Building Intangible Value from the Outside In

BY DAVE ULRICH AND NORM SMALLWOOD

Recent history demonstrates that the intangibles of business—quality of leadership, the ability to make things happen quickly, a clear growth strategy, strong functional competencies, and brand recognition—matter in both bear and bull markets. When the dot-com bubble burst, stories of corporate dishonesty grew, and the economy tumbled into recession, some firms' market value fell more than that of others in the same industry. We believe that firms that survived the market credibility crisis did so because their leaders had made the intangibles tangible.

Intangibles show up in business by boosting—or undercutting—investors' confidence in a firm's performance. Baruch Lev, an accounting professor at NYU and the leading thought leader on intangibles, has shown the importance of intangibles as indicated through the market-to-book value (the ratio of capital market value of companies compared to their net asset value). According to Lev, the market-to-book value of the S&P 500 has risen from 1 to over 6 in the last twenty-five years—suggesting that for every $6 of market value, only $1 occurs on the balance sheet. This data shows that the value of many firms comes as much from perceived value as from hard assets. Value, like beauty, is in the eye of the beholder.

Firms like Coca-Cola and Merck have high market value from brands and patents. Technology-based firms like Amazon and Exult have high market value with relatively little in the way of either hard assets or patents. And even traditional companies like General Motors and 3M are increasing market value by focusing on brands, leveraging the Web, and restructuring.

Understanding and leveraging intangibles are powerful tools for leaders. When intangibles are defined and operationalized, leaders can make choices that affect not only what happens inside their firm but also how investors value those decisions. While Baruch Lev has offered a precise financial definition of intangibles, for our purposes we define intangibles simply as the value of a company not accounted for by current earnings. This definition suggests a new bottom line. The old bottom line consisted of current earnings on the standard P&L statement. The new bottom line includes current earnings as well as the confidence of investors, customers, and employees in the firm's ability to deliver in the future. The traditionally "hard" fields of accounting and finance are now coming together with the softer fields of organizational behavior and human resources to help us understand the new bottom line, focused on financial results *and* intangibles. (See "Measuring the Value of People," *Leader to Leader,* Number 27, Winter 2003.)

Intangibles are most clearly visible when comparing firms within an industry, not across industries, and the variations in P/E (price to earnings) ratios of firms within an industry offer evidence of leadership intangibles in both up and down markets. Companies with high intangible value have higher P/E multiples than their competitors in the same industry. Their leaders have earned the perception that they can be trusted to deliver on their promises about the future. Companies with low intangible value have lower P/E multiples than their competitors because of erosion in confidence in the firm and its leadership.

The good news is that leaders can build higher intangible value for their organizations in both up and down markets. Intangibles become visible when they are understood and managed, allowing specific leadership actions and choices to define and deliver them on demand. When this is done, employee commitment, customer intimacy, and investor confidence rise. To illustrate how to build an intangible capability, we will explore the concept of performance culture. We will demonstrate the value of clearly describing what this intangible is and discuss practical ways leaders can build it. In our book *Why the Bottom Line Isn't* we offer detailed theory and tools for building this and other intangibles that increase organization capability and value.

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Building Culture from the Outside In

Organization culture is rightly the focus of many change efforts. For example, organization cultures that are entitlement oriented or too internally focused lack competitive zeal. Most definitions of culture suggest that it is more than random or isolated activities. Your organization begins to have a culture, a unique identity, when its management approaches outlive any one executive and involve more than any single management practice, fad, or era. We prefer to use the term *shared mindset* for this phenomenon because it represents the essence of what's really happening. First, *shared* implies something common among a group of people that holds them together. A *mindset* represents an enduring thought pattern or framework that you bring to all your activities. When truly and deeply shared, a mindset becomes the enduring identity of the firm not only in the collective mind of employees, but also of customers and investors. A shared mindset exists when customers and investors outside and employees inside have a common view of the organization's identity.

Why do we include customers and investors in our description of a shared mindset? Focusing only on the patterns inside an organization that affect employee behavior ignores how customers and investors perceive and respond to the culture. Dell's commitment to rapid service, for example, affects customers as much as employees—and the perceptions and expectations of Dell's customers also affect employees. Merging internal and external views of identity means that customers perceive the firm in ways that match how employees perceive the firm. *Shared* mindset also shifts focus away from what executives *say* is important in generic value statements to what employees, customers, and investors *demonstrate* is important through their actions.

How a Shared Mindset Creates Intangible Value

A shared mindset produces intangible value when it creates an identity or positive reputation in the mind of employees, customers, and investors that is tied not to a person or product but to the firm itself. This mindset becomes a self-fulfilling prophecy when it affects how each stakeholder behaves toward the firm.

