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The Challenges of Attaining Growth:

The Blenheim & MGSM Insight Series

Authors: Dr. Brett Wright, Mr Gregory W. Robinson & Professor Charles Areni

"Superhuman effort isn't worth a damn unless it achieves results"

Sir Ernest Shackleton

Chapter 5

The Short and the Long of It

"We have the tyranny of instant coffee."

One of the most difficult aspects of specifying growth strategies and targets was getting the right balance between short-term and long-term initiatives. Multiple investor segments and other external constituencies place conflicting demands on Board decisions.

Chapter 5: The Short and the Long of It

"If you see the President, tell him from me whatever happens there will be no turning back"

Ulysses S. Grant

'Short-termism' was a common theme among Directors and there was no shortage of commentary on the subject, some attributing this mindset to pressure from investors for immediate runs on the Board.

Sustainability

"The first thing I'd say is, growth is about sustainability, and I think it is one of the challenges in Australian business, and probably businesses all over the world. We're all focused on what I call short-termism. And everyone's focused on the next round of numbers. … The market won't necessarily focus on growth over 3 to 5 years. It is not that they are not interested, but they're also looking for short-term growth as well. But a real measure of growth is sustainability and someone that has built it year on year."

"If you happen to be in a low growth phase while you roll out your plans for longer term growth, they tend not to be terribly patient and not to reward you."

"The short answer is we can blame it on shareholders and shareholders' expectations, and they have a short term view ….. and they blame it on the CEO and they're gone."

"There are very few long-term investors in this marketplace, and they are all looking for return. …I still think the average time on the register was 8.6 months. So having shareholders telling me you've got to look at the long term when they are only sitting on the register for 8 months is a little bit interesting."

"Shareholder short termism is a fact of life - it is detrimental to and stopping growth".

"Everything is moving to the short term:

- ***Hard to plan and deliver for the long term;***
- ***Something is wrong in the balance; and,***

- ***Shareholders are a driver of the long term view but buy in and out."***

"Australia is incredibly short term."

"Why take risk when you don't need to? – short-termism!"

"Overall compliance/risk burden, reporting cycle and the generally conservative Australian culture are driving a more short term orientation."

Once again, the theme of investors wanting growth without risk emerged in the context of trade-offs between short-term and long-term objectives. Short-term planning and returns is safer than pursuing long-term opportunities. Shareholders and institutional investors at times want short-term delivery from long-term strategy. They essentially want their cake (immediate returns) and eat it too (high growth). And once again, this requires Directors and executives to spend an inordinate amount of time explaining their portfolio of short-term and long-term growth initiatives.

Academic research suggests that, unfortunately, this kind of investor mentality is extremely likely to follow a ***"Black Swan"*** event like the GFC for at least two reasons. First, a negative shock like the GFC causes an overreaction in terms of risk aversion. Investors become more risk averse than they should be[18]. However, they may also anchor their expectations regarding returns to the period preceding the shock such that the risk-return trade-off becomes unrealistic[19]. But others saw these investor demands as being more reasonable, and blamed the Boards themselves for not being able to articulate a clear strategic vision for long-term growth to various investment markets.

"It's as much about the communication from the company, i.e. I think our problem with short termism in recent times has been the inability of companies to articulate a good path for investment over the longer term."

This view was broadly reinforced by a range of participants who while agreeing that articulating the story was a problem, it was unclear as to the cause of this. Was it just a lack of competency in telling the story, or was it more than this? Did they not put the required effort in because they could not see the value, was it more fundamental, in that they did not see why they should or as one participant put it: is it the language of ***"corporate"*** that we have created?

"We have created a language called corporate. It is a problem. Our communication skills are critical and are being tested. We need to get the message across in less than five pages. Promise only on what you can deliver, keep it simple, keep it clear and once again keep the language simple. Then you will get credibility."

"Short termism is just as much about the inability to articulate the story to investors and other stakeholders. The US is better at spelling out the long term. The smart investors like capital appreciation."

"CEOs are not always very gifted at telling the story (selling the story!)"

"Corporate Australia is not very good at talking the long term."

In addition to simply being ***"reasonable"***, recent academic research suggests that a balance between short-term and long-term growth strategies and achieving financial objectives may be a good thing. An imbalance in either direction creates a problem. Directors are correct in suggesting that too much short-term focus can lead to a kind of corporate myopia, where Directors and executives miss sustainable, strategic growth opportunities.

