
Part One

Foundations of Value

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Why Maximize Value?

Chief executives from North America to Europe and Asia may be forgiven if they appear perplexed as they try to figure out how to lead their companies following the tumultuous business evolution of the past decade. A 20-year bull market in equities that began in 1980 carried nearly every company on an upward spiral of wealth generation. Shareholders who reaped these rewards cheered CEOs even as executives built up lucrative stock option packages and in some cases attained rock-star celebrity status. By the time the Internet frenzy peaked at the end of the 1990s, even staunch traditionalists like Warren Buffett pondered whether the economy had entered a new era of prosperity unbounded by traditional constraints. Some economists took to questioning long-held tenets of competitive advantage, and “new economy” analysts asked, with the utmost seriousness, why a three-year-old-money-losing Internet purveyor of pet supplies *shouldn’t* be worth more than a billion dollars.

The subsequent market crash left aftershocks that have yet to be sorted out as we prepare this book. The Internet, source of the dot-com fever, continues to change the way we shop, communicate, and manage; but its assault on the fundamental laws of economics has been brusquely turned back. The sky-high market capitalizations of many Internet companies proved to be simply unsustainable, and their plunge has left a generation of chastened investors in search of a new approach. A flurry of major corporate accounting scandals turned hero CEOs into villains, spawned government investigations and new regulations, and unleashed a new spirit of shareholder activism whose impact on corporate governance has yet to fully play out. For their part, U.S. business groups have begun to challenge the authority of regulators to impose new rules.

Ironically, one thing that did not change was the stock market’s obsession with quarterly earnings. This focus continues to confront business leaders with the dilemma of often having to choose between short-term results and the long-term health of the companies they lead.

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The good news? Amid this angst and uncertainty, executives and investors alike can draw reassurance from an important trend that has gained momentum even through years of the market's twists and turns. More and more investors, analysts, and investment bankers are turning to fundamental financial analysis and sophisticated discounted cash flow (DCF) models as the touchstone of corporate valuation.

This book explains how to value companies using the DCF approach and apply that information to make wiser business and investment decisions. With DCF, assumptions about a company's profits and cash flows years down the road determine a company's stock price. Using it, CEOs can focus on long-term value creation, confident that their stock's market price will eventually reflect their efforts. This is not a book for traders looking to profit from short-term movements in share prices. Nor is it intended for managers trying to manage their company's share price from quarter to quarter. Its purpose is to help managers looking to create lasting value in their companies.

Managers who focus on shareholder value create healthier companies, which in turn provide spillover benefits, such as stronger economies, higher living standards, and more employment opportunities. Our central message: Companies thrive when they create real economic value for their shareholders.

The movement underway to improve corporate governance will encourage companies to focus on long-term value creation. Managers and board members, therefore, should set long-term shareholder value creation as their primary objective. This book tells managers how, explaining specifically what it means to create sustainable value and how to measure value creation.

In the chapters that follow, we lay out the principles of value creation with examples and supporting empirical evidence. Companies create value by investing capital at rates of return that exceed their cost of capital. The more capital they can invest at attractive rates of return, the more value they will create, and as long as returns on capital exceed the cost of that capital, faster growth will create more value. Furthermore, value creation plans must always be grounded in realistic assessments of product market opportunities and the competitive environment. We also explore how value creation principles must be part of important decisions such as corporate strategy, mergers, acquisitions, divestitures, capital structure, and investor communications. We explain why value creation should be part of a company's culture and how it manages itself on a day-to-day basis. And we provide detailed explanations for measuring value.

These fundamental principles have been around for a long time, and the events of the recent past have only strengthened our conviction in them. This may seem counterintuitive, since we learned during the recent past that financial markets may not have been as efficient as we thought

they were. At times, the stock market may not be a reliable indicator of a company's intrinsic value. Paradoxically, the fact that markets can deviate from intrinsic values means that managers have to be more attuned to the underlying value of their businesses and how their companies go about creating value, because they can't always rely on signals from the stock market.

Specifically, managers must not only have a theoretical understanding of value creation, but must be able to create tangible links between their strategies and value creation. This means, for example, focusing less on recent financial performance and more on what they are doing to create a "healthy" company that can create value over the longer term. It means having a thorough grounding in the economics of an industry and setting aspirations accordingly. Once they've mastered the economics of value creation, they need to be able to educate their internal and external constituents. They need to install performance management systems that encourage real value creation, not merely short-term accounting results. Finally, they need to educate their investors about how and when the company will create value.

These principles apply equally to mature manufacturing companies and high-growth technology companies. They apply to companies in all geographies. When managers, boards of directors, and investors forget these simple truths, the consequences can be destructive. Consider the rise and fall of business conglomerates in the 1970s, hostile takeovers in the United States in the 1980s, the collapse of Japan's bubble economy in the 1990s, the Southeast Asian crisis in 1998, the Internet bubble, and the corporate governance scandals of the late 1990s.

We begin this chapter by arguing that, from a long-term perspective, the stock market does indeed track the fundamental performance of companies and the economy. When deviations arise, they typically come from individual sectors and rarely last more than a couple of years. Deviations from fundamentals occur when companies, investors and bankers ignore the principles of economics or assume that they have changed.

MARKETS TRACK ECONOMIC FUNDAMENTALS

The U.S. stock market's behavior from 1980 through today has confused and frustrated investors and managers. For roughly 20 of those years, the market was quite bullish as the Standard & Poor's (S&P) 500 index rose from a level of 108 in January 1980 to 1,469 in December 1999. Including dividends, the nominal annual return to shareholders was 17 percent, or 13 percent after adjusting for inflation, more than double the 6½ percent average annual return that stocks have delivered over the past 100 years. By early 2000, many investors had come to expect consistently high

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returns from equity investing. Then the market abruptly fell, tumbling more than 30 percent over the next three years. Such a large run-up, followed by such a sharp decline, led many to question whether the stock market was anything more than a giant roulette table, essentially unconnected to the real world.

