



CHAIRMAN'S MESSAGE

Dear Shareholders,

The Link Between Organisation Design & Profit

We all know that the profit motive is at the centre of capitalism, the *raison d'être* of an organisation. So profit is the purpose of an organisation, and the shareholder (to serve whom the organisation exists) is the primary stakeholder.

The organisation uses various resources to generate a profit. In economic terms, it uses Land, Labour (human resources), Organisation & Capital (LLOC), i.e., all the resources it uses can be classified in some way or the other into the above heads. If we take the 4 M's: Man, Machine, Materials and Method, they are merely a re-statement of the above LLOC.

Yet, most organisations I know tend to confuse this balance, i.e., they tend to focus excessively on one or the other of the above baskets. At HGL, I notice an excessive focus on doing things, i.e., Labour.

We have customers who tell us what to make from time to time. Through the TQM/ TPM/ 6-Sigma mindset that flows up and down the auto value chain, we all have this huge focus on the 4 M's mentioned above. Most of our conversation is about machine productivity, labour standards, (material) wastage, Overall Equipment uptime or Line Efficiency (OLE), inventory control, etc. In other words, maximising throughput per unit of Capital Employed. So, either you reduce the Capital Employed for a given level of output (as in stagnating markets in the developed world, where they use outsourcing and innovation to do this), or you maximise throughput for a given level of Capital (as in developing countries, where demand is buoyant, but capital is expensive and scarce).

Now compare this to a bank, for example, as in, what does a Bank "do"? Is there any physical transformation in its product? A bank captures 'profit' by ensuring that it raises funds cheaper than what it lends at (assuming it gets back all the money it lent out in the first place).

But this work produces profit, which comes from managing "Capital", one of the 4 economic resources mentioned above.

Similarly, look at Organisation, often called Management Quality, the ability to create knowledge and insight. At Berkshire Hathaway, a small group of wise men are brought together, they understand Risk and Opportunity better than anybody we know. Why (and How) do they stay together? I don't know, but this ability, which creates profit, must be put under the basket called "Organisation".

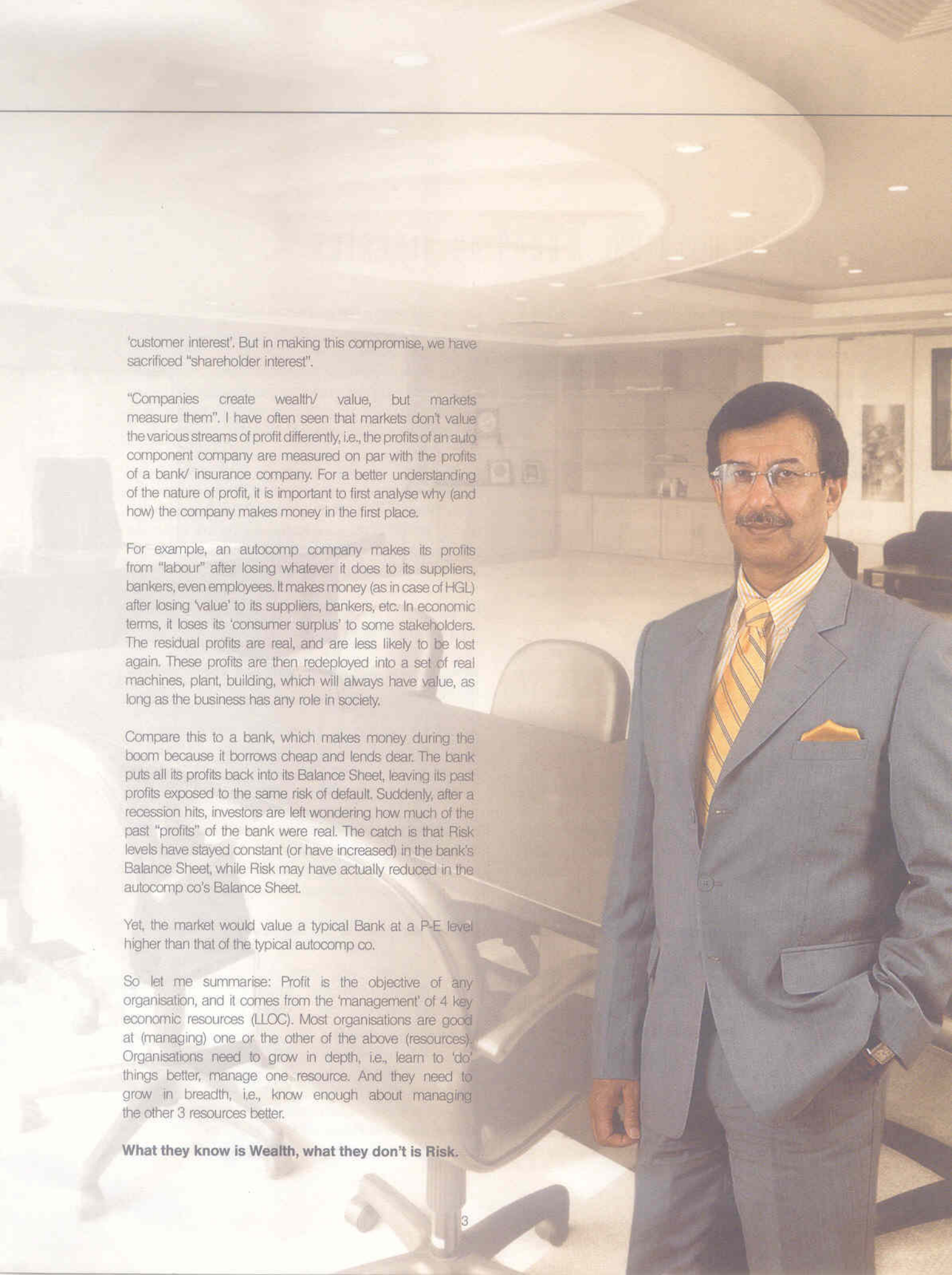
Under this head, I will also put the ability to handle Risk and the other side of the coin, Opportunity. A good Insurance company or an Investment Bank, for example, makes a profit because it charges more premium than it pays out, i.e., it estimates the probability of occurrence of an event better than its customers. And it keeps enough Risk Capital on standby (either on or off its Balance Sheet) to make sure that it never goes bust, especially during those sudden cataclysmic crises that happen every so often these days.

