Part One

Foundations of Value

1

Why Value Value?

The guiding principle of business value creation is a refreshingly simple construct: companies that grow and earn a return on capital that exceeds their cost of capital create value. Articulated as early as 1890 by Alfred Marshall,[1] the concept has proven to be both enduring in its validity and elusive in its application.

Nevertheless, managers, boards of directors, and investors sometimes ignore the foundations of value in the heat of competition or the exuberance of market euphoria. The tulip mania of the early 1600s, the dot-coms that soared spectacularly with the Internet bubble, only then to crash, and the mid-2000's real estate frenzy whose implosion touched off the financial crisis of 2007–2008 can all to some extent be traced to a misunderstanding or misapplication of this guiding principle.

At other moments, the system in which value creation takes place comes under fire. That happened at the turn of the twentieth century in the United States, when 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 many people are again questioning the foundations of capitalism, especially shareholder-oriented capitalism. Challenges such as globalization, climate change, income inequality, and the growing power of technology titans have shaken public confidence in large corporations.[2] Politicians and commentators push for more regulation and fundamental changes in corporate

[1] A. Marshall, *Principles of Economics* (New York: Macmillan, 1890), 1:142.

[2] 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 Gallup, "Confidence in Institutions," www.gallup.com.

governance. Some have gone so far as to argue that "capitalism is destroying the earth."[3]

Many business leaders share the view that change is needed to answer society's call. In August 2019, Business Roundtable, an association of chief executives of leading U.S. corporations, released its Statement on the Purpose of a Corporation. The document's 181 signers declared "a fundamental commitment to <u>all</u>[4] of our stakeholders."[5] The executives 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."

The statement's focus on the future is no accident: issues such as climate change have raised concerns that today's global economic system is shortchanging the future. It is a fair critique of today's capitalism. Managers too often fall victim to short-termism, adopting a focus on meeting short-term performance metrics rather than creating value over the long term. There also is evidence, including the median scores of companies tracked by McKinsey's Corporate Horizon Index from 1999 to 2017, that this trend is on the rise. The roots of short-termism are deep and intertwined, so a collective commitment of business leaders to the long-term future is encouraging.

As business leaders wrestle with that challenge, not to mention broader questions about purpose and how best to manage the coalescing and colliding interests of myriad owners and stakeholders in a modern corporation, they will need a large dose of humility and tolerance for ambiguity. They'll also need crystal clarity about the problems their communities are trying to solve. Otherwise, confusion about objectives could inadvertently undermine capitalism's ability to catalyze progress as it has in the past, whether lifting millions of people out of poverty, contributing to higher literacy rates, or fostering innovations that improve quality of life and lengthen life expectancy.

As business leaders strive to resolve all of those weighty trade-offs, we hope this book will contribute by clarifying the distinction between creating shareholder value and maximizing short-term profits. Companies that conflate the two often put both shareholder value *and* stakeholder interests at risk. In the first decade of this century, banks that acted as if maximizing short-term profits would maximize value precipitated a financial crisis that ultimately destroyed billions of dollars of shareholder value. Similarly, companies whose short-term focus leads to environmental disasters destroy shareholder value by incurring cleanup costs and fines, as well as via lingering reputational damage. The best managers don't skimp on safety, don't make value-destroying decisions just

[3] G. Monbiot, "Capitalism Is Destroying the Earth; We Need a New Human Right for Future Generations," *Guardian*, March 15, 2019, www.guardian.com.
[4] Emphasis added by Business Roundtable.
[5] Kevin Sneader, the global managing partner of McKinsey & Company, is a signatory of the statement.

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 all stakeholders, including shareholders. They are the antithesis of value creation.

To dispel such misguided notions, this chapter begins by describing what value creation *does* mean. We then contrast the value creation perspective with short-termism and acknowledge some of the difficulties of value creation. We offer guidance on reconciling competing interests and adhering to principles that promote value creation. The chapter closes with an overview of the book's remaining topics.

WHAT DOES IT MEAN TO CREATE SHAREHOLDER VALUE?

Particularly at this time of reflection on the virtues and vices of capitalism, it's critical that managers and board directors have a clear understanding of what value creation means. For 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 collective value to its shareholders, now and in the future.

If investors knew as much about a company as its managers do, maximizing its current share price might be equivalent to maximizing its value over time. But in the real world, investors have only a company's published financial results and their own assessment of the quality and integrity of its management team. For large companies, it's difficult even for insiders to know how financial results are generated. Investors in most companies don't know what's really going on inside a company or what decisions managers are making. They can't know, for example, whether the company is improving its margins by finding more efficient ways to work or by skimping on product development, resource management, maintenance, or marketing.

