Chapter 1

Creating Value for Shareholders: From Measurement to Management

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Value, and managing for value, means many things to many people. Since managing for value is the most powerful way to enhance performance and create shareholder value, we need a clear definition of the term. In addition, to make value a day-to-day mind-set, we also need a way to link shareholder value to the everyday decisions that all people make within an organization.

Our link will be the process of managing for value. Managing for value is an organizational mind-set (e.g., information, processes) that helps align decision making with creating shareholder value. It is the foundation on which a pay-for-performance mind-set and shareholder-driven executive compensation design is built. The creation of shareholder value is the ultimate objective of any reward or incentive program design. This objective is particularly important if the program is for the most senior executives. When competing interests are at work, shareholder value creation provides a compass for decision making and design. A clear definition and working knowledge of shareholder value will provide our “true north.” Shareholder value is also a compass for good governance. The topics of governance, pay-for-performance and executive compensation, as well as performance measurement, target-setting, reward design, and communication, are subjects for later chapters in this book.

First we will start with a definition of value, and then we will show how a managing-for-value mind-set is the common thread. Only with this common thread can we identify what performance to measure, create reward programs that help strategy execution, and develop other people programs that change behavior and create alignment around the enterprise objectives.
2 Creating Value for Shareholders: From Measurement to Management

In this chapter we will start the journey, and we will:

• Create a simple, usable definition of value that managers can use every day
• Explain the basic concepts of using the definition as part of managing the business
• Describe how these can be applied every day

By the end, we will see that:

• Value matters
• Value can be managed on a day-to-day basis
• Value creation provides the grounding and line of sight for decisions and management
• Value provides the common thread to align decision makers and key business processes (e.g., reward strategy and performance measurement)
• A managing-for-value mind-set is required for the sustainable, long-term success of an enterprise as well as day-to-day decision making

Illustration

The working team was conducting an educational session for a broad cross-section of the employee population. This company’s value management program had focused on defining a clear corporate objective, establishing aggressive targets, defining a performance measure everyone could understand, and ensuring that everyone knew how each person contributed to making money. As part of the session, the team described how one “unit” of the company’s service generated revenue (everyone cheered), generated costs (everyone rubbed their chins), and then created profit (everyone was surprised at how little). The profit margins in this business were very thin, only making hundreds of dollars on tens of thousands of revenue. Then, from the back of the room, a hand went up. One of the most junior employees, just in his first year, observed that if this was the situation, he would reuse that paintbrush more than once, maybe several times. As the group then discussed the costs of this change, everyone quickly figured that in some cases this could be the difference between making money and not.

What did value and managing for value mean for this organization? Engagement and understanding that managing for value has personal relevance for everyone in the company.
1.1 What Value Is and Why it Matters

(a) Definitions of Value

Our working definition of value will be “market value added.” Therefore, an organization’s primary objective is to create returns above the value of the owner’s investment in the enterprise. From a shareholder (or equity holder) perspective, this return is measured by share price appreciation and dividends over time. For the manager of an enterprise, it represents the economic profit created over time. Economic profits are the returns after covering all expenses and the opportunity costs of the shareholders’ investment.

Four primary definitions related to value need to be understood in order to make this a workable concept for management. (See Exhibit 1.1.)

(i) Market Value Depending on the structure of the organization, this value will come through the appreciation of an ownership stake (e.g., share price) and dividends, if paid. From a public market perspective this is defined as market capitalization, or the book value of equity (BV) plus market value added (MVA).1 (See Exhibit 1.2.)

The book value of equity represents the shareholder investment in the enterprise. Book value of equity and market value of equity are observable from the external market. Therefore, at any point in time, we know the premium (positive MVA) or the discount (negative MVA) that is being applied in the market.

(ii) Market Value Added The MVA is the premium that shareholders put on the value of an enterprise above and beyond the book value of their investment. Management’s primary objective is to drive a positive and growing MVA over time. The source of this premium is determined by several factors, including market risk, competitor risk, current performance, expected future performance, and value of intangibles. Since our objective is to maximize this premium, we need to identify each factor’s contribution to value and then understand how to manage or influence the factors that have the greatest impact on value. This will be the first critical step in moving from measurement to management.

(iii) Book Value of Equity The book value of equity is the value of the investment in the enterprise by the shareholders as reflected on the accounting statement.

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1Market Value of Equity = Market capitalization or Market Value Added + Book Value of Equity

where

Market Capitalization = Share price \times Shares outstanding.
4 Creating Value for Shareholders: From Measurement to Management

Exhibit 1.1  Four Definitions of Value

![Diagram showing the definitions of value including Market Value (MV), Intrinsic or Warranted Value, and Book Value (Equity Capital).]

Source: Mercer Human Resource Consulting.

Exhibit 1.2  Market Value

- Market Value of Equity: $915m
- Market Value Added (MVA): $437m
- Book Value of Equity: $478m

MVA: The premium the stock market puts on the value of a company over and above the book value of its equity.

Source: Mercer Human Resource Consulting.
1.1 What Value Is and Why it Matters

Illustration

During the kickoff of a managing-for-value initiative with a midsize transportation company, a large sample of the senior management was interviewed on various topics surrounding strategic issues, organizational change, and their perspective on specific business processes, programs, and decision making in general. One of the questions asked was “When the CEO says, ‘We had a good year,’ what does he mean?” Twenty people were interviewed, and there were 20 different interpretations, which resulted in very fragmented focus. Some people were driving for new customers (at any price), others were holding the line on price, and still others were driving new service activities. If there had been the resources or strategy to do all of these things, great, but this business did not have that luxury and needed laserlike focus on broad tactics to succeed.

