CFOs and Strategists: Forging a Common Framework

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Increasingly, companies are becoming polarized into two camps: those who consider shareholder value the key to managing the company and those who put their faith in gaining competitive advantage. At companies across the United States, there is an intense struggle taking place between those who formulate business strategy and those who seek to value it. This struggle has created great confusion in the corporate arena. No one feels this confusion more acutely than the CEO who is responsible for developing competitive strategies for the long term, but whose paycheck, in all probability, is still based largely on short-term results. Indeed, that age-old debate between investing for the long term and showing outstanding short-term financial results is back—only this time the camps are flying banners with the new buzzwords of corporate America: competitive advantage and shareholder value.

It is time to put this long and unproductive debate to rest and reconcile the rival camps. For the two dominant business objectives of the past decade—establishing competitive advantage and creating shareholder value—stem from a common economic framework. Long-term productivity lies at the root of both sustainable competitive advantage and consistent results for the shareholder, yet there are those who stubbornly refuse to believe the two can coexist. Let's first explore how the two concepts are linked before we tackle the persistent myths that keep managers from believing the concepts can live comfortably together.

A Common Link

Productivity—the value of the output produced by a unit of labor or capital—is the foundation for creating competitive advantage in the marketplace. A company creates competitive advantage when the long-term value of its output or sales is greater than its total costs, including the cost of capital. This advantage can be achieved by providing superior value or lower costs to customers.

It is also productivity that the stock market reacts to when pricing a company's shares. Embedded in all share prices is a long-term forecast about a company's productivity—that is, its ability to create value in excess of the cost of producing it. When the stock market prices a company's shares according to a belief that the company will be able to create value

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over the long term, it is attributing to the company long-term productivity or, equivalently, a sustainable competitive advantage. In this way, productivity is the hinge on which both competitive advantage and shareholder value hang.

But then why is it that so many executives sense a conflict between the two? Often it is because those companies with competitive advantages do not always produce the best results for their shareholders.

If the competitive advantage that a company enjoys is fully or more than fully incorporated in its stock price when an investor purchases shares, there is no reason to expect that the shareholder will earn anything greater than a normal, market-required return. Only *unexpected* positive changes in investors' perceptions of a company's future prospects will lead to increases in share price that yield above-normal or excess returns. Thus even the best managed companies won't necessarily return above-average rates, and only investors who correctly *anticipate* changes in a company's competitive position that are not yet reflected in the current stock price can expect to earn above-average returns.

Even if a company increases shareholder value by investing at above the market-required rate of return or cost of capital, shareholders will earn more than the market-required rate of return only if the company's performance was not fully anticipated in the stock price when they purchased their shares. As IBM, DEC, and other former high-expectation companies demonstrate, corporate investments made at above the cost of capital but at a rate of return less than previously anticipated by the market lead to stock price declines.

When managers see that the best managed companies with strong competitive advantages do not always produce the best results for their shareholders, they often jump to two mistaken and dangerous conclusions.

1. They stubbornly proclaim that the market does not actually value the long-term productivity of their company but judges it only by its short-term performance.

2. They conclude that they must depart from the shareholder-value model to improve their company's competitive position.

Shareholder Value: Management vs. Stock Market

Let's begin by looking at the ubiquitous difference between the market value of a company's shares and the value managers place on those shares. Surveys consistently show that a majority of managers do not believe the market fairly values their company's shares. A month before the market crashed in October 1987, Louis Harris and Associates conducted a poll of 1,000 CEOs. The pollsters asked: "Is the current price of your company's stock an accurate indicator of its real value?" Of the 58% who responded "no," virtually all believed the market was undervaluing their shares.

There are two reasons why managers consistently cling to the belief that the market does not fairly price their shares. The first and most obvious reason is that managers know more about their businesses than the market does and thus arrive at a different, often higher, value for their company's shares. To reduce the difference between market and management values, managers can disclose additional information—as long as it does not compromise the company's competitive position. But even when a company liberally discloses information, the market may still arrive at a value different from management's.

