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Why culture is so important to long-term business success

By Matthew Kates

By Matthew Kates - Fund Manager, GIB Asset Management

What is culture?

Formal financial qualifications teach us much about the mathematical and statistical theory around companies and markets – accounting, risk, valuation and so forth. The allure is a measure of certainty, of neatness and finality to it all – forecast a company's cash flows, apply a seemingly appropriate discount rate and, hey presto, out pops the intrinsic value. Compare to current share price and Buy, Sell or hold. Job done.

However, practice and experience teaches us that markets are complex, dynamic, even biological systems where agents (investors) constantly adapt to new information, reflected through modified thought and behaviour. Rarely is anything static, least of all intrinsic value.

Granted, the occasional flirtation with behavioural economics warns us of the inherent biases the cognitive process can employ to deal with judgements under conditions of uncertainty, so called heuristics or rules of thumb. However, what's not drummed into us at an early stage is that psychology, sociology and many other non-numerical disciplines are every bit as important as economics, accountancy and mathematics in understanding how markets, and by extension, humans and companies function. Unless we can appreciate group behaviour can we ever fully understand why markets and economies behave as they do? To do that requires studying the myriad linkages that exist within and between a broad array of subjects (Munger's mental models approach).

So in order to truly comprehend what underlies great companies, those that create material value over multiple generations, it is my contention that we need to understand the people behind them: what they stand for, the way they organise themselves, the values and principles they embed in their workforce and the methods they employ as they strive for competitive success.

A company, much like a market, is comprised of individuals organised into groups. Individual behaviour is highly influenced by its interaction with other individuals within a system or group. Only by maximising the quality of those interactions can groups, and ultimately companies, function to their highest potential. Anthony Jay's book, The Corporation Man (1975), reminds us that we have been hunters for 5 million years, farmers for ~300 generations and industrialists for just a tiny fraction of our existence. Set against this context, how can we expect corporations to function well in groups of hundreds, thousands or more when so much of our experience has been almost exclusively confined to small groups?

And that is where culture comes in. So what is culture? In its purest form, it is the beliefs, norms, customs, values and behaviours of a group of people or society. In a business context, it is the way in which a firm and its people operate. Culture defines how a firm interacts with employees, customers, suppliers, competitors, shareholders and other stakeholders. Put another way, it is the character of an organisation; the glue that binds it together and provides the impetus to deliver on its goals.

Why is it important?

To a greater or lesser extent, most of us search for meaning in our lives. A direction, a focus that moves us towards a specific aim or objective - a North Star if you like. In Japanese culture, they refer to it as *'Ikigai'*, which literally translated means *'life worth'* - the concept of one's reason for being, a life purpose. The concept is that everyone has an Ikigai and whilst some people have found it, others are still looking though they most probably carry it within them. Spending our days feeling connected to what is meaningful to us is seen as a foundational pillar to leading a long and happy life. In other words, when people discover their Ikigai, engagement and motivation are amplified and therein strange and wonderful things can happen.

Ray Dalio espouses the twin importance of *'meaningful work and meaningful relationships'*, in order to create the trust and support that people need to push each other to do great things. ASML's CEO Peter Wennink talks about *'human synergy'*, when you bring people together and working towards a collective goal, the output is worth much more than the sum of its parts…*'because people influence each other when they get inspired by the challenge. With human behaviour, and mainly your work, you need to feel you're contributing to something larger than yourself'.*

So surely it follows that if we can find meaning in our work, both in the nature of the work and the relationships we form around it, then there is more than a reasonable chance that we will perform to the best of our abilities. Indeed, we might even surpass our own expectations.

