By Donald Kalff

American mythology and European opportunities

Although much has been made of the American corporate business model, it is clear that it has its defects. The author examines this model and looks at the alternatives and the value they can offer.

Illustration by Dr Cornelia Junghans

"The judgement that large American companies perform poorly is counterintuitive but inescapable. At the top of the economic cycle in the late nineties, profit-per-share – the favoured performance indicator of the top 500 companies in the US – remained stagnant, despite major share buy-back programmes, largely financed with borrowed money"

The time has arrived to take a fresh and agnostic look at the past, present, and future performance of companies in the US and Europe that have embraced the American way of conducting business. Many believe strongly in the virtues of the American approach but their faith is apparently misplaced.

By virtue of this belief in the American model, attractive and highly competitive alternatives are not receiving the attention they reserve. In the light of the perceived flaws of the American model, the search is now on for alternative enterprise models, and the place to look is continental Europe.

Continental Europe harbours many small and large private companies, co-operatives and government-owned companies, many of them producing excellent results.

There is a need for the development of new models. Companies explicitly driven by the creation of economic value as a single objective provide clarity for all those whose interests are at stake.

Companies that acknowledge that economic value is largely created by teams of middle managers and experts working inside and across corporate boundaries will do well. Those with managements that provide perspective, resources and protection for these teams will thrive.

The American way

The defenders of what can be called the American Enterprise Model point to its stark and appealing features: the pursuit of shareholder value, a one-tier board, a strong CEO, the creation of independent divisions and business units that operate close to their markets, tight planning and control, performance evaluation based on financial (or at least quantifiable) targets, substantial monetary incentives and managers that believe in competition and in winning with the widest possible margin.

This model is emulated by virtually all large public companies in Europe and there seem to be no limits to it applicability. Outside its own realm, the model also sets standards for the organisational structure and culture of large sections of the public sector, such as utilities, public transport and healthcare.

The judgement that large American companies perform poorly is counterintuitive but inescapable. At the top of the economic cycle in the late nineties, profit-per-share - the favoured performance indicator of the top 500 companies in the US - remained stagnant, despite major share buy-back programmes, largely financed with borrowed money. Moreover, in retrospect, the profits reported in this period have to be corrected downwards to a very significant degree. Proper accounting of option schemes results in a 30 percent reduction in reported profits. The exclusion of profits from corporate pension funds accounts for a decrease of 15 percent. On top of this, many companies among America's top 500 made insufficient contributions to their pension funds and failed to make provisions for a variety of long-term obligations such as healthcare benefits for pensioners and deferred income of top managers. This should have decreased profits at the time by at least another 15 percent, bringing the total reduction to 60 percent. Further, it should be noted that this figure does not even include the financial impact of all the litigation and criminal investigations that originated in the 90's. All in all, a very poor performance at a time of high economic growth spurred on by a technological revolution that is only comparable with the introduction of the steam engine or electricity.

The rapid growth in corporate profits since the recession of 2001 should also be re-examined. This growth should partially be contributed to a totally unprecedented, and many would argue irresponsible, financial injection into the US economy. The combination of increased government spending, substantial tax reductions, the lowest interest rates in history and a feverish housing market all conspired to secure ongoing growth in consumer spending. In addition, American consumers stopped saving and increased debt. The resulting artificial

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boom in consumer spending in combination with ferocious cost cutting fuelled corporate profits.
Profits and profits-per-share also rose as a result of specific policies that flow from the basic characteristics of the American Enterprise Model. Double-digit growth of profit-per-share was increasingly seen as a stepping-stone to a higher stock price. Shareholder value (the net present value of future revenues and cost, including the cost of capital) was replaced by shareholder return on investment, the rise of the stock price per unit of time.
In combination with the short tenure of American CEOs and the strong link between their income and the performance of their company's stock, this resulted in a significant reduction in the repertoire of corporate policies. Only policies that would pay off within three to four years were worth pursuing. To make matters worse, each of these policies had serious flaws.
Companies that buy their own stock to support their share price sooner or later undermine their financial resilience. Poorly performing business units can be sold or dismantled to improve profits, but this is a one-time gain. Friend and foe now agree that corporate acquisitions, generally aimed at cost cutting, destroy value for the shareholders of the acquiring company. Less well-known is that, in most instances, these cost savings are lower than projected, productivity and market share growth are reduced, and research and development expenditure and research output suffer. The outsourcing of corporate activities remains popular, but, with each step, the risks increase. Flexibility in meeting changes in demand and specifications decreases and the vulnerability of the supply, production and distribution chain increases. Staff reductions immediately contribute to profits but each new round of lay-offs yields less and less and comes at a higher price in terms of the deterioration of the organisation's capacity to rebound, the destruction of imbedded knowledge and the low morale of surviving staff.
To add insult to injury, interesting opportunities for increasing the economic value of a company, such as mergers, partnerships, international expansion and large investments, are all too often ignored for the simple reason that profit-per-share would suffer during the tenure of the CEO.
The damage caused by this corporate straightjacket can hardly be overestimated. The bottom line is that, over the past five years, many US-style companies, concentrating on 'profit-per-share', have, in the name of their shareholders, destroyed 'shareholder value' in its original meaning of 'economic value'. This must be one of the great ironies of our time.
All in all, there is ample reason to break away from the American Enterprise Model. Capitalism deserves better, and the search should be on for alternative enterprise models.

