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RESOURCE ALLOCATION STRATEGIES

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Maximizing Shareholder Value

- o What should management try to do to ensure increase in shareholder value over the long term?
- o How can alternatives be analyzed?

What Business Should We Be In?

- o Identifying strengths to build on.
- o Establishing diversification philosophy and approach.
- o Techniques for building and managing a portfolio of businesses.
- o The role of mergers and acquisitions.

MR. LAWRENCE V. DURLAND, JR.: The first subject for this session is Maximizing Shareholder Value. I hope that that doesn't mean there are just people from stock companies here, because what our instructor is going to say also has application to mutual organizations.

The instructor for this session is Richard A. Furniss, Jr.* Prior to joining TPF&C in 1978, Mr. Furniss was associated for 11 years with William E. Hill and Company, a general management consulting firm, where he was vice president, member of the executive committee and director of corporate development services. Dick's consulting experience includes a broad range of diversification and acquisition planning assignments for banks, investment bankers, mortgage bankers and other financial institutions. He lectures frequently on the subject of corporate development. Dick received a master of business administration degree from The Wharton School.

MR. RICHARD A. FURNISS, JR.: You might have noticed in that introduction, conspicuous by its absence, no reference to the insurance industry nor any reference to actuarial training. So, I would like to say that I am neither an actuary nor do I even pretend to be an insurance expert. If my remarks have to do more with the manufacturing of widgets or the selling of stocks,

* Mr. Furniss, not a member of the Society, is a Vice President of Cresap, McCormick and Paget, a division of Towers, Perrin, Forster & Crosby.

that's because that's where most of my experience lies. However, my colleagues in the insurance industry tell me that the general principles are the same and that maybe after 20 years I will begin to learn how insurance companies work. Please bear in mind that what I am talking about is general return on investment type of strategic planning for asset allocation in any industry. The principles and items that I've learned working in this area for a great number of companies and industries apply across the board.

The context of any resource allocation program or strategy, or even any thinking about resource allocation, cannot start in a vacuum. In many companies, my own included (I've been involved in management of my own organizations in the past), people tend to lose sight of why they are there. You wouldn't think they would, but people do. It's just something where everyone assumes that, "Well, we know why we're here, we'll go on now to figure out where the best places to put our resources are."

However, we think it's best to go back and start at ground zero when taking a look at your portfolio of businesses, and restate your organization's mission. These missions usually express, in one form or another, the obligations of the organization to its stakeholders. (Stakeholders, if any of you have been in strategic planning, is the new buzz word replacing shareholders.) Previously, we were in business only to serve our shareholders. Now, for better or for worse, we have to take a look at some of the other constituencies and make sure that our organization is at least taking their interests into consideration. Obviously, the owner of an enterprise, at least in pure capitalism, is why we're all there. We may be the owner, or we may be management serving an owner, but the interest of the owner has to be important when we come to work in the morning. The owner of an enterprise can make the mission anything he wants. Where we have single-owner companies we see some strange, or at least out of the ordinary, missions.

However, most of us work for enterprises that have a variety of shareholders, and money -- in one form or another -- is the basic mission. Money for the shareholders. Policyholders, whether you are a mutual or a stock company, have to be considered as a constituency. If you are a mutual company, the policyholder is interested in low cost, and you have an obligation to give it to him. You also have an obligation to provide safety, service, and whatever else your policyholder is looking for.

Employees also have to be looked at as a stakeholder. Companies place different priorities on different sets of stakeholders. There are companies that, if you peel away what they say they are doing, are really in business for their employees, and they're hoping the shareholders won't notice. Other companies seem to neglect their employees completely and do everything they can for their shareholders. In any event, you cannot run a business without taking into account what the employees want out of life and their jobs. Customers obviously have to be considered also; so does the community that you're operating in. There are all kinds of constituencies out there that may have no business relationship at all to you but to whom you have some kind of obligation.

The government has become an extremely important stakeholder in all of our companies, and there's probably no end to their increasing interest in our businesses. Companies that neglect their vendors or suppliers are running an important risk. You have to be concerned about the demands of management

and labor unions in structuring a strategy. There are any number of stakeholders to whom some consideration must be given.

However, the most important mission of virtually every profit-making enterprise is to maximize the shareholder value over time. No matter how long a mission statement you write about your concerns for the public and your policyholders, employees and community, maximizing shareholder value should be your main concern -- because without it you cannot take care of the rest of them. Companies that spend too much time worrying about employees, management, customers and vendors, often find themselves out of business. Without the primary focus of an enterprise being on the shareholder and his value over time, then all the other stakeholders are not served very well.

Your shareholder is whoever owns the net assets of the company. If it's a mutual company it's your policyholders, if it's a savings and loan association it's the members of the association. Obviously, if it's a stock company it's the formal shareholders. Many strategies have been developed whose goals are not entirely focused on this. Without this goal, you are running the risk of shortchanging (over time) the other stakeholders. That statement, incidentally, doesn't get universal agreement. It seems very obvious, and it's what we all learn in Economics 101, but out in the real world it isn't always so.

QUESTION: *Can you give me an example of that?*

MR. FURNISS: Without naming names, I've been involved with companies where the culture has built up that our customer is the most important person on earth, and we're going to serve our customer if it kills us. We're going to give him the absolute best quality, and we're going to give him the lowest price. We forget about the bottom line. All of a sudden our profit margins begin to erode, we don't have the money to put into research and development and we are out of business. It's a shifting of emphasis from the bottom line over time to some other measure of performance, like customer satisfaction. The customers are very happy right up until the time they're offered another product, and when they switch to it you're suddenly out of luck.

