"Well I think I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it."

CHARLIE MUNGER.

Warren Buffett's partner and Vice Chairman of Berkshire Hathaway since 1978

Wells Fargo has been and will probably be a great company again. Over the decades, it has outperformed nearly every other major bank on almost every important financial measure. They have also done a better job than most in integrating their acquisitions, growing organically, building a strong and disciplined culture, and preparing for and weathering financial ups and downs.



So how could they have gone so wrong?

- ~2 million forced/fraudulent accounts
- Public embarrassment and breach of trust with customers
- 5,300 employees fired
- \$185 million fine
- \$41 million of CEO compensation rescinded

The answer is simple: **Incentives work - You get what you pay for, even when you are sorry.**We see it all the time.

Another Sad Banking Example

15 years ago, a few of Vici's partners were working with another large and highly successful financial institution. It led the industry in ROE and was among the first to shift from interest-based businesses toward fee-based businesses. One of those fee-based businesses involved processing tax returns and depositing checks for the Internal Revenue Service. It was a tidy, profitable business for them. Until it all blew up.

The team processing the returns and checks was paid on "piece work."

They also had daily quotas. You can easily imagine how it all may have started...

- "Boss, it's my son's ballgame this afternoon. Can I sneak out early and catch up tomorrow?"
- The next morning after the victory pizza party, the employee doesn't make it in early.
- Others try to help him catch up, but they have their own quotas.
- · Daily quotas keep going up.
- Pretty soon everyone is falling behind.
- Eventually, they shove 80,000 tax returns and checks into drawers and shredders.

Needless to say, this did not end well. There were dire consequences for some, the bank was embarrassed, and they lost the business forever.

VICI (ve'-che): OVERCOME, EXCEL, WIN, SURPASS, MASTER

A More Common Example

Several years ago, ViciPartners worked with a medical device company that was losing money (negative 5% in EBIT margins). A few months in, we had helped them get back to break even - which is mathematically convenient for the rest of the story.

Like many companies, they compensated their sales force on revenue with a small kicker for higher gross margins. Our conversation with the Sales VP went like this:

"Bill, how much do you make on your average sale?"

"Mark, I know you think we need to do better, but 35-45 gross margins are pretty good!"

"Bill, how much does the company make?"

"Nothing..."

"So how much does your average sale make?"

It took "Bill" two weeks to internalize the answer - his average sale made the company no money. This was hard news to take in, but the story ends well. We talked again:

"What are the odds that each of your sales makes exactly no money?"

"That would be impossible."

"Yes it would. What is the simplest way to find out what makes money and what loses money - and then decide what to do about it?"

In the following weeks, we helped **the sales team** develop simple net profitability formulas and test the net profitability of products, transactions, customers and channels in sample batches.

Key Point #1. Unless the sales team understands what is/isn't profitable, buys in and sees how their incentives help them do the right thing for the company, nothing will really change. But if they do, all things are possible.

Key Point #2. Solid analytics is a modern-day requirement for making complex trade-offs with quick-changing competitive dynamics. But the key realizations that change sales people's behavior needs to be simple enough to fit on a single sheet of paper. The more complex the "black box", the less sales people will believe it. And the more often they might just be right.

Our medical device client's sales team and senior management ultimately made a lot of discoveries and changes. Here are a few illustrations:

DISCOVERIES	CHANGES
• All orders < \$250 lost an average of \$50	 No Commissions and handling charges for orders \$250 — leading to bundling of orders
Sales discounts were offered all the time	Sharing of "discount pain" between company and commissions
• Capital products were net profitable; 3rd-party supplies were net unprofitable	Increased commissions & training for capital productsReduce commissions on supplies
High costs of transaction processing	Improve online sales portalDirected customers and provided incentives to purchase online

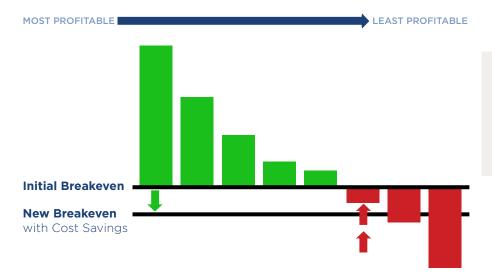
Circling Back to Wells...

Interestingly, Wells Fargo was one of the early pioneers in driving the net profitability of retail banking customers. They even went so far as to shut down some teller windows on Friday afternoons when low-balance account holders tended to come in. Tellers walked the growing lines and asked customers if they would like to learn how to use the ATM.

They knew what was profitable and what wasn't. Then they created the right processes, pricing and incentives to optimize each segment of their customers, transactions, etc.

TYPICAL PROFIT DISTRIBUTION

Transactions, Products, Vendors, Customers, Channels



Example: Wells Fargo (circa 1998)

- ~15% of Deposit Customers Unprofitable
- Started Minimum Deposit, Check Fees
- Trained Customers to Use ATMs
- Charged a Fee for Late Night Calls
- Shifted to Electronic Statements
- Let Their Still-unprofitable Customers go to Other Banks
- Match Price to Value/Cost and Vice Versa
- Incentives for Customer Behavior
- Incentives for Associates
- "Let Go" of Worst Accounts

Unfortunately, at some point they lost perspective and control of their incentive programs. Predictably, things went bad.

I predict they will correct course (as all companies can), and lead out again.

Lessons Learned

- Help your people (especially your sales teams) understand your net profitability drivers
- Re-engineer processes, renegotiate and price to value
- Be willing to "let go" of your worst accounts, knowing it will make your competitors lose money
- Invest to grow what you know is net profitable
- · Align incentives with "what you really want to have happen" because incentives WILL work

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ViciPartners specializes in growing earnings through execution – bringing a proven system to help companies tap into and build the capabilities of their own people. Vici aligns its incentives with results, typically generating over 300 basis points to operating margins. Mark Crockett is a partner of Vici. Please feel free contact him at mcrockett@vicipartners.com or 801-428-8231.