LEADING & *CREATING VALUE* in the KNOWLEDGE ECONOMY

BY MARK VAN CLIEAF

The Knowledge Economy has forced almost every type of company to find new ways of measuring leadership success and create organizational models that consistently deliver shareholder value. The reasons are simple: Shareholders are demanding results-based leadership, and traditional ways of evaluating work no longer apply. Having three layers of management, all with the same accountabilities, does not add value, and decision-making that is concentrated at the top will not allow organizations to respond quickly enough. CEOs need to take a close look at their organization's design, to ensure that each individual role, its contribution and decision-making authority are truly adding value to the organization. Moreover, the talent pool needs to be assessed, selected and developed based on new measures of work complexity and the capabilities required to succeed.

Research conducted by MVC Associates International, along with related research by the Corporate Renaissance Group (CRG), has led to the development of a new framework for evaluating the performance of leadership in public companies. In this article, we will review the analysis of 453 public Canadian companies and show that the leadership teams of 65 percent of those companies are in fact not creating value. We will briefly discuss the performance of the capital markets and the current thinking on Wall Street regarding the measures that should be used to evaluate leadership performance. We will also show why such frequently used measures as EPS growth and ROE are inadequate. Finally, we will illustrate how the leadership team and the business model it develops impact shareholder return over two to five years.

Our seven years of research led to the development of a new organizational model, the Complexity Based Organization™, for evaluating executive work that leads to enterprise sustainability and value creation. We will describe how using new "complexity measures" to define leadership roles at the levels of president (single P&L), group president (multiple P&Ls) and global CEO (multiple sectors of businesses worldwide) identifies the scope and scale jumps of executive work which must be unique in order to truly add value. We will also identify some of the unique leadership capabilities that are required for success at various complexity jumps of general management. Finally, in "the war for talent," we provide the CEO, top HR executive and the board with a basis for aligning the

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organizational systems (performance management, work design, talent management) required to create the leadership selection and development building blocks that create profitable, capital-efficient business results, long term.

TOO MANY LEADERSHIP TEAMS DON'T CREATE VALUE

Many companies today use an increase in stock price and the related Market Value Added (MVA) of the enterprise as a key measure of success. They believe the use of stock options drives value-creating leadership behaviour. But this is only partly true. Many leading economists and Wall Street analysts suggest that 60 to 70 percent of the change in stock price is driven by global macroeconomic factors (interest rates, GDP growth, exchange rates, investor expectations of the equity market), all of which are not within the direct control of CEOs and their leadership teams. However, some 30 to 40 percent of the change in stock price is within their direct control. It has to do with the specifics of how the business performs, i.e., how good the business model is based on numerous financial measures. While stock-price measures wealth creation (or destruction) for the shareholder, it does not measure a business's value creation capability or its underlying economics.

Thus, we really need two different measures to evaluate leadership success. First, how effective are the business model and its underlying economics? Does the business meet customer needs as demonstrated by growing revenues, the efficient use of capital, and a positive "Economic Profit" (Net Operating Profit After Tax, NOPAT) minus its weighted average cost of capital? The Economic Profit measure (EP) was developed by economists in the 1920s under the term "residual income." Economic Profit is equivalent to Economic Value Creation (EVC), developed by the CRG, and Economic Value Added (EVA), developed by Stern Stewart. We have used data from both firms in our analyses of Canadian and U.S. leadership performance.

The second measure for evaluating success is the firm's valuation by equity markets. This includes the assessment of its true earnings and free cash flow, whether it is realizing the current or future value of the business model, and whether this provides a shareholder return that is at least greater than that of the risk-free T-bill rate. The CRG calls this the Annual Economic Return (AER). A positive AER indicates that stock market returns exceeded shareholders' expected return for the given level of risk, thereby creating incremental wealth. This is similar to Stern Stewart's MVA measure. However, AER also takes into account the opportunity cost of investing cash in a risk-free T-bill vs. investing it in the business, as well as new equity raised by the firm. A company can have a positive MVA, but it may not provide a return greater than the opportunity cost of investing the same cash in a risk-free T-bill.