At this point it is important to distinguish the two different sources of capital that an enterprise can use for funding: equity and debt. (See Exhibit 1.3.) Our definition of market value includes equity capital—the money provided by investors. These investors demand a minimum equity capital level of return on their investment. The return required from equity capital is measured from market inputs (a definition of cost of equity follows). The other source of funds is debt. Debt capital investors require an agreed level of return, represented by an interest rate (Kd). This rate of return is determined as one of the conditions for providing the funds. Therefore, this expectation is measured easily.

(iv) Intrinsic Value and Economic Profit  At any point in time, the intrinsic value of a company can be derived from the discounted sum of future economic profits. (See Exhibit 1.4.) Discounting the future economic profit (EP) stream puts the value in today’s dollars. Using this definition of intrinsic value relies on a forecast of the enterprise’s economic profit stream over time, which defines the future returns from the business above the cost of equity \((Ke)^2\).

\[\text{Economic Profit} = \text{Net Income} - (Ke \times \text{Book Equity})\]
\[\text{Net Income} = \text{EBIT} - \text{Interest Expense} - \text{Taxes}\]
\[Ke = Rf + (B \times \text{Market Risk Premium})\]

where
- \(B = \text{beta}\)
- \(\text{EBIT} = \text{earnings before interest and taxes}\)
- \(Ke = \text{cost of equity}\)
- \(Rf = \text{risk-free rate of return}\)
6 Creating Value for Shareholders: From Measurement to Management

Exhibit 1.3 Enterprise Value: Two Sources of Capital

Source: Mercer Human Resource Consulting.

Economic profit represents the returns available to the equity investors of the business. In other words, it represents the returns to the investors after paying for the expenses of operating the business (e.g., cost of goods sold, Selling, General & Administration (SG&A), other overhead) and covering the expense for the equity investment. The expense of the equity investment (an opportunity cost) is a per-

Exhibit 1.4 Intrinsic Value of Equity

Source: Mercer Human Resource Consulting.
1.1 What Value Is and Why it Matters

centage of the total investment in the business as determined by the cost of equity. \( Ke \) is the minimum level of return required for the investor to be indifferent between this investment and a risk-free investment.

Combining the concepts of intrinsic value (an internal measure) and market value (an external measure) allows us to understand the shareholders’ expectations for performance beyond (or below) current and expected performance. (See Exhibit 1.5.)

(b) How a Business Creates Value

Let us consider for a moment the messages we can distill from these measures of value, starting with intrinsic value. When intrinsic value is different from market capitalization, this could mean several things:

- Investors do not understand how the business will create value in the future (intrinsic value > market capitalization). There may be a lag in the information or a credibility gap with the current management given past performance.
- Investors may see more risk in the current plan than management acknowledges and therefore will discount the future value (intrinsic value > market capitalization).
- Investors see more opportunity for the business than management (intrinsic value < market capitalization). For example, the investors may view the company’s industry as providing good performance and growth opportunities.

Exhibit 1.5 Shareholder Expectations for Performance

Source: Mercer Human Resource Consulting.
and therefore expect more from the enterprise. Or the company has not yet identified the opportunities required to meet shareholder expectations and the gap is real.

- Finally, at any one point in time, the two values may be different, given the volatility introduced by market risk and industry risk. But over time, market capitalization and intrinsic value should converge, so only systematic gaps should be of concern.

Drilling underneath our primary external measure of value (market value added) and our primary internal measure of value (intrinsic value), we then explore how economic profit signals value creation. Very simply, if:

\[
\text{Economic Profit} > 0, \text{ the business is exceeding the investors' minimum expectations (ROE} > K_e) .
\]

\[
\text{Economic Profit} < 0, \text{ the business is returning less than the investors' minimum expectations (ROE} < K_e) .
\]

In this characterization we are using \( K_e \) to represent the equity investors’ minimum level of required returns given the risk of this business (operating risk) and the premium required for making risky vs. risk-free investments (market risk premium). Therefore, if:

\[
\text{Economic Profit over time is} > 0, \text{ the business is creating value.}
\]

\[
\text{Economic Profit over time is} < 0, \text{ the business is destroying value.}
\]

What does a decision maker do with this next level of information? In other words, how do we turn this information into insight and continue the path from measurement to management? Using a characterization of value creation or exceeding minimum returns, we can think about simple implications:

- If Economic Profit is \(< 0\), the immediate and highest priority is to get the economic profit above \(0\). If this does not happen quickly, any growth in the business will destroy even more value since we will be growing an unprofitable business.

- If Economic Profit is around \(0\), the priority is much the same, although the business needs to be thinking ahead to prepare for growth and find ways to sustain profitable performance.

- If Economic Profit is \(> 0\), the highest priority is to protect this level of profitability and find ways to grow the enterprise (e.g., invest more to grow a profitable business).

Finally, there are four basic ways that a business will drive value:

1. Grow and/or enter economically profitable elements of the business. This could mean extending profitable products/services into new markets or
1.1 What Value Is and Why it Matters

adding services to profitable customers. It also could mean entering profitable new markets/products/services/customers.

