Shareholder Value Explained

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'Shareholder value is a modern business cliché: a mantra intoned with solemnity at every Annual General Meeting and in every Annual Report. But for all the words, few people have any clear idea of what shareholder value comprises'.

The Sunday Times

In this article, we attempt to clear some of the fog that surrounds the subject of shareholder value. We outline what is meant by shareholder value, how it is measured and how it is created & destroyed. In an accompanying article entitled 'Shareholder Value Illustrated,' we provide some illustrations of the main shareholder value concepts using Boots as the case study. And in a third article entitled 'Why Value-Based Management Goes Wrong', we address the main reasons why many of the companies that have adopted an explicit approach to the creation of shareholder value have not succeeded in delivering the improved value creation performance they desired.

WHAT IS SHAREHOLDER VALUE?

Over the past 20 years, the idea that companies should be managed with a view to maximising the wealth of shareholders has become widely accepted and many of the world's leading companies have become vocal advocates of managing for shareholder value. The drive to put the interests of shareholders at the top of the corporate agenda has been the result of two main factors: -

1. Studies on the consequences of acquisition, the popular and much practised quick fix route to growth, generally conclude that, in at least two out of every three cases, shareholder value is destroyed for acquirer.

2. The institutional investment community has become much less tolerant of mediocre performance and much more willing to apply pressure whenever it deems performance to be less than satisfactory.

Any company that fails to deliver the level of return required by its shareholders risks either being starved of capital, having its senior management replaced or being acquired.

Faced with intense pressure to deliver the improved performance demanded by an increasingly hostile investment community, hundreds of the world's leading companies have chosen to espouse the shareholder value mantra and implement an explicit approach to shareholder value creation, commonly known as value-based management (VBM). The principle of VBM is that the primary aim of a company, its strategy, its day to day operations, its systems, its processes, its performance measures and incentive systems all have the wealth of shareholders as their underlying guiding beacon, and are aligned accordingly. Pioneers of VBM included Coca-Cola, AT&T and Quaker Oats in the US, and Boots and Lloyds TSB in the UK.

The term ‘shareholder value’ refers to the financial worth of shareholders’ investment in a company. There are three main perspectives for assessing the value of shareholders’ investment, the first is balance sheet based, the second is stock market based and the third is economics based.

The Balance Sheet Perspective

The balance sheet perspective on shareholder value is ‘shareholders’ funds’ which typically comprises the nominal value of a company’s issued share capital (i.e. 100m shares issued at £1 per share is recorded at a nominal value of £100m) plus the summation of all the profits retained in the company from its date of incorporation. Whilst the balance sheet is a factually accurate statement of the book value of the shareholders’ investment in a company, it provides a poor insight into the current worth of this investment. This is because the balance sheet is backward looking and is drawn up on the basis of historic cost accounting. Thus, a profit of £10m retained 15 years ago is recorded on the balance sheet at £10m in perpetuity irrespective of the impact of inflation and as shall be explained later, irrespective of the opportunity cost of equity. Likewise, if a company issued shares at £1 per share 15 years ago, these shares are recorded on the balance sheet at £1 per share in perpetuity irrespective of what price the share trades at on the stock market. Consequently, shareholders’ funds on the balance sheet typically under-records the current worth of shareholders’ investment in a company and often by several multiples.

The Stock Market Perspective

The stock market based measure of shareholder value is simply the company’s market capitalisation ie the number of shares in issue multiplied by the share price. Thus, a company with 100m shares trading at £4.00 share has a market capitalisation or shareholder value of £400m. Changes in a company’s share price affect the value of shareholders’ investment in the company, and thus affect shareholder value. If over the course of a year, a company’s market capitalisation were to increase from say £400m to £500m, shareholder value would have increased by £100m. However, as we shall explain in the later section entitled ‘Creating Shareholder Value’, this does not mean that £100m of shareholder value has been created during the year.

The Economics Perspective

The third perspective on shareholder value is economics based and should correspond with the stock market based perspective in the long-term, assuming the stock market functions efficiently.

