Why Business Schools Should Teach MBAs to Maximise Shareholder Value

By Theo Vermaelen , INSEAD Professor of Finance

Maximising value for shareholders is the best way for firms to stay competitive and sustainable.

In a **recent paper** Craig Smith and David Rönnegard argue that business schools should teach stakeholder value maximisation, on equal footing with the current practice which focuses on shareholder value maximisation. Their argument is basically a legal one, arguing that recent changes in legislation no longer specify that board members have a fiduciary responsibility to maximise shareholder value. They also point out the existence of so-called B-corporations (Benefit corporations) in the U.S. who make the explicit promise to make a positive impact on society at large.

However, in our finance courses we don't teach shareholder value maximisation because it is a legal obligation. We teach it because other objective functions are not sustainable in a world with a competitive labour market for CEOs and a competitive market for goods and services. Suppose that you maximise stakeholder value and the value of your firm is US$100

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million and if you maximise shareholder value your firm is worth US$150 million. If you follow the stakeholder route you create an arbitrage opportunity for an activist investor or a hostile bidder to buy shares at the current low price, replace the CEO with a shareholder value maximiser and make an arbitrage profit in the process.

Students should rightly expect from business schools that they learn skills to survive in a globally competitive market. Of course this argument does not hold for non-publicly traded companies or companies shielded from activist investors, such as B-corporations. If these shareholders are quite happy with US$100 million instead of US$150 million because they care about other things than making money, there is, of course, nothing wrong with that. But even in this case, the shareholder value framework taught in finance courses is still useful: by comparing the value of the firm if they would maximise shareholder value (US$150 million) with the stakeholder value maximisation policy (US$100 million) they know that the cost of "doing good" is US$50 million. But perhaps there are then more efficient ways to do good, such as maximising shareholder value and then donate US$25 million to charity.

Even if a firm is shielded from takeover threats or activist investors, it will still face competition. If maximising stakeholder value (for example, no outsourcing to India) leads to higher costs than outsourcing, the firm will be at a competitive disadvantage. While this may not be a problem in the short run for a firm with excess cash and debt capacity, in the long run this may be a problem as the firm will have difficulty attracting new capital and struggle to survive, leading to job losses for MBA graduates. That's why I believe the stakeholder value maximising approach is a better fit for governments. In spite of his 12 percent approval ratings, François Hollande cannot be removed from office until 2017 as it is not possible to do a hostile takeover bid for France. He can afford to maximise stakeholder value as he has access to capital: he can coerce his shareholders (the tax payers) to put up more money and because of this coercive power, investors are willing to lend money at low credit spreads. Privately owned companies don't have this luxury.

What I believe business school professors (especially outside the finance area) can do better is to point out the difference between profits, the stock price and shareholder value. Maximising shareholder value is maximising the present value of all expected free cash flows from now until infinity. So it is per definition a long-term concept, as opposed to profits. So you don't create

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shareholder value if you sell a bad product to a client (which increases profits this year) and as a result you lose the client. Shareholder value may be different from the stock price as well because managers can have better information about future expected cash flows and risks.

Our advice should be to focus on executing the strategy implied by the discounted cash flow spread sheet, not on the stock price (apart from buying back stock when the shares seem to be undervalued). We should also point out that although we don't **balance** the interest of stakeholders we **incorporate** the interest of many stakeholders (customers, workers, suppliers). For example, if our customers are more likely to buy our products if we use expensive alternative energy rather than cheap coal, then we may want to use alternative energy as in this case the clients are paying for the reduction of an externality. However, we shouldn't believe in balancing stakeholder interests as this requires a value judgment on which stakeholder is more important. If I increase wages but make shareholders worse off, how should I make this trade-off? Managers then become politicians and a business school should train managers, not politicians. The irony is that shareholder value maximisation is often attacked as an "ideology" as if we care more about shareholders than workers. But the CEO who maximises shareholder value is not doing it because he or she likes shareholders better than workers. They do it because they and the firm have to survive in a competitive world. Casual empiricism tells me that the opponents of shareholder value are often driven by ideology: workers are preferred to shareholders because shareholders are rich. On the other hand, shareholder value maximisation is not an ideology.

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