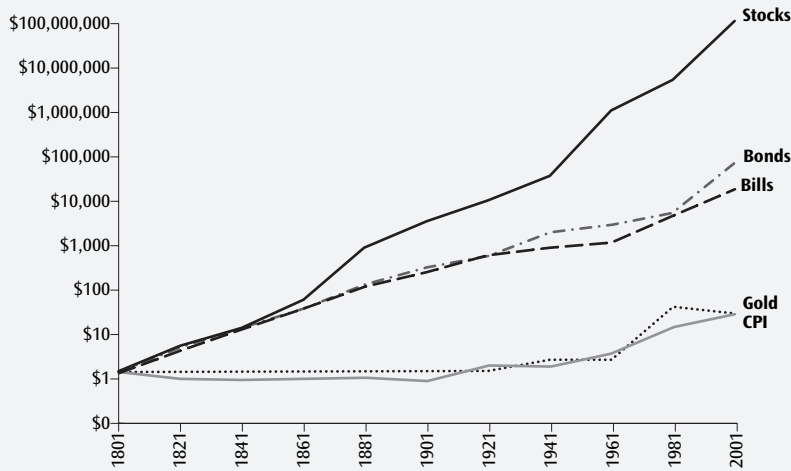
The stock market's performance, however, can be explained. More important, the explanation derives directly from the real economy, in terms of inflation, interest rates, growth in gross domestic product, and corporate profits. This relationship may not be perfect, but research shows that deviations from what we call a company's fundamental, or intrinsic, value based on financial performance and risk, tend to be short-lived and most often limited to certain industrial or service sectors.

The stock market's real surprise lies, not in the occurrence of spectacular share price bubbles, but rather in how closely the market has mirrored economic fundamentals throughout a century of technological revolutions, monetary changes, political and economic crises, and wars. And it is not just true for the U.S. stock market. We believe stock markets in the United States, Europe, and Asia correctly reflect these regions' different underlying economic prospects.

The Stock Market's Long-Term Returns

U.S. equities over the past 200 years have on average returned about 6½ percent annually, adjusted for inflation. Spectacular market bubbles, crashes, or scandals occasionally captivate public attention, as they did during the recent high-tech market frenzy, the accounting scandals of the late 1990s, the Black Monday crash in October 1987, the leveraged-buyout craze of the 1980s, and of course the great Wall Street crash of 1929. But against the backdrop of decade after decade of consistent stock returns, the effect of any of these single events pales. At a minimum, as Exhibit 1.1 shows, stock markets are far from chaotic and do not lead a life of their own.

That 6½ percent long-term real return on common stocks is no random number either. Its origins lie in the fundamental performance of companies and the returns investors have expected for taking on the risk of investing in companies. One way to understand this linkage is to examine the economy's underlying performance and its relationship to stocks. After adjusting for inflation, median price-to-earnings ratios (P/E) tend to revert to a normal level of about 15, suggesting that the typical investor's risk-return trade-offs haven't changed much over the past 100 years. Assuming that investor risk preferences have not changed, we can easily connect shareholders' long-term returns with the fundamental performance of companies. Over the past 70 years, real corporate profits have grown about 3 to 3.5 percent per year. If P/E ratios revert to a normal level over time, stock prices should also increase about 3 to 3.5 percent per year. In addition, corporate

Exhibit 1.1 Shareholder Return Indexes, 1801–2003

Source: The authors wish to thank Jeremy J. Siegel for his update to this data, which first appeared in *Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies*. 2002, New York: McGraw Hill.

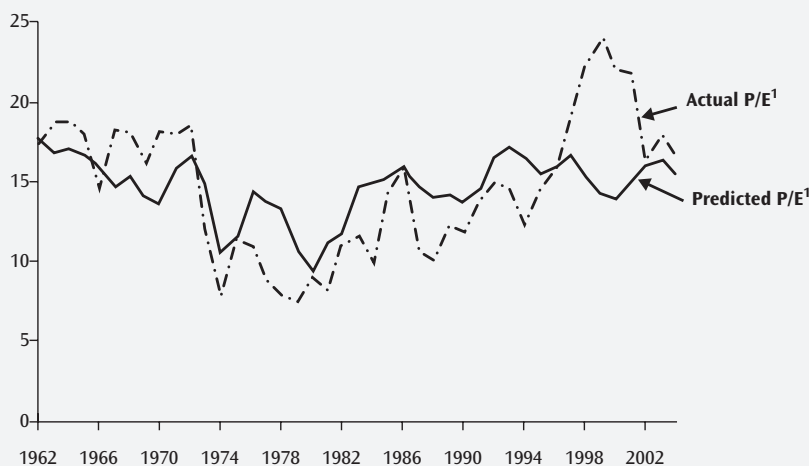
America, as a whole, typically reinvests about 50 percent of its profits every year to achieve this profit growth, leaving the other half to pay to shareholders as dividends and share repurchases. This translates to a cash yield to shareholders of about 3 to 3.5 percent at the long-term average P/E ratio of 15.¹ Adding the annual 3 to 3.5 percent increase in share prices to the cash yield of 3 to 3.5 percent results in total real shareholder returns of about 6½ percent per year.

The Link between Market Price Levels and Fundamentals

Now we need to look at the level of the stock market at different points in time and compare that with what one might expect, given the fundamental performance of companies and the economy. The results show that the overall market tracks our expected fundamental value closely over the past 40 years.

Using a discounted cash flow model, we estimated the intrinsic value for the median company in the U.S. stock market for each year from 1962 to 2003 (see Chapter 4 for more details). We used long-term trends to project

¹The payout ratio is driven by a company's growth and its return on capital. The 50 percent payout ratio is based on a typical company earning a 12 percent return on equity and growing at 3.5 percent in real terms, or 5 to 6 percent including inflation. The cash yield of 3.5 percent equals the inverse of the price-earnings ratio times the payout ratio.

