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The Value Creation Imperative: A User Guide for Managers in the New World

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A User Guide for Managers in the New World

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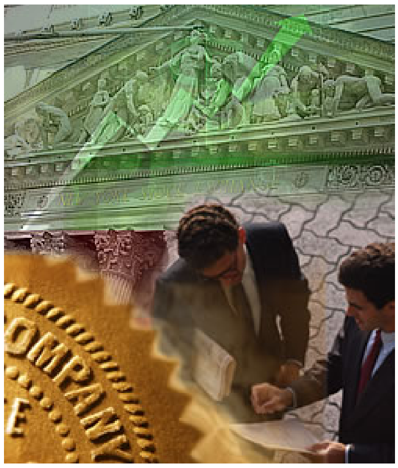

Executive Summary

Figure 1. World's oldest share

Approximately 400 years ago, a new trend began which would eventually transfer the ownership of the world's resources away from the remarkably small number of individuals who owned them then, comprised primarily of a few monarchs/dictators who were ruthless and brutal in their treatment of each other and of the people living in their countries, to those very people who were so badly treated under those regimes. This shift required the development of the global capital market which was the mechanism through which the world's people gradually acquired ownership of the world's resources. The first publicly traded company was the Dutch Vereinigte Oostindische Compaignie (VOC), whose first shares were issued on September 27, 1606 (shown in graphic). As of 2008, we are in the early stages of this transition, however already well more than a billion of the world's people own the world's resources through the publicly traded companies' shares and debts, and the publicly traded banks and financial institutions, via direct investment or via indirect investment through mutual funds, pension funds, etc. Why has this shift occurred? How has it occurred? Who helped it to occur? What are the implications for the managers of the world's companies?

In order to better understand the nature and implications of this transition, it is important to understand who is behind it and why it is happening. As the people of the world, we aren't deciding to take ownership simply to realize the benefits of ownership. To understand the forces behind this we need to consider the roles of the different participants:

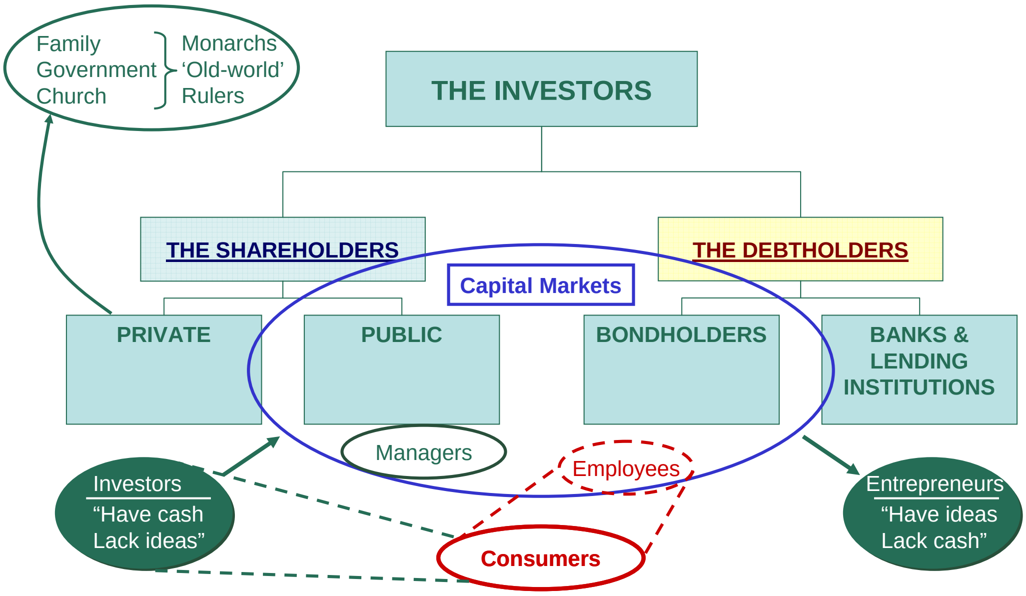

Figure 2. Different roles of different humans and their interactions

Investors – the world's investors, characterized as those with cash but lacking ideas, had extremely limited opportunities to diversify their wealth in the 'old' days (pre-capital markets), and to the extent they did diversify, by investing with their relatives or friends, they sacrificed liquidity nearly entirely. With the capital market, the world's investors are now able to shift consumption through time in ways never before possible, and to do so while diversifying away many catastrophic risks which were heretofor impossible to avoid, while simultaneously maintaining phenomenal liquidity and access to their funds. As a result, the most insignificant investor is now able to enjoy a financial peace-of-mind which the rulers of yesteryear couldn't have imagined in their wildest dreams. Thus, investors have clearly benefited from the transition of ownership from the few to the many, however they were not the driving force.

Entrepreneurs – the world's entrepreneurs, characterized as those with ideas but lacking cash, had extremely limited opportunities to realize their dreams in the old days. They might have considered approaching some of the few people who held the world's resources, such as the local noble, but the response to that effort would often lead to undesirable results. Indeed, in order to even obtain an audience with such a person (someone with cash), it would be critical to know the right person. The importance of relationships was paramount in those days. Given that humans are unable to assess the true value of alternative ideas, and they are much more concerned about the trustworthiness of the person they are entering into the business relationship with, the result is that the few who held the world's resources only shared them with people with whom they had relationships, meaning that the resources remained in the domain of the few. This "relationship-driven" approach to capital allocation was extraordinarily inefficient, with the vast majority of new ideas failing to see the light of day as resources systematically went to the 'wrong' people. The capital market, by contrast, acting in the blind interest of all of us, decides who to allocate capital to based upon only three criteria: cash, cash and cash – specifically, how much cash is needed?, when/how much is it expected to be paid back?, and what is the risk it isn't paid back? The result is that a far higher percentage of the humans' ideas get funded and become reality than ever would have been possible in the "relationship-driven" model of capital allocation.

Former "resource owners" (Governments, Monarchs, Aristocracy, etc.) – the world's former owner's of the world's resources (four hundred years ago a very small number of people controlled the world's resources) and their representatives, have had an extremely difficult time accepting the loss of their control to the rest of us. Indeed, in large parts of the world, including much of Europe, there is such mistrust of those in control, not unreasonably based upon thousands of years of exploitation and abuse, there are few who feel the capital markets will be any more trustworthy. Those who are losing control (the governments and aristocracy of yesteryear) are quick to reinforce this misperception of the lack of trustworthiness of the markets in order to prolong their reign as long as possible. Thus, they have fought the transition of the ownership of the world's resources to us from them, and they continue to fight it today.

The World's Banks – The bankers have operated on a three thousand year-old business model until extremely recently. In that model, certain people who managed to scrape together some savings (the 'investors' referred to above), would deposit money with the banks and the banks would then lend it out to those it felt were able and willing to repay it (as the saying goes, the banks only lend money to "their friends and to people who don't need it"). As a result, the banks were not a useful conduit for getting resources to entrepreneurs. Instead, they typically were a part of the 'problem' of keeping the world's resources concentrated in the hands of the well-connected few and banking was largely a "relationship-driven" business. It has only been in the past few decades that the more sophisticated banks recognized what we have been building over the past few centuries. By 2008, the old business model is defunct, and the financial crisis of 2007-2008 is partially connected to this. The world's investors no longer accept to simply deposit their money in the bank – instead, that money is directed, on the demand of the investors, into the capital market. Indeed, the giant money-management companies do not need to be banks at all in order to take investors' money and transfer it into the capital markets. On the other hand, whereas the old-world banks would take the deposits and lend them out, by 2008 the money to be lent is no longer that of depositors, whose money has been channeled into the capital markets. Instead, the bank accesses the money to be lent from the capital market directly – after selling you a mortgage, or car loan, or commercial real estate loan, most banks quickly package that with a large number of other such loans and "sell" them directly into the capital market as securities (a practice referred to as securitization). The result is that the two elements of the business are now completely separate. The depositors' money is transferred into the capital market and the bank tries to earn fees from this activity. Then the bank uses the capital market to provide the cash it transfers to the borrowers, again trying to earn a fee on the transfer but not actually lending the bank's own money. As a result, the modern bank is simply a retailer trying to earn a margin on the "merchandise" it sells. Unfortunately for the world's banks, as the merchandise they sell is money, the ultimate commodity, they are in serious danger of extinction, at least in their current form, due to the new-world reality where relationships are increasingly irrelevant for both depositors and borrowers.

