
Betting on the Future

A Fresh Look at Company Valuation

CFO Rising 2000

April 5, 2000

Jean-Florent Rérolle, Ernst & Young partner

What is the Value of These Two Companies?

- **Utility company A is:**
 - bigger
 - more profitable
 - more productive
 - more generous with its shareholders
 - and more leveraged to lower its cost of capital
- than Utility Company B,
so...**

.... what premium does it deserve?

	A	B
Sales	4,700	3,200
Income	423	254
Employees	8,886	10,000
Profit margin	9.0%	7.9%
Sales/empl.	529	320
Div. Yield	7%	0%
D/E ratio	4.55	1.04

Size, Profit, Productivity and Dividends are no longer Driving Value

- **Detroit Edison is:**
 - bigger
 - more profitable
 - more productive
 - more generous with its shareholders
 - and more leveraged to lower its cost of capital**than AES Corporation, but...**

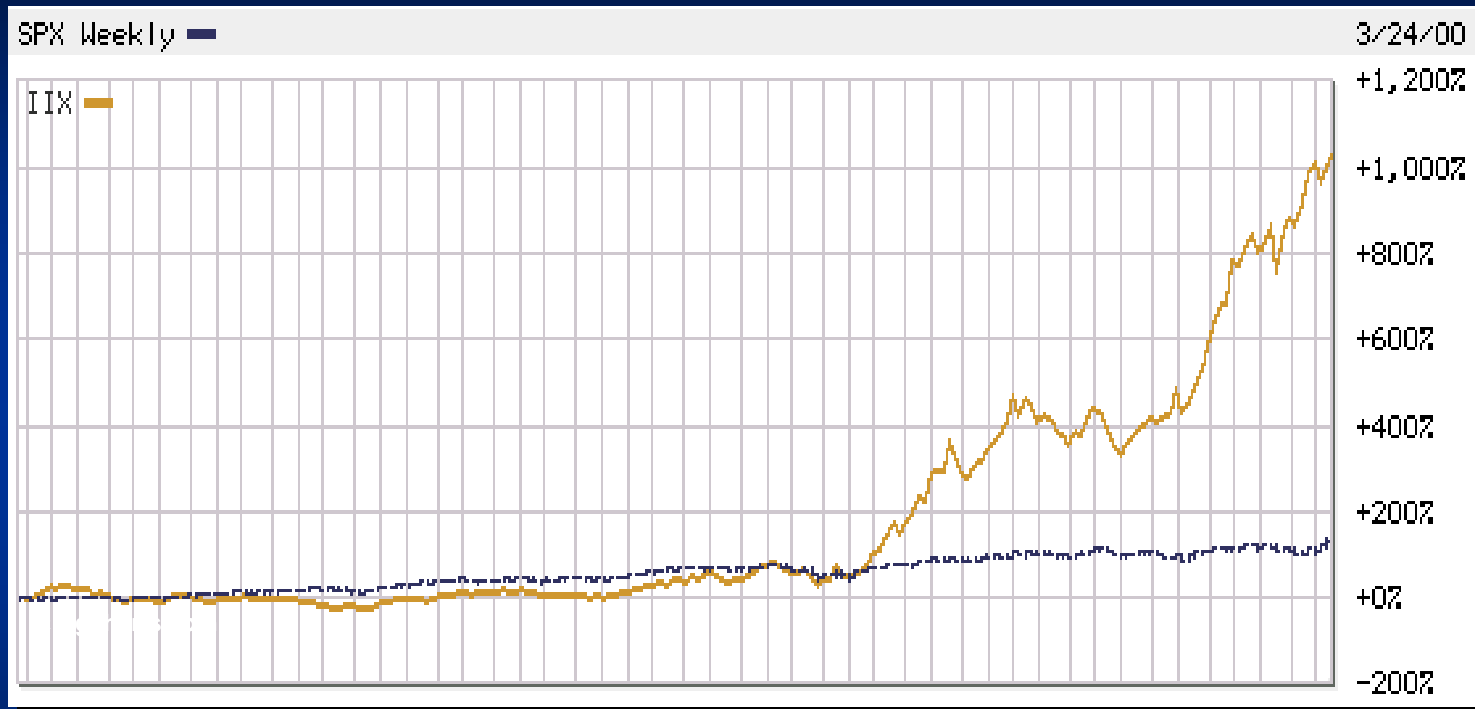
.... is worth barely a quarter of AES

	DTE	AES
Sales	4,700	3,200
Income	423	254
Employees	8,886	10,000
Profit margin	9.0%	7.9%
Sales/empl.	529	320
Div. Yield	7%	0%
D/E ratio	4.55	1.04
Market Cap	4,200	16,000
P/E	10	63

This is the New Economy paradox !

