

# The Age of Customer Capitalism

For three decades, executives have made maximizing shareholder value their top priority. But evidence suggests that shareholders actually do better when firms put the customer first. *by Roger Martin*





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**M**odern capitalism can be broken down into two major eras. The first, managerial capitalism, began in 1932 and was defined by the then radical notion that firms ought to have professional management. The second, shareholder value capitalism, began in 1976. Its governing premise is that the purpose of every corporation should be to maximize shareholders' wealth. If firms pursue this goal, the thinking goes, both shareholders and society will benefit. This is a tragically flawed premise, and it is time we abandoned it and made the shift to a third era: **customer-driven capitalism.**

## TWO MILESTONES IN MANAGEMENT



In 1932, Adolf A. Berle (above) and Gardiner C. Means published their treatise *The Modern Corporation and Private Property*, endorsing the revolutionary idea that owners ought to turn companies over to professional managers.



After Michael C. Jensen and William H. Meckling published “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” in the *Journal of Financial Economics* in 1976, “maximizing shareholder value” became the new corporate mantra.

The first two eras were both heralded by an influential academic work. In 1932, Adolf A. Berle and Gardiner C. Means published their legendary treatise, *The Modern Corporation and Private Property*, which asserted that management should be divorced from ownership. After that, the business world would no longer be dominated by CEO owners like the Rockefellers, Mellons, Carnegies, and Morgans. Firms would be run by the hired help, a new class of professional CEO. This movement, said Berle and Means, was not to be feared; it was part of a brave new era of economic expansion (which would actually take a few years to get going, as it turned out, owing to the Great Depression).

While there certainly continued to be owner-CEOs, professional managers came to dominate the corner office. Entrepreneurs were welcome to start up new firms but would be wise to hand them over to professional managers, who were more dependable and less volatile, once the business reached a significant size.

Then in 1976 managerial capitalism received a stinging rebuke: Michael C. Jensen and William H. Meckling’s “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” published in the *Journal of Financial Economics*. The paper, which has gone on to become the most-cited academic business article of all time, argued that owners were getting short shrift from professional managers, who enhanced their own financial well-being rather than that of the shareholders. This was bad for shareholders and wasteful for the economy, Jensen and Meckling argued; the managers were squandering corporate and societal resources to feather their own nests.

Their critique ushered in the current era of capitalism, as CEOs quickly saw the need to swear allegiance to “maximizing shareholder value.” Boards of directors soon came to view their job as aligning the interests of senior management with those of shareholders through the use of stock-based compensation. No longer would the shareholder be abused—the shareholder would be king.

The two most critical figures of the shareholder movement were perhaps Roberto Goizueta, the CEO of Coca-Cola from 1981 until his death in 1997, and Jack Welch, the CEO of General Electric from 1981 to 2001. A speech that Welch gave at the Pierre Hotel in New York several months after his appointment is seen by many as the true dawn of the era of shareholder value. Though he didn’t use that term

explicitly, the speech marked a clear shift to a profits-first focus. Both men were outspoken advocates of focusing companies on shareholder value, and both received unprecedented amounts of stock-based compensation. Goizueta was the first American manager to become a billionaire on the basis of stock holdings in a company that he’d neither founded nor taken public. And it was estimated that Welch owned as much as \$900 million worth of GE stock at the time he left the company.

## A Flawed Logic



Have shareholders actually been better off since they displaced managers as the center of the business universe? The simple answer is no. From 1933 to the end of 1976, when they were allegedly playing second fiddle to professional managers, shareholders of the S&P 500 earned compound annual real returns of 7.6%. From 1977 to the end of 2008, they did considerably worse—earning real returns of 5.9% a year. If you modify the start and end dates of the two periods, you can produce performance numbers that are at parity, but there’s no sign that shareholders benefited more when their interests were put first and foremost. On this basis, it’s hard to argue that Jensen and Meckling did shareholders a huge favor.

That counterintuitive answer begs a provocative follow-up question: If the shareholders were all you cared about, would focusing on increasing shareholder value be the best way to make sure they benefited?