This leads us to the second and more important reason management and the stock market arrive at different values for the same shares. In pricing a company's shares, the market implicitly assigns a finite time period to the company's ability to create value or, equivalently, to find opportunities to invest at above the cost of capital. This period, which I call the value growth duration, ranges from a high of 10 to 20 years for companies with proven competitive advantages—such as Merck, Microsoft, Wal-Mart, PepsiCo, and Coca-Cola—to a duration approaching zero or less for poorly positioned competitors or those in commodity-based industries.[1] In each case, the market sends a different message to managers—telling the high performers, such as Wal-Mart, that it has faith in their ability to sustain a competitive advantage, while telling low performers, such as Sears, that it does not believe they currently have a competitive advantage and that it doesn't expect to see one in the future.

Managers in companies that do not currently have a competitive advantage often complain the loudest about the stock market's perceived impatience—begging investors to trust them long enough to allow them to capture some market share or otherwise demonstrate a competitive advantage.

But investors risking their capital will assess value growth durations conservatively. Therefore,the mar-

1. At the end of the value growth duration, it is assumed that the company will earn at its cost of capital rate. Thus to justify today's price, the market's horizon goes beyond the value growth duration.

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ket's horizon for value growth is long, but it is never as long and as confident as some managers would like.

Short Term vs. Long Term

This disparity has caused many managers to persist in the mistaken belief that the market relies on short-term measures of earnings instead of a long-term valuation of cash flows. In turn, this preoccupation with short-term financial results has caused some managers to sacrifice crucial investments with substantial long-term payoffs in order to show impressive short-term results. For example, General Electric, Westinghouse, and Cincinnati Milacron have left the industrial robotics field rather than make the substantial technological investments required to compete. This short-term orientation not only is competitively debilitating but also is based on an inaccurate view of the market's pricing mechanisms.

There are three fundamental factors that determine market prices: cash flows, a long-term forecast of these cash flows, and the cost of capital or discount rate that reflects the relative riskiness of a company's cash flows. Taken together, these three factors represent the discounted present value of all cash flows expected from both past and future corporate investments. The present value of a company's cash flows, not its quarterly earnings, determines its stock price. The Alcar Group analyzed the stock prices of 30 Dow Jones Industrial companies (see the table "The Stock Market Takes the Long View") and found that typically between 80% and 90% of the prices were attributable to expected cash flows paid out in the form of dividends beyond five years.

How can so many managers continue to believe that stock prices are driven by short-term accounting numbers despite research evidence to the contrary? Because in certain cases when investors believe that disappointing quarterly earnings reports provide new information about a company's long-term cash flow prospects, reported earnings per share will affect market value. But the market is not reacting myopically to reported EPS per se. Instead, when appropriate, the market uses unexpected changes in earnings as a useful proxy for reassessing a company's future cash flows. There is evidence that the market discriminates between changes in earnings that are and are not expected to affect future cash flows. A disappointing quarterly earnings announcement that is seen as a harbinger of the future will drive the stock price down. In contrast, research studies have shown that announced changes in accounting methods that affect reported earnings but not expected cash flows do not affect stock prices.

Restructuring announcements disclosing management's decision to cut its losses and exit a value-decreasing line of business are almost invariably accompanied by significant write-downs in current earnings and increases in share prices. In these situations, the market is responding not to the unexpected decrease in current earnings but to the long-term consequences of redeploying corporate resources to higher valued uses.

The lesson here is simple and absolutely crucial for value-creating managers. Investors reveal their preferences in the marketplace, and these preferences materialize in stock market prices that are driven by a company's long-term prospects, not its short-term outlook.

The second and more damaging myth that managers cling to is the belief that they must depart from the standard shareholder-value model in order to make investments that ultimately will lead to competitive advantage. Rooted in this mistaken belief is the incorrect assumption that the market will react negatively to long-term investments that might be a short-term drain on both earnings and cash flow.

A recent study of 634 strategic announcements—including future joint ventures, investments in R&D, and new products—by J. Randall Woolridge of Pennsylvania State University found that the market did reward long-term initiatives.[2] In 1987, for example, Disney announced plans to create a theme park in France. The company intended to spend $2 billion over four years and expected to show no returns until the year 2000. After Disney made public its decision to build the park, its shares shot up 4%. The strength of the company's competitive advantage—Mickey Mouse—allowed investors to predict confidently that the investment would create sizable future cash flows. As this case demonstrates, there is no conflict between investing for the future and showing strong short-term stock market results.

