

**Madden, Bartley J. – Value Creation Thinking**

*LearningWhatWorks*, 2016, [Finance] Grade ★★★★★

Most finance and investing books are easy to review. This one was not. Most books keep within a sub-genre where they recycle and mix the usual concepts within the area. This book forced me to think about the philosophy of the firm in ways I hadn't before. The first sentence of the preface is "*The ideas in this book reflect how my worldview evolved.*" This text is the intellectual biography of Bartley Madden. In 1969 he co-founded a firm that would eventually lead to the HOLT framework used by Credit Suisse today. Madden's research, thoughts and work effort is a huge part of the valuation framework and database that is today used by thousands of portfolio managers around the world.

*Value Creation Thinking* has three parts where the first sets the philosophical stage and the following two fill in practical details. As such the first part is more interesting. Madden starts with a defense of capitalism worthy of Milton Friedman. Then he presents his competitive life cycle view of the firm. Successful innovation initially creates high returns on invested capital but this will over time be competed away as other companies enter the profitable area. Next the author discusses the purpose of the firm and the tasks that managers must perform to fulfill this purpose. In short managers must 1) understand how value is created, 2) use resources efficiently and 3) create a knowledge-building corporate culture. From this they can set goals and execute on strategies. The second part of the book covers the third task above and the third part the first task. I broadly agree with these parts and have little to add. I will instead come back to the purpose of the firm.

At any point in time the society has a limited productive capacity. This capacity is in large part the sum of the tangible and intangible capital invested in corporations. These investments aim to, within the constraints of the available capital resources in the society, offer the most benefit to people in the form of products and services. The future stream of benefits net of the costs it takes to produce them equals the value of the firms

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producing them. This net benefit to society equals the net present value of all future free cash flows of the firms. If a firm maximizes shareholder value it also maximizes the benefit to society expressed in this way. On this we both agree.

Madden doesn't think that maximizing shareholder value is the purpose of the firm since it would be a purpose that employees and stakeholders couldn't support. Hence, such a purpose would be self-contradictory, as the firm then couldn't create any shareholder value. Instead the author advocates a purpose package of a) having an inspiring vision and high ethical standards, b) survival through efficiency and innovation, c) creating win-win relationships with stakeholders and d) caring for future generations through environmental sustainability. These input variables will lead to the output e) maximizing the benefit to society (as defined above) that equals maximizing f) the shareholder value. Now, instead of as Madden calling the input variables the purpose, I call the output the purpose. Is this just semantics?

Defining the input variables as the purpose has a more positive tone to it while the opposite easily can be seen as cynical and hurt the image of a firm even though the practical actions might be the same. However, putting the input variables on top means that the ability to optimize on the target of creating maximum "benefits to society" becomes impossible. Therefore, if the democratic society can handle the task of setting rules of the game that truly internalize all costs of business processes, it is my view that defining the output variables as the purpose of the firm will make all of society more prosperous. The daunting task in this is to make people realize that maximizing shareholder value equals maximizing the benefit to society.

Madden has written an intelligent and thoughtful book that many in the business community would benefit from reading. However, the abstraction level is high and the book doesn't fit nicely into a genre so I'm not sure they will. It's their loss.