

## VALUE DRIVERS

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A useful adjunct to a valuation practice is consulting with managements to help them improve their shareholders' value, an objective of nearly every business.

There is an age-old myth, subscribed to by a surprising number of managers that "a well-run business will automatically maximize shareholder value over the long term". This is "not so".

To be achievable, maximization of shareholder value must be a major objective of management rather than just a by-product. In every region, all industries and any phase of the business cycle, some firms increase in value, mainly by doing better than their peers.

In 1999 A T Kearny, a Boston management consultant, undertook a study of more than 1,100 worldwide companies covering 24 industries in 34 countries; it found a strong correlation between revenue growth and the creation of shareholder value over the longer term.

Kearny listed the following benefits of growth:

"Growth is attractive. These organizations exude a confidence and optimism that makes people want to come to work and contribute. It also makes a company an attractive partner for alliances or mergers. If managed properly, this image can rub off on customers as well."

"Growth is exciting. Where there is growth, there is action. Almost by definition, a company that continually outperforms its peers - regardless of the industry - is a leader, not a follower."

"Growth means 'upside'. While many companies have broken new ground in offering employees an attractive working environment, fun is not the only success factor in employee recruitment. The financial side still matters."

### **How Can a Firm Grow**

One route to achieving the desired "Value Growth" is to adopt a strategy of seeking strong stable increases in revenue year-after-year; these should come not only from innovation in new products and geographical expansion in to new markets , but also from controlled risk-taking, such as an e-commerce initiative.

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Management's main thrust should be to secure and stretch the firm's core competitiveness. A policy of "stick-to-your-knitting" and avoiding wide-scale diversification is essential. The worst mistake appears to be diverting funds from a successful unit to bolster performance elsewhere.

While seeking higher revenues is an important part of increasing shareholder value, there are two other essential components. The first is maintaining and even improving profit margins, the second is reducing risks and hence the Capitalization Rate.

In the quest to improve margins an analysis of profitability by customer as well as product or service is essential. Many companies find that the traditional 80:20 rule for products also applies to customers, in that only 80% generate profits, while a minority give rise to offsetting losses. Both the profits and the losses can be large. In one case, ranking customers by "profit" (revenue minus activity based costs) resulted in 75% generating \$7.8 million, while the remaining 25% reduced this figure to \$1.8 million.

An alternative to revenue seeking is "profit protection"; this strategy increases earnings by improving efficiency and cutting costs. Although "growth" from this approach must eventually disappear, in the short term the impact can be very substantial.

Combined with a revenue seeking strategy and maintained margins risk reduction should significantly reduce the Capitalization Rate, both now and in the future. The alternative approach of profit protection is likely to lead to a higher Capitalization Rate reflecting the fact that its profit gains can only last for a relatively short period.

Either approach involves management choosing appropriate strategies and suitable measures of performance. Most small and medium sized companies do not spend significant time on selecting a strategy and rely mainly on financial performance measures.

## **Knowledge Assets**

Financial information is not sufficient to understand and appraise the Legal and Intellectual (Intangible) Assets that are more and more important to the value of most businesses.

Arthur Levitt, Chairman of the SEC, in an October 1999 speech, showed that regulators are well aware of the problem.

"We have long had a good idea of how to value manufacturing inventory or assess what a factory is worth. But today, the value of R & D invested in a software program, or the value of a user base of an Internet shopping site is a lot harder to quantify. As intangible assets continue to grow in both size and scope, more and more people are questioning whether

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the true value -- and the drivers of that value -- is being reflected in a timely manner in publicly available disclosure."

As shares sell for larger and larger multiples of Book Value, the relationship between a firm's current financial position and its Fair Market Value diminishes. Today, for many companies the amounts invested in Legal and Intellectual Assets, whose costs, by accounting convention, are usually expensed, are equal to or even exceed those made in Tangible (Financial and Physical) Assets.

