What are the consequences of the quest for performance on the management of a firm or other type of organization?

Introduction

The quest for performance is primarily a demand for financial performance from the institutional investors. The management of a firm will strive to satisfy them by creating value. Their primary objective will be to develop competitive advantages that will allow them to generate economic rents and profits above the normal profits.

When the firm's management cannot create value through economic rent, they will devise strategies that will transfer value to the firm from outside the horizon of the analysts that follow them. While both strategies deliver the performance demanded in the short term, the second one, value transfer, is not sustainable in the long term: it does not create value in the system and can even destroy value for the firm because it destroys the firm's capacity to deliver sustainable competitive advantages based on the resources it needs to access.

If the objective of shareholder maximization is to be retained, a more accurate measurement of performance must be used to better evaluate the long term impact of strategies that can deplete or damage resources available to the firm. This will preclude practices that push firm management to engage in strategies unsustainable in the long term.

Understanding "Quest for Performance"

To address the question and to insure that a common ground is established in reading this essay, the subject must be developed further, to understand the type of performance the management of an organization is expected to deliver. I will specifically focus on firm management in a traditional business sense, the firm being an organization engaged in the trade of goods or services operating in a capitalist environment, created or owned by investors seeking to realize profits.

Performance is "the execution of an action" or "the fulfillment of a claim, a promise, and a request"[i]. A quest is a pursuit. It is often understood as difficult or perilous, as in medieval romance[ii] such as "The quest for the Holy Grail" or more modern literature, "the quest for gold" or "the quest to win". Therefore if there is a quest for performance, the performance should be above average, worthy of attention. The question is therefore interpreted as the quest for superior performance either in relation to competitors, or from a historical standpoint.

The performance of the firm is usually expressed in terms of "return on investments" or "share performance" in relation to a peer group or a market.

The Intended Audience

Firms compete within their industry for the patronage of their client. To be selected, they must offer products or services that offer advantages over and above those of their competitors. For this audience, performance is defined in terms of product features or, more accurately, in terms of an attractive price for performance ratio. The client's attention will translate into sales, revenue and, if the firm has managed all its costs properly in regard to the price it can sell its products or services, into profits.

Firms also compete for financial markets to access capital. Here the competition set is greater, as they must compete for the attention of investors that can place their assets across multiple industries and countries. Institutional investors represent the majority of investors. For instance, in 2009, in the USA, they represented 62% of holdings (SIFMA 2010[iii]). Moreover, institutional investors are more likely to influence board decisions than retail investors. "When it comes to the interests of retail investors—i.e., individuals with small stakes in a particular firm—the evidence suggests that contested corporate elections are virtually off-limits as a conduit for activism. Retail investors almost never launch a campaign and their interests are not represented well by those who do" (Harris, 2008[iv]).

The Objectives of the Firm and their measure

I have personally observed this focus on the financial performance in most of the companies I worked for or with. Performance in the sense of client satisfaction is primarily the domain of the Marketing and Sales functions, who will discuss it with other functions only if there is an issue. Financial performance, however, is an essential part of the communication from the top management to all functions. Its components are embedded in the performance evaluation of every functional manager of the firm and cascaded down to lower level managers. To insure that this element is strongly linked to personal performance, compensation packages include a variable part linked to the share price of the firm. Some companies, like PepsiCo where I worked for 6 years, add a variable part linked to share performance to the compensation of all employees, regardless of rank[v]. Others reserve the variable part for senior managers[1].

A firm's management generally identifies the institutional investors as its primary audience and matches the firm's objectives to the expectations of those investors. The top management will diffuse those objectives throughout the firm's organization, allocating them to their functional managers, and will have them audited by the executive best able to communicate the message, the "Chief Financial Officer", who will measure how those functional managers succeed as concerns the corporate objective of delivering value for the institutional investors.

Managers will focus their efforts on delivering the value that is expected by the financial community while providing their customers with products or services that are equal or superior to those of their competitors.

The quest for performance is spurred by the need to satisfy these two constraints, which will then drive decisions based on the expectation that the choices will provide a level of satisfaction above the alternatives, or at least above average. As we have shown, this performance must be demonstrated primarily to the analysts who watch over the firms. The working cycle of financial analysis, at least for publicly traded companies, is the quarterly report, so the performance measurement is focused on short term, quarterly, or medium term (yearly) indicators.

