Section 3.4 Influences on business decisions

15 Corporate influences

Definition

Corporate influences are internal factors affecting business decisions including short- versus long-term horizons and scientific versus intuitive approaches to decision-making.

Linked to: Corporate objectives, Ch 1; SWOT analysis, Ch 4; Ratio analysis, Ch 20; Key factors in change, Ch 23

15.1 Introduction to corporate timescales

In October 2009, two years into the life of his brainchild Fresh & Easy (Tesco USA), boss Terry Leahy dismissed the one-year trading loss of $259 million by saying: 'we have been making good progress in developing the Fresh & Easy business'. Actually its 130 American stores were losing $2 million each per year. Oddly, Terry Leahy saw these facts as short-term problems that would seem unimportant in the long term. He hoped to create 1,000 Tesco stores in America and challenge Wal-Mart (the world's number one retailer). Now, with the benefit of hindsight, and the closure of the whole operation, it is clear that the £2 billion Tesco wasted on the whole venture was due to confusion between short- and long-term data analysis. Leahy thought the data was a short-term misreading of the long term. In fact it told exactly the right story: Tesco had nothing to offer the US grocery market.

15.2 Corporate timescales: causes and effects of short-termism

Short-termism is when the actions of managers show an obsession with immediate issues rather than long-term ones. Often such managers will use lots of long-term words such as mission, aims, strategy and legacy; but staff will soon learn when the real spur to action is this year or this month's budget. In a report on the topic, the Institute of Directors produced an interesting list of possible symptoms of short-termism:

- inadequate expenditure on research and development
- accounting adjustments that inflate current earnings
- a bias towards high dividend payouts and share buybacks, at the expense of investment
- adoption of executive pay schemes that reward achievement of short-term financial goals
- overly zealous cuts in employment levels, which destroy the company's stock of human capital
- a disregard for longer-term risks in the company's products, services or business strategy
- an excessive focus on acquisitions rather than organic growth.

The causes of short-termism

The most commonly cited explanation of short-termism by UK companies is the relationship with financial markets; many people believe that the plc structure encourages short-termism. Many years ago Richard Branson's Virgin Group was a publicly quoted plc; he eventually took the group private because he hated the pressures to prioritise immediate results over long-term strategy. The reason for these pressures is simple: City investors are more important today than private shareholders, and the City traders are measured on a quarterly basis. Pension funds controlling £billions judge their main advisors and investors every three months, to measure performance against a **stock market index** such as the FTSE 100. So if City investors are measured every three months, no wonder those investors care passionately about the short-term performance of the companies they've invested in.

Other important causes of short-termism:

- The widespread use in the City of short-term focused performance measures such as **Earnings Per Share** (EPS) as a way of judging the bonus level to be paid to the directors: EPS can be boosted by the ultimate short-termism measure: buying shares back from shareholders; this boosts a company's debt level yet creates a higher share price and therefore bonus level.
- The threat of takeover: when share prices are high there is usually a fashion for making takeover bids. So companies like to make it harder (and more expensive) by boosting their short-term profit.
- The bosses of UK firms are unusually likely to have had a career based in finance: therefore they have no inherent understanding of the long-term thinking that is more instinctive among engineers, scientists and marketing executives. In Germany and Japan, engineers often become the chief executive.

The effects of short-termism

The most important effect of short-termism is underestimating or ignoring the opportunities that may exist in the long term. Primark's fashion/value retail positioning has long made it a natural for China. But Primark keeps opening safety-first stores in Britain and none in China. Quite probably it's now too late to enter this, the world's second biggest market for fashion clothes. By contrast Arsenal FC spent £400 million on the move from Highbury (35,000 capacity) to the Emirates Stadium (capacity 60,000). This showed the board's ability to think about the long-term interests of the club. Interestingly this 'long-termist' example is from a private company, not a plc.

