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A Stake in the Outcome

By

Jack Stack and Bo Burlingham

The Definition of a Culture

And to be an owner, a true owner, you have to care. Owners do not follow a job description. They don't just put in their time. They have something bigger they're working toward, and they feel a sense o responsibility about accomplishing it. They go beyond mere problem solving and look for creative, innovative ways to reach their goals. They are independent-minded, freethinking people, leaders not followers, and they know how to take the bad with the good. Indeed, they're often at their best when the going gets tough. They have what it takes to reach down and find the inner sources of strength that allow them to keep moving forward, no matter what gets in their way.

But to build such a culture—and to sustain it—you must also have a company that comes through on the promises it makes to its employees.

Continuous Learning

The mechanisms allow us to delegate a tremendous amount of authority and responsibility by giving people the information they need to make decisions that are in the best interests of the company, both short and long term.

The mechanisms embody our values and transmit our culture to new employees. With the weekly huddles, the scoreboards and charts on the walls, the constant chatter about hitting targets, it doesn't take long for someone to figure out what we stand for.

…the most critical function of the Great Game mechanisms is education. They are the tools we use to promote continuous learning in every corner of the organization. They are the means by which we make information business training a regular part of our day-to-day routines.

According to an authoritative study conducted by the Center for workforce Development, formal training programs account for only about 30 percent of what people know about their jobs. The rest they pick up informally from the people they work with—at the coffee machine, in the lunchroom, during breaks on the floor.

When new people come in, they usually get some kind of job orientation.

Job-related learning goes on whether or not we're aware of it. People learn through a whole series of events that most companies don't even recognize, and so they never figure out how to leverage the process.

People learning when they have meetings or interact with customers. When you talk with your supervisor, you learn. When you mentor another employee, you learn. When you report to your peers, you learn. When you come up with a replacement so that you can move on to another job, you learn.

It's all about leveraging the informal training process, using the regular routines of the company to promote continuous learning.

There are two things every company must do to stay in business: make money and generate cash.

Business is an unfolding drama. You never reach a point at which you "understand' it in the sense of having all the answers. There are always new questions to consider, new discoveries to make, new problems to confront and mysteries to solve. To be good at business, you need to be continuously learning—even if you're Jack Welch.

The First Rule of Ownership

…we're building a company, not just making products.

But you must have some way of getting people to think in terms of the company they're building and the higher goals they're striving toward, rather than just the products and services they're striving toward, rather than just the products and services they're delivering.

Every company has to design, make, and sell things customers want to buy.

Great companies tend to be known for their great products and services. But they're the result, not the cause, of greatness. Inspired people can do incredible things. The questions is, Where does the inspiration come from? In an ownership culture, it comes from building the kind of company that can let you achieve your higher goals.

Ownership Rule #1

The Company is the product.

People have to understand that they have a direct role to play in creating the kind of company they want, and that creating such a company is their responsibility and the ultimate goal of the enterprise, the end result of all their efforts.

Employees, most of them, after all, have grown up either in the old industrial economy or in institutions that operate by its rules and norms.

Job descriptions, work rules, accountabilities, performance reviews, individual bonuses—they're all designed to make people think in terms of doing the job, performing the function, getting the product out the door. Only the top people are supposed to worry about the company as a whole.

So when you set out to create an ownership culture, you wind up having to fight against all the habits of mind that people have developed in those old-economy environments. You also have to fight against the ways people have been trained to think about their roles.

Most managers, for example, assume that a major part of their job is to manage people. But you can't manage owners, and most people don't like to be managed anyway.

The alternative is to have a system that allows people to manage themselves.

It doesn't matter what job they hold. They can still be leaders. They can choose to lead by taking responsibility for themselves, seizing the opportunities that the company has to offer, reaching out for their own higher goals—even if they're front-line employees being paid an hourly wage.

In an ownership culture, you need to broaden the concept of leadership and delegate leadership. You need to work on developing leaders at all levels of the organization—improving business knowledge and skills, giving people ownership of the job and responsibility for its execution, pushing them to make decisions, encouraging everyone to reach out and move up. You want a workforce full of people who are fast on their feet and ready to take advantage of the opportunities that come along. That's the only way a company can achieve its strategic goals.

You can challenge people. You encourage them. You tell them the truth. You try to help them understand reality. But you don't manage them, at least not in the traditional sense.

Instead you manage the system.

You keep measuring and analyzing the results.

The system is never finished. There will always be parts of it that need fixing or upgrading, or that haven't been invented yet. There will be, that is, as long as the world keeps changing.

So somehow you need to quantify the performance of your ownership culture, if only to determine how well your system is working.

<u>Psychic Ownership and "Real"</u>

Psychic ownership comes, I believe, from the sense of community that develops when you treat people as responsible adults, capable of understanding how the business works, looking out for its best interests, and contributing to its success.

Psychic ownership is important. But psychic ownership doesn't help a company deal with the biggest issues it faces—like succession. I also believe that businesses miss out on the real potential of ownership of stock is not part of the deal.

Equity is, in fact, a kind of a contract. It defines the terms of a shareholder's relationship to the company that issues the stock. When people get stock in the company they work for, they have something real in their hands, a guarantee that they're going to receive a portion of the wealth they help create. What happens to the stock, and what they ultimately get out of it, are different matters, but they do have the promise in writing, and no one can take it away from the.

There's more to equity than simply the rewards people get from it, because they can receive those rewards only by working together to build something of value. You need a group of people to create a company whose stock can be bought and sold. It's almost impossible for anyone to do it alone.

It's about what one person can do for another person. It's not just a set of rewards; it's a reward system.

When people are working toward a common goal, they can rise above the hardships. They can realize how important they are to one another, and come together as a team, and create something better than what existed before. Because people have hope. They have something to look forward to in their lives.

