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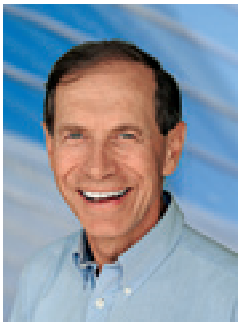
WHO GETS THE REWARDS? PROMOTE VALUE CREATION BY REWARDING THE RIGHT STAKEHOLDERS



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Too often, we boost short-term earnings, rather than distribute rewards to those whose support is critical for long-term value creation. The fear of disappointing investors and analysts is so strong that many executives would give up economic value in exchange for current earnings.[1] They believe that the best way of increasing the value of the firm is to maximize earnings in a predictable way on behalf of the shareholders. When short-term earnings are threatened, this may mean cutting back on discretionary spending by distributing as much as possible to shareholders and as little as possible to other stakeholder groups whose support is key for future growth.

What is the right way to distribute rewards? This article focuses on "growth-critical" stakeholders. These are stakeholders whose input and/or resources are essential for creating additional long-term economic value. Lack of sufficient support from them constrains growth. Getting the necessary support through greater rewards loosens the growth constraints. The basic principle is that value, in the form of rewards beyond the existing market rate, should be distributed to generate the most long-term return on the investment.

By comparing high growth companies to their lower growth peers in the same industries, we've have identified three principles for distributing rewards that are consistent with greater long-term firm value and, hence, avoid the trap of maximizing short-term profits:

- Identify the stakeholders who are critical for and communicate their importance to the financial markets
- Reward these critical stakeholders for growth in excess of existing market standards, despite the short-term earnings impact
- Be wary of using market power to boost earnings by extracting value from stakeholders who directly or indirectly may affect long-term value creation.

The way these principles work in practice can be seen by looking at two of the most successful high growth companies in recent history, Microsoft and Wal-Mart.

Identify the growth-critical stakeholders and communicate their importance

Because giving more rewards to stakeholders beyond the existing market rate reduces short-term earnings, it is crucial to communicate to financial markets why the stakeholders in question are critical for long-term value creation. Why, for example, should compensation for the CEO and top management be increased or top-notch engineers at software companies get generous rewards at the expense of current earnings and

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dividends for the shareholders. There may also be stakeholders who are not directly involved in value creation, but whose support is essential (for example, government, local communities, NGOs and the public at large).

At Microsoft, top software engineers have always been critical for long-term value creation. In Fortune Magazine in 1992, Bill Gates put it this way: "Take our 20 best people away, and I will tell you that Microsoft would become an unimportant company."

Wal-Mart's mission statement, by contrast, clearly indicates that consumers are the critical stakeholders for growth. The lowest prices for consumers "to give ordinary folk the chance to buy the same thing as rich people" are central to its business model.

Reward the critical stakeholders for growth in excess of market standards, despite the impact on short-term earnings

Rewards are the value distributed to stakeholders beyond the market and/or regulatory standard. For shareholders, the value distributed is the extra return on the firm's equity beyond the cost of equity capital. For customers, it's the extra value received beyond the market standard, which may be superior perceived benefits, or a lower price, or both. In short, it is a superior value proposition. For employees, the value distributed includes all compensation in money and in kind beyond the market standard, in the form of bonuses, benefits, pensions, insurance, training opportunities and the like. For suppliers, it is the premiums received above the market price and other benefits from relationships that go beyond the standard, such as reductions in operating costs, increased speed-to-market, and so on. Finally, the value distributed to society includes all contributions made after taxes, like contributions to local institutions, charitable donations and sponsorships.

Microsoft employees get some of the best compensation packages in any industry. The more important employee benefits include a 15% discount on purchases of stock and the award of stock options. Additional benefits include matching of employee charitable contributions; four weeks' paid infant-care leave, for men as well as women; $5000 reimbursement for adoption expenses. According to a Fortune 2006 article, "The software king offers what may be the most generous health-insurance plan in America."[2] It is not surprising that Microsoft has been on Fortune's "100 Best Companies to Work For" list for nine consecutive years.

