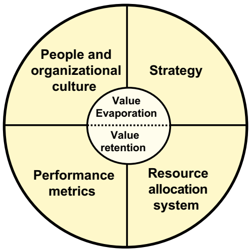

Chapter 1

THE FIRM AND THE VALUE SPHERE: HOW DO WE MAXIMIZE THE CREATION AND RETENTION OF VALUE?

1. The Individual and the Firm

We are routinely inundated with news about exciting new growth companies and stellar mature firms that are earning astronomical returns on their investments. Perhaps the most celebrated picker of such firms is Warren Buffett, CEO of Berkshire Hathaway. *Money* magazine, in its August 2002 issue, reported,

> "But Buffett's strategy of buying and holding big growth stocks with strong franchises has paid off handsomely, with a compound annual return of 24%."

Many believe that one of the secrets of America's economic success is the environment it provides companies to flourish. Indeed, economic growth and national and individual prosperity are commonly viewed as being synonymous with the growth of companies, both mature and new.

But why are firms so important for economic growth?

That is actually a pretty deep question. So, let us step back and first ask: *What is a firm? Why do we need firms?*

Why we may need firms should become apparent when we answer this first question.

1.1. *Jerry's lemonade stand*

To think about this, suppose we have a fellow named Jerry who wants to go into business selling lemonade. He has got all sorts of dreams about his business growing into a national network of lemonade stands and related products with the name "Jerry's Lemonade, Inc." Sort of like Starbuck's Coffee.

But before Jerry invests a lot of his time and money in opening this firm, he must ask himself: "Why should anybody buy my lemonade?" After all, it is not that difficult to imagine potential customers buying lemons and sugar from the grocery store, and going home and making their own lemonade. What can Jerry do for them?

If Jerry is a shrewd businessman, he will realize that his proposed firm is nothing more than an *intermediary* between the grocery store that sells lemons and sugar — which is itself an intermediary between the farmers who grow lemons and buyers like Jerry — and consumers of lemonade. Sort of like your local bank intermediating between borrowers and savers, accepting deposits at 5% interest and lending the same money out at 10%.

Thus, the answer for Jerry is simple. His firm has a reason to exist if he can *add value* for the *customer* beyond what the customer can do on his/her own.

How can Jerry's firm add value?

- By producing a glass of lemonade at a lower cost than the customer can.

Jerry now begins to think about how his firm can produce lemonade cheaper than an individual customer can. This is easy, thinks Jerry, I will buy lemons in large quantities directly from lemon growers rather than grocery stores, and get volume discounts.

Of course, what Jerry must also realize is that the customer's definition of cost includes not just the cost of the materials — lemons, sugar, ice, water, etc — that go into the lemonade, but also the cost of labor. Going to the store, buying lemons and sugar, and then making fresh lemonade at home takes time and effort. By offering the convenience of ready-made lemonade, the customer's time and effort could be spent more enjoyably on other things.

So, if Jerry can buy lemonade-making equipment and train people to make large quantities of fresh lemonade fast, he can reduce the labor that goes into making each glass of lemonade.

Jerry has now discovered *two* ways to make cheaper lemonade — buy inputs in bulk at volume discounts and train people to mass-produce the output at a lower labor cost per unit.

But is there any other way to add value?

- By producing a *better* glass of lemonade than the customer can himself/herself.

That is simple enough, thinks Jerry, but what is better? I suppose it means better quality, but how do I know what that is?

Little does Jerry realize what a profound question he has just asked. In the teachings of W. Edwards Deming about total quality management (TQM), there are many definitions of quality.[1]

In practice, many firms use *manufacturing defects* as an operational measure of quality. For example, Motorola is famous for its "Six Sigma" quality initiatives. In plain English, this means that the manufacturing goal is no more than 3.4 defects per one million opportunities. Variants of this initiative have since been adopted by various firms, including General Electric and Whirlpool.

Should Jerry use this definition of quality to determine how to make a better glass of lemonade? Perhaps he should hear a story before he decides.

RJR Nabisco, the maker of Oreo cookies, was very concerned about the number of broken cookies in each box. After all, such defects indicated shoddy workmanship. People might think Oreo cookies were of low quality. So, the company spent millions of dollars on a comprehensive quality improvement program to reduce the number of broken cookies in each box. And they succeeded in fixing the "problem."