There are many companies where, when you get right down to it, management is running the business for management. There are big salaries, very little demands on management, people come to work late and go home early, and the stock doesn't trade particularly well. For example, one company found itself in a situation where there were no demands, there was no spirit and nobody ever got fired. The stock was held (this was a very large public company) in large blocks by pension funds who were most unhappy with it, but couldn't dump it. All of a sudden an aggressive, unfriendly acquirer came in and bought the company, fired management, made the pension fund very happy, turned the company around and made it very important. The former management is all gone.

It's a problem of misplaced priority. We're wrestling right now with this short-term/long-term focus in American industry. What I described earlier about customer service may be a very valid strategy, and you may want to do it quite consciously because you want to build a position for the future and forget profits this year because you're trying to build customer loyalty now which you can use later. Well, that's all right, as long as you're doing it for a conscious reason.

MR. DURLAND: To make it specific to the insurance industry -- a number of companies have looked for growth for growth's sake, have forgotten the bottom line, and some of them have ended up in liquidation or in the hands of the State Insurance Department. If you are interested in growth, there are different ways to grow and different costs associated with each. The growth versus profit dichotomy, especially in this industry, can produce disastrous results if you lose sight of Dick's statement.

QUESTION: Can you give an example of that as it relates to mutual companies?

MR. FURNISS: In my limited experience in the insurance world I have seen examples of that in mutual companies -- where there are no clear-cut shareholders to answer to. The shareholders are an amorphous group of policyholders and their demands, in the past, may not have been particularly stringent on financial performance. The policyholders are interested in safety, service and some dividends, but management becomes paramount in the hierarchy of the stakeholders. That usually doesn't work over a long period of time. It may take them awhile, but people get smart. There are some savings and loan associations that forgot about financial performance, forgot about the shareholders really, and they are dying.

In the absence of specific identifiable shareholders -- such as a partnership or a one-person firm whose goals may have to do with improving the world we live in -- the best thing to assume is that your shareholders want cash. They may want other things, such as social values, but basically they want cash in one form or another. They may want the stock they buy today to go up so they can sell it. That's cash. They may want dividends paid out, that's cash. They may be willing to take the present value of future payouts. Shareholders are patient, particularly large shareholders who cannot move in and out of the market. They're willing to wait and mentally discount the future earnings from an enterprise. In a mutual company the owners do want lower policy costs. Shareholders or owners of companies may really be running the company to sell it down the road, and there is nothing wrong with that. They will realize their cash by the sale or liquidation of the company. If you are both owner and manager you take your returns in salary; it doesn't matter whether you call it profit or salary, it's cash to you as the owner/manager. So, there are various ways to measure this cash, but by and large it's cash.

My colleagues in the insurance industry tell me that measuring shareholder value for insurance companies isn't too much different from the way we measure that value for widget companies. It's just that the words are different. When you are valuing an insurance company, you have a book value just like widget companies do, and then you have a value for business-in-force, which is really a future value. It's a stream of earnings that you're going to get sometime in the future, but it's business that's presently on your books and it can be measured. The first one can be measured down to the penny, if you're willing to make assumptions, and the second one can be approximated. The third component is the value of the profits that can be generated by your marketing organization, your image and reputation, and it's future earnings from business that is not yet on the books, but that can be assessed and at least some number put on it.

As you may know, among other things, TPF&C designs long-term incentive programs. That isn't my area directly, but the stock option and the stock market have not been particularly popular methods of long-term incentives in the past few years because "the stock market doesn't recognize the value of my company." So there has to be some other way to pay people. In a sense, the stock market knows exactly what the value of a company is, and because of general business conditions the stock market has not been willing to value many companies very highly lately. But it is true that the stock option is not a particularly good way to motivate executives, primarily because it has a finite beginning and a finite end and on the day that it's granted or the day it is exercised there may have been sun spots, or an assassination, or general market decline, or the price of oil may have risen. They get the price out of whack and unable to track long-term performance of the company. So to replace the stock option we have designed a measure of financial performance that simulates the stock market, excluding all extraneous factors. What we're trying to do is to arrive at a measure of financial performance that management can control. We then use that for an incentive plan, but more important, we use it for managing the business and for allocating resources.

What we have found is a very high correlation between a smooth stock price and two measures. One measure is real return on equity or return on equity less the cost of equity. In other words, what are you doing for your shareholder relative to what he could get from a balanced portfolio of stocks? The second measure is growth in equity. We find that those two measures correlate very well. You notice that we don't use growth in earnings per share, which for years was thought to be the major reason we're all in business. Let's get those earnings per share up every year and our stock price will go up. Well, it did for awhile but it wasn't because of earnings per share, it was for other reasons. Growth in earnings per share and stock price haven't correlated for five or six years. Stock prices have gone down while earnings per share continue to go up. It is real return on equity and growth in equity that correlate best. Those are the two things that we, as managers, can affect.

Leverage factor means the multiple of book value that your company's going to sell at in the stock market. If your company is selling at book value it's a 1.0 (Figure 1). It is earning its cost of equity (defined as risk-free rate of return). Cost of equity is not an internal rate of return, it's the shareholders' expected rate of return from a balanced portfolio. So, if you are earning exactly the cost of equity, then the investor is neutral whether he puts his money into your company or somewhere else, and you sell at book value. To the extent that you can earn more than your cost of equity, then you will sell at a premium and your company is worth more than its book value of assets. Very simple. If you're losing money -- in real terms -- you'll sell at a discount.

