Reunion

Shareholder vs. Stakeholder Capitalism
The Shareholder Value Myth?

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Reunion 2023

Reunion

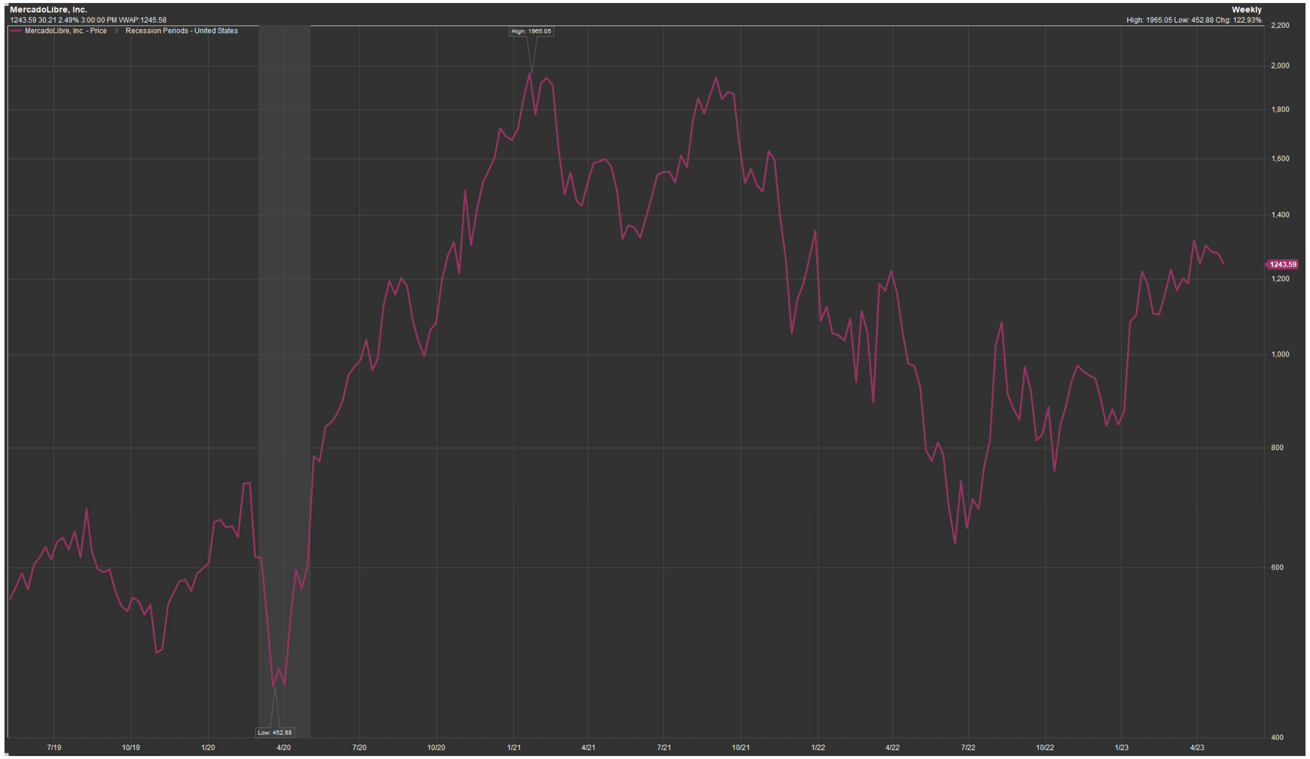
What Do We Maximize In a Corporation?

Let's Start with Two Super Broad Ideas…

Mercado Libre

Stock Price Behavior LTM

- World player of online marketplaces dedicated to e-commerce and online auctions.
  - 89% of their shares floating of which >80% owned by institutional investors
  - 20 broker contributions, >500K volume traded daily on average

