

## WHY FIRMS FAIL TO MAXIMIZE SHAREHOLDER VALUE: HOW VALUE EVAPORATES

### 1. How Does Value Evaporate?

Jerry was impressed by the three cases Bob had given him. The message that stuck with Jerry was that none of the companies got back to a shareholder focus without a major shakeup; a new management team at Coke, the creation of a separate Ceridian business unit out of CDC, and a fundamental, and continuing, restructuring of Daimler.

As Jerry returned the cases to Bob, who had now moved into his new CFO office, he remarked, “These case studies are amazing. How is it that such well-known companies fail to maximize shareholder value? Do you think we could end up making the same mistakes?”

“Well, Jerry, there are things you can do right now to minimize Value Evaporation at our company. Why don’t you take a look at the following (Fig. 5.1) that summarizes the three cases you read. The systematic patterns that emerge are instructive.”

Providing competitive shareholder returns often requires investing in employee training and development to equip employees with the appropriate decision making and leadership tools and also changing the organization culture to make it more shareholder-value focused.

## COCA-COLA

- Focus on customer satisfaction and employee morale is not enough: shareholders must also be taken care of. Shareholders have to be included in any definition of “excellence.”
- Earning a return that is greater than the cost of capital is what keeps shareholder happy. This can only be done by optimizing the value drivers.
- If returns are inadequate, management changes will be made to ensure shareholders are rewarded for their investment. The Board of Directors will ultimately replace poorly performing managers.
- New management has the obligation to recalibrate the company’s strategy to add value if the existing strategy is not doing so.
- Fundamental change is usually needed to resurrect a company that has been performing poorly. And this is not easy.<sup>37</sup>

## CERIDIAN CORPORATION

- It is often better to split a large organization into smaller, more sharply-focused enterprises in order to improve the clarity of strategy and the shareholder-value focus of the organization culture.
- It is important to keep large institutional investors informed about company strategies and operations.
- As residual owners, shareholders have the most at risk in corporations because they have the lowest-priority financial claim. They must therefore have the highest control rights. Taking care of shareholder interests is not incompatible with satisfying customers, employees, communities, and others who have a higher-priority claim on income.
- To protect their claims, shareholders, particularly institutions, have become more active in the affairs of the companies they own.

## DAIMLER

- Layers of ownership structures and significant cross-holding of shares by families, banks, or other companies work to create a system of inside owners which is common for German companies.
- The system of inside-ownership makes hostile takeovers very difficult to succeed. This can hurt shareholders.
- Even with an inside-ownership system, poor performance requires that changes be made, particularly if the firm wants access to global equity capital and lists its shares internationally.
- A strong global brand name does not insulate you from the need to provide competitive shareholder returns.

Fig. 5.1. Summary of Coca-Cola, Ceridian, and Daimler Cases.

<sup>37</sup>As noted by Robert Quinn in his book, *Deep Change: Discovering the Leader Within*, Jossey-Bass Publishers, San Francisco, 1998, there are many who prefer slow death to deep change.

## 2. Generalizing from the Case Studies

Jerry studied the table and remarked, “These companies all thought they could dictate success in their markets; that strong brand names, or technical pioneering, or protected capital markets made them immune to pressures from their shareholders. As time went on, more and more value evaporated until something major needed to be done to stop the evaporation and improve value retention. It appears to me that management just got too complacent, started rationalizing their actions, and inefficiently responded to competitive challenges. The Value Sphere was not synchronized for these companies. I agree with you, Bob. We need to insure that this sort of thing does not happen here. What can we do?”

“Before we can identify a prescription, we must understand Value Evaporation some more,” Bob suggested. “Look at the following (Fig. 5.2) which is another table showed my students listing the various ways companies have allowed value to evaporate.”

As Jerry finished studying the table, Bob remarked: “It seems as if there are countless ways in firms’ evaporate value. However, we can generalize based on the Value Sphere.” He then pulled out a white paper on Value Evaporation to discuss with Jerry.

## 3. Value Evaporation and the Value Sphere: White Paper

The concept of Value Evaporation is part of the Value Sphere (see Fig. 5.3). The Value Sphere asserts that all value creation springs from four aspects of an organization’s design: its strategy, its resource allocation system, its performance metrics, and its people and organization culture.

