The History of Value Based Management

Value-Based Management

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The History

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- The history and development of Value-Based Management ("VBM") and the growth of internal and external corporate complexity over time are highly inter-related
  - VBM is basically a philosophy enabling and supporting maximum value creation in organization
- Prior to the industrial revolution, firms were relatively small and their internal complexity was low.
  - External environment of firms was relatively stable and clear
    - ☑ Value creation was relatively straightforward, simple and obvious

Implicit Value Management

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- The estimated period spans from the 1800s to 1890
- The earliest form of implicit VBM was dated back in 18th century
  - Industrial revolution – machine and equipment
    - ☑had made economies of scale possible
    - ☑Via capital expenditures in machine
    - ☑Via hiring production workers
  - Different locations of facilities
    - ☑Direct supervision becomes difficult
    - ☑More efficient or not?
    - ☑More productive or not?

Implicit Value Management

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- Methods on production processes were being developed
- Production process become crucial
  - Streamlined and smooth
  - Ensuring goal attainment
  - Ensuring achievement of corporate objectives
- In the 19th century, these methods and production processes were gradually improved
  - Improvement on transportation and communication mechanism
    - ☑ Promoting & evaluating the efficiency and productivity of decentralized production processes
      - But, not yet on measuring & managing value creation

Explicit Value Management

- The period spans from 1890 – 2000
- At the end of 19th century, Alfred Marshall sees profit as the residual income
  - Accruing to a firm's owner
  - Return to the investment of his own capital
  - Pains he suffers in exercising his "business power" in planning, supervision & control

Explicit Value Management

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- Frederick Taylor (1911) and Harrington Emerson develop "scientific management"
  - Using detailed physical manufacturing standards
  - Enabling a simple translation to financial standards
- Firms become more complex
  - Firms have diversified product assortments
  - Firms often have several types of activities
    - ☑ *Allocations of assets*
    - ☑ *Better information*
- Management accounting introduced **ROI**
  - Only for top management
  - To allocate resources & judging performance

Explicit Value Management

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- In 1938, Grant made references using **time value of money** in deciding investment projects
- In 1954, Dean published an article in Harvard Business Review on **Discounted Cash Flow**
  - Practically to value investment proposals
  - Later, various methods were introduced
    - ☑Residual income
    - ☑Responsibility accounting
    - ☑Transfer pricing

Explicit Value Management

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- In 1964,
  - Sharpe introduced "**Capital Asset Pricing Model**"
  - Peter Drucker introduced "**Managing for Results**"

- In 1973, Black and Scholes introduced formula to calculate **value of financial options**

- In 1986, Alfred Rappaport introduced "**Creating Shareholder Value**"

- In 1994, Jim McTaggart used the term "**Value-Based Management**"

Explicit Value Management [measurement]

- The framework of thinking in financial/shareholder value has been firmly rooted in business and corporate strategy
  - Market value added
  - Total Shareholder Returns
  - Economic Value Added
  - Cash Flow Return on Investment

To determine the value of firms & investments

Market Value Added

- The difference between the equity market valuation of a listed firm and the sum of the adjusted book value of debt and equity invested in the firm
  - ➘ It reflects the sum of all capital claims held against the firm
  - ➘ It reflects the market value of debt and the market value of equity
    - ☑ The higher the MVA, the better
      - High MVA indicates the firm has created substantial wealth for the shareholders

Market Value Added

- The higher the MVA, the better
  - High MVA indicates the firm has created substantial wealth for the shareholders
  - MVA is equivalent to PV of all futue expected EVAs
  - Negative MVA means that the value of the actions and investment of management is less than the value of the capital contributed to the firm by the capital market
    - ☑It simply means that the wealth or value has been destroyed

Market Value Added

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- The aim is to maximize MVA (not to maximize the value of the firm)
- MVA does not take into account
  - the opportunity costs of the invested capital
  - Intermediate cash returns to shareholders
- MVA cannot be calculated at divisional level (strategic business unit)
- MVA cannot be used for privately held firms

Total Shareholder Returns

- TSR = represents the change in capital value of a listed firms over a period, plus dividends
  - TSR is expressed as a plus or minus percentage of the opening value
  - "period" typically means 1 year
  - TSR can be easily compared between firms
  - TSR can be benchmarked against industry or market returns
    - ☑ Without having to worry about size bias since TSR is a percentage
  - TSR cannot be observed for privately-held firms

Explicit Value Management [finance]

- In 1980s, from "corporate finance"
  - Increased attention for managing value creation in
    - ☑Mergers & acquisitions
    - ☑Leveraged buy-outs
      - Since public debt markets grew rapidly and opened up to borrowers that would not previously have been able to raise loans to pursue what was often an unwilling target
      - This became a major stimulus for managers that ran their companies in ways that mainly served their own private interests (improved authority, control and compensation)
        - Often at the expense of the firms' owners, shareholders, and long-term strength to change their behaviors

