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# Part One

# Company Value and the Manager's Mission

# 1

# Why Value Value?

This book is about how to value companies and use information about valuation to make wiser business decisions. Underlying it is our basic belief that managers who focus on building shareholder value will create healthier companies than those who do not. We also think that healthier companies will, in turn, lead to stronger economies, higher living standards, and more career and business opportunities for individuals.

There has always been, and continues to be, vigorous debate on the importance of shareholder value relative to other measures such as employment, social responsibility, and the environment. The debate is often cast in terms of shareholder versus stakeholder. At least in ideology and legal frameworks, the United States and the United Kingdom have given the most weight to the idea that shareholders are the owners of the corporation, the board of directors is their representative and elected by them, and the objective function of the corporation is to maximize shareholder value.

In continental Europe, an explicitly broader view of the objectives of business organizations has long been more influential. In many cases, it has been incorporated into the governance structures of the corporation form of organization. Under Dutch law, for example, the board of a Structural N.V.—effectively a large corporation—is mandated to ensure the continuity of the business, not to represent shareholders in the pursuit of value maximization. Similar philosophies lay at the foundation of corporate governance in Germany and Scandinavia.

Our principal aim in this book is *not* to analyze, resolve, or even stoke the debate between shareholder and stakeholder models. However, we believe managers should focus on value creation for two reasons. First, in most developed countries, shareholder influence already dominates the agenda

Our thanks to Ennius Bergsma, who co-wrote this chapter.

of top management. Second, shareholder-oriented economies appear to perform better than other economic systems and other stakeholders do not suffer at the hands of shareholders.

## ASCENDANCY OF SHAREHOLDER VALUE

Early in 2000, Vodafone AirTouch acquired the German conglomerate Mannesmann, the first major hostile takeover of a German company by a non-German company.[1] This event signaled the broadening acceptance of the shareholder value model in Europe. It might now be argued that managers in most of the developed world must focus on building shareholder value. Four major factors have played a role in the ascendancy of shareholder value:

1. The emergence of an active market for corporate control in the 1980s, following the apparent inability of many management teams to respond effectively to major changes in their industries.
2. The growing importance of equity-based features in the pay packages of most senior executives in the United States and many in Europe as well.
3. The increased penetration of equity holdings as a percentage of household assets, following the strong performance of the U.S. and European equity markets since 1982.
4. The growing recognition that many social security systems, especially in continental Europe and Japan, are heading for insolvency.

### The Market for Corporate Control

In 1982, the U.S. economy started to recover from a prolonged period of high inflation and low economic growth. Many industrial sectors required major restructuring. For example, the invention of the radial tire had more than doubled the effective life of tires, leading to huge overcapacity. Rather than eliminating excess capacity and taking cash out of the business, most major tire manufacturers continued investing heavily, setting themselves up for a rude awakening later in the decade.

At the same time, pension funds and insurance companies began to provide increasingly large pools of funds to new kinds of investors, principally leveraged buyout (LBO) groups such as Kohlberg, Kravis, and Roberts (KKR) and Clayton, Dubilier, and Rice. In 1981, of 2,328 mergers and acquisitions in

[1] Technically, Mannesmann agreed to a negotiated transaction, but only when it was clear that the shareholders would vote in favor of Vodafone AirTouch.

the United States, 99 were in the form of leveraged buyouts.[2] By 1988, this number had climbed to 381, of a total of 4,049. Probably more important than the hard numbers was the perception of what was happening in the marketplace. The size of the leveraged buyouts had become huge, with the RJR-Nabisco transaction topping the charts at $31.4 billion. This was only four years after the first leveraged buyout exceeding $1 billion, KKR's purchase of the conglomerate Wometco in 1984. While many leveraged buyouts were friendly, the vehicle lent itself to hostile acquisitions as well. Indeed, the most visible hostile transactions in the late 1980s were LBOs, of which RJR-Nabisco was a leading example.

The structure of a leveraged buyout, combined with the emergence of high-yield bonds as a major funding instrument, put much of corporate America within range of hostile takeovers. Not surprisingly, companies that were not dealing effectively with major changes in their industry became targets. In the tire industry, BF Goodrich and UniRoyal were restructured on a friendly basis, but Goodyear and GenCorp (the owners of General Tire) came under attack.

