



# Why value value?

An excerpt from the second edition of *Valuation: Measuring and Managing the Value of Companies*

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“THE FUNDAMENTAL GOAL of all business is to maximize shareholder value.” This statement can be either commonplace or controversial, depending on where you are. In the United States, top management is traditionally expected to seek to maximize shareholder value. Failure to do so results in pressure from the board of directors and activist shareholders, or even in hostile takeover bids.

Elsewhere in the world, companies make different implicit tradeoffs among their various stakeholders. In continental Europe and Japan, intricate weightings are given to the interests of customers, suppliers, workers, the government, debt providers, equity holders, and society at large. Maximizing shareholder value is often seen as short-sighted, inefficient, simplistic, and even antisocial. Proponents of this “balanced stakeholders” approach cite the high standards of living and rapid economic growth in Europe and Japan and the success of Japanese auto and consumer electronics companies to support their view.

But the evidence against these arguments – and in favor of shareholder wealth maximization – is mounting. This article provides evidence that winning companies have higher productivity, greater increases in shareholder wealth, *and* greater employment gains than their competitors in the long run. In other words, even in an increasingly competitive world, winning companies provide benefits for *all* stakeholders. There is no evidence of any conflict between shareholders and employees.

Given the globalization of capital markets, if countries whose economic systems are not based on maximizing shareholder value give investors lower returns, they will slowly be starved of capital. Their fate will be to fall further and further behind in global competition and to lose employment opportunities. A value-based system grows in importance as capital becomes more mobile.

The ability to create such a system depends heavily on a number of factors: the weight companies place on the claims of their various

stakeholders; the ownership and control of sources of capital; and the nature of a country's economy in terms of its GDP, productivity, and employment growth.

## Geographic differences

European and Asian managers often state that they do not regard maximizing shareholder value as the exclusive goal of their businesses. Instead, they place much greater weight on other claims, especially that of labor. The factors underlying this attitude have to do partly with the roles and responsibilities that corporations adopt in society, and partly with the composition of capital ownership and control.

European countries balance stakeholder claims in a different way than the United States does. In Germany, for example, employees have the right to share in decision making, and they elect half of the representatives of their company's supervisory board directly. Workers councils composed of non-executive employees have the power to share decisions in personnel and social matters, although not in issues related to planning or operations. As Exhibit 1 indicates, across Europe as a whole, employees have a larger say in the management process than they do in the United States.

## Ownership and control

Another distinct difference between the US and Europe is the degree of concentration in the ownership and control of sources of capital. German debt, for instance, is dominated by institutional rather than market sources. Debt provides roughly 85 percent of all external capital, most of it privately-placed debt with banks. There is virtually no use of commercial paper, a common publicly-held source of short-term debt financing in the United States. And publicly-traded corporate bonds make up only 0.14 percent of outstanding German bonds. Although banks in Germany own only 8.2 percent of all equity shares for their own accounts, they administer approximately 50 percent of proxy voting rights, giving them substantial voting power.

**Exhibit 1**  
**Employee power across Europe**

Country	Employee power
Germany	Employees have up to 50% of seats on supervisory boards Employees have decision-sharing power in personnel and social matters
Netherlands	Workers councils have a right to information and consultation, and the right to grant or withhold approval of certain decisions Veto on appointment of directors
Belgium	CEOs must provide workers councils with detailed data Workers councils give opinions and suggestions in some areas
France	Two employee representatives may attend board meetings, but have no voting rights Trade unions and workers councils have the right to be consulted about certain activities, but have no right of veto
United Kingdom	Management has no obligation to consult or involve employees in decision making
Denmark	Employees have statutory right to co-determination

The situation is similar in Japan. The lion's share of external funding – some 78 percent – comes from loans from private financial institutions. Publicly-traded corporate bonds provide only 2.8 percent of external capital, and equity issues only 8.9 percent. The major security holders appear to hold shares in order to maintain business relationships. They do very little trading: banks, insurance companies, and nonfinancial business corporations collectively held 61.2 percent of listed shares in 1983, but engaged in only 10.7 percent of trades. Most institutional shareholding is within the large business groups, the *keiretsu*. Cross-holding of this kind acts as a barrier to hostile takeovers and mergers.

