

FOCUSING CAPITAL  
on the **LONG TERM**



## Straight talk for the long term

How to improve the investor-corporate dialogue

March 2015

Focusing Capital on the Long Term ('FCLT') is an initiative for advancing practical actions to focus business and markets on the long term. It was founded by the Canada Pension Plan Investment Board and McKinsey & Company. More information can be found at [fclt.org](http://fclt.org).

## Introduction

Short-term behavior is becoming the norm in modern capital markets. Rather than pursuing and communicating long-term strategies, many public companies dedicate significant resources to meeting quarterly earnings guidance and communicating their performance relative to this guidance.

This focus on short-term actions and communications seems counterproductive, considering that more than 70% to 90% of a typical company's value is created by activities that will take place three or more years in the future.<sup>1</sup> Moreover, research shows that the current emphasis on achieving short-term earnings targets leads to value destroying behaviors. One survey found that 55% of CFOs would avoid undertaking an investment that enhanced net present value if it meant falling short of the quarter's consensus earnings per share (EPS). And 78% of executives said they would take actions to improve quarterly earnings at the expense of long-term value creation.<sup>2</sup> Companies that expressly seek to manage short-term earnings in order to narrowly beat consensus also underperform peers after two years.<sup>3</sup>

The investor-corporate dialogue can help counteract this short-term bias. We define "investor-corporate dialogue" as the flow of information and ideas between corporations and their current and future investors. A healthy dialogue can empower management to make strategic and operating decisions that build value for the long term. Companies can start by changing the focus of their communications to investors, which currently tend to stress short-term performance and metrics. Partly in response to regulatory requirements, these communications have become increasingly complex over the years while focusing mainly on historical results. This has led to growing volumes of data and communication that often obfuscate the information that is critical for longer-term investors.

Financial and performance disclosures can be written in confusing legalese that yields little insight into the company's value drivers or future potential. Rather than highlighting the most important recent developments, many corporate disclosures simply maintain the status quo. These disclosures rarely connect recent performance to long-term strategy and objectives. Instead, opportunities and risks are expressed in generic

terms such as "increased competition" or "changes in commodity prices". At this level of abstraction, it can be difficult for investors to discern what differentiates a company (or a company's businesses) from others in its industry, and what that differentiated value proposition says about its future prospects.

Some companies are reluctant to disclose their long-term strategy for fear that business and industry trends will not unfold as expected, leaving them accountable for plans they can no longer achieve. Others worry about violating fair disclosure regulations. These are reasonable concerns. However, we believe that all corporate stakeholders stand to benefit from an investor-corporate dialogue that adequately considers the company's long-term performance and health as well as its short-term performance.

We have three primary recommendations for companies that seek to strike a better balance between short-term performance and long-term value creation:

- 1 Build a compelling long-term strategy and communicate it to investors.**
- 2 Measure long-term value creation and performance relative to a set of long-term metrics specific to the company's long-term strategy.**
- 3 Report to and engage with investors regarding long-term value creation.**

A diverse group of institutional investors and corporates was brought together to collaborate on this piece and each may pursue the recommendations expressed to varying degrees. Within the context of their unique situations, we encourage organizations to evaluate, adapt and adopt recommendations, enhancing long-term value created for stakeholders.

## 1 Building and communicating a compelling long-term strategy

A core idea behind long-term value creation is that companies need strategies and business models that consider value derived from all stakeholders. The goal should be to create value for these stakeholders by growing the enterprise beyond a product or investment cycle and beyond the average tenure of CEOs or directors.

A review of typical product lifecycles across a variety of industries illustrates the importance of longer-term thinking:

- Average asset turnover across industries is about 10.6 years.<sup>4</sup>
- The average pharmaceutical drug takes 12 years to develop and typically has a product lifespan of about the same duration thereafter.
- A gas turbine takes five years to develop and has a 25-year life expectancy.

Defining what fraction of a company's value comes from activities that will take place five, seven or 10 years out can help suggest an appropriate time horizon for the company's long-term strategy. At a minimum, we recommend a five-year strategic time frame.

