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# The Case for a Shareholder Value Focus

It's the shareholders' company. And if executives would just go by what investors do rather than what they say, they would actually create a lot more value.

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It seems that every few years someone, often from academia, passionately asserts that some form of stakeholder value should be the preferable corporate focus over shareholder value. The most recent example comes from Cornell law professor Lynn Stout, whose book, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations and the Public,* was discussed in the November issue of *CFO*.

Stakeholder value–driven strategies seek outcomes that balance a broad range of goals, such as employee fulfillment, customer satisfaction, environmental conservation, and general public well-being. These strategies seem altruistic and compelling, but their justification often breaks down after any meaningful consideration.

As a practical matter, telling business owners that the managers they have hired should put other priorities before the owners would discourage the necessary investments and risk-taking that our economy needs to grow, to provide employment opportunities, and to raise our standard of living.

There really is no basis for putting other interests before the shareholders. Consider a man or woman who opens a family business. Most of us don't mind if they hire and task a manager to maximize their profits over time. Why should we mind if they grow the company enough that they attract investment by selling shares to the public, and these public investors expect management to work on their behalf as well.

All the while this company will help improve the economy, the employment outlook, and our standard of living simply by doing what benefits the stockholders over time. It's Adam Smith 101. The primacy of shareholder value is simply the extension of the case of the sole proprietorship and is justified by the preservation of private property rights.

**Shareholder Value Is Good for Everyone**

Ethically, many characterize this as class warfare, but this is not a discussion about the super-rich versus the rest of us. To a high and increasing degree, the beneficiary of shareholder-value creation is the broad working public in our society.

A 2011 Gallup Poll showed that 54% of American households invest directly in the stock market through individual stocks, mutual funds, or a self-directed 401(k) or IRA. Further, U.S. Census data shows that from 1952 through 2010, mutual funds, retirement plans, and life-insurance companies went from owning about 5% of all U.S. equity investments to 43%. The rate of growth of these investors is nearly twice that of what the census classifies as the "household" sector, which includes the extremely wealthy.

Thus, increasingly the creation of shareholder value boosts the prosperity of the vast majority of households in our society. The rich may get richer but so do most households, and at the same time pension plans and life-insurance companies become more secure.

As a result of this linkage, the historically poor stock-market returns of the past decade penalized not only the accounts and retirement benefits of wealthy investors but also the majority, if not all, of those with any savings. This has particularly restricted the wealth of retirees and those nearing retirement, and has contributed to the fiscal difficulty facing many municipalities.

Any public or private policies that stand in the way of companies creating long-term shareholder value will jeopardize the wealth and retirement security of all.

**True Shareholder Value Strategies Strengthen the Company**

A great deal of the objection to shareholder value originates from a thorough misinterpretation of what in fact is of value to shareholders. It is hard to blame the stakeholder activists on this front, as this confusion emanates from many journalists, investors, and even executives.

These supposedly shareholder-focused individuals are often misguided as they frequently link short-term actions to shareholder value, even though such actions are actually quite at odds with what truly drives share prices over time.

A true shareholder-value focus aims to create shareholder value over time rather than in the short run. Indeed, many of the actions that drive share prices up in the short run actually weigh on share prices over time, and vice versa. Executives shouldn't be very concerned about their share price over the next week or month; they should care about it over the next few years and beyond.

This may be easy to say and hard to do, especially in a world where C-suite job security has become a "what have you done for me lately" charade, and tenure appears to be shrinking. We have nevertheless found several strategic realities that are quite different from the short-termism often advocated.

Some of these short-term views include, for example, generating consistent growth in earnings per share (EPS), maintaining high returns on capital, avoiding acquisitions, increasing debt leverage, and buying back as many shares as possible.

The facts show that many of these so-called shareholder value–driven strategies actually harm share prices over time. Consider these strategic realities:

**Strategic Reality #1: Maximizing short term EPS and return on capital can limit the growth of shareholder value.**

In the name of shareholder value, quarterly EPS and earnings conference calls have become the primary focus of many company executives. This puts pressure on so-called soft investments such as research and development, advertising, and staff training, which are often the first to be cut when EPS seems inadequate. These quarterly slash-and-burn tactics seem immediately painless, but over the long term they can drain a company's growth and differentiation.

