

Jack Welch Missed His Opportunity With GE

By Carole A. Symonds CPA MST

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Would you buy a stock whose profit had merely kept pace with the long-term government bond yield? Of course not. Why then, are analysts promoting GE stock as a 'buy' and the business world touting Jack Welch as one of the greatest leaders of all time – an “icon of American business”?

Throughout “Winning”, Jack downplays the role of finance and managing the numbers, focusing solely on ‘boundaryless’ and ‘people differentiation’. These factors are important in successful organizations, but they are only part of the puzzle. And ‘20/70/10’ doesn’t make you profitable. He admits as much in his first book, where he relays a story of how the Company showed tremendous revenue growth, but forgot to focus on margin. “What you measure is what you get – what you reward is what you get”¹. Michael Dell understands this, which is why every employee at Dell is trained in ROIC financial concepts² and Dell’s ROIC is 43.5%.

Since 1992, GE’s Return on Invested Capital (ROIC) has been on a downward trend. In 1999, when the company’s stock price traded around \$53 per share, its ROIC was only 7.24%, down from almost 8.5% in 1992. Today, its ROIC is hovering just above 5%, at a time when the minimum ROIC for successful companies exceeds 12%. A far cry from where it should be. Maybe this is why Jack said in a recent interview that he doesn’t give advice to Bill Gates? (by way of reference, Microsoft’s ROIC is 23.7%)

While Mr. Welch was at the helm of global giant GE, he emphasized “consistent earnings growth”³. In fact, he brags about how revenue grew from “\$70 billion ... in 1995 to \$130 billion in 2000”⁴. So intent was Jack on growing the top line, he focused his energy almost exclusively on doing big deals. As he puts it, “mergers and acquisitions give you a faster way to profitable growth.”⁵

And without a doubt, GE’s revenue and earnings have grown consistently, year over year, averaging double digit growth during Mr. Welch’s tenure. But at the same time, Jack was leveraging the company to the hilt, reaching a Debt-to-Equity ratio of almost 5:1 in 1999, (coincidentally, not long before Jack decided to retire.)

Analysts have missed the boat. Most investment decisions are based on growth in sales revenue or net earnings, without any consideration for how efficiently a company is managing its capital. Think about it. The major financial indicators that analysts focus

¹ Jack Welch, “Straight from the Gut”, Warner Books, Inc. 2001, p. 387.

² Michael Dell, “Direct from Dell”, Harper Business, 2000, p. 134

³ Jack Welch, “Straight from the Gut”, Warner Books, p. 113.

⁴ Jack Welch “Straight from the Gut”, Warner Books, p. 204.

⁵ Jack Welch, “Winning”, Harper Business 2005, p. 219.

on – earnings growth, earnings per share, price/earnings ratio – have nothing to do with how much capital has been invested in the business. In and of themselves, the ratios are meaningless.

Another measurement that is widely used that does bear at least some reference to the amount invested in a company is Return on Equity (ROE). ROE shows how much the company has earned during a period of time relative to the amount the shareholders have contributed, including accumulated earnings that shareholders have foregone as distributions. While it is superior to those measurements that focus solely on income, it is lacking in that it allows a company to leverage its equity to inflate its returns. Consider the following statistics from GE’s financial reports:

	<u>ROE</u>	<u>ROIC</u>	<u>Debt:Equity Ratio</u>
1992	20.14%	8.49%	3.5:1
1993	16.71%	7.70%	3.5:1
1994	17.91%	6.45%	3.6:1
1995	22.20%	8.09%	3.9:1
1996	23.39%	7.69%	4.2:1
1997	23.82%	7.90%	4.2:1
1998	23.91%	7.65%	4.5:1
1999	25.18%	7.24%	4.7:1
2000	25.22%	7.95%	4.0:1

In the last decade of Jack’s reign at GE, he used debt to reflect a higher ROE, which pleased the analysts, and in turn Wall Street. I don’t blame Mr. Welch for dancing to the beat of the analysts’ drummer. Without financial training, what more could he have known?

Perhaps Mr. Welch’s retirement was less about ‘repotting the plant’ of GE, as he claims, and more about the writing that was clearly on the wall. Everyone likes to go out a winner, but with GE’s steadily decreasing ROIC and burgeoning debt, it was only a matter of time before investors got wise to the Company’s wasting capital. In fact, by 2003, GE’s stock hit a low of \$21.30 per share, or more than a 50% drop from the time Mr. Welch decided it was time to move on.

There is no doubt that Mr. Welch was a charismatic, visionary leader, who built a strong team of talent throughout the GE organization. But what Jack missed as CEO was leaving a financial legacy in GE. In his own words, “a CEO’s primary social responsibility is to assure the financial success of the company. Only a healthy, winning company has the resources and the capability to do the right thing”¹. Too bad Jack missed his opportunity.

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¹ Jack Welch, “Straight from the Gut”, Warner Books, p. 382