I believe that the answer to this question is also no. To create shareholder value, as I will show, you should instead aim to maximize customer satisfaction. In other words—and nobody should be surprised by this—Peter Drucker had it right when he said that the primary purpose of a business is to acquire and keep customers.

Wait a minute, you might say, why not have a dual objective of maximizing both customer satisfaction and shareholder value? Unfortunately, as optimization theory maintains, there is no way to simultaneously optimize two different things—that is, to maximize two desirable variables or minimize two undesirable variables. It is possible to maximize shareholder value given a minimum hurdle for customer satisfaction, or to maximize customer satisfaction given a minimum hurdle for shareholder value

## Idea in Brief

**The big idea:** It's time to discard the popular belief that corporations must focus first and foremost on maximizing value for shareholders. That idea is inherently, and tragically, flawed.

**The argument:** It's impossible to continually increase shareholder value, because stock prices are driven by shareholders' expectations about the future, which cannot be raised indefinitely.

**What the data show:** The focus on shareholder value hasn't done shareholders any favors. They have actually earned lower returns since corporations adopted it as their guiding principle.

**A better approach:** Make customer value the top priority, as Johnson & Johnson and Procter & Gamble have done. These two companies have generated shareholder returns that are at least as high as, if not higher than, those of leading shareholder-focused companies.

# The harder a CEO is pushed to increase shareholder value, the more the CEO will be tempted to make moves that actually hurt the shareholders.

appreciation, but you can't maximize both. (See the sidebar "Why There Can Be Only One Goal.")

While the concept of shareholder value maximization has always been attractive in its elegance, making it a reality has proved tricky for managers. This difficulty is unavoidable because of the way shareholder value is created. Let's look at that a little more closely.

Shareholders have a residual claim on a firm's assets and earnings, meaning they get what's left after all other claimants—employees and their pension funds, suppliers, tax-collecting governments, debt holders, and preferred shareholders (if any exist)—are paid. The value of their shares, therefore, is the discounted value of all future cash flows minus those payments. Since the future is unknowable, potential shareholders must estimate what that cash flow will be; their collective expectations about the future determine the stock price. Any shareholders who expect that the discounted value of future equity earnings of the company will be less than the current price will sell their stock. Any potential shareholders who expect that the discounted future value will exceed the current price will buy stock.

This means that shareholder value has almost nothing to do with the present. Indeed, present earnings tend to be a small fraction of the value of common shares. Over the past decade, the average yearly price-earnings multiple for the S&P 500 has been 27x, meaning that current earnings represent less than 4% of stock prices.

Undoubtedly, if expectations for a company's future performance are optimistic, shareholder value

will be high. In the fall of 2009 Google's stock traded at a price-earnings multiple near 35x because people believed the company's revenues and importance would continue to grow. Exxon Mobil's stock was trading around 12 times earnings because investors were pessimistic about the long-term future of the oil industry.

For managers, the implications of this are clear: The only sure way to increase shareholder value is to raise expectations about the future performance of the company. Unfortunately, executives simply can't do that indefinitely. Shareholders will look at good results, get excited, and ratchet up their expectations to the point where managers can't continue to meet them. Indeed, it is well documented that shareholders get both overly excited about good prospects and overly despondent about bad prospects. That is why stock markets are much more volatile than the earnings of the companies in them. At the end of 2001, the P/E multiple of the S&P 500 was a frothy 46x because shareholders thought that business had entered a "new paradigm." But when the euphoria ended, the P/E multiple drifted down to 19x and stayed near there until 2007, before rising to 25x in advance of the stock market crash in 2008.

Most executives figure this out; they come to understand that shareholder value creation and destruction are cyclical and, more important, not under their control. They can push shareholder value up in short bursts, but in due course, prices will fall again. So the executives invest in short-term strategies, hoping to get out before the inevitable crash, and often later criticize their successors for failing

to avoid preordained declines. Alternatively, they manage expectations downward so that they can steadily increase shareholder value for a longer period of time. (The financial reporting rules regarding intangible assets and goodwill make attempts to lower expectations extremely costly, however. See the sidebar “Are Accounting Rules Part of the Problem?”) In other words, because they can’t win the game they’re asked to play, CEOs translate it into a game that they can win.

