Compromising principles and chasing targets destroys shareholder value

Recent corporate history shows that managers who strive too hard in chasing volume and profit targets can end up damaging their business. **Mike Cahill** looks at the evidence.

In his 1989 letter to shareholders, Warren Buffett identified management (along with the economics of the industry) as the key investment risk. While it is often said that it is the role of IR to reduce the cost of capital by reducing volatility, it is worth bearing in mind that we are currently not terribly interested in the beta of VW or Enron. Volatility is not the same as risk; and understanding and managing the drivers of risk in the real world is a key part of value creation. Communicating these risks and the approach to their management is central to adding value for IR.

Investors in Volkswagen have clearly had this lesson strongly reinforced with the stock now off some 35% and the potential liability growing daily. Specifically, Buffett's assessment of risk questions the ability of managers to use cash flows for the long-term health of the business and whether management is working for shareholders or for itself. The latter, reflecting the so-called 'agency problem', is at the heart of corporate governance and many recent scandals. Strong management aligned with shareholders and good governance should therefore be at the heart of the business culture and not a regulatory add-on.

While risk is traditionally broken down between business and financial risk, the Volkswagen episode and the value destruction in many large, complex organisations (for example much of the financial sector), has been driven by management decisions that have undermined reputation. Decisions have been driven by the desire to hit targets and short-term goals with the brand and the reputation of the business wrecked in the process, destroying long-term value.

This has led to value destruction on a massive scale. Shareholder value is the return generated by the business in relation to the risks of the business – the focus on growth (which encourages the use of targets) tends to be all about the profit side of the equation with very little consideration of risk. The VW situation has again brought to the fore the impact of going for growth whilst compromising on values and ethics.

Mike Cahill is a consultant at Market Matters.
michael@marketmatters.co.uk

> ‘The target (sell more cars than Toyota) becomes the Holy Grail and distorts the decision-making process’

DESTROYING VALUE

- **Management, and its decision making process, is a key investment risk.**
- **Decisions driven by targets and short-term goals can undermine corporate reputation with severe consequences for value creation.**
- **The desire to hit targets and short-term goals can undermine long-term shareholder value.**
- **There needs to be clarity around a company's values and the need to appreciate a values hierarchy.**

Alarm bells

The challenges faced by VW, the banking and pharmaceutical sectors, Tesco and BP's problems in the Gulf of Mexico, among many others, highlight that compromising on the company's values increases risk dramatically. In the case of BP one might argue that while safety was a value, profit was a higher value and we know the higher value will drive decision-making. Ironically, the impact on profit has been a cost of $54bn. (Importantly, there had been earlier incidents that rang alarm bells which were not acted upon.)

This highlights the need not just for clarity around the company's values but also the need for a clear appreciation of the values hierarchy so decision-makers are conscious of the fact that the highest value is the one that most informs the decision.

Johnson and Johnson's management of the Tylenol crisis in 1982 (where they instantly withdrew a contaminated product which represented 20% of profit) is an example of how having a clear hierarchy of values helps deal with such situations swiftly and effectively.

J&J's top value was customer safety so the decision to withdraw the product completely and immediately was an easy one to make; that clarity made an

> Strong management and good governance should be at the heart of the business culture

enormous difference to the speed and effectiveness of the decision-making process and undoubtedly saved lives. It was also a great example of crisis management.

Staggering figures

However, companies seem incapable of taking on the learnings of this classic case study. The fines alone paid by the finance sector total £166bn while Pharma has been hit by a slew of multi-billion-dollar fines for criminal activity. VW is now facing criminal investigations by both German prosecutors and the US Justice Department; the 6.5bn euro charge taken to cover the losses from the scandal might well be just the tip of the iceberg.

These staggering figures highlight the risks involved when companies compromise on values by putting targets and short-term profit first. A key theme that stands out with VW and other businesses that have imperilled their reputation and destroyed value, is the role targets have played in decision-making.

The target (sell more cars than Toyota) becomes the Holy Grail and distorts the decision-making process as the focus is all about hitting the sales target. Cutting corners is deemed an acceptable consequence of target chasing, generating behaviours that differ sharply with the company's stated values. Importantly, these targets often have only a very tenuous link with shareholder value or deepening competitive advantage.

As ever, Buffett's preoccupation with management as a key investment risk is incredibly astute. The reputational damage and consequent value destruction in many sectors suggests much greater scrutiny of decision-making processes is required to understand why management seems prepared to take such risks with other people's money. Management teams compromising on values is increasingly a key risk for investors to consider. ■