Mark L. Frigo, Editor

Making Intangibles Tangible

BY DAVE ULRICH, NORM SMALLWOOD, & KURT SANDHOLTZ

We recently asked the CEO of a midsize technology firm: "What keeps you awake at night?" His response: "When I earn $100 in profit, the market values it at about $2,000. My largest competitor's $100 is valued at about $4,000. I get a lot of advice on ways to increase earnings by cutting costs or by growing the business. But if my P/E ratio stays at half of my competitor's, I'll never catch up. What do I have to do to get a higher multiple?"

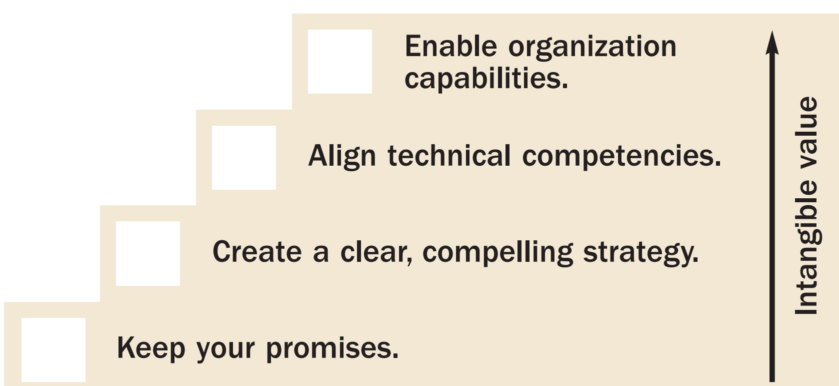
It's a question many leaders are asking these days, with good reason. Research by Baruch Lev and others shows that, in today's financial markets, earnings account for barely more than 50% of a company's market value. The other 50% comes from the firm's "intangibles," a catch-all category of factors not directly related to physical assets. Little wonder that CEOs and CFOs are increasingly frustrated. Under constant pressure to increase their company's market value, they find themselves grappling with a set of variables whose very name—intangibles—suggests they can't be defined, much less managed.

Now for the good news: Leaders can have enormous impact on the value created by their companies' intangible assets. In our work with executive teams, we've seen organizations steadily increase their market capitalization by applying what we call the Architecture for Intangibles (see Figure 1). While it's based on research from a number of studies and from our personal experience, it isn't a quick fix; the framework's four steps require discipline, consistency, and sustained focus over time. The benefit, however, is a shared commitment by leaders at all organizational levels to build and protect intangible value.

Step 1: Keep Your Promises

The foundation of intangible value is trust. For publicly traded companies, this starts with keeping promises made to the investment community (and other stakeholders). Accurate forecasts and reliable quarterly earnings are the "table stakes" for getting into the intangibles game. Keeping promises extends to meeting customer expectations for service, quality, and delivery, and it includes following

Figure 1: The Architecture for Intangibles



through on commitments to employees. Leaders who make and keep promises build credibility, confidence, and conviction.

Avoid dramatic gestures. One high-profile leader boldly and publicly stated her "20/20" vision: 20% revenue growth and 20% increase in profits. The firm delivered 15/8—among the best in its industry but below the expectations she had set. The firm's market value fell, leading to another betrayal of trust and erosion of confidence in the senior management team, ultimately resulting in her resignation. Years later, the company is just beginning to recover its reputation.

Trust is easier to maintain than regain by using the following tips:

- *Promise less, deliver more.* Unrealistic aspirations create enthusiasm in the short term and cynicism thereafter. Find the balance between optimism and self-deception; insist on a frank and rigorous examination of market and organization realities.
- *Be humble in public, confident in private.* Share public credit for successes, and take responsibility for failures. With employees, express absolute faith that they can and will succeed.
- *Start small.* In conversations with employees in his first 90 days, a new HR manager kept hearing complaints about the travel reimbursement policy. While not a major economic issue, it had become a symbol of managerial inattention. A simple policy change immediately gained workers' trust.
- *Anticipate and update.* Even conservative forecasts are subject to surprises. Inform investors of "new promises" before the grapevine takes over. Don't hide or defend your mistakes; show that you've learned and are moving forward.

