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VALUATION

SEVENTH 7 EDITION

MEASURING AND MANAGING THE VALUE OF COMPANIES

TIM KOLLER • MARC GOEDHART • DAVID WESSELS

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VALUATION

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McKinsey & Company is a global management consulting firm committed to helping organizations create change that matters. In more than 130 cities and 65 countries, teams help clients across the private, public, and social sectors shape bold strategies and transform the way they work, embed technology where it unlocks value, and build capabilities to sustain the change. Not just any change, but change that matters—for their organizations, their people, and, in turn, society at large.

About the Authors

The authors are all current or former consultants of McKinsey & Company's Strategy & Corporate Finance Practice. Together they have more than 85 years of experience in consulting and financial education.

* * *

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* * *

Marc Goedhart is a senior expert in McKinsey's Amsterdam office and an endowed professor of corporate valuation at Rotterdam School of Management, Erasmus University (RSM). Over the past 25 years, Marc has served clients across Europe on portfolio restructuring, M&A transactions, and performance management. He received his PhD in finance from Erasmus University.

* * *

David Wessels is an adjunct professor of finance at the Wharton School of the University of Pennsylvania. Named by *Bloomberg Businessweek* as one of America's top business school instructors, he teaches courses on corporate valuation and private equity at the MBA and executive MBA levels. David is also a director in Wharton's executive education group, serving on the executive development faculties of several Fortune 500 companies. A former consultant with McKinsey, he received his PhD from the University of California at Los Angeles.

Preface

The first edition of this book appeared in 1990, and we are encouraged that it continues to attract readers around the world. We believe the book appeals to readers everywhere because the approach it advocates is grounded in universal economic principles. While we continue to improve, update, and expand the text as our experience grows and as business and finance continue to evolve, those universal principles do not change.

The 30 years since that first edition have been a remarkable period in business history, and managers and investors continue to face opportunities and challenges emerging from it. The events of the economic crisis that began in 2007, as well as the Internet boom and its fallout almost a decade earlier, have strengthened our conviction that the core principles of value creation are general economic rules that continue to apply in all market circumstances. Thus, the extraordinarily high anticipated profits represented by stock prices during the Internet bubble never materialized, because there was no "new economy." Similarly, the extraordinarily high profits seen in the financial sector for the two years preceding the start of the 2007–2009 financial crisis were overstated, as subsequent losses demonstrated. The laws of competition should have alerted investors that those extraordinary profits couldn't last and might not be real.

Over time, we have also seen confirmed that for some companies, some of the time, the stock market may not be a reliable indicator of value. Knowing that value signals from the stock market may occasionally be unreliable makes us even more certain that managers need at all times to understand the underlying, intrinsic value of their company and how it can create more value. In our view, clear thinking about valuation and skill in using valuation to guide business decisions are prerequisites for company success.

Today, calls mount for changes in the nature of shareholder capitalism. As we explain in Chapter 1, we believe this criticism derives largely from a misguided focus by corporate leaders on short-term performance that is inconsistent with the value-creation principles we describe in this book. Creating value for shareholders does not mean pumping up today's share price. It means creating value for the collective of current and future shareholders by applying the techniques explained in this book.

WHY THIS BOOK

Not all CEOs, business managers, and financial managers possess a deep understanding of value, although they need to understand it fully if they are to do their jobs well and fulfill their responsibilities. This book offers them the necessary understanding, and its practical intent reflects its origin as a handbook for McKinsey consultants. We publish it for the benefit of current and future managers who want their companies to create value, and also for their investors. It aims to demystify the field of valuation and to clarify the linkages between strategy and finance. So while it draws on leading-edge academic thinking, it is primarily a how-to book and one we hope you will use again and again. This is no coffee-table tome: if we have done our job well, it will soon be full of underlining, margin notations, and highlighting.

The book's messages are simple: Companies thrive when they create real economic value for their shareholders. Companies create value by investing capital at rates of return that exceed their cost of capital. These two truths apply across time and geography. The book explains why these core principles of value creation are genuine and how companies can increase value by applying them.