Growth in equity means, to the extent that you can earn a positive return on your equity by skillful allocation of your resources (if you can earn a positive return), you should grow your equity. The shareholder would rather have you keep the money and not pay it out in dividends. The more you retain the better he likes it. This has to be tempered with the real world where dividend policy enters into it but, in theory -- and actually it is borne out, but most financial officers won't hear of it because you have to

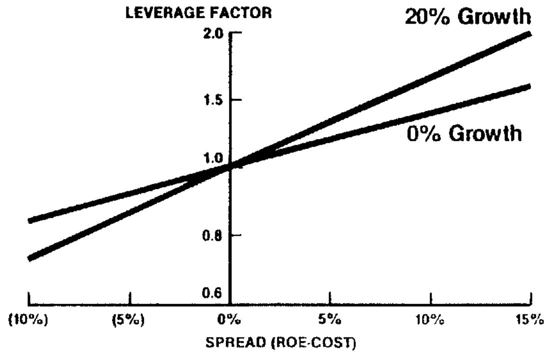

Figure 1

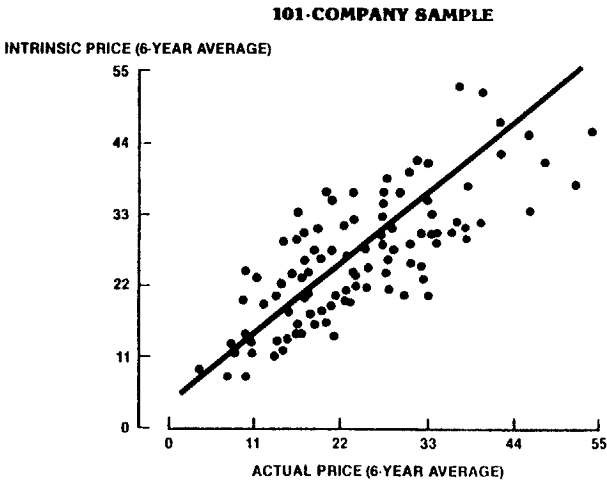

Figure 2

pay dividends -- the higher the return on equity the less dividends you should pay out. Pay out nothing and your stock will sell at a higher premium.

Conversely, if you're earning less than the cost of equity, pay out all of your dividends and liquidate the company. The faster you grow your equity, the worse it is; companies growing very fast showing a negative return will sell at a greater discount. If a company is growing at 20% but is earning a negative spread, it will sell at a greater discount than another, which is paying out a lot of its dividends and retaining none of its earnings.

Not only does it work in theory, but it's nice to know that it works in practice. We have calculated what a stock ought to be by our formula and we've calculated the actual price over six years and we find a reasonable correlation (Figure 2). So it works. We're using this now in designing long-term incentive plans based around, not the stock market price as in an option scheme, but a theoretical price which then over time can pay managers for how well they earn a return on their assets. Regardless of what the stock market says the stock is worth, the manager cannot affect the ups and downs of the stock market or the ins and outs of his industry, but he can affect how much he earns on his net assets -- that's what we're paying him for.

MR. DURLAND: Figure 2 includes financial institutions, and thus it includes the stocks of some life insurance companies. So the correlation is not just with industrial stock, it is with the market as a whole, including life insurance companies.

MR. FURNISS: It does work. Over time investors want to make money. Incidentally the cost of equity now is around 14% or 15%. The Treasury Bill rate is about 9%, and you add a risk premium of about 6%, which is about a 15% return. All of us who are making less than that are really eroding our shareholders' money. But we find a very real correlation between this, and it's across the board, it's not just manufacturing companies.

For those of you who are interested, the formula is shown in Figure 3. It's the capital asset pricing model. There are two components to the value of a company: the net asset value and discounted future earnings. The stock market assumes a future growth rate and discounts those earnings back to arrive at the price. One important determinant is what you did in the past. So, the better you can maximize these returns the better value the stock market is going to put on your price. The variable "g" is simply the growth rate in equity, which has to do with how fast you retain your earnings. If you earn 5% a year and retain all of it then you'll be growing at 5%. The variable "Rf" is the risk-free discount rate and it's not a particularly sophisticated formula. Some of my consulting colleagues have built their whole basis for strategic planning around this premise, that every strategic business unit in the company ought to maximize the overall rate of return and growth of the organization. Once you've divided your company into the strategic business units that can be broken apart, you then analyze each one of them in terms of its real return on assets and revalue the assets to reflect what they actually are, and those that don't measure up, you dispose of. It is a strategic planning tool, and it was a strategic planning tool before it was a compensation tool.

CURRENT COMPONENT

FUTURE COMPONENT: PRESENT VALUE OF "REAL" FUTURE EARNINGS

$$\begin{aligned} IMV = BV/Sh_0 &+ BV/Sh_0 \times (ROE - K_e) \times \left[\frac{1+g}{1+R_f}\right] \\ &+ BV/Sh_0 \times (ROE - K_e) \times \left[\frac{1+g}{1+R_f}\right]^2 \\ &+ \cdots \\ &+ BV/Sh_0 \times (ROE - K_e) \times \left[\frac{1+g}{1+R_f}\right]^n \end{aligned}$$

Book Value/ Share in Valuation Year

Spread (ROE — Equity Cost)

g = Equity Growth Rate
R_f = Risk-Free Discount Rate

Figure 3

ORGANIZATIONAL MODEL --- A FIT BETWEEN

Key Success Factors What we must do well.	and	Distinctive Competencies What we can do well.

