

A MAP to Sustainable Value Growth

The path to sustainable value growth is paved by the proper mindset, alignment and management processes

By Greg Stoklosa

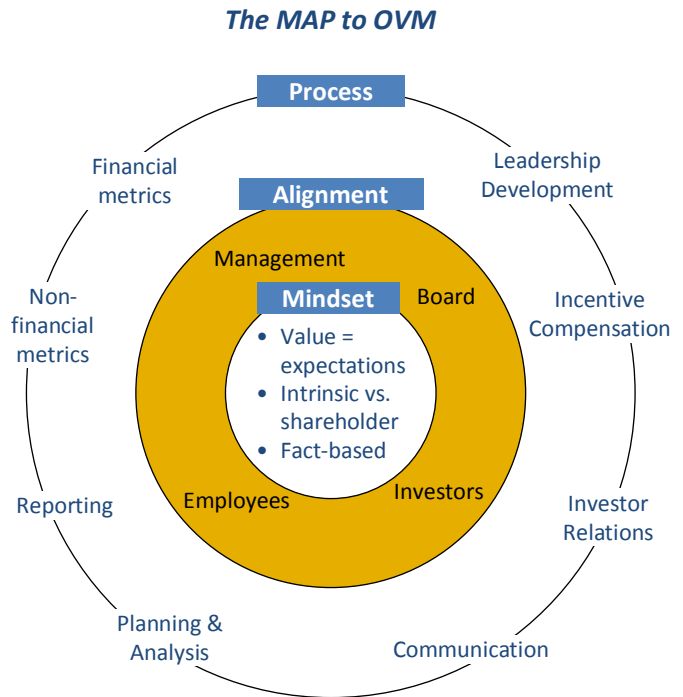
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The unpredictability of the economy has convinced many management teams to suspend quarterly earnings guidance to investors and analysts. Goldman Sachs estimates that only a quarter of S&P 500 companies now provide such guidance, given the current market volatility and its impact on predicting performance with any certainty.

Once the markets stabilize, management teams are likely to resume providing quarterly estimates, primarily to keep investors happy. But should they? Many economists, finance executives and trade groups have argued for some time against the “short-termism” of quarterly forecasts. Over-emphasizing short-term financial results can destroy value. How often have you felt compelled to forgo value-creating investments or expenditures, or otherwise compromise your strategy, in order to meet quarterly earnings expectations?

The current economic crisis may actually provide a window of opportunity for management teams to shift the focus of investors and other stakeholders to long-term value growth, and eliminate quarterly earnings guidance permanently. Doing so would enable management teams to emerge from the recession free of the “short-termism” trap and in greater control of their companies’ value growth strategies.

Leadership teams can’t simply eliminate quarterly earnings guidance, however; they must replace it with an alternate framework and set of metrics that provide transparency and accountability to shareholders, the board, customers, and employees. We have developed such a framework, called Objective Value Management (OVM), to help companies re-focus their efforts on achieving long-term, sustainable value growth. Built and tested at a Fortune 500 commercial printing company in the early 2000s, OVM embraces a value-oriented mindset; aligns management, the board, employees and investors around that mindset; and employs management processes that balance current performance goals with expectations for future performance.



About the Author

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Avondale Consulting advises corporations on how to create *profitable* growth and increase the intrinsic values of their businesses. Avondale works with senior management teams across a range of industries to develop practical and actionable solutions that sustain long-term value growth.

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Underpinnings of OVM

The genesis of Objective Value Management is in the Value-based Management (VBM) approaches popularized by Stern Stewart, BCG/Holt and other practitioners in the 1980s and '90s. These methods were distinguished by their focus on particular financial metrics such as economic profit (e.g., economic value added or EVA) and CFROI (cash flow return on investment). Various forms of VBM were widely adopted by management teams eager to show their dedication to creating shareholder value.