Ownership is not all fun and games. Being an owner involves responsibility—for making payroll, for protecting jobs, for fulfilling commitments, and so on. You give people ownership in part because you want them to share and accept that responsibility.

Ay company can do well when times are good. It's in bad times that we find out what businesses are made of.

No matter how loyal and motivated psychic owners might be, they aren't complete owners if they don't also have an equity stake, and sooner or later the limits of their ownership become apparent. They hit a wall in their education. They may become better employees, but they never encounter the biggest challenges of ownership, and they don't share in its rewards. In the end, it's equity that provides the ultimate economic payoff of business. Unless employees are responsible, not just for helping the company make money, but also for building its equity value, there will always be a division between the "real" owners and the psychic owners, and over time that division will undermine the culture, stunting the growth of the business and that of its people.

When we began our journey, it was considered a radical idea to share ownership and financial information with employees. Now both practices are commonplace.

At SRC, we've come as close as anyone to figuring our how to do that, but it's taken twenty years.

Dreaming

People can accomplish almost anything if they have a common purpose, a higher goal, and they all know what it is, and they're going after it together. Everybody needs to be going somewhere. People need a destination, or they get lost. If they have one, however, and if it's really their own, there's no telling what they can do. They can survive the darkest hours, beat the longest odds, scale the greatest heights.

That's a fundamental truth I've seen demonstrated over and over again throughout my career. I've seen machinists in Melrose Park, Illinois, transform their department from the least productive to the most productive in the plant out of sheer pride.

I've seen all kinds of struggling businesses—retailers, design firms, wholesale distributors, woodworking companies, and on and on—suddenly turn themselves around and take off.

A leader can't make those things happen. A leader can only allow them to happen. How? By coming up with a goal that people can believe in and then showing them how to reach it. Doing that is the most important job a leader has.

In the dark days of 1981, we needed a goal to strive for. We needed a way to keep hope alive. I couldn't think of any better objective than buying the factory ourselves. The idea of having our own company was exciting.

Buddy, Can You Spare a Dime?

I worked every contract I had and followed up every lead I got.

Along the way, I got a tremendous education.

There was one meeting in particular that I'll never forget. I was with Stan Golder, a partner in Golder, Thomas and Co., a leading venture capital firm.

Listen, kid, I want to know about the market. I want to know how big it is and what percentage of it you've got. I want to know how you're going to grow that percentage, what specific steps you're going to take to get a bigger share. And I want to know what that means to me. I want to know how I'm going to get annual interest of 40 percent, compounded, over the next five years and a 500 percent return on equity when I get out at the end of that time.

What Golder said was a revelation to me.   Investors were interested in their money, not in my company! They wanted to know how I was going to help them achieve their financial goals! Eureka!

Ownership Rule #2

A Company isn't worth anything if nobody else wants to own it.

If your aim is to build value in a company, you have to learn how to look at it from the outside in. You can't view it in the way most people in business do, from the inside out. You have to see it as investors see it—coldly, objectively, without any sentimental attachments to people, products, buildings, history, culture.

Why? Because people don't put money into a business unless they feel it's a good investment for them.

Not that it's easy to look at your company from the outside in.

There are actually four different types of investors. The first circle consists of people who lend because they want to help you build and enduring company. The next one is filled with investors who just want to get in and get out. The third circle has the predators—investors who give you money hoping you'll blow it, at which point they'll steal the company from you for a song. Fourth circle: the guys who charge you through the nose and break your kneecaps if you don't pay up.

I've come to realize that dreaming is an essential business activity. A dream is ultimately the expression of your values. It shows what really matters to you. It defines who you are.

Have you created the kind of company you had in mind when you started?

We had to make sure that we were all in the same boat, and everybody's oar was in the water, and we were all rowing. That meant, among other things, that people had to know the financial rewards would be distributed more or less equitably. Otherwise, people wouldn't look at the Big Picture. If they didn't have a share of the pie, they'd have no reason to care about making the pie as big as possible.

Beyond generating wealth, I was thinking about the kind of company we were creating. I wanted a company filled with independent-minded, freethinking people. To me, that meant we all would share the burdens as well as the benefits of ownership. I really didn't want the entire responsibility for feeding everybody. I wanted people to have some responsibility for feeding themselves.

The Design of a Business

Most people, I know, don't think about the company they're designing when they start out in business. They think about the products they're going to make, or the services they're going to provide. They worry about how to raise the money they

need, how to find customers, how to deal with salespeople and suppliers, how to survive. It never occurs to them that, while they're putting together the basic elements of the business, they're also making decisions that are going to determine the type of company they'll have if they're successful.

But a good company, I've learned, is like a good car: it begins with a good design. The company you wind up with reflects the concepts and principles you incorporate at the very beginning.

My natural inclination is to start at the end and work backward, looking for shortcuts as I go.

Harold Geneen, the legendary builder of ITT, believed that the ability to work backward from a goal was the secret to being a good manager. "**You read a book from the beginning to the end," he wrote in *Managing.* "You run a business the opposite way. You start with the end, and then you do everything you must to reach it."**

You move forward in business by running into obstacles and overcoming them.

Every company confronts an endless series of obstacles, each one new and different. You develop business skills by dealing with them one at a time.

The best businesspeople understand the process. They realize that the bigger the obstacle, the more they're going to learn from it. They welcome the challenge even through they know they won't always be successful on the first try. At least they'll lean what they need to do on the first try. At least they'll learn what they need to do differently the next time.

They accept that business is all about problems.

No One Likes to Be Left Out

Out experience taught me two lessons in this regard. First, make your decision in the best interest of the company, then let go of it. You can't please everyone, no matter how much you want to or how hard you try. If you make reasonably good decisions out of pure motives, the vast majority of employees will eventually come to accept and appreciate your decision.

Second, don't give up on the people who feel slighted and angry. We have several people who believe to this day that they were treated unfairly in the buyout—but that hasn't stopped them from making major contributions to the company's success, or from reaping big rewards.