While few executives would question the importance of creating value for the long term, their behavior tells a different story. In a global survey of more than 1,000 senior executives conducted by McKinsey and CPPIB, 44% said their company's management team currently uses a primary time horizon of less than three years for setting corporate strategy. However, the same business leaders acknowledged the importance of thinking longer-term: 73% said the primary time horizon should be more than three years, and 11% said it should be more than seven years.<sup>5</sup>

We believe that better corporate communication can help investors and business leaders focus more on the long term. According to a recent survey of managers from 66 organizations belonging to the International Integrated Reporting Council (IIRC), developing and communicating a rigorous long-term strategy can deliver meaningful benefits for both internal and external audiences. Some 92% of respondents reported having improved their own understanding of how value was being created (and destroyed) within the organization. Another 79% found that business decision-making

had improved, and 78% reported better collaboration between the board and management.<sup>6</sup>

In addition, the IIRC survey showed that more transparent financial reporting helped organizations develop stronger relationships with investors. About 56% of executives reported a positive benefit in relations with institutional investors, and 52% with analysts. Finally, 87% of respondents believed that clearer financial reporting helped investors understand corporate strategy better.<sup>7</sup>

**In our discussions with institutional investors, experts on corporate strategy and CEOs of companies across various industries, we found broad agreement on 10 key elements that companies should include when formulating long-term strategies and communicating them to investors:**

1. Express a **clear statement of purpose, mission, and vision**.
2. Explain **how the company's business model creates long-term value** by identifying key value drivers at the reporting unit level.
3. State **management's view of the market**, major trends impacting the market, potential for growth, the company's relative positioning, and underlying assumptions (e.g., macroeconomic factors).
4. Highlight sources of **competitive advantage** such as talent, access to resources, or other assets that enable the company to execute its strategy and win in the marketplace, clearly substantiated by fact.
5. Disclose **strategic goals** ultimately tied to drivers of value creation (e.g., returns on invested capital, organic revenue growth) in the context of current and future market trends, and the company's competitive advantage.
6. Lay out a **detailed execution roadmap** that defines short-, medium-, and long-term actions linked to key milestones and strategic goals targeted at long-term value creation.
7. Provide **medium- and long-term metrics and targets** that indicate the company's ability to deliver on its strategy, such as customer satisfaction over time, brand strength, and product pipeline investment and returns. Explain how the selected metrics will be measured and tracked consistently.

8. Explain how **capital and non-capital investments**, including the mix of resource allocation, will yield sustained competitive advantage and the creation of long-term value.
9. Provide an **overview of risks** and their mitigation plans, including sustainability challenges (e.g., environmental, social, and governance issues).
10. Articulate how **executive and director compensation** tie to long-term value creation and strategic goals.

Companies may have concerns about releasing information. We believe they should release information about these 10 elements to investors in order to clearly articulate the strategy, explain why it is likely

to produce the desired results, and generate a dialogue with investors around the strategy. Regardless of what is publically disseminated, developing a clear understanding of all 10 elements will help companies craft compelling long-term strategies.

Investors are increasingly demanding this sort of information from companies. In a 2013 survey, the Association of Certified Chartered Accountants (ACCA), asked investors what types of information belonged in the narrative reporting section of an annual report. Key business risks topped the list (38%), followed by key growth opportunities (37%), longer-term business expectations (36%), changes to the competitive environment (29%) and drivers of future performance (27%).<sup>8</sup>



### **Idea in action:** **How leading companies communicate long-term strategy to investors**

#### **Clear statement of purpose, mission, and vision**

Electrolux is the world's second largest appliance maker by units sold. In a single page, the company lays out clearly its vision ("who we want to be"), its mission ("what we want to achieve"), its strategy ("how we want to do it") and its values ("the base for our work").

#### **How the company's business model creates long-term value**

Nedbank is one of South Africa's four largest banking groups by assets and deposits. Nedbank's long-term strategy explains how value is created in the business through three steps: what we do, flow of money, and value added. The document also provides detailed explanations and figures for each business segment.

#### **Management's view of the market**

Metso supplies technology, automation and services to the mining, oil and gas industries. The company supplies investors with a table of its key industries, detailing market drivers and trends, short-term market outlook, organic growth potential, acquisition potential, share of orders received from the industry during the year, and service intensity.

#### **Competitive advantage**

Garanti, Turkey's second largest private bank, dedicates a full page of investor communication to highlighting its competitive advantages and supporting fact base.

#### **Strategic goals**

Amgen is a U.S. multinational biopharmaceutical company with presence in more than 75 countries. In a 2011 investor day presentation, Amgen executives outlined the company's long term strategic goals and gave financial guidance for 2015.

#### **Detailed execution roadmap**

Siemens is a German multinational conglomerate that operates in more than 200 regions worldwide. Its Vision 2020 report articulates the company's long-term strategy, detailing implementation steps in the short, medium and long term.