2. Improve economic cost structure or margins. This might mean lowering costs, rationalizing assets, or investing in new ways to get economies of scale (lower variable costs per unit).

3. Exit unprofitable businesses where there is no possibility of creating economic profit over time and participation in this business does not support value creation in other parts of the business.

4. Reduce the risk on the business relative to competitors, thereby lowering the minimum return required by investors.

(c) Shareholder and Stakeholder Value

Shareholders are not the only ones with an interest in an enterprise. There are other stakeholders and each has different objectives and a different definition of value. (See Exhibit 1.6.)

For example, customers are looking for the best product or service at the best price. Employees are looking for job satisfaction, rewards, and learning opportunities. Each stakeholder is looking for different things.

Much has been written about the balance between shareholder and stakeholder objectives. However, research has demonstrated that in the long term, those companies that focus on and satisfy shareholder demands are also the ones that outperform

Illustration

Following a working session with the senior management team of his company, the president sat back and reflected. This company had been started and run by his father. Essentially he had grown up in this family business, which was now part of a public company. The working session had been about defining the value drivers of the business, or how the business made money. After thinking about what he had heard, he mentioned that he saw three things from his team after the day. The analysis and insight had:

1. Confirmed several of the priorities for the business
2. Reprioritized several items (e.g., some of his most important items were now at the bottom of the list)
3. Added some new high-priority action items

What did value mean for this CEO? Clarity, priorities, and consistency.
on delivering the stakeholder value. The reverse is not true. There are many recent examples, especially in the bull market of the late 1990s, of companies that did little to meet shareholder demands or deliver value for customers or employees, and eventually failed.

(d) Benefits of Focusing on Shareholder Value

There are two ways to understand how a focus on shareholder value is beneficial. The first is from the mind-set, decision-making, or process perspective. The other perspective is the fiduciary responsibility lens.

A shareholder-value driven mind-set and decision-making process is the foundation of how to manage for value. The benefits of approaching the management of an enterprise with this mind-set are multiple, and all directly relate to the clarity of decision making. Specifically, a shareholder-value driven mind-set includes:

- **Clarity on the enterprise objective**: Ultimately, everyone needs to understand why the enterprise exists, how it makes money, and what their role is in this process. Individuals need to understand how their day-to-day actions affect the overall outcomes of the business. Without this common perspective on the corporate objective, people will work in a fragmented manner (at best) and at cross-purposes (at worst).
- **Use of a common language (e.g., objectives, measures) for decision making**: A value mind-set creates a consistent vocabulary to talk about overall objectives and unite people behind an overall purpose. The common language is powerful since it translates the objective and decisions into words that are meaningful to people in their day-to-day activities.

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**Exhibit 1.6  Shareholder and Stakeholder Value**

Source: Mercer Human Resource Consulting.
1.1 What Value Is and Why it Matters

- Ability to make trade-offs in resource allocation: Having one clear way to evaluate decisions avoids competing and unproductive activity.
- Blueprint for change and ability to identify new opportunities: The ability of an enterprise to align behind a common objective and provide a common language for success enables the process of spotting new opportunities and empowers people to pursue them.
- Alignment of key processes: Each business process needs to send the same signals to people in the enterprise. If creating value is the desired outcome, the reward programs must pay for this outcome, the performance measures must explain the inputs to value creation, promotions must recognize value creators, and training programs need to provide the skills.

(e) Different Approaches to Estimate Value

There are several different approaches to estimating value. For our purposes we will focus on two of the most common approaches: spot value and discounted cash flow. Other approaches that we will not cover here include the option value method, which includes the risk-adjusted value of potential choice points over time.

(i) Spot Value

Spot value is determined using today’s results and inputs as a steady-state assumption and projecting the same performance into the future. There

Illustration

In another company, there had been different objectives between the research & development (R&D) and service sides of the business. The R&D people regularly pursued and allocated existing resources to the development of new technologies and services in response to customer needs. No one would argue with this focus on customer service, even when it took resources away from existing products. The field service people were focused on doing everything they could to improve the customer experience for existing customers. In many cases this required product refinements and redevelopment, especially if the issues were quality related. Here was the rub: new product development vs. customer experience. When the field service people went back to the office to refine current products, resources had been pulled on to other projects. This delayed changes that would benefit and solidify current customer relationships. If this situation did not change, the field service people would have been forced to continually look for new relationships only, since they were unable to respond consistently to the needs of existing customers.
are two ways to think about spot value: based on a market multiple or based on a growth model.

A spot value based on a market multiple can be calculated using a variety of multiples (e.g., market/book value, market/revenue). The approach is particularly useful when:

- Comparably valued companies can be identified and analyzed
- Economic profit is positive
- Detailed plan projections have not been developed

A spot value based on a growth assumption is another approach. For example, let us assume that we have a reasonably accurate estimate that the overall growth in our industry will be a nominal 3 percent per year over the next several years. We then can use this to estimate the future capital base or book value of our enterprise and then, assuming today’s level of return on investment, calculate a steady-state cash flow over time. Once again, in this case, economic profit must be positive, and there is no further detailed information on future prospects (e.g., timing of investments, competitor action, new market entry) so that a steady-state growth assumption is our best available information. In addition, we need reasonably good estimates of the weighted average cost of capital (WACC) and the fade rate in returns. The fade rate is the speed at which returns will converge to the cost of equity capital.