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Managers are less likely to focus on value creation when market prices of shares do not reflect good information

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The differences between an economy with widely distributed ownership and control and one where both are closely held manifest themselves in a number of ways. First, the demand for publicly available information is much lower where capital is closely held. When little information is available, capital markets are usually less efficient, and consequently capital is less likely to flow quickly toward new productive uses.

Second, in such an environment, managers are less likely to focus on value creation – a long-term performance metric – because market prices of shares are less likely to reflect good information. Therefore, the market price of equity is commonly disregarded as the best indicator of management performance.

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Economies with concentrated ownership and control inhibit management focus on shareholder value creation

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Economies with concentrated ownership and control appear to inhibit management focus on shareholder value creation. Not only are market prices unlikely to reflect good information; there is also no strong incentive to seek value creation opportunities.

## Performance and value creation

The unique combination of features that make up the capital markets of the United States, Germany, and Japan have distinctive effects on each nation's economy. Looking at gross domestic product, productivity, shareholder value creation, and job creation is one way to discover these effects.

### *Gross domestic product*

All consumption, saving, and investment in an economy are captured in its gross domestic product. If the GDP per capita in one economy remains

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higher than that in another over a long period, its population will generally be better off in terms of material needs. (Environmentalists, of course, have argued that GDP does not capture the actual quality of life.)

**GDP per capita,\* 1950–90**

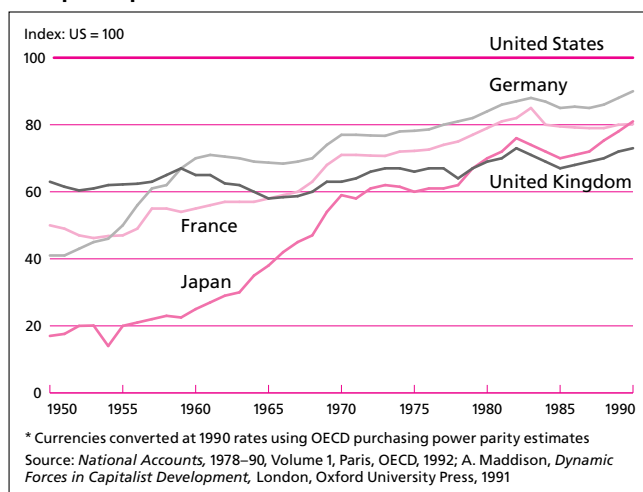


Exhibit 2 shows GDP per capita for five countries for the period 1950–90, with currencies converted at 1990 rates using OECD purchasing power parity estimates. The figures for the United States are set at an index of 100. Until 1980, all the other countries had been rising toward the US level. Since then, only Japan has been catching up. With its shareholder value focus, the United States remains the GDP leader.

### Productivity

Two recent studies by the McKinsey Global Institute shed light on the productivity side of the picture.\* The first examined productivity across the leading economies of the world in five service industries: airlines, telecommunications, retail banking, general merchandise retailing, and restaurants. In recent years, the service sector's role in developed economies has grown in importance. By 1987, it represented 55 percent of employment in Germany, 58 percent in Japan, and 63 percent in the United States. The labor productivity comparisons drawn in the study reveal that the United States is more productive in every case, with the exception of restaurants in France.