Did it help? Not really. Sales did not change much, and neither was Nabisco able to charge a higher price.

What went wrong?

The answer is that Nabisco misdiagnosed the problem. They adopted an *engineering* definition of quality. This definition says that quality is consistency or absence of variation. Thus, quality is the pursuit of ever smaller numbers of "defects" or smaller tolerances.

But what is the only definition of quality that matters?

By now, Jerry has caught on. "It is obvious," he says, "the only thing that matters is what the customer defines as quality."

This is known as *user-based quality*. It is a *subjective* definition of quality, and it says that the sole legitimate judge of quality is the customer. In the case of Oreo cookies, Nabisco ultimately discovered that its customers did not care about the broken cookies. It was how the cookies tasted to them that mattered most. In fact, many parents liked to eat *just* the broken cookies and leave the whole ones for their kids. After all, there are no calories in broken cookies, are there?

So, why do not more firms rely on user-based quality in their TQM programs?

Because it is hard! Engineering-based definitions of quality are easy to quantify and set targets for. Human nature is such that it is easier for people to focus their attention on measurable and quantifiable things. On the other hand, operationalizing user-based quality requires a deep understanding of the customer. In particular, it calls for understanding *how* the customer makes purchase decisions.

[1] W. Edwards Deming, *The New Economics*, MIT Press, Cambridge, MA 02139, November 1993.

But Jerry is not daunted by such challenges. He realizes that understanding his customers is the key to his future success. He is going to have to think about how to do this. And while he is at it, he is also going to have to understand how the different parts of his future organization are going to work together in a harmonious process to create value. For this, he is going to have to understand the concepts of value creation and organizational process maps.

2. Organizational Process Maps and Value Creation

An *organizational process map* is a pictorially descriptive summary of the manner in which value is created by an organization, and the *value-added* roles played by different agents.

Every organization should have one. Few have really good ones.

A good organizational process map should help the organization to:

- clearly link its strategy to the various activities that add value, so as to define the role of each activity in adding value through execution of the strategy;
- communicate to its employees the danger in people optimizing their piece of the value-added chain at the expense of the entire value-added chain and
- quickly pinpoint activities that have, over time, become peripheral to the value-added chain, and should be candidates for divestiture.

An overall organizational process map for any firm would look like Fig. 1.1.

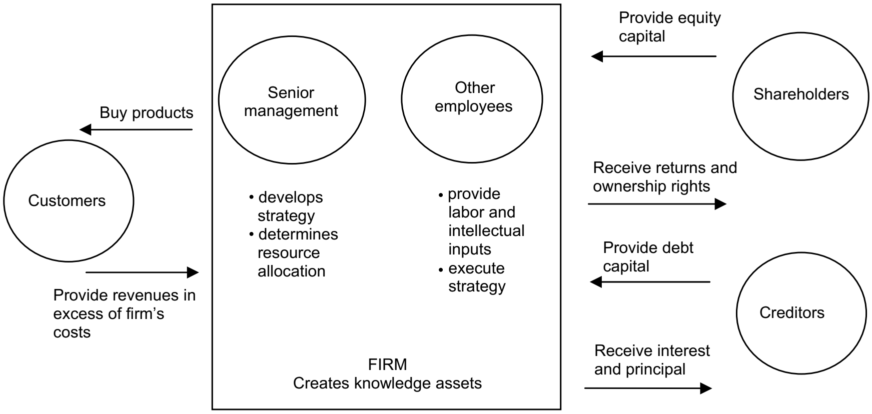

Fig. 1.1. An organizational process map.

Of course, an operationally useful process map would be loaded with far more detail than this.

What our aspiring business tycoon, Jerry, has to understand is that any firm is merely an intermediary between its customers on the one hand and the providers of capital (financiers) on the other.

Financiers will not provide debt and equity capital unless they expect to earn a return on that capital that is at least as great as that which they can earn elsewhere if they took the same risk.

Not all financiers are the same, of course. Jerry's Lemonade has to promise a higher expected return to its shareholders than to its creditors (banks and bond-holders) because the shareholders bear more risk; creditors have priority over share-holders in receiving payment from the firm. But the point is that shareholders will not provide Jerry with equity capital unless they are promised an expected rate of return commensurate with the risk they are taking. The same holds true for the creditors.

