André de Waal – Essay for PricewaterhouseCooper's shareholder value contest 2003

The myth of shareholder value

A fairytale

"Grandpa, grandpa!" Excitedly, Charlie ran into the bleak room of the nursing home. "Please tell us another story."

The old man looked up from his paper. His lustreless eyes began to shine the moment he spotted his grandson. Questioningly he looked at Ellen, his oldest daughter, who had entered the room after the little fellow. She nodded: "As long as you don't make it too scary. Last time he couldn't sleep for hours."

Granddad mumbled an acknowledgment and settled his grandson next to him on the couch. "Did I ever tell you the fairytale about shareholder value?"

"No grandpa, but it doesn't sound like fun at all," Charlie pouted.

"But it is little man, I promise you. There is plenty of disaster and destruction in the story and this fairytale doesn't have a happy ending, just the way you like it."

His daughter coughed reprovingly.

"I won't make it too bad," he hastened to assure her.

"Grandpa, please begin," Charlie urged the old man while pulling his sleeve.

"I told you, I once was the chief executive officer of a large company, didn't I?" granddad began.

"Yes, a hotshot!" the boy exclaimed.

"Well, I'd rather call it a big shot. And do you know what was expected from a big shot in those days?"

The fair-haired boy shook his head.

"That he always puts the interests of a shareholder first."

"What's a shareholder?'

"Someone who gave granddad money, so that I could use it to make the company bigger and make a lot of profit."

The youngster began to wiggle on the sofa. "When does it become creepy, grandpa?"

"Soon, my dear boy, soon," the old man said while ruffling the boy's hair. "You see, the shareholder didn't give the money to your granddad for nothing. He wanted something in return."

"What?" Charlie inquired.

"Dividend and higher share prices, because that made the shareholder very rich. And the richer he became, the more pleased he was with me. And can you guess why I went along with this?'

The clever boy clapped his hands excitedly. "Because you also became very rich?"

"Very good," the old man praised him. "I received options and shares which made me a lot of money, so I really did my best."

"But," the little man hesitated, "what did you do?"

"That wasn't too difficult, I just used short-term thinking."

"Short-term thinking, grandpa?" Charlie wondered.

"Yes, short-term thinking. That means you did all kinds of things to raise profits in the short-term."

"Like what, grandpa?"

"Regularly firing people, outsourcing a lot of production work to low-wage countries, cutting back on training and schooling, and investing little in clean production techniques and all that soft stuff like teamwork and so on. This way, you could earn quite a lot of money in a jiffy."

"Did it really work like that, grandpa?"

"It certainly did." The old man tickled his grandson. "It worked splendidly. Everybody became filthy rich, except for of course the poor slobs who were fired all the time. And the environment also deteriorated, but that was all a small price to pay for progress and higher margins."

"Is that why there are no flowers and no rabbits anymore?" Charlie asked bashfully.

"I'm afraid that's true. That's the logical consequence of not investing in the environment."
The little boy started to cry softly. "This is really sad, grandpa."
The old man nodded. "Actually, I think you are right."
"That's enough, pa," Ellen intervened. "See what you have done, you have upset him again. I think it is time for us to go home." She took her son by the hand and walked briskly to the door. Granddad called after them: "Don't forget to put on your oxygen masks!"
Lost in thought, he watched them through the window but the dense smog obstructed his view and his relatives soon disappeared out of sight. With a sigh, he shuffled back to the couch. 'Sometimes I wish it *was* a fairytale', he pondered. He took a sip of water to moisten his dry throat. "Ugh!" he exclaimed. The recycled sewage water tasted foul. He would give the world for a glass of crystal-clear fresh water. But unfortunately it was no longer available. The old man reached out to call for the nurse on duty, so he could ask her for something else to drink. Then he slowly withdrew his arm, realizing the uselessness of his action, as the nurse was present only once a week, and that was not today. Granddad shook his head, feeling sorry for himself. He had plenty of money, yet he could not get the service he wished for because there simply were not enough nurses to provide it. 'Maybe we *should* have concentrated a bit more on the soft stuff and a little less on the financial aspect', he thought before he fell into an uneasy slumber.

