Commentary

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The Governing Corporate Objective: Shareholders versus Stakeholders

Marakon Associates

THE GOVERNING CORPORATE OBJECTIVE: SHAREHOLDERS VERSUS STAKEHOLDERS

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Virtually all CEOs and directors of publicly traded companies, especially in the United States, acknowledge that creating value for shareholders is an important corporate objective. Typically, however, shareholders are considered to be only one of a number of important constituencies or "stakeholders" vying for a preference in management's evaluation of key decisions. These stakeholders are usually specified to also include customers, employees, suppliers (including creditors), and the wider community.

These competing claims for preference in the allocation of the company's resources have given rise to distinctly different points of view about what the corporation's *governing objective* should be. Some, like ourselves, believe that the best managed companies are those that consistently resolve trade-offs in ways that create the maximum possible value for shareholders. An especially vivid statement of this point of view was expressed over 30 years ago by the CEO of a textile company called Indian Head Mills:

"The objective of our company is to increase the intrinsic value of our common stock. We are not in business to grow bigger for the sake of size, nor to become more diversified, nor to make the most or best of anything, nor to provide jobs, have the most modern plants, the happiest customers, lead in new product development, or to achieve any other status which has no relation to the economic use of capital. Any or all of these may be, from time to time, a means to our objective, but means and ends must never be confused. We are in business solely to improve the inherent value of the common stockholders' equity in the company."[1]

In a second camp are those who believe that the interests of a stakeholder group other than the shareholders should be consistently favored by management. Socialists, for instance, believe the interests of society and employees should supersede the interests of customers and shareholders (the state, in most cases). Given the unbroken string of failures foisted on the taxpayer by state-run companies, however, we see no reason to describe the well known flaws in this argument. Perhaps more relevant to the readers of ***Commentary*** is the view, rapidly becoming the conventional wisdom, that maximizing customer satisfaction should be the corporation's governing objective. Occasionally, the most vocal advocates of making customer satisfaction the governing objective can be quite hostile to any consideration of shareholders' interests. For example, a business school professor recently wrote the following:

"Many managers in the United States still operate under the twin fictions that their most important stakeholders are shareholders, and that their primary purpose in management is to enhance shareholder value. Whether this is true from a legal perspective in the case of publicly traded firms is worthy of debate; but from a strategic and operational perspective, it is dead wrong for any firm - publicly traded or privately held. A business does not exist for the benefit of investors, nor should it be run under that premise."[2] The author went on to say that the primary objective of the company should be to service the needs of its customers, not its shareholders.

While some may be sympathetic to this view, most executives who advocate customer satisfaction as the primary objective at least acknowledge the need to provide benefits to other stakeholder groups. A typical expression of this philosophy comes from Paul Allaire, CEO of Xerox, who said, "I have to change the company substantially to be more market driven. If we do what's right for the customer, our market share and our return on assets will take care of themselves."[3]

Finally, there is a third group that gives priority to somehow finding the right balance among stakeholder interests. One of the strongest advocates in this camp, until it was acquired by AT&T in 1991, was NCR Corporation. In its last annual report, it described itself as follows:

"NCR is a successful, growing company dedicated to achieving superior results by assuring that its actions are aligned with stakeholder expectations. Stakeholders are all constituencies with a stake in the fortunes of the company. NCR's primary mission is to create value for our stakeholders."[4]

A recent survey of directors suggests that NCR was not alone in its views. The survey results led the authors to conclude that "... boards of directors no longer believe that the shareholder is the only constituent to whom they are responsible". They state further that "... this study reveals that these perceived stakeholders are, in the order of their importance, customers and government, stockholders, employees, and society."[5]

In this ***Commentary*** we want to deal with two related questions. First, should the company's governing objective be to maximize the economic benefits to any group other than the shareholders? Second, is balancing competing stakeholder interests an appropriate governing objective for a large corporation?