Therefore, the object of analysis becomes: "What are the consequences of the quest for short to medium term superior financial performance on the management of a firm?" If performance is not superior to that of the other actors in the peer group, which, in the case of the financial community, may be viewed broadly as the other opportunities for investments, managers will not attract the interest of institutional investors. Therefore the performance they seek must be superior to at least the average of the comparison group.

[1] In France, companies of 50 employees and more must implement a system of distribution of a share of the profits to all workers, called "participation"[1] It is not linked to share performance but to benefits. This does not preclude the rewarding of managers with a variable part linked to share price.

Indeed, if performance were not "superior", the firm would offer only "Normal Profits" similar to those in perfect competition markets. It would therefore not attract the interest of financial analysts and institutional investors that are looking for superior performance as part as their own differentiation strategy towards their clients or the interests they represent.

Classic finance theory asserts that the objective of the firm is to maximize value for its shareholders (van Horne 1974[vi]). The legal constitution of shareholder-owned enterprises puts the shareholders in the position of being the residual owners of any financial benefits (profit) that the organization may create through its activities (Neely 2007[vii]). Managers do this by maximizing the present value of future cash flow. The profit maximization was originally present primarily in Anglo-Saxon economies, but it has become prevalent in Western Europe and other economies as a global market designed for corporate control, with the growing importance of equity based compensation packages and the increased penetration of equity holdings (Copeland, Koller, Murrin 2003[viii]). "Business Performance Management" is a set of processes that address financial and operational activities. It helps define strategic goals and measure and manage performance against those roles (Frolick, Ariyachandra 2006[ix]).

Delivering Value

Now that the competitive environment is set, managers must focus their energy on delivering the value that defines performance. They must construct a strategy to harness the potential of the resources available to the firm and use their capacities to create value.

The value creation strategies have been studied at length often based on the observations that economic profits do not exist in perfect competition. Therefore, firms will focus their attention on developing strategies that differentiate them from their competitors, either through superior innovation, protected markets, superior management, or preferential access to resources among others. All of these will provide a competitive advantage. If they possess a competitive advantage, they can deliver the value derived from their position on that superior product or service and the rent that is attached to it. Identifying a competitive advantage is a key of investment decisions: "The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather in determining the competitive advantage of any given company and, above all, the durability of that advantage"(Warren Buffet 1999[x])

Sustainable competitive advantage has been defined (Barney 1991[xi]): "A firm is said to have a sustained competitive advantage when it is implementing a value creating strategy not simultaneously being implemented by any current or potential competitors and when these other firms are unable to duplicate the benefits of this strategy". As Barney's definition implies, having a competitive advantage means that the firm has a value creation strategy that cannot be copied.

In the strategic management literature, two distinct mechanisms—resource-picking and capability-building—have been proposed for understanding how managers create economic rents for their firms (Makadok 2001[xii]). Resources are assets, amongst which are information, financial resources available to the firm (Barney 1991), but also suppliers (Philippart, Verstraete, Wynen 2005[xiii]), and the surroundings of the firm that provides trained workers, infrastructure, legal system of protection. The firm's specific ways to engage the resources in a more effective way than the competition mark its advantage or "capabilities". Makadok views Capabilities as specific resources of the firm that are non transferable. The integration of those resources and capabilities in a strategy deliver competitive advantages and create rents that will deliver value and translate into superior performance.

Three categories of profit can be delivered by firms: normal profits, rents, and monopolistic profits. Ordinary profit is the amount of earnings necessary to compensate the owner(s) for abstinence, indemnity for risk, and remuneration for the labor and skill required to oversee the business (Trailer 2003[xiv]). The normal profit is the result of standard activities and therefore not part of the "Quest for Performance" objective. Monopolies are usually granted, and unchallenged, having limited need for managers to demonstrate extraordinary skills in delivering performance: no quest is involved here. Rents are the most interesting in this discussion as they need to be constructed through the management of what is available to the firm. We will explore different rents and the way managers can access them to deliver performance.