The proposed two measures of wealth and value creation are used to classify companies and their leadership capital into four clusters:

FIGURE 1

LEADERSHIP CAPITAL CLUSTER	POSITIVE	NEGATIVE
VALUE BUILDERS (V)	AER/MVA & EP	
HIDDEN VALUE (H)	EP	AER/MVA
VALUE MYTHS (M)	AER/MVA	EP
VALUE DESTROYERS (D)		AER/MVA & EP

Reviewing the performance of Canadian companies through this framework yields a revealing picture of leadership and value creation in Canada (see Figure 2). Forty-eight percent (216) of the 453 TSE top-listed companies using CRG's data and value creation methodology were in the Value Destroyer category. This should be cause for concern (see *The Canadian Investment Review*, Fall 1999, for more details on the companies and methodology). Moreover, these 216 companies did more than just not create wealth for shareholders over the four years ending in 1999. They actually destroyed value by failing to return a NOPAT greater than the cost of capital they had tied up in the business. This would also suggest that boards of directors may not be fulfilling the leadership and governance roles that they should be. ►

FIGURE 2: LEADERSHIP CAPITAL

LEADERSHIP CAPITAL CLUSTER	CANADA CRG 453 COMPANIES	U.S. STERN STEWART 775 COMPANIES
VALUE BUILDERS (V)	24%	57%
HIDDEN VALUE (H)	11%	8%
POSTIVE EVC/EVA	35%	65%
VALUE MYTHS (M)	17%	25%
VALUE DESTROYERS (D)	48%	10%
NEGATIVE EVC/EVA	65%	35%

A preliminary analysis of the Stern Stewart 1000-ranked companies (including much of the S&P 500) over a five-year period ending in 1999 revealed that 10 percent of the U.S. companies were Value Destroyers, while 57 percent were Value Builders. (The Canadian analysis surveyed data gathered over a four-year period.) While the Canadian data is not exactly comparable to the U.S. data, the methodology is similar. This comparison also reveals that 35 percent of the U.S. companies failed to return a NOPAT greater than their cost of capital; this compared to 65 percent of Canadian companies. This may partly explain why, over 10 years, the TSE 300's annual return has been 10.5 percent, compared to 19.2 percent for the S&P 500.

EVALUATING LEADERSHIP: WHAT REALLY CREATES VALUE?

Increasingly, leading Wall Street equity analysts from CSFB, Merrill Lynch, Robertson Stephens and others have suggested that traditional measures such as EPS growth and Return on Equity are not adequate performance measures. What, then, are the measures that are appropriate for evaluating leadership capability and firm performance?

CSFB has found that there is a correlation between the increase in a firm's total value in the equity markets over two to five years (an external measure of wealth creation for shareholders) and its business performance (internal performance measure of leadership decisions and actual financial results). Specifically, it found the following correlations:

- 50 percent with increase in Free Cash Flow and or NOPAT minus cost of capital
- 35 percent with Return on Equity
- 18 percent with Earnings Per Share Growth

CSFB also suggested that EPS growth does not take into account the:

- risk in the industry/business
- capital intensity
- time value of money for capital invested
- future NOPAT potential after the cost of capital.

We propose that financial measures for determining leadership success be based on both external wealth creation AND internal value creation. Furthermore, they should include business results that are measured over several years, not just one year. A preliminary analysis of the S&P 500 proxy statements shows that 55 percent of these companies are measuring leadership performance and business results only over one-year periods.

Leadership performance and business results measures should include:

- a measure of relative, total shareholder return over three- and five-year periods (ideally adjusted for risk compared to investing in a T-bill)
- a measure of the change in NOPAT minus the cost of capital over three- to five-year periods (i.e., the leadership team's ability to develop a business model, meet customer needs and grow revenue, create operating margin, and deploy assets, intellectual capital and financial capital effectively)
- measures related to customers, employees, the organization and the society in which it operates.

LEADERSHIP, THE BUSINESS MODEL AND EQUITY MARKET PERFORMANCE

Over the last five years the capital markets have shown that they are actually very forward thinking in evaluating the business strategies and investment decisions developed by the leadership teams of listed companies. The markets are not focused solely on short-term earnings, as many believe. In reality, stock price and the overall market capitalization of firms are determined by two factors: current earnings from existing products and services, and the potential for future earnings from new products and services or new business models. The pharmaceutical industry is a good example of this type of evaluation. This also helps to explain why many biotechs and dot-coms have been initially evaluated with large market caps even though they had no current earnings. A price-to-earnings ratio had little meaning in evaluating these companies.

