The Value Mindset

Returning to the First Principles of Capitalist Enterprise

Erik Stern
Mike Hutchinson

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To my parents,
Joel and Karen
—Erik

To my wife, Philippa
—Mike

CONTENTS

PREFACE

The Value Mindset and Strategic Reconfiguration, we believe, are essential concepts for anyone to master. Understanding them in detail requires that we cover a wide range of subject matter, and thus, this volume covers a breadth of topics. From competitive and financial strategy to corporate structure, from compensation to decision making, from the nature of the nation state to that of stateless nations, you will see that everything individuals, corporations, and governments do has value implications and, hence, requires a value mindset. Few activities do not need to be strategically reconfigured. We hope to make understanding and applying the value mindset and strategic reconfiguration as natural and essential to you as breathing.

Although we have sought to cover the maximum number of topics, we have had to strike a balance in terms of depth of analysis, fearing that too shallow an analysis could compromise our ability to make a case for cultural change. Hence, novices in finance, the capital markets, and human resources may find some aspects of our argument overly technical and a slow go. At the same time, experts in strategy, finance, and human resources, as well as hardened politicos, may deride our simplification of theory and practice to allow us to reach a wider audience.

For this reason, we provide a compass to help you navigate the pages ahead, to maximize the value of your experience and the time you devote to those subjects of most importance to you. For example, if you are a general reader of business, a periodic or addicted reader of the business press, then you should plow through Part One, Value Mindset, and Part Two, Strategic Reconfiguration—Unleashing Hidden Value. If you can boast greater financial expertise and have avidly monitored successive deals of the recent boom, then continue straight on to Part Three, Financial Architecture—Challenging Existing Thinking. If you are interested in compensation issues, including pay—from that of executives to those on the shop floor—and perhaps EVA incentive compensation and the recent craze for share options, then foray further into Part Four, Motivating Managers and Employees to Deliver Value. If you count yourself as a general reader of politics, a politician, or a frustrated voter, then your destination should be Part Five, Taking Strategic Reconfiguration Further—The Public Sector.

All readers of the book should at least skim Chapters 1 and 2 and 10 through 12, because they add some muscle to the thesis mapped out in the Introduction and provide the framework and perspective of the general argument in more depth. Naturally, we hope that others, as engaged as we are by the concept of value and how to create it, cannot resist following us all the way through.

There are significant precedents for applying economic and financial theory to business and politics, not least Adam Smith's *The Wealth of Nations*, which inspired this admittedly slighter volume. We underline this fact in the Introduction, where we outline our general thesis across disciplines, and in the Conclusion, where we wrap up our argument. Throughout, we have tried to step back and identify common themes within business, government, and the nation state. We hope this simple road map helps you to make some sense of how much time you want to spend with us before you begin.

Erik Stern
Mike Hutchinson

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Those who contributed to the ideas in this volume deserve special honor. The initial concepts were conceived in the business strategy class of Professors Harry Davis and John P. Gould at the University of Chicago and outlined in Erik's final paper: "Strategy and the American Airline Industry: Fasten Your Seat Belt" (March 1997). John Pigott, cocreator with Erik of Wealth Added, generously discussed over many hours a number of the themes that made their way into this book: No one is better equipped intellectually to test new, and possibly ill-judged, theories. Thanks to our readers and commentators: Joel Stern, managing partner of Stern Stewart & Co. and Chaith Kondragunta, co–managing director with Erik of Stern Stewart's operations in Europe who both offered a series of powerful reality checks. Amnon Danzig, Stern Stewart's agent in Israel, gave Erik the first opportunity to speak professionally on—and thus to clarify—some of the issues in this book. Professor Julian Franks at the London Business School was as helpful as ever in reviewing ideas. Stefan Kirsten, formerly of Metro AG, played a significant role in the creation of Wealth Added.

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Needless to say, any errors or inaccuracies are the responsibilities of the authors alone.

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E.S.
M.H.

