Strategy & Leadership

Emerald Article: From maximizing shareholder value to delighting the customer

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Stephen Denning's latest book, *The Leader's Guide to Radical Management* (Jossey-Bass, 2010), describes principles and practices required to reinvent management to promote innovation and adaptation (steve@stevedenning.com). He is the author of a number of recent *Strategy & Leadership* articles including ''Masterclass: the reinvention of management,'' the winner of the current Outstanding Paper Award.

> There is only one valid definition of a business purpose: to create a customer (Peter Drucker, *The Practice of Management* (1973).[1]

An often invoked mantra of many large organizations today is that the core purpose of the firm is to maximize shareholder value.[2] This idea is pervasive in large corporations in both America and Europe and is prevalent in business schools, management journals and textbooks. Yet it leads to unsound practices. Pursuing the goal of maximizing shareholder value produces less shareholder value than a sharp focus on delighting the customer. Even Jack Welch, considered by many to be a leading practitioner of the idea, recognized in 2009 that shareholder value is a result, not a strategy.[3]

The source of the confusion

How did capitalism get into this mess? The trouble began in 1976 when finance professor Michael Jensen and Dean William Meckling of the Simon School of Business at the University of Rochester published a seemingly innocuous paper in the *Journal of Financial Economics* entitled ''Theory of the firm: managerial behavior, agency costs and ownership structure.''[4]

The article performed the old academic trick of inventing a problem and then proposing a solution to the supposed problem that the article itself had created. The article identified the principal-agent problem as being that the shareholders are the principals of the firm – that is, they own it and benefit from its prosperity, while the executives are agents who are hired by the principals to work on their behalf. The principal-agent problem occurs, the article argued, because agents have an inherent incentive to optimize activities and resources for themselves – high salaries, generous options, luxurious offices, private planes, many minions, munificent perks – rather than for their principals.

Ignoring Peter Drucker's foundational insight of 1973 that the *only valid purpose of a firm* is to create a *customer*, Jensen and Meckling argued that the singular goal of a company should be to maximize the return to *shareholders.* To achieve that goal, they academics argued, the company should give executives a compelling reason to place shareholder-value maximization ahead of their own nest-feathering.

Unfortunately, as often happens with bad ideas that make some people a lot of money, the idea caught on and has even become the conventional wisdom. During his tenure as CEO of GE from 1981 to 2001, Jack Welch came to be seen – rightly or wrongly – as the outstanding exemplar of the theory, as a result of his capacity to grow shareholder value at GE and magically hit his numbers exactly. When Jack Welch retired from GE, the company had gone from a market value of $14 billion to $484 billion at the time of his retirement, making it, according to the stock market, the most valuable and largest company in the world. In 1999 he was named ''Manager of the Century'' by *Fortune* magazine. Since Welch retired in 2001,

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however, GE’s stock price has not fared so well: GE has lost around 60 percent of the market capitalization that Welch ‘‘created.’’

The change had the opposite effect from what was intended

The proponents of shareholder value maximization and stock-based executive compensation hoped that their theories would focus executives on improving the real performance of their companies and thus increasing shareholder value over time.

Yet, precisely the opposite occurred. In the period of shareholder capitalism since 1976, executive compensation has exploded while corporate performance has declined. ‘‘Maximizing shareholder value’’ turned out to worsen the disease it was alleged to cure. Between 1960 and 1980, CEO compensation per dollar of net income earned for the 365 biggest publicly traded American companies fell by 33 percent. CEOs earned more for their shareholders for steadily less and less relative compensation. By contrast, in the decade from 1980 to 1990, CEO compensation per dollar of net earnings produced *doubled,* but from 1990 to 2000 it quadrupled, according to Roger Martin, professor of strategic management at the Rotman School of Management, University of Toronto.[5]

Meanwhile real performance was declining. From 1933 to 1976, real compound annual return on the S&P 500 was 7.5 percent. Since 1976, writes Martin, the total real return on the S&P 500 was 6.5 percent. The situation is even starker if we look at the rate of return on assets, or the rate of return on invested capital, which according to a comprehensive study by Deloitte’s Center For The Edge are today less than one third of what they were in 1965.[6]

Although Jack Welch was seen during his tenure as CEO of GE as the heroic champion of maximizing shareholder value, he came to be one of its strongest critics. On March 12, 2009, he gave an interview with Francesco Guerrera of the *Financial Times* and said, ‘‘On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy . . . your main constituencies are your employees, your customers and your products. Managers and investors should not set share price increases as their overarching goal. . . . Short-term profits should be allied with an increase in the long-term value of a company.’’[7]

The shift to delighting the customer

What to do? Given the numbers of people and the amount of money involved, rescuing capitalism from these catastrophically bad habits won’t be easy. For most organizations, it will take a phase change. It means rethinking the very basis of a corporation and the way business is conducted, as well as the values of an entire society.

‘‘We must shift the focus of companies back to the customer and away from shareholder value,’’ says Roger Martin, author of *Fixing the Game*. ‘‘The shift necessitates a fundamental change in our prevailing theory of the firm . . . The current theory holds that the singular goal of the corporation should be shareholder value maximization. Instead, companies should place customers at the center of the firm and focus on delighting them, while earning an acceptable return for shareholders.’’