The Argument for Maximizing Customer Satisfaction

Without a doubt, the stakeholder group that is seen to pose the greatest challenge to the primacy of shareholder interests is customers. It goes without saying that no company can create great wealth for its shareholders without a stable and growing revenue base, which can only come from having very satisfied and loyal customers. But this result is by no means automatic. It is quite possible to achieve high levels of customer satisfaction and yet be unable to translate this seeming advantage into adequate returns for shareholders, let alone great wealth. A very good, if unfortunate, example of this challenge can be found in American Airlines (AMR). American is generally recognized as the leader among major US airlines in customer service, producing such innovations as the SABRE reservations system and the now ubiquitous frequent flyer programs. The company's management is clearly working hard to satisfy its customers and create good returns for shareholders. And yet, the economics of the industry have been - and are currently - so unfavorable that $100 invested in AMR shares in 1983 would have grown to only $325, far better than the performance of competitors whose shares grew to just $255, but much worse than the $450 investors would have earned from the Standard & Poors 500 Index.

The specific questions we want to address here are: Under what circumstances does the objective of maximizing shareholder value conflict with the objective of maximizing customer satisfaction? And when a conflict does arise, how should management choose to resolve it?

We begin by noting that every product and service provides benefits to customers based on its expected usefulness, or utility, and that these expected benefits have an economic value.

For some products and services, such as a barrel of North Sea crude oil, the dollar value of the benefits provided to the customer can be readily measured. For others, particularly such complex offerings as a CAT scanner, measuring the value of customer benefits is more difficult, requiring the use of sophisticated research techniques, such as conjoint analysis. As long as management sets the price of each product or service no higher than the average dollar value of benefits provided to customers, and the expected benefits materialize, most customers will be satisfied with the transaction (it will be viewed as a fair exchange). In other words, customer satisfaction occurs when the product or service meets or exceeds expectations and is acquired at a price no higher than its perceived value.

In addition to the value perceived by customers, every product and service also makes some contribution to shareholder value. The magnitude of this contribution will depend on the volume sold, the price realized, the cost of making and delivering the product/service to customers and the required investment. These factors interact to generate a cash flow stream for the business. The present value of this cash flow stream determines the economic benefit to shareholders of producing and selling the product or service.

Seen in this way, every product or service generates a value to the customer as measured by its perceived utility in relation to its price, and a value to the *shareholders as measured by the present value of the cash flow the owners will eventually receive from their investment in the customer offer.*

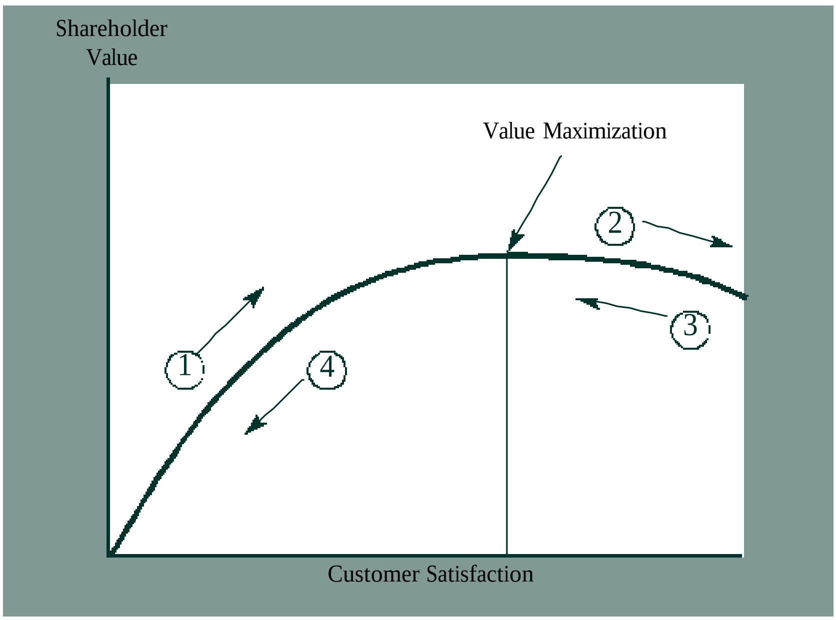
The means by which an increase in customer satisfaction is translated into cash flow for shareholders is important and worthy of some elaboration. Any strategy that calls for increasing the investment of the company's resources to increase customer satisfaction will increase shareholder value only if the economic return on the investment over time exceeds the company's cost of capital. If management is on the offensive, investing in customer satisfaction ahead of its competitors, the return can only come from the customers' willingness to pay a higher price for the increment of satisfaction received. This willingness to pay a price premium increases cash flow over time either through higher margins, if management chooses to price high and hold market share, or faster growth, if the choice is for lower prices and greater share. Note that if customers are unwilling to pay a higher price for the increase in satisfaction, the investment will have failed from the standpoint of both customers and shareholders, regardless of the effort expended.