Employees will be attracted to firms where they perceive a fit between their personal hopes, values, and skills and the existing mindset at the firm. Employee commitment, productivity, and behavior both shape and are shaped by the identity of the firm. Employees who choose to work for Marriott must realize up front that they will be expected to provide exceptional customer service. Once hired, they accept management practices that reinforce the customer service mantra. Employees who don't fit with the service agenda are likely to leave. A shared mindset changes and reinforces employee thinking and action.

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Customers also demonstrate their commitment to a firm's mindset or identity. When a firm develops a reputation for quality, service, or price, customers begin to rely on this identity and do business with the firm based on it. This identity of the firm in the mind of its best customers becomes a firm brand and demonstrates the impact of mindset on customer value. Firm brands are tied not to a single product but to the identity of the firm. Recent research shows that firms with strong and visible brands such as McDonald's, American Express, Harley Davidson, Herman Miller, and so forth create higher shareholder value in part because they have a positive identity as a firm in both up and down markets. Possessing a firm brand becomes even more important for Web-based sales. Firms on the Internet with a known identity and positive reputation attract customers much more than unknown firms do.

Shared mindset also affects investors in two ways. First, investors have a mindset that defines a company and its overall intangibles. Investors may gravitate toward firms with positive identities (as with the run-up on Cisco stock in the dot-com bubble) or rush away from those with negative reputations (as with the explosive run-down on Enron stock). Second, investors may be affected by the extent to which employees have a shared mindset. When every contact with a company reveals the same set of values and goals, it sends a powerful message. On the other hand, if what you hear depends on whom you talk to, the overall message may be one of confusion.

Creating a Shared Mindset

How do you create this outside-in shared mindset? We propose a four-phase process that creates a shared mindset that affects employees, customers, and investors:

1. Create the desired identity.
2. Determine how to make the identity real to customers.
3. Determine how to make the identity real to employees.
4. Build an action plan for implementation.

Phase 1: Create the Desired Identity

We have worked with more than a hundred executive teams to create a desired identity or shared mindset. Some were at the top of an organization and creating a desired identity for the entire organization; others represented a division, a plant, or a function. Regardless of scope, the process for crafting a shared mindset is similar.

First, ask each individual to write a response to the question: "What are the top three things we want to be known for by our best customers in the future?" This question turns attention outward rather than inward by seeing the organization through the eyes of the customers. It highlights the best customers, not the average ones. It focuses attention by asking for three answers, not an unlimited number. It emphasizes identity by asking what the unit is known for, not what it does. And it points toward the future, not the past or present.

Second, collect the responses and categorize them. For example, a team of 10 people will give you 30 total items. Sort the 30 into common answers. Of the 30, you might have 7 that address "service," 6 that focus on "value," and 5 on "reliability," with the other 12 scattered over other categories. It is important to sort rigorously. For example, some people will write things like "service, reliability, or ease of doing business" and imply that they all mean the same thing. This is not a safe assumption. At this point in the exercise, the goal is to see the extent to which a shared mindset exists among the top team, which requires rigor of language and ideas.

Performance appraisal questions show what your firm really values.

Third, add the total number of responses in the top three categories (18 in this example) and divide by total responses (30) for a rough measure of shared mindset (67 percent in this case). Our rule of thumb is that a desired level is 80 percent—which is rare on the first round. Generally, even when firms have strong cultures, executives use differing language and even differ in the aspects of the company they regard as crucial to its success when seen through the lens of customers.

Fourth, talk about themes in the results. Cluster and define themes that emerge from the responses and redo the exercise to see if an 80 percent consensus on the top three items can be reached. Reaching 80 percent consensus generally takes a couple of hours at most. After debate and dialogue, company leaders can usually agree upon what they want to be known for by their best customers.

Fifth, put the themes into words that resonate with customers. For example, at Domino's Pizza in the early 1990s, we did this exercise with the top 14 executives.

When asked the top three things they wanted to be known for, responses included service, reliability, good product, good value, talented employees, easy access, and many more. The unity score was about 40–45 percent after Step 2. On discussion, they came up with themes around quality, service, and talent. Then they put these themes into customer language with the following desired mindset: *hot, fresh, tasty pizza delivered on time by friendly people who drive safely.*

Sixth, test the articulated mindset with customers to make sure it is right. This final step in building a shared mindset—making sure it resonates with target customers—is probably the most important. If the desired mindset will not cause customers to pick your firm over competitors, it is the wrong one. This means having executives share their mindset with customers in one-on-one meetings, in focus groups, and in other customer contact and research methods to assure that it will influence their buying choices.

Points of contact—* touch points *—let you make the desired identity real to your customers.

