# Evenlode Global Income

## September 2019 – Internal Organisation & Silo Busting

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*"If the rate of change on the outside exceeds the rate of change on the inside, the end is near."*

Jack Welch

An efficient internal structure is vital for the successful operation of any company. Without one, data cannot efficiently flow between departments, management strategies cannot be correctly implemented, and costly errors can build undetected. It is therefore unsurprising that many managers spend a significant amount of their time focused on the structure and culture of their organisation. What is surprising however, is the lack of investor focus on internal structure, given the obvious impact for capital efficiency and therefore long-term equity returns. Admittedly, information about the inner workings of companies is not always abundant (often described as of a "competitively sensitive" nature) but, at Evenlode, we believe a diligent investor can detect clues to better understand the company and inform investment decisions. A strong indication of efficient structure is the company's ability to manage the silos (independent groups or divisions) that form within the business. While these silos can help the organisation, for example by focusing operations and returning a division to profitability, they can also prove destructive by creating internal barriers within the organisation.

### Horizontal/Divisional Silos

Multinational companies are particularly susceptible to the formation of R&D silos within the organisation. The products and services offered by the different divisions of the largest companies may appear to have little similarity, leading to separation of research budgets and declining communication between R&D teams. This can result in duplicated effort (famously Sony's multiple mp3 players[1]), failure to learn lessons from technological dead-ends (creating opportunity costs) and inability to effectively scale successful innovation. Importantly, a company may also become focused on the next small (and affordable) innovation for each division or product, missing the greater opportunity that a step change in technology could bring.

When Satya Nadella became CEO of Microsoft in 2014, he inherited a company with R&D silos as described above. An internal culture of competition had been fostered, with the individual departments often working at cross purposes and focused on incremental innovations. In his own words, Nadella began "breaking down any silos and category definitions we may have had in the past". This meant a radical increase in investment in the Azure cloud business, previously an afterthought to the highly profitable Windows operating system and Microsoft Office, and increased co-operation internally. As former employee David Golds describes; "there was a tearing down of walls for software developers and tearing down of walls in the physical office". While the cross-divisional benefits may have been unclear initially, the cloud capabilities developed are now integral to Office 365, Dynamics 365 and a wide range of other Microsoft products. While Windows is yet to move to an internet-based operating system, this option is another that could now be considered (possibly in response to Google's Chrome OS). While the success of Azure has provided a growth engine for investor returns, the willingness demonstrated to break down silos and fully leverage the benefit of new technologies should give the investor confidence of Microsoft's ability to catch the next innovation wave.

[1] See Gillian Tett's excellent book, *The Silo Effect*

## Vertical/Functional Silos

Silos within a company are not limited to the horizontal (or divisional) structure within a company. In search of cost-savings, many companies (especially those in the consumer goods sector) have sought to centralise product design, procurement, manufacturing and marketing. This creates a vertical structure with division by function. This mitigates the dangers of horizontal/divisional silos and can generate impressive economies of scale with suppliers. However, a new risk is introduced if the operational layers form silos that do not adequately communicate or allow data to flow vertically within the company. For example, development teams may design products that are too expensive to produce if they are unable to communicate with procurement or manufacturing. Similarly, if marketing detects a change in customer preferences, the speed with which the rest of the organisation can assess the change and adapt products can mean the difference between being at the forefront of a growth opportunity and missing out. Reducing the barriers to this vertical information flow is therefore important.

Ramon Laguarta, the new Pepsi CEO, set out his vision for the company at the Consumer Analyst Group of New York (CAGNY) conference in February. Laguarta stressed the need for an end-to-end value chain (with information flow between all tiers) in place of functional silos, stating "we think the next generation of value will be created by functions collaborating on an end-to-end of any process versus the very vertical functional optimization". He highlighted the need to share data across the organisation and to empower local operations to leverage Pepsi's shared capabilities. In targeted marketing Laguarta envisages a major impact, moving from creating 20 specialised messages for 100 audiences to creating 1,000 messages for a million audiences. While it remains too early to assess the impact on results, similar programmes at Nestle and Unilever appear to be yielding excellent returns.

## Matrix Structure & Silos

While most companies have a primarily vertical or horizontal internal structure, there are companies that operate in a more complex, matrix-like structure. There are often good reasons for implementing these, such as differences between the customer facing structure and efficient underlying operational structure. Unfortunately, these structures may also evolve through the incomplete integration of acquired companies and/or cultural differences emerging between teams that pride themselves on their own brand or identity. These can result in inefficient competition between the teams, for both customers and internal resources. This competition can lead to a failure to utilise the shared services or share learnings for fear of "losing an edge" against internal competitors. The development and implementation of different systems (e.g. multiple ERP systems) within the teams may then compound the difficulty of future integration.

The advertising industry has been a key example of the drawbacks of the matrix approach. WPP evolved through acquisition, building a portfolio of creative businesses, each with a different brand, profit-loss account and leadership. These brands competed for clients and developed their own specialities; Wunderman became a leader in digital marketing, while JWT demonstrated strengths in television marketing. Staff turnover between the sub-brands was low, resulting in lower information sharing. The many skilled data analysts were spread throughout the company, resulting in a repetition of tasks and a lack of data accessibility. When

customer demand then shifted, management correctly identified the need to improve digital and offer a unified point of service to the customer (coined as "horizonalisation"). However, implementation was ineffective and slow. New CEO Mark Read quickly identified the silos as a significant part of the problem and has set about addressing the issues. Wunderman and JWT have merged, sharing employee expertise and customer accounts. Employees are now encouraged to move between internal businesses. Disparate IT resources are being focused into a centre of excellence. These developments are highly encouraging and while profitability has yet to benefit, the changes do offer encouragement that the turnaround will bear fruit.

There is no "correct" internal structure that suits all businesses. Moreover, as markets change and the competitive landscape evolves, the most efficient structure for a company will also change. Legendary CEO Jack Welch once said, "if the rate of change on the outside exceeds the rate of change on the inside, the end is near". Investors should therefore expect management teams to make changes to the organisational structure and to implement initiatives that improve the information flow throughout the business. Understanding the strengths of these actions can yield important indicators of long-term performance, often not yet visible in the reported numbers. For the patient investor, attention to such details can improve long term returns.