So Jerry has to work backwards, in a sense. He must first figure out how much it is going to cost him to produce the volume of lemonade he wants to sell. This requires estimating all of his operating costs, including materials and labor. He must then figure out how much capital he will need to invest, and how much of it will come from outside shareholders (equity) and how much from creditors (debt).

Once he has a handle on all his costs and his capital outlay, Jerry can calculate the revenues he will need to generate to ensure that his shareholders and creditors receive the returns they are expecting. Capital has a cost too.

Since Jerry also knows the number of glasses of lemonade he hoped to sell when he began this exercise, he now knows the price he must charge for each glass of lemonade so that he can earn the desired revenue.

If Jerry provides good products and services, his customers may be willing to pay this price.

But what if they are not? After all, this is a brutally competitive world, and people watch every penny they spend. It is not easy to charge customers what you would like, especially when the market is served by many able competitors.

This is where Jerry must open his organizational process map, and look carefully at each value-added activity and what it costs:

- Can some of these activities be cut out or reorganized? (Process rationalization).
- Can we make more lemonade with fewer people? (Labor rationalization).
- Can we outsource some of the things we planned to do in-house? (Asset rationalization).

Jerry has only two (not mutually exclusive) choices. He can either bring his costs down so that the price at which customers are willing to buy his lemonade is high enough to generate a revenue sufficient to yield his financiers their desired returns. Or he can figure out a way to get customers to pay a higher price. Jerry learns that this is what corporate strategy is all about.

3. Strategy and the Unending Quest for Value Creation

If he is going to start a new company, Jerry realizes that it will be his responsibility to develop the right strategy for the company.

What would the "right" strategy do for the company?

Jerry has an instinctive feel for this. He knows that cost efficiency is the "price of admission," a necessary condition for being competitive in business.

But it is ultimately a dead-end street. If customers are not willing to pay much for your lemonade because every mall and little shopping center in town has a store that sells lemonade that customers like at least as much, then Jerry will never be able to cut his costs enough!

The key, Jerry knows, is to come up with a way to make customers believe that his lemonade is better than everybody else's. Jerry's mind wanders off to the story of how Howard Schultz created Starbucks.

As recently as 1987, coffee had the status of a "pure commodity" in the United States. Simply put, this means that price was the main dimension along which the major sellers competed with each other. And these sellers had a core belief that price was all their customers cared about.

Maxwell House, owned by General Mills; Folgers, owned by Procter & Gamble; and Nescafé, owned by Nestlé; accounted for 90% of the US coffee market, and were engaged in a vigorous competitive battle.

However, the overall market for coffee was in a downslide. As Americans drank less coffee, sales of all three major brands kept shrinking. Eager to prevent further erosions of their sales volumes, the major players poured millions of dollars into advertising.

They even introduced premium brands, including whole-bean coffee, in an attempt to improve margins.

All of these activities were tangible manifestations of a *common strategy* employed by the three major competitors. The strategy was simple. Provide the cheapest possible coffee to the customer in as many grocery stores as possible, and use as much advertising as affordable to attract the customer's attention.

The strategy was predicated on the basic assumptions that: the target customer base was the entire grocery-buying public, the way to differentiate one product from the other was on the basis of national brands and price, and that the customer wanted mass-produced, long-shelf-life ground coffee at the lowest possible price even if the coffee was mediocre.

Did the strategy work?

No. The whole coffee industry was declining by 1988. United States coffee consumption had dropped to 1.67 cups per day, down from a peak of 3.1. General Foods lost $40 million that year on its domestic coffee business. And Procter & Gamble, even though it was winning the market-share wars, was faced with vanishing profit margins.

Enter Howard Schultz.[2] He was a buyer for Starbucks Coffee Co., a seller of whole-bean coffees in Seattle. On a trip to Italy, Howard saw the enormous social appeal of roadside cafes selling high-quality latte, espresso, and cappuccino. The aroma of these coffees would waft through the streets and attract throngs of people for whom these cafes were a focal point of social interaction.

After unsuccessful attempts to get his bosses back home to support his idea for opening similar cafes in Seattle, he decided to go it alone. He served Starbucks' coffee at his first cafe, opened in 1986 in Seattle.

