

Why Value Value?

Among the most important decisions executives face is the question of how to allocate their organizations' resources. Many leaders find themselves overwhelmed by the technicalities and nuances, often resorting to rules of thumb rather than robust analysis. This text aims to demystify how these highly complex decisions should be made by providing a clear, systematic approach to measuring value and a comprehensive understanding of how and why it is created.

In addition to the math of value creation, we show how to apply a value creation perspective to the complicated decisions that frequently arise in the course of managing a business—decisions such as whether to enter a new market, invest in product development, build a new plant, acquire another company, or divest a business.

While these questions can be daunting, the core concept behind business value creation is refreshingly simple: companies that grow and earn a return on capital that exceeds their cost of capital create value. Articulated as early as 1890 by Alfred Marshall,¹ the concept has proven to be both enduring in its validity and elusive in its application.

Nevertheless, managers, boards of directors, and investors sometimes ignore the foundations of value because of weak analyses or misaligned incentives. The tulip mania of the early 1600s, the collapse of Japan's economy in the 1990s, the internet bubble, and the mid-2000s real estate frenzy that touched off the financial crisis of 2007–2008 can all, to some extent, be traced to a misunderstanding or misapplication of this guiding principle. We see individual companies regularly misapplying the core principles of valuation—to get bigger, to beef up short-term earnings per share (often at the expense of long-term value creation), or to avoid hard choices.

This chapter was coauthored by Michael Birshan and Andy West.

¹ A. Marshall, *Principles of Economics* (New York: Macmillan, 1890), 1: 142.

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Today, phenomena such as global climate change, the distribution of wealth within advanced economies, and the rise of corporations that are more highly valued than any in history are fueling debates about shareholder-oriented capitalism. These are important topics, but the discussion sometimes risks muddling two distinct issues: the perils of short-termism and the question of what responsibilities a company has beyond lawful operations and value creation for shareholders. Much, though not all, of the criticism of shareholder-oriented capitalism is really a critique of companies' short-term behavior.

If we are to truly understand the challenges we face, we must untangle these two issues. Doing that requires a deeper understanding of value, so this chapter begins by describing what value creation does and does not mean. We then discuss the dangers of short-term behavior, followed by the task of reconciling the competing interests of shareholders and other stakeholders. The chapter closes with an overview of what will be covered in the remainder of the book.

WHAT IT MEANS TO CREATE VALUE FOR SHAREHOLDERS

Particularly at this time of reflection on the role of business in society, it's critical that managers and board directors have a clear understanding of what value creation means. For value-minded executives, the definition cannot be limited to simply maximizing today's share price. Rather, a better objective is maximizing a company's collective value to all its shareholders, now and in the future.

In the first decade of this century, some banks acted as if maximizing short-term profits would maximize value—a mistake that ultimately precipitated a financial crisis and destroyed billions of dollars of shareholder value while also hurting non-shareholders, including employees who lost their jobs, borrowers who were taken advantage of, communities where homebuilding ground to a halt, and taxpayers to the extent they funded bailouts. Similarly, companies whose short-term focus leads to environmental disasters destroy shareholder value by incurring cleanup costs and fines and by inflicting lingering reputational damage. While these might be extreme examples, the best managers don't skimp on safety, don't make value-destroying decisions just because their peers are doing so, and don't use accounting or financial gimmicks to boost short-term profits, nor do they underinvest in their people.² Such actions undermine the interests of all stakeholders, including shareholders. They are the antithesis of value creation.

If a company's investors knew as much about its operations as its managers do, maximizing its current share price might be equivalent to maximizing its value over time. But in the real world, investors have only a company's

² A. Madgavkar, B. Schaninger, D. Maor, et al., "Performance through People: Transforming Human Capital into Competitive Advantage," McKinsey Global Institute, February 2, 2023, www.mckinsey.com.

published financial results and their own assessment of the quality and integrity of its management team. Investors in most companies don't know what is really going on inside the company or what decisions managers are making. They can't know, for example, whether the company is improving its margins by finding more efficient ways to work or by underinvesting in important areas such as product development, human capital development, maintenance, or marketing.