If, however, management is on the defensive, reacting to competitor advances in customer satisfaction, calculating the economic return becomes more complicated. In these instances, the return comes from avoiding a loss rather than achieving a gain. If management invests successfully enough to at least match competitors, the return will be produced by either avoiding the necessity to discount price and face declining margins, or by avoiding loss of market share and declining growth rates.

In either case, the economic return can best be measured by analyzing the impact of the investment of resources on the value of the business as a whole. In Exhibit 1 we illustrate the general consequences that various strategies might have on both customer satisfaction and shareholder value.

When management pursues strategies that increase both customer satisfaction and shareholder value, as characterized by arrow #1, there is obviously no conflict of interest between the two groups.

Exhibit 1: Perceived Customer Satisfaction Versus Shareholder Value



This occurs when the strategy succeeds in enhancing customer satisfaction to such an extent that the increase in price they are willing to pay more than offsets the increase in resources invested. The strategy thus generates both happier customers and a return on the required investment that exceeds the cost of capital, thereby creating value for the shareholders. A recent example of this win-win strategy was the introduction by Microsoft of a new software product, "Windows", which was designed to offer the same type of user-friendly features pioneered by Apple's Macintosh. Since its introduction in 1990, Windows has received rave reviews from customers, quickly grabbing 20% of the market, and has helped propel Microsoft's market capitalization up by more than $10 billion, more than doubling its value for shareholders.

Strategies characterized by arrow #2 do present a conflict. Here, management's investment in customer satisfaction has paid off, but the economic cost has exceeded the returns on the investment, producing a negative value impact for the shareholders. An example of this strategy is General Motor's introduction of Saturn, which has been so well received by customers that the company has been unable to keep up with demand. While recent surveys have consistently ranked Saturn high in customer satisfaction, GM has invested nearly $6 billion through 1992 to develop and manufacture the car, an amount so large that the company would have to operate existing facilities at full capacity forever and more than double profit margins, keeping 40% of the dealer's sticker price as net cash flow, simply to earn a return on investment equal to G.M.'s cost of capital.

Within large companies, we generally find that a significant percentage of the products and services have overshot the peak of the curve, providing far more than the customer is willing to pay. Can these strategies be justified on grounds that any increase in customer satisfaction will be worth it in the long run? Basically, the answer has to be no. Whenever shareholders subsidize customers in a significant way, the financial health of the company is diminished, ultimately to the detriment of all stakeholders. Not only is the company's cash flow lower than it otherwise would be, but its long-term competitiveness is also eroded due to the increase in its cost structure and investment base. Over time, any company that pursues this type of uneconomic investment will undoubtedly face competitors that position themselves closer to the peak in Exhibit 1, offering somewhat less customer satisfaction at a far lower cost. These competitors will then find themselves with a cost advantage that may well be exploited either by lowering prices in a bid for market share or by investing in a type of satisfaction that is appropriately valued by the customer.

This does not mean that there are *no* circumstances under which a business should sacrifice shareholder value for the sake of customer satisfaction. In some cases, it may be necessary to defend highly profitable market share against a competitive attack with a strategy that reduces incremental returns below the cost of capital for a short period of time. This would be applauded by shareholders whenever the value loss from not matching the competitor exceeds the value loss by not responding. In other cases, the value destroyed by one product may be more than offset by a complementary product, as is often the case with relationship banking, where corporate loans are loss leaders for profitable fee-based products. Whenever this occurs, however, one should be careful to assess the economic gains relative to losses across the product portfolio to avoid creating an abundance of loss leaders.

