The investor's blind spot: a company's culture

RESILIENCE BEHIND THE MOAT

Assessing a company's culture is a step overlooked by most investors. Company culture is seen as an afterthought in the determination of the intrinsic value of the firm: crunching years of financial data has preference over something as intangible as a firm's culture. But by focusing solely on what is measurable, investors miss what is truly invaluable.

Although the analysis is qualitative, we believe corporate culture is one of the main drivers of an organisation's value. Businesses, especially in the service sector, are quite often little more than the people working for the organization. Therefore the way people behave - the definition of corporate culture - is what drives shareholder value. A strong corporate culture fosters honesty, rewards those who perform and freedom to try new ideas. A weak culture hides from the truth, rewards those who best manage internal politics, and takes irresponsible risks. Selecting companies with a strong corporate culture is likely to improve returns while reducing risk. Corporate history is littered with examples of companies that have been destroyed by bad behaviour. This could only have happened because the (ruined) company's culture allowed it to happen. We believe a framework for assessing corporate culture starts at the top.

Human beings are group animals. We follow the examples we can see, the normative set by others and by our leaders. What human beings don't do is blindly follow a list of values their corporation has published. Even the scandal-ridden Enron listed integrity as one of its four main values, and that did not stop it from going spectacularly bankrupt [1]. We observe real behaviour to see what is appropriate. As investors it is therefore important to focus on management behaviour.

[1] https://www.dlsweb.rmit.edu.au/toolbox/knowmang/content/ethics/values_statement_enron.htm
[2] https://www.wsj.com/articles/ge-expects-6-2-billion-charge-after-reviewing-insurance-reserve-1516104171

One way to infer corporate culture is by looking at the way management communicates externally. Management that issues explicit guidance, makes continuous accounting adjustments and blames external factors for mistakes is unlikely to foster an honest internal culture. The current troubles at GE are likely the result of a culture that spent more time polishing its external image than fixing the economics of the business [2]. We believe management that reports the results as they are, and does not pretend to be able to forecast the future, is also likely to promote candour internally. An honest and open culture makes firms more adaptable to external change, as management signals it is better to face reality than to hide from the truth.

Another indicator of corporate culture is the way management is rewarded. Constant changes in management remuneration policy likely points to a weak corporate culture. This indicates it is more rewarding to manipulate the goal post rather than drive economic value, and sets a precedent amongst employees to spend more time on internal politics rather than creating value for all stakeholders. Companies in which management has a significant portion of their wealth tied to the firm are likely at a reduced risk of this occurring. Firms with high insider ownership have been shown to generate returns in excess of the overall market. We believe this is partially due to owner--operators nurturing a better corporate culture than do managers with limited alignment. Good governance that holds management responsible for its actions is essential in creating a good corporate culture throughout the organization.

Culture also drives a corporation's attitude towards risk. A strong culture is likely to take calculated risks whereas a weak culture takes irresponsible risks. Companies with a strong culture tend to take risks only when it makes sense from the standpoint of a rational long term investor. An indicator of this is a strong capital allocation framework, as well as a track record of sensible investments. A weak culture is often created when management has overly-ambitious growth targets and promotes 'growth for growth's sake'. This fosters a culture where shortcuts are encouraged, as growth needs to be created at all costs. An example of this was the Macondo disaster in the Gulf of Mexico [3]. Pressure to generate growth was seen as more important than safety. The end result was one of the most costly environmental disasters in history.

Inferring corporate culture just from corporate reports, management meetings and proxy statements may give too limited a picture. Additional sources that are useful in getting a broader view of an organisation are employer review websites and conference calls with competitors, as well as analyzing the supply chain.

Corporate culture is intangible and not always easy to judge as an outside investor. By focusing on the honesty and integrity of management, the consistency in remuneration policy and a firm's long term targets we believe a more tangible picture can be formed. A strong corporate culture builds intrinsic value, whereas a weak culture can destroy what has historically been a prosperous business. We believe a solid framework for assessing organisational culture is essential, and likely to add to an investor's long term returns while reducing risk.

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3 http://www.popularmechanics.com/science/energy/a6065/how-the-bp-oil-rig-blowout-happened/

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