

Value Based Management : The shareholder comeback

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One of the fundamental trends in contemporary capitalism is the tendency to replace managerial capitalism by investor capitalism¹. This new situation leads to a return to the forefront of professional investors who, little by little, succeed in imposing new behaviour and new strategies on companies which result in ensuring the shareholders have a rate of return on their investment which corresponds to their profitability demands. The maximisation of shareholder value thus becomes the companies' essential objective.

This revolution is beneficial because it is centred on the basis of the company's strategic action. For too long the growth in market share and research into critical size have been used as alters on which anything could be sacrificed. In reality, growth is acceptable and lasting only if it is profitable and comes hand in hand with a management of the invested capital which is as rigorous as possible. Growth, efficiency and capital avoidance are the three conditions for a balanced and value creating development.

In order to be in a winning position on a long term basis, the company must never forget that it has to fight in two battlefields, the market for goods and services and the financial market, and that its continuity depends on its capacity to be the best in both markets. Therefore the essential management criterion becomes the economic profitability of the assets in place², a profitability which must be compared to the cost of capital which represents the profitability demands of the fund providers. The bigger the difference between these two important indicators, the greater the value created by the company.

With the exception of certain privileged competitive sectors or situations, the creation of value does not take place by chance. It is centred above all on the company's capacity to create and maintain competitive advantages. It results from a deliberate policy which is expressed through the implementation of an organisation, processes, performance and measurement tools which specifically take into account the creation of value.

This holistic conception of management which aims to modify the means of decision taking and to change the culture of the company is known as Value Based Management. Its implementation offers those companies which adopt it a considerable strategic superiority as shown by numerous examples (Coca Cola, Walt Disney, Allied Signal.....).

Faced with this evolution which has had a far reaching effect on Anglo-Saxon capitalism and which, over the last months, has touched Rhineland capitalism, French companies have not

¹ Michale Useem, « Investor capitalism », BasicBooks 1996

² Operating income after tax divided by the amount of economic assets (net fixed assets and working capital needs).

yet taken stock of the necessary transformations, although they are considerably behind in this domain³.

Certainly many have introduced the notion of shareholder value over the last few months in meetings with financial analysts. But this will not be sufficient to convince the financial community, in particular its international component. The market is waiting for real action in this domain, and the adjustments in progress will prove brutal for those companies which attempt to make do with face value measures.

The implementation of a veritable value based management touches many areas of management :

- The financial system has to be totally reconsidered. The diversity of the strategic and financial objectives within a company leads to incoherence and dissipation of efforts. This should cede the way to a unified system around a measurement which is representative of value (such as economic profit⁴). All performance based indicators, even if they are not financial or qualitative, must be chosen on the basis of their contribution to the creation of value or of their importance in the creation of competitive advantages.
- Value based management tools must be diffused, and an adapted training policy must be provided at all the company's decisional levels. These tools enable the managers to identify the key elements in the creation of value and also to measure the consequences of their decisions more effectively. The implantation of these tools is a powerful vector for change management.
- The value creation processes must be given special attention. The same goes for strategic planning. The creation of value begins with good strategic decisions, that is to say those which bring competitive advantages. In the same way, all the action plans and budgets must fall within this perspective. Value based management is also the return of strategy within the company. Lastly, all investment choices (in particular acquisitions) or divestment decisions must be taken with a value creation perspective, as these are the most critical in this respect⁵.
- The financial policy has to be modernised. Thus a mature company which presents insufficient valorisation must not hesitate to go ahead with a study on strong decisions such as buying up shares, a split off of its activities if they are too diversified or even a more aggressive dividend distribution policy. The financial leverage as « creative discipline » must also be more systematically studied.

³ For the period 1991-1995 the rate of return offered to shareholders amounted to 9% in France, compared to 12% in Great Britain and 15% in the United States.

⁴ Economic profit is the difference between the operating income after tax and a capitalistic charge which is destined to remunerate the fund providers. This capitalistic charge is calculated by multiplying the company's opening economic assets by its cost of capital.

⁵ All surveys show that the acquisition of companies mostly lead to a destruction in value particularly due to an insufficiently planned or supervised integration process.

- The relations which the companies have with the market must also be reconsidered. The financial communication will undergo far reaching transformations. It will have to integrate a strong marketing dimension ; in the future, the managing director will have to select his/her shareholders, listen to the market expectations and send them clear signals as to the main actions he/she intends to take.
- The means of remuneration of course constitutes the backbone of the system : numerous American companies have established a bonus system which is based on value creation. They aim at transforming the managers into owners in order to align managers' behaviour with the shareholders' objectives. To reach maximum efficiency, they must be stretched to cover all the company's levels. Of course, although these criteria used to fix the bonuses must be linked to the value creation, they must also be manageable by the interested parties : they must not therefore necessarily be based on purely financial elements.

These transformations will require a modification in cultural and professional approach on the part of top management. The latter will first have to agree to submit their performance to the judgement of the market and to organise a better balance of the powers within their company. Then they will have to acquire new skills : understanding of financial markets, mastery of valuation and financial engineering techniques, acquisition of commercial qualities in order to promote the companies' financial securities. This latter skill is necessary to pass from the status of buyer of resources to that of seller of securities.

The work site is immense, but so are the stakes. How can a veritable value based management be implanted ?

First of all it is indispensable to perform a precise diagnosis of the company, analysing for each strategic segment its value creating (or destroying) status. This work is accomplished on the basis of business plans, sector based comparisons, market data to calculate the cost of capital in each sector, and analysis of the principal value creating processes (investment policy, allocation of capital, performance management, etc.....). It also includes a study of the central services' contribution to the creation of value (financing policy, tax optimisation, ..).

This diagnosis makes it possible to feed the company's strategic discussion on its activity or product portfolio. In fact, on the basis of each sector's value creation capacity, the synergies between them, the invested capital and risk they present, several options are possible : reinvest, diversify, rationalise, maintain or divest.

This diagnosis, which needs to be performed regularly, must naturally be completed by the implementation of a value based management at all the company levels. The challenge of this approach requires that in-depth preparatory work be completed upstream of the implantation of the new system. In fact, the success of such an approach depends on a precise determination of the means of implantation for each operational unit, whatever its level within the group.

The definition of the means of implantation is based on the three dimensions:

- The degree of sophistication of the system of indicators used, which can be simple (one indicator, such as economic profit for example) or detailed (several

qualitative and quantitative indicators), this choice having an impact on the nature of tools to be set up ;

- The degree of implication of the operational teams in the implementation and functioning of the system, which may be imposed by Management or participative ;
- The level of use of the indicators set up : are they indicative or do they constitute a fundamental element in the assessment of the performance of the operational teams ?

The success of the operations depends on several elements : a high level of commitment on the part of the general management, a rigorous project management, tools which are simple but solid from the financial and strategic point of view, the use of change management techniques and mobilisation of the personnel.

The implantation of value based management within a company is a major project, as it aims to transform the decision making processes and requires the mobilisation of the personnel around a federative concept. At the intersection of the organisation and processes, finance, strategy and change management, the implementation of the overall system is a condition precedent for the strategic success of the companies of tomorrow. If French companies do not yet feel forced by their shareholders to enter into this logic, tomorrow they will be obliged to do so in order to resist the increasing pressure from their foreign competitors which, for their part, will have known how to handle this turning point.