Rethinking Value-Based Management

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In the early 1990s, the business press, securities analysts, and management consultants widely touted value-based management (VBM) as a new tool to help investors assess companies and help executives evaluate business performance and shareholder value. And conceptually, VBM was a great idea. But after a decade of experience both on Wall Street and inside companies, has VBM realized its promise as either an investing tool or a management tool?

The answer appears to be mixed. In a recent survey of VBM adopters by professors at INSEAD, respondents’ views ranged from high impact to little or even negative impact of VBM on their companies. The study’s authors concluded that VBM as a discipline added value for those companies that adopted it as a way of life—i.e., a cultural change—and was limited in those that more narrowly deployed it as yet another management tool.

And recent events raise even broader questions about VBM’s impact. Where was the influence of the VBM discipline on Wall Street during the dot-com boom and bust, or in the corporate suite during the more recent and ongoing controversies over executive pay and accounting improprieties? Did investors, venture capitalists, analysts, consultants, boards, and executives fail to heed the principles, or did the principles of VBM fall short in providing guidance? And, looking forward, does VBM still offer a competitive edge or even a relevant management approach for the next decade?

VBM’s mixed track record suggests that we should reexamine the lessons of the last decade and craft a more comprehensive and effective approach to deploying VBM. And, in the end, there really is no alternative but to do so. For many reasons, delivering superior value creation has become senior management’s most pressing task. Investors expect it and respond aggressively to its absence. Management and employee security, opportunity, and

Value-based management theories have fallen short in practice, especially when it comes to investor strategy.

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remuneration are more and more closely tied to stock value performance. Through stock options, its promise has become a key factor in the attraction or retention of both managerial and technical talent. Most major business publications now put a spotlight on annual value creation performance rankings. And—perhaps most importantly—it has become increasingly obvious in many industries that long-term competitive advantage is dependent on access to the capital resources that accompany superior value creation.

The clear challenge is to rethink how management can better apply the principles and practices of VBM to help deliver superior value creation on a sustained basis. Here, there are a number of new insights and evolving best practice approaches that can elevate and extend both the art and the science of managing value creation. These new approaches better connect VBM with capital markets outcomes and better align organizations to deliver sustained value creation.

THREE MISSING LINKS

Traditional VBM approaches did not fully equip executives with comprehensive perspectives and guidelines for managing value creation. As a result, many pursued agendas that either had missing links or disjointed connections with the strategies they were pursuing. And VBM’s credibility as an overarching management framework suffered when executives who bought into the philosophy found the approach too narrow to address important management issues.

For example, VBM showed managers how to improve net present value (NPV), but offered little advice about how to achieve a premium valuation multiple, or price-earnings ratio (P/E). It defined what the organization should strive for and how to assess decisions or tradeoffs along the way, but offered little practical guidance on how to align the organization and its culture to be more proactive and effective at achieving value creation goals. And, often, VBM practices created unintended consequences in internal behavior and external stock price, because the practices were not grounded in a complete systems view and implementation process that resulted in a consistent and reinforcing value creation agenda.

These shortcomings stem from three pragmatic missing links in traditional approaches to VBM. Some might observe that these missing links are more the province of good general management than of VBM. But another view is that VBM has much to offer good general management beyond economic principles and measures, and it loses impact as a respected and enduring discipline if it is not fully woven into the overall fabric of managing long-term value creation. Therefore, it is important that VBM approaches be extended to connect these frequently missing links. They are:

1. An incomplete connection with capital markets realities.
2. An incomplete connection with organization and culture.
3. An incomplete process for managing the system of levers that determine value creation.

Within each of these categories of missing links, there are a number of new insights and implied challenges. For example, a stronger focus on capital market realities reveals the gaps between intrinsic value and actual stock price. The need to bridge this gap puts the responsibility for managing a company’s long-term relative P/E (or other valuation multiple) more squarely on business leaders’ lists of levers to manage proactively. And there are a number of new insights and tools available to quantify and act on the specific drivers of relative valuation multiples.

Similarly, a stronger emphasis on capital markets linkages opens up the opportunity to connect with and manage a company’s investor base more effectively. New thinking about investor strategy extends the VBM principle of stock market efficiency to recognize that, like one’s potential cus-
customer base, stock markets are also segmented around investor groups that have different priorities and that can put different valuations on the same performance.

During the 1990s many companies stumbled in packaging their offerings to investors by assuming that markets were efficient at recognizing intrinsic value improvements and investors would readily migrate to their offering. For example, those in favor of the Merck-Medco business combination undoubtedly believed the intrinsic value improvement logic was obvious, but the different investor segments that sought out pharmaceutical versus pharmaceutical benefits management companies didn’t agree. Extending VBM’s linkages to capital markets provides important insights for portfolio strategy thinking.

The second missing link, connecting VBM with organization and culture, gets to the heart of management practice, and to how VBM can help orchestrate improved value creation. This is perhaps the most difficult yet richest long-term vein to tap for driving sustained superior value creation. From empowering and enabling human capital to building superior management capabilities, there are many levers and practices to manage.