Exhibit 1.2 Predicted P/E Tracks Actual P/E

¹Twelve-month forward-looking price-to-earnings ratio.
Source: IBES, McKinsey.

profit growth, the cost of equity, and returns on equity. We based inflation projections on the most recent year's inflation. To keep the scale constant, we expressed fundamental values in terms of P/E ratios.

Exhibit 1.2 compares our resulting intrinsic values with actual P/E ratios for the median company. As you can see, the P/E ratios associated with our estimates of intrinsic value track the actual P/E ratios, except for the late 1990s Internet bubble. The stock market follows a clear and simple economic logic over the long term; there is not much complexity or chaos in these patterns, despite what some have argued. We conducted similar tests—and found similar results—in the United Kingdom and broader European markets.

What Was behind the 20-Year Bull Market . . .

During the prolonged bull market in the United States from 1980 to 1999, many investors concluded that this period of growth meant that the stock market had somehow changed. From then on, they figured, companies would be valued permanently higher, and high returns would continue for

a long time to come. Many investors and commentators simply extrapolated from the recent past, predicting ongoing high returns because they could perceive nothing that would stop them. Others developed reasoned arguments to back the same view. In 1999, two economists, James Glassman and Kevin Hassett, published a book titled *Dow 36,000: The New Strategy for Profiting from the Coming Rise in the Stock Market*.² Glassman and Hassett predicted that the Dow Jones Industrial Average would reach 36,000 sometime in the 2002 to 2004 period, after rising from 700 in 1980 to 11,000 in 1999. They argued that investors were beginning to realize that stocks were low risk, and were thus bidding up stock prices. Others argued that stocks were gaining broader acceptance and that higher demand for stocks would push up prices.

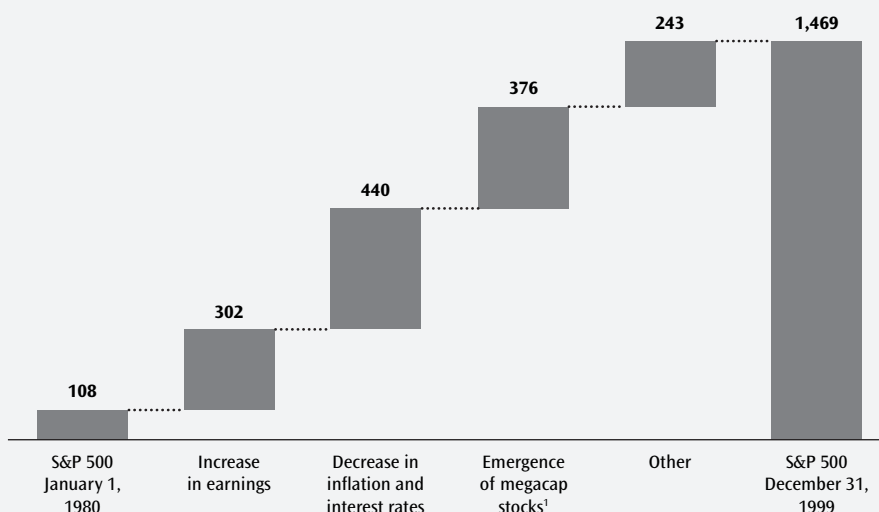
These investors and commentators had failed to understand the real factors behind the long bull market. In our analysis, we identified three elements that were responsible for nearly all the change in the broad market index. The first two, growth in earnings and declines in interest rates and inflation, were precisely the factors one would expect to influence share prices. The third was the temporary emergence of what we call *mega-capitalization* stocks associated with the Internet bubble of the late 1990s (see Exhibit 1.3).

Between 1980 and 1999, earnings per share for the S&P 500 rose from \$15 to \$56. If the forward P/E ratio had remained constant, earnings growth alone would have boosted the index by 302 points. This nominal annual growth in earnings of 6.9 percent equals 3.2 percent in real terms, close to the long-term average growth in real profits for the economy.

Simultaneously, U.S. interest rates and inflation fell dramatically. Long-term U.S. government bond yields peaked at nearly 15 percent in 1981 and then fell, more or less steadily, to 5.7 percent in 1999. The decline in inflation and interest rates drove P/E ratios back up to more typical levels. This occurred because during the high-inflation years, companies were unable to increase returns on capital commensurate with the rise in cost of capital, leading to extremely low P/E ratios.

We attribute much of the remaining increase to a lopsided distribution of value within the index. Between 1997 and 1999, a handful of companies, including Cisco, EMC, and General Electric, attained market capitalizations in the hundreds of billions of dollars, at very high P/E ratios. By 1999, the average P/E of these megacap stocks, representing the 30 largest companies in the index, was twice that of the other 470. Such a divergence in P/E ratios had no precedent in the prior 40 years and has not been definitively explained. As this gap emerged, the resulting increase in forward P/E ratios

²J. Glassman and K. Hassett, *Dow 36,000: The New Strategy for Profiting from the Coming Rise in the Stock Market* (New York: Times Books, 1999).

Exhibit 1.3 Increase in the S&P 500 Index, January 1980–December 1999

¹Measured as the change in the spread between the average and median PE ratio.

accounted for an additional 376 points of the increase in the S&P 500 from 1980 to 1999.

... And the Bear Market That Followed

The same factors were at work as the index tumbled almost 40 percent between the end of 1999 and the end of 2002. Much of the decline was due to a reversal of the gap in P/Es between the megacap stocks and the rest of the market.

In 1999, investors should have realized that share prices could not continue increasing at 17 percent per year. Whereas they might count on corporate profits to continue increasing as the economy grew, interest rates and inflation had reached very low levels and were not likely to boost P/E ratios by declining further. Whether or not you believed that the valuations of the megacap stocks were valid, it would have been unreasonable to expect that they could continue to boost the overall market's P/E in the way they had previously.

Dissecting the causes of the 20-year bull market and the bear market that followed demonstrates something else, too: Periodic deviations from fundamental values do occur. Fortunately, these deviations tend to be concentrated in a small number of stocks, as shown by the behavior of the market in the late 1990s and early 2000s.