The Growing Chasm Between the Old and the New Economy

Comparison between S&P 500 and Internet index over the last 4 years



@bigcharts.com

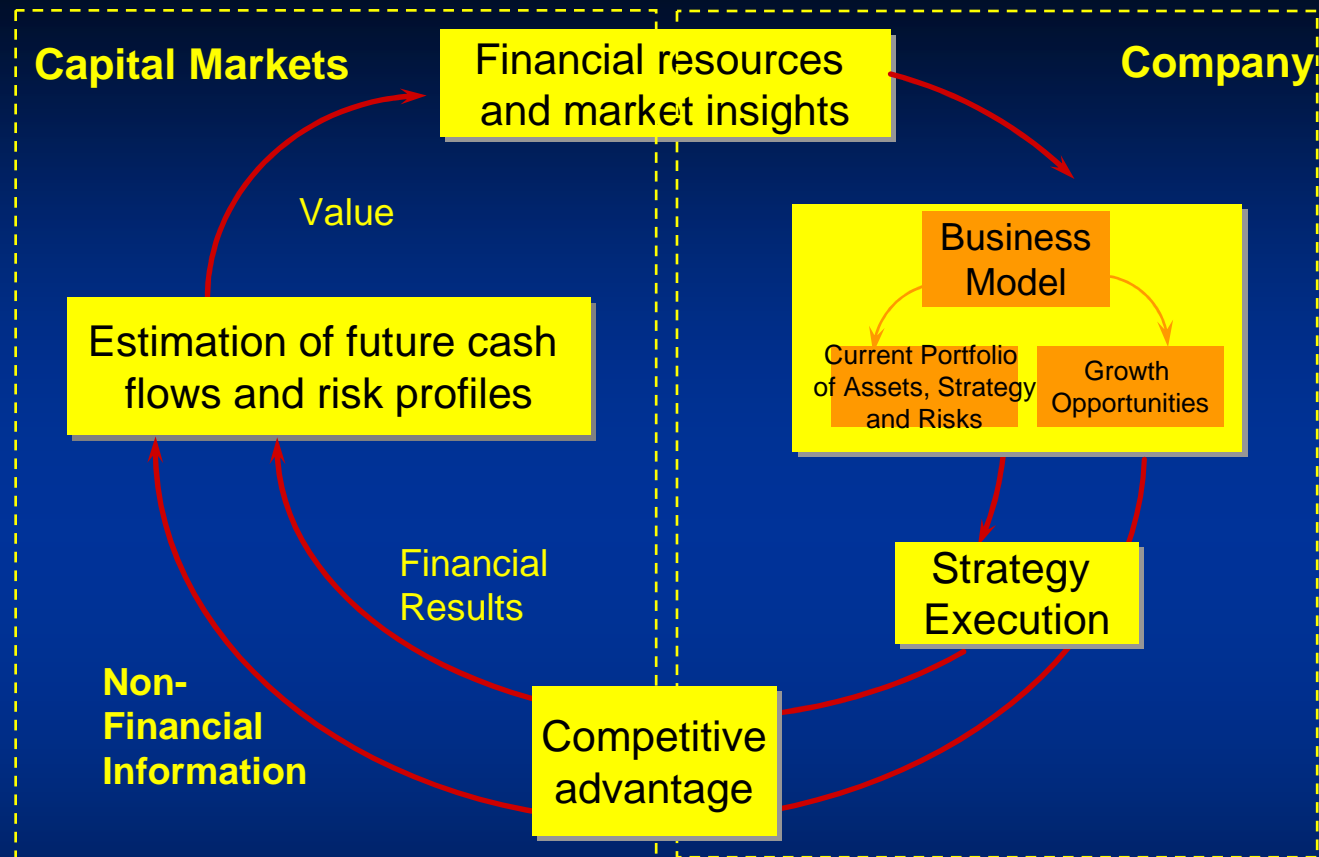
Agenda



- The Value Conundrum
 - Value Creation in the Connected Economy
 - The Irrelevance of Classical Management Tools