**The US maintains its lead in GDP per capita because of its overall lead in productivity**

The second study examined nine industries in the manufacturing sector in Germany, Japan, and the United States: auto assembly, auto parts, metalworking, steel, computers, consumer electronics, soaps and detergents, beer, and processed food. It found that the US is on a par with Germany in steel and metalworking, but ahead of it in the other industries. Japan leads the United States in auto assembly, auto parts, metalworking, steel, and consumer electronics, but has lower overall productivity because

\* *Service Sector Productivity and Manufacturing Productivity*, Washington, DC, October 1992 and October 1993. See the related articles in *The McKinsey Quarterly*: 1992 Number 4, pp. 69–91 and 1993 Number 4, pp. 29–43.

a large proportion of its employment is located in industries with low productivity, especially food processing.

The link between material well-being and productivity is unmistakable. If you want to consume, you need to produce. In manufacturing, as in the service sector, the United States has the highest productivity of all the countries studied. Indeed, the US maintains its lead in GDP per capita because of its overall lead in productivity.

Such productivity gaps can largely be explained by the extent to which an industry is globalized. As Exhibit 3 shows, globalization reduces the differences in productivity among companies in an industry. It follows that if your company is not a leader in productivity, and if your industry is becoming more global, you will need to increase your productivity to survive.

Exhibit 3

**Globalization versus relative productivity**



*Shareholder wealth creation*

To study the relationship between productivity and shareholder wealth creation, we chose the time interval 1983 to 1991 and measured the change in market value added (MVA),\* which is defined as the change in the market value of capital (debt plus equity) minus the change in the book value of invested capital. Because the book value of debt is embedded in both the market value of total capital and the book value of invested capital (since debt is a source of funds for invested capital), the change in MVA is the change in the difference between the market and book value of equity over a given period of time. And that makes it a good measure of shareholder wealth creation. Labor productivity was measured by the McKinsey Global Institute in 1991. Ideally, we would have used productivity estimates for both 1983 and 1991, but only the more recent estimate was available.

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\* To the best of our knowledge, MVA is a term coined by Stern, Stewart and Company, see for example, G. Bennet Stewart II, *The Quest for Value*, New York, HarperCollins, 1991.

Exhibit 4

**Labor productivity versus the change in MVA, 1983–91**

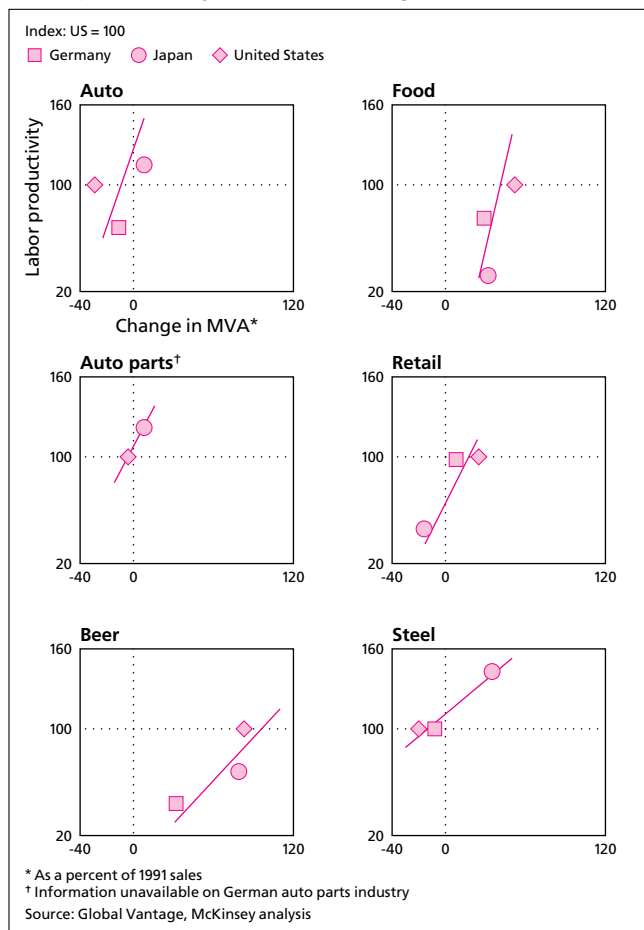


Exhibit 4 shows the relationship between productivity and the change in MVA, our measure of shareholder wealth creation, for five manufacturing industries, as well as the retailing industry in the service sector, across the Triad. In all six cases the relationship is positive.

