Strategic Management Centre
Members Meeting

29th June 2022

Minutes of Meeting

In attendance

Paul Barrett	Babcock
Shane Bottcher	D S Smith
Carl Bourne	Rolls-Royce
Wouter DeKlein	Shell
Florian Huber	Helvetia
Gavin Jackson	Babcock
Eirik Pitkethly	BP
Rob Turpin	ABF
Richard Woods	D S Smith

From the Strategic Management Centre

Stephen Bungay
Neil Monnery

Value Management

The meeting was devoted to Neil Monnery's work on value management. It consisted of three parts: a summary of the principles of value management and what makes it distinctive; the implications of managing for value in the current environment; and some new reflections on the kind of leadership team that is most likely to be successful in the future.

The Holistic Value Manager

Only a minority of senior executives consistently manage for value. This group follow a distinctive set of principles. Value managers embrace long term value creation as the ultimate measure of corporate success, rather than as one of several measures. They do not think about value creation as a trade-off, but are dedicated to building intrinsic value over time.

Warren Buffett has called intrinsic value 'a number that is impossible to pinpoint but essential to estimate'. Common proxies are long term TSR and EPS growth, but neither captures it fully. In Buffett's words, in the short run the stock market is a popularity contest, but in the long run it is a weighing machine.

The most common counter-intuitive belief of value managers is that growth in and of itself is not a driver of TSR. Only profitable growth is likely to create value. When developing innovative new products or services it can be hard to know if the resulting growth will be profitable or not, but the attempt must be made, based on realistic expectations about future cash flows.

Value managers also understand that what matters is not the industry you are in or your past performance, but what you do to affect the future. The opportunity to create value exists in every industry and additionally there is no 'memory effect' – outperforming in one period does not improve the chances of outperforming in the next. Whatever hand you are dealt, you start with a clean slate and have an equal chance of success or failure.

They also recognise that creating value means both making the right choices and delivering on them, so they do not separate strategy and operations. Successful strategies are situation dependent and the quality of execution can make all the difference.

One member asked if managing for value was in conflict with ESG requirements. Neil replied that in his experience there is no inherent conflict. Sometimes indeed it can help. Measurement is critical. Offshoring to China can make ESG numbers look good, but in fact it does not help the environment and probably makes it worse, as well as being long-term value destructive.

Another member asked about the timeframe. How long do you have to wait? Is the market response a lagging indicator? Neil replied that there was no set answer, but he himself ignores the one-year reaction, takes notice of the three-year reaction and takes the five-year reaction very seriously. Buffett's writings offer some useful guidance about this. The important thing managers can do is to create a clear, transparent narrative that the market can understand and follow. Simon Wolfson's annual reports for Next are a good example. He uses management financial metrics and statutory financial metrics as a common form of communication.

There is an enormous difference between the best and worst performers. Between 2001 and 2011, about 25% of the FTSE 350 destroyed value, and 40% earned below the rate of inflation. This represents a tremendous failure, paid for largely by pensioners and holders of life insurance policies. The top quartile, in contrast, earned 9.1% pa against inflation of 3.1%. The average (mean) was 5.5%.

This is true at the sector level. Neil's analysis of the UK retail sector from 2003-14 shows that out of 30 companies, the ten that created the most value turned £1 into £9 over the period. The average group turned it into £2.35, weak performers managed £1.27, and there were 13 value destroyers who lost money for shareholders or actually went bankrupt.

Median TSR outweighs industry performance, and there is no correlation between TSR and sales growth, or historic ROS or even RONA. Even future ROS/RONA shows only a weak correlation. This is because the essence of value management is skilled capital allocation, which involves an understanding of the balance sheet as well as the P&L. Effective value managers improve returns on existing assets, shrink or abandon businesses with poor returns and allocate resources into new value creating activities. They ask: 'what do we have to do in order to be top-quartile?' Poor performers spend money on ineffective operational improvements, invest in weak businesses without improving their position and fail to shift resources into new opportunities. They ask: 'what can we do to fix problems?'

There is no pattern to the steps value managers take. In some cases, they make a large number of small acquisitions, in other cases none or, if their industry is already concentrated, a few big ones. They control capital centrally so that they can invest or disinvest in entire businesses rather than just projects, and their benchmark for returns is the cost of buy-back.

