The Incredible Shrinking Corporation

In trying to please Wall Street, companies have starved themselves nearly to death.

By Susan Webber

If you've visited a grocery store recently, it's hard to miss the cover of *Men's Health*, featuring buff young men, with their chiseled biceps and rock-hard abs, the seeming embodiment of fitness and vitality. Yet these poster boys for hearty living seldom achieve their "cut" through a wholesome process. While a lucky few, in the bloom of their youth, come by their six-packs naturally, the great majority go through a process of "dieting down" that is neither healthy nor sustainable. The typical regime is twelve weeks of rigorous dieting, combined with cardiovascular and weight workouts, resulting in the loss of muscle along with fat. And the use of steroids, stimulants, and diuretics is not uncommon. Even then, *Men's Health* airbrushes some photos.

Just like these sculpted lads, corporate America takes extreme measures to look great for the end-of-quarter shoot. But the problem in the business world is that public companies are "dieting down" all the time, starving their businesses of needed investment and engaging in short-term expediencies.

Even worse, the belief that it is reasonable to try to meet an unhealthy standard has infected the business psyche. Body dysmorphia, a distortedly unflattering perception of the body, occurs when people are dissatisfied and preoccupied with their appearance. Examples include teenage boys who use growth hormone to achieve a muscular look, along with growing numbers of men and women afflicted with eating disorders.

Like individuals who identify with an unattainable standard of perfection, Big Business increasingly suffers from corporate dysmorphia. Corporations deeply and sincerely embrace practices that, like the use of steroids, pump up their performance at the expense of their well-being.

Hitting the Numbers

The pressures that led to corporate dysmorphia date from the 1980s. Raiders like T. Boone Pickens, Carl Icahn, and Ron Perelman targeted and often succeeded in taking over companies with solid cash flow and bloated

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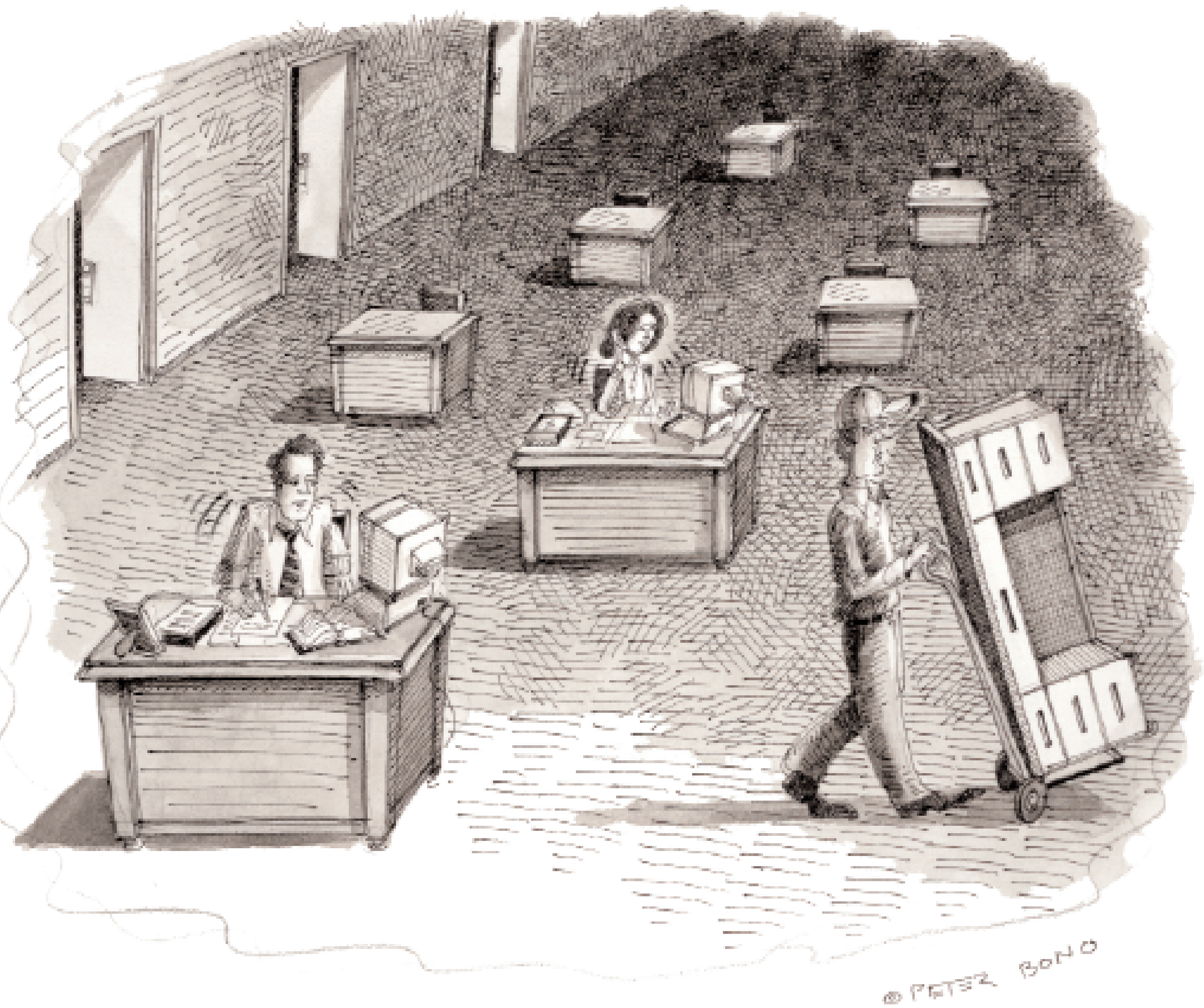