Explicit Value Management *[finance]*

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- In 1980s,
  - **“activity-based costing”**
  - **“activity-based management”**
  - **“transaction-based costing”**

☑Offering more precise and future oriented measurement of profitability & economic value by

- Product
- Channels
- Markets
- Processes
- Organizations

Explicit Value Management [risk]

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- In 1990s,
  - ➘ **“risk-adjusted return on capital”**
    - ☑ Combining risk management & economic profit valuation for allocating capital in financial institutions

Explicit Value Management *[resources]*

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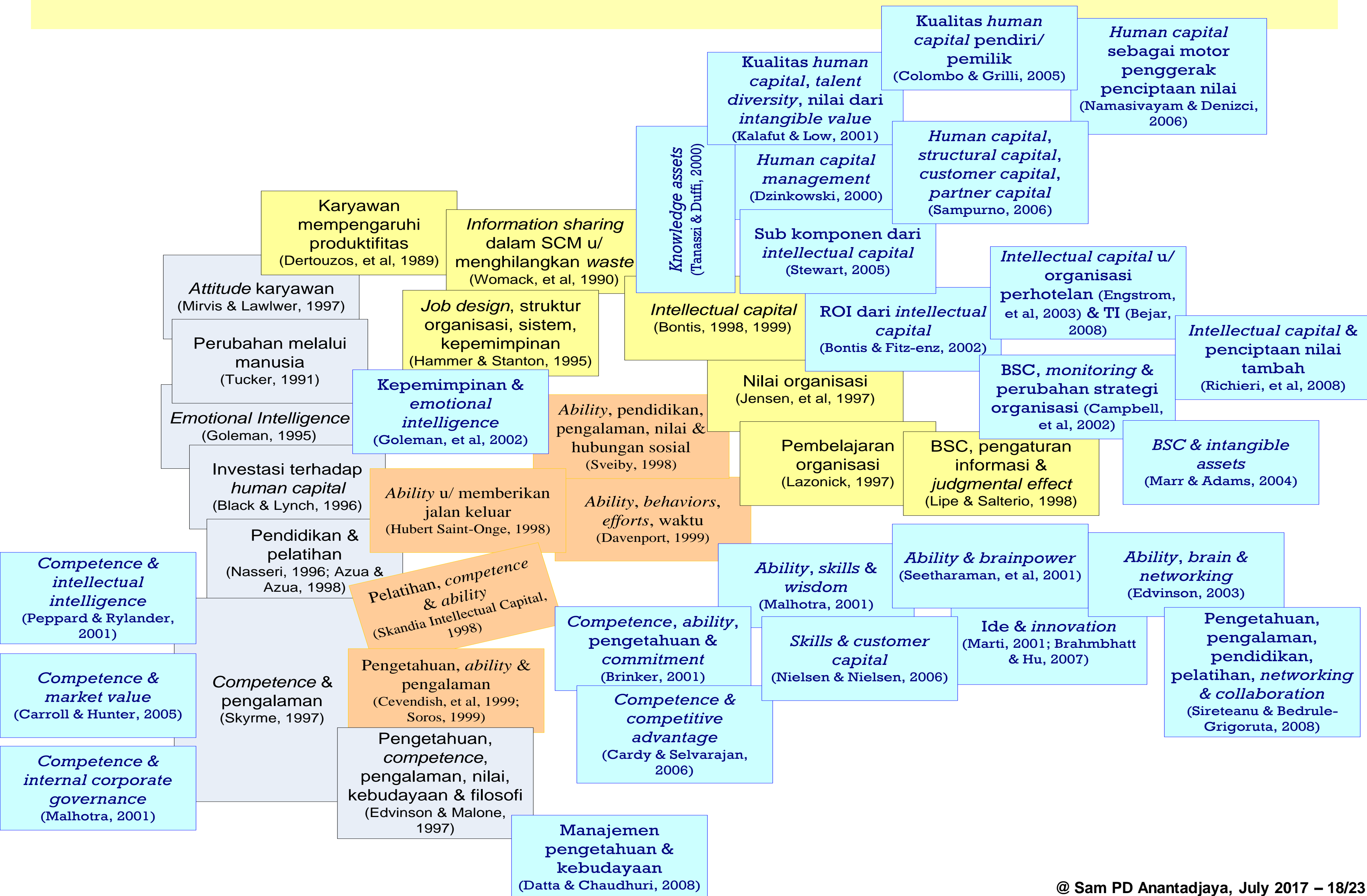
- Following the birth of "www" in 1994;
  - Many new strategic information/knowledge related opportunities and technologies arose
    - ☑ These pushed the level of complexity of the internal and external environment of modern firms
      - **"intellectual capital"**
      - New intangible asset valuation models
        - Skandia navigator
        - Change management

Explicit Value Management [example]



Explicit Value Management [bsc]

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- In 1992, Kaplan & Norton developed
  - ➘ **“balanced scorecard”**
    - ☑ Enabling firms to translate a company’s vision and strategy into implementation
      - Financial perspective
      - Customer perspective
      - Business process
      - Learning & growth perspective

Explicit Value Management [option]

- In 1998, Luehman transfers the formula for determining the value of options into dealing with uncertainty over time in strategic decision making

  - **“real options”**
  - **“scenario planning”**
  - **“game theory”**

Explicit Value Management [new tech]

- New technologies…..

