A Tale of Leadership in Value Creation

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During my last three decades as a management consultant, I've seen more than my share of corporate shortsightedness justified in the name of shareholder value. Before getting to a prescription for rooting out this "short-termism" in corporate organizations, in my recent book, *Curing Corporate Short-Termism: Future Growth vs. Current Earnings*, I offered the following fictional tale as a prologue that reflects a composite of my experiences advising leaders on how to create long-run value in a wide variety of business situations. The purpose of the tale is to show how the principles advocated in my book might be used to help a company and its management team achieve a better balance of short- and long-term objectives, leading to greater wealth and welfare for shareholders and society alike. All names, characters, and incidents are fictitious; no association with actual persons, companies, places, or products is intended or should be inferred.

A Special Acquisition Meeting of the Board of Directors

The CEO of Blue Dynamics Corp., Betty Manning, and her team had spent three hours presenting the proposed acquisition of Sky Annex Corp. to their board for approval. The deal would add 20% to the company's total revenue, would expand their presence in their most successful business unit (Systems Integration), and would also create a platform for international growth, a dimension that had been sorely lacking at Blue Dynamics. Betty had one-on-one calls with several board members over the previous few weeks, but the meeting was the first time that management fully explained the "value proposition" presented by Sky Annex Corp., the benefits to Blue Dynamics' long-term strategic growth, the proposed deal structure, its financing plan, and the strategy for making the acquisition a success. All that was left was for the directors to ask questions before voting to make a decision.

*This article is the prologue to the author's recently published book, *Curing Corporate Short-Termism: Future Growth vs. Current Earnings* (2020).

The deal looked attractive from a strategic as well as an operating perspective, but the purchase price seemed high to some board members. One director expressed his concern by pointing out that the price-to-earnings (PE) multiple being paid was considerably higher than Blue Dynamics' current valuation: "How can you expect us to approve paying a price that is higher than what our investors are willing to pay for our stock? What if our multiple gets applied to their earnings? Won't our share price fall?"

Betty acknowledged the seemingly high price, but then explained to the board that

Sky Annex presents the best opportunity for future profitable growth of any company in and around our Systems Integration business. We have been searching far and wide for investment prospects in order to allocate growth capital and expand our portfolio of high-return businesses, and Sky Annex fulfils this strategic need in several ways. Their product portfolio complements those of our own businesses, so although we plan to operate it separately for now, we can have both sales teams selling both product lines to offer our customers more options,

with minimum sales cannibalization. Over five years ago, Sky Annex expanded into Europe, South America, and Asia, and it has since built a small but effective presence in each market. This potential acquisition represents a substantial opportunity for us to grow their products while also launching our existing offerings in these new markets. Our reinvestment rate has been below average, and this acquisition will provide us with more productive ways to deploy capital into value-creating projects after the deal goes through.

Blue Dynamics' CFO, Topher West, added, "And all of this growth that Betty talks about is expected to be very profitable, since Sky Annex operates at a high rate of return on capital—even higher than Systems Integration, our highest-return business."

Another director asked whether that high rate of return would continue to be the case after the acquisition, given the purchase price and all the goodwill that would be added to the capital base.

Topher responded, saying, "It's true that with the goodwill, the acquisition will deliver a much lower return. But it's the incremental organic return *without the goodwill* that indicates the rate of return we expect on our follow-on investments in the acquired businesses. We need to earn a return on the full investment for this acquisition to create value for our shareholders. The only way to do that is to invest to grow the business at its high organic rate of return, so that over time the overall return of the business—after taking account of the "fixed" goodwill—rises above the cost of capital."

The board seemed satisfied with the explanation on price, and one director even chuckled and remarked, "You get what you pay for." Another board member wondered aloud why there wouldn't be more cost synergies from the deal. He was accustomed to seeing acquisition integration plans that promised extensive cost savings from combining head offices, using shared services, shuttering duplicate activities, and reducing both the real estate footprint and the total number of employees.

"We do expect some cost synergies," Topher explained, "and we folks in finance will be working hard with the leadership in all departments and functions to identify and achieve them where possible, and without cutting into our capabilities and morale. But while we were developing the acquisition plan, our highest priority was to expand this new, high-return platform to enable us to invest more in profitable growth. We do not believe cost savings alone could justify the purchase price, but we *do* believe the growth plan can. In a sense, you can think of the value of the cost savings as a bonus. It's really the icing on the cake!"

