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Value Creation Beyond TSR

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AT A GLANCE

Managing for shareholder value has come under intense scrutiny in recent years, with critics arguing that it contributed to the global economic crisis as well as to recent environmental disasters such as the BP oil spill and Japan's nuclear crisis.

TSR and Broader Social Value

There is nothing in the theory or practice of shareholder value management that compels companies to maximize short-term returns at the expense of long-term sustainability or to reward owners at the expense of alienating other stakeholders.

Systemic Importance

Some companies, however, occupy such a central position that they develop *systemic importance*—the capacity to inflict severe disruption on society, the economy, or the environment.

Managing Systemically Important Companies

Such companies may need to make fundamental changes in their financial objectives and risk profile in order to preclude onerous government regulation. And they must attract and retain suitable investors by targeting investor groups drawn to sustainable performance and low risk.

THE SHAREHOLDER VALUE APPROACH to corporate management has come under increasing scrutiny in recent years, with critics arguing that it contributed to the global economic crisis as well as to recent environmental disasters such as the BP oil spill and Japan's nuclear crisis. It is commonly argued that the approach encourages managers to put the interests of shareholders above those of other stakeholder groups, and to focus on managing quarterly earnings at the expense of long-term sustainable value.

Against the backdrop of this ongoing debate, many companies have been taking concrete steps to broaden their views on value creation, with the majority of *Fortune* 500 and FTSE 100 companies now maintaining a corporate-social-responsibility function and issuing an annual sustainability report for investors. Leaders in the practice, such as BMW and BASF, go so far as to specify their sustainability objectives and achievements on a number of social and environmental dimensions supported by a range of metrics, including value creation for each stakeholder group over a long-term horizon.[1] A handful of companies have taken steps to incorporate sustainability goals into their employees' incentive plans. Royal DSM, for example, links almost one-quarter of management compensation to the company's performance in eco-product development, energy efficiency, and employee engagement, with another quarter tied to greenhouse gas efficiency.[2]

Individual company initiatives are the product of a growing focus on sustainability by the wider business community. A number of indexes have been developed to allow investors to evaluate the performance of companies on criteria related to sustainability. The Dow Jones Sustainability Index (DJSI) measures companies' long-term economic, environmental, and social performance. Other organizations have worked to establish standards for sustainability reporting, such as the widely followed Global Reporting Initiative (GRI). The International Organization for Standardization (ISO), DJSI, GRI, and Bloomberg have all compiled lists of key indicators to assess companies' performance in areas such as reporting transparency, management integrity, risk management, and environmental and social impact.

TSR and Broader Social Value

Meanwhile, a number of business leaders and academics have tried to develop a broader conceptual approach to shareholder value management. Michael Porter and Mark Kramer, for example, recently presented the concept of *shared value,* arguing that the purpose of a company should be redefined as the creation of value for both shareholders and the wider society.[3]

Broader approaches to value creation—such as the shared-value concept—should not prevent most companies from optimizing their total shareholder returns.

BCG's view is that companies should be managed for the purpose of optimizing long-term shareholder value. However, there is nothing in the theory or practice of shareholder value management that compels companies to maximize short-term returns at the expense of long-term sustainability or to reward owners at the expense of alienating customers, employees, or other stakeholders. In fact, managing for long-term shareholder value should serve the interests of all stakeholder groups, not just shareholders.[4] When a company delivers consistent and sustainable improvements in shareholder value, it lays the foundation for long-term returns to all stakeholders: customers enjoy innovative products and better value, employees get stable jobs and rising wages, and suppliers receive more orders. A long-term focus encourages companies to manage their business in a sustainable way. Broader approaches to value creation—such as the shared-value concept—should not prevent most companies from optimizing their total shareholder returns.

Systemic Importance and the Free-Rider Problem

However, recent events have shown that the notion of *systemic importance* needs to be introduced into the debate to reflect the greater responsibility of some companies than others to their larger business ecosystem. The G20 has identified and subjected to special treatment "systemically important financial institutions," whose "disorderly failure…would cause significant disruption to the wider financial system and economic activity."[5] It is anticipated that the new rules will have a significant impact on the relationship between shareholders and stakeholders.