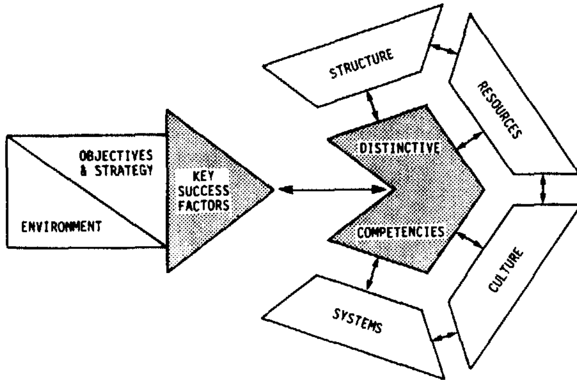

Figure 4

I would like to talk about asset allocation -- primarily, what businesses you should be in. I'm not talking about shifts in your basic business, I'm talking about looking at whole new business areas, and trying to decide if the dollars you are entrusted with are presently in the right place. To maximize shareholder value they have to be in businesses that are inherently profitable. They should be businesses that build on your strengths, otherwise we're talking primarily about investment strategies. A lot of diversification is investments under another name. Buying a free-standing company and letting it run itself is an investment strategy. There's nothing wrong with that, particularly if you're a little short on transferable strengths.

Ideally, you should allocate your resources to get some kind of leverage by doing what you're good at now. This allows you to get some competitive advantages over people that don't have those strengths, and to pay more than someone else might want to pay for the same business because it's worth more to you. Also they ought to be businesses that you can enter and manage. All managers cannot manage all businesses. If you're talking about entering a business from the point of view of actually diversifying, you'd better be able to manage it if and when you have to, even if you don't intend to do so in the beginning.

When I started in consulting in the sixties, diversification was a virtue in its own right. If you remember, in the mid to late sixties if you were diversified it was good and if you weren't diversified it was bad. We then learned in the early seventies that if you were diversified it was bad and if you were in one business it was good. Diversification isn't good or bad. It's a state of being, and if your present-based business isn't meeting your mission and goals, then you'd better move out of it or add things to it. Therefore, you become diversified. The only real virtue in diversification is risk. If you get clobbered in one business and you're diversified, you have another business to fall back on. There are difficulties in running a broadly diversified portfolio of businesses.

In deciding on a diversification philosophy, or really in establishing one, start with what are you trying to accomplish and measure it both financially and otherwise. Before you even set about diversifying you might ask what the prospects are in your present business. If there is nothing wrong with them, and they do what you want them to do, then don't diversify. There are many "greener grass" diversification strategies where companies simply get tired of their own business. All they see are the problems and they say, "That business over there -- it's got to be better than the one I'm in." Then they get into it and they find out that, sure enough, it isn't. I'm afraid a lot of change is encouraged by consultants because whenever there's a change we tend to make money. Companies are now beginning to shrink back. We never did any divestitures in the sixties. In the seventies, we did some and we're continuing to do divestitures, helping companies decide on their core businesses. We never had core businesses until a few years ago. We always wanted to be in many things, but now we're coming back to finding those few things that we do very well, where we make money, and we concentrate and focus on those.

We also should ask what resources we have. This isn't really an across-the-board audit or inventory; it's more focused. What are the resources that we have that are applicable in other businesses? If you can bring something to the party, you've got a leg up on the other people that are also trying to

get into that business. Executives have realized that there are many things that a lot of us aren't good at -- and why try to make money doing them?

Your strengths and weaknesses can be used to measure alternatives. Profitability is a good place to start, since it's either the first or the last thing you do because it's really determined by many other factors. You have to decide what you're trying to accomplish. Earnings growth is important to everyone, return on investment is probably the best single goal, if you had to pick one. It's the thing that we use most in the industry. Resource allocation is simply return on investment, and return on investment is measured by the cost of the investment. Size is important too. If you're a big company you need to do a big thing to have a measurable impact. If you're a little company you don't. This determines the kind of business you can be in. If you're a big company you don't get into a business that's never going to be big. It may be profitable but it won't be big. You have to factor size into your planning at this early stage, because it has a lot to do later on about the kind of businesses you're going to enter.

Many people forget cash needs. I mentioned earlier that cash is what shareholders want. They don't want earnings. They can't spend the earnings that the company made and retained, they can only spend the cash that they as a shareholder receive when they sell that stock or when the dividends are paid out. Many companies, particularly smaller companies, have found themselves in high-growth businesses that they entered by spending all the money they had. All their earnings had to be reinvested, and then some, to keep up with change in the manufacturing world. It's often been the need for more and more reinvestment in new technology. In the insurance world it's even simpler. If you're going to grow it costs money. Growing insurance companies are cash users, not cash generators. If you're going to keep up your market growth strategy, you have to keep putting more cash into it. So these kinds of things have to be thought out ahead of time and used as criteria and screening.

The financial criteria are probably the easiest. In some ways they are the most fun because you can be very precise and you can run models and put them on a computer and play with them. You can put all the scenarios in and many people get all caught up in it and spend all their time worrying about profitability goals and then look for businesses that meet those financial criteria. The next category is more important and much harder. That's the one that has to do with finding things that you bring something to, those that also meet the financial goals but that are compatible. I've got three buzz words: profitability, compatibility and feasibility. Compatibility is the business characteristics that make it something you can either contribute to or at least understand. It has to do with such things as image. If you're going to lend it your corporate identity, this may preclude things that make plenty of money. Or it may lead you into things where your corporate identity is a plus. What kind of markets does this business you're thinking about serve? Where are the other elements of synergy between your company and another company? For example, you always have to have good data processing management information in the insurance business. On the other hand, if you get into the cosmetic business, it is consumer marketing that is critical. That's all there is -- manufacturing costs are irrelevant. Distribution is not particularly important. Research and development is not particularly important. It's consumer marketing, that's the critical thing in the cosmetic business. Every business has a few things like that, and those things ought to be identified and understood ahead of time.