European alternatives

The key difference between Europe and the US is that only 25 percent of the capital requirements of continental European companies are met by stock markets. This is in stark contrast to US firms that depend on stock markets for 75 percent of their capital. As a result most continental companies escape the web of expectations spun by investment bankers, financial analysts, stock-brokers, strategy consultants and the financial media, each and every one of them convinced of the superiority of the American Enterprise Model. This helps to explain why continental Europe harbours a healthy variety of enterprises; from co-operatives to government-owned but independent companies, and from small to very large family-owned businesses. Moreover, there are major national and regional differences, and it is now possible to establish any sort of European corporate legal entity anywhere in the EU. All this flexibility is highly advantageous, as companies go through different stages of development and start to take advantage of the opportunities the EU has to offer. The proposition is that the capacity to adapt governance, management structure, organisation, planning control, performance evaluation and remuneration to changing circumstances in a timely fashion constitutes a competitive advantage.
Of course not all European models have a future. The Rhineland or stakeholder model for example is

no longer an alternative for the American Enterprise Model. Under the stakeholder model the company is beholden to balance the interests of all its constituents: its customers, its suppliers, its shareholders, its employees and the community in which it operates. However, to envisage the company and its development as the result of a variety of external pressures have now turned into another way to destroy economic value.

By definition, none of the stakeholders has the interests of the company as a whole at heart. Shareholder representatives, regulators, consumer organisations, unions, environmental pressure groups and government in its different guises concentrate on single issues at the expense of the interest of the company as a whole. Many concentrate on the short-term and need to prove their mettle in the eyes of their members or voters. Nobody represents the interests of future stakeholders.

Moreover, the group of stakeholders changes continuously. Conflicts among them come and go and take different shapes at different times. Shifts in the balance of power among stakeholders force companies to adapt at the expense of existing commitments and investments.

Particularly harmful is the vested interest stakeholders have in institutionalising their dealings with the company. It starts with the call for transparency but demands for information can never be satisfactorily met. There is always a deeper vein that needs to be tapped. Voluntary codes of conduct are the next rung on the ladder of influence, to be followed by rules and regulations. Obviously, once new rules are in place, compliance must be monitored and enforced. Close monitoring reveals more digressions, triggering demand for more refined procedures and heavier penalties.

The stakeholder approach produces an increasingly unmanageable web of issues in which an ever-increasing number of parties claim a position. Entangled in rules and regulations, companies cannot prune activities that destroy economic value quickly enough, they incur mounting cost and see their innovation efforts stifled.

With both the shareholder and the stakeholder models in disarray, the design and implementation of competitive and practical alternative ways to structure the conduct of business carries a high premium.

A new European company

Particularly competitive new European Enterprise Models should be designed on the basis of the following three principles: the pursuit of a single economically sound objective; a new perspective on ownership and control; and the acknowledgment of the true sources of economic value. No such companies exist at present, but it will become apparent that many very successful family companies, such as Roche, Heineken and Porsche, resemble this notional company.

The corporate objective

Companies should be seen as working communities whose mission is the creation of economic value. Companies are built around business ideas. A business idea is a combination of people, knowledge, equipment and resources that can add value on a sustained basis. The French company Decaux saw long before anyone else that the installation and maintenance of high-quality bus shelters financed by advertisers would meet unmet needs from public transport companies and their customers for years to come.

The value of the company is determined by its projected cash flows (revenues minus expenses realised in the short-, medium- and long-term) and the cost of capital charged by banks and investors. This forward orientation dictates the pursuit of continuity. In turn, continuity implies legitimacy.

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Obviously, societies will only grant legitimacy to companies that stay within the bounds of acceptable practices and not just within legal constraints. It falls to companies to anticipate and manage the social issues relevant to their business. This is economically far more efficient than society relying on general standards and procedures with dubious relevance for many companies. For example, reporting requirements

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for banks and other service providers to demonstrate compliance with environmental standards achieve very little but adds substantially to the regulatory burden. Instead, banks should in their own interest anticipate pressure to withhold support from clients that harm the environment in a substantial way.

Economic value as the one and only unequivocal measure of performance provides a single and superior basis for decision-making. Annual budgets no longer build up to projected profits, investments are no longer evaluated in terms of their impact on the stock price/earnings ratio and the price of takeover targets is no longer expressed as a multiple of revenues.

Concentration on economic value provides the basis for trade-offs between the short- and long-term, and helps in comparing broad sets of alternative options. It is also an objective behind which all members of the community can unite and it makes internal and external communication considerably easier. When business ideas reach the end of their natural life, abandonment is far easier to explain by pointing at the imminent destruction of capital than by pointing at an insufficient level of profit.

A crucial element is that the cost of capital is not derived from the notional investor who has risk-free alternatives and needs to be compensated for inflation, for the risk of holding shares as well as industry-specific risk. The last two factors, oddly enough, derive from historic share price movements.