In the vast majority of cases, however, we believe that the best strategy for any business that has overshot the peak is one that moves the business back up the curve, as illustrated by arrow #3. In many cases, this can best be accomplished by identifying and reducing those costs that contribute little or nothing to customer satisfaction. This was the course chosen by Compaq Computer in late 1991 when the board forced out the founding CEO and abandoned its "follow and upgrade IBM strategy." By a combination of reengineering and out-sourcing, management cut costs by more than 30% and introduced more than 70 new models at far lower price points. This change in strategy enabled the company to more than recapture the share it had previously lost and produced a 140% return to shareholders during a period when the market return was 25%.

In a broader sense, reducing or eliminating low value-added costs is what the "process reengineering" movement is striving to achieve. By analyzing all core business processes that contribute to customer satisfaction, e.g., customer service, it is often possible to simplify and redesign each process in ways that eliminate redundancies and inefficiency. In a recent client engagement, for example, we found potential cost savings ranging from 10-25% in several core business processes that had little or no effect on customer satisfaction.

For some companies, mispricing is the primary reason that the business has overshot the peak of the curve. This usually occurs when management underestimates what its customers would be willing to pay for a particular offering. For example, in the mid-1980s, the new management at Walt Disney realized that while its theme parks had been upgraded over the prior decade, the price of admission had not kept pace with inflation. The effective price discounting led to ever increasing traffic within the parks, which during peak periods actually reduced customer satisfaction. By increasing ticket prices back to the inflation-adjusted level of the 1970s, the profitability of the parks soared with very little impact on the volume of admissions, a strategy which contributed a great deal to the ten-fold increase in Disney's share price.

A final way to move back up the curve is to segment the market and focus on those customers who value the product offering highly enough to pay a price that exceeds economic cost.

This usually requires repositioning the offering to appeal either to those customers who are less price sensitive or to those who are less costly to serve. J.C. Penney, for example, has successfully repositioned itself during the past ten years from a broad, mass market department store chain to a softgoods retailer focusing on women's apparel, generating an annual return to its shareholders some 60% higher than the market as a whole.

Once near the peak, it is always possible to move to the left, as depicted by arrow #4. In these cases, both customer satisfaction and shareholder value are declining, representing the strongest possible signal that the strategy being pursued needs a major overhaul. Perhaps the most celebrated example of this is the decision by the management of Coca-Cola to introduce "New Coke" in 1985. Customers immediately let it be known that they much preferred the "old" Coke and stayed away from the new product in droves. However, having made the mistake, management reacted very swiftly. Without hesitation, the old product was reintroduced as "Coca-Cola Classic", while New Coke, renamed Coke II last year, gradually faded to a niche brand, leaving both customers and shareholders much relieved.

To summarize, as long as management invests in higher levels of customer satisfaction such that it earns an economic return over time that exceeds the cost of capital, there is no conflict between maximizing shareholder value and maximizing customer satisfaction. If, however, the economic return from attempting to increase customer satisfaction falls below the cost of capital, the conflict should be resolved for the benefit of shareholders to avoid diminishing both the financial health and long-term competitiveness of the business.

The Argument for Favoring Other Stakeholders over Shareholders

If the objective of maximizing shareholder value dominates the objective of maximizing customer value, under what circumstances, if any, should management give the economic interests of other stakeholders precedence over the economic interests of the owners?

To begin with, we know of no one who seriously advocates that the governing objective of the corporation should be to maximize the economic interests of the company's vendors. Rather, they propose treating suppliers fairly, which we take to mean that, as a customer, the business strives to pay "market" prices for its supplies, pay its bills on time, and generally treat its suppliers well. Maximizing shareholder value requires the same behavior. Suppliers and supply chain management are both crucial to developing and implementing strategies that generate the highest long-term cash flow. Churning suppliers in an attempt to pay prices that are below market levels or delaying payment as much as possible will typically lead to supply disruptions or quality problems, which will damage the value of the business over time. Indeed, an important part of Total Quality Management focuses on consolidating suppliers to increase volumes purchased, working with each supplier to improve quality, and coordinating delivery-production schedules to minimize cost and inventory, each of which is likely to help maximize value for shareholders.