Unfortunately, as quickly as value-based management grew in popularity, it faded from the business lexicon. The reason: a tenuous link between companies adopting VBM and superior shareholder returns. The pattern was familiar to many management frameworks: early adopters achieved real success, which observers overly attributed to a narrow set of practices. Other companies, searching for a silver bullet value formula, copied those narrow practices of early adopters. But because they applied those practices out of context, the imitators failed to achieve expected results. As a result, the whole VBM approach was discredited.

Objective Value Management provides much-needed context by addressing two critical weaknesses of the previous generation of value-based management. First, OVM focuses less on financial metrics and more on how those metrics are used and interpreted. This is a key distinction: with the right context, traditional accounting metrics can be “value-based;” without this perspective, economic profit can be as misleading as (or more so than) earnings per share. Second, by emphasizing alignment of all key constituents, OVM positions management teams to sustain the execution of value-growth strategies until they bear fruit.

OVM focuses on growing total value through an optimal mix of current performance and building future expectations. Future expectations are based on key value drivers for the business, and measured and through financial and non-financial metrics that are

leading indicators of future performance. These metrics are given as much or more weight as current financial performance in evaluating execution. In this way, the leadership team holds itself accountable for achieving current performance goals and for building expectations for future performance as a means to grow total value (see sidebar on page 3).

The MAP to OVM

The context for Objective Value Management is provided by three main elements: Mindset, Alignment and Process. All three areas of the “MAP” are critical for a company to achieve sustainable value growth.

1. Mindset

Results are a function of our behaviors, and our behaviors are a function of our underlying beliefs and thought processes – in other words, our mindset. In the OVM mindset, the objective for all decisions is to grow intrinsic value, and then to align market or shareholder value with that intrinsic value. With this mindset, strategic and operating decisions are made according to their impact on the present value of expected future cash flows, and the full context of those decisions is communicated to investors to ensure alignment of expectations. This approach to value growth is the same for public and private companies. Forming the foundation of the Objective Value Management mindset are three beliefs:

- **Value = Expectations.** Value is defined by the present value of expected future cash flows – how much goes out, how much comes in, when, and at what risk level. Past performance affects today’s value only to the extent of its impact on the credibility of expectations for cash flow going forward. Value determines multiples of earnings and cash flow, not the other way around.

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Analyzing Total Value

Total Value (TV) is defined as the present value of all expected future cash flows. A useful way to analyze TV is to break down total future cash flow expectations into two parts: 1) Future cash flows that result from maintenance of the current level of financial performance, and 2) Future cash flows that result from expected changes, positive or negative, to the current level of financial performance. We'll call the portion of TV represented by the first part, Current Performance or CP, and by the second part, Future Expectations or FE. Therefore,

$$\text{Total Value (TV)} = \text{Current Performance (CP)} + \text{Future Expectations (FE)}$$

Where CP = present value of current economic profit (e.g., last 12 months), in perpetuity, plus the economic capital currently invested in the business, and FE equals the present value of expected changes to economic profit, or FE equals total market value less CP.

The CP/FE analysis helps ensure a more objective assessment of current TV, aids in setting rational goals for growing TV, and helps balance plans to achieve those goals between financial and non-financial performance.

Assessment of Current Total Value.

