Balancing Ethics and Shareholder Returns: The Case of Google in China

Case

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Abstract

The case provides a timely example of a well-known firm who, in their attempt to act in an ethical manner, generated tremendous financial harm to their shareholders. It provides an interesting counterpoint to the assertion in the literature that shareholder wealth maximization provides an ethical basis for all business decisions. Google is a firm that many students know and admire, and this should spark interest in the case. It can be assigned in the early stages of a corporate finance class, where the topic of discussion is the goal of the firm, or in a business ethics class, where the goal of the firm is evaluated. The case provides an opportunity to evaluate the ethical basis for Google's actions, as well as the resulting impact on shareholder returns. The case may also represent a real-life counterpoint to the oft-repeated maxim that "Good ethics is good business". Information in the case was compiled from secondary sources.

Case

Keywords: financial ethics, stockholder wealth maximization, censorship, stakeholder conflicts, computer hacking, agency theory, efficient markets, common stock valuation.

1. Introduction

In the spring of 2010, the executives and top management of Google, Inc., were worried. The May 13 Annual Meeting of shareholders was rapidly approaching, and shareholders were upset. On January 1, Google's stock price had opened the year at $626.95 per share, and by May 7, it had fallen significantly, closing that day at $493.14. This represents a -21% return over slightly more than a 4-month period. In aggregate dollar terms, Google had lost more than $42 billion of market capitalization. This loss could not be blamed on poor equity market conditions, since the NASDAQ index (Google's shares were traded on the NASDAQ) had declined by only 1% during the same period of time.[1]

What had happened? Google and its conflict with the government of the People's Republic of China had been a major news story in the early months of 2010. That spring, the company decided to redirect its mainland China search requests through its Hong Kong server. This was done in an attempt to circumvent Chinese government demands that the firm censor search activity. The timing of this decision came on the heels of Google's public announcement that the security of their user accounts had been compromised by hacking activity originating within mainland China. The Company never named the Chinese government as the perpetrator of this activity, but the government responded angrily nonetheless. There was speculation that Google would close down its Chinese operations altogether.[2]

Management felt the steps they took were necessary to remain true to their ethical code. While Google's actions are sometimes controversial, the firm is widely cited as a principles-driven company. Ted Leonsis, former AOL Vice-Chairman and principal owner of the Washington Capitals NHL hockey team, labels Google as a "double bottom line" company, which he defines as "an organization that measures its success by both its fiscal results and its positive impact on humanity."[3]

Google's actions in China were motivated by several factors. First, they had an obvious need to protect their own network from the threats posed by hackers. Upon gaining access, hackers can not only destroy the security of a computer network, but its very functionality also. This is a risk Google could not afford to take, especially when the nature of their business is considered.

Second, management felt they had an obligation to preserve the privacy and the integrity of their users. In the decision to close down their search site in mainland China and move it to a server in Hong Kong, David Drummond, Senior Vice President of Google, said the firm was motivated by "…evidence to suggest that the Gmail accounts of dozens of human rights activists connected with China were being routinely accessed by third parties, most likely via phishing scams or malware placed on their computers."[4] Google's #1 value in their code of ethics is "Focus on the user and all else will follow." This focus includes protecting user information and privacy. The Code goes on to state that "…we take great care to serve **you**, rather than our own internal goal or bottom line."[5] (Emphasis in the original document.) The full text of Google's code of ethics, entitled "Our Philosophy", is included as an appendix to this case.

A third explanation for Google's China actions revolves around management's distaste for censorship. No one felt this more strongly than Sergey Brin, Google co-founder, who was born in the former Soviet Union.[6] Brin recognized the value that the free flow of information could have in opening up the political climate in a country like China, and he noted that Google had not censored their search service in any other market. As one observer concluded, "After all, Google's unofficial motto is 'Don't be evil.'"[7]

Google, like other firms, was also under pressure to maximize the value of their shareholder's investment. Not only the shareholders, but much of the public assumed shareholder wealth maximization was a key driver of business decisions. "Most financial economists believe that the primary aim of corporate management is (or, at least, should be) to maximize shareholder value (or, more precisely, the value of the firm)."[8] The principle of shareholder wealth maximization is now fundamental in many business-school textbooks. For example, a leading text in corporate finance states "Consequently, throughout this book, we operate on the assumption that management's primary goal is **stockholder wealth maximization**… If a firm attempts to maximize its stock price, is this good or bad for society?….*the same actions that maximize stock prices also benefit society*."[9] (Emphasis in the original.)