While the total amount of value creation potential of the organization depends on these four aspects, the *actual* amount of value creation enjoyed by the organization is typically far less. The reason is that part of the value creation potential is dissipated due to a key phenomenon called *Value Evaporation*.

Value Evaporation refers to systematic patterns of behavior within organizations that cause value to evaporate. Any organization that employs people suffers from Value Evaporation; the task is to minimize Value Evaporation, not eliminate it. Basically, Value Evaporation stems from systematic errors of omission and commission in decisions that result in the value enjoyed by the shareholders — which we refer to as value retention — being less than the total value creation potential of the organization. Thus value retention = value creation potential – Value Evaporation.

<b>Cause of Value Evaporation</b>	<b>Company situation</b>
1. Not sharing technical standards with others in industry	Apple computer retained complete control over the Macintosh standards. By contrast, IBM adopted an open-architecture approach, so its PC was cloned by many producers, leading to market share dominance of the IBM standard.
2. Too slow from R&D to product commercialization	Philips Electronics NV, the Netherlands company, has a long and rich history of new product research and development. For example, they “invented” the VCR. Unfortunately, due to a flawed internal management system, they were lax in commercializing the concept and conceded the market to Japanese companies such as Panasonic.
3. Permitting loss of market share to competitors with innovative product ideas	The major US television networks, ABC, CBS, and NBC stood by while cable TV companies, independent producers, and satellite companies eroded their markets. So product ideas: failure much market share has been conceded that the networks now have a major problem in regaining their share of TV viewers.
4. Failure to invest in supply chain and distribution	The failure of Sears and others to innovate the supply chain allowed Wal-Mart to revolutionize the mundane business of discount retailing by reengineering the supply and distribution chains within the industry. Consequently, Wal-Mart took considerable market share from Sears and small competitors.
5. Overinvestment in assets	In the 1980s, the oil industry greatly over invested in oil exploration, which was a failure of the resource allocation process within oil companies. The conventional wisdom was that oil prices would keep rising beyond \$40 per barrel. The stock market disagreed, leading to the observation that it was cheaper to drill for oil on Wall Street than in Texas. Ultimately, the market view prevailed and oil companies added value by announcing decreases in exploration spending.
6. Poor definition of market	The major coffee producers such as Procter & Gamble and Nestlé defined the coffee market too narrowly, until the 1980s. They failed to notice Starbucks was redefining the US coffee market with a more European approach. Before long, Starbucks grew beyond the west coast and emerged as a national leader.

Fig. 5.2. Mismanaging the Value Sphere: How value evaporates.

Cause of Value Evaporation	Company situation
7. Artificially increasing sales make the accounting numbers look good at the end of the quarter (“Trade loading”)	Some companies take advantage of the accounting cycle by aggressively shipping product before the end of the quarter or the year. Such actions were motivated by poor management systems that included performance metrics driven by “Trade loading” rather than shareholder value. For example, management system prior to its leveraged buyout, RJR-Nabisco would force its products through the distribution chain in order to book sales revenue in the current year. While such a practice might help current accounting profits, it had a perverse effect on product quality because old, stale products wound up in the distribution chain. Booking profits, which really did not affect cash flow, consequently harmed product quality strategies.
8. Overpaying for merger partners	Much value can be evaporated by overpaying for a merger partner. Such overpayment is often the consequence of flawed financial valuation emanating from a weak resource allocation process. An example is the Quaker Oats acquisition of Snapple. While it may have made strategic sense to add Snapple to Quaker’s existing Gatorade business, the potential value added is not independent of the price paid for the acquisition. As Quaker unfortunately discovered, the potential synergies with Snapple did not materialize and billions of shareholder value disappeared through the Snapple acquisition and subsequent divestiture. Many managers lost their jobs in the process.
9. Use of corporate funds for personal pleasures	Sometimes personal expenditures find their way into corporate for personal pleasures: accounts, thereby evaporating value. For example, for many years, failure of people and Don Dixon ran Vernon Savings & Loan as his personal fiefdom, organization culture running many lavish and questionable expenditures through the company. Travel, art collections, contributions, and the like found their way into the corporate accounts. Unfortunately, such expenditures can continue for a long period of time. Value is enhanced by the departure of such executives.
10. Lack of fresh strategic perspective from outside the industry	The problem of being a dominant, successful firm in an industry is that managerial hubris can take over. A case in point is IBM, which used to control over 70% of

