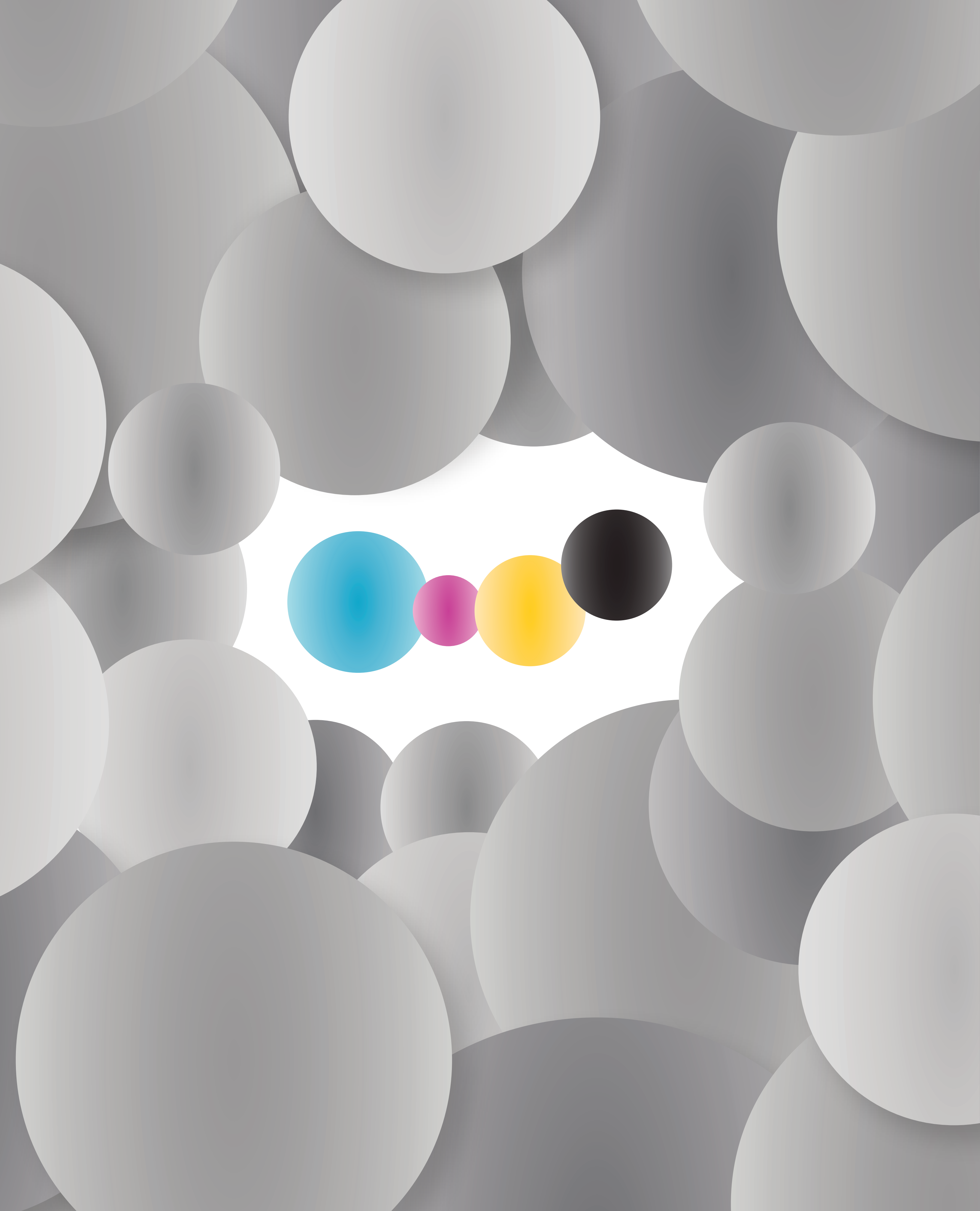

AN AGENDA FOR BUSINESS LEADERS

The outsized success of a few outlier companies points to four steps that every business can take to contribute positively to the future of democratic capitalism.

by Roger L. Martin

WHEN MY WIFE MARIE-LOUISE introduced me to **Joe's Stone Crabs** of Miami Beach, a favourite of hers from when she had lived in South Florida, I was promised a great meal; but I had no idea what an intriguing business experience it would be.