On Wall Street, Google is classified as a growth stock, and its growth potential is a major value driver. Google's presence in mainland China enhanced the growth opportunities of the firm, since the Chinese Internet market was the fastest-growing in the world, and would soon be the largest also.[10]

As of May, 2010, after Google's move to Hong Kong and the Chinese government's response, management realized that Google's future in mainland China was in jeopardy. The 21% decline in the market value of their stock since January was a reflection of Google's uncertain future in China, as stockholders were upset by the loss of Google's growth potential. Management was also frustrated by the apparent conflict between the ethical foundations of their decisions and the goal of maximizing shareholder wealth. One thing was certain, the annual meeting of shareholders was approaching quickly, and management needed justifications for their actions that stockholders would accept before confronting them face-to-face.

2. Google's China Operations

Google's Chinese beginnings can be traced back to the year 2000, when the firm developed a Chinese language interface for use on their website, Google.com. They experienced trouble almost from the beginning, and the site was temporarily unavailable to Chinese users as early as 2002. The company suspected interference from domestic competition, but nothing was proven.[11]

In January, 2006, Google rolled out Google.cn, its China-based search page. As a condition of opening Chinese operations, the Chinese government made it clear that Google would be expected to censor content generated by its web searches. This censorship included not only pornography and other culturally-objectionable material, but political content also. (For example, Google censored information relating to the Dalai Lama, Tibet, Tiananmen Square, and other political issues sensitive to the Chinese government.) The government expected this censorship to be done by the firm, indicating that "Foreign companies operating in China must abide by Chinese laws."[12] The level of censorship actually practiced by Google may have been higher given the fact that specific content to be censored was left undefined by the government.

Google's practice of self-censorship was the subject of widespread criticism. U.S. Representative Tom Lantos, a California Democrat and Holocaust survivor, said that the firm should be "ashamed".[13] Google, however, gave the issue a different spin. They believed their presence in China would promote the free flow of information, indicating "…our continued engagement with China is the best and perhaps only way for Google to help bring the tremendous benefits of universal access to users there."[14] In assessing their censorship in China, management was pulled in opposite directions by two conflicting and contradictory objectives from "Our Philosophy". On one hand, they sought to "focus on the user and all else will follow" by remaining in China and using their presence to promote the free flow of information. On the other hand, "make money without doing evil" would lead Google to avoid censorship, even if the cost was the abandonment of the Chinese market.

More trouble followed in 2009. In March of that year, the Chinese government blocked Google's *YouTube* video site. Three months later, Google's Chinese search site, Gmail, and other Google online services were inaccessible to users in China. The following day, a government official accused Google of spreading obscene content over the Internet. Service was restored within a short time.[15]

Despite their problems, Google's business in China grew steadily. At the end of 2009, Google had a Chinese market share of about 35% (measured by revenues generated), behind Chinese rival Baidu with 58% of the search market. Google had offices in Beijing, Shanghai, and Guangzhou, and employed several hundred persons. Large increases in Chinese employment were planned. While the firm did not break out their Chinese revenues separately, Wall Street analysts estimated that they did about $200 million in annual sales in China in 2008, and JP Morgan estimated that the firm would generate $600 million in revenues during the year 2010, due to both the rapid growth of the number of Chinese Internet users and Google's increasing market share.[16]