  - ➘ **“business performance management”**
  - ➘ **“business intelligence”**
  - ➘ **“business simulation”**

    ☑ Attempting to support more complex decision making & management processes in corporations

    - Many firms struggle with the large-scale implementation of these technologies

Holistic: VBM *[2000-now]*

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- Following the internet bubble burst and 2001's Enron accounting crisis, and several other corporation scandals,
  - Accountants,
  - Stock analysts,
  - Top management,
  - Business school,
  - Media,
  - Shareholders, and
  - Investors

are all blamed…

Holistic: VBM *[2000-now]*

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- Prominent ideas to prevent further disasters are;
  - Strict accounting practices and rules
  - Improved corporate governance
  - Separation of analysts from other banking activities
  - More attention for business ethics and corporate social responsibility
  - Rules for executive remuneration
  - Protection of shareholders' interests
  - Attention for shareholders' interests
  - A long-term view towards value creation

Why Value Based Management

Value-Based Management

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The Background

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- Organizations serve a special purpose
  - They exist to deliver CERTAIN VALUES
    - ☑ remember the birth of organizations...
      - In semester 1
    - ☑ reaching **economic profitability**
      - CSR “triangle”
    - ☑ Organizations must be profitable to survive
      - Earning high returns on shareholders’ equity to build trust
        - High stock price
    - ☑ Organizations are networks of parties and people working together

The Background

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- Organizations use tremendous amount of time, effort, investments, assets, and resources.

  ➘ So it makes perfect sense to ensure, manage, measure, monitor, encourage, and support that maximum value is realized

The Background

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- Value-Based Management is to realize that organizations are **operating and competing in 4 markets**;
  - Markets for products and services
  - Markets for corporate management and control
    - ☑ competition on determining who is in-charge of an organization, threat of takeovers, restructuring, and/or leveraged buyouts
  - Capital markets
    - ☑ competition for investors' favors and savings
  - Employee and managers markets
    - ☑ competition for company image and ability to attract top talents

Trends

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- Since accounting metrics have turned out to be unreliable
  - Particularly when those accounting metrics are used in solitary
  - This pushes for new value-based metrics
    - ☑ Economic Value Added
    - ☑ CFROI
    - ☑ Market Value Added

Economic Value Added

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- It is a financial performance method to calculate the true economic profit of a corporation

- EVA can be calculated as **net operating profit after taxes – charge for the opportunity cost of capital investment**

  - Remember the "weighted average cost of capital"?
    - ☑ $w_d * k_d (1\text{-}tax)/w_e * k_e$

Economic Value Added

- EVA is an estimate of the amount by which earnings exceed or fall short of the required minimum rate of return for shareholders or lenders at comparable risk

  - EVA can be calculated at divisional level (strategic business unit)

  - EVA is a flow and can be used for performance evaluation over time

  - EVA is economic and is based on the idea that a business must cover both the operating costs and the capital costs

Economic Value Added

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- EVA can be used for the following purposes;
  - Setting organizational goals
  - Performance measurements
  - Determining bonuses
  - Communication with shareholders and investors
  - Motivating of managers
  - Capital budgeting
  - Corporate valuation
  - Analyzing equity securities

Economic Value Added

$$\text{EVA} = (\text{ROIC} - \text{WACC}) * (\text{TA} - \text{CL})$$

$$\text{EVA} = [(\frac{\text{NOPAT}}{\text{capital employed}}) - \text{WACC}] * \text{capital employed}$$

$$\text{EVA} = (\text{r} - \text{WACC}) * \text{capital employed}$$

$$\text{EVA} = (\text{r} * \text{capital employed}) - (\text{WACC} * \text{capital employed})$$

$$\text{EVA} = \text{NOPAT} - (\text{WACC} * \text{capital employed})$$

$$\text{EVA} = \text{operating profits} - \text{a capital charge}$$

CFROI

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- CFROI = cash flow return on investment
  - Originally developed by HOLT Value Associates in Chicago, USA
  - It is an **economic profit** (cash flow) based corporate performance/valuation framework on economic profit basis
    - ☑ mainly used by portfolio managers and corporations
  - CFROI is normally calculated on an annual basis and is compared to an inflation-adjusted cost of capital to determine whether a corporation has earned returns superior to its costs of capital

