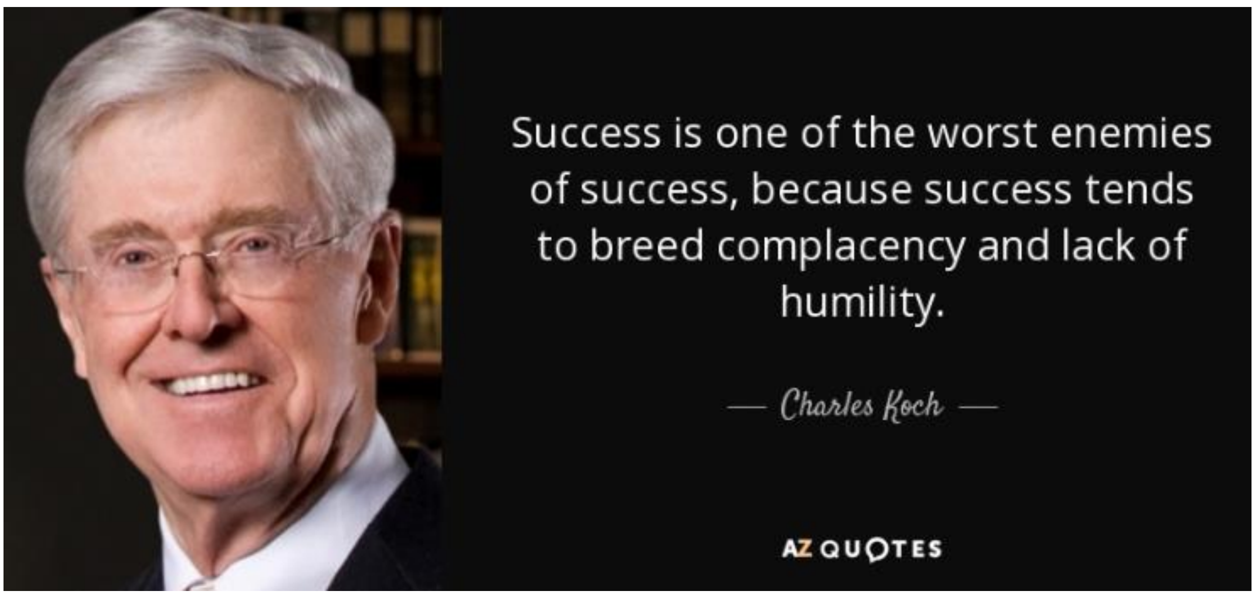
Good Profit

By Charles Koch


Success is one of the worst enemies of success, because success tends to breed complacency and lack of humility.
— Charles Koch —
AZ QUOTES

Summary

1. Charles Koch describes his management philosophy, Market Based Management, how it has evolved over time, and how it has been put to use at Koch Industries. MBM emphasizes Principled Entrepreneurship over corporate welfare, virtue over talent, challenge over hierarchy, comparative advantage over job title, and rewards for long-term value creation over managing to budgets.

Key Takeaways

1. Market Based Management
    1. Charles' goal when he was young was to discover the principles that best enable people to flourish as they live and work together. He grouped his findings into what is now known as MBM. MBM is a reality based tools that helps employees problem solve without explicitly being told what to do and this requires a simple structure that is deeply understood by all. Its goal is to create spontaneous order by providing a simplified set of guiding principles and mental models to guide their behaviors and decisions.
    2. The system must be set up so that everyone knows what the right thing to do is and wants to do it, without overly detailed explanations or rules. Enlightened self-interest gets people to do the right thing for others as it also helps themselves
    3. MBM prompts us to focus on understanding consumers' unmet needs and finding ways to satisfy them. We strive to do this faster and better than existing and potential competitors. This requires that we continuously improve our existing capabilities, such as sales, marketing, operations, distribution, finance, technology, and R&D
    4. MBM guiding principles - integrity, compliance, value creation, customer focus, knowledge, change, respect, fulfillment.
    5. Companies must realize they are not competing just on price and output of existing products. They have to relentlessly strive to come up with new and better products and produce them more efficiently than the alternatives. They also need to constantly improve the way they're organized, so they can innovate and eliminate waste better than their competitors. This is what MBM enables Koch to do.