After a bit more banter on the synergies, and after the directors felt they understood this aspect of the plan, the chairman asked about their ability to manage and grow the offshore businesses, given the lack of international experience at Blue Dynamics. At her last company, Betty acquired extensive international experience, including three tours living abroad and managing businesses in Seoul, São Paulo, and Zurich. She talked briefly about the differences in business culture that she experienced in each country and described the challenges Blue Dynamics would likely face in making their international expansion successful. But she also emphasized the size of the untapped opportunity as well as the benefits that would accrue from acquiring and building on the established, successful country platforms of Sky Annex.

Betty also announced the intention of the Systems Integration management team to retain a majority of the existing Sky Annex country managers to capitalize on their established know-how. Steven Tiles, general manager of Systems Integration, explained that he intended to make each country its own profit center that would be rolled up with the others into a thin, regional group structure. Each country manager would have considerable decision-making authority, coupled with significant accountability. They would be free to adapt their business to fit the local market, yet would be responsible for *outcomes*, as opposed to just "actions." When the Blue Dynamics leadership team met with country managers while conducting due diligence, it was impressed with their positive reaction to Blue Diamond's combination of decentralized authority and accountability.

This discussion of accountability prompted the vice chairman to consider the bigger picture, so he drew his colleagues' attention to what he deemed a pretty optimistic forecast. Betty conceded that the projections were aggressive, but then stressed that they had all been carefully vetted. Every element of projected growth was tied to a specific investment initiative, and the projecting managers had increased the expenditure on sales and marketing to be sure they were positioned to make the growth a reality. This was their "most likely" case—what they really thought would happen.

Betty then looked slowly and deliberately around the long boardroom table and reminded each of the directors that the annual bonuses of management were based on the year-on-year improvement in BDVA—a performance measure that stood for Blue Dynamics Value Added. To improve BDVA, management had to produce large enough increases in EBITDA—or earnings before interest, taxes, depreciation, and amortization—to more than cover a capital charge based on new investment. And their long-term incentives reinforced this target, assuring the managers that to the extent they succeeded

in increasing BDVA, they would make more money. But if they failed, they would make far less—without any opportunity for negotiations, sandbagging, or adjustments.

And the top managers themselves were assuming considerable risk in accepting this new deal: Based on the forecast, the acquisition purchase price implied a heavy charge for the corporate use of capital; and this charge, coupled with the expenditures expected in year one to launch the domestic and international growth plans, would reduce BDVA in the near term. And so for the managers to come out ahead, the increases in BDVA over the next three years would have to more than compensate for the near-term reductions. As Betty then went on to explain,

Our existing businesses are performing well, so without this acquisition my team and I would expect to earn bonuses of about 140 to 150 percent this year; however, with the acquisition this will drop to 40 to 50 percent. None of us are happy to lose the money, but we understand it—and we believe in our forecast. If the BDVA never recovers, this money will be lost forever and some of the value destroyed will come out of our own pockets. But if we achieve the forecast, we expect to earn an extra 200 to 300 percent in bonuses over the next few years. We don't have a crystal ball, but we believe the forecast is doable and are willing to put our own money on the line.

The chairman then leaned back and remarked pleasantly about how far the company had come since Betty became CEO 18 months earlier. In the past, management would have attempted to sell the board on the long-term merits of an investment, knowing all along that they would likely seek a negotiated adjustment of their current-year incentive plan performance target. Then, every year after that, new incentive performance targets would be set based on budgets, without regard for whether the investment had performed well. The directors never knew how much conviction management really had about their forecast. Under the old incentive plan, if the investment did well, the budgets used to set incentive targets were raised each year, so much of the gain was never rewarded. And if the investment underperformed, the budgets and incentive targets were dropped, too, so that management never paid a high price for their mistakes.

With Betty's no-nonsense management style and the company's emphasis on increasing BDVA each year to earn higher incentives, the board now had greater confidence when considering an acquisition like Sky Annex. The managers now seemed to think and act more like long-term, committed owners who treated the capital of the company as their own. Yes, they were very happy with Betty as their CEO.

Eighteen Months Earlier: Understanding What Went Wrong

"So, tell me again, Topher," Betty inquired, "why does the company use EPS for half of our annual bonus plan? You say my predecessor knew the pitfalls of EPS but felt it was best for shareholders? That's what *they* want? And you say not to worry because our managers always aim to do the right thing… They aren't swayed by the incentive plan? It sounds crazy to me. Why use an incentive that managers have to overcome to do the right thing? Should we really trust that our managers will act in the interests of the company when we're rewarding them for taking a different action? Why force our managers to make a tradeoff between their own financial well-being and that of the company?"