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expenses. When it became clear that these buccaneers were able to cut costs, repay creditors, and reap handsome returns, executives began to mimic their approaches to preserve their independence: slashing overheads, selling unproductive assets like real estate and art, increasing production efficiencies.

These steps, on the whole, were beneficial. Too many companies were fat and complacent; Japanese and German manufacturers were ascendant. But they also set in motion a tendency to place shareholder interests above those of other stakeholders.

The Internet boom of the late 1990s altered investor behavior and, with it, corporate responses. Suddenly, retail shareholders could get intra-day stock prices for free, and the dizzying rise of Internet stocks gave them an incentive to check performance frequently. Day traders became a force to be reckoned with. Analysts became more marketing-oriented, and those covering Old Economy stocks needed to find ways to capture the public's attention. One means was hyping quarterly earnings. In the 1980s, quarterly reports were ho-hum events, unless the results fell outside an expected range. Today, missing the quarterly expectations by even a penny or two can move a stock's price.

So as investors became highly reactive, even punitive, executives in public companies became more anxious about meeting their demands. It was no longer sufficient to have a well-managed business that offered either attractive growth prospects or solid cash flows. Increasingly, companies felt pressured to "hit the numbers," creating a daunting new performance standard, particularly for those in mature industries. Just like the teenage boys and middle-aged men who try to attain the unnatural 5 percent body-fat levels of cover models, many companies became fixated on satisfying Wall Street's desires, realistic or not.

From Reasonable to Self-Destructive

What are the symptoms of this corporate pathology? This isn't a straightforward malady, since distorted perception of what is reasonable performance leads to a whole range of self-destructive behaviors.

The pattern of unhealthy corporate responses started in the late 1990s, when CEOs began pumping up corporate profits beyond reason. In a 2002 Brookings Institution paper, Yale economist William Nordhaus noted a decline in corporate profits, reflected in the National Income and Product accounts, from mid-1997 through early 2000 and a further slight fall into 2001. But S&P-reported profits for that period showed a very different picture—they *grew 70 percent* from the beginning of 1998 through early 2000, before falling by nearly 50 percent from early 2000 to early 2001.

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What created this divergence? Robert Gordon, a professor at Northwestern University and a member of the National Bureau of Economic Research, commented on Nordhaus' analysis: "During the 1990s corporate compensation had shifted to relying substantially on stock options, leading first to the temptation to engage in accounting tricks during 1998-2000 to maintain the momentum of earnings growth, and then sheer desperation to cut costs in response to the post-2000 collapse in reported S&P earnings and in the stock market. The stock market collapse had an independent impact on the pressure for corporate cost cutting . . . by shifting many corporate-sponsored defined-benefit pension plans from overfunded to underfunded status."