Joe's is a rarity: an American restaurant that has prospered for over a century. It is currently the top-grossing independent restaurant in America — despite being the only one in the top 100 that closes for three months per year when its principal fare, stone crab, is out of season.

I was entranced from the moment I entered the restaurant. The waitstaff all stopped to greet us warmly. Because I am a business nerd and know that the average annual turnover in the U.S. restaurant industry is 75 per cent per year — which means the average staffer stays for 16 months — I knew that these folks were anything but average.

We were promptly seated in the main dining room, a space of comfortable elegance with an open second story of generous windows. At the next table was a group of elderly ladies dressed in Sunday best. But behind them was a 20-something couple, she in a tank top and he in a short-sleeved shirt. Two more tables over from them, three police officers in uniform chowed down with enthusiasm.

Our waitress, Joan, and the wine steward, Avi, were terrific. I couldn't stop myself from asking: What is going on here? They loved their jobs and the restaurant. Joan told us proudly about her crab pin that was symbolic of the Waiters Fund. Staff sold the gold pins to raise a reserve for waitstaff that come into hard times and need a bit of support. Avi talked about how great it was to work at Joe's. Based on our obvious interest in Joe's model, Avi suggested that we talk to fourth-generation co-owner **Stephen Sawitz** and helped us make that happen.

Several months later, my wife and I had the pleasure of meeting with Stephen and his redoubtable mother **Jo Ann Bass**. We started with a tour of the restaurant, during which Stephen greeted every employee warmly by name and made sure to attend to little pieces of business along the way. Perhaps because he was born in the business, Stephen was incapable of dividing it into siloes. Employees, purveyors, customers and community

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were all present in his and his mother's minds as they spoke about their business.

For employees, Joe's had to make it a productive and rewarding life. Take J.T., the maître d' who had been at Joe's since 1971 and whom Stephen invited to join our conversation. J.T. had come from "a swamp in Louisiana" and after a couple of years of cheerfully and efficiently washing pots, he became a bus boy. After 19 more years, he applied to become one of the dining room captains and got the job. Holding back tears, he credited Jo Ann for having bet on him nearly three decades earlier. After another 12 years, he became maître d', and is still in that position 15 years later.

J.T.'s story is not unique for Joe's. Founder **Joe Weiss** used to drive his workers home after work because in his era, African-Americans weren't allowed on Miami Beach after sunset and Joe wanted them to work at his restaurant. In the 1970s, Joe's offered health insurance, pensions and profit sharing for workers long before those were common benefits in industry in general, let alone in the laggard restaurant industry. In an industry with 75 per cent annual turnover, Joe's hourly employees stay an average of 10 years and its overall staff an average of 15 years.

But the model can't just work for employees only. It has to work for suppliers too — or 'purveyors', as Stephen refers to them. As indicated, Joe's business is founded on stone crabs, which Stephen's great-grandparents introduced to the dining public, and today it is by far the biggest purchaser of stone crabs in the country. Joe's operates fisheries itself and in addition purchases large quantities from independent operations. When we talked about the purveyors, the response was truly systemic. "We want our fishermen and women to be the best paid, so their sons and daughters will want to work with us."

This is not narrow reductionism: it is expansiveness. It balances a traditional separation, in which most companies are transactional in their supplier relationships, with a connectedness that acknowledges the interdependence between Joe's system and that of the fishermen supplying it.

Then there are the customers. With a medium portion going for $44.95 and a large at $69.95, not everyone can afford stone crab claws. Because of this, Joe's insists on having an entrée for customers who want an affordable meal. The fried half-chicken, at $6.95, is the second-most-purchased entrée on the menu.

This was Jo Ann's baby. She recognized that if Joe's features only $45-$70 entrées, it will be a very different place, and not in a good way. The kids in the tank tops and the cops won't come — and it will be a lesser place for their absence. The $6.95 fried half-chicken is a crucial piece of the restaurant's complex adaptive system.

The same thinking is evident in Stephen's decision 25 years ago to change the traditional entrance and put a large service bar where the original entrance used to be. The reaction internally was that the new bar was so big that it eliminated a number of dining tables, which would reduce revenues. Stephen's reaction: "Exactly. And that is fine."