It had only been three weeks since Betty Manning joined Blue Dynamics Corp. as the new CEO, and she was still getting to know the company and her team. She had come from a larger industrial conglomerate where she was the general manager of its second-largest business unit. For years she was recognized as a star performer there, but her path to the top would be tough since her company's CEO and its chief operating officer were both new to their jobs. They were also both younger than she and quite effective as well, so investors and the board of directors were content with them.

She wasn't looking for a new job, but when a headhunter called, her interest was piqued by the thought of becoming the CEO of a public company. She tried not to think about it much, but she knew that's what she always wanted—so she pursued the opportunity. The Nominations Committee of the Blue Dynamics board met a handful of other candidates, but the process ended fairly quickly. Betty was clearly the one for the job, they concluded. The full board of directors was impressed by her immediate understanding of their businesses, competitors, strategies, and financial performance, especially for someone outside the company. Yet the real edge Betty offered was her presence as a natural leader.

Whenever Betty Manning spoke, everyone understood her. She was known for her clear and direct style that made complex matters seem simpler, and she had a way of convincing people of her point of view, seemingly without really trying. She was pragmatic and always appeared to listen more than she spoke. For years, she made sure she heard everyone in a room before making a decision. "Why surround yourself with good people," she would ask, "if you're not going to listen to them?"

Her matter-of-fact style was a breath of fresh air, especially given her predecessor's obsession with convoluted strategies that required a never-ending dialogue with the board of directors on what he described as "the nuances" of how the industry

functioned. When challenged on the financial merits of his ideas, he often declared, "this isn't financial, it's strategic." Each time he said this, one of the directors always mumbled under his breath, "It may be hard to quantify the benefits, but it had better eventually be financial, or it's not very strategic."

Back in her meeting with Topher, he responded,

As I've told you, Bertrand [the former CEO] was a CPA at heart. Even after he was named CEO, and of course before that as CFO, he was an accountant who was always partial to bottom-line accounting numbers, rather than measures of return on capital, margins, and the like. And he succumbed to all the hoopla over earnings per share on our quarterly earnings calls and in the media. Bertrand often pointed out that, when quarterly earnings were announced, the talking heads on CNBC never said, 'Blue Dynamics missed on ROE'—instead, they always talked EPS (earnings per share). We did manage to get return measures into the incentives for the business-unit bonuses, but for the consolidated company, Bertrand mostly seemed to care about EPS.

Betty had seen this before and asked, "Did you try to help him understand that there are better and more comprehensive ways to view performance?"

"I tried to help by showing him margins and return measures to guide him toward a more rounded perspective of the business." Topher continued, "I emphasized cost efficiency and capital productivity. He especially listened when we were talking about the business units. He liked looking at the business-unit returns when we were allocating the capital budget, though of course he had other strategic motives as well."

That hit a nerve with Betty. The prior week, she had spent hours reviewing the allocation of capital across the business. She recalled being puzzled when she noticed that all the poorer-performing businesses seemed to have been allocated more capital as a percentage of their EBITDA. The best performers got very little. She asked Topher to explain how Blue Dynamics's capital allocation process worked.

"It's pretty straightforward, really," he replied.

First, we decide the total budget, which is usually about five to six percent of sales, depending on how we think investors will react. That's the range we have used for the last few years—although three years ago, when the industry was doing better, investors encouraged us to invest more, and we did. Once we set the overall budget, we ask each of the four businesses to submit a capital budget. Last year, the total came in about 17 percent above what we wanted to spend, so we scaled everyone back 15 to 20 percent until we had the total we wanted.

Betty thought about it in silence for a minute, and then asked, "How do you know five to six percent is the right amount?"

Topher hesitated and then, in a soft tone, replied, "We don't."

"And how come Systems Integration isn't investing more? They seem to have decent growth opportunities…and they have by far the most differentiated products and the highest return on capital. I haven't met with them yet, but it seems to me that investing to grow that business is our best use of capital."

"The funny thing is that Systems Integration hasn't asked for much capital in about four or five years," Topher explained. "Seems they really don't have many good investment ideas. Great business, but they never ask for much growth funding."

"I'm having trouble understanding this," Betty responded. "Their segment is growing. They have a quite low market share, so they could grow even faster than the market. And they haven't even explored expanding overseas. Why in the world don't they ask for more investment dollars? This sounds like a huge strategic error."

