

GROWING CULTURES

Mark Urquhart, Investment Manager, Fourth Quarter 2017



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GROWING CULTURES

MARK URQUHART

One of the topics we think a lot about in our research is culture. Indeed, several years ago we changed Question 4 of our Long Term Global Growth 10 Question Research Framework from asking ‘Are your people better than theirs?’ to a more granular question ‘Is your business culture clearly differentiated?’, and recently added a second part – ‘Is it adaptable?’ Both of these changes were deliberate attempts to capture the ongoing development of our thoughts, acknowledging that while a company’s people are hugely important to any business, culture runs deeper and broader than just the people to something intangible. The questions also recognise that, in an age of constant innovation, it is becoming ever more important for companies to challenge themselves from within rather than await external competition.



I was recently at an event where around a dozen people were asked to define culture in the broad sense of the word. I was struck that there were as many different definitions as people in the room. Perhaps betraying my own background in the Arts & Social Sciences, for me culture conjures up images of orchestras, opera, theatre and literature. For others of a more scientific bent, the first thought which occurred to them was of nurturing bacteria and growth. There was a very broad spectrum in between. Perhaps, because the word is so ubiquitous and often used without much thought, it is a difficult concept to define succinctly. This is no bad thing – one of the attractive things about a strong culture is the multi-layered, multi-dimensional nature which it can possess.

Displaying my own educational biases, the *Oxford English Dictionary* definition is as good a place as any to start and it helpfully gives four definitions of culture as a noun:

1
The arts and other manifestations of human intellectual achievement regarded collectively
e.g. '20th century popular culture'

2
The ideas, customs, and social behaviour of a particular people or society
e.g. 'Afro-Caribbean culture'

3
The cultivation of bacteria, tissue cells, etc. in an artificial medium containing nutrients
e.g. 'the cells proliferate readily in culture'

4
The cultivation of plants
e.g. 'this variety of lettuce is popular for its ease of culture'

Taken collectively, this leads me to a joint definition of human achievement; ideas and behaviour; growth and variety, which then becomes a decent starting point from which to explore my understanding of corporate culture.

The etymology of a word is always interesting to me and in the case of culture it has a direct root in the Latin 'cultura' which translates as cultivation. Unsurprisingly at a time of an overwhelmingly agrarian economy, the first meaning of the word was related to physical growth from the soil. It is easy to overlook the fact that it was only after the Renaissance that the word's usage began to spread from 'cultivation of the soil' to 'cultivation of the mind', with the first uses in this vein cited in the 16th century, and the use of 'culture' as a collective noun for human behaviour only dating from the early 19th century. So many fine operas, symphonies, plays and poems were written long before they were collectively described as such! In the rest of this piece, I will try to explain how I think about this concept as it pertains to the companies which we research.

Opposite: *The Star – Dancer on the Stage* by Edgar Degas 1876–1877.
© Corbis Historical/Getty Images.

The first obvious point to make in terms of measuring corporate culture is that there is no financial measure which can capture such a complex and intangible concept. There is no entry on the profit and loss statement or balance sheet which market participants can use as a shorthand (though many will try) for culture. Indeed rather like the intangible assets of brand or customer loyalty the concept is notable by its

absence from financial statements. Nowhere on Apple's very sizeable balance sheet will one find an accounting entry which relates to its culture of design, customer experience and innovation.

It seems almost facetious to say it but this lack of measurability appears to mean that many market participants don't really think about corporate culture. If one is almost entirely focused on the machinations of this or next quarter's numbers then considering more esoteric and harder to define topics is often relegated to oblivion. One need only glance at the transcript for any quarterly earnings call to get a taste for the minutiae which obsesses so many and a feel for how far away the questions asked are from any examination of long-term culture.