#### **Medium- and long-term metrics and targets**

Westpac is a major Australian bank and one of the five biggest companies by market cap listed on the Australian Securities Exchange Limited. Westpac released a detailed report on its 2013-2017 sustainability strategy. The report defines 10 objectives aligned with three sustainability strategies, all backed by clear metrics and targets.



### Idea in action:

## How leading companies communicate long-term strategy to investors (continued)

### Capital and non-capital investments

Sasol, a South African energy and chemical producer, is one of the 10 most valuable companies listed on the Johannesburg Stock Exchange. In its investor communications, Sasol clearly defines the criteria it takes into account when allocating resources. These criteria cover natural capital, human capital, social and relationship capital, intellectual capital, manufactured capital, and financial capital.

### Risks

Deutsche Telekom is one of the world's leading integrated telecommunications companies. The company sorts its risk exposure into three categories: low, medium, and high risks. Deutsche Telekom assesses each risk by probability of occurrence and potential impact.

### Executive and director compensation

Berkeley Group is a British luxury house builder with 2013 revenues of GBP 1.4 billion. Berkeley aligned its long-term strategy with the financial interests of its executives by developing a long-term incentive plan that extends to 2021.

Some companies are uncomfortable sharing overly detailed information with investors, lest it weaken their competitive positioning. Such concerns are valid, especially as it relates to information about the sources of competitive advantage. However, a true competitive advantage is typically not something that is easily replicated in the short term.

For example, Toyota allows other car manufacturers to examine its best-in-class assembly lines, because it would take years for others to master the underlying processes and technology. Wal-Mart has made clear that its competitive advantages include procurement

and supply chain management. Given Wal-Mart's scale and the fact that these competitive advantages are embedded in proprietary IT and distributed across thousands of employees, there is limited risk that a competitor will be able to duplicate them.

There is no silver bullet in terms of the right level of detail to share with investors. However, companies should recognize the tradeoff between protecting a competitive advantage and attracting an investor base that can support the company's strategy over the long term.

## 2

## Measuring long-term value creation and performance relative to a set of long-term metrics specific to the company's long-term strategy

A well-articulated strategy must include metrics that allow companies and investors to track progress against longer-term strategic objectives and assess the company's ability to deliver value over an extended time horizon. These metrics should be rooted in the company's unique value proposition, and should measure how the company creates value over time. Additionally, we share the view that communication about value creation should be the next step in the evolution of corporate reporting.<sup>9</sup>

We do not attempt to present a comprehensive set of medium- and long-term metrics tailored to different industries or situations. Each company should choose its own metrics and adapt them to its strategy, industry and geography. We do aim to establish a framework to guide companies in developing metrics that will be tailored to their strategy and directly tied to their long-term value creation potential.

In brief, this framework requires companies to establish reporting units that reflect their unique value creation models and the way they run their businesses. For each reporting unit, companies should identify key value drivers, metrics for internal use and to share with investors, and set specific targets for the medium and long term. Finally, companies should use these metrics and targets to create appropriate long-term incentives for their executives.