Other effects of short-termism include:

- reluctance to invest in capacity, training, research and development and perhaps also in image-building advertising
- decisions that seem wise in the short term, but not down the line, such as when Waterstones sold its online book sales division – to Amazon!
- performance reward systems may over-focus on short-term gains, encouraging staff to achieve profit today even if it's at the expense of tomorrow; in the ten years to 2015 WHSmith constantly pushed their prices up; this was great for short-term profit but at the expense of long-term market share.

'Any jerk can have short-term earnings. You squeeze, squeeze, squeeze, and the company sinks five years later.'

Jack Welch, business super-leader

'Short-termism curtails ambition, inhibits long-term thinking and provides a disincentive to invest in research, new capabilities, products, training, recruitment and skills.'

Sir George Cox, businessman

15.3 Long-term thinking: the German Mittelstand

For many years big business in Britain has meant publicly listed companies, with shares bought and sold on the stock market. Generally the value of the British stock market is around 100–120 per cent of the value of annual GDP (the national income). Germany, by contrast, has a business sector dominated by world-class, medium-sized but family-owned and -run businesses – the **Mittelstand**. The value of the German stock market is only about 40 per cent of the value of annual German GDP. So whereas the business pages of British papers are dominated by the latest results from plcs, in Germany there is more likely to be reporting on business issues and market opportunities.

When Germans are asked about their Mittelstand, they mention two things: family-owned and humane management. Economists would add in two other features: long-term thinking and a focus on doing one thing well. The latter means that the typical Mittelstand firm is a world leader in a limited field, such as diesel car exhaust systems. A 2013 German government report showed that Germany had 20 times more 'world market leaders' than the UK – and strikingly more than America (see Figure 15.2). This is great for exports but also works well for employment, with the Mittelstand employing nearly 60 per cent of the German workforce, but 80 per cent of all trainees.