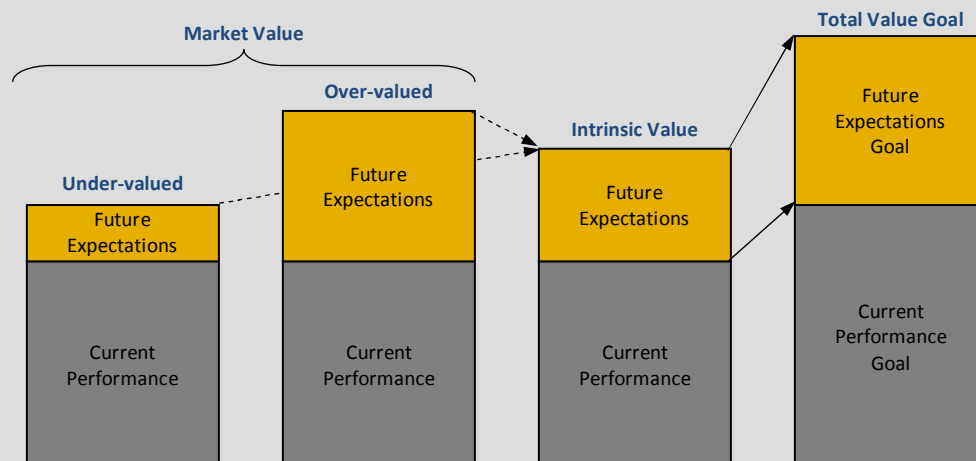
Arriving at expectations for future cash flow is highly judgmental, and vulnerable to incomplete data, biased perspectives, and wishful thinking. The calculation of CP is not. CP objectively accounts for a typically large chunk of TV, thereby isolating and highlighting the assumptions for change that are necessary to justify FE and TV. In other words, CP unequivocally tells us the value of the entity if it continues to perform at its current level forever, and focuses judgment on the value drivers that would cause that performance to change. This helps in a) arriving at an objective and well-supported internal assessment of intrinsic value, b) analyzing market value and the implicit assumptions behind it, and c) understanding the difference.

Setting Rational Goals for Total Value.

CP/FE helps set rational goals for TV by providing clues to strategic priorities. For example, if current TV is composed largely of CP, with little or negative FE, then strategy should focus on improving the market and competitive positions of the company in order to grow FE, perhaps even at the expense of CP. This simple insight can free a company from overly aggressive financial performance goals by illuminating an alternative path to total value growth. On the other hand, if current TV is composed largely of FE, strategic emphasis should be placed on execution of financial performance expectations, taking full advantage of the strong market and competitive positions behind those expectations.

Balancing Financial and non-Financial Execution.

Applying CP/FE to the long-range goal for TV provides a vivid and graphic reminder that reaching that goal is subject not only to achievement of specific financial performance targets, but also to successful achievement of strategic plans to improve expectations for future performance. Remember that year 5 financial performance targets in a long-range plan will, in year 5, account only for the CP portion of TV at that time. Constant re-evaluation of FE and the non-financial leading indicators of FE, helps ensure that achievement of CP financial targets are not over-emphasized to the detriment of FE and TV objectives.



- What is the company's intrinsic value, and how does it compare to market value?
- What must we do to align market value with intrinsic value?
- What is our goal to grow intrinsic value, and align market value?
- What combination of growth in current performance and future expectations is required to reach our goal?
- What are the drivers of growth in current performance? What are the drivers of growth in future expectations?

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- **Intrinsic value and shareholder value are not always equal.** Intrinsic value is a function of expectations for future cash flows to be consumed and generated by the operations of the business. Shareholder value, on the other hand, is a function of expectations for future cash flows arising as a consequence of owning shares of the company. Over time, shareholder value is derivative of, and must converge with, intrinsic value, although the two can and do diverge over shorter periods of time. Shareholder value follows intrinsic value; intrinsic value does not follow shareholder value. For this reason, growth in the stock price will be sustainable only if aligned with growth in intrinsic value. If your objective is sustainable value growth, then an overvalued stock (stock price higher than intrinsic value), is as undesirable as an undervalued stock.
- **Separate facts from assumptions and opinion.** Your expectations for the company must be honest, unbiased and fully informed by knowable facts. If not, your estimate of intrinsic value will be wrong. Only with full and objective understanding of your company's current intrinsic value can you develop meaningful goals for value growth and effective strategies to reach them. Seek facts and alternate perspectives, and reward the truth – even when it's not what you want to hear.