Phase 2: Determine How to Make the Identity Real to Customers

When you are confident that the desired identity will have meaning and impact for targeted customers, the next step is to find ways to make the stated identity real to those customers in their terms. (Phase 3 is a concurrent effort to make it real to employees so that employees have the right mindset and skills to deliver on the customer promises.) To make the identity real to customers find points of contact—*touch points*—between the firm and the target customer and create ways to make the desired identity real in each one.

For example, at Domino's Pizza, executives picked four touch points between the firm and the pizza-buying customer: the call, the delivery, the pizza, and the box. To communicate service during the call, they worked to answer the call by the fourth ring, have a friendly greeting, use caller ID to verify name and address of customer, and make sure staff thanked customers for their patronage. To ensure on-time delivery drivers had maps and drove in areas they knew. In addition, the drivers were friendly people who dressed in clean uniforms, had correct change, and used a positive script in communicating with the customer. The pizza was hot, fresh, and tasty because it was made of good quality ingredients, packed in heat bags to maintain warmth, and delivered quickly after cooking. But as executives thought more about the customer contact, they realized that the call lasted about 30 seconds, the delivery exchange about a minute, and the meal about 10 minutes, but the box often sat around customer kitchens for hours (and in many cases for days). So they chose to use the box for advertising their firm brand and identity. Rather than merely have the box give their name and say "our drivers carry less than $20 in change"—which might communicate an attitude of suspicion toward customers—they placed coupons, slogans, and commitments about the pizza on the box itself.

Phase 3: Determine How to Make the Identity Real to Employees

To make the identity real for customers, companies need to put plans and systems in place that ensure that employees' daily actions reflect the shared mindset. We have found several critical factors for leaders who want to make the mindset real to every employee, including treatment of talent, reward systems, and training and development.

Talent Flow. How a company moves talent into, up, through, and out of the organization sends a powerful message to employees, customers, and investors about the company's values and identity. Hiring new people who embody the right mindset and promoting employees who live the mindset—and removing those who don't—become critical tools for embedding culture. Employees observe what is happening and adapt their behaviors accordingly. Southwest Airlines rigorously screens flight attendants. It looks for employees who have technical skills, but even more it seeks those who are predisposed to engage with passengers, doing the required job with humor and enthusiasm. And in mergers and acquisitions this type of screening becomes critical—for the survival of the combined company, it's essential to assess talent and ensure that the right talent stays and the wrong talent, the talent that doesn't fit, leaves.

Hire new people who embody the right mindset, promote those who live the mindset, remove those who don't.

Rewards. Reward systems both change and reinforce behavior. The goal of a reward system is to turn goals into measures of behavior and outcomes, and then allocate rewards based on the extent to which employees behave in the right way and deliver the desired outcomes.

For a quick look at your firm's current mindset, take a look at its performance management system. The appraisal questions show what your firm values as defined by what it rewards. This reveals its real mindset—which may be quite different from the one fondly espoused in vision statements and other earnest pronouncements. It's also useful to invite customers to review the performance management process and report the extent to which the behaviors and outcomes on the appraisal document reflect what they as customers want from the firm.

Training and Development. Designing and delivering training courses sends messages about what matters. At the same time, it offers leaders skills and tools to act on those messages. An audit of the content of training and development experiences should show that these investments focus on the desired mindset, both conceptually and pragmatically.

Phase 4: Build an Action Plan for Implementation

Developing a shared mindset will change how employees, customers, and investors think and act. When your employees behave in ways that customers would like them to behave, employees, customers, and investors are all well served. In the fourth phase, the ideas from preceding phases are translated to action. To be successful, action plans need to be specific, start small, and have leadership support.

We often ask leaders to look at the ways that they could make the culture real to customers and employees and pick two or three specific areas they could focus on. Prioritizing a few things and getting them done is more useful than talking about a lot of things and accomplishing little or nothing.

Conclusion

We have described four steps necessary to achieve a shared mindset: articulate your unity of identity (what you want to be known for by your best customers); make this identity real to customers at every touch point; make this experience real to employees through selection, development, bonus, and performance management processes; and finally, build an action plan for implementation.

When a strong and desired shared mindset exists between your firm and its customers, tangible and intangible value is created. Customers are more likely to do repeat business, the right kind of employees are more likely to be attracted to your firm, and investors have greater confidence that the growth plans of the firm will materialize in the future.

Leaders' impact on the market value of their companies can be a double-edged sword.

Developing a shared mindset is just one example of how an intangible can add value to an organization. When leaders understand how they can build intangible value, they can begin to identity specific actions they can take to strengthen their firm brand and market value.

Recently, we have witnessed how business leaders' impact on the market value of their companies can be a double-edged sword. Some executives inflated market value through deceit and manipulation—and ultimately devastated their companies. Real leaders built tangible and intangible value and increased the market value of their businesses for the long term. ■