

The
Smart Manager

Mar-Apr 10 VOL 9 ISSUE 2

infosys
the green mile

sramana mitra
entrepreneur journeys

deepak lamba
bloombergUTV: blooming business

gulu mirchandani
expert comment

dr wilfried aulbur
mercedes-benz india
branding in wonderland



purpose of the firm: finally putting customers ahead of shareholders

by Roger Martin

Should maximizing shareholder value continue to remain the main purpose of companies? Or should they focus on customers first, à la Johnson & Johnson or Procter & Gamble?



Roger Martin has served as Dean of the Rotman School of Management at the University of Toronto since 1998. He is an advisor on strategy to the CEOs of several major global corporations. His most recent books are *The Design of Business: Why Design Thinking is the Next Competitive Advantage* (2009) and *Dia-Minds: Decoding the Mental Habits of Successful Thinkers* (with Mihnea Moldoveanu, 2010). Martin serves on the Boards of Thomson Reuters Corporation and Research in Motion and is a trustee of The Hospital for Sick Children in Toronto. He received his MBA from the Harvard Business School in 1981.

the purpose of the firm—the abiding goal of the organization—isn't a matter of much debate these days. Sure, a few voices shout from the margins that the modern corporation should consider its obligations to society at large. But, on the whole, the economy is driven by a single ideology: that the purpose of the firm is to increase the profits it delivers to its shareholders.

The theory goes that owners get short shrift from managers, who tend to enhance their own financial well-being at the expense of the company (and its investors). The problem is that managers and shareholders have fundamentally different incentives; the solution is to align their interests by making management incentives look more like shareholder incentives through the use of stock-based compensation. This way, company profits directly benefit management and shareholders alike.

The shareholder value theory quickly gained traction after a seminal 1976 paper by Mike Jensen and Bill Meckling and a pivotal 1981 speech by Jack Welch, the newly minted CEO of General Electric. Speaking at the Pierre Hotel in New York, Welch didn't use the term 'shareholder value' explicitly, but

has the RISE of shareholder value THEORY really been GOOD for shareholders, as PROMISED?

nonetheless marked a decisive shift to a profits-first position. Welch, CEO of GE from 1981 to 2001, and his contemporary Roberto Goizueta, the CEO of Coca-Cola from 1981 until his death in 1997, became poster boys for shareholder value. Both men were outspoken advocates of the theory, and both received unprecedented levels of stock-based compensation: Goizueta became the first American manager to become a billionaire on the basis of stock holdings in a company that he'd neither founded nor taken public; Welch was estimated to hold as much as \$900 million worth of GE stock at the time of his retirement.

As shareholder value theory has gained sway in boardrooms across America, few have paused to ask what effect it has had on corporations such as Coke and GE that embraced it. Has it been good for them? The simple answer is 'no'. In the years between 1932—when corporations began to shift toward professional management, and 1976—the dawn of the shareholder value era, shareholders of the S&P 500 earned compound annual real returns of 7.6%. From 1977 to the end of 2008, S&P 500 shareholders did considerably worse; earning real returns of 5.9% a year. On this basis, it's hard to argue that the theory did companies a favor. Which begs a further provocative question: Has the rise of shareholder value theory really been good for shareholders, as promised?

Once again, no—a failure owing in large part to the way in which we measure shareholder value. The total value of a company's shares is the discounted value of all future cash flows minus payments

to employees and their pensions, suppliers, tax-collecting governments, debt holders, and preferred shareholders (if any). Since the future is unknown, potential shareholders must estimate what that cash flow will be; their collective expectations about the future determine the stock price. Those who expect that the cash flow will be less than the current price will sell their stock; those who expect that it will exceed the current price will buy. Ultimately, shareholder value has little to do with the present.

For managers, the implications are clear: The only sure way to increase shareholder value is to raise expectations about the future performance of the company. Unfortunately, managers simply can't do that indefinitely. Shareholders will look at good results and proceed to ratchet up expectations to an unsustainable level.

Most managers figure this out; they come to understand that shareholder value creation and destruction are cyclical, and, more importantly, not under their control. They can increase shareholder value in short bursts, but prices will fall again. So managers invest in short-term strategies, hoping to get out before the inevitable crash, or, they manage expectations downward, providing a runway for future increases. In other words, because they can't win at the game they're asked to play, CEOs create a new one.

This is why the goal of shareholder value maximization and the compensation approach that goes with it are bad for shareholders. Talented managers can grow market share, increase margins, and use capital more efficiently, but they can't increase shareholder value if expectations get out of line with reality. The harder a CEO is pushed to increase shareholder value, the more the CEO will be encouraged to make decisions that hurt shareholders.

Take Jack Welch. He transformed GE, from a \$13bn company in 1981 into the most valuable company in the world, worth \$484bn at the time of his retirement. Yet, to keep increasing shareholder value, Welch had to push the company to higher and higher growth. The biggest engine of growth was a unit called GE Capital, which would come to account for almost half of GE's earnings by the end of Welch's

career. In 2009, GE took massive write-offs related to GE Capital, and its market capitalization fell as low as \$80bn. The \$471bn increase in shareholder value that Welch drove looked wonderful, particularly to shareholders selling out at the top, but how much did shareholders benefit in the long term?