If you take care of customers, writes Martin, shareholders will be drawn along for a very nice ride. The opposite is simply not true: if you try to take care of shareholders, customers don’t benefit and, ironically, shareholders don’t get very far either.

With a focus on customers, there is opportunity to build a brand for the long run rather than to exploit short-term transactional opportunities. Working for customers produces meaning and motivation for organizations. The organization can imagine great plans and bring them to fruition.

Examples of the shift

Martin cites three examples of firms that are focused on the real world of customers and products.

Johnson & Johnson. In 1982, when the Tylenol poisonings occurred, ''J&J was in a terrible bind. Tylenol represented almost a fifth of the company's profits, and any decline in its market share would be difficult to reclaim, especially in the face of rampant fear and rumor. Yet, rather than attempt to downplay the crisis – it was after all, likely the work of an individual madman in one tiny part of the country – J&J did just the opposite. Chairman James Burke immediately ordered a halt to all Tylenol production and advertising, distributed warnings to hospitals across the country, and within a week of the first death, announced a nationwide recall of every single bottle of Tylenol on the market. J&J went on to develop tamper-proof packaging for its products; an innovation that would soon become the industry standard.'' Burke's actions were not the heroic act of a single individual, says Martin. The actions flowed from the company credo which is engraved in granite at the entry to company headquarters, which makes crystal clear that customers are first, then employees, and shareholders absolutely last.

Martin contrasts J&J's handling of the Tylenol crisis with British Petroleum's initial handling of the *Deepwater Horizon* platform oil spill in 2010, which he sees as driven by a short-term concern for profits.

Procter & Gamble. P&G ''declares in its purpose statement: '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.' For P&G, consumers come first and shareholder value naturally follows. Per the statement of purpose, if P&G gets things right for consumers, shareholders will be rewarded as a result.''

Apple. The late Steve Jobs seemed to delight in signaling to shareholders that they didn't matter much and that they certainly wouldn't interfere with Apple's pursuit of its customer-focused purpose: ''to make a contribution to the world by making tools for the mind that advance humankind.'' Jobs's feisty, almost combative demeanor at shareholder meetings is legendary. At the meeting in February 2010, one shareholder asked Jobs, ''What keeps you up at night?'' Jobs quickly responded, ''Shareholder meetings.''

Needed changes

Martin also argues for associated changes:

- Corporations must restore authenticity to the lives of executives. The expectations market generates inauthenticity in executives, filling their world with encouragements to suspend moral judgment. They receive incentive compensation, to which the rational response is to game the system. And since they spend most of their time trading value around rather than building it, they lose perspective on how to contribute to society through their work.

> **“ 'On the face of it, shareholder value is the dumbest idea in the world' – Jack Welch. ”**

Customers become marks to be exploited, employees become disposable cogs and relationships become only a means to the end of winning a zero-sum game.

- Corporations and regulators need to address board governance. Boards have become complicit in gaming the expectations market and the associated inflation of executive compensation.
- Government needs to regulate speculative market players, notably hedge funds. Overall, hedge funds create little or no net value for society. They have huge incentives to promote volatility in the expectations market, which is dangerous for us but lucrative for them. Regulators thus need to rein in the power of hedge funds to damage real markets.

Next steps

The economically disastrous practices that enable firms to meet their quarterly targets – drawing on the firm's pension fund,[8] cutting back on worker benefits and outsourcing production to a foreign country in ways that further destroy the firm's ability to innovate and compete[9] – need to be stopped.

Specific management changes are necessary to delight the customer. The command-and-control management of hierarchical bureaucracy is inherently unable to delight anyone – it was never intended to. To delight customers, executives need to adopt radical management – an approach with a different role for the managers, a different way of coordinating work, a different set of values and a different way of communicating.[10]

The shift from maximizing shareholder value to delighting the customer involves a major power shift within the organization. Instead of the company being dominated by salesmen who can pump up the numbers and the accountants who can come up with cuts needed to make the quarterly targets, instead it's the process and product innovators who add genuine value for the customer that have to be empowered.

None of these shifts involve painful sacrifices for the shareholders, the organizations or the economy. That's because delighting the customer is not just profitable: it's hugely profitable.[11]

Bottom-line: capitalism is at risk

It is not too much to say that capitalism hangs in the balance. A large number of rent-collectors and financial middlemen making vast amounts of money are keeping the current system in place. The fact that what they are doing is destroying the economy will not sway their thinking. As the novelist-with-a social-conscience Upton Sinclair noted, ''It is difficult to get a man to understand something, when his salary depends upon his not understanding it.''

Is change possible? Some of the most respected corporate leaders believe so. For instance, the Aspen Institute's Corporate Values Strategy Group has been working on promoting long-term orientation in business decision making and investing. In 2009, twenty-eight leaders representing business, investment, government, academia, and labor – including Warren Buffett, CEO of Berkshire Hathaway, Lou Gerstner, former CEO of IBM and Jim Wolfensohn, former president of the World Bank – joined with the Institute to endorse a bold call to end the focus on value-destroying short-term-ism in our financial markets and create public policies that reward long-term value creation for investors and the public good.[12]

The increasingly widespread recognition that a myopic focus on maximizing shareholder value makes no sense is still a radical idea in many circles. Ultimately, change is bound to happen, because firms operating in the new mode make more money. Once investors realize what is going on, the economics will drive the change forward.

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Notes

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