

Retaining the Spirit of an Emerging Company At

The MathWorks, Inc.

The software industry is dynamic and continually undergoing change. If an organization is successful in this industry, it grows and matures and may lose its edge. The factors that lead to success at one stage of growth often form the seeds of the organization's demise in later stages. The challenge of growth in this dynamic marketplace is being addressed by The MathWorks, Inc., in unique and important ways.

Company Background

The MathWorks was founded in 1984 to address a need among engineers and scientists for a more powerful computing environment than was available with FORTRAN, the then-popular programming language. Founders Jack Little, the current president of The MathWorks, and Cleve Moler, the current chief scientist, were experts in mathematics, engineering, and computer science, they were also driven to start a new business. They created MATLAB, a high-performance technical software environment with a comprehensive set of functions for computations and graphics. The products have been used by companies for the design of cars and air traffic systems, for medical research, and as education tools for scientists. The MathWorks has become the world's leading provider of tools for engineering and scientific professionals.

The company has grown to more than 450 people and has been profitable every year since its inception. It is privately held and does not depend on venture-capital funding. Growth has been financed through strong cash flow management. This has given the company a unique ability to focus on customers, employees, and the products that will retain its market leadership. It does not need to produce a return on investment (ROI) for external constituencies; it does need to remain profitable in order to support growth plans and investments. Consequently, the firm has been able to establish a culture that is driven to serve the needs of a complex marketplace and, in turn, make an impact on its customers' ability to use technology in ways that have never been applied before.

One of the important hallmarks of The MathWorks has been its commitment to keeping people involved and dedicated to the success of the company. This philosophy is embedded in many aspects of the organization, from recruitment and selection, to work assignments and structures, to communication about the company and its actions in the marketplace. Employees are kept highly informed and involved in every aspect of the company's operations. This has led to a responsiveness and continual process of change and development seldom experienced by established companies.

One of Jack Little's common refrains is, "If we're happy and motivated and doing our job, the customer is going to be happy." This commitment to an informal, customer-oriented, fun place to work has shaped the firm's culture. The structure is dynamic, and

the company favors cross-functional teams. All levels of management are actively engaged in promoting new ideas and methods both to improve products and services delivered to customers and to reduce costs. These actions are reinforced by the company's compensation systems as well.

Building Shared Rewards

One of the most powerful reward systems in the company is the Stakeholder Program. This is an incentive program where all employees share in the company's financial performance. It has changed and evolved over time and continues to develop as the organization changes.

The precursor of the Stakeholder Program was started as a year-end bonus, profit-sharing type program. The payouts, while based on performance, were made on a discretionary basis by the senior management team. As the firm grew, the correlation between the performance of an individual and the amount of the bonus payout was not well understood. The program began to be seen as a holiday bonus or entitlement program that was nice to have but did not reflect individual or company performance.

The executive team, lead by Jeanne O'Keefe, the chief financial officer, researched alternatives to change the program. The executives realized that it was important for people to share in the performance of the company and to see how their own contributions made an impact. They considered performance-based stock options, stock appreciation rights, and employee stock ownership programs. Each one of these initiatives seemed to increase dysfunctional pressures on the organization or management's decisions.

The executive team decided not to use stock-related programs because it wanted The MathWorks to remain a privately held company. While one could establish an "internal market" for the private stock in these programs, the greatest gain to individuals would come when the company did an initial public offering and went public. The stock-related programs would place pressure on management to take the company public and to generate capital in the external markets to support the compensation payouts. The executives were also concerned that it would take considerable time to generate sufficient payout under an equity-based plan, and they wanted the incentive plan to have a more immediate impact on behaviors.

Developing a New Approach

To that end, they developed a new approach called the Stakeholder Program. The program is structured to pay out each quarter with no holdback for annual performance. There are three factors that determine payout:

1. The profitability of the company (net operating income before taxes)
2. The individual's current salary

3. The performance rating of the individual

The payout is determined by the following steps:

1. Of the company's profits, 10% is set aside and paid out each quarter for the Stakeholder Program pool. While the quarters vary in profitability, the pool varies as well. This communicates to all staff members that there are cycles to the business and their payouts will vary accordingly. Furthermore, if there is a large investment or expenditure during a particular quarter, there will be effects on the payouts, but these actions should lead to increased payouts in subsequent quarters, thereby promoting a longer time horizon.
2. A share of the pool is determined for each individual based on the percentage of one's salary to the total payroll of all participants (i.e., eligible employees). As the number of people in the firm grows, the percentage share of any one will be reduced. Thus, individuals that are added to staff need to make a contribution to the company in growing its profitability. An individual must be with the company for one and a half years to receive a full vested interest in the program.
3. The share that individuals receive is "modified" by their performance rating. The following are the ratings used by the company: Outstanding, Excellent, Very good, Meets requirements, Needs improvement. Each rating is assigned a weighting factor from 0.5 to 2.5.
4. The payout is then determined by combining the modified amounts of all stakeholders and calculating each individual's percentage share. This percentage is applied to the pool dollars and the amount of the payout is determined.
5. Each manager gives out the payout checks personally. Some groups meet as a team to discuss overall results and then discuss the achievements of each individual during one-on-one sessions; other managers meet one-on-one with each staff member. As a Company, there is always excitement the day the stakeholder payouts are made.

Integrating Pay and Performance Reviews

The performance review process is done by managers and continues to develop and change as the organization becomes more complex. The evaluations are based on a set of performance indicators that reflect the functional area and/or project team in which the individuals work. The performance indicators tend to be based on specific objectives or technical contributions. In some cases, units have developed team-based performance plans, and all members on the team have input to an individual's performance rating. Furthermore, managers review the evaluations of their people annually with a peer group of managers. This is done in a discussion session with the objective to increase the quality and reliability of the assessment. Frequently, peer managers push back on a

manager who either is overly harsh or generous in the performance ratings. Managers need to correlate their unit's performance with ratings of the individuals within the unit. This process enables the distribution of ratings to be achieved without reverting to forced ranking controls.

Recently, The MathWorks has begun a pilot project to institute a multirater assessment process to expand the information on which the stakeholder performance is judged. This was done because of a successful experience with using this feedback process to assess the performance of the executive team. The feedback made a powerful influence on how executives provide leadership, and the factors were adopted for a broader application in The MathWorks. The results will be integrated into the performance ratings of individuals and should be reflected in their stakeholder payouts.

This program has become an integral part of the way people are managed and rewarded at The MathWorks. Although the structure is relatively simple, the supporting actions require concentrated effort. The company has gained an important tool that has contributed greatly to growth and profitability. As stated earlier, the firm has achieved a steady, above-market-average growth for most years since its inception. It has continued to achieve impressive net income results, which has enabled The MathWorks to finance growth and provide attractive payouts to the stakeholders.

The Impact of the Stakeholder Program

From an organizational perspective, this program has achieved the following important outcomes:

1. *People think and act like stakeholders in the company.* People receive monthly updates on the financial progress of the company. Because this information affects their payouts, employees have become keenly interested in the results. This timely information has led many to examine decisions and to exert peer pressure to control costs or increase revenues. Often people are heard asking whether a given action is the "stakeholder-friendly thing to do."
2. *The program shares the profits of the company with those who helped create them.* From the beginning, the executives wanted to create an environment where people shared in the fortunes of the organization. They act to support this principle. However, they did not want to create pressures to take the company public or create ownership rivalries. Thus, the program enables people to be part of the organization, add to its competitiveness, and share in the results.
3. *Performance is rewarded in meaningful ways.* The MathWorks executives realized that a merit pay program alone simply does not always have sufficient impact on people to make a difference. The Stakeholder Program provides a direct link between the performance of individuals, the financial performance of

the company, and one's payouts. It has established a strong link between performance and rewards.

4. *The program requires significant management attention, which is one of the most important activities in which managers are engaged.* Setting performance targets, tracking performance, making product and process improvements, and communicating progress have become important to building a competitive organization. By requiring monthly reports on the progress of the business, and reviewing individual performance on a frequent basis, the culture of the organization has become highly performance oriented. The factors encourage people to focus on customers, market leadership, new product development, and cost management. Everyone is engaged. A major management challenge is to help people see how their actions contribute to or detract from the company's ability to be competitive in the market and effective with customers. They have created an alignment that many organizations would envy.

The Stakeholder Program is not perfect and will most likely undergo changes as the organization becomes larger and more complex. It needs to retain the ability to encourage cross-functional collaboration while providing people with the line-of-sight between their actions and desired results. As the organization grows, the number of participants will grow. The pressure on profits will increase to sustain the desired payout levels. For now, however, the style and nature of The MathWorks management is reflected by the success of this program and the company. An emerging business needs to keep its spirit alive and keep people engaged in the process of growth. This is a continual struggle at The MathWorks, and they have many of the tools to make it worthwhile.