As for the employee-stockholder relationship, the message is similar. Maximizing value for shareholders demands enlightened human resource management, since the company's workforce is a potential source of significant competitive advantage, which can be directly translated into superior value creation. Companies that attempt to pay their employees below market wages, engage in churning of the workforce, or treat their employees in a manner that does not fully utilize their skills and talent are unlikely to create the maximum value possible for shareholders. On the contrary, those companies with the best track records of value creation, such as Coca-Cola, Disney, and General Electric, are also among the very best at human resource management. Not only do they realize the crucial role that their workforce plays in creating and sustaining competitive advantage, which translates into value creation, but they can more easily afford to invest in education and training and share some of the benefits of their success with their employees. Clearly then, there is no inherent conflict between shareholders and employees of companies that are performing reasonably well. Much has been written, however, about the issue of how companies that are performing poorly, and must downsize or restructure, should treat their employees. Specifically, some advocates of balancing stakeholder interests accuse Western (especially U.S.) management of being too eager to lay off employees, particularly when compared with the widespread Japanese policy of lifetime employment. The implicit suggestion made is that, when times are tough, the shareholders should transfer some of their wealth to employees in order to avoid reductions in the workforce. In our view, there is merit to this argument, but only when the downturn in business is seen as temporary, rather than structural. Given the amount of money that most companies must invest in acquiring and training their workforce, it would probably be in the interests of both employees and shareholders to stockpile valuable people when there is a temporary falloff in demand. The reduction in earnings and cash flow that this causes is likely to be more than offset when demand rises again and the company can fully utilize its trained workforce. Thus, unless the near-term penalty is likely to be quite large, companies pursuing the objective of maximizing shareholder value will view their employees as assets to be held onto, so that the perceived conflict between owners and workers will not materialize.

When the downturn in business is structural, however, management will indeed face a shareholder-employee conflict. From the shareholders' perspective, the highest-value strategy will involve a permanent reduction in workforce, probably accompanied by shutdowns of various facilities. From the employees' perspective, those who are likely to be let go would clearly prefer that the shareholders sacrifice some of their wealth to keep them on the job. Those unlikely to be let go would, of course, feel sympathy for their colleagues, but would also want the company to downsize and return to financial health as soon as possible, since this would enhance their own job security. Should management place the objectives of those employees likely to be let go above those of the shareholders? Again, as in the case with unprofitable investment in customer satisfaction, the answer is no. Over time, the company that continuously transfers shareholder value to its employees in order to avoid difficult restructuring decisions will become less and less competitive as its wage costs per unit produced climb above those of competing firms. Rivals with substantially lower wage costs will either lower prices or use the cost advantage to increase investment in customer satisfaction in a bid for market share. Inevitably, the high-wage company will be forced to match or face a steady decline in its fortunes. When this occurs, management usually faces a situation in which it is forced into a restructuring to survive, one that often involves a far greater reduction in force than would have occurred had management acted sooner. In fact, those companies that do manage for shareholder value tend to cut their workforce quickly when they must, and provide the most generous assistance to those let go. *Our conclusion: Pursuing the objective of maximizing value for shareholders also maximizes the economic interests of all employees over time, even when management is forced to downsize the company.*

As for balancing the economic interests of the various communities in which it operates with those of shareholders, the objective of value maximization does not preclude the company from making contributions that enhance the environment for its employees. In fact, one could easily argue that these investments actually offer the prospect of creating value for shareholders since they reflect well on the company, enhancing its image, and add to the quality of life for employees, making recruiting talented people easier than it otherwise would be. Again, when one studies those companies that consistently create value for shareholders at rates far greater than those of their peers, one also finds companies that contribute generously to their local communities.

The Argument for Balancing Stakeholder Interests

Having established that no other group should take precedence over shareholders, we now turn to the second question posed earlier: Is balancing stakeholder interests an appropriate governing objective? The principal argument for balancing stakeholder interests can best be thought of as a "fairness doctrine." Simply put, it is more equitable to optimize the economic interests of all constituencies, so that all share in any wealth that is created and all lose when the company performs poorly, than it is to maximize the benefits for only one constituency -- the owners or shareholders. These critics often emphasize that for many companies, the shareholders are either wealthy individuals or faceless institutions that trade so frequently that it is quite difficult to even know who the shareholders are on any given day. The other constituencies, of course, are represented by people who typically have longstanding ties to the company.