CFROI

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- CFROI applies **dividend discount technique** to **inflation-adjusted cash flow growth projections**, using
  - a firm specific risk premium, plus
  - Market required rate of return to determine the firms warranted value and the equity's warranted price
  - CFROI is a bit complex calculation to apply

$$CFROI = \frac{\text{Cash Flow}}{\text{Market Value of Capital Employed}}$$

Market Value Added

- MVA is the difference between the equity market valuation of a listed firm and the sum of the adjusted book value of debt and equity invested in the firm
  - It is the sum of all capital claims held against the firm – **the market value of debt** and **the market value of equity**
    - ☑ **MVA = firm's market value – invested capital**
- The aim is to **maximize MVA** (not maximizing the value of the firm)

Benefits of VBM

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- VBM can maximize value creation consistently
- VBM increases corporate transparency
- VBM helps organizations deal with globalized and deregulated capital markets
- VBM aligns interests of top managers with the interests of shareholders and stakeholders
- VBM improves internal communication on strategy
- VBM prevents undervaluation of the stock
- VBM sets clear management priorities
- VBM facilitates improvements on decision-making
- VBM streamlines planning and budgeting
- VBM sets effective targets for compensation
- VBM facilitates the use of stock for mergers and acquisitions
- VBM prevents takeovers
- VBM helps to better deal with increased complexity and greater uncertainty and risk

Drawbacks of VBM

- VBM is an all-embracing, holistic management philosophy, often requiring culture change
  - VBM takes time, resources and patience to be successful
- Value creation may sound more simple than corporate strategy, but it isn't.
  - It is actually more or less the same
- Measuring for value, performance management and balanced scorecard are very powerful management support tools and processes, but….
  - Have a cost of their own so it is not advisable to go too deep in detail or use metrics that are over complex

Drawbacks of VBM

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- Extreme caution must be made not to measure the wrong things as this may almost certainly lead to value destruction
- VBM requires strong and explicit CEO and executive board support
- Comprehensive training and consulting support is advisable or even necessary, but can be quite costly
- The perfect VBM or valuation model has yet to be invented……
  - ➘ No matter which one you choose, there will always be drawbacks to consider

Managing for Value Makes a Difference

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The Background

- Managers receive conflicting signals
  - From various performance measures used in each of the management processes
    - ☑ strategic planning
    - ☑ budgeting
    - ☑ reporting
    - ☑ compensation
  - Come in the forms of
    - ☑ planning goals
    - ☑ budget targets
    - ☑ monthly & quarterly financial results
    - ☑ incentive targets
    - ☑ so many other targets

The Background

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- These conflicting signals are simply due to the mis-alignment of management processes
  - Strategic planning focuses on one goal/objective
  - Budgeting processes focus on another goal
  - Incentive system rewards focus on a totally different goal

  - Strategic planning focuses on **GROWTH**
  - While…..
    - ☑ annual budget focuses on **EPS**

