Porsche Changes Tack

“Yes, of course we have heard of shareholder value. But that does not change the fact that we put customers first, then workers, then business partners, suppliers and dealers, and then shareholders.”

Dr. Wendelin Wiedeking, CEO, Porsche

Will Porsche’s new strategy actually create shareholder value?

Porsche Changes Tack: Case Questions

1. What strategic decisions made by Porsche over recent years had given rise to its extremely high return on invested capital?
2. Vesi wondered if her position on Porsche might have to distinguish between the company’s ability to generate results for stockholders versus its willingness to do so. What do you think?
3. Is pursuing the interests of Porsche’s controlling families different from maximizing the returns to its public share owners?

Exhibit 1 Porsche’s Growth in Sales, Profits and Margin

- Porsche’s focus is on stakeholder wealth
  - It has followed what is generally referred to as stakeholder wealth maximization over its history, rather than the increasingly common focus on shareholder wealth maximization common in the Anglo-American markets
  - Stakeholder wealth maximization attempts to balance in theory the needs and returns to the multitude of corporate stakeholders – stockholders, creditors, management, employees, suppliers, customers, community – rather than focus solely on stockholders
  - Porsche’s focus may be one of self-interest
  - Porsche has frequently been accused of operating the company for the primary benefit of the Porsche and Piëch families, and management, over all other stakeholder groups
  - Rewards management in the company primarily on the basis of sales, profits, margins, and other financial measures of corporate performance rather than stock or stock options
  - Porsche has continued to fight industry standards for reporting and disclosure
  - Porsche has continued to report according to German accounting standards long after most other German companies, publicly traded companies, have moved to international standards
  - It has continued to report only semi-annually, not quarterly, arguing that it does not see its business quarterly, and does not want to add to the short-term thinking common among equity investors in today’s equity markets

Corporate Governance at Porsche

- Porsche is a publicly traded family controlled company
- Porsche is a relatively simple company by product line, having three existing and one newly proposed product(s):
  - 911 – the only model produced and assembled completely by Porsche
  - Boxster – licensed manufacturing with Valmet of Finland
  - Cayenne – co-manufactured with Volkswagen of Germany
  - Panamera – to be completely Porsche (at least that’s the plan)
- Porsche’s profitability has been extremely impressive over the past decade – particularly for an automaker
- Porsche has followed a strategy with both the Boxster and the Cayenne which uses a combination of licensing, out-sourcing, and in-sourcing to leverage other people’s money
- As a result of its strategy, Porsche has enjoyed an industry leading return on invested capital (ROIC)
- But two major announcements in the summer and fall of 2005 seemingly indicate that Porsche is changing directions:
  - The Panamera will be manufactured in-house, with Porsche’s own money
  - Porsche has invested 3 billion in taking a 20% interest in Volkswagen (Germany), one of the worst performing automakers in the world

An Overview of Porsche AG, 2005

- Porsche is a publicly traded family controlled company
- Porsche is a relatively simple company by product line, having three existing and one newly proposed product(s):
  - 911 – the only model produced and assembled completely by Porsche
  - Boxster – licensed manufacturing with Valmet of Finland
  - Cayenne – co-manufactured with Volkswagen of Germany
  - Panamera – to be completely Porsche (at least that’s the plan)
- Porsche’s profitability has been extremely impressive over the past decade – particularly for an automaker
- Porsche has followed a strategy with both the Boxster and the Cayenne which uses a combination of licensing, out-sourcing, and in-sourcing to leverage other people’s money
- As a result of its strategy, Porsche has enjoyed an industry leading return on invested capital (ROIC)
- But two major announcements in the summer and fall of 2005 seemingly indicate that Porsche is changing directions:
  - The Panamera will be manufactured in-house, with Porsche’s own money
  - Porsche has invested 3 billion in taking a 20% interest in Volkswagen (Germany), one of the worst performing automakers in the world
Managing to Metrics: ROIC

Return on invested capital is composed of two components calculated from the firm’s income statement and balance sheet, termed operating margin and velocity.

$$\text{ROIC} = \frac{\text{Operating Profits}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Invested Capital}}$$

Operating Margin

Velocity

In both cases, bigger is better. The larger the operating margin and the greater the velocity, the greater the return on invested capital. Traditionally, most companies focus on the operating margin, often concluding they have little capability to alter their basic velocity value. Velocity itself will change only with changes in corporate strategy — including licensing and outsourcing at Porsche, or the growing influence of in-sourcing in other industries.

Porsche and Volkswagen

- Porsche says
  - the investment of €3 billion in VW is in response to mounting future strategic partnership with VW
  - VW is currently responsible for roughly 30% of Porsche’s automotive manufacturing and assembly.
  - The two newer product lines, the Boxster and Cayenne, had both been launched with the capital and technology embedded within other companies.