According to economic theory, the ‘true’ or economic value of a company, sometimes called its business value, is the net present value (NPV) of the company’s future free cash flows discounted by its weighted average opportunity cost of capital (WACC). The value of the company which is attributable to shareholders, also called shareholder value, is then simply the economic value minus the company’s borrowings ie bank loans & corporate bonds etc. Thus, the economic value of shareholders’ investment depends on the company’s future free cash flows, the cost of using shareholders’ & lenders’ capital (WACC) and the size of its borrowings (debt).

Free Cash Flow

A company's cash flow is made up of three main constituents

- The cash flow from its operating activities
- The cash flow from its investing activities
- The cash flow from its financing activities

Free cash flow is a company's post tax cash flow before its financing activities. It is the summation of the cash flows from its operating activities (i.e. operating profit before interest, depreciation & amortisation of goodwill minus taxes paid minus the increase in working capital) and the cash flows from its investing activities (i.e. capital expenditure plus investments in other companies including shareholdings & acquisitions minus any cash received from the disposal of assets). Free cash flow is the residual cash available (i.e. 'free') to the providers of finance to fund interest payments to lenders, dividend payments to shareholders, repayments of loans and buybacks of the company's own shares. If trading conditions are difficult, or if investing activities are particularly heavy, free cash flow can be negative, in which case a company will either have to raise additional capital from its shareholders or its lenders, or reduce its cash/near cash reserves. For many companies, free cash flow can be a volatile measure and one that is often more volatile than accounting profit.

Opportunity Cost of Capital

When investors entrust their money to a company, they expect to receive a return by way of compensation. For lenders, compensation is in the form of interest and for shareholders, compensation is in the form of dividends & share price appreciation. The minimum rate of return required by investors is called the 'opportunity cost of capital' and represents the rate of return foregone by not investing in an alternative investment with the same level of risk.

When investors choose to invest in government bonds of major economies, they are almost certain to receive exactly the level of return expected, and such investments are deemed to be effectively 'risk free'. For example, the rate of return on UK government 10-year bonds as of January 2003 was c 5% and is effectively a guaranteed 'risk free' return.

When company borrows from a bank, the company will be required to pay a premium over and above the risk-free rate to compensate for the risk of default on the loan, and the greater the perceived risk of default, the higher the interest rate the bank will require. The rate of interest charged on borrowings is called the 'opportunity cost of debt'. Because interest is an expense that can be offset against a company's taxation liability, the real cost of debt finance to a company is the net of tax cost (i.e. the gross rate of interest minus the rate of corporation tax, currently 30%. Thus, 10% gross minus 30% tax equals 7% net).

When investors choose to invest in company shares, they will normally require a higher return than lenders. This is because, lenders have first call on a company's free cash flow, whilst shareholders have no guarantee of dividend payments and indeed, should the share price fall, a shareholder's return could potentially be negative. Shareholders will thus require a higher return than lenders to compensate for the greater risk they bear. The minimum return required by shareholders' is called the 'opportunity cost of equity' and varies with the perceived risk of holding a

particular share - the higher the perceived risk, the higher the minimum return that will be required. For example, a venture capitalist investing in a 'high risk' biotechnology start up will expect a significantly higher return than a pension fund investing in a mature 'low risk' non-cyclical utility.

Historically, the return from a diversified, balanced portfolio of shares has fluctuated between 5-8% over & above the 10 year government risk free bond rate. This additional return over & above the risk free rate is called the 'market risk premium'. As of January 2003, the opportunity cost of equity for an average risk FTSE company was thus in the order of 10-13% (i.e. 5% 'risk free' plus 5-8% 'market risk premium').

Weighted Average Opportunity Cost of Capital (WACC)

The weighted average opportunity cost of capital (WACC) for a company depends on four factors:

- its opportunity cost of debt finance – assume 5% net of tax
- its opportunity cost of equity finance – assume 15% (i.e. an above average risk)
- the debt share of total finance – assume 50%
- the equity share of total finance – assume 50%

