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CFO Vision 2013

Innovation. Performance. Growth.

November 20–22, 2013

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A CFO's Guide to Exceptional Performance Harnessing the Three Rules

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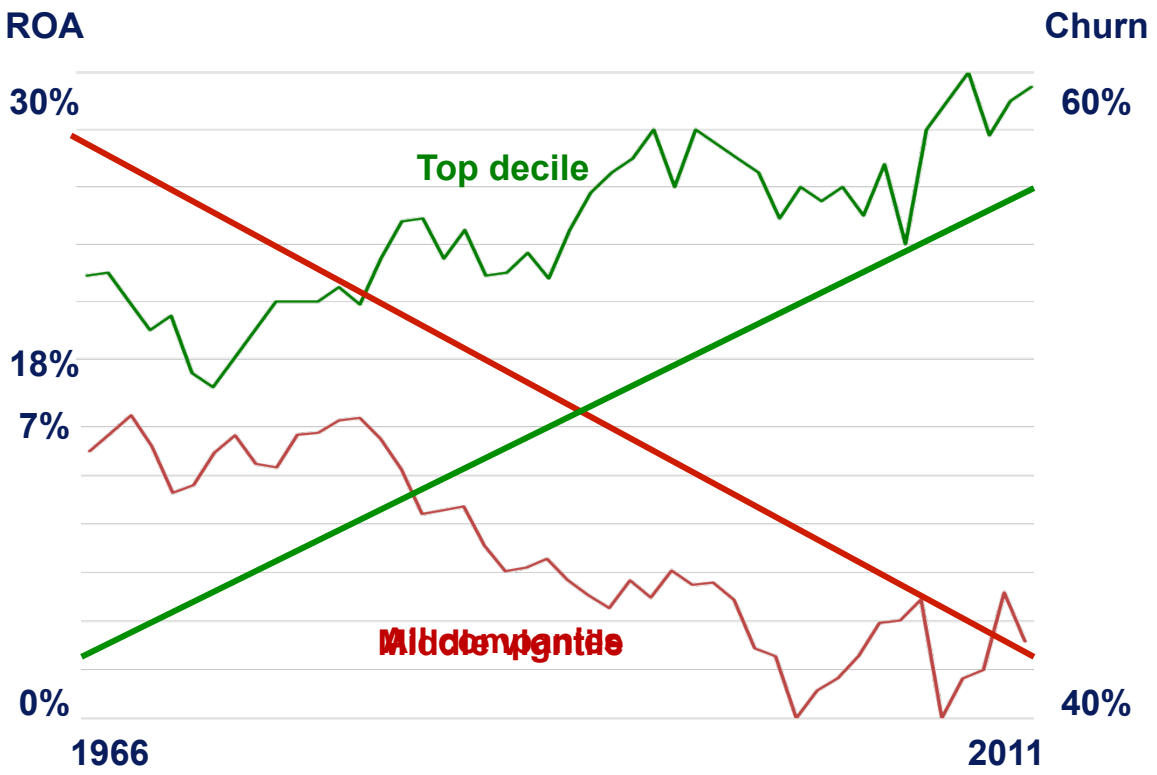
Climbing a greased pole.



High performers are doing better than ever

Everyone else is doing worse than ever

Staying on top is harder than ever

Escaping mediocrity is harder than ever

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What are the drivers of superior performance?

Get the right people on the bus

Don't prematurely abandon your core

Give customers what they want

Find a big enough market insight

Have a clear and focused strategy

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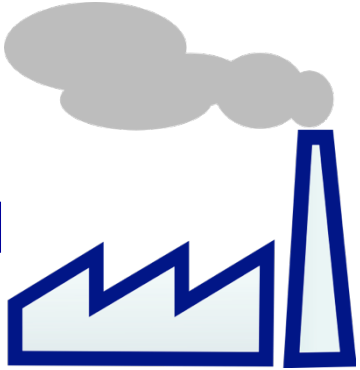
Performance is entirely relative…but to *what*?