Since investors don't have complete information, companies can easily pump up their share price in the short term or even longer. One global consumer products company consistently generated annual growth in earnings per share (EPS) between 11 percent and 16 percent for seven years. Managers attributed the company's success to improved efficiency. Impressed, investors pushed the company's share price above those of its peers—unaware that the company was shortchanging its investment in product development and brand building to inflate short-term profits, even as revenue growth declined. Finally, managers had to admit what they'd done. Not surprisingly, the company went through a painful period of rebuilding. Its stock price took years to recover.

It would be a mistake, however, to conclude that the stock market is not "efficient" in the academic sense that it incorporates all public information. Markets do a great job with public information, but markets are not omniscient. Markets cannot price information they don't have. Think about the analogy of selling an older house. The seller may know that the boiler makes a weird sound every once in a while or that some of the windows are a bit drafty. Unless the seller discloses those facts, a potential buyer may have great difficulty detecting them, even with the help of a professional house inspector.

Despite such challenges, the evidence strongly suggests that companies with a long strategic horizon create more value than those run with a short-term mindset. Banks that had the insight and courage to forgo short-term profits during the last decade's real-estate bubble, for example, earned much better total shareholder returns (TSR) over the longer term. In fact, when we studied the patterns of investment, growth, earnings quality, and earnings management of hundreds of companies across multiple industries between 2001 and 2014, we found that companies whose focus was more on the long term generated superior TSR, with a 50 percent greater likelihood of being in the top decile or top quartile by the end of that 14-year period.[6] In separate research, we've found that long-term revenue growth—particularly organic revenue growth—is the most important driver of shareholder returns for companies with high returns on capital.[7] What's more, investments in research and development (R&D) correlate powerfully with long-term TSR.[8]

Managers who create value for the long term do not take actions to increase today's share price if those actions will damage the company down the road. For example, they don't shortchange product development, reduce product quality, or skimp on safety. When considering investments, they take into account likely future changes in regulation or consumer behavior, especially with regard to environmental and health issues. Today's managers face volatile markets, rapid executive turnover, and intense performance pressures, so making long-term value-creating decisions requires courage. But the fundamental task of management and the board is to demonstrate that courage, despite the short-term consequences, in the name of value creation for the collective interests of shareholders, now and in the future.

SHORT-TERMISM RUNS DEEP

Despite overwhelming evidence linking intrinsic investor preferences to long-term value creation,[9] too many managers continue to plan and execute strategy—and then report their performance—against shorter-term measures, particularly earnings per share (EPS).

[6] *Measuring the Economic Impact of Short-Termism*, McKinsey Global Institute, February 2017, www.mckinsey.com.
[7] B. Jiang and T. Koller, "How to Choose between Growth and ROIC," *McKinsey on Finance*, no. 25 (Autumn 2007): 19–22, www.mckinsey.com. However, we didn't find the same relationship for companies with low returns on capital.
[8] We've performed the same analyses for 15 and 20 years and with different start and end dates, and we've always found similar results.
[9] R. N. Palter, W. Rehm, and J. Shih, "Communicating with the Right Investors," *McKinsey Quarterly* (April 2008), www.mckinsey.com. Chapter 34 of this book also examines the behaviors of intrinsic and other investor types.

As a result of their focus on short-term EPS, major companies often pass up long-term value-creating opportunities. For example, a relatively new CFO of one very large company has instituted a standing rule: every business unit is expected to increase its profits faster than its revenues, every year. Some of the units currently have profit margins above 30 percent and returns on capital of 50 percent or more. That's a terrific outcome if your horizon is the next annual report. But for units to meet that performance bar right now, they are forgoing growth opportunities that have 25 percent profit margins in the years to come. Nor is this an isolated case. In a survey of 400 chief financial officers, two Duke University professors found that fully 80 percent of the CFOs said they would reduce discretionary spending on potentially value-creating activities such as marketing and R&D in order to meet their short-term earnings targets.[10] In addition, 39 percent said they would give discounts to customers to make purchases this quarter rather than next, in order to hit quarterly EPS targets. That's no way to run a railroad—or any other business.

