



# How to operationalize Value creation process

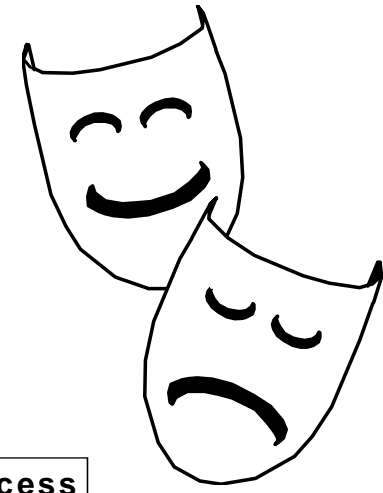
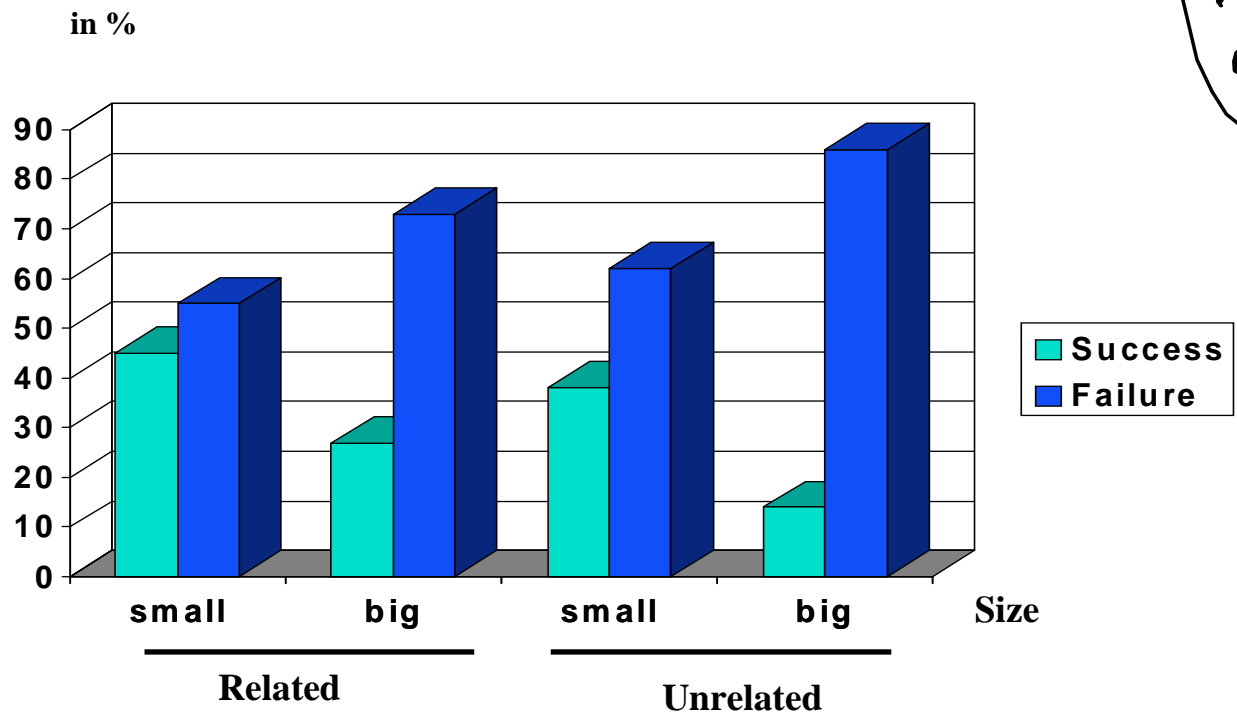
*Séminaire Rencontre d'Affaires*

*26 novembre 1998*

*Jean-Florent\_Rerolle@ernst-young.fr*

*01.46.93.65.88*

# A bad news : the buyer destroys value



Source : McKinsey

# Four traps need to be avoid

- Overestimation of the actual performance
- Overstimation of the buyer abilities
- Irrationality in negotiation
- Poor integration

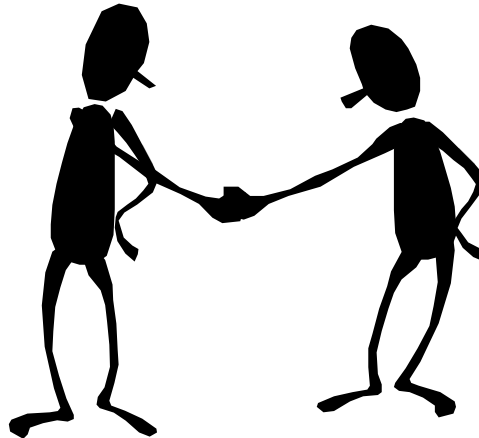


# Valuation plays a triple role

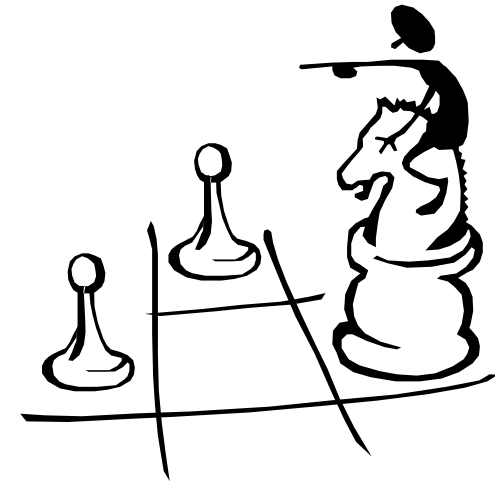
Decide



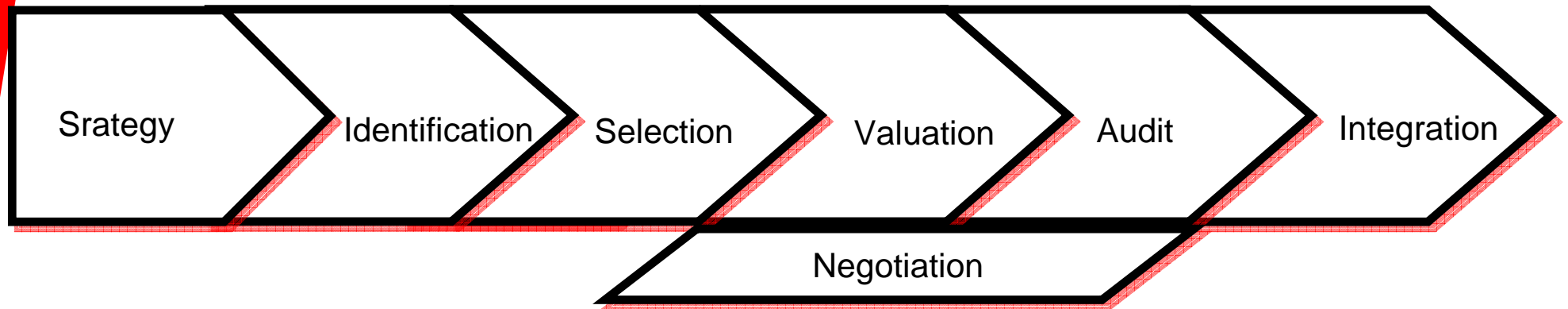
Negotiate



Build



# Value generation acquisition process



- Objectives ?
- Constraints ?
- Industry ?
- Localisation ?
- Candidates' type ?

- Attractivity ?
- Disponibility ?

- What value ?
- Which price
- How to increase value ?

- How to deliver ?



# Agenda

## *A new value environment*

- Value is n°1 priority ...
- but is increasingly difficult to create

## *Our value mindset has to change*

- Understand shareholders...
- and Act accordingly



*A new value environment*

# Shareholder Value ranks n°1 in CEOs' agendas



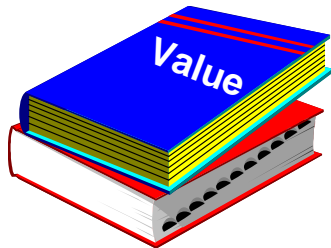
## *Financial Community*

- Institutional investors
- Analysts
- Financial Press



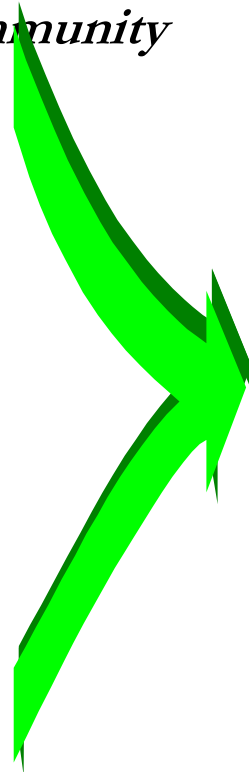
## *Compensation*

- Stocks options
- Value based bonus



## *Education*

- Books
- Conferences
- Studies



Share  
price  
focus

## *Value Communication*

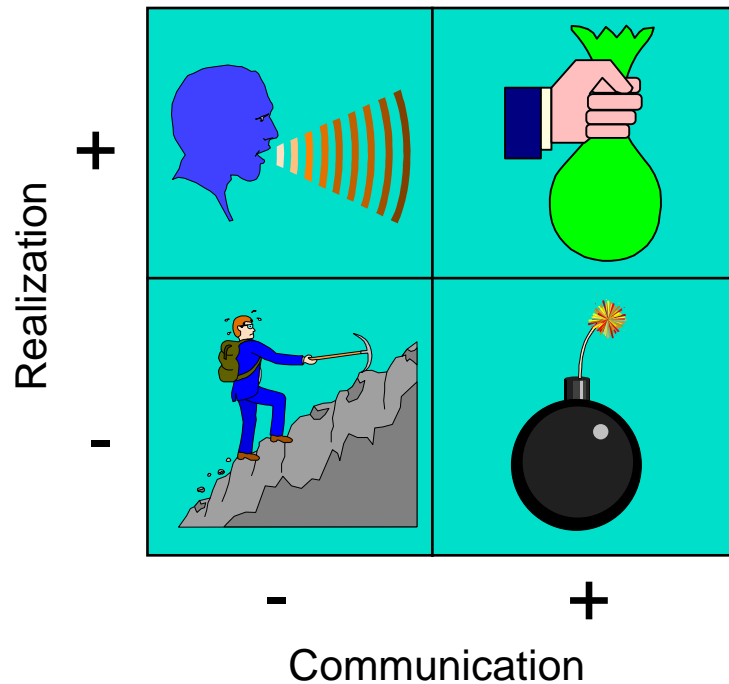
- Share price
- Enriched Information
- Investor relations



