Shareholder Value Creation

A Business Perspective
Shareholder Value Creation

A non-negotiable item on the business agenda
Shareholder Value Creation

• What is it?

• The Metrics

• Shareholder Value Creation in practice – Value based Management
The Basics

What is Shareholder Value Creation?
Shareholder Value Creation is NOT...

Maximizing share price
Managing for earnings
Doing ‘anything’ to make a profit

Businesses that fall into above traps end up being short-term oriented at the expense of long-term value.
The Basic Idea

*Shareholder Value is driven by Long-term Free Cash Flows*

*Shareholder Value is created when Long-term Returns > Cost of Capital and vice versa*
High returns do not always create value

Return on high risk investment (e.g. R&D based business)

Cost of Capital
25%pa

Return
22% pa

Value Eroded

If Actual Return < 25%pa => Value Destroyed
Low returns do not always destroy value

Return on low risk investment (e.g. Utility company)

If Actual Return > 11%pa => Value Created
Value versus Price

Stock price => market’s interpretation of value
Stocks could be undervalued or overvalued

Business Focus => Create Value on the premise that stock price will eventually follow

Investor relations & value unlocking strategies help stock prices reflect shareholder value
High-level Drivers of Shareholder Value

- Profitability
- Capital Efficiency
- Growth
- Real Options
- Cost of Capital

Present Value of Long-term Free Cash Flows
The Metrics

Measuring Shareholder Value Creation
Economic Profit, Economic Value Added and Cash Value Added defined

Economic Profit = NOPAT – Invested Capital x Cost of Capital

EVA® = Adj NOPAT – Adj Invested Capital x Cost of Capital

Cash Value Added = OCF – Gross Investment x Cost of Capital

NOPAT = Net Operating Profit after Tax; OCF = Operating Cash Flow
Annual EP, EVA & CVA do not fully capture Shareholder Value Created

EP, EVA or CVA over a given year, only captures value creation attributable to that year’s operations.

Total value created during a year, comes not only from operations during that year, but also from expectations formed during that year about future years’ operations.

*Shareholder Value Creation is driven by long-term free cash flows to equity holders*
Shareholder Value Creation attributable to future operations

Measure: Shareholder Value Added (SVA)

\[ SVA = \sum PV(\text{Future Free Cash Flows from Operations}) - \text{Capital Invested} \]

\[ SVA = \sum PV (\text{Future EVAs}) \]
SVA is simply an NPV calculation

NPV = \sum PV (Future FCFs) - Capital = \sum PV (Future EVAs)
FCF and EVA Profiles

FCF profile: cash flow generation over time
EVA profile: value creation attributable to future operations of each year

But all of this value is created up front
A Formula for Cumulative Shareholder Value Creation

Cumulative Shareholder Value Created = 
*Sum of all the Past, Present and Future EVAs expressed in terms of today’s value*
Value Based Management

Shareholder Value Creation in Practice
Managing for Value begins with Strategy & ends with Financial Results

Value Based Management (VBM) Programs that are well implemented deliver 5 to 15 percent increase in bottom-line results (McKinsey & Co)
VBM: Aligning Strategy, Measurement & Operations with Value Creation

VBM Framework

- Goal Setting
- Strategy Formulation
- Decision Making
- Operations
- Performance Measurement
- Compensation
Value Based Management Programs focus too much on measurement...

... and too little on management activities that create shareholder value

Successful approaches tightly link measurement to business improvement

VBM implementation should be driven by leadership commitment & change management
VBM Framework
Eight Disciplines of Sustainable Value

Understand the firm’s value position → Anticipate emerging issues → Set sustainable value goals

Anticipate emerging issues → Discover sustainable value → Develop business case

Discover sustainable value → Capture value → Validate Results & capture learning

Validate Results & capture learning → Build sustainable value capacity

Build sustainable value capacity → Understand the firm’s value position

Source: Corporate Strategy Today
Strategy & Execution should be aligned with Value Creation

Corporate Strategy
Which Businesses?
Value Creation

Competitive Strategy
How to compete?
Value Creation

Execution
How to operate?
Value Creation
Select businesses that leads to long-term value creation

