TALENT IN 2019: A 26-PAGE SPECIAL REPORT

Chief Executive

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INNOVATION IS THE ANSWER

EXCLUSIVE: CLAYTON CHRISTENSEN SAYS THE GREATEST BUSINESS OPPORTUNITIES OF THE 21ST CENTURY WILL COME FROM TACKLING THE WORLD'S BIGGEST PROBLEMS. HERE'S HOW.

THOUGHT LEADERSHIP PROVIDED BY GALT & COMPANY

GOVERNANCE: THE ULTIMATE DRIVER OF SHAREHOLDER VALUE

TODAY, ALL INVESTORS are "activists," increasingly impatient with companies that deliver subpar shareholder returns compared to their industry peers. Yet, few corporations have been able to sustain superior shareholder returns for any length of time. In fact, over the last 30 years, only two percent of Fortune 500 companies have been able to deliver shareholder returns in the top quartile of their industries for any consecutive five-year period.

However, there are CEOs who have defied this trend, delivering shareholder returns far in excess of their peers, over extended periods of time and, in some cases, for more than one company during their careers.

These leaders will tell you that sustaining superior shareholder returns has less to do with specific products or strategies and more to do with how a company is managed and governed. In particular, how a company:

1) Defines winning and measures success
2) Determines where and how to compete
3) Drives the corporate agenda
4) Allocates resources
5) Creates an activist culture

The observations of these CEOs have implications for how other CEOs and boards establish their own internal governance standards.

❶ Winning and Measure of Success

"Every company needs a governing objective—a driving force by which it measures its ultimate performance."
—Sir Brian Pitman, former Chairman and CEO, Lloyds TSB

All successful organizations have one thing in common: they are unambiguous about their ultimate objective and how they will measure performance. They recognize it is impossible for an entire organization to keep rowing in the same direction without a single definition of winning and consistent criterion for evaluating strategy and resource allocation decisions. Yet, most companies pursue multiple and sometimes conflicting performance goals that lead to inconsistent decision making and subpar performance.

The ultimate objective of any publicly traded company should be to deliver superior shareholder returns over time. While revenue, earnings per share and return on capital are important measures of performance, it is the growth in cash flow and economic profit* per share that drives shareholder value.

Winning is defined in both the customer and capital markets. To sustain superior shareholder returns companies must generate greater:

• *Customer Value:* by doing a better job than the competition in satisfying customer needs; and

• *Shareholder Value:* by increasing their share of economic profits.

When companies do so, they build a reinvestment advantage that leads to sustainable competitive advantage and superior shareholder returns over time.

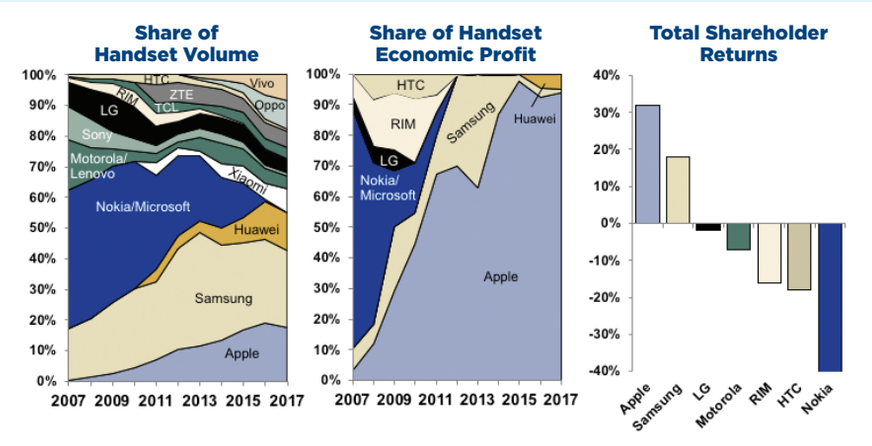
❷ Where and How to Compete

Over 100 percent of the shareholder value of most corporations is generated by less than 40 percent of employed capital, while 25 to 35 percent of employed capital is actually destroying shareholder value.

Most businesses focus on large and growing markets. However, market profits are always highly concentrated, by product category, geographic region, channel and customer segment. Typical performance reports do not measure fully-loaded economic profit contribution at these granular segment levels. As a result, management views

Apple's Mobile Model

Targeting share of market *profits* rather than share of the handset market enabled Apple to deliver superior value.