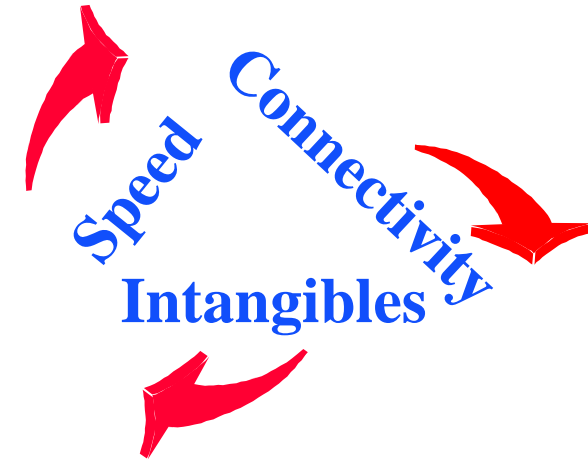
## *New Internal Indicators*

- Cash based
- Assets based
- EVA / CFROI
- TSR

# ... but value creation is another story



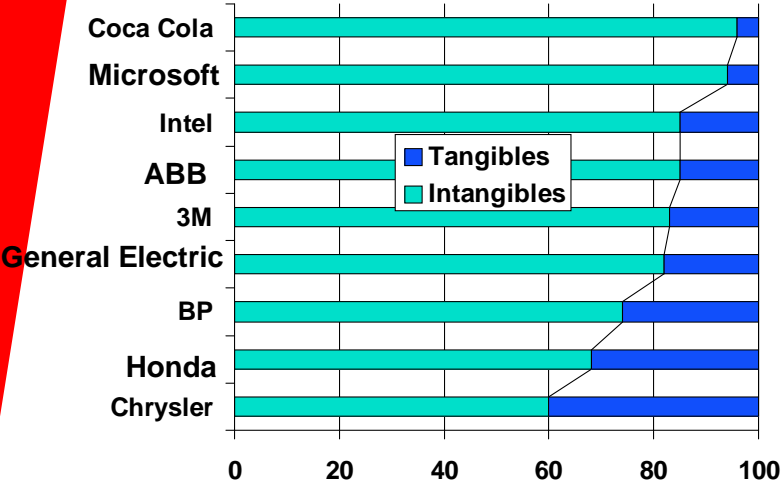
A majority of companies is in the wishing thinking quadrant... which is a mined road



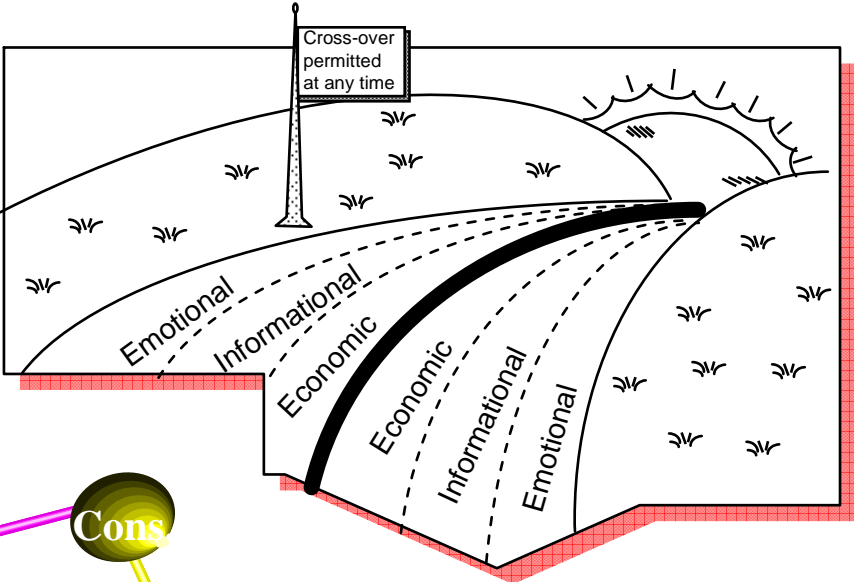
... and at the same time, Value is becoming harder to

- Create
- Define
- Monitor

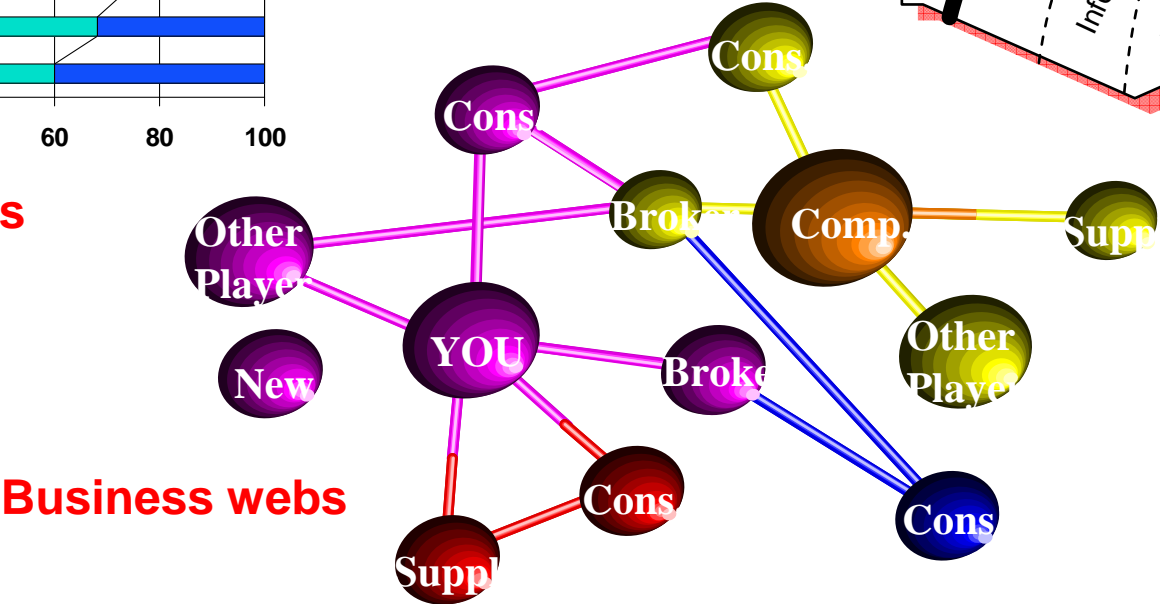
# The new economy challenges our traditional mindset



**Intangibles**



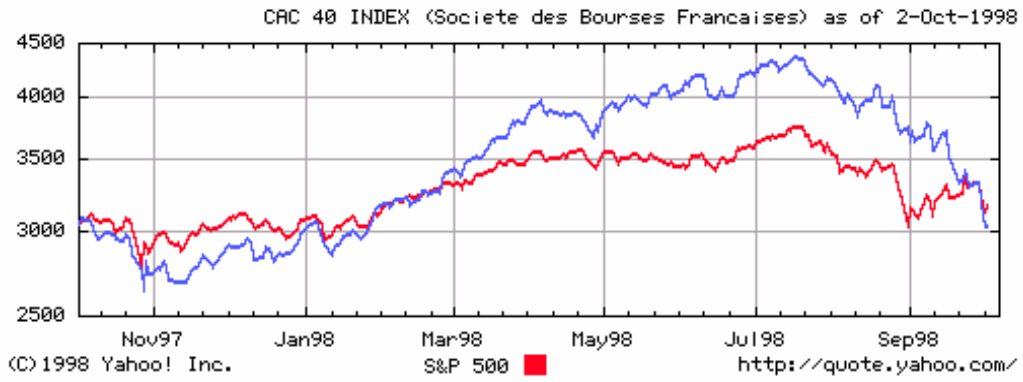
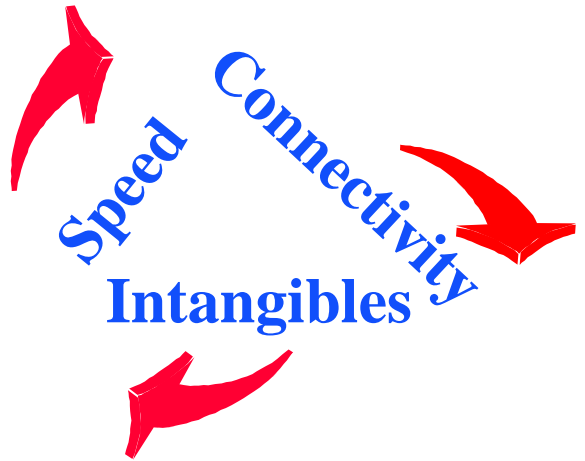
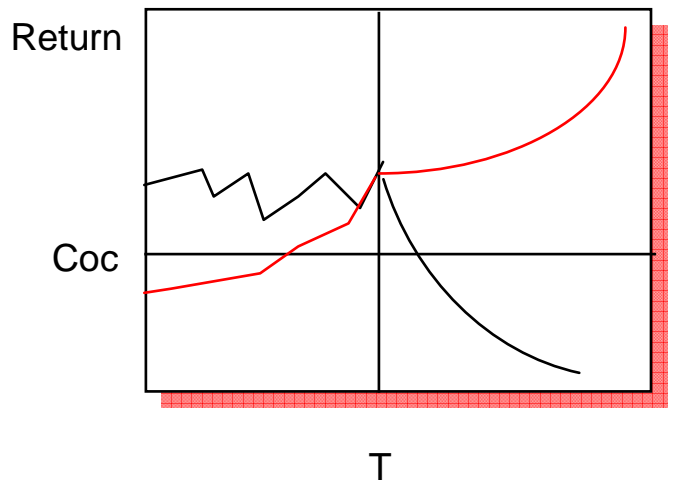
**Exchange**