Stocks Behaving Badly

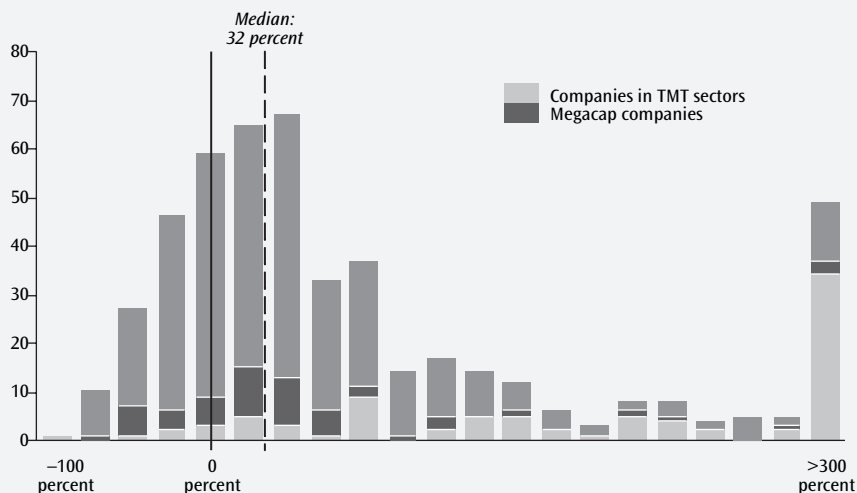
Consider the distribution of shareholder returns stretching from March 1997 through March 2000. In Exhibit 1.4, the bars represent the number of companies in the S&P 500 that increased, by a given amount, over the period. The light-gray bars represent companies in the Technology-Media-Telecommunications (TMT) sector. The dark-gray bars represent the megacap companies. The distribution is somewhat normal, but the TMT and megacap stocks are skewed to the right with the highest returns. The non-TMT stocks increased a median of 21 percent, whereas the megacap and TMT stocks increased a median of 62 percent.

The bear market that settled in between March 2000 and March 2003 was a reversal of the TMT bubble (see Exhibit 1.5). The majority of large decliners were the TMT and megacap companies. In fact, the median S&P 500 company declined only 8 percent from peak to trough, while the index itself, which is value weighted, to give more clout to the mostly highly valued companies, declined by almost 40 percent. Interestingly, fully 40 percent of the companies in the S&P 500 actually increased in value during the bear market.

Most of the companies in the S&P 500 index never went through the major gyrations of the TMT sectors. In other words, the U.S. stock market bubble of the late 1990s was for the most part a large sector bubble. Sector

Exhibit 1.4 Bull Market Driven by TMT Sectors and Megacap Companies¹

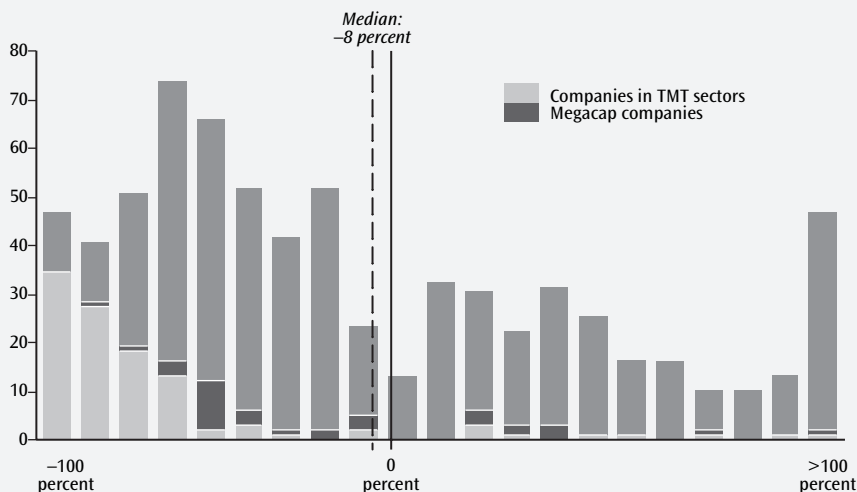
Number of S&P 500 companies per TRS category, March 1997–March 2000



¹Megacap companies in the TMT sectors are included with the TMT companies.

Exhibit 1.5 Bear Market Driven by a Reversal in TMT and Megacap Values

Number of S&P 500 companies per TRS category, March 2000–March 2003



bubbles occur frequently, but generally they are not large enough to distort a broad market index such as the S&P 500.

Maintaining Perspective

It is important to put the recent stock market bubble into its proper perspective. First, against the background of long-term market returns, the 1990s' market bubble was not as dramatic as other market events, such as the inflation-induced bear market of the 1970s. Second, sector bubbles have occurred before and no doubt will return in the future. They arise when some market players do not stick to fundamental economic rules because of greed, ignorance, or both. However, this does not mean that the market as a whole is detached from economic reality.

The European markets experienced a similar bubble in the late 1990s. In Europe, however, companies beyond the TMT sectors experienced extreme share price changes. Thus, the European bear market was much less of a sector phenomenon than it was in the United States. We are not certain why the European boom and bust was broader and flatter, but several factors probably influenced it. First, Europe's monetary unification in the late 1990s may have produced excessive optimism about the benefits that would flow from growth and productivity increases resulting from deeper economic integration. When the U.S. market turned down, the euphoria may have triggered an overly pessimistic response on the part of investors.