The most extreme manifestation of corporations' desperate desire to look good was accounting fraud, which peaked in 2002, with twenty-eight major companies—including the likes of Bristol-Myers, Freddie Mac, Lucent, Qwest, and WorldCom—generating unflattering headlines in that year alone. Admittedly, cooking the books has a proud history (remember Robert Vesco?), but never before had seemingly respectable corporate citizens and their advisers lied to the public on such a scale.

But even companies that have not gone so far as committing fraud have succumbed to the impulse to burnish results. One of the reasons that price/earnings ratios are lower than they should be, given current levels of corporate profits, is that the *quality* of earnings is poor. As early as 1999, chief SEC accountant Lynn Turner commented on the growing tendency of companies to massage their results, and on the use of periodic writedowns to convert costs that should have been classified as operating expenses into extraordinary items. Even though Sarbanes-Oxley made CEOs liable for inaccurate financial reporting, there is still ample room to fudge results. For example, FDIC data show that U.S. banks now have the lowest loan loss reserves in nineteen years, precisely when banks are extending more high-risk credit to maintain growth, such as interest-only consumer and commercial mortgages. Criminal? No, but certainly dangerous—and misleading, if we're to take those banks' earnings statements seriously.

Other manifestations of corporate dysmorphia include:

Employees as liabilities. Despite the cliché "employees are our most important asset," many companies are doing everything in their power to live without them, and to pay the ones they have minimally. This practice may sound like prudent business, but in fact it is a reversal of the insight by Henry Ford that built the middle class and set the foundation for America's prosperity in the twentieth century: that by paying workers well, companies created a virtuous circle, since better-paid staff would consume more goods, enabling companies to hire yet more worker/consumers.

Instead, the Wal-Mart logic increasingly prevails: Pay workers as little as they will accept, skimp on benefits, and wring as much production out of them as possible (sometimes illegally, such as having them clock out and work unpaid hours). The argument is that this pattern is good for the laboring classes, since Wal-Mart can sell goods at lower prices, providing savings to lower-income consumers like, for instance, its employees. The logic is specious: Wal-Mart's workers spend most of their income on goods and services they can't buy at Wal-Mart, such as housing, health care, transportation, and gas, so whatever gains they recoup from Wal-Mart's low prices are more than offset by the rock-bottom pay.

Defenders may argue that in a global economy, Americans must accept competitive (read: lower) wages. But critics such as William Greider and Thomas Frank argue that America has become hostage to a free-trade ideology, while its trading partners have chosen to operate under systems of managed trade. There's little question that other advanced economies do a better job of both protecting their labor markets and producing a better balance of trade—in most cases, a surplus.

The dangers of the U.S. approach are systemic. Real wages have been stagnant since the mid-1970s, but consumer spending keeps climbing. As of June, household savings were .02 percent of income (note the placement of the decimal point), and Americans are carrying historically high levels of debt. According to the Federal Reserve, consumer debt service is 13 percent of income. *The Economist* noted, "Household savings have dwindled to negligible levels as Americans have run down assets and taken on debt to keep the spending binge going." As with their employers, consumers are keeping up the appearance of wealth while their personal financial health decays.

Part of the problem is that companies have not recycled the fruits of their growth back to their workers as they did in the past. In all previous postwar economic recoveries, the lion's share of the increase in national income went to labor compensation (meaning increases in hiring, wages, and benefits) rather than corporate profits, according to the National Bureau of Economic Analysis. In the current upturn, not only is the proportion going to workers far lower than ever before—it is the first time that the share of GDP growth going to corporate coffers has *exceeded* the labor share.

Miserly capital investment. So where are these corporate profits going? One thing is clear: They are not being used to fund future growth. Ordinarily, the business sector borrows to invest in productive projects and assets, and these borrowings are funded by households. But companies are saving at an unprecedented rate, accumulating cash rather than financing new initiatives.

