The transcending point for creating sustainable business excellence – Sigma

How do we differentiate a truly great company from a good company? Most often, our judgments are based on its quarterly earnings and a few ratios. Frequently, we get lost in mediocrity and fail to look beyond these numbers. In the short term, these numbers may make a company look mediocre or excellent, quarter on quarter.

But to go from excellence to true greatness requires a transcending point. It takes more than achieving certain numbers every few quarters or in the short term to make you great. True greatness comes from winning consistently quarter on quarter, and imbibing a culture of results and not reasons.

Take the example of Michael Jordan and Usain Bolt. The all-time great basketball champion, Michael Jordan, may not have won every match but when he set foot on the field, the world believed he would give a stellar performance. Similarly, the world's fastest man, Usain Bolt, did not win every race but is remembered for his consistent wins. In both cases, the consistency of wins overshadows the loss of a few matches or races. This is true greatness.

If we compare this to a company with a top quartile RoE, 18-20% can earn you the stamp of excellence. However, to achieve true greatness a company has to get it right quarter on quarter and year after year. This leaves no room for blaming externalities. The market will start to expect the best out of you if you do this consistently. Unsurprisingly, the results of these expectations get reflected in the value the market attaches to your business.

This transcending point is 'Sigma', which means minimizing the variability of returns over your mean return. An average RoE of 20% can be achieved under various circumstances. The RoE can fluctuate between 18-22%, 10-30%, 0-40% or from minus 10-50%. Which one are you? A truly great company will have a very consistent Sigma, with one goal—maximizing shareholders' wealth and high RoE.

How does one ensure a minimum Sigma? Very simple. Concentrate on your risks and downsides. It is widely believed that Risk Management focuses on threats and failures. Contrary to this, we believe that it is an important enabler in accelerating a company's growth, and focuses on opportunities and successes. Picture this. On an expressway, there are two roads—one with guard rails and one without them. Which one will enable you to drive faster, more efficiently and with the least probability of an accident? Similarly, in any company, identifying and managing your Risk Framework, and setting guard rails around them helps the company to grow fearlessly without accidents.

For risk to be an enabler of business, companies need to clearly structure their Risk Appetite Statement, identify risk hotspots and define early warning signals. For NBFCs, the clearer guidelines facilitate better management of four types of risks: portfolio, liquidity, operational and credit. For example, early warning signals can help manage portfolio risk more efficiently while tight buffers on the liability side can help tackle liquidity risks. In effect, you are forced to react promptly when you notice any of these. In the long run, a stronger risk management system makes the company more resilient.

A company becomes great when it maximizes shareholders' wealth. This is made possible with the trinity of high earnings, high growth and low sigma.