**Business webs**

# Value is becoming harder to create

## Increasing returns



**Increasing volatility**



# Value is becoming harder to define

## *Which cash flows ?*

- Any product shall increasingly include services
- Emotional and informational content of the exchange
- Profitability is more volatile as real markets mimic financial market
- Growing intangible real capital

## *Which perimeter ?*

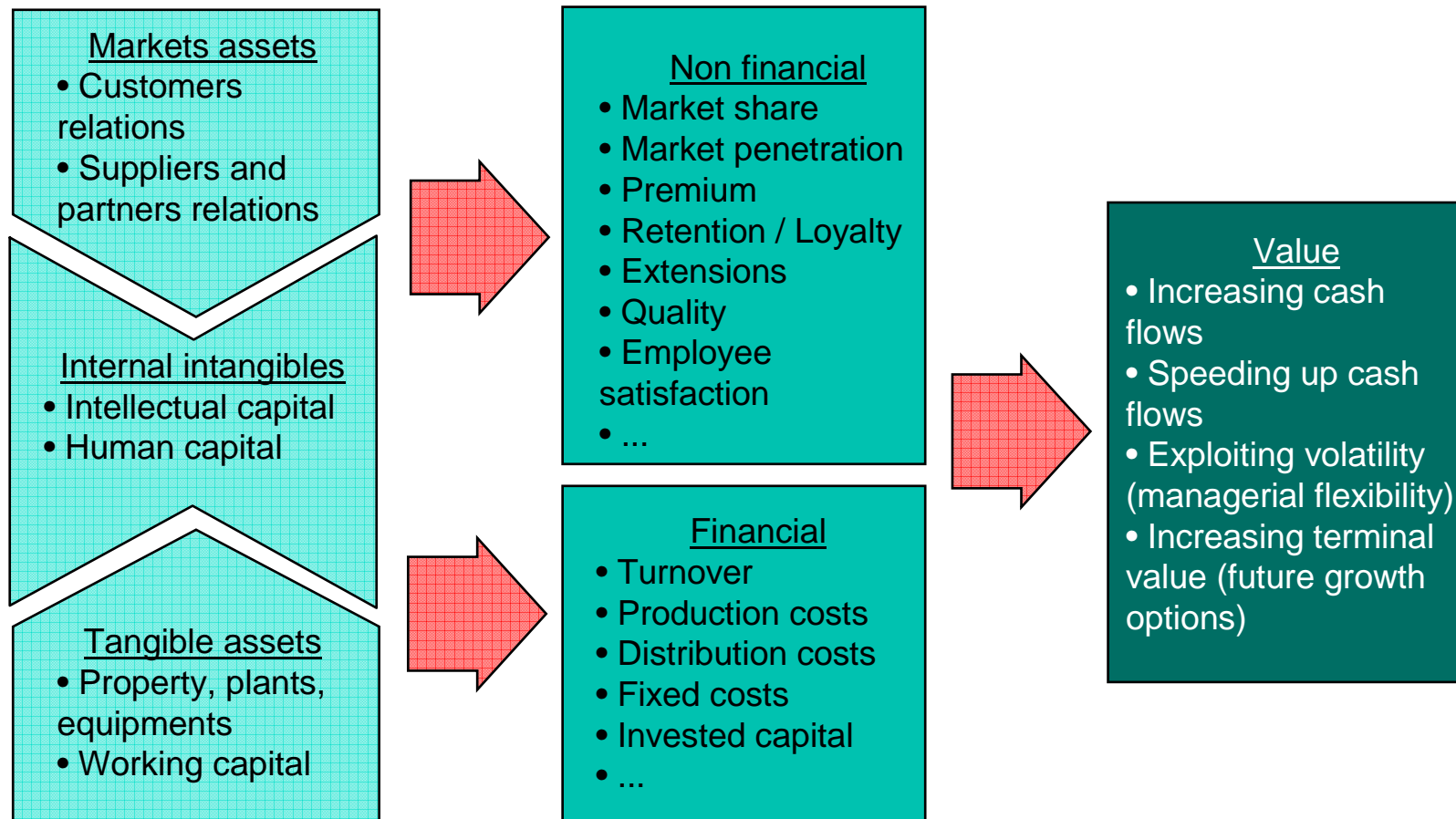
- Blurring boundaries

## *Which competitive advantage period ?*

- Increasing returns
- Managerial flexibility
- Speed accelerate value migration

Value is getting blurred!

# Value is becoming harder to monitor





*Our value mindset has to change*

# A systematic approach to focus on value creation

*Analysing*

- Strategic value assessment
- Risk assessment (Wacc)
- Financial market analysis (MTM, Expected Rate of return)
- Value creation key processes
- Value IPD

*Aligning*

- Financial tools
- Value scorecards
- Decision processes
- Training & communication
- Compensation
- Strategic infrastructure (CC, IT...)
- Risk management
- Corporate Governance

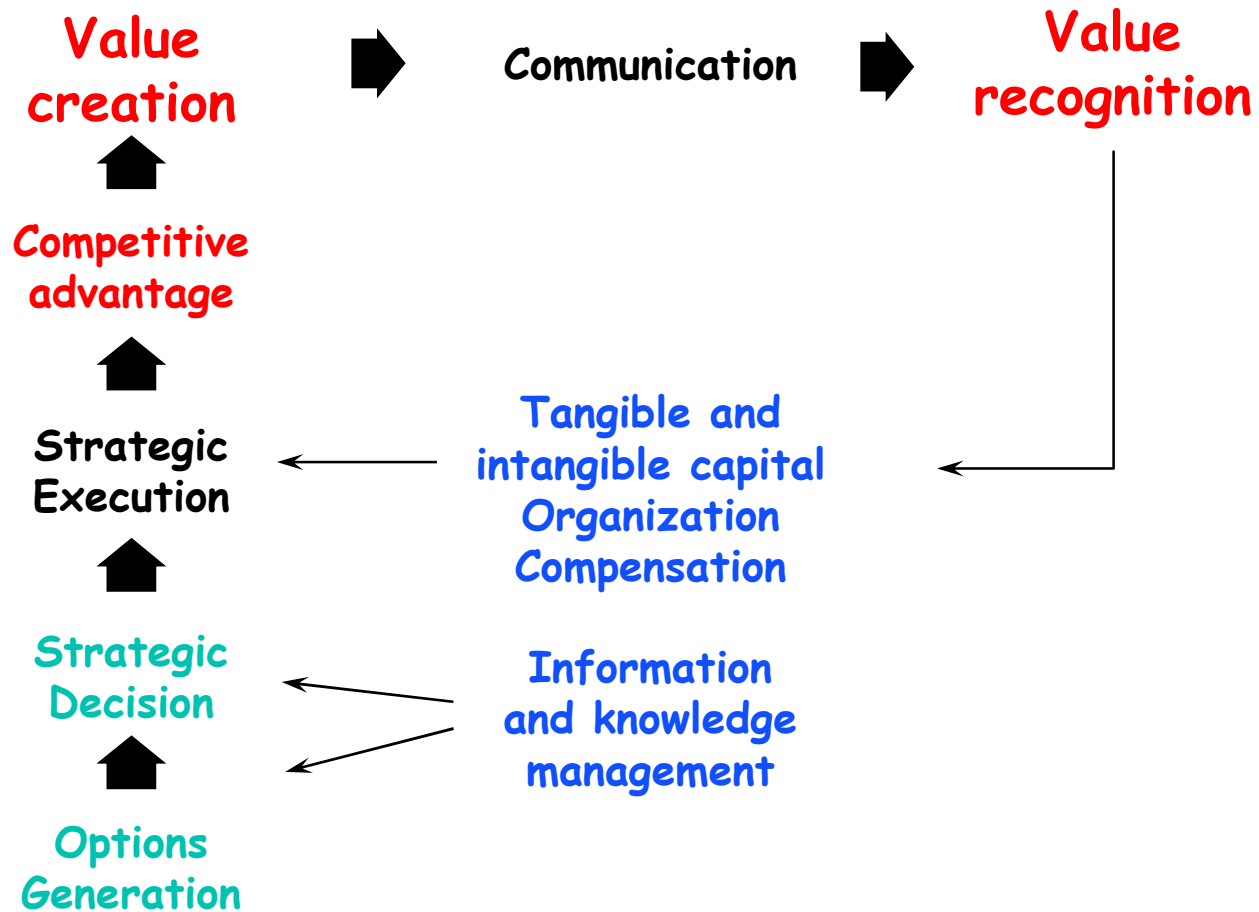
*Creating*

- Strategic decisions (portfolio decision)
- Strategic execution (M&A)
- Financial strategy and signalling policy (IR, Dividend policy, leverage, share buybacks, spin off ...)
- Investment choices