For example, few companies have effectively aligned their planning, budgeting, target setting, and incentive compensation processes. This failure is largely a result of assigning ownership of each process to different functional areas with an unclear accountability and/or process for bringing them together. The consequences are commonly manifested in sandbagged or gamed plans, negotiated budgets or targets, and incentives that conflict with long-term value creation. Or, in a different vein, many companies have not aligned the social contract between corporate and business unit management in ways that effectively balance empowerment, intervention, and accountability for value creation. The result is often no small dose of frustration and cynicism on both sides—rather than team spirit around a shared goal of value creation. Here VBM needs to be extended to address the entire range corporate center practices, that is, to headquarters activities that promote value creation across operating units.

The third missing link is lack of grounding in a process for thinking about and managing the entire system of influences and levers that determine value creation. Here, traditional VBM approaches provided rich guidance for managing a subsystem of economic principles and levers—but little on how to further align strategic, cultural, and behavioral levers. This shortcoming becomes even more pronounced when the capital markets missing link is added to the equation. Portfolio strategy and operational priorities need to be linked to their impact on P/E, their appeal to the type of investors who own the stock, and to the management practices that determine their effective delivery. Conversely, investor ownership mix has implications for portfolio strategy, operational priorities, and the design of internal metrics and incentive plans. Value creation results from how the entire system of influencers, priorities, and levers interact to maximize realized value.

In short, there is both a wide-ranging challenge and a big opportunity to harness VBM to achieve improved value creation. Assumptions, priorities, tradeoffs, tools, mind-sets, and culture all need to be reexamined, and at many levels across a company’s management team.

A SYSTEMS APPROACH TO VALUE CREATION

A recent observation by a senior executive at a Fortune 100 company illustrates the core challenge in developing a value creation agenda: “The easy part of managing value creation is conceptually convincing managers and employees that it is their most important, overriding, and shared focus. The hard part is figuring out where to start and how all of the pieces fit together. Delegation, training, and incentives only take you so far and then they break down into unproductive or misdirected efforts.”

The system depicted in Figure 1 offers a sequence for thinking about value creation in a way that helps crystallize where to start and how
the pieces need to fit together. The sequence of thinking begins with establishing an explicit and quantified value creation aspiration. This goal defines the stretch challenge that the four direct levers for driving value must be orchestrated to meet. These direct levers are shown in the middle section of Figure 1. The more aggressive the aspiration, the more likely that the company will have to manage all all four levers in a reinforcing way. Once management has established the priorities and tradeoffs for managing the direct levers, the corporate center practices—headquarters activities—become the indirect lever that needs to be aligned to ensure effective delivery of the intended plan. As the management team thinks through each element of the framework, a shared consensus should emerge about the aspiration, which levers have priority, which levers are strong or weak elements in the current agenda, and how the corporate center practices have been aligned to enable the organization to deliver.

As one CFO recently put it: “I thought this framework was too high level and obvious to generate much discussion at our senior management offsite to introduce VBM—in the end we spent two hours discussing our priorities, practices, and culture in a way that we never had before. It was surprising to see how little consensus and common views we had as a management team once we got beyond individual issues and had a frame-

**Figure 1. Value Creation Framework**

- **Value Creation Aspirations**
  - “Determine what needs to happen”
  - Operational Effectiveness
  - Competitive Strategy for Growth
  - Portfolio Management, Migration
  - Investor Strategy

- **Corporate Center Practices**
  - “Determine what actually happens”

RTSR is relative total shareholder return. It reflects a company’s capital gains plus dividend yield relative to a peer group or market index.

**VALUE CREATION ASPIRATIONS**

Most executives recognize that it is essential to energize, focus, and align their organizations around a shared mission. When high-level aspirations are clear, compelling, enduring, and reinforced by day-to-day signals, they can have a significant impact. But when they are too general, change from year to year, are not supported by walking the talk, or become diluted by too many supporting goals or qualifiers, they quickly lose their ability to energize and focus an organization to achieve its potential.

Many companies could benefit from an aspirations “tune-up” which revisits the effectiveness of their existing mission, vision, or other aspirations-conveying vehicles. From a value creation perspective, our view is that best practice is to establish an overarching, single, long-term aspiration that is focused on relative total shareholder return (RTSR) performance. For many executives, this is not a new insight conceptually, but in practice most companies do not effectively deploy RTSR as an aspiration-setting tool.

For example, many companies have vision or aspiration statements that focus on achieving multiple goals. One Fortune 100 company states its aspirations around three key goals:

1. Be the leader in markets we serve.
2. Provide superior TSR for shareholders.
3. Promote the well being of all other stakeholders. These sound good on paper and provide a great deal of grist for leadership speeches, but they don’t effectively focus thinking and behavior. Line executives in this company were frustrated when strategies to maximize market share failed to meet short-term financial targets for bonuses, and, conversely, when proposed acquisitions conflicted with corporate definitions of markets served. This latter frustration is similar to what Jack Welch observed in From the Gut about the potential trap of being #1 or #2 if it leads to defining markets in a way that limits growth.

