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In Need of *Internal Capitalism*

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As our economy continues to nosedive, our televisions and newspapers are filled with politicians and pundits blaming corporations and profit-seekers for our woes. In effect, they are blaming capitalism itself for the current ills of our economy and society at large. However, while this debate may be interesting in Washington, the eminent leaders of our free enterprises know that inside their companies, capitalism is the driving force behind efficiency, growth and innovation. Now, perhaps more than ever, corporations need to internalize capitalism.

Executives compete for capital by offering to build a business worth more than the original investment. This capital is employed in investments expected to yield adequate returns to compensate owners for their risk and opportunity cost. The need to provide shareholders with an adequate return on their investment is the most effective and efficient means of allocating capital. As a result of this demand from shareholders, all aspects of society would also benefit as resources are directed to their most fruitful uses by the most industrious users.

Further, most of us benefit as shareholders in one form or another. Whether it's our personal investment accounts or our retirement funds, we all have incentive to see higher shareholder returns. However, the stock market is a merciless treadmill. Every performance improvement is greeted with a demand for further improvements. Chief executives face this cruel task master regularly but most protect their business unit managers rather than relaying the reality downward.

Internal Capitalism unprotects business units and imparts the market's demanding performance pressure inside the company and motivates a path of success where capital is deployed efficiently and growth investments can readily be funded through the attraction of necessary resources.

The spirit of *Internal Capitalism,* as the directive to maximize shareholder value, should steer strategies, decisions and performance measures. Modern corporate finance dictates that value is the present value of the cash flow a business is expected to generate over time. The business units maximize cash flow by operating efficiently while making growth investments that promise an adequate return.

> ***Internal Capitalism*** *is a culture of explicitly developing strategies, making decisions and assessing performance inside the company to boost efficiency, growth and sustainability over time.*

For a shareholder value decision framework to be effective, management must embrace the notion that value creation is the prime objective and practice *Internal Capitalism*. This will lead to an owner-like frame of mind, treating the company's resources as if they were their own.

Concerned about Shareholder Value?

Some in the media question this emphasis on shareholder value and ask, "Why are we only asking executives to worry about shareholders? Shouldn't we seek a broader mandate serving a wider group of stakeholders? Can we really trust the stock market to tell us about value?

Although we hope to benefit all constituents, the best indicator of economic effectiveness is the creation of wealth for shareholders. Make no mistake; successful business leaders are very interested in stakeholders. If a business does not satisfy customers, prices and volumes suffer and so do shareholders. If employees are not satisfied, they seek opportunities elsewhere, and this too harms shareholders. And if we squeeze suppliers too hard, they go to competitors to get a better deal and the shareholder value declines again.

It is true that in the short term a business can jack up profits by squeezing employees, customers or suppliers, but these tactics lead to declining quality, shrinking volumes and a loss of long term value that more than offsets the benefits. Over time, the best indicator of the balanced delivery of stakeholder benefits is the true economic result for shareholders.

When we observe lists such as Fortune's *Most Admired Companies* which evaluates broader criteria such as people management, innovation, social responsibility and product quality, we see that these highly regarded companies also tend to deliver above average shareholder returns. Indeed, many companies such as Apple, Deere, Nike, Exxon Mobil, General Mills, 3M, PepsiCo, McDonald's, Procter & Gamble and Johnson & Johnson; are both "admired" and produce superior share price returns.

The "stakeholder" value maximization approach seems quite appealing but is flawed as it does not provide an adequate framework to address the tradeoffs and tensions that business managers face. A simple customer satisfaction case illustrates this point quite clearly: To improve customer satisfaction, Pepsi could affix a $20 bill to half their cans and bottles pushing customer satisfaction and sales skyward. However, losses and bankruptcy would result in unemployment for the thousands of people relying on Pepsi for their wages and lifestyle. Surely, we would no longer admire PepsiCo.

Though this example may be extreme and obvious, this uneconomic quandary manifests itself daily as managers squander resources on "stakeholder" initiatives. This can drain the very strength of the organization that led to the desire to be benevolent.

Many people question the wisdom of a shareholder value agenda to guide key decisions given how irrational the stock market seems, especially lately. Investors clearly overreact at the top and bottom of the cycle, introducing profound volatility into the market value of the company. For corporate managers, aiming to improve the share price is frustrating due to moving targets, changing expectations and a seemingly fickle investor state of mind.

In fact, short term share price movements can be so misleading, public companies would be better off acting like private companies, making decisions as if they owned the company and over time the share price will respond. This is the very spirit of *Internal Capitalism*.

Another frustration with pursuing shareholder value is that many activities are inappropriately pursued in the name of "shareholder value." For example, many strong performing companies with high business returns deployed their capital to buy back shares rather than reinvest in their very profitable operations. They said this was for shareholders or because of outside pressure from activist investors. However, research shows high return companies create the most value for shareholders when they deploy more capital in growing their operations rather than giving it back to shareholders. As professional managers, senior executives must always make decisions because they are right over the long-term, not just right for right now.

While difficult to perceive, given the investor dialogue and news around activists, market studies show investors typically value long term sustainable performance quite well. Perseverance is rewarded.

What is *Internal Capitalism*?

Internal Capitalism is a culture of explicitly developing strategies, making decisions and assessing performance inside the company aimed at boosting efficiency, growth and sustainability over time. It is the internalization of capitalist principles by embracing the economic model as the path to greatest success.

Internal Capitalism operates at all levels in an organization (either public or private) where there is no observable stock price. Management should develop every business strategy, implement every operating plan, and make every decision with the ambition of building a broad pervasive culture of ownership.

