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"Using the 'Pyramid of Organizational Development' to Create 'Incremental Alpha'"©

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Abstract

The terms "Alpha" and "Beta" are commonly used by invest professionals. The term "Beta" refers to the relationship between risk or risk and return: the greater the risk (of loss) the greater the expected return and vice versa. "Alpha" is the term used by investment professionals to indicate *a differential or incremental value* of a company that is unrelated to Beta. The purpose of this article is to examine how an empirically validated strategic management concept termed "**the Pyramid of organizational development"** can be to create 'incremental alpha.'

The Search for Alpha

Investment professional of all stripes including Warren Buffett, Carl Icahn, Mario Gabelli, and George Soros are typically engaged in the search for Alpha; that is, they want to identify companies to invest in that have created *incremental value* of a company that is unrelated to Beta. Companies that have accomplished this are sometimes said to have a "moat" a term popularized by Warren Buffet) or sustainable competitive advantages. Moats can be attributable to a number of factors such as a leading brand (ie, Coca-Cola, Heineken, or Mercedes); proprietary products such as pharmaceuticals; technologies (ie, Walmart), or operational advantages of scale (ie, Intel and Cisco) or distribution Anheuser Bush and Caterpillar).

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Our focus and Contribution to the Creation of Alpha

Our firm Management Systems is also involved in the creation of alpha. However, it is from a very different perspective. Our focus is not about identifying companies with alpha for investment purposes; it is all about **how managers can Create Alpha!**

Research on Organizational Success and Failure

During the past two decades, I have been engaged in a long term program of empirical research on the determinants of organizational success and failure. The objective was to identify a set of core variables that can determine either organizational success or failure. This research has led to a model of the key determinants or components of organizational success and failure, as shown in Exhibit 1.

All of these variables or factors in this model have been supported by prior research as impacting organizational performance.[2] .However, they were never previously studied as a set (or organized in to a pattern or structure) which, as a unit, impacts or drives performance. Our unique contribution was to view them as a system of variables (or interrelated set of components) that, taken together, impact organizational success and failure. Specifically, these determinants of organizational success and failure have been combined into a framework called the Pyramid of Organizational Development. This pyramid is shown in Exhibit 2.

The Pyramid of Organizational Development

Based upon this research, we have developed a conceptual lens that identifies the true sources of incremental alpha. We call this lens "The Pyramid of Organizational Development," or for brevity simply "The Pyramid."

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[2]See Eric Flamholtz (1995). Managing Organizational Transitions: Implications for Corporate and Human Resource Management. *European Management Journal*, 13(1),39-51.

<u>Why a Pyramid Shape</u>? The Pyramidal shape suggests not only that these six variables are key drivers of performances but that there is a hierarchical aspect of their development. More specifically, the intention is to suggest that Pyramid of Organizational Development *must be built from the bottom up*. Thus the "market" is the most fundamental building block of the Pyramid. The market, which comprises of a set of present and potential customers and competitors of an enterprise, is (or ought to be) the target for the development of the rest of the enterprise. This means that the products and/or services offered depend upon the wants and needs of customers along with competitors comprising the market.

The Strategic Imperative of the Market. This leads to an important strategic principle or imperative of organizational development: *to be successful, the enterprise must be designed or suited to serve a defined purpose in the market*. Although this notion can be viewed as obvious, in reality it is not obvious as indicated by the failure of so many "dot.com" startups, which did not act in accordance with this strategic principle. Many of not most of the dot.com startups were designed to capture interest and "eyeballs"and not to fulfil a defined market need per se. Thus the failed dot.coms never met the initial test of a successful business, which is to demonstrate "proof of concept."

A demonstration of "proof of concept" requires not only that a product or service can be provided per se, but that a business can generate revenue that exceeds the cost of delivery of the product or eservice so that it can ultimately earn a profit. This is a simple restatement of the fundamental economic principle that marginal revenue must exceed marginal cost. For example, if a business like Starbucks can see a cappuccino for a price that exceeds its marginal cost, then ultimately each sore can earn a profit. If, in turn, there are a sufficient number of stores to cover corporate administrative expenses, the enterprise as a whole can earn a profit.