INTRODUCTION

What is your "mindset"—your frame of mind, your general attitude, your outlook or way of thinking? When you make decisions, whether at work or at play, do you explicitly consider the value—that is, the worth or merit—of the consequences? And do you approach decisions at work in the same way that you weigh up options *after* work?

These are not esoteric questions. Most people are one person at work and another at home. Some people are "can do" and "go for it" whether at work or at play. Why? The answer has to do with a sense of ownership.

For people without that sense of ownership, work drags and experiences pall. Their real life begins after the working day ends. By contrast, a person with a *value mindset* takes decisions in *all* walks of life with a sense of owning the results, with the entrepreneurial mentality and the enthusiasm of the franchisee. You experience a greater thrill when the consequences of a decision—the accountability and responsibility—are yours. You may be more or less risk averse; but, depending on your unspoken risk-reward requirements, your roster of abilities, and the opportunities on offer, a value mindset has the potential to stretch anyone "to the max." It is, in the jargon, a value maximizing proposition.

The value mindset is not a purely individual phenomenon. Companies and governments may seem distant from us individually, but in every case, they too are made up of people, bound together by explicit or implicit contracts. Our society is a web of such contracts. We may have been born in our home country or we may have moved there, but we implicitly contract with our fellow citizens to form our society. The terrorist actions of September 11, 2001, so shocked the United States and the world because 19 suicidal fanatics breached the implicit contract of American, Western, democratic, liberal, capitalistic, Judeo-Christian, Enlightenment, humanist, and, yes, even Islamic society.

We feel anger whenever a person, a group, a company, or a government breaches this deeply felt, but largely unspoken, contract. Murderers and other criminals flout it, as do special interests. Companies that monopolize and defraud break the contract. Tyrannies drive a coach and horses through it.

In the West, this social contract offers democratic freedoms and economic liberalism, as well as all the opportunities that go with them. Our icons are those who tore down the Berlin Wall, Nelson Mandela on his long march to freedom, the students of Tiananmen Square, Boris Yeltsin brandishing a revolver on top of a tank, and perhaps, more equivocally, even Margaret Thatcher, dismantling the common wisdom of what government should do. We shudder at despots: Saddam Hussein, Robert Mugabe, Kim Il Sung.

Freedom of opportunity works when we all share the same freedom. This is liberty. It thrives when none of us has undue influence. We each have our interests. We may decry those we see as more avaricious than others, but we all have interests, often strong ones. As long as we keep our interests in perspective, what is wrong with accepting that we are all self-motivated, that we all have wants, needs, expectations, and interests? There is nothing wrong with this. Aspirations—hopes and dreams—may be the essence of the human condition.

We are all self-interested, and self-interest is good, if held in check by everyone else's self-interests. Unimpeded, self-interest can become destructive. It tramples liberty and curtails freedoms. It threatens meritocracy and encourages others, by example, to reject responsibility and accountability. It may not actively breach its contracts with other self-interests—that would be like the parasite killing its host—but it will strain them, and we live daily with the strained consequences. Where self-interests compete freely, there is equilibrium and harmony. Where self-interests are stayed or strengthened, there is volatility and injustice.

None of this is new. Let us pay homage to the father of economics, Adam Smith, who single-handedly identified the role of self-interest in the workings of markets. So much of what we take for granted in economics today derives from him, including such recently rediscovered concepts, invaluable to corporate finance, as the cost of capital and the value of intangible assets. We all owe Smith an incalculable debt.

In *The Wealth of Nations* (1776)—a book that truly deserves the accolade "seminal"—Adam Smith famously argued that capitalism worked because an "invisible hand" of self-interest guided individuals in their dealings with one another in the market. The invisible hand is the motivating force of capitalism and the market system. This profound contribution to economics is perhaps most succinctly described here:

> Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, and not that of the society, which he has in view. But the study of his own advantage naturally, or rather necessarily leads him to prefer that employment which is most advantageous to the society.[1]

What this means is that in a competitive market place, competing self-interests create value for society. They are the value mindset in action. You offer a price for a product or a service. He offers another. She puts a third on the table. I chip in with a fourth. We are all free to offer a price; and in the end, buyers and sellers negotiate to determine the "true" market price, the most accurate price, given all the available information. The result? Consensus. This is, of course, a simplistic model. In reality, only a few people, "at the margin," need to engage in this activity for everyone to benefit. Alas, those who attempt to exploit undue influence disrupt the market's consensus—and few of us can claim to be wholly innocent.

