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Convocation Address at the Indian Institute of Management

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Chairman Narayana Murthy, Director Professor Dholakia, members of the faculty, students, ladies and gentlemen:

It is a great honor to come back to deliver the convocation address at this great institute. It seems only the other day that I received my own diploma here, only the other day that I was making arbit CP in my marketing class, only the other day that we D-11'ites won the inter-dorm cricket tournament. I understand that D-11 has changed sex since, but it would be a fitting sign of the times if it won the cricket tournament again.

For many of you, this day will be an extremely happy one. You are graduating from one of the finest management institutes in the world, with a splendid future in front of you. When you reach my age, India will, if all goes well, have eliminated poverty and be nudging into the ranks of the middle-income countries. Some of you will have climbed your way to the top of Fortune 500 companies, while others will have created them. Some will be charismatic political leaders, and some learned university professors. A number of you will choose to dedicate your lives to helping others through social work or by bringing up a family. The one certainty is that you will all face challenges - after all, that is what makes life exciting - but you will also have the training to overcome them. If you survived the first term at Ahmedabad, you can survive almost anything.

Undoubtedly, you will also be sad in the days to come. Ahmedabad creates a cocoon around you, surrounding you with the best and the brightest, only to tear it apart today so that all of you can be unleashed on the world. You will feel the loss of friends, of mentors, and of community. The knowledge that this is an essential part of the cycle of creation and destruction will be small consolation. But trust me, you will survive the loss, and one day, you will be back to share your experiences of the wider world with future generations of students.

What single piece of advice can I offer you from my life after Ahmedabad? Free advice is usually worth what you pay for. But that is not the advice I want to leave with you; You graduating students have the luxury of choice, of choosing what kind of work you will do and how you will do it. Make full use of that choice. Let me be more specific. When I graduated, I was extremely eager to climb the corporate ladder, to be a vice president in five years, and a CEO in ten. While I did none of those things, I have also come to realize that those were the wrong objectives. Many of you look wiser than your years, and you probably understand why. The fact is when young, we think we will be happy if we achieve a lot - we want fame and fortune, and as rapidly as possible. Yet as the Gita tells us, the goal itself is of limited utility, it is the process that matters. If you do not enjoy the job you are doing, if you do not feel you are a productive, contributing member of society, rapid promotion or increasing renown will simply not be enough compensation. If you do not like going to work every day, the fact that you are driven to it in a Mercedes is not going to make it any more pleasant.

This is why my advice to you is to reach out and explore. Try different things. Be unconventional. You will never starve, your degree from this institution assures you of that. You will, undoubtedly, hit dead ends. However, you also are more likely to reach your vocation in life, the career that was made for you. And when you work with all the passion in your heart, you will find that not only does success come as a matter of course, but also it is incidental because work itself is its own fulfillment.

By the law of averages, many of you will follow your inner conscience to become heads of widely held private corporations. The helm of a corporation is a position of great power, and with great power comes great responsibility. How should one fulfill the trust that is reposed in that position?

The answers might seem easy. One should not commit crimes. One should maximize customer satisfaction. One should treat employees exceedingly well. One should be a good corporate citizen and give freely to charities...Indeed, the answers might seem easy but I will argue that apart from the fact that one should not commit crimes, each of the other objectives I just listed could, and should, be questioned.

The reason is a principle you will have learnt in class, the principle of shareholder value maximization. I will speak first about the logic behind this principle, and why, relative to the alternatives, it offers some useful guideposts, especially in an emerging market like India. I will then argue that it is inadequate, but not necessarily for reasons that its critics trot out. Finally, I will offer some thoughts on how to fix it.

The principle of shareholder value maximization suggests that you as manager should focus on maximizing the value of your company's shares. Note there is nothing here about managerial buzz phrases like exceeding the expectations of your customers every day. I will have more to say on that shortly.

