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The real business of business

Shareholder-oriented capitalism is still the best path to broad economic prosperity, as long as companies focus on the long term.

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The guiding principle of business value creation is a refreshingly simple construct: companies that grow and earn a return on capital that exceeds their cost of capital create value. The financial crisis of 2007–08 and the Great Recession that followed are only the most recent reminders that when managers, boards of directors, and investors forget this guiding principle, the consequences are disastrous—so much so, in fact, that some economists now call into question the very foundations of shareholder-oriented capitalism. Confidence in business has tumbled.[1] Politicians and commentators are pushing for more regulation and fundamental changes in corporate governance. Academics and even some business leaders have called for companies to change their focus from increasing shareholder value to a broader focus on all stakeholders, including customers, employees, suppliers, and local communities.

No question, the complexity of managing the interests of myriad owners and stakeholders in a modern corporation demands that any reform discussion begin with a large dose of humility and tolerance for ambiguity in defining the purpose of business. But we believe the current debate has muddied a fundamental truth: creating shareholder value is not the same as maximizing short-term profits—and companies that confuse the two often put both shareholder value and stakeholder interests at risk. Indeed, a system focused on creating shareholder value from business isn't the problem; short-termism is. Great managers don't skimp on safety, don't make value-destroying investments just because their peers are doing it, and don't use accounting or financial gimmicks to boost short-term profits, because ultimately such moves undermine intrinsic value.

What's needed at this time of reflection on the virtues and vices of capitalism is a clearer definition of shareholder value creation that can guide managers and board directors, rather than blurring their focus with a vague stakeholder agenda. We do believe that companies are better able to deliver long-term value to shareholders when they consider stakeholder concerns; the key is for managers to examine those concerns systematically for opportunities to do both.

What does it mean to create shareholder value?

If investors knew as much about a company as its managers, maximizing its current share price might be equivalent to maximizing value over time. In the real world, investors have only a company's published financial results and their own assessment of the quality and integrity of its management team. For large companies, it's difficult even for insiders to know how the financial results are generated. Investors in most companies don't know what's really going on inside a company or what decisions managers are making. They can't know, for example, whether the company is improving its margins by finding more efficient ways to work or by simply skimping on product development, maintenance, or marketing.

Since investors don't have complete information, it's not difficult for companies to pump up their share price in the short term. For example, from 1997 to 2003, a global consumer-products company consistently generated annual growth in earnings per share (EPS) between 11 and 16 percent. Managers attributed the company's success to improved efficiency. Impressed, investors pushed the company's share price above that of its peers—unaware that the company was shortchanging its investment in product development and brand building to inflate short-term profits, even as revenue growth declined. In 2003, managers were compelled to admit what they'd done. Not surprisingly, the company went through a painful period of rebuilding, and its stock price took years to recover.

In contrast, the evidence makes it clear that companies with a long strategic horizon create more value. The banks that had the insight and courage to forgo short-term profits during the real-estate bubble earned much better returns for shareholders over the longer term.[2] Oil and gas companies known for investing in safety outperform those that haven't. We've found, empirically, that long-term revenue growth—particularly organic revenue growth—is the most important driver of shareholder returns for companies with high returns on capital (though not for companies with low returns on capital).[3] We've also found a strong positive correlation between long-term shareholder returns and investments in R&D—evidence of a commitment to creating value in the longer term.[4]

The weight of such evidence and our experience supports a clear definition of what it means to create shareholder value, which is to create value for the collective of all shareholders, *present and future*. This means managers should not take actions to increase today's share price if they will reduce it down the road. It's the task of management and the board to have the courage to make long-term value-creating decisions despite the short-term consequences.

Can stakeholder interests be reconciled?

Much recent criticism of shareholder-oriented capitalism has called on companies to focus on a broader set of stakeholders, not just shareholders. It's a view that has long been influential in continental Europe, where it is frequently embedded in the governance structures of the corporate form of organization. And we agree that for most companies anywhere in the world, pursuing the creation of long-term shareholder value requires satisfying other stakeholders as well.

We would go even further. We believe that companies dedicated to value creation are healthier and more robust—and that investing for sustainable growth also builds stronger economies, higher living standards, and more opportunities for individuals. Our research shows, for example, that many corporate-social-responsibility initiatives also create shareholder value, and managers should seek out such opportunities.[5] For example, IBM's free web-based resources on business management not only help to build small and midsize enterprises but also improve IBM's reputation and relationships in new markets and develop relationships with potential customers. In another case, Novo Nordisk's "Triple Bottom Line" philosophy of social responsibility, environmental soundness, and economic viability has led to programs to improve diabetes care in China. According to the company, its programs have burnished its brand, added to its market share, and increased sales—at the same time as improving physician education and patient outcomes. Similarly, Best Buy's efforts to reduce attrition among women employees not only lowered turnover among women by more than 5 percent, it also helped them create their own support networks and build leadership skills.