Step 2: Create a Clear, Compelling Strategy

When leaders at the Coca-Cola Co. learned that the average human being drinks 64 ounces of liquid a day, their goal became to increase Coke's "share of stomach." But colas weren't enough to gain a higher percentage of those 64 ounces. So the company has leveraged its marketing and distribution power to acquire and introduce new beverages: juices (Minute Maid, Fruitopia), coffee (Georgia, distributed in Japan), milk (Swerve), and water (Dasani), all in the name of capturing greater share of stomach worldwide.

Coke's strategy passes the "clear and compelling" test: It's easy for every employee to remember and act upon. Clear strategies portray a growth vision that excites and energizes. But they must also lay out the path for realizing that growth. Companies have three generic options: increase customer intimacy by capturing customer share (as in Coke's case), develop innovative products or services that appeal to different customers (Apple has been brilliant at this), or expand geographically and sell to new customers (think of Starbucks or Wal-Mart). Leaders can choose any of these options or combine them, but whatever they choose, they must envision growth and then enable it. This gives customers and investors confidence in the organization's future—which is a key driver of intangible value.

Consider these ideas for action:

- *Get beyond analysis.* We sat in a meeting where a well-known consulting firm presented the results of a thorough (and pricey) strategic analysis. The data was detailed and thought-provoking. After two hours, the consultants sat down. We asked the executives in the room, "So, what's your strategy?" No one could answer. Analysis is a precursor to strategy, not the end product.
- *Prioritize.* We often ask executive teams to divide 20 points across the three generic growth strategies (customer intimacy, product/service innovation, or geographic expansion), with 10 points going to one of the three. No company can be all things to all customers. Focus and prioritize—then invest accordingly.
- *Capture the strategy with a story.* Stories are found in language (Coke's "share of stomach"), images (Nike's swoosh), and heroes (Marriott's celebration of associates who go "above and beyond" for guests). If the story is compelling enough to galvanize all stakeholders, it adds enormous intangible value.
- *Translate the story into action.* Not long ago, we worked with a VP-GM who had articulated a compelling strategy: leverage the firm's technology to continually generate 50% of revenues from products introduced the previous year. When we asked him how he was going to make this happen, he pointed to a stack of committee reports and notebooks full of suggestions for product innovation. Instead, we helped him identify three high-profile decisions he needed to make in the next 30 days to push innovation forward.

Step 3: Align Technical Competencies

In 1983, Isuzu Motors introduced the Impulse, a low-slung, sporty hatchback, to the U.S. With a beautiful Giugiaro-designed body, the car looked like a sophisticated, high-performance driving machine. But people who actually drove it discovered that the Impulse handled like a small truck. Isuzu, the world leader in diesel-powered industrial trucks, couldn't escape its own core technical competencies. The Impulse was doomed, and Isuzu's intangible value diminished.

Technical competencies include more than scientific and engineering know-how—they are the critical few physical work processes that differentiate an organization's products and services. As illustrated by the Impulse, such competencies need to be aligned with strategy (or vice versa); otherwise, the strategy fails, and customers and investors lose confidence.

Rate your organization's alignment in the following areas:

- Do you know what your organization's core technical competencies are?
- Do you invest above industry-average levels in the areas that are core to your strategy?
- Do you reduce investments in functions that are overresourced, where the goal should be nothing more than industry parity?
- Do you manage the "core work" of your organization differently from supporting functional work? In core areas, managers should be developed and rewarded for their ability to build competitive advantage. Managers in noncore areas should be held accountable for ensuring cost efficiencies.

Step 4: Enable Organization Capabilities

Organization capabilities represent the ways an organization applies people and processes to the tasks of competition. In contrast to the core technical competencies mentioned in Step 3, organization capabilities are the "social" or "cultural" competencies that essentially become the organization's identity. They define what it is good at doing and are huge drivers of intangible value because they are almost impossible for competitors to imitate.

Here are seven of the basic capabilities an organization can cultivate and examples of companies that have done so:

- *Talent:* Attracting, motivating, and retaining competent and committed people. Example: Goldman Sachs.
- *Speed:* Making important changes happen fast. Example: Nokia.
- *Shared mind-set:* Ensuring that customers and employees have positive images of and experiences with the organization. Example: Nordstrom.
- *Accountability:* Maintaining the discipline that results in high performance. Example: PepsiCo.
- *Collaboration:* Working to make the whole more than the parts through both efficiency and leverage. Example: Toyota.
- *Learning:* Generating ideas with impact, then generalizing them across the organization. Example: Bain & Co.
- *Leadership:* Embedding branded leaders throughout the organization who deliver the right results in the right way. Example: General Electric.