The Foundation of the Pyramid. As seen in Exhibit 2, the six strategic building block rest of a called called the "Business Foundation."The Business Foundation consists of three things: the business definition, the strategic mission, and the core strategy. A business definition is a description of the business purpose of the business, or what business the organization is in. For example, Coca-Cola is in the beverage business, Marriott is in the hotel business, and Simon Property Group is in the shopping center development and management business. The business definition can have profound strategic implications.

For example, Huawei has brilliantly strategically positioned itself in a unique way vis a vis a host co competitors such as IBM, Cisco, and others. It describes itself as being in the "ICT" business, where ITC stands for information communications technology. No other competitor has positioned itself in this way, which has given Huawei a strategic advantage in focus and specialization. In contrast, Xerox, once a great company, incredibly shot itself in its own foot by defining itself a being in the photocopy business, when it actually had the capacity to be a more broadly defined office equipment provider. Xerox's failure is akin to the classic example of "business concept myopia" by the railroads that defined themselves in the railroad business rather than in the transportation business.

A strategic mission is what the organization wants to achieve over a defined time period. For example, in 1994 Starbucks define is strategic mission to become the leaders brand it he North American Market. This mission was "strategic" because growth was not an end in itself; it was to reach a critical size that was sufficient to defend Starbucks against potential competition of giant players such a McDonalds or Nestle who could preempt Starbucks in the market by opening a very large number of stores.

A core strategy is an overarching strategy around which all other strategies are built. For example, the core strategy of Southwest airlines was for many years low cost no-frills airfare in relatively non-competitive markets. All other strategies such as purchasing only one kind of planes (Boeing) 737 planes, not offering pre assigned seats and nonuse of travel agents were derived from this overarching core strategy. Generally, the business foundation of an organization is not clearly visible to competitors. This "stealth strategy" can be very powerful in creating incremental alpha.

Empirical Research Support for the Pyramid Framework

There has been a significant amount of empirical research designed to assess the predictive validity of the proposed framework and its three core models[3]. The primary criterion variable that has been used in validation was financial results.

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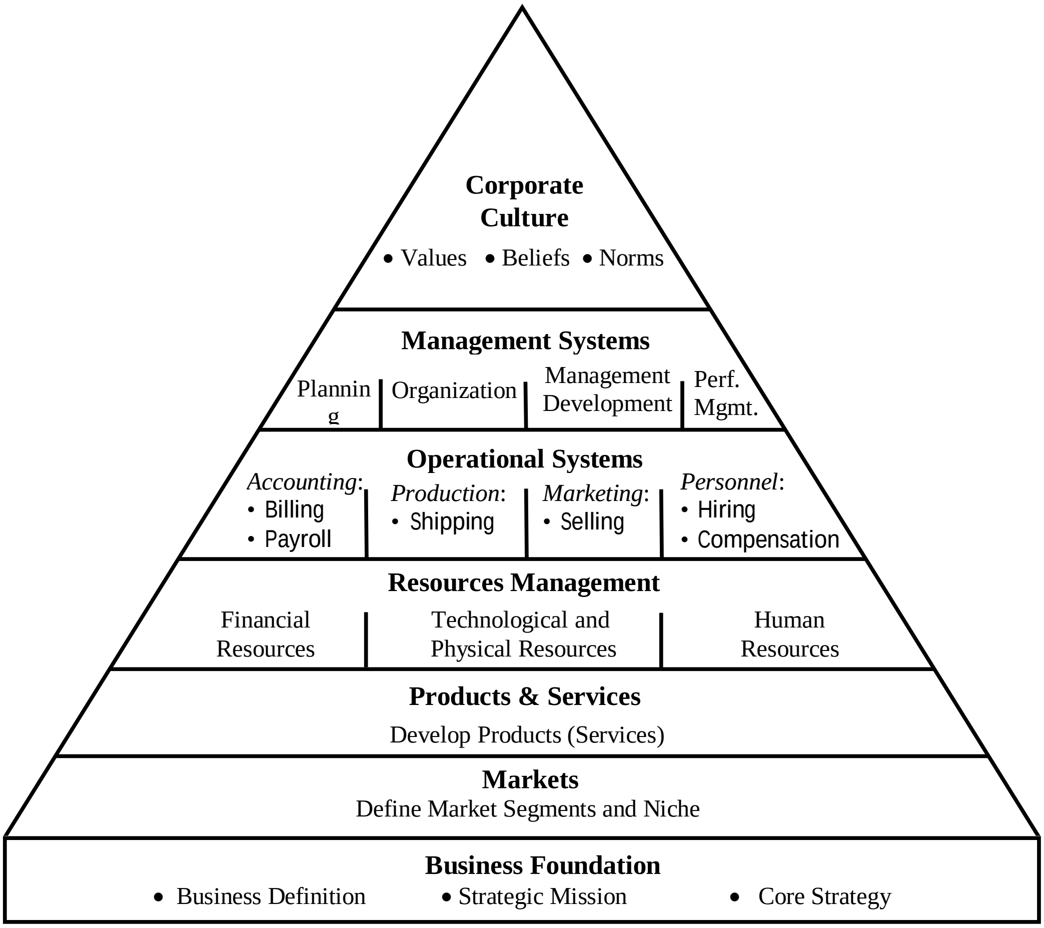
[3]Some of this research has been summarized in Flamholtz (2002-3). Towards an Integrative Theory of Organizational Success and Failure: Previous Research and Future Issues. *International Journal of Entrepreneurship Education*, 1(3), 247-272.