**(ii) Discounted Cash Flow** A discounted cash flow approach is more detailed. It requires a forecast of multiple years of cash flows before applying a steady-state assumption. The forecast period for the discounted cash flow approach will vary based on the level of information available and the business cycle. For example, a retailer may use a 5- to 7-year forecast cycle in order to capture the specific time period that covers the return on new store investments and refurbishments. On the other hand, a natural resource business (e.g., mining company) could use a 15- to 20-year forecast period to incorporate its knowledge of reserves, utilization of reserves, and future value.

### Formulae

**Spot Value—Market Multiple**

\[ \text{2003 EP forecast } \times \text{ market MVA/EP multiple } + \text{ 2003 beginning BV of equity} \]

**Spot Value—Growth Model**

\[ \frac{\text{2003 EP }}{\left( \text{Ke} - \text{EP growth rate} + \text{fade rate} \right)} + \text{2003 beginning BV of capital} \]

**Intrinsic Value**

\[
\begin{align*}
\text{Intrinsic Value} &= 2003 \text{ EP} / (1 + \text{Ke})^1 + 2004 \text{ EP} / (1 + \text{Ke})^2 + 2005 \text{ EP} / (1 + \text{Ke})^3 + 2006 \text{ EP} / (1 + \text{Ke})^4 + 2007 \text{ EP} / (1 + \text{Ke})^5 + \text{terminal value } / (1 + \text{Ke})^5 + \text{2003 beginning BV of equity} \\
\text{Terminal value can be determined as:} & \space 2007 \text{ EP} \times (1 + \text{EP growth rate}) / (\text{Ke} - \text{EP growth rate} + \text{fade rate})
\end{align*}
\]
### 1.2 Primary Forces that Affect Value Creation

This approach can utilize either cash flow or economic profit forecasts. The outcomes should be identical for the same assumptions.

Overall, estimating the value of an enterprise is a four-step process. (See Exhibit 1.7.)

#### (f) Key Messages

This section has covered several key themes that are the foundation of moving from measurement to management of value:

- A valuation reflects investors’ own views of the expected returns over time.
- Shareholder and stakeholder interests are aligned in the long run.
- Book Value is Shareholders’ Equity Capital.
- Market Value Added is the difference between the Book Value and the Market Value.
- Intrinsic value \((MVA + BV)\) is the present value of future economic profit.
- By increasing economic profit, we will increase market value added.
- “Managing for value” means aligning market value added with operating decisions, and we can use economic profit to help us.

#### 1.2 PRIMARY FORCES THAT AFFECT VALUE CREATION

Three types of primary forces act on an enterprise’s ability to create value. A clear understanding of these different forces is the next step in moving from measurement to management. A description of each structural force will provide the next set of clues to the value drivers of the enterprise. The value drivers are the actions

#### Exhibit 1.7 Estimating the Value of an Enterprise

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<tr>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
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<tbody>
<tr>
<td>Select Appropriate Technique</td>
<td>Decide Forecast Horizon</td>
<td>Estimate and Calculate Continuing Value</td>
<td>Discount Continuing Value to Present</td>
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- **Economic Profit**
  - Spot value based on market multiple
  - Spot value based on growth multiple
  - Plan value based on present value forecast period and terminal value

- **Discounted Cash Flow**
  - Decide how far into the future to estimate economic profit performance
  - Base forecast period on:
    - Available information
    - Industry
    - Economic life cycle

- **Market Value**
  - Based on available information, use the appropriate assumptions for the perpetuity calculation

- **Use the cost of capital to discount future performance to the present**

*Source: Mercer Human Resource Consulting.*
or decisions that we will need to focus on to drive market value added. The three primary forces we will focus on are:

Type 1 Sources of share price volatility—market, industry/competitor, business
Type 2 Current performance, expected performance, intangibles
Type 3 Growth vs. returns, elements of the organizational system

The next section gives an overview of how these primary forces support or limit an enterprise’s ability to create value.

(a) Type 1 Sources of Share Price Volatility

So far we have talked about what an enterprise can do to drive market value added directly. These are business-specific value drivers. However, two other factors drive the valuation attributed to any enterprise: industry risk and market risk. In many cases these two elements of secular risk can drive up to half of the movement in share price over time. We will discuss these elements in detail in a later chapter. For our purposes, a working definition of these factors is:

- **Market risk** is how movements in the overall market (e.g., Standard & Poor’s 500) act on the enterprise share price. In other words, when the market goes up by 10 percent, does our share price go up by 10 percent, something more, or something less?
- **Industry risk** is similar. When an index of competitor share prices moves, how does our share price react?
- **Business risk** is the remaining volatility. The source of this risk is the reaction to the enterprise’s performance and future expectations for that performance.

(b) Type 2 Performance and Expectations

Characterizing shareholder expectations is our next step to understanding the drivers of market value added and isolating the value drivers of an enterprise. Fundamentally, two elements in the enterprise’s control drive market value added: performance and expectations. In order to assign a market value added to an enterprise, shareholders are using all available information to evaluate the:

- Impact of current, or demonstrated, performance
- Expectations for future performance
- Contribution of intangibles (e.g., organizational systems)

An analysis of the contribution of these factors reveals that performance can account for a little over half the market value while intangibles account for the remainder. Intangibles are a significant source of value creation. (See Exhibit 1.8.)
Performance is measured easily and can be either demonstrated (current) or expected (future). Future performance is only one element of expectations; the other key element is the value of the intangibles, or the organizational system.

