
Principle Based Management™



**I WANT YOU
TO BE ALL THAT
YOU CAN BE.**

CHARLES KOCH

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INTRODUCTION

The remarkable success of Koch and its employees has always been rooted in proven principles of human progress. The better we've understood and applied these principles, such as mutual benefit, comparative advantage and creative destruction, the more we've prospered by benefiting others. This has been true for nearly 60 years, and our future success depends on continuing to improve our ability to do so. This booklet is designed to help each of us better understand and apply these principles for the benefit of the company, ourselves and all those with whom we interact.

THE NEED FOR A HEIGHTENED FOCUS ON PRINCIPLES IS WHY WE'VE DECIDED TO UPDATE KOCH'S VISION AND FRAMEWORK.

In that respect, this message is not so much an introduction as it is a reminder about the importance of proven principles. We all need to know how they have made us successful in the past and use that understanding to help improve how we apply them in the future. The need for a heightened focus on principles is why we've decided to update Koch's Vision and framework, as we last did in 2018.

But first, some perspective...

More than a decade ago, after many years of high performance, we began to recognize that we were falling behind. We weren't building new capabilities fast enough and many of our investments weren't perform-

ing as we hoped; thus, our returns were deteriorating. So, we began to address the problems; however, those efforts only brought about minor improvements, as we continued to operate in much the same way as in the past.

Around five years ago, we concluded that to truly change our performance we had to transform ourselves, starting with all of us in senior management. It also required taking our application of principles of human progress to a whole new level. So, in 2017, we made what I called at the time "important leadership changes" at the most senior levels of our company, dividing and resetting responsibilities by comparative advantage in order to become much more effective in "driving improvements and advances."

The following year we made some significant changes to Koch's Vision and Our Values (formerly Guiding Principles). For most employees, this was their first exposure to concepts such as virtuous cycles of mutual benefit, preferred partner, continual transformation (as opposed to continual improvement), self-actualization and stewardship. Soon after, we introduced the importance of headwinds and tailwinds. Together, these were keys to accelerating transformation across all of Koch.

I am happy to report that all our business groups quickly acted on these changes and began to transform, as did many of our capability groups and countless employees throughout Koch. The sum of these transformations

led to record results by a very wide margin, as well as building new capabilities that have greatly expanded our future opportunities.

The need for this transformation process is never-ending. If we allow it to stop, the forces of creative destruction and entropy will overwhelm us and we will fail. But if we dedicate ourselves to understanding and applying the principles of human progress to continually transform ourselves and our organizations, we can accomplish more and have better lives than we ever imagined.

ONE OF THE MOST IMPORTANT MEASURES OF SUCCESS FOR THESE EFFORTS WILL BE THE DEGREE OF YOUR OWN SELF-ACTUALIZATION.

That is why we have drawn on the learnings from the improvements we've made over the last five years to once again modify our framework and give it a new name: Principle Based Management™. We have also updated Koch's Vision to the same end.

We believe this additional emphasis on principles will enable us to make our framework even more effective in empowering employees, capturing opportunities, identifying and closing gaps, and addressing headwinds and tailwinds. It will also help those outside Koch understand how and why we do what we do.

This booklet covers these changes and will be followed by stories of how and where principles have

been applied to greatly enhance our performance. You will see their power in transforming our companies, capabilities, investments and employees throughout Koch.

One of the most important measures of success for these efforts will be the degree of your own self-actualization. My goal is for you to more fully develop and apply your talents and passions so you can realize your potential and maximize your contributions to Koch's long-term success.

In other words, I want you to be all that you can be. That's not only the secret to success, it's the secret to a life of meaning.