Peter Drucker, the iconic management thinker, stated that every organisation requires performance in three major areas:

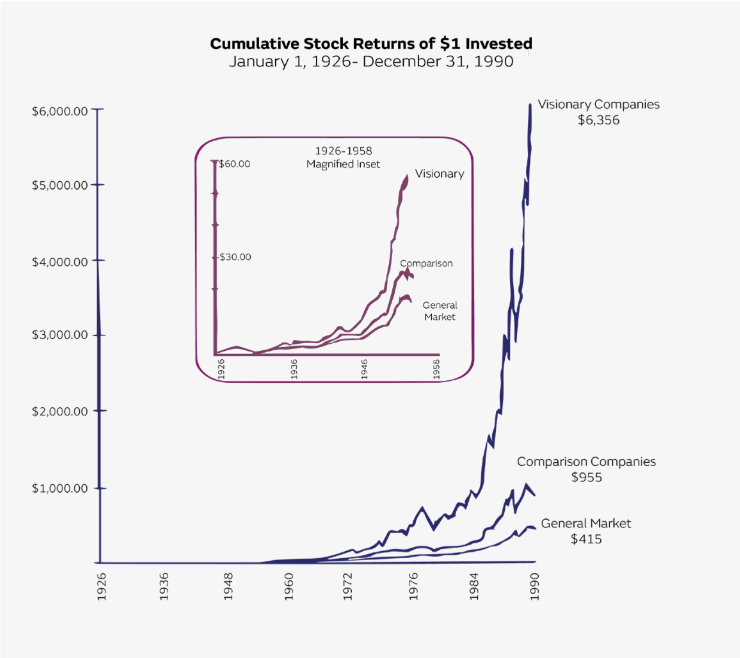
1. Direct results: Sales, profits & cash flow
2. The building and reaffirming of values: An organisation has to stand for something or else it degenerates into confusion & paralysis.
3. Developing the people of tomorrow: An organisation incapable of perpetuating itself ultimately fails. It has to consistently renew & upgrade its base of human capital.

In other words, self-development is central to the development of the organisation. And crucially, all three elements above have to work in concert, with the lack of any one being enough to inhibit a company's progress and consign it to the majority, who typically struggle to survive across multiple generations. Naturally most investors concern themselves with direct results but fail to address much of the source of those results - a focus on purpose, the living and breathing of values and the development of talent.

The point is echoed by Jim Collins in *'Built to Last'*, where he identified the traits of truly enduring, successful businesses. The common characteristics he identified are

- A deeply embedded ideology (purpose & values) – who we are and what we stand for.
- An unrelenting drive for progress – an urge to create, explore, discover, adapt & achieve.
- An organisational design that allows the previous two traits to work in alignment.

'The company is the ultimate creation, not the products or services. Great products and services come from being an outstanding organisation'.



Source: 'Built to Last' by James Collins and Jerry Porras.

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As author Simon Sinek puts it, *'people don't buy what you do, they buy why you do it'*. If your purpose, your cause, your values as a company can resonate with an individual's sense of meaning then two clear benefits follow:

1. A passionate, self-motivated, self-selecting base of human capital that, as a group, can achieve wonderful things;
2. A strong likelihood of developing a broad, loyal base of customers

Culture is also particularly important in a world where the pace of change appears to be accelerating, whether technological, societal, environmental, legal or regulatory etc. Companies that intend to survive in this world order must be open and responsive to change. In my professional lifetime one of the most important words to emerge in the investment lexicon is *'disruption'* – both as an opportunity and a threat. Companies that cannot adapt to the rapidly shifting tectonic plates of industries and economies face, at best, mediocrity and at worst, a fast track to extinction. Having an awareness of, and focus on disruptive threats and opportunities - an ability to identify and understand where profit pools are shifting within industry value chains - requires real humility, curiosity, honesty and insight. Having the resources, processes and values to recognise and embrace disruption is more relevant than ever before. Against this backdrop, having a strong culture is critical.

In summary, I tend to think of return on capital employed (ROCE) as the quantitative determination of a company's moat or competitive advantage, and culture as the qualitative determination of the durability of that moat. Companies with the right culture in place tend to display a remarkable resilience, an ability to persevere through adverse conditions, largely because they have a natural tendency to do the right thing, regardless of cost. Put another way, they are able to adapt to a changing environment on any number of levels: customer needs, employee & community interests and shareholder requirements.

Perhaps this quote brings it all together neatly: *'maximising stakeholder value is best positioned not as the purpose of the firm but as a result of the firm successfully achieving its purpose'* - Bartley Madden.

Great companies do not chase profits, they chase the vision.