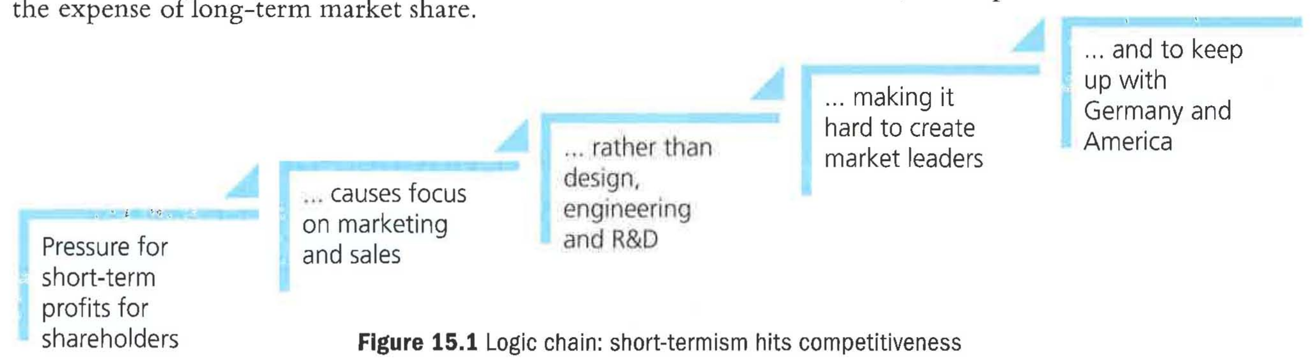

Figure 15.1 Logic chain: short-termism hits competitiveness

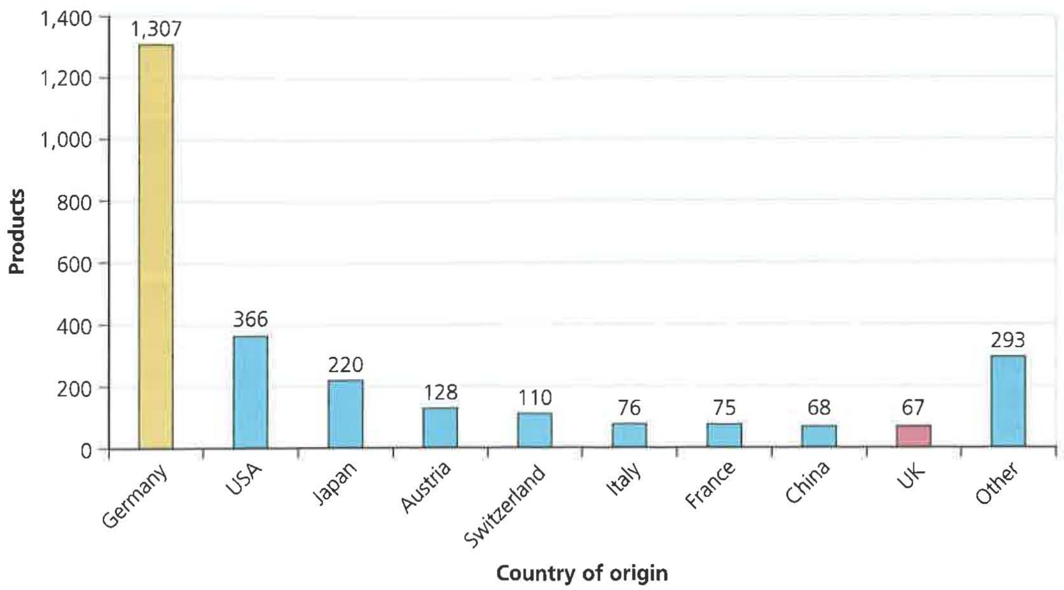

Figure 15.2 World market-leading products by country of origin (source: German Federal Ministry of Economics and Technology 2013)

The amazing success story of the German Mittelstand must be contrasted with the plc. First and foremost legal requirements force large plcs to report on profits and trading every six months. Then City analysts and the media will pore over the figures and declare the business a 'star' or a 'dog'. Tesco was unbeatable until it suddenly became untouchable. Every chief executive is in thrall to 'the market' and has to organise strategy and publicity accordingly.

The result is an excessive focus on the next set of results. This is rather more like the life of a Premier League manager than makes any sense. This helps to explain how a business such as Marks & Spencer can spend 20 years, under many different bosses – all failing to address the company's underlying problems. Long-term strategy can become empty words in the short-termist world of the plc.

	Plc	Mittelstand
Typical financial structure	Strong base of share capital with moderate gearing	Strong base of share capital with moderate gearing
Typical ownership structure	Owned by many, relatively small shareholders	Family-owned or majority family-owned with some shares listed on the stock market
Typical approach to spending on R&D and trainee staff	Varies, but many will look for a low-spend model with high levels of outsourcing (and low investment in staff)	Desire for very long-term success and a sense of moral duty creates a culture of investment in people and technology
Typical business objectives	Maximise short-term share price to keep the market happy, and to enjoy a big bonus due to the high share price	Maintain a world-leading position to hand over a continuingly successful business to the next generation

Table 15.1 The short-termist plc vs the long-termist Mittelstand

'The result of long term relationships (with suppliers) is better and better quality and lower and lower costs.'

W. Edwards Deming, quality guru

15.4 Evidence-based versus subjective decision-making

Evidence-based (or 'scientific') decision-making is becoming increasingly dominated by computers. For example, a McDonald's store manager is sent details of how many staff should be employed every hour for next Saturday. The computer makes the 'decision' based on a sales forecast using data from last year and recent weeks. In this way the decision-making can be 'scientific' – in the sense that it is based on objective, numerical data – as opposed to **intuition**, that is subjective decision-making.

When the decision is more strategic, by definition there will be more uncertainty. When Whitbread plc decided to back Costa Coffee, it couldn't know that it would be able to build the business from 50 outlets to 3,000 (including 350 in China). So computer programs can't punch out answers. Therefore there is a far greater need for opinion-based, subjective judgement. Whitbread made a brilliant call; Morrisons made a disastrous one when it bought online site Kiddicare for £70 million in 2011 and sold it for £2 million in 2014!

Evidence-based decision-making is the goal for most firms because it suggests a method that can be applied in a routine way to measure opportunities or problems. When considering whether to launch a proposed new product, large companies like to have a testing system that they can use for every proposal. Then, over time, enough data is gathered to start making accurate forecasts.