The technical chapters of the book aim to explain, step-by-step, how to do valuation well. We spell out valuation frameworks that we use in our consulting work, and we illustrate them with detailed case studies that highlight the practical judgments involved in developing and using valuations. Just as important, the management chapters discuss how to use valuation to make good decisions about courses of action for a company. Specifically, they will help business managers understand how to:

- Decide among alternative business strategies by estimating the value of each strategic choice.
- Develop a corporate portfolio strategy, based on understanding which business units a corporate parent is best positioned to own and which might perform better under someone else's ownership.
- Assess major transactions, including acquisitions, divestitures, and restructurings.

- Improve a company's strategic planning and performance management systems to align the organization's various parts behind improved execution of strategic priorities and create value.
- Communicate effectively with investors, including whom to talk with and how.
- Design an effective capital structure to support the corporation's strategy and minimize the risk of financial distress.

STRUCTURE OF THE BOOK

In this seventh edition, we continue to expand the practical application of finance to real business problems, reflecting the economic events of the past decade, new developments in academic finance, and the authors' own experiences. The edition is organized into five parts, each with a distinct focus.

Part One, "Foundations of Value," provides an overview of value creation. We make the case that managers should focus on long-term value creation for current and future shareholders, not just some of today's shareholders looking for an immediate pop in the share price. We explain the two core principles of value creation: (1) the idea that return on invested capital and growth drive cash flow, which in turn drives value, and (2) the conservation of value principle, which says that anything that doesn't increase cash flow doesn't create value (unless it reduces risk). We devote a chapter each to return on invested capital and to growth, including strategic principles and empirical insights.

Part Two, "Core Valuation Techniques," is a self-contained handbook for using discounted cash flow (DCF) to value a company. The reader will learn how to analyze historical performance, forecast free cash flows, estimate the appropriate opportunity cost of capital, identify sources of value, and interpret results. We also show how to use multiples of comparable companies to supplement DCF valuations.

Part Three, "Advanced Valuation Techniques," explains how to analyze and incorporate in your valuation such complex issues as taxes, pensions, reserves, capital-light business models, inflation, and foreign currency. It also discusses alternative return-on-capital measures and applications.

Part Four, "Managing for Value," applies the value-creation principles to practical decisions that managers face. It explains how to design a portfolio of businesses; how to run effective strategic-planning and performance management processes; how to create value through mergers, acquisitions, and divestitures; how to construct an appropriate capital structure and payout policy; and how companies can improve their communications with the financial markets.

Part Five, "Special Situations," is devoted to valuation in more complex contexts. It explores the challenges of valuing high-growth companies, companies in emerging markets, cyclical companies, and banks. In addition, it shows how uncertainty and flexibility affect value and how to apply option-pricing theory and decision trees in valuations.

Finally, our nine appendixes provide a full accounting of our methodology in this book. They provide theoretical proofs, mathematical formulas, and underlying calculations for chapters where additional detail might be helpful in the practical application of our approach. Appendix H, in particular, pulls into one place the spreadsheets for the comprehensive valuation case study of Costco featured in this edition.

VALUATION SPREADSHEET

An Excel spreadsheet valuation model is available via Web download. This valuation model is similar to the model we use in practice. Practitioners will find the model easy to use in a variety of situations: mergers and acquisitions, valuing business units for restructuring or value-based management, or testing the implications of major strategic decisions on the value of your company. We accept no responsibility for any decisions based on your inputs to the model. If you would like to purchase the model (ISBN 978-1-118-61090-8 or ISBN 978-1-118-61246-9), please call (800) 225-5945, or visit www.wileyvaluation.com.

Acknowledgments

No book is solely the effort of its authors. This book is certainly no exception, especially since it grew out of the collective work of McKinsey's Strategy & Corporate Finance Practice and the experiences of its consultants throughout the world.

Most important, we would like to thank Tom Copeland and Jack Murrin, two of the coauthors of the first three editions of this book. We are deeply indebted to them for establishing the book's early success, for mentoring the current authors, and for their hard work in providing the foundations on which this edition builds.

Ennius Bergsma deserves our special thanks. Ennius initiated the development of McKinsey's Strategy & Corporate Finance Practice in the mid-1980s. He inspired the original internal McKinsey valuation handbook and mustered the support and sponsorship to turn that handbook into a real book for an external audience.

