

The value of value creation

Long-term value creation can—and should—take into account the interests of all stakeholders.

by Marc Goedhart and Tim Koller

Challenges such as globalization, climate change, income inequality, and the growing power of technology titans have shaken public confidence in large corporations. In an annual Gallup poll, more than one in three of those surveyed express little or no confidence in big business—seven percentage points worse than two decades ago.¹ Politicians and commentators push for more regulation and fundamental changes in corporate governance. Some have gone so far as to argue that “capitalism is destroying the earth.”²

This is hardly the first time that the system in which value creation takes place has come under fire. At the turn of the 20th century in the United States, fears about the growing power of business combinations raised questions that led to more rigorous enforcement of antitrust laws. The Great Depression of the 1930s was another such moment, when prolonged unemployment undermined confidence in the ability of the capitalist system to mobilize resources, leading to a range of new policies in democracies around the world.

Today's critique includes a call on companies to include a broader set of stakeholders in their decision making, beyond just their shareholders. It's a view that has long been influential in continental Europe, where it is frequently embedded in corporate-governance structures. The approach is gaining traction in the United States, as well, with the emergence of public-benefit corporations, which explicitly empower directors to take into account the interests of constituencies other than shareholders.

¹ An annual Gallup poll in the United States showed that the percentage of respondents with little or no confidence in big business increased from 27 percent in 1997 to 34 percent in 2019, and those with “a great deal” or “quite a lot” of confidence in big business decreased by five percentage points over that period, from 28 percent to 23 percent. Conversely, those with “a great deal” or “quite a lot” of confidence in small business *increased* by five percentage points over the same period (from 63 percent in 1997 to 68 percent in 2019). For more, see “Confidence in institutions,” Gallup, [gallup.com](https://www.gallup.com).

² George Monbiot, “Capitalism is destroying the earth. We need a new human right for future generations,” *Guardian*, March 15, 2019, [guardian.com](https://www.guardian.com).

Particularly at this time of reflection on the virtues and vices of capitalism, we believe it's critical that managers and board directors have a clear understanding of what value creation means. For today's value-minded executives, creating value cannot be limited to simply maximizing today's share price. Rather, the evidence points to a better objective: maximizing a company's value to its shareholders, now and in the future.

Answering society's call

Recently, the US Business Roundtable released its 2019 "Statement on the purpose of a corporation." Dozens of business leaders (the managing director of McKinsey among them) declared "a fundamental commitment to *all* of our stakeholders [emphasis in the original]." Signatories affirmed that their companies have a responsibility to customers, employees, suppliers, communities (including the physical environment), and shareholders. "We commit to deliver value to all of them," the statement concludes, "for the future success of our companies, our communities and our country."

A focus on the future

The Business Roundtable's focus on the future is no accident: issues such as climate change and income inequality have raised concerns that today's global economic system is shortchanging the future. We agree. The chief culprit, however, is not long-term value creation but its antithesis: short-termism. Managers and investors alike too often fixate on short-term performance metrics, particularly earnings per share, rather than on the creation of value over the long term. By prioritizing (or, perhaps more correctly, mischaracterizing) shareholders' best interests in terms of beating analyst estimates on near-term quarterly earnings, the financial system can seem to institutionalize a model that cares only for today and all but ignores tomorrow. There also is evidence, including the median scores of companies tracked by McKinsey's Corporate Horizon Index from 1999 to 2017, that the tendency toward short-termism has been on the rise. Certainly, the roots of short-termism are deep and intertwined. A collective commitment of business leaders to clear the weeds and cultivate future value is therefore highly encouraging.

Companies that conflate short-termism with value creation often put both shareholder value and stakeholder interests at risk. Banks that confused the two in the first decade of this century precipitated a financial crisis that ultimately destroyed billions of dollars of shareholder value. Companies whose short-term focus leads to environmental disasters also destroy shareholder value, not just directly through cleanup costs and fines but via lingering reputational damage. The best managers don't skimp on safety, don't make value-destroying decisions just because their peers are doing so, and don't use accounting or financial gimmicks to boost short-term profits. Such actions undermine the interests of shareholders and all stakeholders and are the antithesis of value creation.

Value creation is inclusive

For companies anywhere in the world, creating long-term shareholder value requires satisfying other stakeholders as well. You can't create long-term value by ignoring the needs of your customers, suppliers, and employees. Investing for sustainable growth should and often does result in stronger economies, higher living standards, and more opportunities for individuals. It should not be surprising, then, that value-creating

capitalism has served to catalyze progress, whether by lifting millions of people out of poverty, contributing to higher literacy rates, or fostering innovations that improve quality of life and lengthen life expectancy.

