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Creating Sustained Shareholder Value - And Dispelling Some Myths

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Summary
Determining how a company can create sustained shareholder value lies at the heart of strategy, say Anjan Thakor, Jeff DeGraff and Robert Quinn. The secret lies in discovering the key value drivers in the business and then tying the strategy to them. In this article the authors identify a range of myths which cloud people's thinking; they explain why pure accounting measures can be misleading; and they present a model aimed at helping companies identify what drives value. Ultimately, the real myth is that which suggests one can generalise in the application of value creation to all companies.

One of the most frequently used terms in business today is "Shareholder Value". The "equity culture" wildfire is spreading rapidly from the US to the rest of the world. There are many reasons why CEOs are worshipping at the altar of shareholder value - an important one is corporate control pressures.

During the 1980's and the 1990's, corporate control contests in the US often resulted in removal of CEO's whose companies failed to deliver adequate shareholder value. One striking example was the replacement of Ron Miller by Michael Eisner as Chairman of the Walt Disney Company in 1984. This was a consequence of the hostile takeover attempts provoked by Disney's relatively mediocre performance on shareholder value.

Interestingly, a year prior to these takeover attempts, Tom Peters and Waterman in their widely read book, In Search of Excellence!, had rated Walt Disney as one of their 14 "excellent companies".

A second important reason for the focus on shareholder value is executive compensation. Large institutional investors are increasingly influencing corporate policies. They are creating a

heightened awareness of the role of compensation-based incentives in focusing executive efforts on creating shareholder value. Companies are rewarding senior executives with shares and with options on these shares. Thus, share price is now critical for most senior executives.

Share prices, of course, often show significant unanticipated volatility over time. They are driven by a host of factors, many of which are beyond the control of the company's management. Consequently, the "scorecard" of many companies focuses on the sustained creation of shareholder value. Such orientation provides a long-term view of shareholder value.

Measurements

There are various ways of measuring the long-term perspective. One is to look at total annual shareholder returns. This figure is calculated by taking share price appreciation, adding dividends paid during the year, divided by the share price at the beginning of the year. This process is done over many years. The goal of using total annual shareholder returns is to surpass the performance of a "benchmark portfolio." The benchmark portfolio can be the whole stock market, the industry to which the company belongs, or a subset of companies within the industry. Another approach to assessing long-term value is to look at the average Market Value Added (MVA) per year over a 5- or 10-year time horizon. MVA is defined as the difference between the company's market and book values at a given point in time. If book value is the capital invested in the company by its shareholders and bondholders and market value is the market's assessment of what this invested capital is truly worth, then MVA measures how much net value has been created for the owners of the company, the shareholders. Companies that have created the most MVA for their shareholders include retailer Wal-Mart, General Electric, Microsoft, and Coca-Cola. In fact, Coca-Cola had the highest MVA (almost $125bn) at the end of 1996.

How do companies achieve sustained creation of shareholder value? The answer lies in strategy. We believe strategy is simply determining how the company will create shareholder value. This requires defining the scope of permissible activities and determining the allocation of resources to these activities. A security analyst once remarked: "To understand a company's strategy, I don't read what the CEO says. I look at where the company is allocating resources." If the right strategy is chosen, and then properly executed, sustained shareholder value should follow, as long as the strategy is adapted to changing environmental conditions.

The power of successful strategies is seen in companies that have created spectacular value for their shareholders. What helped turn the Walt Disney Company around was a new strategy. Michael Eisner, new chief executive of the giant entertainment enterprise, focused the company on animated films. All of Disney's other business lines such as theme parks, consumer products, real estate, etc., have since fed off the success of the company in creating new films.

In other companies, other strategies are necessary. Wal-Mart for example, has focused on size expansion and constant improvement in asset productivity. This focus has been driven by the nature of the retailing industry where scale economies are significant and considerable assets are deployed, so that a small improvement in per-unit asset productivity can have a large overall effect on value.

How do companies develop winning strategies? The secret lies in discovering the key value drivers in the business, and then tying the strategy to those value drivers. Eisner recognised that the key value driver for Disney was its creative output. Making animated films was a tangible manifestation of that creative output. Sam Walton founder of Wal-Mart recognised that the key value driver in the retailing business was how fast you turned over your inventories, and not gross margins. In a brutally competitive industry, where competing companies exhibit little differentiation from each other in customer and vendor selection, it is difficult to outperform your rivals on gross margin. This is why Wal-Mart has focused so much on its asset turnover. Its entire business design, including its management information system and its relationship with suppliers, is predicated on driving improvements in asset turnover. It is on this dimension that Wal-Mart has outperformed its rivals.

Simply put, to create sustained shareholder value, you need the right strategy, and to craft the right strategy, you need to discover the key value drivers in your business. This, of course, is not easy, as we tend to be blinded by a number of myths.

The myths of shareholder value creation

Numerous myths about shareholder value cloud people's thinking. Clouded thinking results in misallocation of resources and dissipation of value. What are some of the popular myths?