 - The new CFOs responsibilities
 - Financial Market Management
 - Risk Optimization
-

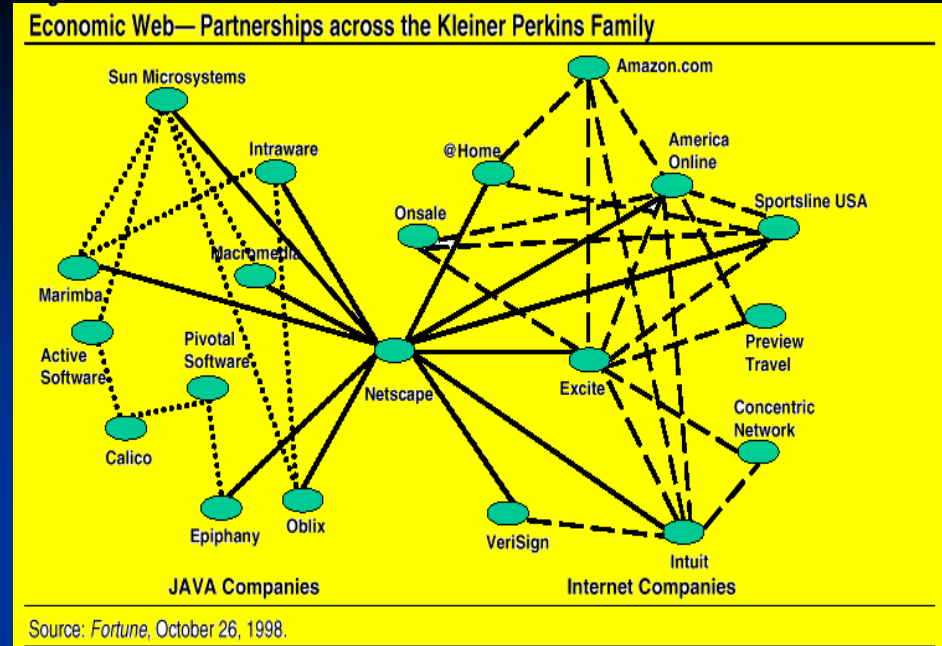
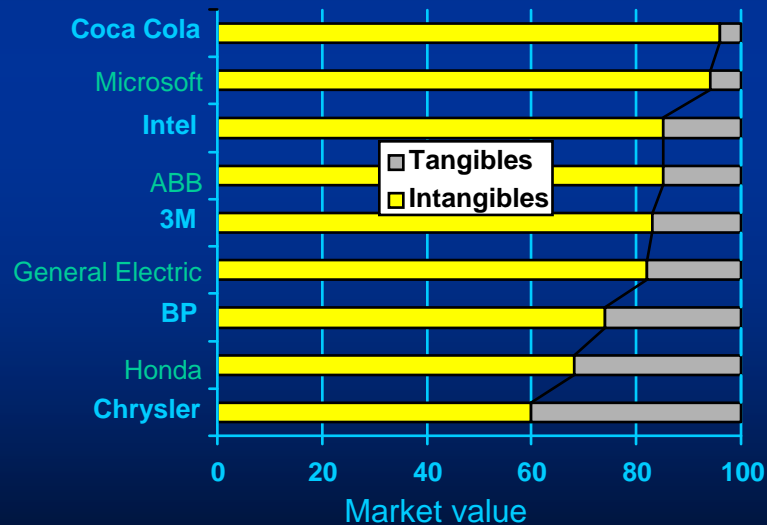
The Capital Market Dialogue Covers More Than Cash Flows



The value creation feedback loop

New Business Models of the Connected Economy

- **New business models** based on:
 - Organizational and strategic flexibility
 - Intangible asset management
 - Network (business web) management
 - Growth options portfolio management

