

Creating Value and Investors

What does “value creation” mean? How can companies prevent value improvement plans from culminating in value destruction? The answers lie in Value Based Management

Why do value improvement plans so often fail to impact the company's market value? Is it an undervaluation issue? How can managers change the market's assessment? The answers lie in the Active Shareholder Management, a framework designed to identify target investors through segmentation and to develop a strategy that, consistent with value creation plans, enables a company to optimize its market and shareholder value.

The following presents a comprehensive view of value creation, from an internal point of view, Value Based Management, and from an external view, Active Shareholder Management.

What does “value creation” mean?

It is common for management to announce plans to create value for stockholders. It is also common for their financial statements down the line to reveal that if anything, value has been destroyed. What went wrong? It is crucial for managers to realize that “value creation” is

a clearly defined and tangible measure, based on interpretation or personal assessments. Mathematical formulas exist that objectively and rigorously verify whether value has been actually created, based on financial statements. These formulas are based on the EVA™ or Economic Profit concept, which is defined as the difference between the return on the invested capital and its cost (Figure 1).

Once “value creation” is defined, how can it be maximized?

Based on our consulting experience, companies that have low value creation trends are usually plagued by poor managerial processes. VBM (Value Based Management) is an approach that aims to maximize value creation by effectively leveraging and aligning strategic actions, resource allocation, performance as-

Figure 1 – From Economic Profit to MVA

- Economic Profit (EP) is commonly used to represent company value creation
- EP is given by the difference between the return on average capital employed (ROACE) and its weighted cost (WACC)

$$EP = (ROACE - WACC) \cdot CIN$$

- The Market Value (number of existing shares multiplied by their market price) can be written as the sum of Book Value and Market Value Added (MVA)...

$$MV = BookValue + MVA$$

- ... and MVA, as defined in theoretic mdels, represents the present value of future EP:

$$MVA = \sum_t \frac{EP_t}{(1+WACC)^t}$$

As a result, EP improvements should be reflected into market value growths

If the return on the capital employed is higher than its cost, the firm is creating value. Otherwise, it is destroying value.

assessment, and management rewards. VBM has been successfully implemented by a large number of widely diverse compa-

Managing

Paolo Cervini and Alberto Totaro

nies around the world. Some demonstrate the approach in their external communications: For example, see the section of the BASF website dedicated to value creation. Companies may differ in terms of size and business focus, but if they successfully implemented VBM, they share two elements: an organic approach and a well-designed roadmap.

Deploying VBM means redesign and aligning all internal processes. Once the value creation indicator is well defined, every process, from the strategic plan to management incentives, has to be renewed. Logically, VBM must start with building a strategic plan designed to maximally improve the value creation indicator. The next stage is disciplined execution, which is monitored by a system of Key Performance Indicators. Lastly, the management incentive plan must be shaped to focus on value creation.

VBM implementation

The standard VBM framework can be altered based on the needs and priorities of the client. Timing and characteristics of implementation may also be changed.

The key point for a successful VBM program is organic implementation, even if the sequence of projects and ac-

tions differ from company to company. VBM deployment requires discipline in following a precise action plan. Management must have a roadmap in place that clearly defines all actions that have to be taken along some key dimensions (value indicators, processes, systems and incentives), and sets clear milestones.

A medium to long-term range of vision is necessary to effectively drive implementation (as demonstrated in VBM roadmap, figure 2). That is why CEOs with a “short term scope” tend not to start such programs.

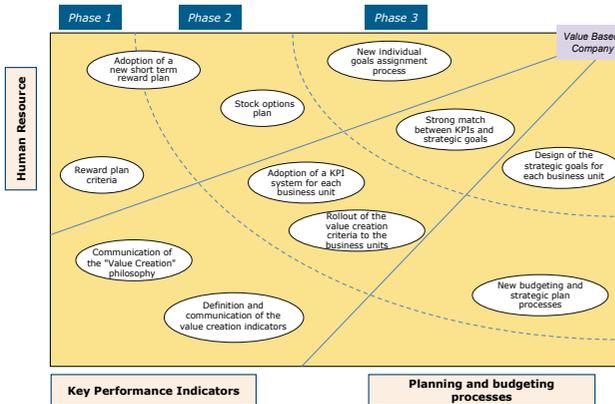
VBM is a comprehensive program that requires a strong leader, typically the CEO, to drive its implementation. Introducing the approach is an opportunity for a significant cultural shift and upgrade at the company. Within the roadmap, management must also plan times for collective discussions, sharing, and alignment involving the entire management team, in addition to communication and training sessions throughout the organization.

VBM is not just something to make the company work better. It is the key methodology in maximizing economic profit and, consequently, company share value. In fact, the firm's market value is directly linked

It is common for VBM adopters to fail to translate improvement plans into higher market value

Following buy-back announcements, financial analysts frequently revise their earnings forecast estimates upwards. An empirical study showed an average abnormal share return of 3.42%

Figure 2 – VBM Roadmap Example



to the present value of future company performance, measured as economic profit (Figure 1). Merely deciding to adopt VBM isn't enough. It is common for VBM adopters to fail to translate improvement plans into higher market value. The mismatch lies in two root causes: unrealistic hypotheses about planned future performance and secondly, the financial community's failure to recognize the company's fair value. This article investigates the second problem.