The capacity to inflict severe disruption on an ecosystem or a regional economy is not limited to financial institutions. The operational or financial failure of companies across a spectrum of industries can have similarly destabilizing effects, whether because of the size of their workforce, the concentration of their suppliers, the dependency of their customers, or the risks that their operations pose to the environment. All such companies should be considered systemically important. Typically, their failure can have two major impacts.

Economic Contagion. The failure of a large, interconnected company can generate shock waves throughout an entire ecosystem, destabilizing multiple businesses. The near collapse of General Motors in 2008 illustrated the complex web of dependencies that can exist within an industry. GM's 2,100 parts suppliers received orders totaling some $31 billion annually. Its 14,000-strong dealer network represented almost half the 29,000 U.S. dealers specializing in domestic vehicles. Some commentators estimated that as many as one in ten jobs in the U.S. were dependent on GM at the time.[6] Ultimately, the U.S. government decided that it could not allow the automaker to fail.

Many companies provide services that are essential to business and society. Some, such as water and electricity companies, are highly regulated in order to guarantee their continued provision of services. But many others are not. The collapse of leading food retailers, airport operators, or telecommunications companies, for example, could cause widespread disruption as multiple businesses were denied services vital to their operations. The collapse of major employers can also cause a systemic problem at the regional or national level, with concentrated job losses threatening the economic welfare and social stability of entire communities, in addition to personal tragedy for those directly affected.

Environmental Damage. Many companies are required to make daily judgments balancing the needs of their business against the risks that their operations pose to the environment. In some cases, these risks can be catastrophic, causing severe damage to the environment and the wider society, in addition to destabilization of the business ecosystems upon which numerous other companies depend. Recent events in Japan serve as a stark reminder of the systemic impact that energy companies can have on their ecosystems.

Likewise, the financial or operational failure of a systemically important company can cause catastrophic disruption to its ecosystem. In some cases, the costs of disruption can be an order of magnitude greater than the capital costs of the company, exceeding the latter's capacity to absorb them. In that case, the costs are externalized and borne by third parties—government, society, employees, and other businesses. This can give rise to a free-rider problem: a systemically important company can have an incentive to take certain risks because it knows it will not be required to pay for the full consequences of its actions. In the absence of a regulatory requirement to internalize these costs, there is limited economic incentive for such a company to reduce its risk profile and expected return.

If systemically important companies were required to pay for the external costs of the risks that they pose to their ecosystems, we would no doubt see a change in their behavior. However, since assessing the full magnitude of these costs before the event is impossible, it is difficult for regulators to impose a price on the risks that a company is taking. When regulators do eventually force companies to pay for their externalities—often in the aftermath of a crisis—it can result in disruption for all stakeholders.

Implications for Senior Management

Understanding the notion of systemic importance is important for large and small companies alike. Large, interconnected companies need to determine for themselves whether they—or parts of their business—are systemically important, while all companies need to understand the extent of their exposure to systemically important companies across their supply chain. The characteristics of systemic importance vary across industries and regions, but there are some key questions that companies can ask themselves to assist in their analysis:

- Does our employee base represent a large portion of a regional or national workforce?
- How dependent is our network of suppliers on our business?
- To what extent does our customer base depend on the services that our company provides?
- Could an operational failure result in a serious environmental hazard?