The myth of shareholder value

Is there a conflict between the pursuit of shareholder value and sustainable economic growth? In my opinion there certainly is, as the above fictitious story of illustrates. But is this bleak image of shareholder value thinking affecting top management behaviour negatively really just fiction, I wonder? Had I written this story a few years ago, many people would probably have thought of me as an eccentric. But this is the year 2003. Recent scandals like those of Enron and WorldCom have shown the economic world that too much focus on shareholder value may well threaten a company's continuity. As a consequence, the important position shareholder value has in management thinking needs re-evaluation. Viewed in this light, the story of the old man and his grandson is not such an improbable story after all.

Shareholder value has been the central theme of business in the last ten years. Many organisations aim at maximizing shareholder value and, as a result, are constantly looking for new opportunities to create added value, or EVA™. Especially in listed companies, this emphasis on shareholder value seems to lead to short-term thinking. These companies pay a lot of attention to the short-term objectives and targets, like continuous increase of quarterly profits by delaying needed investments or focus on mergers and acquisitions, and considerably less attention to the long-term objectives, like investing in clean production techniques, innovation, the quality of personnel and the environment. Such a short-term focus, however, is not without danger and is a potential threat to the continuity of an organisation. The company will not be able to achieve sustainable growth and will not be innovative enough to keep its customers satisfied with new products and services. In short, a focus on the short-term bottom line prevents a company from becoming and staying a 'living' organisation.[1] For becoming such a company, a balance in focus between short-term and long-term objectives is needed, together with attention for all *stake*holders, rather than just shareholders, of the company.

The myth of economic growth

In addition to short-term thinking, too much focus on shareholder value has another, less obvious adverse effect on management's behaviour: the blind pursuit of short-term growth. CEOs can bring their organisations, and themselves, in severe difficulties by promising the stock market that their companies will grow fifteen percent in turnover a year. In itself it is not so surprising that a CEO makes these forecasts time after time. After all, a yearly growth of fifteen percent means profits can double every five years, which will make the CEO the favourite of analysts and shareholders. The CEO concerned will be ranked among the most-admired business leaders, a temptation only few will be able to resist. Unfortunately, the reality is rather more complex. Research shows that a growth rate of fifteen percent is unattainable for most companies and can therefore be considered an illusion. This was the outcome of a study which calculated the average growth rate in earnings per share for a cross section of Fortune 500 companies, over the last four decades (Exhibit 1).[2]

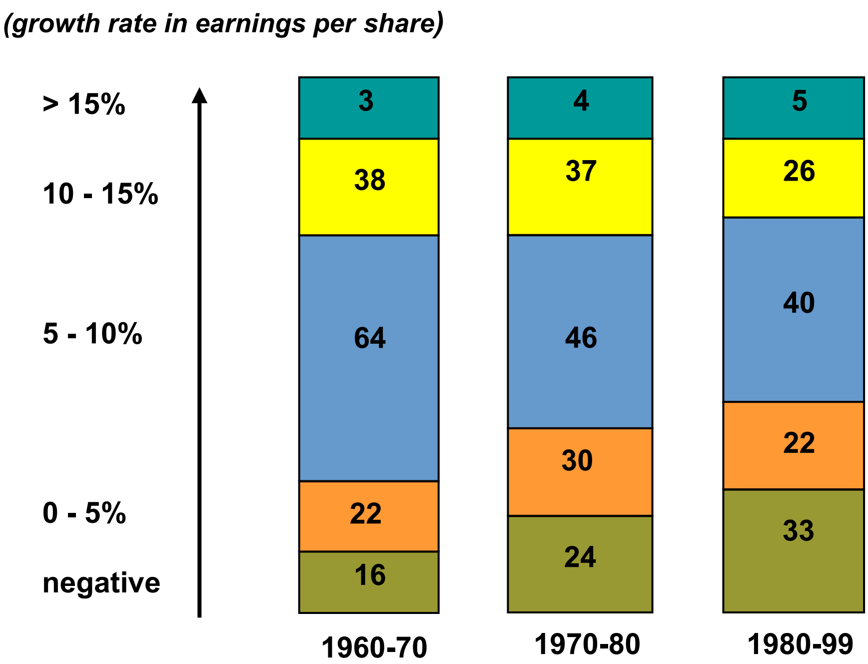

Exhibit 1: Average growth rate in earnings per share for a cross section of Fortune 500 companies

The results are astonishing: only five companies of those examined obtained an average growth rate of fifteen percent or more. At the same time, there was a considerable number of companies with a negative growth rate. Companies which repeatedly fail to realize forecasted growth are likely to practise rollercoaster management (Exhibit 2).