Higher productivity is associated with greater shareholder wealth creation. If there were a 50/50 chance of observing a positive relationship, the probability of observing six out of six to be positive by chance is only 1.6 percent. We thus conclude that there is strong evidence that more productive companies create greater wealth for their shareholders. This is not an unexpected result.

**Job creation**

It is always possible that increases in productivity

and shareholder wealth are achieved at the expense of labor. However, since the most productive companies in an industry gain market share, these increases benefit labor as well as sources of capital in the long run. Indeed, as Exhibit 5 shows, there is no evidence that labor suffers to benefit shareholders. In other words, winning companies have higher productivity, higher market share, and *higher employment growth*.

In the auto assembly industry, Germany, Japan, and the US all experienced growth in employment, but the Japanese, with the highest productivity, had the greatest. Similarly in the steel industry, where technological change has led to overcapacity and shrinking employment, Germany had greater change in MVA and better employment results than the United States.

In the short term, increases in productivity may, of course, be accompanied by falling employment, but the most successful and productive companies

within each industry are generally the first to increase employment. Over time, these companies generate both more growth in employment than their laggard rivals *and* greater increases in shareholder wealth. This suggests that protectionist government policies that delay productivity increases, especially in globally competitive industries, only harm employment in the long run. A better strategy would be to focus on retraining and relocating labor, and to provide the necessary support during the transition period.

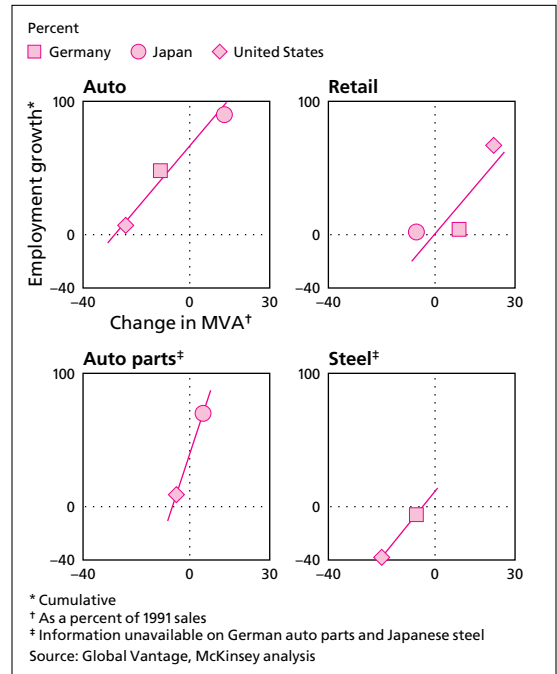
The cross-national scorecard shows a clear link between GDP per capita, productivity, and value creation. Productivity is the ratio of output relative to the inputs needed to produce it. The objective is always to produce more output with less input. When this is achieved, value is created. In a competitive environment, productivity growth is not merely the source of increased value, but the key to survival itself. Companies that cannot match the productivity increases of their rivals will find themselves losing market share. Countries that cannot match the productivity of competing nations will suffer a flight of capital, the emigration of skilled personnel, and a standard of living that is declining in relation to that of more productive countries.

### The value of value

Empirical evidence indicates that increasing shareholder value does not conflict with the long-term interests of other stakeholders. The evidence is clear: “winning” companies create greater value for all stakeholders – customers, labor, the government (via taxes), and suppliers of capital. Other reasons, more conceptual in nature, but equally compelling, also support a system that emphasizes shareholder value.