Note that the world's investment bankers were not in the same position as the commercial bankers. The investment bankers, whether housed inside large universal banks or inside specialized or boutique investment banks, were a facilitating force in the entire transition, enabling the increasing development of the capital markets and the transfer of ownership of the world's resources from the few to the many. As a result, and due to the incredibly vast amount of wealth and happiness being created from this transition, investment bankers earned many times what nearly any other professional business person could expect to earn over any given period.

It is interesting, and rather sad, to note that the current financial crisis is causing a serious setback for this trend. The cause of this crisis is far outside the scope of this short note, but it is clear that the bankers, due to many macroeconomic factors and individual incentives, caused a catastrophic collapse in confidence by lending trillions of dollars to the wrong people. The mechanism described above was used to "sell" the risks into the capital market, but the mechanism for ensuring proper assessment of risk was unable to function due to a collection of factors - incompetence or deliberate hiding of the risks by the bankers, ratings agencies and other players. As a result, when the capital market finally understood what had happened, it reacted properly and appropriately and severely punished those responsible. The result is that the financial system, and the capital market, has "shutdown" temporarily. An additional result is that the investment bank, which was so pivotal to the creation and development of the capital markets, has become a thing of the past.

Managers – The modern manager is a new breed of human being, unlike anything we've seen before. As we transferred the ownership of the world's resources from the few to the many, we created the role of manager to oversee and manage these resources. As a result, there has been an increasing separation of ownership and control, relative to the 'old-world', and this separation results in a problem known as the principle-agent problem wherein the agent, acting in the interests of the principle, will not necessarily maximize the principle's objective function. The resulting underperformance is referred to as ***agency cost***. These agency costs are easy to visualize in the context of any modern corporation. They include the large expense accounts enjoyed by executives, the fact that executives often fly business class when traveling on company time and money, but economy class when on their own time and money, the artwork which graces the walls of the executive suite visible only to the executives but paid for with the shareholders' money, etc. To appreciate the scale of the problem, consider the recent "retirement" of three different CEOs in the USA, from Pfizer, Home Depot, and Merrill Lynch. In each case, the CEO had delivered underperformance relative to their industry during their tenure, but in each case the fired CEO received in excess of USD160 million (Merrill Lynch's Stanley O'Neal received over $160m after reporting a quarterly loss of over $8billion in October 2007, Home Depot's Bob

Nardelli received a total of over $210m after being fired for underperformance over his six-year tenure in January 2001 (HD's share price fell during that time while the S&P500 rose approximately 20%), and Pfizer's Hank McKinnell, who left in early 2006, received approximately $200m. These are only the tip of the iceberg, however. The real 'cost' to shareholders is the underperformance due to lack of deliberate and focused effort by all employees to increase customer value and capture it as revenues while motivating employees and suppliers to be as efficient and as productive in delivering the customer value as they can be during each minute while they are on the job.

Employees – The employees are certainly benefiting from the transition. As we take ownership of the world's resources away from the few, we are also the world's employees and we wish to be treated fairly and with respect, we expect to be offered training and development opportunities, offered fair compensation for the value we contribute, and sufficient time off to enjoy the fruits of our efforts, among many other things. Within the modern corporation, employees are receiving these elements in ever increasing amounts.

