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# In Defense of Shareholder Value

## Setting the Record Straight on What Shareholder Value Really Means


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On the face of it, shareholder value is the dumbest idea in the world.

Jack Welch, former chairman and CEO of General Electric
*Financial Times*[1]

It is time to scrap shareholder value theory.

Roger Martin, dean at the Rotman School of Management
*Financial Times*[2]

### A (Big) Problem of Definition

It is not surprising that the recent financial crisis has encouraged introspection among leaders in finance, business, and government. These people want to know what pushed the financial system to the brink and what caused the breathtaking loss of wealth and jobs. These are reasonable questions, and how we answer them will play an important role in shaping the future.

Commonly cited culprits for the boom and bust cycle include perverse incentives, unchecked greed, and toothless regulation. The concept of shareholder value has also come under fire as a central source of today's woes. Jack Welch, the former chairman and CEO of General Electric, called it "the dumbest idea in the world." Roger Martin, dean of the business school at the University of Toronto, argued that it's time to "scrap shareholder value theory." Such comments by prominent voices in the business community have encouraged, or validated, criticism of the concept. [3]

While there are many reasons the economy went awry, adherence to the principles of shareholder value is certainly not one of them. The attacks on the concept are ignorant, and they must stop. Stated simply, these critics are challenging behaviors that are totally inconsistent with managing for shareholder value. While many corporate executives have usurped the term "shareholder value" to justify their actions, they have failed to act in accordance with the concept's principles.

The core of the problem seems to be what managing for shareholder value means. [4] Welch, Martin and others imply that the theory is about maximizing the stock price. Companies that manage for shareholder value, the thinking goes, do whatever it takes to engineer a lofty market price, including delivering the highest possible earnings per share. That is a profound misunderstanding of what creating shareholder value is about.

Managers create shareholder value when they invest to maximize the present value of long-term free cash flows. Investments include capital spending, research and development, mergers and acquisitions (M&A), and share repurchases. These investments also include managing human capital, the task of putting the right people in the right jobs.

Shareholder value also considers cash flows the lifeblood of business, not reported earnings. The goal is to maximize the free cash flow over the life of the business. Since discounting assures that future cash flows are worth less than those today, there is a healthy balance between the short term and long term.

The term "value" is also crucial to the concept of creating shareholder value. The premise is that if a company builds value, the stock price will eventually follow. The objective is to build value and then let the price reflect that value. Executives adhering to shareholder value principles manage for value, not price. (See exhibit 1.)

**Exhibit 1: Creating Shareholder Value**

Source: LMCM analysis.

Welch, Martin, and others properly condemn the mindset that suggests executives make decisions based on what they perceive will lift the stock. Tragically, these decisions are often at direct odds with true shareholder value principles, even as they are wrapped in the same label. (See exhibit 2.) For example, a survey of chief financial officers revealed that nearly 80 percent of them would be willing to forgo value-creating projects in order to deliver smooth earnings. The premise behind this choice is that a cosmetic improvement in earnings would lead to a higher immediate stock price than would a true value-creating investment. [5]

**Exhibit 2: Maximizing Stock Price**

Source: LMCM analysis.

In denouncing shareholder value, Martin makes explicit his confusion by invoking the metaphor of sports betting. He suggests that shareholder value is like betting on the outcome of a game, while managers should focus on the game itself, or the "real market." Using American football as his example, Martin suggests that business executives have been "encouraged, if not required," to focus on the point spread instead of touchdowns and field goals. He understands shareholder value as boosting the stock price, a caricature of the true meaning. For Martin and others, shareholder value has come to represent something very different than what the term's originator, Al Rappaport, had in mind. [6]

You might argue that this is just semantics, and that Welch and Martin are correct in what they are decrying. On one level this is true. These leaders are not condemning shareholder value; they are condemning the misguided behavior that has come to be improperly labeled "shareholder value."

But the stakes are now too high to leave it at that. In recent decades, executives have justified a slew of poor management practices in the name of shareholder value without embracing the concept's true principles. It is not shareholder value that has let down management; it is management that has let down shareholder value. It is time to set the record straight on what creating shareholder value is really all about.

## What Shareholder Value Is *Not* About

In their attempt to increase stock price—the false sense of shareholder value—executives typically focus on three levers: managing earnings per share (EPS), equity-based compensation, and investor communications. These levers not only fail to represent the principles of shareholder value, they are often at odds with them. Let's take a look at each.