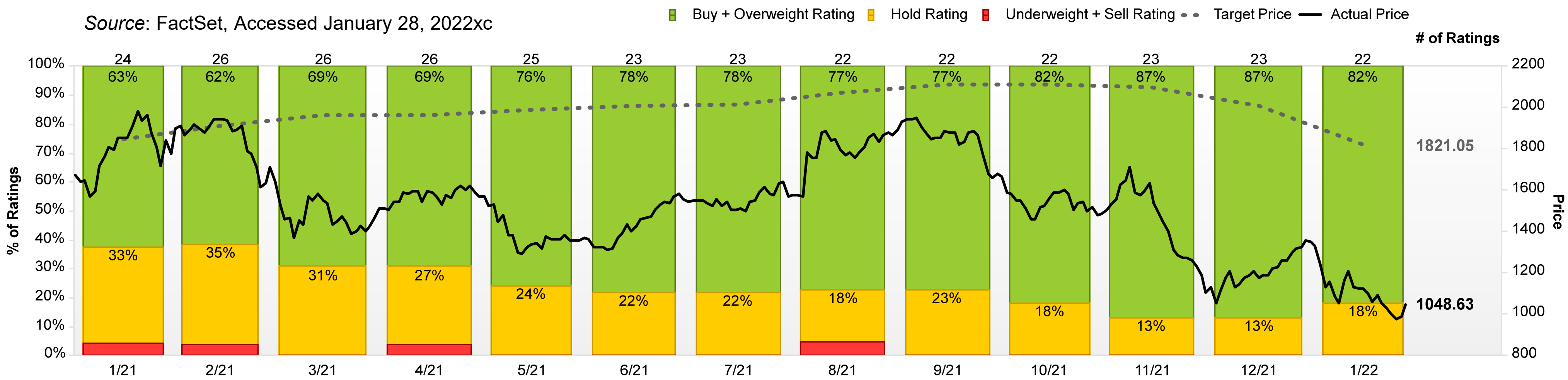


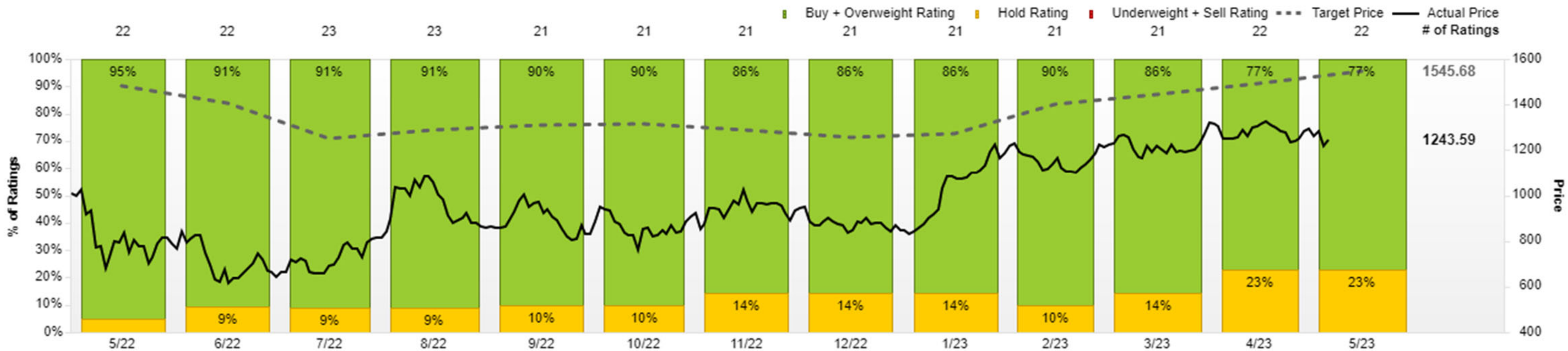
Source: FactSet, Accessed May 5, 2023

Mercado Libre

Equity Analyst Coverage: Recommendations

Source: FactSet, Accessed January 28, 2022xc





Source: FactSet, Accessed May 6, 2023

Prices as a Discounting Mechanism

- We think about value maximization in terms of “some kind of” long-term net present value
  - Not maximizing next week’s profits
  - “Short-termism” may put us into problems on how to interpret numbers

- Not claiming that markets are efficient
  - Even Eugene Fama in his third day of class would say that the notion of perfect efficiency is a little crazy
    - This is a long-term perspective
  - Theory says that today’s stock prices reflect the PV of E[CF], but…
    - It moves a lot, perhaps for ephemeral reasons, but the big changes usually result from changes in investors’ long-term expectations
  - Even apparently short-term moves in stock prices reflect often a reassessment of that long-term horizon

Markets are Not Myopic
But Maybe a Bit Farsighted?

- Stock markets are never perfect, but they are *not* grossly inefficient

- Markets are less efficient in the short-term than the long-term, but markets are still exceptionally hard to beat
  - If it is obvious which firms are squandering their capital in the hope of getting a short-term pop in their stock price, the job of active managers would be easy

- **Example:** FAAMG stocks have driven most of the overall market performance in recent years
  - Those price moves have all been about future long-term expected growth
  - If you believe markets are inefficient, and are particularly inefficient today, you must agree that investors are in the grip of an irrationally long-term perspective!
  - Far from short-term oriented, they are exhibiting farsightedness, a willingness, right or wrong, to pay a ton for cash flows in the far distant future

First Idea: Long-Term Perspective

Sycamore and The Jones Group
Nine West LBO Security Litigation (Dec 4, 2020 SDNY)

- Before 2014 Jones Group [JG] was a publicly traded global footwear and apparel company selling brands such as Nine West, Anne Klein, and Gloria Vanderbilt, organized under Pennsylvania law
  - Dark-side: Company struggling revenue was flat, target earnings missed, and store counts were down
  - Bright-side: Performance of Stuart Weitzman and Kurt Geiger brands

- In 2014 JG was considering a take-private cash bid from Sycamore Group, a private equity sponsor

- The Jones Group board had previously been advised that, under the then-current projections, they could support a D/EBITDA = 5.1x one year forward EBITDA

Sycamore and The Jones Group
Nine West LBO Security Litigation (Dec 4, 2020)

- As part of the Sycamore bid accepted by the JG board, Sycamore was proposing to, among other things:
  - Transfer certain "crown jewel" assets of JG to a Sycamore-controlled vehicle for what was subsequently alleged to be "*substantially less than fair market value*,"
  - Cause post-transaction JG to be levered at approximately 7.8x management's projected EBITDA

- JG directors and officers were allegedly aware that company projections were continuing to decline in the face of what would be, post-transaction, a more highly levered balance sheet
  - Post-transaction, the "RemainCo" JG business was re-branded as Nine West
    - Nine West filed for Chapter 11 approximately four years later in 2018

Judge Sumnmary

US District Court Southern District of New York

- Litigation trust formed through the bankruptcy process sued certain Jones Group directors for breaches of fiduciary duty in conjunction with the 2014 Sycamore LBO

- The court determined that the directors in question could be liable for their failure to adequately investigate JG's post-sale solvency
  - The court:
    - Held that the pre- and post-sale transactions could be "collapsed" for purposes of assessing fiduciary duties
    - Found that the business judgment rule would not even apply since directors failed to even consider post-transaction solvency

Judge Decision

Key Takeaways

- Directors of a selling company may find themselves responsible for wrong-doings (or alleged wrongs) inflicted by the LBO buyer on its creditors

