If You Want to Maximize Profits, Manage for the Long-Term

Yrjö Koskinen
Haskayne School of Business, University of Calgary

J. Ari Pandes
Haskayne School of Business, University of Calgary

Shuai (Kevin) Yang*
Haskayne School of Business, University of Calgary

August 28, 2020

* Shuai (Kevin) Yang is the recipient of Bertram Scholarship and is supervised by Dr. J. Ari Pandes and Dr. Yrjö Koskinen.

The title of an opinion piece that appeared in *The New York Times* on December 2019 puts the state of America's free-market capitalism succinctly: *Short-Term Thinking is Poisoning American Business*[1].

Several pieces of evidence suggest that corporations are increasingly focused on the short-term. The average age of a public firm is less than 10 years recently, down from 65 years in the 1920s; in only a decade, CEO job tenure on average dropped from 8.1 years in 2000 to 6.3 years in 2009 (*The Economist*, 2012). Moreover, trading velocity has increased: in the 1950s, a shareholder held a listed stock on average for seven years, but now it has shrunk to six months (Meyerson, 2012). And, shareholders have become more activist and higher maintenance if short-term targets and share price appreciation are not met. A frequently cited study by Graham, Harvey and Rajgopal (2005) finds that 78 percent of the managers in public firms were willing to boost short-term share price by forgoing economic value in the long run.

Notably, in August 2019 nearly 200 CEOs who are members of the Business Roundtable made an attention-grabbing announcement calling for a governance model that is more stakeholder friendly (*Business Roundtable*, 2019). The concerns with short-term incentives and their consequences have (re)-ignited the debate over shareholder primacy versus stakeholder capitalism. In the former, the duty of corporate fiduciaries is to act in the best interests of the shareholders. In the latter, the duty of corporate fiduciaries is to act for all of their stakeholders – customers, employees, suppliers, communities, as well as shareholders. But what if the two objectives are ultimately aligned?

In this paper, we investigate this question and examine the effect of a stakeholder regime on shareholder value. We use a quasi-natural experiment and study the staggered adoption of corporate constituency statutes in 35 U.S. states. These statues enable corporate directors to consider the impact of corporate decisions on all of the corporation's stakeholders. Since the enactment of these laws is exogenous, we are able to draw causal conclusions.

Our results reveal important findings. First, we find that constituency statutes encourage firms to manage for the long-term. In particular, after the adoption of constituency statutes, we show that executives have a longer-term oriented compensation structure, the shareholder composition changes towards greater institutional ownership with longer-term horizons, employees are more loyal, firms conduct less earnings management and fewer share repurchases, and firms extend more trade credit that reflects longer-term relationships with their customers.

Second, we examine whether the shift to longer-term thinking matters for firm performance. We look into whether a firm's long-termism can increase firm profits. The current literature suggests a positive relationship. We first examine firm sales normalized by assets (i.e., asset turnover), cost of goods sold (COGS), and the selling, general and administrative (SG&A) expenses. We find that after the enactment of constituency statutes, sales increase and COGS and SG&A expenses decrease. We further document an increase in profits, as measured by gross profit margin, operating profit margin, pre-tax profit margin,

[1] Beck and Seru, December 21, 2019.

and net profit margin. In addition, we show that operating cash flows increase after the enactment of constituency statutes. These results indicate that the shift to longer-term thinking matters for firm performance.

Third, we reinforce our findings by examining cross-sectionally whether our results are more pronounced for firms in which the focus on the long-term is more important. In particular, firms with more intangible assets and which focus on technology and R&D activities are by their nature longer-term oriented, since it takes time for these investments to yield profits. We thus partition our sample of firms into subgroups based on their focus on intangible investments and find that among the firms with more intangible assets, the shift to a longer-term orientation and the consequent improvement in firm performance is materially stronger.

Overall, we make important contributions to the shareholder/stakeholder debate. We show that the stakeholder orientation mitigates short-term opportunism and encourages firms to manage for the long-term, which ultimately improves profitability, consistent with shareholder value maximization. Our paper also sets us apart from the existing literature that examines the adoption of constituency statutes. In particular, since constituency statutes were generally enacted to fend off hostile takeover bids, much of the literature has focused on the efficacy of the statutes on the takeover market. However, Cain, McKeon and Solomon (2017) and Bebchuk, Kastiel and Tallarita (2020) show, and we confirm, that constituency statues do not affect the overall rate of takeover activity. Specifically, we show that the constituency statutes do not change a firm’s likelihood of receiving a bid or completing a deal, or the takeover premium if there is a deal. In contrast, we make unique contributions by studying the long-term thinking encouraged by the enactment of constituency statutes. Our long-termism channel is motivated by a literature that discusses how constituency statutes also feature the consideration of long-term interests as one of the common provisions. In particular, Bisconti (2008) discusses how the provisions in constituency statutes commonly state that “the directors may consider both long-term and short-term interests of the corporation”. Standley (2012) concurs and argues that these provisions should serve the long-term standing and continued independence of a firm. We thus focus on this aspect of the constituency statutes to show that long-term thinking bridges the gap between a stakeholder friendly approach and shareholder profit maximization.

To summarize, we show that constituency statutes encourage firms to manage for the long-term. Importantly, this longer-term orientation improves firm performance, which suggests that stakeholder capitalism is ultimately aligned with shareholder primacy. Our study provides suggestions to Canadian legislators, boards of directors and stakeholders on issues related to stakeholder orientation in corporate governance. The role of stakeholders in corporate governance is still an underexplored area in the Canadian context. Given the increasing emphasis on stakeholder interests, it is important for Canadian institutions to know the effect of stakeholder orientation on firm operations.

References

Bebchuk, L. A., Kastiel, K., & Tallarita, R. (2020). For whom corporate leaders bargain. Working paper.

Beck, R. and Seru, A. (2019, December 21). Short-term thinking is poisoning American business. *The New York Times*.

Bisconti, A. (2008). The double bottom line: can constituency statutes protect socially responsible corporations stuck in Revlon land. *Loyola of Los Angeles Law Review*, *42*, 765-806.

Business Roundtable. (2019, August 19). Statement on the purpose of a corporation.

Cain, M. D., McKeon, S. B., & Solomon, S. D. (2017). Do takeover laws matter? Evidence from five decades of hostile takeovers. *Journal of Financial Economics*, *124*(3), 464-485.

Graham, J. R., Harvey, C. R., & Rajgopal, S. (2005). The economic implications of corporate financial reporting. *Journal of Accounting and Economics*, *40*(1-3), 3-73.

Meyerson, H. (2012, July 11). Failures of shareholder capitalism. *The Washington Post*.

Standley, N. E. (2012). Lessons learned from the capitulation of the constituency statute. *Elon Law Review*, *4*, 209-233.

The Economist. (2012, May 19). The endangered public company.