As an illustration of how executives get caught up in a short-term EPS focus, consider our experience with companies analyzing a prospective acquisition. The most frequent question managers ask is whether the transaction will dilute EPS over the first year or two. Given the popularity of EPS as a yardstick for company decisions, you might think that a predicted improvement in EPS would be an important indication of an acquisition's potential to create value. However, there is no empirical evidence linking increased EPS with the value created by a transaction.[11] Deals that strengthen EPS and deals that dilute EPS are equally likely to create or destroy value.

If such fallacies have no impact on value, why do they prevail? The impetus for a short-term view varies. Some executives argue that investors won't let them focus on the long term; others fault the rise of activist shareholders in particular. Yet our research shows that even if short-term investors cause day-to-day fluctuations in a company's share price and dominate quarterly earnings calls, longer-term investors are the ones who align market prices with intrinsic value.[12] Moreover, the evidence shows that, on average, activist investors strengthen the long-term health of the companies they pursue—for example, challenging existing compensation structures that encourage short-termism.[13] Instead, we often find that executives themselves or their boards are the source of short-termism. In one relatively recent survey of more than 1,000 executives and board members, most cited their own executive teams

[10] J. R. Graham, C. R. Harvey, and S. Rajgopal, "Value Destruction and Financial Reporting Decisions," *Financial Analysts Journal* 62, no. 6 (2006): 27–39.
[11] R. Dobbs, B. Nand, and W. Rehm, "Merger Valuation: Time to Jettison EPS," *McKinsey Quarterly* (March 2005), www.mckinsey.com.
[12] Palter et al., "Communicating with the Right Investors."
[13] J. Cyriac, R. De Backer, and J. Sanders, "Preparing for Bigger, Bolder Shareholder Activists," *McKinsey on Finance* (March 2014), www.mckinsey.com.

and boards (rather than investors, analysts, and others outside the company) as the greatest sources of pressure for short-term performance.[14]

The results can defy logic. At a company pursuing a major acquisition, we participated in a discussion about whether the deal's likely earnings dilution was important. One of the company's bankers said he knew any impact on EPS would be irrelevant to value, but he used it as a simple way to communicate with boards of directors. Elsewhere, we've heard company executives acknowledge that they, too, doubt the importance of impact on EPS but use it anyway, "for the benefit of Wall Street analysts." Investors also tell us that a deal's short-term impact on EPS is not that important. Apparently, everyone knows that a transaction's short-term impact on EPS doesn't matter. Yet they all pay attention to it.

The pressure to show strong short-term results often builds when businesses start to mature and see their growth begin to moderate. Investors continue to bay for high profit growth. Managers are tempted to find ways to keep profits rising in the short term while they try to stimulate longer-term growth. However, any short-term efforts to massage earnings that undercut productive investment make achieving long-term growth even more difficult, spawning a vicious circle.

Some analysts and some short-term-oriented investors will always clamor for short-term results. However, even though a company bent on growing long-term value will not be able to meet their demands all the time, this continuous pressure has the virtue of keeping managers on their toes. Sorting out the trade-offs between short-term earnings and long-term value creation is part of a manager's job, just as having the courage to make the right call is a critical personal quality. Perhaps even more important, it is up to corporate boards to investigate and understand the economics of the businesses in their portfolio well enough to judge when managers are making the right trade-offs and, above all, to protect managers when they choose to build long-term value at the expense of short-term profits.

Improving a company's corporate governance proposition might help. In a 2019 McKinsey survey, an overwhelming majority of executives (83 percent) reported that they would be willing to pay about a 10 percent median premium to acquire a company with a positive reputation for environmental, regulatory, and governance (ESG) issues over one with a negative reputation.

[14] Commissioned by McKinsey & Company and by the Canada Pension Plan Investment Board, the online survey, "Looking toward the Long Term," was in the field from April 30 to May 10, 2013, and garnered responses from 1,038 executives representing the full range of industries and company sizes globally. Of these respondents, 722 identified themselves as C-level executives and answered questions in the context of that role, and 316 identified themselves as board directors and answered accordingly. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global gross domestic product (GDP). For more, see J. Bailey, V. Bérubé, J. Godsall, and C. Kehoe, "Short-termism: Insights from Business Leaders," FCLTGlobal, January 2014, https://www.fcltglobal.org.

Investors seem to agree; one recent report found that global sustainable investment topped $30 trillion in 2018, rising 34 percent over the previous two years.[15]

Board members might also benefit from spending more time on their board activities, so they have a better understanding of the economics of the companies they oversee and the strategic and short-term decisions managers are making. In a survey of 20 UK board members who had served on the boards of both exchange-listed companies and companies owned by private-equity firms, 15 of 20 respondents said that private-equity boards clearly added more value. Their answers suggested two key differences. First, private-equity directors spend on average nearly three times as many days on their roles as do those at listed companies. Second, listed-company directors are more focused on risk avoidance than value creation.[16]

Changes in CEO evaluation and compensation might help as well. The compensation of many CEOs and senior executives is still skewed to short-term accounting profits, often by formula. Given the complexity of managing a large multinational company, we find it odd that so much weight is given to a single number.