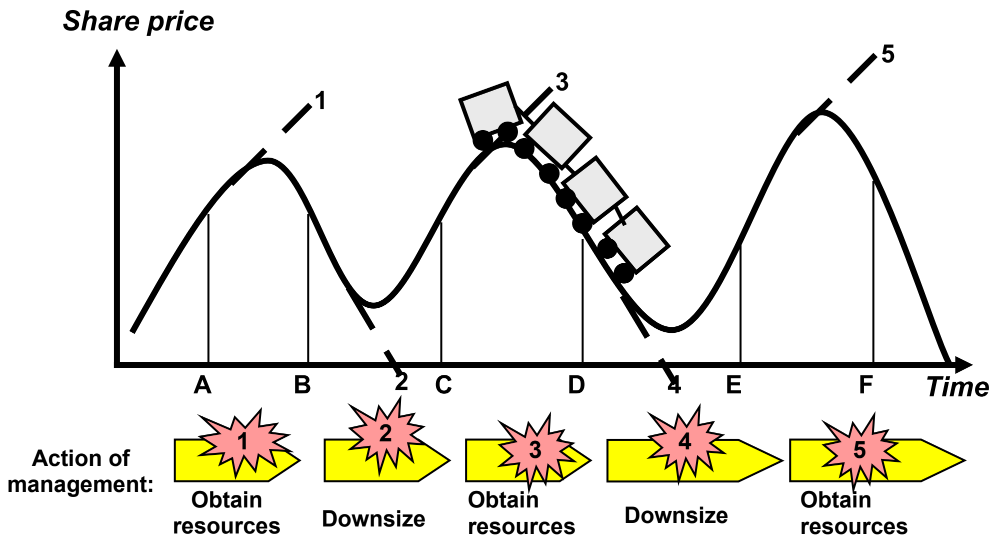

Exhibit 2: Rollercoaster management

Once a company has announced its growth expectations, management has to obtain and employ the resources needed to process the expected volume of trade (situation 1 in Exhibit 2). The stock market rewards this vigour of management with a rising share price. However, when turnover growth and profits lag behind the expectations, the stock market 'punishes' the company by selling of shares: the share price goes down. On top of this, the organisation now has a resource surplus which it has to get rid of: dismissals are the result (situation 2). In the next stage, new management makes new promises. Again, the stock market rewards this vigour and the share price rises (situation 3), et cetera. Needless to say, this kind of management brings a lot of havoc to an organisation and its people.

The urge to grow fast does not produce a good strategy. A study shows that of the hundred largest American companies at the beginning of the twentieth century, only sixteen made it to the end of the century.[3] It turned out that company size was not indicative for the chance of survival of a company. Another study shows that fast growth does not necessarily yield higher profits or shareholder value.[4] On the contrary, fast growth can in fact have an opposite effect. When the results of almost three thousand organisations in the period 1993 to 1998 were examined, it turned out that companies with a moderate but steady growth of turnover and assets had the highest return on investment and EVA! A one-sided focus on fast growth can make a CEO lose sight of a company's main goal: continuity. In addition to achieving a certain margin and return for all stakeholders, a CEO has to guarantee the survival of the company. It is therefore important that management changes its strategic orientation from 'growth and shareholder value now, continuity tomorrow' to 'profitable and sustainable growth today'.

<u>A fundamental choice for stakeholder management</u>

Of course the shareholder is important to the organisation. However, there are also many other interested parties , such as employees, suppliers, customers, society and regulators, which the organisation has to satisfy in order to stay a profitable and viable company on the long term. This makes it important to strike a balance between these various groups of stakeholders.[5] It is from a management point of view not enough to concentrate on only the bottom line because this benefits the interests of just one group of stakeholders. In recent years, we have seen in many examples of the excesses to which this can lead.