In our experience, RTSR can be the most useful single way to define and communicate a company’s aspirations and the supporting plan for action—if it is done in the right way. That is, if it is grounded in external value realization, explicitly quantified, and then cascaded down into the organization as a long-term goal that energizes line management and empowers local entrepreneurial thinking about all of the levers to achieve it.

The process of doing so is not arcane, and it creates targets that are objective, appropriately stretch, and directly link business area management to capital markets discipline. As one senior executive put it: “Translating our RTSR goal into business unit targets made managers accountable for value creation as if they were CEOs of their own publicly traded companies—and, you can’t negotiate performance targets with investors.”

Whether the RTSR goal was met at the corporate level can be readily measured after the fact by simply ranking a company’s TSR against its selected peer group’s TSR. Management can also set a forward-looking target for RTSR and use it to assess the impact of corporate and business unit plans or major strategic initiatives. This requires translating a ranking goal such as top half, top third, or top quartile TSR into a specific number—a number that, if achieved internally, will have a high probability of resulting in reaching the targeted ranking for actual external TSR in the future. Figure 2 illustrates the calculations required to develop a forward-looking RTSR target.

In Figure 2, the first calculation arrives at an investor’s view of the risk-adjusted average expected return that a company, peer group, or market index is priced to deliver. In this sense it represents a fair not superior return, and can be thought of as reflecting the expected average TSR for the market or a peer group. There are several methods available for estimating the cost of equity, including capital asset pricing models (CAPM) arbitrage pricing theory (APT), and dividend discount models, but for most companies today, the expected cost of equity is in the 10% range.

The second calculation requires judgment to select the stretch above-average TSR that is aspired to. Here a word or two of caution is in order. Achieving superior TSR year in and year out is a difficult challenge, because it is accomplished only through superior performance improvements and not simply by maintaining superior absolute levels of performance (i.e., return on equity, ROE; return on capital employed, ROCE; economic value added, EVA®, etc.). Figure 3 displays two key considerations in selecting a goal for relative TSR spread above average.

The left panel in Figure 3 shows the probability of outperforming the S&P 500 average over consecutive years. By definition only half of the companies will be above median in any given year. For those that outperform in one year, the probability that they will outperform again in the next year is only 25%, and only 12% for outperforming three years in a row. In this sense, it’s more difficult to continue to be the most improved player in the league each year than it is to continue to be voted the most valuable player each year. From a value creation perspective, it is more reasonable to set goals for superior achievement cumulatively over three, five, or ten years than it is to strive for continuous superior performance each year.

The right-hand panel in Figure 3 provides benchmarks for the degree of stretch required to meet a cumulative top quartile TSR goal over different time periods. On average over the last 20 years a company needed to deliver a TSR that was
210% of the S&P 500 median TSR to be top quartile in any given year. This stretch dropped to 160% to be top quartile over any given five-year period. Thus, if the S&P 500 median TSR in a given year was 10%, it would have taken a 21% TSR that year to make it into the top quartile. Similarly, if the five-year compound average TSR for the S&P 500 was 10%, it would have taken a compound average 16% TSR to be top quartile over five years.

With no change in a company’s P/E multiple and during periods of normal (i.e., 10%) stock market returns, top-quartile TSR performance over a five-year period requires an 16% growth in EPS, minus a company’s dividend yield. This is actually a heroic accomplishment to deliver consistently, considering that the historical average EPS growth for the S&P 500 is in the range of 6% per year. Aspirations need to be believable and achievable to have positive impact on motivation and behavior. Many companies would be better suited to set aspirations for long-term RTSR at 2-3% points above the market average—after all, most fund managers would be pleased to achieve this level of performance for their portfolios cumulatively over the long term.

Once management has set a RTSR aspiration, the next task is to cascade it down into the organization (business units, geographies, product lines) as a local accountability. Doing so requires choices in two different areas. One is whether or not to de-average the overall target to take into account business unit or product line near-term potential. For example, if the overall target is 16%, should business unit A, which is competitively disadvantaged, have a 12% target while business unit B, which has just launched a blockbuster new product, have a 20% target, or should all businesses always have an 16% target? The best approach will vary given cultural norms, management philosophy, and diversity of business characteristics. Most, but not all, of BCG clients that employ this approach have opted for a common target across all businesses or product lines as the fairest and most objective way to allocate capital markets requirements to internal business units.

The second choice is what internal measure the company will employ to capture a business unit’s or product line’s contribution to the RTSR goal. Here, the most effective approach is to use the total business return (TBR) measure. This measure captures the capital gain and dividend yield contribution of a business unit or product line in a simple and transparent formula. Figure 4 shows one version of the formula, using growth in earnings before interest, tax, depreciation and amortization (EBITDA) as the driver of capital gains. The formula can be readily adapted to use earnings before interest and taxes (EBIT), net operating profit after tax (NOPAT), or operating income for businesses that are not capital-intensive.