The highlights of some of this research as well as other related studies are presented below. The “Pyramid model” proposes that there are six key factors or “strategic building blocks” of successful organizations, and the six key variables must be designed as a holistic system, termed “The Pyramid of Organizational Success.” This model has been supported by empirical research. Flamholtz and Aksehirli (2000) tested a link between the organizational success model and the financial success of a set of 16 organizations (8 pairs of successful versus less successful) in eight different industries. Using the Friedman Two-way Analysis of Variance and a regression analysis, they found a statistically significant relationship between the proposed model of organizational success and financial performance. The Pyramid model explains approximately 28% of financial performance for the sample firms. This empirical analysis showed a clear relationship between the organizational development pyramid framework and financial performance.

Exhibit 1: Six Key Determinants of Organizational Success and Failure

Markets:	Clearly identifying the customer that the company wants to serve and developing systems that allow the company to track customer needs. Developing a market niche: A place in the marketplace where the company has a sustainable competitive advantage.
Products/Services:	Developing products and/or services to meet the needs of the customers that the company wishes to serve.
Resources:	Acquiring and effectively managing the resources – human, technological, physical, and financial – needed to support the long- and short-term development of the company.
Operational Systems:	Developing, implementing, and successfully managing the systems needed to support the company’s day-to-day operations (e.g., information systems, accounting, human resources management, communication, production, sales, marketing, etc.).
Management Systems:	Developing, implementing, and successfully managing the systems needed to support the company’s long-term development (planning, performance management, organizational structure, and management development).
Corporate Culture:	Having a well-defined and communicated corporate culture and having systems in place to promote behavior consistent with the values, beliefs, and norms of the company (which support the achievement of the company’s long-term goals).

Exhibit 2: Pyramid of Organizational Development[4]



In addition, Flamholtz and Hua (2002 A) reported the results of an empirical test of the hypothesized relationship regarding financial success and the degree of development of six key variables (or “strategic building blocks”) included in the organizational development pyramid within a **single** firm. The research site was a U.S.-based, medium-sized industrial enterprise. To assess this issue, they compared divisional data on the average degree of organizational development with divisional “EBIT” (earnings before interest, and taxes), a classic measure of financial performance for eighteen divisions.

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[4] Flamholtz and Randle, 2016, p. 28.*Growing Pains: Building Sustainably Successful Organizations.* Hoboken, New Jersey: John Wiley & Sons.