"It never troubled Bertrand." Topher paused and then continued. "He always liked telling investors he would balance investing in the business with shareholder distributions. If the capital budget went up, there would be less for distributions. We started paying a dividend a few years ago, but mostly Bertrand liked talking about the EPS accretion from his buyback program. He loved telling investors he was demonstrating his commitment and confidence in the future. He often said he was buying the stock because it was cheap, and investors should buy more, too. I once overheard him tell a board member that half the company's EPS growth was from his buyback program and the other half was from what everyone else did."

Betty stared at Topher in disbelief. Was it Bertrand's arrogance that bothered her? Did the nonsense about buybacks worry her? And did Bertrand really believe that taking a dollar inside the company and giving it to an investor outside the company at fair value somehow created value? Perhaps more important, did Topher believe that, too? She sat quietly and wondered how many good investment opportunities the company had turned down to give money back to shareholders. She suddenly snapped out of her ruminations when Topher said he had to get going. She thanked him for sharing his views and said goodbye.

The following Tuesday, Betty met the Systems Integration management and got a tour of their aging facility, which seemed desperately in need of a new coat of paint and, more critically, some modernized equipment. The Systems Integra-

tion team explained the business, and she even tried out some of the robotic simulators. The technology was exciting and she enjoyed seeing it in action. It was the last of the four businesses to meet with her, and she was considerably more impressed with it than with the others.

Steven Tiles of Systems Integration presented her with the business-unit strategy, their business plan projections, and an overview of opportunities and threats. Betty found herself genuinely excited at the prospects, but also a bit confused as to why they weren't trying to invest more to grow this promising business faster. When she asked, Steven deflected her question with talk of being selective and careful. After the second and third time she asked, Steven sat back in his chair and said, "OK, Betty, I'll tell you how it is. We have been blessed in this business with wonderful opportunities. With this and hard work from our team, we have been able to increase our return on operating assets from 20% just a few years ago to 45% last year. It will be higher this year. It's hard to find investments that earn a higher return than that."

"Oh, I see," she said. "You have built a great business, but you have also been tasked with improving returns; so if you invest at a lower return, it will bring down the average for the business unit."

Steven confirmed her suspicion—"You're a quick study, Betty. Our business-unit management incentive is half based on the percentage by which we improve the return on operating assets. When they told us about it seven or eight years ago, we thought it made great sense. What could go wrong if we improved our profits and became more productive with capital? But there's no reward for growth. And over time, by trial and error, we realized that investing at returns below the current return cost us money out of our own pockets. As we improved our returns, the hurdle for new investments became higher and higher. It didn't seem right, so we tried explaining to Bertrand that we thought we should invest and grow more. But he said he needed to keep our returns high to woo investors."

After a brief pause, the confession continued. "He also liked having money left over for his buybacks… but I wouldn't know much about that."

When Betty returned to her office, she dug into a stack of quarterly reports going back several years. She stayed late into the night and compared one performance report after another to the capital investment tracking reports. The more data she examined, the more the picture became clear. The focus on improving returns led her best business unit to turn down most investments—even those earning 30% or more. With the business unit earning 45% or greater, the bar had been set too high.

As she worked through the numbers, she felt shocked to realize that the opposite was true in her worst-performing business unit. With a mere 4% return, the Assembly Fabrication unit could improve its returns by investing at 6%. They had planned capital expenditure projects to replace a key manufacturing line with a modest increase in capacity, along with a series of other investments that didn't seem to meaningfully improve efficiency, productivity, or capacity. It hit her that she had one business turning down investments with 30% returns while another was gladly investing at 6%.

It wasn't funny, though Betty couldn't help but laugh. She began to wonder if this was a practical joke. Who would invest virtually all their capital in their worst business and almost nothing in their best business? Who would starve a business earning a 45% return in order to give the money right back to shareholders? Was there a camera in her office to see how she reacted to this madness? Maybe she was being set up on *Punk'd* or *Candid Camera*. As she looked around, she noticed the eye of the duck sparkling in the picture behind her desk, so she stood on a chair to confirm there was no camera. There was no joke…this was her new reality. She wasn't laughing anymore.

She looked further into the capital investment tracking reports. Of course, the low-return investments in Assembly Fabrication were forecast as 12% or 15% returns in the capital requests. The actual performance never seemed to live up to the projections. But as long as it ended up above the existing return—a mere 4%—it brought up the business unit's average return, and as a result the Assembly Fabrication management received a higher bonus. They weren't accountable for hitting their projections or for hitting their cost of capital return.

