BOOK OF THE MONTH SUMMARY

FOR MEMBERS

OVERVIEW

Value Creation Principles

The Pragmatic Theory of the Firm Begins with Purpose and Ends with Sustainable Capitalism

by Bartley J. Madden

Recommendation

Wonder why the stocks of old-school companies struggle, while the shares of stars like Amazon, Apple and Netflix keep soaring? This book offers valuable insights into the shift from the old economy to the new. The author highlights the fact that, in the 20th century, blue-chip firms leveraged factories and other hard assets, but today, the most valuable companies prosper by also monetizing less tangible assets. This intriguing text for investors and economists describes the secret sauce behind the real value of some of the world's most iconic firms.

About the Author

Bartley J. Madden is an independent researcher who focuses on value creation and knowledge building. He retired as a managing director at Credit Suisse HOLT and founded Callard Madden & Associates.

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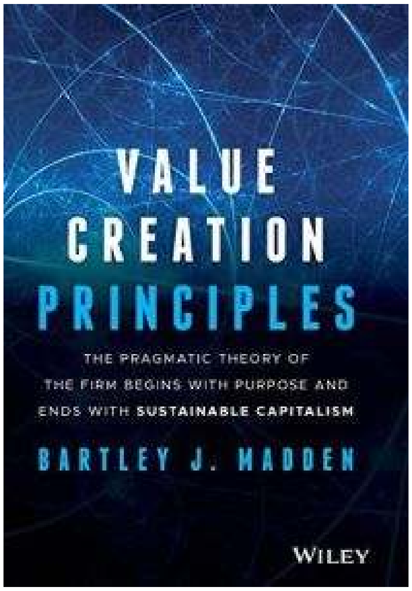

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The Pragmatic Theory of the Firm Begins with Purpose and Ends with Sustainable Capitalism

Bartley J. Madden
Wiley, 2020

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Wonder why the stocks of old-school companies struggle, while the shares of stars like Amazon, Apple and Netflix keep soaring? Investment researcher Bartley J. Madden offers some valuable insights into the shift from the old economy to the new. He highlights the fact that, in the 20th century, blue-chip firms leveraged factories and other hard assets, but today, the most valuable companies prosper by creating virtual platforms and strong brands. This intriguing text for investors describes the secret sauce behind some of the world's most iconic firms.

Take-Aways

- A new, knowledge-based approach to management is taking hold.
- Lean strategies offer a way for capital-heavy companies to transition to a focus on human capital.
- Struggling phone maker Nokia used "paranoid optimism" to mount a comeback.
- Amazon has outperformed the stock market by focusing on a knowledge culture.
- The New Economy is all about platforms.
- Brands provide an important bit of intangible value.

- Netflix leveraged intangible assets to become a massive success.
- Market analysts tend to overlook long-term valuation and knowledge building.

Summary

A new, knowledge-based approach to management is taking hold.
In the 20th century, successful firms were stable ventures that created value by leveraging tangible assets. Today, the New Economy relies on global information, intangible assets and knowledge. Modern companies gain competitive advantage and create value by being more effective than their rivals at building knowledge and leveraging brands and platform effects. Amid this sea change, seemingly overvalued companies have thrived, while asset-rich operations that appear undervalued have struggled. It's unclear whether traditional economists and mainstream market analysts understand how to measure such changes. A century ago, the shift from horses to automobiles ushered in an era of rising living standards, yet economists weren't sure how to fit those dramatic changes into their models.

In our fast-paced New Economy, it is even more imperative to develop an intellectual structure that enables a fundamental understanding of how (and why) firms succeed and fail.

The economist Paul Romer understood as early as 1990 how the knowledge economy had changed the corporate landscape. Romer helped define the limits of the physical economy, while noting the knowledge economy's comparative lack of limits. Physical assets such as oil and copper are finite, but ideas are nearly infinite. What's more, the information economy offers an advantageous cost structure. While a petroleum driller or copper miner sees costs rise to match increasing output, knowledge firms face a more favorable calculus. Microsoft might invest heavily to develop a new operating system. But after that initial investment, producing new copies of its product for sale comes with almost no cost.

In this context, a new management theory has emerged. Instead of focusing on short-term results and shareholder returns, enlightened managers realize that building sustainable success requires a different approach – one that rewards ideas over hard assets. They've embraced the four principles of creating value:

- **Vision –** Companies should communicate goals and values that unite and motivate employees and shareholders.
- **Continuous improvement –** The "survive and prosper" mind-set requires constant analysis of what works and what doesn't. Netflix vanquished Blockbuster by mailing DVDs to users, but that business model disappeared years ago. Netflix has prospered by positioning itself for constant change.
- **"Win-win relationships" –** Companies once thrived by getting the better of their customers; today, the value proposition must go both ways. Financial institution BB&T illustrated this concept during the lending frenzy leading up to the Great Recession. The bank refused to sell risky negative-amortization loans. BB&T was the best-performing major bank from 2007 to 2009.