The impact of current performance is simply the most recent economic profit performance. The value of expected performance is the extension of current performance into the future. It represents the promise of performance beyond today’s results, in other words, value creating growth. The value given to this future performance is a subjective assessment based on the information the enterprise has provided to the market (e.g., new products, new customers, overall business strategy) and the assessment of the competitive landscape (e.g., market growth, competitor response).

Finally, there are the intangibles, or the organizational system. (See Exhibit 1.9.) The organizational system of the business translates strategy into shareholder value. The best performance, without an effective organizational system, will not sustain value-creating performance.

The organizational system is made up of several components:
Creating Value for Shareholders: From Measurement to Management

Exhibit 1.9 Intangibles: The Organizational System

- **Culture and values**: The grounding of any organizational system is the culture and values, or what the enterprise believes and what it aspires to be. Culture and values are distinct from the climate of the organization, or the environment in which people work. Culture and values are lasting and difficult to change. Climate is an evolving situation. Culture and values are deeply ingrained and, whether spoken or unspoken, are much harder to change. However, despite the qualitative nature of this element, culture and values are key drivers of an enterprise’s ability to put strategy into action.

- **Organization architecture**: This is the structure of the enterprise, including roles, responsibilities, and reporting lines. In addition to these formal lines and boxes, there are also key elements of authority and degree of centralization.

- **Human capital**: The most basic definition of human capital is the people and the people programs that an enterprise employs. At its simplest level, this includes how people enter the enterprise, work and develop, and leave the enterprise. In addition to this basic construct, other elements of human capital include feedback, training, and career pathing programs.

- **Work, processes, and information flows**: This broad category includes work flows, how decisions are made, how resources are allocated, technology, and communication.

- **Measures**: This is the language of the enterprise and how it will communicate and translate its strategy into action. Measures highlight what is important and define what is required to succeed. The next chapter talks about the use and development of performance measurement in detail.

(d) Key Messages

In order ultimately to define the value drivers of a business, we need to begin by understanding the primary forces that affect the enterprise. As we develop an understanding of each type of primary force, we take the next step beyond simply
measuring value and get closer and closer to understanding the sources of value creation and, therefore, how to drive the creation of market value added.

The Type 1 (sources of shareholder volatility) forces define the contribution of market, industry, and business risk to movements in share price. An understanding of the relative impact of each of these factors will influence our value creation agenda. For example, if market performance is a significant force, we should look at how we can redefine the market we compete in, set new ground rules, and change the economics and nature of competition. If industry risk is the key, then we should be looking at opportunities to drive our competitive positioning within the market in which we compete. Changes to competitive positioning may involve differentiation, pricing, and changes to relative cost structure. Finally, if business risk is the key, then we need to focus our attention on our performance regardless of the actions of others or the context of our industry.

The Type 2 (performance and expectations) forces are the items that help an enterprise change or create markets, industry, or business performance. For example, business performance is driven by actual performance and expectations.

The Type 3 (growth/return performance, intangibles) forces are current performance, expected performance, and intangibles. Both performance and effective organizational systems are required to deliver sustained value creation over time. The organizational system:

- Is generally the most expensive (but also the most valuable) asset the company has
- Is generally the asset that the company knows the least about (e.g., level of investment, productivity, reallocation)
18 Creating Value for Shareholders: From Measurement to Management

- Can be the most powerful source of strategic control (e.g., sustainable competitive advantage)
- Can be measured and quantified to determine how to better align human capital with business strategy
- Should be viewed as an investment with a required return

Understanding each type of primary force is a critical step on the journey from measurement to management. Building a fact base of measurable, actionable information is key. It is the only way to translate strategy into action.

1.3 LINK BETWEEN STRATEGY AND VALUE

Business strategy is the what and how of an enterprise. It is the first step on the path to valued creation. At its simplest level, strategy is the answer to three questions:

1. What product/service are we selling?
2. Whom are we selling it to?
3. How much will we sell it for?

However simple these questions, answering them in a unique way and creating value (i.e., making money) in the process is an ongoing challenge.

(a) What Is Strategy?

Strategy is defined by the interplay over time of market economics and competitive position. These two basic concepts, originally defined by Michael Porter’s research, are the playing field of strategy development.6

(i) Market Economics Market economics is the structure, or environment, that each competitor in an industry must understand and address. For example, the airline industry has been characterized by overcapacity, which creates intense pressure on costs and encourages price based competition. Several industry players have tried to change the overall economic opportunity by brand building and switching costs (e.g., frequent flyer programs), but the economic returns still tend to be limited, except for a few cases (e.g., Southwest, Alaska). The basic elements of market economics each act to support (drive up) or limit (drive down) the ability of an enterprise to make money in a specific industry. These factors in-

include five primary elements. Each can be further broken down to assess its impact on the profitability of the industry and what will affect it over time.