In Canada, the CRG analyzed both the Annual Economic Return (AER) and Economic Valuation Creation (EVC) in 15 industry sectors. It found that, within each industry, the difference between the highest and lowest returns was quite large, even in the same industry sector. We have found similar results in our preliminary analysis of the S&P 500. In contrasting the two- to five-year performance of Dell versus Compaq, South West Airlines versus TWA, Nucor versus US Steel, a key variable of performance in these examples is what we call the Leadership Value Added-LVA™ of the executive team. The CEOs and leadership teams of these companies have all developed a business model (the design of the business system and flow of activities that creates above-average profits) that sustained a competitive advantage and resulted in superior returns.

There appears to be no such thing as good and bad industries, as some believe, but only good and not-so-good executive leadership teams and the business models they have designed and implemented. This includes the amount of capital they have chosen to invest and how they have invested it.

ORGANIZATION DESIGN AND LEADERSHIP FOR VALUE CREATION

A firm's total market capitalization (Figure 3) will reflect:

- cash flow and NOPAT minus the cost of capital from resulting current products and services
- the business model, related growth initiatives and future earnings potential of invested capital
- the current organizational structure of the firm and how it drives future NOPAT
- how well the leadership team has communicated its strategy for growth externally, and how credible the analysts and media find the strategy
- the combined accountability of the total leadership team in relation to the drivers of achieving current and future Economic Profit or EVA/EVC.

To achieve a 15- to 20-percent growth in Economic Profit and shareholder return in today's business environment, the innovation pipeline must be structured differently than the one for meeting targets in the 6- to 10-percent range. In the Knowledge Economy, "complexity" is the key factor in organization design that enables companies to achieve aggressive growth and return targets. One example is innovation, which exhibits itself at different complexity levels, including the process, product/service and business-model levels. Jumps in innovation complexity and the leadership skills required at each distinct level need to be designed into the enterprise's model if the organization is to achieve 15- to 20-percent or more growth.

Over the past seven years, our research has identified a number of complexity factors that impact organizational design and leadership, and truly drive value and wealth creation. In the Complexity Based Organization™, seven levels of complexity are illustrated by such factors as innovation, planning and leadership, with each of these factors being discrete. These seven levels are meant to indicate significant jumps in complexity and to describe and differentiate work contribution that adds real value (see Figure 4). We stress these factors are NOT based on a traditional hierarchy in an Old Economy company. They have their foundation in complexity jumps of scope, scale, variety, uncertainty and decision making.

In the Complexity Based Organization™, decision making moves from a vertical, command-and-control structure with centralized decision making, to value-added work or unique contribution and distributed decision making, what we call Organization Value Added - OVA™. Compensation is no longer based on the size of the team or budget but on the complexity of the work. For example, one CEO commented that his executive team once erred by assuming a product manager's role in running a $ 400-million business in the U.S. was more complex than a general manager's role in running a $30-million business in ▸