Charles Koch

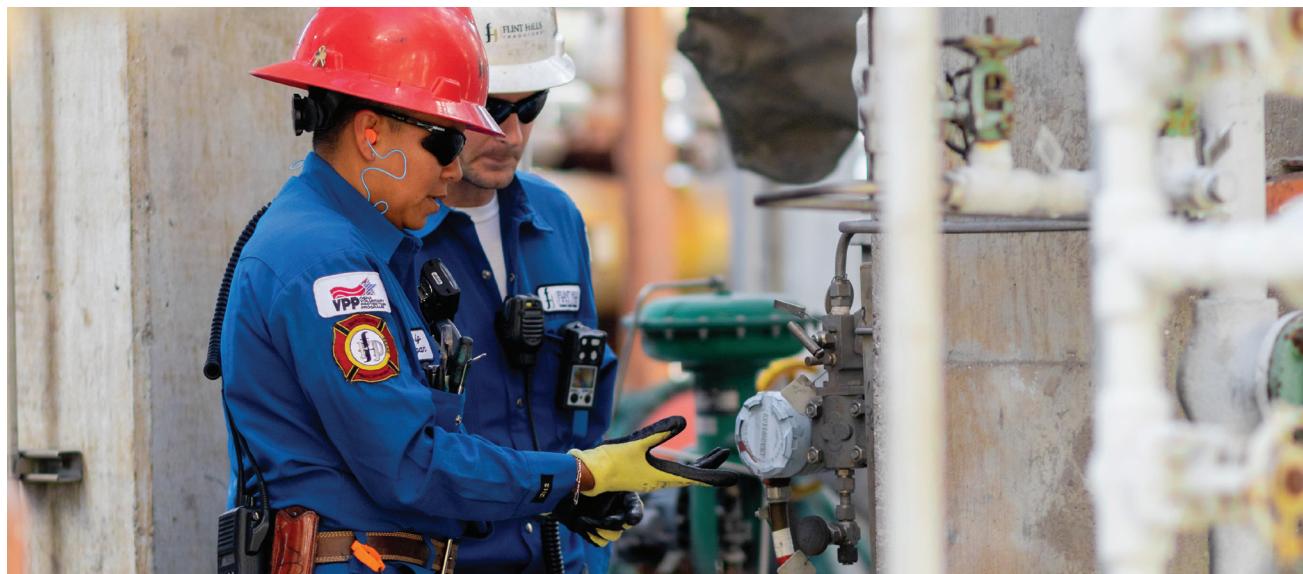


UPDATING OUR FRAMEWORK

Principle Based Management™ is a framework based on the principles of human progress that enables individuals and organizations to succeed long term by creating superior value for others. Our emphasis on principles of human progress is certainly not new. But today's world requires an even greater urgency and commitment to these principles, which, throughout history, have enabled individuals, organizations and societies to progress. When practiced and correctly applied, they promote peace, civility, opportunity, progress, fulfillment and business success. We have succeeded to the extent we have correctly applied them and failed when we haven't. They apply universally, whereas detailed rules and methods only work in specific applications under certain conditions and even then tend to stifle motivation and creativity. For us, principles of human progress provide the standard by which we evaluate everything.

This is why we are changing from Market-Based Management® to Principle Based Management™ – to put even more emphasis on these principles. It is not enough to simply understand principles of human progress. They are central to our whole approach to business, so we continually strive to learn how to better apply them.

Thus, we have revised the five dimensions to better enable each of us to identify and close the gaps between what we are accomplishing in our organizations and what we could be accomplishing if we were more fully applying this framework. Included in what follows are explanations of the changes, descriptions of each dimension and a list of applicable principles.



**The Five Dimensions of
Principle Based Management™**

VISION

VIRTUE AND TALENTS

KNOWLEDGE

COMPARATIVE ADVANTAGE

MOTIVATION

VISION

Description

Koch's success is dependent on empowered employees who apply principles of human progress. Each of us can contribute our abilities and knowledge to promote a culture that enables Koch to build the capabilities that create products and services benefiting others.