The rationale behind shareholder maximization is simple. Everyone who deals with the firm does so on a fair, arm's length basis. Employees are paid a fair wage, while customers get fair value for money. The surplus that is left over after everyone is paid goes to the shareholder. By maximizing what goes to the shareholder, the manager maximizes the size of the pie that is created for society. Moreover, if investors know that the CEO will be guided by such principles, they will be willing to invest substantial amounts in the firm. In an emerging market like India, the application of such a principle by courts, regulators, and managers themselves can be very valuable in expanding the amount of finance available to firms, making more firms possible, leading to greater employment and economic growth.

While the principle of shareholder value maximization would tell you not to lie, cheat, or steal - as would any sensible principle - it also suggests limits to how "good" you should be. For example, for a mature company to significantly exceed its customers' expectations every day cannot be good strategy. That would mean that the company is giving customers more than they pay for, that the company is leaving money on the table so that profits, and ultimately share values, are less than they might be. While it makes sense to exceed your customers' expectations every once in a while, or a little bit all the time, so as to give them a warm and fuzzy feeling towards your company, for a mature company to exceed expectations by a large amount on a consistent basis suggests it is doing a poor job managing customers' expectations. It is a clear sign it needs a new director of marketing.

Shareholder value maximization also sets limits on how mean a company should be, even when it is acting within the law. A true life caselet in the WIMWI tradition should make the point. A multinational bank, which shall remain unnamed for obvious reasons, had a practice called "cholesterol pricing" in the days when exchange rates were still quoted over the phone. If a client called for a quote, the client's relationship manager at the bank would say, "How much do you want to buy? Give me 15 minutes while I find you a good quote." When the client called back, the relationship manager's associate would pick up the phone and say "Shyam is away from his desk but he has scribbled some numbers on his note pad" and proceed to quote an outrageous price. If the client did not die immediately of heart attack on hearing the price, that was the price the client got. If, however, he expressed outrage, the associate would reply smoothly, "Oh, sorry, that is probably his laundry bill, Shyam will call you when he gets back", and the transaction would get done at a more sensible price.

When asked, a senior manager in the bank told me this was a perfectly acceptable practice - after all, the first rule of markets is caveat emptor, or let the buyer beware. Is it the bank's job to educate its clients and suffer the fools amongst them?

I think, however, this practice fails the test of shareholder value maximization for at least three reasons: The first is that it is terrible for creating strong and valuable client relationships. Clients sense when they are cheated, and a bank that behaves like a used-car-salesman will be trusted like one. Shareholder value maximization does not imply myopic transaction-by-transaction maximization. Short run profit can be destructive of shareholder value. While it is silly to continuously exceed client expectations, it is equally bad to continuously disappoint them.

The second reason is that it fails the "light of day" test. In this era of transparency, everything a corporation does should be publishable in a newspaper without inspiring public revulsion. Otherwise, there are simply too many channels through which the information will get out, and hurt the company. Even if it is not illegal or unethical, if you are in the trust business - and which company is not nowadays -- so long as it looks bad in the light of day, you cannot condone it because it will eventually get out.

The third reason it fails the test of shareholder value maximization is it makes management more difficult. If employees know that sharp practices are acceptable with clients, then they are also more likely to adopt sharp practices vis-à-vis each other or the company. When trust within the company breaks down, the company is finished. For all these reasons, shareholder value maximization would suggest that cholesterol pricing, even though not illegal, fails the test of shareholder value maximization.

Similarly, shareholder value maximization is perfectly consistent with corporate social responsibility, provided every action can be justified in terms of long term shareholder value. It is reasonable for a company to beautify its neighborhood if the local government is incompetent - in the long run, the goodwill of employees and the local population towards the company, and hence the effects on the bottom line, outweigh the costs. In an emerging market like India, where government capacity is often constrained, corporations may have to provide public services themselves just to function. In the long run, however, it would be best if they pressured the government to utilize taxpayer resources well and provide those services. Corporate hyperactivity can lead to government atrophy, to everyone's detriment.

