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Rethinking what shareholder value means

By not ending too early, the current financial and economic crisis can actually be beneficial for shareholder value, says Urs Peyer, INSEAD associate professor of finance.

The crisis will weed out companies that have the wrong ideas about shareholder value and the wrong implementation methods because such companies will likely be among the first to fail, says Peyer.

Peyer, who was a speaker at the INSEAD Leadership Summit held recently at the school's Europe campus in Fontainebleau, explains that creating shareholder value is not about focusing on share price management. Indeed, the job of CEOs is not to manage earnings expectations but to create value.

"Shareholder value is still - and has always been - about creating value for customers, looking at what your employees want, paying them a fair price, looking at all other stakeholders that have - or don't have - a say in it, and compensating your investors."

"If you cover all those costs with your revenues and there's something left over, this is what is called shareholder value."

To be sure, the current crisis has not invalidated the shareholder maximisation model, says Peyer, but it has disproved the idea that shareholder value maximisation is about boosting share prices through earnings manipulation – as evident in the collapse of highly-leveraged major financial institutions.

Reforming executive remuneration

What is clear is that company directors need to reform their executive remuneration system, which has played a significant role in exacerbating the current crisis, Peyer argues. The boards of companies should also be clear about how the remuneration incentives motivate management executives and what the side effects of the incentives are.

Indeed, the executive remuneration system is important in setting the framework in ensuring that management is focused on creating the right kind of shareholder value, he adds.

Another panellist, **Patrick Snowball**, chairman of Towergate Financial and non-executive director of Jardine Lloyd Thompson Group, agrees.

"When you look at some of the short-term remuneration and also the behaviour of some of the chief executives and chairmen of the big banks who knowingly were re-basing bonuses when they knew they were in trouble, you have to believe that can't go on,"

"But again there's always the danger that the actions of the few lead to the disadvantaging of the many, and I think we've got to be very careful about that."

Ask if you don't understand

In addition, the various corporate implosions were partly because board members, non-executive directors and audit committees did not understand the risks involved. It's therefore vital that they speak out if they do not fully understand the risks that management is taking, and make sure that the risk and compliance structure is "running at the same speed as the appetite to do business", says Snowball.

"The days of sitting on a board and taking corporate responsibility for something you don't understand, I think, are numbered."

With regards to tackling systemic risks, **Sir Andrew Large**, a former deputy governor of the Bank of England and an INSEAD alumnus (MBA '70), believes that the world lacks an effective policy framework and "policy delivery mechanism" that addresses risks posed by asset bubbles.

Such a policy-making framework is necessary to prevent financial leveraging from reaching a tipping point, he says, "when confidence goes and demand to be paid back rises".

Furthermore, the free market thinking that it's hard to pinpoint where asset bubbles are building up and hence it's cheaper and easier to "clean up the mess" later, is flawed, Large argues.

While conceding that it's difficult to conduct a policy mechanism to prevent excessive financial leveraging, Large believes that there's "sufficient understanding of the delivery framework" and that it's worth building one. Failure to do so could mean "we'll be back here again in 20 years' time, however good the underlying regulations may be."

The implications of rising corporate nationalisation

On the issue of how rising state equity in private corporations – such as the nationalisation of banks and the auto industry in the US – would affect shareholder value, Large argues that this is the best way of minimising the social cost of the current crisis even if it may not necessarily be positive for shareholder value.

Large sees three implications from the nationalisation trend. The first is the unpredictability of the actions of the governments.

"How will (governments) act in relation to being a competitor as opposed to a shareholder? Look at cases in the banking world of the state wanting to increase lending."

"Well, increasing lending may, in a narrow sense, be negative for shareholder value if the lending is imprudent, even though (it's) politically motivated."

The second implication is that the share prices of companies, in which the government is a significant shareholder, are really just "option plays on the policy responses that may come from the governments themselves". This means share price movements would be divorced from fundamentals such as brand and business value.

The last implication involves the question of how companies and governments can best address the nationalisation trend. On their part, companies should try to understand the public policy-making process to anticipate and make sense of the actions of the state, says Large. Furthermore, the divide between the business sector and the government has to be broken - companies have to resolve their disdain for government, and government has to address its unwillingness to get involved in the affairs of the business sector.

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