

Newsletter from CIO – Innovation management best practices

Koch Industries

A ‘mini’ profile of innovation in this large, entrepreneurial, privately- held, company

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Koch Industries has come to our attention by way of an article in The Economist – June 7th, 2014, ‘Dissecting the Kochtopus’.

Koch has over 100,000 employees, is global, with an estimated turnover of \$115 billion, and happens to have a set of policies and management practices which are remarkably in line with the results of our research into highly-innovative companies.

Koch has managed to maintain its entrepreneurial nature in spite of its bigness. Are there some lessons to be learned? We pursue this common ground in this paper.

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*Koch’s practices align with W&P’s best for
16 out of 19 ‘Factors’*

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Koch’s policies and management practices are closely in line with the results of our research into highly-innovative companies but the difference is that Koch is privately-held and most of our research has been done on publically-held companies. There are differences to note!

For those who think that meeting quarterly results for public companies is not a problem, read on. Clearly Koch believes in the advantages of being privately held. So does Michael Dell! Are other companies to follow?

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Brief background on Koch Industries

Koch Industries, Inc. is a privately-held conglomerate¹, founded in 1940 by Fred C. Koch with its head office located in Wichita, Kansas. The company is into asphalt, chemicals, commodities trading, energy, fibers, fertilizers, finance, minerals, natural gas, plastics, petroleum, pulp and paper and ranching. The company² is owned 84% by the Koch family and currently has Charles Koch, a son, as Chairman and CEO.

According to David Robertson³, President and COO of Koch Industries Inc., ten years ago, Koch Industries had 15,000 employees and just over \$35 billion in annual revenues. Today, it has about 60,000 employees helping generate \$115 billion in revenues. Since 2003, we have fueled our growth by investing more than \$50 billion in capital expenditures and acquisitions. The book value of the company has grown, too – up almost 3,500-fold since 1960.

The Guiding Principles, as set out in Appendix A, are; integrity, compliance, value creation, principled entrepreneurship, customer focus, knowledge, change, humility, respect and fulfillment. Charles Koch is the author and source of these principles which have been under development for the last 50 years. The guiding principles are conveyed as a ‘holistic approach to management that integrates theory and practice’. MBM – copyrighted – is the ‘engine that powers Koch companies’.

Sources of information for this Profile.

- Columbia Business School, an investment newsletter from the students of the school from the firm of Graham and Doddsville, fall of 2013.
- Koch Industries – Creating Value in Society.
- MBM Perspective; The Importance of Market-Based Management® in Achieving Environmental, Health and Safety Excellence, and Austrian Lessons for a Vibrant Economy
- Frequently Asked Questions – The Science of Success - How was the Market-Based Management® business philosophy developed?
- An interview given by Dave Robertson, President and COO, Koch Industries, Inc. as of 8/1/2013 on Leadership expectations.

For more information on innovation management, best practices, and an explanation of the on-line survey, go to; <http://www.corporateinnovationonline.com>

¹ Source is Wikipedia

² www.kochindustriesinc.com/files/kochfacts.pdf

³ Interview given as of August 1st 2013.

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Congruence between Koch's and CIO's best policies and management practices for innovation

Our interest is primarily the subject of innovation in a corporate setting and, as such, the focus of this paper is on those policies and management practice which relate more directly to innovation management. In reality all of the 'Guiding Principles' impact innovativeness, some more directly than others. Our research into highly-innovative companies confirms that not only is there, most often, a nest or guiding principles which are embedded in the corporate psyche but that these principles are promulgated widely throughout the organization. This is the case with Koch Industries. We aim to tease out those policies and management practices which are an extension of the corporate psyche in terms of actual management practices.

Largely based on a research project – interview based - conducted by students from the Columbia Business School and presented in an investment⁴ letter published in the fall of 2013, we can get a good handle on how guiding principles are translated into policies and management practices – which is how the rubber hits the road.

We take a look at each of 25 Factors⁵ which make up the survey instrument which we use to dissect the policies and management practices of highly-innovative companies. We tease out those statements from several of the above noted sources which relate to each Factor. The congruence among Koch's practices and our research into highly-innovative companies is clear.

The 25 Factors have been segmented into three headings;

- Leadership
- Organization and management of day-to-day affairs
- Idea generation and realization

Where information is lacking, as it is for several Factors, this has been noted.

Comments which are direct quotes from the company's publically available material are noted in italics and draw on the sources of information noted above. For certain Factors, we have added a comment to provide more clarity around the issue and this is noted in 'bold'.

Registrants' opinions, as entered into our on-line survey, for each Factor are set out for reference purposes.

⁴ Graham and Doddsville

⁵ Visit www.corporateinnovationonline.com for further information on Factors and the on-line survey

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Leadership Factors

Koch scores four out of five

We first set out the **Factors which relate to leadership** and note Koch's statements for each Factor. Leadership Factors relate to; management's emphasis on short versus longer-term profits – F#1, extent to which management explicitly looks for innovation – F#2, whether planning emphasizes opportunities and not just cost reduction – F#4, the use of career ladders and recognition of innovators – F#7 and, the tolerance for risk in the planning process – F#9.