Such a spontaneous order comes about when each of us is in the right role and motivated to make the greatest contribution. Then, when the conditions are right, we can create virtuous cycles of mutual benefit by becoming a preferred partner and continually transforming. This involves pursuing opportunities where we can create superior value for customers who will reward us accordingly and exiting those assets and businesses where we can't.



WHEN THE CONDITIONS ARE RIGHT, WE CAN CREATE VIRTUOUS CYCLES OF MUTUAL BENEFIT BY BECOMING A PREFERRED PARTNER AND CONTINUALLY TRANSFORMING.

The focus on our long-term success also requires us to prioritize the future rather than the current period. This long-term focus is a major reason we remain private and reinvest 90% of our earnings.

Applying key principles – such as risk-adjusted Net Present Value, return on scarce resources (capital, capabilities and people), headwinds and tailwinds – helps guide which products and businesses we are in, the capabilities we need to build, and where and how we invest.

Job one for supervisors at every level is to create an inclusive environment in which employees understand how to succeed by maximizing value creation in harmony with our principle-based framework.

What has changed

Our first dimension, Vision, has been built for many years on our belief about the role of business in society: to help people improve their lives by providing products and services they value more than their alternatives, and to do so responsibly while consuming fewer resources. When we accomplish this, we create good profit – profit that is a valid measure of the value we create in society.

We have also long emphasized the importance of continually improving to drive, rather than be a victim of, creative destruction. But in recent years, as the speed and magnitude of these changes accelerated, a heightened sense of urgency was required to not only improve but transform our performance.

This led our businesses and capability groups to apply the concept of headwinds and tailwinds to transform their ability to succeed in a variety of environments by modifying their visions and strategies, and building the required capabilities.

Headwinds exist for a product where its long-term opportunities and profitability are being seriously eroded by declining demand or a reduction in the barriers to entry. These winds can be generated by, among other things, competition from new technologies or products, unfavorable changes in consumer preferences or government interventions.

Tailwinds exist for a product where its long-term profitability has the potential to greatly increase. These winds can be generated by, among other things, new technologies, products or strategies, favorable changes in customer preferences or distortive government subsidies and mandates.

Wherever a headwind or tailwind exists it creates competitive forces in the opposite direction. The effects of headwinds are lessened by negative factors, such as those listed above, which deter new entrants, investments and innovations. The effects of tailwinds are lessened by stimulating a flood of new competitors, investments and innovation. The headwinds/tailwinds model we developed for entering or remaining in a business, based on whether we have or can build the right capabilities for whatever conditions exist, has been a major factor in our recent successes.

Other principles we have been emphasizing that have been particularly powerful in contributing to our improvements are:

- Empowering all employees to self-actualize
- The division of labor by comparative advantage
- Stewardship
- Mutual benefit and becoming a preferred partner

VISION

CONTINUED

HIGHLIGHTED PRINCIPLES

- + Principled Entrepreneurship™
- + Virtuous cycles of mutual benefit
- + Bottom-up vs. top-down
- + POV: headwinds and tailwinds
- + Capabilities
- + Stewardship
- + Innovation: identifying and closing gaps
- + Empowerment
- + Creative destruction
- + Options
- + Economic measures
- + Time preference
- + Satisfy unmet needs
- + Partner with those who share our vision and values, and have complementary capabilities
- + Overcoming entropy and bureaucracy
- + Contribution-motivated employees
- + Experimentation and experimental discovery

EACH OF US CAN
CONTRIBUTE OUR ABILITIES
AND KNOWLEDGE TO
PROMOTE A CULTURE THAT
ENABLES KOCH TO BUILD THE
CAPABILITIES THAT CREATE
PRODUCTS AND SERVICES
BENEFITING OTHERS.

VIRTUE AND TALENTS

Description

Each of us has a responsibility to live by Our Values. When we do, we have the opportunity to self-actualize and create our own personal virtuous cycles of mutual benefit.

Koch seeks employees who are contribution motivated, have a talent that will help us succeed and are committed to our framework. Such employees use a principle-based approach to help others succeed.

