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Value-Based Management

Abstract::

To be effective, value-based management must add transparency to the decision-making process: it must let you see the likely impact of specific decisions on the value of the business - not just major strategic decisions like mergers and acquisitions, but operational decisions too. Your objective must be to combine historic and predictive views with financial and non-financial drivers of the business. You must incentivize people at all levels to pursue the overriding objective of improving shareholder value. To operationalize value-based management, take four essential steps:

- *Understand what drives value*
- *Find where value is created or destroyed*
- *Establish value as the criterion for decision-making*
- *embed value into your culture*

You will experience plenty of barriers to implementing value-based management. So it's as well to prepare for them now. From marketers, you may hear: 'It's a narrow financial view of the world. What about our markets and products?'. From others: 'Shareholder value management treats employees as money-making machines rather than as assets to be nurtured'. Almost certainly expect this: 'You're obsessed with shareholders. We have to consider government, unions, community, suppliers and customers too'. The business case for VBM is a highly persuasive one, but you're going to need the strongest possible buy-in at board level, right from the outset. To become operational, value principles have to be embedded in the company's culture. And that means roll-out must be an evolutionary – not revolutionary – process. Fully-managed stakeholder communication – with investors, management, employees, customers and business partners – is critical for success. You'll need to strike the right balance between concept and reality too. In this paper we had tried to cover all above four steps for the effective value based management for any industry.

Introduction::

Value-Based Management:

To be effective, value-based management must add transparency to the decision-making process: it must let you see the likely impact of specific decisions on the value of the business - not just major strategic decisions like mergers and acquisitions, but operational decisions too.

What will be the impact on shareholder value of i.e,

Reducing Lead Time?
Of Reconfiguring the Supply Chain?
Of Rationalizing the Product Range?
By expressing shareholder value in terms that everyone can understand, you can forge a link from corporate strategy through to operations and the actual value being created by executing management's plans.

Objectives:

Objective must be to combine historic and predictive views with financial and non-financial drivers of

the business. We must incentivize people at all levels to pursue the overriding objective of improving shareholder value. To operationalize value-based management, take four essential steps:

- understand what drives value
- find where value is created or destroyed
- establish value as the criterion for decision-making
- embed value into your culture.

At each step, information systems are critical to success - as the following descriptions demonstrate.

Step-1

Understand What Drives Value:

How do large institutional investors assess the economic value of companies? Earnings per share (EPS) has long been recognized by investment management firms as a convenient shorthand for valuing stocks, but is increasingly being replaced by cash measures. This is because EPS has several well-known limitations. These include the use of different accounting methods across companies and countries (a practical reality that makes earnings comparisons difficult); the need for investment in fixed and working capital which, for the most part, is excluded from earnings calculations; the need to assess risk that is not included in an earnings figure; and the fact that earnings do not take account of future expectations or the time value of money.

Research shows that investors’ focus is moving away from classic attempts to model earnings based returns, toward assessments based on growth expectations, cash flow return on invested capital, and risk. In response to the changing concerns of institutional investors, equity analysts at securities firms are also revising their approaches to value analysis. Typically, shareholder value is defined as total corporate value less debt, where corporate value is no different from the economic value of any asset – that is, the future free cash flow that investors expect the company to generate over a defined timeframe, discounted by the cost of capital appropriate for the business

This means you need to consider seven value drivers – macro level factors that, for most industries, determine shareholder value. Five are operationally based. Turnover growth and cash profit margins drive the amount of cash coming into the business. The cash tax rate (actual tax paid) drives the amount going out. So does investment in the business, in terms of fixed asset and working capital expenditure.

In addition to these, there is the weighted average cost of capital (WACC): the rate of return demanded by investors – in relation to both debt and equity – based on the risk associated with the business and its capital structure (ratio of debt to equity). The company creates shareholder value only if it generates returns in excess of its cost of capital. The seventh value driver is the timeframe over which the market expects your business to achieve this, known as the competitive advantage period (or growth duration period).