By 1987, Schultz had bought out his former bosses and put the Starbucks name on three cafes.

By 1994, Starbucks, then national in scope, had a market value of over $1 billion and in 2005, the market capitalization reached $18 billion. Much of this growth came at the expense of the major players who were plying coffee as a commodity.

Starbucks, on the other hand, was earning handsome margins. People were paying more than $2 for a cup of coffee. The assumption that coffee was a commodity and that price is all that mattered to the customer had been proven to be spectacularly wrong.

What enabled Starbucks to create value where others had failed?

The answer, Jerry realizes now, lies in *strategy*. Schultz's strategy was the complete opposite of that of Procter & Gamble, General Foods, and Nestlé. His strategy was based on the assumption that people would pay the price if the coffee was viewed as so different from — and superior to — what customers could buy in the grocery stores that he *would not even have to compete* with grocery-store coffee. And he also did not view his customer base as the entire grocery-store public.

He had a different customer base in mind. His customers, at least initially, were the upwardly-mobile professionals, many of whom had been to Europe and enjoyed the fine coffees over there. They would pay, he reasoned, if he could deliver the

[2]For further details on the Schultz story, see Adrian J. Slywotzky, *Value Migration*, Harvard Business School Press, Boston, MA, 1996.

"total experience" of fine coffee. This strategy completely changed the rules of the game. Starbucks has now evolved into a "community," offering wireless Internet access and music downloading in some locations.

Jerry knows he must come up with a similar strategy if he wants to create *real* value. But what defines a good strategy?

A distinguished expert on strategy once said, not entirely facetiously, "A good strategy is one that works!" If one looks at the numerous *ex post* accounts of successful corporate strategies in books on the subject, it is hard to argue with this statement. In hindsight, it is easy to have 20-20 vision.

But Jerry wanted something more. After studying numerous successful strategies, from Avon in the 1960s and 1970s to Disney in the late 1980s to Starbucks in the 1990s, he concluded that a good strategy must satisfy the following five conditions:

- It must be simple, so that everybody in the organization can understand it, relate to it, and internalize their role in executing it. As a product of the television age, Jerry thought that a good strategy must have a "two-minute" sound bite that captures its essence. That way employees would not have to refer to a manual every time they wanted to know what the company's strategy was.
- It must clearly define what the company will do and what it will *not* do. There are far too many flowery (and very wordy) statements of corporate strategy that are conspicuously silent about what they commit the corporation to *not* do. They are not worth much. The goal of a good strategy must be to guide corporate resource allocation. As a wise observer once said, "Having a strategy means being able to say no to good ideas."
- It must be closely tied to the way capital and other resources are allocated in the business.
- It must be clearly tied to the key *value drivers* in the business.
- It must differ enough from our competitors' strategies to give us a distinctive competitive advantage.

For Howard Schultz and Starbucks, the key value driver was the superior quality of the coffee as perceived by the customer and the whole coffee experience.

For Walt Disney & Co., the value driver was the firm's creative output, as reflected in the films it made.

The value drivers differ from firm to firm. But the fact remains that strategy must be anchored by these drivers. Figure 1.2 illustrates this point.

So, Jerry's strategy must reflect his knowledge of what the customer is really buying when he orders a glass of lemonade at Jerry's Lemonade, Inc. This knowledge is essential to crafting a value-creating strategy.

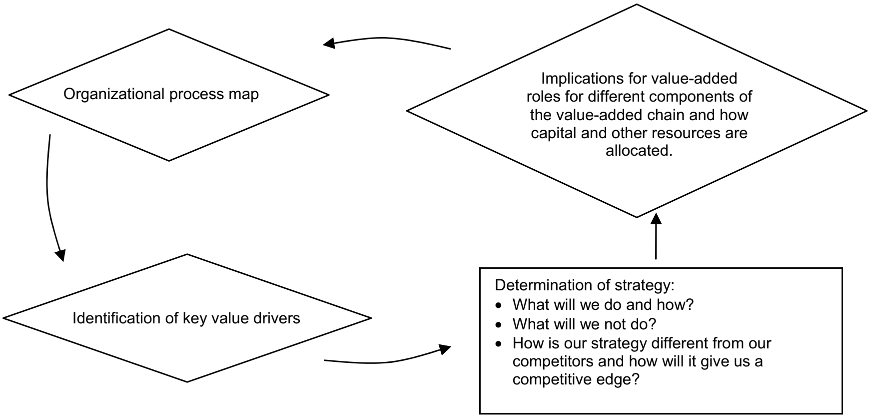

Fig. 1.2. Linking value drivers to strategy.