Finally, there's feasibility. Theoretically sound and well-argued elegant strategists often forget to look out in the real world. An attractive business may be identified, but you may not be able to get into it. It's dominated by people now and the prices are so high that you can't afford it. For instance, I did a study once for a company that had virtually no strengths of any kind except money. It was basically a holding company that did not know how to run anything. We identified for them one of the world's best businesses -- the soft drink bottling business. It runs itself, Coke and Pepsi do all the work for you, and you have no competition from anyone that you have to worry about. All you have to do is run a small labor force and the business coins money. Unfortunately, it costs 20 times earnings to get into it. It is worth more to someone who is already in it than it is to someone getting into it, because you combine contiguous franchises and combine plants. While it met all the other criteria -- our client could run it and it would meet all his financial needs once he's in it -- he couldn't afford to get into it. At least didn't think he could and so he decided not to. That's the price of entry.

Then, of course, the regulatory issues must be examined and they are changing all the time. They are particularly important in the financial services business. But while they are important, they're not clear. They're clear today but it isn't clear what they're going to be tomorrow. There the strategy, of course, is to get all ready to do something that isn't feasible today, because it probably will be tomorrow, and if you're all ready to do it then you will have the jump on other people. So that's something that has to be considered.

Consultants always have models for things. We developed this model (Figure 4) for organization planning and found it's got application everywhere. On the arrow side of it, we have the business environment that the organization is operating in and the objectives and the strategy to accomplish whatever its mission is. These lead to key success factors, which are those few things that you have to do well to succeed in your strategy given your environment. There is also a picture of a company, or an enterprise or division. The four things on the outside define your resources, which interact to create certain things that you do well. If those things that you do well coincide with those things that you must do well, then everything is fine. If they don't, then something better be changed.

We think this is a useful model for inventorying your strengths and weaknesses. Strengths and weaknesses, while everyone understands it, is a misnomer in a way. We don't mean strengths and weaknesses as much as we mean strengths and limitations. If you're not very good at dreaming up consumer advertising campaigns with singing jingles and lots of television sponsorship, it isn't a weakness in your present business if it isn't needed. It is, however, a limitation and therefore you might not want to go into a business that requires it. So while we call it weaknesses when we're looking at resources, it shouldn't be looked at as weaknesses because we're considering new businesses. We're trying to identify things you're good at and identify holes in your set of overall resources that might preclude you from getting into certain businesses.

The organizational structure has to do with whether a company is centralized or decentralized -- whether it's organized geographically, whether it's organized functionally, and how your responsibilities are arrayed. If you're a highly centralized company with decision making focused at the top,

that isn't good or bad but it is a given. If you are thinking of getting into a business that requires a great deal of authority and autonomy at fairly low organizational levels, you might want to think about it. It's something that you're not now organized to do. An objective assessment of how you're now structured will have a lot to say about the kinds of businesses that you're going to be comfortable with later on.

The "resource" box in Figure 4 sums up many of the resources that we're talking about bringing to bear. Organizational structure is not so much a resource as it is a framework or a way of arranging resources. The most important resources, other than financial resources, are human resources. This, of course, is what all of the conglomerates neglected back in the sixties. They neglected the management skills that were needed to run these businesses they were getting into when they got into trouble. The markets changed and the millionaires they had created decided to go to Florida and stay there. The conglomerates with their lean corporate staffs they are so proud of suddenly found themselves with lawn sprinkler businesses, motorcycle businesses and cosmetic businesses and the former owners/managers were still in Florida. These businesses were out of control, and they didn't have the management resources in their lean corporate headquarters to go out there and run them. It has a lot to do with why companies are beginning to look much more carefully now at their own internal management resources, not only in terms of numbers of people but the kinds of skills their managers have and their abilities, background and spans of control.

Physical resources could be defined as your geographical location. Where do you have an established office and infrastructure? Where are you known? Technical resources could be anything from a very good data processing system to patentable technology. The marketing resource is extremely important in the insurance industry, and many companies are trying to build diversification strategies around it. Can they move through their marketing and distribution system to capitalize on their customer position? It's an extremely important resource. Image is another resource. Insurance companies are typically very well connected with the financial community and can raise money -- they know how to raise money. Many other companies don't know how to raise money -- they don't have the relationships established. So there are all kinds of things that can be looked at that may be given and that you may be used to because you live with them every day, but in the context of new businesses they could be very real resources.

The hardest resource to define is also the hardest one to change and is probably the most important organizational element -- culture. It is the one we try to change last because you really can't change it. We certainly can't change anything as consultants. We can't even recommend that you change your culture. We can recommend that other things be changed in light of the culture and that programs be initiated to change the culture over time, but it is probably the hardest thing to get your hands around. It's probably the easiest thing to see but the hardest thing to describe and the most important constraint in terms of diversifying. It has to do with traditions, not only in the business of the company but in the industry. The insurance industry has a set of traditions totally foreign to the automobile industry. There are values and beliefs that grow up in an industry and in a company that are there forever. Even new chief executive officers cannot change cultures overnight. It can happen over time but it takes a very long time. It has to do with the value systems in a company. What do people think their bosses want them to do? There are a lot of companies

where growth was the way the old man built the business and the old man said if we go out there and sell more widgets then that's all I want -- growth. Long forgotten is profit and return on investment and everybody is out there for growth. If you're suddenly trying to shift, for instance, to a stable market, a declining market or a mature market, growth is the old culture you have to shift.