Microsoft shareholders have also benefited enormously. From 1996 to 2005, Microsoft's shares earned an average 22.1% annually in extra return beyond the performance of the S&P 500. In the 20 years from 1986 to 2005, its market cap increased 230 times.

By contrast, at Microsoft's earlier competitor, Novell, employees did not receive comparable extra rewards. In 1994 and 1995, Novell spent five times less than Microsoft did on employee benefits. At the time, Novell was growing at a speed comparable to Microsoft with return on capital employed of 21% and 19% respectively. However, rather than distributing rewards to software engineers to encourage more in-house innovation, CEO Ray Noorda attempted to compete with Microsoft through the acquisition of rights to the Unix operating system, WordPerfect, Borland's QuattroPro spreadsheet and Digital Research's DR-DOS.

The product-based acquisition approach did not work: the Unix business was assigned to the Santa Cruz Operation in 1995, WordPerfect and Quattro Pro were sold to Corel in 1996 and DR-Dos was sold to Caldera Systems in 1996. In the following years, Microsoft continued to outspend Novell on employee benefits. In the 10 years from 1996 to 2005, Novell sales decreased by 0.705% and ROCE slipped to 9%.

Compared to competitors, Wal-Mart rewards its customers handsomely by selling goods at prices below market standards. Estimates of the consumer savings provided by Wal-Mart in 2004 vary from $19 billion to $263 billion.[3] According to a 2006 report in the Academy of Management Perspectives, shoppers at Wal-Mart in 2004 saved an estimated $30 billion on $124 billion of groceries that would have cost $146 billion at other supermarkets. And they saved at least five percent, or another $8 billion, on the other merchandise Wal-Mart sells. "That's the equivalent of a $270 Wal-Mart rebate check for every family in America every year."[4]

Wal-Mart's shareholders have benefited enormously. From 1996 to 2005, it provided an average extra return of 13.6% annually beyond the performance of the S&P 500, according to our calculations using Thomson Financial data. And in the 25 years since 1980, it has multiplied its market cap almost 200-fold.

The experience of a Wal-Mart competitor helps to demonstrate the danger in rewarding stakeholders who are not critical for growth. Sears & Robuck, now Sears Holdings Inc., has continually tried to distribute value to consumers with low prices. In the 1990s, Sears tried to improve growth by distributing value to its junior managers with a stock option program. However, the cost of this business model overall far outweighed the benefits in the low end of the retail market. In 2004, Sears discontinued the stock options program, except for directors and vice presidents.

Be wary of using market power to extract value from stakeholders who can affect long-term value creation

Rapid growth may lead to market power that allows companies to avoid distributing value and, instead, boost short-term earnings by extracting value from some stakeholders, giving them less than the market standard. For example, managers can appropriate value from shareholders by taking hidden risks and using their privileged access to information to extract excessive compensation from the board. Companies with dominant market positions can use their market power to deprive their customers of value, through overcharging, under-delivering, or competitive practices that reduce choice or otherwise harm the interest of customers. On the supply side, dominant companies can exploit their employees, driving wages down, or giving them less advantageous conditions than the standard in comparable markets. They can squeeze their suppliers or transfer the costs of their actions onto public institutions and society.

Value extraction may be an integral part of a business model, as in the downward pressure that Wal-Mart exercises on its supplier prices or an inevitable side-effect of pursuing value creation to its limits, as in the way that Microsoft exploits the dominance of its software platform. However, the positive impact of value extraction on short-term profits often disappears in the longer run, because value extraction increasingly engenders its own direct costs in the form of lower growth and/or a negative public image, regulatory and NGO pressure or legal claims. Extracting value only makes economic sense provided the value extracted is greater than its cost, measured by the negative impact on long-term value creation.

