Supplementary Reading for

Chapter 10

How Jack Welch Runs GE

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Was Jack Welch's Run All It Was Cracked Up to Be?

by Nanette Byrnes

When Jack Welch stepped down as CEO of General Electric Co. (GE) last September, he bequeathed many gifts to his successor, Jeff Immelt. Among them: operating companies that are No. 1 or No. 2 in their market, a deep bench of executive talent, and a stock seen as near bulletproof. All in all, an enterprise that Goldman, Sachs & Co. analyst Martin Sankey calls "a prototype of a postindustrial company."

Welch was mythic, and under him GE had become so, too. After all, Welch's management practices and strategic insights have become the stuff of B-school case studies. Constant improvement through a Six Sigma quality push. The notion that an industrial manufacturer could offer low-margin products as a base for building high-margin service businesses. An unparalleled focus on training and retaining talent. The transformation of a U.S.-focused firm into a global powerhouse. These are all lasting contributions from Welch.

But other aspects of his reign are coming under sharp reassessment. More than anything, what set Welch apart from his peers was his uncanny ability to make the earnings numbers he promised investors. Quarter in, quarter out, GE hit the mark. In the past 10 years, the company says it has only missed twice. But in the seven months since Welch left GE, people have begun to question that performance. Following blowups at Enron and Tyco International and revelations that even blue chips like IBM have used questionable accounting to make their numbers, GE has come under fire. No one is claiming fraud, or even that GE broke accounting rules. But critics are asking one very tough question: Was GE's great performance under Welch too good to be true?

Welch, of course, says absolutely not: "GE has a multitude of businesses, it has strong cash flow, it has enormous productivity." Many who know the company well, like Sankey (who recommends the stock to his clients), agree. Sankey notes that quarterly growth in GE's cash flow from operations excluding progress collections, has closely tracked its net income over the past three years. (Progress collections are installment payments that GE gets on gas turbines and jet engines. Because this number fluctuates widely, analysts and GE both prefer to exclude it when analyzing cash flow or comparing it with earnings.)

That's comforting because cash flow is widely perceived to be the hardest number in the financial statement to monkey with. If cash is growing at a comparable rate to net income, it's a sign that the net income number hasn't been fudged. "In the annual report, there is a chart that shows GE expanding earnings over economic cycles between 10% and 17% since 1979. No down years, no big write-offs," Sankey says. "That kind of performance reflects business management, not accounting fiction."

The balance sheet also stacks up. GE is one of only eight companies in the U.S. with a triple-A debt rating, a grade it's had for 21 years. Thanks to its industrial operations, which carry negligible debt, it has been able to comfortably handle the debt carried by its finance arm, GE Capital. Concerns that it was overly dependent on short-term commercial paper have been addressed by issuing longer-term obligations, including an $11 billion bond offering in March. An Enron-style meltdown couldn't be less likely.

But in today's market, 20 years of nonstop growth seems more a cause for suspicion than celebration. Partly, GE is suffering from a more critical approach to valuing all companies' earnings. For years, General Electric has, along with other industrial giants like IBM and Lucent Technologies, benefited from the combination of an overfunded pension plan and a bull market. The result: a noncash earnings booster called pension income. In 1999, GE gained $1.4 billion in pension income, or 16% of its operating earnings. No one minded that boost back then, and there's nothing underhanded or illegal about the accounting, but these days, when quality is an issue, noncash earnings look bad.

In addition to gains from accounting wrinkles, GE has also benefited from rules that have kept its expenses low. As a big advocate of pay for performance, Welch transformed GE into a large issuer of stock options. Because stock options are not expensed as cash compensation is, this too resulted in savings of hundreds of millions of dollars and, by some measures, inflated income.

This isn't the first time GE has come in for criticism of its accounting. In general, though, the company has been singled out far more often for its smart management, financial discipline--and its ability to turn accounting and tax rules to its advantage. "Shorts and skeptics for years were ignored. They were backwater guys, nobody was particularly paying attention," says Lehman Brothers Inc. accounting expert Robert Willens.