Contract theory and the efficiency of the market—that it processes and acts upon all information available to it, impartially—provide the background to the discussion that follows, in both the corporate and the state sectors and in the context of government. How do we align the interests of *all* those involved in each of these networks of contracts? In team sports, for instance, alignment is almost perfect. It is not an idle aspiration but the *sine qua non* of success. All the players, their support staff, and their supporters are clear about what constitutes "victory." How can that clarity and alignment be replicated within companies and the state?

With companies, the restraints on Adam Smith's invisible hand are perhaps most obvious, so let us turn to those first. Often, those restraints are inbuilt and prevent the company from generating more than a certain level of value. Politics, or politicking, is often the culprit. On an individual level, company managers may be encouraged to seek short-term outcomes through what have been dubbed "perverse incentives," damaging the company's value in the process. At a wider level, the company as a whole may become fixated on a strange, faintly grotesque quality—*size*. For reasons we will explore, size can drive much of corporate thinking. Size is a goal, rather than an outcome, and value suffers. Companies become huge and diverse—so much so that there are aspects within the enterprise that are at war with each other and that diffuse and defeat a focus on value creation.

In many ways, such an enterprise is rather like one of the old failed conglomerates, with all the drawbacks of those cumbersome beasts. Each of its constituent parts is significantly, and damagingly, different. Some parts specialize in asset management of all kinds; others are focused on logistics; yet others can boast of expertise in varieties of intellectual content. Few companies focus on one of these different "businesses" alone. Crucially, the risk profiles of each differ. When such businesses subsidize each other within an organization, they considerably weaken its potential for creating value. How would a value mindset change things?

The value mindset resists the siren call of size for its own sake: To the value mindset, the acquisitions and divestments and alliances that a company may have the opportunity to pursue are all on a par, and the measure of their success is how much value they create. The focus is *value*, whatever it takes.

And what it takes may alarm, if value has been wasted in such a wholesale fashion that major surgery is required. Take that tremendous euphemism of the 1980s business culture, particularly in the United States, "the active market for corporate control." "Corporate control" was the question of who managed the company. "Active market" meant, in practice, a series of bitterly contested takeovers. (For "active," read "seriously determined.") In fact, there were relatively few hostile takeovers of this kind, but the fear they generated served to encourage less shameful destruction of value throughout the corporate world.

The active market for corporate control reached thrilling heights—in the United States, at least—before largely being emasculated by legislation. And its achievements were considerable. This active market laudably created huge shareholder value.[2] Indeed, the shareholder value created had to be on an enormous scale, because no one launches an expensive hostile takeover without being certain that there are vast reservoirs of untapped value that will serve to pay for the bid. In the 1980s, what was outrageous was not the savagery of a few high-profile takeover battles, but the existence of so many untapped reservoirs of value to be exploited. How on earth did they evolve?

Create value the active market certainly did. But, with a few understandably self-interested exceptions, in no one's book would the fear of hostile takeover be the preferred method of encouraging value creation. There had to be better, more constructive ways. Was there a measure, or a series of measures, that replicated sport's clarity, transparency, and alignment of activity and interests by encouraging the creation of value?

There was. EVA—*Economic Value Added*—a form of economic profit pioneered by the management consultancy Stern Stewart, became highly popular around the world in the 1990s. EVA—value created over and above the expectations of investors and reflected in market valuations—enabled enterprises to extract enormous, untapped value from their organizations, encouraging value creation not only among managers, but also, potentially, among all employees. EVA has proved its worth to many enterprises—in particular, at Coca-Cola, of which more shortly.

Tapping value this way is no one-shot activity. It does not simply stop one day. But what if, as we said, there are limits imposed by the structure of the company itself? How would a value mindset approach this dilemma?