Specifically, they ran a regression between: 1) the degree to which each division was perceived as being developed on the six key strategic building blocks as a whole (i.e., the average pyramid development score) and 2) EBIT. Adjusted R^2 is 0.55, and is statistically significant at 0.0003 levels. This means that approximately 55% of EBIT is explained by the six variables comprising the Pyramid of Organizational Development. There is a 99.97% probability that this result could not occur by chance alone. This result supports the hypothesis of a relationship between the degree of strategic organizational development and the financial performance of organizations.

Additional research on the predicative validity of the Pyramid and financial performance has also been conducted by Flamholtz and Kurland (2005). That study was conducted with several divisions of a large financial services firm. The results of an empirical test of the hypothesized relationship regarding the degree of development of six key variables included in the organizational development pyramid and financial success indicated that Adjusted R^2 is 0.735, and is statistically significant at 0.018 (0.02) level.

In conclusion, all of the empirical research to date on the validity of the Pyramid model has indicated that there is a statistically significant relationship between the Pyramid and financial results. This is an indication that the hypothesized relationship is valid.

How Managers Can Create Incremental Alpha Using The Pyramid

Building upon the prior discussion, we will now explain how managers can use the Pyramid to create incremental alpha. The Pyramid is a template for both identifying and or creating "alpha." Specifically, The Pyramid identifies six key building blocks of successful organizations. It can be used, as we will explain, to both assess the source of a company moat or sustainable advantages; it can also be used as a template to plan the creation of a company's moat or sustainable advantages.

Two Sources of Differential Alpha

Organizations as explained below, can, create incremental alpha in two primary ways. They can create it: 1) in their business foundations and 2) also in their top three levels of the Pyramid.

The Business Foundation as a Source of incremental Alpha. The way a business foundation is defined or constructed can be a source of incremental alpha. As discussed above, Huawei has created incremental alpha from its unique business definition; Starbucks created it from its unique strategic mission that allowed the company to become the leader in its space; and Southwest airlines created it from its disciplined and focused core strategy.

The Top Three Pyramid Levels as a Source of incremental Alpha. What we have also learned from our research is that the sources of competitive advantage in the Pyramid are at the top three levels, especially the top two levels, but generally not at the bottom three levels. Specifically, organizations generally are essentially the same at the bottom three levels of the Pyramid. The exception is when there is some uniqueness in product such as pharmaceuticals under patent protection, as with "Neupogen" at Amgen. However, even when there is initially a unique product, competition typically erodes that first mover advantage. For example, Viagra developed by Pfizer was the first miracle drug for erectile dysfunction. It was some followed by Cialis by Eli Lilly and Levitra by Bayer.

The differential advantages at the top three pyramid levels (operational systems, management systems, and culture management) tend to be more sustainable. They are sustainable because these factors are not easily replicated or copied by competition.

Competitive Advantages from Operational Systems. For example, Walmart has developed sustainable competitive advantages in is world class logistics and distributions systems. K-mart, historically Walmart's main competitor, does not have the same operational systems for logistics and distributions systems. They are at a sustainable competitive disadvantage *vis a vis* Walmart!

The result of Walmart's sustainable competitive advantage *vis a vis* Kmart can be clearly seen the stock prices of both companies. Specifically during the decade from 1990 to 1999, the stock price of K-mart increased from about $12 per share to about $25 per share, while the stock price of Walmart increase from about $25 per share to about $275 per share. Then K-Mart filed for bankruptcy in 2002 while Walmart's stock priced dipped due to the overall market decline to about $190 per share.

What makes these examples comparison particularly important is that the both Walmart and K-mart were and still are in the same business, with each having virtually identical products? Given that their product are the same, the differences in success as measured by their respective stock prices (and with one being successful and the other failed in bankruptcy) must be attributed to "other factors." In fact the differences in the success of Walmart and the failure of Kmart are attributable to the differences in their operational systems.

Competitive Advantages from Management Systems. Management systems include the planning system, organizational design, performance management system, and leadership development system of an enterprise. Like custom software, these systems are not "commodities" and cannot be easily copied. The development of management systems can require from two to five years or longer to be created. Accordingly, once they are developed they comprise a source of sustainable competitive advantage.