## EPS Growth ≠ Shareholder Value

When surveyed, a vast majority of executives cite earnings per share as the most important measure they report to outsiders. They perceive earnings to be much more important than metrics like revenues or cash flow. [7] But the link between earnings and value is at best tenuous, and there are a wide range of corporate decisions that can increase earnings and decrease value.

The value of a financial asset is the present value of future cash flows. A business must eventually return cash to its owners to be of value. It is easy to see this concept in fixed income markets, where cash flows are contractually set. Small business owners understand this point intimately, as their livelihood is based on the cash that comes in the door versus the cash that goes out. Ask a small business owner about her reported earnings and you'll likely get a quizzical look. Ask her about the cash flows and you'll get the story.

The problem with earnings is they do not provide any approximation of a company's value, nor were they ever intended to. [8] Valuation is the investor's job, and earnings are only helpful to the extent that they offer some insight about the magnitude, timing, and riskiness of future cash flows. But the informational value of earnings is limited for a couple of reasons.

Companies continue to have a great deal of latitude in the accounting choices they make while adhering to accepted accounting principles. Earnings combine the realities of cash flows with accruals, which are basically assumptions about the future. The same company can adopt a range of views on the amount and timing of accruals—items like depreciation, amortization, employee pension costs, taxes, and in some cases revenue—leading to very different earnings. Indeed, executives routinely revisit these assumptions to see if they can present a rosier picture of earnings.

The more fundamental problem with earnings per share, however, is that it is possible for a company to make decisions that increase EPS but destroy shareholder value. [9] This is the nub of the debate. The core concept behind shareholder value is that companies should only invest in strategies that generate returns in excess of the cost of capital. [10] Short-term earnings provide little indication about whether an investment adds value.

The dichotomy between earnings growth and value creation is prominent in a wide range of corporate decisions, including M&A and share repurchases. M&A is a clear example because you can compute the value a deal adds by subtracting the premium an acquirer pays from the present value of the synergies it expects to generate. Ironically, many companies emphasize the benefit to

near-term earnings when announcing a deal, and then go on to share synergy and premium figures that *demonstrate* they are destroying value.

For instance, in July 2008 Dow Chemical announced its purchase of Rohm and Haas and trumpeted an era of a "New Dow: An Earnings Growth Company." Also in the press release was an estimate of $800 million in pretax savings from combining the two companies. Capitalizing that synergy after taxes generated a sum less than the steep premium Dow offered to pay for Rohm and Haas. Even as Dow was regaling in its self-proclaimed status as an earnings growth company, it was providing all the information the market needed to reduce its appraisal of Dow's value. The market didn't miss its cue, and sent the shares down 4 percent when the deal was revealed.

So if earnings are such a poor proxy for value, why are so many executives focused on their bottom line? Our belief is that there are two factors at work. One is a bias that arises from the availability heuristic, which says that "people assess the frequency, probability, or likely causes of an event by the degree to which instances or occurrences of that event are readily 'available' in memory." [11] The bias is presumed association. Simply, because everybody talks about earnings—companies, the press, analysts—executives presume that earnings drive stock prices. For many companies, that presumption shapes behavior. In an interview about financial reporting, one CFO confided, "You have to start with the premise that every company manages earnings." [12]

Related is the mistake of inappropriately extrapolating individual behaviors to explain collective behavior. Individual behavior considers how people decide—the language they use, the tools they employ, and the rules they live by. Collective behavior captures the interaction of individuals. One of the most profound lessons from the study of complex systems is that you can't comprehend collective behavior by studying the individual parts. For example, you can't understand an ant colony by studying the individual ants. Unique properties and characteristics of the collective emerge from the interaction of the underlying individuals.

Since the market is a canonical example of a complex system, you would expect reductionism to fail to explain its behavior as with other examples. You can see this most vividly in various research approaches. If you ask individuals what matters most to the market, they will likely answer in a way consistent with the association bias and mention EPS. But studies of how the market assimilates information show consistently that the market is reasonably good at deciphering economic value. Very few investors and executives are aware of the limitations of reductionism.

