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An executive's "financial signature" is the key to how he or she evaluates risk and reward to build company value.

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CEOs and other top executives have certain financial preferences that are ultimately expressed in their management decisions. Some, for instance, are comfortable investing in potentially lucrative but risky ventures while others much prefer pursuing a market with razor-thin margins and low entry costs. Still other executives are adept at exploiting businesses with high margins but minimal indirect expenses. Are any of these approaches inherently superior — or inferior — for building value?

Answering that question first requires a way to measure the different fiscal behaviors of executives. "Financial signatures" can capture such information by measuring particular approaches by executives for building value and for using resources to achieve such goals. Standard models for measuring leadership capabilities tend to focus on certain attributes such as strategic vision and the ability to execute, but they do not directly take into account leaders' financial approaches. They might, for instance, focus on a person's ability to cut costs within a given vision but fail to look at the specific ways in which the individual tackles such issues. Financial signatures provide that missing view.

What Is a "Financial Signature"?

Business leaders have two basic drives: to add value to products or services and to deploy resources with a certain amount of efficiency. The first drive can be inferred from a business' gross margin, defined as gross profits (that is, revenues minus the cost of goods sold, or COGS) divided by revenues. Gross margin is generally accepted by financial analysts as a way to measure the amount of value added to a product or service. It is a far more accurate measure in that respect than profits, which can sometimes be high when value-added is low and vice versa. The second drive can be inferred from a business's relative indirect expenses, defined as expenses not included in COGS divided by revenues. This number might not be the best measure of resource utilization, but it does provide a good indication of that quantity, and information on expenses is readily obtainable from a profit and loss statement.

The financial signature incorporates both numbers — gross margin and relative indirect expenses — to determine an executive's particular fiscal approach to business. To ensure the comparison of apples with apples, it specifically looks at those two quantities with respect to the average values for a particular industry or market. It is important to remember that financial signatures define executives only in terms of their economic approaches. Unlike Myers-Briggs and other similar psychological assessments, the signature is not based on a person's personality but on how different people evaluate the financial risks and rewards of business situations.

To understand that process, consider that the gross margins associated with executives can range from high to low, as can expenses. Thus there are four extreme categories of financial signatures: (1) gross margin and expenses are both high, (2) high gross margin and low expenses, (3) low gross margin and high expenses and (4) gross margin and expenses are both low. Each of these categories has a characteristic set of financial behaviors that are labeled "venture capitalist," "buccaneer," "mercantilist" and "discounter," respectively. Details of the four signatures reveal how they utilize resources in different ways to build value.

The Venture Capitalist Venture capitalists do things the hard way. They invest in activities that will have high gross margins, knowing that such projects typically require considerable expenditures over several years for the investments to pay off.

When successful, they hit the ball out of the park. In the vast majority of cases, though, they strike out. In other words, venture capitalists have a high-risk/high-reward approach to business. There are no short cuts for them. Focused on increasing the value-added to products or services in a significant and possibly radical way, they will expend considerable resources to achieve that goal. Their mission is similar to that of a patient investor who equates long investment cycles with high returns.

Steve Jobs has a classic venture-capitalist signature, as illustrated by his startup NeXT Software Inc., the computer firm, and his investment in Pixar Animation Studios, the film-making company. Both of those ventures had the potential to become businesses with very high gross margins. NeXT had the ambitious goal of creating the next breakthrough in computing, just like the original Apple had done. Pixar had a similarly bold objective: to change the way movies are made. In both cases, Jobs invested tremendous amounts of resources, with differing results. The NeXT computer was an aesthetic breakthrough but a commercial flop. Pixar, too, lost an enormous amount of money, but it eventually succeeded, allowing Jobs to take it public. Today the company is the leader in its field. And those results are typical of the venture-capitalist signature, in that occasionally one investment will succeed spectacularly while others will fail miserably.

“Buccaneers” search for that magic land of high margins and low expenses. They exploit market inefficiencies, finding overlooked opportunities.