FIGURE 3: MARKET VALUE AND ORGANIZATION DESIGN

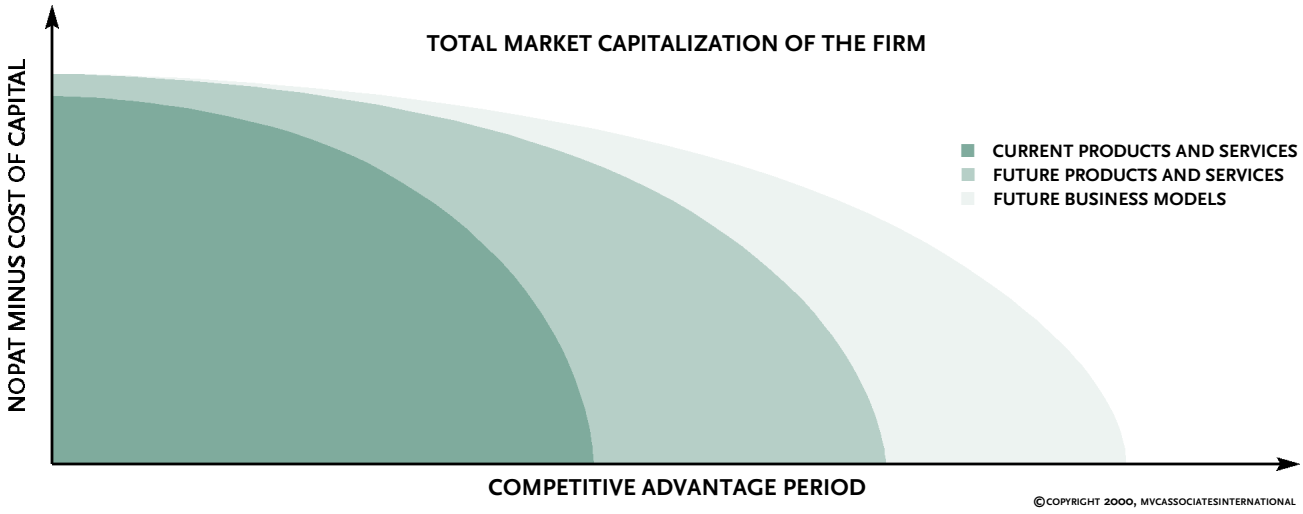

FIGURE 4: COMPLEXITY BASED ORGANIZATION™

INNOVATION COMPLEXITY	PLANNING COMPLEXITY	LEADERSHIP COMPLEXITY	COMPLEXITY LEVEL
CUSTOMER SERVICE	0 TO 3 MONTHS	LEAD SELF	1
QUALITY & CONTINUOUS IMPROVEMENT	3 MONTHS TO 1 YEAR	LEAD TEAM	2
PROCESS	1 TO 2 YEARS	LEAD OTHERS WHO LEAD TEAMS	3
NEW PRODUCT/NEW SERVICE	2 TO 5 YEARS	LEAD MULTIPLE FUNCTIONS/PROCESSES	4
NEW BUSINESS MODEL	5 TO 10 YEARS	LEAD BUSINESS UNIT	5
STEWARDSHIP/CITIZENSHIP	10 YEARS +	LEAD MULTIPLE BUSINESS UNITS	6
ENTERPRISE PURPOSE/PHILOSOPHY	10 YEARS +	LEAD GLOBAL ENTERPRISE	7

Asia. Decision-making authority is no longer based on title or status, but on the capability to manage complexity at various levels, innovate and add value. The Complexity Based Organization™ is about the unique leadership skills that truly add value to the firm at each level of complexity.

COMPLEXITY LEVELS OF GENERAL MANAGEMENT LEADERSHIP

Consider the difference in executive work and leadership skills that creates value for customers, shareholders and employees between a:

- vice-president/general manager of a business with shared services
- president of a stand-alone, profit-and-loss business
- group president of a sector of multiple P&L businesses with presidents reporting from across two or more continents
- global CEO leading two or more group presidents with business sectors worldwide

In a study over the last seven years, over 300 executives in these roles were interviewed around the world. The fundamental difference in these roles, if they are truly adding value, is in the scope and scale of complexity of the work and decision making.

While different titles exist in organizations, in many there are no true differences in the way work is designed (lack of OVA™), or the leadership skills (lack of LVA™) required to create value. Thus, when there is no truly unique contribution by leaders at different levels, these general-management roles are not adding value and exist only because of bureaucracy or internal politics.

For a U.S. client, we applied the Complexity Based Organization™ framework business-wide. We analyzed roles using six complexity factors in the framework and found positions with the title of president operating at Complexity Level 3, other presidential positions operating at Complexity Level 4, and still others at Complexity Level 5. In that kind of situation, it's impossible to compare presidential roles and leadership talent for succession planning. There was a large discrepancy in the work being done, expected results, performance measures and required leadership skills. After discussing the complexity levels, the presidents understood why there were situations where too many executives were doing work of similar complexity, and thus not adding value. One president commented, "I now have an enhanced perspective of what my role should be, how its unique contribution should be measured, the skills I need to develop, and where I should be spending my time to create value."