A related trend starting in the 1980s has been the increased use of sophisticated measures of return on capital and economic profit, which were often implemented in the name of "shareholder value." These new ways of planning, decision making, and performance management often encourage reductions in investments in plant, equipment, and other assets. The focus on asset efficiency can also restrict long-term business prospects.

We have found high total shareholder returns are strongly related to having relatively high rates of reinvestment in the form of capital expenditures, R&D, working capital, acquisitions, and other assets. Companies that slash investment in the name of shareholder value usually achieve the opposite.

**Strategic Reality #2: While acquisition announcements tend to suppress share prices, frequent acquirers tend to outperform the market.**

Although it has become cliché to say that acquisitions destroy value, most of the academic research supporting this claim examines immediate share-price reactions within 5 to 15 days after deals are announced. These studies usually fail to capture the performance of companies over extended periods of time.

Our research reveals that the most frequent acquirers of companies tend to deliver better share-price returns over time than their less-acquisitive peers. For example, one of our published studies shows that the share prices of the majority of acquirers have outperformed the S&P 500 from the year before to the year after an acquisition, measured over the past 10 years.

**Strategic Reality #3**: **Companies with above-industry median debt leverage tend to grow revenue less and deliver lower shareholder returns.**

Any bank's financial-strategy group can prepare an analysis showing that shareholder value is created when the weighted average cost of capital (WACC) is minimized through debt leverage. The interest on debt, unlike dividends, is tax deductible, which is shown to lower a company's WACC. It is anticipated that a lower WACC will drive a company's share price higher by reducing the discount on its future cash flows.

On the contrary, our research shows that companies with above-median debt leverage within their respective industry deliver lower total shareholder returns over time than companies with less leverage.

Interestingly, these highly levered companies also tend to deliver lower top-line revenue growth. It may be true that leverage reduces WACC, but this benefit seems to be more than offset by the lower growth that may come from the conservatism often displayed by companies saddled with heavy debt burdens. The idea that managerial behavior is unaffected by leverage drives the misconception that higher leverage creates shareholder value.

**Strategic Reality #4: For most companies, stock buybacks do not create shareholder value.** Stock buybacks are often argued to be shareholder-value friendly, but our research shows that over time the companies that utilize a greater percentage of the cash they generate to buy back stock tend to deliver below-average share-price performance. This seems to be true because most companies demonstrate a tendency to buy back more stock when it is expensive and less when it is cheap, leading to low buyback return on investment.

It seems that much of the reason for stock-buyback programs is to boost EPS, since the net income of the company will be spread over fewer shares. We have found, however, that the more a company boosts EPS through buybacks, the more its price-to-earnings multiple tends to fall.

**Balancing the Inputs**

It is fair to say that many so-called shareholder value “wisdoms” are incorrect and are rightfully criticized by stakeholder-value advocates. However, the solution is not to abandon shareholder value but to better understand what it really means.

As a managerial construct, shareholder value provides a standard against which to set long-term goals, evaluate investment opportunities, and assess performance. It provides a means of balancing all the inputs to achieve success.

If a company creates an environment that attracts the necessary employees and makes the investments required to develop and efficiently produce products that please customers at reasonable prices, it is likely to deliver long-term shareholder value. After all, driving strong long-term share-price performance requires satisfied customers, employees, and other stakeholders. A smart executive realizes this and doesn’t take short-term actions that may boost the company’s EPS and share price next week while depleting the company’s ability to grow and thrive in a successful and enduring manner.

It’s no surprise that Apple, Google, and Amazon topped *Fortune* magazine’s list of the 50 most admired companies for 2012, and there is little question that the top companies deliver excellent value to many groups of stakeholders. Simultaneously these most admired companies deliver an average total shareholder return 6% to 7% higher per year over time!

But here is the rub: it is very important to understand the causality. If you set out to deliver stakeholder value without worrying about profitability and shareholders, you are likely to wind up with an inefficient organization that has little focus and scarce ability to finance growth and success. As a result, you will probably do less for all stakeholders, including shareholders.

If you set out to deliver shareholder value, you have to ensure that you efficiently deliver stakeholder value, or your shareholders will be unlikely to be satisfied over time. To create long-term shareholder value requires a balance of satisfied stakeholders on all fronts.

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