Private Equity

Access to private sources of equity was identified as a mechanism for escaping the risk averse, short-term orientation of shareholders. In essence, selling shares to generate cash was seen as part of the overall problem. Some Directors contrasted the reality in Australia with the US equity markets where large amounts of equity were more readily available.

Similarly private equity was identified as a way to escape the scrutiny of the share market. There is too much pressure in a public company to perform to investors' timetables that precludes many growth opportunities.

"But if it's got 8 billion dollars of debt, and cash flows to support that, I'm presuming once it's paid down, that that cash flow will go from the point of debt to the bottom line and, at the minimum, we have a likely cap of 8 billion dollars. That's how a venture capitalist would think of it privately and, as a public company you really can't do that in Australia."

"Private equity works very efficiently in seizing those opportunities. And sometimes, the best thing for business is to not be public."

In this sense then, Australia's highly cautious and overly regulated approach to monitoring foreign investment may be a source of disadvantage in allowing Australian Boards to pursue riskier, longer-term growth opportunities[3].

Directors referred to a kind of 'market based managerial myopia' that can take over thinking on Boards and in the executive suite. Companies can effectively be penalised by their long-term success in certain markets. This can often result in Board members wearing a set of 'institutional blinders' that prevents Directors from spotting opportunities for growth in other markets.

"We found our way into a remarkably good business model, and we were so successful for such a long period. During that period it felt like ..… look at us,

we're nailing it, our investors love us, the market loves us, we're just going to keep doing things our way, right. That's all fine on the way up, but when it turned, and it turned really quite suddenly, we went from being successful and a little bit probably focused internally to being defensive really quickly. And I think that impedes your ability to have that continuous balanced approach, inside the walls and outside the walls."

Investors may also contribute to this kind of corporate mentality by demanding that management ***"tends the garden"*** they have invested in. Moving into new industry sectors via acquisitions may be seen as abandoning the very reason that investors injected cash into the company in the first place. Executives may have to earn the mandate for growth via M&As by first generating organic growth to the satisfaction of investors.

This notion of managerial myopia has been verified by academic research examining the content of internal communications between management and shareholders. Specifically, managerial myopia often takes the form of seeing growth opportunities mainly in terms of current industries, existing technologies, immediate competitors, and current geographic markets. Company Boards and executives may fail to see growth prospects in new foreign markets and unfamiliar industries, and may fail to appreciate opportunities to improve financial performance via investing in infrastructure development[20].

Once again, the scrutiny of the investment market and its short-term orientation was linked to the more general notion of risk aversion being fundamental to Australian cultural values.

"So culturally, we're an egalitarian society, it's lovely to live here but it's terrible to produce fast horses. Here you are afraid to feed the fast horse more."

Many of the participants further articulated a romanticised view of the US as an environment for conducting business. If Australians were described as overly conservative, short-term, seekers of dividends, American investors were described as having a longer-term focus on capital management. U.S. investors, particularly institutional shareholders, were identified as tolerating a longer-term investment strategy that might not yield any discernible result in the short-term.