Last, let's come to Land. Don't take this term literally. In Ricardian terms, land used to mean anything whose supply was not controlled by human beings. The simplest example was land itself. In those days, if you owned land, you got to charge Rent, from which came the term, Economic Rent.

But to now get to the nub of my point. I don't think too many companies examine their Organisation Design, to see whether they are able to exploit all the sources of profit possible. Every external interface of the company creates an external stakeholder. Do we examine each such interface to see how it is losing money/ value or exploiting the relationship for profit?

We are one of the best-rated auto component companies, according to a recent poll by a leading TV channel. Yet, it is my personal opinion that we give away half our net profit, by choosing to stay with single-material/ supplier relationships, rather than convert to multiple sources.

I have often argued that perhaps we, as management, are averse to building "strategic sourcing" skills. How many material-substitution proposals have we given to our customers in the past 5 years, for example? So we have chosen to take the prices we are given, under the garb of

A man with a mustache and glasses, wearing a blue suit, a yellow and white striped shirt, and a yellow and white striped tie, stands in an office. He is looking towards the camera. The office has a modern design with a curved ceiling and recessed lighting. There are office chairs and desks visible in the background.

'customer interest'. But in making this compromise, we have sacrificed "shareholder interest".

"Companies create wealth/ value, but markets measure them". I have often seen that markets don't value the various streams of profit differently, i.e., the profits of an auto component company are measured on par with the profits of a bank/ insurance company. For a better understanding of the nature of profit, it is important to first analyse why (and how) the company makes money in the first place.

For example, an autocomp company makes its profits from "labour" after losing whatever it does to its suppliers, bankers, even employees. It makes money (as in case of HGL) after losing 'value' to its suppliers, bankers, etc. In economic terms, it loses its 'consumer surplus' to some stakeholders. The residual profits are real, and are less likely to be lost again. These profits are then redeployed into a set of real machines, plant, building, which will always have value, as long as the business has any role in society.

Compare this to a bank, which makes money during the boom because it borrows cheap and lends dear. The bank puts all its profits back into its Balance Sheet, leaving its past profits exposed to the same risk of default. Suddenly, after a recession hits, investors are left wondering how much of the past "profits" of the bank were real. The catch is that Risk levels have stayed constant (or have increased) in the bank's Balance Sheet, while Risk may have actually reduced in the autocomp co's Balance Sheet.

Yet, the market would value a typical Bank at a P-E level higher than that of the typical autocomp co.

So let me summarise: Profit is the objective of any organisation, and it comes from the 'management' of 4 key economic resources (LLOC). Most organisations are good at (managing) one or the other of the above (resources). Organisations need to grow in depth, i.e., learn to 'do' things better, manage one resource. And they need to grow in breadth, i.e., know enough about managing the other 3 resources better.

What they know is Wealth, what they don't is Risk.