Betty knew her first 100 days would be important. She needed to set a new course that would not only drive results but let everyone know that she meant business. To this end, she settled on her first major initiative to improve performance at Blue Dynamics. Though she needed to think through the strategies of each business—and there was much room for improvement there—in the short term she realized that her highest priority should be to address the behaviors of her management team. To improve the company's performance, her managers needed to invest more in the good parts of the business, fix its weaker parts, and push harder to deliver results. If she merely realigned the incentives to encourage the right behavior, things would start moving in the proper direction, she concluded.

Assembly Fabrication, she realized, had to hit the brakes and focus on improving what it already had. It was crucial that it cut costs to improve margins. Asset intensity could have been improved by eliminating unproductive capital—for example, by reducing inventory, collecting outstanding

overdue accounts receivable, and, most important, by changing how it contracted with customers to get paid earlier. Perhaps it even could have considered a new pricing strategy. But mostly, Assembly Fabrication needed to stop investing in growth until it "earned the right to grow."

In contrast, Systems Integration needed to step on the gas by investing in every profitable growth opportunity that the business unit management believed would earn meaningfully more than its cost of capital. It had opportunities to expand its product line and offer high-, medium-, and low-capability alternatives to meet the needs of a wider variety of customers. The software that came with each unit could be enhanced with more useful features and sold separately as SaaS, or *software as a service*. And maybe Systems Integration could capture an ongoing annuity of revenue, making every sale that much more valuable.

Several Systems Integration assembly plants were old and running over their rated capacity, which increased costs and made it hard to hit client delivery deadlines. Investments in new capacity would be helpful immediately. From a marketing perspective, they could have moved into new domestic end-user markets, and there was clear demand to support expansion into Europe and Asia. Even if their returns dropped from 45% to, say, 35%, while the business doubled or tripled in size, it would be a great outcome since they would still be earning a high return across a much larger base.

BDVA: A New Basis for Target Setting and Performance Measurement

To encourage her team to make all this happen, she implemented Blue Dynamics Value Added, or BDVA, as a financial performance measure. It was defined simply as the business's EBITDA less a capital charge based on 12% of their gross invested capital.

The use of BDVA encouraged managers to improve volumes, efficiency, pricing, and profit margins, since the resulting increases in EBITDA would increase BDVA. And by enhancing capacity utilization, driving down unnecessary inventories, and collecting on customer invoices in a timelier fashion, they could also drive BDVA higher by reducing their invested capital. What's more, and critically important in this case, BDVA would increase whenever they invested in growth as long as the incremental EBITDA more than covered the increase in capital charge.

Topher's team completed a historical analysis and found that, although Blue Dynamics had delivered revenue and EBITDA growth in most years, its BDVA had fluctuated and was in fact a bit lower than five years earlier. Betty advocated an incentive framework in which the target BDVA each year would equal the prior year's actual. This seemed fair, given the historically flat and declining BDVA; and, most important, it would set a rigid, target-setting approach that was separated from the budget to eliminate target negotiations and sandbagging. In the future, if she asked one of her business-unit teams to try to come up with a way to improve performance and plan for it, they may or may not agree—but at least they would know that if they did, their bonuses would be higher and so would Betty's. They were more like partners and less like adversaries.

This novel approach to target-setting provided an incentive to invest in the future even when the immediate effect was a decline in BDVA. As long as they had confidence that the investment would eventually pay off, any bonus they forfeited in year one would be more than earned back if and when the new investment contributed positive BDVA. Betty no longer had to wonder if her business unit heads believed the forecasts they showed for the recommended investment programs. If the EBITDA didn't grow enough to cover the capital charge, BDVA would decline and some of the value that would be destroyed would come out of management's paycheck. She still had to exercise judgment in deciding what to approve, but at least she knew that the incentives of the managers proposing the investment were aligned with her own. Betty had wanted such a compensation arrangement for years—and she was finally in a position to implement it.

It started to work almost immediately, and even better than she hoped. Right after BDVA was introduced, Steven Tiles and his Systems Integration management team studied their business from every angle imaginable to identify opportunities for BDVA improvement. For example, they allocated costs and capital in order to estimate the BDVA contribution of each customer and customer group, and they tasked the sales team with making improvements both in their pricing models and in negotiating the terms of customer contracts. In the past, such efforts had tended to get bogged down in "analysis-paralysis." This time, there seemed to be more of a sustained drive to achieve results.