Many companies have found TBR to be a useful capstone measure because it requires business unit management to balance tradeoffs between growing EBITDA and managing capital investments. In order to increase TBR, a business unit that elects to use cash for investments to improve EBITDA must provide a capital gain that is greater than the free cash flow “dividend” yield they would
have gotten by returning the cash to corporate. And, empirical studies by BCG indicate that the TBR measure has a much higher correlation to actual RTSR than other measures such as EPS growth, change in EVA, and improvement in ROE.

Companies deploying the TBR measure internally send a clear, objective, and empowering message to their business area teams: “You are in charge of the value creation tradeoffs in your business as if you were CEOs of your own publicly traded companies. You must manage them to deliver a value contribution that is consistent with capital markets expectations for any publicly traded company—either through increasing value or by freeing up cash to return to corporate.”

This philosophy removes corporate as a buffer between business units and capital markets accountability, eliminates unproductive negotiations about targets, and empowers and disciplines business unit management to chart their own course for improved value creation.

In summary, aspirations are an important tool to focus, align, and stretch an organization, but they must be clear, quantifiable, achievable, locally empowering, and linked directly to capital markets expectations. Grounding aspirations in a RTSR goal that is cascaded down to business unit accountabilities is the leading-edge approach for activating the aspiration lever. Companies that have effectively incorporated this approach into their planning and incentive compensation processes experience a number of benefits: Negotiations around targets are eliminated, sandbagging or gaming of plans and budgets disappear, requests for resources are more honestly linked to value creation, and local empowerment and accountability for value creation delivery are increased. And, the usefulness of aspirations as a vehicle for driving reexamination and stretch thinking about operational effectiveness and competitive strategy at the business unit level is greatly enhanced.

**DIRECT LEVERS FOR VALUE CREATION**

Management has four basic levers that they can directly activate to meet their RTSR goal: operational effectiveness, competitive strategy, portfolio management, and investor strategy. These levers are not independent and must be activated in a way that aligns them with each other and with value creation.

Most traditional VBM approaches focus on how to improve the first three levers and largely ignore the investor strategy lever. The intent of traditional approaches was to provide economic principles and supporting measures that helped managers focus these three levers on value creation. Earn a return above the cost of capital, grow profitably, and maximize cash flow, not accounting earnings, were the guiding principles of new value metrics such as cash flow return on investment (CFROI), EVA, net present value (NPV), and others. These principles and measures promised a rational and common language for assessing business plans, evaluating operating tradeoffs, allocating resources, measuring performance results, rewarding managers, and managing the overall portfolio.

All in all, it was a compelling array of potential benefits that prompted many companies to adopt one form of VBM or another. But, while many companies achieved a number of these benefits,
many others did not. And many non-VBM adopters had TSRs that outperformed industry peers that had adopted a formal VBM approach. Clearly, adopting VBM was not a panacea for delivering superior value creation.

Traditional VBM principles fell short of providing the best guidance for value creation largely because they ignored the fourth direct lever—investor strategy. Most approaches to VBM focused on delivering improvements to underlying intrinsic (theoretical) value and not externally realized value. Figure 6 illustrates how a number of common VBM principles take on different implications when viewed from an investor’s perspective—and how those principles need to evolve to provide better guidance for operations, strategy, and portfolio management activities.

“Earn a return above the cost of capital” has been a core underpinning of all approaches to VBM. But most approaches have viewed this principle solely from an internal perspective. The operational guides most VBM users focus on are getting the ROI on existing assets up to or above the cost of capital and ensuring that all incremental new investments earn returns above the cost of capital. Yet these prescriptions can fall short or even distort the ultimate goal when viewed from an investor’s perspective. For investors, earning a return above their cost of capital means achieving a risk-adjusted capital gain or dividend yield that is above average (i.e., RTSR >1). Their goal is to invest in companies that will deliver fundamental performance that exceeds the performance expectations already imbedded in the company’s current stock price. They are less concerned with whether a company’s ROI on existing assets is above the cost of capital than with whether it will improve from its current or expected level. Low ROI companies that improve ROI are good investments while high ROI companies that are not improving can be bad investments. Change, not level of ROI on sunk costs, is what matters to investors. Figure 7 shows the relative TSR performance of companies in the S&P 500 given their starting level of ROI.

As shown in Figure 7, companies that had the lowest quartile ROIs on existing assets delivered RTSRs during the next five-year period that were on par with those that were originally in the highest quartile of ROI. The implication of this investor-centered logic is that having a high ROI relative to the cost of capital does not equate to a superior TSR. To drive value, ROIs must either improve above expected levels or be accompanied by greater than expected reinvestment growth. And internal targets for ROI improvement or reinvestment for growth need to reflect the expectations that are already in the current stock price. High ROI business units can’t coast, and low ROI business units are not value eroders per se if they can improve ROI above expectations.

In the 1990s many managers were side-tracked by VBM implementations based on the narrow conclusion that ROI levels below the cost of capital were bad and ROI levels above the cost of capital were good. This prompted unproductive debates about sunk cost, acquisition good will, allocating shared assets, or calculating the cost of capital—debates that distracted from the focus on improving fundamental performance.

