

Is there a conflict between the pursuit of shareholder value and sustainable economic growth?

How the pursuit of shareholder value can achieve sustainable economic growth By Lucia Dore

The economy has become more competitive and more dynamic in recent years and to succeed in it companies must juggle a host of conflicting demands. They must find ways of cutting costs and operating more efficiently. They must respond swiftly to changing customer demands and technological change. They must focus on nurturing the wellbeing of their employees who, in this new “knowledge” economy, are now recognised as core assets. They must constantly innovate if they want to keep up with and stay ahead of the competition. They must also carry out socially responsible actions, which help to reinforce their corporate reputation and brand image.

As a consequence of companies trying to meet so many conflicting demands, however, traditional models and measures of company performance are being questioned, especially the shareholder value model. Is it valid in the current economic environment and will its use foster sustainable economic growth?

The purpose of this essay is to prove there is no conflict between the pursuit of shareholder value and sustainable economic growth. It will consider why the shareholder value philosophy has come under fire and why its basic premise — value creation — is misunderstood. It will also look at the alternatives to shareholder value and show why the pursuit of shareholder value is not only compatible with sustainable economic growth but is the best way to achieve it.

What do we mean by shareholder value and why has it come under fire?

Creating shareholder value is ultimately about value creation. It is about using assets — tangible and intangible — as efficiently and effectively as possible to create value for the owners of the company, the shareholders. In its simplest form, shareholder value means managing a publicly listed company to achieve enhanced share price performance and dividend growth. Dividend growth is only possible however if a company is managed for the long term, not the short. An unrelenting focus on interim and quarterly results, and on share price alone, will fail to meet these expectations. Share price is a poor indicator of a company’s underlying performance. It is highly volatile, heavily influenced by opinion, assumptions, and investor sentiment.

Yet time and again shareholder value and share price is confused. Take for example the comment by management consultant and author Allan Kennedy, in his book *The End of Shareholder Value*: “With futures mortgaged in pursuit of higher stock prices now and angry stakeholders demanding a bigger and bigger piece of the corporate pie, the prognosis for corporate success is quite glum. That, unfortunately, is the legacy on the

US business scene after less than two decades of obsession with maximising shareholder value.”¹¹ In fact this latter sentence should read, “obsession with maximising share price”.

But with short-term thinking now dominating the investment community it is hardly surprising that there is such confusion. The investment community is driven by the unrealistic expectations of investors, as well as by analysts who use accounting measures to determine the market value of a company rather than more sophisticated, and more accurate methods such as discounted cash flow analysis or economic profit.

If shareholder value is to be measured and comparisons made the following external measures are among those that can be used: total shareholder returns (TSR), market-to-book ratio and market value added (MVA). But since these measures are influenced by share price movements unrelated to the operating decisions of the company, internal measures must be used to set targets, plan and measure a company’s performance at a divisional level and to measure performance-related remuneration schemes. These internal measures include: discounted cash flow, cash flow return on investment, shareholder value added (SVA) (a variation of discounted cash flow), total business returns (TBR) and economic profit (EP), Stern Stewart’s economic value added (EVA), and Boston Consulting Group’s cash value added (CVA). All these metrics require an accurate estimate of the cost of capital either to use inherently in the measure or to compare against it.

The focus on share price means that some companies are choosing to use traditional accounting measures rather than those that measure shareholder value. These measures are: revenue growth, operating margins, price to earnings growth (PEG), earnings per share (EPS), return on investment (ROI), return on assets (ROA), return on capital employed (ROCE) and return on equity (ROE). Empirical evidence shows, however, that there is a poor correlation between these accounting measures and actual shareholder value.

And as companies become increasingly focused on quarterly results EPS and the very simple accounting standard EBITDA are favoured. But these do not measure long-term shareholder returns (TSR) and can be easily manipulated. EPS can be pushed to unrealistic and unsustainable levels, as we saw during the dot.com era.

During this time the use of discounted cash flow analysis was abandoned, amid cries that dotcoms represented a new paradigm and the old valuation tools must be discarded. This is why, according to Peter Clark and Stephen Neill in their book *Net Value*² that “there were often ‘stratospheric’ multiples, especially when PEG was used”.

They also say: “The theory is reasonable enough. Investor-shareholders should be willing to pay an extra premium for extraordinarily high revenue growth. So that if that particular

¹ Kennedy, A (2000) *The End of Shareholder Value (The Real Effects of the Shareholder Value Phenomenon and the Crisis it is Bringing to Business)*. Orion Business Books, London

² Clark, P.J & Neill S (2001) *Net Value (Valuing Dot-Com Companies — Uncovering the Reality Behind the Hype)*. Amacom, American Management Association

analyst's reasonable threshold is, say 2:1, that means that 100 times P/E might actually be described as reasonable if the annual revenue growth rate is more than 50%.