This is why the goal of shareholder value maximization and the compensation approach that goes with it are bad for shareholders. The very executives who must achieve the goal realize that they can’t. Talented executives can grow market share and sales, increase margins, and use capital more efficiently, but no matter how good they are, they can’t increase shareholder value if expectations get out of line with reality. The harder a CEO is pushed to increase shareholder value, the more the CEO will be tempted to make moves that actually hurt the shareholders.

Take the poster boy for shareholder value maximization, Jack Welch. He is famous for transforming GE from a firm with a market capitalization of \$13 billion in 1981 into the most valuable company in the world, worth \$484 billion at his retirement, in 2001. Yet, to keep increasing shareholder value, Welch had to keep pushing the company to higher and higher growth. The biggest engine of growth at his disposal was an initially insignificant unit called GE Capital, which came to account for about half of GE’s earnings by the end of his career. Yet in 2009, GE took massive write-offs related to GE Capital and saw its market capitalization fall as low as \$75 billion. (This was early in the year, however; by September it had climbed back to \$170 billion.) While the \$471 billion increase in shareholder value that Welch oversaw seemed wonderful at the time of his retirement—particularly to shareholders selling out at the top—it is questionable how much shareholders benefited in the long term.

Roberto Goizueta’s story is similar. When he took the helm of Coca-Cola, its stock price had been stagnant for 20 years. Goizueta increased shareholder

## Why There Can Be Only One Goal

Linear programming is a mathematical technique for optimizing a given variable, subject to other constraints. For example, an oil refinery will use a linear program to maximize the dollar value of the output it produces (such as unleaded gasoline, heating oil, and jet fuel) from an incoming barrel of crude oil. Of course, the refinery

would have certain minimum constraints on the products required (for instance, a minimum of this much heating oil and that much regular unleaded gasoline). The constraints it sets will affect the maximum dollar value obtainable from the barrel of oil.

It’s important to understand that when people

value by a factor of more than 40 during his time as CEO. The company’s market cap peaked at \$180 billion shortly after his tenure, but it has never attained that lofty level again, and his successors have struggled to deal productively with the legacy of rapid growth and frenzied acquisition that took place on his watch.

## Let the Customers Take Over



etermining what your customers value and focusing on always pleasing them is a better optimization formula. Of course, companies face obvious constraints on customer satisfaction; they’d quickly go bankrupt if they made customers happier by charging ever-lower prices for ever-greater value. Rather, companies should seek to maximize customer satisfaction while ensuring that shareholders earn an acceptable risk-adjusted return on their equity.

Consider Johnson & Johnson. It has the corporate world’s single most eloquent statement of purpose—its “credo,” which hasn’t changed since J&J’s legendary chairman Robert Wood Johnson created it in 1943. Here it is, in abbreviated form:

“We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services.... We are responsible to our employees, the men and women who work with us throughout the world.... We are responsible to the communities in which we

**J&J has confidence that when customers are at the top of its list, shareholders will do just fine. So far, the bet has paid off.**

or computers perform the steps required for this kind of calculation, they can maximize or minimize only one variable. Michael Jensen makes this point forcefully in arguing that shareholder value maximization should be the single “objective function” of the firm. The only exception to this rule is when one of the variables is a subset of

another. For example, if I ask you to take a 1,000-gram ball of Play-Doh and maximize both the number of one-gram spheres and the number of one-gram cubes you create with it, it will be impossible for you to accomplish. The more balls, the fewer cubes; it is as simple as that. If instead I ask you to maximize the number of both objects and spheres, you

can do it because spheres are a subset of objects. You can make 1,000 spheres and also produce 1,000 objects.