Microsoft has been accused of extracting value from stakeholders, with the appropriation of shareholder value through option backdating, and depriving customers of value through overcharging and preventing competition. "From 1992 through 1999, Microsoft awarded employees options that were retroactively keyed to its stock's monthly lows. Annual awards were given in July, at that month's low point. Awards to new employees were given at the lowest closing price during the month after they were hired. Microsoft disclosed and ended the practice in 1999, taking a $217 million charge."[5] Depriving stakeholders through monopolistic practices incurs regulatory costs. In February 2008, the European Commission imposed a record $1.3 billion fine on Microsoft for failing to fully comply with a 2004 antitrust decision.

Wal-Mart has been accused of squeezing suppliers, exploiting its workers and transferring costs to society. Wal-Mart expects a five percent a year price cut from suppliers. With cost of goods sold of approximately $200 billion in 2004, this amounts to value extracted from suppliers in the U.S. of about $10 billion. By contrast, in other markets, like Germany, Brazil and Argentina, Wal-Mart has much lower market share and

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very little leverage over its suppliers to get them to lower prices. A recent estimate suggests that in 2005, relative to other large retailers, Wal-Mart paid its employees about $3 billion less.[6] An average of 52,500 employees per month leave their jobs at Wal-Mart, which corresponds to an employee turnover of more than 45% per year, some 15% higher than the average at other retailers. Wal-Mart has also been criticized for low benefits, especially the percent of workers covered by its health insurance program.[7]

Wal-Mart has commissioned studies of its impact on the U.S. economy. Even though the numbers produced in some of these studies are hotly contested, it is widely agreed that the savings Wal-Mart generates for consumers far exceeds whatever it is extracting from employees and even its suppliers. Since employees are also consumers, the value distributed to consumers offsets the value extracted from the same people as employees. So much so that even journalists from the liberal New York Times and Washington Post have taken up Wal-Mart's defense "arguing that the retailer's low prices benefit low-income families more than its labor practices could possibly harm them."[8]

Beyond getting its story out, Wal-Mart is also moving to distribute more to stakeholders who are not critical for its growth. Its website reports an increase in benefits spending for employees from 1.5% in 2002 to 1.9% of sales in 2005, an increase of 15% per year over the last three years. Hourly employees now also receive bonuses and other incentives for helping to achieve company objectives. More than three quarters of employees now have health coverage. Wal-Mart also claims to be the largest corporate donor of cash for charity in the U.S., distributing $245 million in 2005.

These examples show that rewards in the form of value distribution are key to long-term value creation. Because it is an important part of the business model, the value distribution policy should be made explicit, (i.e. - a part of corporate strategy). This should be done by top management and the board. When the board approves the dividend payout and compensation policy, it needs to review the rewards distributed to all stakeholder groups and determine which of them are critical for value creation.

The objective must be to create long-term value for the shareholders. Not to boost short-term earnings to look good to the analysts, not to keep management happy, or other favorite stakeholders. Value should only be distributed to those who can make a bigger difference to the value created than the rewards they get.

1 Graham, John, Campbell Harvey, and Shiva Rajgopal, 2005, "The Economic Implications of Corporate Financial Reporting." Journal of Accounting and Economics, issue 40, page 3–73.

2 http://money.cnn.com/magazines/fortune/bestcompanies/snapshots/879.html

3 Global Insight, The Economic Impact of Wal-Mart, http://www.globalinsight.com/gcpath/Wal-Mart_June_2006.pdf

4 Fishman, Charles, 2006, "The Wal-Mart Effect and a decent society: Who knew shopping was so important?" Academy of Management Perspectives, August 2006, page 6-25.

5 http://news.com.com/5208-1047_3-0.html?forumID=1&threadID=23868&messageID=223069&start=-1

6 Bernstein, Jared, Josh Bivens, and Arindrajit Dube, 2006, "Wrestling with Wal-Mart," Working Paper, Economic Policy Institute. http://www.epi.org/content.cfm/wp276

7 Norman Al, 2004, The Case Against Wal-Mart, Raphel Marketing, page 6.

8 See John Tierney's "The Good Goliath." November 29, 2005, the New York Times and Sebastian Mallaby's "Progressive Wal-Mart. Really." November 28, 2005, The Washington Post.

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