Revenue	Employee satisfaction	Customer satisfaction
48%	80%	89%
More likely	More likely	More likely

Key findings from PWC Culture survey in 2021[1], indicate that culture is a source of competitive advance, and shows that sincere leadership and cultural cohesion are aligned to higher levels of connectivity. Base: Those who say they have a distinct culture: 1986
Note base number represents 'agree' and 'strongly agree' responses combined

[1]Source: https://www.pwc.com/gx/en/issues/upskilling/global-culture-survey-2021/global-culture-survey-2021-report.html#content-free-1-b9e4

Finding a great culture - start by avoiding a bad one!

Another benefit of focusing on culture lies in its utility as a risk management tool. Not only do you improve the chances of identifying a great company but, flipping the problem on its head, you also materially increase the probability of avoiding a losing one. When you are in the business of protecting and growing client capital, both sides of the equation are of equal importance. Culture serves as a practical filter as it helps to uncover Warren Buffett's *'ABCs of business decay'*: Arrogance, Bureaucracy and Complacency. Experience has taught me that when any of these are recurrently identifiable, steer as wide a course around the business as possible, as the odds on having identified a toxic culture increase exponentially.

'The Nokia syndrome' demonstrates this point in action: *'...the subconscious assumption that our past success guaranteed our future success. The unspoken message...was: We are Nokia. We invented this industry.....Nobody does it better'.*

And if you are too young to remember the fate of Nokia then perhaps this, from Steve Jobs in 2010, will help out: *'....our goal (Apple) is to make the best devices in the world, not to be the biggest...and to drive the cost down while constantly making the products better at the same time.....As you know, Nokia's the biggest. And we admire them......but we don't aspire to be like them'.*

The banking sector is a deep reservoir of cultural dereliction. In its 2015 report, Banking Conduct and Culture – A Call for Sustained and Comprehensive Reform, the G30 focused on the governance challenges surrounding the industry and how, both pre- and post-global financial crisis, it *'needs to repair the damage done by failures in culture, values and behaviours'.* Perhaps the opening quote sums it up best: *'Splendid financiering is not legitimate banking, and splendid financiers in banking are generally rascals or humbugs'.*

Old habits, seemingly, die-hard: *"...you have to be careful not to confuse firefighters and arsonists. The board of directors and executive board are responsible for Credit Suisse..."* - Swiss Finance Minister Karin Keller-Sutter.

The important point here is that of 'tone from the top....' If the culture in the boardroom and executive suite is corrupt then what is to be expected further down the ranks in terms of acceptable behaviour? Role modelling is hard-wired into humans so there cannot be anything but a strong link between actions within the senior ranks and subsequent behaviour below. Throw in one of Cialdini's 'weapons of influence[2]' – Authority – and it becomes an almost certain bet that toxicity in the upper echelons will infiltrate almost every corner of an organisation. Groups tend to self-select, often in a highly detrimental way.

The message is clear: toxic cultures kill companies.

What constitutes a great culture?

Well the clue is in the name....CULTure. In reality, the strongest cultures tend to have a cult-like following, just not in the usual pejorative sense of the word. The roots typically form from a founder-led ideology that is subsequently indoctrinated into its followers, who find meaning in the philosophy. What that does not mean, however, is that good culture is synonymous with a cosy, comfortable, stress-free environment. The characteristics that we all desire from our companies: tolerance for failure, willingness to experiment, collaboration and empowerment etc come at a cost – they must be managed by strong leaders who set the tone through their own behaviour: demand high standards, provide candid feedback and constant challenge.

[2]Cialdini's 6 Principles of Influence are reciprocity, commitment or consistency, consensus or social proof, authority, liking, and scarcity.

Costco, for example, has built its culture, and reputation, on simple business tenets – customer focus, high quality and low cost - but has taken them to the point of obsession: an unwavering discipline to pass on lower prices to build customer trust and loyalty. To many customers and employees, Costco has achieved cult-like status. Yet whilst the company is known for its outstanding commitment to employees (pay & benefits, organic talent development etc.), it is also clear that their culture is not for everyone. A typical warehouse job application form states, inter alia, their employee commitment: *'We believe that if you don't want to do your best, Costco Wholesale is not the place for you'.*

L'Oreal has spent over a century at the forefront of the cosmetics industry and built an enviable track record of success. How? A relentless drive for excellence - focus on the customer, keep quality high & keep costs low. But with that comes a demanding workplace environment:

'L'Oreal has a very distinctive culture that is not to everyone's liking, but those who do like it will really invest and thrive here.....people either stay three months, three years or 30 years....aggressive promotion of the most promising employees is a key part of the company's culture...' – Chairman Jean-Paul Agon.