For example, when Neil was strategy director of W H Smith, the top team invested heavily in the smaller but faster-growing travel business – the stores located in airports – and disinvested in the large but declining high street stores. They managed themselves out of certain lines, such as DVD's, in the face of much resistance. A more conventional view would have been that the core high street business was in trouble and needed investment to reinvigorate it, whilst the travel business needed no help. This was indeed the policy of the previous management team.

To make value management work, management incentives must be aligned. For example, someone in charge of a shrinking business might be rewarded for generating the maximum amount of cash whilst exiting. CEOs like Simon Wolfson eschew bonuses but have large shareholdings.

Neil has developed a model of three different sets of practices. In comparing Wolfson's practice at Next with Justin King's at Sainsbury (a weak value creator), Wolfson's practices were all clustered in the value focus column and King's spread around the other two. Over the period, Next created seven times more value than Sainsbury:

Next and Sainsbury illustrated different approaches well

Managerial Focus	Goal Focus	Value Focus
Wide range of objectives	Handful of key goals JS	Unambiguous objective of value creation NEXT
Objectives a mix of ends and means	Levers support key goals JS	Neutral on levers of value NEXT
Balanced business scorecard	Clear link levers to goals; unclear how to trade-off between goals JS	Clear articulation of how levers drive value creation NEXT
Capex used to build all businesses JS	Capex skewed to key goals	Capex skewed to high return opportunities NEXT
Most capital retained JS	Capex vs returning cash driven by business needs	Capex vs returning cash driven by prospective ROCE NEXT
Radical strategies rarely examined JS	Business strategy driven by goals	Business strategy driven by value NEXT
Tendency to empire build	Portfolio optimised to meet corporate goals JS	Corporate shape driven by businesses value creation NEXT
Targets set by bottom up budgets	Targets set by bottom up budget and top down strategic goals JS	Targets set by value creation goals, inc dividend & capital gain NEXT
Budget process primary	Budget process shaped by strategy process JS	All management processes aligned around value creation NEXT
Risk register mostly operational	Risk register operational + strategic JS	Risk register operational + strategic + to value
Prefer internally measured incentives	Mix of incentives JS	Value creation drives incentive structure NEXT

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This table distinguishes three types of manager – the managerial, goal focused and value focused.

The managerial approach has a wide range of objectives, depending on the operational problem of the moment.

Goal focused CEOs and boards have a limited number of goals, but they only create value when the goals match the way to generate value, so their actual performance varies.

Value managers are very clear that managing intrinsic value is the prime objective. It is at the top of a goal hierarchy, and all subordinate goals are treated pragmatically. Value managers are agnostic as to which levers to pull in order to maximise value and will use different ones according to circumstances. This could mean investing in growth, or cutting back investment, paying higher dividends or buying back shares. Unless value creation is clearly the dominant objective, other goals get in the way of doing so.

Non-value managers have other objectives (most commonly growth) as their primary objective. This may be due to biases, or alternative sets of beliefs which can be reinforced by incentives. Value managers create incentive systems that reinforce the value creation objective and often stand to personally gain very substantially from it.

One Member asked whether there might be some periods in the life of a business when you do not need a value manager. Neil answered that that can sometimes be the case. For examples, a PE owner, who will almost certainly be value focussed themselves, may pick a goal focussed CEO who is good at doing what is needed at the time to create value. But in the end, the environment will change and tough decisions will be called for. At that point the PE company will get rid of them.

Managing Value in the New Environment

Neil suggested that the current environment differs from the environment of three years ago in four main ways: lower growth because of the pandemic, war and a less integrated world economy; high inflation and, as interest rates rise more slowly than inflation, negative real interest rates making it harder to make real returns; continued technological change; and greater intervention on the part of governments.

These factors have consequences. The lower cost of capital will create opportunities, including in M&A, but demand tighter discipline. High valuations driven by higher multiples will create greater risk to value creation – any mistake will lead to a proportionately greater fall. Similarly, it will be rational to increase leverage, but increasing long-term debt will also increase risk. The combination of low growth and continual technology shifts will also make value shifts more likely and result in an even greater divergence between winners and losers. That implies a need for greater selectivity in choosing where to invest. All in all, the task of the value manager has become more difficult. The current and future environment will challenge A teams. Those challenges will also be faced by B teams and many will be unequal to them.