Google's main competition in the Chinese market was Baidu, Inc. Baidu was founded by Li Yanhong, and is currently the world's third largest search engine and the #1 search engine in China. From a low-key start in a Beijing hotel room, Li's firm grew to generate revenues of $468 million in 2008, and their stock is traded in the U.S. on the NASDAQ. Li's personal fortune is estimated at $2.1 billion, placing him on *Fortune* magazine's list of the world's wealthiest individuals.[17]

3. Events of December, 2009 and January, 2010

On January 12, 2010, Google announced that email accounts of Chinese human rights activists had been breached during December, 2009. However, the hackers were only able to access "from" and "to" information, and the message content remained secure. In addition, Google announced that dozens of Gmail accounts in China, Europe, and the United States had been regularly accessed through phishing and malware on the user's computers, rather than through a security breach at Google.[18] Google did not immediately accuse the Chinese government of originating this activity. Later, it became known that the breach began with an instant message sent to a Google employee in China which, by clicking on a link, installed a modified version of a Trojan called Hydraq. A Trojan is malware that, once inside a computer, allows others unauthorized access. The attack was labeled "sophisticated" due to the fact that the hackers knew who to attack, not due to the sophistication of the malware itself. Local media reported that Google suspected the attacks were aided by its employees, and, after the attacks, some Google employees were put on leave, some transferred to other offices in China, and others were denied access to internal networks.[19] A week later, on January 18, a journalists' advocacy group announced that the Gmail accounts of at least two foreign journalists in Beijing had been compromised. In this attack, hackers changed Gmail program settings so that all messages would be forwarded to unfamiliar addresses.[20]

Google's response to these attacks was swift. On January 12, they indicated that they would no longer practice self-censorship of the web searches conducted on *Google.cn*, and threatened to leave the country entirely if the situation could not be resolved. Despite this announcement, the firm reinstituted their self-censorship of search results shortly thereafter. The Chinese government, in turn, made it clear that they were unhappy with Google's public stance. "Foreign firms in China should respect China's laws and regulations, and assume the corresponding social responsibilities, and of course Google is no exception" said Chinese Foreign Ministry spokesman Ma Zhaoxu.[21] Both parties found the actions of the other unacceptable, and negotiations began in an attempt to resolve the impasse.

During their investigation of the attacks, Google learned that as many as 34 other firms, as well as the government of India, may have also been targeted. A mix of technology firms and defense contractors were attacked, including Adobe, Yahoo, Northrop Grumman, GoDaddy, and Dow Chemical.[22] Unlike Google, most of these firms did not respond publicly to the attack, but there were exceptions. Adobe issued a public response within hours of the Google announcement, stating "Adobe became aware on January 2, 2010, of a computer security incident involving a sophisticated, coordinated attack against corporate network systems managed by Adobe and other companies."[23] Scottsdale, Arizona-based GoDaddy went a step further, announcing on March 24 that it planned to stop registering domain names in China. "We believe that many of the current abuses of the Internet originating in China are due to a lack of enforcement against criminal activities by the Chinese government," said

Corporate General Counsel Christine Jones. She also indicated that her firm had suffered "dozens" of serious attacks, apparently originating from within China, within the past three months. Responses to GoDaddy's actions were quick. "I complement Google and I complement GoDaddy," said Democratic Senator Byron Dorgan, Chairman of the Congressional-Executive Commission on China, which focuses on Chinese human rights violations. Republican Congressman Chris Smith labeled GoDaddy's actions as "…a powerful sign that American IT companies want to do the right thing in repressive countries."[24]

However, most firms were reluctant to respond publicly to the attacks. "Google approached other companies to seek help in drawing attention to the cyber attacks and was frustrated by their reluctance to come forward."[25] An unnamed executive with business experience in China, and who wished to remain anonymous because he was concerned about "ruffling Chinese feathers", said "The Chinese government and the Communist party have a unique ability to reach out and touch companies in a way that can make it very difficult to do business …I think people want to kind of see how it impacts me, rather than take a sort of broad position, or industry position." [26]

