

Show Them the Money

CEOs Fail When Investors Defect

Why are so many CEOs losing their jobs these days? How about failure to advance a winning strategy, which leads to falling valuation? Strategies fail because they fall short of satisfying the “Holy Trinity” of stakeholders — namely, investors, customers, and employees. General Electric’s Jack Welch clearly understands this need, a reason Welch and GE have set the gold standard for increasing value.

CEOs are failing at an accelerating rate. In the first nine months of 2000, CEOs from 39 out of the 200 largest U.S. companies left their jobs.¹ Many of these CEOs left with spectacularly short tenures: Richard Thoman (Xerox, 13 months), Durk Jager (P&G, 17 months), Michael Hawley (Gillette, 17 months), M. Douglas Ivester (Coca-Cola, 28 months). All of these were proven executives. Their successful careers incurred a spectacular failure.

The root cause of each of these CEO departures was poor strategy followed by falling shareholder valuation. Shareholders and boards of directors had little confidence in the future valuation of the company under the leadership and strategy of the incumbent CEO.

While lower valuations do not always lead to resignations of CEOs, they do lead to a higher cost of capital. With a rising cost of capital, CEOs have fewer options and corporations can no longer afford to place bets on several different strategies. Instead, they are limited to investing heavily in a single, hopefully winning, strategy.

The key question is, “What constitutes a winning strategy?” Obviously, a winning strat-

egy is one that produces a higher valuation, but how does a company get there? Why haven’t proven CEOs produced the results that they did in the past? And why are they failing at an accelerating rate?

The “Holy Trinity”

A winning strategy must satisfy three constituencies that normally are not thought to be customers for strategy. These three groups, which together comprise the essential stakeholders of the company, are the shareholders, customers, and employees.² Collectively, these can be considered the Holy Trinity for increasing shareholder value.

The member groups of the Holy Trinity

About the Writers

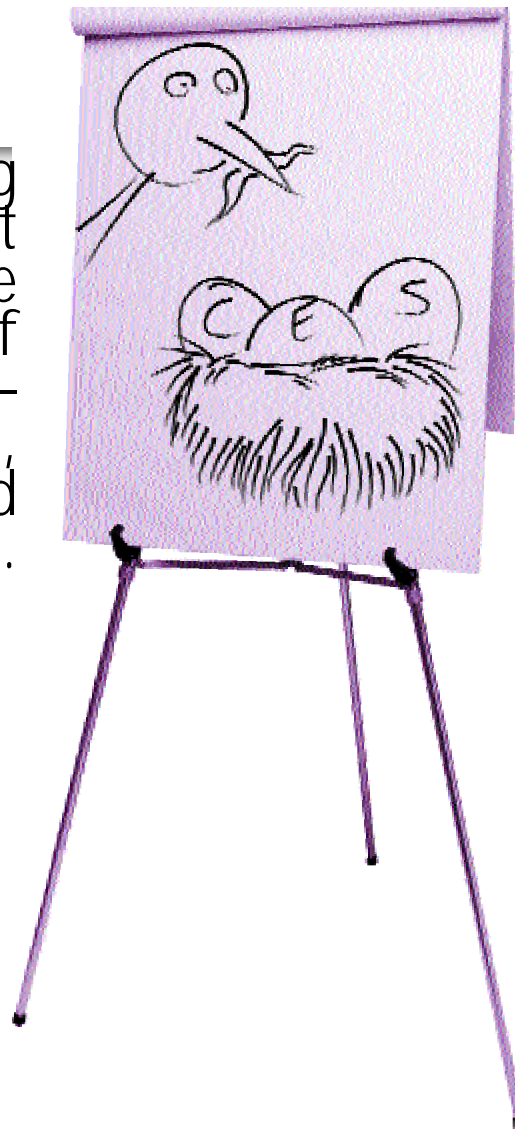
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A winning strategy must satisfy the **Holy Trinity** of constituents – customers, employees, and shareholders.



are not new, but what makes satisfying these three constituencies so difficult now is their rapidly changing expectations. CEOs and their strategies have less time to demonstrate positive and obvious results.

A greater pace of innovation, a more competitive environment, and a tighter labor market have shortened the duration of a company's competitive advantage. A winning strategy has less durability. Shareholders have enjoyed spectacular returns in the market in general. The increased dynamics of the marketplace have produced an unprecedented number of choices for customers. Employees are reaping the rewards of the single-digit unemployment rate. In short, no CEO can take for granted any element of this Holy Trinity.

The Key to Valuation

Traditionally, CEOs have been rewarded for stock market appreciation. Increased valuation is, of course, the result of earnings growth and an expansion in P/E ratios. The question remains, however, "What causes growth in earnings and

high P/E ratios?"

As a framework for new insight into this question, consider the work of our colleague, Geoffrey Moore (see "An Interview with Geoffrey Moore" elsewhere in this issue). Moore has substantially added to the understanding of shareholder value by distinguishing, as components of value, the level of excess profitability and the duration of excess profitability. The level of excess profitability (or "distance" from the competition), he refers to as Competitive-Advantage Gap, or "GAP." The duration or sustainability of excess profitability, he calls the Competitive-Advantage Period, or CAP.³ (See chart: Competitive Advantage.)