Real business

The *Grocer* magazine regularly features independent research into new product launches using a system called Cambridge Fast Foodfax. It uses various quantitative measures to test the likelihood of sales success. From the answers to those questions a rating score is devised. A look at the data below shows why Marks & Spencer felt optimistic about sales of its new lemonade.

From *The Grocer*: 2–9 August 2014	Asda Choc Chip Muffin Cheesecake £1.50	Cadbury Dairy Milk Banana Caramel Crisp £2.99	M&S Still Blackcurrant Lemonade £1.00
Pre-trial purchase	49%	46%	44%
Post-trial purchase	44%	39%	48%
Better than what's out there	30%	37%	54%
New and different	59%	93%	89%
Overall score	38/50	37/50	41/50

Table 15.2 Objective evidence about the potential of new product ideas

On these measures experience has shown that a score of 45+ shows a product of huge potential. Between 40 and 44 also shows promise. This approach enables big firms to scrap unpromising new products before taking them to market.

Evidence-based decision-making

The desire for a scientific approach to management dates back, at least, to F.W. Taylor and the late nineteenth century. Taylor wanted managers to find the 'one best way' to do things, and then instruct and incentivise workers to follow that one best method. Taylor believed in 'time and motion' studies that measured exactly how and when workers completed certain tasks. He also advocated high division of labour, forcing staff to do simple, repetitive tasks in the workplace. With simple tasks came ease of measurement; and from there it was only a short step to the business saying: 'measurement is management'. In other words, once you start measuring things in the workplace, staff pay more attention and start behaving differently.

Today managers still want to control business variables, from absenteeism to morale. They also want to control external variables as much as possible. So sales are forecast with great precision, and computer software is used to model every foreseeable situation, e.g. an August bank holiday with cloudy but not rainy weather. Evidence-based management tries to take the art out of business decision-making – replacing subjectivity with facts and quantitative forecasts.

Figure 15.3 Forecasting can help estimate sales given any potential condition, for example a cloudy bank holiday weekend in August

Good business decisions	Bad business decisions
Coca-Cola buys Innocent Drinks – giving it a real competitor to PepsiCo's Tropicana. The £200 million deal was completed in 2013	Waterstones bookshop decides to stop selling books online, because 'online will never be more than 10% of the market'
In June 2000, Nick Robertson and Quentin Griffiths launch 'As Seen on Screen'; first year sales are £3.6m. By 2014 ASOS has sales of £1,000 million.	Malcolm Walker, owner of Iceland Frozen Foods, takes the business upmarket – focusing on organic products: it didn't last
Unloved Mondelez (owner of Cadbury) launched Belvita Breakfast Biscuits in 2010. The grocery trade laughed at the idea, but by 2013 Belvita sales had grown to £58 million – that's more than Jaffa Cakes	Rupert Murdoch, media mogul, sells MySpace website for $35m, having bought it for $580m six years before
With recession biting, Waitrose launched its Essentials range of lower-priced groceries. By 2015 sales of Essentials exceeded £1 billion a year and Waitrose extended the range to 400 more items	Nestlé re-launches its Willy Wonka chocolate bar range in 2013 (sales were poor when it first launched in 2005); time is no healer and the whole range was discontinued in 2014

Table 15.3 Some good and some awful real business decisions

'The best class of scientific mind is the same as the best class of business mind. The great desideratum in either case is to know how much evidence is enough to warrant action.'

Samuel Butler, British novelist (1835–1902)

'Whenever decisions are made strictly on the basis of bottom-line arithmetic, human beings get crunched along with the numbers.'