Ownership and Control Are Different

The next part of the design had to do with the issue of control, which people often confuse with ownership. They think that owners automatically have control over decisions. Conversely, I know experienced businesspeople who believe they can't be in control if they don't have at least 51 percent of a company's stock.

You can easily separate ownership from control by having two classes of stock. The people with voting stock elect the board of directors. People with nonvoting stock are also owners. They have certain legal rights, and they get to share the rewards. But they don't have a say in electing the board, which is the ultimate authority. Whoever controls the board controls the company.

I was absolutely certain that I couldn't make all the right decisions on my own. What's more, I didn't want the responsibility that comes along with absolute power.

So I was determined to develop an alternative to the top-down, command-and-control business structure that was the norm in those days.

The decision-making process would have to be very clear, very fast, and very direct. In the beginning, there would be time to work on consensus building, team building.

How to Control a Board

It's important to understand exactly how a board of directors works.

The board is elected by the shareholders who own voting stock.

Only the voting stock can be used to elect members of the board, which has the final say on the company's strategy and direction. The board exercises its authority by approving or rejecting the annual plan it gets from management prior to the start of the year, and by making certain key decisions—about hiring and firing the top officers, for example, or approving what the top people earn. Thus whoever controls the board ultimately controls the company.

Ownership Rule #3

The bigger the pie, the bigger the individual slices.

That was my introduction to one of the great challenges of equity-sharing—namely, the difficulty of getting people to think about what's possible rather than focusing on what they have. You give them stock hoping it will motivate them to grow the business.

Everything Sends a Message

When you're a leader, how you think and act is as important as what you do. People pay attention to the details, the unconscious messages, the little signals that you send often without realizing it.

It's often not the decision itself, but the thought process behind it that send the loudest message. People can accept a decision they don't like if they understand that you made it for the greater good of the organization.

Success Is Harder Than Failure

As Sheppard kept reminding us, you have to design a business understanding that your biggest problems won't come with failure. They'll come with success. That's hard. Nobody starts a business worrying about the dangers of success.

Setting the Value

Should we value the company at two times book value (that is, twice the amount left over after subtracting the company's liabilities from its assets)?

We realized that whatever we came up with had to be as clear and as clean as possible. We wanted a valuation method that we all found acceptable, and that would allow us to live together harmoniously and separate peacefully, come what may. That is a golden rule of equity-sharing: The clearer you can be up front about your method of valuation, the better off you're going to be.

Trust is a key element of long-term business success, and you can't have trust without honesty and openness. By agreeing in advance to a fair method of valuation, and then by sticking with the process year after year, we were able to create an environment in which trust, honesty, and openness were understood to be fundamental elements of the way we did business.

Only when we were confronted with a crisis, however, did I understand that a buyout formula is not just a good idea; it's an essential element of any equity-sharing arrangement.

For those thinking about entering such an arrangement, never, ever go forward without agreeing in advance to a formula you're going to use to cash shareholders out when they leave.

What to Look For In an Adviser

- You need a good listener who focuses on help you reach your goals, not on changing them.
- You need someone with practical business experience as well as legal and technical expertise.
- You need someone who is thorough

Hazards of Employee Thinking

There are two extremes in the debate over how companies ought to be run. One extreme says business is business:

…screw or be screwed.

On the other extreme are people who believe that business utopia is just around the corner.

Ownership Rule #4
Stock is not a magic pill.

When you've spent your entire adult life focusing on a job description, it's difficult to stop thinking like an employee and start thinking about what's best for the company as a whole. Old habits die hard.

By "employee thinking," I mean the habit of focusing on your little piece of the company instead of looking at the whole thing. That's how we'd all been trained.

As owners, however, we could no longer afford that type of thinking.

Field Notes
"Ownership is active concern," the members explained in an orientation for new employees. …An owner chooses to constantly grow, and does not wait for someone else to tell him what new skills to learn…An owner builds the entire team."

Ownership Rule #5
It takes a team to build equity value.

An ownership culture is build on mutual trust and respect, and it's almost impossible to have either one unless people throughout the company are engaged in frank, open, and honest communication about the state of the business.

Manageable Failures
Everybody who goes into business wants to be successful. The mistake most of us make is to think that the path to success is a straight line. Every big success, we believe, is the result of a series of small successes. The assumption is that you will eventually get what you want if you just take it a step at a time, going from one small victory to the next, until you reach your ultimate goal.

What we miss are all the failures that play a critical role in every success story. Many of those failures are personal. I'm talking about people not living up to expectations, not rising to the challenge, blowing opportunities, giving up, falling by the wayside. I'm talking about serious miscalculations, grave lapses in judgment, disastrous blunders, severe disappointments, even betrayals. We've had them all from day one.

We've grown stronger with every failure.

Success is a series of manageable failures.

Ownership Rule #6
Failures are fine as long as they strengthen the company.

The company gets in trouble only when people lose sight of the common goals.

In the course of building an ownership culture, you're going to have a lot of failures, most of which will be people failures.

Commissions Discourage Teamwork

The hallmark of that culture was an intense individualism, which got in the way of teamwork. When you pay people a sales commission, you're giving them a powerful reason to make sales their first priority, and selling is a solitary activity. It's hard enough for salespeople to think about the greater good or the long-term reward under any circumstances. It's almost impossible when their entire compensation is based on what they sell today.

Individualism Is the Enemy of Performance

The effect is to encourage sales people to focus on themselves, and so you get individualism, which is the enemy of performance—unless maybe you have a one-person business. Phil Jackson, the former coach of the Chicago Bulls, used to beat that message into Michael Jordan. "What will make you a superstar," he said, "is not being the star." That is so true, and Jordan knew it. When he was questioned about his loyalty to Jackson, he said, "he taught me to let other people have the sunshine."

