HELPING MANAGEMENT TO CREATE SHAREHOLDER VALUE

A Business Appraiser's Tool-Kit Presents: An Opportunity for Business Appraisers

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Business Appraisers value companies and prepare Business Plans for various purposes; however, except for ESOPs, that does not occur too often for the same client. Repeat business seems to happen about every four to five years, but there is something you can do to shorten that interval, as our firm, Corporate Valuation Services Limited, happily manages to do.

The secret is to assist management in establishing appropriate, tough, but realistic Business Plans, whose objective is to increase Shareholder Value even by dealing with "sacred cows". This activity can create one of those rare win-win situations, with regular business for you and higher values for your client's shareholders.
I live in Canada, which has had an undefended border with the United States since 1817; recent politics have caused that border to become even less of an obstacle. As we are both more or less enthusiastic NAFTA partners, our commercial worlds are closely inter-twined. Therefore, I am displaying some unmitigated gall in my initial column by referring to a recent Canadian Survey on the subject.

"Shareholder Value Measurement in Canada - 1997 Survey" was under-taken by the Canadian Institute of Chartered Accountants and the Financial Executives Institute Canada; it covers 111 public and 57 private Canadian companies. To be eligible for the Survey, a firm had to have a minimum tangible Net Worth of $3.5 million (CAN $5 million).

The respondents varied greatly in size: 25% had revenues of less than $65 million, while twelve were over $6.5 billion. They came from many industries: the major categories, for listed companies, were: Mining, Oil & Gas (17%); Manufacturing (14%); Utilities (13%), and Multiple Industries (12%).

Among the unlisted firms, Multiple Industries (18%) was the largest group, followed by Manufacturing (16%) and Utilities (16%). All the categories in this Canadian sample would be found in roughly similar proportions in the US, except that there would likely be fewer resource businesses and many more high-tech industries.

I don't remember who said it, but it was drilled into me at the beginning of my financial career, that "companies tend to manage what they measure and fail to manage what they don't". Among the listed companies, 90% took that edict to heart, but only 51% of the unlisted firms considered increasing Shareholder Value a key corporate objective; 84% of the public companies and 58% of the private ones took action by actually measuring it.

For management to regard increasing Shareholder Value as an important corporate objective has been demonstrated to pay off handsomely: in the year to April 30, 1998, the shares of the listed firms sampled outperformed all of the components of the Toronto Stock Exchange 300 Index, except for the banks; as we all know, they march to a different drummer, whose beat is accelerated by merger fever.

In addition to their shareholders, all businesses have other stakeholders, some of which carry considerable clout. There has been a decades-old debate as to where a company's duty lies, with its shareholders, or with a broader group of stakeholders. The Survey came strongly out on the side of the stakeholders, as shown in the following table, which lists the percentage of responses considering various participants important:

Public Companies %		**Companies Private %**	
Shareholders	86	Customers	92
Customers	82	Employees	74
Employees	79	Shareholders	62
Communities/Public	40	Communities/Public	56

Although public companies were fairly conscious of their fiduciary responsibilities to their owners, this does not seem to be a strong motivation for private organizations, where other stakeholders take precedence.

Our professional experience has shown that things are not that different in the US; management of private as well as some publicly traded companies often displays greater loyalty to their customers and employees, even to the communities in which they operate, than to the shareholders. This trait has contributed to the success of numerous recent leveraged buyouts of both public and private entities.

Not too many of us will ever be in a position to value Coca Cola or prepare a business plan for a company of similar size or scope, but one can always learn from their success. The Coca Cola Company is recognized as one of the leading organizations in the world for creating Shareholder Value; it increased its stock market capitalization by over ten times in ten years, from $14.2 billion in 1988 to $154 billion in 1997, at a rate of about 27% per year.

Their view of the interdependence of the interests of the various stakeholders, including shareholders, is well set out in its 1996 Annual Report.

> "To be of unique value to our owners over the long haul, we must also be of unique value to our consumers, our customers, our bottling partners, our fellow employees and all other stakeholders over the long haul".

In most jurisdictions, corporate law specifies that directors and management are required to act in the interest of the shareholders who elect them. However, acting only in their narrow interests is self-defeating; to create Shareholder Value, it is essential that the organization satisfy all its stakeholders.