Auditing Your Firm's Intangibles

Let's return now to the CEO who was worried about his P/E ratio. In order to start building intangible value, we suggest that he first conduct an "intangibles audit." Just as financial audits allow leaders to monitor cash flow, intangibles audits help leaders to identify how to have the greatest impact on the intangible side of market valuation. The audit should measure how well intangibles are being defined and delivered, leading to an action plan for improving specific practices. Information for the audit is provided by stakeholders internally (executives and employees) and externally (analysts, targeted customers, regulators, and suppliers).

A case example may be instructive. In early 2003, London-headquartered Intercontinental Hotels Group (IHG) was seen as a prime takeover candidate. Its costs were as far above industry parity as its P/E ratio was below. IHG's senior team knew it had to start making and keeping financial promises. A severe cost-cutting effort netted annual savings of $100 million. This was an important first step in re-earning investor confidence—necessary, but not sufficient. An intangibles audit revealed a number of key insights:

1. Financial analysts who followed IHG's stock still saw it as an underperformer. They recommended further cost cuts and divestitures.

2. Customers and employees saw a different picture. Cost cutting wasn't the answer, they said. IHG needed to focus on growth by creating stronger brand unity and increasing its level of customer service.

3. Organization capabilities where IHG needed to be world class were collaboration and speed. Its current level of capability was judged to be marginally below industry parity.

Armed with this data, the CEO took bold action to create a new growth strategy for the hotel group. The primary focus was to be customer intimacy, with a secondary strategy of geographic expansion. They would continue striving for operational efficiencies wherever possible, but the core competencies they chose to invest in were (1) outstanding point-of-contact service through *continued on page 61*

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hiring, training, and rewarding excellent front-line service providers; (2) new distribution channels through a consolidated reservations system that covered all IHG properties; and (3) savvy brand standards that modernized their individual hotel brands and made them part of a recognizable "family" of hospitality services. As mentioned above, the capabilities that drove these changes were collaboration across business units and speed of change.

The turnaround was dramatic. In little more than a year, IHG's share price increased 71%, doubling the return of the FTSE 100. The company survived a hostile takeover attempt. Employee surveys showed marked increases in employee morale and confidence in company leadership. In short, the tangible and intangible factors combined to create tremendous value—not only for shareholders, but for other stakeholders as well.

Building Strong Organizations

The Architecture for Intangibles provides a way for leaders to actively manage intangible assets. As such, it demystifies the valuation process and puts senior leaders more in control. By keeping promises, creating strategies that energize growth, aligning core competencies, and building key organization capabilities, executives can have tremendous impact on the intangible value of their respective companies. By making intangibles tangible, leaders can build strong organizations that delight customers, investors, and employees. ■

Dave Ulrich, Ph.D., is Professor of Business Administration at the Ross School of Business at the University of Michigan and a partner at The RBL Group, a consulting firm focused on helping organizations and leaders deliver value. He studies how organizations build capabilities of speed, learning, collaboration, accountability, talent, and leadership through leveraging human resources. You can reach Dave at dou@umich.edu.

Norm Smallwood is a recognized authority in developing businesses and their leaders to deliver results and increase value. His current work relates to increasing business value by building organization, strategic HR, and leadership capabilities that measurably impact market value. He is cofounder (with Dave Ulrich) of The RBL Group (www.rbl.net). You can reach Norm at nsmallwood@rbl.net.

Kurt Sandholtz is a director with The RBL Group, where he is in charge of new product development. He consults with Fortune *500 organizations across such diverse sectors as consumer products, high tech, research and development, chemicals, oil and gas, and banking. Kurt was recently a visiting instructor of organizational behavior at the Marriott School of Management, BYU. You can reach Kurt at ksandholtz@rbl.net.*

EDITOR'S NOTE

Managing and aligning intangible assets toward greater value creation is one of the primary challenges facing executive teams today. Although this challenge is acknowledged by most business leaders, what is often lacking are actionable ways to address it. The Architecture for Intangibles presented in this article is an innovative and useful approach to make the connection between intangible assets and the value they can create.—Mark L. Frigo, Ph.D., CMA, CPA, The Center for Strategy, Execution, and Valuation, Kellstadt Graduate School of Business, DePaul University.