This emergence of the market for corporate control provoked a backlash from established enterprises and their executives. By 1984, the Business Roundtable, an organization that represents the largest corporations in the United States, had already issued a working paper that supported the stakeholder view of corporate governance, largely echoing the prevalent point of view in Europe. By the end of the decade, an increasingly large and vocal opposition to the market for corporate control—as embodied by highly leveraged and hostile transactions—led to its curtailment, but only temporarily.

By the end of the 1990s, the buyout market was again hot, except this time most of the deals were friendly. Managers had learned the lessons of shareholder value and weren't waiting for hostile bidders. At the same time, the LBO had moved to Europe. Many European buyout groups were formed and American firms began to look for deals in Europe as well.

How do LBOs create value? The argument runs along these lines: Many mature, established industries that have been subject to hostile takeovers generate high levels of free cash flow. Some companies in this situation, such as those in the tire, oil and gas, and consumer packaged goods industries, often do not have sufficient attractive investment opportunities. Nevertheless, the natural inclination of an enterprise is to reinvest its cash, rather than give it back to shareholders. Such an approach can result in bad investments that reduce shareholder value. The poor investments take these forms: Money is invested in businesses that the company knows, but are not attractive, or in businesses it does not know and is unlikely to succeed in.

[2] G. Baker and G. Smith, *The New Financial Capitalists: Kohlberg Kravis Roberts and the Creation of Corporate Value* (Cambridge, England: Cambridge University Press, 1998).

Outside intervention is an instrument through which this economically suboptimal allocation of cash resources can be stopped. In the case of an LBO, this occurs through substituting equity with debt, forcing much of the free cash flow out of the enterprise and back into the capital markets in the form of interest and principal payments. This need not be done through outside intervention; it can also be accomplished voluntarily through a leveraged recapitalization, where a company takes on debt and uses the proceeds to repurchase a large proportion of its own equity.

What both situations have in common, though, is that they usually lead to significant increases in value accruing to existing shareholders. Indeed, if the corporate objective is shareholder value maximization, spending on unattractive investments is much more likely to be curtailed than if managers are following some other objective, such as employment preservation.

To summarize, the restructuring movement of the 1980s was a reaction to the inability of many corporations to adjust and change direction as their traditional product and market opportunities matured or became otherwise unattractive. The instrument through which much of this restructuring took place was the market for corporate control. The basic premise of the market for corporate control is that managers have the right to manage the corporation as long as its market value cannot be significantly enhanced by an alternate group of managers with an alternate strategy. Accordingly, the key driver for change was the poor performance of a company in terms of shareholder value.

## The Increased Role of Stock Options

In the mid-1970s in the United States, there was growing concern about the perceived divergence between managers' and shareholders' interest. In part, this feeling reflected anxiousness over 10 years of falling corporate profitability and stagnant share prices. The concern was also fueled by the increasing attention paid to stakeholder model arguments, which, in the eyes of shareholder value proponents, had become an excuse for inadequate performance. Meanwhile, a number of academics became interested in management's motivation in decisions relating to the allocation of resources, a branch of research known as agency theory. In 1976, Jensen and Meckling published a paper, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure."[3] They laid out how over the previous decades corporate management had pursued strategies and projects that were not likely to optimize resources from a shareholder's perspective

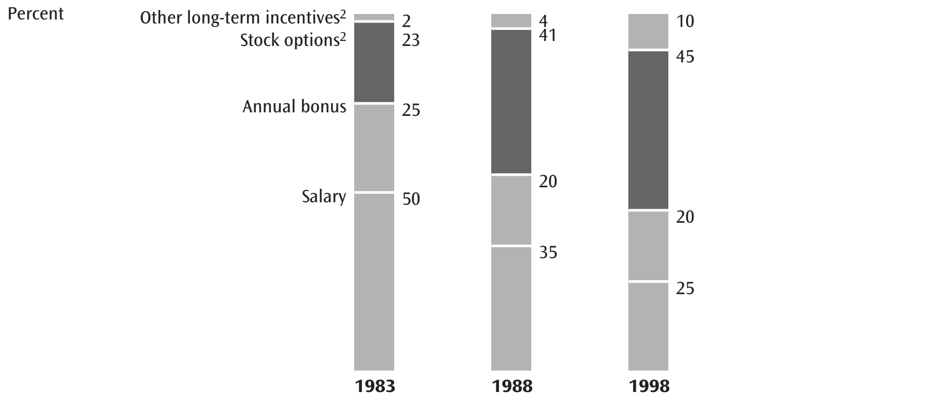
[3] M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics* (October 1976), pp. 305–360.