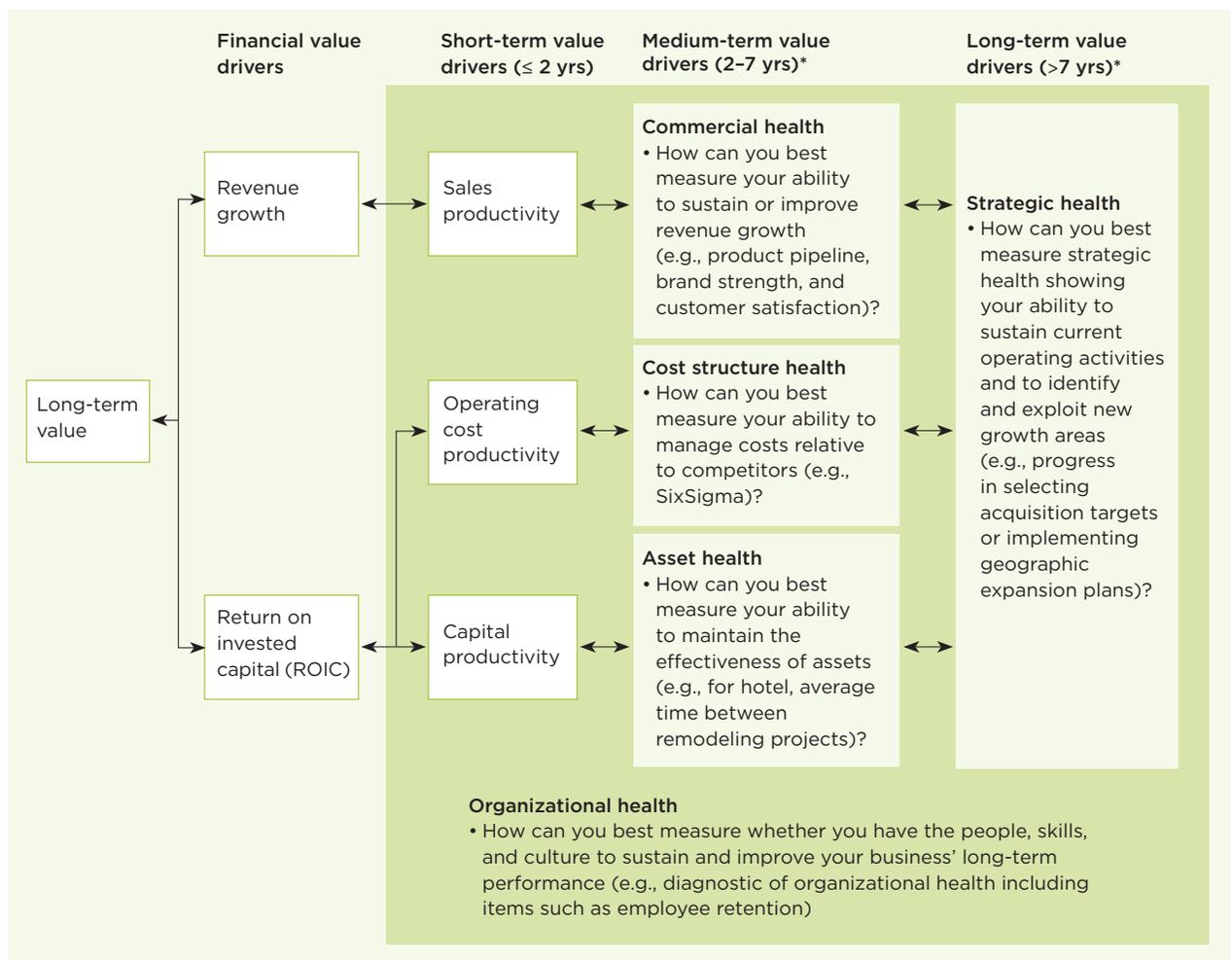
Importantly, companies need to communicate metrics that allow investors to evaluate their long-term potential. For example, more than 70% of S&P 500 companies report on sustainability. However, these metrics often lack the practicality needed to support investor valuations. As a first step in shifting investor behaviors and mindsets toward the long-term, corporations

will need to establish a closer and more explicit link between longer-term metrics and measurable financial impact.

Many companies focus on short-term profits at the expense of healthy revenue growth and increases in ROIC. Failing to achieve proper balance here can damage a company's health, hurt its performance and ultimately destroy value. In order to mitigate this costly risk, companies need to understand their longer-term value drivers and related metrics.

Once value drivers have been identified, companies can develop specific metrics directly linked to aspects of future performance, allowing management and investors to better track progress against strategic metrics.

### Questions to ask while developing medium and long-term metrics



\* Metrics measured today to forecast the performance in the medium and long term



**Idea in action:**  
**Measuring strategy as it relates to financial impact**

Toyota follows a strictly measured strategy tied to annual financial impact. Its current five-year plan requires 34% reduction in global CO2 emissions from manufacturing compared to 2001 levels, as well as a 9% reduction in CO2 emissions from transport compared to 2006 levels, and other targets in a range of countries. Toyota sets targets for fuel efficiency and the total number of

hybrid vehicles sold. For FY2013, Toyota reported cost reductions of \$10 million from reduced energy consumption, and \$156 million in sales from recyclable goods and income from environment-related technologies. The company also reported \$6.8 billion in benefit provided to consumers worldwide through reduction in gasoline consumption due to a switch to hybrid vehicles.<sup>10</sup>

Companies often have the most difficulty in defining and communicating their medium- to long-term metrics, including measures of financial, operational, organizational, marketplace, and network health.