Since investors have limited information, companies can pump up their share price in the short to medium term. One global consumer product company consistently generated annual growth in earnings per share (EPS) between 11 and 16 percent for seven years. Managers attributed the company's success to improved efficiency. Impressed, investors pushed the company's share price above those of its peers—unaware that the company was shortchanging its investments in product development and brand building to inflate short-term profits even as revenue growth declined. Finally, managers had to admit what they'd done. Not surprisingly, the company went through a painful period of rebuilding. Its stock price took years to recover.

It would be a mistake, however, to conclude that the stock market is not “efficient” in the academic sense that it incorporates all public information. Markets do a great job with public information, but markets are not omniscient. In other words, they cannot take into account information they don't have. Think about the analogy of selling an older house. The seller may know that the boiler makes a weird sound sometimes or that some of the windows are a bit drafty. But unless the seller discloses those facts, a potential buyer may have great difficulty detecting them, even with the help of a professional house inspector—and these problems would not be incorporated into the market value of the house.

Overall, the evidence suggests that companies with a long strategic horizon create more value than those run with a short-term mindset.³ Banks that had the insight and courage to forgo short-term profits during the real estate bubble of the 2000s, for example, earned much better total shareholder returns (TSR) over the longer term. In fact, when we studied the patterns of investment, growth, earnings quality, and earnings management of hundreds of companies across multiple industries over a 14-year period, we found that companies with a long-term focus tended to generate superior TSR, with a 50 percent greater likelihood of being in the top quartile by the end of the period studied.⁴ In separate research, we've found that long-term revenue growth is the most important driver of shareholder returns for companies with high

³ The studies we cite in this paragraph acknowledge that correlation is not causation. In fact, one could argue there is reverse causation—that is, companies' satisfactory financial performance gives them the luxury to place greater emphasis on long-term concerns.

⁴ *Measuring the Economic Impact of Short-Termism*, McKinsey Global Institute, February 2017, www.mckinsey.com.

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returns on capital.⁵ In our 2023 survey of 721 executives, respondents who said their companies prioritize long-term value creation over short-term profits were 2.3 times more likely than other respondents to describe their company as more innovative than its peers and 2.5 times more likely to say their five-year revenue growth exceeded that of their peers. What's more, investments in research and development (R&D) correlate powerfully with long-term TSR.⁶ Further evidence on employee and customer satisfaction indirectly supports the benefits of a long-term orientation.⁷

What this means is that managers who create value for the long term will not take actions to increase today's share price if those actions are likely to damage the company down the road. For example, they don't shortchange product development or reduce product quality. When considering investments, they take into account likely future changes in regulation or consumer behavior, especially with regard to environmental and health issues. All of this is easier said than done. Making long-term value-creating decisions requires courage and often a mindset that extends beyond one's own time in a specific role. But the fundamental task of management and the board is to demonstrate this courage, despite the possibility of short-term consequences.

SHORT-TERMISM RUNS DEEP

Despite evidence that what investors really want is long-term value creation,⁸ too many managers continue to plan and execute strategy—and then report their performance—against shorter-term measures, particularly earnings per share (EPS). The widespread occurrence of short-termism presents challenges to managers but also a set of opportunities for companies and investors with greater foresight.

The Pressure on Managers

As a result of their focus on short-term EPS, major companies often pass up long-term value-creating opportunities. The CFO of one very large company instituted a standing rule: every year, every business unit must increase its profits faster than its revenues. Some of the units had profit margins above

⁵ B. Jiang and T. Koller, "How to Choose between Growth and ROIC," *McKinsey on Finance*, no. 25 (Autumn 2007): 19–22, www.mckinsey.com. However, we didn't find the same relationship for companies with low returns on capital.

⁶ We've performed the same analyses for 15 and 20 years and with different start and end dates, and we've always found similar results.

⁷ A. Edmans, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit* (Cambridge University Press, 2020), chap. 4.

⁸ R. N. Palter, W. Rehm, and J. Shih, "Communicating with the Right Investors," *McKinsey Quarterly* (April 2008), www.mckinsey.com. Chapter 36 of this book also examines the behaviors of intrinsic and other investor types.

30 percent and returns on capital of 50 percent or more. Increasing margins every year sounds great if your horizon is the next annual report. But for units that already have high margins and a high return on capital, such a rule may incentivize passing up attractive future growth opportunities.