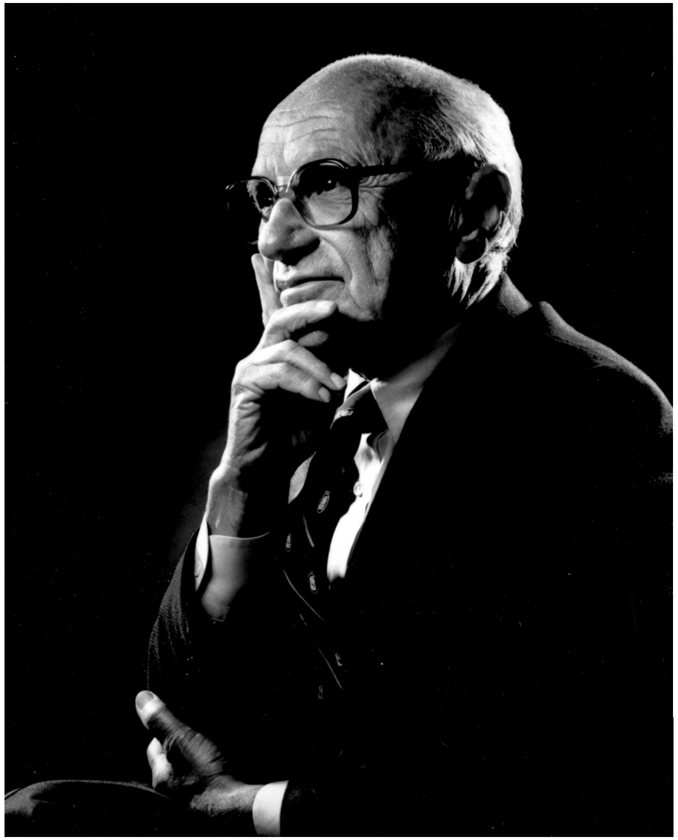
- Directors cannot ignore the selling company's post-transaction balance sheet or foreseeable carve-out transactions or subsequent dispositions to be undertaken by the buyer

- Ruling creates *tension* between directors' broader duty to maximize stakeholder value vs. shareholders when asked to consider a potential sale
  - Directors cannot focus only on obtaining the highest possible price for their shareholders, but need to think about the *whole corporation*
    - Directors must also assess the post-transaction risks facing the business in question, even when the business is "under new management"

Second Idea: Constituency Statute

What is the *Purpose* of a Corporation?

Milton Friedman
53 Years Later…



Friedman’s Legacy:
What is the Purpose of Business?

- Free market manifesto that changed the world: Free Market Capitalism
  - *The Social Responsibility of Business is to Increase its Profits* (NYT Magazine, September 13, 1970)
- Friedman’s View:
  - Maximize shareholder value in a society where there are no monopolies, no regulatory capture, and have no influence on legislation
    - Managers view as employees of the shareholders
- What is optimal for shareholders and/or what is optimal for society?
- Shareholder-primacy view of the corporation has been the modus operandi of United States capitalism
  - Little voice to workers, customers and communities

Why Did This View Become so Dominant?

- Rationale: *Practicality?*
  - Rather than being asked to balance multiple, often conflicting, interests among many stakeholders, the manager is given a simple objective function
    - Maximize the value of those who hire her/him
  - Dominant, maybe naïve belief in the Chicago school at the time, that what is good for shareholders is good for society
    - A belief that rested on the assumption of perfectly functioning markets. Unfortunately, such perfect markets exist only in your MBA textbooks ☺
    - In Friedman's view, the rules of the external rules were fixed, but…

- People over the years realized that external rules are **not** fixed:
  - The changing nature of the rules is very important, and of course, political gain/ incentive gains is what makes the rules change, and the view get distorted…

What Is The Responsibility of Business?

- Friedman (1970):
  - *"The social responsibility of business is to increase profits"*
  - **Question:** Do you agree?

- Additional Quotes:
  - "*while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom*"
  - "*increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud*"

The Business Roundtable Statement
Redefines the Purpose of a Corporation

BR Business Roundtable

CORPORATE GOVERNANCE

Business Roundtable Redefines the Purpose of a Corporation to Promote ‘An Economy That Serves All Americans’

AUG 19, 2019

Updated Statement Moves Away from Shareholder Primacy, Includes Commitment to All Stakeholders

The Business Roundtable Statement
Redefines the Purpose of a Corporation (Seriously?)

- We share a fundamental commitment to all our stakeholders. We commit to:
  - Delivering value to our customers
  - Investing in our employees
  - Dealing fairly and ethically with our suppliers
  - Supporting the communities in which we work
  - Generating long-term value for shareholders

- **Remark: Is not this simply increasing (long-term) profits?**

- Friedman:
  - "*It may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill*"

European Commission Study on Directors' Duties

European Commission

Study on directors' duties and sustainable corporate governance

FINAL REPORT

ABSTRACT (EN)

The focus of corporate decision-makers on short-term shareholder value maximisation rather than on the long-term interests of the company reduces the long-term economic, environmental and social sustainability of European businesses.

What Does Shareholder Value Really Mean?

- EC claim on focusing on corporate decision-makers on short-term shareholder value maximization seem to advocate a move towards stakeholder capitalism

- From any of your basic finance classes, shareholder value is inherently a long-term concept –I wrote it as "nerdy" as possible…

$$P_t = E\left[\sum_{t=0}^{\infty} \frac{C_t}{(1+r)^t}\right]$$

- Solution may be **more** shareholder capitalism and **not less!**
  - Less managerial capitalism or less focused on short-term profits since both will shrink the pie

Was Friedman Right?