4. Executing the Strategy: Resource Allocation

Once Jerry comes up with the right strategy, he must worry about executing it. Execution of the strategy means a number of things for Jerry. For example, he must decide:

- where to locate his stores;
- what production process and associated equipment to use;
- what customer segments to attract with advertising;
- how to price his lemonade and
- the number of stores, the size of each store, and common interior design to use.

A large part of Jerry's strategy execution is going to boil down to the *magnitude* of the resources Jerry will commit to the business, and *where* these resources will be allocated.

A smart financial analyst once said, "When I want to understand a company's strategy, I do not read what the CEO says. I look at where the *capital* is being allocated."

It is fairly obvious that the decisions Jerry makes about capital allocation will influence how much value his business will create.

Between 1987 and 1991, Wal-Mart invested huge amounts of capital in expanding its business by opening many new stores. The company had a *negative* cash flow in each of those years because it was investing more cash than the business was generating. This was achieved by borrowing additional amounts from banks and raising more money from the shareholders.

The key was that Wal-Mart was investing all this capital at a rate of return that was about twice that available in similar-risk businesses. The consequence was a *five-fold* increase in Wal-Mart's shareholder value over this short time period.

What made all of this possible?

There were basically two reasons for this phenomenal value creation. First, Wal-Mart recognized that the key value driver in its business was how fast it turned over its inventory.[3] That is, how high its asset productivity was. Simply put, Wal-Mart recognized that the faster it moved products through the value chain from its suppliers to its customers, the more money it would make with less invested in inventory relative to sales, even if this meant sacrificing a bit of its profit margin.

There is an important lesson for Jerry here in executing strategy. Do not get hung up over profit margins. It is not that there is anything wrong with high margins. But sometimes you can create more wealth by lowering your profit margin and increasing the rate at which you move your product inventory through the value chain.

Second, Wal-Mart explicitly tied its competitive growth strategy to this value driver. The whole business design of the company was focused on maximizing asset productivity, with major contributions from information technology and logistics. Moreover, this business design also involved expanding the number of stores to further exploit scale economies that would facilitate an increase in the rate at which the company could turn over its inventory assets. Thus, capital was allocated to opening new stores and warehouses to stock these inventories.

There is another lesson for Jerry here. Once you have identified a value driver that is pivotal to the success of the business, invest as much capital as you can to exploit that value driver. Stop investing more only when the marginal return on investing that capital equals its marginal cost.

If Jerry faces a cost of capital of say 10% and the return on investing this capital in opening a new lemonade store is 15%, it would be unwise for Jerry to get timid and decide not to open the new store.

5. Executing the Strategy: Value Evaporation, Value Retention, and the Value Sphere

What may be less obvious to Jerry is that the capital allocation system he designs to execute his company's strategy should also have another goal: minimizing *Value Evaporation* and maximizing *value retention*.

[3] The two key asset items on Wal-Mart's balance sheet were its stores and its inventory. Wal-Mart, which owns most of its stores, was rapidly expanding its number of stores during this time.

By Value Evaporation we mean the literally countless ways in which a company's value creation is diminished due to poor decisions in *executing* the strategy. Thus, strategy creates value but some of it evaporates due to poor execution and other organizational frictions. What remains is value retention. Given a strategy, our goal should be to maximize value retention.

To understand Value Evaporation, we start with the assumption that the strategy is right and, therefore, value creating. Thus, if there is any loss in value due to a poor strategy, it is *not* part of Value Evaporation. Here are a few examples of Value Evaporation.

- Consider the following conversation between two managers in a company:

"You know, I have this equipment I'd like to purchase, but I have exhausted my annual capital budget," says the first manager.

"That's why God invented leasing," replies the second.

Managers in many companies routinely circumvent the rigors of their internal capital budgeting processes by pouring millions of dollars into leasing equipment. They mistakenly think that leasing is somehow fundamentally different from investing capital. Unfortunately for the shareholders, leasing ties up debt capacity just like borrowing the money would. If buying the equipment was a bad idea, it is very likely that leasing is too.