An alternative means to achieve the aim of unlocking value from companies is proposed in this book. Our aim: Rethink, reconsider, reconfigure. Strategic reconfiguration is a radical, but palatable, alternative to hostile takeover. In effect, it is a more active internal governance system, one that depends on an explicit, systematic value mindset. What strategic reconfiguration aims to do is to identify how a company splits, in terms of its businesses, and which businesses constitute the company's key expertise, in terms of value creation. It is on that business that the company concentrates.

If this sounds similar to outsourcing, it differs in two key respects. First, companies that outsource usually outsource peripheral activities, such as payroll. *Core* is defined as everything that is not peripheral. Strategic reconfiguration is much more rigorous about what is core and what is not. Core creates value. However, where core activities could be better performed by another company, even a competitor—and by "better performed," we mean "better create value"—they should be reconfigured. This is as far from outsourcing as the Lindisfarne Gospels are from cave paintings.

Second, unlike outsourcing, strategic reconfiguration pays for itself. If our company reconfigures to concentrate on asset management, then the "businesses" more concerned with logistics and content will earn their fee from the value they create over and above the value the business is currently creating, or might be expected to generate on its own. In other words, unless the company brought in to manage the reconfigured businesses creates extra value, it is not going to benefit—*even though the reconfiguring company may.*

In a strategically reconfigured world, all companies focus on the aspects of their business where they can boast the most value-creating expertise. They offer their value-destroying (and less value-creating) businesses to be managed by companies that have greater value-creating expertise, at least in that particular business. The added value created is split in a win-win agreement. However, we should stress at this point—and we make no apology for it—that strategic reconfiguration releases value over the long term, and is thus aimed at companies that are owned by a core of sophisticated long-term investors. Of course, there are lessons to be learned for other firms, but a long-term view is key. All investors, including short-term investors, benefit from a company's long-term focus.

With strategic reconfiguration, we can achieve all the goals of the active market for corporate control, without any of the unpalatable side effects. The value mindset that constructs these strategic reconfigurations is promarket, not probusiness. Of course, business benefits from reconfigurations—there would be little point in suggesting them otherwise—but our focus is on the market. Too often, a probusiness policy, as pursued by a government is antimarket. Preferring and protecting certain companies or industries stays Adam Smith's invisible hand, which unstayed sees self-interests as competing equally. Strategic reconfiguration allows, and encourages, the invisible hand to do its benign work.

Both the value mindset and strategic reconfiguration are revolutionary, in the true sense of the word; but pioneers of value creation have prefigured both. In the first part of this book, we investigate two pioneering companies that illustrate the concentrated focus on value that derives from the value mindset: (1) the Four Seasons hotel group of Isadore Sharp and (2) the Coca-Cola of the late Roberto Goizueta.

When we develop the principles and practice of the value mindset, in the second and third parts of this book, the examples given tend to be large U.K. and U.S. companies; but the principles of strategic reconfiguration and the benefits of the value mindset apply equally to small companies and to those in other countries, too. These principles, founded as they are on the efficiency of the market and on the rationality of the invisible hand, are universal.

Democratizing decision making and management and even, further, democratizing the ownership of value created by employees have tremendous potential, as discussed in the fourth part of this book. It gives employees the chance to vote for responsibility—an opportunity they have had under few previous political or corporate regimes. In claiming the right to own the value they have helped to create, accountability is enhanced.

Why might the ideas behind strategic reconfiguration not be applied to the state and to government? After all, as we saw, contracts, implicit and explicit, underpin all human intercourse, not just the activities of the company. They are there in the state, in government, and even in the family (what else is marriage?).[3] The wider benefits of a value mindset are discussed in the fifth part of this book. Effectively, a value mindset proposes a democratization of capitalism—a "capitalist manifesto," as it were. The methods of strategically reconfiguring a company are brought to bear on the state and on the way democracy works. In particular, government's pernicious practice of goal-seeking equality of outcome, rather than equality of opportunity, comes under scrutiny.