and called for redesigning management's incentives to be more closely aligned with the interests of the shareholders. Stock options had been a component of the pay packages of most senior executives in the United States, but the size of option grants coupled with the anemic performance of the stock market as a result of high inflation, effectively made them weak motivators of managerial behavior.

The situation changed in the early 1980s. The emergence of the LBO, and especially the management buyout, created instances where both the performance of the company in shareholder value terms and the pay packages accruing to executives as a result of their equity holdings became very large and noted by the public. At about the same time, in 1982, the U.S. Federal Reserve Board embarked on a program that drastically reduced inflation, which in turn prompted a sustained rise in equity values. As a result of this confluence of factors, the role of stock options in executive pay soared. As illustrated in Exhibit 1.1, by 1998, the estimated present value of stock options represented 45 percent of the median pay package for chief executive officers of public corporations.

Over the same period, boards of directors had come under increased criticism for perceived negligence in representing shareholder interests (which, at least under the legal requirements in the United States, they were supposed to do). A movement developed to require that nonexecutive board members have an equity stake in the companies they represented so that they would be more inclined to pay attention to shareholder returns, if only for self-interest. By the late 1990s, 48 percent of medium and large

**Exhibit 1.1 Elements of Median CEO Pay Package in USA[1]**




1 Public companies with more than $1 billion in revenues in 1983, more than $3 billion in 1988, more than $5 billion in 1998.
2 Estimated present value of gains at time of grant.

Source: Sibson & Company.

companies had a stock grant or option package for board members, in contrast to virtually none in 1983.

The widening use of stock options has greatly increased the importance of shareholder returns in the measurement of managerial performance. Such developments are not limited to the United States. Stock options and share grants have become important elements of executive pay in England and France. As the competition for executive talent becomes global, it seems likely that the use of stock options will become more and more popular in most open economies.

## The Popularization of Equity

The remarkable performance of U.S. and European equity markets since the early 1980s not only contributed to the popularization of stock options in executive pay packages, but also to the increase in stock ownership by households in many countries. This is not to say that many U.S. and non-U.S. households have become active investors in individual equities. What has happened is that growing segments of the population are becoming shareholders through mutual funds and retirement programs. Among the most vocal proponents of shareholder value are the managers of major retirement systems, such as the California Public Employees Retirement System, which has $130 billion in assets under management, a large part of which is in equities.

As shown in Exhibit 1.2, equities are by far the largest asset class in which pension funds are invested in the United States and the United Kingdom, with 58 percent and 76 percent, respectively, in 1996. The difference compared to countries like Germany, with 8 percent, and Italy, with 3 percent, is quite striking. But the situation in these countries is changing rapidly, with an increasing proportion of pension assets moving into equities.

**Exhibit 1.2 Pension Fund Asset Allocations**

1996 ($ billion)

| | USA | | France | | Germany | | Italy | | Netherlands | | UK | | Japan | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | $ | % | $ | % | $ | % | $ | % | $ | % | $ | % | $ | % |
| Cash | 225 | 5 | 8 | 12 | 9 | 7 | 12 | 17 | 8 | 2 | 43 | 4 | 112 | 10 |
| Bonds | 1,130 | 25 | 36 | 54 | 61 | 47 | 21 | 29 | 105 | 30 | 142 | 14 | 538 | 46 |
| Equities | 2,618 | 58 | 16 | 24 | 10 | 8 | 2 | 3 | 107 | 31 | 784 | 76 | 360 | 31 |
| Other | 546 | 12 | 7 | 10 | 49 | 38 | 38 | 52 | 130 | 37 | 61 | 6 | 155 | 13 |

Source: Investment Company Institute.