Hence, the oil refinery cannot maximize both the value of its outputs and, say, the number of gallons of heating oil, no matter how sophisticated its linear program is. It has to pick one main objective function and

treat the others as constraints. Similarly, a firm cannot maximize both customer value and shareholder value. You have to choose, therefore, between making shareholder value your primary goal, subject to meeting a basic customer value hurdle, and making customer value your main goal, subject to creating a minimum shareholder value.

live and work and to the world community as well.... Our final responsibility is to our stockholders.... When we operate according to these principles, the stockholders should realize a fair return.”

The credo bluntly spells out the pecking order: Customers come first, and shareholders last. However, J&J has confidence that when customer satisfaction is at the top of the list, shareholders will do just fine.

So far, the bet has paid off. Take former CEO James Burke’s handling of the 1982 Tylenol poisonings, in which seven Chicago-area consumers died after ingesting Tylenol capsules that had been tampered with. J&J’s response is considered the textbook case of a company’s “doing the right thing” regardless of the impact on profits. The deaths occurred only in the Chicago area, but Burke promptly issued a recall of every capsule of Tylenol across America, even though the government hadn’t demanded it and Tylenol represented a fifth of J&J’s profits. After the recall, sales and market share plummeted.

Commentators expressed surprise that the CEO of a publicly traded company would throw thoughts of profit to the wind and heaped praise on Burke for taking an exemplary personal moral stance. One look at the credo, however, reveals that his decision was less about his personal morals and more about J&J’s clearly defined objectives. Arguably, Burke was simply following the credo as a dutiful CEO. Customers came first and stockholders came fourth—and he acted accordingly. He didn’t put meeting quarterly profit expectations at the top of his list. In fact, he put it squarely at the bottom.

In the long run, that decision didn’t hurt J&J at all. In fact, loyalty toward Tylenol soared after the company demonstrated that customer safety came first and also introduced the world’s first tamper-resistant packaging for over-the-counter health products. In September 2009, J&J’s market capi-

talization was \$167 billion, the ninth highest in the world. J&J seems to have indeed provided long-term shareholders more than a “fair return.”

Other companies have also done well by shareholders by not putting them first. P&G, the world’s biggest consumer products company, which had the world’s eighth-highest market capitalization in September, put the consumer at the center of its universe long ago. P&G’s statement of Purpose, Values and Principles, which was written in 1986, describes a hierarchy that is strikingly similar to J&J’s:

“We will provide branded products and services of superior quality and value that improve the lives of the world’s consumers.

“As a result, consumers will reward us with leadership sales, profit and value creation, allowing our people, our shareholders and the communities in which we live and work to prosper.”

Here, increased shareholder value is one of the by-products of a focus on customer satisfaction; it is clearly not the top priority.

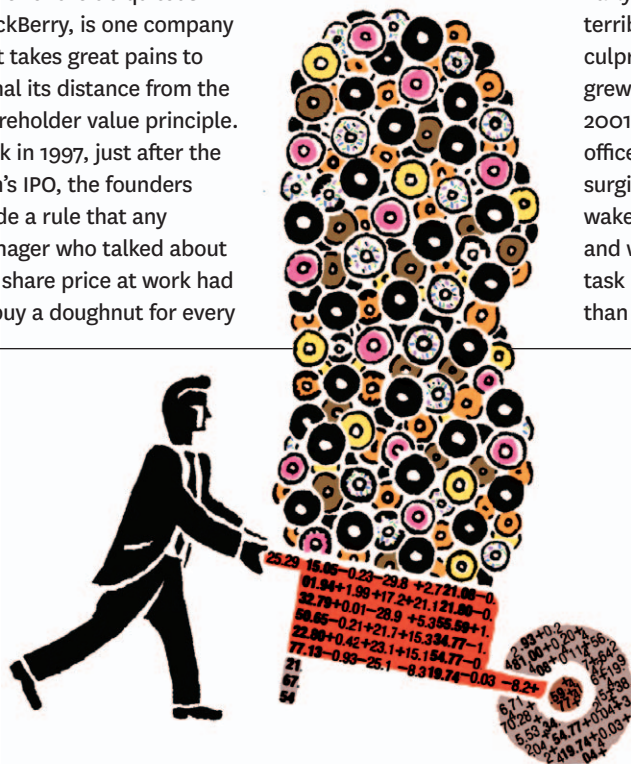
None of this means that the companies that pioneered the pursuit of shareholder value as their central objective did badly. They certainly did not. General Electric and Coca-Cola are still among the world’s top 25 firms by market cap (at #6 and #22, respectively, in September). During the Welch and Goizueta eras, both companies grew shareholder value reasonably faster than the S&P 500 did; the compound annual growth rate of GE’s total shareholder return was 12.3% versus 10% for the S&P 500, and Coke’s was 15% to the S&P 500’s 10.8%. But neither company has managed to create more shareholder value over the long term than leading companies that tell shareholders in no uncertain terms to get to the back of the corporate bus. J&J and P&G have created the most shareholder value in their respective sectors. And when you put them head-to-head against GE in the period after Welch became CEO, they again

