SHAREHOLDER VALUE AND BEYOND

Michel Aglietta and Antoine Rebérioux

for the TUAC panel

October 11, 2005

SHAREHOLDER VALUE AND BEYOND

- Shareholder sovereignty and shareholder value: a critical view
- Stakeholder view of corporate governance
- Improving on capital market imperfections and institutional investor behavior

WHAT IS SHAREHOLDER SOVEREIGNTY?

Shareholder sovereignty can be defined at three levels :

- Legal and economic **theory of the firm**
- Mode of **control** of the corporation by the stock market
- A **rule of business conduct** for managers: EVA

WHAT IS SHAREHOLDER SOVEREIGNTY?

A legal theory of ownership ?

It cannot be an absolute ownership right of an individual on :

- Productive assets
- Labor: the power on labor refers to subordination in coordinating the use of capabilities not to the absolute control on an object
- The firm

WHAT IS SHAREHOLDER SOVEREIGNTY?

An economic theory of the firm ?

– Firm as a "*nexus of contracts*".

– Shareholders as the only residual claimers

HOW IS CONTROL FULFILLED?

Firms must maximize the return on shareholder investment.

But dispersed shareholders cannot control directly : cf. Berle and Means 1932

HOW IS CONTROL FULFILLED?

The controlling entity is the Stock market. But it is an abstract mechanism whose ways of control require mediations:

- Threats and incentives to align managers' conduct on shareholders' interest: *market for control* and *stock options*
- *Gatekeepers* : *Analysts*, *rating agencies*, *investment bankers* and the like who help assess the profit-generating capacity of firms
- A delegated institution to check that managers maximize shareholder return: the *Board of Directors*

SHORTCOMINGS OF A PRO-SHAREHOLDER GOVERNANCE

- EVA → required ROE> Market Return

  The latter becomes a *minimal*, rather than an *equilibrium* return, yield to give a *rent* to shareholders called *shareholder value*.

Pursued as a management commitment, shareholder value conveys imbalances in capital markets

SHORTCOMINGS OF A PRO-SHAREHOLDER GOVERNANCE

Shareholder value provides wrong incentives:

- M&A and LBO to boost share prices due to financial appeal with dire future economic impact
- Share buybacks to increase ROE
- Debt-financing leverages financial structures to raise ROE
- Asset light strategies through SPV (the Enron syndrome).

SHORTCOMINGS OF A PRO-SHAREHOLDER GOVERNANCE

Shareholder value feeds an unbalanced dynamic in capital markets:

- Speculation drives Stock market prices well above their fundamental values (bubbles)
- Debt-financing leverages financial structures to raise ROE

→ *A vicious circle of credit expansion and asset price overvaluation fosters a fragile financial structure due to the under-pricing of risk*

SHORTCOMINGS OF A PRO-SHAREHOLDER GOVERNANCE

The crash of the bubble reveals financial fragility.

Deterioration of credit quality+ compliance with shareholder value $\longrightarrow$ Balance Sheet Restructuring:

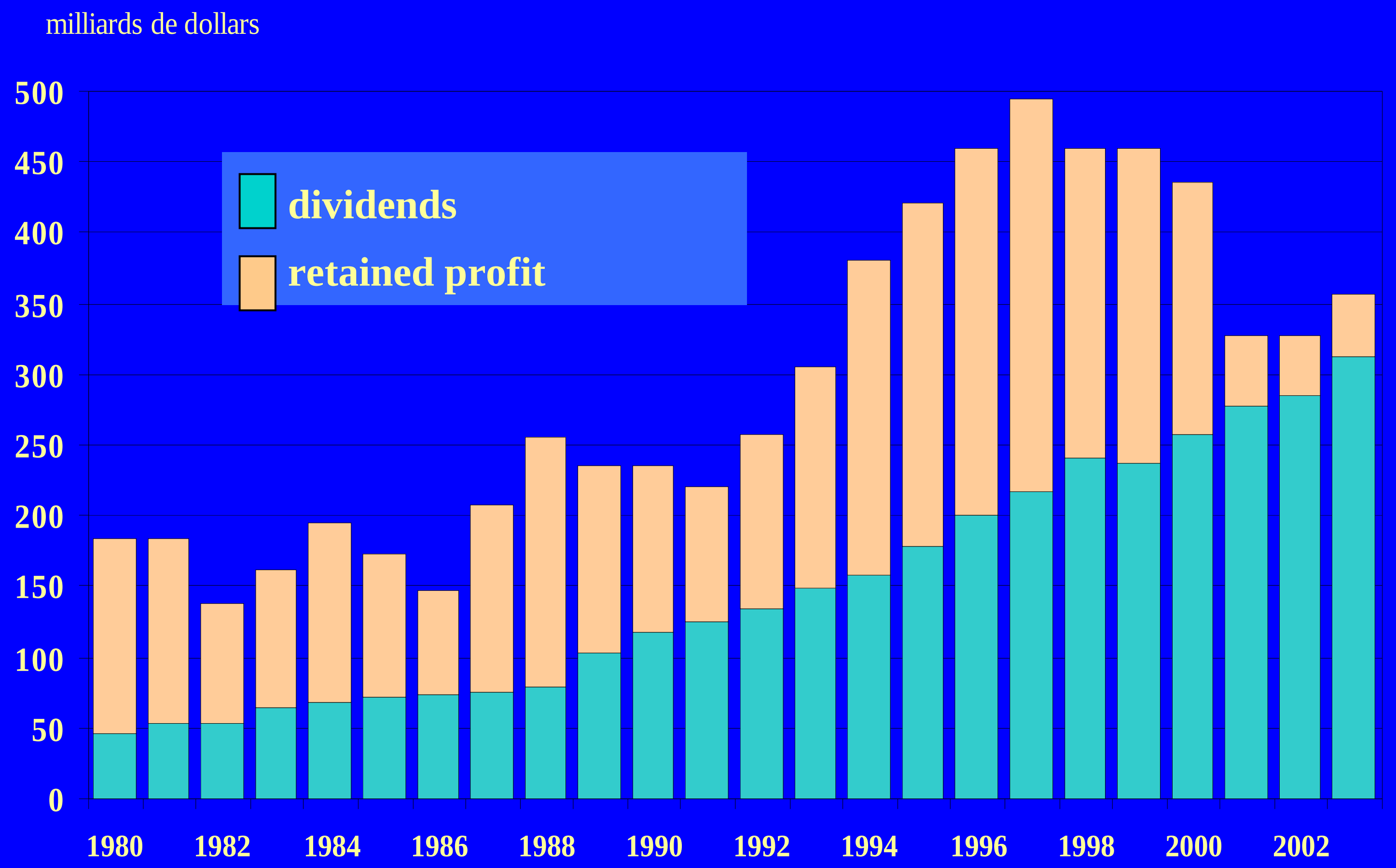
- Priority to debt reduction: corporations become *suppliers* of finance instead of *absorbers* of finance
- Heavy distribution of dividends to preserve the return to shareholders despite their capital losses
- Savage cuts in productive investment followed by parsimonious productivity-enhancing capital appropriations
- Pressures on labor costs to stabilize profit margins and shift risk onto labor

Net financial balance (on average per period, as % of GDP)

Countries and economic areas	1996-2000	2001-2004
USA	-5.0	+6.0
Euro Zone	-4.0	+3.8
UK	-6.3	+8.2

Source : J. P. Morgan Research, Corporates are driving the global saving glut, June 24, p.4.

Evolution of dividends as a proportion of total net profits (before tax) for non-financial companies (excluding farming) in the USA



STAKEHOLDER VIEW OF CORPORATE GOVERNANCE: THE CORPORATION

The corporation: legal entity versus nexus of contracts

- Capital is not an object of ownership for shareholders. It is a social process: *a self-generating value.* Valorization is the aim of capital independently of any subjective will.