6th decile

8th decile

18% in 1997



3% in 1981

Exogenous factors

- ✓ Year
- ✓ Industry
- ✓ Competitive intensity

Endogenous factors

- ✓ Size (revenue)
- ✓ Market share
- ✓ Leverage
- ✓ Survivorship

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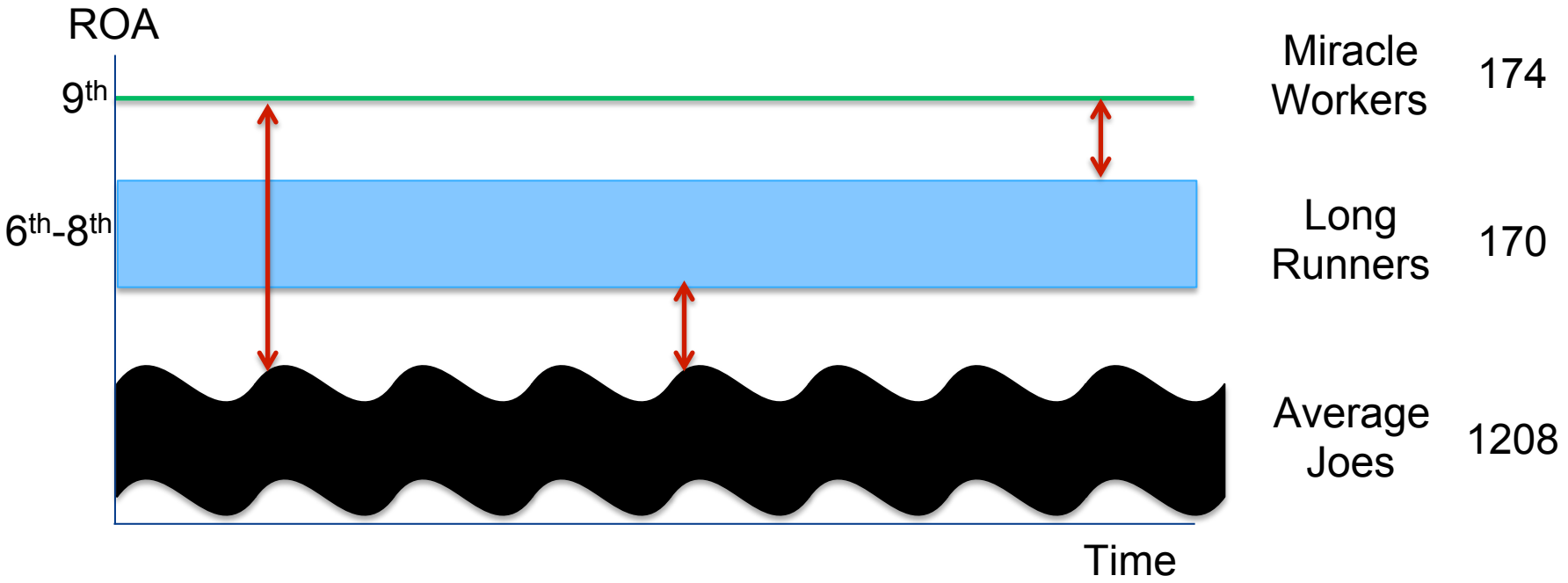
We defined two types of exceptional performance.



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Detailed case studies allowed us to search for causes.

Kept it	Found it	Lost it
Abercrombie & Fitch	LINEAR TECHNOLOGY	weis
Heart Land Express	Medtronic	MAYTAG
MERCK	WRIGLEY	Thomas&Betts

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It's not how they act…it's how they *think*.