Contribution-motivated employees seek growth and challenge. They find meaning in work that utilizes their abilities, enabling them to realize their potential by creating value. They are fulfilled by this work, which they perform well in a spontaneous and creative way. They identify problems and seek solutions with an entrepreneurial mindset.

The responsibility of supervisors is to ensure each employee is in the right role, has the right responsibilities and the opportunity to self-actualize.

CONTRIBUTION-MOTIVATED EMPLOYEES SEEK GROWTH AND CHALLENGE.





What has changed

Our Values are a critical part of this dimension, which we have modified to help each of us more fully apply them.

We have also modified our approach to this dimension. When evaluating talents in the past, we focused on having the knowledge and skill needed to meet or exceed job expectations. We have found we get much better results when we design a role around a person's talents and passions. And we have increased our focus on hiring and retaining those who are con-

tribution motivated and have a talent that will help us succeed.

We have also clarified that a supervisor's most important responsibility is helping their employees self-actualize by respecting them as unique individuals, continually evaluating and adjusting their roles and responsibilities, and providing the kind of ongoing coaching and feedback that promotes learning, growth and development.

HIGHLIGHTED PRINCIPLES

- + Our Values
- + Self-actualize
- + Talents
- + Comparative advantage
- + Right role
- + Building trust
- + Bottom-up vs. top-down
- + Contribution motivated
- + Mutual benefit
- + Supervisor responsibilities

VIRTUE AND TALENTS

CONTINUED

Of all the proven principles of human progress, these eight are the foundational values of our culture and thus are among the most important for all of us to exemplify daily. They are an essential aspect of our Virtue and Talents dimension. They define who we are as an organization and are necessary for the long-term success of Koch and each of us.

Our Values	What has changed*
1. INTEGRITY Have the courage to always act with integrity. 2. STEWARDSHIP & COMPLIANCE Act with proper regard for the rights of others, especially regarding safety and the environment. Comply with all laws and regulations. Stop, think and ask.	Unchanged.
3. PRINCIPLED ENTREPRENEURSHIP™ Create virtuous cycles of mutual benefit by becoming a preferred partner of customers, employees, suppliers, communities and other core constituencies. Continually seek to identify and close the gaps between what you are and what you could be accomplishing if you were fully applying Principle Based Management™.	Clarified that our focus on safety and the environment is driven by our regard for the rights of others. Changed to focus on virtuous cycles of mutual benefit, closing gaps and applying Principle Based Management™.

*For a full description of each, see the 2018 Vision, Capabilities and Guiding Principles booklet.

4. TRANSFORMATION

Transform yourself and help the company and others to do the same. Develop the visions, strategies, capabilities, products and services that will enable us to satisfy unmet needs and create superior value.

Broadened to include helping others transform themselves.

5. KNOWLEDGE

Seek and acquire the best knowledge from any and all sources that will enable you to innovate and improve results. Share your knowledge proactively. Provide and solicit challenge consistently and respectfully.

Added that we need to seek as well as acquire the best knowledge and use it to innovate.

6. HUMILITY

Be humble, intellectually honest and deal with reality constructively. Develop an accurate sense of self-worth based on your strengths, limitations and contributions. Hold yourself and others accountable to these standards.

Unchanged.

7. RESPECT

Treat everyone with honesty, dignity, respect and sensitivity. Include and embrace different perspectives, experiences, aptitudes, knowledge and skills in order to leverage the power of diversity.

Broadened by adding the word include.

8. SELF-ACTUALIZE

Be all you can be. Identify, develop and apply your gifts and passions so you can best contribute in ways that are most meaningful to you. Be a lifelong learner.

Changed the name to clarify that self-actualizing is a never-ending process, not an end state. Also changed to describe the requirements for self-actualizing rather than the benefits.