Thomas Horton, US business leader

Five whys and a how

Questions	Answers
Why is business short-termism a problem for the British economy?	Because it limits our ability to innovate and makes it hard for engineering and manufacturing to grow and thrive – stifling economic growth.
Why doesn't a government change the rules, and allow financial reporting only once a year? Wouldn't that help?	It probably would help. Perhaps only allow an interim, six-month report in exceptional circumstances. It would take a degree of short-term pressure off the back of plc bosses.
Why doesn't the UK build a Mittelstand like Germany?	It's enormously difficult to change a national culture: in Britain, business is about making money; in Germany it's about building something great.
Why may middle managers be inclined to make decisions made on short-term criteria?	Because they are focused more on their next career step than on the long-term best interests of the whole business.
Why might 'short-termism curtail ambition' (quote from Sir George Cox, page 103)?	It's hard to have ambitions about the future when you're trying to cope with short-term pressures.
How can a firm make sure to take evidence-based decisions?	By gathering as much numerical data as possible and weighing it up using a standardised method such as decision trees (see Chapter 13).

15.5 Corporate influences – evaluation

A surprising feature of business is that whereas middle managers have to justify their decisions with evidence and data, those at the top are able to make subjective, quite personal decisions. Sometimes these come off, as with the launch of Apple's iPod and iPhone. On other occasions, they can be massive mistakes, as with the RBS purchase of ABN Amro Bank (loss: at least £50 billion), Tesco's launch into America (a mere £2 billion loss) and BP's careless attitude to safety in the Gulf of Mexico (which will end up costing more than $50 billion, not to mention the appalling environmental impact).

Ultimately, though, the style of decision matters little compared with the issue of timescale. RBS was in too much of a hurry to win a battle against Barclays – and ended up with a dog. And BP's attitude to safety was probably influenced by a determination to meet short-term profit targets. Businesses that can take a long-term view will usually outstrip those that are focused on the next set of financial results.

Key terms

Earnings Per Share: company profits after tax divided by the number of shares issued; a rising EPS makes it easy to pay out rising dividends to shareholders.

Intuition: deducing something from circumstances without any direct evidence.

Mittelstand: the family-owned small and medium-sized businesses that are the backbone of the German economy.

Stock market index: a weighted average of the share prices of many companies are added together, adjusted to equal 100, then measured for percentage change over time.

15.6 Workbook

Revision questions

(30 marks; 30 minutes)

1. Explain one possible reason why Terry Leahy wanted to 'challenge Wal-Mart' (see Section 15.1). (4)
2. Explain why 'inadequate expenditure on research and development' might be a symptom of short-termism (see Section 15.2). (4)
3. Explain one possible benefit to a company if it appoints an engineer rather than an accountant to the role of chief executive. (4)
4. Explain why 'City analysts' play an important role in creating a business culture of short-termism. (4)
5. Explain why subjective thinking may be more important for a long-term, strategic decision than for a short-term one. (4)
6. Outline two factors that might undermine the accuracy of the data used in an evidence-based decision. (6)
7. Explain what Thomas Horton meant in the quote shown on page 106. (4)

Revision activities

Data response

Why strategy matters – Topshop, Zara and China

Back in 2002, when Philip Green bought Arcadia (Topshop), it and Inditex (Zara) were of a similar size. By 2013/2014 Inditex was making nearly 20 times more profit than Arcadia. Topshop was and is a retail jewel, with the potential to be huge internationally. It is a retail brand suited perfectly to the emerging young middle classes in China. But by early 2015, Zara owned over 150 stores in China and its owner Inditex had become the world's biggest clothes retailer. Topshop has no stores in China and is a minnow globally. What went wrong?

Green appears regularly in lists of Britain's most admired businesspeople. Yet a simple look at Arcadia's performance since 2002 makes it hard to see why. Britain needs business successes such as Zara, creating jobs and earnings from overseas. Why couldn't Topshop have achieved what Zara has? (In the graph of Zara vs Topshop, the actual figures are for Zara's owner Inditex vs Topshop's owner Arcadia Ltd.)