“The logic flaw in PEG is double-counting for growth, market price already reflects all factors relating to that company's worth, including the future expected rate of revenue growth and the probability that the expectation can be achieved.”

Enron and WorldCom, as well as Marconi in the UK and Vivendi in France highlighted how this short-term thinking and adoption of poor accounting techniques could ruin a company, although the immediate response from the media and public to these events is that they were a direct result of the pressure facing management to achieve ever-higher shareholder returns. In fact, the cause was the exact opposite: too *little* emphasis on shareholder value improvement, correctly defined

When the Enron collapse was investigated further, amid allegations of fraud and corruption, “financial engineering”(that is extraordinarily complicated and opaque off-balance sheet financial manipulations) was found to have played a significant part in maintaining the share price. Enron was so good at it in fact that its senior financial officer, Andrew Plaistow, was crowned Man of the Year by the once-influential *CFO Magazine*.

In reality, the way in which Enron was managed harks back to before the birth of the shareholder value movement. Take this quote by Kennedy: “Before the shareholder value movement moved to centre stage in the mid-1980s many companies were run by their managers as personal fiefdoms; they answered to no one regarding results.” Just like Enron.

Marconi is also an excellent example of the subversion of shareholder value, as Mark Goyder director at Tomorrow's Company points out in his paper *Lessons from Enron*. Writing about the CEO's response to the share price collapse — the share price fell to £7, from a high of £12, to 20p — he states that the value-destroying decision to put all the eggs in the telecom basket was not the biggest mistake. “The real failure was not cashing-in in time by finding someone else willing to take on this case. This is what is sometimes described as the ‘greater fool’ school of shareholder value: it doesn't matter how foolish your strategy. As long as you can find a greater fool to take it off your hands.”

Inappropriate remuneration and incentive structures and poor corporate governance practices also play an important part in the downfall of companies like Enron. In this instance, the incentive structures were at odds with the corporate philosophy — respect, integrity, communication and excellence. Employees were incentivised to boost the company's bottom line and ultimately the share price. “There were no rewards for saving the company from a potential loss. There were only rewards for doing a deal that could be outwardly reported as revenue or earnings, says one former employee.” (FT, 9 April 02. P30). Communication within the company was also poor and the fear that was instilled in employees was such that they did not question off-balance sheet arrangements.

The use of share options to incentivise managers, linking their performance directly with the share price is also a big concern. As Allan Kennedy writes: “This philosophy has come to entail getting as much as you can as fast as you can for shareholders, who almost always include (through options or direct shareholdings) managers of the enterprise itself.”

But contrary to what critics of shareholder value maintain, this is the result of the failure to understand the business goals of a company and introduce the appropriate employee incentives to reinforce these goals.

The stakeholder approach

Those who argue that the pursuit of shareholder value is to blame for the corporate excesses of recent years —like Allan Kennedy and author and economist John Kay— because of its seemingly exclusive focus on financial measures, insist that a more “inclusive” approach, like stakeholder value, is the appropriate way forward; indeed is the only way forward to ensure sustainable economic growth.

Supporters of the stakeholder approach argue that the demands of all constituents should be given equal weighting when making management decisions. Consequently, the frameworks that are put in place for managing and assessing management performance are multi-dimensional and the most common among them is the balanced score card. Its appeal has been universal, especially in European and Asian countries, where the stakeholder approach is favoured.

According to a 1997 study published in an Austrian publication only 22% of managers in France, 18% in Germany, and not more than 3% in Japan, embraced the shareholder value philosophy compared with 76% of managers in the US and 70% in the UK. Although these figures would have increased since then there is still a very wide gap between the Anglo-Saxon and European positions.

In part, as Tom Copeland pointed out in his 1994 study,³ this is explained by different composition of ownership and control and partly with the roles and responsibilities that organisations adopt in society. Stakeholder claims are balanced in different ways across Europe, which is reflected in varying degrees of employee participation on company management.”

Another significant difference between the US, continental Europe and Japan is the degree of concentration of ownership and control of sources of capital. In summarising the research in his work *Shareholder Value or Stakeholder Value?* Ray Shaw⁴ writes: “It is claimed that the US capital markets are more efficient, arising from the need to provide much more public information, with capital flowing much quicker to more productive uses. Second, in the European/Asian model management is less likely to focus on value creation because the market price of shares is much less likely to reflect good

³ Copeland, TE (1994) *Why Value Value?* McKinsey Quarterly No 4

⁴ Edited by Leo Schuster (2000) *Shareholder Value Management in Banks* MacMillan Press; Shaw R, *Shareholder Value or Stakeholder Value?*

information. Therefore, the market price of shares is often disregarded as the best indicator of management performance.”