A large Canadian client with global operations recently asked the top five global executive search firms to present their credentials to the global CEO and the corporate head of HR/OD. The enterprise needed to conduct a global search for a group president to lead a key emerging sector of business worldwide. The search firms were asked to come prepared to address the differences between a president and a group president. To its disappointment, our client found that not one of the global search firms had a point of view on how to assess and differentiate general-manager leadership talent at various levels of complexity. In this case, the search firms are not alone, as many of the board members and HR executives we have interviewed over the last seven years did not have a discernible point of view either. If those in a position to select CEOs (the board) are unable to match the complexity of the role with the required executive capability, we can then expect to see continued turnover of CEOs.

Based on more than 300 interviews at various complexity levels of general management, we observed that a number of critical leadership capabilities are required for a Level 5 Complexity presidential role. These include:

- an ability to conceptualize the business model, the profit drivers where value is created, and how this may need

to change to maintain competitive advantage
- an ability to succinctly describe their customers' needs, the competitive set, the potential size of the market and how this may change
- a recognition of how capital efficiency and the cost of capital impacts the business model and Economic Profit and Free Cash Flow
- an ability to integrate the links between sales, marketing, operations, finance, human resources.

A review of career biographies and articles about dot-com's business strategies indicates that many of the presidents of these firms and their executive teams would probably not measure up against the above leadership capabilities. It is not surprising that some of these businesses have burned through $20 to $200 million plus in cash, have not demonstrated that they are sustainable, and, if public, had a market value below the current value of cash in the bank (cash that was rapidly depleting). The market value was less than the amount of cash in the bank because going forward, the equity markets did not believe that a viable business model existed, so that if the cash was deployed, it would not provide a return greater than the cost of capital.

CREATING VALUE AND DEVELOPING LEADERS: AN INTEGRATED ORGANIZATIONAL SYSTEM

Leadership cannot be separated from the organizational structure in which it exists. Our experience in executive search and talent development shows that when a highly capable executive is recruited into a poorly designed work system, the organization will win nine times out of 10 in not allowing the executive to fully use his or her capability. Therefore, our inital focus is on ensuring that the organization is designed so that every level adds value (i.e., earnings driven through optimizing processes or earnings from new products/services), based on the complexity of the role being recruited for. This front-end, job-design process is required to establish a standard to assess the leadership capability of candidates, and the extent to which they can add value.

Promoting executives to positions in which they cannot operate at the required complexity level will destroy shareholder value and derail career development. There are lessons from the dot-coms in particular here. Putting highly capable, high-potential executives in a reporting structure in which they are more capable than the work they are asked to do creates "jam-up" (organizational dysfunction with its true origin in the work system). This almost guarantees the attrition of top talent.

Top talent migrates to where it can be challenged. If the organization fails to understand this reality and to match the level of work complexity with the capability of executive talent, leadership talent will move to career opportunities where it can be nicely stretched. The Complexity Based Organization™ model identifies the building blocks of executive selection, executive development, learning platforms and how these impact enterprise value.

In the Knowledge Economy, successful businesses that create sustainable shareholder value greater than 10 percent annual growth will demonstrate best practices in:
- business planning and performance measurement
- organization/work design
- leadership capability and talent management.

All three are integrated into the organizational system and all are differentiated at each complexity level.

These complexity levels of work and leadership are engineered into the organization concurrently, and at various levels. How executive work is designed and measured will be unique for each level of complexity. Compensation for both internal value creation and external wealth creation is tied into this organizational framework at the appropriate level.

Over the last few years, articles by such management experts as Gary Hamel and Mike Hammer have debated whether leaders who create value should focus on a new business model or re-engineering processes. In reality, both approaches are right. Ultimately, the challenge is where to design multiple, value-creation activities that take place at the same time into the organization's structure, decision making and leadership system.

Jack Welch of GE has figured this out by integrating unique, value-adding work into the organization's work design and leadership-development framework. As an example, GE is using Six Sigma concurrently with a "destroy-your-business.com" approach.

The board and CEO of a company should ensure that the performance-measurement, organization-design and leadership capabilities of the enterprise are integrated at each level of complexity of work that is truly adding value. Finally, it should be recognized that the "war for leadership talent" and the "war for shareholder value" are one and the same. ■

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