Under pressure from a low growth environment, underperformers will pursue growth that is not value creating; find that they lack the means to earn above the cost of capital; suffer severe falls in valuation when profit forecasts are missed or innovative business models begin to look challenged; and will be tempted to avoid the difficult calls demanded by strategy and over-focus on operational excellence, which is easier to achieve but will condemn them to mediocrity. One further pitfall will be to position themselves in the wrong part of the value chain.

This raises the question of whether it is possible to identify in advance the distinctive characteristics of an A team. We know quite a lot about successful value managers from Buffett, through Habgood and Swann to Wolfson. They are different personalities facing different circumstances but they all apply the same principles. It is likely that they and other future value managers will continue to apply those principles, but they will have to do so with even greater skill. The challenges, complexities and ambiguities of the environment will lead to nervousness and anxiety on the part of investors and it is equally likely that that will lead to the prominence of super-ego CEO's who will claim to have mastered the complexity with some simple fixes and make big promises. It is more than likely that the latter will fail.

Leadership Lessons from Value Creators

The literature on leadership is vast and growing. We are exhorted to imitate certain successful leaders from the past, ranging from Genghis Khan to Earnest Shackleton, study the habits of highly successful people and cultivate the personality traits of unusual individuals because they achieved great things in their domain.

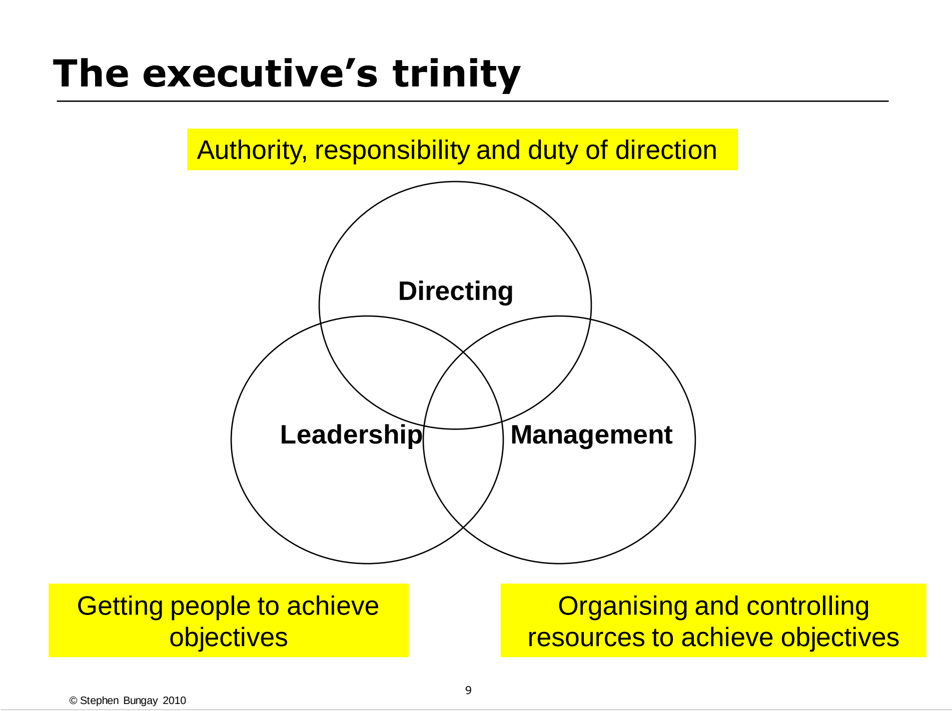
Universals are hard to identify. The literature often mixes up personality, acquired skills, and behaviour, all of which are exhibited in quite different contexts. Academic frameworks tend to describe different styles, such as autocratic, democratic, coaching or transformational, with little sense of which works under which circumstances or indeed if alternative styles would have worked equally well.

Historically, leadership was viewed for a long time as something which inhered in certain heroic individuals, a quality inherited by classes of people born to lead, particularly kings, or based on religious authority. In the C20th, the sociologist Max Weber introduced the concept of rational leadership and this took hold in the business world, systematised by Taylor in his seminal work *The Principles of Scientific Management* published in 1911. An effective business leader was in fact a manager. Management was about efficient organisation, resource allocation and control.