Fig. 5.2. (Continued)

Cause of Value Evaporation	Company situation
11. Belief in the “quick fix” of cost cutting	<p>the mainframe computing market. Such dominance can be taken as a given and there is a reluctance to take a fresh perspective. DEC used this reluctance on the part of IBM to make huge inroads into IBM’s business through the introduction of midrange computers. Unfortunately, DEC suffered the same fate when personal computers and computing network servers cut into their market.</p> <p>Many firms sacrifice long-term value because they want short-term numbers to look good. Such “slash and burn” tactics may be appropriate at companies with significant corporate flab. But their indiscriminate use can be disastrous, e.g., “Chainsaw” Al Dunlap’s failure at Sunbeam.</p>
12. Focus on accounting numbers instead of value	<p>A management performance evaluation system that focuses unduly on accounting numbers can also lead to value problems. A bad management example is Cendant, which was ordered by the SEC to restate its system accounts. “Manufacturing” accounting earnings instead of products and services cost this company billions. Another example is Oracle which lost significant market value in 1990 when it was revealed that it had aggressively (and erroneously) recognized some trial sales as actual sales. Many of the corporate governance scandals that led to the enactment of the Sarbanes-Oxley Act in 2002 involved accounting statement irregularities.</p>
13. Fraudulent manipulation of investors	<p>Sometimes, there is Value Evaporation because of fraud. A notable case is that of BreX mining, which doctored geological data to mislead people. Investors flocked to the stock in light of the promising discovery, only to be scalped when the analysis was shown to be a sham.</p>
14. Inaction while competitors change the business design	<p>Toyota changed the business design in the auto industry and gained considerable market share at the expense of the big three US auto manufacturers. Toyota engaged their suppliers in a cooperative effort to manage inventory levels and product quality. As a result, Toyota cars achieved much higher quality and were produced with less investment in inventories.</p>

Fig. 5.2. (Continued)

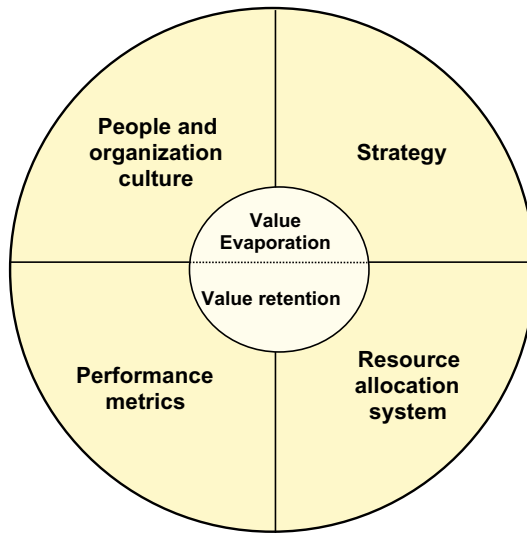


Fig. 5.3. The Value Sphere.

Value evaporation occurs due to four basic reasons:

1. The decision maker does *not* know the strategy;
2. The decision maker is in a *bad* management system;
3. The decision maker does *not* have the tools to decide, manage, and lead and
4. The decision maker does *not* feel like an owner.

That is, the literally thousands of ways in which value evaporates in organizations can be classified into these four high-level groups.

It is important to note that Value Evaporation is *not* the value lost due to honest, unavoidable mistakes. Examples would be previously-made decisions that now look bad because of an unexpected recession or war. Value Evaporation is also *not* the value lost due to the unfavorable realization of an uncertainty, such as lightning or flood or say credit drying up due to a bank run. Basically, Value Evaporation refers to the value lost in a situation in which the decision made could have been improved by improving on one or more of the four basic reasons mentioned previously: the strategy; the management system; the tools for deciding, managing and leading; and the sense of ownership.

By reducing Value Evaporation, an organization can substantially increase the shareholder value it creates, without changing its strategy, operating environment, or people.

