**Leaders don’t understand the strategy for creating value.**

**Purpose of this article**
The purpose of this article is to help board directors and the C-Suite determine if they understand: the strategy, how value is created, and industry dynamics.

**Most company directors do not understand: the strategy, how value is created, and industry dynamics.**
1) A McKinsey survey of board directors showed that most had little understanding of their companies. Only 16 percent said they strongly understood the dynamics of their industries, just 22 percent said they were aware of how their firms created value, and a mere 34 percent said they fully comprehended their companies’ strategies.[1]
2) I believe this lack of understanding reflects the lack of understanding of the CEO and C-Suite.
3) Directors are not stupid and lazy.  The CEO and C-Suite are not hiding things from the board directors.  The leaders simply lack the company facts and knowledge to enable their understanding.

**Leaders’ lack of knowledge results in few major companies having sustained value creation.**
1) McKinsey analyzed the world’s 2,393 largest corporations from 2010 to 2014. The top 20% generated 158% of the total economic profit (i.e. profit after cost of capital) created by those corporations.  This was an average economic profit of $1,426 million per year. The middle 60% generated little economic profit, an average of $47 million  per year. The bottom 20% all generated negative economic profit, with an average loss of $670 million per year.[2]
2) Less than 13% of global companies had sustained value creation in the 1990s.[3]
3) 12% of public companies had sustained value creation from 2002 to 2012.[4]
4) Mark Leonard, CEO of Constellation Software, in his final annual CEO letter said:  “According to the 2017 Hendrik Bessembinder study of approximately 26,000 stocks in the CRSP database, only 4% of the stocks generated all of the stock market’s return in excess of one-month T-Bills during the last 90 years. The other 96% of the stocks generated, in aggregate, the T-Bill rate over that period. This means that 4% of boards oversaw all the long-term wealth creation by markets during that period. Even more disturbing, the boards for over 50% of public companies saw their businesses generate negative returns during their entire existence as public companies.”[5]

**Leaders’ lack of knowledge results in most companies not surviving.**
<u>Few major companies survive:</u>
1) 16% of major companies in 1962 survived until 1998.[6]
2) Of the 500 companies in the S&P 500 in 1957, only 74 remained on the list in 1997.  Only 12 of those 74 outperformed the 1957-1997 S&P index.  An investor who put money into the survivors would have done worse than someone who invested only in the index.[6]
3) 31% of Fortune 500 companies went bankrupt or were acquired from 1995 to 2004.[7]
4) 50% of the S&P 500 will not be on the list in 10 years’ time.[8]

<u>Most public companies will not survive</u>.[9]
1) A Fortune 500 company will survive an average of 16 years.
2) The typical half-life of a North American public company is 10 years.
3) Global public companies with $250 million+ market cap have a typical half-life of 10 years.

<u>Companies do not recover from crisis</u>.[10]
1) 20% of companies grow from insurgency to incumbency, but then two-thirds of them stall out and less than 1 in 7 stall-outs recover.
2) At any given moment, 5%-7% of companies are in free fall or about to tip into it. Only10%-15% of companies pull out of free fall.

**What are the missing facts and knowledge?**
The following outlines some critical facts and knowledge the leadership must have.  This is not intended to be a comprehensive list.

<u>#1 What is value?</u>
1) Define value and how it’s measured.
2) In today’s purpose driven work, there are multiple stakeholders with different types of value expectations.
3) What is value to the customers?  What problems and needs are urgent enough that they are both willing and able to pay for a solution?
4) Another value measure is economic profit(total profit minus cost of investor and lender capital) as a percentage of invested capital.

5) A critical value driver is the number of customers who believe they have an urgent problem or need that they are willing and able to spend money to address. Do these customers perceive that your company's solution provides more value than the competition?

<u>#2 How does the company create and preserve value?</u>
There are two major ways the company enables value creation and preservation.
1) The first way is growth in the number of customers, growth in the number of problems and needs being addressed, and growth in what the customers are both willing and able to pay. The customers must perceive your company has a better solution that both the competition and the status quo.
2) The second way is retaining customers by ensuring they don't perceive they'd be better off with a competitors solution or no solution at all.

