Fortuna Advisors LLC

Buona Fortuna!

March 12, 2010

Buona Fortuna! is published by Fortuna Advisors LLC to share views on business strategy, corporate finance and valuation.

An *Internal Capitalism* Checkup

How well aligned is your company?

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In his bestselling book, *Good to Great,* Jim Collins uncovers 11 companies that made the leap from "Good to Great." The study was extensive, evaluating over 1,400 companies across a 40 year span. Of the 11 "great" companies, only two materially outperformed the S&P 500 from publication through 2009, and an equal number collapsed during the economic downturn.

We all know past performance is not indicative of future results. Even *great* companies can fail when short-term focus overshadows long-term goals via excessive risk and poor execution.

Inside the company, we need a visible hand to simulate market-like forces to align and focus individual activities and biases.

Overconfidence contributes to complacency, tunnel vision, and muted business cycle awareness. In many companies, strategies are developed and important decisions are enacted based on extrapolations of recent performance and optimism.

A select few companies such as Best Buy, IBM, and ExxonMobil seem to be ahead of the curve, defining the market rather than reacting to it. These industry shapers are most likely to maximize long term value for shareholders.

These companies are set apart from their peers by being more proactive, opportunistic, analytically driven and results-oriented in their approach to strategy formulation, planning, and execution. As an example, in the midst of the March 2009 doldrums, IBM announced a comprehensive growth strategy backed by a large counter-cyclical investment:

IBM CEO Samuel Palmisano told shareholders:

> ***"We are not looking back, we are looking ahead. We are continuing to invest in R&D, in strategic acquisitions, in growth initiatives -- and most importantly, during these difficult times, in our people"***

How is IBM able to be so bold in the face of such harsh conditions? Cynics say "it's because they're IBM." But what is it about IBM? Many companies had the financial stability to withstand the recession and make investments to drive future value, yet most did not.

Leading companies embrace value maximization as the prime corporate objective. They recognize that focusing on value clarifies goals, while allowing greater strategic and operating flexibility on how to achieve those goals, fostering an ownership mentality and culture.

In downturns, most companies focus inward, shedding employees and assets, and curtailing marketing, research, and training investments in an effort to "ride out the storm." While difficult financial times require tough actions, often the response is disproportional to the situation and can damage the company's future competitive position.

Many companies lack a management framework for balancing long versus short-term goals; opportunities versus adversity; and innovation versus accountability. In short, they lack a culture of ownership, a pervasive culture we call *Internal Capitalism*.

Internal Capitalism is a culture of explicitly developing strategies, making decisions, assessing and managing performance inside the company aimed at boosting efficiency, growth and sustainability over time.

To generate sustainable results, corporate leaders must be able to answer the questions: Does our approach direct the firm's resources towards maximizing value? What formal and informal obstacles impede innovation, growth, stretch performance and value maximization?

Internal Capitalism instills the same level of accountability inside the company that investors place on management when they provide the capital needed to operate. *Internal Capitalism* is a systematic management philosophy that aligns the organization's focus with the goal of value maximization and avoids the trap of complacency.

Understanding on how well a company's inner workings reflect *Internal Capitalism* is a multifaceted task since most companies have a fairly complex set of formal, informal and evolved processes for running the business. The following brief checklist provides a starting point for identifying strengths and weaknesses within an organization.

Culture

A well integrated ownership culture creates a substantial advantage for a company. It aids in attracting more qualified and effective employees, adapting to change, and being more decisive in strategic execution. Having an ownership mindset creates power, provides direction, momentum, and accountability inside an organization.

For many companies, the misalignment between the externally stated goal of creating value for shareholders and internal priorities leads to organizational deficiencies, inadequate performance and frustrated employees. Not surprisingly, this is well correlated with investor dissatisfaction.

With an ownership culture, executives are able to articulate a vision that balances the demands of customers, employees, and investors. For example, consider a creative software developer's need for artistic expression, a biotech researcher's desire for scientific recognition, and an industrial engineer's desire to streamline a process. These motivations can be more powerful than corporate procedures and reward programs in driving behavior.

Often, personal pursuits are beneficial to the company. Unharnessed and unfocused, however, motivations of individual employees can be at odds with value creation via wasteful spending initiatives.

Achieving only the benefits of creativity, scientific discovery, and process efficiency may be possible in a small single business company; but these managerial responsibilities become exponentially more complex in large or multi-line businesses. Command and control is ineffective when countless forces are in opposition.

In a true capitalist setting, employees are rewarded when they efficiently and efficiently deliver differentiated products and services that are valued by customers. Aligning the goals of the organization with those of the owners and instilling a results-oriented structure allows freedom in how we get "there" while clearly establishing where "there" is.

Strategy & Decision Making

Inevitably, strategy boils down to making largely unalterable decisions while addressing a never ending series of smaller but collectively very important choices amidst an uncertain and ever-changing backdrop.

Deciding where to compete and deploy resources is perhaps the greatest challenge executives' face. Those that capitalize on the strengths and minimize the weaknesses of the enterprise, allocate resources most effectively and act in a manner that recognizes cyclicality, ultimately create the most value.

A value-based approach to resource allocation ensures all forms of capital are directed toward the highest potential profit opportunity after covering all costs including the required return on capital.

With *Internal Capitalism*, the company's leadership and employees become the *market forces* for the *internal economy*. In the market, Adam Smith described an *invisible hand* that encourages the optimal allocation of resources. Inside the company, we need a *visible hand* to simulate market-like forces to align and focus individual activities and biases.

Being an internal capitalist means at times doing what is right for the company despite an adverse effect on short term earnings. Quite often, the objectives of driving value and driving earnings are well aligned, so there is no conflict. However, when they diverge, management should embrace the correct decision for the long term and candidly explain the decision to investors.