6. No one can decide which products and services a customer values better than the customer. Dedicating ourselves to satisfying what she values is showing respect for her. This is what generates good profit. Bad profit comes from disrespecting customers by making them subsidize our business with their tax dollars and higher prices, siphoning away the good profit other companies could have earned
7. Over time, we have made changes, not only to our vision, but to our entire approach to recruitment and management, our internships, university relationships, junior military outreach, trade school relationships, compensation system, opportunity origination networks, methods for achieving environmental and safety excellence, and MBM training and application programs.
8. MBM strives to create a spontaneous order of self-actualizing people by hiring, retaining, and motivating those who internalize and exemplify all ten Guiding Principles - those with integrity and humility who want to create real value. Toward this end, it's important for leaders to understand the potential and the subjective values of their employees. This is impossible without establishing open and honest communication in order to know employees well enough on a personal level to do so. For some employees, non-financial incentives - such as being praised for a job well done - can be as important as financial incentives. But care must be taken to ensure that such praise is truly earned
9. MBM is broken down into five core areas including vision, virtues and talents, knowledge process, decision rights, and incentives. These five areas lead to emergent effects as the whole is greater than sum of its parts and become mutually reinforcing. This is a never ending process of learning and improvement and just like the Red Queen Effect, stasis equals death. Even successful companies struggle to keep up because, given human nature, we all tend to become complacent, self-protective, and less innovative as we succeed. It can be far more difficult to overcome success than adversity. I think often about a lesson my father impressed on me at an early age: "Often adversity is a blessing in disguise and is certainly the greatest character builder"
    1. Vision
        1. Determining where and how the organization can create the greatest long-term value. Koch's is different than most as its focused on value creation and people, not product, industry, profit, or anything else. Koch must create real, sustainable value for its customers, for society, and for itself. It can only do so by inspiring and attracting customers, suppliers, and partners.

2. Having a clear vision is critical to attracting the best talent. Understanding what a business is trying to achieve and how it creates value not only enables employees to focus and prioritize, it helps them develop and find fulfillment. Having a shared vision guides the development of roles, responsibilities, and expectations. That's why getting the vision right, helping employees (especially leaders) internalize it, and updating it as often as necessary is essential. Because the future is unknown and unknowable, a company's vision needs to be open-ended and to embrace creative destruction on a fundamental level. In our experience, a company tends to be better served when it is capability-focused rather than industry-focused. The breadth of a company's vision should vary with the breadth of its capabilities. At the same time, a business must have a vision specific enough to guide its strategies, decision making, allocation of resources, and the roles, responsibilities, and expectations of all employees. Each vision also needs to be aspirational in order to expand the thinking of leaders and employees through the organization.
3. Koch underscores that in order to achieve long-term success a business cannot rely on short-term profits but must accept the necessity of what economist Schumpeter calls "creative destruction." This means that a firm must innovate at least as quickly as its most effective competitor. Building on these insights, Koch explains that at the heart of MBM is the understanding that the role of business is to help people improve their lives by providing products and services they value more highly than their alternatives, and to do so while consuming fewer resources.
4. Koch's vision is its north star and acts as a strategic guide which is constant and ever changing and drives the innovation culture and values of the organization
5. Koch's vision:
    1. Remain family owned, well-diversified, stable and financially conservative
    2. Grow organically faster than inflation, and achieve additional growth through acquisitions.

    3. Be an employer of choice through extensive team member development and engagement activities
    4. Have our portfolio businesses recognized as "best in class" within their respective industries
    5. Be model corporate citizens in the communities we call home
2. Virtue and Talents
    1. Helping ensure that people with the right values, skills and capabilities are hired, retained and developed
    2. The company has a list of ten "Guiding Principles," which include integrity, compliance, value creation, Principled Entrepreneurship, customer focus, knowledge, change, humility, respect, and fulfillment. Interviews are based around these traits and open-ended questions are used to discern a candidate's probability of success in demonstrating the desired traits. Once interviews are completed, a challenge session among the recruiter, interviewers, and hiring manager is held to ensure the best knowledge is shared when making a hiring determination. Employee referrals have resulted in some of our best hires and we have also developed strategic relationships with external sources, including search firms familiar with MBM and our Guiding Principles. We invest heavily in college recruiting efforts and a well-developed internship program
    3. No matter how difficult the role is to fill, it is critical that we not lower our standards. A bad hiring decision is much more costly in many, many ways than is the delay in finding the right candidate
    4. There are many different kinds of intelligence and they should all be taken into account: interpersonal, intrapersonal, linguistic, logical-mathematical, spatial, naturalist, bodily-kinesthetic, and musical
3. Knowledge Processes
    1. Creating, acquiring, sharing and applying relevant knowledge, and measuring and tracking profitability
    2. Knowing why something is profitable is often as valuable as knowing what is profitable.