- When Friedman wrote this article in the 1970s, what he saw as the main threat to the American economy were weaknesses in managerial capitalism
  - **Concern:** Dissipation of shareholder value through the conglomerate movement, and the associated loss of corporate focus and accountability

- Friedman felt that a private-sector focus on shareholder value maximization was the key to creating social wealth and general prosperity

- **Critical Assumption:** (one that tends to get lost in today's polemics) is the impossibility of maximizing long-run value in highly competitive product and labor markets without taking care of all your important stakeholders
  - If you're failing to treat workers fairly in a competitive market, if you are not treating your suppliers and local communities fairly:
    - There is no way to maximize the long-term value of the firm

Was Friedman Right?

- Do not think that the problems with today's market competition affects the power of Friedman's strong intuition about the social role of a corporation
  - Article was a defense of corporate accountability
    - Who decides what purpose the firm's funds should be used for?

- If we keep in mind that Friedman was referring to the maximization of long-run profits and not next quarter's earnings, as many of the critics assume, Friedman intuition was on the right path…

Was Friedman Right?

- Friedman was talking about the long term
  - Although he talked about maximizing profits throughout the original essay, he mentioned the work stock prices only *once*

- The idea that Friedman was advocating maximizing next week's profits, even if it dooms future profits, is in fact **silly**
  - If management is trying to maximize short-term profits, it may come at the expense of long-term profits. Would this be bad for the stock price? Maybe…
    - Management would be failing to invest in or build their businesses. So, how would that reflect a focus on shareholder value?

- When people criticize Friedman on the grounds of short-termism, they are not only misrepresenting his beliefs, but they are also making a statement that I don't think they intend or are even aware of
  - They are implying that stock prices are wildly inaccurate and irrational

Shareholder Value Myth?

Lynn Stout

- The business judgment rule ensures that, contrary to popular belief, the managers of public companies have no enforceable legal duty to maximize shareholder value

- They can choose to maximize profits; but…
  - They can also choose to pursue any other objective that is not unlawful, including taking care of employees and suppliers, pleasing customers, benefiting the community and the broader society, and preserving and protecting the corporate entity itself

- Shareholder primacy is a managerial choice – **not** a legal requirement
  - Are CEOs at fault?
    - In public dispersed corporations with who is the main ownership partner?

Maximizing shareholder value is a **managerial choice**, not a legal choice

So Why Do CEOs Focus On EPS and Earnings Calls?

Whom Do They Partner With?

Applying Friedman's View

- Applied to the public corporation with a dispersed shareholder framework
  - Separation of ownership and control

- **Question:** How to reconcile this view in a closely-held public firm or a private firm or in a dual-stock structure with a founder effectively controlling the firm?
  - This is when Friedman's view start getting in an unclear/gray area

Applying Friedman’s View
The New York Times (NYT)

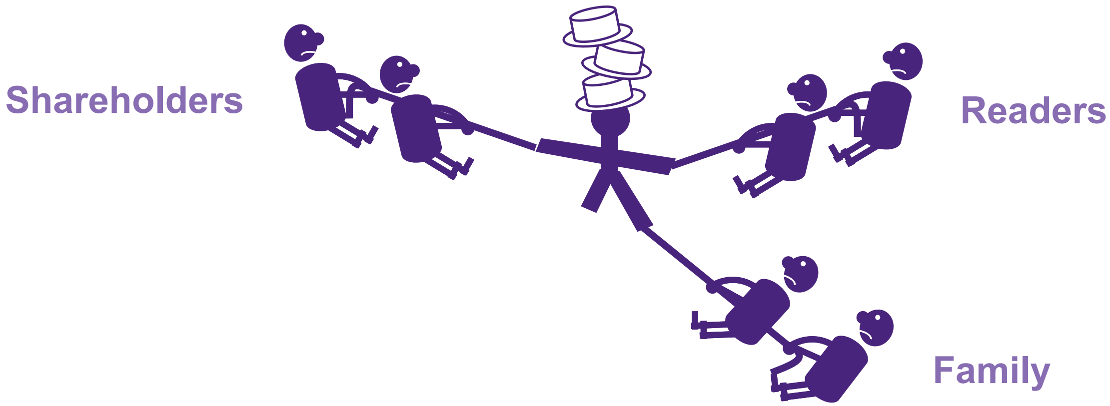
- NYT is a family-controlled company, not family-owned
  - The Sulzberger's control the company through a dual stock structure which allows them to control the board
    - Main partner of the family are institutional investors

- **Two Questions:**
  - Why is understanding who is the partner important?
  - With whom is Sulzberger’s fiduciary responsibility?

Applying Friedman's View

The New York Times (NYT)

- Sulzberger feels torn by his responsibilities to **three** different constituencies:
  - Readers or even "Society at Large"
  - Family
  - Shareholders:
    - Activist shareholders
    - Other non-family shareholders
    - Institutional investors who have fiduciary duties to their clients



Back to…What is a Responsible Business?

- What is a responsible business, and how does this differ from one that maximizes shareholder value or *long-term* profits?

