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. . . .
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> 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

> these companies totally miss their primary calling, which is to stick to the business of creating value.[16]

That value was created over time, helped by a healthy respect for the balance sheet, as the sale of bottling assets demonstrated. Crucially, a rejection of "instant" value—"overnight," as Goizueta put it—prevented managers from becoming shortsighted:

> If our mission were merely to create value, we could suddenly make hundreds of decisions that would deliver a staggering short-term windfall. We could gouge our customers and suppliers. We could cut salaries and benefits. We could stop behaving like good corporate citizens. We could even put our business up for sale to the highest bidder. But that type of behavior has nothing to do with sustaining value creation over time. To be of unique value to your owners over the long haul, you must also be of unique value to your consumers, your customers, your partners, and your fellow employees over the long haul. That is why I am against a scorched earth adherence to profit at all costs.
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> I am against slashing today to boost the numbers tomorrow, with no regard to what happens the following day. Certainly, harsh competitive situations can sometimes call for harsh medicine. But in the main, our share-owners look to us to deliver sustained, long-term value.[17]

Within a year of that supreme statement of shareholder value focus—a paradigm of the value mindset—Goizueta had died. He had earlier claimed that more than 99 percent of his personal wealth was tied up in Coca-Cola shares. In other words, he was an owner, and he thought like an owner. Therein lies one of the keys to the value mindset. It is not necessary to be an owner, but to think like one is crucial.

Sadly, Coke's overriding focus on value creation did not survive this extraordinary American. The following year, Coca-Cola ceded first place in the Stern Stewart/*Fortune* value ranking to Jack Welch's GE. The year after that, both companies had to step aside, as Bill Gates's Microsoft claimed the laurels. Table 1.2 demonstrates that in the three years after Goizueta,

Table 1.2 Capital Employed by Coca-Cola and Pepsi-Cola ($ billions), 1998 to 2000

	1998	*1999*	*2000*
Coca-Cola	15,976	18,815	20,230
Pepsi-Cola	20,448	15,076	14,876

Coke's use of capital soared, even as Pepsi's capital employed began to come under control.

How could Goizueta's legacy have been so swiftly frittered away? The fact is that Goizueta was a pioneer of the value mindset. The strength of Coke's brand survived him, but not the value culture. Like a prophet in his own land, Goizueta's achievement was not honored by his successors. Coke's progress in creating value after Goizueta faltered. Goizueta's successor, Doug Ivestor, unaccountably scrapped Coke's value-linked incentives and its unparalleled focus on value creation. Even at Coke, complacency set in.[18]

It is no coincidence that Four Seasons also demonstrates a determined focus on capital allocation. An important part of the company's strategy is to maintain the strength of its balance sheet. Its latest annual report (2002) claims:

> Accordingly, the Corporation intends to continue to be disciplined in the allocation of its capital. . . . The capital investment plans for the Corporation remain focused on allocating the majority of its deployed capital for investment opportunities that are intended to establish new long-term management contracts in key destinations or enhance existing management contracts. Investments and advances will only be made where the overall economic return to the Corporation justifies the investment or advance.

This, again, should come as no surprise when we learn that 58.52 percent of the shares in Four Seasons are owned by the company's own employees. They employ capital as owners—carefully and rigorously—because they are owners.[19]

Together, Isadore Sharp's Four Seasons and Coca-Cola, at least under Goizueta, give us the themes that inform this book. They illustrate the basic tenet of the value mindset—the compelling tendency for managers and other employees to think like owners, with all that follows from that, including the efficient use of capital. And, using a value mindset, they suggest that there might be potential for reorganizing companies to create enhanced value, in the form of strategic reconfiguration.

NOTES

1. The gist of the parable was that when it comes to the talents awarded to you, you must use them or lose them. The tale's genius is that in Biblical times, talents were not only the form of human capital familiar to us, but also a unit of currency. Failing to invest either for fear of the risk is craven.

2. "We are suspicious of those CEOs who regularly claim they do know the future—and we become downright incredulous if they consistently reach their declared targets. Managers that always promise to 'make the numbers' will at some point be tempted to make up the numbers." Annual letter to Berkshire Hathaway shareholders, 2002.
3. Four Seasons annual report, 2002.
4. Ibid.
5. Ibid.
6. Ibid.
7. Joseph A. Schumpeter, *Theory of Economic Development* (Somerset, N.J.: Transaction Publishers, 1980). Schumpeter, one of the greatest economists of the twentieth century, saw economies as constantly being "disrupted" by technological innovation, resulting in long waves of industrial activity.
8. On August 25, 1997, to delegates at Coca-Cola's world bottler meeting, Monte Carlo.
9. The ranking was based on Market Value Added (MVA), which is the difference between a company's enterprise value—the net debt plus the market value of equity, which is the number of shares multiplied by the share price—and the capital a company employs. In other words, MVA is the wealth created for investors over and above what they invested.
10. John Huey, "In Search of Roberto's Secret Formula," *Fortune*, December 29, 1997, 230.
11. David Greising, *I'd Like the World to Buy a Coke: The Life and Leadership of Roberto Goizueta* (New York: John Wiley & Sons, 1998), 75.
12. "Hardworking and thrifty, Señor Cantera impressed on the young Roberto the importance of cash and an abhorrence of debt." Ibid., 7.
13. Ultimately, Coca-Cola bought back about a third of its shares at an average $11 each in one of the most aggressive and extended repurchase programs in the history of corporate America. Since Buffett sat on Coke's board, Goizueta was tremendously encouraged in this kind of value-creating practice. Coke at that time was Warren Buffett's largest holding, and Berkshire Hathaway is still Coke's largest investor, with 200 billion shares, or 8.119 percent of the total.
14. "The compensation system was the key to driving shareholder value. . . . It completely aligned bottom-line productivity with the stock price": Herbert Allen, chairman of Coke's compensation committee, quoted in Huey, "In Search of Roberto's Secret Formula," 230.
15. Coke's arch rival, Pepsi, followed this value-creating move, but not until well over a decade later, in 1999.
16. Roberto Goizueta, "The Real Essence of Business," speech to The Executives' Club of Chicago, November 20, 1996.
17. Ibid.
18. Warren Buffett can be wrong. In his 1997 annual letter to Berkshire Hathaway shareholders, following a touching tribute to Goizueta, he added: "The Coca-Cola company will be the same steamroller [in terms of shareholder value]

under Doug [Ivestor] as it was under Roberto." Buffett's reticence on the subject of Coke's performance in subsequent letters to shareholders speaks volumes.

19. Employee shareholdings are not universally successful, though, as United Air Lines demonstrates. In March 2003, after the airline filed for bankruptcy and after nine years of 55 percent employee ownership, enough employees sold shares to push their stake below 20 percent, triggering the official demise of the United States' most extensive experiment in employee ownership.