A shareholder culture seems to be developing in many European countries. This has been prompted partly by privatization of large government monopolies in areas such as telecommunications, where governments became active marketers of the shares of these companies. Noteworthy was the German "Deutschland Aktienland" (Germany: Country of shares) campaign in support of the privatization of Deutsche Telekom. The subsequent strong performance of the shares of the privatized companies gave a boost to the popularity of stock investment in these countries.

Exhibit 1.3 illustrates how significant equities have become in terms of market penetration in the United States, covering both direct and indirect share ownership through mutual funds, retirement accounts, and defined contribution plans. While in 1975, 25 million people, representing 12 percent of the population, owned equity shares, by 1995 this number had surged to 69 million and 26 percent, respectively. Under these circumstances, the old notions of labor versus capital are losing currency. No longer is the shareholder someone else: The shareholder is us. As a consequence, the ideological tension that fired the debate on shareholders versus stakeholders is diminishing. With more and more people as shareholders, the support for shareholder value as the objective function for a corporation is gaining momentum.

## Pension Insolvency

The fourth contributing factor for the increasing importance of shareholder value is the time bomb ticking away under the public pension systems of most developed countries. In these countries, mandatory public pensions represent the largest part of the income of retirees, with Germany and Sweden leading with respectively 95 percent and 91 percent of retiree income derived from public pensions. Most of these public plans are set up as pay-as-you-go systems where contributions by workers today are used to pay

**Exhibit 1.3 Ownership of Equity Shares in the United States**

| | **People** (millions) | **Share of population** (percent) |
|---|---|---|
| **1975** | 25.3 | 11.9 |
| **1980** | 30.2 | 13.5 |
| **1985** | 47.0 | 20.1 |
| **1990** | 51.4 | 21.1 |
| **1995** | 69.3 | 26.3 |

Source: New York Stock Exchange "Share ownership," various editions.

the retirement of current retirees. This system worked fine as long as there were relatively few retirees in relation to contributing workers. This is changing.

In 1990, for example, there were almost two workers in Germany to support one retiree. By 2035, this number will drop to one retiree per worker. As a consequence, the average contribution rate for a German worker to the mandatory public pension system will rise to 34.1 percent of gross wages in 2035 if no actions are taken, compared with 19.7 percent in 1996. This is the stuff of which revolutions are made.

Although avoiding a pension crisis is possible, there are no easy fixes. Most analysts agree that these countries have no choice but to move to some form of funded pension system, where at least a part of the premiums that workers pay are actually set aside for their retirement. The challenge is how to make it through the transition from pure pay-as-you-go to partially or wholly funded. While there are several variations of funded pensions systems, they all lead to the same conclusion—there is no solution *unless the savings in the funded part of the system generate attractive returns.*

With this in mind, one solution would be to increase premiums by a sufficient amount to build a surplus that can be reinvested, with the combination of premiums and investment returns covering the future shortfall. Here is a simplified example of how this might work in Germany. If the additional premiums were invested in German government bonds, which historically have yielded real returns of about 4 percent, the necessary incremental premium would amount to 3,103 marks, a 13 percent reduction in disposable income. If, on the other hand, these savings were invested in Germany's private sector, where real long-term returns between 1974 and 1993 have averaged 7.4 percent, these premiums would drop to 2,068 marks. If the German private sector were as successful as its U.S. equivalent, which generated real long-term returns in the same period of 9.1 percent, the annual premiums would drop to 1,706 marks, a reduction in disposable income of just 7 percent.

Thus, in combination with measures such as gradually increasing the retirement age, the burden can be reduced to a level where political consensus becomes feasible, if the investment funds generate good returns. Defusing the pension fund bomb dictates that the private sector be held to a standard where generating high returns on invested capital and creating opportunities to invest additional capital at high returns is of paramount importance. It is not coincidental that California's public employee retirement fund is one of the most vocal advocates of creating shareholder value in the United States, and has made it clear that it expects shareholder value to be a priority in other markets.

If the funded plans are to work and intergenerational competition is to be avoided—whether in Germany or other developed nations—then there must be steady pressure on companies to generate shareholder value.