Fundamental Question	Fundamental Answer
How do you create value for customers?	Rule #1 Better *before* cheaper
How do you capture value for yourself?	Rule #2 Revenue *before* cost
What do you change when the world around you changes?	Rule #3 There are no other rules

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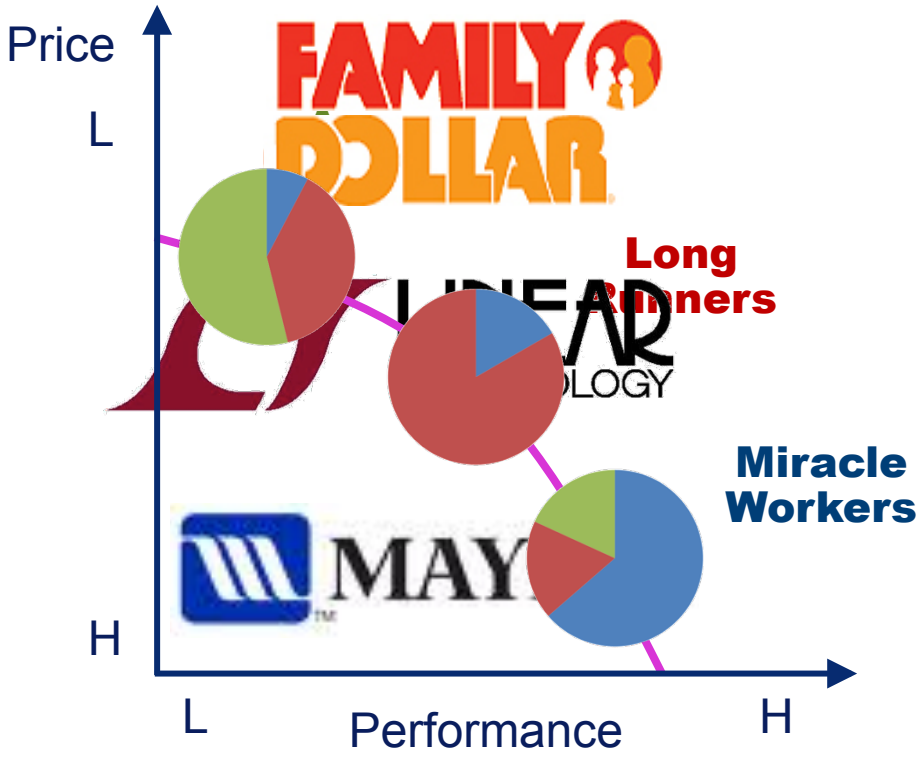
Rule #1: Better before cheaper.



- How do you create value for customers?
- It is possible to have the lowest price and the highest quality…
- …but in reality it tends not to happen very often
- You face a CHOICE