• **Intensity of competition**: Another way to think about the intensity of direct competition is to consider how many companies are competing for the same customer with the same product. When thinking about how to answer this question, consider that:
  — A large number of competitors will reduce the prices that any one company can charge.
  — Limited differences between products will further intensify the pricing pressures.
  — Switching costs are psychological or economic barriers that make it difficult for a customer to choose a competitor (e.g., shipping costs might make a supplier across the street more attractive than one across the country).
  — Low growth will make it difficult to find new customers or markets.
  — Exit barriers prevent competitors from leaving the industry (e.g., highly specialized equipment with little resale value).

• **Buyer power**: When thinking about buyer power, the other key factor, consider how important the product is to a customer and how much the customer is willing to pay. Then consider:
  — Very few potential customers (e.g., auto manufacturers are the only buyers) will result in significant negotiating power.
  — Product differentiation will be important only if the differences have meaning to the buyer.
  — Low costs to switching will allow buyers to seek the best price.
  — Substitute products make it possible for buyers to find completely different products that meet their needs.
  — Products that result in significant cost improvements or other competitive advantages for buyers will be more important to them and are likely to receive a higher price.

The other three forces are limiting factors, which essentially cap the performance or returns possible from an enterprise. Each acts in its own way:

• **Potential entrants**: Low barriers to entry will lead to a significant increase in competition should an industry be seen as very attractive.

• **Supplier power**: Suppliers with a great deal of bargaining power over the industry will seek to take a share of the profits for themselves.

• **Substitute products**: The availability of other products that may potentially meet customers’ needs will limit price increases (customers will weigh the price/benefit trade-off) and increase buyer bargaining power.
Other factors may have a significant influence in how returns play out, but are very dependent on the industry. These include:

- **Government regulation**: Regulations create significant barriers to entry in the utilities industry. Environmental concerns may increase the costs of doing business for manufacturers. International trade policy can open new markets or bring in new competition.
- **Technology**: The use of technology can create product differentiation, reduce costs, and so on. Technical innovation can reduce barriers to entry. Changes in technology may make certain products obsolete or increase the attractiveness of substitutes.
- **Macroeconomic factors**: Competition may become more intense for certain industries during a recession.

Finally, there is a relationship between market economics and profitability and the ability to generate returns over time. For example, when there is high:

- threat of new entrants,
- intensity of competition,
- bargaining power of buyers,
- bargaining power of suppliers, and
- threat of substitutes,

there is downward pressure on profitability and a good chance that the market/industry is economically *unprofitable*. When there is low:

- threat of new entrants,
- intensity of competition,
- bargaining power of buyers,
- bargaining power of suppliers, and
- threat of substitutes,

there is upward pressure/support for profitability and a good chance that the market/industry is economically *profitable*.

**(ii) Competitive Position** Competitive position generally can be broken down into differentiation and relative economic cost position.
1.3 Link between Strategy and Value

Differentiation is how a company offers a unique product or service to customers, and includes several potential sources:

- Establish differentiation which generally results in a price or volume advantage.
- Create new product offerings that can be very broad, full service, or highly specialized.
- Review customer segmentation that will identify a focus on meeting specific customer needs.
- Investigate geographic distribution which can reach customers otherwise overlooked.

Relative cost/asset position affects how much money a company can make relative to competitors. A lower cost/asset position will allow a company to receive superior returns even with limited differentiation or, for the same volume, be able to earn higher margins. There are several potential sources:

- Economies of scale: where size may create unique advantages not available to other competitors.
- Technological innovation may create a lower cost structure than competitors.
- Unique access to low-cost supplies.
- Highly efficient operations.

(b) Strategy’s Role in Supporting Value Creation—Business Design

The process of developing a strategy is one step in the business design process. A truly differentiated strategy development approach takes the fundamental elements of market economics and competitive position, and creates a total design based on the insights. Based on the research and experience of my colleagues at Mercer Management Consulting, a robust business design includes:

- Customer selection and a value proposition: What high-value customer opportunity is targeted? With what differentiated value proposition?
- Value capture and profit model: What profit model is used to capture value? Where does high profit happen? How do we expand there?
- Scope: What activities must we perform (vs. others)? What assets must we own (vs. others)?
- Strategic control: How can we maximize the sustainability of future cash flows?
Once these four elements of business design are defined, a link is developed to the organizational system and the specific people programs, processes, information, and structure needed to execute the business design.

Strategy and business design play very important roles in the process of value creation. Once the overall objective of the enterprise is defined, the business design provides:

- A road map for change
- The basis for resource allocation
- A way to evaluate success

**(c) Key Messages**

Strategy is the what and how of a business. At the level of business design, it is part of creating a unique competitive advantage for an enterprise. Market economics and competitive position are the fundamental building blocks of strategy and business design. In addition, by describing the enterprise in these terms, we develop a “strategic mind-set,” even if we are not developing a new strategy.

This is the first step to redefining a strategy and identifying new value-creation opportunities. On a day-to-day basis, it also helps us move from measurement to management. This characterization gives management the context, questions, and insight needed for the best operating decisions. A strategic mind-set is fundamental since it helps people answer four basic questions:

1. How the enterprise “works” today
2. How the enterprise will “work” in the future
3. What the enterprise will do next
4. How the enterprise will make it happen

If decision makers can walk around on a day-to-day basis with cogent responses to these four questions, they will be well grounded for developing a managing-for-value mind-set.