## Doughnuts and BlackBerrys

Research in Motion (RIM), maker of the ubiquitous BlackBerry, is one company that takes great pains to signal its distance from the shareholder value principle. Back in 1997, just after the firm's IPO, the founders made a rule that any manager who talked about the share price at work had to buy a doughnut for every

person in the company. Early infractions were not terribly painful for the culprit, but as the company grew, that changed. In 2001, the chief operating officer mentioned RIM's surging stock price in the wake of a call with analysts and was saddled with the task of delivering more than 800 doughnuts to

the next weekly meeting of employees. He even had to make special arrangements with local doughnut shops to get enough. That incident apparently seared the doughnut rule into the neurons of managers at RIM, which hasn't recorded an infraction since then.



look better: Returns grew at a compound annual rate of 15.2% at P&G, 14.5% at J&J, and 12.3% at GE. J&J and P&G's performance was about the same as Coke's, with compound annual growth rates of 15.0% and 14.6%, respectively, versus Coke's rate of 15.1%, in the period after Goizueta was appointed CEO.

### The Principle at Work



Why is it that companies that don't focus on maximizing shareholder value deliver such impressive returns? Because their CEOs are

free to concentrate on building the real business, rather than on managing shareholder expectations. When A.G. Lafley took over as CEO at P&G, he was comfortable, within the context of P&G's culture, telling the shareholders that things would continue to get worse in the near term because the company needed to fix a number of its business fundamentals, and that would take time. Most CEOs would be hesitant to send that message to Wall Street and would attempt quick, rather than meaningful, fixes. And most boards would discourage if not outright disallow such communications to shareholders.

Perhaps the most telling indication of the shareholders' new status at P&G was Lafley's decision

to remove the screens that tracked the company's stock price from its headquarters. These had been installed throughout the office by the previous CEO to encourage employees to focus on creating shareholder value. Lafley is by no means alone in realizing the importance of such symbolic acts. Research in Motion, the company that makes the ubiquitous BlackBerry, did something similar. (See the sidebar "Doughnuts and BlackBerrys.")

Compensation is another key point of difference. When companies aren't bent on increasing shareholder value, their boards generally don't distract their CEOs with stock-based compensation that is short-term focused or realized at retirement. Short-term rewards encourage CEOs to manage short-term expectations rather than push for real progress. And rewards priced at the time of retirement only get CEOs to manage to the finish line. If, like a marathon runner, the company crashes to the ground after crossing it, that's someone else's problem. One has only to look at a historical stock chart for GE to see the impact of Welch's retirement-oriented stock compensation. It's clear that his successor, Jeff Immelt, inherited a company suffering from the classic problems associated with a fixation on the finish line. Even if he manages outstandingly, Immelt will have little, if any, chance to get shareholder value back to where it was when he took over.