The team also analyzed and evaluated each product line to identify those that were contributing the most BDVA and found that such success was associated with how unique and differentiated each product was. So they set about spending more on marketing and sales to drive extra growth in the products contributing the most BDVA, while also investing in innovation to improve differentiation in those products with lower BDVA contributions. And they even terminated a few products that were contributing negative BDVA, since they didn't think investing to improve them would be worth it.

Most important, the high-performing businesses that Steven managed would no longer be starved of capital investment. They upgraded and improved the technology being applied in their previously aging facilities, which immediately improved both capacity and product quality. As mentioned, they also increased product development expenditures, and they even began experimenting with new products that might take time to pay off—which had been neglected for years.

Six Months Later

Gradually, Betty's entire management team seemed to get the point of her efforts. She noticed significant improvement in the plans, decisions, and performance of all business units. The focus on BDVA served as a common language across different functions and helped achieve alignment—the good of the whole became more important than who did what. In one notable meeting, a mid-level manager from the Assembly Fabrication unit hinted, confidentially, that corporate should cancel one of his own projects that had been approved the year before and was in line for implementation. Instead, he suggested they give the funding to his colleagues at Systems Integration, noting that, "They have potential investments that are better than all but our best ones."

Topher helped Betty revamp the performance measures and incentives to encourage a better balance of returns and growth investment. The businesses developed new strategic plans, and resources were largely being funneled toward the best opportunities. To make sure there was enough money to go around, they paused the buyback program. Investors balked a bit at first, as did the brokerage analysts. But any concerns faded quickly as stakeholders turned their attention to the growth plan. While some investors decided this was not for them, others whose risk profiles suited growth companies bought in. Though the buyback program was formally still active and they could restart it anytime, Betty viewed it as dead unless their shares took a significant hit.

One Monday morning, Topher entered Betty's office at 8 a.m. for their weekly 30-minute update. Betty immediately began by saying, "Topher, do you realize we spent almost three times as much time discussing and reviewing the Assembly Fabrication plan as we did the Systems Integration plan?"

"Squeaky wheel gets the grease," Topher replied with a smile.

"Yes, maybe, but they spend more time with IT, quality control, legal, and human resources, too. I've spoken to every corporate functional group, and every single manager said that Assembly Fabrication is a drain on their time and people. That business unit has a lot of problems."

"But what's the alternative? They need help."

Betty hesitated for the first time since Topher met her. "Topher, maybe it's time we stop wasting our resources on such a poor performer."

Topher abruptly expressed his view that the company would be better off if they waited until they could turn it around before selling it. If they could improve performance and get some momentum, they might get a higher price.

Betty responded, "Every bit of attention that is siphoned away from Systems Integration and our other more successful businesses costs us money. It's hard to measure, but I believe we're losing more through our lack of attention to our successful businesses than we stand to gain from improving our fixer-upper. Even if we get 50 cents on the dollar by selling it now, it will likely be worth it. And I'm not sure we can ever get the full dollar, anyway."

In days to come, Betty and Topher sat through countless long meetings with bankers and tax advisors and ultimately decided to spin off Assembly Fabrication as its own public company. The business assumed a modest debt burden to maintain discipline, but not so much as to put the new publicly owned company at risk. The spinoff distributed one share in the new Assembly Fabrication public company for every five shares of their company stock. After the transaction, investors could trade the two separately.

The spinoff, they decided, was better than selling the business. In a sale, they would pay tax on the gain over the extremely low tax basis. Both Betty and Topher preferred a tax-free transaction. The bankers advocated selling the business to private equity investors that specialized in turnarounds and using the net proceeds to buy back Blue Dynamics stock. They claimed this would be good for shareholders and made their case with a series of academic studies showing that stock prices typically increased when stock buybacks were announced. They also did the math to show how a business-unit sale and a stock buyback would generate the highest EPS accretion of all the options being considered.

But Betty and Topher didn't think their stock was especially cheap, so they didn't see how the buyback would be helpful to the remaining shareholders. Betty kept asking the bankers, "If we buy back shares at fair value, and the transaction drives up our EPS, isn't our price to earnings multiple likely to fall?" A satisfactory response never came.