The stakeholders who have a direct influence and effect on the results of a company are the customers and the employees. The relation between these two parties is illustrated by the case of Sears, Roebuck & Co. This case shows that employee loyalty is related to customer satisfaction, which, in turn, is related to the organization's growth and profits.[6] Statistical analysis of sales data at Sears, Roebuck & Co. revealed that employee attitudes drove both customer satisfaction and changes in revenue. A 5% improvement in employee attitude resulted in a 1.3% improvement in customer satisfaction, which in turn resulted in a 0.5% increase in revenue. Independent surveys at the time showed that the national retail customer satisfaction had been declining for several years. Meanwhile, employee satisfaction at Sears had risen by 4%, and customer satisfaction by almost 4%. This translated into more than $200 million in additional revenues for that year, and increased Sears' market capitalization at that time by nearly one-quarter of a billion dollars.

The above example shows it is imperative that sufficient employee value is generated to satisfy those responsible for conducting the organisation's daily activities, while at the same time creating enough customer value by growing and maintaining an active customer base. And, as a precondition for survival, the organisation should have sufficient access to the financial markets, to be able to satisfy its financial needs, so shareholder value also has to be created.[7] Looking after the interests of these three parties simultaneously is a field of tension for every organisation, because on the short term these interests may, and likely will, be different. The consequence of this is that management constantly has to reconcile these different interests (Exhibit 3).

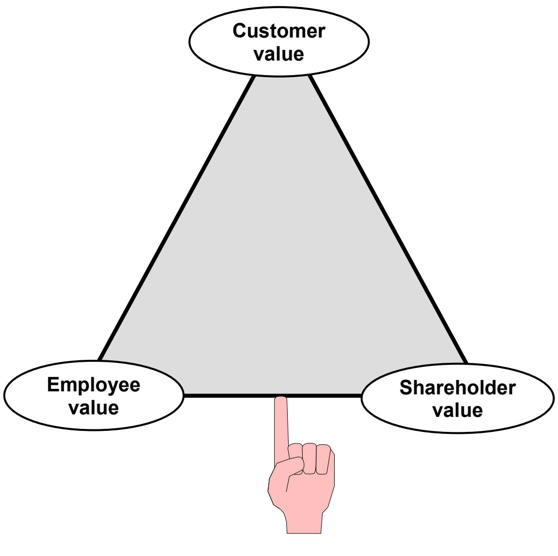

Exhibit 3: Management's balancing act (based on: Lewy, 2002)

Achieving the goals of continuity and sustained wealth creation requires an organisation to maintain a precarious balance between the short-term and long-term interests of the various stakeholders. As Lewy[8] puts it: 'Competitive forces, technological change and social pressures powerfully influence the weightings accorded to each of the value goals represented in the triangle. This calls for continual fine tuning by management and – at times – radical readjustments. In performing this balancing act, management's options are not unlimited and include

boundaries determined by (differences between) national cultures, values and economic and legal systems. But whatever the boundaries, these do not absolve management from it's ultimate responsibility which is to seek and secure the company's continuity, growth and survival in the marketplace.'
In conclusion, the question 'Is there a conflict between the pursuit of shareholder value and sustainable economic growth?' should be answered as follows: 'Yes, but there is should *not* be a conflict between the pursuit of the combination of shareholder *and* stakeholder value and sustainable economic growth.' This means that an organisation should actively invest in stakeholder management while at the same time focussing on sustainable growth.

Long-term orientation

The question remains how one can achieve *sustainable* growth. Sustainable growth, in the sense of continuity, demands a shift of orientation of the company from the short-term to the long-term. Many organisations will find it difficult to make this shift, because in the last decade the trend has clearly been in the opposite direction, towards the short-term. Shareholders wanted to see return on their investment as soon as possible and the more North-American emphasis on quarterly earnings all caused an excessive focus on the quick satisfaction of stock market's needs.