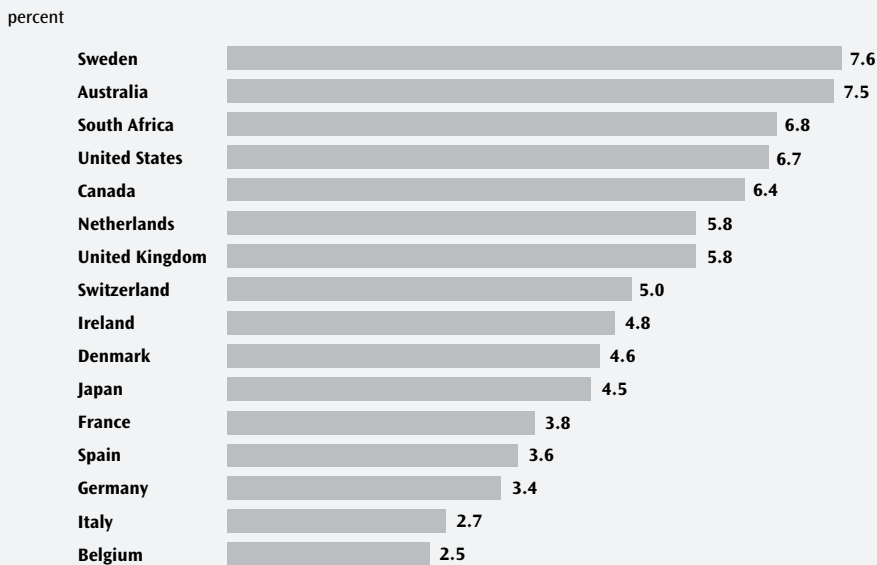
Another factor may have been that Europe's corporate incumbents stood more likely to capture benefits from the new economy than their United States counterparts, where small start-up companies were better financed. Finally, European investors may have bid up prices to match those of the U.S. market without fully grasping that U.S. stock prices were mainly driven by TMT stocks, a sector that has a far more modest role in Europe.

Cross-Country Comparisons

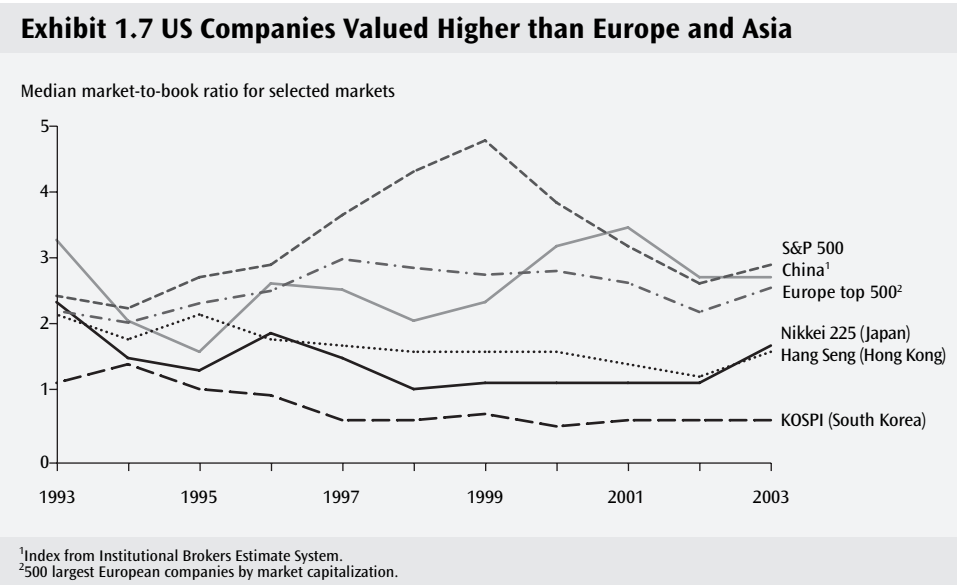
Differences in fundamental economic performance also explain variations in performance from country to country. A look at the 100-year real returns for the stock markets of 16 countries shows a range of returns from 2.5 percent per year in Belgium to 7.6 percent in Sweden, with most countries between 4.5 percent and 7.0 percent, as shown in Exhibit 1.6. Anecdotally, the countries with the lowest returns have been those that experienced the most economic upheaval, often with long periods of high inflation, civil strife, or defeat in war. The high returns in South Africa and Australia flowed from these countries' dependence on metals and mining, sectors that happened to earn high returns during this period. Also, most of these markets have relatively few companies listed on stock markets, compared with the United States and United Kingdom, so they may not be representative of the entire economy.

In addition to higher returns in the United States, P/E and market-to-book ratios have been significantly higher for the U.S. market when

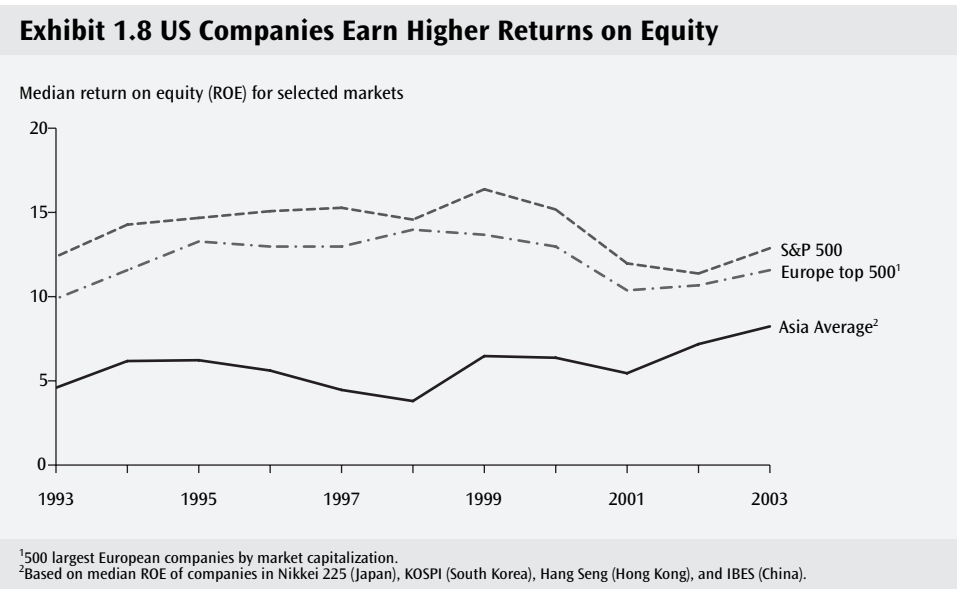
Exhibit 1.6 Real TRS around the World, 1900–2000



Source: Elroy Dimson, Paul Marsh, and Mike Staunton, *Triumph of the Optimists: 101 Years of Global Investment Returns*. 2002, Princeton, NJ: Princeton University Press.



compared with Europe and key Asian markets (see Exhibit 1.7). Although accounting rules, monetary conditions, and corporate governance have differed over time, performance differences can explain much of the difference in valuation, particularly in the case of return on capital. U.S. companies, for example, consistently earned higher returns on capital than companies in Europe and Asia (see Exhibit 1.8). We see this as further proof that economic fundamentals drive stock markets.