The Background

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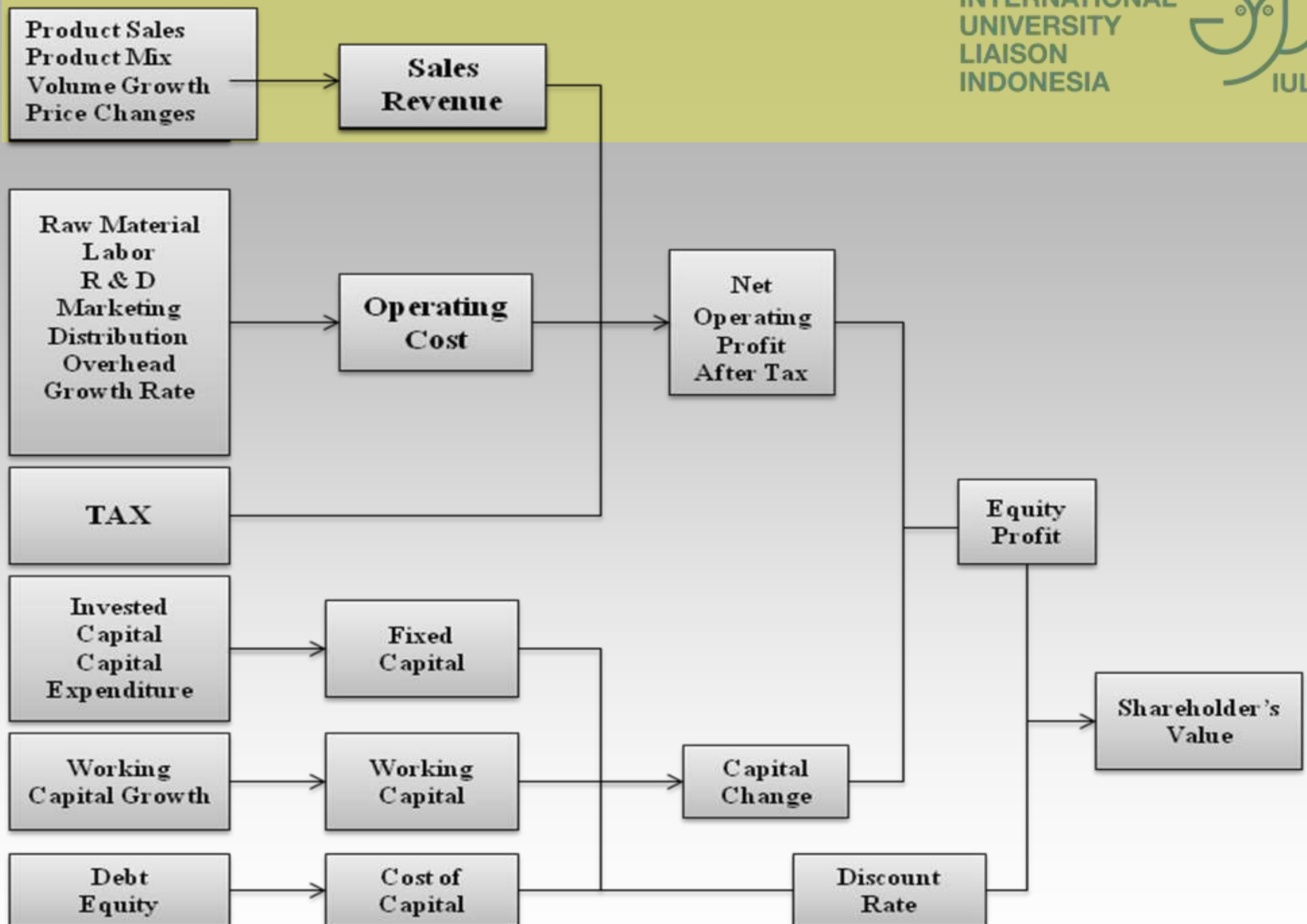
- Managers are also confused by differing **PRIORITIES**
  - This month = quality initiatives
  - Next month = capabilities enhancement
  - Next month = process re-engineering
  - Solution…..

☑ adopting the **mindset of managing for value**

- Prioritizing initiatives in the context of the company's goal

✶ Consistency **creating shareholder value**

what is "shareholder value"?



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Product Sales
Product Mix
Volume Growth
Price Changes
Sales Revenue
Raw Material
Labor
R & D
Marketing
Distribution
Overhead
Growth Rate
Operating Cost
Net Operating Profit After Tax
TAX
Equity Profit
Invested Capital
Capital Expenditure
Fixed Capital
Shareholder's Value
Working Capital Growth
Working Capital
Capital Change
Debt
Equity
Cost of Capital
Discount Rate

The Background

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- To achieve maximum value, organization must translate the mindset into reality
  - Using it in frontline decision making in the daily operating and investment decisions all managers are making
  - Managing for value does not mean just installing a new performance measure such as **economic value added**
    - ☑ economic value added means thinking through how you will create value
    - ☑ Managing for value begins with strategy and ends with financial results

The Background

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- If one tries to manage financial results without strategy, one will fall short of managing for value
  - Conversely, if you manage for strategy and fail to deliver financial results, one will fail to create value

value management is the link between strategy & financial results

The Background

- Management must develop a business strategy to achieve the goal of **MAXIMIZING VALUE CREATION**

- The mindset needs to be included in the way
  - the company measures itself
  - The processes the company uses for managing itself
  - The resources decisions the company makes to improve operations (or make new investment)

Categories of Value Management

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goal
Importance of creating value

strategy
Achieving the goal

measures
Selecting appropriate performance measures

corporate processes
strategic planning, operating planning
financial reporting, incentive compensations
Aligning measures & processes

operating decisions
Establishing line-of-sight

Clarifying Goals

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- All too often, firms get confused by multiple objectives
  - Firms get seduced into believing that no single objective will cover the interests of all the constituents
  - Hence, firms need multiple objectives beyond value creation to satisfy the investors

Managing a firm for value requires delivering maximum return to the investors…

while….

balancing the interests of the other important stakeholders, including customers and employees

This is the trap that leads to conflicting signals, confusing priorities & poor decision making

Strategy

- "strategy" is probably the most overused word in business language
  - Every business person talks about strategy, but the word is used to mean many different things;
    - ☑ objective
    - ☑ vision
    - ☑ what the company does
    - ☑ how the company competes
- The word "strategy" is also used as adjective "strategic"
  - To describe a variety of activities, including alliances, partners, initiatives, products, projects

"strategy" is often confused with "goal" or "objective"