Myth number one:

The way to create shareholder value is to have a single-minded focus on the "bottom line." This often means managing the company constantly to meet or exceed stock market expectations about a company's earnings per share (EPS) or some other bottom-line measure of financial performance.

Myth number two:

There are unavoidable tensions between the interests of stakeholders. Consequently, maximising the value to shareholders will involve subordinating and sacrificing the interests of other stakeholders, like employees and customers.

Myth number three:

Giving every employee a share of stock is a sure way to motivate employees to maximise shareholder value.

Myth number four:

The stock market is myopic and cares only about short-term earnings.

In Table A, we summarise how these myths can steer corporate behaviour away from the sustained creation of shareholder value.

Table A

Myth	Corresponding outcomes
(1) Shareholder value is created by an exclusive focus on the bottom line.	- Excessive focus on quarterly earnings, budgets, cost cutting, head-count slashing.
(2) Maximising shareholder value means sacrificing the interests of employees and customers.	- Alienated customers, due to poor customer service; low employee loyalty; high turnover; lost capacity.
(3) Giving employees shares of stock makes them act like owners.	- Employees typically perceive that their individual actions will minimally affect the stock price and it becomes less likely that employees will behave like owners.
(4) The stock market is myopic and cares only about the short run.	- Excessive focus on immediate financial results at the expense of sustainable and long-term value creation, including cutting back on employee development, research and development investment, new product introduction.

This table outlines how companies guided by myths make decisions that can destroy shareholder value. In short, strategies become misguided. For example, in the 1980s, virtually every major airline, guided by the fiercely competitive nature of the industry and the usual obsession with short-term financial performance, designed its strategy to become a low-cost provider of air transportation. The resulting business design was driven by the fundamental assumption that most air travellers wanted just to get from point A to point B at the lowest possible cost. Customer service was cut to the bone.

By contrast, British Airways, under its then chief executive Sir Colin Marshall, crafted a strategy that focused on providing the customer with a truly satisfying travel experience. Many dimensions of customer service, including the quality of the food and wine served on board, were enhanced, rather than sacrificed. British Airways' approach was truly product differentiation by strategic design at its best. It allowed the airline to create wider margins and outperform rivals financially. It is somewhat ironic that it has recently been criticised for its customer service while its share price has under performed in the market, just as the Walt Disney company has recently been criticised for lacking a clear strategy and having a weak board of directors.

Slow death

The question that should now be asked is why is it that a singular focus on the bottom line leads companies astray and fails to create sustained shareholder value? Perhaps the most intriguing of the many reasons, is that companies monitor operational performance to determine whether they are creating value by keeping an eye on accounting measures of performance. Thus performance targets are typically set in accounting terms - EPS or operating project targets, sales growth targets, and revenue targets. The problem is that accounting has become a tool to disguise the slow death of a company. Because of the considerable flexibility companies have in reporting accounting numbers, reported results are often not an accurate indicator of performance in that period.

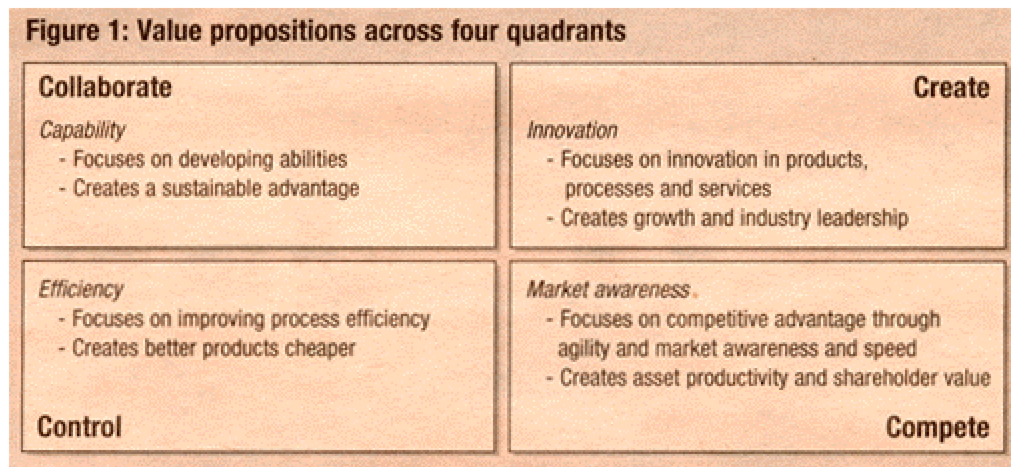
Companies typically "smooth" reported numbers relative to actual results. This smoothing hides poor performance during hard times by adding to "reserves" during times of relative prosperity. A company that has accumulated substantial reserves due to past success, but is now in a slow death, can keep reporting relatively high earnings by drawing down on its reserves, even though actual profits are spiralling downward.

This disguising through accounting manipulations is possible to a greater extent in Europe than in the US. This was clearly seen in the substantial new information that was revealed about Daimler Benz's financial condition when it decided to list on the New York Stock Exchange. However, the problem is increasing in the US as well. For example, Arthur Levitt, Jr., Chairman of the Securities and Exchange Commission (SEC) was quoted in the CPA Journal in December 1998 as saying: "Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation."