But what about companies that have not been awarded a long value growth duration by the market? When a company makes a strategic investment, the CEO may believe that the benefits of that investment will last beyond the market's value growth duration. For example, suppose a company's shares are priced as if it is expected to invest at above the cost of capital for a period of five years. Assume management expects a strategic investment in technology,

2. J. Randall Woolridge, "Competitive Decline and Corporate Restructuring: Is a Myopic Stock Market to Blame?" *Continental Bank Journal of Applied Corporate Finance* (Spring 1988), pp. 26–36.

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The Stock Market Takes The Long View

Company	Price (as of 12/31/91)	Cumulative Present Value of Five Year Dividend Forecast	% of Current Share Price Attributable to Expectations Beyond Five Years
ALCOA	$ 64.38	$ 6.22	90.3%
Allied-Signal	43.88	3.56	91.9
American Express	20.50	3.80	81.5
AT&T	39.13	5.92	84.9
Bethlehem Steel	14.00	2.15	84.7
Boeing	47.75	5.11	89.3
Caterpillar	43.88	5.02	88.6
Chevron	69.00	13.59	80.3
Coca-Cola	80.25	4.72	94.1
Disney	114.50	3.18	97.2
Du Pont	46.63	7.00	85.0
Eastman Kodak	48.25	7.42	84.6
Exxon	60.88	11.36	81.3
General Electric	76.50	8.77	88.5
General Motors	28.88	6.06	79.0
Goodyear	53.50	1.79	96.7
IBM	89.00	19.73	77.8
International Paper	70.75	6.65	90.6
McDonald's	38.00	1.61	95.8
Merck	166.50	11.51	93.1
3M	95.25	12.67	86.7
J.P. Morgan	68.63	7.96	88.4
Philip Morris	80.25	10.05	87.5
Procter & Gamble	93.88	9.45	89.9
Sears, Roebuck	37.88	7.12	81.2
Texaco	61.25	12.56	79.5
Union Carbide	20.25	3.56	82.4
United Technologies	54.25	6.86	87.4
Westinghouse	18.00	5.07	71.8
Woolworth	26.50	4.43	83.3

quality, or a product-extension acquisition to contribute value for a period well beyond five years. If management expectations materialize, then even if the market reacts negatively to the initial investment announcement, shareholders should benefit as favorable events unfold.

The conviction to engage in value-creating investments despite initial stock market skepticism is in the best tradition of shareholder-value management. The risk is that management's cash flow projections may be based on unrealistically optimistic assumptions about the future behavior of customers and competitors. Too often forecasts are designed to support a decision favored by top management rather than to test accurately the value-creating potential of the strategic investment.

Still, other managers insist that it is sometimes necessary to depart from the shareholder-value model to compete with aggressive global or domestic competitors. These managers believe that even though investment is absolutely essential to remain competitive, the market value of the company will decrease when the company announces an investment at an expected rate of return less than the cost of capital. This is an incomplete analysis that draws the wrong conclusions about how the stock market will respond.

A proper application of shareholder-value analysis calls not only for valuing the decision to invest but also for factoring in the consequences of not investing. In the usual capital-budgeting exercise, the consequences of not investing are assumed to be neutral. But in this case, the costs of not investing are substantially more damaging than those associated with investing at below the cost of capital. If management's expectations are reasonable, then its decision

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Does The Stock Market Penalize Long-Term Thinking? The Case of Apple Computer

"The move by Apple Computer to gain market share by introducing lower-priced machines is succeeding, but the resulting strain on profits has driven its stock down. Its supporters among Wall Street analysts say that the company is being penalized for long-term planning."

The New York Times
May 20, 1991

This quote from an article by Lawrence M. Fisher summarizes what many managers believe happens when they try to think long term. They believe the stock market penalizes companies like Apple Computer when they show even the slightest willingness to trade short-term earnings for long-term growth.

Despite widespread acceptance of this view, we have to ask ourselves: Did the market really penalize Apple for its long-term strategic initiatives? After careful consideration, we maintain the answer is no. We believe the market has accurately responded to Apple's recent decision to forego short-term earnings in an attempt to recapture its competitive advantage.