4. The Move to Hong Kong

Negotiations between Google and the Chinese government continued throughout the months of January-March, 2010. Both sides made their positions clear. Google would not continue to practice self-censorship of web searches originating from their Chinese site, and the government refused to do the censorship itself, also indicating that uncensored searches would never be allowed. The Chinese government further questioned Google's motivations. In a statement on Xinhua, China's official state news agency, spokespersons said "Regrettably, Google's recent behaviors show that the company not just aims at expanding business in China, but is playing an active role in exporting culture, value and ideas…It is unfair for Google to impose its own value and yardsticks on Internet regulation to China, which has its own time-honored tradition, culture and value."[27] They added that "And whether leaving or not, Google should not continue to politicalize itself, as linking its withdrawal to political issues will lose Google's credibility among Chinese netizens." (sic)[28]

The impasse was broken with Google's March 21 announcement that they were closing down their mainland Chinese website and moving search operations to their Hong Kong server. Google's Hong Kong service, *Google.com.hk*, operates without a censorship requirement. While Hong Kong is a part of China, it operates as a "Special Administrative Region" and enjoys relative freedom in everything from finance to its judicial and legal systems.[29] In making this move, Google was able to continue to serve the Chinese market without continuing the practice of self-censorship. Mainland Chinese users were still unable to access politically-sensitive material, because a government firewall continued to censor all Internet content generated from non-mainland servers.[30]

The Chinese government's response to the Google move was swift. In an official statement issued by the China State Council Information Office and published by the government-run Xinhua news agency, they said:

> Foreign companies operating in China must abide by Chinese laws. Google has violated the written promise it made on entering the Chinese market. It is totally wrong in halting filtering of its search provider and also in making aspersions and

> accusations toward China about hacking attacks. We firmly oppose politicizing commercial issues, and express our dissatisfaction and anger at Google Inc.'s unreasonable accusations and practices.[31]

The non-official response from Chinese Internet users was less restrained. Comments posted on the *Global Times* website included "Get the hell out" and another wrote "Ha ha, I'm going to buy firecrackers and celebrate!" [32]

In the U.S., the reaction of Wall Street analysts was a mixture of admiration and criticism. Dan Olds, an analyst for The Gabriel Consulting Group, said "Google is putting its money where its mouth is, and staying true to its principles and following through on their earlier rhetoric. It was definitely a brave move and one that will garner them some positive attention for a change…users worldwide will now feel they can trust Google as an honest broker of information." Augie Ray, an analyst at Forrester, said "Google made a smart move. Rather than unilaterally pulling out, they took an action that puts the ball back in China's court. While Google feels redirecting Chinese users to their Hong Kong site is entirely legal, it seems unlikely the Chinese government will see this as anything other than an attempt to bypass their laws and direction. Their actions cannot hurt their reputation in the West, but it remains to be seen if improved reputation equates to any particular business benefit. In the end, it seems Google did not take this action primarily to generate goodwill, but because they believed it was the right thing to do for their culture, vision, and business." Rob Enderle, analyst with the Enderle Group, was more critical of Google. "You have a choice to follow the laws in the countries where you do business, chose not to do business in those countries, or break the law. Google has apparently decided to break the law…The law they are breaking isn't popular in the West. On the other hand, governments don't want to reward companies that break laws. This will do a lot of damage to their potential in China and make other governments nervous about them."[33]

5. The Impact on Google Stakeholders

Google's decision to move their search activities to Hong Kong had an immediate impact on the firm's stakeholders. With their decision not to censor Internet searches, the company was "shunned" by Chinese business partners. Tom Online, a popular Chinese web portal, switched to Google's rival *Baidu.com* for Internet searches from its site. Google seemed to be recognizing their new competitive weakness when they announced that "Over time, we will not be syndicating censored search to partners in China."[34]

The most obvious immediate beneficiary was Google's search competitor Baidu, who gained significant market share at the expense of Google. As mentioned earlier, Baidu is a Chinese firm, and they maintain strict compliance with all Chinese governmental requirements, including those calling for censorship of search results. Even Microsoft, who recently launched a Chinese version of its Bing search site, stands to gain market share.[35]