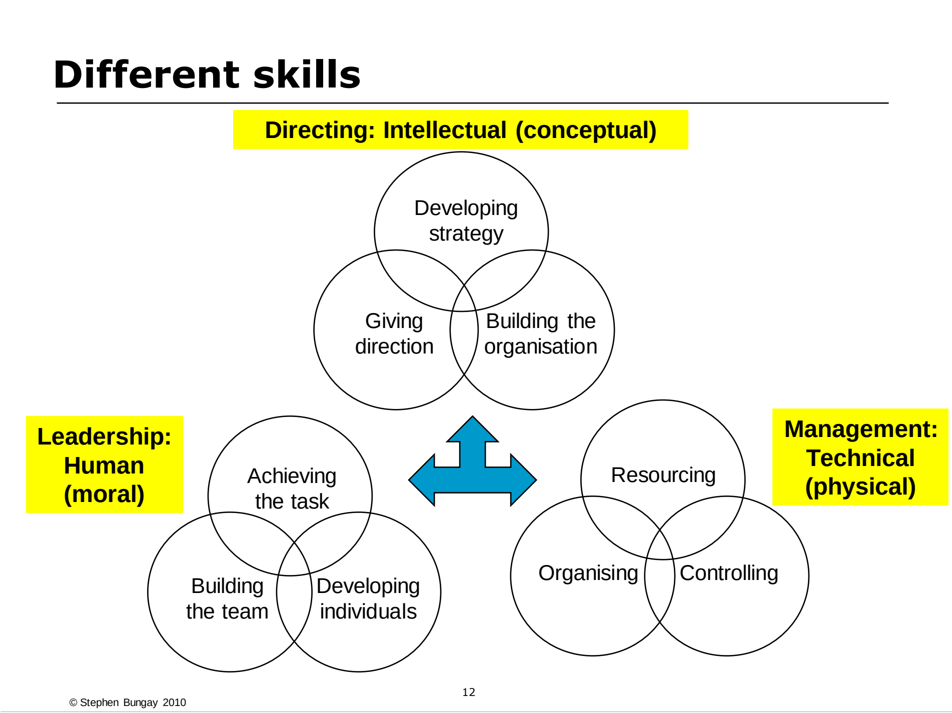
This was challenged in 1977 with the publication in HBR of another seminal piece by the psychologist Abraham Zaleznick with the title *'Leaders and Managers – Are They Different?'* Zaleznick's answer was a resounding yes. With his Freudian background, he re-introduced emotion and irrationality into the mix, arguing that leaders integrated the ego and id. Whereas managers are good at running an organisation in a steady state, change requires leaders who can set challenging goals and inspire people. Charisma was therefore back in play, and from the 1980's onwards, the business press developed a cult of the CEO as a hero. The corporate scandals of the early 2000's created a backlash, with the recognition that leadership could be great but also toxic.

It was in 2001 that Jim Collins introduced some complexity into the discussion of leadership in his second best-seller '*From Good to Great'*. He noticed that all his 'great' companies were led over a long period of time by individuals who were decidedly unheroic and displayed little charisma, but consistently made sound and often bold decisions. He called these modest, self-effacing but strong-willed individuals 'level-5 leaders'. They look a lot like value managers.

Drawing on his studies of military thinking, Stephen believes that the 'level-5 leader' is not someone who has reached the ultimate level of leadership, but someone with quite different skills from Zaleznick's inspiring driver of achievement. The 'level-5 leader' is in fact not a leader at all, but what the military call a 'commander'. In the context of business, Stephen calls command 'directing'. The commander/director does a different kind of job from the manager and the leader, and an organisation, whether it is an army or a business, needs all three. They constitute the 'executive's trinity':