KNOWLEDGE

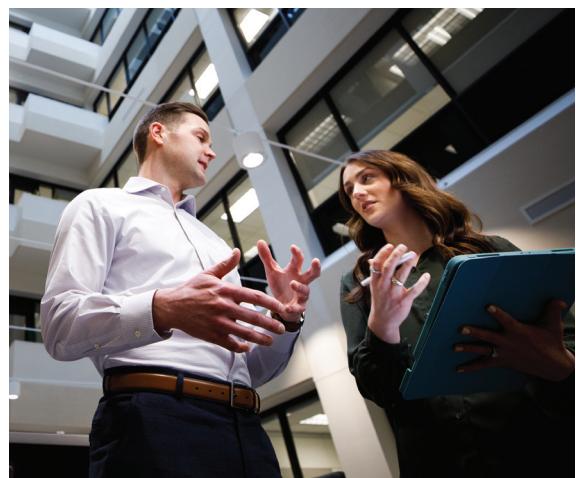
Description

Long-term success comes from having superior knowledge and a culture based on principles of human progress.

No matter how well we are doing today we can always do better. Thus, we constantly seek to identify and close gaps between how we are performing today and what is possible when we fully apply Principle Based Management™.

In our application of the Republic of Science principle, we all are focused on innovating where we have the ability and passion to make the greatest contribution by sharing knowledge and challenging one another. We strive to learn at an ever-increasing rate in order to succeed and thrive in a rapidly changing world. We learn and innovate through broad knowledge networks, well-designed experiments and reality-based measures that increase our rate of transformation in an environment where innovation and challenge are expected and rewarded.

WE STRIVE TO LEARN AT AN EVER-INCREASING RATE IN ORDER TO SUCCEED AND THRIVE IN A RAPIDLY CHANGING WORLD.



What has changed

What used to be called our Knowledge Processes dimension is now Knowledge alone. We want to emphasize an even stronger commitment to principles rather than processes, systems or tools. This dimension continues to highlight the need for all kinds of knowledge.

HIGHLIGHTED PRINCIPLES

- + Republic of Science
- + Personal knowledge vs. conceptual knowledge
- + Innovation: identifying and closing gaps
- + Measures
- + Benchmarking
- + Risk management
- + Openness
- + Scientific method and challenge
- + Economic thinking
- + Experimentation and experimental discovery
- + Marginal analysis

COMPARATIVE ADVANTAGE

Description

We succeed to the extent we apply the principle of division of labor by comparative advantage, resulting in superior application of individual abilities, cooperation and teamwork.

To maximize results, supervisors at every level continually revisit comparative advantages as team members, business conditions and opportunities change. Leaders apply comparative advantage across Koch, not just in their organization. They continually ensure everyone is in a role where they can best contribute, with the right responsibilities and decision rights, and receives feedback that helps them grow, develop and self-actualize.



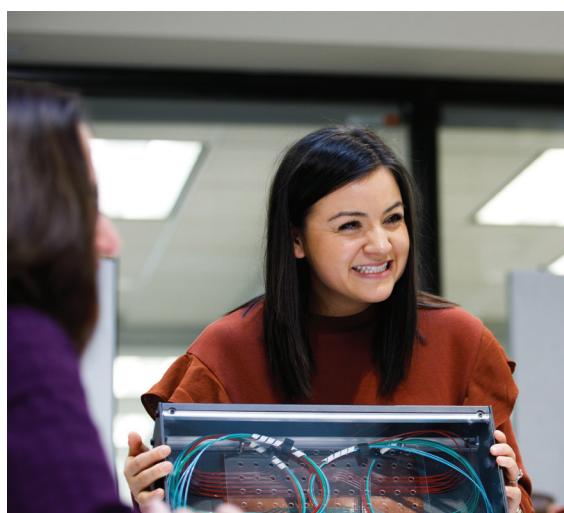
PEOPLE BECOME INCREASINGLY MOTIVATED AS THEY HAVE OPPORTUNITIES TO DEVELOP PERSONAL KNOWLEDGE IN THEIR ROLES AND EARN GREATER DECISION RIGHTS.