This book takes the principles behind EVA and the creation of value further than they have been taken before. We meet a new metric, Wealth Added, for instance; but perhaps more importantly, we consider how a value mindset applies to value-based management in practice. Many of the best value-focused companies worldwide—among them manufacturers like Herman Miller, Briggs & Stratton, SPX, and Siemens—are object lessons in value creation; but even they, and certainly others who think that they are managing for value, may profitably take up some of these ideas. Our first challenge is to them: to transform robust theory into profitable practice, to rethink, reconsider, and reconfigure.

However, this is a book that is not meant just for practitioners, who will find most interest in the technical ideas within its covers. We hope there are chapters that will prove of interest to investors and, particularly the final part, to all of us who are citizens of the nation state. We apply a value mindset not just to business strategy and company finance, but also to people in general and to the political systems that have evolved, in the process anatomizing the twenty-first century individual. Throughout, the ideas—in common with all robust micro- and macroeconomic ideas—are grounded in the first principles developed by Adam Smith.

This book is published in a U.S. election year, from which an apology, a question, and a second challenge flow. Our apology is specifically to those who are not U.S. nationals or who live outside the United States. One of your authors is American and the other is British. We have tried hard not to make this book, and particularly the final part, too U.S.-oriented. But the forthcoming U.S. election comes at a time of particular significance and, hence, is of particular significance in itself, not just to the United States but to all nations of the world. Offering some ideas on how the United States might achieve its "manifest destiny" of becoming a "city on a hill"—a beacon to other nations—seemed appropriate, but these ideas apply as urgently to Europe as they do to the United States.

Our question is one for you, dear reader. In the Western democracy in which you live, do you feel that your vote counts? Chances are that you don't. After all, Western elections regularly see voter turnouts below 50 percent. Clearly, many voters are frustrated with their political system, or they would not stay away. This book includes some thoughts on reconfiguring democracy to take the politics out of government and to make individual votes count. If this sounds intriguing, then our second challenge is yours. Stand up and make your vote count, not only as a voter but also as a manager or a worker, perhaps as a shareholder, and in all other incarnations as a value-oriented individual.

The aim of this radical manifesto is to encourage more effective use of both physical and mental capital, encouraging higher productivity, growth, and self-esteem. Needless to say, this is as valuable for nation states as it is for individuals. After September 11—in the aftermath of which every last one of us is destined to spend the rest of his or her days—we suggest some ideas for reconfiguring how nations relate to each other. With more than a wink at the leveraged buyouts of the 1980s, we suggest that a value mindset can construct ways of promoting value creation by reconfiguring the stale, unproductive concepts of aid to and patronage of the developing world. This may well be the biggest prize on offer from the value mindset: peace.

NOTES

1. Adam Smith, *The Wealth of Nations*, bk. 4, chap. 2, ed. Edwin Cannan (1776; reprint, New York: Modern Library, 2000), 482.
2. See Michael C. Jensen with Donald H. Chew, "U.S. Corporate Governance: Lessons from the 1980s," in *The Portable MBA in Investment*, ed. Peter L. Bernstein (New York: John Wiley & Sons, 1995), 377–406; and in abridged form in Michael C. Jensen *A Theory of the Firm: Governance, Residual Claims, and Organizational Forms* (Cambridge, Mass.: Harvard University Press, 2000), 9–15. Available from Social Science Research Network Electronic Library (http://papers.ssrn.com). See also two excellent contributions to the *Journal of Applied Corporate Finance*: (1) Andrei Schleifer and Robert W. Vishney, "The Takeover Wave of the 1980s" (vol. 4, no. 3 [Fall 1991]); and (2) Gordon Donaldson, "Corporate Restructuring in the 1980s" (vol. 6, no. 4 [Winter 1994]).
3. In 1954, the U.S. Supreme Court interpreted the Fourteenth Amendment (1868) of the U.S. Constitution—"no State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States"—to be broadly in defense of corporate interests. A corporation was also a "person."

PART ONE

Value Mindset

1

A REVOLUTION IN VALUE

R*evolution* is a much-abused word. Its accepted meaning is "complete change." In fact, a revolution is, as the word suggests, a return to the original. There is a world of difference between a revolt and a revolution.