It's an enormous wrench for a lot of companies to try and shift their focus or culture in their environment. There probably are not two ends of the financial spectrum farther apart than mutual insurance companies and investment bankers in terms of culture: both are financial services companies, but the values and the ways you make money and what you do when you come to work in the morning are pretty different. But this isn't any great surprise to most of the large insurance companies who are moving that way. It is recognized, pretty well accepted and understood. But it has got to be causing some wrenching conflicts and changes within the two organizations when they try and merge.

QUESTION: Can you give me an example of how change comes about?

MR. FURNISS: Yes, we have a particular kind of situation now where growth has been literally the way the old man built the business. It's a two-billion-dollar business, but it's the way the old man built it. Marketing was the most important part of the company, and you had to sell more this month than you sold last month or you were in big trouble. The industry matured a few years ago, but the company is still operating as if it were growing.

Now at the top the problem is fairly well understood, but down in the trenches this culture is so embedded that they don't know how to handle the product development necessary to keep up with a market that has matured. Their manufacturing people aren't low-cost oriented, they're high-volume oriented. Once you get below the platitudes of the strategic plan, the pronouncements of the president, and the clear understanding of the senior management, you get down in the trenches and the old culture is still there.

One way to change it, oddly enough, is through changing incentive plans. This company's incentive plans were under review and we found that many of them were oriented around shipping tonnage and not around, in effect, making profits in the new environment. Now we're trying to shift the measurement for the incentive plans to cost-cutting so that people are paid to cut costs, not to ship tons. But it's hard, and top management has to support it, line managers have to support it. Changing the culture of an organization almost always follows a change in the chief executive officer. A strong CEO can affect the culture in a fairly short time. A weak CEO could never change it, and one in the middle just takes longer.

Some companies, of course, recognize this need for cultural change in making acquisition or diversification to accomplish it. One way to do this is to add a new piece that already has the appropriate culture and hope by osmosis it will affect your company. Often it does. A new hard-charging, highly motivated management team can often be brought in and change an all-stable, mature, business-as-usual team. Often the combined company is better simply because of the cultural change.

MR. DURLAND: Culture is very difficult to change. The example that Dick just gave presents a very difficult situation, because you create a conflict within the new combined organization. You have to make sure that the existing culture does not smother the values and practices that were desirable in the newly acquired organization.

MR. FURNISS: Risk is a very important subject to management and I've read many articles in the management press about how American managers are risk adverse and how they're paid to be risk adverse. They figure out that the value system rewards them not for taking risks and succeeding, but for avoiding failures. I think there is a lot of truth in that. They realize that their downside is a lot more severe than their upside for taking a chance, so they don't. In some businesses that's fine, in others it isn't. It ought to be something that you recognize ahead of time, before you think about getting into a business that requires risk taking.

If you decide, after taking this inventory, that you are not right for Business A, that doesn't necessarily mean that you should not go into it. However, it does mean that if you do go into it, go into it with the understanding that things are different there and you'd better not try and change it to look like you. Going into a new business in a small way that's quite different from yours often fails, because you tend to tuck it into some subordinate position in your company and overwhelm it with your systems and reports and your need to do things the way the parent does them. Often too-small companies, just by definition, don't have management infrastructures that lend themselves to growth. That's often why they're small, because they are one-man shows. A one-man organization is not a very safe way to get into a dramatically new business. It's too much risk on that one man being able to build something under him. So, if the business you're moving into is quite different it tends to argue that you better do it in a big way. Or, at least, in a self-sufficient stand. What we call a stand-alone kind of a way.

Finally we come to the systems, the wires and paperwork that hold the company together. This becomes a very real resource for a lot of insurance companies. Most American industries don't have the information-handling capability that the insurance industry has, which includes the more formal systems of management reporting, internal communications, financial reporting, budgeting and the informal communication system. The grapevine is a given in all companies and has to be viewed as something that is there to start with and the question is what are we going to do with it when we're looking at new businesses.

There is a set of criteria that we use to actually screen investment alternatives. One of our clients was a fairly profitable business that wanted a return on invested capital of 15% to 20% and average earnings growth of 10% to 15% -- fairly high targets. They wanted real growth above inflation, wanted low reciprocality, and had $30 or $40 million to spend. This helped to define the kinds of businesses they wanted to get into. They wanted to make the investment of $30 or $40 million and then wanted it to break even from a cash-flow point of view. They didn't need any more cash but, on the other hand, they didn't have any more cash to put in. This pretty well defined the financial criteria that we used to search for alternatives. This company was not a risk taker, but they wanted moderate risk, whatever that means. Moderate doesn't mean anything until you actually put

something like genetic engineering at one end of the spectrum and Treasury Bills on the other, and then try to determine alternatives and see where you are comfortable.

In this case, we decided to concentrate on what not to do. This company had been a holding company and didn't have much hands-on management experience, so we tried to define a lot of negative factors that we could use to screen alternatives. We did not want to get into a business that required very specialized individual knowledge. We didn't want to be in the popular music business, for instance, because the only way to succeed in the popular music business was to have a guy who knows what people are going to buy. It isn't technology; it isn't distribution; and it's not even the value of your label. It is someone who can pick tomorrow's rock star. We didn't want a business that required an individual to make it go. We wanted something that could be, at least to a certain extent, institutionalized so that basic, readily available management talent could make the business fly.