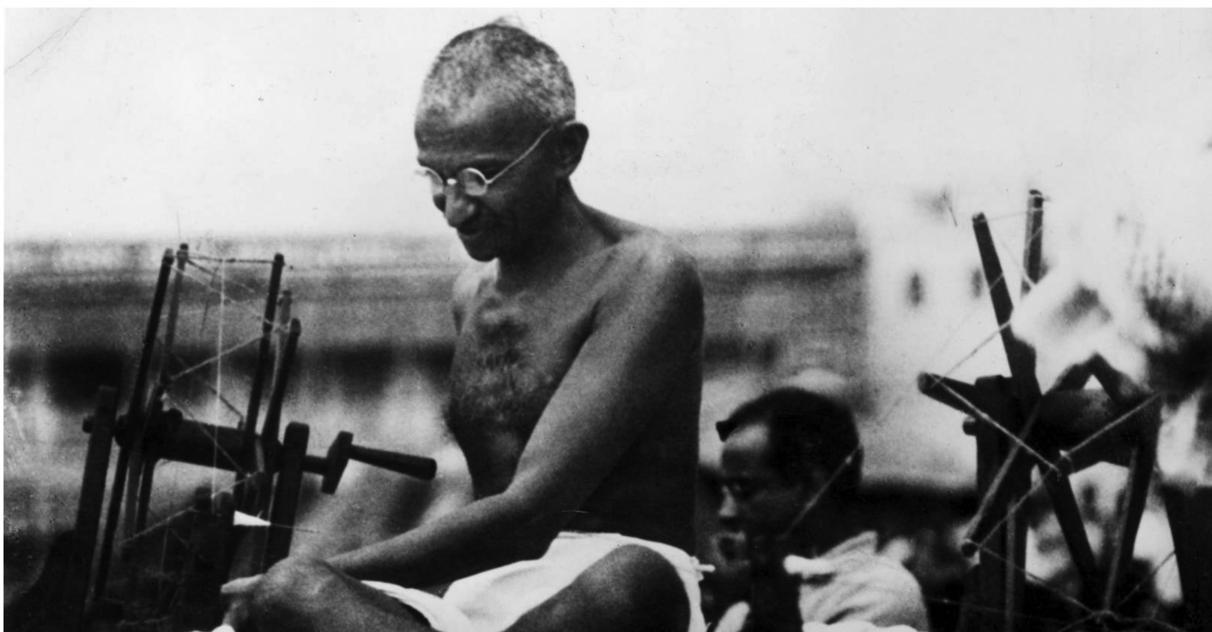
"'Is your dividend guaranteed … is it guaranteed? So we always used to say 'No, you want a guarantee, go buy a fridge.'"

"They (US investors) really understand good deals, they understand business strategy, and they are happy to go for the ride. If, on doing their homework they believe it's a good deal."

Culture

But others questioned whether there were broad cultural differences in investor motives.

"The array of investment styles, right across, and in each of the major investment markets is such that I don't think you could say the Americans think this way and the British think that way and the Australians think that. There are different types of investors in each of those countries who think exactly the same way and as a cohort."



"We must become the change we want to see"

Mahatma Gandhi

Others referred to the high standards of living in Australia and wondered why anybody would be inclined to take risk in such a situation.

"I think it's a function of the nature of the lifestyle here. It's an easy place to live, therefore why take the risk? … Why take the risk to be a lot better, when in fact the downside is so much greater if I get it wrong?"

There is very little in the academic literature to suggest broad cultural differences in investor motives or expectation between Australia and the US, or anywhere else for that matter. Instead, economically developed countries exhibit similar patterns of financial market segmentation, suggesting a high degree of integration of financial markets and common mindsets among the investor segments comprising those markets[21].

Research/Analyst

Part of the Australian inability to articulate a coherent story to investors is a lack of commitment to comprehensive research about markets and trends. Australian investors want a ***"quick fix".*** The analyst community are in part to blame.

"You'd go overseas and there are 5 analysts that you're talking to, it's sort of like a triangle behind them, there's another 5, 6 or 10 people behind them that are doing their homework. They have trends by industry, and questions by industry, and they're far more thorough and innovative in their research. So as an example, we went overseas and said, 'We're (company), we're the biggest (business). We sell to a large particular constituency and the analysts say, 'How many are suing you in court?" In 17 years I've never been asked that question in Australia. So I said 'None!' He says 'None? You sure?' 'None.' 'Oh ok, tick, next…' Because obviously the people behind him had said every time you hear the word constituent, ask how many are suing them in court because they haven't delivered what they promised. The most common question in Australia is … 'What are other investors asking you that I haven't asked you?' They're too bone lazy to do their homework!"

Remuneration & Alignment

An interesting contradiction from the short-termism focus is on how the executives in these companies are rewarded. If investors are staying on the register for shorter periods and if they are driving such a short-term orientation that they are impeding growth and long-term value, then why are they strong advocates of executive remuneration systems being ***"highly aligned with shareholders"?*** This seems contradictory as the long-term incentive arrangements are by their very nature long term and growth or out-performance orientated for full payouts to occur. That is executive incentives are designed for growth over the longer term and biased to growth that outperforms peers. Is this a blind spot for some investors, in that the mantra of alignment meets the rhetoric test, but in reality does it align with their actions as investors?

However not all agreed that the remuneration systems are in good shape. Many thought the remuneration systems were more aligned to strategy, not outcomes. A far simpler approach was advocated ***"aligned to outcomes".***

Directors identified balancing the desire for immediate rewards in certain investment markets with longer-term, strategic growth initiatives as a major dimension of the advice Boards give to company executives, with some suggesting a 'risk portfolio' approach to having the best of both worlds.