DEVIATIONS ASSOCIATED WITH SLOPPY ECONOMIC ANALYSIS

An implication emerges from the stock market's overall reflection of long-term economic fundamentals: Deviations are usually short-lived, focused on a particular segment of the economy, or both. Managers are therefore best off focusing their energy on long-term value creation and not worrying about the latest stock market trends. In fact, when managers and market participants take their eye off the fundamentals of long-term value creation, market bubbles can result. Two examples come to mind: the LBO bubble in the late 1980s and the Internet bubble a decade later.

The LBO Bubble

In the early 1980s the U.S. Federal Reserve wrestled inflation under control, the U.S. economy began to grow again, and companies and investors rediscovered the confidence to innovate. A market for corporate control emerged, in which companies and private investors (later grouped under the moniker of *corporate raiders*) demonstrated their ability to successfully undertake hostile takeovers of poorly performing companies. Once in control, the new owners would often improve operations, divest unrelated businesses, and then resell the newly made-over company for a substantial profit. Although large companies led many of the early hostile takeovers, the emergence of high-yield bond financing opened the door for smaller investors, known as *leveraged-buyout* (LBO) firms, to take a leading role in the hostile-takeover game.

The LBO firms' early successes attracted the attention of other investors, commercial bankers, and investment bankers. Every year, more LBO firms formed to go after deals, investment bankers scrambled to identify opportunities, and lenders saw opportunities to earn lucrative fees. In 1981, 99 LBO deals took place in the United States; by 1988, the number was 381. Early on, LBO players grounded their deal activity in solid analysis and realistic economics. Yet as the number of participants in the hot market increased, discipline declined. The swelling ranks of LBO firms bid up prices for takeover prospects encouraged by investment bankers, who stood to reap large advisory fees, as well as with the help of commercial bankers, who were willing to support aggressive financing plans.

We have reviewed some financial projections that underpinned several high-profile LBO bankruptcies in the late 1980s. Many of these transactions were based on assumptions that the companies could achieve levels of performance, revenue growth, operating margins, and capital utilization never before achieved in their industry. The buyers of these companies typically had no concrete plans for executing the financial performance necessary to meet their obligations. In many such transactions, the buyers simply assumed that they could resell pieces of the acquired companies for a higher price to someone else.

Why wouldn't investors see through such shoddy analyses? In many of these failed transactions, bankers and loan committees felt great pressure to keep up with their peers and generate big up-front fees, so they approved highly questionable loans. In other cases, each participant assumed someone else had carefully done the homework. Buyers assumed that if they could get financing, the deal must be good. High-yield bond investors figured that the commercial bankers providing the senior debt must surely have worked their numbers properly. After all, the bankers selling the bonds had their reputations at stake, and the buyers had some capital in the game as well.

Whatever the assumption, however, the immutable laws of economics and value creation prevailed. Many deals went under. Since then, participants seem to have learned their lesson. Today, LBO deals are typically built on more moderate levels of debt and are mostly based on sound economics, though recent signs of too much capital chasing too few deals are troubling. LBO deals and high-yield debt continue to thrive and play an important role in corporate restructuring and value creation.

The Internet Bubble

A decade after the heyday of the LBO deal, the business world once again found itself consumed by a frenzy, this time around the development of the Internet. When Netscape Communications became a public company in 1995, the company saw its market capitalization soar to \$6 billion on an annual revenue base of just \$85 million, the financial world quickly became convinced that the Internet would change the world. That set off a race to create companies and take them public. Between 1995 and 2000, more than 4,700 companies went public in the United States and Europe, many with billion-dollar-plus market capitalizations. Such apparently easy wealth led individual investors to quickly invest in the stock market. The trend gave birth to a new kind of investing animal, the day trader, who specialized in trading stocks for the money that could be earned from short-term swings. As the bull market rolled on, many investors amassed impressive paper wealth before the excitement ended. The NASDAQ index, a proxy for technology stocks, increased from 2,010 in January 1997 to 5,047 at its peak in March 2000. It subsequently fell to 1,945 in December 2001.

During the mania of the Internet boom, some real substance fed the hype amid the rise in share values. Many of the companies born in this era, including Amazon.com, eBay, and Yahoo! have created and are likely to create substantial profits and economic value. But for every solid, innovative new business idea, there were dozens of companies that represented the triumph of hype over experience in terms of their ability to generate revenue or profit in either the short or long term.

As with the LBO era, many executives and investors either forgot or purposely threw out fundamental rules of economics in the rarified air of

the Internet revolution. Consider the concept of *increasing returns to scale*, also known as “network effects” or “demand-side economies of scale.” The idea enjoyed great popularity during the 1990s after Carl Shapiro and Hal Varian, professors at the University of California–Berkeley, described it in a book titled *Information Rules: A Strategic Guide to the Network Economy*.³

The basic idea is this: In certain situations, as companies get bigger, they can earn higher margins and return on capital because their product becomes more valuable with each customer who purchases it. In most industries, competition forces returns back to reasonable levels. But in so-called increasing-return industries, returns become high and stay there.

Take Microsoft’s Office software, which provides word processing, spreadsheets, and graphics. It is important for customers to be able to share their work with others, so they are unwilling to purchase and use competing products. As the installed base gets bigger and bigger, it becomes even more attractive for customers to use Office for these tasks. Because of this advantage, Microsoft earns 75 percent margins and operating profits of \$7 billion on this product, one of the most profitable products of all time.