This example is by no means an isolated case. In a seminal survey of 400 chief financial officers in 2006, two Duke University professors found that fully 80 percent of the CFOs said they would reduce discretionary spending on potentially value-creating activities such as marketing and R&D in order to meet their short-term earnings targets.⁹ In 2023, when we surveyed 721 executives working in various roles, only 35 percent said their organization prioritizes long-term value creation over short-term profit targets. In 2017, researchers published a paper showing that CEOs tended to reduce R&D spending and increase EPS guidance around the times when their stock options were vesting.¹⁰ That's no way to run a railroad—or any other business.

Some analysts and some short-term-oriented investors will always clamor for short-term results. However, even though a company bent on growing long-term value will not be able to meet their demands all the time, this continuous pressure has the virtue of keeping managers on their toes. Sorting out the trade-offs between short-term earnings and long-term value creation is part of a manager's job. Perhaps even more important, it is up to corporate boards to investigate and understand the economics of the businesses in their portfolio well enough to judge when managers are making the right trade-offs and, above all, to protect managers when they choose to build long-term value at the expense of short-term profits.

THE STAKEHOLDER CONUNDRUM

One concern that has been posed consistently to business leaders for decades is skepticism over whether they are adequately considering the impact of their actions on others, beyond just shareholders. In some places, such as certain European countries, the interests of other stakeholder groups are embedded in corporate governance structures. Similarly, in many jurisdictions, companies are now required to be more transparent about their greenhouse gas emissions and the risks that climate change poses to their financial health.

We agree that for most companies around the world, creating long-term shareholder value requires satisfying other stakeholders as well. You can't create long-term value by ignoring the needs of your customers, suppliers, and

⁹ J. R. Graham, C. R. Harvey, and S. Rajgopal, "Value Destruction and Financial Reporting Decisions," *Financial Analysts Journal* 62, no. 6 (2006): 27–39.

¹⁰ A. Edmans, V. W. Fang, and K. A. Lewellen, "Equity Vesting and Investment," *Review of Financial Studies* 30, no. 7 (July 2017): 2229–2271, doi.org/10.1093/rfs/hhx018.

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employees and the impact on the environment and climate. And investing for sustainable growth should and often does result in stronger economies, higher living standards, and more opportunities for individuals.

When Interests Collide

Research has shown that many corporate social-responsibility initiatives create shareholder value.¹¹ Inevitably, though, there will be times when the interests of a company's stakeholders are not entirely complementary. Strategic decisions involve trade-offs, and the interests of different groups can be at odds with one another. These are times for managers to lead, and in many cases the most pragmatic approach is to focus on the long-term interests of shareholders—subject to law and regulation, of course, which are the primary mechanisms for ensuring that the activity of companies is aligned with the overall interests of society. As we will show in the next section, long-term value creation leads to better resource allocation across the economy and better economic health, which ultimately creates more jobs and a higher standard of living for all. While skilled managers focus on the long-term interests of shareholders above all, they must also actively consider a broad set of priorities when making difficult decisions.

Consider employee stakeholders. A company that tries to boost profits by providing a shabby work environment or underpaying employees will have trouble attracting and retaining productive employees. Operating with less capable or motivated employees can result in lower-quality products, reduced demand, and damage to the brand reputation. Given these circumstances, many companies choose to pay wages that are high enough to attract suitable employees and keep them motivated and productive. Companies, then, must strike a careful balance, calibrating compensation so it is competitively attractive but not significantly above the market rate.

Similarly, consider pricing decisions. Here, too, the interests of customers are not entirely aligned with the interests of shareholders. When considering any adjustments to prices, managers must weigh the value of a lower price to buyers against the value of a higher price to shareholders and perhaps other stakeholders.

Economy-Wide Benefits of Prioritizing Value Creation

Value creation also plays a meaningful role in the health of an economy. When we examined employment from 2014 to 2023, we found that the U.S. and European companies that created the most shareholder value, measured as total shareholder returns, showed stronger-than-average employment growth

¹¹ S. Bonini, T. Koller, and P. H. Mirvis, "Valuing Social Responsibility Programs," *McKinsey Quarterly* (July 2009), www.mckinsey.com.

EXHIBIT 1.1 **Companies Creating More Shareholder Value Create More Jobs**

Correlation between total shareholder returns (TSR) and employment growth¹

Compound annual growth rate, 2014–2023



¹ Sample includes companies with real revenues greater than \$1,000 million and excludes 2% top and bottom outliers in employment growth.