But since Enron, "these guys are the oracles. These are the people everyone's listening to."

GE's stock price makes that clear. On Apr. 15, GE fell to a six-month low after a story appeared in *The New York Times* questioning the quality of its earnings in the first quarter. In late 1999, the heyday of Welch, GE stock traded at a price-to-earnings multiple of 48, well in excess of the Standard & Poor's 500-stock index's p-e of 33. Today, that's flipped, with GE trading at a discount to the S&P 500.

This is despite the fact that over the same period, GE's earnings per share have grown much faster than the S&P 500's. In that, accounting consultant Thornton L. O'Glove sees a sensible reconsideration of the sustainability of GE's earnings and the value of contributors like pension income, which do not generate cash. "The market's peeling off layers of earnings now," he says. "[Investors] are asking `Why would I give a high multiple for a paper item that doesn't even impact cash?'"

That's a question Jack Welch never had to face.

By Nanette Byrnes

With Frederick F. Jespersen and Diane Brady in New York

(2)

GE's Jeff Immelt: His Own Man

Is there room for improvement at General Electric after Jack Welch? The incoming CEO thinks so

Jeffrey R. Immelt is sitting in a company boardroom wearing a crisp dark suit. Problem is, he donned the tie only to meet with top brass from Wal-Mart Stores Inc., but they all dressed down to meet the usually casual executive. And he couldn't meet in his new corner office. It's full of workers removing 20 years of John F. Welch's stuff. But Immelt does not look the least bit bothered, though he's just days away from taking over the $130 billion-a-year General Electric Co. from the legendary Welch. Instead, as he leans back in his chair downing pretzels and Diet Coke, he's got the easy air of someone who takes success for granted. "I've never measured my self-worth by whether or not I got this job," he says.

Heroic words for someone who's following the most praised CEO of his generation. No one had to tell this 6-foot, 4-inch college jock that he has big shoes to fill when Welch steps down on Sept. 7. The outgoing chief may barely reach to the new CEO's shoulders, but there's little doubt that Welch has been the Michael Jordan of American business execs -- even with GE's failed $45-billion takeover of Honeywell International Inc. and a government decision to make GE pay $460 million to clean up PCBs in the Hudson River.

Shareholders loved him. Insiders often feared him. But Immelt doesn't see himself as replacing Jack. He's here to run General Electric, and, frankly, he thinks the world's most valuable company has lots of room to improve -- by using technology better, getting closer to customers, diversifying its mix of businesses, and reducing the glut of white guys at the top.

"COMPLETELY DIFFERENT." In fact, the new chairman and chief executive is plotting GE's future with the confidence of a seasoned veteran. Immelt, 45, promises to deliver consistent earnings growth through the ugliest downturn in years -- although he admits that if the economy gets worse, "there are scenarios in which GE earnings [growth] would be very tough." He's intent on speeding up the spread of technology throughout the company and turning the Research & Development Center into an intellectual hothouse.

He wants to overhaul GE's relationship with its customers. He's planning to make major acquisitions in strong units such as medical systems, power systems, and aircraft engines while downplaying the company's slower-growing divisions -- but brushing aside rumors that he'll kick them off the island. In short, he promises a GE that looks "completely different in three or four years," but he doesn't need a Next Big Thing to do it.

Meeting Jeff Immelt, there's a sense that this is a guy who wakes up after his five hours of sleep, looks in the mirror and says, "Damn, you're good." It's confidence, not hubris. If anything, he shows an interest in others that could put Dale Carnegie to shame. This isn't a scrappy, stuttering kid from outside Boston with something to prove, like Welch. Winning is part of Immelt's life script. He's the star athlete, the Ivy Leaguer, the fraternity president, a guy so likeable and so decent that Dartmouth College gave him an award for character -- a distinction that Immelt jokes was given to whoever could chug the most beer.