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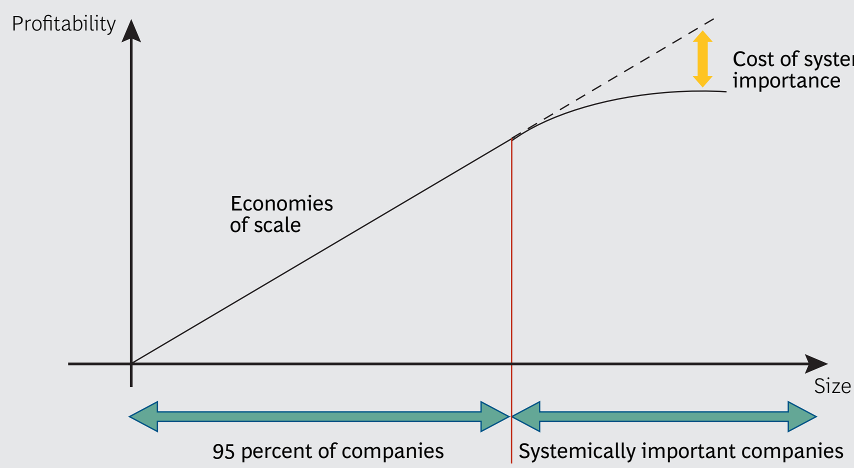
Systemically important companies must understand and anticipate the threat of regulatory intervention. Regulation can change the dynamics of an industry and affect the long-term competitive position of its stakeholders. The financial sector offers a stark illustration of the tough restrictions that regulators can impose on business activity. The first wave of regulation following the recent crisis proposed new capital, leverage, and liquidity standards for global banks under Basel III and was followed in the U.S. by the Dodd-Frank Financial Reform Act. The G20's Financial Stability Board is close to prescribing further restrictions on systemically important financial institutions, and (in the U.S.) there have even been calls from some quarters for the reinstatement of the Glass-Steagall Act of 1932.[7] Senior management must recognize that systemically important companies need to take a broader view of value creation if they are to avert the imposition of onerous regulatory constraints on their business. Part of the solution will involve revisiting the way that shareholder and stakeholder interests are balanced in decision making. Ultimately, management of systemic companies will need to take the following concrete actions.

Set realistic financial objectives. The managers of systemically important companies will need to exercise greater financial caution in running their companies. This may require adjustments to growth and profitability targets that will result in the company's incurring a systemic cost—the loss of profit caused by managing for systemic risk. (See the exhibit below.) This is comparable to the reduced return on equity that large banks can expect to achieve in the wake of the Basel III requirement to increase capital reserves.

Systemically Important Companies Need to Exercise Financial Caution

Profitability according to systemic importance



Source: BCG analysis.

Competitive pressures may deter the managers of some systemically important companies from adjusting their growth and profitability targets. In such cases, industry councils or similar mechanisms could prove useful in facilitating coordination and cooperation among market participants. It will also be important for companies to align their governance structures, including individual performance assessments and compensation incentives, with their financial objectives.

Run stress tests and adjust risk exposure. Financial institutions in the U.S. and EU are required by regulators to conduct stress tests to assess their ability to meet capital and liquidity requirements under a range of stressed conditions. Many banks also conduct their own stress tests as a matter of good practice. BCG recommends that companies perform stress tests in order to assess their systemic importance, understand their exposure to the failure of other systemically important companies, and judge their ability to withstand a range of financial, operational, and environmental risks. Stress tests should be added to the suite of tools used by managers to make business strategy, risk management, and capital planning decisions.

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To help clients stress-test their business, BCG has developed a methodology comprising the design and execution of tests tailored to the individual business. (For examples of techniques and approaches to assess macroeconomic risks, see BCG's Collateral Damage series of articles at www.bcgperspectives.com.) These tests examine how the company would fare financially and operationally under a range of exceptional but plausible scenarios, given specific macroeconomic and business conditions, operational failures, natural hazards, and man-made events. The scenarios have three crucial characteristics:

- They are *credible*—tailored to the individual company and agreed to by stakeholders.
- They are *realistic*—based on historical or probable events.
- They are *extreme*—including tail risks and low-probability, high-impact events.

Financial stress tests help companies ensure that they have sufficient capital and liquidity to withstand a range of scenarios, enabling them to optimize their financial structure. Operational stress tests determine whether companies meet the capability and resource criteria required to survive shocks to the business, enabling them to optimize contingency and disaster response planning. There are several specific forms of stress test to which companies can subject their business:

- *Analytical models* define the relationship between a scenario and its consequences and model the impact of those consequences on key factors (such as liquidity and capacity).
- *Physical simulations* subject the company's processes and procedures to simulated stresses. This may require a complex setup and careful management to ensure that normal processes are not disrupted.
- *Scenario planning and war games* use workshops to simulate and test management's responses to a particular scenario. Functional specialists challenge the responses to identify capability gaps.

It will be important for systemically important companies to communicate that they still present an attractive investment opportunity.