When you break down shareholder value using the value drivers, you can begin to view the business from the inside exactly as it is viewed by external investors. You might find that the market’s expectations of returns are much higher than the cost of your company’s invested capital.

A major pharmaceutical company, for example, currently has a WACC of 10% but the compound return expected by the marketplace over the next 15 years (the competitive advantage period) is 23% pa. Because this expectation is already incorporated in the current share price, delivering a return that merely equals the cost of capital will, for this company, be value destroying.

Comparing the market’s expectations with your own cash flow projections allows you to establish the value gap that your strategy must close. Since the future is uncertain, analysis of expected cash flows requires judging the relative sensitivity of each value driver to key assumptions. Understanding these sensitivities will help you assess the impact of strategic alternatives on the value of your business - giving insights into where to concentrate efforts to close the value gap.

This framework allows companies to value their strategies: if the value is consistent with the market’s valuation, the current share price will be sustainable. If the company’s objective is to enhance value,

as in the case of one major multinational aiming for 20% annual TSR - in other words, for a doubling of its value in five years - the framework will show whether current strategies will successfully deliver the required result.

Effective strategic planning depends on having the right information - financial and non-financial, historic and predictive, internal and external. Only then, can you begin to understand the complex interplay between your strategy and your business environment. Of course, you need to be able to keep track of your competitors, your customers, your suppliers, the regulatory and political environment, social trends and economics.

In addition, you must be aware of new entrants to the marketplace, of potential substitute products, and of the performance of companies - perhaps from different sectors - that may compete with you for investors' capital. In the Internet age, such external, often qualitative, information is available in overwhelming quantities - and it lacks structure. You must have an information system that is capable of identifying, filtering, and analyzing information to make it relevant to your decision-making needs.

The system must also have a simulation capability to allow you to model the effect of various strategic choices on the business. Alternative scenarios should be analyzed to determine their impact on the value drivers and different assumptions concerning risk should be tested. For instance, you could study the probable impact of a strategy to generate increased revenues, or to decrease selling or marketing costs, or to optimize global tax payments.

Step - 2

Find Where Value Is Created or Destroyed

You must make decisions about how to allocate resources - financial, human and intellectual - to maximize returns overall, not simply because individual projects are expected to deliver higher returns. Resources therefore need to be allocated to strategies, not individual projects: this makes resource allocation an integral part of strategy appraisal.

By adopting shareholder value as the standard for implementing plans and allocating resources, both the corporate parent and its business units will be operating under a common framework - and so will make better decisions. Nevertheless, management should assess performance regularly and objectively: if investments are not performing against value-based objectives, the capital should be freed for a high-return strategic investment elsewhere.

One technique you can use to analyze issues of resource allocation is value mapping. Convert the results of your shareholder value analysis into a value map by plotting, for each strategic business unit, the value generated against the level of investment needed to generate it. Giving a vivid picture of which business units create value and which consume value, this technique can open up a whole new perspective for executive managers. Confronted by a value map, they're prompted to challenge basic assumptions that govern the way they constitute, structure and manage the enterprise.

After value mapping at business unit level, you may need to decompose value further, examining lower level value centers. These could be product or customer groups, or even groups of processes such as a supply chain - as discussed in the next step.

Step - 3

Make Value the Criterion for Decision-Making

Corporations take three types of decision: investment, financing and operational. To evaluate investment and financing decisions, most use reasonably sophisticated discounted cash flow (DCF) techniques. But often, they're applied on an incremental basis.

They may cover only some of the value drivers – and so fail to pick up the full impact of a decision on the business as a whole. For example, conventional investment appraisal of a proposal to build a new factory would not normally reflect its implications for the company's competitive advantage period.

When it comes to operational decisions, companies seldom look at these in shareholder value terms at all. Yet establishing a value creating strategy – though clearly important – is not on its own enough to secure success in today's investment climate. Senior executives must keep in mind that value is created or destroyed at every point where decisions are made.

To be certain that value creation can be sustained and improved operationally by front-line managers, you need an infrastructure - including the appropriate information systems - that gives managers at all levels a coherent understanding of how to take value-based decisions.