Non-price positions perform better

Moving toward a non-price position improves performance

Moving away from a non-price position erodes performance

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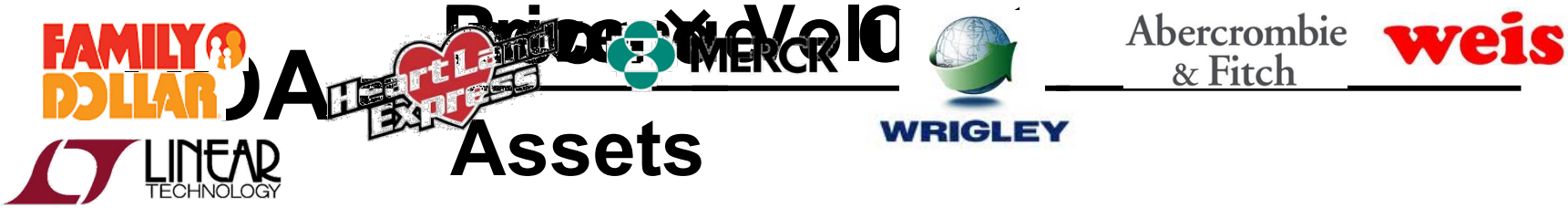
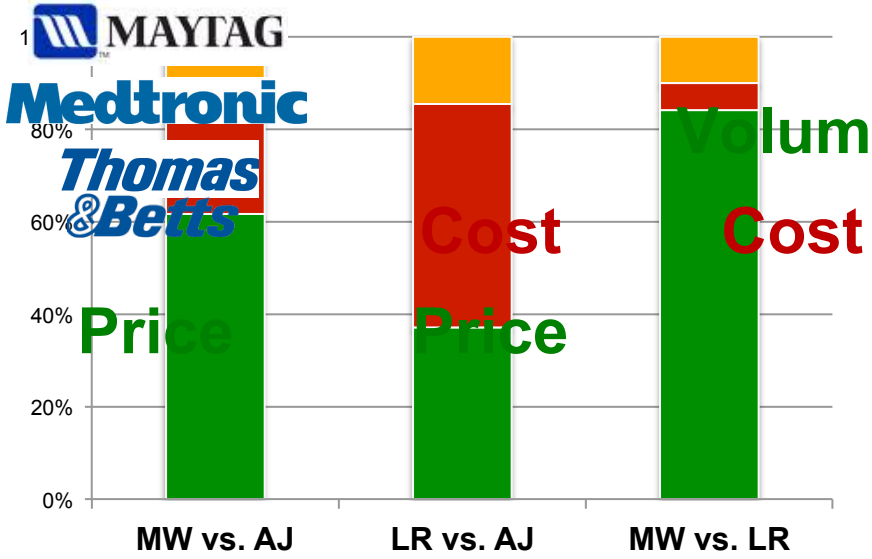
Rule #2: Revenue *before* cost.





- There is a pattern to the structure of superior profitability
- Higher gross margin percentage matters more than lower cost
- Asset efficiency is almost irrelevant

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Rule #3: There are no other rules.

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Using the Three Rules

When you face a difficult choice…

Follow the rules…

Use your compass to point you toward your overall goal.

But you can't just walk a straight line to your destination…

And the data are ambiguous…

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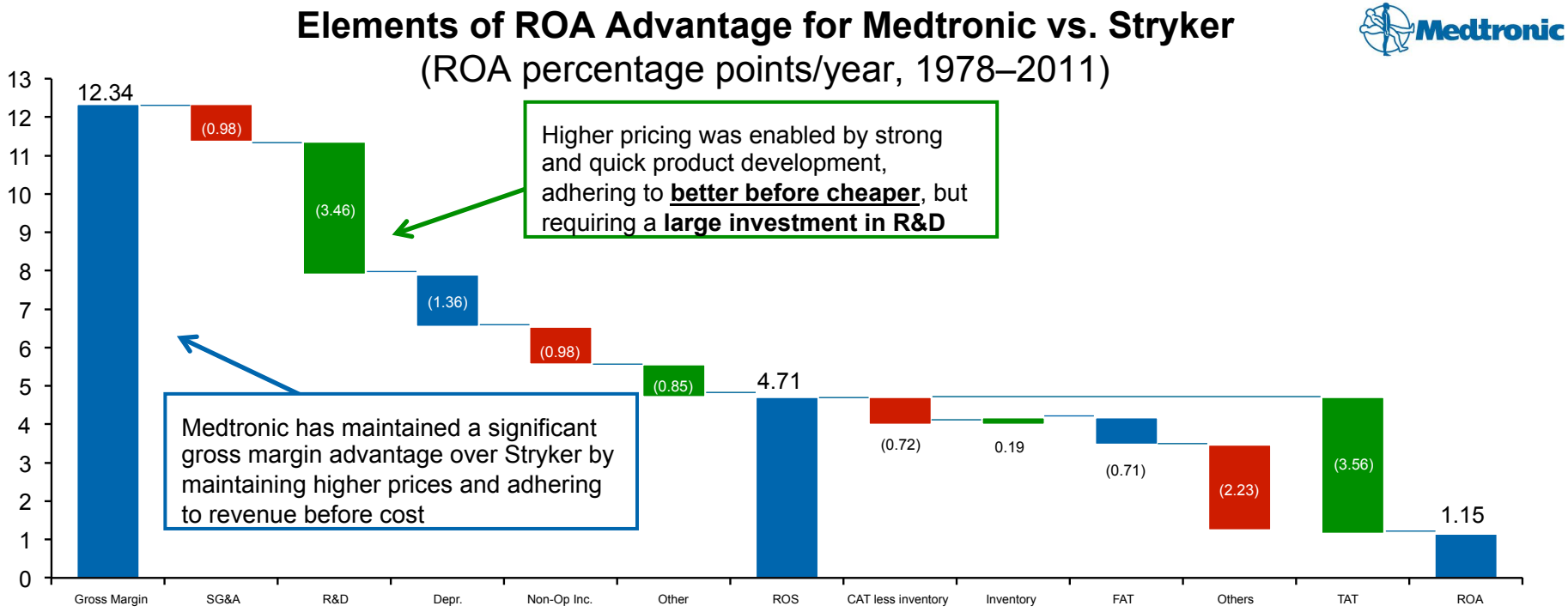
Case Study: Medtronic – Superior Return on Assets (ROA)