**Medium-term health metrics** help measure value two to seven years out. These metrics include:

- **Commercial health**, which tracks a company's ability to sustain or improve organic revenue growth (e.g., product pipeline, brand strength, and customer satisfaction). Commercial health metrics vary widely by industry. For example, a pharmaceutical company might tend to prioritize research and development, while an online retailer will put more emphasis on customer satisfaction and brand strength. Metrics should emphasize sustainable value creation and organic growth (as opposed to simply cutting costs to increase profits, for example).
- **Cost structure health**, which measures ability to manage costs relative to competitors (e.g., assessments of Six Sigma programs).
- **Asset health**, which measures ability to maintain and develop the effectiveness of assets. For a hotel property, average time between remodeling projects could be a useful proxy for asset health. Asset health metrics should also reveal whether a company has the asset flexibility required to pursue attractive investment opportunities as they arise.

**Long-term strategic health metrics** evaluate a company's ability to sustain its current operating activities, for example by assessing threats that could make its current business less profitable. These metrics are also designed to help companies identify and exploit future growth areas. In cases where strategic health is hard to quantify, qualitative milestones may be used instead of metrics. In the case of Microsoft, for example, a long-term strategic health metric might evaluate its ability to provide differentiated services within the cloud market.

**Organizational health metrics** measure whether a company's people, skills, and culture can execute on the strategy and deliver long-term, sustainable results. Employee retention is one example of an organizational health metric.

We strongly recommend that companies provide several years of past data when sharing long-term metrics. The goal is not to overwhelm investors with more metrics. It is to share the right ones. Companies should steer away from only measuring short-term performance. Instead they should incentivize management to act in the long-term interest of the company by developing, sharing, and being held to account by longer-term metrics. Such actions will give investors a deeper understanding of the company's roadmap and future prospects. The intended result is a more enduring investor base, giving management more flexibility to invest for the long term.

### 3 Reporting to and engaging with investors

Companies that seek to focus on long-term growth should identify long-term investors and create communications that meet their needs. Companies can segment their investor base by analyzing holding periods, investment portfolio concentrations, the number of professionals involved in investment decisions, average trading volumes, and the level of research required to trade. Results can be benchmarked against system-wide data.

Long-term investors drive long-term share price for a number of reasons. They tend to be knowledgeable about the industry as well as the company's management and strategy. Typically, they spend meaningful amounts of time analyzing and modeling the company before meeting with management.

Long-term investors also tend to make calculated long-term decisions that show a focus on longer-term value creation rather than quarterly or annual EPS. Examples include extended holding periods and increases in position when short-term expectations push share prices downward.

Of course, all investors need transparent information. Companies should define efficient protocols to handle inbound calls and requests, embedding a screening process that is consistent with their investor segmentation. Companies must of course ensure all investors have access to information in ways consistent with fair disclosure principles. As part of this, companies should clearly define how management and directors will interact with shareholders and what information will be disclosed.



#### Idea in action: Fostering a long-term investor base

The US research company Gartner fosters a long-term investor base by being selective about how its executives spend time with investors. The head of investor relations ensures executives are meeting the right people. Gartner executives

routinely decline meetings with high-trading, high-turnover clients, even if requested by banks or brokers. This tactic has helped Gartner shift its investor base toward low- and moderate-turnover investors.<sup>11</sup>

A well-developed strategy, supported by the right set of quantitative and qualitative metrics, can steer a business toward successful execution and value creation. By transparently reporting strategic progress to investors in a way that fosters a long-term dialogue, companies can potentially reduce the volatility of their stock price along with their cost of capital.<sup>12</sup>

As companies and investors look to increase the value derived from their interactions, they should consider how to enhance the content they share and the channels they leverage in order to focus on long-term value creation. One-on-one meetings are an opportunity for both management and directors to focus time and resources on longer-term investors, ensuring the

long-term strategy is fully understood. Investor days are another excellent opportunity for companies to go deep in presenting their long-term strategy to investors. An annual investor day can foster regular turnout and promote investor engagement.

Companies and investors need to communicate clearly when performance has not met expectations. In the age of real-time media, controlling this message becomes increasingly important. Investors are well aware that business is volatile, but they want to understand management's assessment of the situation as well as any possible risk mitigating actions. Open discussions can help build the trust in management that investors need in order to back a company for the long haul.

Meanwhile, there is increasing awareness that quarterly EPS guidance is not helpful in assessing the value of companies. More and more companies are abandoning the practice. Instead, companies like General Electric and Arrow Electronics release target ranges for returns on capital. Humana provides long-term guidance on estimated membership in its health insurance plans. Gartner sets a range of long-term goals, including growth targets by business unit, margin-improvement targets, and capital-spending goals. One reason for the change is that long-term investors are less interested than shorter-term investors in whether a company “hits its numbers.”