But what should be done when the interests of stakeholders don't naturally complement those of a company, for instance, when it comes to questions of employee compensation and benefits, supplier management, and local community relationships? Most advocates of managing for stakeholders appear to argue that companies can maximize value for all stakeholders and shareholders simultaneously—without making trade-offs among them. This includes, for example, Cornell Law School professor Lynn Stout's book, *The Shareholder Value Myth*,[6] in which Stout argues persuasively that nothing in US corporate law requires companies to focus on shareholder value creation. But her argument that putting shareholders first harms nearly everyone is really an argument against short-termism, not a prescription for how to make trade-offs. Similarly, R. Edward Freeman, a professor at the University of Virginia's Darden School of Business, has written at length proposing a stakeholder value orientation. In his recent book, *Managing for Stakeholders*, he and his coauthors assert that "there is really no inherent conflict between the interests of financiers and other stakeholders."[7] John Mackey, founder and co-CEO of Whole Foods, recently wrote *Conscious Capitalism*,[8] in which he, too, asserts that there are no trade-offs to be made.

Such criticism is naive. Strategic decisions often require myriad trade-offs among the interests of different groups that are often at odds with one another. And in the absence of other principled guidelines for such decisions, when there are trade-offs to be made, prioritizing long-term value

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creation is best for the allocation of resources and the health of the economy.

Consider employee stakeholders. A company that tries to boost profits by providing a shabby work environment relative to competitors, underpaying employees, or skimping on benefits will have trouble attracting and retaining high-quality employees. Lower-quality employees can mean lower-quality products, reducing demand and hurting reputation. More injury and illness can invite regulatory scrutiny and more union pressure. More turnover will inevitably increase training costs. With today's more mobile and more educated workforce, such a company would struggle in the long term against competitors offering more attractive environments. If the company earns more than its cost of capital, it might afford to pay above-market wages and still prosper—and treating employees well can be good business. But how well is well enough? A stakeholder focus doesn't provide an answer. A shareholder focus does. Pay wages that are just enough to attract quality employees and keep them happy and productive, pairing those with a range of nonmonetary benefits and rewards.

Or consider how high a price a company should charge for its products. A shareholder focus would weigh price, volume, and customer satisfaction to determine a price that creates the most shareholder value. However, that price would also have to entice consumers to buy the products—and not just once but multiple times, for different generations of products. A company might still thrive if it charged lower prices, but there's no way to determine whether the value of a lower price is greater for consumers than the value of a higher price to its shareholders. Finally, consider whether companies in mature, competitive industries should keep open high-cost plants that lose money just to keep employees working and prevent suppliers from going bankrupt. To do so in a globalizing industry would distort the allocation of resources in the economy.

These can be agonizing decisions for managers and are difficult all around. But consumers benefit when goods are produced at the lowest possible cost, and the economy benefits when unproductive plants are closed and employees move to new jobs with more competitive companies. And while it's true that employees often can't just pick up and relocate, it's also true that value-creating companies create more jobs. When examining employment, we found that the European and US companies that created the most shareholder value in the past 15 years have shown stronger employment growth.[9]

Short-termism runs deep

What's most relevant about Stout's argument, and that of others, is its implicit criticism of short-termism—and that is a fair critique of today's capitalism. Despite overwhelming evidence linking intrinsic investor preferences to long-term value creation,[10] too many managers continue to plan and execute strategy, and then report their performance against shorter-term measures, EPS in particular.

As a result of their focus on short-term EPS, major companies often pass up value-creating opportunities. In a survey of 400 CFOs, two Duke University professors found that fully 80 percent of the CFOs said they would reduce discretionary spending on potentially value-creating activities such as marketing and R&D in order to meet their short-term earnings targets.[11] In addition, 39 percent said they would give discounts to customers to make purchases this quarter, rather than next, in order to hit quarterly EPS targets. Such biases shortchange all stakeholders.

As an illustration of how executives get caught up in a short-term EPS focus, consider our experience with companies analyzing a prospective acquisition. The most frequent question managers ask is whether the transaction will dilute EPS over the first year or two. Given the popularity of EPS as a yardstick for company decisions, you might think that a predicted improvement in EPS would be an important indication of an acquisition's potential to create value. However, there is no empirical evidence linking increased EPS with the value created by a transaction.[12] Deals that strengthen EPS and deals that dilute EPS are equally likely to create or destroy value.