As the Microsoft example illustrates, the concept of increasing returns to scale is sound economics. What was unsound during the Internet era was its application to almost every product and service related to the Internet. Shapiro and Varian describe the rare conditions that permit increasing returns to scale. In the case of Microsoft Office, a key driver is the desire for compatibility to share documents. But during the Internet bubble, the concept was misinterpreted to mean that merely getting big faster than your competitors in a given market would result in enormous profits. Some analysts applied the idea to mobile-phone service providers, even though customers can and do easily switch from provider to provider, forcing these providers to compete largely on price. The same logic seemed to apply to Internet grocery delivery services, even though the result of attracting more customers is that these services need more drivers, trucks, warehouses, and inventory.

The Internet bubble years were full of such intellectual shortcuts to justify absurd share prices for technology companies. The history of innovation has shown how difficult it is to earn monopoly-sized rents except in very limited circumstances. But that was no matter to the commentators who ignored those lessons. Those who questioned the new economics were branded as people who simply “didn’t get it”—the new-economy equivalents of the defenders of Ptolemaic astronomy.

When the laws of economics prevailed, as they always do, competition reined in returns in most product areas. The Internet has revolutionized the

³C. Shapiro and H. Varian, *Information Rules: A Strategic Guide to the Network Economy* (Boston: Harvard Business School Press, 1999).

economy, as have other innovations, but it could not render obsolete the rules of economics and competition.

The Internet bubble shows what happens when managers, investors, and bankers ignore the fundamental principles of economics and the underlying history of value creation. It was also a classic example of herding behavior, as investors, managers, and commentators followed the crowd instead of relying on their own independent analysis. For example, many equity analysts could not justify the values of companies based on fundamentals, so they resorted to commenting only on relative values—how one company was valued relative to another—instead of dealing in absolute terms.

CHANGES IN CORPORATE GOVERNANCE AND SHAREHOLDER INFLUENCE

With share prices steadily rising for 20 years, shareholders accepted the oversized pay packages CEOs began to take home. Boards of directors reaped windfalls as well, so they were unlikely to ask hard questions about the value-creation priorities of senior management. But in the wake of corporate scandals and a market correction back to more historical levels, shareholders, regulators, and boards have become engaged in a struggle with executive management. The objective is to remake the corporate landscape in a way that restores the faith of battered shareholders and imposes greater discipline on management to focus on long-term value creation.

Some initial actions have been controversial. Reforms under the Sarbanes-Oxley legislation passed by the U.S. Congress create strict requirements for CEOs and CFOs to attest to the validity of their financial statements and to strengthen and document internal control processes. In Europe, many countries have also adopted corporate governance codes. In the Netherlands, the traditional corporate form (known as *Structuur NV*) was radically reformed in 2004. Under the old law, the supervisory boards of most major companies elected themselves, and shareholders had no say in the choice of directors. Soon shareholders will be able to elect the board members of the companies whose shares they own.

Shareholders, particularly large institutional investors, have become more activist in the companies they own, especially when they oppose the strategic direction management is taking. In 2003, shareholders voted down a proposed pay package for the CEO of one of the United Kingdom's largest companies. The following year, many large companies in the United States, including Boeing, Dell, the Walt Disney Company, Oracle, and Tenet Healthcare, separated the roles of chairman and chief executive officer, sometimes under shareholder pressure.

Board members are looking for ways to improve their oversight of companies. In a recent survey of 150 U.S. corporate directors, 72 percent

supported separating the roles of CEO and chairman, an approach that has been standard practice at companies in the United Kingdom and Europe for many years.⁴ In the same survey, board directors expressed support for the need to improve the accountability of the board and to reform executive compensation.

The crosscurrents of corporate scandals, newly active shareholders and board members, and regulatory reforms are not easy to read. But in the wake of the corporate excesses of the past decade, it is safe to say that there will be more pressure on CEOs to build long-term shareholder value.

FOCUSING ON VALUE LEADS TO HEALTHIER COMPANIES

Why should management's primary objective be long-term value creation? Companies dedicated to value creation are healthier and build stronger economies, higher living standards, and more opportunities for individuals.

There has long been 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.

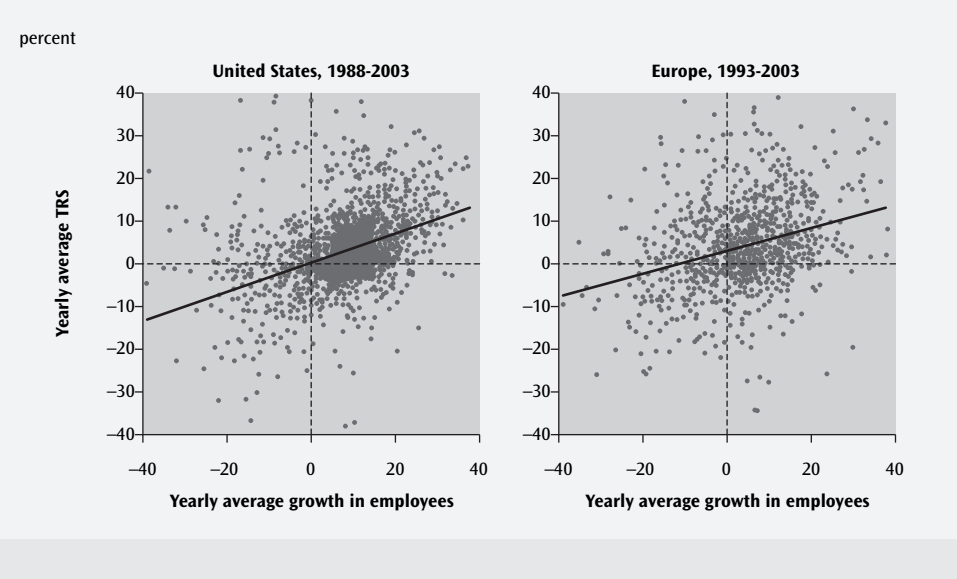
In continental Europe, an explicitly broader view of the objectives of business organizations has long been more influential. In many cases, it is embedded in the governance structures of the corporate form of organization. In the Netherlands and Germany, the board of a large corporation has its fiduciary duties toward the corporation (e.g., in support of the continuity of the business in the interests of all its stakeholders), not only toward shareholders in the pursuit of value maximization. Similar philosophies lay at the foundation of corporate governance in other continental European countries.