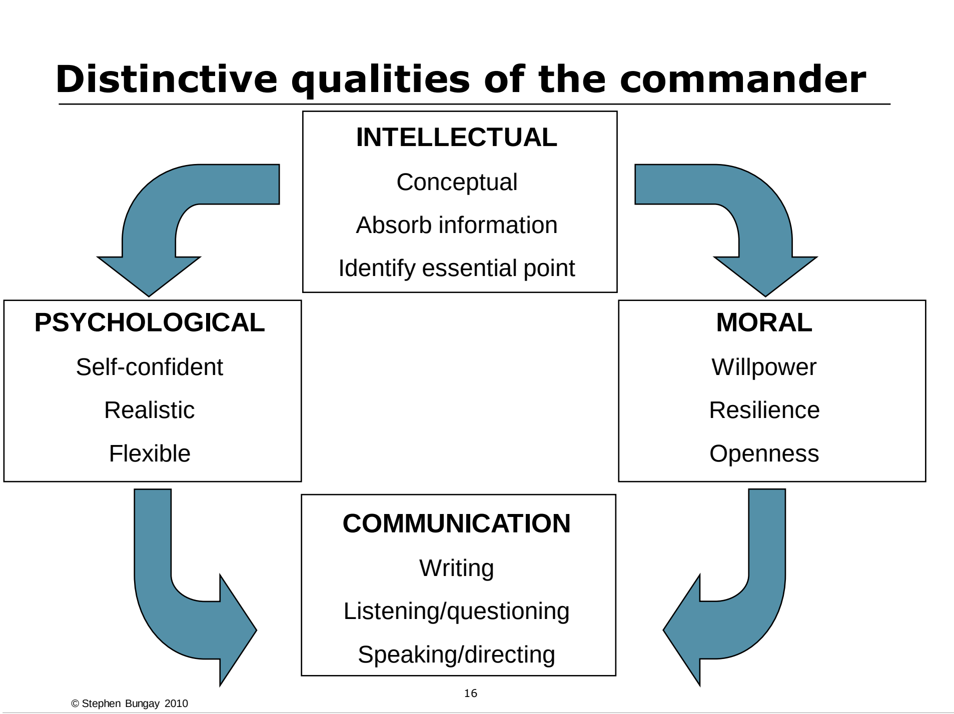


The specific tasks within each role mean that the value manager is someone who has mastered the skills of directing:



The trinity explains how Zaleznick's inspiring people-person and Taylor's administrator relate to each other, but adds the critical role of developing strategy, building an organisation which can execute the strategy and actually giving direction. The skills of the director are distinctive and cannot be reduced to leadership or management. A comparison between value managers and the great commanders of history shows striking parallels. In fact, one might even say that they are doing the same thing in a different context.

In addressing military audiences, and quite independently from Neil, Stephen has attempted to identify the core qualities of effective commanders and they can be applied equally to directors. The convergence of the his and Neil's lists suggests that this is more than coincidence.



The great commanders show few commonalities in terms of personality. Though, given the nature of the tasks, most are introverts, some are extroverts. Many, like Napoleon and Nelson, had big egos but some, like von Moltke and Grant, were self-effacing. All of them, however, put the achievement of the task before their own ego.

Leaving personality on one side, all of them were people of high intellect, able to absorb and process information very quickly, conceptualise to see beyond the obvious, and grasp the essential point. The combination of logic applied to common sense and guided by pattern recognition enabled them to make sound decisions at remarkable speed, even when under extreme pressure. To observers who lacked this ability they often therefore appeared to be very bold, but they in fact were generally very careful about what risks they took.

They had the psychological resilience to shoulder the burden of responsibility and withstand enormous pressure because they were basically self-confident. This also enabled them to be open, to accept and indeed encourage challenge, and change their views as the situation changed. They were data-hungry and obsessed with getting as accurate a view of reality as possible. They usually took decisions on the basis of partial or conflicting information. Once they had taken a decision, they followed through with great determination. They made no distinction between strategy and execution.

The fourth characteristic is unexpected. Some were great orators and some were not, but they were all superb writers. They were able to formulate instructions quickly in clear, unambiguous prose, and often did so at night after a day of great exertion. They usually wrote orders and directives themselves. They mastered what Neil has referred to as the narrative.