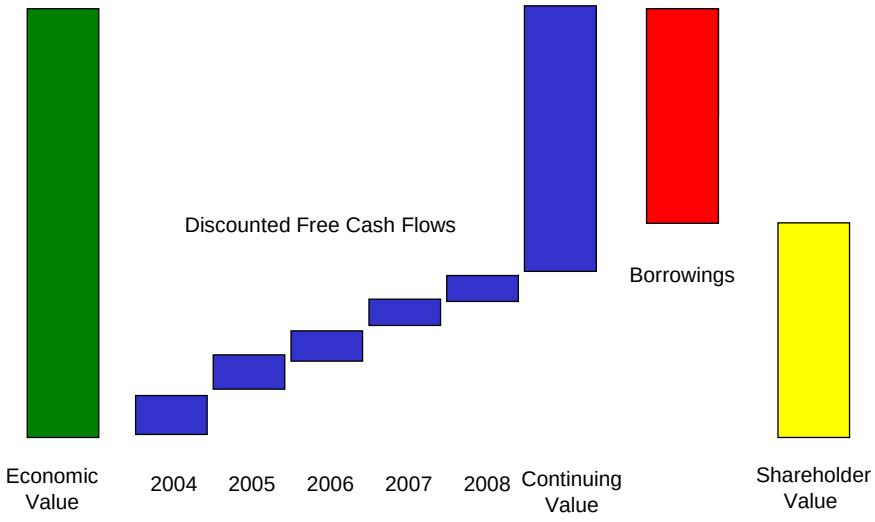
In this instance, the company's WACC is 10.0% and is calculated as follows:

	Share of Total Finance	Opportunity Cost	WACC
Debt	50%	5%	2.5%
Equity	50%	15%	7.5%
			10.0%

Net Present Value (NPV)

Because investors require compensation for forgoing cash today in expectation of more cash tomorrow, a company's future free cash flows have to be discounted by its WACC in order to convert them into a today's equivalent. For example, if a company's WACC is 10%, £100 at the end of the year is only worth £91 in today's money (£100/1.10). At the end of the following year, £100 is only worth £83 in today's money (£100/1.10^2) and at the end of the following year, only worth £75 (£100/1.10^3). When all the future discounted free cash flows have been added together, the total is called the 'net present value' or 'economic value' of a company. It is the value of the company's future expected free cash flows in today's money after having accounted for its shareholders & lenders minimum compensation requirements. The value of the company that is attributable to shareholders, i.e. the shareholder value, is then the net present value (economic value) minus the company's borrowings (debt).

LINK TO SHAREHOLDER VALUE



The Link Between The Stock Market & The Economics Perspectives

When the stock market places a value on a company's shares, it is factoring into the price all the publicly available information on the company in order to make an estimate of the company's net present value by discounting its future expected free cash flows by the WACC. However, at any point in time, the prevailing share price may be above or below the company's 'true' economic valuation. This is because there are many factors that combine to affect the day to day price of a company's shares including unsubstantiated rumours about either the company or its competitors, momentum investing, panic selling, misinterpretation of information and many others. Nevertheless, in the long-run, it does appear that 'truth does get out' and that stock markets generally function efficiently with share prices being anchored, albeit elastically, to some underlying notion of the 'true' economic worth of the shareholders' investment in the company

If the stock market estimates a company's future expected free cash flows, when discounted by the WACC, to be worth £1000m, the net present value of the company, or its economic value, is £1000m. Assuming the company was financed by £500m of borrowings (debt), the value of the company attributable to shareholders, i.e. its shareholder value, would be £500m (economic value of £1000m minus £500m borrowings). The market capitalisation of the company's shares would also be £500m and assuming the company had 100m shares in issue, the current price of the company's shares would be £5.00 (£500m divided by 100m shares). Should the stock market revise upwards its estimate of the company's economic value, then the market price of the company shares would also move upwards increasing both the company's market capitalisation and the value of shareholders' investment in the company, i.e. shareholder value would increase.

MEASURING SHAREHOLDER VALUE CREATION PERFORMANCE

As more & more companies have converted to managing explicitly for shareholder value, there has been growing recognition that traditional accounting measures of corporate performance such as operating profit, earnings and earnings per share are poor guides to shareholder value creation performance. There are three main reasons for this: -

1. Firstly, traditional performance measures rely on the application of subjective accounting rules that present numerous opportunities for management to manipulate reported financial results. The current mis-reporting scandals surrounding Enron, WorldCom, Xerox and others being timely reminders of the inherent subjectivity in financial reporting.

