The CEO SERIES

Business Leaders: Thought and Action

Expectations Set—And Met
Lessons From A Successful Spinoff

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CEO Series Issue No. 26
September 1998

CSAB
Center for the Study of American Business
Washington University in St. Louis

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Introduction

Some companies are born of great new products. Others gain currency by targeting an emerging market at precisely the right point in time. Solutia has taken a different path to success, harnessing the power of appropriate expectations to launch a notably successful new corporation following our spinoff from Monsanto Company in 1997.

For more than a decade, a range of expectations has shaped the performance of the businesses which make up Solutia—and not always for the better. Our story shows how the same set of businesses, seen through different mindsets and guided toward different objectives, can be managed to decidedly more exciting outcomes. There are important lessons to be learned from our experience, too: lessons about how to turn unrealized potential into increased value for shareholders.

Origins of the Spinoff—The "ATM" Expectation

Our course was set in motion in the early 1980s, with Monsanto's strategic shift away from its traditional base in chemicals and plastics and toward the life sciences. Two events served to crystallize the strategy: the acquisition of the G.D. Searle pharmaceutical company and the sale of our ethylene production joint venture to DuPont. If you followed the money, you could see Monsanto was looking less and less like a tweaker of petrochemical molecules,

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and more and more like a research-oriented biotechnology firm.

Still, there was no clean break from chemicals. Monsanto had more than a few gems in its Chemicals portfolio—valuable, value-added products and technologies that were (and are) capable of contributing solid earnings. As the nascent Life Science businesses developed, management set the expectation that Chemicals would serve as a reliable "ATM," churning out dollars for biotech R&D.

It wasn't an unreasonable request. Chemicals wasn't the first, and won't be the last, attractive business to be run for cash. But management's "ATM" expectation had clear consequences. It meant Chemicals faced an uphill climb to compete internally for capital. Without reinvestment, the division would inevitably lose ground to its world-class manufacturing competitors, and morale would become an increasingly significant issue. Chemicals was in danger of becoming a wasting asset, largely because its strategy and business needs differed sharply from (and were subordinate to) those of Monsanto's growth-oriented Life Science business.

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What's more, because we were trying to run two fundamentally different companies under one roof, Monsanto's shareowners were paying a price: the company's stock was trading at lower multiples than it would if it were valued as a pure growth stock. To their credit, Monsanto's CEO and Board of Directors recognized this conflict and decided to do something about it. Rather than let the Chemicals business run dry, they began to explore a range of strategic options, including a spinoff into an independent, publicly-traded company.

The ultimate disposition of Chemicals was anything but a foregone conclusion in the 1995-96 time frame. An easy (and perhaps defensible) course might have been to do nothing, especially given Life Science's appetite for cash.

But one of the important lessons to be learned from our experience is that certain times in a company's history call for fundamental change. Of course, you don't get a warning light on the dashboard—"Divestiture Ahead." For the most part, the signals are much more subtle. Still, it's an important part of management's and the board's responsibility to watch constantly for the signals—and to make the necessary tough decisions soon **(Lesson #1)**.

Expectations In Transition: Preparing For The Spinoff

It's natural enough that in a time of transition, expectations tend to get muddied. That certainly happened at Monsanto in the mid-1990s: to accommodate the company's emerging growth culture, a handful of large, traditional groups were dissolved to form a larger collection of "small and connected" business units.

All of the company's business units—including some previously run for cash—seemingly were invited to participate in Monsanto's growth. This set up an initially energizing but ultimately misleading expectation: all may have been invited, but only the Life Science units actually fit Monsanto's long-term criteria for growth. Therefore, only they ultimately would qualify for significant investment.

It's important to remember: this was a time of transition. No final course had been set for the Chemicals businesses. Understandably, Chemicals business units were eager to prove they too belonged in Monsanto's growth portfolio. But that eagerness had a somewhat corrupting influence on their fundamentals: costs increased, and profits became less reliable as these good, sound businesses chased development opportunities they'd never be allowed to consummate.

Meanwhile, at the corporate level, management efforts to reach a permanent disposition for Chemicals continued. Monsanto actively explored a range of strategic options, including an asset swap, a piecemeal sale, and a total sale or merger into another chemical company. By summer 1996 it was becoming clear that a spinoff was not only possible but preferable, largely because it created the fewest tax consequences and the greatest potential value for shareowners. With that realization, the spinoff process began in earnest.

It was at times a contentious undertaking to turn one company into two—and it was anything but democratic. Again and again, we saw proof that Monsanto held all the cards. Because our spinoff involved the foundation businesses of a 100-year-old company, the discussions were often charged with emotions. Fair or not, we often had to resolve simply to play the hand we were dealt. Still, it helped soothe the sting to remind ourselves why we were going through the process in the first place: to do what was best for shareowners. Sometimes, that commitment served as a tie-breaker in our discussions. More often, from our perspective in Chemicals, it helped us keep our eyes on the prize: a chance at independence and the opportunity to unlock what we believed to be underutilized potential in our operations. But in every case, doing what was best for shareowners proved to be the best criterion for each decision we were called upon to make **(Lesson #2)**.