Corporate Finance plays a crucial role in Corporate Strategy

- Identify value creating businesses to invest & value eroding businesses to divest
- Optimal financing strategies & dividend policies

But less scientific aspects such as deal making & change management is where value is created or destroyed the most

- Failures of Corporate Strategy: Daimler Chrysler deal – ‘soft aspects’ were not properly addressed
Aligning Corporate Strategy with Value Creation – Practical Issues

• Understanding the risks of various businesses
• Hurdle rates in a volatile environment
• Capital budgeting and financial feasibilities – ability to challenge the numbers & see beyond them
• Motivating managers to invest for the long-term, even if it means lower short-term results
• Making objective decisions, overcoming temptations to invest in unviable ventures
• Exiting unviable businesses at the right time
Competitive Strategy is about being different

Southwest Airlines Co

- Short-haul, low-cost, point-to-point service
- Fast turnaround between mid-sized cities and secondary airports in large cities

Deliberately avoids fully-fledged services

- No route coordination, baggage transfer, flight meals

Leading to a set of activities aligned with Value Creation

- Cost savings passed through to customer
- Minimum turnaround time
Aligning Competitive Strategy with Value Creation – Practical Issues

• Businesses can tend to get complacent about strategy, only focusing on execution
• Reward systems may tempt businesses to focus on short-term practices
• Managers may resort to ‘conservative strategies’ even if it is detrimental from a value perspective
• Lack of innovation that is required to develop ‘winning strategies’
Value Creation is about making the right strategic choices

Strategic choices should lead to a sustainable competitive advantage in order to sustain value creation over the long term.

If you need to completely change your competitive strategy as a result of a new entrant to the market, then you know your strategy is not sustainable.
Making Strategic Choices

**Hospital**

- Value Discipline – Operational Excellence, Product/Service Leadership, Customer Intimacy
- Choice of location – metropolitan, suburban
- Choice of Services – secondary care, tertiary care, specialties

**FMCG**

- Discontinuation of distribution services offered to strategic business partners, in order to grow own brands despite losing income in the short-term
Aligning Execution with Value Creation – Practical Issues

• Resource mismatch to execute strategy
• Wrong KPI’s and targets – not understanding the value drivers
• Agency problem – Shareholder’s interests versus Managers’ interests
• Lack of a value-creating strategy
Businesses that interpret maximizing performance as maximizing earnings or stock price will fall into the trap of being short-term oriented at the expense of long-term value creation.

Alfred Rappaport prescribes ten Basic Governance Principles a company adopt for long-term shareholder value creation.
Principles of Shareholder Value Creation

- Do not manage earnings or provide earnings guidance. 
  Earnings have no connection with value or change in value.

- Make strategic decisions that maximize expected value even at the expense of lowering near-term earnings. 
  What is the expected incremental value of future cash flows associated with a given strategic decision?

- Make acquisitions that maximize expected value even at the expense of lowering near-term earnings. 
  Sound M&A decisions are based on their prospects for creating value, not their immediate EPS impact.
Principles of Shareholder Value Creation

- Carry assets only if they maximize value
- Reduce capital employed by focusing on high value adding activities and outsourcing low value adding activities
- Return cash to shareholders when there are no credible opportunities to invest
- Shareholders can earn a better return elsewhere
- Reward CEO’s and senior executives for delivering superior long-term returns
- Have effective pay incentives at senior levels that influence correct long-term behavior
Principles of Shareholder Value Creation

- Reward operating unit executives for adding superior multi-year value
- Implement Shareholder Value Added at operating unit level
- Reward middle managers & frontline employees on key value drivers they influence
- Develop leading indicators that front line employees influence
- Require senior executives to bear risks of ownership
- A proper balance between benefits of ownership and restrictions on liquidity
- Provide investors with value-relevant information
- Antidote to short-term earnings obsession
Berkshire Hathaway comes closest to implementing all Ten Principles

Berkshire Hathaway VS S&P 500

Berkshire Hathaway ~ 21%pa
S&P500 ~ 9%pa
Businesses should focus on Creating Value
Stock prices will follow

Thank you