Notes: (1) ROS = return on sales; (2) CAT = current asset turnover; (3) FAT = fixed asset turnover; (4) TAT = total asset turnover
Source: *The Three Rules*, by Michael E. Raynor and Mumtaz Ahmed; Exceptionalyzer tool (exceptional.deloitte.com)

Case Study: Medtronic – The Three Rules

Medtronic developed a differentiated, superior product and succeeded in a difficult marketplace with adherence to the three rules.

1 Better before cheaper

- Established **specialty in high-tech, innovative products** since originating as a pioneer in pacemakers
- Used robust R&D to **accommodate the needs of precise consumer segments**
  - E.g., pacemakers designed to treat CHF by interfacing with distinct regions of the heart, depending on the condition

2 Revenue before cost

- Held a **pricing advantage** over industry competitors
  - Sold pacemakers at a $300/unit premium over market competitors[1]
- Maintained **increased volumes** by avoiding costly recalls through disproportionate investment in quality control

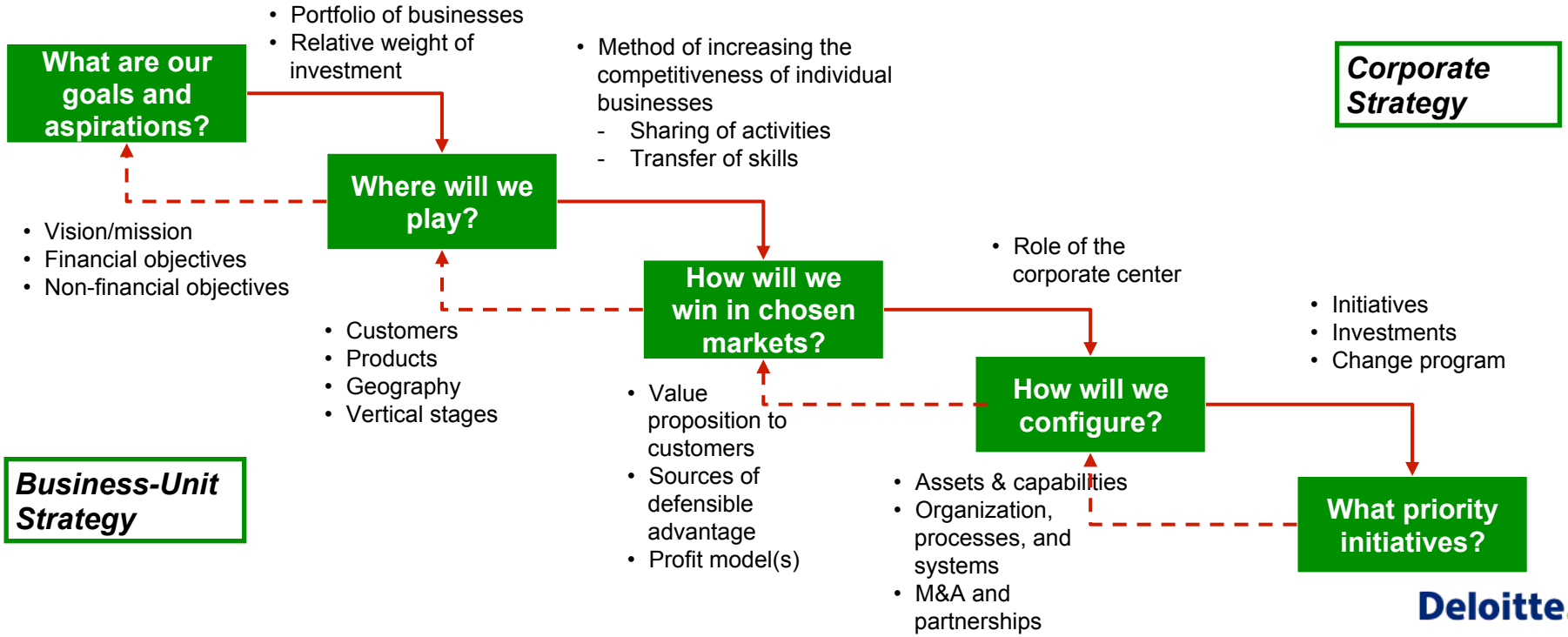
3 There are no other rules

- Medtronic has **maintained its non-price positioning** for close to a half century and has **yielded industry-leading ROA** nearly every year since 1986[1]

Source: (1) *The Three Rules*, by Michael E. Raynor and Mumtaz Ahmed; Deloitte analysis

The Strategic Choice Cascade

Strategy is an interrelated set of choices expressed along five dimensions; the Choice Cascade is a simple and powerful tool for articulating a strategy—current or future



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Case Study: Medtronic – Strategic Choice Cascade

Medtronic has made a series of strategic choices that has enabled it to capture and retain market share with an innovative, high-quality product.

Medtronic