Companies typically invest in times like these, when profits are high and interest rates low. Yet a recent JP Morgan report notes that, since 2002, American companies have incurred an average net financial surplus of 1.7 percent of GDP, which contrasts with an average *deficit* of 1.2 percent of GDP for the preceding forty years. While firms in aggregate have occasionally run a surplus, ". . . the recent level of saving by corporates is unprecedented. . . . It is important to stress that the present situation is in some sense unnatural. A more normal situation would be for the global corporate sector—in both the G6 and emerging economies—to be borrowing, and for households in the G6 economies to be saving more, ahead of the deterioration in demographics."

This anorexic spending isn't simply suboptimal for individual companies—it jeopardizes the world economy. Indeed, the JP Morgan paper blames the rise in corporate savings for the 2000-03 decline in global growth rates. Look at Japan's companies: Since 1994, they have been net savers, paying down debt incurred during the country's bubble era. But while the companies' bottom lines look solid, their weak investment and hiring have reduced Japan's growth to an anemic level. Continued high levels of corporate savings could put America on the Japanese trajectory.

While JP Morgan believes this high level of savings is starting to reverse itself, other observers, such as HSBC, argue that companies are likely to remain cautious about investing, particularly if the housing market starts to slip.

A dearth of grand strategies. The corollary to the lack of capital investment is a lack of long-term vision. In the days when industrial companies ruled the earth, big business had long planning horizons—after all, it took time to build factories, shift production, and train workforces. Indeed, in capital-intensive industries such as oil or paper, twenty-year vistas were common.

It would be a mistake to think that these timeframes were simply a function of these business's physicality. It usually takes a long time to build a great enterprise. Marvin Bower envisioned and developed the modern consulting industry, but his firm, McKinsey & Co., didn't become preeminent until the mid-1980s. Similarly, Goldman Sachs began hiring top Harvard MBAs in the 1950s—not just in investment banking but in securities sales, when these practices were unheard of—but it took more than two decades for Goldman to secure its position as a top investment bank. (For those who cite eBay and Amazon as counter-examples, the tremendous interest in the Internet's growth meant that the dotcom survivors emerged with disproportionate brand-name recognition, a powerful asset.)

The pressure to placate the market has distorted the CEO frame of reference so that it increasingly corresponds to the twelve-to-eighteen-month vantage of equity analysts. One could cynically argue, for instance, that Hewlett-Packard's acquisition of Compaq, viewed skeptically by many commentators at the time, was born out of desperation, out of a recognition that there was little that Carly Fiorina could do to improve HP's performance materially in the next two years. Purchasing Compaq bought her a stay of execution.

CEOs can argue, correctly, that they are doing the best they can in an era of intolerance of missed targets and shortened CEO tenures. But that is precisely the point. The diminished life expectancy of corporate leaders is a direct result of boards and business commentators expecting unrealistic results. We shouldn't be surprised that CEOs resort to the corporate equivalent of crash diets and steroids—or that it comes back to haunt them.

Risky cost-cutting. Typically, businessmen gamble on growth, but their penchant for reducing expenses is also becoming increasingly hazardous. The most obvious example is the extensive use of outsourcing. I'm not arguing that outsourcing isn't a useful tool—it is, of course—but that companies have often underestimated the risks of entrusting outside parties with supposedly non-core elements of their operations.

Consider the recent debacle at British Airways. One thousand ground staffers went on an illegal one-day sympathy strike when BA's caterer, Gate Gourmet, summarily fired 670 employees. Gate Gourmet was once part of BA, and many employees still see it as kin. Seventy thousand passengers were stranded, their images broadcast around the world. *The Economist* estimated the foregone revenue at \$75 to \$110 million, plus further losses from passengers who will avoid flying with the carrier in the future.

BA suffered clear and substantial damage due to outsourcing. Other companies have jeopardized their operations in less obvious ways. A 2004 *Wall Street Journal* article set forth how IBM had penciled out the savings for outsourcing software programming to China. The key metric was that the cost of programmers was under 25 percent of that in the United States. However, Dean Davidson, a Meta Group expert on outsourcing, says that simple wage comparisons are misleading. "The reality is a general savings of 15 to 20 percent during the first year."

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The gap between the labor-cost reduction and the estimated total savings results from additional coordination and supervision costs. More layers means less flexibility, less responsiveness, more opportunity for noise to creep into the signal. And even though IBM surely outsourced what it considered to be non-critical tasks, these tasks are often part of larger projects. If those projects fail or are delayed, they can impair the overall effort. Fifteen to 20 percent savings seems insufficient to warrant taking on this sort of rigidity and risk. And there is the real possibility that even this level of cost reduction will not be attained.