TURING

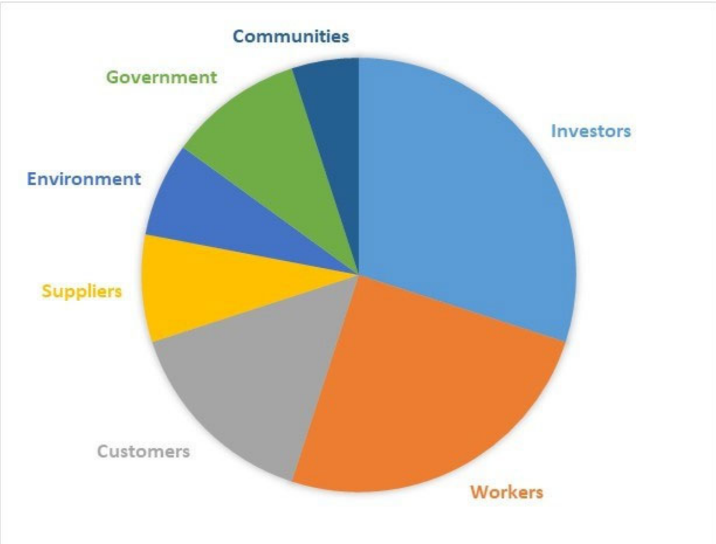
PHARMACEUTICALS

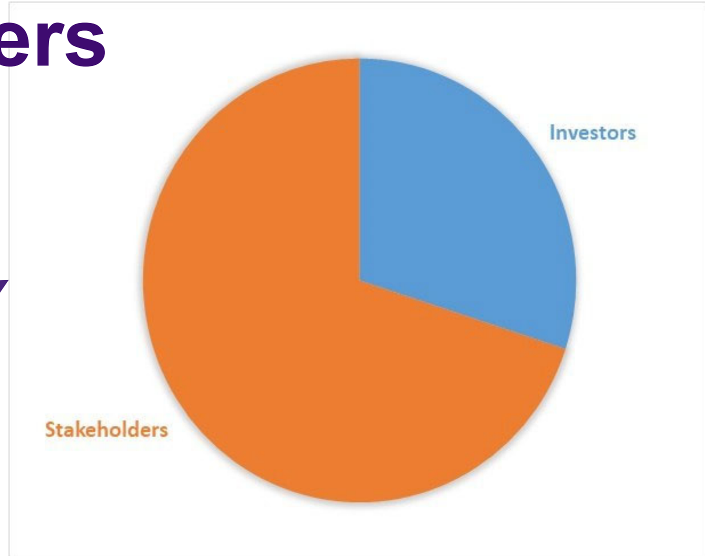
Darapim Price Hike…
Overnight!

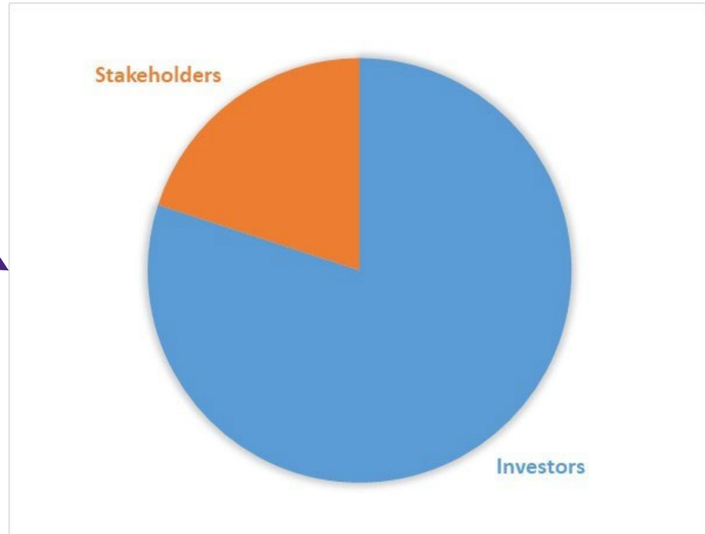
- The man was Martin Shkreli, the former CEO of Turing Pharmaceuticals, who was called before Cummings' committee in February 2016
- After hiking the price of an old drug for parasitic infections to $750 a pill from $13.50, Shkreli became the poster boy for pharmaceutical greed that helped define the past decade
- Watch Dirty Money (Netflix); Short Drugs: Episode on Valeant and *Fahmi Quadir vs Ackman*
  - Cut R&D from 18% to 3% (of Sales)
  - Increase short term profits

Do Short Sellers Exist to Fix the Problems or To Shed Light on the Problems?