**1.4 A MANAGING-FOR-VALUE MIND-SET**

So far we have measured value, measured movement in share price, and characterized market economics and competition position. Also, at each step we have talked about implications. Now we need to make this information and insight actionable on a day-to-day basis. This is where managing for value plays a role.

Managing for value is a managerial mind-set of translating shareholder objectives into day-to-day decisions. (See Exhibit 1.10.) It is decision making and busi-
ness processes working together to achieve the corporate objective and execute the business strategy. Performance measures are the language of a managing-for-value mind-set.

In other words, managing for value is:

- **A way of thinking**
  - The primary objective of any business is to maximize the equity value it creates for the shareholders.
  - Shareholder value can be managed on a “day-to-day” basis by the managers and all employees of the business.

- **A decision-making process**
  - Decisions must address the long-term economic trade-offs between returns and growth.
  - The decision-making process must include the identification and evaluation of alternatives.
  - The best decisions create the most long-term equity value for the business, thereby maximizing market value added.

- **A way of managing**
  - The building block business processes of strategy development, resource allocation, performance measurement, performance management, and rewards must be aligned and integrated.

Exhibit 1.10 Managing for Value: A Managerial Mind-Set

Source: Mercer Human Resource Consulting.
A managing-for-value mind-set is also something that exists on the level of the individual, not just the enterprise. Individuals with this mind-set understand:

• How their decisions and day-to-day actions contribute to the value creation of the enterprise.
• What drives the value of the enterprise and how the enterprise makes money.
• How to systematically recognize new value-creation opportunities and allocate resources accordingly.

Whether at the coal-face or on the shop floor, it means understanding the part one person plays in making money for the enterprise.

The process of developing a managing-for-value mind-set is a journey from awareness to accountability. (See Exhibit 1.11.) It is not a single communication, training session, mandate, or initiative. It is a change process that becomes an ongoing part of the enterprise’s cultural fabric.

The first steps on this journey are varied, but usually start with measurement of value and an understanding of the enterprise’s objective. This is a data-driven approach. Other enterprises might decide to start with a broad education and training program given how their culture responds to change. Each enterprise is unique, and so is every managing-for-value program.

The transition to awareness begins when information evolves into insight. Insight then can lead to impact. Once the people of the enterprise see that they have

Illustration

For one organization, the process of identifying new opportunities really went to the shop floor. In this beverage company, technology had been a significant driver of improvements over time and particularly when it came to throughput. The enterprise had continued to invest in new high-speed and customizable machinery to respond to increased demand and the ever-increasing variety of packaging in the market. However, no one had given any thought how to leverage the improvement in the precision of fill-levels in the new equipment over time. It used to be that you overfilled by 10 ml to ensure that you matched your stated size; now you only needed to overfill by 3 ml. Over a year, and hundreds of thousands of liters of production, this made a significant difference in raw material costs. Just imagine the extra bottles or cans that could be filled with this additional volume. Who spotted this opportunity? The second-shift canning line supervisor who had just been through a quick introduction to a managing-for-value initiative and a new performance measure for the enterprise.
the ability to affect the results, the process of institutionalization has begun. Key processes are aligned, information is shared, rewards are linked to value-creating actions, and decision makers begin systematically to identify new opportunities for value creation.

(a) Key Messages

Managing for value is a mind-set that links day-to-day operating decisions with shareholder value. Managing for value is not a new performance measure, a new strategy, or a new business management process, although each of these plays a role. Managing for value is about creating alignment and consistent signals. It is different for every enterprise. Finally, managing for value is a journey, not an initiative.

1.5 VALUE DRIVERS

There are many definitions of value drivers. However, if we are using value drivers in the context of a managing-for-value effort, they must fulfill several specific roles, including:

- Provide an insight on opportunities for value creation and facilitate the ongoing strategy development process
- Help prioritize resource allocation and decision making
Creating Value for Shareholders: From Measurement to Management

So far we have talked about Type 1, 2, and 3 external forces. At some level these are value drivers since they help an enterprise diagnose and focus on key priorities and sources of value creation (e.g., impact of growth vs. returns, what shareholders expect, how we organize). At this level, these drivers are actionable only by senior leadership and on a large scale. It is true that everyone participates, but only a few are responsible. For our purposes, value drivers must be the language of the masses.

Value drivers can be thought of as:

- “Input” factors with a significant influence upon a company’s value
- A way to tell the story of the strategy
- Actionable leverage points
- Unique customer propositions
  - Serving specific customer segments
  - Providing certain products/services
  - Bundling of products/services into a “customer solution”
  - Serving specific geographical areas
- Differentiated business processes
  - Streamlined process
  - Focus on core processes
  - Organizational development

In other words, value drivers are the operating behaviors and financial results that have the most impact on creating shareholder value. A clear definition of the value drivers highlights the most important day-to-day decisions for managers, thereby improving line of sight. Knowledge of value drivers helps individuals:

- Answer the question “What do I do differently today?”
- Understand their role in creating value.
- Make high-level business strategy actionable.
- Identify metrics that have a demonstrated and meaningful link to the eventual creation of shareholder value. Once identified, they can be incorporated into incentive plans, strengthening the link between shareholder and employee experience.
- Provide a foundation for evaluating the current business strategy and identifying new opportunities for value creation.