Vernon Smith, a professor of economics at George Mason University and the 2002 winner of the Nobel Prize in Economic Sciences, said, "Predominantly, both economists and psychologists are reluctant to allow that naïve and unsophisticated agents can achieve socially optimal ends without a comprehensive understanding of the whole, as well as their individual parts, implemented by deliberate actions." [13] In plain words, Smith argues that people have a hard time believing that the market can be smart (i.e., understand value) even as individuals are dumb (i.e., focus on earnings). If you want to understand what the market cares about, ask the market. Don't dwell on individuals and what they say.

## Executive Pay Goes Off the Rails

As recently as 1985, only about one percent of CEO pay was tied to the stock price. At that time, boards based most executive pay on meeting corporate performance objectives like rates of sales or earnings growth. Twenty years later, well over half of CEO pay was linked to the stock price. The formalization of the idea of agency costs in the mid-1970s set the stage for equity-based compensation. Professors Michael Jensen and William Meckling distilled the agency cost argument: "There is good reason to believe that the agent [manager] will not always act in the best interests of the principal [owner]." [14] Jensen and Meckling spelled out clearly what many already knew: What is good for the manager may not be good for the shareholder.

Equity-based pay got another lift in the 1980s as the market for corporate control took off. For the first time in a generation, executives who didn't build shareholder value were at risk of having their companies snatched away from them by a corporate raider or an opportunistic strategic buyer. Startled boards woke to the realization that aligning the interests of managers and shareholders was vital, and they settled on a vehicle to do that: compensation via employee stock options.

A properly structured employee stock option compensation program is a good idea, and is consistent with the principles of shareholder value. But from the mid 1980s to the late 1990s the use of options programs went from being virtually non-existent to widely misused. Options never really had a chance to address the agency problem and to encourage value creation as they were intended to do. While option programs are often held up as evidence of a shareholder value orientation, in most cases they have had the opposite effect. Here are some of the problems with employee stock options:

- *Options reinforce an earnings focus*. With a generous number of options in hand, executives naturally seek to increase the stock price of the companies they run. Reasoning incorrectly that the path to a higher stock is higher earnings, they focus even more intently on managing and maximizing earnings. Indeed, research shows that companies that most closely tied CEO compensation to stock and option holdings in the 1990s saw greater use of discretionary accruals to manipulate EPS. [15]

- *Options overcompensate in a bull market and under compensate in a bear market*. Executive compensation programs should strive to reward superior performance. Options allow executives of companies that underperform their peers, and their own internal strategic plans, to reap massive remuneration solely as a result of a rising stock market. Likewise, those executives who deliver above-average performance in a bear market suffer despite their excellent efforts. The solution to this challenge is to offer options indexed to an appropriate market benchmark or peer group. Only a tiny percentage of companies have adopted indexed options. [16]

- *Options expense didn't show up on income statements until 2006*. Until relatively recently, a company was not required to treat employee stock options as an expense and only had to disclose the details of the program in the footnotes to its financial statements. This accounting treatment encouraged more profligate use of options and created the illusion of healthier earnings. Once the accounting rules made options expensing mandatory, companies reduced their rate of option grants. Further, event studies show little or no evidence that mandatory expensing led to lower stock prices, thus affirming that the market understands that EPS do not determine value.

- *Options are granted too broadly*. Options are typically considered a form of incentive compensation. An incentive is something that helps shape behavior. Over the past two decades, it has been common for companies to distribute options widely throughout the organization, saving the heaviest concentration, of course, for the executives. But in reality, an option provides little incentive to a typical frontline employee, whose day to day activities are remotely related to the stock price. Rappaport suggests an approach that is more consistent with shareholder value. Grant indexed options to the CEO and corporate-level executives, the individuals who can have an influence on the stock price. And match the incentives for operating unit heads and frontline employees with the drivers of shareholder value that they can control. His scheme puts the incentive back into incentive compensation and aligns all employees to the objective of building shareholder value. [17]

## Investor Communication: You Get the Shareholders You Deserve

Academic research suggests a strong interplay between companies trying to manage their stock price and the types of investors they attract. Brian Bushee, an accounting professor at the University of Pennsylvania's Wharton School, has studied investors based on their investment and trading behavior. He found three broad categories of investors. Quasi-indexers, who represent 61 percent of the investor population, have low turnover and small stakes. Transients, just under one-third of the population, have high turnover and small stakes. Finally, dedicated investors, who make up less than ten percent of the total, have low turnover and large stakes.

