Insight

Board Focus for Long-Term Success

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Principal
Introduction

The world is in the early stages of the most amazing transformation ever seen in human history. This fact significantly increases the complexity and risks involved in discharging the responsibilities of boards.

I have spent significant time over the past 18 months:

- Reading material daily from many global sources about what these technological and other forces are, and what opportunities and threats emanate from them
- Speaking to over 40 Chairs and directors about these issues to understand how boards are dealing with these
- Investigating how the best companies globally are dealing with these.

This paper is the product of this research and discussions with a large number of people.

The intent of this paper is to provide some thoughts to boards on how best to discharge their responsibilities of ensuring the long-term survival, sustainability and performance of the business.

Ingredients of Corporate Success Driven by the Board

The companies that have thrived over the long term have the following in common:

- A very strong purpose
- A long-term perspective
- A balanced view on who the key stakeholders are
- Leadership that is obsessed with delivering customer value, driving a very strong innovation culture and developing a new generation of leaders
- Leadership that uses this innovation energy and applies it to driving down the costs of operations and support, and expand the reach of their products and services
- An “always on” strategy mindset and process
• A very strong culture underpinned by aligned remuneration and measurement systems
• A strong board that has a sweet spot in tenure of about 9 years

The board has a crucial role to play in all of these points

A Very Strong Purpose

Various studies have demonstrated a powerful link between purpose and performance. When leaders clarify purpose – when employees embrace purpose – when the organisation lives it, rather than just proclaims it – business results follow.

BCG studied 50 companies in five major sectors: technology, media, telecommunications, consumer products, and financial services. BCG analysed the results from multiple angles, using measures such as TSR, revenue and EBITDA.

Their findings: purpose, when its truly ingrained, correlates with 10-year TSR. So, purpose does pay – and it does so over the long term. See the following exhibit:
At the launch of the Model 3 EV on 28th July this year, Elon Musk spoke about a core purpose behind Tesla driving incredible innovation of the electric car. It is to help radically reduce the amount of CO2 in the atmosphere, and so halt the acceleration of global warming. This is a truly inspiring purpose that drives Musk and his companies in this part of the market.

See the link: [https://futurism.com/teslas-model-3-is-more-than-a-car-its-a-revolution/](https://futurism.com/teslas-model-3-is-more-than-a-car-its-a-revolution/)

Many companies have powerful purpose or mission statements, for example:

- **Microsoft** – “Our mission is to empower every person and every organisation on the planet to achieve more.

- **Amazon** – “We seek to be Earth’s most customer-centric company. We are guided by four principles: customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking”

- **Google** – “To organize the world’s information and make it universally accessible and useful”

Appendix 1 provides further data on the link between purpose and performance.

**A Long-Term Perspective**

One of the best pieces I have read on this topic comes from Amazon CEO Jeff Bezos' annual shareholder letter. At the end of each year's letter, he appends the original 1997 letter which captures the essence of many high performing businesses.

The section on long-termism is copied below, in part, with the balance in Appendix 2.

“We believe that a fundamental measure of our success will be the shareholder value we create over the long term. This value will be a direct result of our ability to extend and solidify our current market leadership position. The stronger our market leadership, the more powerful our economic model. Market leadership can translate directly to higher revenue, higher profitability, greater capital velocity, and correspondingly stronger returns on invested capital.

Our decisions have consistently reflected this focus. We first measure ourselves in terms of the metrics most indicative of our market leadership: customer and revenue growth, the degree to which our customers continue to purchase from us on a repeat basis, and the strength of our
brand. We have invested and will continue to invest aggressively to expand and leverage our customer base, brand, and infrastructure as we move to establish an enduring franchise.”

A Balanced View of Who are the Main Stakeholders

There has been much written about whether the primary stakeholder focus of a company should be the shareholder or a broader group of stakeholders.

Harvard Business School Professors Joseph Bower and Lynn Paine have written a seminal article in June 2017’s HBR titled “Managing for the Long Term.”

This paper argues that a more realistic foundation for effective corporate governance requires a broader focus than just the shareholder. They argue that corporations are independent entities, that with the right leadership can be managed to serve markets and society over long periods of time.