CONSUMERS - Who is behind this transition? Who is the driving force? It is us: the people of the earth. Why are we pushing this agenda? Because by taking ownership of the world's resources and building the value-driven capital market to serve as the capital allocation mechanism for these resources, we have succeeded simultaneously in ensuring that many of the ideas which may enhance our lives (from medical devices and pharmaceuticals to transportation technologies, to communication capabilities, to education, to food, to security and defense, to electronics for gaming and leisure pleasure, etc., etc.) become reality, while also ensuring that by undermining and removing the old-world owners of the world's resources and increasing transparency and access to information, we have dramatically reduced the importance of relationships to ensure that each individual has a better chance of realizing his/her dreams based upon the merits of their contributions to society rather than based upon who they know, where they went to school, what color their skin is, where they were born, or any other criteria.

How have we managed to accomplish this? We gradually assumed the ownership of the world's resources away from the old-world rulers by buying their stakes, piece by piece, step by step, largely without them fully appreciating the process underway which would eventually undermine their position completely and totally. The beauty of the maneuver is that there was no coordinated leadership. Just as bacteria, in large enough numbers, are able to crack any code we throw at them in the form of antibiotics, even though individually their intelligence level is approximately zero, humans, in large enough numbers, are also able to crack nearly any code even though any individual or even a large team of them couldn't possibly even begin to crack the code. This is the magic of the market. This transition is happening because we want it to happen, even though it may be true that not a single one of us understands it or is even aware that it is happening nor understands the implications. Nonetheless, we want it to happen and we've been pushing for it to happen and given the success we've had thusfar, it is safe to say that we will not go back to the old-world. At the same time, many of the 'old-world' rulers are not yet extinguished and they are fighting for their lives with their lives daily. They may not understand the extent of their battle, but it is indeed a battle and this battle will wage for many years to come as their situation becomes more desperate.

The result of our having taken ownership of the world's resources via the capital market was the phenomenal explosion of quality-of-life improvements from medical care to safe and convenient food and water, education and communication, etc., offering even the poorest people in the developed world access to security, convenience, leisure and pleasure, which even the kings of yesteryear could never have dreamed of accessing. However, it also created the agency problem.

Now, we are looking to address this problem as well. The managers of our companies are about to feel tremendous pressure. As we have taken ownership, we are demanding that we receive better, safer products with more features and more reliability, but we aren't wishing to pay for them (think PCs, cell phones, internet, etc.). We are also demanding that we are treated more fairly as employees, with safer working environments, proper support and development and higher pay. We are also demanding that the managers of our resources treat the communities and the planet with respect in a responsible and considerate way. This is showing up in the increasing pressure on managers to account for the impact they have on the planet at large. As explained above in relation to bacteria who appear as intelligent as a super computer in large numbers where each individually has no intelligence whatsoever, so too do humans appear superhuman when in large numbers. As a single human, our ability to remember the past or to connect with the future is extremely limited, however the capital market has the capacity to recall the past remarkably well and, more importantly, has demonstrated phenomenal ability to see forward and anticipate the impact of our actions into the distant future. As a result, the concept of Corporate Social Responsibility is being driven by the capital market, which is to say by us as we take ownership of the world's resources.

As a result of all of this, in the new world the consumers, which is to say, all humans, are in charge. We are slowly taking control away from the governments and the rulers of the past in order to get our way. We have succeeded in beginning the transition of ownership from the few to the many of us. As we have assumed ownership as the world's shareholders and debtholders of publicly traded companies, we have started to change the rules to benefit us. The managers of today are starting to feel this pressure from all angles. We, acting as consumers want safer, more reliable, more feature-rich products and services and we want them more cheaply than ever before. We, acting as employees, wish to be treating with respect and paid relative to the value we contribute. We, as shareholders want to minimize the agency costs, inefficiency and waste in the system which prevents the efficient delivery of higher quality products at lower cost. We, as citizens of the planet, want our managers to treat our communities and planet with respect and consideration. Woe to the manager who misinterprets the capital market as the tool of the shareholder or debtholder to the detriment of the consumer. It is the consumer as shareholder who has taken control and in the consumer's own mind, as both consumer and shareholder, it is the consumer role which takes precedence Thus the trend to ever-higher quality products and services at ever lower cost, with ever more difficulty to provide a good return to shareholders and debtholders – as long as we, the consumers, are in charge, we will privilege ourselves as consumers over ourselves as shareholders. And we are only just beginning…