    3. Benchmarking involves identifying, understanding, and adopting superior practices from anywhere in the world - internally, competitors, great businesses in any field.
4. Decision Rights
    1. Ensuring the right people are in the right roles with the right authority to make decisions and holding them accountable. This should demonstrate an employee's comparative advantages.
    2. The bestowal of decision rights upon an individual, moreover, should not be predicated upon that individual's position in the corporate hierarchy.
    3. Many of the things that go wrong or opportunities that go unrealized in business are a result of the tragedy of the commons - shared areas with unclear (or nonexistent) demarcation of responsibilities. At Koch, we use decision rights to replicate the benefits and responsibilities of property rights in society. Just as we think of employees as entrepreneurs at Koch, we think of decision rights as property rights in the organization. Unless people have clearly defined areas of responsibility, it's difficult - if not impossible - to elicit beneficial proactive behavior, or to hold people accountable when things go wrong. When no one has clear ownership of a resource, no one can be help responsible for its efficient use. In MBM, decision rights are synonymous with authority. If you have the decision rights to decide something, not only do you have the authority to decide it; you are responsible and accountable for it.
    4. Decision rights should reflect an employee's demonstrated comparative advantages. An employee's comparative advantages are evident in those activities for which she can create the greatest value compared to the opportunity cost of her time. When these are optimized among a group, the value it creates is maximized. Employees who focus on their comparative advantages and consistently make good decisions will have expanding decision rights, regardless of their role or position in the organization. Understanding and applying this concept - that the person with the comparative advantage to make that decision well (not necessarily

   the highest-ranking person) should be the decision maker - leads to greater value creation.
   5. Competitively advantaged innovation requires working on the best opportunities, establishing a clear owner, having the right people in the right roles, effectively experimenting, rapidly and efficiently scaling up, and finding the balance between short and longer-term disruptive innovations. In other words, the very nature of innovation requires a dynamic approach to decision rights, with frequent reviews and adjustments.
5. Incentives
   1. The first goal of incentives is to harmonize the interests of the individual with those of the company. This reinforces our individual employee's desire to do the right thing and help the company prosper. Second, compensation should be consistent with the notion that no two employees are alike; thus, their compensation can vary considerably depending on the value of their contributions. As a result of difference in vision, desire, values, and ability, people vary in the advantage they take of the nearly limitless opportunities to create value. This is why two employees performing similar roles may well be compensated differently. Third, no limit should be put on an employee's compensation, so employees will not put a limit on the value they create. Finally, incentives should be structured in such a way that the company can effectively attract, motivate, and retain principle entrepreneurs
   2. Rewarding people according to the value they create for the organization. There are several tools to accomplish this, including base pay adjustments, annual incentive compensation, spot bonuses, deferred compensation, and other incentives. A key role of managers is to retain and motivate employees who are adding superior value. By paying for value created, we help ensure the firm's competitiveness
   3. Important to align incentives across business units so that there is no in-fighting
   4. The value of missed opportunities and avoidance of errors should also try to be estimated and included. Makes opportunity cost

tangible by taking missed opportunities into account with bonuses and salaries

5. Koch advises entrepreneurs to stay private no matter how big their company gets
6. Incentives are incredibly important. Koch incentivizes its employees by paying on marginal contribution and value created in their unit and then based on their contribution. It will never be perfect but it must be directionally correct and the reasoning behind it must be explained as well. Must signal what is valued most highly and doing so in a principled manner. Must be financial and non-financial - meaning, challenge, competition, praise, belief in the mission, being part of a successful team, personal growth
7. Incentives are as important for external counter parties such as customers, suppliers, contractors, shareholders, distributors, agents, trading partners, former industry employees, specialists, universities, technology developers, consultants, communities, and governments. Aligning incentives with performance is almost always effective but must take these external parties into account too. Must understand what each values and deliver on it. Communities want a good neighbor, who takes care of the area, protects the environment, operates safely, and provides good jobs
8. Budgets are often useless and sometimes counterproductive if they perverse behavior through misaligned incentives
9. Framework for determining incentive pay (never perfect but directionally correct and must be explained to the employee)
    1. Determine the value created by the employee's business unit, facility, or service group to Koch, considering current earnings and return on capital, change in capabilities, competitive position, and the risk-adjusted value of innovations and growth initiatives - that is, the prospect for future earnings
    2. After thoroughly assessing all the employee's contributions to the value the unit created (positive and negative), we compare this to the contribution necessary for her base compensation. To the extent that her contribution exceeds

this amount, we award a bonus or other incentive compensation based on that difference