The venture-capital signature is especially common in the high-tech industry, but it can also be found elsewhere, especially in markets that have high value-added products or services that require large investments. It typically requires the combination of a visionary approach, a global-change mentality, tremendous patience and a gambler’s acceptance that many bets won’t pay off.

The Buccaneer Buccaneers aim for very high returns *and* extremely low expenses. These individuals are not known for their patience or persistence and are usually unwilling to spend years developing a product or service. Often this type of executive achieves lucrative returns through some ingenious means that no one has thought of before. As such, buccaneers often have few initial competitors until others begin to copy their maneuvers. The buccaneer’s aim of high returns and low expenses is the dream of many executives, but it can be extremely difficult to pull off depending on a given organization’s limitations on product, market and internal culture. People who do accomplish it become the darlings of investors and Wall Street.

One example is Sandy Weill, CEO and chairman of Citigroup Inc., the diversified global financial services company. Weill’s focus on low expenses is legendary, and his obsession with cost control gave him a competitive edge that enabled his successive takeovers of Commercial Credit, Travelers and eventually Citigroup. Even at organizations that historically had high-expense cultures, such as Citigroup, Weill was able to apply his low-cost approach. But he was not interested in just any business. In fact, he targeted companies that significantly exceeded the average gross margins of their industry. That drive led him to Commercial Credit, which made consumer loans at very high rates to people who had trouble borrowing money elsewhere. The business ethics of such loans aside, Weill rightly realized that Commercial Credit’s position in the market was where gross margins were potentially the highest. Weill’s passion for businesses with high gross margins coupled with his unremitting cost control is what buccaneers are all about.

Buccaneers are constantly searching for that magic land of attractive margins and low expenses. They are not seeking marginal, long-term or even reasonable returns. They want spectacular earnings, and they want them quickly. If that means entering unglamorous businesses that others disdain, so be it. Buccaneers are also adept at exploiting market inefficiencies, finding opportunities that others miss. Consider Pierre Omidyar and Jeff Skoll, co-founders of eBay Inc. One of the few dot-coms that has not only survived but thrived, eBay boasts gross margins in excess of 80% — an amazing figure for retailing — while keeping expenses at a downright frugal level. The foundation for eBay’s success is that Omidyar and Skoll were able to implement a clever business model for conducting auctions over the Internet. Indeed, buccaneers rarely create any technology or products themselves. Their gift is their ability to spot and exploit opportunities that others have overlooked. They tend to avoid any businesses in which margins are razor thin, however, because they typically have little patience for that type of operation. Instead, their fast-moving style of doing business makes them pursue markets in which they can apply their bold strokes swiftly to obtain quick results.

The Mercantilist The commonly understood meaning of mercantilist refers to the economic behavior of certain nations that use state resources to explore and exploit new territories. This type of behavior can also be seen in the executive who is not focused on adding value to products but still uses a high level of resources. These expenditures might be for sales and marketing or for general and administrative costs but not for research and development. Often the resources reside in physical inventory and logistics, just as with the mercantilist nations of old. In general, a mercantilist strategy imposes substantial costs and considerable risk. The trick is to find ways for the high expense levels to result in decent company returns *without* having to invest in the products themselves. One obvious approach is to increase market share, using volume to spread costs. But that tactic is inherently risky. If the high investments do not pay off and gross margins remain too low, the company will suffer major difficulties.

Consider the plight of Chuck Conaway, the CEO of Kmart Corp. in the late 1990s. Under his leadership, Kmart reintroduced its trademark "blue-light specials" for cutting prices, but the move failed to generate sufficient sales volumes. The company was forced to file for bankruptcy, close hundreds of stores and lay off tens of thousands of employees. To make matters worse, creditors filed a civil suit against Conaway and other executives, alleging that their poor management cost Kmart more than $1 billion in personal and business expenses. Among the lawsuit's claims are that Conaway billed Kmart for improvements to his home, two luxury cars and a private chauffeur for his children — all during a time when the company was headed toward disaster because of a failure to move enough products.