Similarly, the focus on improving intrinsic value
created mind-sets and priorities that fell short of maximizing realized value creation. An over-reliance on improving internal measures such as EVA or NPV resulted in lack of attention to managing the company’s valuation multiple. Most managers believed their multiple was not manageable or it would take care of itself (i.e., reflect intrinsic value improvement) and focused on measuring intrinsic value correctly and then taking actions to improve it. Absolute valuation multiples do, in fact, depend on macroeconomic and investor sentiment factors that are outside management’s influence. However, relative valuation multiples are largely driven by factors that are under management’s control. Management of risk, transparency of reporting, portfolio mix composition, consistency of results, management and meeting of expectations, and the relative priority among revenue growth, margin improvement, and balance-sheet management at the operating level all determine the appeal of a company’s value proposition to investors.

A number of tools are available to isolate and quantify the manageable drivers of a company’s relative valuation multiple. These include investor interviews, benchmarking against a high-multiple peer, regression analysis of industry multiple differentiators, and longer-term market multiple analyses. But the overriding focus on intrinsic value thinking in the 1990s prevented many companies from taking steps to manage their valuation multiple. As a consequence many executives were frustrated when their “NPV packages” did not impress investors or created investor compromises that undermined their valuation multiple.

In a related, but somewhat different, vein, the principle of stock market efficiency masked the requirement and opportunity to proactively increase a company’s appeal to investors. While markets are efficient, they are also segmented. Growth investors will look at a company’s NPV proposition through a different lens than will value or income investors. In essence, they are like customer segments that look for different features, benefits, and branding. It is difficult to create a single package that will appeal to all segments at the same time. As a result, each company needs to develop an effective investor strategy that identifies how it can improve value in a way that the targeted investor segments will find attractive over the long term. This means that companies need a capital markets fact base that includes a careful analysis of investor segments that currently own them, and a process for incorporating the ownership mix implications into the other direct levers that make up a company’s value proposition—operational effectiveness priorities, competitive strategies for growth, and overall portfolio strategy.

Good things to do from an intrinsic value perspective may not be the best things to do from a realized value perspective, particularly in the short to medium term. Introducing a balance sheet management program driven by EVA will not impress the growth investor base of a high P/E company, and it may even result in erosion of the multiple (realized value) if the program distracts managers from a top-line revenue growth priority. Adding a growth leg to a mature business portfolio will attract few growth investors and may alienate existing value investors who prefer that management focus on improving the core business and use free cash flow to repurchase shares, reduce debt, or increase dividends. Many moves that
increase intrinsic value measures such as NPV or EVA may also reduce a company’s valuation multiple. This is because they may dilute the company’s appeal to its current investor base and, at the same time, fail to appeal to new investors.

In summary, managing the tradeoff between improving intrinsic value and improving realized value is a key challenge that was masked by the assumptions in traditional VBM approaches. This tradeoff affects how each of management’s four levers should be activated. Adjusting traditional VBM principles so that they are more investor focused is the first step in better maneuvering those levers for value creation. The follow-up step is to equip investor-oriented VBM principles with more effective tools for identifying and quantifying opportunities to increase realized value.

Here there are two additional tools that can help enhance a company’s ability to manage realized value. One focuses on understanding the fundamental performance drivers behind relative P/E or other valuation multiples. The other focuses on understanding the investor-oriented drivers of premiums or discounts to a company’s valuation. Combined, they provide rich insights about how to improve realized valuation and what accompanying changes to priorities or tradeoffs in operations, competitive strategy, portfolio management, or financial policies are necessary.

**Quantifying relative P/E drivers.** Until the last decade, P/E multiples were widely used as the primary indicators of company valuation. But with the advent of value measurement techniques emphasizing net present value, EVA, and cash flow return on investment—and with increasing academic and consultancy research showing low correlations between P/E levels and EPS growth—the defensibility of P/E ratios as a management benchmark came into question. Yet many senior executives still talk about, worry about, and wonder about how to improve their P/E ratio, and it is still the metric that investment bankers and sell-side analysts emphasize when speaking with corporate executives about their stock market valuation. And, when properly interpreted, P/E ratios (or other valuation benchmark multiples) provide important information that can help management shape a value creation agenda.

Although P/E ratios are a residual measure and not a hands-on driver of stock price (i.e., you can’t directly pull the P/E lever), they do summarize the health of underlying factors that determine the valuation investors assign to a company’s EPS. As such, the ratio is a reservoir of important insights that can be acted upon to improve valuation (if those insights can be clearly identified). This won’t happen by simply comparing company P/E ratios—even when artful investment bank or analyst interpretations are applied.