"objective" is what you are going to do

"strategy" is how you are going to achieve the objective

"goals" & "objectives" lead to strategy…

which leads to the tactics necessary to execute the strategy

"strategy" is also confused with planning…

planning is not strategy

Planning is an expression of how the company will implement its strategy

A plan expresses how the strategy will be executed

Performance Measures

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- The performance measures a company chooses need to support and reinforce the company’s strategy and help managers achieve the goal of value creation

    - ➘ The performance measurements should do more than reflect financial results (that only capture events after the fact)

        - ☑ instead, performance measurements should help management make good decisions

Performance Measures

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- Performance measurements should reflect the firm's business strategy & focusing managers on decision making that creates value

  - Performance measurements **DO NOT NEED** to reflect financial results
    - ☑ it is often desirable to balance financial measures with non-financial measures, such as customer satisfaction vs. employee retention
    - ☑ these types of performance measures address the valid concern of management that the right decisions for business do not always show up in a single period's measures
      - Performance measurements should be CUSTOMIZED!!

Performance Measures

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- Performance measures do not replace strategy
  - Performance measures capture the results of strategy
    - ☑ short-term & long-term strategy
- Performance measures do not replace management judgment
  - To affect managerial decision making, one must integrate the performance measures into the management processes

Management Processes

- 4 key management processes to consider
  - Strategic planning
  - Budgeting
  - Reporting
  - Incentives

- These management processes need to send consistent signals to managers and reinforce the value mindset

Management Processes

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- Performance measures must be included in the processes
  - The processes must be designed to reinforce consistent signaling to managers that support the firm's strategy
  - One management process is often focused on 1 priority, while….
    - ☑ another management process is focused on a different priority

Operating & Investment Decisions

- Organizational value is created in firms through operating & investment decisions
- Making strategy and value creation actionable within the company means focusing management on making decisions that create value
  - Daily decisions is what controls the allocation of physical & human resources

Strategic Planning

Is the firm's current business strategy projected to create value?

What is the firm's value creation potential based on alternative strategies?

Budgeting

What is the firm's expected short-term performance?

How much capital is expected to be invested in each business unit?

Financial Reporting

How successful is the firm at meeting its performance goals?

Is the firm showing a profit?

How is the firm performing relative to the external environment?

Incentive Compensation

Are targets tied to performance that creates value?

Are incentives linked to change in value

What is the appropriate balance between short and long-term?

Key performance attributes:

Low price
Support
Quality
Delivery
Safe buy
R & D

Competitive Issues:

Financial performance (vs. competitors)
Primary focus
Source of increased profits
Business planning
Competitor intelligence
Business objectives
Employees' perceived ability to influence results
Management incentives
Production capacity
Product line profitability

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Value Creation

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What is it?

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- Value creation is the wealth created for a company's stockholders through **PRICE APPRECIATION** and **DIVIDENDS**

- Value creation by publicly-traded firms can be calculated straightforward
  - P_{stock} at t_0: US$91.38
  - Dividends paid: US$1.40
  - P_{stock} at t_1: US$151.50

What is it?

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- The calculations become more challenging for value to be created in the future
  - ➘ Making comparisons between **historical value created** and **value to be created in the future**
- Value in the future is not always easy to calculate because there are different perspectives on what value is or should be
  - ➘ Value usually implies a mathematical calculation
    - ☑ This leads us to believe that **value is objective**
      - All value (past, present & future) is very **SUBJECTIVE**

What is it?

Value created per share

Ending share price: 151.50
Beginning share price: 91.38
Share price appreciation: 60.12
Dividends earned: 1.40
Value Created: 61.52

Percentage Value Created

Value created per share: 61.52
Beginning share price: 91.38
Value Created: 67%

Indexed Dollar Value Created

Dollar investment: 1.00
Percentage value created: 0.67
Value Created: 1.67

Equity Value Created

Value created per share: 61.52
Shares outstanding (million): 527.79
Value Created (million): 32,469.64

so, what is the value created?

What is it?

- The ending share price is indisputable since this price was actually the close price on that particular day.

  - However…..

    - ☑the value itself is subjective because

      - the value of shares on that day was nothing more than the value of the stock traded between the last 2 investors on that day

      - Value is an imprecise term whose analysis is more **ART** than **SCIENCE**

What is it?

- Value has a variety of meanings
  - People can have very different views of what the value of a company is at any given time
  - They may disagree on today's value or future value
    - ☑ This dynamic of different views of value plays itself out every day in the securities markets
      - where buyers and sellers declare their beliefs about firms' values…
      - Through the actions of buying and selling the stock

