TOMORROW'S CHALLENGES

BIG BUSINESS MODELS ARE BACK-TO-FRONT

Create long-term value by putting shareholders at the back-end of cash flow distribution

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Large firms have been treating their shareholders as their most critical stakeholders. In the short run this might make sense, but not in the long term. The author argues that in order to safeguard and increase the industry's long-term performance and cash flows, it is critical that big business starts to identify their critical stakeholders and adapt their mission.

President Trump has been pushing big business to give stakeholders other than their shareholders a better deal. For example, Big Pharma firms, such as Pfizer, Novartis and Merck have been persuaded to suspend price increases. Beyond giving his base something to cheer for, Trump's attacks have highlighted a fundamental economic flaw in the business models of big business.

Big business mostly has been putting shareholders at the front-end of cash distribution. In 2016 for example, S&P 500 firms spent more than 100% of their operating earnings on dividends and share buybacks. Large firms have been treating their shareholders as their most critical stakeholders. In the short run this might make sense since shareholders can drive down the share price and related executive compensation if they don't like the distribution policy.

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Yet the shareholders of established firms, apart from activists, have zero impact on the future cash flows that determine the long-term value of the firm. The value-critical stakeholders, those with the biggest impact on future cash flows, should be at the front-end of cash distribution, not the shareholders. Before distributing dividends and buybacks, firms should offer their critical stakeholders win-win propositions to the point where no additional firm-value can be created.

However, the boards and executive teams of large companies often live in rarefied worlds out of touch with the stakeholders who can make or break their business. They interact mainly with one another, and less frequently with analysts, consultants and regulators. They may have little if any ongoing contact with those who really know how to offer an attractive deal to the stakeholders most likely to affect their future cash flows.

In the case of Big Pharma, the shareholder-first business model will come under increasing pressure owing to the shifting contribution and threat to future cash flows from the industry's different stakeholder groups. Apart from the way Trump's tweets are undermining the effectiveness of lobbying in preserving the industry's pricing power, new entrants like Amazon's acquisition of the online pharmacy, PillPack, are threatening to disrupt the traditional pricing structure. In addition, the insurance and pharmacy oligopolies are pushing new reimbursement schemes to capture a greater share of the industry's pricing power. Consumer groups are promoting patient-centric care, generics, biosimilars and value-based payments. Fiscal authorities on both sides of the Atlantic are making it more difficult for the industry to reduce its tax bill.

Suspending price increases will not be enough. Big Pharma will have to go further and offer critical stakeholders win-win value propositions that safeguard and increase the industry's long-term cash flows. With Trump's attention and Amazon building out a direct online pharmacy channel, patients and their advisors have become value-critical stakeholders.

Offering them an attractive value proposition will require demonstrating medical benefits, justifying prices and providing digital engagement options. This will mean engaging with patients, as well as critical employees and experimenting with new direct online business models. Only after these moves can Big Pharma in the long run afford to distribute dividends and buybacks to shareholders. As the online channel picks up momentum the other intermediaries in the industry, such as wholesalers, benefit managers and pharmacies, will face an existential threat if they maintain existing shareholder payouts without identifying their critical stakeholders and adapting their mission.

The challenge goes well beyond the healthcare industry. The disruption unleashed by big data, artificial intelligence and robotics is creating new critical stakeholders undermining the shareholder-first logic of large firms in most established industries. Even the high growth hi-tech firms have new value-critical stakeholders associated with their socio-political impact. The sooner big business starts creating long-term value with their critical stakeholders rather than obsessing about short-term profits, the better the chances of ultimately rewarding rather than squandering their shareholders' investment.

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