Costco and L'Oreal are very different businesses, but with very similar elements: create the right environment, find the right people, empower them, enlarge their responsibilities and let them grow.

Whilst no two cultures are alike, our research suggests there are some common traits amongst strong cultures, with perhaps differing emphasis placed on each of the following points:

Simplicity:
From organisational structure to clarity on roles and responsibilities to incentive compensation programs. Are not laden with rules, committees & process but instead principles. Use clear language and are concise.

Trust:
Established through devolved responsibility (empowerment), clear accountability and alignment of interests. As Charlie Munger states: 'The right culture, the highest and best culture, is a seamless web of deserved trust. Not much procedure, just totally reliable people correctly trusting one another'.

Humility & Authenticity:
Leaders who live and breathe the values, who think and act in terms of service to a cause, to others and not themselves. Leaders with real ambition but channelled outwards, instilling confidence in others. Understand the harm that ego, bias and emotions can inflict on decision-making.

Curiosity & Passion:
Foster a hunger to learn, build knowledge and promote self-development (training, investment & feedback loops). Attitudes to mistakes and failure are unusually constructive (innovation and progress requires failure). Their greatest competitor is themselves.

Communication:
Share information and ideas openly. Listen and provide regular feedback but are candid and not afraid to challenge. Report bad news early.

Diversity & Independence:
Understand that an optimal decision-making process should include diverse and independent opinions. Recognise that under the right circumstances, groups are remarkably intelligent and are often smarter than the smartest people in them.

The result is a powerful source of competitive advantage that can lead to sustained superior financial performance, owing largely to a culture that combines the following characteristics, according to Jay Barney:

1. Being valuable – enabling a firm to add economic value
2. Being rare – having attributes that are not common to the cultures of a large number of other firms
3. Being imperfectly imitable – firms without these cultures cannot replicate them

Reed Hastings, co-founder of Netflix, described company culture as the only sustainable competitive advantage that he has complete control over.

Lastly, we find some of the benefits of a strong culture are:

- **Loyalty:** from all stakeholders – customers, employees, suppliers, community and shareholders.
- **Decision-making:** faster and higher quality - solve problems, innovate & outmanoeuvre competitors.
- **Lower cost & improved efficiency:** self-motivated people do not need layers of monitoring/oversight.
- **Roots out mediocrity & attracts great people:** average colleagues or unchallenging work kills personal development. Motivated, empowered people attract great people.
- **Endurance:** enhances ability to adapt, develop and persevere in the face of adversity – is highly regenerative.

How do you build it?

As stated, culture usually originates around one or two people, typically the founder(s). The values they display become embedded within the firm and are surprisingly sticky through generations of leaders and multiple iterations of business model. The basic philosophy of doing business tends to be timeless; it is the strategies and tactics that change.