Capitalism, Consumerism and Shareholder Value

While the objective of any individual human may be essentially to live happily (whatever pattern of individual consumption that might imply) and to control the way they die, it doesn't make sense to talk of the 'objective' of an organization, such as a company. An organization exists because some collection of humans wishes for it to exist, and it is important to understand that organizations are simply a means to an end. As such, when it becomes a destroyer of net happiness, rather than a net producer of happiness, then the humans will wish to shut it down. Depending upon the different parties to the organization and the relative power of the winners and losers to its continued existence, it may take a long time to shut it down, however one thing is certain – any organization which remains a net destroyer of human happiness for a sustained period of time, will be dismantled by the humans eventually. This fate awaits every company, government, religion, or any other social institution. Thus, when we consider that value is just another word for happiness, then it is clear that the objective of any company is value creation. (What is the "value" of your house to you? What is the "value" of your partner or children to you? It is clear that "value" is not about money or finance. It is about happiness, or, as economists refer to it, utility.)

Thus, as we, the consuming public, have taken ownership we have changed the rules. The managers of today are starting to feel this pressure from all angles. We, acting as consumers, want safer, more reliable, more feature-rich products and services and we don't want to pay much for them. We, acting as employees, wish to be treated with respect, offered opportunities for development and autonomy and and paid relative to the value we contribute. We, as shareholders, want to minimize the agency costs, inefficiency and waste in the system which prevents the efficient delivery of higher quality products at lower cost. We, as citizens of the planet, want our managers to treat our communities and planet with respect and consideration. The increased importance of Corporate Social Responsibility (CSR), far from being opposed by the capital market, is better understood as one of the creations of the capital market. As we have gotten control, we have demanded increased sensitivities of 'our' managers towards the impact they have on the communities and the planet we inhabit. As this movement sweeps the world, recognize that it originated where the capital market is most established and where we have taken ownership, and is least adopted in those parts of the world where the capital market is least present and where the "few" still rule over the local resources. .

Woe to the manager who misinterprets the capital market as the tool of the shareholder or debtholder to the detriment of the consumer. It is the consumer as shareholder who has taken control and in the consumer's own mind, as both consumer and shareholder, it is the consumer role which takes precedence. Thus the trend to ever-higher quality products and services at ever lower cost, while it becomes ever more difficult to provide a good return to shareholders and debtholders. As long as we, the consumers, are in charge, we will privilege ourselves as consumers over ourselves as shareholders. Like the organizations we create, the capital market itself is simply a means to an end as is our role as shareholder. It is not our objective to simply have ownership – it is our objective to take ownership in order to direct those resources to those pursuits which best justify their use – creating and delivering happiness to us, otherwise known as value creation.

It is critical to understand that the manager's performance at the center of the web of conflicting stakeholders is best measured by looking at the shareholder value metric. If the objective for each company (or institution) is value creation, then the metric which reveals whether a manager is successfully delivering on this challenge is shareholder value as the residual claim in the company. It is important to recognize that this in no way implies that shareholders are a more important constituency than any other group – quite the opposite. It is the fact that shareholders are the residual claimant that makes their claim the metric to assess how well management are doing their jobs. If this value is declining, then we know management are killing the company and in the long run, if they don't reverse the trends, the companies' employees, customers, suppliers, communities, etc. will all suffer as a result.