The value mindset is a revolutionary concept, in that it returns to the very roots of capitalism: the concept of investing resources in order to generate a return based on the risk taken. Jesus Christ's Parable of the Talents takes the idea back two millennia.[1] Likewise, the value mindset was not alien to the original capitalists who despatched galleons to the Spice Islands or raised satanic mills on England's green and pleasant land. These capitalists managed directly for value. The money risked was theirs, and the rewards that flowed from taking that risk—after sharing the booty with surviving sailors or paying the mill workers—came directly to them.

Fast forward to the present. What do we see? Like government, companies grow big, diversify, cross subsidize, bloat, and stagnate. As with government, goal seeking and politics compromise the quest for value. Creating value is in practice a "take it or leave it" option—either you create value, or you do not. There is no half way. And yet shareholder value has become a mantra, much repeated. When challenged, every chief executive will claim value lies at the heart of everything he or she does and close to the heart of every manager in the enterprise. The finance director will provide reams of numbers in support of this laudable assertion, showing how the company has met or exceeded last quarter's or last year's self-imposed targets.

Discussion over. Is it any wonder that each feels obligated to goal seek outcomes and massage the numbers? As legendary investor Warren Buffett put it, those who make the numbers are eventually tempted to make up the numbers.[2] Goal seeking in soccer is straightforward; goal seeking in business is not.

Two value champions of recent years illustrate the kind of mindset that focuses fully and completely on value. They are the prophets of our revolution. The first is Isadore Sharp of the Four Seasons hotel chain, who has taken steps toward the kind of specialization we would expect of a company that reconfigures in the way we shall explore in more detail later. The second is Roberto Goizueta, the late chief executive of Coca-Cola.

Isadore Sharp is probably the doyen of the world of service. Trained as an architect, he emigrated from Israel to Canada, where he built motels throughout the 1950s. In 1961, he opened the first of his Four Seasons hotels in downtown Toronto; a second opened its doors in London in 1970. Four Seasons Hotels and Resorts now operates 57 properties in 26 countries. Even during the dark days following September 11, 2001, Four Seasons remained profitable. In many ways, it is an exemplar of good business practice.

Its secret? Four Seasons is the only company in the world to focus exclusively on midsize luxury hotels and resorts of exceptional quality. As what purports to be the world's premier luxury hospitality company, Four Seasons instills in its employees an ethic of personal service that is second to none. *And yet it owns few hotels.*

Indeed, if Four Seasons had its way, it would not be burdened with ownership of hotels at all. For sure, it manages and owns hotels, but it clearly wishes it were otherwise:

> It is Four Seasons' objective to maximize the percentage of its operating earnings from the management operations segment, and generally to make investments in the ownership of hotels, resorts and Residence Clubs only where required to secure additional management opportunities or to improve the management agreements for existing properties.[3]

In other words, here is a hotel chain that would rather not own hotels. What is going on? All is explained a little later in the company's key document[4] for 2002:

> Four Seasons is principally a management company. Under its management agreements, Four Seasons generally supervises all aspects of the day-to-day operations of its hotels and resorts on behalf of the owners, including sales and

marketing, reservations, accounting, purchasing, budgeting and the hiring, training and supervising of staff.

In addition, at the corporate level, Four Seasons may provide strategic management services, including developing and implementing sales and marketing strategies, operating a central reservations system, recommending information technology systems, and developing database applications. It assists, where required, with sourcing financing for and developing new hotels and resorts. It advises on the design or construction of new or renovated hotels and resorts, helps with refurbishment, and purchases goods centrally.

And yet, to stress the point, it owns few hotels. Indeed, it would own *no* hotels if it had its way. Where, then, does the money come from? For providing a range of management services, Four Seasons generally receives a variety of fees and levies a range of charges, including a base fee, an incentive fee, a sales and marketing charge, a reservation charge, and purchasing and preopening fees. The base fee is calculated as a percentage of the gross revenues of each hotel and resort that it manages. The incentive fee, which Four Seasons is entitled to collect from the majority of the properties it manages, is calculated based on the operating performance of the hotel or resort.