Let's contrast the OVM mindset with what we'll call "stock price management," or SPM. At the heart of an SPM mindset is a belief that the company's stock price, or shareholder value, can and should be managed independently from the company's intrinsic value (or worse, that it should be managed instead of intrinsic value). Typically, SPM proponents believe that "Wall Street" doesn't understand or is uninterested in long-term strategy, but rather simply rewards companies that consistently beat quarterly consensus EPS estimates (and punishes those that miss). Adherents of SPM believe that a higher stock price is always the goal, even when it bears no relationship to the intrinsic

value of the company.

The SPM mindset drives much different behavior than OVM. Management teams make operating decisions (and sometimes accounting decisions) and alter strategies to ensure that quarterly earnings estimates are achieved, even if they're using supposedly value-based metrics such as discounted cash flow, CFROI or economic profit. Bad news will be suppressed, or labeled "non-recurring." An SPM mindset will trump value-based processes.

Stock price management can and does "work" in the sense that it may support a higher stock price for finite periods of time. But a stock price cannot be sustained if it differs from the intrinsic value of the company. Moreover, efforts to maintain or grow an overvalued stock price, if not inherently fraudulent, are frequently value-destroying. This is why the OVM mindset is the foundation of sustainable value growth. A higher stock price is a great result, but a lousy goal.

2. Alignment

Ask any executive, director or investor about a company's objectives, and the answer generally will be passionate and unanimous: "Increase shareholder value!" But how does each of these constituents define shareholder value? Higher stock price? Higher total shareholder return? Higher EPS, P/E ratio, cash flow, growth? Over what time frame? Do these groups agree on the key drivers of value?

Misalignment among management, the board, employees and investors on any of these issues can undermine the successful development and sustained execution of strategies to grow value. Without an open dialogue around what constitutes value, key decision-makers tend to assume that the other groups are on the same page as they. A process to achieve and maintain alignment among key constituents on each of the questions above is critical to sustained execution of value growth strategies. Investors are often viewed as barriers to

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attempts to de-emphasize quarterly earnings and adopt value-based measures. Keep in mind, however, that all shareholders are not created equal. They tend to fall into one of two broad categories: intrinsic investors and stock traders. Intrinsic investors share the OVM mindset – they are not interested in quarterly EPS guidance and will support long-term value growth strategies. Stock traders, on the other hand, are interested in volatility to create short-term trading opportunities, and quarterly earnings fluctuations often provide just that. It is important to note that stock traders do not require long-term growth in the stock price to make money.

You can't please both groups – nor do you want to. Efforts to placate stock traders will give them just what they want: volatility, with no assurance of sustainable value growth. Just as the goal of your marketing programs is to attract customers who create the most value for your business, the goal of investor relations should be to attract shareholders who align with your value goals. If you behave and communicate according to the OVM mindset, your company will attract intrinsic investors and discourage stock traders, empowering you to develop and execute sustainable value growth strategies.

Alignment was a key factor in the ability of the management team at the commercial printing company to focus the organizational mindset and metrics around intrinsic value. The managers themselves embraced a value-based approach, then revamped training and compensation programs to cultivate a similar mindset among employees. Senior managers also successfully attracted investors who understood and appreciated intrinsic value. The moves helped the company shift from its commodity manufacturing roots into more value-creating positions in the market.

There was one group, however, that was reluctant to fully embrace the new mindset: the board. Key directors remained focused on EPS growth and quarterly earnings performance. The lingering stock price management mindset of the board ultimately

led to abandonment of management's value growth strategies, despite achievement of total shareholder return that exceeded the company's goals.

3. Process

Improvement initiatives often begin with processes. We replicate what appear to be successful incentive compensation plans; we revamp planning processes; we implement lean manufacturing; we change financial metrics; and so on, in order to achieve certain results. The assumption behind this approach is that those results are functions of the processes we choose.