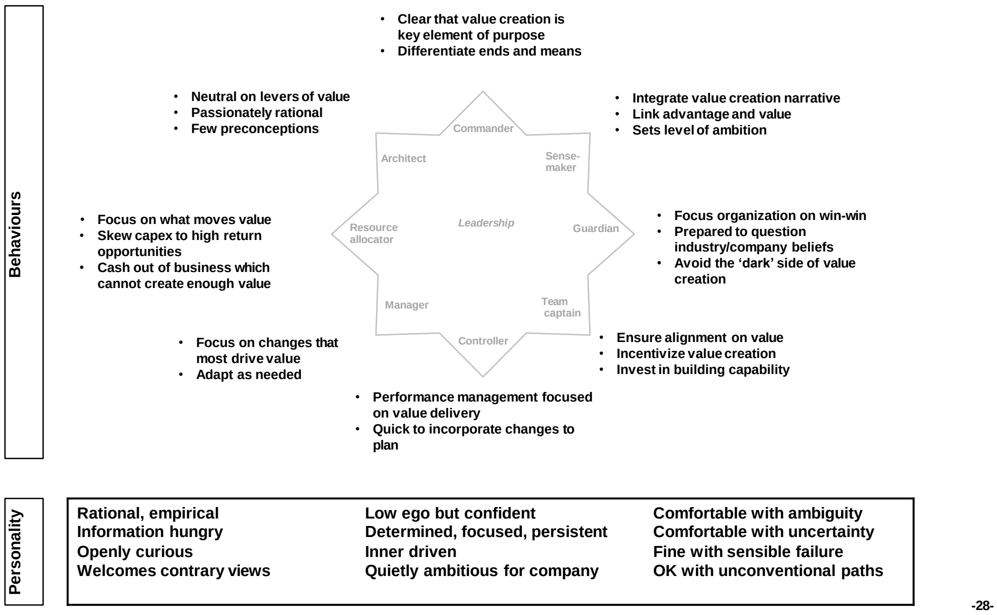
Neil then suggested that directing, managing and leading could be broken down into eight roles, each of which involve the use of different tools to perform different tasks:

The commander role, typically played by the CEO, involves deciding what the organisation should try to achieve. The architect, often the CSO, works out how that should be done. That role is tightly linked to that of the sense-maker who communicates the narrative internally and to markets. Both of these roles in particular are going to get more difficult. The other distinct roles are largely managerial, and every executive has leadership responsibility towards their people.

There was some discussion about the place of a vision and the extent to which it had to be shared among the top team. Neil's view is that it is a matter of Weltanschauung. There has to be a common commitment to managing for value, but room for argument about how to achieve it and the choice of means. A good top team is diverse but able to work together effectively as a team, with mutual respect and trust. Stephen commented that another common trait of great commanders is people judgement. They put a lot of effort into creating a group of highly competent people with whom they worked closely, sometimes developing them themselves based on merit (such as Napoleon's Marshals whom he promoted from the ranks) or training them personally (such as von Moltke's General Staff officers). Neil added that if people do not fit into the team, they should leave. Value managers are quicker than most in making such judgements and acting on them.

Value managers also perform the eight roles in a distinctive way:

Value managers do the same tasks, but differently



With that, in order to accommodate the needs of the venue, the meeting sadly had to draw to an early close.

Future meetings

As members already know, this will be the final year of the Centre, at least in its current form.

We will be holding our final **Members' Meeting** from 13.00 – 17.30 on **13th October 2022**. It will be held at our traditional venue, The Royal Horseguards Hotel, 2 Whitehall Court, Whitehall, London SW1A 2EJ.

This meeting will be a retrospective, covering the history of the Centre's contributions to strategic thinking.

After the meeting we will gather for pre-dinner drinks and will be joined by some further guests for a celebration dinner.

Members are also reminded about the next Strategy Team Seminar and our Strategy Bootcamp.

Each Member has two free places on the **Strategy Team Seminars**. The next one is on **Thursday 28th July**, 10.00 – 16.00 held virtually using Zoom. The subject will be the evolving nature of strategy in a VUCA environment and will be led by Marcus Alexander.

We are currently planning to hold our five-day **Strategy Bootcamp** virtually from **26th – 30th September**. It is aimed at those in a corporate or BU strategy role who have not received much training in strategy or who would like a refresher. The subjects covered will include strategy development, value creation, strategy tools, strategy and finance, corporate strategy, execution and how to deal with uncertainty.

The Members fee for the Bootcamp is £3,500 plus VAT but places booked before 1st August will qualify for an early bird discount and will cost £2,750 plus VAT. It would be helpful if you could indicate interest as soon as possible as we need to assess whether we can make up a quorum.

For more information or to reserve places for members of your team, please contact Angela Scutts (ea@strategicmanagementcenter.com).