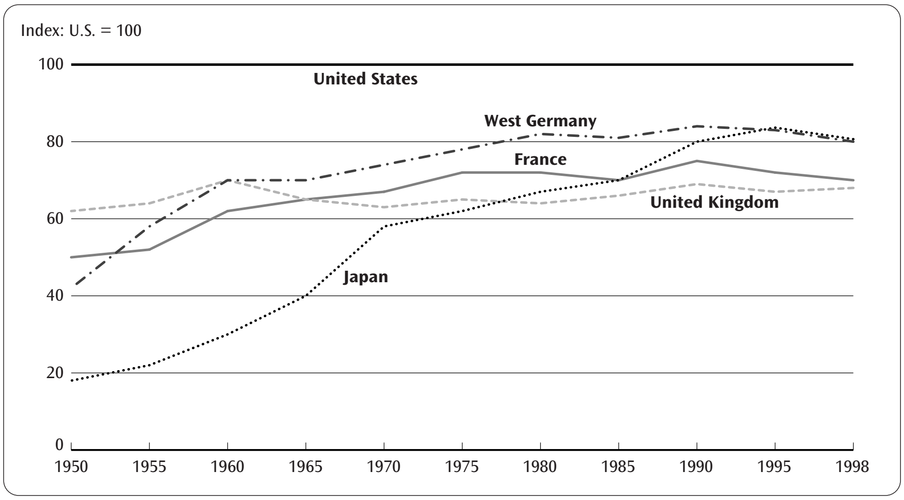
## SHAREHOLDER-ORIENTED ECONOMIES PERFORM BETTER

We doubt that the strong economic performance of the United States since the mid-1980s would have taken place without the discipline of shareholder capitalism and an increasingly sharp eye by many participants in its economy on creating shareholder value.

The U.S. corporate focus on shareholder value tends to limit investment in outdated strategies—even encourage divestment—well before any competing governance model would. Schumpeter's "creative destruction" is fostered by a bottom-line focus. Moreover, it is hard to claim (as many have at times, albeit often managers of poorly performing companies) that the capital markets are shortsighted compared with other corporate governors—the high number and value of technology and internet companies going public in recent years attests to this. Foolish maybe, but shortsighted? Certainly not.

But what about actual economic performance? Economists widely agree that the dominant measure of an economy's success is GDP per capita. As Exhibit 1.4 shows, the United States—the world's most capitalist, shareholder friendly economy—has a lead of more than 20 percent over other major countries. Up to 1975 other countries were catching up, but this convergence has since stopped. If anything, the lead of the United States has been widening.