This is not to say at all that a strong culture can't have a profound impact on a company's financials; indeed I would contend that it is quite the opposite. For instance, in the case of Apple, surely its astonishing sustaining of profitability – which is a multiple of any other electronics industry participant – is a direct result of its confidence in the products created by its culture which, in turn, in large part explains its



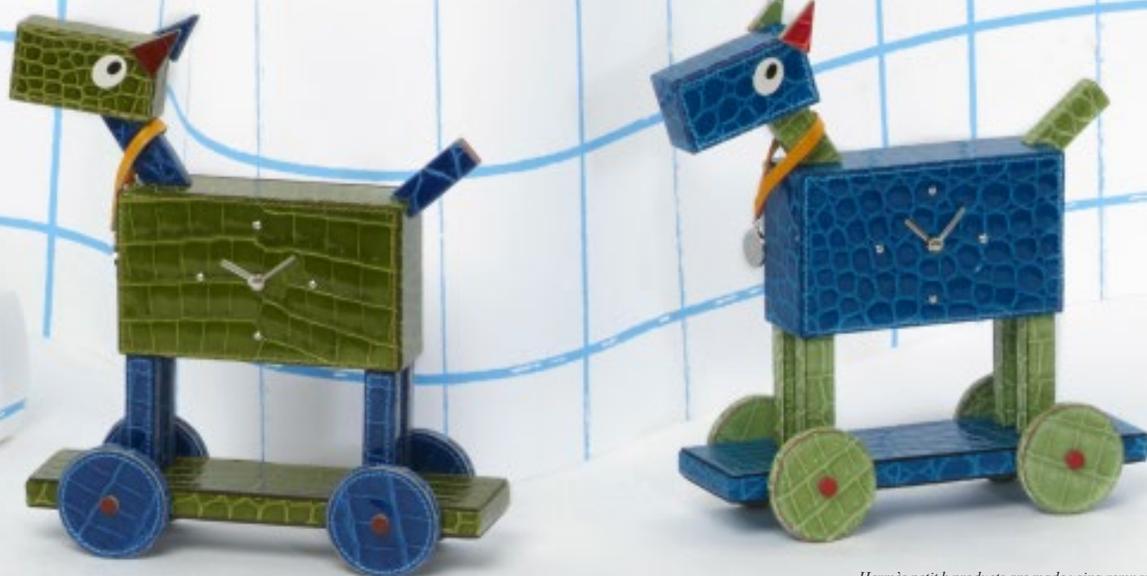
– *Hermès' culture is built on a cornerstone of family owners whose chief desire is to pass the business on to their grandchildren.*

record-breaking market capitalisation. However, it requires removing oneself from the hamster wheel of quarterly noise to appreciate the window on culture which such sustainability of margins provides.

In my view there are three broad ways in which we should think about the strength of a company's culture:

The first is to consider a company's actions not its words – any business can create a narrative around itself but it is how it operates which defines the values of the enterprise. The very public scandal surrounding Theranos is a powerful example of this – the narrative of a start-up business seeking to change diagnostics appears diametrically opposed to the business malpractices which are still emerging. How a company acts and behaves carries far more signal than the noisy image it might seek to project.

A positive example of behaviour is a story about Hermès and its hit beach bags which I have recounted many times. Over a decade ago, the company had a surprise hit bag on its hands, a relatively cheap beach bag which was very popular in Tokyo. Rather than produce as many bags as they could, management were appalled by the potential long-term damage to the brand so removed them from sale and destroyed the stock. To my mind, this action is an exemplar of a very strong long-term culture and the antithesis of short-term profit maximisation. Even more strikingly, the then CEO told of the occasion of reporting these actions to the Board and receiving a standing ovation. Hermès' culture is built on a cornerstone of family owners whose chief desire is to pass the business on to their grandchildren.



Hermès petit h products are made using remnant materials available at the time, making each one completely unique.

© Courtesy of Hermès.

Second, how companies communicate or think of themselves is another window on their corporate culture. Each interaction with the company, whether that's reading annual reports, discussing attitudes to quarterly guidance, acknowledging the inherent uncertainty of capital allocation and the thousand other conversations we have with management, provides a little piece of the mosaic which makes up their culture. Whilst almost all companies are now required by regulation to report some form of three-monthly numbers, there is no direction on how they view or commentate on these short periods of time. Amazon's very wide quarterly guidance has demented more than a few sell-side analysts who want to be spoon-fed numbers for their own spreadsheets, but they seem a much fairer reflection of the randomness of predicting short periods of time in a fast growing business. In meeting management for the first time I always try to ask how they view the next decade and beyond. There are a myriad of answers but I instinctively trust those who have a vision of where they would like to get their business over the next decade rather than those who revert to a recently published Gartner style third party report on their total addressable market.

