## Rappaport, Alfred – Creating Shareholder Value: A Guide For Managers and Investors

*The Free Press, 1998 (1st ed 1986), [Business]* Grade ★★★★

During the summer InvestingByTheBooks will review some older books that we never got around to writing about although we think they are important. Alfred Rappaport's *Creating Shareholder Value* from 1986 is a yardstick for the shareholder value movement. The author shows how corporate managers can apply the shareholder value approach to managing companies and supplies the tools for doing so. Hence, the main audience is corporate managers but the book is equally useful to anyone on the financial markets as it addresses issues bordering between business and finance.

The introductory chapter is of more philosophical nature than the remainder and the author develops his thoughts on why the shareholder value approach is the one to adhere to for businesses. Rappaport points to the moral aspects of the proprietorship that comes with owning something and to the efficiency aspects of optimized capital allocation and how the model benefits the broad masses through both their pensions and higher economic growth – in essence this is how the world rose from the middle ages. It's much the same discussion that is being held today 30 years later. In retrospect it's obvious that the CSR and stakeholder camp is winning the match by a mile at the moment. Capitalism is not en vogue in 2015.

The author explains the concept of shareholder value as the present value of all future free cash flows discounted by the cost of capital, net of net debt. Value is created by investing capital in the business that generates a return on investment which is higher than the cost for the invested capital. Thus, trying to increase shareholder value includes handling all the difficult choices between investing now to hopefully generate higher cash flow in the future. Rappaport is careful to differentiate the creation of shareholder value from the shareholder return on the stock market. The latter will only correlate to the former on average and over long term. He also contrasts the creation of shareholder value to the shortcomings of accounting based estimates of value creation. *"How can so many managers continue to believe that stock prices are driven by short-term accounting numbers despite impressive evidence to the contrary?"* Most still haven't understood.

To me the most interesting chapters are those where Rappaport not only links the creation of shareholder value to corporate strategy and execution but also manager evaluation and remuneration. The author discusses the chance of gaining a competitive advantage in various industries and shows that management can work with a number of value drivers to increase shareholder value a) sales growth rate, b) profit margin, c) working capital investment, d) fixed capital investment and e) the cost of capital. By breaking this down on "value driver maps" the KPIs, the leading indicators, that have the highest impact on the value drivers for a specific company can be located, be it measures of customer satisfaction, quality improvements etc.

Options were for Rappaport a way to try to mitigate the risk that management would enrich themselves at the expense of the owners of the company. The author advices that the allocation of options should be tied to the above leading indicators and that to the extent the share performance plays a role, one must look to the relative price performance compared to industry peers. Today, with the benefit of hindsight of the excesses of the period around the millennium the text on options strikes you as a bit naïve. There is nothing wrong with the intent but the insight in how greedy persons would use the carte blanche of issuing options isn't there.

Creating Shareholder Value is a short concise book. It's theoretically stringent and you often perceive what's being said as obvious when stated but it doesn't go into much detail as it sweeps over several important topics. This important text makes it blatantly obvious that the short-termism that the shareholder movement often is accused of is a faulty later day rationalization.

Mats Larsson, July 13, 2015

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