Adjust the financial structure. Before the financial crisis, many companies relied on their credit ratings to determine appropriate levels of borrowing and used leverage as a means of optimizing their weighted-average cost of capital. This resulted in overleverage and subsequent refinancing issues, causing numerous businesses to fail. As long as liquidity has a cost, systemically important companies must ensure that their chosen level of financial leverage reflects the risks that the business faces. In this new environment, conducting stress tests is the best way to determine the appropriate leverage. Ultimately, capital is the best protection for any company—systemically important or not—against a severe financial or economic crisis.

Adjust the equity story. In the wake of the financial crisis, systemically important companies will have to adjust their equity story to reflect the new economic reality. Key messages will include the following:

- *Much Lower Growth.* Since more capital is required to cover systemic risk, growth will involve much more capital for systemically important companies than for other companies. In the financial sector, for example, systemically important banks are required to hold up to 20 percent more capital than banks that are not systemically important, hindering their ability to make acquisitions or grow organically.

- *Higher Returns.* The premium given to market leaders will therefore fade, and systemically important companies will have to adjust their performance toward yield and deliver more dividends in order to justify capital investors' interest.

- *Fewer Risks.* Systemically important companies will be scrutinized and eventually rescued by public authorities in the event of failure. We also anticipate that risk management and risk exposure will become an essential part of the equity story, thereby reducing volatility, which can impose such a penalty on large companies.

- *Lower Borrowing Costs.* Implicit support from governments may translate into lower borrowing costs.

Proactively manage the investor base. The new equity story will be a repellent for growth investors, hedge funds, and other investor groups that seek volatility. It will therefore be important for systemically important companies to communicate that they still present an attractive investment opportunity. Investor groups that might be attracted to the new equity story include the following:

- Investors with a long-term-yield perspective, such as sovereign wealth funds or government agencies

- Nonconventional groups of investors with a direct interest in the sustainability of the company, such as employees, customers, or key suppliers

- Institutional investors such as pension funds and insurance companies attracted by the offer of stable, long-term returns (it should be noted that mutual banks and insurance companies have, overall, fared better during the recent crisis than their more capitalistic competitors)

Systemically important companies could benefit from a higher level of stakeholder ownership. If these groups can be encouraged to take a role as shareholders, it would represent a significant step toward creating an investor base whose primary concern is the long-term sustainability of the company.

Ultimately, managers face two key challenges. The first is how to prevent the imposition of onerous regulatory constraints on their business. They must start by acknowledging that governments are likely to intervene to prevent systemic impacts and may require fundamental changes to the company's financial objectives and risk profile. The second is how to attract and retain suitable investors given the company's new risk profile. Systemically important companies must recognize that some investor groups will be more predisposed to investing in them than others. Investors, too, may have to adjust their expectations—something that has been and will continue to be especially difficult in turbulent times.

Notes

1. BMW Group, *Sustainable Value Report 2010,* available at http://www.bmwgroup.com/e/0_0_www_bmwgroup_com/verantwortung/ueberblick/svr2010.html.

2. Royal DSM, "Sustainability Reporting Approach," in *Integrated Annual Report 2010,* available at http://www.annualreport2010.dsm.com/pages/EN/Sustainability_reporting_approach.html.

3. Michael Porter and Mark Kramer, "The Big Idea: Creating Shared Value," *Harvard Business Review,* January 2011, available at http://www.waterhealth.com/sites/default/files/Harvard_Buiness_Review_Shared_Value.pdf.

4. See "Why Shareholder Value Still Matters," BCG article, September 2010, available at https://www.bcgperspectives.com/content/articles/value_creation_strategy_corporate_strategy_portfolio_management_why_shareholder_value_still_matters/.

5. Financial Stability Board, "Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines," October 20, 2010, available at http://www.financialstabilityboard.org/publications/r_101111a.pdf.

6. "GM Failure: The Shockwave," CNNMoney, November 14, 2008, available at http://money.cnn.com/2008/11/14/autos/auto_failure_ripple_effect/index.htm?postversion=2008111412.

7. In December 2009, for example, Senators John McCain and Maria Cantwell jointly proposed reenacting this law. See "An Odd Post-Crash Couple," *Newsweek,* December 14, 2009, available at http://www.thedailybeast.com/newsweek/2009/12/14/an-odd-post-crash-couple.html.

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