Related to the above is the third method which I find useful for digging into corporate culture, namely getting as deep as one can into an organisation. There is often very little to be learned from a highly polished Investor Relations

professional with a tight corporate script. Insights are more likely to come from long-serving employees who are less experienced in communicating with investors and therefore possess a veracity which can shine a light on cultural features.

I remember several years ago visiting a Bottega Veneta production plant in the North-West of Italy – all of the production is done there because the fine sewing skills from Italy's historic dominance of shoes and other leather goods reside there. During the tour we stopped and talked to a gentleman dressed in his brown overall, who had worked there for almost four decades and whose job it was to decide on the quality of crocodile leather for tanning. Much to the surprise of the tour party he rejected a €2,000 crocodile hide because it had blemishes. To me this is culture writ large and is not something I could have gleaned without meeting this man.

Pulling this together, there is no Pauline moment at which a company's culture is revealed, rather it is a constant learning process in which each interaction and iteration provide fragments of information which help form a picture of the company in question. Equally, one never has a full picture because the companies themselves are changing in terms of size, people, opportunity sets, etc. which leads me onto the importance of adaptability.



...he rejected a €2,000 crocodile hide because it had blemishes.



... Kodak was one of the strongest brands of the twentieth century – from its launch of the Box Brownie in 1900 to the heights of the Instamatic era.

One of the best stories which illustrates the need to adapt is the tale of Eastman Kodak's rejection of digital photography. I don't think it is historic hyperbole to say that Kodak was one of the strongest brands of the twentieth century – from its launch of the Box Brownie in 1900 to the heights of the Instamatic era. It was described as a 'curator of memories' and many people had a strong emotional attachment to the small yellow rolls of film or Kodak chromatic slides. This was an iconic brand which touched millions of people at some of the happiest times of their lives. By all accounts, this was a business with a strong innovative culture and, right at the height of its powers in 1975, it had an extraordinary breakthrough when engineer Steve Sasson saved images using electronic circuits to a tape cassette and then made them viewable on a TV screen within twenty seconds. The company executives famously rejected any further work in this area to protect the golden egg of the company's mammoth film business therefore opening the door to Japanese competition and sowing the seeds of Kodak's bankruptcy several decades later.

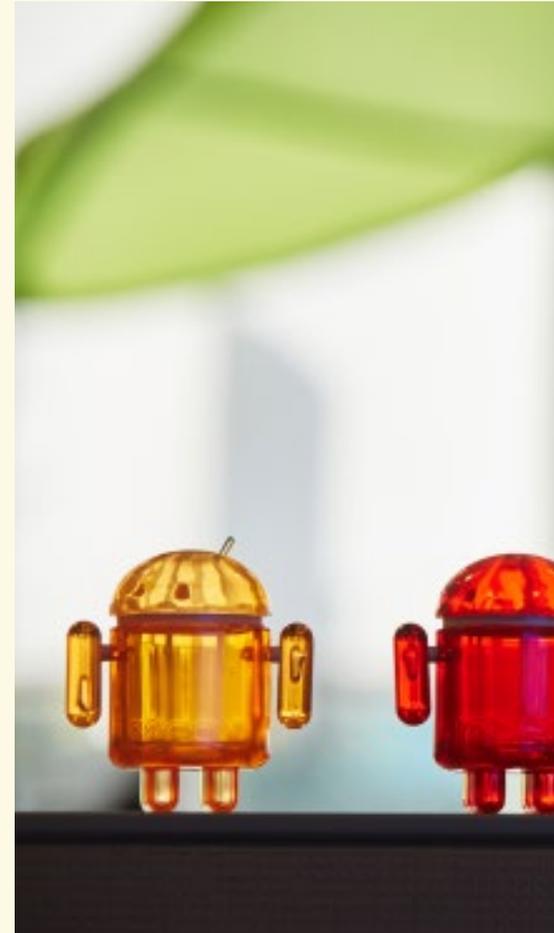
This is a classic example of Christensen's 'Innovator's Dilemma' with dramatic consequences. I am in no way saying that these corporate decisions are easy. Back in 1975 Kodak was defending an outsize 'Nifty Fifty' market cap and had one of the most perfect razor blade type businesses which Wall Street had ever seen, yet the cultural defence of this strong and seemingly bullet-proof film franchise ultimately left the Achilles Heel of digital photography wide open to competition.