"NO BOWING." He even laughs that seven years ago Welch threatened to give him the boot if he didn't get prices up at the plastics unit where he was running half the business. He did, he says, and the experience made him only stronger. So does Welch intimidate him? Please. He loves the man. Says GE Director Kenneth Langone, co-founder of Home Depot Inc.: "There's no bowing in that relationship."

There's also no doubt that after nine months of helping run GE as chairman-elect while Welch delayed his retirement to handle the Honeywell deal, the two men have different management styles. Where Welch poked, prodded, and deployed his troops as if they were heading off to war, Immelt cheers them on as if they're the home team before a big game. "There was a bit of that fear factor with Jack," says David L. Calhoun, CEO and president of GE Aircraft Engines. Another senior manager is blunt: "When Jack calls, you shiver. When Jeff calls, you smile."

Many GE types revered Chairman Jack. They adore Chairman Jeff. He's the dude in the next dorm room. The guy who will carry one of your ankle weights if you carry the other, as he did for former colleague and neighbor Bob Gariano as long as the puffing executive agreed to finish their morning jog. GE Director Shelly Lazarus, chairwoman and CEO of Ogilvy & Mather Worldwide, uses terms such as "self-effacing," "great humanity," and "quiet strength" to describe the new leader. "Jeff doesn't use the I-word hardly at all," she says, instead it's "we" and "the team." Had Welch staged a beauty contest instead of a horse race for the top spot, Immelt would have come away with Mr. Congeniality at the very least.

TOO SOFT? The question, of course, is whether a nice guy can deliver results. For all of the grumbling about Welch's blistering in-your-face manner, it was clear to every GE employee that you put up or you perished on the career ladder. Strike that. You were out on your ass. Some observers fret that Jeff may be too nice to run a far-flung empire like GE. When introducing Immelt as the new CEO of the medical-systems unit almost five years ago, Welch even joked that he was soft. Immelt then proceeded to boost sales at the unit from $4 billion to $6 billion in his first two years through aggressive acquisitions, increased customer service, and pushing his top people to produce better results.

Yoshiaki Fujimori, who managed the unit's Asia region under Immelt and now heads GE Plastics, argues that his boss's manner can be deceiving. "He sounds like a nice guy, and weaker people might think that means they don't have to deliver as much. That's wrong."

Still, Immelt is the very soul of consideration -- going out of his way, for example, to be decent to GE's least-sexy units. Appliances and lighting are two old-line businesses whose growth tends to lumber along in the low single digits behind higher-margin, service-intensive siblings such as power systems, medical systems, and aircraft engines. Analysts like to debate which one is likely to be dumped first. Even Welch said he tried to sell appliances at one point. Immelt will say only that no more businesses will be added to those units, and he praises them as good places to generate cash, train people, and build the brand. He won't even admit that they're lower on the priority list.

INDUSTRIAL DEALS? It's like trying to pick between children, he says: He loves them all. Immelt, however, knows better than most that some kids rise to the top. Take GE Capital, the roaring financial-services unit that now accounts for 40% of overall earnings and an even higher portion of revenue. Left unchecked, it could easily overtake the manufacturing side, making GE too reliant on often-volatile financial revenues and hurting its vaunted price-earnings multiple. As Keith S. Sherin, GE's chief financial officer, notes: "If it starts to deliver over 50% of our earnings, that might have an impact on our multiple." Aware of that, Immelt says big industrial acquisitions will help him keep the capital unit to under 45% of GE earnings for at least the next three years.

Then again, the multiple isn't looking so stellar these days. GE's stock is down almost one-third from its 52-week high, to about $41, even as the company continues to churn out yet more quarters of 15% earnings growth at a time when many rivals have tanked. That's still roughly 30 times earnings, down from 51, while financial institutions tend to trade around 20 times earnings. But is it a reflection on Immelt that the so-called Welch premium doesn't seem to be boosting the stock anymore? He won't speculate. Hey, the world will soon see how Jeff Immelt makes his mark.