- VW and major VW shareholders
  - see a significant conflict of interest between Porsche and VW, including prioritization of VW’s and Porsche’s portfolio valuations, as well as the competitive conflict between Porsche and Audi of VW.
  - VW is one of the two biggest underperformers in the European auto industry at present, and is in need of a strong organizational change to reduce redundancies which is not consistent with Porsche’s track record of strong organizational change and cost reductions. Porsche suggests it is a strong feature of traditional German business practices.

- Auto Analysts and Critics and Stockholders argue
  - that the investment of €3 billion in VW is an attempt by Ferdinand Piëch, non-executive chairman of VW, to acquire other people’s money. "Valmet owns its own factory and tools, and builds the Boxster for Porsche. It’s a manufacturing agreement that allows Porsche to effectively use ‘other people’s money.’" Valmet owns its own factory and tools, and builds the Boxster for Porsche.

- The Porsche Cayenne was co-manufactured with Volkswagen. The Cayenne chassis was assembled on the same production line as the Volkswagen Touareg in Bratislava in the Slovak Republic, again greatly reducing the required capital to support Porsche’s business.

What is Invested Capital?

Porsche’s problem in recent years is that it has accumulated a very large cash balance. Cash is not free; it must be funded on the right-hand-side of the balance sheet. If Porsche had dispensed the excess cash rather than retaining it, its invested capital base would not have grown, undermining its ROIC. Porsche has one other complicating factor; it possesses a large amount of non-interest bearing long-term liabilities, a feature of traditional German business practices.

Porsche Changes Tack: Case Questions

1. What strategic decisions made by Porsche over recent years had given rise to its extremely high return on invested capital?
   - Return on invested capital (ROIC) combines operating margins, found on the income statement, with greater capital utilization, which is derived from the balance sheet.
   - All three Porsche product lines – the 911, the Boxster, and most recently the Cayenne – enjoyed high operating margins compared to nearly any other major European automobile manufacturer.
   - The Porsche Cayenne was co-manufactured with Volkswagen. The Cayenne chassis was assembled on the same production line as the Volkswagen Touareg in Bratislava in the Slovak Republic, again greatly reducing the required capital to support Porsche’s business.

Exhibit 2 Return on Invested Capital (ROIC) for European Automakers, 2004

Exhibit 3 Porsche’s Velocity, Margin, and ROIC

Exhibit 1-1 to 1-12
2. Vesi wondered if her position on Porsche might have to distinguish between the company’s ability to generate results for stockholders versus its willingness to do so. What do you think?

- This is a question which is growing in significance when investors examine the motivations and performance expectations of management in publicly traded companies. Porsche rewards management on business financial performance – the numbers found on the three major financial statements – and not on the market’s opinion of the company’s value (share price).
- This is considered as highly controversial because for the better part of the last 40 years academics have argued that management needs to share the same motivations, rewards, and risks as stockholders do – the share price as core to investor and management returns.
- But Porsche has seemingly focused on executing the business with the highest of regard for the company’s long-term performance and profitability (much like a family owned business), the result of which has been obviously appreciated by the market.
- One key point here is whether the use of 3 billion euros to purchase a growing (and in the end controlling) position in VW was motivated by business needs to family bias? As the real results continue to roll out, it appears to be more and more of both.

Porsche Changes Tack: Case Questions

3. Is pursuing the interests of Porsche’s controlling families different from maximizing the returns to its public share owners?

- Yes, there is. Although the interests of family ownership and public shareholders are both based on growing and profitable and sustainable business, there is one key difference between families and markets: a focus on growth.
- The returns to a family from its ownership of a business are derived from distributed profits (dividends), salary and compensation (family members employed by the firm), and financial support (family members often enjoy company-owned assets and expenditures).
- The returns to a shareholder in a publicly traded firm are derived from dividends (dividend yield) and share price appreciation (capital gains). Although the dividend yield concept is similar, the capital gains concept of a market driving a share price upwards is much more complex and difficult to “drive” from a leadership perspective than what most family based businesses focus on.
- Clearly, in the end, one of the primary drivers of share prices is a company which promises and delivers profitable growth in both the top-line and bottom-line of the income statement. A family owned and managed business is as interested in sustainability and control as it is in rapid growth.

Porsche’s announcement of its investment in VW was not well-received by the equity markets. As illustrated here, the downward spike just prior to 27.09.05 is the market’s reaction to the announcement – a one day loss of approximately 30% of its value which was then largely reversed, then lost again, in the following month.

Porsche’s share price performance over the 2004-2005 period, however, recovered and was very good by all comparable measures.