In 1994, I was engaged by Starbucks, which had revenue of about $165 million but was growing at a hyper-growth rate, to help them manage their growing pains and develop the management systems required to enable them to scale to $1 billion plus. We worked intensively with them for about 3.5 years. Howard Schultz cited my work in his book[5]. By 2000, Starbucks not only scaled to become a multi-billion company; it became the dominant company in its space, leaving competitors such as Coffee Bean and Tea Leaf, Caribou Coffee, Gloria Jeans, Diedrich Coffee and others in the dust. By 2000, it was Starbucks and the 7 dwarfs!

Competitive Advantages from Culture Management. Competitive advantages from culture management are quite possibly the ultimate source of sustainable competitive advantage (Flamholtz and Randle, 2011). All cultures are virtually unique, even if the same verbiage is used to describe two companies' core values. Culture begins with the "cultural DNA" of its founders.[6]

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[5]Howard Schultz, and Dori Jones Yang, *Pour Your Heart into it: How Starbucks Built a Company One Cup at a Time*, Hyperion, 1997.

[6] See Flamholtz and Randle, 2011.*Corporate Culture: The Ultimate Strategic Asset*. Stanford, California: Stanford University Press.

Because cultural values can "mutate" over time as people enter and leave an organization, it must always be managed. Accordingly, the existence of a culture management system is a necessary tool for effective management of corporate values. Corporate culture is quite possibly the only truly unique thing a company can create that is a sustainable advantage over time. That is why we have termed it "the ultimate strategic asset."

Culture is especially important to companies whose products are essentially commodities, such as Starbucks' coffee, financial service firms, and airlines. Yet some savvy CEOs have created their business models around culture as *a key differentiating factor*, including Howard Schultz at Starbucks, Herb Kelleher (the founder) at Southwest Airlines, and Sam Walton of Walmart.

Another important example of the role of culture is at Huawei. There are many aspects of Huawei that would or should be of interest to management theorists and leaders of actual organizations. However, a statement by its founder, Ren Zhengfei, Founder and Deputy Chairman of the Board, of Huawei Technologies Co. Ltd (known more simply as "Huawei")concerning corporate culture is most relevant to this discussion. Specifically, he has stated that "Corporate Culture is the 'Nuclear Bomb' of Huawei"?

What does this mean? The "nuclear bomb" is the ultimate weapon in any war. Huawei views itself as being in a battle or war with all of its competitors. It is a "continuous battle for survival." In that battle the ultimate weapon is corporate culture. This notion is consistent with the title of the book on corporate culture written by myself and Yvonne Randle, and titled: *Corporate Culture: the Ultimate Strategic Asset*.[7] To get insight into Huawei's distinctive culture, you might also look at their web site where its "core values" are the first item listed under "Corporate Information.[8]"

[7] Eric Flamholtz and Yvonne Randle, Corporate Culture: The Ultimate Strategic Asset, Stanford University Press, 2011.
[8] See also JuroOsawa, "Bootcamp Culture Drives Huawei," *Wall Street Journal*, Business and Finance, December 5, 2016, pp. 1 & 5.

The Bottom Line

Organizations can create incremental alpha in two primary ways. They can achieve incremental alpha by something unique in their business foundation, as Huawei, Starbucks, and Southwest Airlines have done. They can also achieve incremental alpha by creating competitive advantages in the top three levels of their Pyramid, as Starbucks, Southwest Airlines, Walmart, and others (including many of our clients) have done.[9]

A key tool that can be used to do this is the Pyramid of Organizational Development. As we have explained above, the Pyramid serves as a strategic lens for creating competitive advantage which is ultimately the source of incremental alpha. The bottom line is that while investors such as Buffett, *et. al*. are *searching* for Alpha, you can actually *create it* by using the framework, methods and tools we have developed and applied.

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[9]Flamholtz, E. & Randle, Y. (2016). *Growing Pains: Building Sustainably Successful Organizations.* Hoboken, New Jersey: John Wiley & Sons.

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