Apple, which introduced its Macintosh family of microcomputers in 1984, was born with competitive advantage. The Macintosh, with its unique, user-friendly interface, garnered immediate support from customers and enabled Apple to achieve a highly differentiated position within the desktop personal computer segment. Early on, Apple chose to exploit its advantage by focusing on the business market and pricing the Macintosh at a significant premium relative to competing products.

From 1986 through 1990, Apple surpassed its competitors, earning rates of return on equity that averaged in excess of 30%. Furthermore, during this same period, Apple's annual revenue and earnings growth also exceeded 30%—magnifying the value created for the company's shareholders.

But in 1990 the bubble burst. The market for microcomputers was beginning to ebb, and Apple's unit

Apple Acts: The Stock Market Reacts

Event	Date	Share Price	Long-Term Implied Return on Equity	Long-Term Implied Growth	Discounted Cash Value
Premium priced Macintosh	6/90	$40's	27–29%	13–15%	$37–45
Windows sales strong and speculation of Apple price cutting	9–10/90	27	18–20	13–15	27–35
Classic sales unexpectedly strong	10–11/90	47	24–26	15–17	40–50
Apple margins remain unexpectedly high	3–4/91	71	42–44	15–17	61–73
Compaq and IBM cut prices	4–5/91	47	30–32	14–16	43–53
Fed lowers discount rate	12/91	60	30–32	14–16	54–67

When investors attempt to estimate Apple's expected cash flow, or that of any other company, they must wrestle with two interlocking uncertainties: the likely pattern of returns (ROE) over time, and the likely level of growth. Thus, at any point in time, the market's forecast of Apple's long-term ROE and sustainable growth are implicitly embodied in the company's share price. Changes in Apple's strategy triggers changes in the investors' forecasts for the company's long-term returns and growth. Alterations in the market's assessment of Apple's profitability, in turn, resulted in changes in the discounted cash flow (DCF) value for Apple's shares and, ultimately, the market value of the company's common stock.

to invest is fully consistent with maximizing shareholder value. If the market is knowledgeable about the company's competitive circumstances and places confidence in management's ability, little or no stock price change should occur after the investment is announced. If investors previously doubted management's inclination to invest, the announcement can even be expected to generate a positive response from the stock market.

The message for managers is straightforward. Max-

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growth began to slow dramatically as the company lost market share to its lower-priced competitors. This decline in unit growth, in turn, threatened to reduce third-party software development—efforts that most industry observers believed were critical to maintaining Apple's differentiated market position.

In August 1990, Value Line forecast Apple's future ROEs in the high-20% range with earnings growth of 13% to 15% annually. Using a discounted cash flow model, these forecasts justified a stock price in the $40 to $50 range—precisely the range in which the stock traded in 1989 and the first half of 1990.

However, by the summer of 1990, Apple found itself on the brink of a crisis. The price differential between the Macintosh and other personal computers was growing at an alarming rate as IBM-clone makers began offering cut-rate prices. As a result, the company's market share (in units) declined for the fourth consecutive year. Making matters worse, Microsoft Corporation's introduction of Windows 3.0 came dangerously close to eliminating the source of Apple's competitive advantage—its differentiated graphical user interface. Within five months of its introduction, Window's sales exceeded annual Macintosh shipments by some 50%. As a result, Apple's stock price fell to its lowest level since 1986—dropping precipitously from the mid-$40s to the mid-$20s.

On October 3, 1990, in the midst of a significant management shake-up, Apple announced a major change in strategy. The company introduced three new downscaled versions of the Macintosh—the Classic, LC, and IIsi—at radically lower price points. The introduction of a low-priced Classic line represented both a defensive reaction to the clone makers in the low end of the business market as well as a new thrust into the home market.

The stock market's initial reaction to the company's change in strategy was positive. The market expected the new course to significantly improve Apple's long-term returns, even if it meant a short-term decline in earnings. Although the new strategy would unquestionably reduce the company's net margins, the growth in unit volume was expected to improve Apple's asset turnover (its ratio of revenue-to-assets), which would lead eventually to an increase in ROE. Over time, the growth in revenue might also provide opportunities to restore net margins, producing an additional increase in returns.