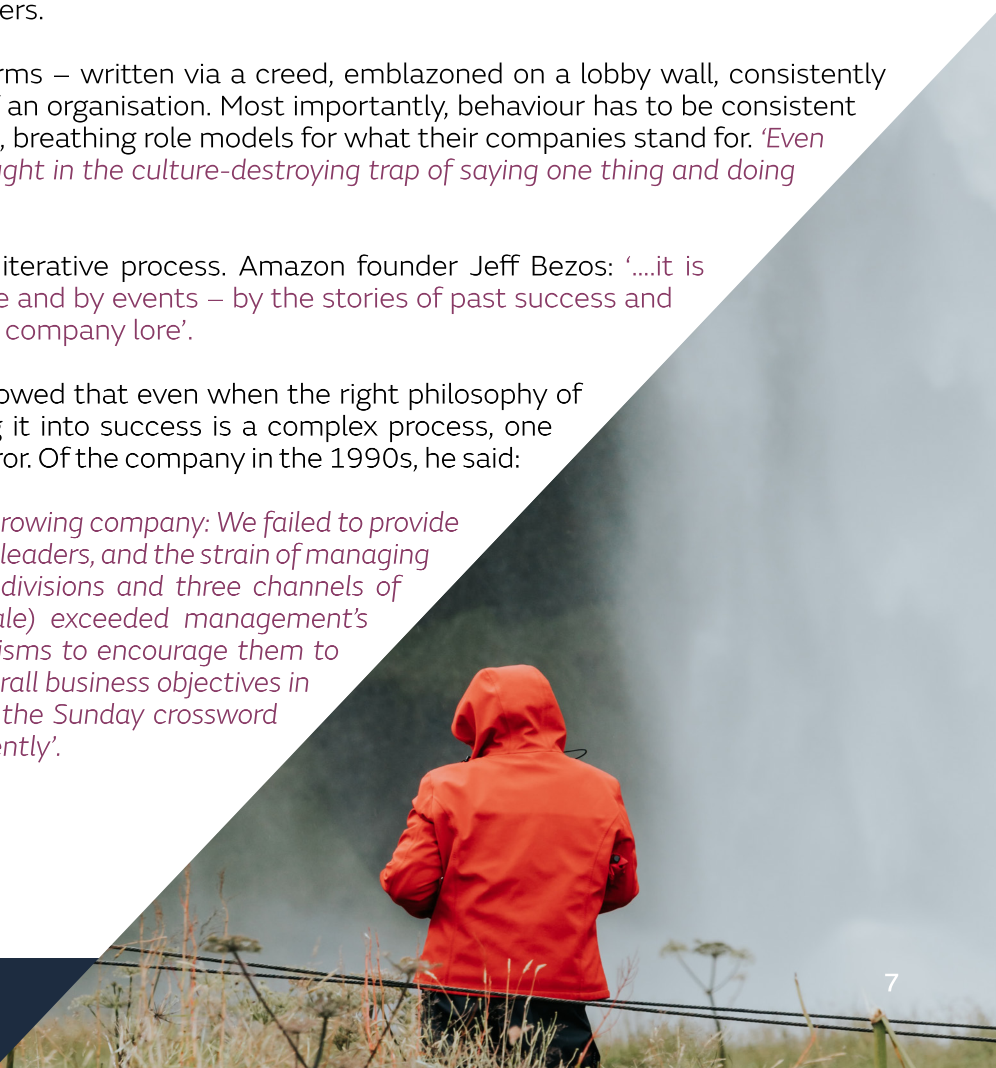
In most cases, cultural preservation is conscious and deliberate – preserving a company's core values is a key task of leadership. Successful managers spend as much time looking inwards to the firm as they do outwards – to customers and broader stakeholders.

Culture can be elucidated in many forms – written via a creed, emblazoned on a lobby wall, consistently spoken about throughout the ranks of an organisation. Most importantly, behaviour has to be consistent with values – managers must be living, breathing role models for what their companies stand for. *'Even in times of crisis they've rarely been caught in the culture-destroying trap of saying one thing and doing another'* - John P. Kotter

And building it is typically a lengthy, iterative process. Amazon founder Jeff Bezos: '....it is created slowly over time by the people and by events – by the stories of past success and failure that become a deep part of the company lore'.

Patagonia founder Yvon Chouinard showed that even when the right philosophy of doing business is in place....translating it into success is a complex process, one that can only be learned by trial and error. Of the company in the 1990s, he said:

'...we made all the classic mistakes of a growing company: We failed to provide the proper training for the new company leaders, and the strain of managing a company with autonomous product divisions and three channels of distribution (retail, mail order, wholesale) exceeded management's skills. We never developed the mechanisms to encourage them to work together in ways that kept the overall business objectives in sight. Organisational charts looked like the Sunday crossword puzzle and were issued almost as frequently'.



Kotter's research reinforces the idea that what typically separates the development of successful and unsuccessful cultures at an early stage is the degree of buy-in from management into the corporate philosophy; one that stresses in almost equal importance a focus on customers, employees and shareholders whilst enforcing the requirement to be adaptable to a changing environment (sounds almost Darwinian). After that, it is about working hard to maintain it.

Can you turn a poor culture around?

Evidence suggests so, but it is rare, principally because it is so hard and complex a process. Rebooting deeply held beliefs and ways of doing things requires a radical approach because humans are inherently resistant to change. The tendency is to accept it in some small part, only to find that reluctance creeps in, often in a subtle and pernicious way that ultimately succeeds in re-establishing the status quo. Fearing the pain of loss, people often cling to the old and familiar. The overriding requirement, in such circumstances, is effective leadership.