Fortunately, things started to change gradually at the end of the last century. There was an increased interest in non-financials, intangibles and performance driven behaviour, as a result if which these subjects started to appear on management agendas. In addition, there was a renewed interest in strategy formulation and strategy implementation. In a survey of Bain, the two most popular senior management tools turned out to be 'strategic planning' and 'mission and vision statements'. However, twenty years ago Fortune Magazine reported that less than 10% of organization's strategies are effectively formulated and executed. In 1999, the same magazine reported that this problem was still not solved. The magazine stated that for organizations that ran into financial trouble, in 70% of the cases this trouble was not caused by the inability of management to come up with the right strategy. Instead, the trouble was caused by the inability of management to execute the strategy.[9] In recent years investors have also started to show more interest in this subject: research shows that the belief of investors in the ability of the organization to effectively execute its strategy is the foremost non-financial factor that drives them to value the stock of that company highly.[10]

The ability to execute the organisation's strategy and make people more performance driven is greatly enhanced by performance management.[11] It is therefore not surprising that the number of organizations which have implemented performance management has increased considerably in the past few years. In performance management, efficient and effective steering and control of the organisation is achieved by formulating the mission, strategy and objectives of the organisation, and subsequently translating these to the various management levels of the organisation. The objectives are measured with critical success factors, key performance indicators and the balanced scorecard. Regular reporting of the indicator results makes quick corrective action taking possible. In addition, organisational members act in an action and result oriented manner because of the information they regularly get. An important characteristic of modern performance management is that it deals with a combination of financial indicators – which provide information on the short-term, financial success of the company – and non-financial indicators – which give an indication of the expected, long-term results. Non-financial indicators give information about for instance customer satisfaction, employee satisfaction, quality, innovation, patents, copyrights and technology.

An increasing body of anecdotal evidence can be found about the positive relation between the use of performance management and the long-term performance of the organization.[12] Research among Forbes 500 companies revealed that organisations with well-implemented performance management had 64% more turnover and four times more profit than organisations with no or mediocre performance management. Another study showed that in companies with good performance management the sales per employee were three times higher and gross margin 45% higher than less well equipped companies in this respect. According to the Institute of Management Accountants, some of the best companies in the world, such as AT&T, BellSouth, Bristol-Meyers Squibb, Dun & Bradstreet, DuPont, Emerson Electric, General Electric, Hewlett-Packard, Johnson & Johnson, Merck, Motorola, Pepsico, Wal-Mart and Xerox, cite their integrated performance management system as one of the key drivers of their success.[13] The general tendency in the literature is that organizations which have implemented performance management and are using it, perform financially as well as non-financially better than organizations which are less performance-driven. This is explained by the fact that performance indicators direct focus and motivate organizational members in a strategically desirable way. The indicators also help management to assess the organisation's progress in relation to its strategic goals. Finally, performance indicators help individuals in gaining a clear understanding of their part in the enterprise.

The relation between strategy formulation, strategy execution, performance management and sustainable growth is further illustrated by a recent online survey which was conducted by the Balanced Scorecard Collaborative among the members of the collaborative. [14] Of the 500 respondents, 250 reported that they had a balanced scorecard. Of these, 125 said it was too early to tell the impact of the scorecard. Of the other 125, 19 reported to have achieved significantly better results, 80 said they saw some progress, and 26 said they had limited or no better results. At first this seems a disappointing result, but a closer look reveals that there is a significant difference in behaviour between the 'winners' and the 'losers' (Exhibit 4). The winners – organizations with breakthrough results – created, for instance, a better sense of urgency for performance management and the scorecard, made more use of strategy maps, and communicated more extensively than the organizations with lesser results.

Behaviour	Number of organizations showing this behaviour (in percentage per category)		
	Breakthrough results	**Some progress**	**No results**
Executive team has created a sense of urgency.	84%	38%	20%
Strategy is translated into a strategy map and a balanced scorecard.	84%	41%	0%
Corporate/business unit measures are linked and aligned.	72%	39%	0%
Employees are aware of the strategy	56%	32%	0%
Individual and team goals are aligned with the strategy.	42%	26%	0%
The balanced scorecard is an integral part of the strategic planning process.	100%	40%	0%
The budget is driven by the strategy.	42%	29%	0%

Exhibit 4: What separates the winners from the losers?

Conclusion

In order to achieve sustainable economic growth, it is crucial that the management of an organisation pays close attention to the shareholders as well as other stakeholders of the company. In addition, it should invest in performance management, and put a distinct emphasis on strategy execution and major focus on ensuring the continuity of the organisation. Only if organisations realize the importance of these actions to achieving sustainable economic growth, the fairytale of granddad and Charlie will prove to be just that: a fairytale.

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Notes

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