- **A focus on the future –** Successful firms reduce harm by minimizing pollution and waste.

Lean strategies offer a way for capital-heavy companies to transition to a focus on human capital.
Toyota provides a prime example of this approach. The company launched amid the wreckage of World War II, and it possessed scant financial resources. Engineer Taiichi Ohno adapted by focusing on lean thinking, a system that places a priority on human ingenuity and production efficiency. Ohno's insight was to recognize that mass production required carrying large amounts of inventory and that those hefty inventories could mask waste and inefficiency. He strived to minimize inventory and to shorten the time from taking a customer's order to collecting the customer's payment.

Lean managers are skilled at asking the right questions.

However, it would be too simple to say that lean production focuses only on paring inventory. The approach is more holistic than that. Employees and managers are encouraged to root out waste and then to find more economical ways of operating. Toyota pioneered the kata approach to production, which encourages questioning everything and, in the process, building knowledge. Toyota proved its system worked in 1984, when General Motors brought Toyota managers into an underperforming factory in Fremont, California. The plant produced shoddy cars and was known for disgruntled workers. As GM's joint venture partner, Toyota kept 85% of the former employees, but the Fremont factory quickly became GM's best performer. Toyota took steps such as eliminating sclerotic work rules. When demand for the Chevy Novas made in Fremont slipped, Toyota kept workers on the payroll by bringing in previously outsourced work.

Struggling phone maker Nokia used "paranoid optimism" to mount a comeback.
The Finnish company had enjoyed success in the 1990s, thanks to its dominant position in the mobile phone market: In 1998, Nokia controlled nearly half the global market for cellphones. However, by 2012, the company had entered a phase of decline familiar to many firms focused on tangible assets. Nokia had been eclipsed by Apple, and the Finnish firm was a fading giant, saddled with 100,000 demoralized workers and facing the prospect of bankruptcy. Following an unfortunate combination of management missteps and a misguided sense of entitlement, Nokia was on the brink of disappearing.

An important point emphasized throughout this book is that the root cause of value creation or dissipation resides in the degree of a firm's knowledge-building proficiency.

The company brought in a new leader, Risto Siilasmaa, who diagnosed Nokia's fundamental problem. Executives and workers felt that their past victories meant they didn't need to change. As a result, they ignored the bad news that threatened the company's survival. Siilasmaa's response was paranoid optimism – a way of thinking that said Nokia could once again thrive but only by admitting its shortcomings, tackling its problems head-on and transitioning to a knowledge-based platform. The firm quickly changed strategies, selling its mobile business to Microsoft and instead aiming its attention on telecom infrastructure. The overhaul set Nokia on a new path, one that allows it to capitalize on the rise of 5G networks.

Amazon has outperformed the stock market by focusing on a knowledge culture.
Perhaps no company better illustrates the rewards for building a knowledge-based strategy than Amazon. It has crushed the rest of the stock market, outperforming the S&P 500 by 100 times from 1997 to 2018. Founder Jeff Bezos characterizes the company's approach to consumer needs by noting that Amazon builds products "starting with customers and working backwards." What's more, Amazon is willing to spend years developing new products, a long-term approach unusual in corporate America. True to his word, Bezos shrugged off the failure of Amazon's Fire mobile phone as a necessary risk – an innovative company will have some flops.

Over the long term, stock prices represent an especially knowledgeable vote on a firm's ability to achieve its purpose.

Amazon builds its own momentum. It lures customers with cheap prices, plentiful offerings, and convenient delivery. Those features translate to more customers and more sellers. Amazon Prime members get free delivery, which only reinforces the "virtuous cycle." Low prices mean low margins, but that's not all bad; rivals aren't keen to compete with Amazon if the cost of entry is steep and the reward is a low-margin business. Meanwhile, the company keeps growing, achieving a scale that poses a formidable barrier to entry to would-be competitors.

The New Economy is all about platforms.
In the Old Economy, the most successful operators cornered physical assets, such as supply chains or factories. In the New Economy, companies create value by dominating virtual platforms. Google aggregates eyeballs to its search engine. eBay brings together sellers and buyers of a variety of new and used goods. Amazon offers an increasingly ubiquitous alternative to brick-and-mortar retailers. Thriving networks, by definition, continue to become more compelling to their users. Each new user who joins adds some small new value, yet the network's marginal cost to serve that member declines as the platform grows. Facebook and Uber also illustrate the power of the network effect.