A four-quadrant approach to value creation

To avoid the common myths of shareholder value and achieve sustained value creation, companies need to understand how value-driver analysis, strategy, leadership and resource allocation can be integrated constructively, so the truth behind the four myths can be extracted.

One way is to use the Four-Quadrant Value Propositions (FQVP) hypothesis outlined in Figure 1. This is derived from the Wholonics Model, a total-value approach by the authors to developing integrated capabilities at all levels: strategic, organisational and individual. We focus on the FQVP aspect of the model here because it is the most relevant for the alignment between strategy and leadership that we want to explore here.



The FQVP hypothesis asserts that there are four quadrants in which any organisation creates value. Typically trade-offs are involved, so that an organisation must choose its focus and resource allocation in each quadrant. Depending on its strategy, each organisation will be positioned differently across these four quadrants. The central insight of the model is that this positioning will determine everything that has value-creation implications for the organisation - resource allocation, performance metrics, organisation culture, compensation contracts, and leadership style. This, in

turn, means that all of these must be consistent with each other and with the overall strategy. In using this model, one begins with an identification of the key value drivers in the business. These then help to define the strategy.

By way of illustration, consider two organisations: a power plant and an entertainment company like Walt Disney. The key value driver for the power plant is cost efficiency, which is driven by operating scale. Market awareness and innovation are relatively less important. Capability in employees is important, but can be readily purchased in the labour market. Thus, the strategy for the power company is to have large, efficient plants that focus on diminishing reliance on labour. By contrast, the entertainment company's success is driven by its product innovation, which means its key value driver is its creativity. Thus, the strategy for the entertainment company is to focus on hiring the most creative people in the industry and providing ample opportunities for their creative output to be manifested in the company's products and services. Thus, the strategic value propositions fro these two companies are as in Figure 2 below.

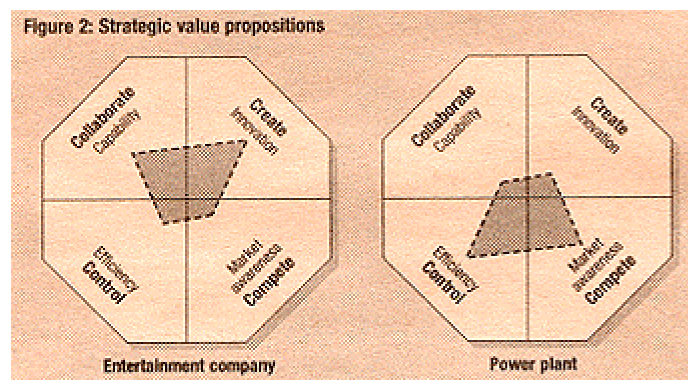


Figure 2: Strategic value propositions

As the two figures show, efficiency is the principal focus for the power plant, although it cannot entirely ignore the other quadrants. By contrast, for the entertainment company, building individual capabilities and fostering innovation are just as important as the creative output of its employees, although this company cannot be oblivious to efficiency and market pressures.

These two organisations should look very different on a number of dimensions. First, the power plant performance measures will include cost productivity and power generation reliability. Conversely, the entertainment company metrics will include new product introductions, value of brand equity, employee turnover, revenue and margin growth, economic value added, etc. Second, the power plant will allocate most of its resources to projects that lower per-unit costs, via fuller capacity utilisation, scale augmentation, equipment replacement, re-negotiation of terms with vendors, etc. However, the entertainment company will allocate most of its resources to producing new shows or movies and leveraging the creative output of these shows or movies across other products.

These two companies will also differ in organisation design and leadership style. The power plant, with its efficiency focus, will be hierarchical and will benefit from a command-and-control top-down leadership style. The entertainment company will be flatter and more decentralised, with less of a command-and-control leadership style.

Each company, with the proper alignment between its value drivers, strategy, resource allocation, performance metrics, organisation design and culture, can create significant value for its shareholders. But each will do so in different ways.

Finally, in determining a strategy, companies should understand that what is a shareholder value myth for one company may be the appropriate guiding light for another.

For example, the power plant should focus on the bottom line and immediate results. That is, myth number one "Shareholder Value is created by an exclusive focus on the bottom line" and myth number four "the Stock Market is myopic and cares only about the short run" are not myths for the power plant.

But if the entertainment company were to use these myths as its guiding principles, and cut back on the resources it devoted to product innovation and people/capability development, it would be in serious trouble.

Conclusion

Ultimately, the real myth is that it is appropriate to apply generalisations about value creation to all companies, regardless of how they are strategically positioned in the four quadrants. An exclusive focus on shareholder value may be the key to creating shareholder value for a company like Wal-Mart that is primarily positioned in the Market Awareness quadrant. It might prove to be the death-knell though for an Internet start-up or one like Walt Disney which may be positioned largely in the Capabilities and Innovation quadrants of the same figure.

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