We did not want a business that was based on highly technical factors for success because management wasn't comfortable dealing in areas that they didn't understand. The decisions to run the business and build it for the future would have to be made on the basis of trust. You'd have to trust the head of research and development who says that you need another $10 million to put into Project X and it's going to pay off.

This company was very uncomfortable doing anything other than selling everything at list and paying list for everything, and they didn't want to even have a hint of any kind of under-the-table dealing or sharp practices or anything else. They were not comfortable with consumer advertising and wanted to keep a very low profile. They did not want to be based on vulnerable supply relationships which, unfortunately, has happened to some companies where you get into a business and you are dependent on one supplier.

Now these criteria were not necessarily absolutes. Some criteria became absolute, while others are simply things they'd like to have. They didn't want a business that was regulated to constrain profitability, but they didn't mind it being regulated to encourage profitability. There's less of both these days, but there's certainly more constraints on profitability than there are to encourage it. They did not want the business to be sensitive to inflation or deflation. Who does?

What they wanted were things where the factors for success are management-dependent, where if you worked hard and had bright people you could get ahead and you didn't have to hope that the business environment would make you get ahead. You didn't have to hope that some kind of commodity price would go up because that's the only way you could make money. You had a lot of value additives, something that you bring to the whole manufacturing chain to make it more profitable, and that you can do better than the next guy.

Now we get into some criteria that are much harder to define but they wanted to put them in because they had read Michael Porter's book, which I suggest all of you read. They had just read it, so they all wanted to put these things in about achievement of competitive advantage. That is nice and we all want to do that -- to allow a high degree of control over destiny and establish a defensible position. They didn't want to be at the mercy of

someone else. You obviously want to be able to defend yourself against your competitors. They wanted high barriers to entry and low barriers to exit and all the things they've gotten out of Chapter 8 of Porter's book. They are all good things to have, but you can get too long a list of criteria and spend all of your time analyzing things, and then you don't go anywhere either.

Geographic factors happen to be important. This company was in an out-of-the-way place, but they loved it there and they didn't want to be anywhere else. It wasn't a requirement that their new business be located there, but if it was somewhere they could get to and back in a day, that would be desirable. It became a perquisite that they wouldn't have to be away from home too much. Regionality was also important because they were very comfortable dealing with state and local governments. The business that they had been in before had built an expertise in working the intricacies of local governments. It would be an advantage for them to be in a business that required getting approvals for things and working them through the local government. This was one of the few strengths they had. They also happened to have a tax position that favored real estate investments, so if the business had real estate it would be an advantage. It didn't have to because they had a separate real estate investment strategy underway.

It was fairly important though to have this acquisition as a base for the future. They didn't really want to make a one-shot acquisition. They were fairly young and they could see building a business that would grow for quite a long time. This wasn't just a one-shot acquisition into a good business that didn't allow them to go any farther. So, if it allowed them to go farther and actually built quite a large business, that would be good. And then finally, they didn't want to start this business internally. They were in a hurry and for many reasons they would rather acquire someone than start this business internally.

After reviewing the criteria, we identified four businesses that were attractive acquisition candidates. The temporary-help business is a very attractive business -- although we haven't looked at it lately. Industrial components -- that's a buzz word for specific kinds of companies that we were looking at. Hospital supply distribution turned out to be a good business -- even though it is getting harder and harder to get into, there are still opportunities. And then, as I said, soft drink bottling turns out to be one of the world's best businesses, if you're willing to pay the price of entry. We looked at each of them against each of their criteria. None of them fit perfectly, although all of them met the financial goals. We decided that basically these four would be the businesses that we were going to pursue.

So the criteria not only screened the universe, but they served a very important internal management purpose: to get managers on board early on. If any of you are involved in developing resource allocation strategies for your company, I would suggest that you set up a program that gets the decision makers on board right from the beginning. If they don't sign off on the mission, then you'd better go back and rethink it with them until they do. Then they'd better sign off on your resources, strengths, limitations and criteria. Because if you do all of that yourself and then go back to them, you'll never get anywhere. But, if you get them to sign off on the criteria, you can array a new business direction against the criteria and show them how well it meets it, and you will be way ahead of the game.

There's always someone that's not going to like a new business and often it's a very important person. It's much easier to do nothing, stay in your own business and not make any investments. Unfortunately, consultants will be glad to help you do that, because we're hired to find things wrong with something and we can always find something wrong with anything. So, not only should you get all your criteria laid out in as much detail as possible and get them agreed to, but you should be comprehensive about looking at everything. These four candidates came out of a look at virtually the whole world. If you've looked at everything it makes it more difficult for someone in your senior management to say, "Well, that's a great business you've found finally, but what about something else?" You have to then be able to say that the "something else" was considered and explain why it won't work.

Here is an example (Figure 5) of diversification alternatives for life insurance companies in which we have arrayed them on a target. This doesn't mean that the world revolves around individual life companies, which someone thought I was trying to say. What it means is that if you array alternative businesses in terms of how similar they are to your basic business, and you happen to be in an individual life company, this is what it might look like. You could then say, well, if I'm going to diversify and I think staying close to what I know how to do now is a virtue, then the farther I get from the center, the worse it is. Now you can take each of those businesses and look at it in terms of all the other criteria. You may understand all there is to know about the annuities business, but you may decide that it doesn't meet your criteria. Maybe you can't make any money in it because there are too many other people in it, or maybe it doesn't fit your distribution system, but you can look at each one of these things and move slowly outward looking at each of those businesses against your criteria. Most of you will recognize that those are real diversification moves by life insurance companies. Some insurance companies have decided to diversify outside the sphere of the things they know best, but are still in areas where they think they can make money.