2. Secondly, and more significantly, traditional accounting measures ignore both the amount of capital employed and the minimum rate of return investors' expect to receive from their investment (i.e. the opportunity cost of capital).

3. And thirdly, because shareholder value creation is dependant on future discounted free cash flows, the current amount of operating profit, earnings or earnings per share reported in any one year will almost inevitably be a poor ruler with which to assess the long-term value of shareholders' investment in a company.

In response to these concerns, a plethora of new value-based measures have emerged, which advocates claim provide a much more reliable basis for judging value creation performance than the traditional accounting measures. These new measures vary from the comparatively simple to the highly technical & complex, and include such acronymic delights as total shareholder returns (TSR), total business returns (TBR), cash flow return on investment (CFROI), economic profit (EP), economic value added (EVA® - EVA® is a registered trademark of Stern Stewart & Co.), market value added (MVA), cash value added (CVA), and so on. The most commonly used new measures are total shareholder returns (TSR), economic profit (EP) and its close relative, economic value added (EVA®).

Total Shareholder Returns (TSR)

The total return a shareholder receives is made up of two constituents, dividends (income) and changes in the company's share price (capital gains or losses). TSR is measured by adding the value of any dividends received per share to the increase in the share price over the period of measurement, and dividing by the initial share price. If the resulting percentage is greater than the opportunity cost of equity, i.e. the minimum return expected by shareholders, shareholder value is said to have been 'created'. If TSR equates to the minimum expected return, value is said to have been 'maintained'. And if TSR is less than the minimum expected return, value is said to have been 'destroyed'. TSR can be measured over any time period and it is normally assumed that dividend payments are re-invested in the company's shares. The TSR performance of an individual company may be affected by the general prevailing economic climate, industry specific factors and company specific factors all of which will exert an influence on TSR through fluctuations in the share price. Therefore, it is normal for a company to compare its TSR performance with that of a peer group of similar companies in the same industry and usually over a 3-5 year

rolling period to smooth out any short-term 'unsubstantiated' fluctuations in share prices.

For most companies, the change in the share price will usually be a much more significant factor than dividends in determining TSR. This is because in recent years, the average dividend yield (dividend per share divided by the share price) of FTSE companies has been less than 3% and all of the extra return necessary to deliver the opportunity cost of equity has to come from share price appreciation. Estimating the opportunity cost of equity is not easy, not least because opinion on the forward market risk premium is divided. Nevertheless, with a January 2003 UK Government 10-year 'risk free' bond rate of 5%, the opportunity cost of equity for the average FTSE company in January 2003 is probably in the range of 10-13% (i.e. 5% risk free plus 5-8% market risk premium). If we assume for convenience that the opportunity cost of equity is 10%, and that the average FTSE company were to maintain a 2% dividend yield, the required increase in the share price to deliver the cost of equity would be 8%. Because shareholders will expect to receive at least the cost of equity each and every year, the share price of the average company will have to increase by 8% each & every year merely to meet shareholders' minimum expectations. This means doubling the share price every 10 years merely to maintain shareholder value. Anything less and shareholder value will be destroyed. Value creation is a tough master to serve.

Economic profit (EP)

When looking at the value creating performance of a publicly quoted company, the availability of share price and dividend data means that calculating TSR is relatively straightforward. However, when measuring the shareholder value creation performance of a private company, or at a more detailed level within a publicly quoted company, for example at the level of a subsidiary or an individual business unit or an individual brand, TSR is of little practical assistance. To help overcome this problem, many companies such as Cadbury Schweppes, Coca-Cola, Diageo, ICI & Unilever have adopted an economic profit measure for internal use. The technical details & names of these measures all vary slightly from company to company, nevertheless their great beauty is that they all produce a single number, which captures elements from both the profit & loss account and the balance sheet.