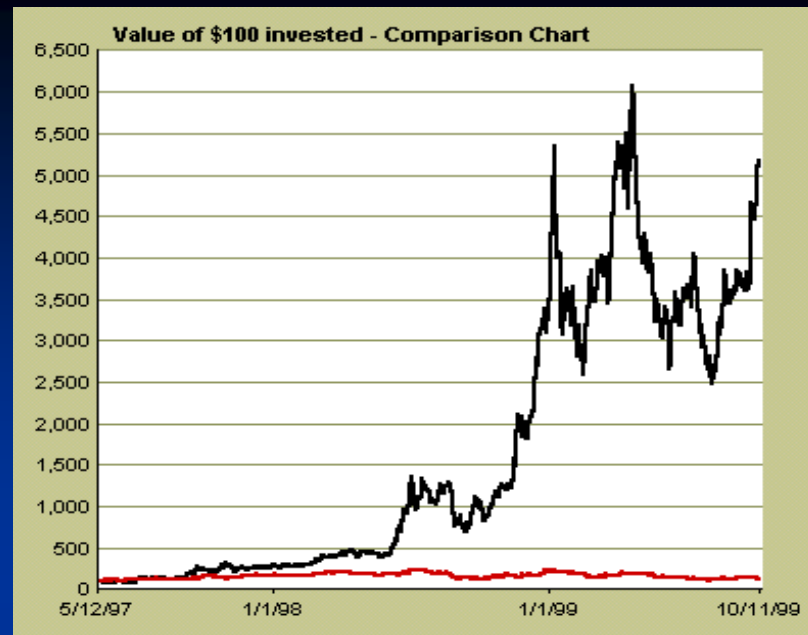
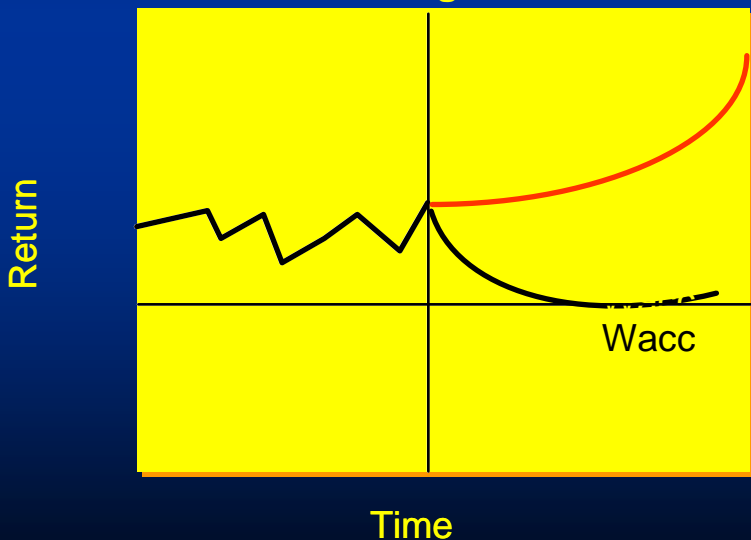


- **Strategic execution** becomes more important than the strategy itself.
 - The ability to change strategic direction overnight is critical to adapt to an ever changing universe

The Nature of Competitive Advantage is Being Transformed

- **Competitive advantages** are easier to create and more difficult to maintain
 - Differentiation comes from knowledge management, innovation and strategic execution
 - Speed and connectivity reduce the duration of competitive advantage
 - Companies are in search of Increasing returns

**Increasing
Diminishing Returns**



- **Financial market** translates competitive advantage into value:
 - Anticipates the ability of a company to recreate competitive advantages over time
 - Accelerates (exaggerates ?) real market trends by polarizing resources on the presumed winners

Agenda

- The Value Conundrum
 - Value Creation in the Connected Economy
 - The Irrelevance of Classical Management Tools
- The new CFOs responsibilities
 - Financial Market Management
 - Risk Optimization



The Classical Framework is Too Simplistic

Old framework



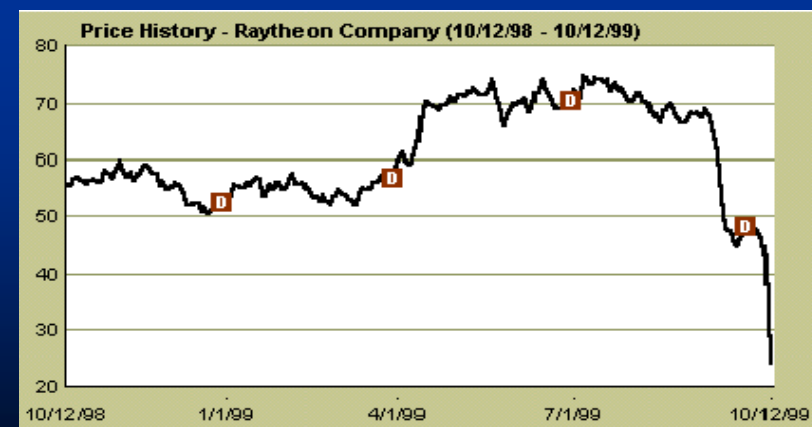
New framework



- **Financial Markets are now critical to:**
 - attract the best people
 - accelerate growth

Talent market, customer market and financial market are connected.
Relationship between Strategy and Finance is tighter.