The structure of Lafley's compensation at P&G, by contrast, was indicative of a company with a culture of maximizing customer satisfaction. Approximately 90% of his total compensation was in stock options or restricted stock. While that's not highly unusual for today's CEOs, the stock options had a particularly long vesting period—three years—and a two-year subsequent holding period. Lafley also chose to hold options twice as long as required and to sell shares only under the restrictions of a planned-sale program. As for the restricted stock, which represented

a significant portion of Lafley's incentive compensation, none of it actually vested before or even at retirement. The vesting period will begin a year after his retirement and will last 10 years. Had Lafley managed shareholders' expectations to peak at his retirement, only to fall off thereafter, he would have hurt his own compensation. Hence, for his entire tenure as CEO, he had the incentive to build the business for the very long term, groom a great successor, and leave P&G in excellent condition.

Many executives would take exception to compensation arrangements like Lafley's, arguing that they'd be unfairly exposed to the mistakes of their successors. That is where culture comes in. P&G's compensation system would indeed be unfair in a culture in which compensation is stock-based and short-term-oriented, in which it is "every man for himself." In such cultures, it is difficult to install longer-term compensation, so the culture inevitably remains "every man for himself." However, in a culture oriented toward serving the customer, a compensation structure like Lafley's makes lots of sense and isn't difficult to install—and it reinforces the behaviors that build real value for the long term.

Even when customer value maximization is the primary objective, the culture is right, and stock-based compensation has exceedingly long vesting periods, the siren call of shareholder value maxi-

mization is ever present. At P&G, Lafley inherited a year-old compensation system that tied rewards for senior executives to total shareholder return (TSR), which was defined as the increase in share price plus dividends (if reinvested in stock) over a three-year period. Under the system, P&G's TSR was benchmarked against that of a peer group; if the company's TSR was in the upper half of the group, the executives received bonuses.

Lafley, however, quickly noticed that great TSR performance in a given year was routinely followed by poor performance the next year, because high total shareholder returns were spurred by a pronounced jump in expectations that simply couldn't be reproduced the next year. He came to realize that increases in shareholder value had very little to do with real business performance and a lot to do with the fertile imaginations of shareholders, who were speculating what the company's future might hold. This insight prompted Lafley to switch the bonus metric from TSR to something called operating TSR, which is based on a combination of three real operating performance measures—sales growth, profit margin improvement, and increase in capital efficiency. His belief was that if P&G satisfied its customers, operating TSR would increase, and the stock price would take care of itself over the long term. Moreover, operating TSR is a number that P&G's business unit presidents can truly influence, unlike the market-based TSR number.

## Are Accounting Rules Part of the Problem?

The doctrine of shareholder value maximization is actually embedded in the U.S. rules governing financial reporting. In June 2001 the Financial Accounting and Standards Board (FASB) issued Statement 142, which changed the way auditors treat intangible assets and goodwill.

Previously, companies had to write down intangible assets and goodwill over time, on a fixed amortization schedule. Statement 142 ended this practice and mandated that auditors instead had to declare annually whether intangible assets and goodwill were "impaired" or had retained their value. If they were impaired, the auditors had to write the assets down to current market value.

In determining whether an asset is impaired, auditing firms now compare their calculations for the value of a company's discounted future cash flows with the current shareholder value—as determined by the current stock price. If the shareholder value is deemed too low relative to the estimated discounted cash flows, the auditor would have cause to write down the assets of the firm.

As a consequence, CEOs who fail to manage shareholder expectations upward risk being forced to take a sizable write-down on their company's assets—and the announcement could very well set off a downward spiral of further reduced expectations and further write-downs.

**OF COURSE**, not every company that puts customer satisfaction first will be a P&G or a J&J. But I firmly believe that if more companies made customers the top priority, the quality of corporate decision making would improve because thinking about the customer forces you to focus on improving your operations and the products and services you provide, rather than on spinning lines to shareholders. This does not mean that you will lose cost discipline; the profit motive will not go away. Managers like profits just as much as shareholders do, because the more profits the firm makes, the more money is available to pay managers. In other words, the need for a healthy share price is a natural constraint on any other objective you set. Making it the prime objective, however, creates the temptation to trade long-term gains in operations-driven value away for temporary gains in expectations-driven value. To get CEOs to focus on the first, we need to reinvent the purpose of the firm. ♥

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