*Iterating*



# Value creation results from robust management processes





## A blurred value mindset

*In a blurred environment, management will :*

- Follow market signals
- Focus on flexibility and manage uncertainty
  - Real options
  - Simulations
- Monitor non financial value drivers
  - The value scorecard

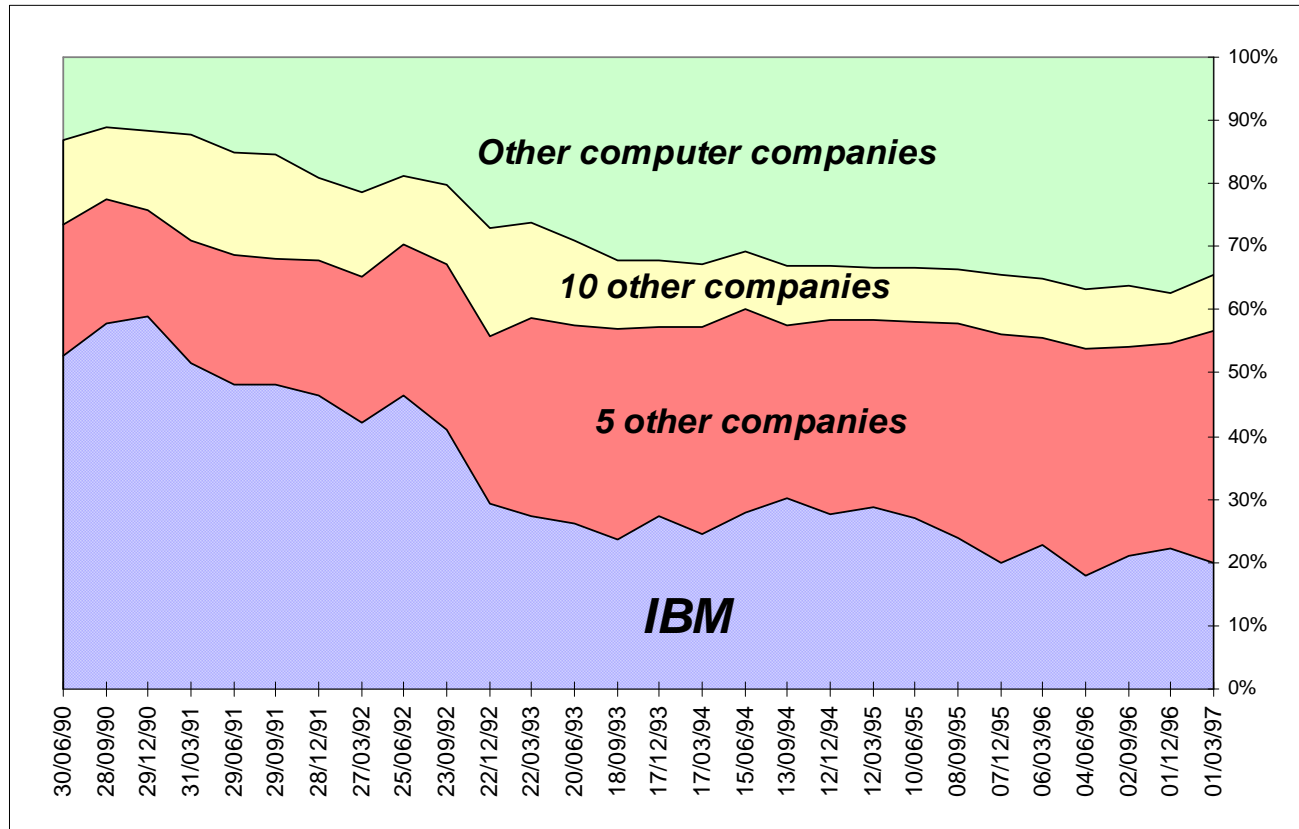


# Markets are the ultimate way of measuring companies

- Even with sophisticated or soft techniques, value remain uncertain
- Value migration is a major trend in the connected economy
- Blurring boundaries of real and financial markets
- European financial market are getting stronger and more efficient
  - let the market value your company
  - help the market value your company (non financial information)

# Let the market value your company

## Financial market share as a management indicator





# Help the market value your company

- Do not let the market over estimate your competitive situation
- Exchange information with the market to reduce expectation gap
  - listen : Identify «Measures that matters»
  - speak : Investor relationship
  - act : Organize yourself to meet expectations

# Understand what are shareholder's financial expectations

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Beg capital	900	1000	1096	1201	1317	1443	1581
NOPAT	117	120	132	144	158	173	190
inv rate	86%	80%					
Capital incr	100	96	105	115	126	139	152
End Capita	1000	1096	1201	1317	1443	1581	1733
RONI			12,0%				
ROIC	13,0%	12,0%					
Economic return		12,0%	12,0%	12,0%	12,0%	12,0%	12,0%
Cost of capital		10,0%					
Capital charge		100	110	120	132	144	158
EP		20	22	24	26	29	32
Terminal value EP						316	
EP valuation		1287	1391	1504	1626		
FCF		24	26	29	32	35	38
Terminal value DCF						1898	
DCF valuation		1287	1391	1504	1626		
Acquisition price		1287					
Total flows for a sale in							TSR
Year 1		-1287	1415				10,0%
Year 2		-1287	24	1530			10,0%
Year 3		-1287	24	26	1655		10,0%

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Beg capital	900	1000	1096	1200	1314	1438	1572
NOPAT	117	120	131	142	155	168	183
inv rate	86%	80%					
Capital incr	100	96	104	114	124	135	146
End Capita	1000	1096	1200	1314	1438	1572	1719
RONI						11,0%	
ROIC	13,0%	12,0%					
Economic return		12,0%	11,9%	11,8%	11,8%	11,7%	11,6%
Cost of capital		10,0%					
Capital charge		100	110	120	131	144	157
EP		20	21	22	23	24	26
Terminal value EP						257	
EP valuation		1243	1343	1451	1568		
FCF		24	26	28	31	34	37
Terminal value DCF						1830	
DCF valuation		1243	1343	1451	1568		
Acquisition price		1287					
Total flows for a sale in							TSR
Year 1		-1287	1367				6,2%
Year 2		-1287	24	1477			8,1%
Year 3		-1287	24	26	1596		8,7%



## ...and listen to the market

### ■ «Measures that Matter»

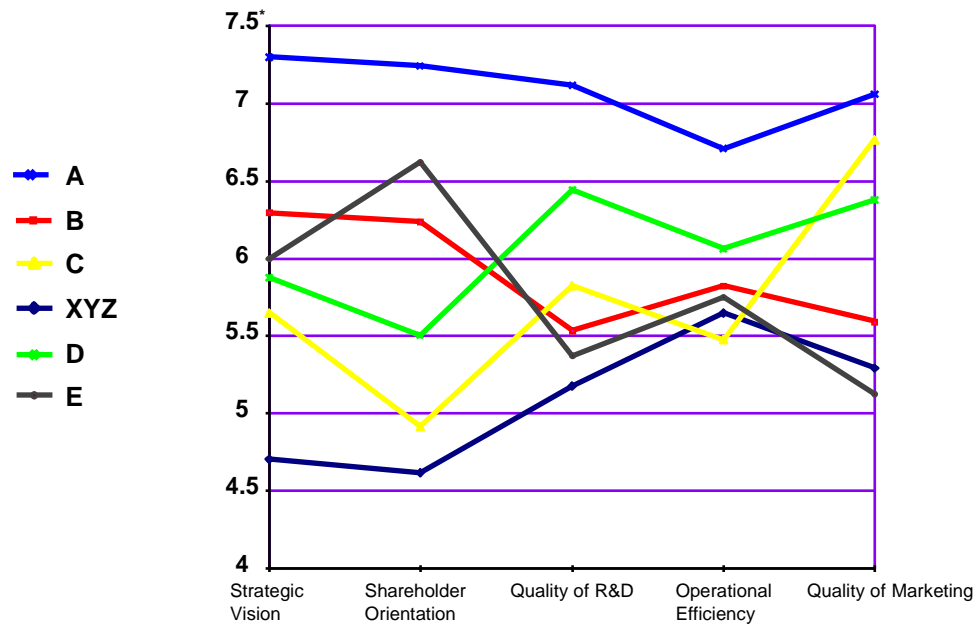
- 35 % of investment decisions are based on non financial data
- Analyst forecast are improved when they use non financial data
- Nature and ranking of these indicators are different for each industry and company

### ■ The «Top Ten» measures

- Strategy Execution
- Management Credibility
- Quality of Strategy
- Innovativeness
- Ability to Attract Talented People
- Market Share
- Management Experience
- Executive Compensation
- Quality of Major Processes
- Research Leadership