There are a lot of ways to diversify, and there is absolutely nothing wrong with diversifying through internal efforts, particularly if it's fairly close to home -- you can simply hire people. You can add products with a slight shift in emphasis from your marketing organization, and you can begin to serve new markets and achieve diversification. A more common way of doing it -- certainly a larger, faster and less risky way -- is to acquire someone. Then you know what you have because, if you do your homework, you know the record of the people that you've acquired. Acquisition may be more expensive, but there's less risk.

Joint venture is an interim way to enter a new business. It's usually not a good way to stay there. Very few joint ventures survive forever because the goals of the two partners cannot be expected to stay parallel forever. Sometimes they do, particularly when the two partners are in quite different lines of business with each supplying something that is important to the joint venture. Often offshore companies will use joint ventures to get into the U.S. and get a feel for the U.S., but as I tell both partners, you'd better not expect it to last forever because if your overall goals and objectives aren't different now, they probably will be.

Divestiture is a very real part of corporate resource allocation. It's the other side of the coin. Divestiture is no longer an admission that we

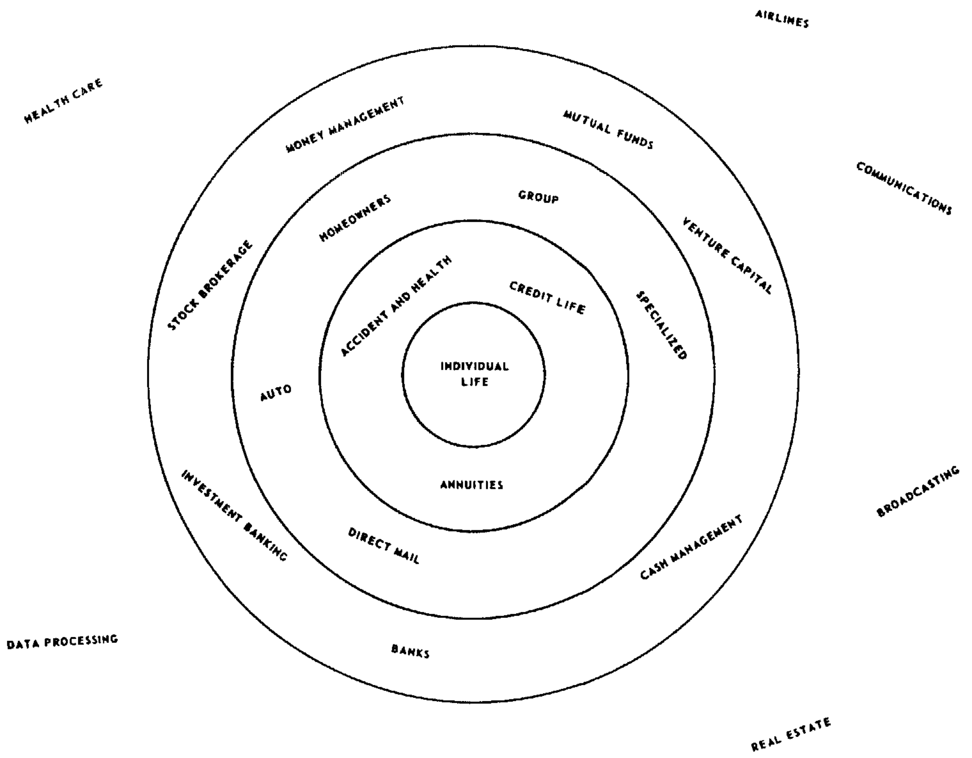

Figure 5

failed. We've also learned in our compensation studies that the average life of a CEO is five or six years. So in five or six years you'll have a new CEO and he can redirect the strategy and it's not an admission of failure, it's just a redirection of strategy. So, many very good businesses are being sold, or are available for sale, or could be spun off -- not necessarily because there's anything wrong with them. People use to say we're selling this business because "it doesn't fit our strategy," and what they meant was that our strategy includes being profitable. But now there are good profitable businesses that are being spun off because they don't have the right growth, or they're so far apart that it isn't worth the management effort. That's a very big, unreal and unquantifiable aspect of running diversified businesses -- you get a little business somewhere and it can take a great deal of management's time to make sure it's running right. So dispose of it and concentrate on large things where you can get some management leverage out of your talents.

Often we find divestitures where there is a significant cultural difference. The subsidiary is a very strong company growing better than the corporation as a whole and doesn't require any management from the corporation, except that they're whining and complaining about compensation, procedures or meetings. The corporation would rather dispose of them, and the subsidiary would rather be spun off because they'd be happier either in another home or off by themselves. So, there are many reasons to look at your portfolio to see how you might make it more harmonious. There are of course legal considerations. An obvious one would be the broadcasting business where you can only own a limited number of stations -- you might want to sell one. Or, if you're in the newspaper business you cannot own newspapers and radio stations. I'm sure there are a lot of things in the financial services business where if you dispose of one business, then you can move to another.

To sum up what I've been trying to talk about today, shareholder value over some time period is really what ought to be used to generate the diversification alternatives and to compare these alternatives in terms of whether or not you should get into them.