Access to natural resources or raw materials can be a source of rent called Ricardian Rents if it is restricted. Firm management can identify those hard to find resources and manage them to insure a privileged access for their firm, making sure that competitors cannot benefit from the same advantages. Today, access to organic produce is a competitive advantage for companies that manage cafeterias, for example, for numerous French schools and public offices. The number of clients requesting organic produce has increased significantly, faster than the ability of farmers to convert their farms to organic standards[xv]; therefore, the management of one of the leading companies in this area takes special care to manage the providers of organic produces to maximize the output allocated to them. On a global scale, the privileged access to rare earth is providing China and Chinese companies a competitive advantage in many fast growing high technology products (Forbes Magazine[xvi]). The Chinese government has structured an advantage for its domestic firms by managing the access to the rare earths.

Another source of rent is innovation, or Schumpeterian rent; it can be generated internally or provided by partners in alliances. This type of rent can be of different natures because it exists only until such time as the competition can copy the innovation. Apple has captured Schumpeterian rents by innovating both hardware and software for its range of products, such as the iPad and the iPhone which have generated a very large and loyal following versus its direct competitors[xvii]. It has made Apple share grow much faster than its peer group. In the last 2 years, Apple share price has grown 150% while the NASDAC has grown 50%[xviii]. Innovation can also be provided by suppliers. For instance, Repower captured a strong position in 5 MW wind turbines through its collaboration with Renk to develop gearboxes that were able to handle the torque generated by the blades in high wind, while being durable and easy to maintain. The relationship was established around 2000 and persists today, where Repower still mentions its relation with Renk as a longstanding partnership[xix]. Repower has grown from a minor player in the industry to being the fastest growing and most profitable company in that business over the last 10 years[xx].

Firms can also develop competitive advantages through their human resource talents. Those talents would be applied to perform the same tasks as competitors with access to the same resources but in a more efficient way. A famous example of this kind of superior exploitation of resources through better management is the development of the "Toyota Way" and the elimination of "Muda", the seven wastes (Liker 2004[xxi]). The philosophy of the "Toyota Production Way" starts with a focus on adding value: "TPS starts with the customer, by asking, "What value are we adding from the customer's perspective?". It shows that management attention focuses on value creation. Toyota has built its ascension from a minor local manufacturer of cars in Japan to global leadership in volume, technology and quality based on this philosophy, delivering tremendous value to its shareholders and partners.

In all the situations above, value is created for the firms that have the possibility to deploy those strategies. Value is also created as a whole; as needs previously unsatisfied are met, waste is eliminated. The overall system benefits from the value created: the firm, its suppliers, its clients, its partners, its surroundings.

Transferring Value

Some of the sources of value creation may be depleted. Overall, less value appears to be created. The S&P 500 has not yet returned to its peak of August 2000[xxii]. The average labor productivity growth in the G7 countries as measured by the OECD has decreased each decade since the 70's, from 3.1% growth annually from 1971 to 1979, to 1.6% from 2000 to 2009[xxiii]. If the value creation strategy is similar between all actors in a business market, competitive pressures force the returns on invested assets "normal profit".

So if value creation potential is diminishing, or not available, firm management cannot always develop a strategy to create economic profits in their quest for performance. Without a competitive advantage, the firm managements must look at other avenues to deliver the performance that has become the expectation of their industry watchers. They must either invest in the development of future sustainable competitive advantages, which is neither easily achieved nor achievable in the short to medium term time horizons imposed by the external analysts of their performance, or use their managerial skills to find value elsewhere.

What, therefore, are the options for the managers that do not have superiority in one of the resources they exploit or one of the capabilities they possess? Complacency is not an option. Managers would at best lose their "performance related bonus or compensation package", at worst be expelled from their position. Therefore, the only avenue left to the management of the firms under high performance pressure is to borrow or transfer value from outside the analysis horizon to within the analysis horizon of analysts evaluating the performance of the firm. Different approaches have been developed to transfer value. We will explore them in turn, without judging them.

From Suppliers

When a firm does not have a competitive advantage but has superior bargaining power because of its size, the training of its buyers or its control over channels, it can use this power to force suppliers to sell below normal profit.

This can be obtained through superior negotiation techniques, for instance when the first electronic auctions were introduced, initially by Freemarkets in 1995 (Fortune Magazine[xxiv]). Sellers unaccustomed to this new approach to negotiation often sold below their full cost of production. The tool did not create value but transferred value from the sellers to the buyers.