Google's Chinese employees reacted to the firm's moves. Fearing governmental accusations and retaliation because they helped Google "break the law", local Chinese media reported a steady stream of employees leaving Google for other firms.[36]

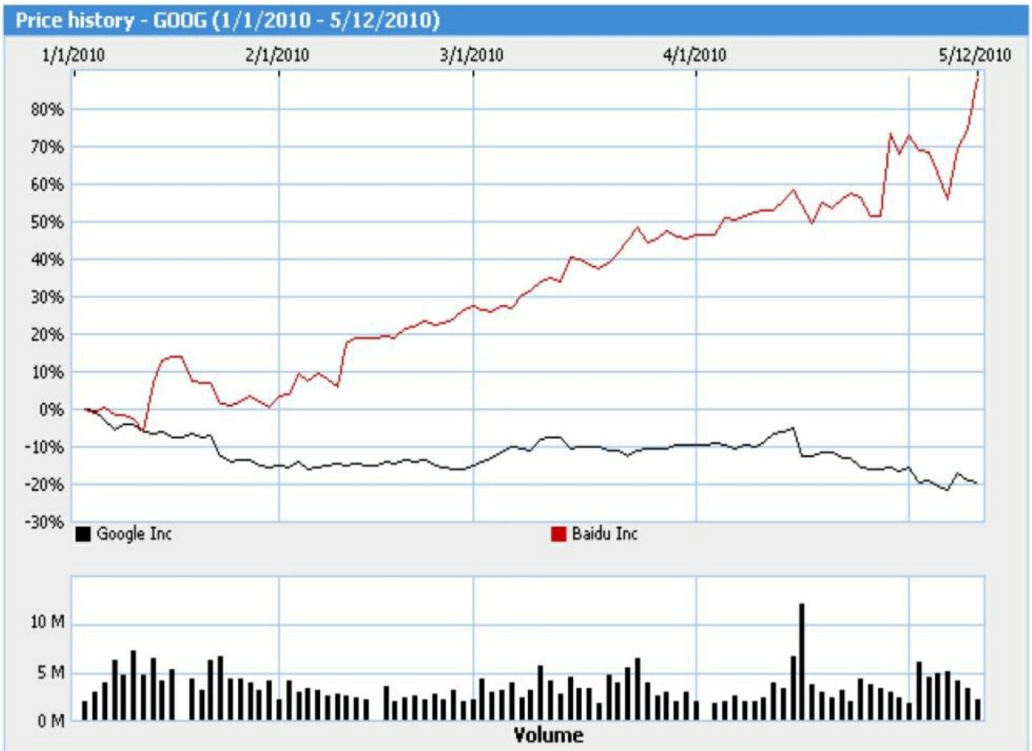
Advertising revenues, the heart of Google's business, were also endangered by their move to Hong Kong. "Analysts said it was unclear how Google China's ad resellers would react to the company's decision to shift its China business to *google.com.hk*. Much depends upon whether Beijing decides to block access to *google.com.hk*, in which case Chinese web users would not be able to access the site even if they wanted, making it of little or no interest to advertisers."[37]

6. Financial Impact on Google

Stock market reaction to Google's decision was swift and significant. Google's stock price fell by 21% between the start of the year and May 7, 2010. This represents an overall loss in market capitalization of $42 billion. All this occurred during a time period when the returns on the overall NASDAQ index were essentially flat. (The NASDAQ stock index fell by 1% during the same period).