Through identifying the financial, operating, and activity-related drivers of value creation, we bring the shareholder value objective into the daily life and decisions of the people who run the business. Add this up across all of the individuals and all of the roles, and the impact is across the total business.
1.5 Value Drivers

Illustration

During a working session, the senior management team was reviewing the product profitability across the business portfolio. To date, they had operated under the working assumption that the enterprise needed more and more high gross margin products. This was the path to growth. As we reviewed the outcomes of the analysis, they discovered that a high gross margin did not imply a high product profit. In many cases, the opposite was actually true. It was only when they drilled underneath the highest-level forces (e.g., growth vs. returns) that they understood the real drivers were speed of new market penetration and level of rework. What did value and managing for value mean for this organization? A new mind-set on how to create value and the need for a new strategy.

One way to develop and then represent this continuum is through a combination of financial and value chain analysis. We can develop a picture that creates a link between managers of the business and shareholder value. This is the analysis that brings shareholder value to the shop floor and gives people something different to do on Monday. (See Exhibit 1.12.)

Defining the value drivers of an enterprise is a critical step in:

- Understanding how the business makes money
- Creating a common language for value creation

Exhibit 1.12 Financial and Value Chain Continuum

| Source: Mercer Human Resource Consulting. |
(a) Key Messages

Value drivers are the engine of managing for value and focusing on value as the overall objective. They are the last step in moving from measurement to management. Without this last step, our process of measurement would be like laying the cable down the neighborhood streets and not connecting any of the houses to it. Value drivers are the “last mile” of shareholder value and a managing-for-value mind-set. Value drivers are also dynamic. As strategies, markets, and competitors change, so will the value drivers. This makes identifying value drivers a core skill.

1.6 CONCLUDING THOUGHTS

Through this chapter we have developed a detailed understanding of what value means, how to measure it, and the insight we can gain from knowing this information. The detailed definitions and measurement create the awareness we need to start our managing-for-value journey. Our awareness works through three major areas:

1. Measurement of value creation (market value, intrinsic value)
2. Sources of value creation (Type 1, 2, 3 external forces)
3. Value drivers (financial, operating, activity drivers)

The use of performance measures as part of this system is critical and will be covered in the next chapter. This information is the foundation for the accountability each enterprise must develop. This information provides the foundation to move from insight to impact, and from measurement to management. A managing-for-value mind-set drives us down this path. It is the foundation of creating alignment in mind-set, decision making, and business processes. From here we can work to align our people processes and programs in a way that adds additional value to the enterprise and becomes a source of value creation through the intangible value included by investors in every market value added.

Remember, the journey is not just the steps; it is a lifelong pursuit.

1.7 CASE STUDY: GLOBAL FINANCIAL INSTITUTION—CREATING THE FUTURE BY MANAGING FOR VALUE

FinCo is a global brand name with millions of customers and a presence in multiple countries around the world. At the time it realized it needed to improve its
value creation capabilities, it was a highly valued company and a leader in the global growth of financial services.

At this point, there was an important reevaluation taking place. Despite an outstanding performance track record and historical share price performance, the new chief executive officer (CEO) believed it should go much higher. Very soon after reporting the largest profits of any institution at that time, the new CEO delivered his message: “This result does not guarantee our success, it is a reflection of our efforts to date. We need to find ways to create value in the future, or others will step in and create it for our investors.”

FinCo’s challenge was to create a strategy that augmented their evolution, but also instilled a style of managing that focused on shareholder value. The new CEO reflected further, “We had a strong enterprise and culture. These served as the foundation as we looked to leverage the company’s strengths. The whole process of change was called Managing for Value (MFV).”

Overall, FinCo wanted to create and communicate a broad strategy throughout the company. It also wanted to clearly establish what it meant to work with and at this company. In order to get the process started at FinCo, it created a pilot program and ran a trial with selected executives. The program was highly customized to match the strategy and culture of FinCo and translate MFV from concept into actionable steps for a worldwide audience.

For FinCo, MFV meant two things:

1. Thinking about everything in the organization in terms of shareholder value
2. Beginning to measure everything from an economic value perspective

The message needed to be simple, and it was not about fixing the business—it was about driving it to new heights. In other words, it was essential that the corporate “brain” was wired in a common way.

The tailoring of MFV for FinCo was the critical step. Several key initiatives were launched to create this customized approach, including:

• Working with trainers in each of the company’s major business units, a modified MFV message was developed to incorporate into ongoing training
• Delivering a significant number of local sessions around the world to communicate an ongoing message to middle management
• Creating an MFV booklet that took the imperatives of the program and put them in easy-to-understand language about what it means in day-to-day practice; a major application of this booklet is small, local working team meetings and brainstorming sessions
• Developing a training/introduction program for new hires around the world

In addition, the messages of MFV needed to be integrated into other key processes in order to align the day-to-day workings of the organization with the
overall objective. This required changes to the reward programs as well as performance measurement and planning systems.

After all of these initial changes, and a year into the process, FinCo is still at the beginning of the journey. The destination has been identified, real progress has been made, and new opportunities are emerging. Many of these new opportunities are only apparent given the MFV mind-set. It is a continuous, dynamic process.

Overall, individuals embraced the concept. The key group of middle managers understand the enterprise objective, have a common language of success, and understand what they do, and need to do, to add value to the business. The strongest outcome has been how it has focused the company on what needed to be done. It created focus, and that is critical in a global, decentralized, and diverse organization.