First, value – measured in terms of discounted cash flows – is the best metric for company performance that we know. Second, shareholders are the only stakeholders of a corporation who, in seeking to maximize their own claim, simultaneously maximize *everyone’s* claim. And finally,

**Employment growth versus the change in MVA, 1983–91**



companies that fail to perform will find that capital flows away from them and toward their competitors.

*The best metric*

Making good decisions usually depends on having good information, and value is the performance metric that uses the best – and most complete – information. To understand value creation, you have to adopt a long-term perspective, manage all cash flows across both income statement and balance sheet, and understand how to compare cash flows from different periods on a risk-adjusted basis. It is this dependence on the full picture that makes value the best metric.

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No other measure of corporate performance is as comprehensive or as well correlated with a company's market value. Earnings per share or return on equity tend to be used myopically, looking only a few years ahead at best. Furthermore, the earnings measure generally focuses on managing the income statement and plays down the actual amount and timing of cash flows. Even the difference between return on invested capital (ROIC) and cost of capital can be a bad metric. If it is used only in the short term, it tends to encourage underinvestment in – or the harvesting of – a business to increase ROIC.

If you adopt instead the perspective of managing value, you will make better decisions and tradeoffs, regardless of social context. All systems, whether European, American, or Japanese, make tradeoffs among stakeholders. Value allows for more transparent and accurate tradeoffs, since *any* stakeholder claim can be valued. Take labor, for example. The value of labor's claim on a company is the discounted present value of all of the cash flows that labor expects to receive from the company now and in the future.

Exhibit 6 illustrates a pro forma income statement and balance sheet projected into the future. It represents the basic information needed to value the claims that various stakeholders have on a company. The value to customers, for example, is the present value of what customers would be willing to pay for the company's goods and services *minus* what the company receives as revenues. Economists call this consumer surplus. If the company increases its prices, and nothing else changes, the value of consumer surplus falls and that of equity rises.

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## Pro forma financials

\$ million		Today	Distant future	Present value of...
	Perceived value to customers	1,100	4,400	
		(100)	(400)	Consumer surplus
<b>Income statement</b>	<b>Sales revenue</b>	<b>1,000</b>	<b>4,000</b>	
<b>Costs</b>	Labor costs	(400)	(1,600)	Labor's claim
	Cost of goods and services	(300)	(1,200)	Suppliers' claim
	Depreciation	(100)	(400)	
		(800)	(3,200)	
<b>Income</b>	<b>Operating income</b>	<b>200</b>	<b>800</b>	
	Interest expenses	(50)	(200)	Debt claim
	<b>Taxable income</b>	<b>150</b>	<b>600</b>	
	Taxes	(75)	(300)	Government claim
	<b>Net income</b>	<b>75</b>	<b>300</b>	
	Retained earnings	(40)	(160)	
	<b>Dividends</b>	<b>35</b>	<b>140</b>	Equity claim
<b>Balance sheet</b>				
<b>Assets</b>	Cash	50	200	
	Accounts receivable	200	800	Uses of working capital
	Inventories	250	1,000	
	Net property, plant, equipment	1,000	4,000	Uses of physical capital
	<b>Total assets</b>	<b>1,500</b>	<b>6,000</b>	
<b>Liabilities</b>	Accounts payable	100	400	Sources of working capital
	Accruals	150	600	
	Debt	500	2,000	Sources of debt
	Retained earnings	500	2,000	
	Common equity	250	1,000	Sources of equity
	<b>Total liabilities</b>	<b>1,500</b>	<b>6,000</b>	

The exhibit shows that tradeoffs between the various stakeholders of a company can be made explicit by using a value-based approach. Too often, these tradeoffs are made on an emotional or political basis, with no attempt to bring the facts to the table. The balance among claimants often determines the very structure of a company.

Consider the difference between claims of varying capital intensity (excluding consumer surplus, which is very difficult to estimate). Because the value of labor at public accounting firms outweighs all other claims, such firms are often organized as partnerships, with each partner owning a small "equity" claim. For them, managing the value of labor's claim is clearly the key to success.