Authorities are dispersed according to each person's comparative advantage. They are not centralized or decentralized, rather, they flow to and from individuals based on the profitability and timeliness of decisions. People become increasingly motivated as they have opportunities to develop personal knowledge in their roles and earn greater decision rights.

Decision-makers seek input and challenge from those with diverse perspectives, experiences and knowledge who can contribute to better decisions.

What has changed

The name of this dimension has changed from Decision Rights, since the division of labor by comparative advantage is the principle that guides how we organize and how we allocate decision rights.



HIGHLIGHTED PRINCIPLES

- + Division of labor by comparative advantage
- + Multiple intelligences
- + Personal knowledge
- + Partnerships
- + Property rights
- + Cooperation and teamwork
- + Overcoming entropy and bureaucracy
- + Accountability
- + Principled Entrepreneurship™
- + Diversity
- + Stewardship
- + Principle-based vs. detailed-rule-based

MOTIVATION

Description

Koch succeeds to the extent everyone is motivated to develop and apply their abilities in harmony with our principle-based framework.

We seek to align the interests of all employees with what will be beneficial for them and the organization. This alignment provides roles, work, authorities and rewards that motivate the maximum contribution to their organization and ultimately to Koch's long-term success.

We provide rewards that motivate greater contributions and reinforce performance feedback. We recognize contributions that have built capabilities and have generated or will generate results – including past contributions that haven't been fully rewarded.

We don't penalize well-designed experiments that fail, because they create knowledge leading to better decisions.

**WE SEEK TO ALIGN
THE INTERESTS OF ALL
EMPLOYEES WITH WHAT
WILL BE BENEFICIAL
FOR THEM AND THE
ORGANIZATION.**



What has changed

We have changed the name of this dimension in recognition of the fact that motivating people to maximize their contribution to their organization and ultimately to Koch's long-term success requires much more than financial incentives.

To become fully motivated in this way, people also need: to have meaningful work that fits their talents and passions; to be treated fairly and with dignity and respect; to be given the opportunity to have some control over their activity and be creative; to be able to develop and grow and increasingly believe in themselves; and to become what they are capable of becoming.

Beneficial financial incentives reinforce these attributes by rewarding contributions to the long-term success of Koch. A primary responsibility of supervisors is to ensure employees understand how they earned their compensation and how to increase it.

HIGHLIGHTED PRINCIPLES

- + Contribution to Koch's long-term success
- + Contribution motivated
- + Synergy
- + Self-actualize
- + Alignment of incentives
- + Rewards, recognition and compensation
- + Requirements for human action
- + Subjective value

KOCH'S VISION

Our Vision is to succeed long term by applying proven principles of human progress to help people improve their lives.

This requires:

- + Building the capabilities that enable us to create value for others
- + Creating good profit long term by providing products and services customers value more than their alternatives, while consuming fewer resources
- + Building mutually beneficial relationships with all core constituencies
- + Consistently practicing stewardship and compliance, especially regarding safety and the environment

We continually transform our ability to realize these aspirations by:

- + Empowering all employees to self-actualize and realize their potential
- + Continually improving – no matter how well we are performing – given the accelerating rate of creative destruction
- + Understanding long-term headwinds and tailwinds, and creating the visions, strategies and capabilities that will enable us to achieve superior returns
- + Better applying all five dimensions of Principle Based Management™

By being principle based, empowering employees, becoming a preferred partner and continually transforming, we create virtuous cycles of mutual benefit. These not only maximize our contributions to others, and our results, they create opportunities for individual growth.

What has changed

We have revised our Vision to emphasize the factors that have been the biggest contributors to our recent successes.

These factors are:

- Creating superior value for others in a way that is mutually beneficial
- Empowering all employees to become contribution motivated, focus on their comparative advantage and self-actualize
- Better applying our principle-based framework
- Understanding headwinds and tailwinds, and effectively responding
- Continually improving in everything we do to differentiate ourselves and transform



WHAT NOW?