And that, in a nutshell, is the problem: Mercantilist companies that rely on high volume to spread costs can easily be burned by that tactic. Any disruption in their distribution system, for instance, can be catastrophic. Typically, mercantilist executives operate in a very large industrial or retail setting in which the market is mature, discouraging the entry of innovative leaders. They often thrive in commoditized businesses for which gross margins are slim yet expense levels are fixed and high. Consumer electronics and personal computers are two examples of such businesses in that their products are commodities that require substantial fixed costs for manufacturing and distribution. Because of these factors, gross margins are slim. In large companies, mercantilists might be corporate stewards, such as division presidents or general managers. These individuals may be given considerable resources to accomplish a particular goal, which might be to prevent mercantilists at other companies from gaining a foothold in the market.

The Discounter Discounters are very risk-averse people who avoid speculation. Their modus operandi is to offset low gross margins with extreme thriftiness. In general, they do not focus on adding value to products. Instead they concentrate on lowering resource use. Discounters are often frugal in their personal lives, and they tend to be detail- and control-oriented rather than focused on the big picture. They are more likely to be obsessed with points of market share and gross margins than with dominating a market.

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A good example is the late Reginald Lewis, whose $1 billion leveraged buyout of TLC Beatrice International Holdings, the international food company, was one of the largest deals of its type. It followed his equally successful leveraged buyout of the McCall Pattern Co. The hallmark of Lewis' style was that he was a hands-off owner who added little value to the companies he acquired. Instead, he was a financial engineer who took over enterprises in the classic LBO style. He had no vision for the companies except to make money, something he did very well. Lewis' style of low resource utilization led to stagnant and even declining sales at the companies he bought, but he still came out ahead financially. With McCall, he later sold the business for a hefty profit. With Beatrice, he sold off parts of the enterprise but held onto the money-making assets. At the time of his death from brain cancer in 1993 at the age of 50, his fortune was estimated to be $400 million, making him one of the wealthiest people in the United States.

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Like mercantilists, discounters are often found in commodity markets. But the difference is that mercantilists typically thrive where fixed costs are high (such as with durable goods), whereas discounters tend to favor industries in which such costs are low (such as with nondurables and services). Consequently, although both the mercantilist and the discounter need to move high volumes of products because margins are thin, that imperative isn't as crucial for discounters because their costs are less burdensome. Thus they do not necessarily need to operate on a global or even national scale. They could, for instance, be a local retailer or wholesaler.

Organizational Fit

Most executives fall somewhere between the four archetypal categories. Many people, for instance, tend to operate with gross margins and expenses both at moderate levels — a category of financial signature called "consolidator," because of the inclinations of those executives for adding value and cutting costs by merging different businesses.

Certain financial signatures are best suited for particular industries. As was mentioned earlier, mercantilists are ideal for a commodity market with high fixed costs. Moreover, companies might require executives with different financial signatures at various stages in their companies' life cycles. A start-up, for instance, might be better off with a venture capitalist at the helm. Later, that same firm might need to fill its executive suites with discounters.

No matter how capable the leader, a mismatch between an organization's requirements and the actual financial signature of its CEO can lead to management problems, possibly even to company failure. It could be argued, for instance, that Chuck Conaway was the wrong person to head Kmart at that time because of his tendency to expend resources. In theory, a diversity of financial signatures within the senior leadership of a company would be advantageous if it were to lead to constructive debate over the best course of action for that firm. In practice, though, such diversity can easily result in irreconcilable management conflicts that adversely affect the organization's ability to compete.

In the ongoing search by businesses for more effective leaders, financial signatures provide an additional tool for selecting and developing executives. One advantage of using them is that they can be measured with the same operational metrics as those already used in a company's normal functioning. In this way, the conventional finances of a company, division or group, as measured by its P&L statement and balance sheet, can provide a direct link with the financial approaches of its leaders. Moreover, financial signatures help establish a new criterion and possible benchmarks for executives, allowing companies to establish more effective support programs for managers. And they reveal new paths for assessing the building of company value and for identifying valuation trajectories that might be linked to the financial signatures of company leaders.

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