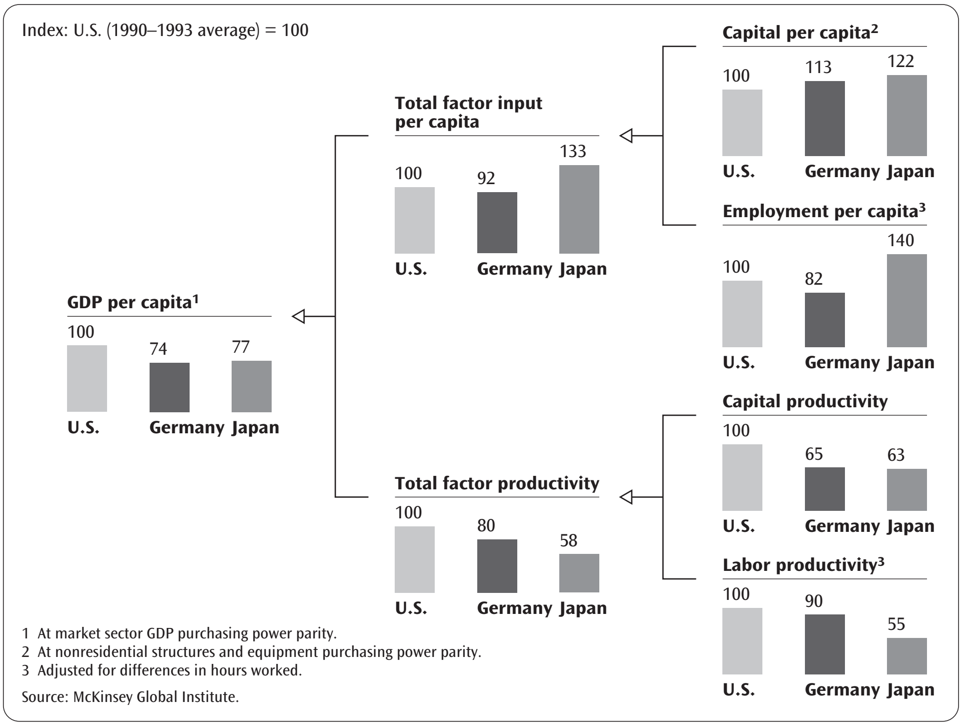
**Exhibit 1.4 GDP per Capita**



From 1994 to 1997, the McKinsey Global Institute carried out a series of research projects to analyze the differences in GDP per capita between the United States and other countries. The research, which focused on the United States, Germany, and Japan, attributed the U.S. advantage to much higher factor productivity, especially capital productivity (see Exhibit 1.5). How can the United States be outperforming other countries with a savings rate that is often deplored as wholly inadequate? The answer is what happens to those savings. In the United States they are invested in more productive (i.e., economically profitable or value creating) projects than in either Germany or Japan. As shown in Exhibit 1.6, financial returns in the corporate sector in the United States between 1974 and 1993 were dramatically higher than in Germany or Japan.

This is not to say that the shareholder value system is always perceived as fair. Job losses from restructuring disrupt lives. At the same time, one can argue that an economy's ability to create jobs, or its lack thereof, is the better measure of fairness. On that score, the track record of the United States compared with the other countries speaks for itself.

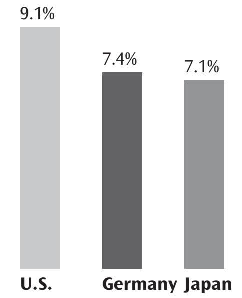
**Exhibit 1.5 Sources of Differences in Market Sector GDP per Capita**




1 At market sector GDP purchasing power parity.
2 At nonresidential structures and equipment purchasing power parity.
3 Adjusted for differences in hours worked.

Source: McKinsey Global Institute.

**Exhibit 1.6 Annual Financial Returns in Corporate Sector 1974–1993[1]**

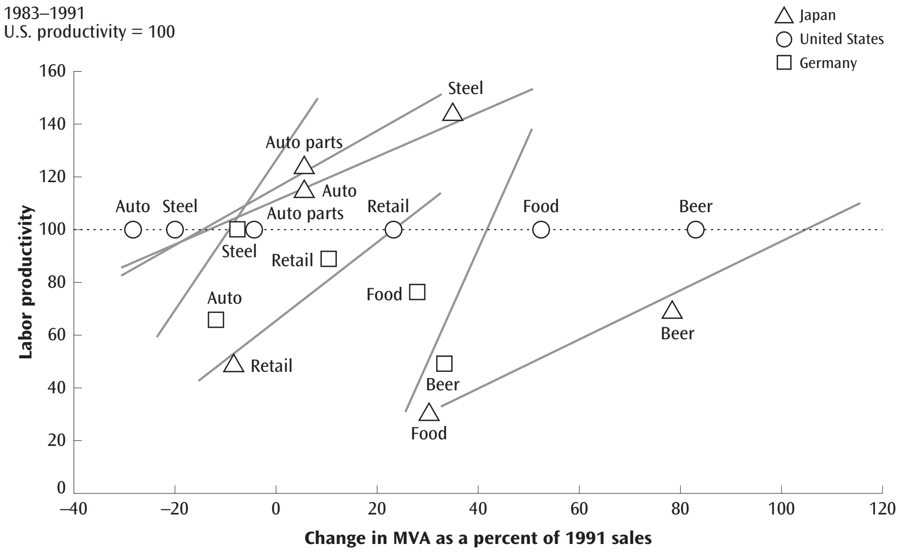



1 Calculated as the real internal rate of return to all investments (debt and equity) in the corporate sector after corporate tax and before income tax.

Source: McKinsey Global Institute.

Two centuries ago, Adam Smith postulated that the most productive and innovative companies would create the highest returns to shareholders and attract better workers, who would be more productive and increase returns further—a virtuous cycle. On the other hand, companies that destroy value would create a vicious cycle and eventually wither away.

