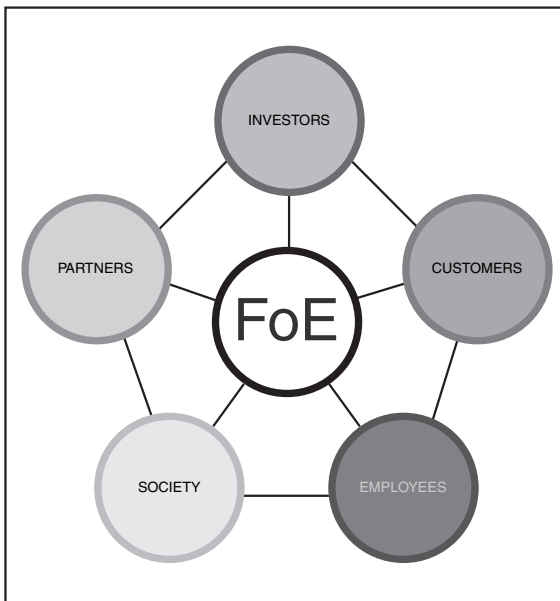


## ***FoE Stakeholders***

This book is organized around the five major stakeholders of modern corporations. As a memory tool, we have listed them below in a way that creates the acronym SPICE.

<b>Stakeholder</b>	<b>Definition</b>
<b>Society</b>	Local and broader communities as well as governments and other societal institutions, especially nongovernmental organizations (NGOs)
<b>Partners</b>	Upstream partners such as suppliers, horizontal partners, and downstream partners such as retailers
<b>Investors</b>	Individual and institutional shareholders, lenders
<b>Customers</b>	Individual and organizational customers; current, future, and past customers
<b>Employees</b>	Current, future, and past employees and their families

As Figure 1-1 shows, each stakeholder is important in its own right, and each is also linked to all of the other components. As with any good recipe, the individual ingredients come together to form something completely new; as the expression goes, the whole is greater than the sum of the parts.



**FIGURE 1-1** The SPICE stakeholder model

Each of these relationships is an essential piece of the puzzle, and each must be managed in a way that (a) a two-way flow of value exists between both parties to the relationship, and (b) the interests of both parties are aligned. This is the essence of great management. It is what all corporations should strive for. It is the way to maximize the returns to society of all the investments that flow into every organization. It is the *Firms of Endearment* way.

# Shareholders vs. Stakeholders

As we noted in the Prologue, University of Virginia business school professor R. Edward Freeman is credited with being the first to frame the idea of a *stakeholder relationship management* (SRM) business model. In his groundbreaking book *Strategic Management: A Stakeholder Approach*, he posited that shareholders were best served when all stakeholders were well served. Freeman defined a stakeholder as “any group or individual who can be or is affected by the achievement of a firm’s objectives.” He disdained Milton Friedman’s idea of shareholder supremacy, preferring instead to view shareholders as one among others in a constellation of interdependent stakeholders.

A distinguishing core value of FoEs is service to all stakeholders without favoring one over another. This is an irreplaceable factor in these companies’ ability to outperform most if not all their direct competitors. We found this all the more remarkable after learning that companies listed in Jim Collins’s management bestseller *Good to Great* dramatically trailed FoEs in returns to shareholders over the past 10 years (details in Chapter 6, “Investors—Reaping What FoEs Sow”).

Collins claimed there are no specific “right” core values for becoming an enduring great company. That may have once been true, but no longer is. Collins writes, “A company need not have passion for its customers (Sony didn’t), or respect for the individual (Disney didn’t), or quality (Wal-Mart didn’t) or social responsibility (Ford didn’t) in order to become enduring and great.”<sup>20</sup> He wrote that in 2001. As we write this, each of those companies has been failing investors’ expectations for some time.

Being a firm of endearment pays. The 13 FoEs profiled in this book that have been public companies for at least the past 10 years significantly outperformed the 11 big-name companies featured in *Good to Great*. Again, as the years roll on, the most enduring companies will likely be the most endearing companies.

In our view, the “shareholder versus stakeholder” debate presents a false dichotomy. Judging by the felicitous outcomes achieved by the exemplary companies in this book, we believe that the best way to serve shareholders in the long run is by embracing an SRM business

model, as Costco does, for example. Costco competes directly with Wal-Mart's Sam's Club, which benefits from the parent company's enormous buying clout and advanced logistics capabilities. However, Costco still manages to do very well. On average, Costco pays its employees about 65 percent more than Wal-Mart and 40 percent more than Sam's Club. Its benefits are also much more generous. *Yet, Costco generates significantly more profit per employee than Sam's Club.* It achieves this seeming act of alchemy by being far more efficient (spending only 9.8 percent of its sales on SG&A) and having very low employee turnover (only 6 percent in the first year, compared to 21 percent at Sam's and 50 percent at Wal-Mart). Costco's better paid and we might presume happier employees (a full-time cashier makes more than \$40,000 a year after just four years on the job) are likely more highly motivated and productive. Moreover, with deeper company loyalty than is common in retail, these more highly motivated employees are sure to be a fertile source of new ideas for further improving productivity.