IBM is not an isolated case. In April 2005, Deloitte Consulting published the results of a survey of twenty-five companies whose revenues averaged $50 billion. It concluded, "In the real world, outsourcing frequently fails to deliver its promise." Over 70 percent of the survey participants had "significantly negative" experiences. Deloitte principal Ken Landis noted, "There wasn't a single participant in the study whose contract went to term. All of them had renegotiated prior to the contract expiration period."

Rather than hope for the best, companies can take an active course.

Markets ascendant. Warren Buffett once said, "In the short term, the market is a popularity contest, and in the long term, it is a weighing machine." But in CEOs' minds, it has also become their most important constituency.

A quarter-century ago, financial institutions were the handmaiden of industry. But now companies often seem like the tail that wags the dog of the financial markets. A recent *New York Times* article about Costco Wholesale illustrates this topsy-turvy relationship. By any measure, Costco, America's fifth-largest retailer, is a successful company. A members-only discount retailer, it supplies a limited selection (4,000 SKUs versus 100,000 for Wal-Mart) of bulk products. To induce customers to shop frequently, it sprinkles in one-off deals on upmarket goods such as Coach purses, plasma screens, and fancy cheeses. Unlike its peers, Costco pays its staff well (an average of $17 per hour) and offers a generous healthcare package.

Chief executive Jim Sinegal, who has worked in the discount industry virtually from its beginning, considers these elements all crucial to the strategy. The minimal markups and high volumes preclude others in his category from undercutting him. The relatively high wages keep turnover (costly in and of itself) to a minimum, and also keep down employee pilferage. And Costco's patrons, more affluent than the average discount shopper, feel good about getting bargains while doing right by workers. As a result, the stock is a cult favorite, since customers often become shareholders, and trades at a premium (23 times earnings versus 19 times for Wal-Mart).

A successful business model with good prospects for growth, and a highly valued stock—what more is there to want? Yet some equity analysts are critical of Costco, arguing that it should increase its margins and cut its pay and benefits to employees. This kind of shortsightedness—tinkering with a successful strategy to produce modest gains in earnings to the likely detriment of the entire enterprise—exemplifies what is wrong with putting Wall Street in the driver's seat.

More Than the Sum of Their P/E Ratios

What are the possible treatments for this condition? Unfortunately, social pathologies are not easy to remedy. It's possible that companies and commentators will recognize that this trend has gone beyond the point of maximum benefit, and will renounce some of the excesses. For instance, in a September *Wall Street Journal* article, "Why Happy Workers Are the Best Workers," Steve Kent, a Goldman Sachs analyst of consumer-service companies, discussed how his thinking about labor costs had changed: "I don't think enough investors have asked the more important question: Can companies be even more successful by focusing on optimizing each employee's contribution, rather than simply looking for ways to reduce the cost of employing them?"

It is simultaneously refreshing to hear this point of view—and alarming that the *Journal* considered it to be novel. But until more people like Kent, who can influence public opinion, begin to look at companies organically, rather than as the sum of their financial ratios, the daunting expectations are unlikely to change.

Rather than hope for the best, companies can take an active course. The more that successful companies openly renounce an obsession with short-term targets, the more acceptable that will become. Indeed, the markets might come to perceive that farsighted companies are well managed while those focused on the quarter are reactive.

Another option is to go private. The big buyout firms are flush with cash and eager to do large deals, particularly after seven private equity firms purchased SunGard Data Systems for $11.3 billion. If more well-run companies elect to take themselves out of the unflattering light of public ownership, particularly if they are vocal that being public made it hard to run their business well, it would pressure analysts and the media to change their posture.

Until attitudes toward corporate performance change, CEOs who dare to defy the demand for the perfect picture every quarter will face a lonely, uphill battle. Yet historically, business leaders are revered for building organizations and launching new products, not for increasing gross margins by a few points. Those fixated on their longevity or compensation won't have the stomach for this fight. But the ones who care about the health of their companies and their legacies will. ♦