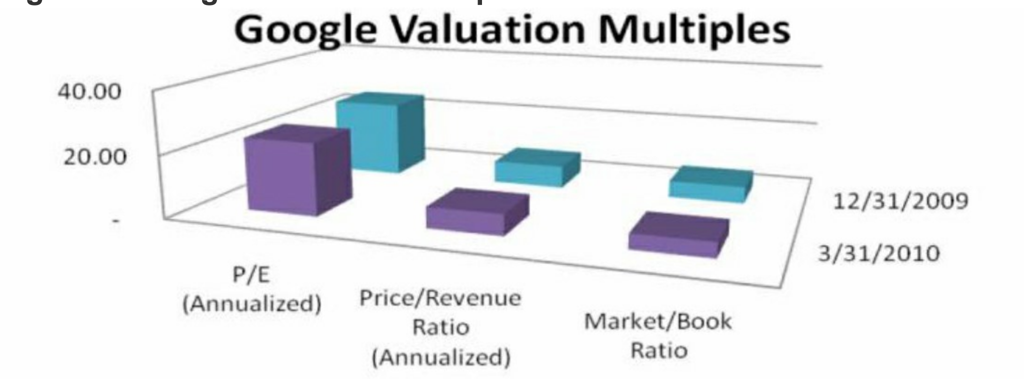
Baidu, Inc. was the main beneficiary of Google's demise. Their stock opened the 2010 year at $41.00 per share (adjusted for a subsequent 10:1 split), and on May 7, it closed trading at $63.95, representing a 56% return in slightly over four months. Figure 1 is a graph of the two firm's stock prices, normalized so that the initial price of both firms is 100%.

Figure 1: Stock Price of Google and Baidu[38] (1 January, 2010 to 12 May, 2010)



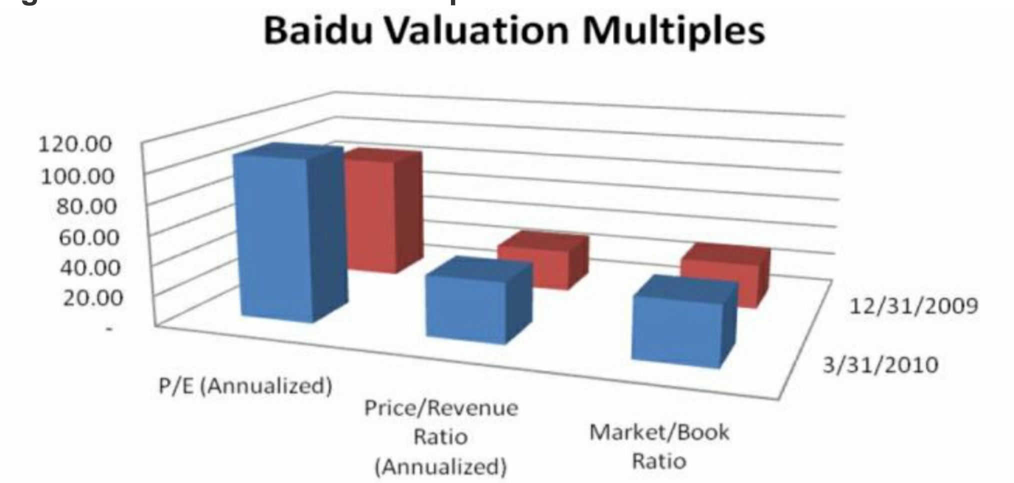
Google's stock price decline occurred during a period of continued positive financial results for the firm. Google's price-earnings multiple, price-sales multiple, and market-to-book ratio all declined, evidence that investors were penalizing Google for reasons other than a decline in their financial performance. Baidu, on the other hand, showed significant increases in all these ratios, including an impressive price-earnings multiple of 108.38 at the end of the first quarter, 2010. A chart depicting valuation multiples for Google is included as Figure 2; the same multiples for Baidu are included as Figure 3.[39]

Figure 2: Google Valuation Multiples



	P/E (Annualized)	Price/Revenue Ratio (Annualized)	Market/Book Ratio
3/31/2010	23.40	6.75	4.78
12/31/2009	24.91	7.37	5.46

Figure 3: Baidu Valuation Multiples



	P/E (Annualized)	Price/Revenue Ratio (Annualized)	Market/Book Ratio
3/31/2010	108.38	40.25	39.61
12/31/2009	83.81	28.44	30.18