Economic profit measures the surplus earned by a business after the deduction of all its operating costs including its liability to pay tax and the opportunity cost of using the capital employed in the company, subsidiary, business unit or brand. At its simplest, economic profit is calculated as follows:

Operating profit before tax	£300m
Tax liability (£300m x 30% tax rate)	(£90m)
Charge on capital employed*	(£100m)
Economic profit	£110m

* Capital employed x WACC in this example £1000m x 10%

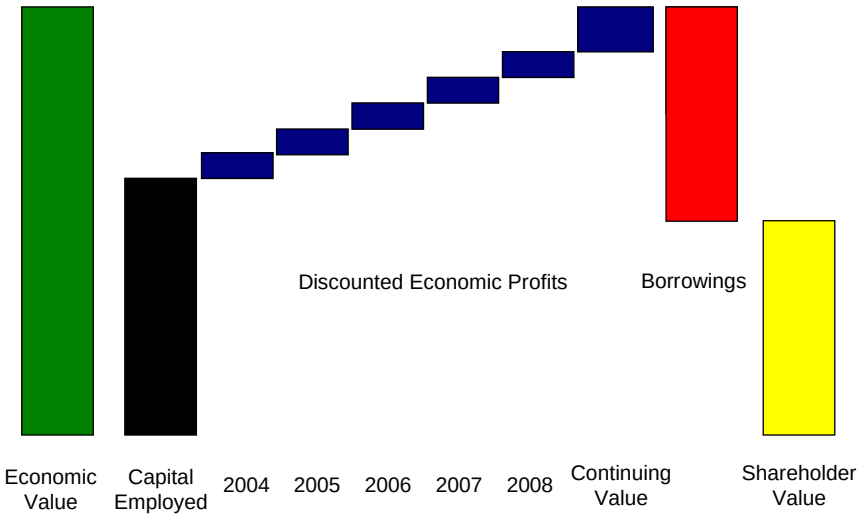
A more complex version of economic profit is economic value added (EVA®), Stern Stewart & Co's trademarked measure, which involves up to 164 accounting adjustments to operating profit and capital employed. The term EVA® is commonly

used within companies although few bother to make all the adjustments advocated by Stern Stewart.

Measures of economic profit provide powerful insights. Some business units and activities which previously have been thought to be good performers generating healthy accounting profits are very often shown to be 'economically unprofitable' once the costs of tax and capital employed are taken into account. Nevertheless, reading too much into a single year's economic profit performance can be deeply misleading. As with traditional accounting measures, economic profit is a single period measure, which is also susceptible to manipulation by management. For example, a positive economic profit may have been achieved by cutting back on R&D, training and marketing expenditure, all of which are likely to impact adversely upon the long-term value by diminishing future economic performance. Likewise, a negative economic profit may be the result of significant capital investment over preceding years, which even if long-term value creative, will have an adverse effect on near-term economic profitability. It is therefore important to consider the future flows of economic profits over time rather than in any one single period.

Economic profit has one further highly useful feature and links directly to shareholder value. Just as the net present value (economic value) of a company is the summation of its future expected free cash flows discounted by its WACC, it is also the summation of the company's capital employed (shareholders' funds plus borrowings from the balance sheet) plus the summation of all its future expected economic profits discounted by its WACC. The value of the company that is attributable to shareholders, i.e. the shareholder value, is then the economic value minus its borrowings.