This is an important marker of non-reductionist thinking: Yes, the big bar might reduce the number of tables; but patrons at the main bar won't have bartenders juggling their orders with the drink orders for tables (the primary function of the service bar). And it would help those waiters get drinks to their table patrons faster. Introducing a friction in the form of a table-cannibalizing bar may have made the restaurant appear less efficient at first blush, but in Stephen's view the move was a no-brainer in the long term for improving the guest experience and reducing the pressure on both his bartending and waitstaff.

This decision is part of a pattern at Joe's: experimentation. Stephen has continually experimented — whether with a new entrance and outsized service bar, an outdoor dining area, a takeout business or a summer menu to shrink the summer closure from five to three months. All are thoughtful and reflective, though not traditional, tweaks to a complex adaptive system.

The business model is also environmentally sustainable. Stone crabs are not killed in the process of harvesting and selling them. Depending on size and sex, one or both claws of the crab are removed by the fisherman. If the removal is properly done, the stone crab can be returned to the sea where it can survive and regrow its claw or claws. Joe's can take credit for popularizing the only meat meal that doesn't involve killing the animal.

Strictly speaking, Joe's pursues inefficiently high compensation for both employees and suppliers, inefficient use of space in the restaurant and inefficient sale of low-price chicken entrées. That notwithstanding, its model has been proven to be monumentally effective for over a century, with no sign of slowing down.

Joe's outsized success points to four steps that every business can take to contribute positively to the future of democratic capitalism: turn your back on reductionism; recognize that slack is not the enemy; guard against surrogation by using multiple measures; and appreciate that monopolization is not a sustainable goal. Let's take a closer look at each.

STEP ONE: Turn Your Back on Reductionism

Executives are taught to manage machines. Most have an educational background in business administration or engineering/computer science, or both. This training teaches them to break down their companies into constituent parts — individual disciplinary pieces — and optimize each piece; all with the assumption that the pieces can be added back up to produce a productive and useful result.

Even if they weren't formally educated that way, they are indoctrinated into that approach the instant they start their working career when they are assigned to a narrow job in an organization that is structured by piece-parts. This reductionism has handy elements, to be sure. It makes the resulting narrowly-defined jobs much easier to fill and training employees much simpler. But it also makes employees much less valuable, interchangeable cogs in a big and not very effective machine.

On one hand, there is downward pressure on the compensation for the interchangeable cogs because candidates with narrow, specialized skills are relatively plentiful and their ability to add true value is constrained by the way they are used to produce ineffective piece-parts within what is actually a complex adaptive system. Meanwhile, companies have an insatiable desire for the rare few magic value creators who know how to perform integrations that are necessary for and consistent with a complex adaptive system. This means the majority of employees are driven towards subsistence compensation and a very few are given whatever it takes to acquire their services.

The results of this managerial reductionism are negative for all stakeholders: An unstable, unbalanced Pareto distribution of employee incomes; an unsatisfactory, repetitive existence for most employees; and mediocre outcomes for customers, who never want to hear a service professional say 'I can't help you. It is not my job. You need to speak with the [fill in the blank] department.'

As Joe's Stone Crabs illustrates, leaders should instead embrace the reality that a business is a complex adaptive system in which the components and subsystems are highly interdependent human processes and that over-optimizing one part compromises optimization of another part and can lead to alienation and disengagement from the very people you need to be most engaged.

STEP 2: Recognize That Slack is Not the Enemy

In the dominant machine-based model, slack, which is equated with waste, must be eliminated in order to maximize the machine's efficiency. The management tools we use to do this are based on the techniques originally pioneered by **W. Edwards Deming** — who would probably turn in his grave if he knew where we had taken his ideas. Deming's tools have been a great boom to business efficiency and their application can contribute to a competitive cost structure, which is necessary for competitiveness. But when the drive to eliminate slack is taken too far, it can wreak havoc. Deming himself recognized the systemic complexity of businesses and taught that there is always an optimal level of slack for any business system — and that level is not zero. Slack is a manifestation of friction — of the sort that in the right amounts contributes to greater resilience.

Brazilian private equity firm **3G Capital** is learning this the hard way with its **Kraft Heinz** investment. Flushed with its apparent success in consolidating the global brewing industry with **Anheuser-Busch InBev** (ABI), 3G successively gained control of Heinz in 2013 and Kraft in 2015 and then engineered a merger of the two food companies. It saw the resulting food conglomerate as riddled with slack that could be taken out with its zero-based budgeting (ZBB) approach.