Some kinds of corporate social responsibilities, however, fail the test of adding to shareholder value. For a company's CEO to donate freely to charitable causes from corporate coffers is simply not acceptable if it does nothing for the firm. Tyco alleged that its former CEO, Dennis Koslowski, spent $46 million of the company's money on charitable donations for his own benefit or represented as his personal donation. Among the worthy causes he supported was a donation to the Nantucket Conservation Foundation, so that it would buy the undeveloped land next to his $5 million home, thus preserving the unspoilt view from his home.

This is not to say that charity is not a good thing. But the manager should create wealth for shareholders then let them decide where they want to give. The manager's charitable giving should come out of her own personal account. The biography of John D. Rockefeller bears reading - a ruthless businessman, he retired early and spent the rest of his life cleverly using the wealth he had amassed for the greater good of mankind. He founded both the University of Chicago and the

Rockefeller Institute, together home of more Nobel prizes than one can count. In many ways, he did as much or more good in retirement as in building his oil company, but had he not maximized shareholder value early on, he would not have had the wealth to do good.

The notion of keeping personal life separate from professional is one that is, at first, foreign in a society like India's. The family firm that employed every incompetent bhai-bhatija of the founding father simply reflected the fact that in India, one's responsibility was first to family and community, and only then to society and nation. This is changing. As India becomes a market economy, competition no longer permits firms to be run by one's ne'er do well brother-in-law. And it demands that, at least in business, you treat the ink on a contract with an anonymous stranger be a stronger bond than the blood that ties you to your brother.

The portrait of a CEO that I am painting may not resonate with some of you. The tight-fisted bean counter, evaluating every action in terms of its monetary impact, looks very different from the expansive charismatic boss that many of you aspire to be. But let me assure you, deep inside every successful CEO, a Bill Gates, a Jack Welch, a Lakshmi Mittal, and dare I say, a Narayan Murthy, is an accountant, who calculates the costs and benefits of each action. This is not to say that vision and strategy are not important, but ultimately they have to be rooted in the bottom line. There is nothing more destructive of societal value than a CEO with vision that is unanchored in profits - Michael Armstrong who turned AT&T from a household name to a has-been is just one of many examples.

How does one get managers to internalize shareholder value maximization? One way to align managerial interests with shareholder interests is by offering managers an equity stake in the firm. But all too often the stake they get provides little in the way of incentive alignment, and the principle of shareholder value maximization is simply a cover for egregious payouts to managers. Let me offer some examples.

A study some years ago found that there was a positive correlation between the grant of stock options to managers in the United States and the subsequent performance of firms. This seemed like a vindication of the role of stock options in providing managers incentives. Yet a closer examination revealed that the reason for the correlation was that managers timed the grant of stock options to themselves just before the announcement of good news by the firm.

Similarly, managers should be paid more -- via stock, options, or bonuses -- when their effort genuinely contributes to greater profits for the firm. Yet all too often, they get massive payouts if the company does well regardless of whether or not it is due to their effort, and they do not get penalized if the company does badly. A study of pay in the oil industry found that CEOs were paid more simply if the price of oil rose, something that they clearly had no hand in. Similarly, a number of promoters in India have tried to funnel out value from their firms by having their pet boards grant them enormous quantities of shares. Since these promoters already have a sizeable stake in the firm, and have interests well aligned with shareholders, there is really no logic to give them more shares, especially when these allotments are done without full shareholder oversight.

Finally, payment in stock or options is misused because it may not be fully clear to shareholders that it costs them anything. The reluctance to show the true cost of stock option grants in corporate income statements in the United States stems primarily from the fear corporations have that shareholders will balk when they see how expensive option grants truly are.

In sum then, managers can misuse the concept of shareholder value maximization to justify excessive pay to themselves. However, these abuses can be fixed by requiring more transparency in the process of awarding payouts as well as greater shareholder voice in approving them, clearer links between payouts and incentives, and much tighter accounting of the costs to shareholders.

Let me turn finally to a recent important criticism of shareholder value maximization by the late Professor Sumantra Ghoshal.[1] He argues that "the root cause of the recent corporate scandals in the United States lies in this over-emphasis American corporations have been forced to give in recent years to maximizing shareholder value without regard for their effects of their actions on other stakeholders". To many students of finance, this would seem a strange criticism, since the lying and cheating by the CEOs involved in the corporate scandals were destructive of shareholder value.