<i>Factor Description</i>	Koch statements/W&P in bold	On-line survey results
1. Management's emphasis is on short-term versus long-term profit.	<p><i>We are fortunate to be a private company with shareholders who consistently reinvest 90 percent of the profits back into the company. But, at times, it's harder than you might think to find a good home for our capital.</i></p> <p><i>We also want our leaders focused on long-term results. They have to be willing to build and be rewarded over time – not just focused on this year's results.</i></p> <p><i>We look at our business over the next 20 years. We do not worry too much about short-term data points that might help explain our quarterly earnings.</i></p>	Emphasis is on very long term
2. Management explicitly looks for or has no interest in innovation.	<p><i>"We want leaders focused on employee development, innovation and business growth"</i></p> <p><i>MBM encourages innovations that create value by making people's lives better and contributing to prosperity in society.</i></p>	Explicit objectives for innovation.
4. Planning emphasizes rationing resources or identifying opportunities.	<p><i>That's why we push our leaders to find opportunities for investment and foster the kind of innovation that will help us grow.</i></p> <p><i>So we're looking at any and all opportunities and then trying to pick the ones that provide the best return on the risk we're taking.</i></p>	Focus is on identifying opportunities.

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<i>Factor Description</i>	Koch statements/W&P in bold	On-line survey results
7. Corporation provides career ladders, powers and titles for innovators or not.	<i>Leaders who promote innovation are doing more than just growing their company. They are helping create additional opportunities for employees. We worked to train employees on its (MBM) principles and drive adoption of it throughout the organization. A book was prepared to convey the ideas to a wider audience.</i>	Innovators have careers and recognition.

<i>Factor Description</i>	Koch statements/W&P in bold	On-line survey results
9. Management's tolerance for uncertainty (as distinct from risk) in the planning process or not.	White & Partners does not sufficient information to comment on this Factor.	Plans have a very high tolerance for risk.

Organization and management of day-to-day affairs Factors

Koch scores seven out of eight

We next set out the **Factors which most relate to the organization and management of day-to-day affairs**; emphasis on management of people and their interactions – F#6, the degree of formal communications in the organization – F#10, use of independent work groups – F#11, whether management decisions are made with input from a broad cross section of employees – F#12, the formality of the decision process – F#13, whether the organization is planning versus action orientation – F#15, whether the organization has an emphasis on decentralization versus centralized hierarchy – F#18, extent of staff versus line involvement in the decision process – F#20.

<i>Factor Description</i>	Koch statements/W&P in bold	On-line survey results
6. Leaders emphasize management of people and their interactions or not.	<i>“We want leaders focused on employee development, innovation and business growth” Leaders must treat all employees with dignity and respect so we can create an open environment. Each of us must have the humility to invite and accept challenges.</i>	Very much emphasize people management.

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<i>Factor Description</i>	Koch statements/W&P in bold	On-line survey results
<i>10. Style of communication within the organization.</i>	<p><i>We stress this idea to all of our employees that we're not seeking the type of advantage where you win and someone loses. Not every business thinks of it this way. We think of this as subsidization or cronyism which distorts markets and is not good for society.</i></p> <p><i>What makes us different, if not unique, is that we take the difficult steps to ensure that these principles reach the hearts and minds and change the habits of every employee.</i></p> <p>Intra-company communications are emphasized by management.</p>	Communication is highly formal.
<i>11. Management's discourages or encourages use of independent work groups for special purposes.</i>	<p><i>We have business development (BD) personnel in all of our different businesses. So for example, Georgia-Pacific has a BD Team and Flint Hills has a BD team. Within Steve's group at a corporate level, we also have a business development team. Those teams' daily activity is to find actionable opportunities that would fit our capabilities. We have well over 100 business development personnel across all the companies.</i></p>	Use of independent work groups is greatly discouraged.
<i>12. Management makes decisions with lots of input from the rest of the corporation or not.</i>	<p><i>Leaders are also expected to solicit challenges. We encourage a challenge culture at Koch because it leads to better decisions. It also helps all of us learn and develop.</i></p> <p><i>We can't just dream up or manufacture these opportunities amongst business development people. They have to have contacts and relationships in the industry to have the opportunities shown to us. So it requires a lot of different interactions to be able to size up, screen, and think about where the opportunities might be. You have to talk to the employees, customers, and suppliers.</i></p>	Lots of input is sought.
<i>13. Decision process is elaborate and formal versus short and informal.</i>	<p><i>It's a little bit of first-come, first served in that when we see good opportunities that present an attractive return on the risk, we go after them.</i></p> <p>White & Partners is no information on whether there is an informal or formal process - or both.</p>	Process is short and informal.