* Notes: Economic Profit is after-tax earnings less a charge for capital employed. Companies with negative profits not shown on profit graph (Motorola/Lenovo, Sony, Xiaomi, Oppo, Vivo, TCL, ZTE); Samsung includes adjustment for $2.2B one-time writedowns in 2Q and 3Q 2014. Excluding adjustments, Samsung economic profits in 2014 would be negative; Total shareholder returns are for the period 2007-2017 except Motorola, which is 2007-2014.
Sources: Canaccord, Asymco, Company Reports, FactSet, Galt Analysis

all revenues as "good" and all costs as "bad," while the balance sheet receives little attention. Management teams that understand where and why economic profits are concentrated can unlock significant shareholder value by better focusing their strategies and resources on growing profitable segments while fixing or withdrawing resources from consistently unprofitable ones.

Consider the history of the mobile phone market. While most competitors were focused on gaining share of global handsets, Apple focused on capturing a leading share of economic profits. They reinvested those profits to build an ecosystem of applications and services that improved competitive position and generated additional economic profit growth. As a result, Apple has sustained superior shareholder returns. (See charts.)

❸ Managing to an Explicit Value Improvement Agenda

"Risk diversification and risk minimization does not come from putting my chips all over the board. It comes from focusing my chips in the places where I have a decisive competitive advantage." *—Warren Buffett, Chairman, Berkshire Hathaway*

Outperforming investor expectations is a never ending task since those expectations always increase as performance improves. Continuing to meet rising expectations requires a constant focus on the limited number of decisions and actions that will have a material impact on economic profit growth and shareholder value.

Jim Kilts, who as chief executive led turnarounds at Kraft Foods, Nabisco and Gillette, calls this "doing what matters." As Jim states, "Experience teaches you that nothing gets done when you try to do too much." Shareholder value contribution is always highly concentrated, and so too are the opportunities to materially improve shareholder value. Leaders who consistently deliver superior shareholder returns manage to an explicit list of high value-at-stake issues and opportunities. They use this "value improvement agenda" to keep their organizations focused on the handful of things that will significantly increase their companies' intrinsic value.

❹ Proactive Reallocation of Resources

Sustainable improvement in economic profit growth requires continual reallocation of resources away from business strategies that do not create value and toward those that do.

In addition to pursuing a prioritized agenda of highest value-at-stake opportunities, companies must also differentially allocate resources. Too often, investment dollars are spread among businesses in proportion to their existing capital base. That may seem "fair," but economically it makes little sense. Resources should be differentially allocated to the businesses that will create the most value, while withdrawing resources from value-consuming businesses.

❺ Creating an Activist Culture

"The surest way to avoid shareholder activists is to do their job for them." *—Travis Engen, former Chief Executive, ITT Industries and Alcan Aluminum*

The best CEOs often think about their companies like activist investors—they seek to maximize economic profit and cash flow over time and deliver higher returns than investors could achieve from putting their money elsewhere. Activist CEOs take a direct role in seeing that traditional views about the business are challenged in order to arrive at the value maximizing strategy. They also recognize that shareholder value is impacted by the daily decisions and actions of hundreds, if not thousands of managers across their organization.

These executives appreciate that one of their primary responsibilities is to instill throughout the company a set of beliefs and behaviors that are aligned with the long-term interests of the company's shareholders. They recognize that the ability to sustain superior performance is the result of an organizational advantage. These leaders work to build the organizational capabilities and establish the governance conditions that align management and shareholder interests, thus creating a culture of entrepreneurial owners throughout the corporation.

How the Directors Can Help

Effective CEOs appreciate that the level of strategic and organizational change needed to achieve and sustain superior shareholder returns cannot be accomplished without the understanding and support of their boards. For this reason, those CEOs devote meaningful effort to discussing these concepts with their directors. They actively involve their boards in reviewing the highest value-at-stake issues and opportunities facing the company, the strategic and organizational alternatives they are considering and what will be required to implement these changes. In doing so, these chief executives have enabled their directors to be much more effective representatives of the company's shareholders.

The Authors

Scott Gillis, Lee Mergy and Joe Shalleck are co-founders of Galt & Company. Galt helps Fortune 500 Companies develop the strategies and organizational capabilities to achieve and sustain superior shareholder returns. The firm has been associated with several of the more notable corporate transformation of the last two decades.

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