CHAPTER 2: SHAREHOLDERS' VALUE

Maximizing shareholder value has become a favourite catchphrase among business commentators and academics over the past years. The signs of this phenomenon abound. A quick scan of the business section in any bookstore reveals a growing number of titles on the subject. The mass media provides extensive coverage of the day's stock movements. New MBAs enter the workforce preaching that the shareholder is king. And scarcely a day passes when today's executives are not called upon to defend their business strategies on the basis of increasing shareholder wealth.

These quick observations signal a more serious trend. Today, more than ever before, CEOs and their companies are held accountable for the proper stewardship of shareholders funds. Management's tenure is increasingly linked to the value they create, as measured by both the dividends the owners receive and the company's appreciation in stock price. While this trend has been observable globally for some time now it is a far more recent development in Asia, hastened by the economic crisis that has gripped this region since early 1997. Scarcity of capital, combined with a much tougher operating environment, has intensified scruting of Asian CEOs and their companies to an extent not witnessed previously. Companies are experiencing a rapid transformation of their businesses by a multitude of forces. Changes in technologies, business design and international competition make management's strategic and operating decisions more complex. As companies strive to exceed shareholders' expectations, the creation of value is fundamental to the success of the directors and management.

Shareholder value has become one of the most frequently used expressions in international business, and one of the least understood. Senior executives from around the world pay lip service to the concept, but do not always understand how to deliver it. Institutions look for shareholders value in they invest in, but do not necessarily find it.

Shareholder value is simply the market price of a company's equity capital. That is, the share price multiplied by the number of shares in issue. The share price is important in many ways. It is the most compelling measure of company's financial performance. It is the basis of senior executives' pay package, and it is the way management is judged by international capital markets.

Shareholder value, more specifically the creation of shareholder value rather than its destruction, is the main criterion on which institutional investors such as pension funds and mutual funds make their investments. They put their money where they think value is going to be created, and they withdraw it when they judge that value will be squandered.

Fund manager influence has grown with the globalization of the world's capital markets. Companies from all around the world are competing for capital on the same terms. Those that generate value attract the investment; those that don't will find themselves starved of capital resources. And the ability to raise capital on the most favorable terms is the key factor in a company's ability to compete.

The large volume of privatizations over recent years has added to the pool of companies competing for capital. Increasingly large amounts of capital are concentrated in the hands of institutional investors. Industry has been deregulated. All these factors increase pressure to generate superior financial returns, leading to a focus on a shareholder value.

Most fund managers evaluate shareholder value by discounting future cash flows. They work out how much a company should have to pay for its capital (cost of capital) and use this as a discount rate to work out the value of future cash flows in today's money. They can decide whether a company is under-or over-valued in relation to its future ability to make cash, and make their investment decisions accordingly. They back companies that are creating shareholder value – that is, those whose cash returns exceed their cost of capital; they sell those doing the opposite – destroying shareholder value.

In many companies the all-important quest for value is being confounded by a hopelessly obsolete financial management system. The wrong financial goals, performance measures, and valuation procedures are emphasized. Managers are improperly and in many cases inadequately rewarded for their efforts. Balance sheets are but dully structured when surgical sharpness often is needed. These shortcomings cry out for approaches to financial management so profoundly different from current ones that nothing less than a revolution in thinking is called for.