#### **4. The Solution to the Value Evaporation Problem: Making Employees into Smart Owners**

Jerry wanted to get Bob to focus on the specific issues of his company, “Well, Bob, as you know we have over 20 stores now, and managerial delegation is the norm. We train our people well, but I am not totally sure they always act in the shareholders’ best interests. At your insistence, we have added an internal audit staff to monitor compliance with good accounting practice and to correct accounting problems that surface. The accounting group has also been very good at developing systems that allow us to measure performance at the stores, control cash collections, optimize disbursements, and the like. Do you think the internal audit staff is enough to ensure the store managers and employees act in the best interests of the company and its shareholders?”

Bob looked out the window, thought for a moment, and said, “While our internal auditors are essential, they are not sufficient to solve the Value Evaporation problem. All of the firms on my list that suffered significant Value Evaporation had employed internal auditors. Many of the audit teams at the companies were quite good, particularly at detecting outright fraud. However, fraud is the issue only in a very few Value Evaporation cases. This means there needs to be more than a good internal audit staff to stop Value Evaporation.”

Jerry was getting a bit irritated now, “If the internal audit group won’t stop Value Evaporation, what will?”

Bob sensed Jerry’s slight irritation and said, “Well, Jerry, the four categories of Value Evaporation I referred to earlier provide a useful framework to think about how one can address Value Evaporation. Here’s the framework as a diagram”.

With that Bob showed Jerry Fig. 5.4.

Bob continued, “So you see Jerry, the first thing we need to do is to clearly communicate our strategy and corporate focus to our employees. Make sure they know where we, and the company, are headed.”

Jerry nodded, “Ok. So they will make resource allocation decisions in a way that is consistent with our strategy. That is a communication issue. I am sure you will handle it. What next?”

“Well,” said Bob, “It may be more than just a communication issue, but we also need to take a careful look at our internal management process — resource allocation, performance metrics, information systems, delegation in decision making, etc. We need to make sure these are facilitating the execution of our strategy and not impeding it.”

Jerry mused, “Hmm... that sounds like a tall order. Not something I could expect tomorrow, eh?”

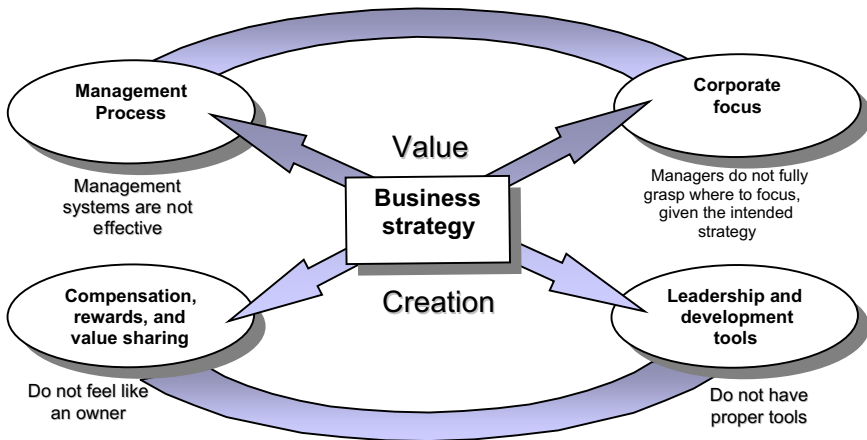


Fig. 5.4. The framework to assess the causes of Value Evaporation.

“Exactly,” agreed Bob, “that is something we will have to address over the next few months. But I will talk to some folks and get the ball rolling. The third issue is to see if our employees have the necessary tools to make the right decisions and that we are attending to their leadership development.”

Jerry smiled, “I did not realize we were not doing that, Bob. But I suppose Barb Sidwell can handle that.”

Bob nodded. Barb was the VP of human resources. And a good executive. If he could have a brief meeting with her, he was sure he could get her to attend to the leadership and development tools issues he had in mind.

“Now comes the hardest part, Jerry,” continued Bob.

“And what is that?” asked Jerry, looking at his watch. He was expecting this meeting to wind down soon.

Bob sensed Jerry’s impatience and said, “Well, Jerry, we need to align the interests of the managers and employees with those of the shareholders. The easiest way to do this would be to make all the managers and employees shareholders. If we do that, then we will increase the odds that they will take actions with the shareholders’ interests at heart.”