If such fallacies have no impact on value, why do they prevail? The impetus for short-termism varies. Some executives argue that investors won't let them focus on the long term; others fault the rise of shareholder activists in particular. Yet our research shows that even if short-term investors cause day-to-day fluctuations in a company's share price and dominate quarterly earnings calls, longer-term investors are the ones who align market prices with intrinsic value.[13] Moreover, the evidence shows that, on average, activist investors strengthen the long-term health of the companies they pursue, often challenging existing compensation structures, for example, that encourage short-termism.[14] Instead, we often find that executives themselves or their boards are usually the source of short-termism. A 2013 survey of more than 1,000 executives and board members found, for example, that most cited their own executive teams and boards (rather than investors, analysts, and others outside the company) as the greatest sources of pressure for short-term performance.[15]

The results can defy logic. We recently participated in a discussion with a company pursuing a major acquisition about whether the deal's likely earnings dilution was important. One of the company's bankers opined that he knew any impact on EPS would be irrelevant to value, but he used it as a simple way to communicate with boards of directors. Elsewhere, we've heard company executives acknowledge that they, too, doubt that the impact on EPS is so important—but they use it anyway, they say, for the benefit of Wall Street analysts. Investors also tell us that a deal's short-term impact on EPS is not that important. Apparently everyone knows that a transaction's short-term impact on EPS doesn't matter, yet they all pay attention to it.

Shareholder capitalism won't solve all social issues

There are some trade-offs that company managers can't make—and neither a shareholder nor a stakeholder approach to governance can help. This is especially true when it comes to issues that affect people who aren't immediately involved with the company as investors, customers, or suppliers. These so-called externalities—parties affected by a company who did not choose to be so—are often beyond the ken of corporate decision making because there is no objective basis for making trade-offs among parties.

If, for example, climate change is one of the largest social issues facing the world, then one natural place to look for a solution is coal-fired power plants, among the largest man-made sources of carbon emissions. But how are the managers of a coal-mining company to make all the trade-offs needed to begin solving our environmental problems? If a long-term shareholder focus led them to anticipate potential regulatory changes, they should modify their investment strategies accordingly; they may not want to open new mines, for example. But if the company abruptly stopped operating existing ones, not only would its shareholders be wiped out but so would its bondholders (since bonds are often held by pension funds). All of its employees would be out of work, with magnifying effects on the entire local community. Second-order effects would be unpredictable. Without concerted action among all coal producers, another supplier could step up to meet demand. Even with concerted action, power plants might be unable to produce electricity, idling their workers and causing electricity shortages that undermine the economy. What objective criteria would any individual company use to weigh the economic and environmental trade-offs of such decisions—whether they're privileging shareholders or stakeholders?

In some cases, individual companies won't be able to satisfy all stakeholders. For any individual company, the complexity of addressing universal social issues such as climate change leaves us with an unresolved question: If not them, then who? Some might argue that it would be better for the government to develop incentives, regulations, and taxes, for example, to encourage a migration away from polluting sources of energy. Others may espouse a free-market approach, allowing creative destruction

to replace aging technologies and systems with cleaner, more efficient sources of power.

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Shareholder capitalism has taken its lumps in recent years, no question. And given the complexity of the issues, it's unlikely that either the shareholder or stakeholder model of governance can be analytically proved superior. Yet we see in our work that the shareholder model, thoughtfully embraced as a collective approach to present and future value creation, is the best at bridging the broad and varied interests of shareholders and stake-holders alike.

[1] An annual Gallup poll in the United States showed that the percent of respondents with little or no confidence in big business increased from 27 percent in the 1983–86 period to 38 percent in the 2011–14 period. For more, see "Confidence in institutions," gallup.com.
[2] Bin Jiang and Tim Koller, "How to choose between growth and ROIC," *McKinsey on Finance*, September 2007, mckinsey.com.
[3] Jiang and Koller, "How to choose between growth and ROIC."
[4] Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, fifth edition, Hoboken, NJ: John Wiley & Sons, 2010.
[5] Sheila Bonini, Tim Koller, and Philip H. Mirvis, "Valuing social responsibility programs," *McKinsey Quarterly*, July 2009, mckinsey.com.
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[9] Koller, Goedhart, and Wessels, *Valuation*, fifth edition.
[10] Robert N. Palter, Werner Rehm, and Jonathan Shih, "Communicating with the right investors," *McKinsey Quarterly*, April 2008, mckinsey.com.
[11] John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, "Value destruction and financial reporting decisions," *Financial Analysts Journal*, 2006, Volume 62, Number 6, pp. 27–39.
[12] Richard Dobbs, Billy Nand, and Werner Rehm, "Merger valuation: Time to jettison EPS," *McKinsey Quarterly*, March 2005, mckinsey.com.
[13] Palter, Rehm, and Shih, "Communicating with the right investors."
[14] Joseph Cyriac, Ruth De Backer, and Justin Sanders, "Preparing for bigger, bolder shareholder activists," *McKinsey on Finance*, March 2014, mckinsey.com.
[15] Commissioned by the Canada Pension Plan Investment Board and McKinsey & Company, the online survey, "Looking toward the long term," ran from April 30 to May 10, 2013, and garnered responses from 1,038 executives representing the full range of industries and company sizes globally. Of these respondents, 722 identified themselves as C-level executives and answered questions in the context of that role, and 316 identified themselves as board directors and answered accordingly. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP. For more, see fclt.org.

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