At RSC, it appeared that no one wanted to let anyone else have the sunshine, and the commissions just reinforced the behavior. The held people back, kept RSC from fulfilling its potential.

In addition, the commissions created huge problems inside SRC. The RSC guys were so single-minded in pursuit of the sale that they were oblivious to the pain they were inflicting on the rest of us.

The experience convinced me that our salespeople had to be integrated into the company.

But there's a curious thing about business, real business, as it's practiced in the real world. You often have difficult experiences, and learn important lessons, and yet when you look back, you realize that you wouldn't necessarily have done much differently.

We should have base the commissions on gross margins rather than sales, which would have forced the RSC guys to think about the cost of producing the stuff they brought in. In addition, we probably should have limited the commission part of their compensation to sales of products that had already been researched, designed, engineered, and produced.

Instead of selling the water pump we already made, they were forcing us to engineer a totally different water pump. As a result, we were always falling short. We were constantly late, and so we walked around with a tremendous feeling of inadequacy.

What we hadn't anticipated was the difficulty of getting everybody to work together—or the price we'd have to pay to find that out.

People go to work in traditional businesses and learn traditional ways of thinking and acting, which become habits over time. You can't change those habits overnight. You can't change them by logic and rational discourse. Sometimes you can't even change them by appealing to self-interest. You can change them only by developing a process, by repetition—in effect, by replacing employee habits with owner habits.

You have to show them a different way of thinking about the business and their role in it. You have to set up an educational process that's going to allow everyone to learn together. And that mean making big changes in the organizational structure, the relationships between people, the paths of communication, the whole concept of responsibilities and duties and goals.

"Reality is something you have to teach people"
A culture, any culture, is based on relationships and values. So when you set out to create a particular type of culture, it's important to be clear about the values you want to promote and the kind of relationships you want to foster.

I wanted a company of independent people, independent thinkers. I didn't want paternalism. I wanted people to be motivated because they saw the opportunity they had, not because I'd tricked them into doing what I wanted, or what was good for me. We were giving them a tremendous opportunity in the form of ownership. I wanted them to make the most of it by taking responsibility for themselves instead of counting on someone else to look after them.

<u>Ownership Rule #7</u>
Ownership needs to be taught.

If people don't recognize the opportunity they have to create some financial security for themselves and for one another, they won't be motivated by it.

If you want stock to have the desired effect, you have to help people make the transition from employee to owner. You have to teach them the meaning of economic value—what it is, where it comes from, how they can create it.

Maybe we could set up a game around hitting the goals. In order to win, people would have to learn about financial concepts, and we'd be there to teach them. In effect, we'd trick people into learning. Over time, they'd begin to understand the larger opportunity they had as owners, and then they'd motivate themselves to take advantage of it.

<u>How to Launch a Management System</u>
1. Provide information business training to people throughout the organization; and keep us all focused on the goal of building the kind of company we wanted.

We wanted to engage the minds of our employees, knowing that their hearts would follow.

The process was, and is, fairly straightforward:

- You begin by setting up a game around hitting a critical number—that is, a performance target that will address your greatest weakness as an organization.
- Next, you do everything you can to education people about the target—what it is, why it's important, how each person can contribute to achieving it.
- You also encourage people to give their own spin to the game and work with them to develop additional mechanisms (scoreboards, scorecards, huddles, and so on) that can help them win.
- They win; everybody celebrates; and you do it again, and again—steadily refining the process, adding new mechanisms, looking for ways to improve the system.

First, we identified our critical number, which was easy. After a year in business, our financed debt still totaled $7.2 million and cast a shadow over everything we did. We decided we'd shoot for reducing our financed debt by $3 million in the coming year. It was a goal that everybody could understand and get behind, since meeting it would greatly increase the job security for us all.

We also set a target of $2.2 million in pretax profit for the year. Hitting the one would ensure that (a) we didn't sacrifice profitability to meet the debt-reduction goals; (b) we'd have enough cash to pay whatever bonuses we earned; and (c) we'd be able to get people focused on learning about the income statement and its relationship to the balance sheet.

The next step was to come up with a set of rewards for winning the game. We figured that, if we actually hit the two goals, we could afford to pay $300,000 in bonuses, which amounted to about 8 percent of our annual payroll. So that was the pot. Each of us would be playing for potential bonus of 8 percent of our pay.

We also realized that it was important to keep everybody involved in the game throughout the year. So we decided to have specific targets—and potential bonuses—for each quarter.

In the first quarter, 10 percent of the annual bonus pool would be up for grabs; in the second, another 20 percent; in the third, another 30 percent; and in the last quarter, the remaining 40 percent. (hence, the 10-20-30-40 bonus plan.)

What's more, any part of the bonus we didn't earn in one quarter would be added to the pot in the next quarter. So even if we feel short in the first three quarters, we could still come back and win it all at the end of the year.

I put our standard cost accountant, Doug Rothert, in charge of production, which came as a shock to him since he had no experience in manufacturing. I told him not to worry: His job was to teach finance to the people in the plan. He began conducting almost daily tutorials with individual supervisors, going through work orders, showing how the numbers flowed back to the income statement and how the

income statement flowed into the balance sheet. The supervisors then went out and did the same thing with the hourly people.

Meanwhile, the other manager ran training sessions of their own, and we talked up the game at every chance we got. Our CFO, Dan McCoy, would regularly go on the public address system to give updates on the score. At the end of each quarter, we'd hold a series of informational meetings throughout the company to review the results with all of the employees.

We began holding weekly meetings at which the department managers would report their numbers for the prior week.

The managers would then take the information back to their departments and fill in the people who hadn't been at the meeting. The front-line supervisors would do the same with people on the shop floor.

It wasn't enough to get the prior week's numbers. We needed to know what was coming up. So each week we began having the managers forecast what they expected their month-end numbers to be. We could then compare the forecast with the plan to see how we thought we were doing in the game—and later compare the forecast with the actual result to see how much control we had of the numbers. That practice evolved into the mechanism known as forward-looking financials.