Wall Street, in training management to focus on quarters, drives corporate strategy to increase GAP, near-term profitability, rather than CAP, durable excess profitability. When CEOs and executives act without listening carefully to the market or to shareholders, they often develop strategies designed to increase their GAP and defer projects that could result in prolonging their CAP. This is the reason current profitability should never be an indicator of future profitability. Current profitability is a lagging indicator, reflecting the effectiveness of past strategies and past

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executive actions.

Long CAPs, not high GAPs, cause high P/Es, earnings growth, and increased company valuations.

The Shareholders as Customer (or, Avoiding Shareholder Defection)

With the SEC's new Fair Disclosure regulations, companies and analysts are being pushed away from their prior addiction to "earnings guidance" and forced instead to discuss and evaluate corporate vision and strategies for gaining power in the marketplace. In short, they are being pushed to think about things that matter, rather than the quarterly "number."

To satisfy shareholders, CEOs must develop a compelling, long-term strategic vision. If shareholders do not endorse a company's strategy, they will not wait long for it to fail. With less confidence in the future valuation of the company, they will sell the stock.

This leads to a rising cost of capital, fewer resources to select and implement projects that will earn more than their cost of capital, and a focus on short-term profitability. Such a strategy is a prescription for long-term failure.

The Customers as Customer (or, Avoiding Customer Desertion)

Customers too must value not only the current products and services of a company, but also the company's long-term strategies. Customers will judge a company's future stream of products, its viability in the marketplace, and its place in the value chain (the capacity of the product to work with complementary products and the value of alliance partners). In short, they assess a company's strategies and how well it will be able to continue to fulfill on these strategies.

Companies that are valued by their customers are granted high margins and excess profits. When these profits are durable, due to barriers to entry for competitors or barriers to exit for customers, it is reflected in a high GAP and a long CAP. When profits are not durable, customers desert and shareholders defect.

A company that gets into this position drives executives crazy. The harder they work, the less Wall Street appreciates



their current results. So, they adopt another round of cost-cutting initiatives. They defer investments that would extend their CAP, or competitive advantage, and they increase the amperage on shareholder relations activities. The stock price declines anyway.

The Employees as Customer (or, Avoiding Employee Attrition)

Employees, the third member of the Holy Trinity, are increasingly becoming shareholders through stock option plans. A fall in shareholder valuation discourages employees. Competitors with promises of more options and higher returns persistently court key employees. With unemployment in single digits, it is harder and harder to retain good people.

Keeping key employees is essential to the successful implementation and sustainability of any strategy. Employees must understand and adopt the strategy and its attendant goals and processes. They must be incented to win. Employee attrition leads to delay in implementation, confusion, and defeat of any strategy.

The Gold Standard: GE Under Jack Welch

Jack Welch holds the record for increasing shareholder valuation. Since 1981, when Welch started as CEO, General Electric has risen from a market cap of \$13 billion to around \$500 billion today. GE's returns to shareholders have dramatically exceeded returns from market indices. (See chart: GE Shareholders Beat the Market.) Welch has become the CEO executives would least like to replace. His spectacular 20-year career has been built around paying attention to the members of the Holy Trinity.

A key element to Welch's great success is the small number of initiatives he has launched during his tenure. There have been only four (globalization, services expansion, six-sigma quality, and the transformation of GE into an e-business⁴), but these four changed the history of GE and demonstrated Welch's ability to re-align and reposition the company with new interpretations about what the marketplace would value.

Welch is a pragmatist, never following the business fads or strategies du jour. Sometimes he was early, as when he downsized GE, restructured, and went global in the early 1980s, or when he pushed into financial services and communications in the mid-1980s. Sometimes he was late, as when he ignored six-sigma, then made it a GE religion, or when he ignored the Internet and then repositioned the company to be Internet-enabled. But, always, Welch has moved with awareness and appreciation of what would satisfy the members of the Holy Trinity. The strategies were appreciated by shareholders, brought increasing value to customers, and could be understood and implemented by employees.

Here are examples of how GE treats shareholders, customers, and employees as customers for strategy.

GE Shareholders

Over the course of his tenure, Welch has continually repositioned GE and moved into new areas that investors would come to appreciate (such as financial services and communications) or areas they already appreciated (such as the Internet). Many "adult" investors realized that the dot-coms were not businesses and wanted to find an Internet-enabled, "real" company in which to invest.

With the 1999 launch of his fourth initiative — transforming GE into an e-business — Welch moved to attract these investors. Welch understands that the Internet is not a business, not even a strategy, but an essential tool to be used as part of a successful strategy. Of the Honeywell merger, Welch said,

"We're merging two real high-tech companies, with real earnings, doing real things." GE is moving quickly. For example, a new business unit — GE's Global eXchange Services (GXS) — has resulted from the merger, and expects to "move \$15 billion in procurement this year through its GXS-developed GE Global Supplier Networks."⁵

Clearly, Old Economy companies that innovate using New Economy methods and business models will produce some of the greatest investment returns. Any company that does not innovate (through customer retention strategies, supply chain management, proprietary products, new business practices, etc.) is at risk of losing customers to the company that does.