Value Creation *vs.* Value Transfers

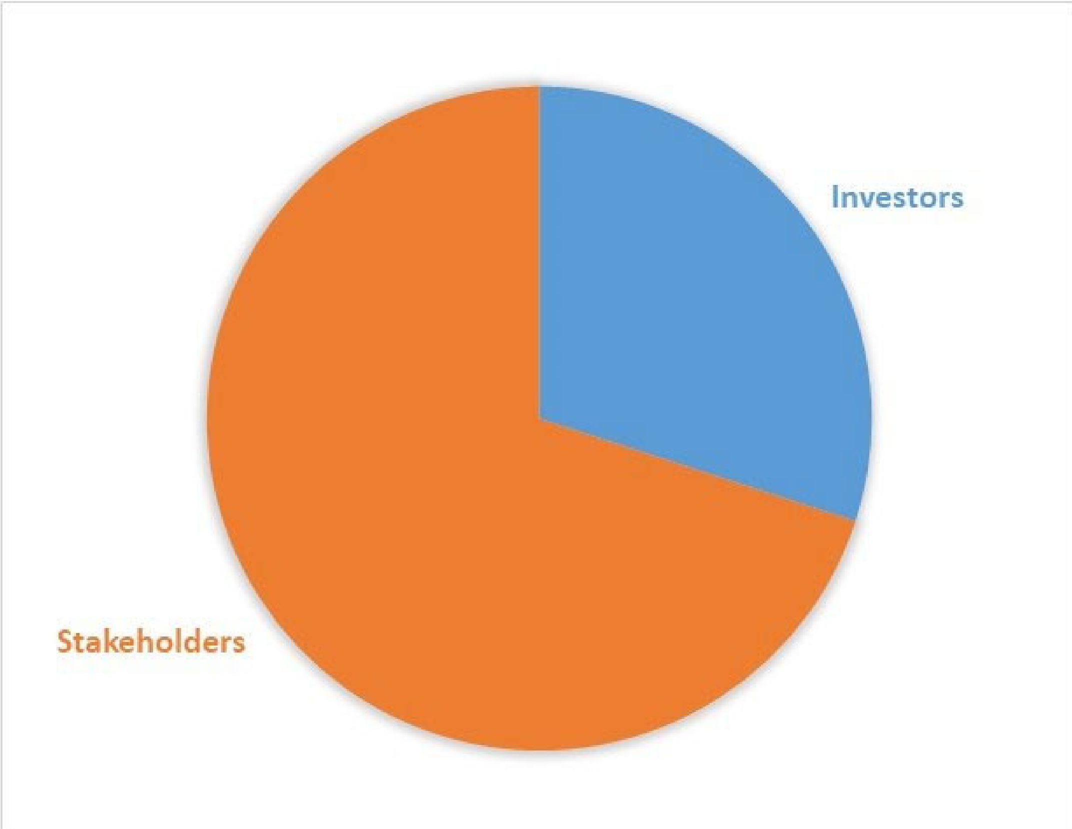






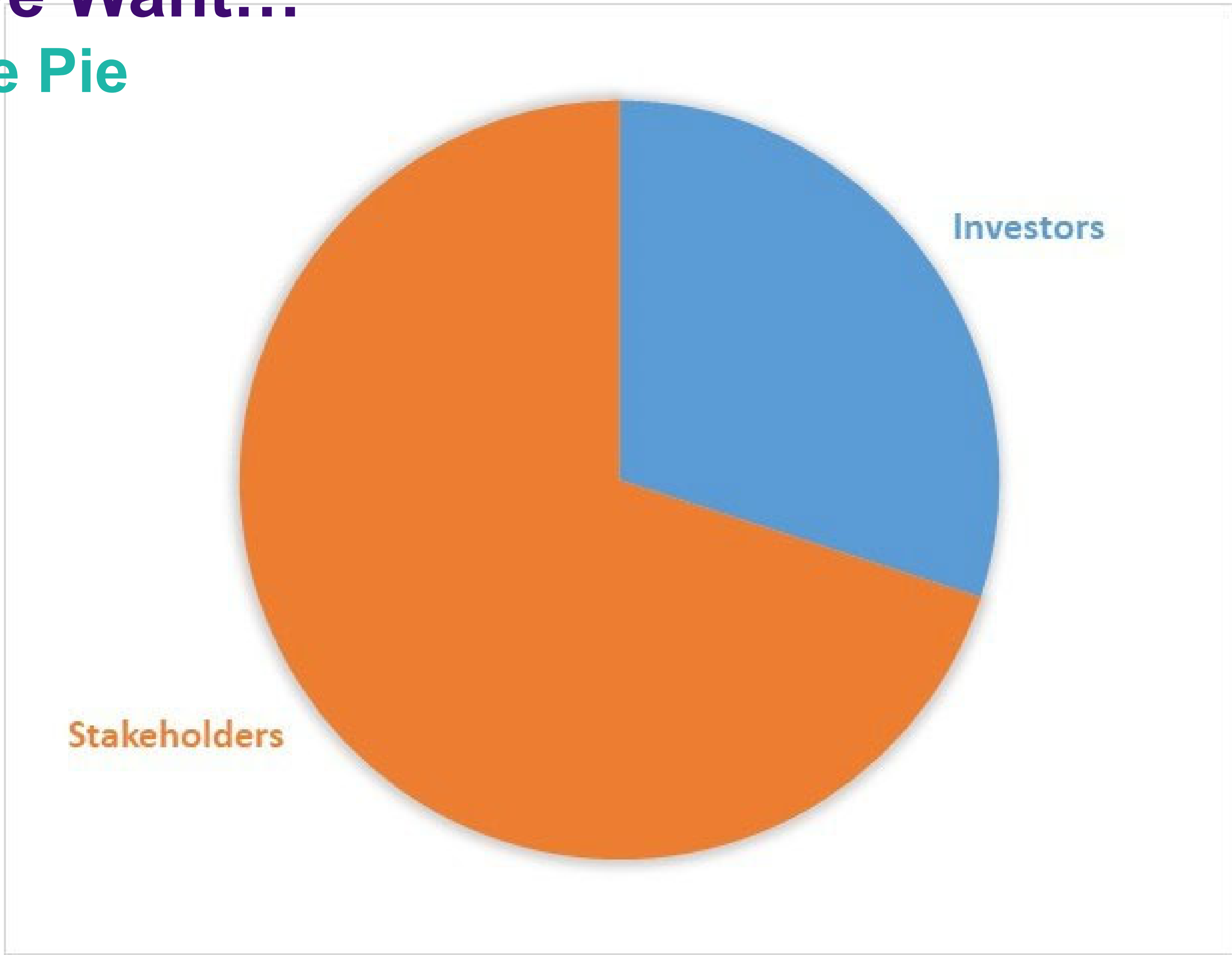
What We Want…

Grow the Pie



What We Want…

Grow the Pie



What Is A Responsible Business?