Research shows that "best-in-class" companies pay as much attention to data about employee and customer satisfaction, which are considered to be leading indicators of future business success, as to current financial performance. While the various stakeholders may appear to have temporarily conflicting interests, R.C. Goizueta, the late Chairman and Chief Executive Officer of Coca Cola, in the 1996 Annual Report, stated that:

> "The real possibility for conflict, then, is not between share owners and stakeholders, but between the long-term and short-term interests of both".

Coca Cola has obviously done some soul searching on how to serve more than one master, asking the important questions about "What Can Management Do" to increase Shareholder Value without causing antagonism in the other camps. The same approach holds true for private companies, with an even more pertinent question, "What Can Business Appraisers Do" to help management achieve that goal.

The first step is to determine the appropriate measure of Share-holder Value; four are in general use:

- Return on Equity
- Return on Net Assets
- Economic Value Generated
- Cash Flow Return on Investment

The most commonly applied is Return on Equity, but, as it rises with the level of debt, results can be misleading. Therefore, a modification, Return on Net Assets, was developed to eliminate the impact of the debt structure. Although this measure is simple to apply, it is, in my view, more appropriate to valuing a project rather than the equity of a corporation.

The one I have found most useful is Economic Value Generated, which can work for the benefit of all interested parties. This is the operating profit of the business, less notional income tax and a Capital Charge. The Capital Charge is simply the total of the money invested in the particular business, multiplied by the weighted average cost of capital. For that concept, see Shannon Pratt's recent book "Cost of Capital".

This is a subject of which many companies are unaware. Again, using the Canadian Survey as an example, only 71% of the public companies, and a mere 42% of the private ones had made the effort to determine the cost of capital.

The approach was originally developed in the seventies as "Economic Value AddedTM" by Stern Stewart & Co. of New York, and has since been expanded by numerous practitioners; it is a very useful management tool, as it can be applied not only to subsidiaries and divisions, but also to branches and even departments.

The final approach, Cash Flow Return on Investment, is considered by its avid users to provide the most accurate estimate of Share-holder Value, as it is cash based. However, we do not totally concur, as it is very complex to use, and highly dependent on the accuracy of long term cash flow projections.

After selecting the appropriate objective measure, the next step is to apply it to every unit of the business for which operating statements and allocations of invested funds are available. This process may involve adjusting and normalizing the profits; if the amounts are material, adjustments are often made for: Extraordinary Items, Discontinued Operations, Unusual Events, such as strikes, Deferred Taxes, Capitalized Operating Leases, Reserves, and Amortization of Goodwill. The invested funds are sometimes adjusted to reflect the current value of the "Property, Plant and Equipment". The result will indicate the status of all activities; some will have a return below the cost of capital, others will exceed it.

However, knowing the cost of capital is not enough; decisions require comparisons with the actual performance. Decisive action cannot be taken until the Business Appraiser has helped management select the measure for the contribution to Shareholder Value of each activity, department or division. While it may be difficult to achieve the envisaged results, at least six steps should be considered:

1. Discussing the contribution of each unit to Shareholder Value with key employees, so that they are all aware of the Stars and the Dogs;
2. Encouraging management to concentrate on the contribution of their unit to Shareholder Value by making it the basis of everyone's incentive compensation;
3. You will likely come across "value reducing activities"; unless there are valid reasons to the contrary, these and any other situations with negative impact on Shareholder Value have to be eliminated - which may be considered a euphemism for downsizing;
4. Reducing funds employed by lower rated units, unless they represent a recognised brand or are able to improve margins within a certain period;

5. Considering strategic changes to expand the Star units;
6. Lowering the cost of capital by changing the debt/equity mix.

For many years, Coca Cola used a version of Economic Value Genera-ted as part of its strategic planning; another exponent is Monsanto Company, which moved from being primarily a basic chemical producer (this business was spun off in September, 1997) to concentrating on agricultural products, food ingredients (such as NutraSweet), and pharmaceuticals. Between January, 1995 and the end of July, 1998, Monsanto increased its market capitalization by 50% a year, from $8.1 billion to $34.5 billion. At present, Monsanto is planning to merge with American Home Products Corporation to expand their pharmaceutical operation.

Again, in many instances, large corporations know what they are doing. Even if your clients are not in that league, you can offer them a similar service as a matter of the business continuing to thrive. A Business Appraiser is the ideal professional to assist management in developing and implementing the necessary systems to measure the status of Shareholder Value.

In the long run, no enterprise can survive unless it earns returns greater than, or equal to, its cost of capital. To achieve this means not only satisfying the needs of its stakeholders, but also generating an attractive return to those who supply its capital.