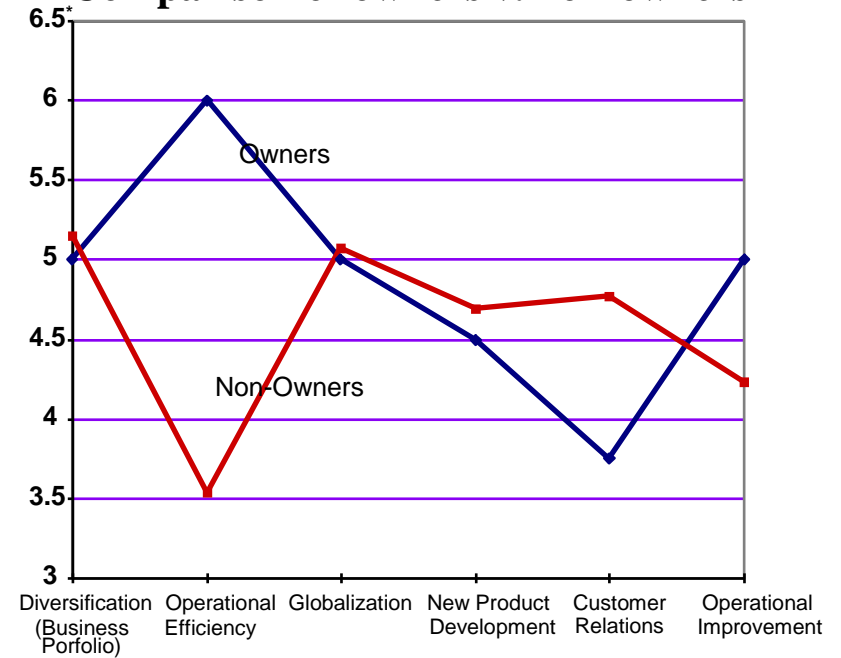
# Example of a financial market benchmarking

**Comparative Analysis**



\* 0 to 10 pt scale, where 0 = very poor and 10 = outstanding

**Comparison of owners v. non-owners**

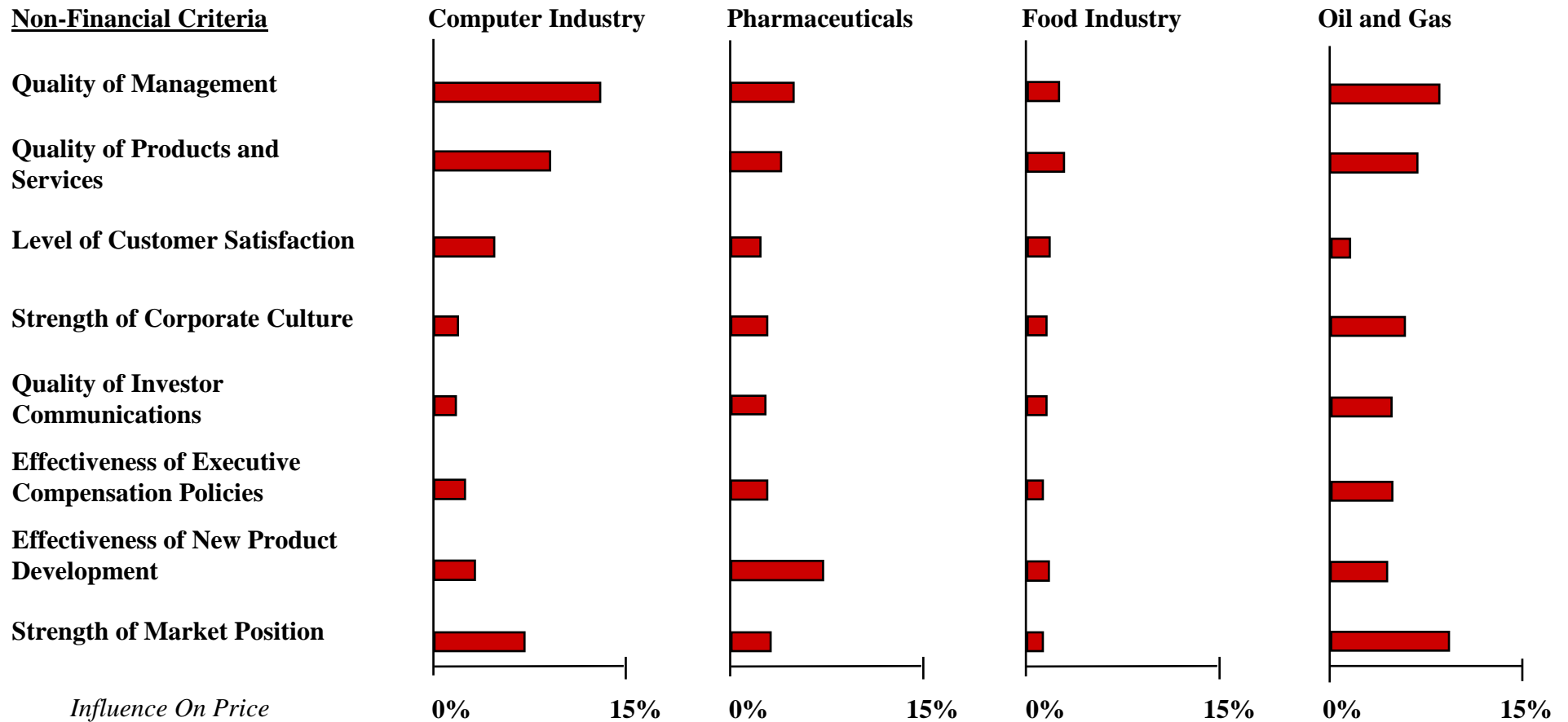


\* 0 to 10 pt scale where 0 = too little, 5 = just right and 10 = too much

Source: buy-side surveys

# Non financial indicators and value

**% Increase in Price / Earnings ratio given a one-unit change in....**





# Optionality needs to be scrutinized

## *Our old DCF vision*

- Fixed cash flows
- Fixed term
- Uncertainty reflected in the discount rate

## *Real life*

- Uncertain payoff
- Ability to modify a planned investment
  - defer
  - alter (accelerate, expand, shut down and restart)
  - abandon
  - time to build
  - switch

# Leveraging flexibility

Determinants of value of financial options	Current Value of underlying asset	Strike price of the option	Variance of underlying asset	Dividend paid on the underlying asset	Time to expiration on the option	Riskless interest rate (duration of the option)
Determinants of value of real options	Present value of expected cash inflows	Present value of expected outflows	Uncertainty of expected cash outflows	Value lost by waiting to exercise	Investment opportunity duration	Riskless interest rate
Management of real options	Increase	Reduce	Increase	Reduce	Increase	Keep up with
Examples of associated blurred strategies	Create Business webs with low-cost suppliers	Invest in intellectual capital, not in tangible assets	Accelerate innovation and R&D	Lock-up critical resources	Create Business webs with customers	
	Create standards and platforms	Design assets to be easily reconfigured	Let the market manage offer	Develop structural capital	Maintain technology lead	
	Increase Marketing expenses	Leverage economies of scale	Organize for instability and adaptability	Lock-up customer base	Lock-up distribution channels	



# The organization web

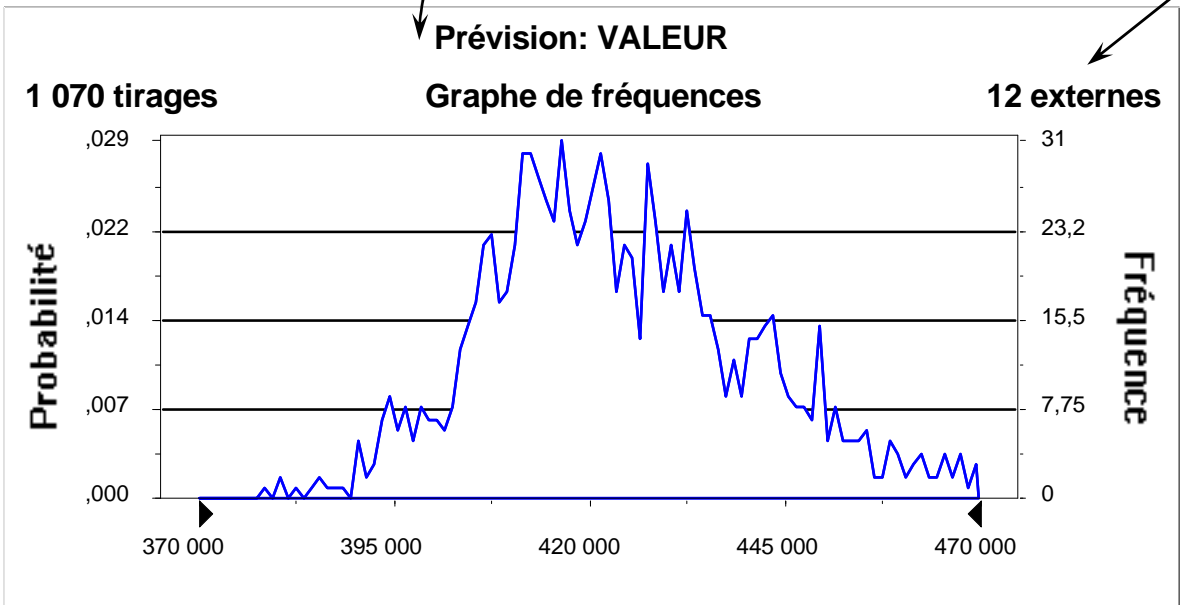
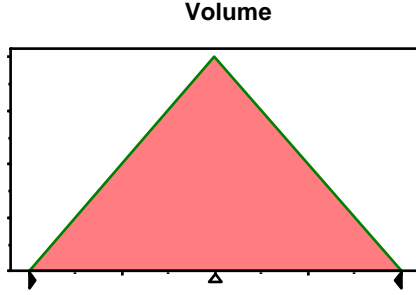
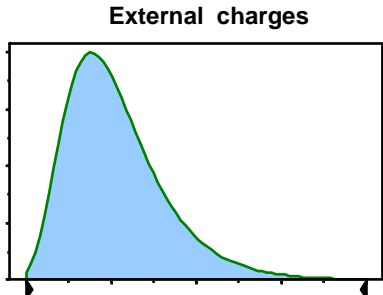
*In order to create an adaptative organisation*