Perhaps a more extreme example that I have come across is an experiment conducted in the 1980s at a small, private Brazilian company. *'Maverick'* is the story of Semco, a manufacturer of myriad industrial parts (commercial dishwashers to marine pumps...), which was transformed by Ricardo Semler, the founder's son, by turning its culture almost literally inside out.

From the brink of financial ruin it became one of Brazil's fastest growing companies, with a sevenfold rise in productivity and a backlog of more than 2,000 job applications (at one point a poll of college graduates revealed that 25% of men and 13%[2] of women named Semco as the company they most wanted to work for). How did this come about? The answer is strikingly simple: freedom, democracy and trust – in abundance. Semler took what was, by all accounts, a staid, functionally organised system and introduced some radical measures, including:

- No more searches of employees as they entered & exited factories – treat everybody like adults
- Encouragement to work from home (in the 80s!)
- Staff could determine their own hours, even set their own pay (but available for all to see)
- Unions were embraced and given greater say
- Idea generation was stimulated across diverse working groups to improve processes & innovation
- Organisational hierarchies, departmental divisions and systems were disbanded to encourage collaboration
- Workers could regularly evaluate their managers, interview prospective bosses & vote on key issues
- 25% of profits were distributed to employees – to see the connection between productivity & profit

Semco opened up its accounts for everyone in the company to view, and even provided basic accounting training to equip employees to read them.

The result was chaos....but with it came motivation, creativity, innovation, loyalty and accountability. Further, as workers began to exercise more control over their jobs and an increased share of voice over policies, the need for supervisors diminished. Swathes of middle managers left – their jobs became either redundant or they could not adapt to the new system (it self-selected). Within the central headquarter function (legal, accounting and marketing) headcount was reduced by ~75%.[2]

The change is, perhaps, exemplified by the following anecdote:

'Not long ago the wife of one of our workers came to see a member of our HR staff. She was puzzled about her husband's behaviour. He no longer yelled at the kids, she said, and asked everyone what they wanted to do on the weekends. He wasn't his usual, grumpy, autocratic self'.
Could that person have found their Ikigai?

Microsoft is perhaps the more obvious, recent example. Satya Nadella, on becoming CEO in 2014, announced it was time to *'rediscover the soul of Microsoft, our reason for being'.* In a nutshell, Nadella shook the organisation to its core, in the process breaking up cosy fiefdoms, reigniting curiosity and passion. It is a rare example of cultural revolutionary success, at scale, and one that merits studying in detail.

[2]https://epicworkepiclife.com/semco-insanity-that-works/

How fragile is culture?

Arguably the area most up for debate. Some think it unbreakable; others believe it to be fragile. I tend to fall between the two and use a surfboard analogy by way of example. Used in the arena for which it was intended a board - ultimately a slab of styrene foam coated in resin – is strong. Of course, an outsized wave with tremendous force will break it...but its tolerances in most environments are high. However, step out of the water and drop the same board on a concrete floor and it is most likely damaged beyond repair. What I am saying is that culture can take a strong buffeting in its natural habitat. However, change the habitat too much and it becomes extremely fragile.

Two examples might better explain the point: one of relative overnight change and the other of slow, incremental deterioration.

Boeing

For about 80 years, the company essentially functioned as an association of engineers. The sole focus was on building airplanes of supreme quality by harnessing the collective and collaborative power of its workforce. It had a safety-first culture, one of learning & continuous improvement and with that came financial success – between 1980-1997 the share price increased by an impressive ~17.5% per year (with dividends reinvested).

Then, in 1997, the company bought McDonnell Douglas (McD), and with that came a de-facto reverse takeover by McD senior management, who shifted the focus of attention from safety to profit. The ensuing cost cutting (e.g. "over-staffed" quality control department) even saw a shift of headquarters from Seattle to Chicago – far from its manufacturing heartland. Quite simply, Boeing's culture was turned upside down.