It can also occur when the buyers operate as an oligopsony, a market where the supplier pool is large relative to the number of buyers, who therefore have comparatively significantly more negotiation power. Some agricultural product markets selling to large scale retailers are of an oligopsonistic nature. The buyers use aggressive commercial practices to impose a downward pressure on the farmer's or fisherman's margin. In Europe, various systems of subsidies and assistance are called into action to give to those farmers or fishermen a compensation income. In this case, value is transferred from the farmers and the governments (regional, national or Europe) to the buyers, and to the final consumers. Studies of the upward and downward elasticity of price in large scale retailers tend to suggest that the retailers keep most of the benefit of that value transfer rather than passing it on to the final consumers.

Similar cases of pressure on suppliers have been observed in the automotive industry.

Between 1992 and 1997 a study of 51 automotive suppliers in the USA showed that their business performance declined in spite of rising sales and gross profits[xxv]. In 2005, the US Auto Supplier Sector was in the worst shape ever. “This collapse highlights the culpability of General Motors, Ford, and DaimlerChrysler. During the recent three decades, driven by the lunatic monetarist doctrines of "shareholder value" and "globalization," the Big Three U.S. automakers slashed costs relentlessly, shutting down valuable capacity, laying off workers, cutting not the flab, but the bone and muscle of the companies, all in the frenzied drive to increase the value of the stock and dividends.”[xxvi]. So during the period 2001 to 2008 KPMG reported automotive companies that collectively accounted for more than $72 billion in sales have filed for Chapter 11 protection[xxvii]

From Workers

From the workers: again, using favorable power ratio, firms can transfer value from the workforce to the management. This can be illustrated by looking at the growth of executive compensation in regard to workers compensation. In the USA, a study of average CEO to average worker pay ratio showed that this ratio increased from 42 in 1980 to 525, its peak in 2000 before retreating to 263 in 2009[xxviii]. The gap between the CEO pay and the average employee pay of companies on the London Stock Exchange's benchmark index FTSE 100 grew from 47 times in 1998 to 115 times for 2009, according to a joint study by the UK-based human resource consultancy MM&K and global proxy advisor Manifest[xxix]. In France, average salaries increased 7% in constant currency from 1988 to 2003[xxx], while CEO compensation increased 33% on the same basis[xxxi]. The human resource expenses to workers that have been reduced allowed growing profit, and justifying the increase in compensation for the executives.

To go even further, another study of increases between 1990 and 2005 shows that CEO pay increased 298%, which closely matches the evolution of stock performance, 261%, but not that of company profits, 107% or the workers, 4,3%. This shows that value has been transferred from workers to investors and executives[xxxii]. It shows the correlation between management rewards and investors’ rewards.

This discrepancy has recently created a push for more regulations, especially in Europe. Studies have also shown that productivity suffers as disparity between CEO and employees increases (Faleye, Reis, Venkateswaran 2010[xxxiii]

From Customers

A way to generate value for firms is to sell products with “planned obsolescence” the practice of making products that will quickly become old-fashioned, or will not last long, so that people will need to replace them[xxxiv]. Although there was already a mention of that term in 1932 (London [xxxv]), it has become a practice in some industries that either design products for short lifecycle or make repairs difficult. The term was popularized in the 1960s (Packard [xxxvi]).

The approach is still found today, with firms of all size. Apple is using proprietary five-point security screws in the iPhone 4 and new MacBook Air. The special screws were first used in the 2009 MacBook Pro to stop users from replacing the battery. It also makes the consumers either dependant on Apple for repairs or forces them to replace rather than repair[xxxvii]. Another example is the practice of toner or battery manufacturers to implant a chip in their device that purposely limits the number of cycles of usage to a preset usage rather than allowing the products to live their entire lifespan. I personally observed that the HP drum for the Color LaserJet 4550 is limited to 25000 copies, and costs about 75€ to replace, while replacing the memory chip with an aftermarket part will cost a few Euros and triple the life of the drum.

Planned obsolescence will create value for the firms that engage in it but will destroy value for the consumers, and the society as a whole, as a device that could easily see its life extended at minimal cost is wasted.