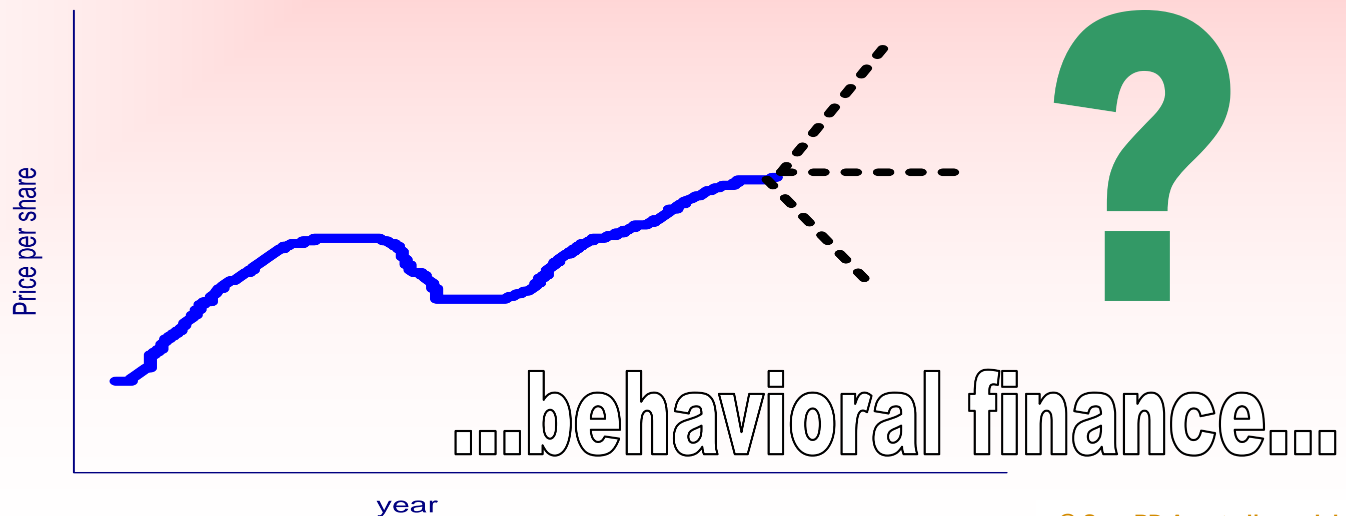
What is it?

- People **BUY** stock when they **BELIEVE** the value is greater than the value represented by the price in the market

  - Market price represents…
  - the value that all owners of stock feel is not too high, and
  - that all potential owners feel is not too low

Value is Subjective

- The expression of past value appears objective.
  - ➘ But, the PV or FV are opened for disagreement
    - ☑ This is simply due to inability to have direct observation
    - ☑ Thus, PV and FV become subjective in nature



Value is Subjective

- The possible "direction" of the share price is solely dependent on individual's perceptions and beliefs
- Also, depends on ….
  - Quality of information
  - Perception of control
  - Time horizon
  - Uncertainty
  - Tolerance of risk

Quality of Information

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- Information about the past is objective
  - But….

    ☑Information about the future is subjective

    ☑Also…

      - Different people = different information
      - Though they all have received the same information, the level of understanding and the way to understand is different

asymmetric information

Perception of Control

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- “Sense of controllership” provides high influence toward willingness to pay a certain amount
- People with some senses of control would likely to pay more for the opportunity
  - ➘ INSIDERS usually believe they have more control over the future events in a firm, and of the outcome that firm will generate…
    - ☑ Insiders are likely to pay more for the firm than individuals without any perceived control over the company's future

Time Horizon

- Different time horizon also influence value
  - Short-term vs. long-term range
  - Managers have the tendency to focus on **short-term results** and only on a time horizon of a **single quarter**
  - Short-term thinking = discourages growth investments

Uncertainty

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- How certain is value?
- What does the value depend on?
- If the value today is the expectation of future financial results, how sure are we about those expected results?

➘ The greater the uncertainty about future results, the greater the variance in the potential value

➘ Uncertainty works both ways

☑ Acting to **reduce value**

☑ Acting to **increase value**

Uncertainty

- In most cases, "uncertainty" reduces value
  - With the prominent exception of values in high technology where uncertainty actually becomes positive
    - ☑ The greater the uncertainty in the future, the lower the value
- Uncertainty is a subjective judgment
  - Without the certainty of future results, investors are likely to discount future results by some factor in setting their expectations for the value of the firm
    - ☑ The greater the uncertainty about the future results, the greater the discount investors will place on the future results

Tolerance of Risk

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- Different people = different level of tolerance
  - Same information, same perception of control, and same level of uncertainty about future prospects = different level of tolerance
  - People with **more tolerant toward risk**,
    - ☑have **higher tolerance for uncertainty**,
    - ☑will **pay a higher value** for a company with uncertain prospects.

Types of Values

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- Value in the present time and future time is subjective
  - But…
    - ☑It does not mean that such a value cannot be quantified
      - Discounted Cash Flow
      - Net Present Value
      - Book Value
      - Market Value
      - Intellectual Capital Value
      - Enterprise Value
      - Franchise Value
      - Liquidation Value
      - Others…….