Every mechanism we came up with evolved over time, as did the entire management system. We tinkered with it constantly, and we still do. I don't think anyone who develops a management system ever stops tinkering with it. You're always looking for ways to refine and improve it, and you're always having to adapt it to changing conditions.

<u>Learning to Love the Variances</u>

We were manufacturers, after all, and we had a manufacturing mentality. We went about developing the management system more or less the same way we would have developed any other process. Our approach was to:

- identify a function
- define a process for carrying out the function
- figure out how to quantify the key elements of the process
- measure the results at regular intervals
- focus on the deviations and the variances
- tweak the process until we got the results we wanted.

If you want to make your management system better, you have to learn to love the variances, which doesn't come naturally.

You come to realize that you need the variances. They're clues that can help you understand what's wrong with your management system, your processes, your

model. They point you toward the changes that will make you stronger. They show you what you have to do differently, so that you don't keep having the same problems and making the same mistakes year after year after year.

You can't trust success

There's a common mistake people make when they're setting out on their first business venture. They think all they have to do is survive.

They don't even realize that there are any stages beyond survival. I've learned that a company has to go through at least three stages to reach its full potential: the survival stage, the growth stage, and the maturity stage.

"You won't know what real problems are until you've successful."

We learned how behavior can change when a company takes off and the stock value soars. We discovered how various forms of blindness can set in, posing threats you can't imagine when you're starting out.

It began to dawn on me that most people hate owners.

I had no idea of the depth of animosity that exists toward owners as a class.

Many owners bring it on themselves.

One way or another, they make it clear that they're different. The flaunt their wealth and status and power.

That's what I call "playing the owner card."

People become very passive when the owner card is played. They may be angry, but they don't fight back. Instead they clam up. They shut down. They just obey. You don't get any creativity from them, any engagement. They do what they're told to do and nothing more. So they don't learn.

Sooner or later, you want to spend some of it. You feel like acquiring some of the nice things that are your reward for working hard and taking risks. As soon as you do, however, you notice that people are looking at you differently. They don't think, "Well, he had nothing, and he earned it." They just look at the fact that you have it and they don't.

What people resent is not wealth or ownership per se. It's the flaunting of wealth and ownership. It's the feeling of being excluded. If you don't want people to have that feeling, you need to recognize the messages you may be sending unconsciously by the type of car you drive and the way you talk.

<u>Ownership Rule #8</u>
You build an ownership culture by breaking down walls.

You have to show people that ownership means opportunity, not exclusion.

We can all learn something from Sam Walton, the founder of Wal-Mart, in this regard. Here you had the most successful owner of his time, the richest man in the world, and yet he was almost universally loved and respected. Why? Because he was plugged into reality. He understood what ordinary people were thinking and feeling. And so he was able to sell the concept of ownership to his own employees and to people all over the world. He got rid of the class distinctions by putting stock in everyone's hand and also by being careful about the symbols. He didn't divide his company into owners and non-owners. He created a picture of owners as one class—the class that you wanted to be in.

Owners do not hitch up their spurs and ride higher than the crowd. The don't stand over anyone. They don't let ownership go to their head. The show respect, and they receive it. Yes, some people in a company may have more shares than others, but you want everyone to understand that the organization is being guided, not by the narrow interests of the largest shareholders, but by a commitment to doing the right thing at the right time for the majority of people who are going to be affected.

The more they play the owner card, the more isolated they become. It's only a matter of time before everyone realizes they have to go.

GM, it turned out, didn't need nearly as many remanufactured diesel automotive engines as we'd signed up to produce.

Overnight, we'd lose 17 percent of the sales we'd been counting on for the coming year and, with them, the cash to employ 20 percent of our workforce.

As the CEO, my job was to make sure we'd anticipated such threats and developed contingency plans to deal with them. In that, I'd failed miserably. We'd been oblivious to the danger. We had no fallback position—no big customer waiting in the wings, no new product lines ready to get up and running, no other business we could quickly start.

But the experience of the GM cutback taught me some absolutely critical lessons about business. It forced me to go back and re-examine the entire way I'd been thinking about our company and its future.

We'd told ourselves, for example, that we were diversified, that we had viable business in four or five different market segments—including automotive, where we though we were doing great.

But, in fact, we were hardly diversified at all, and automotive was far from being a viable business.

There's an acid test you can use to figure out whether or not a business is truly viable: Would anybody want to buy it from you? In retrospect, it was clear that our automotive division couldn't have passed the test. Who would pay for a business with one customer that could cancel its contract at any moment? Minus the GM account, we didn't even have an automotive business. We had some real estate, some equipment, and some people—that's all.

Buyers would have no good reason to be believe they'd get a decent return on whatever money they invested—and so they wouldn't invest.

We'd taken for granted our ability to keep growing indefinitely. We'd assumed General Motors and all of our other customers would be around forever.

To avoid experiencing a comparable surprise in the future, we looked for ways to protect ourselves.

We changed our entire planning process, for example, putting more emphasis on the need for contingencies and trapdoors.

We began to insist that each business unit go into the year with contingencies equal to 15 percent of its projected sales for the year. The unit had to include the contingencies in the forecast in presented to the rest of the company and tell us the stage of development each one was in.

<u>Ownership Rule #9</u>
Getting out is harder than getting in.

How do you leave with a clean conscience?

It's what no one tells you when you go into business.

How to Avoid the Founder's Trap: Start Early
Succession is, of course, an issue that sooner or later confronts every business and every business leader.

In such situation, the concern is that the next generation of leaders won't sustain the culture, and the company will therefore lose its competitive edge.

Having an exit strategy and getting out with a clean conscience, moreover, are two different things.