3. Deductions are taken for any compliance or EH&S problems to which the employee has contributed. If such problems are serious enough, they could wipe out the employee's entire award. Additions to, or subtractions from, the employee's compensation will also be made if she has had a significant positive (or negative) effect on the unit's culture

10. Good Profit
    1. Good Profit is about providing value to the customer while also benefiting society and comes from Principled Entrepreneurship: creating superior value while using fewer resources and always acting lawfully and with integrity. It comes from contributing something to society. This is the vision of Market Based Management which Charles Koch began developing in the '60s. It takes a win-win framework and allows Koch Industries to adapt and deal with change more effectively than others. They have prospered through the years with no government aid or external help because their focus is always on producing value. MBM, while simple, is not easy. The whole organization must understand the principles so deeply that they can adapt to any problems or circumstances
    2. Good Profit is what follows when long-term value is generated for customers, employers, shareholders, and society. MBM generates Good Profit
    3. Good Profit 101: providing the best hassle-free service to our clients at the lowest cost to them and attracting the best employees based on the opportunities we offered. Our goal was - and still is - to be the counterparty of choice to our customers, vendors, communities, and employees
    4. The most reliable signal that a business is using reality-grounded mental models and providing service that customers truly value is a profit made over time under beneficial rules of just conduct
    5. Opportunity Cost - the true cost of any activity is the highest-value activity forgone
    6. Subjective Value - At Koch we also urge our salespeople to understand each customer's subjective values and tailor the way we deal with them

accordingly. Many public companies value steady, predictable earnings more than larger (on average) earnings that are more volatile, since steady earnings tend to result in a higher stock price. Because of this difference in subjective values between us and our customers, it can be mutually beneficial for us to absorb the price risk in our contracts, and for them to compensate us for it. Koch is always willing to do this kind of win-win business. Listen to partners particular needs and design structures that suit both parties well. Strive for speed, certainty, confidentiality, efficient and responsive deal screening, and to concede terms that are important to the seller but not as important to Koch.

11. 8 steps in the Decision Making Framework
    1. Briefly describe the authority being requested
    2. Give the background and a summary of the value proposition
    3. Outline the objective with the strategic fit
    4. Prepare an economic summary with a base case, as well as other plausible scenarios that could make the project much better or worse
    5. Identify the key value drivers
    6. Describe the key risks and mitigants
    7. List the alternatives considered and why the one shown is best
    8. Project the timeline for future steps
        1. Decision traps - overconfidence, framing, anchoring, status quo bias, sunk costs, information / confirmation bias, confusing random events with patterns, allowing a leader's past rejections to stop the consideration of good future opportunities, conservatism trap
12. Ludwig von Mises (*Human Action)* was a big influence in Koch's philosophy and management style (as was Polanyi's *Republic of Science*)
    1. The more books I read, the more passionately I embraced the truth that widespread human well-being demands a system that clearly defines and protects private property rights, allows people to speak freely without intimidation or legal repercussions, refrains from interference with private parties' agreements and exchanges, and allows human action - rather than arbitrary notions about how much things "should" cost - to guide prices. Allowing people the freedom to pursue their own interests (within the limits of just conduct) is the best and only sustainable way to achieve societal progress. For individuals to develop and have a chance at

happiness, they must be free to make their own choices and mistakes, rather than be forced to accept choices made for them by others. As I digested this and went about my business, it dawned on me that these principles are fundamental to the well-being not only of societies - as I learned through my interdisciplinary studies - but also of organizations, which are essentially small societies. When encountering a challenge at work (such as sunk cost or competitive disadvantage), I began responding with the principles of a free society in mind. And sure enough, one concept at a time, I saw that that the principles that worked in society also worked in an organization.

2. As a young man Charles spent his nights in Wichita Kansas reading every subject trying to understand what principle allows people to flourish. He took ideas from all disciplines such as physics and Newton's Third Law of Motion regarding reciprocation. Came to understand that organizations are like miniature societies and what would benefit society at large would also benefit organizations

13. Experimental Discovery > A Grand Plan

    1. Must have an experimental discovery mindset rather than a grand plan mindset. Must also know when you are experimenting and bet accordingly. The point is that progress - whether in business, an economy, or science - comes through experimentation and failure. Those who favor a "grand plan" over experimentation fail to understand the role that failed experiments play in creating progress in society. Failures quickly and efficiently signal what doesn't work, minimizing waste and redirecting scarce resources to what does work. A market economy is an experimental discovery process, in which business failures are inevitable and any attempt to eliminate them only ensures even greater failures. For experimental discovery to work, we have to not only design experiments properly but also *recognize* when we are experimenting so we can limit the bet accordingly. Koch companies have suffered whenever we forgot we were experimenting and made bets as if the risks were small when they were not.
    2. Smith and Hayek demonstrated that prosperity can take place only through spontaneous order, an order that results from unscripted human action, not human design.