Jerry looked disturbed, “Wait a minute, Bob. I didn’t put in all the hard work of nursing this company along just to give it away to some youngster just completing our training program. I’ve already got big shareholders breathing down my neck as a result of the IPO. Now you want me to give away shares to all the managers and employees. At least the IPO investors paid for their shares.”

Bob, slightly taken aback by Jerry's annoyance, interjected, "Wait a second, Jerry. Let me explain. I never said we should give shares to the managers and employees. Rather, I said we should *make* them shareholders, including having them buy stock. Let me outline some alternatives:

1. Establish an ESOP (Employee Stock Ownership Plan) that serves as a pension for the managers and employees. The pension invests in our stock, and we get to deduct contributions to the plan as compensation expense. Thus, the employees "earn" the shares.<sup>38</sup>
2. An Employee Stock Purchase Plan could be created that would permit all employees to purchase shares periodically through payroll deduction. The shares could be offered at a discount price and the company could match the shares purchased according to some formula. For example, the company could give one share to the employee for every four purchased. There could even be a time delay to the share gift; say one year. That would provide an incentive for the employee to stay with the company, particularly with a rising share price.
3. We could, as you indicate, just give the shares to the employees.
4. The gift of shares or options could be tied to a bonus plan as an incentive for employees to work hard.

In fact, there are many other creative ways to link employee compensation to shareholdings or shareholder value performance. At this stage, I'd suggest we not get too fancy with our compensation system. That can come later. I do think we should establish something along the lines of the second plan I mentioned."

Jerry still seemed unconvinced, "I don't know, Bob. Are there any examples of companies that have succeeded with such stock purchase plans?"

Bob smiled and spoke, "Sure. Many successful companies have established employee stock purchase plans. Probably the most famous are Wal-Mart, Microsoft, and Starbucks. Wal-Mart insists that all of its employees own stock. And virtually all of Microsoft's and Starbuck's permanent workforce owns stock. These companies have made many of their employees millionaires. But they became millionaires only because these companies produced enormous shareholder value. If we can get all of our managers and employees to act like shareholders, we'll be a much better company."

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<sup>38</sup>We are *not* advocating that an individual should hold *only* the stock of his/her employing firm. Interest diversification in one's investment accounts is a "tried and true" component at any sound saving/retirement strategy.

Jerry was beginning to see Bob's viewpoint now. But he persisted, "Your arguments make sense. But wouldn't we dilute the number of shares outstanding if we move to an employee stock purchase plan?"

Bob pressed on. "Keep in mind, Jerry, I am recommending a stock purchase plan. This means employees buy our stock. This will generate cash that will aid our efforts to finance our explosive growth. I further suggest that we allow the managers and employees to purchase the shares at a 10% share price discount through a payroll deduction plan. After one year of employment, we will match their purchased shares one for four, i.e., they will receive one share at no cost for every four shares they purchased a year earlier. This incentive should help cut down our already low employee turnover. If dilution of your ownership position is a serious problem for you, Jerry, we can repurchase our shares in the open market to obtain the shares needed for the program. Thus, the total number of shares outstanding could remain constant with no dilution."

Jerry still had an emotional wall between himself and Bob's proposal, "I still don't see why it is in my benefit to have the managers and employees own shares."

Bob sensed that what he needed was to put the finishing touches on his argument. "The way you have to see it is that the actions taken by the managers and employees will be taken with a shareholder value focus. That should increase the value of the firm. Even if you suffer some dilution, your wealth is likely to be greater than it would be if the managers and employees did not have the shareholder focus and took actions that evaporated value.

"In my view, it is almost a crime in some public companies that even the top management, including the board of directors, own but a few shares. That creates a danger that key decision makers may grow indifferent to shareholder value and mismanage the Value Sphere. We can't let that attitude of shareholder value indifference and the resulting Value Evaporation creep in here. At least you and Sallie still own a large block of stock. Let's go forward with the stock purchase plan and align the motives of all employees with shareholder value."

Jerry seemed to be convinced now. "Okay, Bob. Go ahead and implement the plan."