Getting out is, in fact, the furthest thing from most people's mind when they launch a business. If the subject comes up at all, they figure they'll deal with it when the time comes. They say, "We'll sell the company" or "We'll go public." Unless they have outside investors, they don't address the tough issues like valuation or buyout formulas, which is a huge mistake.

In the beginning, you're too worried about staying alive to be concerned about getting out.

Even after you get beyond the survival stage, those habits stay with you. You see the business as an unfolding drama, a story that you're writing as you go along. You don't think much, if at all, about the end of the story. You figure you'll wait until it comes and let yourself be surprised.

If you own all of the stock, or if all of it is in your family, there isn't much pressure to change the way you think about your business. Chances, are, your whole identity is centered around the company. It's your baby. You can hardly imagine life without it. You figure you'll be there forever, or maybe pass the business along to your children. In any case, you don't seriously contemplate leaving—which affects your decisions in ways you probably don't even notice.

You may, for example, develop a subtle bias against experimenting, innovating, pushing the business in new directions. In particular, you may shy away from diversifying. Why? Because you prefer to stick with what you know, with what's worked for you in the past. Most people tend to be somewhat risk averse as it is, and they get a lot of encouragement to "stick to the knitting." It's supposedly a tried-and-true strategy.

And you may be successful with it. I've seen many good businesses-people who focus on doing one thing extraordinarily well, and who make a ton of money in the process. They don't even give a thought to diversifying. Why should they?

There's only one reason to do it: because you're thinking about the future. You know that the good times aren't going to last forever, and you have to be prepared. Fear leads you to diversify, and fear can be a great motivator. To be an entrepreneur, to innovate, you can't be comfortable. You have to be afraid of something. Our fear was that we wouldn't be a le to pay off these people when time came, that we wouldn't be able to deliver on our promises.

You don't have that pressure if you own all the stock. You're not faced with the prospect of having a lot of shareholders thinking you let them down. You have one thing to worry about: making sure you have the cash you need to survive.

In that situation, there's natural tendency to protect the present rather than position yourself for the future. You develop a whole rational around staying in your core business, being really good at a few things. You keep all your eggs in one basket, and then you watch that basket, as mark Twain said. That's what I mean by protecting the present, and you can be very successful at it. I know companies that have done very well without diversifying, without thinking about the future.

But the owner can't die.

And that's the whole problem. It takes time to figure out how to leave with a clean conscience. It takes time to develop a realistic exit strategy. It takes time to come up with choices you'll feel good about as you're waling out the door.

The vast majority of privately owned businesses turn out to be un-sellable. But even if people can find a buyer, they rarely get the kind of terms they want unless they've spent a lot of time laying the groundwork in advance.

I'm talking here about entrepreneurs, founders, people who've build companies or inherited family business and who want to do the right thing when they leave.

Sooner or later, we all leave the businesses we've built. Some of us may have to be carried out, but we're gone just the same.

If you wait too long, you'll wind up with limited options. There's good chance you'll simply run out of time.

I go back to the observation of Harold Geneen: "You read a book from the beginning to the end. You run a business the opposite way. You start with the end, and then you do everything you must to reach it." It's one of the best pieces of business advice I've ever received, particularly when it comes to getting out.

<u>Crossing the Great Divide</u>
In order to build a great company, a company that will endure, you have to imagine getting out. You have to think about turning your business over to someone.

<u>The Road to the Next Level</u>
There are only three ways to get out of any business of any type and size, and two of them aren't very appealing.

First, you can decide simply to close the company down: sell your assets, pay off your debts, and go out of business. That's really your only good option if the business itself isn't salable, and it won't be unless it can survive without you. If you're the owner of such a business, and you're planning to retire, you may have no choice but to get out as gracefully as possible.

Unfortunately, a graceful exit is not always possible. If you can't make ends meet, your creditors will take you to court in an attempt to make you pay your bills. Under the U.s. bankruptcy laws, you'll have an opportunity come up with a plan for paying them off while you keep the business going.

The third way to get out is to sell the stock to people who intend to keep the business running after you've left. The buyer could be another individual, a company, an investment group, your employees or partners, or even a bunch of strangers you've never met.

Whoever the buyers may be, what they're buying is the opportunity to own your business. Why? Because they think they can earn a return on their investment. The bigger the return they expect, the more they're willing to pay for your stock.

So the goal is to make sure, first that your business is salable and, second, that when you do sell you can get the best price for your stock.

And how do you achieve the goal? By making your company better, stronger, able to stand on its own. If you want to maximize the company's value, you have to practice the fundamentals of good business. You have to figure out what it really takes to succeed under capitalism.

So we asked ourselves the logical questions. Who would buy our stock? Why would they buy it? How much might it be worth to them? What would it take to get them to pay a higher price?

Just by asking those questions, you're forced to look at your business in a different light. You can no longer think only in terms of what you might want to do with the company. You have to ask yourself what somebody else might want do with it, what would make it an attractive investment.

Previously we'd focused all of our attention on the operational side of the business. How can we survive? How can we reduce our debt? How can we become more efficient? How should we handle the various aspects of running a company day to day, week to week, month to month, year to year?

Now, in contemplating the possibility that we might want to sell all or part of the company someday, we began focusing on the choices we had about different ways of growing. If we went in the wrong direction, the company might not be worth anything when it came time to sell. Then again, if we made the right moves, it could be worth a lot.

<u>Ownership Rule #10B</u>
To maximize equity value, you have to think strategically.

The value of a business depends on much more than having efficient production, great customer service, on-time delivery, and all the other things you think about from an operational standpoint. You have to start looking at the business strategically if you're going to increase its equity value. You have to think about improving its position in the marketplace.

So we began looking for ways to improve our position, to make ourselves more attractive to investors, and we wound up reinventing our business.

Increasing our options became, in fact the goal of the entire process. The whole idea was to make sure we'd have more choices tomorrow than we had today.