Decomposing the corporation's value into value centers may not prove straightforward. You need financial data that's not always readily available: you may have to construct it specially for the purpose. But once you've developed a lower-level value model, you can use it to test the impact on shareholder value of operational decision-making scenarios.

VBM lets you value operational scenarios - in the same way that you might value an external transaction such as an acquisition - select the right option, and then establish a set of performance measures to monitor day-to-day decisions at the operational front-line. The seven value drivers provide a common planning platform.

The linkage of financial planning to business operations and tactical decision-making, however, requires that these drivers be mapped into the business-specific measures that drive success with markets, customers and production. Via metrics like receivables, debtor days and lead times, linked to value, the company can see how well it's doing in operationalizing value strategies.

In a unit driven by innovation, for example, this driver mapping will focus on research, development, prototyping and time-to-market measurements. A customer service business, on the other hand, may need to focus on highly valued customer segments through market penetration, customer acquisition, product extensions and business retention measures. In both cases, the operational measures are clearly and explicitly linked to the key value drivers.

What's different about this approach is that it makes shareholder value targets meaningful to front-line managers. Individuals responsible for slices of the working capital pie – inbound logistics, manufacturing, outbound logistics, sales and finance – all know precisely what they must do to deliver the targets, and how their efforts will be measured and reported. Metrics need to be correlated with the business units' value chains and strategies. Aided by linkage through a balanced set of performance measures, senior executives and managers will have their hands on all the controls needed to implement strategy and achieve objectives.

Once senior management has identified the measures that can be managed to create shareholder value, people at all levels must be compensated according to how well they perform against these targets. This promotes a culture of performance that rewards shareholder value maximization and empowers employees to manage the business as if it were their own. This approach goes a long way toward ensuring that the interests of shareholders and employees remain fully aligned. No one measure is appropriate for all employees at all levels. Nor is one timeframe applicable to all people.

A compensation system based on value creation has features that distinguish it from traditional plans. This type of system is organized around economic performance - with the emphasis on cash flow, the capital invested to generate that cash flow, and the cost of the invested capital. It also employs different periods of time to motivate short-term and longer-term results which will collectively maximize value.

Senior managers should address shareholder value with a longer-range perspective and goals, while people at the operational front-line should view value through a short-term lens. By designing a value-based incentive plan that contains appropriate levels of risk and reward, a company can energize all its employees to work for value creation.

Everything we've described above relies on the accessibility of information. Relevant, timely, consistent information should be made available to all decision-makers. These include external decision-makers such as the investment community and other stakeholders. You must ensure that investors understand your company's value-based strategies and goals - and that they are confident in management's ability to implement those strategies and deliver on them.

With the right information, investors can develop an informed view on growth, return and risk assumptions in assessing value. Credibility with the markets is a major asset: if investors do not understand or do not believe in management's ability to deliver on these strategies, then your market value will reflect a less informed - or more pessimistic - view of your company's prospects.

Step - 4

Embed Value into Your Culture

You will experience plenty of barriers to implementing value-based management. So it's as well to prepare for them now. From marketers, you may hear: 'It's a narrow financial view of the world. What about our markets and products?'. From others: 'Shareholder value management treats employees as money-making machines rather than as assets to be nurtured.

Almost certainly expect this: 'You're obsessed with shareholders. We have to consider government, unions, community, suppliers and customers too. And there are always the procrastinators: 'We'd love to install VBM but we don't have the people or systems. Come back in 2010!.

The business case for VBM is a highly persuasive one, but you're going to need the strongest possible buy-in at board level, right from the outset. To become operational, value principles have to be embedded in the company's culture. And that means roll-out must be an evolutionary – not revolutionary – process.

Fully-managed stakeholder communication – with investors, management, employees, customers and business partners – is critical for success. You'll need to strike the right balance between concept and reality too: VBM can all too easily smack of academic theory if it's not presented in the down-to-earth context of business decision-making.

But the real secret to winning the necessary commitment and ownership, at all levels, lies in communicating information that allows people to participate – in a way that connects the value agenda to their personal agenda.

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