Under ZBB, each budget year starts with zero costs and every cost item has to be justified one by one. It sounds good in theory and has delivered early cost wins for some 3G Capital companies, including ABI. Initially, Kraft Heinz looked as if it might follow suit. Between 2015 and 2018, ZBB was able to drive sales, general and administrative costs (SG&A) at the merged company from 10 per cent of sales to 8 per cent of sales — an impressive 20 per cent improvement in overhead cost efficiency, consistent with an all-out attack on the enemy: slack. However, it appears in hindsight that some of those costs weren't entirely wasteful slack. During the short period from the takeover in 2015, the gross margin at Kraft Heinz — i.e. revenues less cost of goods sold as a percentage of sales—fell by 3.5 percentage points from 39.5 per cent of sales to 36 per cent of sales. Taken together, the two percentage-point reduction in costs begot a 3.5 percentage-point reduction in profit margin — a net detriment to the business of 1.5 percentage points.

This substantial decay in its business prospects forced Kraft Heinz to announce a massive $15.4 billion write-down in its assets in February 2019, one of the ten largest corporate write-downs of the decade. 3G Capital is learning an important lesson: Serving the customer distinctively at a profit is a goal that requires thoughtful and intelligent slack — friction against efficiency.

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So, what does positive friction look like in such situations? In a body of work presented in her 2015 book *The Good Jobs Strategy*, MIT/Sloan Professor **Zeynep Ton** studied retailers to understand the implications of staffing decisions for retailer profitability and success. In retailing, after the unavoidable cost of the goods on the shelves, the biggest cost is the cost of the staff. She observed that most retailers had evolved to a model in which minimizing the cost of store staff is a central goal. One way was to pay the lowest wages possible, which is why retail clerks and cashiers are among the lowest wage jobs in America. Still another way was to drive out all slack by reducing the number of store-staff hours to the bare minimum required to serve customers. Increased efficiency through low wages and the elimination of slack is their theorized success formula.

But a smaller number of retailers — including **Costco**, **Trader Joe**'s and **QuikTrip** — have followed a very different model. In addition to paying much higher wages than is customary in the industry, they consciously and deliberately build meaningful slack into their staffing. These are salesperson, clerk and cashier hours that the staffing formulae used by their competitors would deem to be excessive. But rather than being less profitable due to these purposely higher costs, these retailers earn much higher sales per square foot of space and much higher profitability than retailers who follow the standard model.

Why? Because customers love the superior service that they receive from cheery and effective workers in a delivery system that features the presence of multiple manifestations of friction. These retailers understand that they exist in and are a part of a complex adaptive system. In that system, slack is not an unalloyed enemy and all things that seem like 'efficiency' are not efficient.

STEP 3: Guard Against Surrogation with Multiple Measurements

The surrogation of proxies for models is a natural and dangerous occurrence in the business domain, where it facilitates gaming and makes executives unreflective about how their business really works. The best defence against a proxy becoming the implicit surrogate for your model is to use multiple measurements as proxies for progress of the model against the goal — in particular, proxies that are internally contradictory.

Contradictory proxies encourage managers to think integratively and to take a systems perspective on the company's operations. At **Wells Fargo**, imagine if, rather than the single proxy of 'number of accounts per customer', the proxies had been 'number of accounts per customer; activity level per account; growth in customer-bank interactions; and customer retention'. More accounts makes it harder to have more activity per account, so the number of accounts wouldn't have been slavishly pursued. Rather, a balance would have needed to be targeted. That would mean working harder to make more customers happy than trying to acquire more customers who would be unhappy with a lack of attention.

Some companies already do think and operate in this fashion. Since its inception in 1970, **Southwest Airlines** has been the most successful airline in America by nearly every accepted measure. Its unique low-cost strategy is heralded by many as being a key source of its success. But another thing that contributes to Southwest's striking success is its multiplicity of internally-contradictory proxies for success: Southwest seeks to be both the lowest cost airline in America and No. 1 in customer satisfaction, employee satisfaction and profitability.

This means, for example, that it can't possibly pursue low cost by driving down wage levels. It has to find cleverer ways to keep control of employee costs, and it does so by paying them better than any competitor while helping them be so productive that labour costs per passenger seat-mile and as a percentage of revenues are lower, not higher than competitors.

The very fact of having four proxies reinforces that these four proxies add up to an approximate measurement of the model's outcomes, not a representation of the model itself. More generally, it recognizes that a system is a complex combination of parts and that success requires maintaining a balance between that interdependence of the parts and separation between them.