"When I think growth, you've got to look at short term, long term growth, and balance up. There are some times where you can pursue short term strategies for growth and good shareholder returns, there are times when you've got to take a much longer term view and that could impact short term shareholder returns. You've got to take those risks and you've got to be able to explain that to shareholders where it occurs. I think the issue of balancing short and long term interests is an important one."

The reality is that this whole short-termism phenomena is not just a consequence of external pressures but some internal as well, including the tenure of the CEO.

Tenure of CEO

"The tenure of Chief Executives is ridiculously short. You cannot change culture in 4.5 years."

"Short tenure of Chief Executives is a real problem. They don't live through their implemented changes. They don't live to be measured against their change. Instead, the baton seems to be passed to the next person who blames their predecessor. It is a ridiculous merry-go-round."

Academic research supports the contention that CEOs who perceive that their tenure is likely to be short, or feel that they are ***"under the gun"*** for any reason, will tend to pursue growth opportunities that offer relatively faster paybacks at the expense of investing in longer-term value creation[22]. From this perspective, the increasingly shorter tenures of CEOs in Australia may be a direct contributor to short-termism.

Likewise, CEOs with remuneration schemes that focus on share value are likely to pursue ***"growth"*** initiatives that encourage investor speculation designed to increase share prices, without adding genuine value to the firm in the long-term. In many cases, this share price ***"gamesmanship"*** may actually decrease firm value in the long-term[23]. So, selecting the right combination of cash and equity holdings, and specifying the right set of growth KPIs is critical to offsetting short-termism on the part of CEOs.

Others might point out that the tenure of Directors is longer, sometimes two to three times that of the CEO and that this compensates for the shorter tenures of CEOs. Directors however do not manage the implementation or execution of strategy, and the dislocation created by the short tenures of CEOs on average, with their ***"reinvention, renewal or refresh of the strategy"*** works against the long term.

What it all means however is that it results in the question ***"What do you need to do to be in business in five years' time?"*** rarely being asked.

Comment

So what of short-termism? Perhaps the part quote at the beginning of this section ***("We have the tyranny of instant coffee.")*** sums it up, but the full quote below explains why it is so important.

"We have the tyranny of instant coffee, short termism, not taking the time to make things right."

In many ways what we are hearing is that growth is not what is required, but that sustainable growth over the longer term should be the goal. To do this it is imperative that all stakeholders including Boards and executives align in ensuring that strategies are put in place across the short, medium and long term to ensure sustainable growth over time for companies. A failure to do this will have disastrous consequences, resulting in short-term planning and growth trajectories that over time will challenge the ability of companies to deliver sustainable growth.

This is because no one will be looking out, asking the ***"what if"*** question or ***"looking over the front of the boat"*** to identify future opportunities and threats.

This will have consequences for all stakeholders including:

- Reputations of Boards and executives;
- Earning potential for executives;
- Longer term sustainable capital and dividend growth for investors;
- Superannuation returns for Australians more generally to live on in retirement;
- The viability of the companies themselves; and,
- The security of jobs for employees.

Growth, what it is and how to best define it for your company at this point in time in your market varied greatly across participants. What was interesting in the contrasting views was whether growth included incremental or was it only substantial?

"If businesses grow only incrementally the business will not survive long-term."

"Big is not necessarily beautiful. We want sustainable growth and business is about people. The winner thinks that there always has to be a better way of doing things. The loser says this is the way we have always done it."

"Growth is not about being incremental, it is about substantial growth. That is buying another business, moving into another geography, creating new divisions or achieving multiples of the market."

Some participants saw this growth as the fundamental prerogative of the CEO; the essence of what CEOs do for their companies.

"I had someone once explain to me what my job was. You're not the CEO; you're the Chief Growth Officer."

To make this happen and drive the company, the participant explained the role of the CEO was to ***"aggravate, educate and motivate."***

It is evident that growth for growth's sake is not a goal to be strived for. ***"Profitless prosperity"*** will not be tolerated. However, growth is not a generic outcome with a set formula. How it is achieved, what is achieved, in what timeframe and the context within which it is assessed are all important variables in determining whether growth is acceptable in terms of profitability, sustainability and timeframe for investors.

Directors and CEOs have a difficult task in putting all these variables into the equation for solving – and it is an equation and a unique one for each company. The success in solving the equations determines the success of all, stakeholders, Board, executives and Investors.