BCG has employed two different analytical approaches to assessing the underlying drivers that determine client P/E ratios (or any other valuation multiple such as EBITDA/total value, price/book, or price/revenue multiples). One approach is a paired comparison of fundamental drivers between two companies with different valuation multiples. By comparing the two companies, it is possible to identify the factors that would intuitively explain differences in valuation from an investor’s perspective (e.g., performance volatility, leverage risk, cash flow leakage, ROI, portfolio complexity, consistency of strategy). Where there is a direct peer with a higher P/E, this approach can pinpoint clear actions that can improve the company’s valuation.

A second approach uses regression analysis to derive the fundamental factors that explain differences in valuation multiples across a group of companies. The technique, termed relative multiple factor analysis, empirically derives the fundamental factors that explain differences in valuation multiples across a specific sample of companies.

Sometimes these factors are traditional financial performance variables (e.g., return on net assets, return on sales volatility, sales growth, gross margin, debt to capital). But sometimes they are

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more operational factors such as the ratio of self-service to full-service customers (brokerage industry). The approach allows testing of a wide range of potential valuation differentiators, and results in a formula that quantifies the potential impact of changing the performance of any given indicator.

**Investor strategy premium/discount.** Developing an effective customer-oriented strategy is a fundamental pillar of good business practice. But disciplines such as customer segmentation and product packaging have not been widely applied to a company's ultimate customers—investors.

Like end-use customers of a product or service offering, investors differ widely in their appreciation of different combinations of features or benefits. And, as in the case of product/service customer strategy, companies need to develop an investor strategy that best meets the needs or desires of targeted investor segments.

Simply offering a future NPV outcome that is high is not enough. Investors care about the packaging of the NPV perhaps more than they care about what the bottom line number is. NPV packages that impress or satisfy management may not connect with current investor or potential investor segments, resulting in a valuation that is a discount to underlying intrinsic value.

For example, until senior executives know what matters most to their key investors, they can make strategic moves that destroy value rather than create it. That is what nearly happened to one company with a strong brand franchise and a long history of delivering modest, but profitable, organic growth. Senior executives were concerned about how the company was going to meet investors' expectations. They assumed that sustaining the company's unusually high P/E required that the company grow more rapidly.

Management was well down the road toward a new acquisition and a major geographic expansion when it discovered that these big strategic bets were precisely what its core investors did not want. The company's institutional investors were dominated by "growth at a reasonable price" (GARP) shareholders. They were looking primarily for stability—consistent, above-average earnings growth but with very low risk. They were eager to see aggressive reinvestment to protect and grow the main franchise, but not an expensive acquisition and a potentially risky expansion into volatile economies with significant exchange rate risks. The company's plan ran the risk of alienating its major investors, thereby destroying its P/E multiple rather than saving it.

The goal of investor strategy is to create a product offering that either eliminates discounts to underlying intrinsic value or that creates a sustainable valuation premium. Figure 8 outlines the sources of company discounts.

Obviously, a company's value will suffer if its strategy is misguided or its operational execution is poor; these represent failures to capitalize on intrinsic value improvement opportunities. This first source of company discounts is a classic focus for traditional VBM activities, but is unrelated to investor strategy.

The remaining three sources of discount are directly related to investor strategy. Each represents management's a failure to align the offering to investors' needs and desires. A governance discount occurs when the needs or interests of different segments of investors are in conflict. It typically arises where there is a mix of dominant and marginal investors, different classes of shares, or partial listings of subsidiaries. These situations are more common than is appreciated.

![Figure 8. Sources of Discount](image-url)
Individuals, management, family trusts, or foundations that have significant holdings can have very different objectives than institutional investors. For example, the interests of the Ford Foundation trust can differ not only from those of Ford management but also from those of their institutional investors. How well managements align these diverse interests will determine whether institutional investors place a discount on the company’s value.

A credibility discount occurs when management’s agenda is either not clear to investors or is inconsistently delivered upon. Lack of clarity arises from either vague or incomplete discussions of strategic intentions, or from ineffective line of business or strategic milestone reporting that leaves key operational performance insights to the investor’s imagination. Inconsistency erodes credibility when management’s statements of strategic intent change frequently, when actions don’t match stated intent, or when results don’t follow commitments. Credibility with investors can be a company’s most important “off balance sheet” asset, if managed effectively.

Compromise discounts occur when management offers an overall NPV package that contains trade-offs that are not attractive to investors. Mixing businesses having value characteristics with businesses having growth characteristics in the same portfolio is a clear cause of compromise discounts. For example, companies in mature industries that add new growth businesses to their portfolios may not be able to capture the underlying value of these new businesses. Growth investors prefer “pure play” investments that have critical mass around growth opportunities, while value investors prefer that management does not dilute near-term value realization potential by making risky or longer-term growth investments with excess free cash flow. Also, as many firms have discovered, mixing businesses with radically different risk profiles can result in a discount to their intrinsic risk-adjusted value. Novartis, Monsanto, and others discovered this when they mixed high-risk biotechnology businesses with lower risk pharmaceutical businesses. Financial theory describes an efficient frontier for risk-return tradeoff—it is difficult to occupy different places on that frontier at the same time and maintain an optimal valuation.