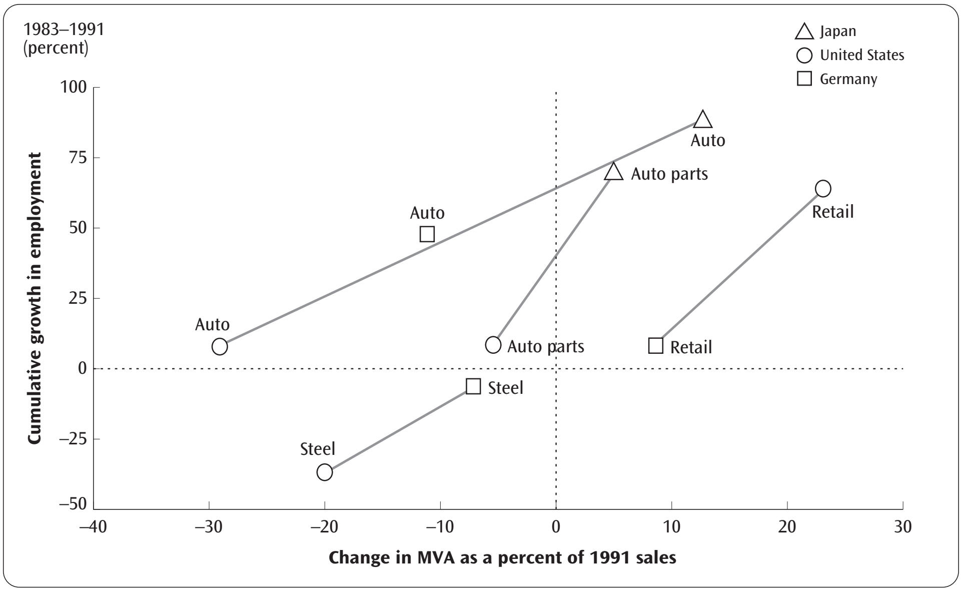
**Exhibit 1.7 Market Value Added (MVA) and Productivity**



In today's terms, we believe that a company that focuses on building shareholder value is served well by being a good corporate citizen. Why? Simply because such a company will create more value for its shareholders. Consider the employee stakeholders. A company that tries to fatten its profits by providing a shabby work environment, underpaying employees, and skimping on benefits will have trouble attracting and retaining high quality employees. With today's increased labor mobility and more educated workforce, this kind of a company will be less profitable. While it may feel good to treat people well, it's also good business.

The empirical record also strongly supports the conclusion that shareholder wealth creation does not come at the expense of other stakeholders. For the second edition of this book, we analyzed the relationship among labor productivity, increases in shareholder wealth, and employment growth across a range of industries in the United States, Japan, and Germany. Those results are shown in Exhibits 1.7 and 1.8. Our conclusions are that companies with higher labor productivity are more likely to create more value than those with lower productivity, and that these gains do not come at the expense of employees in general. Companies that are able to create more value also create more jobs.

**Exhibit 1.8 Market Value Added (MVA) versus Employment Growth**



## SUMMARY

The ascendancy of shareholders in most developed countries has led more and more managers to focus on value creation as the most important metric of corporate performance. Is this good? The evidence seems to point in the direction that a shareholder value focus not only is good for shareholders (a group that increasingly includes all of us) but also good for the economy and other stakeholders.

## REVIEW QUESTIONS

1. Compare and contrast shareholder and stakeholder mandates relative to the definition of "value."
2. Describe the effect of market forces that are changing the ideological tension between shareholder and stakeholder.
3. Summarize the premise and argument for LBO methods of rearranging value. Relate the premise to the realization of shareholder and stakeholder mandates.
4. Describe incentives that share/stakeholders can use to align managers' activities with enterprise goals.
5. What are the principal forces and directions of the pressure on companies to generate shareholder value?
6. Why should equity holders have the most decision-making power in the firm? Relate your reasons to the resolution of the savings paradox in OECD countries.
7. What is management's challenge in creating value in the United States, Europe, and Japan relative to the sources of differences in GDP per capita?
8. Summarize why value creation is the ultimate metric for corporate performance.