Instead of looking at your business from the inside out, you develop the habit of looking at it from the outside in, the way you would if you were considering whether or not to buy it.

You also spend a lot of time thinking about the future—about what could go wrong and what could go right.

You become acutely aware of your vulnerabilities and search for ways to eliminate them. At the same time, you're on the lookout for new opportunities. You develop the courage to innovate, to take calculated risks, to make the investments today that will pay off down the road and provide the funds you need to cash people out.

Step by step, your business moves to another level.

You have a destination. You have a strategy. You know where you're going, and you have a much better chance of getting there. Surprises will still come along and knock you off course, but you'll be able to recover quickly and continue on your journey. You have the tools you need to guide you to your port of call.

Learning to Think Differently

- What is this company really worth?
- What are our weaknesses?
- What would make us more attractive to a buyer or investor?
- What can we do to give ourselves more options in the future?

You need to use every tool available to see yourselves objectively. You need to strip away all the things you think are great about your company and view it the cold eye of someone who has no attachments to the people, no sentimental memories, no love for the culture. Then you can decide what you're going to do based on an objective assessment of your strengths and weaknesses.

Why Businesses Get Bought and Sold

Why do people buy companies, anyway? What are the factors that make a particular enterprise attractive to an investor or an acquirer?

The buyer is looking for one of the following things:

1. market share
2. earnings
3. cash flow
4. strategic advantage
5. some sort of synergy

People need a reason for buying something. They don't usually acquire an asset simply for the satisfaction of owning it. They buy it because they believe it will allow them to improve their earnings, cash flow, or whatever.

A sixth criterion; "human capital"—that is, its people.

If you're planning to sell your company at some point, or to bring in outside investors, you need to consider, first, how well it measures up in terms of those five (or six) criteria and, second, whether you want to grow the business with an eye toward strengthening it in one or more of those areas.

The Secret of the Chinese Firecracker Factory

There's an old saying that, when the student is ready, the teacher appears. One of my teachers turned out to be a guy from Springfield named Mike Ingram, who's a wholesaler of fireworks.

Ingram had recently returned from a buying trip to China, he talked about his visit to one of the big fireworks manufacturers, with which he wanted to cut a deal.

The manufacturer, he said, was located in a remote region of the country, and there was no easy way to get there. After driving for several hours, they'd come to the base of a hill. The guide had told Ingram that the factory was on the other side.

When they reached the top, he said, all he could see was a village with hundreds of little huts.

"Where's the factory?" he'd asked the guide.

"Down there, the guide had said.

Where do they make the fireworks?"

"Down there, down there."

"I mean, the factory. I only see huts."

"The huts are the factory," said the guide. "They put two workers in each hut. If one hut blows up, it doesn't destroy the whole village."

Weren't we protecting a village, just like the fireworks manufacturer? Maybe we could break our village into huts as well. Maybe we could put a limited number of people in every hut. Maybe we could use the huts to diversify in away that would add to the value of the company.

The True Profit of Business

OWNERSHIP RULE #11
You create wealth by building companies, not by selling products and services.

When you play the game of business at the highest level, you understand that the company is your product, not the pen.

Once you make that leap, your whole perspective on business changes. For openers, you realize that there's a lot more money to be made in building and selling products.

What you need at that point is a formula that allows you to take advantage of the opportunities, preferably with resources you already have. If you can start businesses with your own people, with a minimum of capital, and with high probability of success, the world becomes your oyster.

We were mainly trying to solve a problem we were having with an engine component known as an oil cooler.

A Problem of Innovation

In fact, however, the oil cooler problem was a symptom of a much larger problem—namely, our growing inability to innovate internally.

So a small group of us got together and started a business, Engines Plus, to remanufacture oil coolers for SRC.

I wanted to see if we could generate wealth—and do it quickly—by harnessing the power of leverage.

The Power of Leverage

Because Engines Plus was an experiment, and because experiments often fail, we made sure that there wouldn't be any negative repercussions for SRC. We didn't take people out of SRC to work on it. We didn't use SRC facilities or equipment. We'd didn't put SRC funds at risk. If things fell apart, SRC would be able to recover whatever working capital it had advanced either from the assets of the business or from the partners. We wanted this to be a separate deal.

What we didn't expect was that the experiment would be so successful so soon.

Designing Engines Plus
The SRC officers—Carrigan, Callison, Sheppard, and I—would won 75 percent of the stock. That turned out to be a more important number than I realized. Why? Because we intended to sell our stock to SRC if Engines Plus was successful. So SRC would ultimately get our 75 percent stake, which posed a problem. If your company owns less

than 80 percent of the stock of a subsidiary, you can't take out your share of cash without paying taxes on it. As a result, those earnings wind up being taxed twice—first at the subsidiary, then at the parent company. We'd have divided the stock differently if we'd thought about that at the time.

The value of the stock owned by the SRC officers was the price at which SRC could buy it. We set that price at one-half of book value, which we defined as assets minus liabilities.

Paulsen's stock value was another matter.

We wanted Paulsen to be watching every nickel, and so we set the value of his stock at two times book. In other words, his stock price would rise fifty cents (25 percent of two dollars) for every dollar he invested in the company, either by increasing its assets or reducing its liabilities.

<u>A Question of Stewardship</u>

When you build a business, you create a community.

You wake up one day and discover that your company is not only a business but a sort of ecosystem, a society in which people are spending a significant part of their lives.

Make sure that the members of the community are also businesspeople—that they know what's going on, understand their roles, and benefit from the results.

Communities are built around rules. The rules may be explicit or implied, but they're understood and accepted by everybody. They provide the glue that holds the community together, and you can't violate them without doing a tremendous amount of damage.

We'd built our community around a common understanding that we'd share whatever wealth we created.

<u>Five Imperatives of a Mature Business</u>

So what exactly does it take to move a company up the ladder of durability—to go from what I call the growth stage to the maturity stage?