SHAREHOLDER CAPITALISM CANNOT SOLVE EVERY CHALLENGE

Short-termism is a critical affliction, but it isn't the only source of today's crisis of trust in corporate capitalism. Imagine that short-termism were magically cured. Would other foundational problems suddenly disappear as well? Of course not. Managers struggle to make many trade-offs for 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—for example, a company's carbon emissions affecting parties that may be far away and not even know what the company is doing. These so-called externalities can be extremely challenging for corporate decision making, because there is no objective basis for making trade-offs among parties.

Consider how this applies to climate change. One natural place to look for a solution is to reduce coal production used to make electricity, among the largest human-made sources of carbon emissions.[17] How might the managers of a coal-mining company assess the trade-offs needed to begin solving environmental problems? If a long-term shareholder focus led them to anticipate

[15] *2018 Global Sustainable Investment Review*, Global Sustainable Investment Alliance, 2018, www.gsi-alliance.org.

[16] V. Acharya, C. Kehoe, and M. Reyner, "The Voice of Experience: Public versus Private Equity," *McKinsey on Finance* (Spring 2009): 16–21.

[17] In 2011, coal accounted for 44 percent of the global CO_2 emissions from energy production. CO_2 Emissions from Fuel Combustion online data service, International Energy Agency, 2013, www.iea.org.

potential regulatory changes, they would modify their investment strategies accordingly; they might not want to open new mines, for example.

With perfect knowledge a decade or even five years ago, a coal company could have reduced production dramatically or even closed mines in accordance with the decline in demand from U.S. coal-fired power plants. But perfect information is a scarce resource indeed, sometimes even in hindsight, and the timing of production changes and, especially, mine closures, would inevitably be abrupt. Further, closures would result in significant consequences even if the choice is the "right" one.

In the case of mine closures, not only would the company's shareholders lose their entire investment, but so would its bondholders, who are often pension funds. All the company's employees would be out of work, with magnifying effects on the entire local community. Second-order effects would be unpredictable. Without concerted action among all coal producers, another supplier could step up to meet demand. Even with concerted action, power plants might be unable to produce electricity, idling workers and causing electricity shortages that undermine the economy. What objective criteria would any individual company use to weigh the economic and environmental trade-offs of such decisions—whether they're privileging shareholders or stakeholders?

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

Still, the obvious complexity of striving to manage global threats like climate change that affect so many people, now and in the future, places bigger demands on governments. Trading off different economic interests and time horizons is precisely what people charge their governments to do. In the case of climate change, governments can create regulations and tax and other incentives that encourage 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. Failure by governments to price or control the impact of externalities will lead to a misallocation of resources that can stress and divide shareholders and other stakeholders alike.

Institutional investors such as pension funds, as stewards of the millions of men and women whose financial futures are often at stake, can play a critical supporting role. Already, longer-term investors concerned with environmental issues such as carbon emissions, water scarcity, and land degradation are connecting value and long-term sustainability. In 2014, heirs to the Rockefeller Standard Oil fortune decided to join Stanford University's board of trustees in a campaign to divest shares in coal and other fossil fuel companies.

Long-term-oriented companies must be attuned to long-term changes that investors and governments will demand. This enables executives to adjust their strategies over a 5-, 10-, or 20-year time horizon and reduce the risk of holding still-productive assets that can't be used because of environmental or other issues. For value-minded executives, what bears remembering is that a delicate chemistry will always exist between government policy and long-term investors, and between shareholder value creation and the impact of externalities.

CAN STAKEHOLDER INTERESTS BE RECONCILED?

Much recent criticism of shareholder-oriented capitalism has called on companies to focus on a broader set of stakeholders beyond just its shareholders. It's a view that has long been influential in continental Europe, where it is frequently embedded in corporate governance structures. It's gaining traction in the United States as well, with the rise of public-benefit corporations, which explicitly empower directors to consider the interests of constituencies other than shareholders.

For most companies anywhere in the world, pursuing the creation of 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.