**Bower and Paine argue the following propositions for effective long-term governance:**

- Corporations are complex organisations whose effective functioning depends on talented leaders and managers

- Corporations can prosper over the long term only if they are able to learn, adapt and regularly transform themselves – i.e. they are innovative

- Corporations perform many functions in society. They:
  - Generate wealth
  - Produce goods and services
  - Provide employment
  - Develop technologies
  - Pay taxes
  - Make contributions to their broader communities

- Companies succeed only if customers want their products or services, leaders want to work for them, employees want to work for them, shareholders want to buy their stock, and communities want their presence
• Companies must have ethical standards to guide interactions with all their constituencies, including shareholders and society at large

• Companies are embedded in a political and socioeconomic system whose health is vital to their sustainability

• In summary, you can only create shareholder value if you have motivated leaders and staff creating value for customers on a continuous and sustained basis.

Bower and Paine believe that the implications for a broader based governance process are far-reaching, and they would expect to see boards adopt some or all of the following features:

• More board level attention to succession planning and leadership development

• More time devoted to strategies for the company’s continuing growth and renewal

• Closer links between executive compensation and achieving the company’s strategic goals

• More attention to risk analysis and political and environmental uncertainty

• A strategic – rather than narrowly financial – approach to resource allocation

• A stronger focus on investments in new capabilities and innovation

• More conservative use of leverage as a cushion against market volatility

• Concern with corporate citizenship and ethical issues that go beyond legal compliance

My work over the past two years strongly supports these points.

A Long-Term Perspective and Strong Innovation Culture

Australian Analysis

I have been collaborating for 20 years with Denis Kilroy and Marvin Schneider of KBA, who have developed a ground-breaking method of analysing listed company performance which strips out the effects of market movements, and allows focus on the real creation of shareholder value over the long term by the leaders of a business.
It is centred on a concept KBA call the Bow Wave of Expected Economic Profits. The EP Bow Wave provides the first truly reliable mechanism with which to establish how the performance achieved by management in the market for their company’s products and services, translates into the capital market outcomes experienced by shareholders.

The outcome of an analysis of 120 of Australia’s leading companies by KBA is captured in the following exhibit.

<table>
<thead>
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<tbody>
<tr>
<td>Significantly Outperformed Market on a Risk Adjusted Basis</td>
<td>41</td>
<td>100.0%</td>
</tr>
<tr>
<td>Outperformed Market on a Risk Adjusted Basis</td>
<td>29</td>
<td>100.0%</td>
</tr>
<tr>
<td>Matched or Underperformed Market on a Risk Adjusted Basis</td>
<td>41</td>
<td>(100.0%)</td>
</tr>
<tr>
<td>All Companies</td>
<td>120</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

| Component Due to EP Bow Wave Extension | 7.3% | 47.0% |
| Component Due to Improvement in Underlying Economics | 110.1% | 73.1% | 37.0% |
| Biotechnology & Pharmaceuticals | 6 | 100.0% | (10.5%) | 37.0% |
| Utilities | 3 | (100.0%) | (54.2%) | (58.6%) |
| Banks | 6 | 100.0% | 23.3% | 51.6% | 24.0% |

When we look at the aggregate wealth creation and destruction that occurred over the period 2009-2016 within the 120 companies in the study, there were 49 top performing companies that created significant shareholder wealth. All the wealth created by these companies came from an increase in expectations during the measurement period, in relation to the EP to be delivered beyond the measurement period. It did not come from exceeding existing EP expectations during the measurement period.

Just over half the wealth created came from enhancing the sustainability of the companies’ EP streams. The remainder came from an improvement in the underlying economics of the business, in the form of an increase in expectations in relation to future returns and growth.

In the case of the 26 good performing companies, 93% of the wealth created again came from an increase in expectations in relation to the EP to be delivered beyond the measurement period.

In general, among the 49 top performers and the 26 good performers, the more successful a company was in creating shareholder wealth, the higher the proportion of the wealth created that
came from establishing new EP expectations, and the greater the proportion attributable to making the EP stream more sustainable.

The picture for the 45 under-performing companies was completely different.

These findings suggest a longer-term focus exists within the better performing companies. These companies have an ability to innovate that enables them to continually come up with new customer value propositions and better business strategies, that produce ongoing EP uplift over the long term.

The Biotechnology and Pharmaceuticals sector (which includes CSL Limited) is an excellent example of this phenomenon. Utilities paint the opposite picture.

A similar analysis has been done for the Top 100 US and UK companies, and the exact same conclusions were reached in this research as well. Unilever and Amazon both create significant shareholder value based upon the markets’ views of the quality of new economic profit streams beyond the measurement period.