At the opposite extreme are capital-intensive companies like those in telecommunications, electric utilities, and pulp and paper. The relative importance of labor is lower, and the need for capital from debt and equity holders becomes paramount. Such companies cannot survive unless they provide an adequate long-term return to providers of capital as well as competitive compensation for workers.

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The exhibit also helps to demonstrate that value-based decision making is not short-sighted. A regulatory body that holds energy prices down for a short time but later raises them, for example, may actually reduce the present value of consumer surplus. A labor union that is successful in winning abnormally high wages and benefits in the short run could, in fact, harm the value of labor's claim if the company is eventually forced out of business or loses market share.

A company that pays below market wages to economize on its labor bill will lose productive workers and finish worse off in the end. A company that milks the market with high product prices may destroy long-term shareholder value if such prices accelerate the entry of strong new competitors into the market. Tradeoffs between current and future cash flows are never easy, but they are vital to good decision making.

### *The shareholders' claim*

Not all stakeholders need to have complete information about a company in order to make decisions for their own benefit. When employees decide on a wage claim, for example, they do not need, nor do they seek, a full picture of all the other claims on their company. But this is not the case with equity holders, who are the "residual" claimants on a company's cash flows. Shareholders take the greatest risk, but even more important, they

are the only group to need full details of all other claims by all other stakeholders before they can make good decisions on their own behalf.

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**Shareholders take the greatest risk – they are the only group to need full details of all other claims by all other stakeholders**

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Consumers, for example, need to know only the attributes and price of a product or service in order to make their decision. Whether a particular auto maker is profitable or not is irrelevant when they buy a new car. Shareholders are at the opposite extreme. Before making their claim, they must know prices and sales volumes; the cost of goods sold, including labor, materials and energy costs; interest costs on debt; and taxes – in short, they must have complete information about the company.

But why should shareholders be in control? To answer this, we need to consider why corporations are organized as they are. They are not organized as pure Athenian democracies, with all stakeholders having an equal vote on every critical decision. Nor are they dictatorships, with a single individual exerting total control. Neither of these extremes would represent the optimal form of organization in a competitive environment.

If a group of people need to organize to perform a task in the face of competition for scarce resources, what arrangement will they make among

themselves? Some will choose to carry out specialized tasks requiring limited information about the activities of the rest of the group in return for relatively fixed compensation protected by employment contracts. If capital is needed, some of it will be provided in return for a priority claim on cash flows, and it will be protected by covenants that restrict what the group can do. The remaining, or residual, capital accepts the greatest risk, but receives decision-making authority. This is the equity claim.

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**All claimants benefit when shareholders use their information and decision-making authority to maximize the value of their own residual claim**

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Equity holders have the strongest incentive to manage the labor and capital resources of the business so as to succeed in long-term competition with other companies. Though their actions are constrained by their contracts with both labor and providers of debt, the other stakeholders grant them authority to organize scarce resources. All claimants benefit when shareholders use their information and their decision-making authority to maximize the value of their own residual claim. In other words, shareholders maximize the value of all other claims in attempting to maximize their own. This alignment of information and incentives within the equity claim is what makes the modern corporation the best competitive mechanism there is.

### *The flow of capital*

Regardless of views about the relative merits of various stakeholder claims, one thing is certain. If suppliers of capital in one country do not receive a fair return to compensate them for the risks they are taking, they will move their capital across national borders in search of better returns – or, if the law prevents, they will consume more and invest less. Either way, nations that fail to provide global investors with adequate returns on invested capital are doomed to fall behind in the race for global competitiveness and to suffer a stagnating or declining standard of living.