Companies can remove discounts and achieve a modest sustainable premium to underlying intrinsic value by creating a company brand that either reduces investors’ perceptions of risk or increases their confidence in the stability or extendibility of a company’s sources of value creation advantage. Under Jack Welch, GE established such a “brand” that led to a sustained premium over the discounted cash flow valuation of underlying performance. But the underlying brand features must be sustainable or the premium quickly disappears and can even lead to a “disappointment” discount. Figure 9 outlines an investor strategy approach to creating a sustainable premium—or at least ensuring the absence of a discount.

If you were to build a powerful product or service brand, you would first assemble a rigorous customer fact base and then use that knowledge to drive both your product/service development agenda and your marketing/advertising agenda to support it. The same is true for building a company brand that investors can have high confidence in.
brand that creates a premium price with investors.

As outlined in Figure 9, the process begins with a clear understanding of the current investor segmentation, what their expectations and needs are, what NPV features are most attractive to them, what the company’s credibility quotient is, and how the firm could migrate to new investor segments to maximize the appeal of its NPV offering. This information then feeds back to management’s action agenda to orchestrate the content, priority, timing, and consistency of strategic, operational, and financial policy actions. It also feeds forward to establish the focus, content, and positioning of investor relations communications.

Many companies trade at a discount to intrinsic value; very few trade at a sustainable premium. An effective investor strategy can eliminate the former and promote the latter. When deep knowledge of investors is combined with analysis of fundamental factors that explain valuation multiple differences among peers, actionable insights to raise valuation become clear and high priority. Figure 10 shows the results for “XYZ Inc.”

Over the last decade, XYZ Inc. had consistently experienced a lower EBITDA multiple than the leading peer in its industry—even though XYZ consistently had a higher ROCE than its peer. Using direct benchmarking and relative multiple factor analysis, XYZ quantified the four primary drivers of the discount that the company’s value-oriented investors were concerned with. Subsequently, management developed and implemented a revised value creation agenda that, within six months, significantly closed the gap in their relative multiple.

**CORPORATE CENTER PRACTICES**

Once management has developed a game plan for activating the four levers for value creation, it must align corporate center practices—that is, headquarters activities—to ensure delivery. This is a more important and difficult task than most executives perceive.

Yet the practices of the corporate center are critical to sustained superior value creation. When they are aligned with value creation, they empower, enable, discipline, and orchestrate an organization’s ability to reach its full potential in delivering value. When they are unaligned or misaligned, they can create barriers or foster counterproductive thinking and behavior. And the cumulative impact of these headquarters activities largely determines the pragmatic aspects of company culture. Corporate center practices convey beliefs and values, establish behavior norms, and signal priorities. Reinforcing or changing culture to focus on value creation is largely a matter of how corporate center practices are designed and carried out.

More often than not, the combined impact of corporate center practices is neutral to negative in fostering value creation. Often these practices have not been subject to a comprehensive reexamination that identifies strong vs. weak practices, misalignment across practices, or missing links within the overall set of practices. Figure 11 depicts the range of corporate center practices that can either foster or inhibit an organization’s ability to deliver sustained superior value creation.

There are three steps to developing an aligned set of corporate center practices that contribute

**Figure 10. Example of Multiple Drivers**
optimally to value creation. The first is to reexamine the appropriate balance among four different goals: empowerment, enablement, discipline, and orchestration. Is the overarching goal of long-term value creation better served by fostering a greater sense of local empowerment, thus making line managers more proactive? Will exploiting corporate talent, skills, and capabilities through direct interventions better enable line managers to improve results? Will a more rigorous discipline for accountability and for results most enhance value creation? Is it to better orchestrate synergies across businesses, to capture between-business opportunities, or to develop common platforms or capabilities?

It is simply not possible to fully realize all four goals at the same time. There are tensions between these goals that make it difficult to give all of them equal emphasis. For example, approaches that increase local empowerment tend to reduce enablement and orchestration—and vice versa. And the priority of these goals will differ, depending on a company’s characteristics (focused vs. diversified, high growth vs. mature, etc.) and cultural starting point.

Too often, companies continually tweak their corporate center practices to try to achieve the best of all worlds—and end up with the worst of all worlds. One recent BCG study revealed how far out of alignment corporate center goals and supporting practices can get. Several years previously, a company had realigned its planning, budgeting, and incentive processes to foster greater empowerment and accountability for its business unit management teams. Management wanted to increase entrepreneurialism and eliminate unproductive budget negotiations. But when the program didn’t produce positive results as fast as expected, corporate launched a series of top-down enablement programs—a balanced scorecard tool, a customer relationship management program, and then an asset productivity program. These programs disrupted local managements’ focus and priorities, caused them to miss previously established incentive targets (requiring reengaging the negotiation process), and resulted in an erosion of corporate credibility with line managers. The disconnect reached a climax when corporate uncovered a significant opportunity to reduce costs and improve new product development by orchestrating a best practices sharing program for manufacturing and technology development. None of the business unit leaders would agree to champion the effort or offer their best people to support it. Cynicism so pervaded the atmosphere between corporate and business units that driving value creation became secondary to managing organizational politics.