LINK TO SHAREHOLDER VALUE



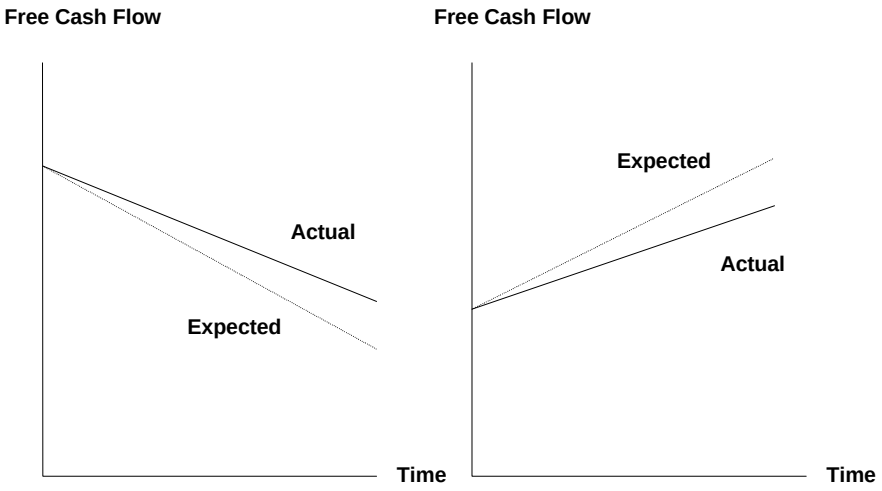
CREATING SHAREHOLDER VALUE

When a company chooses to manage for value, its minimum target is to meet its shareholders expectations by delivering the opportunity cost of equity through the combination of dividends and share price appreciation year after year ad infinitum. If the company delivers current expectations, shareholders will expect it to continue delivering against its future expectations and consequently, the share price will continue to increase by an amount sufficient to deliver the opportunity cost of equity. In this situation, the resulting TSR will equate to the opportunity cost of equity and shareholder value will have been 'maintained'. If a company exceeds its shareholders' minimum expectations, the share price will rise faster than is necessary to deliver the opportunity cost of equity. In this situation, the resulting TSR will exceed the opportunity cost of equity and shareholder value will have been 'created'. However, should the company fail to deliver against it shareholders' expectations, the share price will either rise more slowly, or perhaps even fall, as shareholders' divest in search of more attractive investment opportunities elsewhere. In either case, the resulting TSR will be less than the opportunity cost of equity and shareholder value will have been 'destroyed'. It is thus possible for a company to increase its market value of its shares by virtue of an increase in its share price, whilst at the same time, destroying shareholder value. This situation will arise whenever the increase in the share price plus dividends is not sufficient to result in a TSR that meets its shareholders' minimum expectations, i.e. the opportunity cost of equity.

If a company wishes to exceed its shareholders' minimum expectations, thereby 'creating' shareholder value, the company has to produce a continuous stream of new value creating surprises, which have not yet been factored into the company's share price. When a new value creating surprise becomes known to the stock market, whether it be an unexpected improvement in the company's underlying economic performance, or the announcement of a new investment decision, the anticipated improvement in the long-term economic value of the company will be immediately factored into the share price, causing the share price to increase. From that point onwards, for the company merely to maintain shareholder value (i.e. by producing a TSR that equates to the opportunity cost of equity), the company has to deliver performance in line with the market's revised higher expectations, no matter how difficult this is to achieve. Any thing less and shareholder value will be destroyed. Value creation is a tough master to serve, and one that makes no allowance for previous good performance.

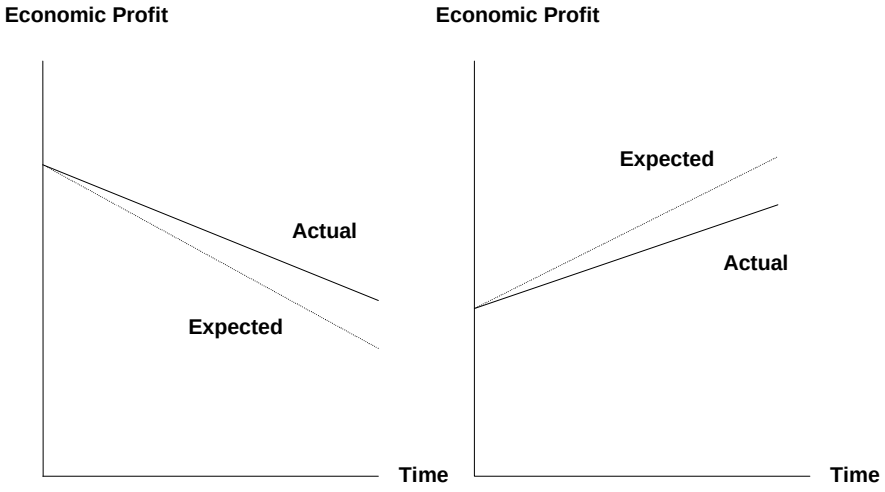
But whilst value creation is a tough master to serve, it is also a fair master to serve. This is because the value creation master affords all companies a level playing field where the challenge is to beat future expected economic performance, good or bad. Thus, a low-margin declining business with decreasing free cash flows can create shareholder value by performing a little less badly than expected, and a high-margin fast growing business with increasing free cash flows can destroy shareholder value by performing not quite as well as expected.