- This abstract aim is given a legal form in the *corporation*: it holds property rights on capital by destination (valorization).

- To fulfill the aim of capital, the corporation is the owner of the *firm*: the organization (collective structure) where valorization is performed

STAKEHOLDER VIEW OF CORPORATE GOVERNANCE: THE FIRM

- Within the firm, capital becomes a bundle of capabilities (human, material, informational) gathered in the aim of valorization
- The firm: organization *coordinating* complementary capabilities in view of fulfilling the aim of the corporation
- Coordination makes the firm a *locus of power*. It is the power of *management* regulated by *a norm of governance*

STAKEHOLDER VIEW OF CORPORATE GOVERNANCE: BOARD OF DIRECTORS

From the aim of capital to the norm of governance

Ownership by destination corporation	Assigns →	Rights to organize Firm	Allocates →	Power to control Stakeholders

- The firm produces an organizational quasi-rent stemming from the coordination of specific and complementary capabilities
- The mode of coordination depends on the norm of governance which is the source of the power of management. It shall be submitted to the control of the Board of Directors

STAKEHOLDER VIEW OF CORPORATE GOVERNANCE: THE COMMON INTEREST

- Stakeholders bear multiple interests that should be represented in the Board of Directors
- The latter defines a *common objective* by deliberation and embodies it in a norm of corporate governance
- It exerts control over the executive management:

→ Separation chairman of the Board/CEO

→ Organs of inside control (audit and other committees) under the authority of the Board and separated from executive management

→ Criteria and tools of control (financial and non-financial) to assess the performance of management

WHY DO SOCIAL ISSUES IMPINGE UPON THE OBJECTIVES OF CORPORATIONS ?

Social pressures on corporate governance reveal factors which impact the economic return and the long-run competitiveness of firms but are ignored in financial analysis under shareholder value:

- Consumer protection and public safety
- Rising costs of social conflicts and workers’ lack of motivation in knowledge economies
- Non-price competition in network economies
- Implication of public constituencies: environmental risk, scarce resources and concern for the territorial distribution of productive activities

STAKEHOLDER VIEW OF CORPORATE GOVERNANCE: EMPOWERING LABOR

- **Labor has incentives to participate in governance :**
  - Human capital as specific capabilities in interaction with other productive assets (collective knowledge)
  - Legal protection of labor rights has declined with the surge of global competition
  - Labor representatives are independent of management with a knowledge of inside rules and corporate culture

- **Degrees of labor participation in decision-making:**
  - *Works councils*: information, consultations, negotiations with management and report to the Board
  - Outright representation in the Board as independent directors

CHALLENGES FOR INSTITUTIONAL INVESTORS

Inefficiencies in financial asset management

- Ultimate savers in the USA have no control on the allocation of their wealth:
  - No formal participation of savers in the strategic allocation of their saving
  - Pension funds and mutual funds gather huge amount of saving, delegate the management to professionals and exert dubious control.

CHALLENGES FOR INSTITUTIONAL INVESTORS

- Perverse effects of delegated management:
  - High costs because asset managers extract huge profits
  - Dual strategies: benchmark-tracking portfolios and high-risk, high-turnover funds
  - Cut-throat competition between fund managers entails a short-run bias in assessing performance

CHALLENGES FOR INSTITUTIONAL INVESTORS

Institutional investors have incentives to move beyond financial management

- With the sheer size of their assets
- With the long-run nature and the social contract embodied in their liabilities (retirement funds and employee collective saving plans)

Long-run strategies call for tighter control on saving allocation and more involvement in corporate governance

CHALLENGES FOR INSTITUTIONAL INVESTORS

- Workers should have a say on the strategies of pension and other collective funds via *supervisory boards*
- As long-run shareholders the funds should vote on explicit agendas in general assemblies and appoint directors on the board of companies to promote social responsibility
- Institutional investors have incentive to demand the development of non-financial criteria of business performance and their integration in the strategic planning of the corporations