- Here is another fascinating conversation:

"You know, it looks like we won't be able to invest in this project after all. Management says that the return is not high enough to justify the investment, given all the other projects that are competing for funds," says one manager.

"Perhaps not. But if you tell me how high a return management wants, I could rerun the numbers to see if we can get there," responds the other.

How many companies invest huge amounts of capital in projects that never yield the rates of return they promised? Every company we know has a hurdle rate for project acceptance — the minimum acceptable rate of return on the project — that is at or *above* the cost of the company's capital. It is the only thing that makes sense.

Common sense says that if you only invest in projects with expected rates of return above your cost of capital, on average the company should earn a rate of return on its assets that exceeds its cost of capital. But what do the facts say? Hundreds of large publicly-held firms routinely *fail* to earn enough on their assets to cover all of their costs, including the cost of capital. For example, in 1993, stellar firms like Procter & Gamble, BellSouth Corporation, Mobil Corporation, and DuPont fell in this category.

Why does this happen? Is it because these firms did not have good strategies? No. A good strategy is necessary to create value. But it is not sufficient. It cannot prevent the evaporation of value.

Think of a tropical village that is perpetually short of water. So, the villagers come up with a strategy. It involves digging a big hole in the ground to create a reservoir of water from natural rain. The strategy works. The reservoir fills up. But the villagers forgot how mercilessly hot the tropical sun can be. The reservoir did not last very long. Evaporation returned its water to the atmosphere.

For the villagers, what matters is not just how much water was there in the reservoir initially, but how much is *retained* after evaporation. The same is true for any organization. Its goal is to come up with a strategy that maximizes *value creation*. But it must then follow up with *performance metrics*, a *resource allocation system* and an *organization culture* that minimize Value Evaporation, and maximize *value retention*. This is shown pictorially in the **Value Sphere** in Fig. 1.3. Moreover, the Value Sphere must be synchronized, i.e., each of its elements must be attended to and made consistent with each other.

All this is quite a bit for Jerry to think about. The issues are getting more complex as the plot thickens. The question is: What gives rise to Value Evaporation and how do we minimize it?

Fig. 1.3. The Value Sphere.

The rest of this book is devoted to answering this question. Our goal is nothing less than making Jerry's Lemonade, Inc. the next Starbucks.

The basic theme that guides the remaining chapters is that as the global marketplace becomes even more fiercely competitive, we believe the concept of the Value Sphere will become a core element of an integrated approach to improving competitiveness. We will show Jerry how he can go about developing the Value Sphere for his company. The different elements of the Value Sphere must be synchronized with each other. The resource allocation system must ensure that resources are allocated in a way that executes the strategy. The performance metrics must incent people to behave in a way that furthers the execution of the strategy and minimizes Value Evaporation. And the organization culture must help maximize value retention. In each chapter we will highlight the element of the Value Sphere that is the subject of that chapter.

Main Lessons

- The only definition of quality that matters is the customer's.
- Once we understand how the customer defines quality, an organizational process map should be used to identify the value creation chain and the critical value drivers in the business.
- A clearly-enunciated corporate strategy must be simple and tied explicitly to the critical value drivers.
- The key to creating value and maximizing its retention is to create a Value Sphere that harmoniously balances strategy, resource allocation, performance metrics, and organization culture.

End-of-Chapter Exercises

1. How does your company define quality? How was this definition arrived at? What evidence do you have that this is how your customers define quality?
2. How do your competitors define quality? How different is your definition of quality?
3. Is it an advantage or a disadvantage for you if you and your competitors define quality in exactly the same way?
4. Do you have an organizational process map?
5. What is your company's strategy? Does it meet the five conditions identified in this chapter?
6. What are the key value drivers in your business?

7. What exactly is the link between these value drivers and your strategy?
8. Can you list the five most significant ways in which value is being evaporated in your company?
9. Do you know how to stop this Value Evaporation?
10. Examine the different parts of the Value Sphere for your company. Are they synchronized?

Practice Problems

1. What is the Value Sphere and why is it important?
2. What are the consequences of a Value Sphere that is not synchronized?
3. What are the requirements of a good strategy?
4. What is a value driver and what is its importance in the formulation of strategy?
5. What is Value Evaporation?