CREATING VALUE **DESTROYING VALUE**



Likewise, a low-margin declining business with a negative or decreasing economic profit can create shareholder value by performing a little less badly than expected, and a high-margin fast growing business with a positive or increasing economic profit can destroy shareholder value by performing not quite as well as expected.

CREATING VALUE **DESTROYING VALUE**



From a financial perspective, there are four general ways in which a company can create shareholder value: -

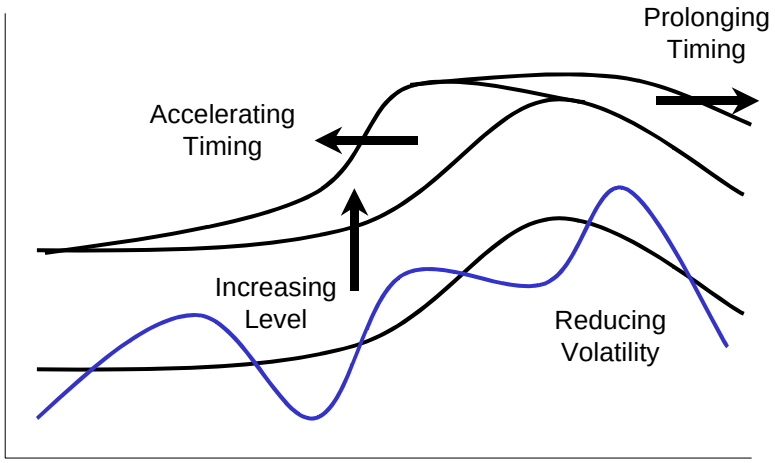
1. Reducing the volatility of its future expected discounted free cash flows – reducing volatility reduces risk and thus reduces the WACC.

2. Increasing the level of future expected discounted free cash flows – more cash is always worth more than less cash.

3. Accelerating the timing of future expected discounted free cash flows – cash that arrives sooner is always worth more than the same amount of cash arriving later.

4. Prolonging the timing of future expected discounted free cash flows – cash flows that last longer are always worth more than cash flows that dry up sooner.

FREE CASH FLOWS



However, in an attempt to create shareholder value, companies often face trade-offs between: -

1. Increasing the underlying long-term level versus reducing near-term free cash flow - increasing near-term investment in the expectation of increasing the underlying longer-term level will usually reduce near-term free cash flows.

2. Increasing the underlying long-term level versus near-term volatility – increasing near-term investment in the expectation of increasing the underlying long-term level will usually make near-term free cash flows more volatile.

3. Prolonging the timing v reducing near-term cash flow – increasing near-term investment in the expectation of prolonging the underlying long-term level will usually reduce near-term free cash flows

4. Increasing the near-term cash flows versus reducing the long-term level and the longevity of free cash flows – reducing near-term investment will usually improve near-term free cash flow, but at the risk of the prejudicing the long-term level and longevity i.e. milking.

Because shareholder value also depends on future expected discounted economic profits, the above four routes to creating shareholder value and the four trade-offs described equally apply to the future expected discounted economic profits as they

do to future expected discounted free cash flows. Simply substitute the term 'free cash flows' with the term 'economic profits'.

It is also vitally important to remember that it is the total discounted flow of future expected free cash flows (or economic profits) that determine shareholder value. It is not necessarily a requirement to increase free cash flow (or economic profit) year on year in order to create shareholder value, merely that the total future discounted flow over time increases.

Value Drivers

For any company intent on managing for value, it is important to that it has a thorough understanding of what really drives value. The main factors that affect a company's net present value or economic value are called 'value drivers' and will vary from company to company, from business unit to business unit, and from brand/product/service to brand/product/service within a company. Nevertheless, there are three sets of common value drivers that apply to almost every company and every business unit. These are the financial drivers, the strategic drivers and the organisational drivers.

COMMON VALUE DRIVERS

Financial Drivers

The four main financial drivers are sales growth, new investments, return on capital employed (ROCE) and weighted average cost of capital (WACC).

Growth is a powerful driver of value creation and it is difficult for companies to create shareholder value (i.e. exceed minimum expectations) without growth. However, not all growth is necessarily good, as growth can either be value creative or value destructive.