His priority is people, and the ones who don't get enough attention from GE, in his view, are the customers. He has spent the past nine months crisscrossing the globe to connect with key clients. He's passionate about the big ones, the little ones, the ones that got away. It's enough to make a guy known for knit shirts and no socks dig out a tie. What bowled over Delta Air Lines Inc. Chairman Leo F. Mullin wasn't Immelt's offer to fly down for dinner, something Welch never did. It was getting phoned during Delta's recent labor woes. "He just called to say he thought I was doing well," marvels Mullin. "That meant a lot to me."

DIVERSITY DRIVE. Immelt wants that personal touch to permeate GE's sales force. On the best days, he says, the salespeople now spend 30% of their time in front of the customer. Under Immelt, they'll be freed up to devote 70% or 80% of their days to customers, anticipating their needs and making sure that GE makes them money. GE now gets 41% of its sales outside the U.S., and Immelt believes that to get to the customers, GE must become more like them -- especially in the top ranks. That means more Chinese, more Indians, more blacks, more women. In short, not just white men.

Diversity, in fact, is where many think Immelt may make his greatest immediate impact. Fujimori of Japan is the first foreign national to head a GE unit, and in a recent speech in Tokyo, Immelt promised there'll be "many more Fujis to come." He says he was "haunted" by a newspaper article that ran with pictures of GE's senior staff. Today, of 31 top executives, there is one black man and not a single female.

Immelt, who moved quickly to diversify GE Medical Systems, promises to do the same with the rest of GE. He thinks that it will be easy, noting that women and minorities at lower levels now run GE businesses reaping $30 billion in annual sales. The key is to give them opportunities to rise to the top ranks -- something that rarely seemed to happen during Welch's era.

Internally, Immelt is also on a drive to enlist his fiercely competitive colleagues on his side. He has brought in a friend, Dallas-based management guru Ram Charan, to work with him in canvassing General Electric's elite and consolidating their support. As Immelt explains, the transition is a time when such executives need to be engaged. "That group of leaders can't think this window opened and closed without their chance to have a voice, to shape the future, to be involved." And why Charan? "One thing I get with Ram is purity; he doesn't filter it," says Immelt, all too aware that people like to treat the top guy with kid gloves.

ABSOLUTE STANDARDS. One message that he's keen to broadcast both inside and outside GE is that, like Welch, he will be skeptical and digging and tough when the times demand. In his view, the beauty of GE is consequence. Good is good, and bad is bad. Standards are absolute. Effort is encouraged, but results are what count. Anyone who doesn't deliver is out. He wants to make the place leaner and meaner -- although he won't say whether that means mass layoffs like those that earned Welch his much-hated title of Neutron Jack.

At the very least, Immelt has been spared the task of cutting tens of thousands of jobs after a Honeywell acquisition. Nixed in July by the European Commission, the merger could have been Welch's swan song and Immelt's biggest headache. He claims to be deeply disappointed by the EC's decision, although he says "in a place like this, the disappointment lasts seven seconds." He would like to snap up some choice cuts of the company should Honeywell Chairman and CEO Lawrence Bossidy, a GE alum, decide to slice and dice it for sale.

For the time being, though, Immelt is simply happy to pick up where his celebrated boss left off.

The Genius of Welch, Immelt argues, was not so much how he pushed himself as how he pushed others toward new heights of excellence. Immelt calls General Electric a bunch of ordinary people who, together, have done extraordinary things. And the reverence for Jack is "not because we're all psychos and weirdos and drinking the Kool-Aid. It's because a lot of us never thought we would do this." Today, Immelt must keep the fire going in a tough economic climate. Maybe now, Mr. Congeniality will really bare his teeth.