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Matching Expectations With An Organization Design

During internal discussions, three issues in particular flared as sources of conflict: the amount of corporate debt that would be assigned to the spinoff, the amount of unfunded retiree obligations the new company would be asked to take on, and the disposition of the Monsanto name. Ultimately, the Chemicals businesses, which generated about a third of Monsanto's 1996 revenues, wound up taking on more than half of the company's debt, and about 70% of its unfunded retiree obligations—and the name stayed with Life Sciences.

You can certainly debate whether those were the best decisions for Monsanto's shareholders. But they did produce at least one important benefit. They made expectations crystal clear for the soon-to-be independent Chemicals company. We knew we couldn't sustain the "spend-and-grow" approach that had characterized Monsanto's recent history. Instead, we would have to focus immediately on maximizing free cash flow and creating growth in earnings per share.

A key factor in our eventual success was our willingness to act on the realities of our situation. We didn't wait for the corporate steering committee (populated by corporate officers, plus representatives from Chemicals and Life Sciences) or the Board of Directors to pull the trigger on a spinoff decision. John Hunter, then head of Monsanto's Fibers business unit and my President and COO-designate, and I started to assemble our leadership team, which ran the businesses, and an invaluable transition team, which managed strategic negotiations with Monsanto and thousands of details. This work to design the enterprise began as early as mid-1996—half a year before the Board formally approved the spinoff plan.

Right from the start, our focus on maximizing cash flow and creating shareholder value helped us shape the new organization into something that was quite different from Monsanto.

To be sure, we had a reasonable head start. Our businesses were each number one or a close number two in their relevant markets, and we had up-to-date facilities. But right from the start, our focus on maximizing cash flow and creating shareholder value helped us shape the new organization into something that was quite different from Monsanto: a doggedly cost-conscious structure featuring lower head counts, staff resources leveraged across the enterprise, and lean business units focused only on making and selling. We didn't want any resource-wasting mini-kingdoms inside the new company, so we took steps to ensure that the needs of the enterprise would always come first.

A reasonable question could be asked: why didn't we operate that way as part of Monsanto, since we had essentially the same people running things? That wasn't

Monsanto's corporate strategy for the Chemical businesses, and it turns out that running a spinoff requires a different mindset. We took advantage of the opportunity for a fresh start, looking for ways to improve work processes, so that we could augment our excellent manufacturing operations with new efficiencies up and down the supply chain. We also developed a plan to use the SAP software installation, which was under way, and all its associated process re-engineering to facilitate the break from Monsanto, significantly enhance enterprise productivity, and solve our Year 2000 problems to boot.

Getting an early start on building the team and designing the enterprise around its new mission proved critical as events unfolded **(Lesson #3)**. Had we waited until December 1996, when the spinoff decision was officially approved, we probably would not have had enough time to get the company ready for a successful launch some nine months later.

Putting Expectations To Paper — The 30-Month Plan & Solutia Identity

Another key undertaking was to get the businesses clearly on point. It worked to our advantage that we'd be running businesses we knew very well. We used that experience to create a 30-month plan: a detailed blueprint, showing exactly how we intended to run the company from July 1997 through the end of the decade.

All of the people on our executive leadership team (comprised of both business and staff leaders) helped develop the plan. We still use it today. We manage, quite literally, by the book—to prioritize spending, resources, projects, and expected contributions. Under the 30-month plan, targets are explicit; expectations are very clear. That has been absolutely essential to our early success.

Corporate identity was another critical issue. For months into 1997, we didn't know whether Life Sciences would retain the Monsanto name or whether it would be available to us. We liked the name, and we asked to keep it. We regret losing it, even more so now that it appears the Monsanto corporate name may disappear forever as the result of Monsanto's merger with American Home Products.

But that's all academic. Since a decision on the Monsanto name was clearly out of our hands, and didn't seem to be forthcoming, we opted to take productive steps instead. True to our emerging hands-on, task-focused culture, we put an internal team to work on creating a new identity for Chemicals. We worked closely with a small but respected corporate identity agency. Our goal: To create an identity that was memorable and would tell customers (and to some extent, investors) what to expect of us.

This proved to be a valuable exercise for the company and our people. We've heard from many customers and peers who think the Solutia name, tag line ("Applied Chemistry, Creative Solutions"), and logo work very well together. They create exactly the right kind of expectation—not only among customers, but for employees, shareholders, and other important audiences as well.

It will take years for Solutia to build the kind of name recognition that the Monsanto name would have given us. But we've also learned that a new identity and image can have important benefits for a spinoff **(Lesson #4)**. In our case, it has helped employees rethink our company as a 100-year-old start-up, and it has simplified efforts to convince the external world that there's something truly different about the chemical company they've known for years.

Communicating & Managing Expectations

With a management team named, marching orders set, and a powerful new identity taking shape, there was a growing sense of confidence among the Chemicals people in early 1997 that this new company could and would be a winner.