Instead, long-term investors look beyond the next quarter and beyond EPS, which can be influenced not only by important value drivers such as growth and operating margins, but also by tangential items such as tax effects and share buybacks. In addition, some important measures of value creation, such as capital intensity through depreciation, only indirectly affect EPS, so they are at best a proxy for true economic earnings.

In order to build strong relationships with long-term investors, companies need to create investor communications that articulate strategy and report transparently on performance. One-on-one meetings and investor days are opportunities for thoughtful engagement between management and investors. All these tactics should be designed to tilt the investor-corporate dialogue toward long-term value creation.



#### Idea in action:

#### Communicate openly with investors in good times and bad.

Progressive Insurance is a good example of a company that communicates openly with investors in good times and bad. In the third quarter of 2006, Progressive lowered its policy rates to encourage faster growth, making what then-CEO Glenn Renwick described as “an explicit trade-off of margin for longer-term customer growth.” Renwick noted that, while Progressive might never know the outcome of alternative decisions, “we feel very good about the focus on customer growth.”

When the strategy did not work out as planned, Renwick addressed the subject directly in the first two sentences of his 2007 letter to shareholders. “Profitability and premium growth are both down and they directly reflect the pricing strategy we enacted,” he wrote. That strategy “did not produce the aggregate revenue growth we had hoped for.”

## Conclusion

All corporate stakeholders stand to benefit from an investor-corporate dialogue that considers the company’s long-term performance and health as well as its short-term performance. Fostering a long-term dialogue is not solely the responsibility of companies, however. Long-term investors also have a substantial role to play in proactively engaging management and, where appropriate, directors as well.

Companies that articulate a compelling long-term strategy backed by measurable results are more likely to attract investors who look beyond quarterly earnings and focus on sustained value creation. Over time, corporations and investors should form relationships in which both parties see the benefit of communicating long-term plans without sacrificing the level of discipline and financial disclosure imposed by quarterly performance guidance.

## Notes and references

- <sup>1</sup> Dominic Barton, “Capitalism for the Long Term,” *Harvard Business Review*, March 2011. [hbr.org](http://hbr.org).
- <sup>2</sup> John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, “Value destruction and financial reporting decisions,” *Financial Analysts Journal*, 2006, Volume 62, Number 6, pp. 27–39.
- <sup>3</sup> Sanjeev Bhojraj et al., “Making sense of cents: An examination of firms that marginally miss or beat analyst forecasts,” *The Journal of Finance*, 2009, Volume 64, Issue 5, pp. 2361–88.
- <sup>4</sup> McKinsey analysis: asset turnover by industry (number of years) = net fixed assets/annual depreciation (calculated by taking the average of the top ten companies by market cap in each sector from 2007 to 2011).
- <sup>5</sup> Jonathan Bailey and Jonathan Godsall, *Short-termism: Insights from business leaders—Findings from a global survey of business leaders commissioned by McKinsey & Company and CPP Investment Board*, December 26, 2013, [fclt.org](http://fclt.org).
- <sup>6</sup> Susan Blesener, “Realizing the benefits: the impact of Integrated Reporting,” International Integrated Reporting Council, 2014, [theiirc.org](http://theiirc.org).
- <sup>7</sup> Ibid.
- <sup>8</sup> *Understanding investors: directions for corporate reporting*, Association of Certified Chartered Accountants, June 2013, [accaglobal.com](http://accaglobal.com).
- <sup>9</sup> Much of the analysis in this section is based on work by Tim Koller, Mark Goedhart and David Wessels in their book *Valuation: measuring and managing the value of companies (fifth edition)*. McKinsey & Company, 2010.
- <sup>10</sup> Toyota, “The Fifth Toyota Environmental Action Plan (FY2011 - FY2015),” [toyota-global.com](http://toyota-global.com).
- <sup>11</sup> Timothy Koller and Werner Rehm, “Better communications for better investors: an interview with the CFO of Gartner,” *McKinsey Quarterly*, November 2008.
- <sup>12</sup> Francois Brochet, Maria Loumioti, and George Serafeim, “Short-termism: Don’t blame investors,” *Harvard Business Review*, June 2012, Volume 90, Number 6, [hbr.org](http://hbr.org).