Bushee found that transient investors buy "heavily" when companies are enjoying "strings of earnings increases," leading to an ever-higher stock price. These earnings gains may be the result of good luck or earnings management. But transients are quick to dump a stock when the streak ends. These investors are specifically drawn to companies that provide a lot of "information events" like "investor relations activities and interim reports."

Basically, companies that seek to promote their stock via chatter with the financial community entice the quickest to flee, least-loyal investor base. Like earnings management or ill-structured compensation programs, promotionally-oriented communication with the financial community aimed solely at lifting the stock price is antithetical to shareholder value principles. Bushee summarizes, "Perhaps the most important step that managers could take would be to discourage transient ownership by refusing to manage reported earnings." [18]

## Key Principles of Shareholder Value

## Value Creation is Not About Exploitation

When a proper shareholder-value mindset is in place, executives allocate capital so as to maximize the present value of long-term free cash flows. It is worth spending a moment on showing why that objective is the right one, and how other stakeholders (employees, customers, suppliers, etc.) fit into the picture. [19]

Free cash flow (FCF) represents the pool of cash available for distribution to debt and equity claimholders. As such, FCF takes into consideration all taxes and investment needs (i.e., working capital changes and capital expenditures) but does not include financing costs such as interest expense. (See exhibit 3.) What's important is that to maximize long-term FCF, a company must properly manage its relationships with key stakeholders. For example, sales are the result of a relationship with customers. Companies that charge too much for their goods or services will lose out to the competition or will fail to entice customers. Companies that charge too little may have happy customers but will be unable to meet their other financial obligations, like paying employees and suppliers. So a successful shareholder-value-oriented company must find the price that adds value for the customer and the company.

The same logic applies to expenses and investments. Paying employees too little ensures a substandard workforce in a highly competitive world. Paying employees too much (as the auto companies discovered) hampers a company's ability remain competitive over the long haul. Similar logic extends to suppliers, the government, and local communities.

**Exhibit 3: Definition of Free Cash Flow and Relevant Stakeholders**

| Financial statement item(s) | Relevant stakeholder |
|---|---|
| Sales | Customers |
| - Expenses/investments | Suppliers, employees |
| - Taxes | Government |
| = Free cash flow | |

Source: LMCM analysis.

In short, companies that manage to maximize shareholder value must effectively deal with all of their stakeholders. A company's viability will be tested if any one stakeholder gets too much or too little for an extended period. The shareholder value approach acknowledges the difficult trade-offs that corporate executives face. But one point is clear: A company cannot maximize shareholder value through systematic exploitation of its stakeholders.

The present value of future free cash flows, including a residual value, equals corporate value. [20] To get to shareholder value, you must reduce corporate value by debt and other liabilities (e.g., pension liabilities, employee stock options). Shareholder value is based on a residual claim. (See exhibit 4.) Shareholders get what's left over after the company has satisfied the claims of all the other stakeholders.

**Exhibit 4: Definition of Shareholder Value and Relevant Stakeholders**

| Financial item | Relevant stakeholder |
|---|---|
| Corporate value (PV of FCF) * | |
| - Debt | Debt holders |
| - Other liabilities | Employees, other |
| = Shareholder value | Shareholders |

(*) = includes residual value estimate.
Source: LMCM analysis.

So how exactly does a company manage for shareholder value? The key principle is to invest so as to generate a return in excess of the cost of capital. The cost of capital represents the opportunity cost of capital providers, including the debt holders and shareholders. In corporate finance, value creating investments are called "net present value positive." For example, say a company makes a $125 million investment that allows it to generate $10 million in incremental annual cash flow. Assuming an 8 percent cost of capital, this investment is shareholder value neutral:

Shareholder value = present value of free cash flow – investment
= $10/8% – $125
$0 = $125 – $125

An investment like this may benefit customers, employees, and the government, but is value neutral for the company. If, in contrast, the same investment adds $12 million in annual cash flow, it adds $25 million in value:

$25 = $12/8% – $125

If the investment only generates $8 million annually, it destroys $25 million in value. The crucial idea is that for an investment to add value, all stakeholders have to be satisfied and there must be some surplus of economic value. Earnings, or changes in earnings, do not capture this essential feature of the shareholder value equation. Executives who manage for value cannot place earnings front and center in their thinking.