² Includes companies from EU27, United Kingdom, and Switzerland.

Source: Corporate Performance Analytics by McKinsey.

(Exhibit 1.1). This finding suggests an association between long-term corporate success and employment.¹²

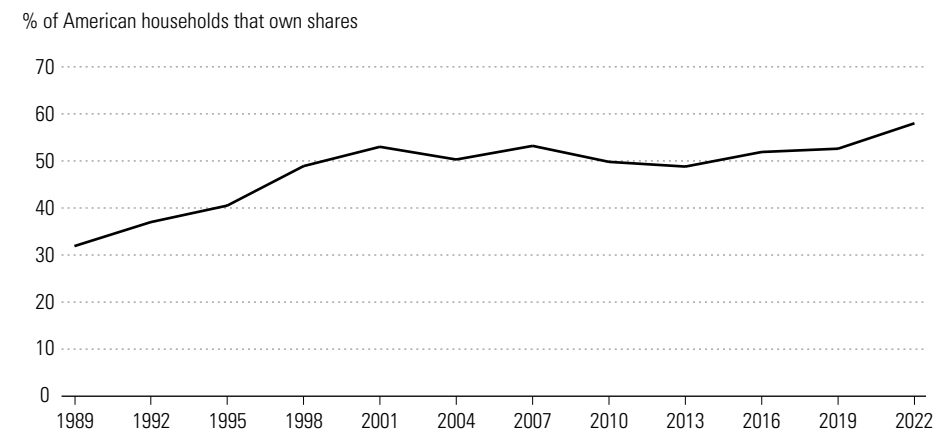
Yet this is not the full picture. Sometimes, managers face unhappier circumstances. For example, companies in mature, competitive industries may have to grapple with whether to keep open high-cost plants (which support employment and local suppliers even as they sometimes lose money). In some cases, investing in innovation, productivity, and differentiation can justify higher-cost locations and create a win-win situation. In others, however, securing a future for the company as a whole—and all who depend on it—requires tough choices. In our experience, managers carefully weigh shareholder value impact *and* agonize over decisions that have pronounced consequences on workers' lives and community well-being.

For those making these difficult trade-offs, it's important to also consider who ultimately benefits from shareholder value creation. It is comforting to know that shares in most listed companies are held by retail investors, pension funds, and mutual funds. The ultimate beneficiaries are mostly people saving for retirement. In fact, a recent report found that the portion of shares owned by individuals—whether direct or indirect holdings—has continued to

¹² We've performed the same analyses for 15 and 20 years and with different start and end dates, and we've always found similar results.

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EXHIBIT 1.2 **Increasing Percentage of American Households Owning Stocks**



¹ Sum of direct and indirect stock holdings. Examples of indirect holdings are pooled investment funds, retirement accounts, and other managed assets. Indirect holdings, particularly through tax-deferred retirement accounts, are much more common than direct holdings.

Source: Board of Governors of the Federal Reserve System, Survey of Consumer Finances (SCF), [federalreserve.gov](https://www.federalreserve.gov), accessed Jan. 2024.

increase and reached an all-time high of just under 60 percent in 2022, compared with 30 percent in 1989 (Exhibit 1.2).¹³

We can observe the importance of long-term value creation to the overall economy in widespread improvements to the standard of living in advanced economies such as the United States, where access to conveniences such as air conditioning, automobiles, and mobile phones has steadily increased over time. In 2020, almost 90 percent of U.S. homes had air conditioning.¹⁴ In the 1940s and 1950s, such conveniences were far less common. In 1900, the agriculture sector required almost 40 percent of the workforce to feed the country's population. By 1950, thanks to technological advances and improvements in efficiency, that number had dropped to just over 10 percent, and it has since fallen below 2 percent.¹⁵

In their 2022 book, *Superabundance: The Story of Population Growth, Innovation, and Human Flourishing on an Infinitely Bountiful Planet*, authors Marian Tupy and Gale Pooley measure economic progress in terms of time prices—the hours of work required to buy a certain quantity of goods. They report, “Between 1980 and 2020, while [global] population grew by 75 percent, time prices of the 50 key commodities that sustain life dropped by

¹³ H. Miao, “More Americans than Ever Own Stocks,” *Wall Street Journal*, December 18, 2023, www.wsj.com.