- More organism than machine
- Permeable boundaries
- At the edge of chaos

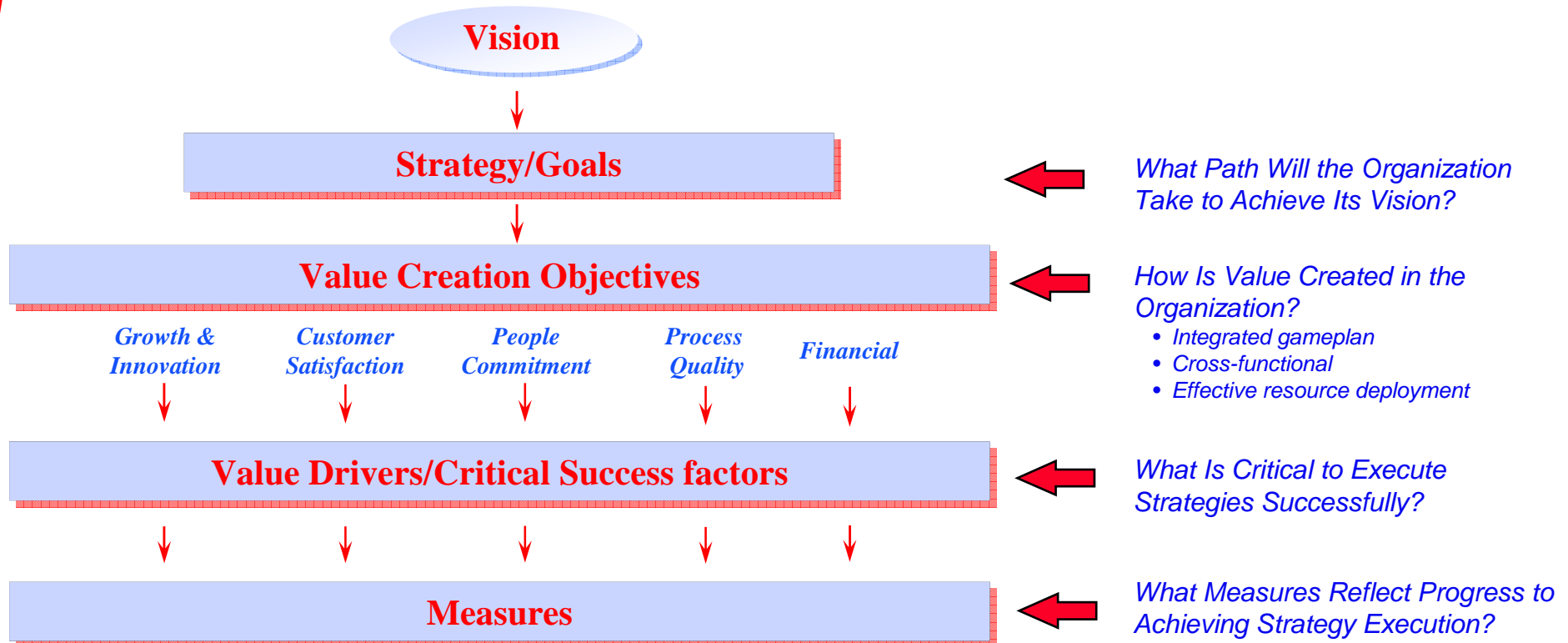
*...companies need to churn*

- their offer
- their knowledge
- their people

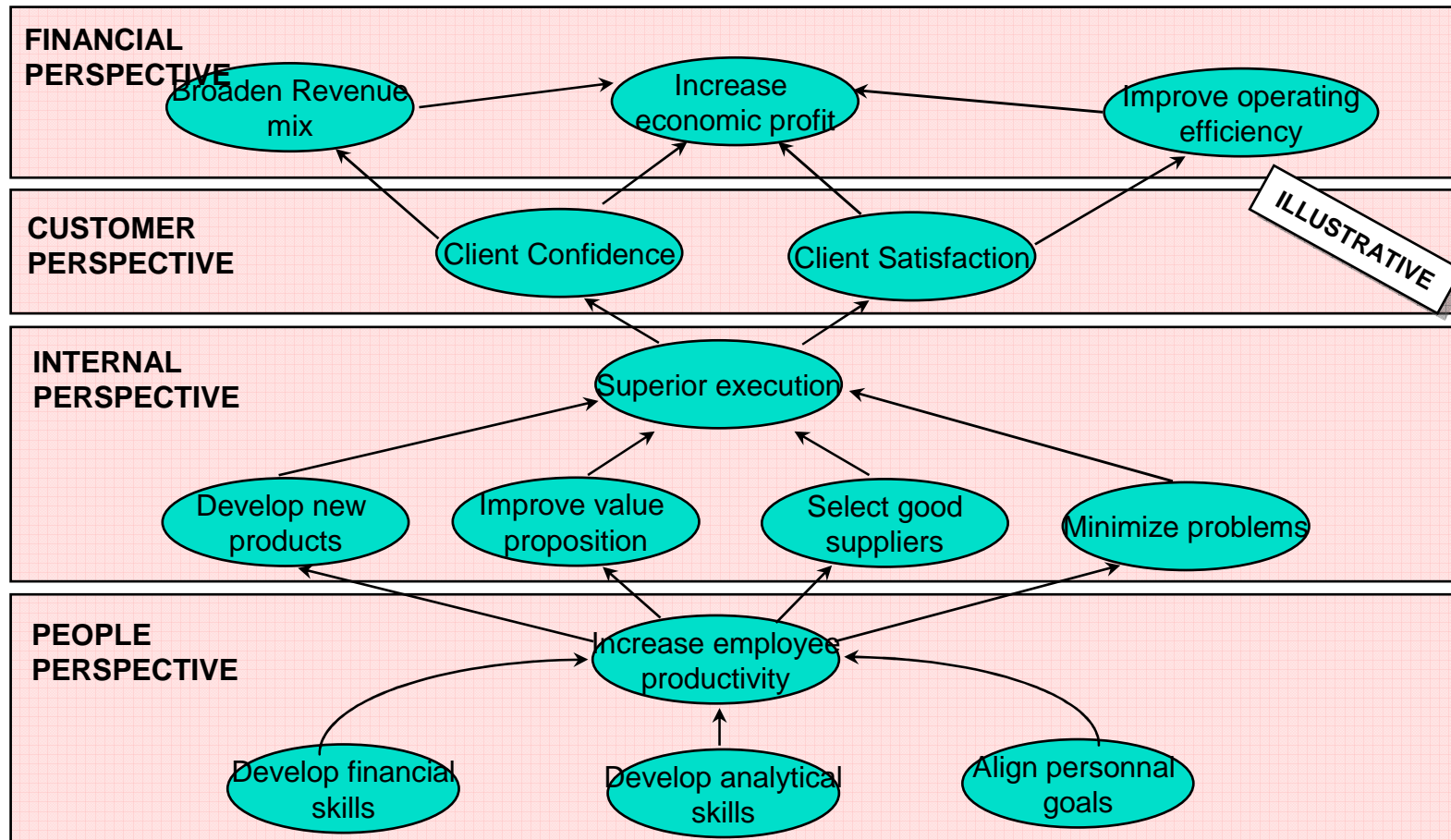
# Monte Carlo simulations to improve value analysis