- One that grows the pie rather than just profits
  - Creates profits through creating value for society

- The most responsible actions are not to split the pie differently but to grow the pie to *create social value*
  - Responsible business is not necessarily CSR/ESG investments

	Responsible Business	CSR
Leader's Mindset	Grow the Pie / Actively Do Good	Split the Pie / Do No Harm
Activities Affected	Core	Ancillary
Critical to Avoid	Errors of Omission	Errors of Commission
Profits Viewed As	Value Creation	Value Extraction
Perspective	Ex Ante	Ex Post

Instrumental *vs.* Intrinsic Value

- Friedman recognizes the importance of investing in stakeholders, but only as an *instrumental* way to increase profits
  - (Instrumental) NPV analysis works for tangible assets, but most key assets in the modern firm are intangible

- A responsible business is *intrinsically* motivated to create value for society; profits are a by-product of the first decision
  - Shift in thinking will lead to far more investments being made, especially intangible ones
  - But not a free license to make all investments

- Friedman was on the right path again…

Responsible Business In The Crisis
Pie Splitting

- **Executive Pay**
  - Some CEOs worked for free (e.g., Boeing, United, Qantas)
  - A quarter of FTSE 100 CEOs accepted pay cuts of ≥ 20%
  - Emaar (Dubai property developer): pay cuts of 100% for chairman, 50% for senior mgt, 40% for middle mgt, 30% for junior staff, 0% for support staff

- **Workers**
  - Unilever guaranteeing all 155,000 jobs (incl. contractors)
  - Wynn Resorts paying all employees while hotels are shut
  - Marriott continuing to pay healthcare

- **Customers**
  - In-kind donations by Unilever, Morrisons, Google etc.

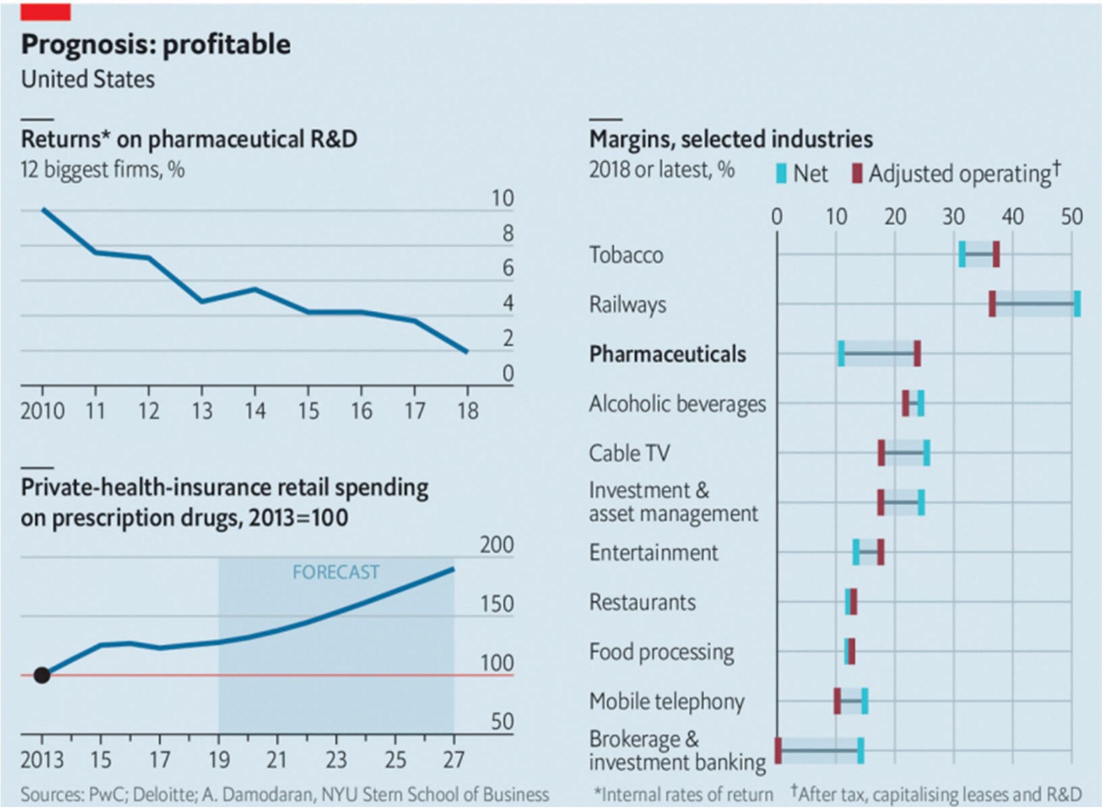
But We Know Externalities Still Exist…

- Too naïve and overly-simplistic to think that every responsible action improves profits, even in long run
  - How much more will customers spend on Unilever products due to No Deforestation, No Peat, No Exploitation Strategy?
    - Do they even know which brands are Unilever's?!?
  - How much more will customers spend on Apple products given the Daisy recycling robot?

- First evidence linking smoking to cancer was published in 1954, nevertheless…

But We Know Externalities Still Exist…

The Economist (June 22, 2019)



Shareholder Value ≠ Shareholder Return

- Fiduciary Duty is to the Corporation **and** its stockholders
  - But this means *more* than maximizing shareholder return!