Pursuing shareholder value does not mean that other stakeholders suffer. Consider 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, such a company would be less profitable. While it may feel good to treat people well, it is also good business.

When examining employment, we found that the United States and European companies that created the most shareholder value in the past 15 years have shown healthier employment growth. In Exhibit 1.9, companies with the highest total returns to shareholders (TRS) also had the largest

⁴R. Felton, "What Directors and Investors Want from Governance Reform," *McKinsey Quarterly*, 2 (2004): pp. 30–39.

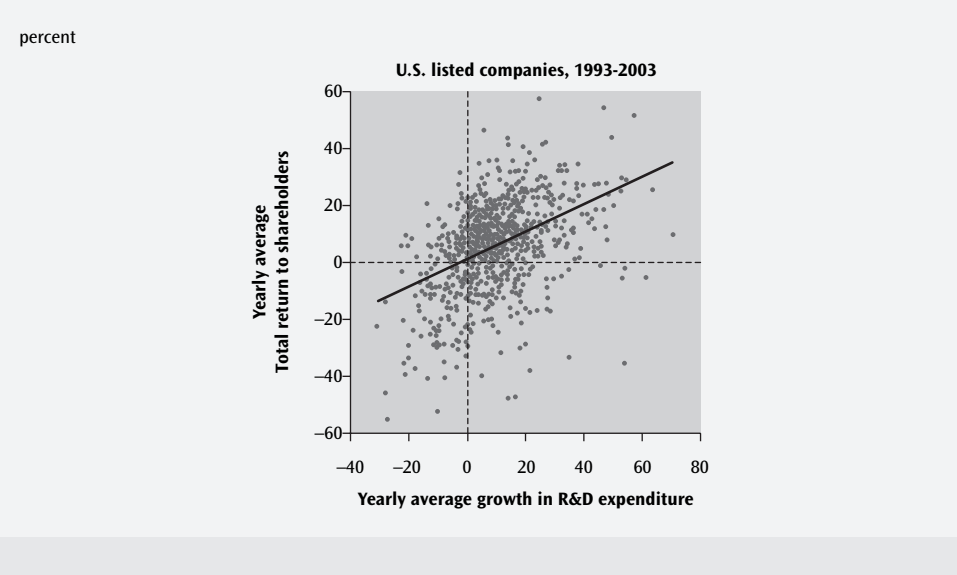
Exhibit 1.9 Correlation between TRS and Employment Growth



increases in employment. We also tested this link within individual sectors of the economy and found similar results.

Another often-expressed concern is that companies that emphasize creating value for shareholders are shortsighted. We disagree. For example, we found a strong positive correlation between shareholder returns and investments in research and development (R&D). As shown in Exhibit 1.10, com-

Exhibit 1.10 Correlation between TRS and R&D Expenditures



panies that earned the highest shareholder returns also invested the most in R&D. These results also hold within individual sectors in the economy.

CAUTIOUS OPTIMISM

Overall, capital markets reward companies that focus on long-term value creation, and these companies help the economy and other stakeholders. It is unfortunate but true, however, that managers are often under pressure to achieve short-term results at the expense of long-term value creation. Many succumb. In a recent survey of 401 executives, 55 percent of them said they would delay or cancel a value-creating project to avoid missing the consensus analysts' forecast for the current quarter's earnings.⁵

The pressure to show short-term results often occurs when companies start to mature and begin a transition from high to low growth. Investors clamor for high growth. Managers are tempted to find ways to keep profits growing in the short term while they try to stimulate longer-term growth. Usually, the short-term efforts make achieving long-term growth even more difficult, spawning a vicious cycle.

Perhaps no action was more disappointing and damaging than the wave of accounting fraud that managers resorted to in the late 1990s and early 2000s to improve the appearance of their short-term results. Eventually, fraudulent profits must be turned into real profits, so we wonder how these managers thought they would ultimately generate enough real earnings to cover the fraudulent ones.

Stock markets will always clamor for short-term results, just as coaches push athletes to achieve a higher level of performance. That pressure will always be there, and it is not all bad. It is up to managers to sort out the trade-offs between short-term earnings and long-term value creation and be courageous enough to act accordingly. Perhaps even more important, it is up to corporate boards to investigate sufficiently and be active enough to judge when managers are making the right trade-offs—and to protect them when they choose to build long-term value.

REVIEW QUESTIONS

1. Compare and contrast shareholder value maximization to stakeholder value maximization. Describe market forces that influence the ideological tension between shareholder and stakeholder. How does a shareholder define value?

⁵J. Graham, C. Harvey, and S. Rajgopal, "The Economic Implications of Corporate Financial Reporting" (*Journal of Accounting and Economics*, forthcoming).

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2. How can a short-term orientation, which focuses on metrics such as ROI and EPS, negatively impact shareholder value?
3. Describe both the principal forces and the directions of the pressure placed on companies to generate shareholder value.
4. Why should equity holders have the greatest decision-making power in the firm?
5. Identify two examples where the capital markets misjudged corporate values. In your answer, emphasize the impact of executives maintaining a short-term focus stressing industry and company fundamentals versus a long-term focus of corporate valuation.
6. Has the role of the institutional investor influenced managerial decision making over the past 25 years?
7. Critique the following statement: "Companies that focus on shareholder value create healthier companies."
8. Describe the linkage between the long-run TRS of the market and key macroeconomic variables, such as GDP growth, inflation, interest rates, and return on capital.
9. Describe one of the fundamental performance factors that explains why U.S. companies are valued more highly than European or Asian companies.