There are many ways to skin a cat and at least as many ways to make a buck. Like other FoEs, Costco has designed a business model that enables it to pay its employees well, make good money for investors, have highly satisfied customers and suppliers, and generally be welcomed with open arms into every community it wants to enter.

SRM is a business model, not a moral code. It is difficult for analysts trained to look at companies through a traditional lens of numbers to comprehend the value producing potential of the SRM business model. Most have yet to discover the secret ingredient behind the success of these companies. As a result, some firms of endearment are subject to criticism by analysts for operating in a manner that defies conventional management logic and Wall Street dogma. Indeed, Wall Street has many analysts who think the Wal-Mart way is the better way. According to them, Costco co-founder and CEO James Sinegal is guilty of robbing investors to coddle its customers and line the pockets of undeserving employees. Here is Bill Dreher of Deutsche Bank Securities: "From the perspective of investors, Costco's benefits are overly generous. Public companies need to care for shareholders first. Costco runs its business like it is a private company."<sup>21</sup>

Dreher appears to us to be misguided. Public companies that are managed as though they were enlightened private companies often turn out to be great investments. Herb Keller's velvet-gloved iron hand runs Southwest Airlines like it were a private company. There have been no shareholder complaints about that. Southwest is the only Big Eight airline that continued making a profit after 9/11.

Listen to Jim Sinegal elaborating on why he is "overly generous" with Costco employees:

*Paying your employees well is not only the right thing to do but it makes for good business. In the final analysis, you get what you pay for.<sup>22</sup> Paying rock-bottom wages is wrong. It doesn't pay the right dividends. It doesn't keep employees happy. It keeps them looking for other jobs. Plus, managers spend all their time hiring replacements rather than running your business. We would rather have our employees running our business. When employees are happy, they are your very best ambassadors ... If we take care of the business and keep our eye on the goal line, the stock price will take care of itself.<sup>23</sup>*

As we write this in mid-2006, Costco's stock has risen about 40 percent over the past two years. During the same period, Wal-Mart's stock has fallen by 10 percent. One wonders how Deutsche Bank Securities' Bill Dreher can account for this in light of his view that Costco shortchanges shareholders to line the pockets of workers.

The problem is that many financial analysts are uncomfortable with anything other than conventional business models. Even then their understanding is limited by images of corporate reality taken almost exclusively from sightings through the lens of numbers. From the great mind of Albert Einstein came this nugget of eternal wisdom that deserves greater attention on Wall Street:

*As far as the laws of mathematics refer to reality, they are not certain, and as far as they are certain, they do not refer to reality.<sup>24</sup>*

Analysts have extensive data on "norms" against which to judge companies. When a company spends more than the norm in one

category—as Costco does in the wages category—analysts often overlook offsetting gains. Costco’s higher wages buy it reduced recruiting and training costs and better relationships with customers that lead to higher sales per customer and deeper customer loyalty. By contrast, Wal-Mart reportedly hired 620,000 new workers in 2004 just to replace those who left or were let go. By following the Costco business model, Wal-Mart might save huge sums. Its “Everyday Low Prices Everyday” might even be lower!

One of the biggest “secrets” of FoEs’ successes is how they become the preferred companies to do business with for every stakeholder group. For example, manufacturers of high-quality products such as Titleist and Cuisinart initially shunned warehouse-style retail stores because of their “bare-bones” image. Today, such companies eagerly sell their products at Costco, which attracts a high proportion of affluent shoppers. The best employees woo FoEs. For example, UPS has a 4- to 12-year waiting list of highly qualified drivers. Patagonia receives about 10,000 resumés annually to fill 100 new openings. FoEs do little costly advertising. Customers come into a company’s space without being called by Madison Avenue-style pitches. Sometimes FoEs’ primary problem is not getting customers, but keeping up with customer demand. This is a perennial problem at FoE Harley-Davidson. Communities often are anxious to attract FoEs to locate in them. The family-owned grocery chain Wegmans receives hundreds of letters monthly from customers pleading with it to open a store in their community.

Apparent recent interest in a SRM business model by industry titans General Electric and Wal-Mart probably makes it safe to say, “The tide is turning.” The rising assertiveness of members in every stakeholder group toward companies they invest in, buy from, work for, and permit to operate through public license is causing companies to lean toward the SRM business model. We see this as not just another management fad that seems destined to pass quickly, but an enduring trend helped along by a moral revolution in the executive suites of America.

The ironic bottom line here is that focusing intently on the bottom line alone usually leads to poor bottom-line performance. Placing shareholders far above all other stakeholders may be the worst long-term position a company can put them in. The record of the

exemplary firms in this book indicates that shareholders can gain more when their interests align with the interests of all other stakeholder groups. We say this without regard for day traders and other high-churn investors. They only take transient value; they do not create long-term value. In the *SRM economic ecosystem*, only stakeholders who create long-term value make long-term sense.