3. The process of discovery begins when we observe, often vaguely, a gap between what is and what could be. Our intuition tells us something better is just beyond the range of our mind's eye. To build a culture of discovery, we must encourage, not discourage, the passionate pursuit of hunches (no matter the origin!).

14. Metrics
    1. Knowing why something is profitable is often as valuable as knowing what is profitable. For this reason, a business must also develop measures that help it understand the drivers of profitability. Prices and profit and loss tell us what people value and the best methods and resources to satisfy those values. They are also the primary indicators of whether we are doing the right thing as a company. In a true market economy, one in which prices are allowed to freely adjust, profit and loss is the market's objective measure of the value a business is contributing to society. To succeed, a business must not only develop profit and loss measures, but also determine their underlying drivers, in order to understand what is adding value, what is not, and why. This knowledge informs its vision and strategies, leads to innovations, creates opportunities to eliminate waste, and guides continuous improvement
    2. The most valuable measures keep us on track in advancing our vision by enabling us to identify opportunities and problems, and by stimulating innovations,
    3. A successful organization should measure - and do its best to understand - the profitability (and profitability drivers) of its assets, products, strategies, customers, agreements, and employees, and anything else for which it is practical to do so
    4. When measuring, accuracy should always be emphasized over precision. As we use the terms, accuracy is the degree of correctness that creates value. Precision goes beyond that, to near perfection. Perfection, thus, is thus the enemy of progress
    5. Most decisions should be made using marginal analysis. This requires understanding the difference between costs and benefits that are marginal and those that are not, such as sunk costs. Only by making decisions on the appropriate margin will a business consistently enhance its profitability and eliminate waste. That margin will vary enormously depending on the decision.

15. Other
    1. Charles father, Fred, founded what would later become Koch Industries. When Charles joined in 1961 it had a net worth of about $21 million and as of 2015 the number has reached an approximate $100 billion. Father always stressed integrity, humility, character and the fact that adversity is the best way to improve your character and to learn. His father put them to work full-time when he was young following that his son would never become a country club bum
    2. Since Charles took over, they have reinvested 90% if their profits and aim to double profits every 6 years (~12% annual growth)
    3. Their strong balance sheet insured their suppliers that they would pay in full and promptly. Their goal was always to be the counterparty of choice
    4. Corporate welfare is damaging because it limits competition, innovation, and customer options
    5. Koch makes acquisitions when they can provide additional value through their internal capabilities, can improve existing businesses or provide new platforms for growth. I often think of what we do as bricklaying. Or perhaps more precisely, stonemasonry. Once a stone has been carefully selected and set, it shapes a new space in which the mason can set yet another well chosen stone. Each stone is different, but they all fit together to create a framework that is mutually reinforcing
    6. Getting the right people was Charles' main focus from day one
    7. Creative destruction, while painful for some, is a net positive for society while corporate welfare is a net negative
    8. The man who understands principles can apply his own methods, the man who tries methods, ignoring principles, is sure to have trouble
    9. Deciding the order in which to do things can be just as important in deciding what to do. Three step process: quantify, simplify, prioritize
    10. Hiring, retaining, teaching, and inspiring people is one of the most important functions of the organization. You should aim to always hire virtuous people regardless of open positions. Coach employees to be the best that they can and consider moving them around within the company if their skills aren’t lined up with their role
    11. Avoid entering into partnerships without an exit mechanism

12. The apprentice model has been extremely effective at teaching newer hires. There are 4 stages - I do, you watch; I do, you help; you do, I help; you do, I watch
13. Every organization has its own culture. If that culture is not created consciously and purposively, it will degenerate into a cult of personality or an anything goes environment. You can never think of yourself as too big or too good to fail. Koch's culture comes from the framework of the free society, where innovation and productivity thrive - to the degree that the framework is upheld. The second category is the theories of philosophers and psychologists whose behavioral prescriptions strike me as refreshingly reality-based - thinkers such as Hayek, Polanyi, and Maslow. The third is my own life experience, which was spent working with all different kinds of people.

What I got out of it

1. An amazing look into what has turned Koch from a $21m operation in the '60s to an over $100b organization today. Simple (but not easy) principles which are scale invariant, win-win, sustainable, and adaptable. An organization is a mini free-society and what works at the largest level of society, works just as well at the level of organizations. Treat people as they want to be treated, be trusting, reward people for the value they create