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**Nations that fail to provide global investors with adequate returns on invested capital are doomed to fall behind**

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It is easy to see how capital flows if we adopt an investor's point of view. If a company's return on invested capital is less than zero, it will not

be able to generate enough cash to stay in business. Either it will go bankrupt, or it will require government support. If the ROIC is greater than zero, but less than its weighted average cost of capital (WACC), the company may be "profitable," but it will not deliver an adequate return to its capital providers. From their perspective, the company is destroying value. If this value destruction persists, the company will no longer be able to obtain new capital and sustain its existence.

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A third category is where most companies might be found in a competitive economy. Averaged across business cycles, their ROIC should equal the cost of capital. Over time, we might expect half the companies in a society to earn more and half to earn less than their WACC. Since providers of capital can expect, on average, to earn a fair return, this is a sustainable equilibrium.

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The task of management is to create value by earning more than a company's cost of capital over the long term

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Some companies, not many, earn a rate of return in excess of their cost of capital over a long period. Usually their competitive advantage is controlled by society in one way or another. Patents and trademarks are protected internationally, for example, and local monopolies are regulated by government.

The task of management, then, is to create value by earning more than their company's cost of capital over the long term. When capital is not earning the required rate of return, the market reduces the company's value until the rate of return reaches competitive levels again. In the process, value is destroyed.

### The management challenge

The link between productivity and maximizing shareholder value is too strong to ignore. If more output is produced with fewer inputs, then the residual value – the shareholder's value – is greater. But over time *all* claims, including labor's, benefit when a company is a "winner" in its industry. Modern corporations give control over decision making to their shareholders because they are the only stakeholders who both require complete information to make decisions in their own self-interest, and have the incentive to make their companies successful.

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The precise form of this challenge for management varies from country to country. In particular, the consequences of failure – that is, of *not* maximizing shareholder value – differ in pace from the United States to Europe and from Europe to Japan.

In the US, for example, things happen quickly. Hostile takeovers frequently force out underperforming management. Investor activism is on the rise. Pension and mutual funds own 53 percent of all US stock outstanding, and they are beginning to use their clout. In March 1993, the \$73 billion Calpers pension fund announced plans to spend nearly \$1 billion on large stakes in companies whose managers are not measuring up, with a view to

demanding better financial results. The chairman and CEO of at least one major firm has stepped down in the face of pressure from the New York City Employees' Retirement System. And the Securities and Exchange Commission is sympathetic: it has relaxed rules that previously limited communications between large activist shareholders.

In Europe, chronic uncompetitiveness results in slow change – for the worse. Productivity is lower than in the US and Japan. Rates of absenteeism are far higher than elsewhere, and so are pay for time not worked and the social charges borne by employers. Demographic trends are placing an increasing burden on workers in funding pension benefits for retirees. In Germany, for instance, public pension payments are expected to account for over 14 percent of GDP by the end of the century, and almost 25 percent by 2030.\* Unless Europe increases productivity by managing value better, its promise of a better social system will become an empty one.

In Japan, world-class management is already highly productive and creates tremendous shareholder value, although that is not its stated objective. But those sectors of the economy that are not competitive are holding back the entire economy. They need to be reorganized to create more value.



Shareholder wealth creation, then, does not come at the expense of other stakeholders. Quite the opposite: when compared with their competitors, successful companies have not only greater increases in shareholder wealth, but also greater productivity and higher levels of employment. Maximizing shareholder wealth may be an overt goal, as it is for its many companies in the US, or the outcome of other correct decisions, as with many companies in Europe, and especially Japan. Either way, it cannot be ignored. Managers must measure and manage the value of their companies. **Q**

*Tom Copeland* is a partner in McKinsey's New York office. This article has been adapted from the second edition of *Valuation: Measuring and Managing the Value of Companies* by Tom Copeland, Tim Koller, and Jack Murrin, published by John Wiley & Sons, New York, 1994. Copyright © 1994 McKinsey & Company. All rights reserved.

\* Heino Fassbender and Susan Cooper-Hedegaard, "The ticking bomb at the core of Europe," *The McKinsey Quarterly*, 1993 Number 3, pp. 127–42.