BY THEMSELVES, WORDS ON A PAGE OR A SCREEN DON'T CHANGE ANYTHING. BUT WHEN WE SEEK TO BETTER UNDERSTAND THE MEANING OF WHAT IS BEING SAID AND TO TRANSLATE THOSE WORDS INTO ACTION, WE CAN ACCOMPLISH GREAT THINGS.

Here are half a dozen suggestions for how you can immediately begin putting our new framework and Vision to work:

1 BELIEVE IN YOURSELF

You have talents, abilities, passions and interests, any or all of which may be used to benefit others as well as yourself. Focus your efforts on being the best that you can be. “Every person is, in part, his own project,” Maslow said, “and makes himself.”

4 BE OPEN

Lifelong learners open themselves to new ideas and ways of doing things. The willingness to learn from anyone who has something to teach us enhances the chance we will succeed — not just today but over a lifetime. To increase your contributions, seek the insights of others rather than relying only on your own opinions. Don’t complain without offering solutions.

2 SEEK MUTUAL BENEFIT

Honestly evaluate whatever value you are creating, then begin thinking about how you can become even more successful by benefiting others. No matter how good our intentions might be, if we are not creating value in a spirit of mutual benefit, we are missing the mark.

5 BUILD PERSONAL KNOWLEDGE

We succeed by converting our conceptual knowledge of the principles that constitute our framework into personal knowledge – into effective tools for solving problems and making discoveries. Personal knowledge is built by correct and frequent practice over time.

3 EMBRACE CHANGE

Creative destruction requires us to embrace change. It’s why however well we are doing, long-term success requires that we continually strive to do even better. Don’t resist something just because it isn’t what you prefer, or because it requires effort to learn how to make the change.

6 SEEK HELP

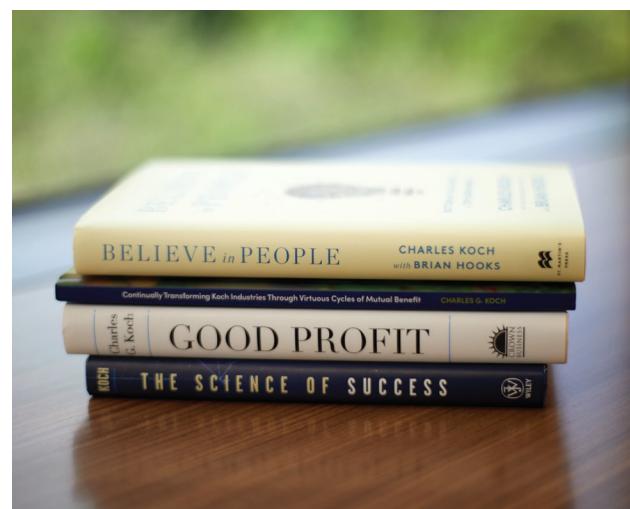
To develop the understanding of how to use principles to achieve results, seek help wherever you can find it: from supervisors, co-workers and others. Then, question and challenge, and try different ways to apply principles. Also, take advantage of the many online resources available.

RESOURCES

BOOKS

- Science of Success
- Good Profit
- Continually Transforming Koch Industries Through Virtuous Cycles of Mutual Benefit
- Believe in People

PrincipleBasedManagement.com



**TO MAKE THE GROWTH
CHOICE INSTEAD OF
THE FEAR CHOICE A
DOZEN TIMES A DAY IS
TO MOVE A DOZEN
TIMES A DAY TOWARDS
SELF-ACTUALIZATION.**

ABRAHAM MASLOW

**THE WILLINGNESS TO LEARN
FROM ANYONE WHO HAS
SOMETHING TO TEACH US
ENHANCES THE CHANCE WE
WILL SUCCEED – NOT JUST
TODAY BUT OVER A LIFETIME.**

CHARLES KOCH



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