Given that Google's stock price declined significantly, but their financial performance did not, why would investors penalize the firm in such a significant manner? To answer this question, we need to examine Google's growth potential. Google was known as a growth stock. Typical of many growth stocks, Google paid no dividends and traditionally sold at a high multiple of its current earnings. During the first quarter of 2010, Google's domestic market share continued to rise, reaching 71.4%. Its main domestic competitors (Yahoo and Microsoft Bing) both lost share during the same period.[40] In contrast, Google's market share in China dropped during the quarter to 30.9%, down from 35.6% the previous quarter. Not surprisingly, Baidu was the main beneficiary of Google's decisions, increasing its share of the Chinese market from 58.4% to 64%. The first quarter of 2010 marked only the second drop in market share that Google had experienced in China since they initiated their search service in 2006.[41]

Even more telling were the future growth estimates generated by Wall Street analysts. These growth estimates are crucial in the valuation of stock prices. As of May, 2010, the consensus earnings growth rate of Wall Street security analysts for Google was 22.7% over the next five years. This is less than half the actual growth rate of the preceding five years, which was 48.3%. Consensus estimates of Google's earnings per share for fiscal year 2011 also fell during the spring of 2010. Baidu's growth estimates, in contrast, all showed increases. Their consensus earnings growth rate over the next five years was estimated to be 46%, more than twice the level of Google's, and their forecasted EPS for fiscal year 2011 rose during the spring of 2010 from $1.40 to $1.83, a 31% increase.[42]

Growth is one of the most important inputs into the valuation of common stocks like Google. In early 2010, Google's investment in China had reached a critical stage. China had just become the world's largest and fastest-growing market of Internet users, eclipsing the U.S. The beginning of 2010 represented the fourth year that Google had participated in this market, and their market share had grown consistently since their entry. With the company's start-up expenses behind them, many felt that China represented a significant part of Google's future. Google's sudden withdrawal from this market hurt the stock significantly.

Google sponsors a page on their website where shareholders can submit questions for management to address at the upcoming shareholder meeting.[43] These questions are posted and shareholders then vote on those that they would most like management to address at the next shareholder's meeting. In the spring of 2010, of the five questions receiving the most votes, four concerned Google's actions in China. All four of the China-related questions have a critical tone, and the frustration of Google investors is apparent in each one. The top five questions, as of spring, 2010, are in Table 1 below.

Table 1: Most Popular Stockholder Questions for 2010 Annual Meeting[44]

1.	When will the investment in YouTube become profitable?
2.	Google seems to have burned its bridges in China and created animosity with the Chinese government. What was management and the Board thinking?
3.	The investment community is punishing Google shareholder value for exiting China and battling Apple, as well as Microsoft. What are the plans to change the discourse, and attitude, regarding Google, within the investment community?
4.	What needs to happen for Google to go back into China?

5.	When Google exited China, the decision has benefitted no one (not the Chinese people, not the Google shareholders, not Google future growth, …) (sic) Only your competitors are benefitted. What were you thinking? Look at Google's stock price!

7. Where Do We Go From Here?

As Google executives pondered the impact of their recent decisions, it was clear that their attempts to remain true to the company's code of ethics had hurt their stockholders. The decisions they made were not easily reversible. They endangered Google's growth potential and their long-term position in the Chinese market. There were two obvious alternatives; (1) leave mainland China altogether, or (2) capitulate to demands of the Chinese government. Neither of these was totally satisfactory.

An ideal resolution might involve some sort of compromise between these two options. So far, though, the Chinese government had shown no tendency to compromise, and Google's hard line stance had done little to change the outlook of government officials.

Time was closing in on Google executives in the spring of 2010. The annual meeting of shareholders was coming up on May 13, and the company's actions in the Chinese market would need to be explained. In addition, the company's license to do business in China expired on July 1, and Google needed to take steps to de-escalate their conflicts with the Chinese government before that date. Could Google risk being thrown out of China, the largest and fastest-growing Internet market in the world? Should they compromise their ethical code and resume censorship, if that was necessary to stay in China? Management felt the questions were significant, and the answers complex.

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