- Shareholders' expectations are setting the **speed of a treadmill**. Exceeding those expectations results in accelerating the pace of the treadmill and in raising again the markets' requirements.
- An **uncontrolled speed** generally ends up in a diving share price, a weaker financial brand and a destroyed credibility. This might result in the creation of a vicious circle jeopardizing the future development of the company.



Classical Tools are Built on Definitions that no longer Apply

Returns

• Which cash flows ?

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

Boundaries

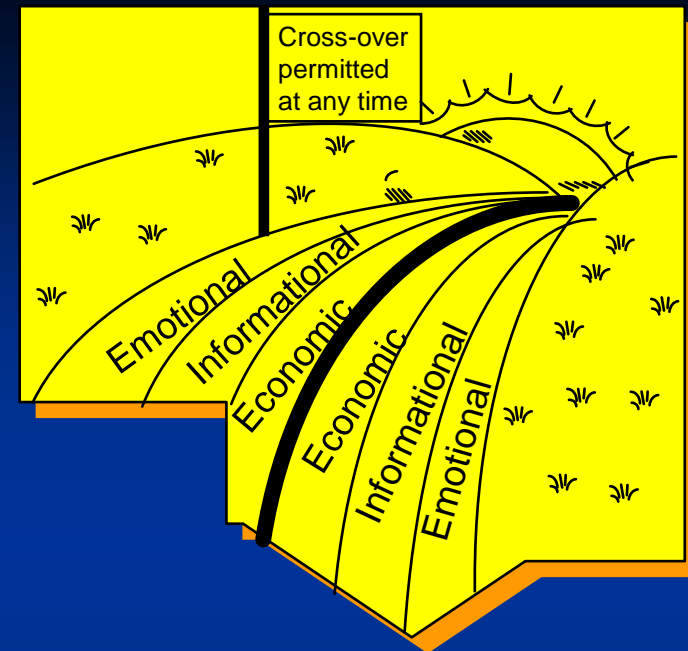
• Which perimeter ?

- Boundaries between the firm and its partners are blurring
- Complex partnering agreements are replacing classical acquisitions

Time

• Longevity of competitive advantage?

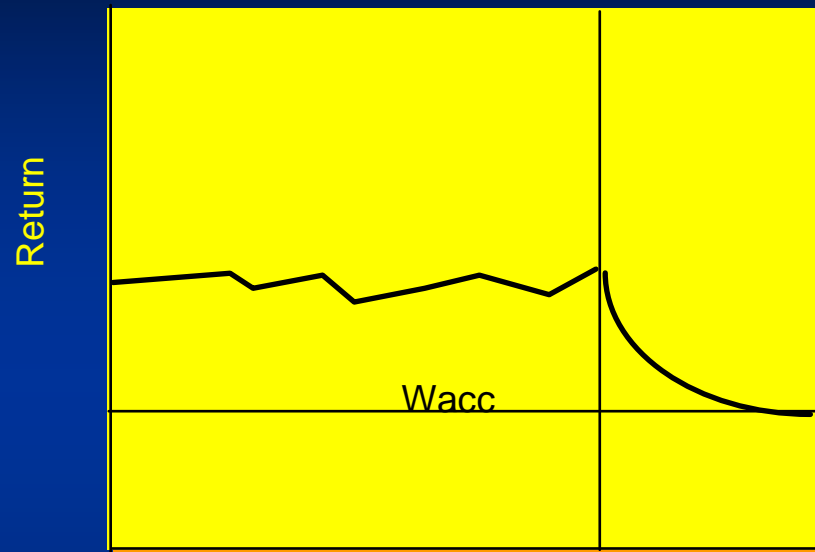
- Increasing returns
- Managerial flexibility is a virtue
- Speed accelerate value migration



The exchange taking place between players is more complex. Cash is not anymore the essential component to measure it

Classical Management Tools Value a Company as a “Bond”

Premise: Business Plans describe a perfect future, all uncertainty/risk is downside