An alternative is to tinker with the specifications to reduce the costs through lower quality ingredients or component replacements, unbundling of services, etc. Manufactured food products offer prime examples of this practice, with the adjunction of thickeners to creams and yoghurts to replace milk and cream as well as the use of artificial colors. While some of those additives have a value creation purpose, like preventing flavor degradation due to oxygen or light, others have no other purpose than to reduce the bill of material of the product while mimicking the aspect of a richer product.

From the assets to the results

Strategic decisions about the financial management of the firm can also improve a firm’s performance within the analysis horizon described above. One of the methods of assessing the value of a firm is the “Discounted Cash Flow” approach. If management reduces investments in new assets, cash flow will improve immediately. In the USA, for instance, the rate of capital investment have been reduced from an average 4.1% of sales between 1998 and 2004, to 3.7% of sales on average between 2005 and 2009[xxxviii]. If expenses to maintain current assets are reduced, the results are improved, so not only cash flow improves, but also the return on investments.

This approach can be used to look not only at physical capital, but also human capital, or intellectual capital and all the intangible assets of the firm.

Reduction of investments can have an impact on long term results, but they have a short term impact that is certain while the impact of lower investments is difficult to assess, and the future results are discounted in valuation models. Therefore, as certainty has more value than future projection, value is delivered to the investors.

From their local ecosystem

In business, the ecosystem of the firm is defined as “An economic community supported by a foundation of interacting organizations and individuals”. The initial references to ecosystems referred to companies that co-evolve capabilities around a new innovation (Moore 1993 [xxxix]). I prefer to extend this view by using the biological definition of ecosystems “An ecosystem is a biological environment consisting of all the organisms living in a particular area, as well as all the nonliving, physical components of the environment with which the organisms interact, such as air, soil, water and sunlight” (Campbell 2009[xl]) which suggests a broader definition for the firm’s ecosystem. The firm lives in a surrounding made of suppliers, but also a region that provides trained workers, supply roads, a protective legal environment, etc. The region surrounding the production site usually provides a percentage of the customers of the firm. In return for their contribution, firms pay suppliers, but also provide salaries to the workers and taxes to the communities that support them.

When firms use fiscal engineering to reduce their tax exposure, or move some decision centers to geographical zones that offer less constraining environments in terms of regulation, cost of labor, etc. they transfer value from their ecosystem to their shareholders. Large, profitable companies efficiently exploit all the opportunities offered by different countries to reduce or even completely avoid paying taxes in their host country. For instance, in France, the CAC 40 companies pay taxes at an average rate of 8%, while the SME pay at 22%; the standard rate is 33%[xli]. The company "Total" paid no taxes at all.

When they replace local labor by labor from lower cost countries, firms also transfer value from their local ecosystem to their balance sheet.

Impact of Value Transfer Strategies

Are these decisions inherently good or bad? After all, there is a consensus in business that "There is one and only one social responsibility of business-to use its resources and engage in activities to increase its profits" (Friedman 1962[xlii]). So isn't the mandate of a firm management to do so?

Those strategies transfer value, as we have seen, unlike the resource based strategies that create economic rents. Some of them are not even delivering value for the firms that apply them but rather move value across the time horizon.

In the two alternatives analyzed above, creating value and transferring value, the managers use resources available to the firm in a broad sense. According to the "Resource-Based View" of competition, unique resources can create sustainable competitive advantages (Peteraf 1993[xliii]).

The issue with the value transfer strategy is that it jeopardizes the ability of the firm to operate in the long term:

- Reduces its ability to deliver future growth by under investing in its capital, its capacities to exploit resources
- Reduces its ability to access the resources it needs for its future growth by alienating those resources, being suppliers, workers or the ecosystem

The value transfer strategies are limited in the sense that they reduce the ability of the firm to access those resources successfully in the future, especially if other firms have created a more constructive, collaborative approach to work with the resources.