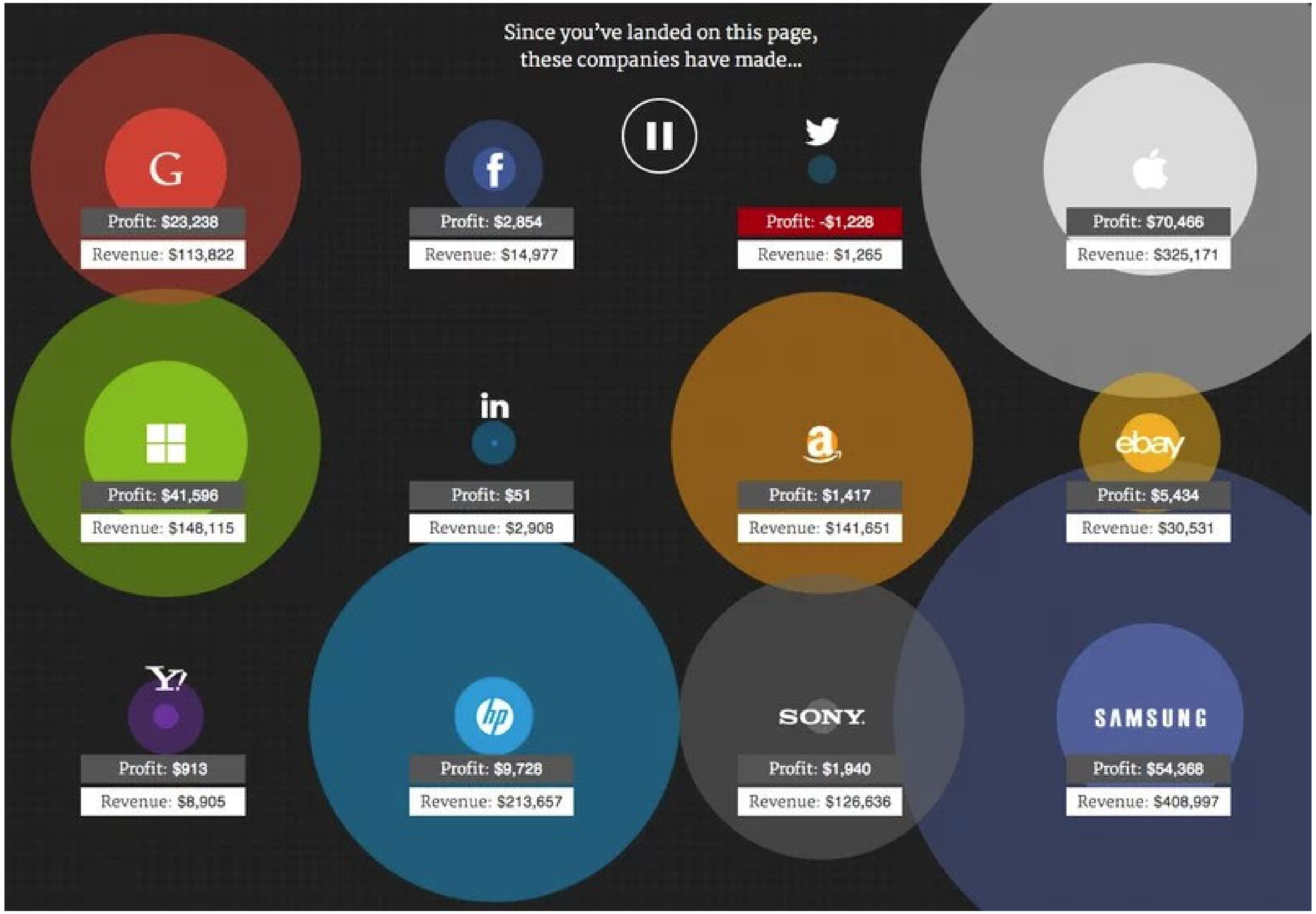
- Shareholders care about how the company affects their future standard of living. Depends on:
  - Future price of energy, raw materials
  - Contribution to global warming, modern slavery
  - Unemployment, inequality
  - Competition, crony capitalism

- **Food for Thought:**
  - But why shouldn't elected politicians deal with externalities?

What Is An Irresponsible Business?

TIME

Every 60 Seconds, Apple Makes More Money Than You Do in a Year



AFL-CIO

More for Them, Less for Us

$13.9M

The average compensation for an **S&P 500 CEO** last year.

361

Times more the average **S&P 500 CEO** made last year compared to the average U.S. rank-and-file worker.

4,987

Times more the **CEO** of Mattel made last year compared to the pay of its median employee.

791

Times more the average **S&P 500 CEO** in the retail industry made last year compared to the average median pay of their employees.

What Is An Irresponsible Business?

- High profits and CEO pay are **not** automatically a sign of irresponsibility
  - Might be a result of pie-splitting
  - But, particularly over the long run, may result from pie-growing

- The most irresponsible actions are not to split the pie differently, but to fail to grow the pie / allow it to shrink
  - Errors of omission are more serious than errors of commission

Kodak Story

Kodak's Patented Digital Camera (1975)

Launch of Sony Mavica (1981)

Kodak's Lack of Response
Aftermath: Disaster…

- Clear market leader in film. Sales >$10B, nearly all from film
  - Study by head of market intelligence, Vince Barabba, predicted digital would replace film, but in the long future (at that time 10 years)
    - "*The company just never got around to developing the technology, because the money to be made from its traditional business of old-fashioned photographic film was so much bigger*"
- Went bankrupt in 2012, a disaster for society:
  - Worth $31B in 1997
  - Employed 145,300 in 1988
- Rarely thought of as an act of irresponsibility
  - No errors of commission (no fraud or wrong-doing)
  - Investors and executives did not steal from other stakeholders, but an error of omission

Takeaways

- Heated debate on Friedman's Capitalism manifesto
  - Stock prices as a discounting mechanism: long-term view of investors
- Friedman had a long-term view
  - If you're maximizing the short term to the detriment of the company, you're hurting shareholders
  - Understanding constituency statutes is key
- A responsible business seeks to create profits through creating value for society – to grow the pie
  - A good business will invest in stakeholders, but only instrumentally.
    - It will forgo many investments, because their profit impact cannot be forecasted
  - Even if there are "true" externalities that won't affect profits, even in the long-run, a responsible business will consider them
  - Irresponsibility is not only about errors of commission (splitting the pie unfairly) but errors of omission (failure to grow the pie)