A strong environmental, social, and governance (ESG) proposition also creates shareholder value.³ For example, Alphabet's free suite of tools for education, including Google Classroom, not only seeks to help equip teachers with resources to make their work easier and more productive, but it can also familiarize students around the world with Google applications—especially those in underserved communities who might otherwise not have access to meaningful computer engagement at all. Nor is Alphabet reticent about choosing not to do business in instances that it deems harmful to vulnerable populations; the Google Play app store now prohibits apps for personal loans with exorbitant annual percentage rates, an all-too-common feature of predatory payday loans.⁴

Similarly, Lego's mission to "play well"—to use the power of play to inspire "the builders of tomorrow, their environment and communities"—has led to a program that unites dozens of children in rural China with their working parents. Programs such as these no doubt play a role in burnishing Lego's brand throughout communities and within company walls, where, it reports, employee motivation and satisfaction levels beat 2018 targets by 50 percent. Or take Sodexo's efforts to encourage gender balance among managers. Sodexo says the program has increased the retention of not only employees, by 8 percent, but also clients, by 9 percent, and boosted operating margins by 8 percent as well.⁵

Shareholders and stakeholders: A balanced approach

Inevitably, there will also be times when the interests of all of a company's stakeholders are not complementary. Strategic decisions of all kinds involve myriad trade-offs, and the reality is that the interests of different groups can be at odds with one another. Implicit in the Business Roundtable's 2019 statement of purpose is concern that business leaders have skewed some of their decisions too much toward the interests of shareholders.

Stakeholders for the long term

Time will tell how they act on this conviction. As a starting point, we'd encourage leaders, when there are trade-offs to be made, to prioritize long-term value creation, given the advantages it holds for resource allocation and economic health. Consider employee stakeholders. A company that tries to boost profits by providing a shabby work environment, underpaying employees, or skimping on benefits will have trouble attracting and retaining high-quality employees. Lower-quality employees can mean lower-quality products, reduced demand, and damage to the brand reputation.

³ Sheila Bonini, Timothy M. Koller, and Philip H. Mirvis, "Valuing social responsibility programs," *McKinsey Quarterly*, July 2009, McKinsey.com; Witold Henisz, Tim Koller, and Robin Nuttall, "Five ways that ESG creates value," *McKinsey Quarterly*, November 2019, McKinsey.com.

⁴ Yuka Hayashi, "Google shuts out payday loans with app-store ban," *Wall Street Journal*, October 12, 2019, wsj.com.

⁵ *Diversity & inclusion at Sodexo: Making a world of difference*, Sodexo, 2018, sodexo.com.

More injury and illness can invite regulatory scrutiny and more union pressure. Higher turnover will inevitably increase training costs. With today's mobile and educated workforce, such a company will struggle in the long term against competitors offering more attractive environments. If the company earns more than its cost of capital, it might afford to pay above-market wages and still prosper, and treating employees well can be good business.

How well is well enough? A long-term value-creation focus suggests paying wages that are sufficient to attract quality employees and keep them happy and productive and pairing those wages with a range of nonmonetary benefits and rewards. Even companies that have shifted manufacturing of products such as clothing and textiles to low-cost countries with weak labor protection have found that they need to monitor the working conditions of their suppliers or face a consumer backlash.

Or consider how high a price a company should charge for its products. A long-term approach would weigh price, volume, and customer satisfaction to determine a price that creates sustainable value. That price would have to entice consumers to buy the products—not just once, but multiple times, for different generations of products. The company might still thrive at a lower price point, but there's no way to determine whether the value of a lower price is greater for consumers than the value of a higher price to shareholders, and indeed to all corporate stakeholders, without taking a long-term view.

Social consequences

Far more often, the lines are gray, not black or white. Companies in mature, competitive industries, for example, grapple with whether they should keep open high-cost plants that lose money, just to keep employees working and prevent suppliers from going bankrupt. To do so in a globalizing industry would distort the allocation of resources in the economy, notwithstanding the significant short-term local costs associated with plant closures. At the same time, politicians on both sides of the aisle pressure companies to keep failing plants open. Sometimes, the government is also a major customer of the company's products or services.