Measuring this shareholder value concept is difficult. A useful indicator is the company's share price, which is easily observed when the company is publicly traded. However this is only an indicator of shareholder value, it is not the "truth". Consider the famous catastrophe at Enron – those managers must have known full well that they were destroying value for years even while the share price was rising at the same time, demonstrating clearly that management can be destroying value and killing the company while the share price fails to reflect this. Thus, we, as shareholders, will demand that our managers deliver the products and services we want, while using resources as efficiently as possible, and managing the company's various relationships in a way to ensure its continued delivery into the future.

How will we know if they are succeeding, if the share price is only an indicator? What is the "real objective" if it isn't share price? The true measure of shareholder value is the present value of expected future cash flows generated by the company. While each of us may have our own view of what those cash flows might be, the phrase "the expected future cash flows" does not leave room for opinions. To see this, note that each decision taken by a manager will, in fact, either create value or destroy value. The fact that the manager may not know which it is does not change the fact that it happened. Thus, when we say "expected future cash flows" we are not referring to any given person's expectations, but rather the true "the expected" cash flows which may be unknown to all humans. Thus, the job of management is to simultaneously study the consumer's interests and trends, the employees' motivations for working which will help management to get the most from them, the competitive landscape, any technological innovations and developments, the changing regulatory environment, the relationships with present and potential future suppliers, etc., so as to understand what the impact might be of each of his/her decisions, at least in terms of what is **reasonable to expect**. If the objective is value creation, then we, the owners of the world's resources, can summarize any manager's job as simply: accept the value creating ideas and reject the value destroying ones. The manager who is unable to put together a forecast of the cash flows which are reasonable to expect as a result of a given decision, and thus is unable to assess the value impact of his/her decisions, and thus is the wrong person for the job.

The capital market is absolutely clear, and brutal on this point. In the old world it was more important to know the right person, attend the right school, be born to the right parents, kiss the right butts and pull the right strings in order to succeed in business or politics. In the new world where we have taken ownership of the world's resources via the capital market, the only way to be sure to survive as a company, and keep your job as an employee, is to create value – Value creation is all we care about and we're very serious about it. Indeed, as employees, we are sick and tired of the 'old-world' approach to management in which it is more important to know the right people, or to kiss the right butt or to lie most successfully in order to get promoted. We each have a "fairness-meter" implanted in our brains at birth, and we will never consider these "fair" reasons for someone being promoted instead of ourselves. We also have a "value-meter" implanted in our brains at birth, and it turns out that the two meters, the "fairness-meter" and "value-meter" are inseparably connected to one another. The one determinant that we will accept as "fair" is value – as long as it is those who create the most value who enjoy promotions and success, we will not revolt, but when it is value destroyers who enjoy the material success in the company or in society, we will fight the system in an effort to correct this "unfairness".

The shareholder value metric is the measure to aspire to deliver, yet try as you might, our shareholding in the world's companies is simply a means to an end – it is what enables us to take control of our lives away from the old-world rulers. As such, maximizing the shareholder value will remain the metric, but it will be like the pot of gold at the end of the rainbow. The closer a company gets to it, the more competition will rise to challenge the value creators in an effort to get some of their own, the more employees will react to capture more for themselves, and the more consumers will respond by demanding still higher quality products and services at better prices, making maximization of shareholder value a very elusive target with self-regulating forces to ensure it remains so. This is simply the lesson of Adam Smith's Invisible Hand, first offered to the world in 1776 in "The Wealth of Nations", which is alive and well today as it always has been and always will be. It is rather shocking and unfortunate that this lesson has been misunderstood and underappreciated by so many since its first release. No doubt, for the old-world rulers and corporate executives who stand to lose their control the world's resources, they have worked hard to prevent dissemination of this understanding. In our self-regulating world, driven by us for our benefit, the providers of capital will neither earn more nor less than the opportunity cost of their capital. We will see to it and the evidence from the capital markets is already fairly clear on this point. We are moving toward a world where we all share in the ownership of the world's resources and we direct their application toward the individual happiness of each of us, whatever that may entail, rather than toward the happiness of the few rulers. It is a form shared ownership, it is called capitalism, but that is a misnomer and reflects a lack of understanding of what is happening. Owning the capital is simply the means to the end. The end is to have the world's resources redirected to those pursuits which best deliver the consumption demands of the humans, thus, it is more appropriately referred to as "consumerism".