Discounted Cash Flow

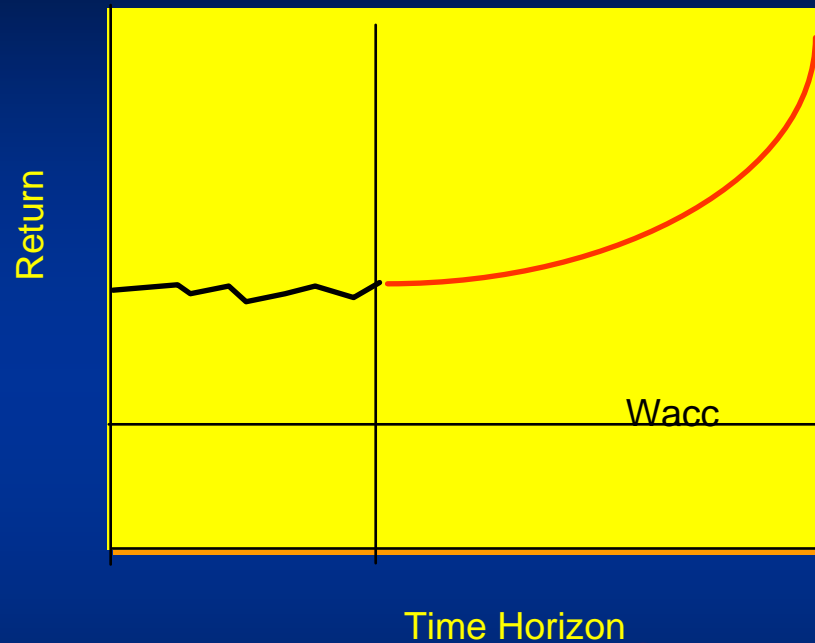
- Developed to value bonds
- Static valuation model
- Bond payments are fixed with limited upside
- Uncertainty captured by the discount rate - in the denominator
- **Uncertainty decreases value**

Value:



Today, Successful Companies Present Themselves as “Options”

Premise: Business Plans are an admission ticket to an exciting future, all uncertainty/risk is upside



Black-Scholes

- Developed to value options
- Dynamic valuation model
- Options have an unlimited upside potential
- Uncertainty captured by volatility - in the numerator
- **Uncertainty increases value**

Value:



Agenda

- The Value Conundrum
 - Value Creation in the Connected Economy
 - The Irrelevance of Classical Management Tools
- The new CFOs responsibilities
 - Financial Market Management
 - Risk Optimization



To Manage the Financial Markets, CFOs Must Internalize the Market's View on Value

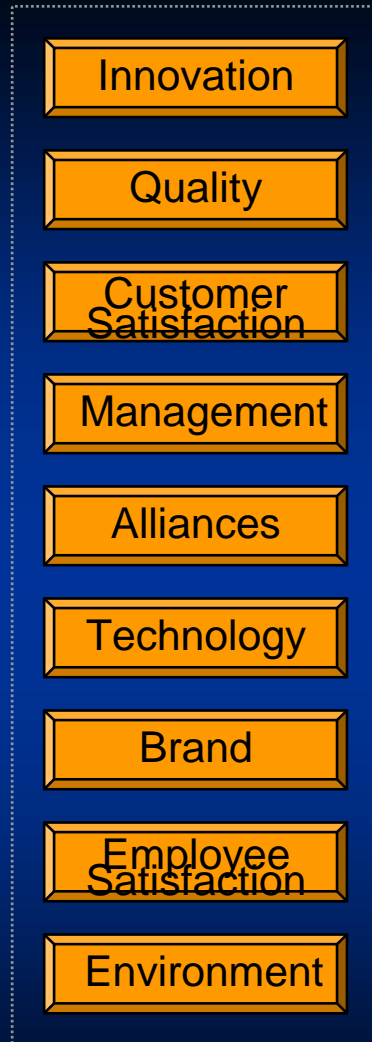
Market Value = Value of Current Business + Value of Future Growth Options

- *goal: efficiency*
- *measured by financial measures*
- *requires planning and forecasting*
- *valued like a "bond"*
- *uncertainty destroys value*

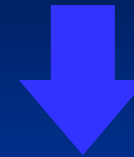
- *goal: flexibility*
- *measured by non-financial measures*
- *requires experimentation and iteration*
- *valued like an "option"*
- *uncertainty creates value*