¹⁴ “Nearly 90% of U.S. Households Used Air Conditioning in 2020,” *Today in Energy* (U.S. Energy Information Administration), May 31, 2022, www.eia.gov.

¹⁵ “Changes in Agriculture, 1900 to 1950,” in *1950 Census of Agriculture*, vol. 5, *Special Reports* (US Census Bureau, 1952), available at www.census.gov.

75 percent.”¹⁶ For example, in emerging markets like India, the time price of rice as food for a day has dropped from seven hours in 1960 to under an hour today.¹⁷

CONSEQUENCES OF FORGETTING VALUE CREATION PRINCIPLES

When companies forget the simple value creation principles, the negative consequences to the economy can be huge. One example of many executives failing in their duty to focus on true value creation is the internet bubble of the 1990s.

During the internet bubble, managers and investors lost sight of what drives return on invested capital (ROIC); indeed, many forgot the importance of this ratio entirely. Multiple executives and investors either forgot or threw out fundamental rules of economics in the rarefied air of the internet revolution. The notion of “winner takes all” led companies and investors to believe that all that mattered was getting big fast, on the assumption they could wait until later to worry about creating an effective business model. At the same time, the logic of achieving ever-increasing returns was mistakenly applied to areas such as online pet supplies, grocery delivery services, and others where a growing customer base would require investing (unsustainably, eventually) in more drivers, trucks, warehouses, and inventory. When the laws of economics prevailed, as they always do, it became clear that many internet businesses lacked the unassailable competitive advantages required to earn even modest returns on invested capital. Although the internet has revolutionized the economy (as have other innovations), it did not and could not render obsolete the rules of economics, competition, and value creation.

THIS BOOK

This book is a guide to how to measure and manage the value of a company. The faster companies increase their revenues and deploy more capital at attractive rates of return, the more value they create. The combination of growth and return on invested capital (ROIC), relative to its cost, is what drives cash flow and value. Anything that doesn’t increase ROIC or growth at an attractive ROIC doesn’t create value, such as when a company changes the ownership of claims to cash flows or uses accounting techniques that change the timing of profits without actually changing cash flows.¹⁸

¹⁶ G. Pooley and M. L. Tupy, *Superabundance: The Story of Population Growth, Innovation, and Human Flourishing on an Infinitely Bountiful Planet* (Washington, DC: Cato Institute, 2022).

¹⁷ Ibid.

¹⁸ See Chapter 3 for more details.

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This guiding principle of value creation links directly to competitive advantage, the core concept of business strategy. Only if companies have a well-defined competitive advantage can they sustain strong growth and high returns on invested capital. To the core principles, we add the empirical observation that creating sustainable value is a long-term endeavor—one that must take into account wider social, environmental, technological, and regulatory trends.

Competition tends to erode competitive advantages and, with them, returns on invested capital. Therefore, to create long-term value, companies must continually seek and exploit new sources of competitive advantage. To that end, managers must resist short-term pressure to take actions that create illusory value quickly at the expense of the real thing in the long term. Creating value is not the same as, for example, meeting the analysts' consensus earnings forecast for the next quarter. It does not come from ignoring the effects of decisions made today that may create greater costs down the road, such as the cost of retrofitting plants to meet future pollution regulations or attracting talent despite a tarnished reputation. It means balancing near-term financial performance against what it takes to develop a healthy company that can create value for decades ahead—a demanding challenge.

This book explains both the economics of value creation (for instance, how competitive advantage enables some companies to earn higher returns on invested capital than others) and the process of measuring value (for example, how to calculate return on invested capital from a company's accounting statements). With this knowledge, companies can make wiser strategic and operating decisions, such as what businesses to own and how to make trade-offs between growth and return on invested capital. Equally, this knowledge will enable investors to calculate the risks and returns of their investments with greater confidence.

Applying the principles of value creation requires making decisions based on long-term outcomes, which sometimes involves going against the crowd. It means accepting that there are no free lunches. It means relying on data, thoughtful analysis, a deep understanding of the competitive dynamics of your industry, and a broad, well-informed perspective on how society continually affects and is affected by your business. We hope this book provides readers with the knowledge that helps them throughout their careers make and defend decisions that will create value for investors and for society at large.