This seems simple yet can be harder than it appears. Even inefficient businesses with less desirable products often earn a decent return in good economic times. It is hard to improve or part with inefficient performers when the tide has lifted all boats. But as boom-times recede, weak businesses are exposed and they sap corporate strength. Presently many CEOs are spending considerable time fixing problem businesses.

Many executives knew the businesses within their portfolio which had serious problems even when times were good but did little about it. They were fixated on their growth projects and lost sight of efficiency.

Now we have the opposite problem. Far less effort is focused on developing growth plans for and investing in strong businesses - executives are consumed with fixing problems. At the bottom of a business cycle most companies miss the opportunity to create value through growth investments as all their attention and resources are diverted.

How does this happen? Most management teams that embrace shareholder value use a measure of return or economic profit and emphasize efficiency over growth. Keeping the balance of growth and efficiency in place throughout the business cycle requires business strategies, financial management and incentive processes that drive the ownership culture.

Internal Capitalism is an Ownership Culture

Many companies benefit from being relatively decentralized. Although control authority for major decisions is held by executives and the board of directors, business units are encouraged to develop their own strategies and plans for execution. Considerable authority exists in business units which affords several advantages.

A. FOCUS: Decentralization allows business units to consider core competencies and focus on their business issues without being distracted by the other businesses. This is especially important in a diverse company, but holds where the operations are similar but differences such as the geographic scope may suggest modifications to a core strategy. If a business unit would benefit most from growth by expanding the sales force and a sister unit needs to cut costs, both will be poorly served if a single strategy is smeared across the two.

B. CREATIVITY: Long term success always involves innovation in terms of product development, process improvement, marketing enhancement and the like. The creativity and "out of the box" thinking required to deliver innovations tends to be squelched in larger groups that resort to peer pressure to resist change. Many good ideas have been killed by creators unwilling to stand up when outnumbered by naysayers chanting "that's not the way we do it here". Separate business units tend to be more creative.

C. CLARITY: Free standing business structures tend to break down the harmful cross subsidies that conceal persistent inefficiencies. "Taking One for the Team" by giving a sister business unit a break on transfer pricing seems a great idea when the sister unit is a start up. But these masked financial supports are rarely unwound and the true economic performance of both business units becomes concealed. The strong business seems less strong and it is starved of the growth resources it should deploy. The subsidized business keeps pouring good money after bad while its financial performance is propped up.

This is not to say we should never subsidize a business. Indeed a great strength of the large corporation is the ability to commit resources to sound long term ideas in ways that venture capitalists find frightening. But these investments should be transparent internally to avoid deceptive veiled realities.

To make this decentralization of decision rights work, local management must have the owner-like frame of mind and the training and tools to properly evaluate strategic and tactical decisions. With decentralized authority must come decentralized accountability via incentives that mimic owner like risks and rewards. The chances of substantial wealth creation go up considerably under these conditions.

Prescription for *Internal Capitalism*

To embrace *Internal Capitalism* requires management commitment and the implementation of a straightforward four step process:

1. **Better Understand Investor Expectations**: Evaluate your company, business strategies and performance from the view of a sophisticated buy-side investor and develop an analysis of the public view of your company. Consider views from equity research and rating agency reports to identify perceived opportunities and risks. Collect similar insights on peer companies to serve as benchmarks. What are investors telling you based on the growth and efficiency they have embedded in your share price (not just what they say on conference calls)? Compare to your management plan to understand the gaps in strategy, performance and/or investor communications. Are core competencies appreciated and valued by investors? Market signals can keep management from becoming too inwardly focused and overconfident.

2. **Evaluate and Refine the Business Portfolio**: Which businesses have productive growth options going forward? Have resources been supplied to businesses that create value and withdrawn from those that do not? Evaluate the past, present and future expected growth and efficiency of each business unit. Always consider these analyses "over the cycle" to avoid being overly pessimistic in economic troughs and optimistic in boom times.

   Consider portfolio options such as growing strong business units both organically and acquisitively, and separating poor performers through divestitures and spin offs. Lean toward putting assets to work when times are tough and separating assets when times are good to practice "Buy Low, Sell High", but don't be afraid to separate business at any point in the cycle if they are attracting too much management attention away from the pursuit of growth investments.

3. **Align Strategies with Shareholder Interests**: Value is created when resources are "put to work" earning adequate returns and when assets are sold for more than they are worth internally. The common practice of planning to extrapolate the past with a bit of a hockey stick upside no longer cuts it. Planning needs to directly address growth, differentiation and efficiency.

   Begin with an evaluation of the competitive landscape and the customer's value proposition. Look for underserved gaps and identify a group of potential new strategic initiatives that broaden/deepen market penetration, improve profitability or otherwise materially boost financial performance. Then prioritize and select initiatives based on growth, differentiation and efficiency. The strategic plan establishes a "business case" for each initiative and a roadmap for achievement.

4. **Embed Discipline in Management Processes**: To reinforce the strategy, processes for budgeting, measurement and compensation must be aligned with the shareholder value focus. The very same measures used to develop the strategy need to be the focus of the budgets and scorecards to ensure accountability for execution.

   To motivate owner-like behavior requires incentives based on comprehensive measures of growth and efficiency at the appropriate level of the organization. If suitable, incentives can be multi-year, with money at risk and with serious upside opportunities to simulate ownership inside the organization, but care must be taken to avoid promoting a gambling mentality.

By taking these prescribed steps and embedding *Internal Capitalism*, executives will have the tools and frameworks necessary to deliver the performance demanded by that relentless task master—the shareholders.

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