stage. We see this in the new strategies and business models being developed by such powerhouses as Microsoft Corporation, E*TRADE Group, Inc., and Amazon.com, Inc. Successful companies will combine both old and New Economy assets. In fact, it is the combination and interaction of various assets—more than any other factor—that will determine a business' economic success.

! New business models create new risks.

Companies are increasingly employing unique business models, which push the boundaries of traditional controls. That is, leading-edge companies are finding that their management and measurement systems are no longer aligned with the assets that they are using to create value. What's more, the New Economy is producing a whole set of different risks—from new transactions and new markets to new technologies, new competitors, and new relationships. But risk in the New Economy encompasses the upside, as well as the downside. As a result, companies need to embrace (as well as manage) risk to prosper and succeed.

! New processes and tools are needed to succeed.

How a company builds and manages its portfolio of assets ultimately determines its success. But despite the growing importance of intangible assets in the New Economy, most businesses don't have formal processes and systems to manage these assets and the risks they create. And while some processes are becoming out-moded, others, from brand management to distance learning, are rising to importance. Businesses need new processes for setting strategy, operating, managing risk, and using information in decision making.

! Transparency of information is vital to value creation.

Even as new markets and technologies like the Internet create and distribute better information about all the assets that matter, managers need more to support value creation. Real-time financial reporting is almost a reality for some companies, as are systems integrating internal and external data for delivery to the corporate desktop.

Thus, businesses must recognize that the old models of information for decision-making—including measurement and reporting—are becoming obsolete. Under the models of the past, companies have focused primarily on internal information, while resisting disclosing more than the bare minimum required by regulation. The model of the future is transparent and user-driven, and allows stakeholders to readily access the information they need to know, when they need to know it. Companies will need to measure all of their value-creating assets, including the difficult-to-measure intangibles. Being approximately right is more important in these areas than being precisely wrong.

With these issues as a backdrop, you are about to begin a journey with a single destination—value creation. What to do differently and how to do it are the subjects of this book.

In the New Economy, managers must think of competition in terms of competing business models, whose power comes in part from how the assets within their portfolios interact. Specifically, we argue that assets —including technologies—combine, re-combine, and interact in infinite ways to create economic value. Using human genetics as an analogy, we think of assets as the substance of the "business genome," the economic DNA of enterprises.

Scientists have identified the four amino acids that make up DNA and the double-helix structure of the molecule itself. Different sequences of these four bases generate the infinite variety of biological life on the planet, as well as the genetic messages that help create the individuality of every human being. Based on these discoveries, scientists are in a race to map the human genome. Their goal: Crack the biochemical code for each of the 100,000 genes that determine the physical characteristics of the human body.

Similarly, companies in today's superheated economies are in a race to discover the underlying code of value creation. That is, they are trying

The interaction of a company's assets—its economic DNA—creates or destroys value.

to find out which combinations of assets—tangible and intangible—create the greatest amounts of economic value and to avoid those combinations that destroy it.

In biological dynamics, says Brian Goodwin, a British biologist, "what is important is the pattern of relationships and interactions that exist and how they contribute to the system as an integrated whole."[4] So too with the dynamics of value creation. It is the complex interaction of a company's mix of assets—its economic DNA if you will—that creates or destroys value.

In this book, we show how you can begin to crack the value code for your company. Our insights come not only from the three-year Arthur Andersen study, but also from our own work with clients. They reflect our experience as consultants to companies in every industry and on every continent.

To bring our ideas alive, we offer a wealth of company case studies. We sincerely hope that you will ask yourself how the insights of Value Dynamics can be applied to your own organization. Look for the questions to answer at the end of each chapter. These will help you frame your ideas in terms of the value creation journey for your company.

Specifically, here's what lies ahead.

- **Part I** opens with a question: How do companies create value today? Our answer: To succeed, they need to see what matters—all of the assets contributing to value creation.

- **Part II** shows how a number of businesses in different industries are leading the way by leveraging specific types of assets to create exceptional value.

- **Part III** outlines the challenges you face—and the actions you need to take—to design, build, and manage a business model for success in the New Economy. Look for tools to help you examine your own company.

Finally, the Epilogue looks to the future. It encourages business leaders, investors, employees, customers, regulators, and professional associations to take up the effort to better understand how business and society can thrive.

What's next?

The focus throughout this book is on value creation—seeing, investing in, managing, and measuring all of what matters in the New Economy. The goal—to crack the code of value creation.

What stops companies from participating in unprecedented value-creating opportunities? The first chapter uncovers the problem.

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