Many corporate social-responsibility initiatives also create shareholder value.[18] Consider Alphabet's free suite of tools for education, including Google Classroom, which equips teachers with resources to make their work easier and more productive. As the suite meets that societal need, it also familiarizes students around the world with Google applications—especially in underserved communities, where people might otherwise not have access to meaningful computer science education at all. Nor is Alphabet reticent about choosing *not* to do business in instances the company deems harmful to vulnerable populations; the Google Play app store now prohibits apps for personal loans with an annual percentage rate of 36 percent or higher, an all too common feature of predatory payday loans.[19]

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 children in rural China with their working parents.

[18] S. Bonini, T. Koller, and P. H. Mirvis, "Valuing Social Responsibility Programs," *McKinsey Quarterly* (July 2009), www.mckinsey.com.
[19] Y. Hayashi, "Google Shuts Out Payday Loans with App-Store Ban," *Wall Street Journal*, October 13, 2019, www.wsj.com.

Programs such as these no doubt play a role in burnishing Lego's brand throughout communities and within company walls, where it reports that 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 not only increased employee retention by 8 percent, but also increased client retention by 9 percent and boosted operating margins by 8 percent.

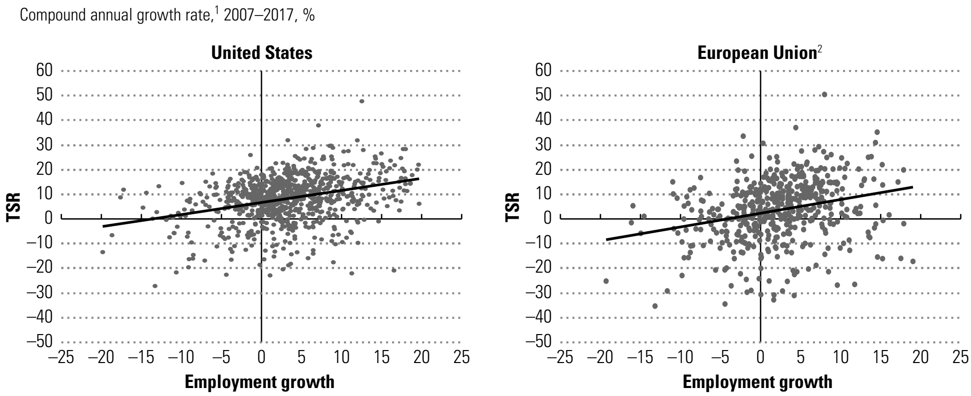
Inevitably, though, there will be times when the interests of a company's stakeholders are not entirely complementary. Strategic decisions involve trade-offs, and the interests of different groups can be at odds with one another. Implicit in the Business Roundtable's 2019 statement of purpose is concern that business leaders have skewed some of their decisions too much toward the interests of shareholders. As a starting point, we'd encourage leaders, when trade-offs must 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. More injury and illness can invite regulatory scrutiny and step up friction with workers. Higher turnover will inevitably increase training costs. With today's mobile and educated workforce, such a company would 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; treating employees well can be good business. But how well is well enough? A focus on long-term value creation suggests paying wages that are sufficient to attract quality employees and keep them happy and productive, pairing those wages with a range of non-monetary benefits and rewards. Even companies that have shifted manufacturing of products like 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.

Similarly, consider pricing decisions. 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. Any adjustments to the price would need to weigh the value of a lower price to buyers against the value of a higher price to shareholders and perhaps other stakeholders. A premium price that signals prestige for a luxury good can contribute long-term value. An obvious instance of going too far—or more accurately, not looking far enough ahead—is Turing Pharmaceuticals. In 2015, the company acquired the rights to a medication commonly used to treat

EXHIBIT 1.1 **Correlation between Total Shareholder Returns and Employment Growth**



[1] Samples include companies with real revenues greater than $500 million and excludes outliers with more than 20% employment growth.
[2] Sample includes companies in the core 15 EU member states.

AIDS-related illnesses and then raised the price per pill by more than 5,000 percent. The tactic prompted outrage and a wave of government investigations. The CEO was even derided as "the most hated man in America."[20]

But far more often, the lines between creating and destroying value are gray. 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.[21] At the same time, politicians pressure companies to keep failing plants open. The government may even be a major customer of the company's products or services.

In our experience, not only do managers carefully weigh bottom-line impact, they 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 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 U.S. and European companies that created the most shareholder value from

[20] Z. Thomas and T. Swift, "Who Is Martin Shkreli—'the Most Hated Man in America'?" BBC News, August 4, 2017, www.bbc.com.
[21] Some argue that well-functioning markets also need well-functioning governments to provide the safety nets and retraining support to make essential restructuring processes more equitable.