Not that there wasn't risk involved for employees—who, after all, were being asked to choose an unproven start-up over Mother Monsanto. But because we made our expectations clear, because we had identified both the objective and the means to the objective, people had the information they needed to assess the risk. As a result, we had an extremely good batting average in recruiting key managers and employees to the Chemicals team.

In the months following the spinoff, we invited all employees to participate in a unique, fun, and engaging set of discussions about our direction—using table-sized "maps" to explain topics such as shareowner value and asset management. Today, we continue to make a conscious effort to help employees understand what our targets are and why it's important that we hit them. Our compensation plan has been completely redesigned, linking all employees to the same performance targets. We also explain the potential rewards for outstanding performance—an important motivator, since virtually all of our people are shareowners themselves. In so doing, we've created a context in which shareowner value has real meaning for employees **(Lesson #5)**. Because they believe in what we're doing, because they consider it both challenging and worthwhile, they're pulling out all the stops to get the job done.

In the 1990s, Monsanto's stock had migrated unmistakably from the "value" to the "growth" camp … We were preparing to launch a "value" company.

We're getting much the same kind of support from our customers. In fact, many were and are eager to do business with an independent Solutia—a supplier who is once again free to reinvest in manufacturing improvements, new product development and other value-creating initiatives.

But prior to the spinoff, we knew that one very important audience—shareholders—didn't necessarily have a compelling reason to cast their lot with Solutia. In the 1990s, Monsanto's stock had migrated unmistakably from the "value" to the "growth" camp among institutional investors. We were preparing to launch a "value" company. That meant we would have our work cut out for us, trying to explain to the investment community who we were, where we were going, why current owners should stick with us, and why new owners would want to buy in.

We presented a capsulized version of the 30-month plan to get the point across to about two dozen investment houses—including both current institutional owners and firms that were likely to be interested in a consistently profitable chemical manufacturing company. We told much the same story to the credit rating agencies and investment banking community—audiences that were every bit as important as the equity market, since we'd have $1 billion in commercial paper to refinance once the spinoff became official.

In both cases—equity and debt—communicating expectations was a critical building block. If we didn't do it right, we'd never get the chance to move Solutia much beyond the starting gate.

Investors evidently liked what they heard. On the equity side, a large number of shares changed hands in the early going, with volume during the first six months equal to 100% of Solutia's shares outstanding. But our stock price is none the worse for the wear: after opening around $18, it's climbed steadily to the high 20s, providing a total market capitalization of about $3.5 billion.

In the debt market, we got the investment grade rating we wanted, allowing us to place $600 million in long-term instruments in one day and achieve a very manageable all-in blended interest rate of 7.16%.

Our former chairman at Monsanto, Dick Mahoney, was fond of observing, "If you don't know where you're going, any path will get you there." Solutia's experience provides a supporting corollary: when everyone knows the plan, it dramatically increases the chance that you'll actually reach your destination **(Lesson #6)**.

Charting Solutia's Future Course

Solutia's successful launch illustrates the importance of matching expectations to business models. Set the bar too low, and you run the danger of wasting opportunities or allowing assets to languish. Conversely, unrealistic expectations can divert attention and energy away from the substantial value that can be produced through operational excellence and disciplined decision making.

In Solutia's case, getting the expectations right has created a powerful competitor and unlocked significant value for shareowners. Among the most significant accomplishments of our first year:

- Accomplished spinoff on schedule, without losing any customers.
- Won the support of chemical analysts.
- Reduced debt $400 million through second quarter 1998.
- Established $3.5 billion in market capitalization.
- Repurchased about 3 million shares, to return value to shareowners.
- Restructured compensation and benefit plans to create better alignment with our strategy.
- Structured advanced payment contracts (totaling almost $200 million) to secure capital for several major manufacturing projects.
- Exceeded consensus earnings per share estimates every quarter through second quarter 1998.
- Broke ground on a new headquarters building (scheduled for occupancy, Fall 1999), designed with Solutia's team-oriented culture in mind.

> *In many respects, then, Solutia's story is—and will continue to be—one of expectations set and met.*

We're taking steps to ensure that the business stays on course and keeps the interests of shareholders squarely in its sights. We're now unveiling an aggressive plan to ensure the profitable growth of Solutia longer-term, well beyond the end of our 30-month plan.

This next step is designed to reshape Solutia's portfolio, so that we're running businesses whose profit margins, revenues, and earnings growth rates will reward our owners with price/earnings multiples reserved for the top tier of specialty chemicals companies.

Just as the explicit expectations of the 30-month plan were important to our early success, so, too, is the road map that our next-phase plans provide. We've reached the point where we must articulate the next steps for Solutia

(Lesson #7). Both employees and our owners need to know what we're building toward. Both audiences want to be reassured that our definition of value creation isn't static—that we don't intend to rely on cost-cutting alone as our path to prosperity.

In many respects, then, Solutia's story is—and will continue to be—one of expectations set and met. The need for targets is clear during a time of major restructuring. But they're no less vital when a company is going about the normal business of making, selling, and developing valuable products. Expectations can, and must, continue to evolve in order to advance the interests of shareowners. However, evolve as they may, those expectations must be very clear, very measurable, and the organization must be held accountable for achieving them.

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