Incremental tweaks to corporate center goals and practices can result in one step forward and one or two steps backward. A more effective approach is to periodically reexamine all elements in the corporate center and then align them in a new direction as appropriate. This reexamination process begins with assessing the match between corporate center goals and the existing corporate center style. Figure 12 illustrates how different styles interact with different goals.

The three corporate center styles shown on the left of Figure 12 represent the range of ways in
which corporate can position its “social contract” with line managers. One extreme is the hands-on owner style, where corporate executives control most of the major decisions about priorities, trade-offs, and new initiatives that affect day-to-day operating results. Many companies with a focused customer set, technology base, or common business model across geographies gravitate toward this style. At the other extreme is the hands-off investor style, where corporate has little or no direct influence on day-to-day operating matters and focuses on disciplining financial results and making decisions about managing the portfolio mix. Many diversified companies adopt this style.

As indicated in the cells of the matrix, the two styles tend to be polar opposites in their impact on empowerment, enablement, discipline, and orchestration goals. As a result, many corporate centers are tempted to vacillate between the two styles to get the best of both worlds. They do this by of and on direct interventions, periodic tweaks to management processes (e.g., planning, budgeting, or incentives), and leadership pronouncements. Done carefully, this can work well—for a while. But more often it eventually results in frustration—not a healthy tension—among both corporate and business unit management.

If staying at or moving to either style extreme is not appropriate for a company, then the activist partner style may be the right answer. It represents a different type of “social contract” than vacillation between hands-on and hands-off styles. And it puts a different burden on corporate behavior and supporting practices. But it is a style that has to be constantly worked at to maintain its integrity. General Electric is a leading-edge example of how this style is applied.

The activist partner style works to create a team spirit around a shared long-term goal of value creation based on an enduring respect for clearly established roles and boundaries for both corporate executive and line manager behavior. Empowerment is granted to line managers, but coaching and thought partnering is expected. Enablement is done primarily through high-level capability development programs, not specific interventions. Accountability and discipline are promoted through frequent and open inter-year reviews and flexible incentive program design. Orchestration is done by corporate taking the time to sell its case for synergies, common platforms, or shared services to line executives.

Any of the above three styles can work—if it fits the business characteristics and is adhered to consistently. Lack of alignment of practices around one style or vacillation across styles can diminish the contribution from corporate center activities.

Once goals and style have been defined, the remaining issue is to clearly align specific corporate center practices to support them. Practices for leadership and guidance, exploitation of linkages, and management processes need to reflect the priority of goals and the intended corporate style. For example, performance metrics used if the goal were maximum empowerment under a hands-off style would be very different from those used if the goal were maximum discipline under a hands-on owner style. In the former case, one high-level metric (e.g., EVA or TBR) that allowed local trade-offs to be optimized would be appropriate. In the latter case, a larger number of focused metrics that limited local degrees of freedom would be appropriate (e.g., revenue growth, margin, capital turns, free cash flow targets).
The cumulative impact of headquarters activities largely determines the pragmatic aspects of company culture.

Similarly, a larger range in annual bonus potential may be more appropriate for a hands-off style, and a narrower range of bonus with a higher base salary may better fit a hands-on owner style. Or a disciplined and robust long-range business unit planning process may better accompany a hands-off style and a more limited business unit annual budget process may better suit a hands-on style.

Few companies have developed a formal process for reexamining and aligning corporate center goals, styles, and practices. Evolution through tweaking is the norm. Best practice is to step back periodically (every three to five years, or after a major acquisition) and charter a task force to comprehensively reexamine how effectively the corporate center is fostering value creation. The task-force should start by developing a capabilities and culture fact base—one that solicits a wide range of inputs and assembles objective data on capabilities and the effectiveness of practices. Mapping this fact base against the current agenda for management’s four direct value creation levers reveals the viability of current corporate center goals, style, and practices. Then the (often surprisingly obvious) alignment steps can be implemented.

Company characteristics or the business environment can change significantly over any given three- to five-year period. Companies need to manage the evolution of their corporate center practices in a systematic way to capture untapped opportunities for in value creation.

REAPING THE BENEFITS

The full benefits of VBM will accrue to those companies that best connect VBM practices externally with capital markets and internally with their organizations. Focusing the organization’s efforts around a relative total shareholder return aspiration that is cascaded down into business areas is a first step. Managing direct levers for value creation in a way that recognizes tradeoffs between intrinsic value improvement and realized value improvement is a second. Doing so requires a focus on the levers that determine relative valuation multiples and cause investor discounts. The third step is to align corporate center practices to leverage capabilities and the impact of culture on value creation.

These steps seem straightforward on paper, but they have long been overlooked. In fact, it is clear that the last decade’s VBM approaches either did not fully address them or masked the importance of tackling them with a fact-based and systems perspective.

We hope the past lessons, new insights, and organizing frameworks described here will provide readers with the ingredients to craft and implement a VBM approach that delivers a successful value creation agenda for next decade.

FURTHER READING