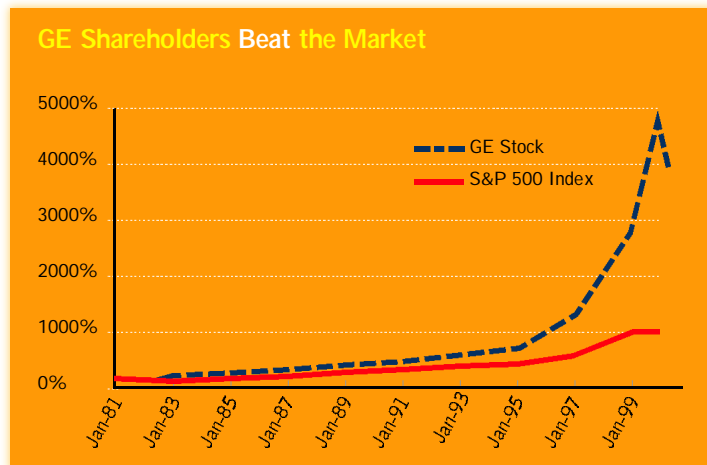
To succeed with a new initiative or strategic direction requires not only successful implementation but a realignment of investor relations as well. Strategies and visions must be well articulated and understood by investors. As was the case with GE's transition out of manufacturing and into financial services, sometimes a new class of investors must be targeted.

GE Customers

Customers care about corporate strategy because they will judge not only the value of the products or services they purchase, but also the future viability and reliability of the vendor. "Is the product development strategy sound? Will they address my company's future needs? Will this vendor remain competitive in the marketplace?"

Businesses do not want to buy a product or service that gets abandoned in a technological cul-de-sac. Particularly when they buy a long-life product such as a gas turbine or diesel locomotive, they do not want a product that lasts longer than the manufacturer. Customers think about life cycle ownership — all in terms of costs.

GE has organized itself to fully support customers and



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their long-term needs. Customers value GE's ability to finance, lease, service, maintain, and resell long-life capital equipment. Customers trust that GE will not only support them through the product's life cycle, but also will be in business when the next power plant or diesel locomotive is needed.

The use of Internet technology is another element of GE's strategy for simplifying transactions for existing customers as well as attracting new ones. For example, GE has installed kiosks at Home Depot stores that enable customers to order appliances and schedule delivery right from the store. The Internet-based order system also allows GE and Home Depot to track, manage, and minimize inventory.

GE Employees


Employees are critical for strategy implementation. They must work from values, not rules. Welch understood this early on, when he said that the way to "harness the power of our people is to protect them, not to sit on them, but to turn them loose, let them go — get the management layers off their backs, the bureaucratic shackles off their feet, and the functional barriers out of their way."⁶ And for their success, and the success of GE, employees were well rewarded.

Welch clearly understands the importance to employees of understanding the strategy and being on a winning team. This is why videotapes are used to carry the message down to all levels of the organization. He understands that executives and managers must participate in strategy development. For example, as part of the e-business initiative, Welch required that every business unit create a DYB — Destroy Your Business — team to research how a dot-com might threaten future viability and to generate a strategy for overcoming this threat. In

this way, GE managers were instrumental in devising and owning the strategy.

Next Issue

The points made here can appear both obvious and simple. Everyone agrees with the importance of paying attention to shareholders, customers, and employees. But there's more to it than that. This article has addressed why and in what ways CEOs should consider these groups as customers for strategy, using GE as an exemplar, but there are no recommendations for how to proceed.

What's missing from this article, and from most business publications, is "how" to achieve the results, or what actions to take based on the insight developed. This will be the subject of next issue's article. The next issue will take a look at the day-to-day actions that are critical to producing satisfaction in the Holy Trinity — specifically, how to go about setting up the processes, metrics, and people to implement the strategies that will increase shareholder value. 

Notes

1. Anthony Bianco and Lavelle Louis, "The CEO Trap," *BusinessWeek* (December 11, 2000), pp.86–92.
2. For additional discussion on the value of addressing these three groups as stakeholders, see "Culture, Dreams, and Shareholder Value: An Interview with John Kotter," *Shareholder Value* (Jan./Feb.,2001).
3. Geoffrey Moore, *Living on the Faultline: Managing for Shareholder Value in the Age of the Internet*. (New York: Harper Business Books, 2000), pp. 50–52.
4. Jon Burke, "The Last Internet Company," *Red Herring* (December 19, 2000), p.55.
5. *Ibid.*, p.54.
6. Jack Welch, as quoted by Robert Slater in *Jack Welch & The G.E. Way: Management Insights and Leadership Secrets of the Legendary CEO* (New York:McGraw-Hill,1999),p.144.