There are two reasons that the argument for balancing stakeholder interests is fundamentally flawed. The first is that the central premise underlying the fairness doctrine is predicated on the false belief that there are substantial conflicts between the economic interests of shareholders and other stakeholders. In other words, the advocates of balancing believe that managing a business is similar to a zero-sum game, where a victory for shareholders must somehow diminish the welfare of other stakeholders. As argued above, this is clearly not the case - there is no inherent economic conflict between shareholders and other stakeholders over time, with the result that maximizing shareholder value will also maximize the benefits to all stakeholders.

The second reason is that it is impractical. The primary purpose of a governing objective for any corporation is to establish a consistent criterion by which the organization can make decisions. This is extremely important for large companies that have decentralized decision making and empowered employees far down in the organization. Since it is extremely difficult, if not impossible, to measure the economic impact, or change in satisfaction, of a particular decision on each stakeholder group, balancing the competing interests will always depend on judgment. While some senior executives may be comfortable making these judgment calls, they cannot make all of the decisions for the company.

Managers down in the organization, where hundreds, if not thousands of decisions are made each week, must have a clear understanding of how the choices and trade-offs they face should be resolved. For example, how should a business unit general manager respond if a competitor launches an aggressive attack, including a 20% price cut? Should the business match the price cut and try to hold market share, pleasing its customers, or should it hold its current pricing position, protecting its return on investment and risk losing customers? Should a manufacturing manager invest in a new process technology that would increase ROI and customer satisfaction, but would also result in a 15% reduction in headcount? Decisions such as these cannot be sent up the chain of command to a few wise judges without paralyzing the company. And yet judgment cannot be widely decentralized without a clear, common criterion, since individual judgments will vary substantially, causing redundancy and conflict.
In short, establishing the concept of balancing stakeholder interests as a governing objective will not work in today's decentralized corporation.

Conclusion

The governing objective for all publicly traded companies should be to maximize the value of the company for shareholders. Achieving this objective not only serves the interests of the company's owners but also serves the economic interests of all stakeholders over time. While this may call for some stakeholders to face economic harm in some situations, such as when a restructuring leads unavoidably to layoffs, over any reasonably long-time horizon, the economic interests of all stakeholders will be maximized only from decisions made in the interests of the shareholders. In short: Maximizing shareholder value is not merely the best way but is the *only* way to maximize the economic interests of all stakeholders over time.

Among the many benefits conferred by adopting value maximization as the governing objective, two stand out in our minds as particularly important. The first has to do with decision making. Business is a game of choices. Hundreds of decisions are made every day in large organizations that involve complex trade-offs between current earnings and long-term payoffs or between maintaining profit margins and maintaining market share. All large companies need a clear objective that can be translated into a decision criterion. Comparing the value impact of various strategic or tactical alternatives and choosing the option that creates the most value for shareholders is both clear and consistent and can be made operational throughout a large, complex company. All other criteria, such as global dominance, earnings growth, quality leadership and ROI, will inevitably lead to either overinvestment, profitless growth, or harmful disinvestment.

The second benefit is the positive feedback effect that occurs when a company succeeds in making value creation a core competency. Accomplishing this typically requires new and better information and strategic analysis, coupled with changes in organizational structure and management processes, which over time produce an institutional advantage in both learning and decision making. The advantage emerges in many forms, such as a common vocabulary, consensus about goals and performance measures, higher-quality strategic plans, better and faster execution, and economically driven capital allocation. As the institutional advantage grows, the company's human and financial resources also expand, as do the strategic advantages within its business units. This enables even greater investment in securing competitive advantage, which ultimately produces both higher cash flow for shareholders as well as the highest level of economic benefits for all stakeholders.

[1] Excerpted from the Indian Head Mills Co. Manual in "The Chief Shows Them How at Indian Head." *Fortune*. May 1962: 129-130

[2] Harari, Oren. "Your're Not in Business to Make a Profit." *Management Review*. July 1992: 53-55

[3] *ibid.*

[4] NCR 1990 Annual Report: 2.

[5] Wang, Jia and Dewhirst, H. Dudley. "Boards of Directors and Stakeholder Orientation." *Journal of Business Ethics.* Vol. 11.2 (Feb. 1992): 115-123.

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