## **Main Lessons**

- There are many ways for value to evaporate at companies. Some of these ways become so deeply ingrained in the company's culture that most employees see no alternative to behaving that way. However, all these ways to evaporate value

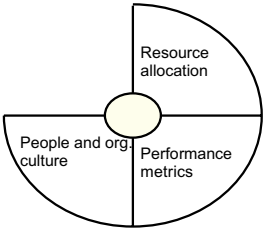
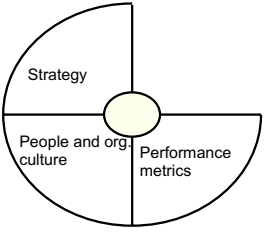
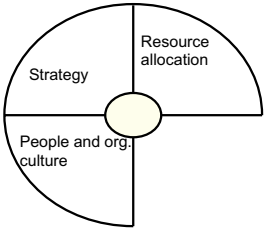
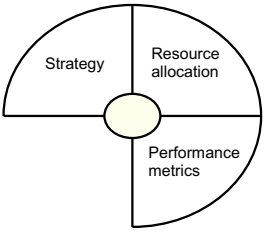
Elements of Value Sphere	Consequence
<p><i>Corporate focus</i></p> 	<ul style="list-style-type: none"> <li>• Company loses sense of direction</li> <li>• Decisions are tactical, not strategic</li> <li>• No innovations in business design (e.g., Japanese firms focusing only on market share growth)</li> </ul>
<p><i>Management process</i></p> 	<ul style="list-style-type: none"> <li>• Allocation of resources do NOT correspond to what strategy requires</li> <li>• Poor execution of strategy (e.g., Eli Lilly's resource allocation system in the early 1980s not focusing on allocating resources to R&amp;D)</li> </ul>
<p><i>Compensation rewards and value sharing</i></p> 	<ul style="list-style-type: none"> <li>• People and projects are NOT judged in a way that ensures optimal execution of strategy</li> <li>• Behavioral incentives are misaligned relative to what is best for shareholders (e.g., Japanese banks in the 1980s focusing on rewarding managers for growth in market share in U.S. 2-3% ROE)</li> </ul>
<p><i>Leadership and development goals</i></p> 	<ul style="list-style-type: none"> <li>• The organization culture does NOT support the strategy (e.g., strategy may call for aggressive new product introductions, but the organization culture does not reward risk taking)</li> <li>• Behavior of individuals and groups will NOT permit effective execution of strategy (e.g. conservative companies preaching "risk taking")</li> </ul>

Fig. 5.5. Consequences of lack of synchronized Value Sphere.

fall into four broad categories: employees do not understand the strategy, they operate in a bad management system, they lack the tools to decide and lead, and they do not feel like owners.

- Even successful companies are not immune to Value Evaporation. Stemming the tide of Value Evaporation often requires careful introspection and a willingness to change. This is particularly difficult if the company is successful.
- A strong internal audit staff is no guarantee that Value Evaporation will not occur because Value Evaporation is not limited to fraud or visible violations of company policies and procedures. In fact, policies and procedures could contribute to Value Evaporation.
- Value evaporation essentially occurs because the Value Sphere is not synchronized, as shown in Fig. 5.5. This diagram depicts the consequences when each element of the Value Sphere is missing (not synchronized) and how this relates to Fig. 5.4.
- The best way to guard against Value Evaporation is to clearly communicate corporate strategy to employees, give them a good management system to work with, provide the necessary tools to help employees decide and lead, and make all employees shareholders so that they make decisions consonant with shareholder value maximization.

### **End-of-Chapter Exercises**

1. Gather a group of 10 employees in your organization who represent two to three levels in the reporting hierarchy. Provide them with the four broad categories of Value Evaporation discussed in this chapter. Ask each employee to list the most prominent examples of Value Evaporation in your company in each category. Collect the list and then, as a group, choose the five that evaporate the most value. Then estimate how much value is evaporated each year by each practice. Now develop an organizational change plan to eliminate these five practices. Calculate the resulting improvement in value retention.
2. Describe the ways in which your organization attempts to align all employees with shareholder value. Are all elements of the compensation system consistent with optimizing the Value Sphere?
3. What are the main lessons for your organization from the various Value Evaporation cases discussed in this chapter?

**Practice Problems**

1. What are the four high-level reasons why value evaporates at companies? How are these reasons linked to the Value Sphere?
2. Which of these reasons is linked to the agency costs of equity covered in the previous chapter? Explain your answer.
3. Can making employees act like owners completely eliminate Value Evaporation? Why or why not? To what extent can it help?