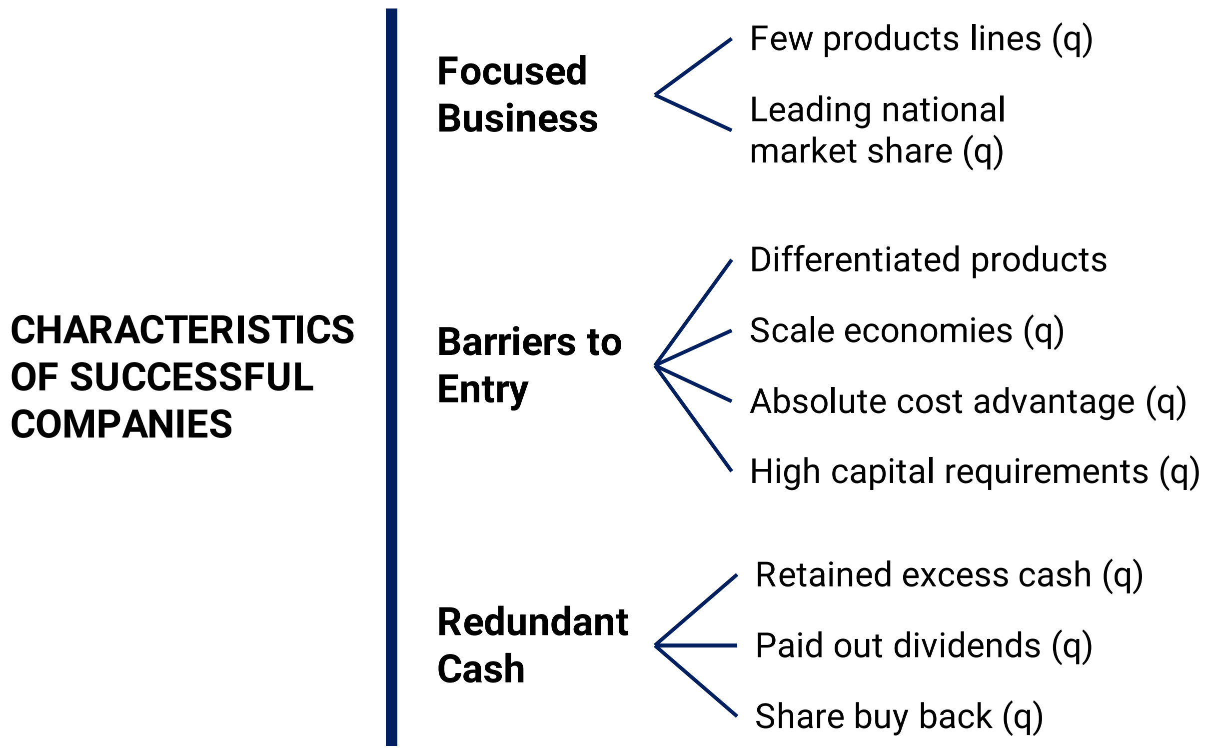

# FRUHAN'S MARKERS FOR CORPORATE SUCCESS

How do we evaluate whether a company is successful? There are many frameworks but let us draw attention to our chairman's Harvard Business School professor William Fruhan's markers of success, from his brilliant book 'Financial Strategy'.[1]

He noted what may seem obvious but is not. He could have had many more markers but chose the three[2] in the graph as the best explainers of success. They in turn lead to a high 'market value-to-book value' ratio (MV/BV). The framework applies to mature, large companies. It does not apply to, e.g., tech companies in the build-up phase.

In the graph, we indicate what is quantifiable and thus something Tellusant will automate.

The framework applies to any large company regardless of industry.




(q) = quantifiable

Source: W. Fruhan - Financial Strategy; Tellusant synthesis

## FOCUSED BUSINESS

It is well known since several decades that focused companies do better than diversified companies or conglomerates. Fruhan argues that two metrics suffice to measure this:

- The company should have few product lines.
- It is critical to be the market share leader.

## BARRIERS TO ENTRY

Let us say we meet the focused business condition. But this in itself does not lead to financial and other success. It is equally important to have significant barriers to entry.

- Differentiated products can be built on branding, unique design, and more
- Scale economies have repeatedly been shown to contribute to success. It interacts with leading market share but may go against differentiation.
- Absolute cost advantage applies to companies that have a location-based asset. For example, a mining company that has the only source of high grade or, or a brewer that built a large brewery before the competition in a particular area.
- High capital means that it is prohibitively costly to replicate what the company has. One could imagine that it is possible to build a new cola brand, but the cost is realistically beyond reach for any company.

## REDUNDANT CASH

Meeting the first two criteria does not mean that you are successful. You may squander those advantages by being inefficient and lazy.

Fruhan understandably saw a company's ability to generate redundant cash as the most important measure of efficiency. Since cash flow is the ultimate performance metric, it makes sense.

Generated cash flow shows up in three places: as retained excess cash, as dividends, and as share buyback. The mix is up to each company to figure out.

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In sum, Fruhan's framework is deceptively simple, yet powerful, and is founded in micro economic theory. It can serve as the basis for any diagnostic in a strategic review. After such a diagnostic, the more detailed work begins.

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[1] Fruhan, W. (1979). *Financial Strategy. Studies in the Creation, Transfer, and Destruction of Shareholder Value*. Richard D. Irwin, Inc.

[2] Why is high growth not a marker of success? Because there are many successful companies that are not growing. Also, if growth is high but ROE < COE, then value is destroyed.