To illustrate the long term value destruction risk of value transfer strategies, we can focus on supplier management. In supplier management, studies in the US automotive industry have shown that there is a correlation between the quality of the relation between the automotive suppliers and the long term performance of their clients. Every year, Planning Perspective measures the quality of the relation with its "Working Relation Index"[xliv]. The index shows that Japanese car manufacturers in the US have a better relation with their suppliers than their American competitors, and that the gap has increased from 2002, date of the first survey, to 2008 when Ford, then Chrysler and GM significantly changed their approach and improved their results[xlv]. The results of that index have been correlated with the operational and financial performance of their clients. In 2007 Planning Perspective Inc[xlvi] specifically measured the change in Supplier R&D expenditures for each OEM and found that between 2003 and 2007 R&D budget allocated to US car manufacturers decreased year after year, while it increased year after year for the Japanese car manufacturers based in the USA.

Cooperative-trusting OEM supplier relationships improve performance on four counts (Milas 2008[xlvii])

- Significantly reduce overhead and material costs
- Increase the level of innovation while reducing OEM investment in research, which is acknowledged by OEM as having an impact on competitive advantages
- Foster quality of individual components and overall end product fit
- Enhance material management practices

The elements above contribute to the value of the firm. Their impact can be seen, ultimately, in the evolution of the ranking of American firms versus Japanese firms expressed by the preferences of their customers with a market share dropping regularly[xlviii] and expressed by the preference of the investment communities who stopped recommending the shares of US Automotive Manufacturers (Michael Bruynesteyn 2004-2006[xlix])

Toyota and Honda US operations have built great supplier relations by using six steps that allow them to exploit the full potential of the suppliers while the US companies have not been able to develop the same type of relation, and built supply chains that mimic the Japanese approach without altering the nature of their relations with their suppliers, driven by a culture of confrontation rather than cooperation (Liker, Choi, 2006[l])

This focus on the supplier resource demonstrated that the short term focus on value transfer, used by Ford, GM, and Chrysler, actually destroyed value in the long term.

Conclusions

The consequences of the quest for performance on managers will be to spur them to deliver more value to the firm, and to its shareholders. Management will be selected for its ability to design and implement value delivering strategies to generate profits.

The value creating option is to exploit resources to better create rents that will deliver competitive advantages and the ability to price products or services at a level that will deliver economic profits. The value is created for all the participants in the value chain.

When the demand for performance is superior to the ability of the management to create value, the second venue is to transfer value to the firms from outside the horizon of the people measuring that performance, primarily the institutional investors.

In both cases the objective of the firm remains to maximize shareholder value, because shareholder value maximization is inconsistent with exploitation or alienation of other constituencies[li]. So why are the value transfer mechanisms rewarded even as we have seen that they can destroy value in the long term?

Further study can focus on limitations of current measures of value as used by institutional investors. They do not integrate well factors that are not direct outputs of firms finance management systems. Also they probably discount too much long term implications. The skills to pick stocks is not prevalent. A study concludes that the average fund manager has no talent (Fama, French 2010[lii]).

There may be a need to establish a better measure of externalities, to allow public policy to correct for the incentives to use value transfer rather than value creation strategies in the quest for performance of firm management.

Finally, firms will realize that investors can have multiple objectives that they will balance in allocating their resources. Most of the literature has focused on the financial value maximization while investors and investing firms have begun to advertise funds that go beyond financial objectives to include societal and sustainable objectives.

To do so, the manager must be able to harness true leadership, which is not only the ability to deliver results based on expertise but also to communicate and convince the audience of the validity of ethical actions as the essential elements of future value creation opportunities.

Shareholder value maximization must remain the preferred corporate goal (Sundaram, Inkpen 2004), but the measurement must more accurately reflect long term effects of management strategies, and government policies must correct for the impact that cannot be accounted for in the financial reporting of firms. Socially responsible behavior can actually improve a firm's future cash flow and is therefore compatible with the wealth-maximizing interests of the firm's shareholders (Mackay, Mackay, Barney 2007[liii]). Additionally, firms can broaden their understanding of investor's demands. Today, investors demand improved sustainability reporting[liv], which significantly broaden the perspectives for the management of firms to deliver to the expectations of investors.

In conclusion, I quote Jeff Trailer who framed the action of manager as an ethical pursuit: "Strategy is the ethical pursuit of returns in excess of the "ordinary" rate of profit. As such, the field of strategy has employed the theory of rent as a basis for arguing behavior that will produce such returns"(Trailer 2003). For me, the Ethics of the Manager is to preserve all future options for the firm, rather than following the pervasive quest for short term performance.

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