And we are only just beginning…

What are the five "need to knows" which will enable every manager to lead more effectively without destroying value.

1. **Consumers come first** – always ask how your decisions will benefit consumers, either by delivering higher quality products/services with the features they will value, or by enabling more efficient use of resources to drive down the cost to the consumers of the high quality, feature-rich products/services you provide to them.
2. **Value-driven** – ask always how your decisions will enable the organization to create, deliver and capture more value to enable it to survive another day in order to try again
3. **Integrity is critical to management and leadership** – we do not accept any determinant for promotion as "fair" other than value creation. Those organizations which are able to see past the traditional criteria for promotions, such as who went to what school, who knows whom, who is more effective at "politicking" inside the organization, who lies the best, etc., and instead promote simply based upon who is best able to understand, create, deliver, and capture value with be accepted as "fair" and thus respected by all employees resulting in higher morale and effectiveness and leading to better performance on points 1. and 2. We will refer to such organizations as "having integrity". Those organizations in which it is the traditional criteria which determine who gets promoted will be referred to as "lacking integrity."
4. **Indicators are not objectives** – the objective is value creation. There are many indicators in business, just as there are indicators in a car – the speedometer indicates the speed you are traveling while the fuel gauge indicates the level of fuel remaining – don't look at the fuel gauge if you wish to know how fast you are traveling. Many organizations mistakenly give their managers performance objectives based upon the indicators with the result that they manage the indicator directly. The result is they do not manage for value creation. This results in two negative results – (1) any indicator target can be obtained through either value creating methods or value destroying methods (e.g., attain 30% market share by spending only €1 million, or attain 30% market share by spending €1 billion) – of the two, delivery

through value destroying methods will almost always be easier. As a result, managers who are focused on performance objectives based on indicators will very often deliver on these by destroying value, but will be rewarded with promotions and bonuses – resulting in a situation all will consider unfair which demotivates other employees and does not serve the objective of the organization, which is value creation. The second negative result is, (2) because the managers are "managing" the indicators, they are no longer reliable indicators. Thus, all we know about such organizations is: (1) they are not focused on value creation and (2) the indicators are almost certainly not indicating what we think they are indicating and (3) all of the employees are probably demotivated by the lack of integrity in the organization

5. **Value creation is about expectations** – value cannot be assessed after the fact. When a manager takes a decision, the value impact is based upon whether the expected cash flows are positive in present value (not the cash flows the manager expects, but rather "the" expected cash flows which are not a matter of opinion but are those cash flows which are truly expected based upon all of the random elements which will drive the eventual outcome). After the fact, one of the infinite potential outcomes which might have occurred will be the one we actually observe as the outcome which happened. This outcome cannot help us to assess whether value was created or destroyed – it simply tells us what happened. To understand whether value was created or destroyed we need to know what was expected at the time of the decision. Due to this, management must be sufficiently knowledgeable and courageous to be able to recognize that some "good ideas" (those which are value creating) may turn out badly and some "bad ideas" (those which are value destroying) may turn out well, but that these outcomes must not be used to determine promotions or bonuses in the organization. As GE's Jack Welsh liked to emphasize, good ideas which turn out badly will not mean "career damage" in a value-driven organization. The pressure this puts on management to be able to have the knowledge to distinguish good ideas which turn out badly from bad ideas which turn out badly is enormous. This will require the full effort of a "learning organization" focused entirely on understanding value and value creation and built from top to bottom on a system of integrity. A company with integrity will be one which is in fact value focused, simply having the intention of being value focused isn't good enough – in addition to having the right "character", the organization and its management need to have the "competence" to know the difference between value creating and value destroying decisions, even if the value creating ones sometimes turn out badly or the value destroying ones sometimes turn out well.

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