## Value Strategies, Not Projects

While the principle of funding only net present value (NPV) positive investments is widely accepted in finance circles, some practitioners continue to remain apprehensive about the approach's usefulness. [21] One concern is that it is difficult to forecast future cash flows and therefore to assess NPV accurately. This is indeed true, as few investments are sure bets. Riskiness is inherent to business. But NPV remains the right way to go because it is solidly rooted in economics.

Another worry about NPV is if it is misapplied, it doesn't capture the whole picture. For example, companies may find projects that are NPV positive within strategies that are not. Consider the possibility that a newspaper company could find a small NPV positive investment within one of its printing press operations—say, some machinery that would reduce labor costs. That is a case where a project might look good within a strategy that is doomed.

A proper shareholder value perspective considers investments in the context of a broader strategy, not just as a grab bag of projects. This point of view can lead to counterintuitive insights. For instance, there may be cases where investing in a value-neutral, or even value-destroying, project may be better than sticking with the status quo. In other words, the cost of doing nothing may be greater than the cost of doing something. So an executive steeped in the shareholder value mindset is constantly considering trade-offs. How should the company allocate its resources so as to create the most value possible?

## Compensate Properly

We have already seen the problem with employee stock options. The irony is that stock options, introduced as a way to reduce the agent-principal (manager-shareholder) divide, actually widened it in many cases. Company after company used employee stock options as a pay delivery system rather than as a properly-functioning means to reduce agency costs.

Tying a sizeable portion of senior executive pay to the company's long-term excess stock price performance is sensible. But incentive programs for operating unit heads and frontline managers and employees must align closely with the metrics they can control. For example, granting options to an accounts receivable clerk is unlikely to change his behavior, but linking his incentive pay to better on-the-job performance has a good chance of success. Executives should set the targets for operating and frontline employees based on an intelligent assessment of the leading indicators of value—those metrics that roll up to determine free cash flow and corporate value. This allows all employees to contribute to building shareholder value, and the further down in the organization you go the finer the details about the tasks.

Also crucial is avoiding what Warren Buffett calls the "institutional imperative," basically mimicking the behaviors of others in an industry. The institutional imperative has been in full view with compensation practices. Companies have maintained that they want to pay people in the top half or third of their peer group—ostensibly to attract the best and the brightest. But since all of the other companies are doing the same thing, median compensation creeps up without any consideration of whether the performance justifies it.

## Understand Expectations

In recent years, companies have bet over $5 trillion on decisions relating to their stock. These decisions include share repurchase programs, stock-funded acquisitions, and equity issuance. Given this amount, you might expect that companies have a clear understanding of what their stock price implies about future financial performance. But, in fact, that is rarely the case. Most executives have only a cursory sense of what their stock price implies. [22]

Executives who embrace the shareholder value approach know what performance is reflected in their company's stock price. Managers can reasonably distill this performance into value drivers—sales, operating profit margins, and investment needs. Understanding where the bar of corporate performance is set is the first step in assessing value versus price. Executives have spent trillions without a firm grasp of what they were giving or getting.

A useful tool in the shareholder value toolbox is reverse engineering the expectations built into the price. This exercise yields three possible outcomes. In the first scenario the market has it about right. In this case, there's not much to do besides focusing on building even more value.

Second, the market's expectations may be more modest than those of the company—i.e., the stock is cheap. In this case, executives can either communicate the specific value gap to the financial community, or take steps (like a buyback program) to take advantage of the price-to-value disparity.

Finally, the market's expectations may be too high, an assessment that the company is unlikely to deliver the performance the financial community expects. Again, companies can address this discrepancy by communicating—talking down expectations—or by issuing overvalued currency. There is some evidence that overvalued companies use their stock to make acquisitions. [23]

## Conclusion

Some high profile individuals have suggested that the concept of shareholder value was a perpetrator in the recent financial calamity, citing management efforts to boost stock prices. This accusation reflects a false understanding of what shareholder value stands for. Indeed, the current woes reflect decisions that ignored shareholder value precepts. A proper grasp and execution of shareholder value ideals remains an appropriate, if elusive, management objective. [24]

**Endnotes**

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[10] To be slightly more technical, companies should only invest in strategies that are net present value positive, i.e., the present value of future cash flows exceeds the investment outlay.
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