After the spinoff, the managers of Assembly Fabrication became much more accountable, since they faced investors directly and had no crutch to lean on. Within two years, returns for the spun-off business were above the cost of capital. Before the spinoff, their plan had assumed it would take four years to achieve this, and everyone thought that was a stretch. And they did it with the same

management team that led the business when it was a unit of Blue Dynamics. What's more, management actually started investing and growing the business again, while share price performance appreciated significantly. Betty was one of their biggest fans and maintained a good business friendship with the Assembly Fabrication CEO, who used to work for her.

Back at Blue Dynamics, performance also improved as a result of the spinoff. Betty, Topher, and the corporate staff had more time to help Steven and his people build the Systems Integration business beyond all their expectations. They then made many investments, some of which had the effect of reducing the average return. But they still experienced so much growth that they expected to surpass the whole corporation's pre-spinoff revenue and profit fairly quickly—*and* with higher corporate returns and BDVA than ever.

Just Before the Special Acquisition Board Meeting

Before Betty's arrival, a large activist hedge fund had bought into Blue Dynamics' stock. The activist demanded that management stop investing so much in Assembly Fabrication and instead use the funds to accelerate buybacks. The hedge fund even encouraged the company to borrow to fund these buybacks. A rigorous analysis was put forth suggesting that the company should outsource most of its production to lower-cost regions around the world, which is what their competitors did. And they wanted Bertrand to go.

But the stock popped so much when the activist went public with its demands that the fund decided to dump its holdings; they were in and out in no time. And the share price fell back within months and not much had changed, except that the experience apparently soured some of the board members on Bertrand. He was nearing retirement anyway, but this probably pushed him out a year or two earlier than he had planned.

Although she wasn't there when it happened, Betty decided to revisit this activist episode to better understand the investors' demands and see if there was anything else she should be doing that she had not thought of. Initially, she sat through presentations delivered by her team. Topher gave her the first briefing, but he supplemented this with presentations by folks from investor relations, strategic planning, and the general counsel's office, all of whom had been closely involved when the activist showed up. She then supplemented this with meetings with the bankers and outside law firms that had advised the company.

Indeed, Betty went so far as to visit the hedge fund managers themselves to better understand what they saw that was wrong and why they chose to come after Blue Dynamics rather than another company. The lack of confidence in the prior management led to a depressed stock valuation that seemingly reflected not just poor current performance, but also the expectation of future bad investments that hadn't yet occurred or even been announced. The activist referred to this as a discount for "reinvestment risk," and claimed that merely putting an end to such risk presented a great investment opportunity. It had been a good time for the activist to buy the stock—after all, activist investors tend to be value investors at heart, and the stock seemed cheap. The activist fund manager then sought to unlock value by forcing management to focus all its attention on improving efficiencies, reducing investment in the business, and giving all the money they could back to shareholders—out of the reach of management. Betty remembered one of them claiming that "if management just stopped making bad investments, the stock would pop!"

The activist fund managers congratulated Betty for the company's improved strategy development and tactical execution under her leadership. And the results showed. Where management once had to be careful to avoid investor cynicism—which kept them from trying anything bold—they now were beginning to establish a track record and foster the confidence of their largest investors; and so they felt more at liberty to pursue what appeared to be the best long-run strategy, having the assurance that investors would likely buy in. The activist managers also told Betty that they would not be buying any Blue Dynamics stock, since such a rapidly improving situation just didn't fit their strategy—and they wished her luck. She found the meeting very informative.

For some time thereafter, Betty advocated increasing the amount of investment in the highly successful Systems Integration business. The unit's managers worked closely with her corporate development team to consider all possible ways to augment their already expanded internal investment program with a targeted acquisition. They not only wanted to make a good investment via the acquisition transaction itself, they also wanted to establish an additional platform for new, high-return internal investments after the deal. Betty believed that most acquisitions were justified too heavily by projected cost-cutting and not enough by actual opportunities for revenue growth.

So, Betty and her team identified every public and private company in and around their group of direct competitors. Each potential acquisition target was tracked as an investor might look for buying opportunities, thus ensuring that management's sense of performance and valuation trends would guide the timing of their acquisitions. Strategic criteria were established to assess the fit of the business, including

a heavy emphasis on how well the key drivers of the target business matched the core competencies at Blue Dynamics. Betty had experienced poor acquisitions, and she found they almost always occurred when the acquirers didn't fully understand the success factors of the acquired business. By trying to force the wrong strategy, acquisitions often did more harm than good.

