Shareholders vs Stakeholders: For whose benefits?

By **K. SADASHIV**

Is maximising benefits for shareholders at odds with maximising benefits for all stakeholders? Or is the shareholder merely another type of stakeholder whose long-term interests is tied to that of all the other stakeholders?

In his seminal book, *Strategic Management: A Stakeholder Approach*, Edward Freeman crystallised the proposition that stakeholders go beyond shareholders.

He defines a stakeholder as "any group or individual who can affect or is affected by the achievement of the firm's objectives". Stakeholders would include shareholders who are the reason for the firm's existence in the first place. But stakeholders go beyond to include customers, suppliers, financiers, communities, governmental bodies, political groups, employees, trade associations, trade unions, and, in some cases, even competitors.

Freeman analysed the different types of strategies and noted the contrast between:

- The shareholder strategy, which seeks to maximise benefits to the shareholders or "financial stakeholders".
- The utilitarian strategy, which seeks to maximise the benefits to all stakeholders, and consequently benefits to society as a whole.

Many boards and directors view the two strategies as conflicting and have debated their relative merits and disadvantages.

However, do these two strategies have to be in conflict? Let us examine each of them.

The shareholder strategy

The rise of the shareholder primacy theory is due to the influence of economist Milton Friedman. In 1970, Friedman argued that the social responsibility of business is to increase profits.

Six years later, economists Michael Jensen and William Meckling turned to agency theory to explain why it was the sole obligation of corporations to maximise profits. They posited that corporate executives acted as agents for the shareholders of the business, the principals. Maximising shareholder value became a shared goal that served to align the interests of shareowners and management, the latter via generous incentive compensation plans.

Shareholder value is maximised when there is high dividend distribution and increase in the share price.

However, satisfying shareholders' desire for immediate gains could encourage management behaviour and actions that generate sharp share price movements upwards but may not necessarily translate into long-term shareholder value creation. In fact, seeking to maximise returns every quarter for investors or activist shareholders who are looking to cash out quickly, could lead to poor strategic planning and hasty business decisions.

Unfortunately, executives are often compensated based on short-term price performance rather than long-term business feasibility, which can misalign the interests of management and current shareholders with the true long-term welfare of the company.

At the core, what committed shareholders inherently seek is a sustained increase in the value of their holdings, rather than mere short-term increase. Ironically, it is shareholders themselves who may have created the confusion, especially through certain investors such as activist hedge funds who have short-term interests.

The objective of maximising returns for investors alone may work well for small and mid-sized privately-held businesses where the senior managers hold the major ownership stakes; here investor returns and the company's interests can be perfectly aligned. It also works well for private equity sponsored deals where the investors play a role in the management of the company. However, for large enterprises, and public companies in particular, the reverse can be true.

Shareholders do not always hold a preferred claim to a company's profits or assets. The rights of debt holders, retirees, employees, and even some large suppliers and customers can supersede those of shareholders at times and under different circumstances (for example, bankruptcies). This implies that CEOs who run a company (primarily for shareholders) should focus as much on the preservation and growth of the business as much as the maximisation of shareholder wealth. In the long term, in a free market system, the two objectives will converge, even if they may diverge in the short-term.

That is not to say that CEOs and boards should prioritise equity holders over other stakeholders and the interests of the company in every case, but the obsession with shareholder value can sometimes compromise a company's innovation and strategic direction in favour of immediate returns.