Financial and human capital is allocated towards value growth initiatives and value preservation activities.

<u>#3 What is the strategy?</u>
The strategy must describe what is, how value is being created and preserved.
1) The customers, and their perceived urgent problems and needs for which they are willing able to spend money to address. How many of these customers are there?
2) How do customers perceive the competition?
3) Where is the financial and human resource capital being deployed?
4) What are the specific growth initiatives? What is the expected impact on customers and their spending? What is the economic profit expected from each initiative? Who within the company is accountable for: the changes in customer behaviour and the economic profit?
5) What capital and human resources are devoted to customer retention? What customer perceived weaknesses would be addressed? How was it validated that these perceived weaknesses would change customer buying behaviour? E.g. My wife and I own Apple iPhones which are expensive. But that is not a competitive weakness. We're not going to buy a $100 Android phone.
6) What are the future scenarios? It is impossible to predict the future, therefore what is the company's approach for being successful in a variety of emerging future scenarios?

<u>#4 What are the industry dynamics?</u>
First look at the historical trends leading up to the current situation:
1) How have customer problems and needs changed?
2) How has customer perception of your company changed relative to the competition over the years? What have competitors done to change this perception?
3) How has the ways in which customers interact with your company changed?
4) What new entrants have come in? Startups? Major players from adjacent markets?
5) How have market sizes changed? i.e. the number of customers?
6) How has the competition changed in terms of Mergers & Acquisitions or exits?
7) Why have competitors failed?
8) How have your benchmarking comparisons changed?

Then look at the external trends
It is impossible to predict the future, therefore you must consider scenarios, not just a single forecast.
1) What are the trends? Technology, Demographics? Economic? Regulatory? Public expectations of company behaviour? Political? Talent availability?
2) What are the implications of these trends? What will be the future problems and needs customers will be willing and able to spend money to address? How will customers expect to interact with your company? (I.e. how will the customer experience change)? How big will the market be? (i.e. how many customers?). Who will be the new competitors (i.e. startups, new entrants)? How will existing competitors respond? What will be the M&A activity? How should you perform in your future benchmarking?

**Your next steps**
1) Build a list of questions, relevant to your situation, using the above questions as a starter.
2) Review your strategic plan including the supporting appendices.
3) What are the facts? What are the unvalidated assumptions?
4) What are the long-term implications of your findings?
5) What changes are need to your planning, monitoring, and risk management processes?

**Footnotes**

[1] "Corporate Boards need a facelift", Eric Kutcher, (McKinsey Partner) McKinsey website, May 4, 2018 https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-strategy-and-corporate-finance-blog/corporate-boards-need-a-facelift

[2] Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds", McKinsey Quarterly February 2018, https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/strategy-to-beat-the-odds

[3] "Profit from the Core" by Chris Zook. 1,800 companies in seven countries with sales in excess of $500 million analyzed. Criteria were: 5.5% after inflation sales growth; 5.5% real earnings growth; total shareholder returns exceed cost of capital.

[4] Christoph Loos, CEO Hilti Group, Swiss AmCham Luncheon, September 1, 2015. Analysis based on about 2,000 public companies in 2002 with revenues greater than $500 million. Sustainable value creation defined as: real revenue growth exceeding 5.5% per year, real profit growth exceeding 5.5% per year, and earning cost of capital.

[5] https://www.csisoftware.com/docs/default-source/investor-relations/presidents-letter/presidents-letter-april-2018-final.pdf

[6] "Creative Destruction – why companies that are built to last, underperform the market", by Richard Foster & Sarah Kaplan

[7] "Unstoppable" by Chris Zook, 2007, page 7

[8] "2018 Longevity Report" by Innosight Consulting

[9] "Corporate Longevity", Credit Suisse, February 7, 2017

[10] "The founders mentality", by Chris Zook and James Allen, 2016

**Further reading:**

Do you understand your customers?
http://koorandassociates.org/understanding-customers/do-you-understand-your-customers/

Traditional strategic planning dooms companies to failure.
http://koorandassociates.org/strategy-and-strategic-planning/traditional-strategic-planning-dooms-companies-to-failure/