2007 to 2017—measured as total shareholder returns—have shown stronger employment growth (see Exhibit 1.1).[22]

CONSEQUENCES OF FORGETTING VALUE-CREATION PRINCIPLES

When companies forget the simple value-creation principles, the negative consequences to the economy can be huge. Two recent examples of many executives failing in their duty to focus on true value creation are the Internet bubble of the 1990s and the financial crisis of 2008.

During the Internet bubble, managers and investors lost sight of what drives return on invested capital (ROIC); indeed, many forgot the importance of this ratio entirely. Multiple executives and investors either forgot or threw out fundamental rules of economics in the rarefied air of the Internet revolution. The notion of "winner take all" led companies and investors to believe that all that mattered was getting big fast, on the assumption that they could wait until later to worry about creating an effective business model. The logic of achieving ever-increasing returns was also mistakenly applied to online pet supplies and grocery delivery services, even though these firms had to invest (unsustainably, eventually) in more drivers, trucks, warehouses, and inventory when their customer base grew. When the laws of economics prevailed, as they always do, it was clear that many Internet businesses did not have the unassailable competitive advantages required to earn even modest returns on invested capital. The Internet has revolutionized the economy, as have other innovations, but it did not and could not render obsolete the rules of economics, competition, and value creation.

Shortsighted focus can breed dishonorable dealing, and sometimes the consequences can shake confidence in capitalism to its foundations. In 2008, too many financial institutions ignored core principles. Banks lent money to individuals and speculators at low teaser rates on the assumption that housing prices would only increase. Banks packaged these high-risk debts into long-term securities and sold them to investors who used short-term debt to finance the purchase, thus creating a long-term risk for whoever lent them the money. When the home buyers could no longer afford the payments, the real estate market crashed, pushing the values of many homes below the values of the loans taken out to buy them. At that point, homeowners could neither make the required payments nor sell their homes. Seeing this, the banks that had issued short-term loans to investors in securities backed by mortgages became unwilling to roll over those loans, prompting the investors to sell all such securities at once. The value of the securities plummeted. Finally, many of the large banks themselves owned these securities, which they, of course, had also financed with short-term debt they could no longer roll over.

[22] We've performed the same analyses for 15 and 20 years and with different start and end dates, and we've always found similar results.

THIS BOOK

This book is a guide to how to measure and manage the value of a company. The faster companies can increase their revenues and deploy more capital at attractive rates of return, the more value they create. The combination of growth and return on invested capital (ROIC), relative to its cost, is what drives cash flow and value. Anything that doesn't increase ROIC or growth at an attractive ROIC doesn't create value. This category can include steps that change the ownership of claims to cash flows, and accounting techniques that may change the timing of profits without actually changing cash flows.

This guiding principle of value creation links directly to competitive advantage, the core concept of business strategy. Only if companies have a well-defined competitive advantage can they sustain strong growth and high returns on invested capital. To the core principles, we add the empirical observation that creating sustainable value is a long-term endeavor, one that needs to take into account wider social, environmental, technological, and regulatory trends.

Competition tends to erode competitive advantages and, with them, returns on invested capital. Therefore, companies must continually seek and exploit new sources of competitive advantage if they are to create long-term value. To that end, managers must resist short-term pressure to take actions that create illusory value quickly at the expense of the real thing in the long term. Creating value is not the same as, for example, meeting the analysts' consensus earnings forecast for the next quarter. Nor is it ignoring the effects of decisions made today that may create greater costs down the road, from environmental cleanup to retrofitting plants to meet future pollution regulations. It means balancing near-term financial performance against what it takes to develop a healthy company that can create value for decades ahead—a demanding challenge.

This book explains both the economics of value creation (for instance, how competitive advantage enables some companies to earn higher returns on invested capital than others) and the process of measuring value (for example, how to calculate return on invested capital from a company's accounting statements). With this knowledge, companies can make wiser strategic and operating decisions, such as what businesses to own and how to make trade-offs between growth and return on invested capital. Equally, this knowledge will enable investors to calculate the risks and returns of their investments with greater confidence.

Applying the principles of value creation sometimes means going against the crowd. It means accepting that there are no free lunches. It means relying on data, thoughtful analysis, a deep understanding of the competitive dynamics of your industry, and a broad, well-informed perspective on how society continually affects and is affected by your business. We hope this book provides readers with the knowledge to help them throughout their careers to make and defend decisions that will create value for investors and for society at large.