The Roberto Goizueta story is similar. When he took the reins of Coca-Cola, its stock price had been stagnant for thirty years. Goizueta increased shareholder value by a factor of more than forty during his time as CEO. The company's market cap peaked at \$180bn, shortly after the end of his tenure, but it never attained that lofty level again, as his successors struggled to deal productively with the legacy of rapid growth and frenzied acquisition that took place on Goizueta's watch.

Focusing on maximizing shareholder value is not the answer. It incentivizes management to think almost entirely in the short term and destroys value over the long term. Instead, to really create shareholder value, a company should aim to maximize customer satisfaction. In other words—and nobody should be surprised by this—Peter Drucker had it right when he said that the primary purpose of a business is to acquire and keep customers.

Some companies have already embraced the customer-first philosophy. Consider Johnson & Johnson (J&J). It has a singularly eloquent statement of purpose, its 'credo', which hasn't changed since it was created in 1943. Here it is, in abbreviated form.

"We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services... We are responsible to our employees, the men and women who work with us throughout the world... We

are responsible to the communities in which we live and work and to the world community as well... Our final responsibility is to our stockholders... When we operate according to these principles, the stockholders should realize a fair return."

The credo bluntly spells out the pecking order: Customers come first, and shareholders last. However, J&J has confidence that when customer satisfaction is at the top of the list, shareholders will do just fine. How does this play out? Recall the 1982 Tylenol poisonings, in which seven consumers died after consuming capsules that had been poisoned. The deaths occurred only in the Chicago area, but CEO James Burke issued a recall of every Tylenol capsule across America. Tylenol represented nearly a fifth of J&J's profits, and, inevitably, sales plummeted.

Commentators praised Burke for taking an exemplary moral stance. One look at the credo, however, reveals that the decision was clearly based on J&J's long-defined objectives. Burke looked to the credo—customers come first and stockholders come fourth—and acted accordingly. Meeting quarterly profit expectations wasn't at the top of his list; it was squarely at the bottom. In the long run, the recall didn't hurt J&J. Loyalty toward Tylenol soared and J&J led the market in the development of tamper-proof packaging. In 2010, J&J's market capitalization is the eighth highest in the world. The company has indeed provided long-term shareholders with more than a 'fair return'.

Then there is Procter & Gamble. The consumer goods giant is the seventh largest company (by market cap) in the world, and it too placed the consumer at the center of its universe a long time ago. The company's statement of Purpose, Values and Principles (PVP), written in 1986, describes a hierarchy that is eerily similar to J&J's:



how do COMPANIES that put the CUSTOMER first do RELATIVE to shareholder value ACOLYTES?

“We will provide branded products and services of superior quality and value that improve the lives of the world’s consumers, now, and for generations to come. As a result, consumers will reward us with leadership sales, profit and value creation, allowing our people, our shareholders and the communities in which we live and work to prosper.”

Here, increased shareholder value is one of the by-products of the focus on customer satisfaction rather than an end unto itself.

How do companies that put the customer first do relative to shareholder value acolytes? First, GE and Coke: they have done well and are among the world’s top 25 firms by market cap (number 9 and number 22 respectively). During the Welch and Goizueta eras, each grew shareholder value faster than the S&P 500 Index did, GE’s compound annual growth rate was 12.3% versus 10% for the S&P 500, and Coke’s was 15% to the S&P 500’s 10.8%. But neither GE nor Coke was able to substantially outperform J&J and P&G, each of which created the most shareholder value in their sectors. Under Welch, GE’s compound annual growth rate was 12.3%. At P&G, it was 15.2%. At J&J, 14.5%. Goizueta’s Coke comes out a little better; its performance was about the same as J&J and P&G, with compound annual growth rates 15.1% to 15% for J&J and 14.6% for P&G.

Why should companies that choose not to focus on maximizing shareholder value still be able to produce that value? Because their CEOs are free to concentrate on building the real business, rather than managing shareholder expectations. Their CEOs aren’t

distracted by the wrong incentives; stock-based compensation that matures in the near future or at retirement. Short-term rewards encourage CEOs to manage short-term expectations, and rewards priced at retirement cause CEOs to manage to the finish line. One has only to look at a historical stock chart for GE to see the impact of Welch’s retirement-oriented stock compensation. Even if his successor, Jeff Immelt, manages outstandingly, he will have little chance to get shareholder value back to where it was at the time when he took over.

By contrast, consider AG Lafley’s compensation at P&G. Like many CEOs, approximately 90% of his total compensation was in stock options or restricted stock. But those stock options had a long vesting period; three years, with a subsequent two-year holding period. As for the restricted stock, which represented a significant portion of Lafley’s incentive compensation, none of it was vested before or even at the time of retirement. The vesting period begins a year after his retirement and lasts ten years. Had Lafley managed shareholders’ expectations to peak at his retirement, only to fall off thereafter, he would have hurt his own compensation. Hence, for his entire tenure as CEO, he had incentive to build the business for the very long term, groom a great successor, and leave P&G in excellent condition.

Of course, not every company that puts customer satisfaction first will be a P&G or a J&J. But putting the customer first will improve the quality of corporate-decision making, helping focus on improving operations rather than on spinning lines to shareholders. Cost discipline won’t disappear; the profit motive will remain. Managers realize that the more profits the firm makes, the more money is available to pay managers. In other words, the need for a healthy share price is a natural constraint on other objectives. Making it the prime objective, however, creates the temptation to trade long-term gains in real value away for temporary gains in expectations. To get CEOs to focus on the first, we need to reinvent the purpose of the firm. ■