If management is generally right in such decisions, the market will reward the company. If instead, "long term" decisions typically turn out poorly, investors may question management's effectiveness and demand near-term results until confidence in their ability to deliver is restored.

One of the greatest strengths of capitalism is its self correcting mechanism; whereby poor investments and underperforming businesses fail to attract new investment. These poor performers are forced out of business or taken over by new owners who can turn-around the operations.

However, inside many companies, poor performing businesses and initiatives are infused with fresh capital despite their inability to generate a sufficient return. There is often unwillingness to 'unfund' underperforming businesses due to capital allocation processes based on flawed analysis, internal politics or overly-optimistic plans.

These "uneconomic behaviors" appear in many different ways. Take for example, a mining company that doubled its capital expenditures when commodity prices were at an all time high, only to see these assets come online after the commodity prices had collapsed. Predictably, the company ended up selling the underutilized assets 18 months later at a painful loss. Or, consider a life sciences company whose cash flow from its best product was used to fund an ill conceived and poorly timed acquisition. Or the financial institution that provided bridge financing for a mega LBO just before the credit crisis?

The strategy and decision making in these very real situations were not aligned with the interests of owners. The *visible hand* was not present. In fact, it is management's failure to fulfill its role as internal capitalist that allows dissident or activist shareholders to realize gains by taking an assertive, often public role in corporate governance and strategy development.

Performance Assessment and Management

Performance assessment and management capabilities are the compass and rudder used to navigate the corporate ship. In many companies these tools are either misaligned or incomplete and therefore unable to adequately fulfill their functions.

Most companies regularly perform diagnostic activities, re-engineer processes, and implement IT systems as a means of "managing for value."

Yet these activities tend to identify and reduce only a fraction of the value gap. Typically they are too narrowly focused and/or not well aligned and integrated with the key drivers of value.

For example, one common error made in the "shareholder value movement" was the assumption that to drive performance and manage for value, a company only needed to realign its compensation system. This resulted in many companies pushing equity-based rewards deep into the company only to find employees become disenfranchised when changes in the broader equity markets caused the value of these rewards to decline despite taking the proper actions internally.

This exposure to uncontrollable events caused many companies to scrap "shareholder value initiatives."

While compensation may be a key component, it is only one part of the equation. To become an *internal capitalist*, comprehensive performance assessment tools as well as robust end-to-end performance management capabilities connected to the economic drivers of value are required. These tools and capabilities must be supported by continuous training and education.

For example, an IT services company that consistently leads peers in return on capital, yet lags over time in total shareholder returns, or a trucking company that cuts maintenance expense to boost earnings but requires more frequent capex, or an oil and gas company that fails to hedge production when prices are at all time highs.

Hindsight is always much clearer, but an opportunistic and value oriented management team has better management processes that are more likely to identify the gaps and opportunities first.

Final Thoughts

For a company to continually outperform investor expectations, strategies must be explicitly linked to the drivers of value and consistently re-balanced. The capital market, despite imperfections, provides continuous feedback on changing expectations. These expectations are the market's "bet" on a company's strategy to create adequate value after adjusting for potential risks.

While the market often overreacts in the short term, over a long enough period the market is an outstanding aggregator of information and is exceptionally good at separating the winners from the losers.

To achieve the benefits of being an *internal capitalist* management needs to ensure that their internal processes are equally robust and focused on the drivers of value.

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An Internal Capitalism Checklist

Score your company 1, 2, 3 on each of the following questions. Be honest and the insights will be useful. There is a scale at the end to see how well your company advocates a shareholder value perspective.

Culture

1. At all levels of the organization, employees embrace the primary corporate objective as value maximization. It is clear to all employees how their job connects to value creation.

   [ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

2. Senior leadership does a good job of internally simulating *market forces*. Employees at appropriate levels think and act like owners.

   [ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

3. The corporate center is not command and control, but employees are empowered to make good decisions. Empowerment is balanced with accountability.

   [ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

4. Employees generally understand the company's sources of competitive advantage and seek to develop strategies that build and reinforce differentiation in the eyes of customers.

   [ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

Strategy and Decision Making

5. Corporate strategy, resource allocation, capital structure and investor communication are approached proactively, reflect economics of the business and are well aligned with one-another.

   [ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

6. Strategic options are routinely developed and compared on value and risk dimensions, and underperforming businesses or projects are routinely fixed, scaled back or harvested.

   [ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

7. The key drivers of value and their sensitivities are known and embedded in fact based management processes that form the basis for all decision-making.

   [ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

8. Resources are systematically committed to desirable, long-term projects offering the highest potential economic returns even if short-term earnings might suffer.

   [ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

9. Capital allocation decisions are not made in isolation; instead, management considers the economic performance of each business unit in deploying resources to their most highly valued uses.

   [ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

Performance Assessment and Management

10. Investors' expectations are well understood and can be quantified beyond consensus equity research and EPS, and cast in terms of the drivers of value.

[ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

11. Continuous improvement in all aspects of the business is emphasized. Stretch goals are set in excess of investor expectations.

[ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

12. Performance scorecards and management reports highlight key growth and return metrics as well as business specific performance drivers.

[ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

13. Measures, metrics, and reporting are consistent across the strategic and financial management processes with clear accountability and comprehension.

[ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

14. Performance measurement gives adequate consideration to cyclical realities via relative performance benchmarking, allowing accountability to be maintained in a downturn.

[ ] 1: DISAGREE [ ] 2: PARTIALLY AGREE [ ] 3: FULLY AGREE

Add up your responses for the 14 questions and use the following guide to see how your company rates on alignment with the principles of ***Internal Capitalism***:

Score	Comments
14-23	Poorly Aligned
24-32	Partially Aligned
33-41	Strongly Aligned
42	Go ahead, brag about it!