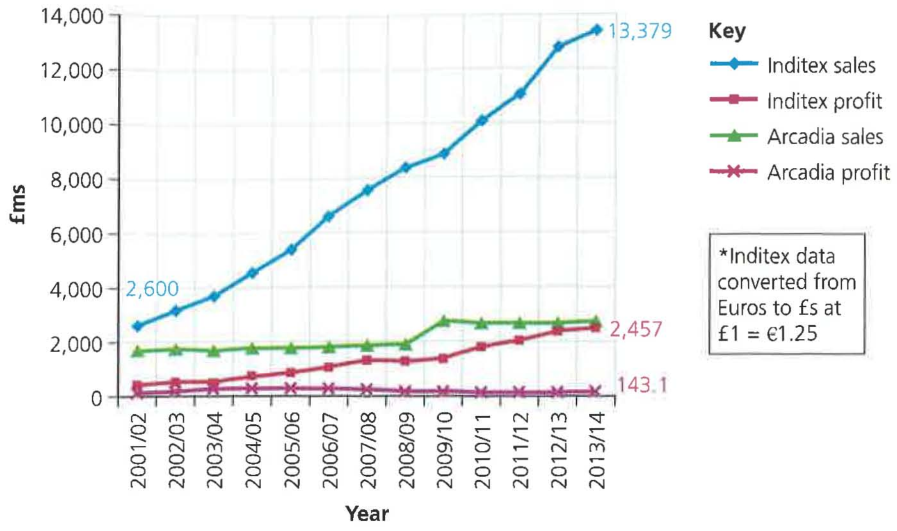

Figure 15.4 Booming Zara/Arcadia flatlining: Topshop vs Arcadia 2001–2014 (sources: Inditex accounts*; Arcadia press releases)

Zara began in 1975 and has grown thanks to the desire by owner Amancio Ortega to create something of lasting value. At a time when his rivals were getting all their clothes made in the Far East, Ortega was proud that more than half his supplies came from Spain and Portugal. His company Inditex has been famous for its long-term approach to the clothing industry, with care taken over suppliers, staff and the environment.

Cleverly, Zara turned its west European production into an advantage – being able to respond more quickly than others to changes in catwalk fashion. Today Zara delivers brand new designs twice a week to its stores worldwide, and can respond very quickly to any strong new trend. From early on, Zara adopted lean production as its way of working. Constant attacks on wastage suited Ortega's approach to business, as did minimising the amount of cash tied up in stock.

By contrast, Sir Philip Green's business has stood still for ten years, perhaps in part because of his famously short-term way of looking at investment. His rule of thumb has always been a twelve-month pay-back period – which is exceptionally rapid. Therefore only sure-fire, ultra-profitable investments work out. In Table 15.4 sales jumped in 2009 solely because Green decided to merge BHS in with the rest of Arcadia. Excluding that, there has been no significant growth.

	Arcadia sales (£millions)	Arcadia profits (£millions)
2006/07	£1,850	£293
2007/08	£1,840	£275
2008/09	£1,900	£214
2009/10	£2,800	£213
2010/11	£2,680	£133
2011/12	£2,679	£167
2012/13	£2,683	£148
2013/14	£2,707	£143

Table 15.4 Sales and profits of Arcadia (2006–2014)

It seems that owner Sir Phillip Green has been distracted by other priorities. In 2005, famously, Arcadia declared a £1,200 million dividend to be paid out to the sole shareholder of the business: his wife Mrs Green. As a resident of Monaco, no tax would be paid on this. To find this huge sum, Arcadia needed to borrow £1,000 million, which was not that hard to do in pre-crash 2005. Surely this sum would have been better invested taking Topshop to China. Ironically, it may have made Green more money in the longer term.

Is it too late for Topshop to make it in China? Perhaps not, though the middle-market positioning has been adopted in China by Zara, H&M, Gap and many others. Most striking, however, is the importance of focus on the long-term health of a business: Zara's Ortega had it, Arcadia's Green did not.

Questions (30 marks; 40 minutes)

1 Analyse two possible reasons why Zara (Inditex) was so successful between 2002 and 2014. (10)

2 Using this business example together with any other businesses you're aware of, evaluate whether short-termism is a particular problem for British businesses and businesspeople. (20)

Extended writing

1 Evaluate whether the government should try to tackle short-termism in British business. (20)

2 Former Apple boss John Sculley once said that 'No great marketing decisions have ever been made on quantitative data.' Evaluate whether this proves that subjective decisions are more effective than those based on evidence. (20)