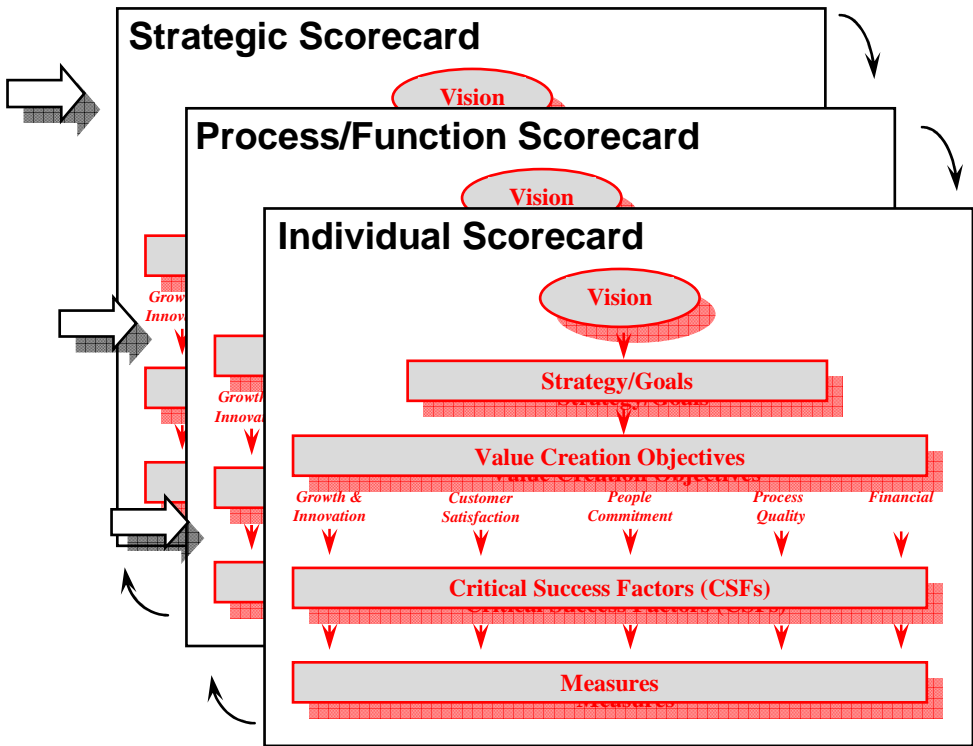
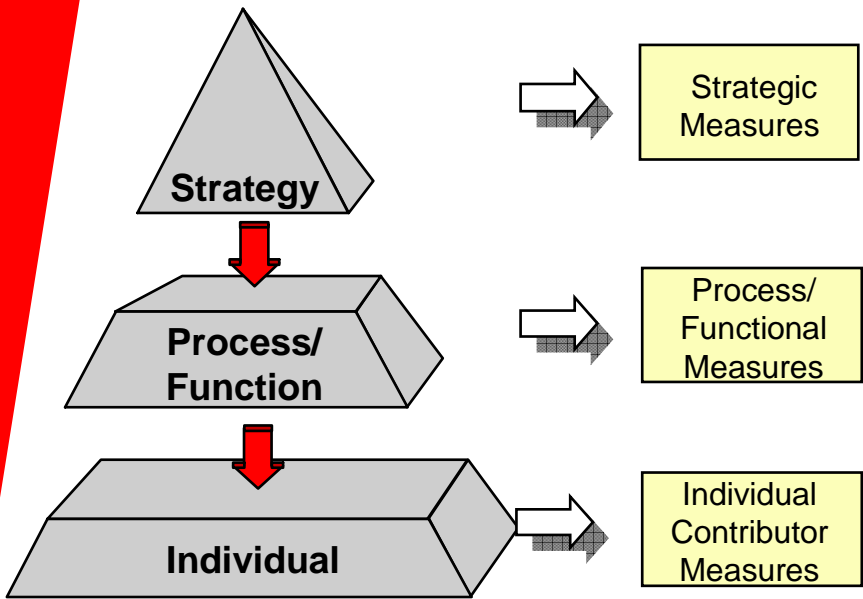
# Monitoring value drivers in a value scorecard



# Identify CSF through strategic linkage



# Value scorecard need to be drill down the organisation



# Illustration of a value scorecard

## Strategy/Goals

- 1) Committed to Enhancing the Company Brand through Building On-Going Relationships with both the Dealer and the Consumer
- 2) Dedicated to Creating & Maintaining a Cohesive European Dealer Network
- 3) Focused on Efficiently Managing Key Business Processes to Improve Business Results

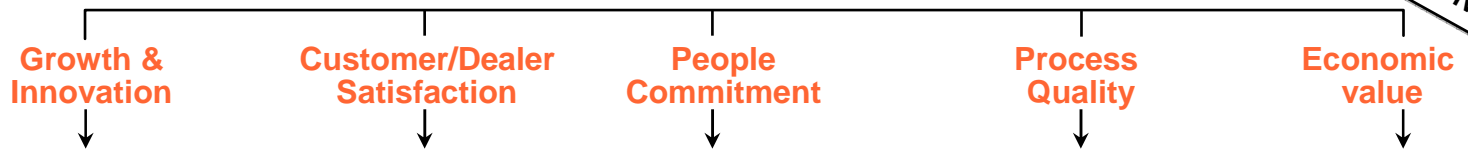
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### Strategies

### How will the Company Differ?

### What are the Critical Success Factors?

### What are the Critical Measures?



## Critical Success Factors (CSFs)

- ◆ Viable Business Potential
- ◆ Dealer Management
- ◆ Widen Dealer Offerings
- ◆ Racing Programs and Customer Events

- ◆ Customer Loyalty
- ◆ Enhanced Ownership Experience
- ◆ Dealer Business Plan
- ◆ Vehicle Logistics

- ◆ Upgrade Company & Dealer Service and Support Capabilities
- ◆ Profile Dealers
- ◆ Introduce Team Culture

- ◆ Vehicle History
- ◆ Prospecting
- ◆ Streamline Company and Dealer Business Processes
- ◆ Customer Info Repository
- ◆ Company Information Sharing

- ◆ Dealer Mgmt and Development
- ◆ Inventory Management
- ◆ Perceived Value
- ◆ Competitive Market Pricing
- ◆ Cost & Break-even Containment

## Balanced Scorecard Measurements

- ◆ Performance vs. Potential (by area)
- ◆ Performance vs. Composites
- ◆ % Dealer "Share of Wallet"
  - Financing
  - Warranty
  - Insurance
  - Accessories & Parts
- ◆ Brand Awareness
- ◆ % New Customers

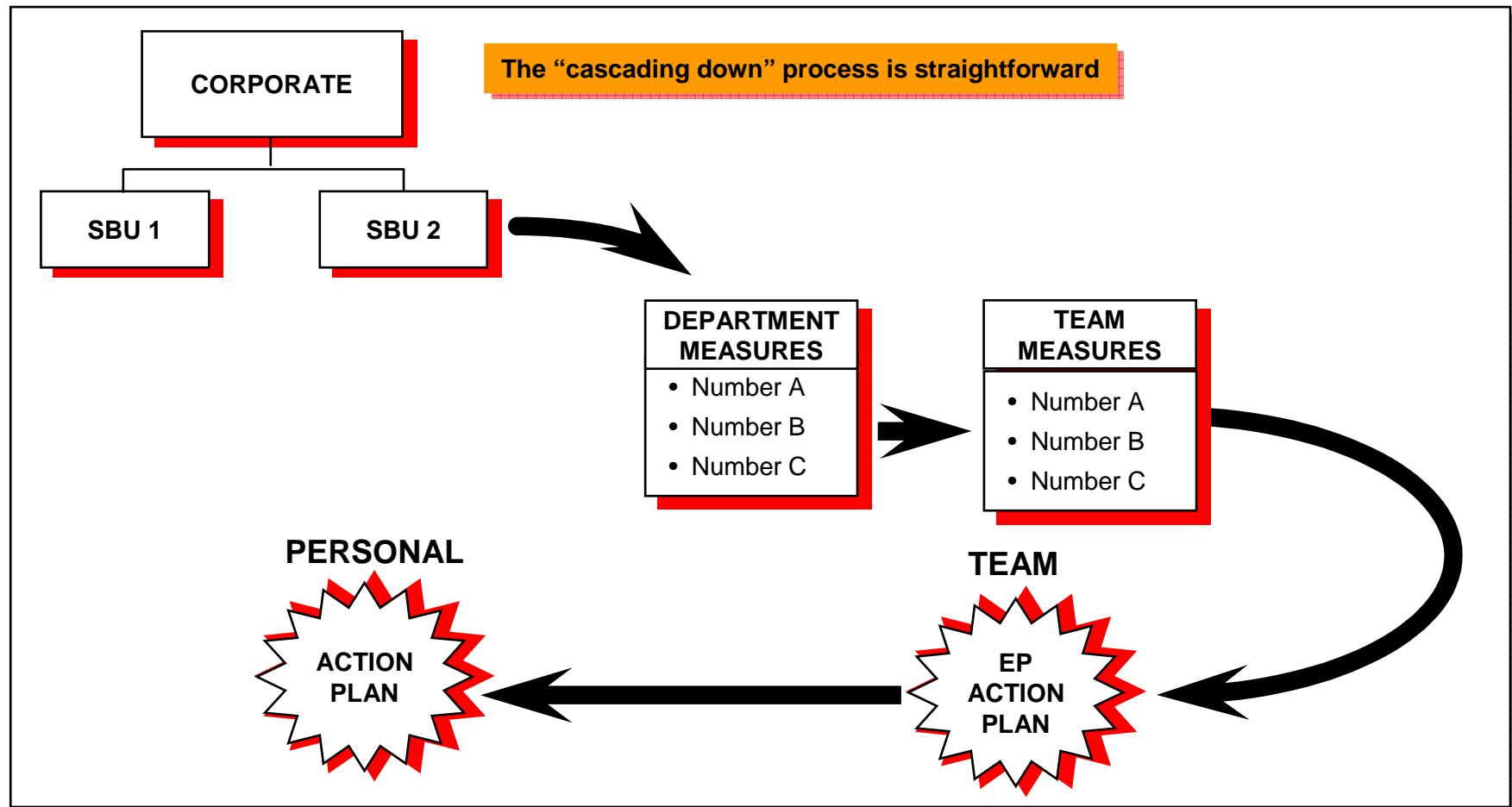
- ◆ # Repeat Sales
- ◆ Consumer Satisfaction Index
- ◆ Dealer Satisfaction Index
- ◆ Pipeline Measures
  - Cycle Time (Factory to Dealer)
  - Addressable Inventory Days
  - # Stockouts