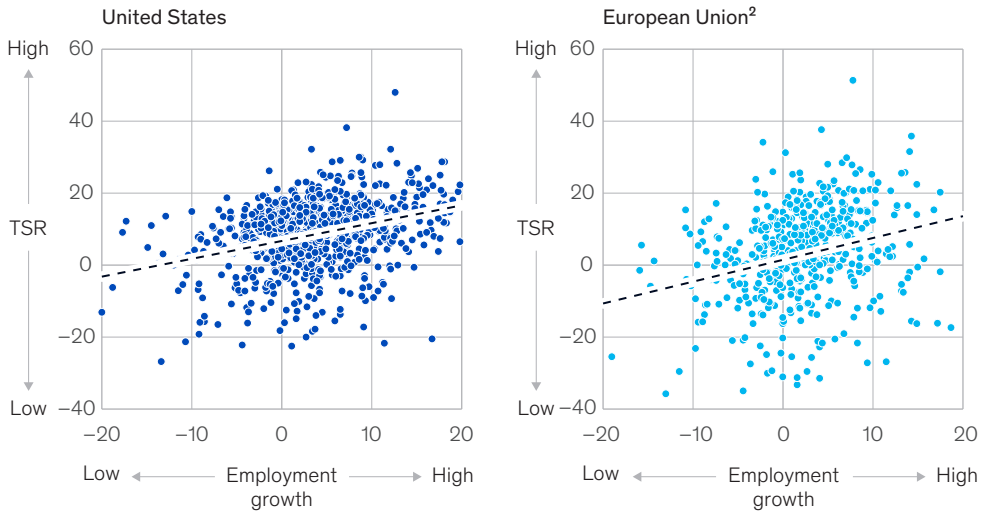
In our experience, managers not only carefully weigh bottom-line impact but also agonize over decisions that have pronounced consequences on workers' lives and community well-being. But consumers benefit when goods are produced at the lowest possible cost, and the economy benefits when operations that have become a drain on public resources are closed and employees move to new jobs with more competitive companies. And while it's true that employees often can't just pick up and relocate, it's also true that value-creating companies create more jobs. When examining employment, we found that the US and European companies that created the most shareholder value in the past 15 years have shown stronger employment growth (exhibit).⁶

⁶ We've performed the same analyses for 15- and 20-year periods and with different start and end dates and have always found similar results.

Exhibit

US and European companies that created the most shareholder value in the past 15 years have shown stronger employment growth.

Correlation between total shareholder returns (TSR) and employment growth, CAGR,¹ 2007–17, %



¹ CAGR = compound annual growth rate; sample includes companies with real revenues >\$500 million and excludes outliers with >20% employment growth.

² Sample includes companies in the core 15 EU member states.

Value creation is not a magic wand

Long-term value creation historically has been a massive force for public good, just as short-termism has proved to be a scourge. But short-termism isn't the only source for today's sense of crisis. Imagine, in fact, that short-termism were magically cured. Would other foundational problems suddenly disappear as well? Of course not. There are many trade-offs that company managers struggle to make, in which neither a shareholder nor a stakeholder approach offers a clear path forward. This is especially true when it comes to issues affecting people who aren't immediately involved with the company. These so-called externalities—perhaps most prominently, a company's carbon emissions affecting parties that otherwise have no direct contact with the company—can be extremely challenging for corporate decision making because there is no objective basis for making trade-offs among parties.

That's not to say that business leaders should just dismiss the problem of externalities as unsolvable, or something to be solved on a distant day. Punting is the essence of short-termism. With respect to the climate, some of the largest energy companies in the world, including BP and Shell, are taking bold measures right now toward carbon reduction, including tying executive compensation to emissions targets.

Still, the complexity is obvious for any individual company striving to comprehensively solve global threats such as climate change that will affect so many people, now and in the future. That places bigger demands on governments and investors. Governments can create incentives, regulations, and taxes that encourage a migration away from polluting sources of energy. Ideally, such approaches would work in harmony with market-oriented approaches, allowing creative destruction to replace aging technologies and systems with cleaner and more efficient sources of power. This trading off of different economic interests and time horizons is precisely what people charge their governments to do.

Institutional investors such as pension funds, as stewards of the millions of men and women whose financial futures are often at stake, can also play a critical supporting role. In the case of climate change, longer-term investors concerned with environmental issues such as carbon emissions, water scarcity, and land degradation are connecting value and long-term sustainability. Indeed, investor scrutiny has been increasing. Long-term-oriented companies must be attuned to long-term changes that will be demanded by both investors and governments, so that they can adjust their strategies over a five-, ten-, or 20-year time horizon and reduce the risk of stranded assets, or those that are still productive but not in use because of environmental or other issues.

Unfortunately, governments and long-term investors don't always play their roles effectively. Breakdowns can lead to divergences between shareholder value creation and the impact of externalities. Failure to price or control for externalities will also lead to a misallocation of resources. Those effects can create new stresses, and sometimes outright divisions, between shareholders and other stakeholders.

Yet as the Business Roundtable statement affirms, the interests of shareholders and stakeholders can go hand in hand. Businesses make a vital contribution by creating value for the long term. Doing so in a sustainable manner calls for meeting the concerns of communities (including the environment), consumers, employees, suppliers, and shareholders alike. A short-term focus necessarily shortchanges some or all of these constituencies. A long-term commitment toward value creation, by contrast, almost axiomatically takes a broad range of constituent interests into account. Of course, it's not the cure for all social ills (beware of anything that purports to be!), but a commitment to long-term value creation is something worth valuing indeed. Q

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