A particularly important way to create significant value in the New Economy is winning the competitive battle to secure a dominant platform that efficiently makes connections that were previously either unavailable or expensive in time and money.

Nokia's mobile business faded in part because of its inability to create a platform. When Apple introduced the iPhone, it also launched a strategy of developing self-perpetuating growth for the iPhone platform. An attractive user experience would entice consumers to buy iPhones; the growing user base, in turn, would attract developers to churn out apps for iPhones. The exploding number of apps would reinforce the cycle by luring even more consumers. Nokia couldn't keep pace with the network effect achieved by Apple.

Brands provide an important bit of intangible value.
Brand value originated with such Old Economy companies as General Motors and Kraft. But a brand is an intangible. It's essentially the value of a promise to consumers and those consumers' beliefs about the brand. The best brands develop deep emotional connections with their customers, who have faith that the product will deliver for them. Starbucks, Jack Daniel's and

Red Bull are among the brand names flourishing in the New Economy. Starbucks has built so much brand value that Nestle agreed to pay $7 billion for the right to use Starbucks's mark on Nestle coffee products. Jack Daniel's was so dear to the late singer Frank Sinatra that he asked to be buried with a bottle of the famous whiskey.

With the most valuable brands, consumers emotionally bond with the product, believing that it excels in delivering what is important to them.

As valuable as a brand name can be, that valuation is constantly under threat. In 2019, Kraft Heinz wrote down the value of its Kraft and Oscar Mayer brands by $15 billion. The reduction reflected shifting consumer preferences. Health-minded shoppers wanted fresh fare rather than the processed foods marketed by Kraft and Oscar Mayer. As a result, the share price of Kraft Heinz plunged 27% in one day. Blockbuster and Kodak stand as other examples of once-valuable brands whose appeal faded. BlackBerry had once built a formidable brand, but Apple's iPhone ended BlackBerry's lock on the smartphone market.

Netflix leveraged intangible assets to become a massive success.
The brainstorm for Netflix's original model of mailing DVDs occurred to Reed Hastings as he fumed over a $40 late fee for a VHS version of Apollo 13. That bit of consumer pain spurred Hastings to co-found a company that would offer a different business model. Netflix originally positioned itself to knock off Blockbuster. In a dramatic example of a New Economy upstart defeating an Old Economy stalwart, Blockbuster disappeared when it proved unable to repurpose its tangible assets in a compelling way. Blockbuster could have bought Netflix for $50 million in 2000 but declined.

Netflix is a huge winner in the New Economy.

Netflix is another New Economy leader that has outperformed the stock market by a factor of 100. Its early success drew competition from Walmart and Amazon, forcing Netflix to hone its value proposition. The company has continued to adapt, launching a streaming service in 2007. The firm has reinvested by creating its own movies and TV series. Just as Netflix knows what movies an individual customer might like; it can use its knowledge of its consumers' preferences to determine what sorts of original content will attract a wide audience. Netflix's success has drawn competition from Disney and others. It has excelled in part by narrowing its focus; it describes its business model as "Starbucks, not 7-Eleven." In other words, Netflix isn't looking to expand beyond its core offering – selling streaming content to subscribers.

Market analysts tend to overlook long-term valuation and knowledge building.
In the New Economy, investors struggle to accurately analyze companies. Old Economy value investors ignored such winners as Amazon, Facebook, and Google parent Alphabet, because their price-to-earnings (PE) ratios seemed impossibly rich. However, the old accounting methods don't properly value intangible assets and platform models. Classic value investors avoided those winners for low-PE firms such as Barnes & Noble, JC Penney and Sears. Those Old Economy stalwarts have proven unable to compete with a new breed of internet-powered rivals.

Those who viewed the stock market as somewhat of a mystery in the Old Economy must be genuinely puzzled by the challenge of analyzing value creation in the New Economy.

The typical Wall Street analyst's report focuses on spreadsheets filled with numbers that purport to illustrate revenue growth, profitability, and other short-term measures of value. These fill-in-the-blank reports focus on the most recent quarter and upcoming quarters, but they do little to reveal a company's underlying prospects. What really determines a business's prospects is more complicated: Its ability to build knowledge is one crucial factor. Other major determinants of success include employee engagement and the rationale behind a company's strategy. However, such metrics are hard to quantify, and none of them appear in the typical analyst's report.

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