- ◆ % Sales Increase
- ◆ Service productivity
- ◆ Service penetration
- ◆ % Profile Dealers
- ◆ Employee Turnover

- ◆ % Car Pedigrees/Total Vehicles
- ◆ Prospect Process Measures
  - # Inquiries
  - # Closures/# Qualified
- ◆ Financial Closing Cycle Time
- ◆ FTE/Business Unit
- ◆ Customer Response Time

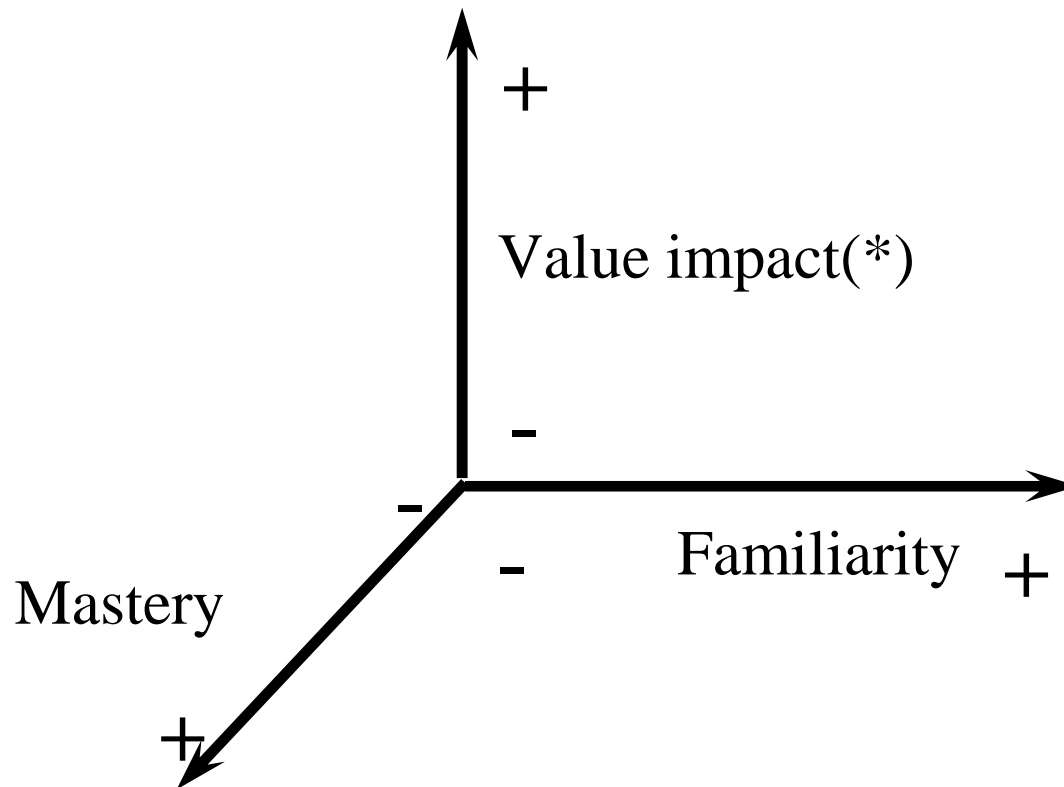
- ◆ Dealer Profitability
- ◆ Inventory \$s
  - New/Used
  - Parts
- ◆ Market Price
  - New: Actual/Sticker Price
  - Used: Resale Value
- ◆ # Lemon Law Violations
- ◆ Company Break-even Point
- ◆ Financial Penetration

# Architecture must be made explicit





# A pragmatic selection of value based indicators



(\*) measurable or not

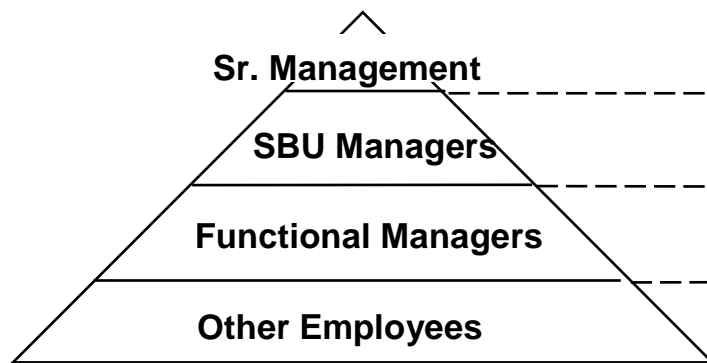
# A realistic Value measurement system

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<b>Measurement Examples:</b>	<ul style="list-style-type: none"> <li>Economic earnings</li> <li>Adjusted share price</li> <li>Market capitalisation share</li> </ul>	<ul style="list-style-type: none"> <li>Change in Economic Earnings</li> <li>Capital Turnover</li> <li>Capital costs</li> <li>Operating costs</li> <li>Customer Satisfaction</li> <li>Employee satisfaction</li> </ul>	<ul style="list-style-type: none"> <li>Production cost per unit</li> <li>Customer satisfaction</li> <li>Market share</li> <li>New product development</li> </ul>
<b>Measured Relative To:</b>	<ul style="list-style-type: none"> <li>External benchmarks (market, peer group)</li> </ul>	<ul style="list-style-type: none"> <li>Strategic/tactical plan targets</li> </ul>	<ul style="list-style-type: none"> <li>Individual/team performance targets</li> </ul>

**Performance Measures:**

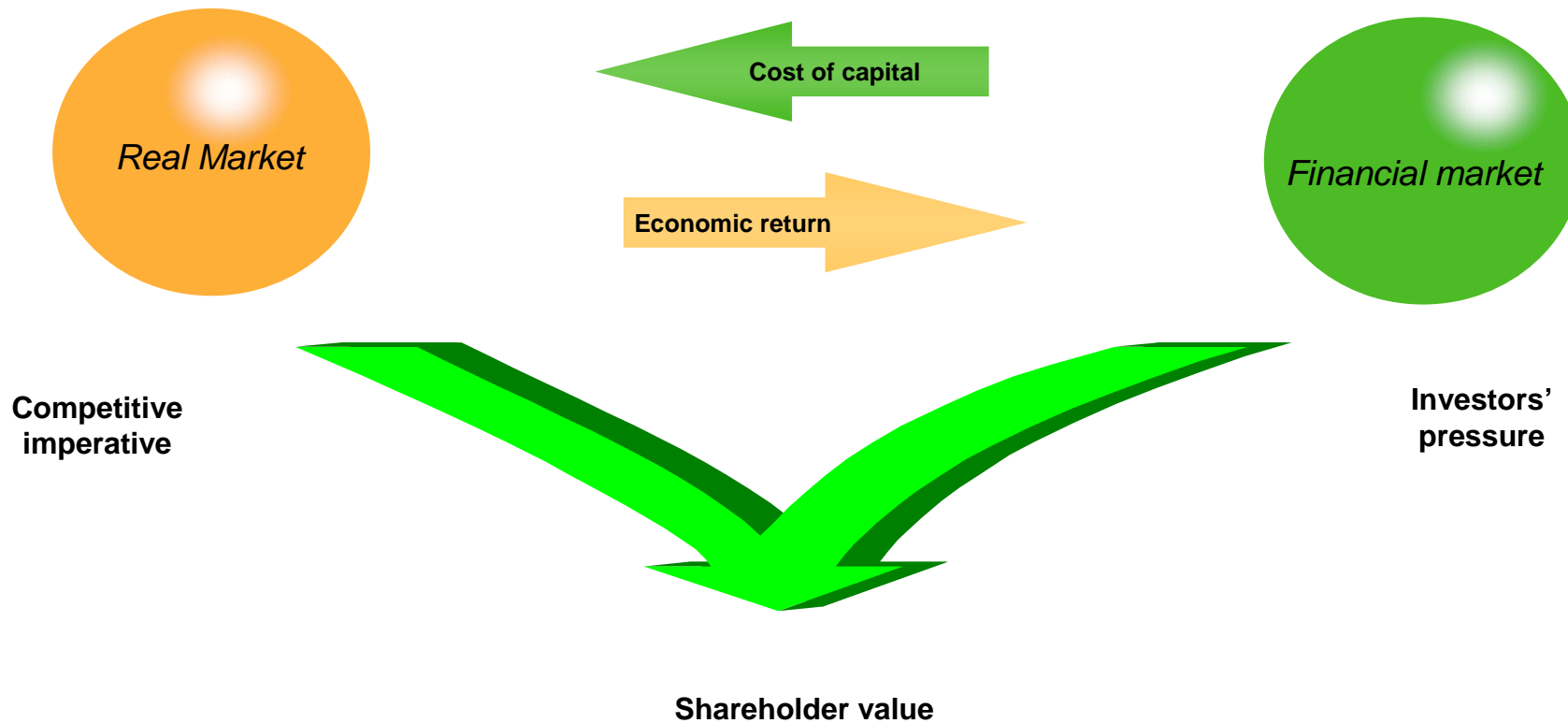
External Financial Measures	Internal Financial And Other Measures	Operating Measures
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*Conclusion*

# A company needs to perform on its two markets





# How to create value in a connected economy ?

*Some new rules for value creation*

- Blur your company
- Prioritize intangibles investments
- Make intangibles more «tangible» in order to
  - measure them better
  - retain them in the long term
- Manage trade-offs between intangibles and company's obligations