Four Seasons' fee revenues fell by $12.8 million Canadian dollars (C$), from C$160.7 million in 2001 to C$147.9 million in 2002—a decline of 8 percent.[5] But in the first full year after September 11, 2001, given the worldwide slowdown in business and leisure travel that resulted, such figures are hardly shameful, contributing as they did to net earnings of C$21.2 million in 2002. Four Seasons' Wealth Added—a more complete measure of value that we shall explore in more detail later—in the 15 years to the end of 2000 was some C$1.8 billion. The company's focus on managing hotels, at the expense of owning them, is highlighted by the results from each activity. Management fees yielded C$82 million in revenues in 2002—down C$13.3 million, or 13.9 percent, from 2001. But over the same period, losses from ownership rose by C$9.4 million to C$19.6 million.[6] Four Seasons clearly knows where its competitive advantage lies, and it is not in owning or managing a real estate portfolio.

Why is this important? Because the focus of Four Seasons on what it does best—service—in an industry where we might reasonably expect it also to own and control property, provides one of the starting points for our exploration of strategic reconfiguration. Instead of owning hotels and managing them, Four Seasons has measured up its core competencies and stepped back from the standard paradigm. This holds a lesson for all companies, and indeed for all industries, a lesson that is not confined to a split between service provision and property management. The implications spread much wider and involve the "creative destruction" envisaged by the great Austrian economist Joseph A. Schumpeter[7] across a range of industries—indeed, on the grandest of scales.

Before we leave Four Seasons, the company holds one further lesson that will be useful in the journey to come. As we noted, for its management services, Four Seasons receives a range of fees and levies a number of charges. Of most interest to us at this point is the incentive fee. The base fee is contractual, like the basic wages earned by an individual. What provides the spur to excellence is the incentive fee. Incentive fees were earned from 32 of the company's 57 hotels and resorts and from one of the two residence clubs managed by the corporation in 2002, compared with 35 of its 53 hotels and resorts and both residence clubs in 2001. That clearly reflects how the travel and hospitality trades suffered over this period. What is important is not the figures themselves but their nature *as incentives.* Key to our theme is the use of incentives to encourage the creation of value—which brings us to Coca-Cola, at least under our second value champion, Roberto Goizueta.

The world is full of businesses that vow to become Number One, but Coca-Cola *is* Number One, or at least was when Coca-Cola's then chief executive and chairman, Roberto Goizueta, made that claim.[8] The previous year, 1996, Coke had topped the Stern Stewart/*Fortune* value ranking, beating General Electric and Microsoft to top place with value creation of $2.6 billion.[9] And the achievement was very largely Goizueta's. He took Coke's market value from a mere $4.3 billion in 1981, when the company appointed him chief executive, to $180 billion in 1997. In that same year, just months after making his Number One claim, he became a victim of lung cancer.

Goizueta, the son of a wealthy Cuban sugar magnate, became an impoverished immigrant when he fled to the United States following Castro's rise to power in 1959. Between them, he and his wife had $40 and 100 shares in Coca-Cola. Earlier, having graduated with a degree in chemical engineering, the young independent-minded Goizueta had answered a newspaper ad and landed a job as an entry-level chemist with Coca-Cola. He joined on July 4, 1954, and the company offered him a job in its new Miami office in October 1960. He stayed with the company for the rest of his life.

When Goizueta became chairman and chief executive of Coke on March 1, 1981, he reportedly knew the cost of every cent of capital Coke had invested anywhere in the world—in other words, the rate of return investors could expect for investing in a basket of companies of similar risk.