Unlike Financial Options, the Value of Real Options is Driven by a Multitude of Parameters

Value Drivers



Identify Value Drivers



Focus on Value Drivers that matter



Identify leading Indicators

Ernst & Young has Completed an Empirical Study of the Value Drivers in the Connected Economy

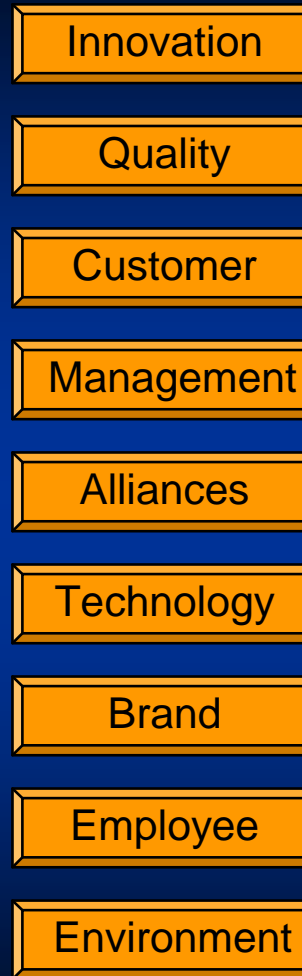
Non-financial performance grows in significance

- Even for large, mature companies, at least 35% of valuation is attributable to non-financial information
- Investments in R&D, brand development, relationships, and training exceed total investments in tangible assets
- The more non-financial information analysts use, the more accurate are their forecasts
- Non-financial information is now widely utilized as a leading indicator of future financial performance

Indicators

- # of alliances
- # of alliance partners
- # of supplier partners
- # of marketing agreements
- # of joint ventures

Value Drivers



Performance

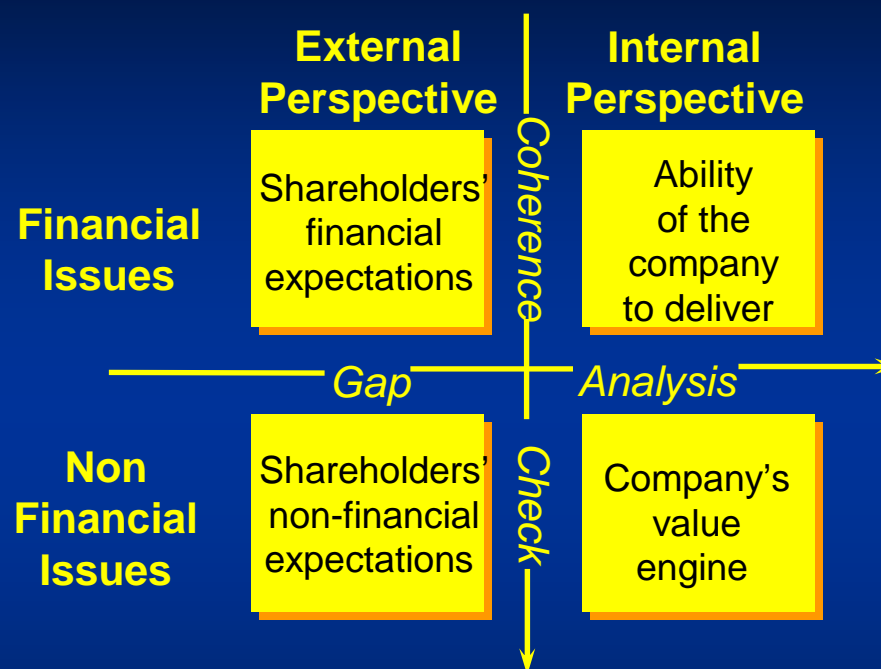
Value
Creation
Index

Market

Value

Based on an Understanding of Their Value Drivers, CFOs Must Set and Fulfill Market Expectations

- **Financial marketing techniques** to manage market expectations:
 - Constantly monitor investors' expectations for the company and its peers
 - Plan to exceed these expectations by crafting a business engine capable of maximizing their growth opportunities
 - Send meaningful signals to the financial community
- Management responsibility is:
 - Help the market setting **realistic long term goals**
 - Reach **short term objectives** to convince shareholder that the company is on the right track