1. Diversification. No company can last unless it protects itself against the surprises of the market, and diversification is still the best form of protection anyone has come up with. Identifying your vulnerabilities.

We used our knowledge of the industry to diversify into new types of remanufacturing—with different products, different customers, different market segments.

2. Innovation and entrepreneurship. Beyond diversification, every business is under pressure these days to reinvent itself constantly, if only to keep up with changes in the competitive environment.

3. **Leadership development. Third, you need to get your people ready to take advantage of the opportunities you see. Once you get beyond the survival stage, a shortage of people is the only obstacle to growth. There's never a shortage of opportunities, and capital isn't a problem, either. In most cases, you're generating enough cash internally to finance your growth. If not, there are numerous sources of outside capital available to fill in the gaps.**

We'd need replacements, after all, for the managers who were going to the new business.

4. Financial discipline. The fourth imperative involves improving your ability to make wise decisions about spending your cash. Make sure you're using your cash to build the future rather than simply to maintain the past.

5. Experimentation. You need to keep trying out new ideas, taking chances, running into obstacles, making mistakes, and doing all of the others things that allow you to learn and move forward.

<u>The New Priorities</u>

I wound up focusing on five areas of the business that I sensed would ultimately determine the amount of control we'd have over our destiny.

1. *What new ventures should we be starting, and why?* There is never a shortage of opportunities.

We've tended to choose the ones that meet the following criteria:

- We have people who are ready to run them
- They serve an important strategic purpose (diversification, for example)
- They can help us meet our business goals, specifically our target of fifteen percent sales growth per year
- They will allow us to experiment in areas we consider it important to explore (eg., joint ventures with customers)

2. *What other trapdoors and contingency plans can we build into the company?*

3. *What new things can we learn about the art of doing deals?*
4. *Is our management system working, and how can we improve it?* You can't count on individuals to carry you indefinitely. Individuals don't last.

The system provides the continuity and the structure that allows the culture to endure.

The system is never finished. That's where leadership comes in. Leaders look for the parts of the system that need fixing, or improving, or that haven't been developed yet—so that people have the tools they need to keep the culture alive.

5. *Are we doing all that we should to develop our people?*

Ownership Rule #12
A company is only as good as its people.

I saw people development as my primary responsibility.

Ownership Rule #13

Ownership is all about the future.

The value of a business depends not on how much money you made yesterday or are making today but on what you're going to be making down the road. That's why buyers are willing to pay a multiple for your stock. They believe the returns they'll get in the future will pay back their investment many times over. It's all about future earnings, future growth, future ideas, future cash flow.

Reality Testing
There's a critical discovery you make somewhere along the road to becoming an owner.

When people do make the connection, a transformation occurs. They think about the concept for a while, and pretty soon a bright light goes off in their head. They realize, "Gee, if we can grow our sales at 15 percent per year, we can probably grow our earnings and cash flow at the same rate, and if we can keep doing it, we'll be on our way. If we can figure out a formula for growing 15 percent year after year, if we can establish a long-term track record, if we can build in mechanisms to maintain our growth rate even in a bad economy, my God, we'll be in control of our destiny."

To one degree or another, the whole process of building an ownership culture is geared toward leading people to that epiphany.

The better people understand how business really works, the easier it is to make the necessary connections.

Teach everybody the realities of business, while keeping us all informed about what's going on in the company and focused on what we have to do to achieve our goals.

Two Managers, Two Cultures

My job, I thought, was to help people understand reality, and in business the reality is that you are constantly facing threats, some of which you can identify, some of which you can't. So you need an element of fear. You need to be aware of the real dangers that are lurking out there in the market and that could cost you your job if you're not careful.

I wanted a culture in which people were always a little uncomfortable. Not that they should live in constant fear, but they needed to realize that their only real security would come from working together to protect themselves against the dangers they faced. So they had to be aware of the dangers and the role each person, each department, each part of the business played in overcoming them. That way, people would understand why it was important for them to do their part and to support others in doing theirs.

I thought we should be challenging people to think about the possibility, to dream a little, and then we should be doing all we could to help them achieve their dreams—for their sake and everybody else's. As a community, we needed people to be learning, growing, and moving up in order to protect ourselves.

Finding the Next Generation of Leaders

Six key problems:

1. What should be the succession process in the company?

2. How can we take better care of our people?

3. How can we use twenty-first-century manufacturing methods to make ourselves more competitive?

4. How can we broaden our customer base and get closer to our end users?

5. How can we raise the capital we'll need in the future to buy out shareholders and build the company?

6. What should be our strategy with regard to information technology?

Once we had the issues, we divided the future leaders into six groups and gave each group one problem to work on for the next year.

Epilogue: The Long Road

I remember reading an interview with Kelleher in *The Wall Street Journal* a few years back. The interviewer asked him what he meant when he said that Southwest's culture was its biggest competitive advantage. "The intangibles are more important than the tangibles," Kelleher replied. "Someone can go out and buy airplanes from Boeing and ticket counters, but they can't buy our culture, our esprit de corps."

You have to recognize that people are still most important. How you treat them determines how they treat people on the outside.

As Kevin and Jackie Freiberg note in *Nuts!*, their fine book on Southwest Airlines, “Trust is a prerequisite to ownership because it strengthens self-confidence….One of the reasons pilots are willing to assume ownership for Southwest’s success is that they are confident they will have a crucial role in shaping the company’s future.”

What Trust and Business Education Can Do

That combination of trust and business intelligence is the hallmark of an ownership culture as well as an extraordinary powerful competitive advantage.

Ownership is a state of mind. Ownership is hope. It’s curiosity, openness, an eagerness to learn and grow. It’s caring about yourself and the people around you. It’s wanting to contribute, to make a difference. It’s confidence, self-esteem, and pride. It’s the ability to handle diversity. It’s giving back to your community and appreciating the gifts you’ve received.