The utilitarian strategy

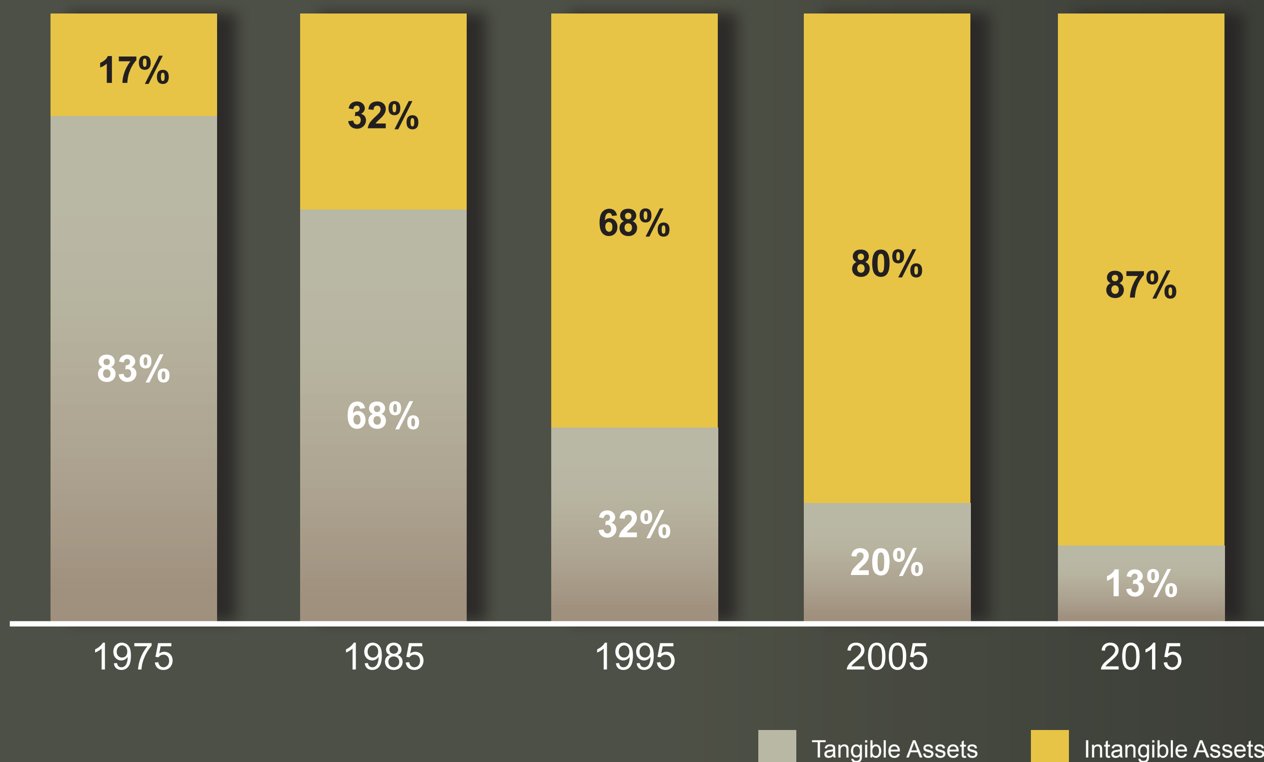
Numerous studies have shown that the value of intangible assets can far exceed that of tangible assets for the majority of firms. The weight of tangible to intangible assets has inverted over the last three decades. (See chart, "Components of S&P 500 Market Value".)

The key intangible assets that drive the lion's share of corporate value are:

- **Human capital.** This is the value derived from the accumulated skills, explicit and tacit knowledge and experience of company employees.
- **Relationship capital.** This is the value tied up in positive relationships with employees, suppliers, partners, customers and government.
- **Brand capital.** This is the value energised from consistent verbal and visual messaging, and individualistic character.

All these three forms of capital involve stakeholders, who need not be shareholders.

In stakeholder theory, the firm is defined by its value chain, with suppliers and customers as the two key stakeholders, and the rest of business actions by employees, financiers, regulators, media, communities, trade unions, associations and even competitors.



Source: Ocean Tomo LLC, *Ocean Tomo's Annual Study of Intangible Asset Market Value — 2015*, 5 March 2015.

The utilitarian approach assesses corporate actions in terms of their consequences, and strives to achieve the greatest good for the largest number while creating the least amount of harm or suffering.

Stakeholder theory emphasises that organisations have a social responsibility, and management should go beyond shareholders' interests when making decisions, taking into consideration every entity involved in and affected by the company's decisions. The interests of stakeholders should be considered as the means by which organisations achieve their strategic goals.

An INSEAD faculty and research paper, "What's at stake? Stakeholder engagement strategy as the key to sustainable growth", argues that the basic premise of Freeman's stakeholder theory is: "Management should not relegate the company's effects of stakeholders to the status of externalities that are irrelevant to the firm's main objective of profit maximisation and value maximisation but rather should view each class of stakeholders as holding intrinsic value of their own".

In other words, adopting broader stakeholder engagement enables an organisation to secure an advantageous position through good relations with key stakeholders, which, in turn, can enhance valuable intangible assets that result in improved financial returns.

The justification of this premise exists at three basic levels:

- **Descriptive** – the way things are done.
- **Normative** – the way things ought to be done.
- **Instrumental** – doing it is good for business.

The last rationale, instrumental, erases the contradiction between "business-oriented" and "socially responsible" approaches.

Research indicates that taking into account a broad view of stakeholders' interest and concerns is positively correlated with maximising long-term shareholder value. There are five major ways by which stakeholder engagement can contribute to a company's performance:

- It engenders trust, a key ingredient for securing the license to operate.
- It secures the support of potentially influential partners.
- It can solve problems as one of the best benefits of building trust.
- It helps management see the future.
- It can enhance the firm's public image.

Thus, effective stakeholder engagement can deliver quality results, although it does require considerable resources and time.

Shareholders as stakeholders

The end-goal of shareholders and stakeholders are similar: the long-term viability and prosperity of the organisation.

Any definition of shareholder value creation as being linked to short-term share price increase is potentially flawed since sustained value enhancement is the objective of long term shareholders, and is the very reason for the firm's existence.

Hence, rather than debate about strategies for shareholders or stakeholders, the position should be that the organisation's strategies need to serve shareholders (as stakeholders) as well as all other stakeholders. ■

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