The data clearly shows that companies with a strong long-term focus and a strong innovation engine deliver much higher shareholder returns than those without.

The full study for this paper can be seen here: Innovation, Wealth Creation and the EP Bow Wave.

Denis and Marvin have written a book on this topic which will be released this week. You can see further details here: Customer Value, Shareholder Wealth, Community Wellbeing.

American Analysis by McKinsey

A paper co-authored by Dominic Barton – global Managing Director of McKinsey – attempts to answer the question - “Does short-termism destroy value?”

Seeking to quantify the effects of short-termism at the company level and to assess its cumulative impact on the nation’s economy, Dominic Barton’s team tracked data on 615 non-financial US companies from 2001 to 2014. These companies represented about 60% of total US market cap.

Adjusting for company size and industry, the team identified 167 companies that had a long-term orientation – 27% of total companies analysed.

The results were clear as the graphs in Appendix 3 show - the long-term focussed companies:
• Surpassed their short term-focussed peers on several important financial measures and created significantly more jobs

• Delivered above average returns to shareholders

• Had a 50% greater likelihood of being in the top quartile or decile for financial performance at the end of the measurement period

If all US companies had taken a similarly long-term approach, then the benefits that would flow to the US economy include:

• Equity markets could have added more than $1 trillion in asset value

• Companies could have created five million more jobs in the US

• This growth in jobs would have unlocked as much a $1 trillion in additional GDP

It is clear from all the various analyses that companies taking a long-term view add enormous value not only to their shareholders, but to the broader community as well.

This point is worthy of further discussion and debate in Australia.

Leadership & Culture

The board is responsible for the long-term performance and sustainability of the business, and the key driver of those outcomes is the quality of leadership at all levels, including the board.

It is worth reminding ourselves that the average tenure of a CEO in the US and Australia is around 4.5 years.

As a consequence of this very short CEO tenure, boards play a major role in ensuring their long-term responsibilities are delivered upon.

Building leadership starts with the board:

• The chair has an enormous influence and impact on the tone set by the board

• Hence the selection of the chair is arguably the most important selection in any business

• The size and composition of the board is another critical factor in building the leadership of the company - what skills and experience do we need to:
- Assess key risks?
- Assess the strength of the culture?
- Review the adequacy of the company’s core capabilities – platforms, systems and technology?
- Assess proposals brought to the board?
- Evaluate company performance and executive leadership capability? Select future leaders?
- Understand the forces at work in the markets the company competes in? Stress test the strategies put forward by management?

A major role of the board is to formulate questions – ask the “right” questions – and this role has become even more important given the pace and scale of digital and other disruptions.

The board has a key role in ensuring that the executive leadership team has the experience and capabilities to:

- Build effective strategies to capture market opportunities
- Execute the strategies, and so
- Deliver expected performance levels
- Sustain and strengthen the culture through their behaviours

Boards do this by:

- Selecting and removing the CEO
- Being heavily involved in selecting other key executives
- Implementing succession planning processes that ensure a stock of leaders is being developed throughout the organisation.

The quality of these leaders will determine whether the business innovates at the level required to create customer value and so create shareholder value on a continuous basis.
The board has a major role to play in establishing and sustaining the culture of the business. They:

- Appoint the CEO
- Establish the business culture
- Have a role in appointing the direct reports to the CEO
- Decide the basis for remunerating the CEO and other senior leaders
- Agree the remuneration philosophy and system for the entire business
- Set the performance expectations of the business – growth, returns etc.
- Observe the behaviours of the leadership team in many settings – these observations provide important clues to leadership character – and therefore their impacts on culture
- Observe how the leaders build and cultivate a strong innovation culture

There has been much discussion lately as to whether the board is responsible for culture or not. In my opinion it is crystal clear given the above points.

Board Leadership, Tenure and Financial Performance

There has been considerable research done over the years on the relationship between board tenure and company financial performance.

Quantitative Management Associates (QMA) – US fund manager with $130 bn of assets under management - studied in 2016 the relationship between board tenure and firm market value and performance on 3,000 US companies over an 18-year period.

See link for details: Board Tenure Paper

QMA analysis found that:

- Longer board tenure is positively related to stock returns, as well as current and future firm value
- The market rewards firms with stable boards with a ‘stability' premium
However, over time, the effectiveness of two primary board functions – monitoring management and technological advice – deteriorates.