So what became of that focus on profit over purpose? From 1997 to the present day, the share price CAGR has been ~7.5%, little better than the S&P 500.[3]

Hewlett Packard

HP was known for having a strong culture, instilled by Bill Hewlett & David Packard in the late 1930s. They developed a philosophy of how to run a business – the 'HP Way'- that became deeply embedded within the company (customer focus, shared values, and talent development). The firm thrived in the 1950s & 60s. However, the 1970s & 80s heralded big changes to the business environment – most acutely the advent of the personal computer. At the same time long-standing managers started to retire.

Incremental cultural changes – barely perceptible in the moment – led to material changes over time. Centralisation, less emphasis on entrepreneurialism, more emphasis on hiring outsiders, employees being laid off for the first time etc. Once the rot set in, the culture was not strong enough to withstand it.

Stock price performance (CAGR):
1962-1979: ~16%
1980-2015: ~7%[4]

[3 & 4] Bloomberg as at September 2023.

Arguably, the lesson is best expressed by Berkshire Hathaway's view of the role of a Board of Directors:

1. Jealously guard and nurture the culture of the business
2. Challenge and resist the Institutional Imperative (resists change, ill-conceived M&A, slavishly imitating peer company behaviour).

If number 1 is adhered to then number 2 should take care of itself!

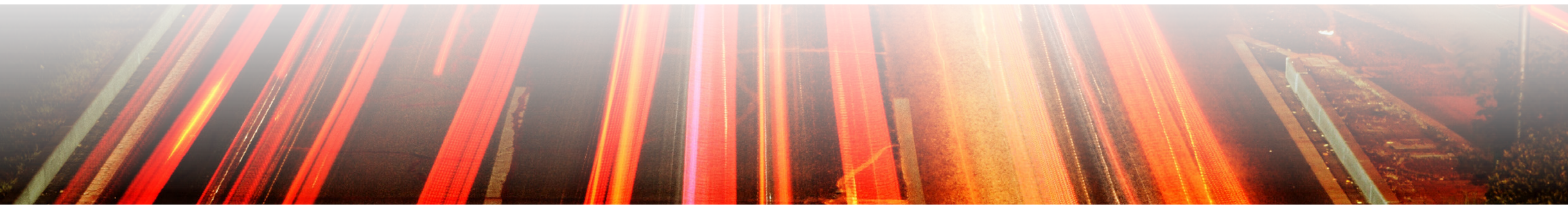
Conclusion

There is little doubt that business models, industry structure and competitive dynamics play an important role in determining the success or failure of companies. However, when it comes to adaptability and genuine sustainability then there is only one real answer – the right culture. Of course, there is no magic formula and certainly no guarantee of success – each company must forge its own path and find its own recipe for long-term survival. But the search for successful companies is as much about judgments of people as it is about business models. When both the qualitative and the quantitative work in synchrony, the outcomes are often both marvellously profitable and wonderfully enduring.

When you boil it down, the ingredients are simple - do the right thing, treat people well (customers, employees, shareholders and community), apply consistently and persevere. Cast aside the ego, defer gratification and surround yourself with those who share your values but offer complimentary skills. Work to get that bit better, that bit wiser each and every day. Acknowledge that it is a never-ending journey of discipline, hard work and the pursuit of ever-higher standards. Sounds a bit like a manuscript for living one's life!

Why do so few companies manage it? Ultimately because it is hard. Hard to keep at it consistently over decades, let alone centuries. The easier option is to give in to arrogance and complacency, particularly after having encountered periods of success. It is easy to be ensnared in the short-term traps of immediate gratification, intuitive thinking and decision-making instead of deeper, critical thought and reasoning. It is easy to give up in the face of adversity.

However, the reality is that it is all out there for the taking. Great companies have done nothing that cannot be replicated in at least some shape or form. They have simply wanted it more.



At GIB Asset Management, we have built the European Focus Fund investment philosophy around these principles; that behind every successful, enduring business we find the typical quantitative hallmarks (consistently high returns and growth), which we refer to as 'physical capital'. However of equal importance, in our view, are an under-appreciated set of qualitative, or cultural characteristics which we refer to as 'human capital' that allow companies to sustain, and even extend, their competitive advantage over time.

We believe that these elements of physical and human capital coalesce to create a highly focused, innovative, efficient, adaptable and resilient organisation. It is these truly sustainable businesses that we seek to own in the European Focus Fund.

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