As such, we try to look for companies that are open to change and will experiment and adapt. An obvious example here is Amazon's decision to launch the Kindle a decade ago – conventional wisdom suggested that with books by far its largest category, it was simply cannibalising its own business. Jeff Bezos' view (never conventional) was that digital books were an unstoppable trend but there was no device on the market which met customer needs in terms of user experience both from a readability and connectivity point of view, hence the decision to launch the Kindle. In fact, much of the twenty plus year history of Amazon's ascent can be seen through the prism of a company whose culture is based on experimentation and adapting – Prime Delivery, AWS, Alexa, video streaming and e-gaming can all be seen through this lens.

It is not just newer companies and start-ups which have to adapt. If one thinks of the seismic changes in brand advertising which the internet has brought about, this has created challenges and opportunities for numerous branded goods companies. Only five years ago, it was almost unthinkable that Gucci would be growing at such fast rates and at least some of this appears to lie in the cultural adaptability which new designer, Alessandro Michele, has brought to mediums such as Instagram – they have been used as a positive to connect and adapt the brand to new millennial audiences.



Multicoloured Android operating system figurines.
© Images courtesy of Google.



The list of companies whose cultures have eroded over the years attests to the difficult task which maintaining a strong culture presents for corporations. In many ways the completely rotten cultures at companies such as Enron or RBS, where greed ran unfettered, are of less interest to me because they are so clearly signalled and represent the types of acquisitive, aggressive and uncompromising business cultures to which we would not be attracted. What to me is more dangerous, and that which we must guard against, is the slow erosion of culture which it appears can happen at times below the radar. The atrophy of Hewlett Packard – at one time *the* place where all engineers aspired to work in Silicon Valley – is a sad and totemic example of how great companies can be slowly but surely destroyed from the inside.

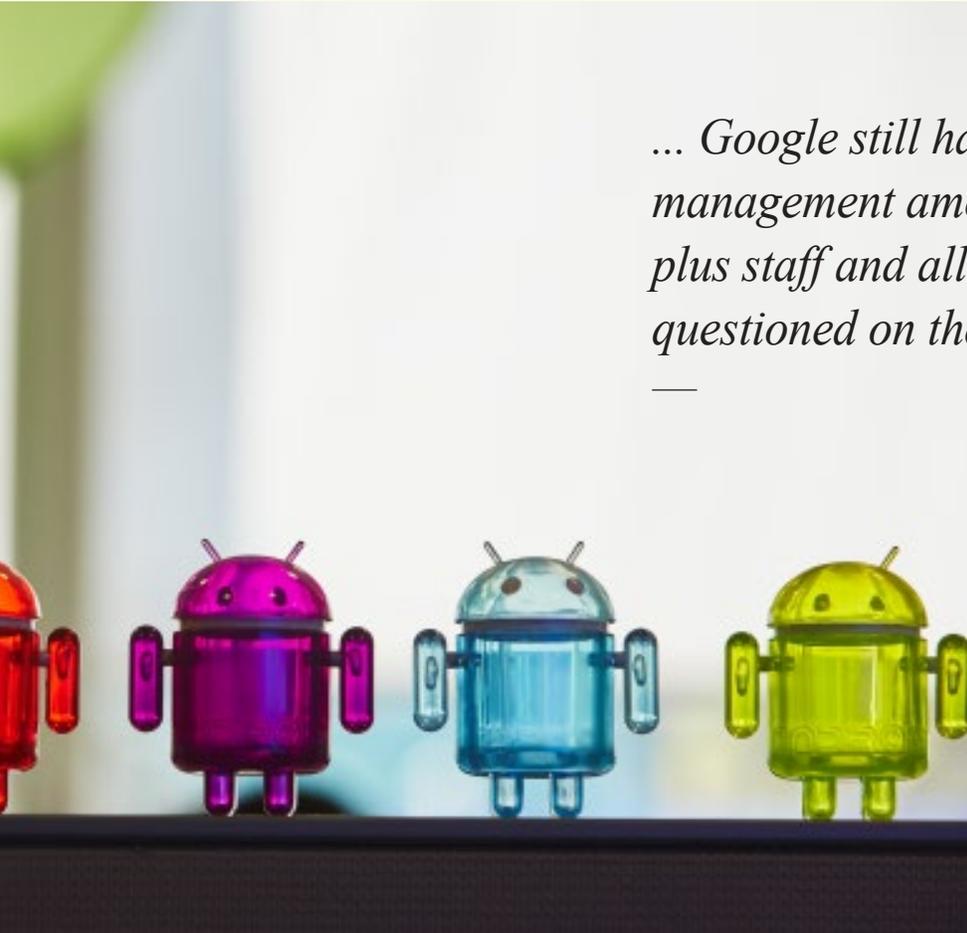
Certainly size is a factor in this but it would seem that some companies manage to navigate size precisely because their culture is so strong. For example, Alphabet, Google’s parent company, still has only six layers of management amongst all of their 50,000 plus staff, and all potential recruits are questioned on their ‘Googliness’. This is an active attempt to subvert the tentacles of bureaucracy