Active Shareholder Management

Some managers accuse the market of not being rational enough. We, however, believe that the problem is not an uneven playing field." The main source of mismatched market value to expected Economic Profit improvements lies in management's failure to properly communicate the firm's value to the external world.

Active Shareholder Management (ASM) is an innovative methodology to enhance company market value by managing key financial investors. The main goal of ASM is to develop a strategy that, given internal plans and results, maximizes value to shareholders. The ASM approach is based on Investor Segmentation, a tool to identify and understand major investors and, consequently, to manage them. Investor Segmentation exploits the breadth of increasingly available information channels in order to provide CEOs and CFOs with the elements required to target new investors and define an active and effective financial communication strategy. Investor Segmentation is based on a coordinated analytical effort. It can be carried out through various data gathering methods and market intelligence sources. Focused interviews with investors are performed to outline manage-

ment styles and behaviours. Desk research allows investigation of different investor strategies and clusters them homogeneously. Particular attention should be paid to investors holding significant assets in similar companies, which identifies the most relevant shareholders - including ones who currently do not hold positions and could stand to be further explored. With the identification of key investors in hand, managers are equipped to visualize the actions required to improve shareholder value. In fact, based on the ASM approach, managers can "test" their potential actions by simulating investor reactions with the help of mathematical models, and can therefore predict the impact on the share value. Future investor behaviour is a relevant input for business, financial, and communication strategy. Consider dividend strategy. Some investors do not "appreciate" dividends, many of these for tax reasons. Others do like them, for instance stockholders in low tax brackets who need cash from dividend payments or tax-exempt institutions that need periodic cash. Many investors are simply used to receiving dividends from a given company and would frown on any reduction. There are also investors who prefer companies that pay no dividends, channeling the money instead into ambitious



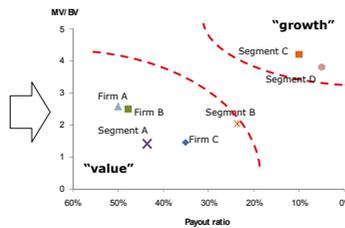
“growth stock” strategies. Other investors prefer more stable behaviors, typically “value stock” companies, where dividends are usually quite high and constant (see Figure 3 for a comparison of the strategies).

These preferences are often public knowledge and can heavily influence the actual portfolio strategy of fund managers. Awareness of this information can help managers better understand which investors would be attracted

Figure 3 - Growth Stock vs. Value Stock Strategy

Theoretic positioning ratios	
“Growth stock”	“Value stock”
High risk	Low risk
Delayed returns	Immediate returns
High MV/BV	Low MV/BV
Market needs for financing	Finance independence
Low payout ratio	High payout ratio

Low dividends	High dividends
High capital gain	Low capital gain



by their strategies. Buy-back operations and stock splits, common tools to increase company market value, must also be planned with key investors in mind, factoring in their needs and foreseeable reactions. Equity repurchasing can deliver a strong signal of management confidence in future performance. Following buy-back announcements, financial analysts frequently revise their earnings forecast estimates upwards. An empirical study showed an average abnormal share return of 3.42%.

Managers have to develop ad hoc approaches for each segment of investors identified. For instance, investors who rely on analyses based on “strategic” issues would prefer information regarding industry trends, competitive strengths, and new “growth stories”. Meanwhile, “finance-oriented” investors prefer data related to cash flow, operating profitability, and working capital returns. Communication actions such as preferred channels and frequency of

the meetings must be tailored accordingly.

ASM Implementation

ASM managerial methodology has not yet attained the popularity of VBM, mainly because investor management is usually restricted to the Investor Relations team, yet it should be a process that involves the whole organization. Many companies, including large corporations, manage investors with a highly qualitative approach, based on personal relationships. Analytics are rarely and poorly used,

which is a striking difference compared with standard sales and marketing activities and tools, that essentially help a company to sell a product/service to someone (a client, not an investor).

To create momentum for ASM implementation, a clear benefit case must be built. In addition to the advantages already described, a further key benefit of ASM is the opportunity for top managers to spend their valuable and expensive time more accurately. Deep knowledge of target investors improves focus: management can attend only the “right” events and meet only the “right” investors. In conclusion, value creation can be, and should be, measured analytically. It is an objective quantity, not a qualitative interpretation. Best Practices apply Value Based Management as a tool to manage internal processes with the aim of increasing the value created for shareholders. When improvements fail to be reflected in market value, management must work on communication strategies. Active Shareholder Management can be leveraged to influence market perception by delivering the right messages to the right investors, in a way that they can hear loud and clear.

Paolo Cervini - Associate Partner, Tefen VC Italy
 Alberto Totaro - Consultant, Tefen VC Italy