We often learn the hard way, however, that results are a function of behaviors, and behaviors are a function of mindset, not process. Processes help organize and channel individual behaviors so that they are more or less efficient or effective, but they change behavior only to the extent that they affect mindset. Process changes that conflict with mindset, particularly that of senior management and the board, will eventually be overwhelmed by the mindset's supporting behaviors, and expected results will be undermined.

For example, many companies adopted Economic Value Added, or EVA, in the 1990's not because they embraced a value-based mindset, but because they interpreted EVA to be a good way to grow EPS. Implementing a value-based process with a stock price management mindset is unlikely to change behaviors, and may actually hurt results by creating organizational confusion.

On the other hand, process changes that reflect the mindset of senior management and the board, and are designed to reinforce and leverage desired behaviors, can transform organizational behaviors and enhance expected results. Changes in behaviors and results will be smoother and more rapid if certain key processes are changed in a coordinated manner. Special care should be taken to ensure that

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the following management processes are aligned in principle and objective with the Objective Value Management mindset: leadership development; internal and external communication, including investor relations; decision support processes, including short and long term planning, operations review, and reporting; financial and non-financial metrics; and, of course, incentive compensation, (See Table 2).

Getting Started

Leadership teams do not have to hit the reset button on their business to implement an OVM framework. Value can be grown even as change is gradually rolled out to the organization. Here are four steps to get you headed in the right direction.

1. Develop a fact base.

Effective and sustainable value growth strategy begins with a granular, fact-based understanding of the current reality of the business. Management must take as much of the guesswork and opinions as possible out of the planning process in order to frame the appropriate starting point for the value growth discussion. In addition, uncovering new facts and insights often help move skeptics toward the OVM mindset. To begin building an actionable fact base, ask yourself and your team these questions:

- Where is value being created and destroyed in the company today, and why?
- Which products, services, customers and geographies generate returns in excess of the cost of capital employed, and which do not?
- Are the drivers of these results understood and measured?
- Do the reporting processes of the company routinely and accurately update this information and reach key decision makers in time?

2. Engage your key constituents.

Proper alignment spans multiple stakeholders, from the leadership team and the board to employees and investors. Getting all groups to adopt a common mindset around value growth may require a change to the culture – a significant challenge in any environment. Keep in mind that each constituency requires a different alignment approach. The foundation for a strong relationship between management and the board, for example, is the set of expectations represented by the company's strategy. For employees, buy-in is predicated upon their understanding of what constitutes value, as

Table 2: OVM Process Principles & Objectives

<i>Process</i>	<i>Principle</i>	<i>Objective</i>
Leadership Development	Value-based culture through training, performance management and recruiting	Alignment of values and behaviors to requirements of the vision and value growth strategies
Communication	Full, fact-based disclosure of both good and bad news, internal and external, geared to target audiences	Alignment of intrinsic and market values, engagement of employees, alignment of key constituents
Decision Support	STAAR reporting (simple, timely, accurate, accessible, reliable) to decision-makers, reporting structured to plan, F and non-FP&A	Fact-based evaluation and decisions required to execute the business model and value growth strategies
Metrics	Financial and non-financial, leading and lagging, every objective has goal and metrics or observables	Accountability, feedback for continuous improvement, performance attribution
Incentive Compensation	Tied to both current performance and future expectations (lagging and leading indicators), consistent with value goal and timeframe	Management rewards consistent with those of intrinsic investors

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well as the behaviors required to create that value. Begin by understanding how your key constituents answer the following questions:

- How is the value growth objective defined? What is the goal and timeframe for value growth? How and when should the goal be modified?
- What is the starting point? What is the company's intrinsic value today and how does it compare to market value? What's the reason for any difference, and what is the strategy to close the gap?
- How much value should be created by growing current performance, and how much by growing future expectations?
- What are the drivers of current performance and future expectations? What is the current status of those drivers and what are the plans to improve them? Which value drivers are under management's control and which are not?