Therein lay his secret. As journalist John Huey put it, recalling his first meeting with Goizueta:

> Basically, he said, the company now had a strategy that would focus entirely on increasing long-term share-owner value (he hated the word "shareholder" because he said it wasn't precise enough). He planned to reduce the percentage of earnings paid out in dividends from almost 60 percent to around 35 percent, he explained, and for the first time Coke would take on debt. This would free the company to explore new opportunities and—very important—lower its cost of capital. He would divest businesses that weren't likely to pay off for shareholders, and there would be no sacred cows. Performance would be rewarded; perfect attendance would not. It was the only time a CEO ever explained to me a strategy so simple that it seemed almost naïve, and I, along with everyone else outside the company, was sceptical.[10]

At the time, Huey pointed out, Coke was in disarray. It had lost significant momentum to hard-charging Pepsi and had yielded only a 1 percent compound annual return to shareholders for an entire decade. Its culture was one of entitlement and arrogance. It was locked in a paralyzing war with its own bottlers. And to compound its problems, the company had no communication with Wall Street and unusually hostile relations with the business press.

The key to Goizueta's success was what was to become gospel to almost everyone who worked at Coca-Cola—that the name of the game was creating wealth for what Goizueta himself called share-owners. The key to that was efficient allocation of capital. As Goizueta warned his managers, "Don't even come to us with a project that doesn't yield more money than the cost of money. . . . You'll get no hearing, much less a 'No.'"[11]

Goizueta's maternal grandfather Marcelo Cantera, a significant influence on his life, had been a great believer in cash flow. Earnings was a manmade convention, as the saying went, but cash was cash. The larger a company was, the less it understood cash flow. The smaller the business, the better it understood cash flow.[12]

That insight is something to which we will return. Meanwhile, how did Goizueta put into practice Coca-Cola's publicly stated mission—to create value over time for the owners of the business? Goizueta recognized that Coca-Cola was essentially two things: (1) the flavored drink developed a century earlier by Atlanta pharmacist John Styth Pemberton, and (2) its image, which was to be transformed into the world's most powerful brand. He concentrated on these, single-mindedly. A previous acquisition of Columbia Pictures was reversed, bringing a cash windfall. Shares were bought back at what turned out to be bargain prices, in a classic move approved by Warren

Buffett, who joined Coke's board.[13] Incentive pay was linked to value creation, making millionaires of even lower-level managers.[14] And, in the name of creating value, the highest debt rating—AAA—was abandoned.

All of these activities will become familiar by the time we complete our examination of strategic configuration for value. But perhaps the most interesting of Goizueta's actions was effectively to relinquish ownership and control of Coca-Cola's bottlers. Once you place assets on the balance sheet, as you should do to reveal their value potential, he reasoned, the onus is on them to earn their full return on capital. Viewed through this lens, many companies peripheral to Coke's core business, such as bottling, destroyed value. Goizueta's argument was that Coca-Cola should not be in bottling. Would it, for instance, bottle its competitors' products? No. The company divested its capital-intensive bottling assets, taking enough in the way of a stake to be able to influence activities, without having to burden its balance sheet.[15] That way, Coke was able to control its bottling needs without tying up as much capital. Table 1.1 compares Coke's and Pepsi's capital employed in the last three years of Goizueta's stewardship and demonstrates the company's zeal.

It may not be irrelevant that, at university, Goizueta majored in chemical engineering. His stringent control of capital has a quality of small-scale, detailed focus to it. Neither is it irrelevant that he took the oath of allegiance to the U.S. flag after fleeing Cuba. He had the same straight-up-and-down loyalty to his shareholders throughout his career at the helm of Coca-Cola, an alignment with his owners' thinking that was perhaps fostered by growing up in a family business.

> We work for our share-owners. That is literally what they have put us in business to do. That may sound simplistic. But I believe that just as oftentimes the government tries to expand its role beyond the purpose for which it was created, we see companies that have forgotten the reason they exist—to reward their owners with an appropriate return on their investment. . . .
>
> They may, in the name of loyalty, prevent change from taking place, or they may assume their business must be all things to all stakeholders. In the process,

Table 1.1 Capital Employed by Coca-Cola and Pepsi-Cola ($ billions), 1995 to 1997

	1995	*1996*	*1997*
Coca-Cola	11,175	13,015	13,775
Pepsi-Cola	22,825	23,167	17,545