The deterioration in monitoring is due to long-tenured board members becoming less vigilant, and the deterioration in technological advice is due to board members not keeping pace with the technical changes in the company's business.

Effectiveness peaks at tenures of about nine years, at which point long-tenured board members begin to become a drag on the company valuation relative to the nine-year tenure.

This reduction in effectiveness is especially pronounced for high-growth firms for which up-to-date technical knowledge is especially important for the company's success.

"Always on" Strategy

I think everyone agrees that the old method of the management team going through a long strategy presentation once a year doesn't cut it today.

The world is changing too fast for that method to work.

Key questions for boards are – “Is our strategy relevant, and is it being executed effectively?”

I listened to many chairs talk about this point, and it seems that the best way to answer this question is as follows:

- Understand what's going on in the markets
- Go and spend time in the stores if you are a retailer
- Go and talk to customers
- Visit disruption examples anywhere in the world
- Talk to leaders in new technologies
- Set up an Advisory Board of global thought leaders
- Read extensively – a lot of relevant information is available out there
- Listen carefully to what management has to say
• Review the data – particularly changes in market share, buying patterns

• Focus on building strong platforms and an agile and innovative culture

• Absorb and learn what is happening in the company's markets

• Boards also have an obligation to help directors learn – many boards take annual trips to Silicon Valley for example

• Build a strategic reporting system – for example

• Customer acquisition & retention

• Market share trends – Australia and overseas

• Break through cost structures and market reach models in alternative business models

• Benchmarking against best practice global competitors – cost ratios and the like

• Time allocation

• This is a real biggie

Boards need to allocate much more time to strategic issues in each board meeting o To achieve this, many boards will need to adjust board agendas to make time – probably by setting up sub-committees that do the detailed work on risk and compliance management issues.

The bottom line is that the more time the board spends getting up to speed in what is happening in their markets, the better able they are to answer the core questions outlined above.
Appendix 1 - Data on Link between Purpose and Performance

For 18 years BrightHouse has been helping companies discover their purpose. Purpose is a key driver for affecting top and bottom line growth. How effective? Here's how:

Other data:

91% of global consumers would switch brands if a different brand of similar price and quality supported a good cause.

Employees who say their company has a strong sense of purpose say it has:

- 89% clearly defined values/beliefs
• 94% strong customer satisfaction

• 79% strong employee satisfaction

Source Deloitte 2013 Core Beliefs & Culture Survey

Employees now seek greater and deeper fulfilment from their working lives:

• 65% of respondents claimed that purpose would motivate them to go the “extra mile” in their jobs.

• 64% claimed it would engender a greater sense of loyalty towards the organisation they work for.

Source: 2012 Calling Brands Study

Appendix 2 - "Balance of Amazon 1997 Shareholder Letter"

“Because of our emphasis on the long term, we may make decisions and weigh trade-offs differently than some companies. Accordingly, we want to share with you our fundamental management and decision-making approach so that you, our shareholders, may confirm that it is consistent with your investment philosophy:

• We will continue to focus relentlessly on our customers

• We will continue to make investment decisions in light of long-term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions

• We will continue to measure our programs and the effectiveness of our investments analytically, to jettison those that do not provide acceptable returns, and to step up our investment in those that work best

• We will continue to learn from both our successes and our failures

• We will make bold rather than timid investment decisions where we see a sufficient probability of gaining market leadership advantages. Some of these investments will pay off, others will not, and we will have learned another valuable lesson in either case

• When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we'll take the cash flows
• We will share our strategic thought processes with you when we make bold choices (to the extent competitive pressures allow), so that you may evaluate for yourselves whether we are making rational long-term leadership investments

• We will work hard to spend wisely and maintain our lean culture. We understand the importance of continually reinforcing a cost-conscious culture, particularly in a business incurring net losses

• We will balance our focus on growth with emphasis on long-term profitability and capital management. At this stage, we choose to prioritize growth because we believe that scale is central to achieving the potential of our business model

• We will continue to focus on hiring and retaining versatile and talented employees, and continue to weight their compensation to stock options rather than cash. We know our success will be largely affected by our ability to attract and retain a motivated employee base, each of whom must think like, and therefore must actually be, an owner.”

For further details see: Amazon Annual Report will highlight later in this paper that taking a long-term focus such as this delivers much better financial returns in all the world’s major markets.
Appendix 3 - "Data on Link between Long-term Focus and Performance"
Thanks for reading