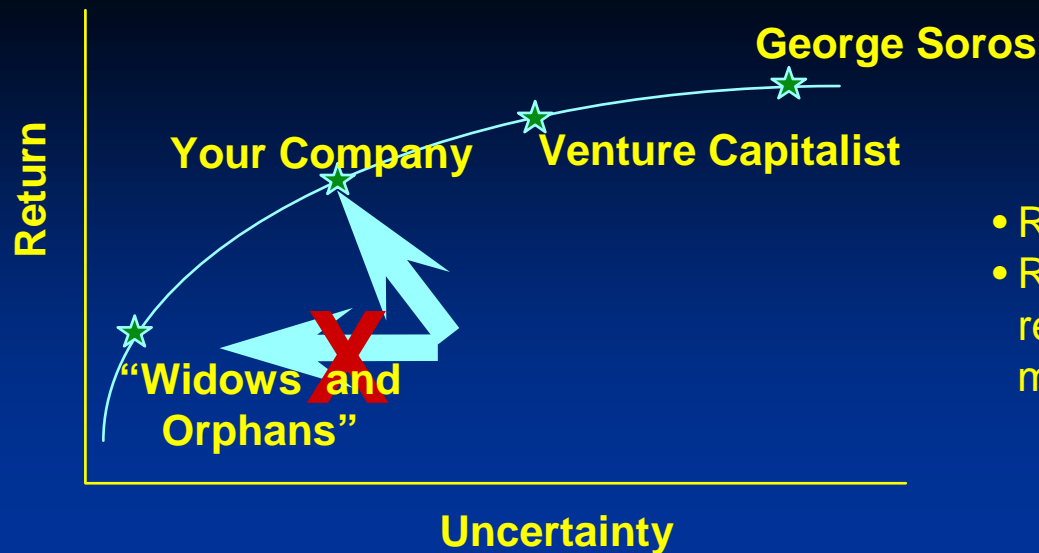


Agenda

- The Value Conundrum
 - Value Creation in the Connected Economy
 - The Irrelevance of Classical Management Tools
- The new CFOs responsibilities
 - Financial Market Management
 - Risk Optimization



Maximizing Your “Return on Risk” Requires Positioning on the “Efficient Frontier”



- Risk Avoidance is not Possible
- Risk Minimization does not earn the returns expected by the financial markets

New Markets for Risk Make Virtually All Risks Fungible

- **British Aerospace** - *Revenue insurance for airplane leasing business*
- **Bombardier** - *Customer snowfall insurance for snowmobiles*
- **Apparel Retailers** - *Cold weather insurance*
- **Times-Mirror Group** - *Insured costs for newsprint*
- **Reliance Insurance** - *Offers policies on operating profits*

CFOs Must Choose the Risks Their Companies Like

Low ← Value of Risk → High

Lay Off To Others

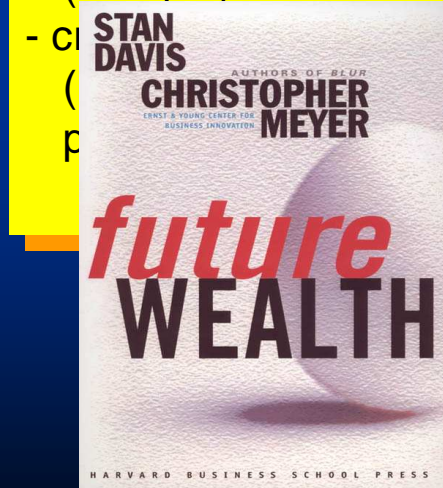
- business practices/ contracts (e.g. buy warranties)
- financial markets (hedges)
- risk markets (insurance policies)
- create Real Options (e.g. manufacture where you sell)

Value of any risk to your company depends on:

- Information Advantage
- Relation to Risk Portfolio
- Ability to Influence Outcomes

Acquire From Others

- business practices/ contracts (grant warranties)
- financial markets (hedges)



“Outsource risks, buy opportunities”

Meet the New CFO

- **The most important Salesman**
 - The only one to cover the sales territory called “Capital Markets”
 - **The Communications Manager**
 - All (!) external communication is judged by the financial markets and set their expectations
 - **The Chief Risk Officer**
 - Select risks that provide flexibility and growth options for the entire range of reasonable scenarios for the future
 - **The Teacher**
 - Teach new valuation tools, I.e. options pricing, to the internal decision makers
 - **The Psychologist**
 - Get a conservative management team and board to embrace the uncertainty of today’s economy and understand risk as upside to be leveraged
-