To accommodate the demand for a more inclusive approach Robert Kaplan and David Norton devised the balanced scorecard back in 1992 and it became one of the most important new management tools in the past 75 years. As well as measuring financials it focused on customer relations, the internal business process, and learning and growth.

This approach also has problems however, as Mike Bourne, director of programmes for the Centre for Business Performance, Cranfield School of Management, points out in a *Financial World* article (August 2002). He writes: “Although there are a few studies that show the balanced score card makes an impact on performance, many of its implementations are considered to fail or to not create the management satisfaction with performance measurement we might expect. In addition, the scorecard is far from comprehensive as it ignores those stakeholders who are becoming important to the long-term success of the enterprise.”

The first of these stakeholders are the people who run the business — though the innovation and learning aspect of the balanced score card is often put into a people’s perspective. He maintains that a people’s perspective is vital for two reasons. First, people are an important driver of performance and second, ignoring them completely sends out the wrong signals. “Not measuring people gives the impression that they don’t matter to the business and are not something to promote when implementing a new way of working,” he writes.

He also believes the balanced score card does not give suppliers the visibility they deserve and fails to recognise the importance of regulation, environmental issues and competitors.

Also central to the stakeholder argument is corporate social responsibility (CSR). Advocates of the stakeholder approach argue that businesses, like professions, should exist first and foremost to carry out socially responsible deeds. In his paper, *A Stakeholding Society: What does it mean for business?*⁵ John Kay equates being a doctor with running a business. But this is not comparing like with like for the key value drivers of each are fundamentally different.

Social responsibility is fundamental to being a doctor. On the one hand, it is not the least bit contentious to say that a doctor would not be doing his job if the well being of the patient were not his first priority. In fact it would be quite the opposite. On the other, the real reason for running a business is to achieve profitability and growth —unless a business is operating in the public sector and has no need to create wealth. This does not however preclude a business carrying out socially responsible functions; it is just that doing so is not necessarily its primary or only priority.

⁵ Kay J, *A Stakeholding Society — what does it mean for business?* Scottish Journal of Political Economy, Vol. 44, No. 4, September 1997

If a business were to put social responsibility above everything else it would not have the resources to treat its employees well — some may even have to be laid off — and the division of any residue profits between worthwhile causes, like charities, would not be possible.

In this regard, empirical evidence also shows the stakeholder argument to be flawed. For example, in the UK those companies that pursue shareholder value are among the largest givers to charitable foundations. According to Maps Charity Funding (July 2003) in 2002, the largest corporate donors were the oil companies BP PLC and Shell Transport & Trading, which between them donated nearly £124m. The banks — Lloyds TSB, Barclays, HSBC and the Royal Bank of Scotland — also featured in the ten top corporate donors, with combined contributions of £101.4m.

Recent research from Boston Consulting Group (BCG) published its Value Creators 2002 report also shows there is “growing evidence that socially responsible corporations generate above average shareholder returns” and that it is an increasingly important part of managing corporate reputation. The report cites two reasons for this: “First, responsibility equals predictability and consequently low risk, thereby increasing demand for the stock. Second, some investors might be drawn to these types of firms for emotional not just financial reasons, just as some football fans invest in their club.”

Advocates of a stakeholder approach also argue that companies pursuing shareholder value will sacrifice innovation for short-term growth. But evidence shows the opposite to be true. According to the BCG Value Creators report: “The most fruitful source of growth in terms of sustainable shareholder returns is organic growth. Innovation is an especially rich source of this, particularly when protected by patents and other intellectual property rights.”

With this in mind, it comes as no surprise that in the BCG survey Best Buy, one of the world’s most innovative retailers, is ranked number one in the world in terms of TSR (the measure of market performance) and number six in terms of (TBR). On October 22, when announcing its first-ever shareholder dividend CEO Brad Anderson commented: “The four strategic initiatives that we are pursuing are aimed at re-engineering the company, and we intend to change forever how consumer electronics retailing is done and broaden significantly the gap between Best Buy and our competition.” Even though Best Buy is clearly focused on shareholder value — “We remain committed to growth, we are focused on shareholder value and we are very optimistic about our future,” Anderson says — innovation is an integral part of the strategy.

Why the pursuit of shareholder value is compatible with sustainable economic growth?

Even though advocates of the stakeholder approach maintain that it is more socially acceptable than the shareholder value approach not only are there fundamental flaws in the argument but that there is no proof that a stakeholder approach, specifically as shown by the balanced score card, yields a significantly strong performance in terms of economic growth to warrant its use.