which envelop any organisation of size. Another such example would be Facebook’s town hall meetings every Friday, where any employee can ask a question of Mark Zuckerberg. The role of leadership is crucial in trying to maintain culture as businesses grow – the over-certainty of a Jack Welch style ‘this is how we do things’ structure, stands in contrast to companies who try to allow challenge, multitudes of ideas and diverse sources of growth; companies such as Alibaba and Tencent. Is it any coincidence that a Bezos-led Amazon has triumphed in e-commerce over the more functional eBay whose founder, Pierre Omidyar, departed and was replaced by a management consultant?

One other symptom of potential cultural erosion, which links back to another of our Ten Questions, is how businesses treat their customers. The need to respond both quickly and honourably to PR challenges appears never higher as the ease with which customers are able to record poor service and trumpet it on social media shines a constant spotlight on every business. The recent incident surrounding over-booking of a United flight is not surprising to anyone who has flown in the US in the last twenty

years but the poor, defensive and slow response by the company turned a damaging episode into a potentially catastrophic one. Of course, all companies will face challenges but the manner of response is an important cultural symbol – contrast Volkswagen’s denial of how far up the corporate chain its diesel emission cheating scandal extended, to Robin Li’s open letter to Baidu’s employees outlining his concern that Baidu’s corporate culture was drifting away from its customers following the

... Google still has only six layers of management amongst all of their 50,000 plus staff and all potential recruits are questioned on their Googliness.



difficult healthcare advertising issues which it has experienced. Baidu faces operational challenges which we need to debate but I am confident that the culture remains robust.

A strong culture alone will not determine the success of an investment. Indeed, in the last couple of years, we have sold businesses such as Novozymes and Whole Foods, which have tremendous cultures because other factors, such as the opportunity set and profitability, had changed. What I do think is that close examination

of culture may help us avoid making some of the inevitable mistakes which growth investing entails. For instance, the revolving door of CEOs at First Solar, or the tensions between Israeli and American management factions at Stratasys, were clear signals of cultural difficulties. Perhaps the investment decision I am proudest of being part of in the last few years was our passing on the opportunity to invest in Uber on cultural grounds – we could see the tremendous market opportunity of ride-sharing but the company failed the

cultural sniff test, which a couple of years later appears to be coming back to haunt them operationally.

Culture is a fascinating topic and one which I am constantly learning about and thus my views continue to evolve. It is the intangible glue which can hold fast-growing businesses together, it is the facilitator which gives space for innovation and the standard behind which companies can emerge stronger from adversity. I believe a strong corporate culture encompassing my definition of ‘human achievement; ideas and behaviour; growth and variety’ can be the bedrock upon which companies can build a long-lasting and successful business.



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