STEP 4: Realize that Monopolization Is Not a Sustainable Goal

Eliminating the competition feels like a natural goal; it means you've won. That's why **Intel** attempted to eliminate **Advanced Micro Devices** (AMD), for which it was fined by the European Union. That is why **Facebook** is using its deep pockets and huge user-base to empower its **Instagram** subsidiary to 'kneecap' its rival **Snapchat** by copying its core product. Managers feel more secure when their customers have no alternative to the product/service they produce. Given that American monopolists from **Rockefeller** to **Zuckerberg** have become among the richest men in history, the appeal of establishing a monopoly is understandable. But it has a downside: Monopolies don't last in the natural world and they don't last in business either.

Monopolies don't last in nature because they don't adapt, and the fundamental rule of nature, as posited by **Charles Darwin**, is survival of the fittest — by which he meant those most able to adapt to the environment. And what drives adaptation in business? It is learning from one's customers how to provide better value for them. *Customers* define value, not those who serve them. Providers can only hypothesize about what constitutes customer value. Providers learn based on customer feedback and hence customer feedback is the linchpin of positive adaptation. It is very difficult to become a better provider of a given product or service in the absence of real customer feedback.

It is not the mere existence of customer feedback that produces positive adaptation. Listening to customer feedback and taking action on it are both necessary preconditions for positive adaptation. But change is never easy; it is tiring and expensive. As a consequence, most companies, most of the time will only listen to customers when they must, and they only have to when the customer can credibly threaten to become an ex-customer if the provider doesn't listen and change.

Therein lies the fundamental sustainability problem for monopolists. They don't have to listen to their customers. Anybody who has to wait days to get their cable television service problem fixed recognizes the phenomenon. The monopoly provider of cable TV in your region doesn't have to be responsive, because if you want cable TV, you have no choice. In the end, monopolists exist to serve themselves, not to serve their customers. They don't get the training that customers normally provide because the monopolist doesn't have to train.

As a consequence, monopolists stultify over time. They may have virtually unlimited resources, but they don't have the motivation to deploy them productively. When the environment in which they operate necessitates major adaptation, they are unable to adjust because they are out of practice.

A great company needs great competitors to stay great. Of the 10 companies that have been a component of the Dow Jones 30 for more than 30 years, nine (**Exxon Mobi**l, **P&G**, **United Technologies**, **3M**, **Merck**, **Amex**, **McDonald's**, **Coca-Cola** and **Boeing**) have always had at least one formidable competitor. The only exception is **IBM**, which arguably didn't have strong enough competitors for too long a time and is now in a long-term swoon from which it may never recover.

Companies should compete aggressively against their competitors; just not with the intent of driving them out of business. That is because the only way to stay sustainably strong is to compete aggressively to win the hearts, minds and pocketbooks of customers against formidable competition.

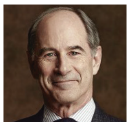
In closing

It won't be easy for executives to get started on this agenda, because it will mean unlearning ideas and beliefs that are deeply embedded. The best way to get started is for executives to use themselves as a proxy for the people in whatever system they are attempting to understand and operate. If they are starting down the path of reductionism by breaking a problem into independent piece parts, they need to ask themselves: Is that how I think about problems/issues pertaining to myself? About my family? Or, do I think about problems that affect me in a more holistic manner? And if so, how could I think of this problem equally holistically?

If they are working their way towards the elimination of all slack, they need to ask themselves: How do I feel when I have absolutely no slack and am forced to run from one activity to the next without a break? Do I do my best work under those circumstances, let alone decent work? If not, why should I assume that the process/activity from which I am eliminating all slack will work efficiently when I am done?

If they are enthusiastically pursuing the achievement of progress on a given measurement, they need to ask themselves: Do I respond well to being measured on one single dimension? Or do I prefer and see as more realistic a multifaceted approach? If so, how could I add further attributes to my measurement system to make it something more consistent with how I would want to be measured?

Finally, if they are enthusiastically working towards the elimination of competitors and achievement of monopoly position, they need to ask themselves: If there were no consequences to ignoring our customers, would I work hard to listen to them and change what we do to make them happy? If not, then what would cause me to believe that if we achieve the sought-after monopoly, we would continue to listen to and respond to customers? My hope is that these small things will help executives get started. ***RM***



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