3. Adjust your management processes to support both current performance and future expectations.

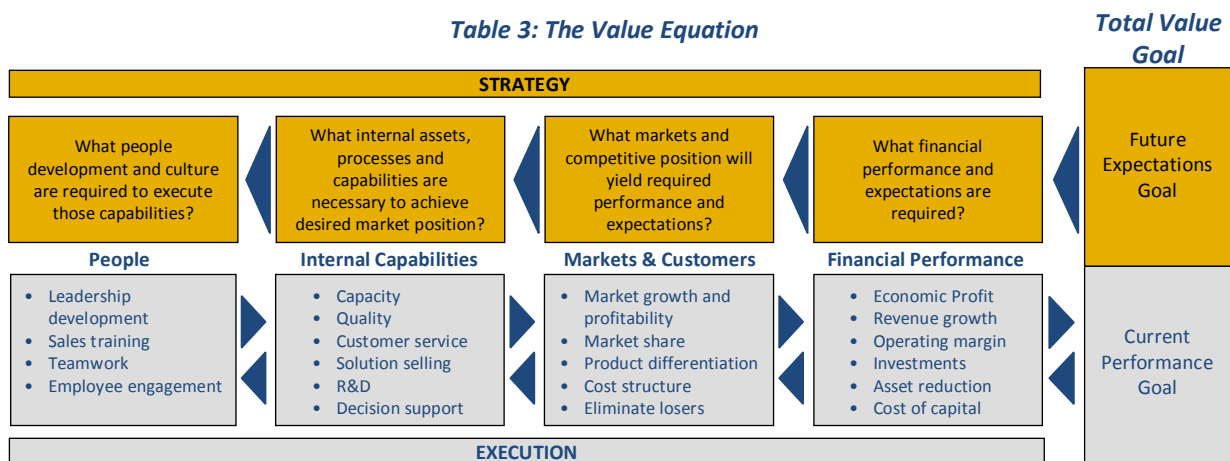
Unless your management processes identify and hold managers accountable for the achievement of non-financial indicators of future performance, the company runs the risk of ignoring or destroying a large

component of total value. Think about typical planning processes: during the planning exercise, management teams discuss how to achieve key operating and functional objectives along with planned financial performance. But as planning moves to execution, achievement of financial goals tends to dominate. At the end of the planning horizon, achievement of the financial targets will represent only the current performance portion of total value at that time; this approach overlooks growth in future expectations that may provide the greatest opportunity for creating value.

4. Measure and learn.

In the OVM framework, non-financial, leading indicators of performance must be viewed with equal importance as financial profitability metrics such as EVA or CFROI, which unavoidably become lagging performance indicators. Tools such as the Value Equation (for discovering, prioritizing, measuring, and communicating business value drivers), (see Table 3), and OGSM (an organizational alignment methodology pioneered by Proctor & Gamble), will help the leadership team develop a series of well-defined and resourced plans throughout the company that guide the execution of the value growth strategy.

Table 3: The Value Equation



Many strategic planning processes target only Current Performance goals. The Value Equation supports strategy development and execution targeting both Current Performance and Future Expectations components of Total Value.

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Conclusion

Management teams must understand that when it comes to value growth, there are no “short-term” or “long-term” decisions. Every decision has an immediate impact on total intrinsic value through its impact on current performance and future expectations. Think about it this way: If you cut important training programs to lower expenses for the current quarter or fiscal year, you will boost current financial performance but lower future expectations for the company, possibly reducing total value. Conversely, if you strategically decide to invest \$20 million in more attractive markets a year from now, you will have no impact on current performance, but your decision will have an immediate impact on value by altering expectations for future performance.

The Objective Value Management framework provides a comprehensive context to enable decisions that grow total value by balancing current performance with future expectations. Implementing the core elements of OVM – the proper mindset, stakeholder alignment and appropriate management processes – requires perseverance and often courage. But if you long to replace “short-termism” with the freedom to develop and execute sustainable value growth strategies, Objective Value Management is well worth the effort.