As a result, ROI (Return on Investment), a standard measure of performance is becoming less useful as its trends deviate more and more from historical levels. Both components are affected; the return is reduced by the cost of acquiring the intangibles, while the investment excludes initially generated or expensed items, normally nearly all the "real" intangible assets.

### Non-Financial Factors

While valuers tend to put more emphasis on financial factors, most financial analysts use both financial and non-financial performance measures in assessing publicly traded stocks; some studies attribute up to 35% of institutional investors' decision making processes to non-financial factors in particular with respect to establishing an appropriate Price/Earnings Ratio.

The following non-financial measures of Management and Corporate performance are frequently applied by financial analysts.

#### Management

Experience

Credibility

Appropriateness of Strategy

Execution of Strategy

Basis of Executive Compensation

#### Corporate

Market Position

Ability to Attract Talent

Innovation Record

Research Leadership

Quality of Major Processes

The first two Management factors will normally be considered in determining the various specific risks used to establish the Capitalization Rate under the Built-up method. However, very few Valuation Reports look at any of the other measures except sometimes "Market Position". Very rarely is there a discussion of "Innovation Record" or "Quality of Major Processes", much less "Research Leadership".

Managements and Investors seem to have rather different views of the importance of the non-financial factors that affect the shareholder value. In 1996, Forbes magazine undertook a survey of managers concerning the performance measurement systems they use and its relationships with

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their corporate strategies. The conclusion was that the alignment was: good for only 19%; fair for 36%; and poor for 45%.

The survey also considered nine potential value drivers, which the managers were asked to rank by both importance and adequacy of measurement. The table below sets out those rankings together with those of established in 1997 by the Ernst & Young Center for Business Innovation, for durable and non-durable manufacturers as well as e-Commerce firms.

	Ernst & Young			Forbes	
	Durable	Non-Durable	e-Commerce	Performance	Measurement
Alliances	4H	6H	1H	8	9
Brands	7M	7M	4H	5	10
Customers	9L	9L	3H	1	5
Employees	2H	3H	n.a.	2	4
Environment	6H	5H	n.a.	10	8
Financial	n.a.	n.a.	n.a.	6	1
Innovation	1H	1H	2H	4	2
Management	3H	2H	5M	n.a.	n.a.
Quality	5H	4H	n.a.	9	7
Suppliers	n.a.	n.a.	n.a.	3	3
Technology	8L	8L	6L	7	6

Managements' rankings, according to the Forbes survey, vary greatly from those of Ernst & Young, which relate to large enterprises. Their rankings for durable manufacturers are very similar to those for non-durables, but totally different from e-Commerce firms.

The following indicators were used to establish the Value Drivers:

- Alliances: Number of Alliances and Joint Ventures, Number of Alliance Partners (Security Data Corp.)
- Brands: Advertising Expenditures (Compustat), Financial World Brand Values
- Customers: American Customer Satisfaction Index
- Employees: Kinder, Lydenberg, Domini ("KLD") Diversity Score, KLD Employee Relations Score, Fortune Magazine Employee Talent Score, Fortune Best Places to Work, Computer World Best Places to Work
- Environment: KLD Environment Score, KLD Community Service, Fortune Social Score;
- Innovation: Number of Patents (US Government), Research and Development Expenditures, Fortune Innovation Score, Patent Importance
- Management: CEO Reputation Score (Burson-Marsteller), Fortune Management Quality Score, Industry Week Best Managed Companies, Worth 50 Best CEOs Mention

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- Quality: ISO 9000 Certification, Fortune Product/Service Quality Score
- Technology: Information Week: 500 Best Technology Users' Ranking

Unfortunately similarly appropriate measures are not normally available for the types of small and medium sized companies, valuers normally deal with. However we believe that considering all these factors, even on a subjective basis, can help identify positive and negative influences on shareholder value and allow the valuator to make suitable recommendations to managements.

## **Conclusion**

The types of analysis discussed in this article, in particular the application of non-financial value drivers and measures to reduce risk can result in a successful engagement that significantly increases the client's shareholder value.