Information Controls Value

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- What an **investor expects** to happen to the company's cash flows is the largest determinant of value
  - There are so many factors contribute to investors' perception
    - ☑Value is always based on expectations of the future
    - ☑It is difficult to quantify, even for public firms

Information Controls Value

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Buyers purchase stocks since they believe the value of the stock will rise

Sellers sell stocks since they believe the value of the stock will drop

Somebody is definitely wrong

Slippery Slope of Value Creation

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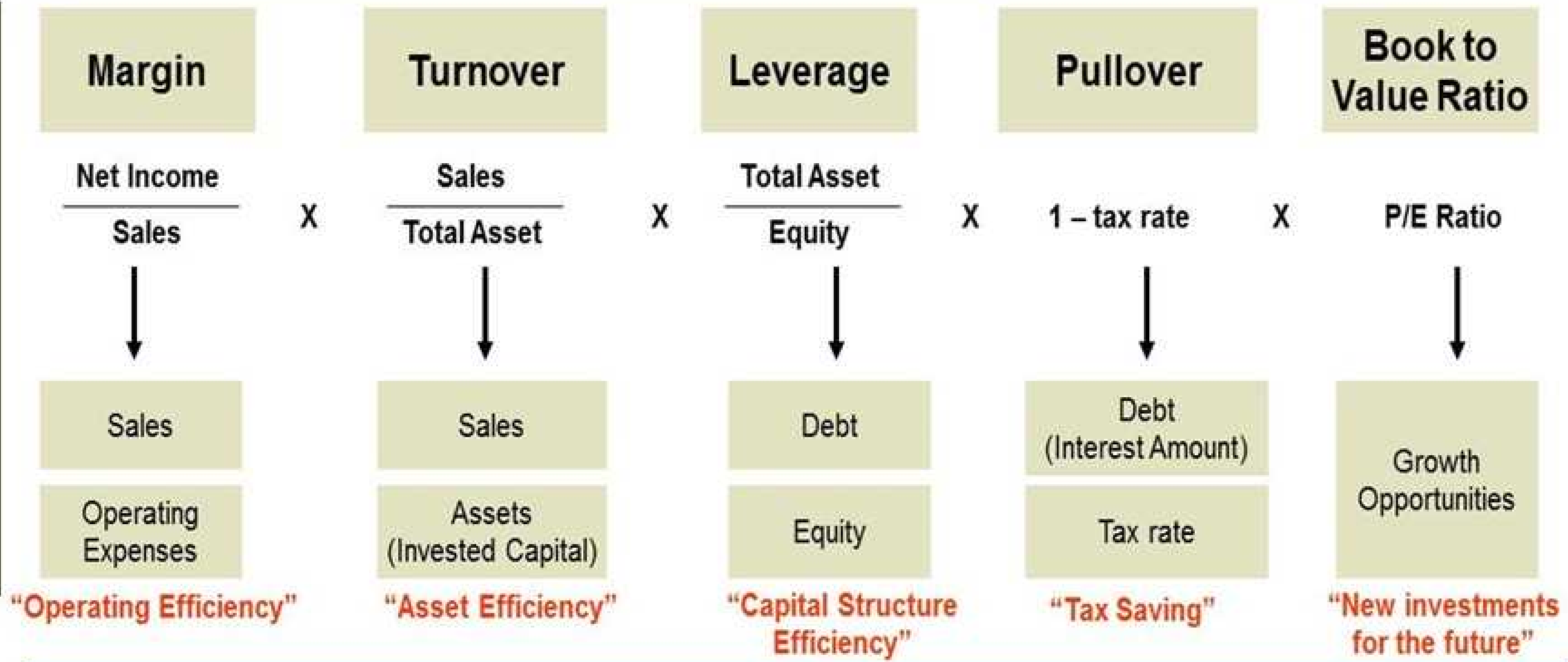
- Just because a company is highly profitable does not guarantee value creation for investors in the company
- Creating value for shareholders operates under three rules;
  - Level of **profitability** has nothing to do with value creation.
    - ☑ When it comes to creating value for shareholders, companies that are very profitable have no advantage over firms that are less profitable
  - All management teams start on the same level toward value creation
  - Different firms face different challenges in creating value

Example

Company	Key Strategies
Coca Cola	Promoted brand awareness Growth Global expansion
Wells Fargo	Successful acquisitions New customer acquisitions Fee-based income
Mattel	Leverage time-tested brands Global growth

5 Main Influential Value Drivers for Organizations

Dupont Model: Share Value = M x T x L x U x B (MTLUB)



Examples on Maximizing Shareholders' Value

VALUE CREATION STRATEGY

Margin	Turnover	Leverage	Pullover	Book to Value Ratio
Increase margin with the combinations of Price & Cost of Production	Increase sales volume on every assets owned	Increase loan & borrowing within the firm's repayment ability	Reduce tax payment as long as legally possible	Increase investment in new & prospecting projects

Triple Helix in Business & Management