It turns out that Sumantra is not really railing against shareholder value maximization but against an off-shoot called agency theory, which suggests that managers will feather their nest when they can, unless they are constrained by corporate governance rules. He goes on to say "a theory that assumes that people can behave opportunistically and draws its conclusions for managing people based on that assumption...[is] likely to enhance opportunistic behavior among people." In other words, corporate governance leads to corporate crime.

This is an interesting view, but it simply fails to fit the facts Sumantra is trying to explain. The managers of Enron did not feather their nest because the board was exercising serious oversight, they feathered their nest because the board was asleep at the wheel. If Sumantra is right, Russia, where managers have far more of a free hand to run their corporations, should have far better run public corporations than the United States. Few would argue they do. India's stock market is vibrant today because of improved corporate governance, not despite it. While indeed too little trust can breed cynicism and misbehavior, too much trust leads to license. As Ronald Reagan said, "Trust but verify", and that is what good corporate governance systems try to do.

The more useful criticism Sumantra makes is one that my colleague, Luigi Zingales, has also made. It is that in some firms, the assumption that shareholders are the residual claimant may not hold. To see why, think of a software firm creating some very specialized software. Over time, the employees of the firm know only how to work with that software platform and really have few outside career options. Their knowledge simply does not translate to other platforms. On the other hand, if they leave, the firm will have to recreate all their experience at tremendous cost. Employees and shareholders are mutually dependent, and employees will be paid, not at a wage set in a competitive market, but through a bargaining process where they get a share of the profits. Both employees and shareholders are residual claimants. In this case, maximizing only shareholder wealth need not lead to maximizing the value of the firm - that will happen only if managers maximize both shareholder and employee wealth. In fact, unless employees feel they are protected, they may not want to join the firm and place their human capital at the whims and fancies of some anonymous shareholder.

This is an important criticism. Market economies, however, have found a way out. Think of many of the human capital intensive firms you know - law firms, consulting firms, investment banks, etc. The way they manage the tension between employees and shareholders is by making them one and the same - that is, by incorporating as partnerships or by giving their employees extensive stock holdings. So shareholder value maximization still holds when you are an employee of a consulting firm, though the shareholder is no longer some anonymous stranger, it is you.

More generally, as human capital becomes more important, I am sure we will see many more innovations in corporate organizational form, aimed at reducing the tension between owners of human capital and the owners of physical capital. These innovations will be particularly important in India, where the service economy is so vibrant. While there is much to learn from Western forms of organization, there is no reason why Eastern forms of business, some created by you students, should not emerge.

It is time for me to close. While I have offered some examples of how shareholder value maximization can be a useful guide for managerial behavior, I have also suggested that much depends on how it is practiced. There is a more general point here. The rules suggested by management theory cannot blindly be applied, as one would a cookbook recipe. As we have seen, it is not always clear where shareholder value lies and what decisions benefit it. Often, the situations in which decisions are made are neither easy to analyze nor remotely similar to anything in one's experience. This is why the best management schools -- such as IIM Ahmedabad -- teach you not what to think but how to think.

There is, however, a second point. And that is when we reach the limits of analysis, management decisions have to be guided by an inner sense of what is right. This inner sense -- your moral compass or conscience -- cannot really be taught. In the final analysis, it is this that makes the difference between merely a competent manager and a great manager. I am sure all of you have the elements of that inner sense within you, you only have to make sure you nurture it and never allow it to be suppressed simply because you want to get ahead.

In conclusion, you are embarking on a most exciting journey. The world out there is fiercely competitive, but you should have no fear. You have been tempered by one of the most rigorous programs in the world and are now ready to show your mettle. Congratulations to all the graduating students, good luck, and may you fulfill your dreams. Thank you all.

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[1] "Bad Management Theories are Destroying Good Management Practice", Academy of Management Learning and Education, 2005, vol. 4, no 1, 75-91.

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