The problem with trying to balance the demands of different constituent groups is that the interests and needs of competing groups invariably conflict. Unlike the shareholder value approach the stakeholder approach has no clear governing objective, which means it is easy for decision making to become unfocused and ambiguous.

Critics of shareholder value also see its pursuit as an end in itself, the reason for a company's existence, rather than simply a measure of a company's success. They fail to grasp that shareholder value is really the outcome of a business's success— it is, as Jukka Laitamaki and Raymond Kordupleski,⁶ say a measurable determinant of value creation, the real purpose of which is to “create and provide products and services for customers that are of value to them”. In the long run, a business organisation can produce shareholder value only if it first provides competitive customer value added.”

In other words, if you are a clothes retailer, or even a bank, it is only possible to maximise shareholder value by delivering what customers want. This does not mean that companies should respond to the demands of the customers (who are also likely to be the shareholders) without considering other stakeholders; if it were to do so it may go bankrupt.

A business might have one overall goal, in this case improving shareholder value, but it is only possible to reach that goal if the right building blocks are in place. This means not only meeting the demands of customers but also those of employees, suppliers and shareholders; being innovative and seeking market leadership; making socially responsible decisions which, in turn, help to build a corporate reputation and strong brand; seeking transparency by having in place good corporate governance and accounting practices; and restructuring compensation packages so that managers manage for value and not for share price.

The argument therefore is not about measurement, though what is measured reinforces certain behaviours, but it is about how to change the key value drivers of a business at the right time and in the right way. Measuring shareholder value, by the internal measures outlined above, enables management to identify any business units that destroy value. Only by adopting a shareholder value approach can value-destroying businesses be identified and resources allocated efficiently.

That the pursuit of shareholder value is compatible with sustainable economic growth at a macro-level is also clear. Back in 1994 Tom Copeland argued that based upon the measurements of gross domestic product (GDP), productivity, shareholder value creation and job creation, the US economy performs much better than Germany and Japan. He also finds a clear link between per capital GDP, productivity and shareholder value. He concluded that increasing shareholder value does not conflict with the long-term interests of stakeholders and that winning companies created value for all stakeholders.

⁶ Laitamaki, J and Kordupleski R, *Building and Deploying Profitable Growth Strategies based on the Waterfall of Customer Value Added*, European Management Journal, Vol.15, No. 2, 1997

More recent studies also bear out these findings. The BCG 2002 Value Creators survey in which it ranks the world's top 10 companies according to shareholder value (or value creation) shows that nine of the top 10 companies in the TBR rankings (which measures fundamental performance) are American: Dell Computer is the leader. It is probably no coincidence then that the US continues to be the engine of world economic growth with, according to the Economist, GDP forecasts for 2004 at 3.7% compared to the euro area of 1.8%. The BCG survey also suggests that even if some companies have corrupted the meaning of shareholder value by pursuing share price, those who pursue shareholder value, correctly defined, continue to turn in strong performances.

It is also worth asking whether the more rigorous and hard-edged approach to business can account for some of the difference in the economic performance between the US and Europe over the past century. Robert J Gordon, in a paper entitled *Two Centuries of Economic Growth: Europe Chasing the American Frontier*,⁷ asks: "How do we interpret data showing that Europe has recently almost caught up with the US in terms of level of output per hour (labour productivity) but remains significantly behind in output per capita? How could Europe be so productive yet so poor?"

Perhaps the answer lies in the fact that resources are allocated less efficiently than they would otherwise be if a shareholder value approach were to be adopted in continental Europe rather than the stakeholder one that is preferred. If companies seek to be socially responsible rather than to manage for value, in the long run all stakeholders will be worse off.

Conclusion

The shareholder value approach to managing companies has been subject to a great deal of criticism principally because there is confusion about what that philosophy really means. It means managing for value, not for share price, and understanding that in the long run all stakeholders benefit from pursuing this approach.

To ensure this is the case, however, it is necessary to change the expectations of analysts and investors so that they think long-term rather than short. CEOs must learn to set more realistic targets, be clear about their corporate values and ensure that their business practice reinforces them, especially corporate governance practices. These should be designed to improve the transparency and accountability of management decision making to shareholders. Compensation packages must also be restructured so that managers manage for value and not for share price.

Pursuing a shareholder value philosophy requires total management commitment and a deep understanding of how an organisation creates value at every business unit. Shareholder value is the only way to identify value-destroying businesses and allocate

⁷ Gordon, R, *Two Centuries of Economic Growth: Europe Chasing the American Frontier*, Northwestern University and NBER. October 17. 2002

resources efficiently. Only when all this is understood will all companies be able to pursue shareholder value and achieve sustainable economic growth.

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