A Culture for Great Long-Term Returns?

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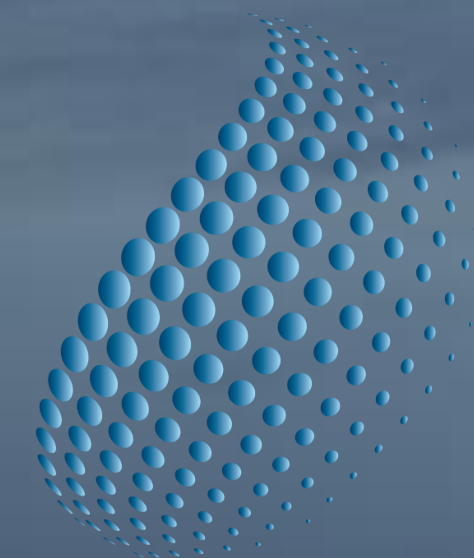

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Over time, strong adaptive cultures generate the best results in pretty much every undertaking. Most investors base their investment decisions primarily on financial analysis, typically focusing on key metrics like margins, earnings growth, and return on capital. However, what many investors tend to forget, is to evaluate how a company's culture is doing.

Culture is a wide definition that cannot easily be measured or quantified. Given the broad definition, it is understandable that this is an area of the investment analysis that is often overlooked. Organizational culture is the personality of an organization. It relates to the shared behaviors of employees within the same work environment and how they act and engage within the organization.

In the book "Corporate Culture and Performance" by Kotter and Heskett, the authors found that corporate culture is a strong predictor of financial performance. The authors found that corporate cultures which emphasized customers, employees and stakeholders, and had quality leadership at all levels, significantly outperformed companies with a lack of these qualities. By studying 200 companies over an eleven-year period, Kotter and Heskett found that companies with good corporate cultures significantly outperformed revenue and net income growth compared to a control group, growing their share prices by 901% versus 74% for the control group. This should incentivize investors to place higher emphasis on corporate culture in their investment decisions.

What characterizes good corporate culture?

At REQ Capital we prefer investing in companies with strong corporate cultures, as we believe this is crucial for creating sustainable shareholder value. We believe good corporate culture is a culture where goals are aligned for employees and other stakeholders. The organization is structured, but without too much bureaucracy. Employees are motivated and incentivized to generate results.

We have identified three variables that we believe are pivotal for a good corporate culture:

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Management

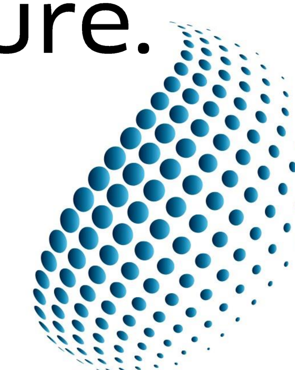
Good management is key for developing a strong corporate culture. Management should be able to create trust and be transparent so that employees understand and share the same vision as management. Employees should be provided with sufficient responsibility so that they feel accountable for their own performance. At the same time, they should be incentivized correctly so that they maximize their own utility. They should be mentored so that they continuously develop their own skillset and feel ownership to their areas of responsibilities. Management should also be adaptive and non-bureaucratic, as very hierarchical organizations often diminish individual responsibility.

At REQ Capital our experience is that companies with decentralized business models are often good at creating outstanding corporate cultures, as the organizations are managed on a local basis, with proper incentive models. Local management sits close to the organization, whilst top management focuses on top-level strategic decisions like capital allocation and longer-term growth. Most of our portfolio holdings have decentralized business models.

Measurement

Employees must be measured and evaluated in a way that promotes results, rather than being destructive. Whilst management would want to ensure that employees are working hard persistently, most of us would agree that such continuous monitoring would feel intrusive and distrustful. By creating transparent and trustful measurement reporting systems, employees should feel more trusted and work harder, and this allows for a better corporate culture.

At REQ Capital the companies we are invested in often have very rigorous measurement systems, in which all subsidiaries often report to HQ on a frequent basis. However, if the KPIs are performing in line with expectations, HQ does not involve itself with the daily operations of the subsidiaries. This gives the subsidiaries a high degree of freedom, which is positive for developing a good corporate culture.



Incentives

Employees must be given proper incentives to perform a good job. Incentives do not only comprise financial incentives, but also personal freedom, increased responsibility, personal development, and leisure time. To create a strong corporate culture, employees must be incentivized in such a manner that their utility is maximized, and that their goals are aligned with the company's overall strategy.

At REQ Capital we believe that incentives designed to optimize profitable capital allocation are key for creating shareholder value. Motivated and happy employees are more loyal to the organization and create higher value for all stakeholders. This also includes top management in our view. We place large emphasis on CEO ownership when we make an investment decision, as we prefer investing in companies where the CEO has "skin in the game".

Companies that share the traits above are the companies that we are looking to invest in, as we believe these companies will outperform peers over time.

Not all strong corporate cultures are good

Strong corporate cultures can also become dysfunctional for an organization. In some organizations subcultures can develop, in which employees have deviating goals or targets from other employees or stakeholders. This can particularly be a problem in large and bureaucratic organizations. Large acquisitions or mergers can also be dilutive to corporate culture, as different corporate cultures clash. As organizations grow larger and larger, day to day operations become more and more complex. There is less focus on vision, strategies, culture and inspiration. Employees in such organizations often focus mostly on maximizing their own utility, and not towards contributing to the overall strategy of the company.

Due to this, we avoid investing in companies that do few and large M&A transactions and prefer serial acquirers that add small bolt-on acquisitions that are easier to integrate in the overall corporate culture.

We have witnessed several times that organizations with problem cultures do not perform. If employees are not properly motivated or incentivized to do a good job, they don't do it. This can result in lower sales, lower margins, a build-up in inventory, and subsequently lower overall returns and/or cash conversion. The problem with such poor corporate cultures is often that it is very difficult to observe it from the outside before it is too late.

At REQ Capital we prefer speaking with employees and ex-employees in the companies we are invested in, to properly understand how the corporate culture is before we make an investment decision. Changing problem cultures can be very difficult, and often it is not sufficient to do changes at top-management level. Due to this we are cautious about investing in turn-around stories.

Conclusion

There is no “right” culture across different industries and companies. The culture needs to be aligned with the strategy of the company, and it also needs to be adaptive. We spend a substantial amount of time analyzing the corporate cultures in the companies we invest in, to properly understand the underlying drivers for the company's performance.

We believe that strong corporate cultures are key for creating long term value, given that these are good corporate cultures that are well aligned with the organization's overall strategy. A strong corporate culture is a key competitive advantage for a company, that will differentiate it from peers, and be a catalyst for future growth. A strong, enduring culture is the single biggest competitive advantage in a fast-changing world.