In the end, they decided to target Sky Annex Corp., which was attractive on a stand-alone basis, offered a desirable platform for investing in both domestic and international growth after the deal, and would fit in well operationally and culturally under their Systems Integration unit. Betty, Steve, and the corporate development team tracked Sky Annex for some time, met with its management informally at industry and banking conferences, and developed a good sense of the hard and soft factors that they thought would be keys to success for the company if the acquisition went through.

The Sky Annex share price was high, at least in relation to its current performance. It was as if investors were pricing in a premium, knowing that they were a good acquisition target, whether for Blue Dynamics, another strategic acquirer, or a private equity investment fund. But, to Betty, the acquisition appeared to provide so many opportunities for synergy-related growth that it still seemed poised to provide good value.

Once she got the go-ahead from the board to open discussions, the process moved at lightning speed. They completed due diligence, negotiated a tentative deal structure and price, and began seeking approval from the board of directors.

Back to the Board Meeting

After the Q&A period, it was clear that the board of directors was split on the decision. Betty asked the rest of her management team, except the general counsel, to leave the room, and the board continued in executive session. She knew this was the most intense and important moment yet of her 18-month tenure.

The chairman asked the directors to go around the table and share their informal views and remaining questions. They revisited the international strategy, the idea of keeping Sky Annex as a separate business, the need to find some cost synergies, and the board's concerns about the amount of growth in the forecast. One by one, Betty won over most of the less enthusiastic directors, and it seemed more and more likely that the vote would be affirmative.

However, one important director still seemed reluctant. He was a self-made success, rising from underprivileged beginnings to found and build a large, successful private company. He had been one of Betty's strongest advocates both when BDVA was introduced and later when the new incentives were proposed and approved. He had always been a quiet critic of public-company gamesmanship and was not a fan of Bertrand when he was in charge.

He began by expressing his general support for the acquisition strategy and said that he too preferred acquisitions in which there were more growth synergies than cost synergies, since this approach had often been more successful in his own company. It was hard for Betty to figure out what his concerns were until he asked what would happen to her base salary the following year. In the past, he had watched CEOs of public companies get almost automatic pay increases when their company grew by acquisition. The larger size and scale of the business stepped up the size of the peer companies that would be benchmarked by the compensation consultants, and bigger companies tended to pay CEOs higher salaries. On top of this, he said his experience was that the enhanced international exposure increased the complexity of the business, and this complexity tended to increase salary as well. Of course, if her salary increased, so would her target annual bonus and her long-term incentive opportunities, since these programs were all set as a percentage of salary.

The director looked Betty in the eye and asked if she would be willing to put a hold on her salary for a few years until they could see how well her team performed in onboarding the new acquisition.

Traditionally, the compensation committee would consider any changes to Betty's salary each year, based on peer benchmarking and other factors, including CEO performance. If she agreed to a fixed salary, she would be giving up a lot, relative to what her peers were getting. But she did understand the perspective and didn't see why she should be rewarded just for making the company bigger. So, she proposed a compromise in which the board would still consider her salary each year, but they wouldn't change the comparison group despite the increase in the size of her company. She further suggested that if, after a few years, the BDVA contribution of Sky Annex had turned decently positive, perhaps the compensation committee would then consider changing the compensation peer group to include companies that were larger and more complex.

The director agreed to her proposals, and the board swiftly voted to approve the acquisition. Betty knew the real hard work was to come after the deal closed, but she was pleased by the support she had received from the board.

What Changed at Blue Dynamics?

The biggest difference was that Betty was a far better CEO and leader than Bertrand had been—and all the other changes followed from this. She created an owner-like culture in which

results mattered more than excuses, the long- and short-term were equally important, and there was a simultaneous focus on investing to grow the business *and improving* rates of return. Those who succeeded were rewarded, without any need to play budget-sandbagging games, and resources were more consistently funneled to the best opportunities for success. Betty's management team members viewed one another more as partners, while viewing her as the managing partner.

The book that follows provides a prescription for curing corporate short-termism in its many manifestations. One of the biggest obstacles to economic growth, employment expansion, financial security, and social well-being is that companies are investing less in building their future while devoting more capital to activities that provide a quick fix but deliver few, if any, lasting benefits. Many believe companies cannot maintain accountability for period-by-period performance and invest in the future at the same time. Talking about the "long term" is sometimes seen as code for "I'm about to have a bad quarter" or "I need to justify why my budget shows less profit than last year." The chapters that follow will prove this to be a false characterization. With the right measures in place, suitable planning and decision processes, and appropriate incentive programs, companies can encourage managerial behaviors that better balance the long and short term and deliver more success for all stakeholders.

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