In the six months following the announcement, the market's expectations of Apple's long-term returns and growth improved dramatically, and the company's stock price shot from a low of $26 to nearly $70. Contrary to the analysts' view summarized by the *New York Times* in May 1991, the market thunderously applauded Apple's decision to sacrifice short-term earnings for an improved competitive position. In fact, the market may have been overly optimistic in its assumptions about Apple's future profitability. In order to justify the $71 that investors were paying for Apple's stock in mid-April 1991, the stock market must have been forecasting sustainable returns in excess of 40% and growth near 20%—either of which would have placed Apple in the pantheon of value-creating enterprises.

By November of 1990, Macintosh shipments had surged 85%, and Apple was experiencing considerable difficulty meeting customer demand. By April of the following year, Apple held a 27% market share, topping IBM's 25% share for the first time in history. Of course, Apple's competitors didn't merely sit back and watch their respective market positions deteriorate. Apple's two primary competitors, IBM and Compaq, struck back with dramatic price reductions on most of their major models. As a consequence, Apple's stock retreated to the mid-$40 range as investors internalized the price-matching tactics of IBM and Compaq.

At the beginning of 1992, with Apple's stock trading near $60 per share, it is difficult to conclude that the stock market has imposed any significant penalty on Apple management for its long-term thinking. The company's stock has clearly outperformed the languishing shares of a troubled IBM and a slowly-recovering Compaq. Moreover, with the market forecasting Apple's returns to exceed 30% over the next ten years, we believe that most managers would pay to be in the same "penalty box" as Apple's.

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imum returns for current shareholders will materialize only when managers maximize long-term shareholder value and deliver interim results that attest credibly to the sustainability of competitive advantage.

So What's a Manager to Do?

Despite the fact that competitive advantage and shareholder value are based on the identical eco-

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nomic model, they do not live comfortably together in many companies. Many businesses simply have no consistent link between the processes of *formulating* and *valuing* strategies. Competitive analysis leading to strategy formulation entails analyzing the attractiveness of the industry, evaluating the business's competitive position within the industry, and identifying sources of competitive advantage. Shareholder-value analysis, on the other hand, evaluates the preferred strategies to see whether they are likely to create a sustainable competitive advantage.

There is no conflict when operating managers can comfortably translate competitive strategy variables into cash-flow forecasts. However, in companies that treat strategy formulation and valuation as separate processes, strategy analysis often focuses on customers and competitors without an explicit testing of shareholder-value consequences.

The mistake that CFOs and other financial analysts make is looking at short-term productivity instead of long-term productivity, which usually translates into quarterly earnings reports. The mistake that corporate strategists make is to project cash flows much more optimistically and much further into the future than the marketplace does. Any strategy designed to promote competitive advantage must, in the final analysis, meet the test of sustainable value creation. The value-creation process, in turn, depends on the translation of competitive dynamics into sustainable cash flows.

Providing a comparable product at a lower cost than competitors or providing superior value to the customer through higher quality, special features, or postsale service are not genuine advantages if the total long-term costs, including the cost of capital, are greater than the cash generated by sales. A business that provides more value than customers are willing to pay for is hardly competitive—and may not even be viable. For example, the current euphoria associated with investments in total quality programs sometimes exempts such major investments from careful shareholder-value scrutiny. The Wallace Company, a Houston, Texas-based pipe and valve distributor, won the Malcolm Baldrige National Quality Award in 1990. Wallace's quality program significantly increased on-time deliveries as well as its market share. Customers, however, were unwilling to accept the price increases initiated to offset the costs of the quality program. As a result, the company is now losing money, laying off employees, and operating in Chapter 11.

It's time to move competitive advantage and shareholder value from public and investor relations slogans to an integrated operational framework for managing publicly held companies. By making shareholder value the standard for measuring performance, management imposes on itself the long-term view so critical to gaining competitive advantage. Companies such as PepsiCo have found that sharpening their resource allocation by institutionalizing shareholder value at all levels of the company is a competitive advantage in its own right. Even managers who continue to be skeptical of the market's ability to reflect their company's prospects should recognize that shareholder-value principles are simply commonsense tools to make a business more competitive.

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