Bill Javetski, our lead editor, ensured that our ideas were expressed clearly and concisely. Dennis Swinford edited and oversaw the production of more than 390 exhibits, ensuring that they were carefully aligned with the text. Karen Schenkenfelder provided careful editing and feedback throughout the process. We are indebted to her excellent eye for detail.

Tim and Marc are founders of McKinsey's Strategy & Corporate Finance Insights team, a group of dedicated corporate-finance experts who influence our thinking every day. A special thank-you to Bernie Ferrari, who initiated the group and nurtured its development. The team is currently overseen by Werner Rehm and Chris Mulligan. Other leaders we are indebted to include Haripreet Batra, Matt Bereman, Alok Bothra, Josue Calderon, Susan Nolen Foushee, Andre Gaeta, Prateek Gakhar, Abhishek Goel, Baris Guener, Paulo Guimaraes, Anuj Gupta, Chetan Gupta, Peeyush Karnani, David Kohn, Tarun Khurana, Bharat Lakhwani, Ankit Mittal, Siddharth Periwal, Katherine Peters, Abhishek Saxena, João Lopes Sousa, Ram Sekar, Anurag Srivastava, and Zane Williams.

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Michael Cichello, professor of finance at Georgetown University, expertly prepared many of the teaching materials that accompany this book, including the end-of-chapter problems and answers for the university edition and exam questions and answers. These teaching materials are an essential supplement for professors and students using this book for finance courses. Thank you to our Costa Rica research team for their help in preparing and answering questions for these materials.

Concurrent with the fifth edition, McKinsey published a shorter book, titled *Value: The Four Cornerstones of Corporate Finance*, which explains the principles of value and their implications for managers and investors without going into the technical detail of this how-to guide. We've greatly benefited from the ideas of that book's coauthors, Richard Dobbs and Bill Huyett.

The intellectual origins of this book lie in the present-value method of capital budgeting and in the valuation approach developed by Nobel laureates Merton Miller and Franco Modigliani in their 1961 *Journal of Business* article titled "Dividend Policy, Growth, and the Valuation of Shares." Others have gone far to popularize their approach. In particular, Professor Alfred Rappaport (Northwestern University, Professor Emeritus) and the late Joel Stern (Stern Stewart & Co.) were among the first to extend the Miller-Modigliani enterprise valuation formula to real-world applications. In addition to these founders of the discipline, we would also like to acknowledge those who have personally shaped our knowledge of valuation, corporate finance, and strategy. For their support, teachings, and inspiration, we thank Buford Alexander, Tony Bernardo, Richard Dobbs, the late Mikel Dodd, Bernie Ferrari, Dick Foster, Bob Holthausen, Bill Huyett, Rob Kazanjian, Ofer Nemirovsky, Eduardo Schwartz, Chandan Sengupta, Jaap Spronk, the late Joel Stern, Bennett Stewart, Sunil Wahal, and Ivo Welch.

A number of colleagues worked closely with us on the seventh edition, providing support that was essential to its completion. In Part One, "Foundations of Value," David Schwartz, Bill Javetski, and Allen Webb helped with the always-difficult task of writing the first chapter to position the book properly. The discussion of valuation and ESG in Chapter 6 was based on an article

coauthored by Witold Henisz and Robin Nuttall. The discussion of valuing digital initiatives in the same chapter benefited from collaboration with Liz Ericsson.

Over the years, we have valued many companies in Parts Two and Three. We would like to thank Wharton graduates Caleb Carter and Daniel Romeu for the extensive analysis they have conducted to underpin these sections.

Part Four, "Managing for Value," adds substantial new insights on how companies can improve the translation of their strategies into action and aligned resource allocation. We are indebted to Chris Bradley, Dan Lovallo, Robert Uhlaner, Loek Zonnenberg, and a host of others for this new material. Matt Gage and Steve Santulli provided analysis for the M&A chapter. The investor communications chapter benefits greatly from the work of Rob Palter and Werner Rehm. In Part Five, "Special Situations," Marco de Heer's dissertation formed the basis for the chapter on valuing cyclical companies.

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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.