What are our goals and aspirations?

- **Vision/Mission:** Be the world's leading medical technology company specializing in implantable and interventional therapies[1]
- **Financial:** Increase revenue and EPS at a rate of 15+% and net income at 17-18% over the next five years[2]

Where will we play?

- **Customers:** Hospitals, clinics, and third-party health care providers[3]
- **Products:** Primarily high-tech implantable devices for cardiovascular and restorative therapies (e.g., pacemakers)
- **Geography:** Primary focus on the U.S. (60% of sales), but serve 140+ international markets via independent distributors[3]

How will we win in chosen markets?

- **Differentiated Value Proposition:**
  - Brand associated with industry-leading quality due to minimization of recalls[5]
  - Superior user experience supported by training for physicians on product use, surgical procedures, etc.[5]
- **Sources of Competitive Advantage:**
  - Rapid commercialization of new technologies supported fast turn-around R&D cycle (now 18-month development cycle vs. four years in the 1980s)[5]
  - Higher R&D budget relative to peers[5]
- **Profit Models:** Premium pricing (e.g., $300/unit premium on pacemakers)[5]

How will we configure?

- **Organization Design:** Developed independent R&D budgets to invest in disruptive technologies outside the core businesses[4]
- **M&A:** Use acquisitions to obtain innovative products in target markets or segments (e.g., PEAK Surgical and Salient Surgical Technologies to expand surgical portfolio)[2]

Sources: (1) FY1997 Medtronic annual report; (2) November 1997 Morgan Stanley Medtronic report; (3) Medtronic 1997 10-K filing; (4) *Harvard Business Review*, "The Idea That Led to 10 Years of Double-Digit Growth"; (5) *The Three Rules*, Michael E. Raynor, Mumtaz Ahmed