Management's use of the resulting, artificially high, discount rate in evaluating their options is far too often an abdication of responsibility. It would be better to address issues such as disbelief in the underlying assumptions held by those who seek approval for their proposals or the lack of confidence in the project management directly. Shielding behind perceptions of considerable risk held by past shareholders does not assist management credibility.

What matters are the actual cost of capital during the lifetime of an investment and management's preparedness to confront the real uncertainties associated with the effort. It also makes sense to apply different discount rates for cost and revenues, and to have higher discount rates for net cash flows further into the future.

Ownership and control

Under European Enterprise Models, corporate ownership rests with the entrepreneur and not with the shareholders. As a matter of principle, those who have conceived the business idea that underpins the company own it. The underlying premise is that there is no fundamental difference between business ideas and scientific findings, brands or works of art. They are all forms of intellectual property and inalienable rights are established at the moment of creation.

In the real world ownership comes with variable degrees of control. If companies want to remain independent, they have to rely on their cash flow to expand, but, if they want to grow faster, they need more capital. They have to enter markets on which a variety of inter-dependent commodities are being traded. Shares in the economic value of corporate business ideas, the amount of capital required, the duration of the supplier of capital's commitment, the kind and degree of control the provider of capital can exercise and the way the company is managed and organised. For firms with a solid cash flow that pursue truly inspiring business ideas proposed by first-class managers, money is cheap. Interest rates for these companies are low, repayment of the principle flexible, the bank's collateral reasonable and the bank's control over the company modest or even non-existent. In the case of private equity financing, investors will take their fair share of the company's economic value and secure their interests in areas that are important to them but will otherwise take a back seat and leave the company's owners to get on with their business.

Clearly, the price for money goes up, when companies are less than outstanding and the risks higher. These firms have to pay more both in terms

of interest rates and other financial conditions and in terms of the degree of control the company has to yield to financiers. This is most visible when companies are close to the abyss and their banks take full control, as was, for example, the case with Eurotunnel.

Negotiations between financiers and owners result in governance and management arrangements that are tailored to the specific qualities of managers and the companies over which they preside. They do justice to the corporate strategy, the company's competitive position and future prospects. These arrangements are laid down in shareholder and loan agreements, hundreds of which are made - far from the glare of equity markets - every day all over Europe.

It is crucially important that management remains totally independent in these negotiations. In the case of attracting capital, there is no reason to deviate from the well-established practice that management should be free to select the best suppliers for the company; equipment, services and money should all be treated equally. This rules out that financiers buy management cooperation by allotting shares for reaching milestones that serve their purposes but harm the economic value of the company.

Sources of economic value

The identification of the main source of economic value starts with the notion that technological developments and fragmenting markets force technologists and sales and marketing managers to ever-increasing degrees of specialisation. As a result, the exploitation of existing business ideas, let alone the identification and implementation of new ones, depends more and more on cooperation.

Companies rely increasingly on teams to protect and create value both inside the company and in alliances with third parties. It is therefore no surprise that internal boundaries are now frequently crossed and that the growth in the number of alliances far exceeds the number of takeovers and mergers.

Kleisterlee of Philips and Spinetta of Air France/KLM form a new breed of leaders that show the effectiveness of this approach.

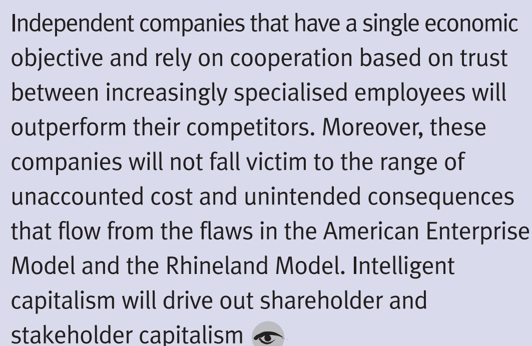
Under the European Enterprise Model, managers become entrepreneurs. They express the corporate vision that guides the search for new business ideas. They set the principles that direct all corporate action. They select, guide, encourage and protect the teams that are responsible for the further development and testing of ideas. And they are also in charge when partners have to be selected, contacts initiated and joint teams mandated.

Team members are not human resources. They are the company. They are provided with a structure and a working culture that enables them to trust management and their colleagues. Team leaders stand up for their troops. Their members feel able to speak their mind at the risk of embarrassing their superiors, peers, subordinates or themselves.

Management makes sure that identified economic potential is realised by making the necessary organisational arrangements, allocating the right resources and securing the commitment of their colleagues and their board.

Management is also present when teams and partnerships are unsuccessful and have to be abandoned. Good managers safeguard value by avoiding unnecessary damage to morale and by preserving the company's reputation as a partner.

Conclusion



Independent companies that have a single economic objective and rely on cooperation based on trust between increasingly specialised employees will outperform their competitors. Moreover, these companies will not fall victim to the range of unaccounted cost and unintended consequences that flow from the flaws in the American Enterprise Model and the Rhineland Model. Intelligent capitalism will drive out shareholder and stakeholder capitalism

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