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<i>Factor Description</i>	Koch statements/W&P in bold	On-line survey results
<i>15. The organization is planning-oriented versus action-oriented.</i>	<p><i>Our transaction excellence capability is the discipline that Steve's talking about. We can evaluate each of these opportunities, whether it's a project to add on to an existing facility, an acquisition, or an equity investment. We're putting each of those through the same rigor and analysis to determine the expected risk-adjusted return.</i></p> <p><i>Another critical dimension is to stay very rigorous in your discipline. All too often, you'll hear public companies acquiring business for "strategic reasons". For us, strategic should mean you're creating value in society.</i></p> <p>Whatever the process, it seems to be working!</p>	Not reliable
<i>18. The organization has a decentralized or centralized hierarchy..</i>	<p><i>Our transaction excellence capability is the discipline that Steve's talking about. We can evaluate each of these opportunities, whether it's a project to add on to an existing facility, an acquisition, or an equity investment. We're putting each of those through the same rigor and analysis to determine the expected risk-adjusted return.</i></p> <p><i>Another critical dimension is to stay very rigorous in your discipline. All too often, you'll hear public companies acquiring business for "strategic reasons". For us, strategic should mean you're creating value in society.</i></p> <p>Whatever the process, it seems to be working!</p>	Highly decentralized hierarchy.
<i>20. Extent of staff involvement (as opposed to line involvement) in the decision process.</i>	<p>White & Partners does not have sufficient information to make comment. The question refers to the use of line versus staff personnel in decision making. We surmise that there is considerable due diligence undertaken for acquisitions and considerable involvement of a range of line and staff in decision making.</p>	Lots of staff involvement in decisions.

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Idea generation and realization Factors

Koch scores five out of six

And finally the **Factors which most relate to idea generation and realization**; tolerance for mavericks – F#3, tolerance for failure – F#5, tolerance for variation from a corporate norm – F#8, mechanisms in place to reward innovators – F#14, whether resources generally available for new ventures – F#19, whether the R&D budget levels are above the competition – F#23.

<i>Factor Description</i>	Koch statements/W&P in bold	On-line survey results
3. <i>Management's tolerance for mavericks or not.</i>	Insufficient information to make a comment.	A lot of tolerance.
5. <i>Management's tolerance for failure or not.</i>	<i>Sometimes leaders have to push us out of our comfort zone in order to get us to accept risk, truly innovate or seize new opportunities. (And sometimes the leaders need to be pushed.) Innovation requires experimentation, and often the best experiments will fail. That's not a problem if the experiments are well-designed and we learn from these failures.</i>	Very high tolerance for failure.
8. <i>Corporation is tolerant towards variances from the corporate norm or not.</i>	<i>If you feel uncomfortable challenging your leader in good faith, something is wrong. Employees must challenge the status quo in order to improve processes and create value.</i>	Corporation highly tolerates differences.

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<i>Factor Description</i>	Koch statements/W&P in bold	On-line survey results
14. The corporation has specific mechanisms available for rewarding innovation or not.	<p><i>Our incentive system is very key to unleashing those pent-up ideas and innovations. The system allows all of our employees to share in a portion of the value that they are creating. It doesn't matter what your role is—if you can find ways to help us better serve our customers so that we profit more, we want you to share in some of that profit. You are rewarded like an entrepreneur is rewarded. If you're successful at that, you'll do better and if you fail, then you won't do as well.</i></p> <p><i>Entrepreneurs are rewarded by getting to keep a portion of the value they create in society. Our emphasis is on long-term value.</i></p> <p>Koch publishes an 'awards and recognition' section on their web site.</p>	Mechanisms exist for rewarding innovation.
19. Resources (budget, personnel, time, etc.) are generally available for new ventures or not.	<p><i>It's a little bit of first-come, first-served in that when we see good opportunities that present an attractive return on the risk, then we go after them.</i></p>	Resources are generally available.
23. The R&D budget is less or more than the competition.	<p><i>Innovation is what moves us into the future. If we succeed in innovating faster or better than our competitors, we grow and prosper.</i></p> <p>A broad definition of R&D is used here – but White & Partners has no specific information on actual spending levels.</p>	R&D spending greatly exceeds competition's spending.

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Appendix A; Koch Guiding Principles explained

Integrity; Conduct all affairs with integrity, for which courage is the foundation.

Compliance; Strive for 10,000% compliance with all laws and regulations, which requires 100% of employees fully complying 100% of the time. Stop, think and ask.

Value Creation; Create long-term value by the economic means for customers, the company and society. Apply MBM to achieve superior results by making better decisions, pursuing safety and environmental excellence, eliminating waste, optimizing and innovating.

Principled Entrepreneurship™; Apply the judgment, responsibility, initiative, economic and critical thinking skills, and sense of urgency necessary to generate the greatest contribution, consistent with the company's risk philosophy.

Customer Focus; Understand and develop relationships with customers to profitably anticipate and satisfy their needs.

Knowledge; Seek and use the best knowledge and proactively share your knowledge while embracing a challenge process. Develop measures that lead to profitable action.

Change; Anticipate and embrace change. Envision what could be, challenge the status quo and drive creative destruction through experimental discovery.

Humility; Exemplify humility and intellectual honesty. Constantly seek to understand and constructively deal with reality to create value and achieve personal improvement. Hold yourself and others accountable.

Respect; Treat others with honesty, dignity, respect and sensitivity. Appreciate the value of diversity. Encourage and practice teamwork.

Fulfillment; Find fulfillment and meaning in your work by fully developing your capabilities to produce results that create the greatest value.