There are two main ways by which a company can grow; firstly by utilising its existing assets to generate more sales & profit, and secondly by new investment. The first

type of growth usually improves the 'efficiency' with which capital employed is converted into economic profit & free cash flow and is almost always value creative. For the second type of growth to be value creative, the return on investment must exceed the WACC. If the return achieved is less than the WACC, value will have been destroyed. Growth by new investment embodies everything from new capital equipment to acquisitions to marketing expenditure to R&D expenditure etc. Growth by acquisition is fraught with dangers and at least two out of three acquisitions result in value destruction for the acquiring company's shareholders. Consequently, the investment community generally prefers companies with a track record of organic growth to those who pursue growth by acquisition.

Not all investments have to be focused on growth in order for them to be value creative. For an investment to be value creative, all that is required is that the return on investment exceeds the WACC. This applies to all investments of cash whether they are for growth, efficiency, site closures, operating cost or headcount reductions, increases in the size of the field sales force, marketing expenditure or whatever. Unlike the tyranny of conventional accounting, value creation does not discriminate between cash that is spent on capital expenditure and cash that is spent on revenue expenditure. Cash is simply cash, and investors expect companies to invest cash in projects that deliver a return that at least equals the WACC. Anything less and value will be destroyed.

ROCE is a measure of the 'efficiency' by which a company converts its capital employed into operating profit. Improvements in ROCE will almost always create value and can be derived either by improving the net operating margin (gross margin less overheads less tax) and/or by improving the asset utilisation (the value of sales generated per £ of capital employed). There are numerous individual actions that can contribute to an improvement in ROCE. These include increasing prices, improving the sales mix, reducing operating & overhead costs as a % of sales turnover, reducing working capital as a % of sales turnover, and improving the fixed asset utilisation through sales growth.

Although the WACC is a complex & technical issue, it is an important factor in determining value creation, as it is both the denominator for discounting future free cash flows (and future economic profits) and the minimum hurdle rate that new investment opportunities have to clear. Reductions in the WACC improve both a company's economic value and its shareholder value. Reductions in the WACC also make previously unattractive investment opportunities viable by lowering the height of the hurdle that must cleared in order for the investment to create value. It is, however, difficult for a company to manage its WACC. This is because both the opportunity cost of debt and the opportunity cost of equity are mainly at the mercy of the capital markets.

It is interesting that many companies who actively set out to manage for value put considerable effort into downsizing and structural cost reductions as the quick fix solution to improving value creation performance. This contrasts with the findings of a Boston Consulting Group study of major US & European companies during the mid-1990's, which made two general conclusions: -

1. Growth is a more powerful creator of value than restructuring.

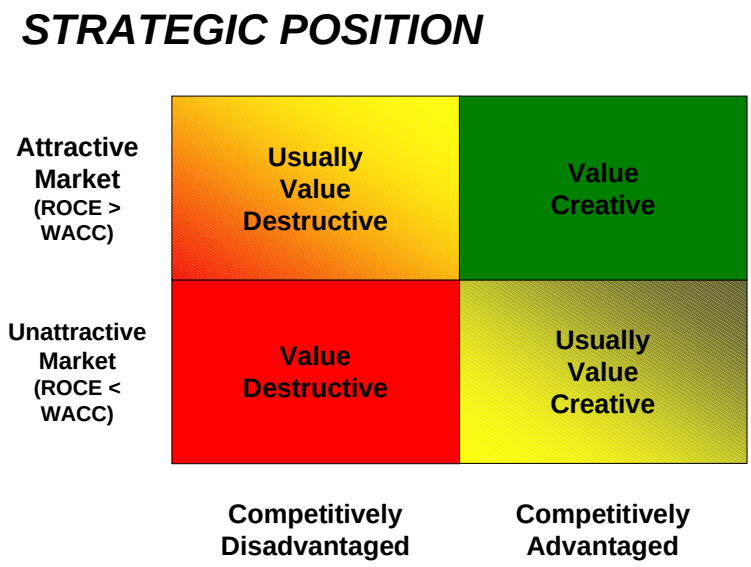
2. The gains to be made from new investments far exceed those to be had from trying to squeeze extra juice & efficiency out of old investments.

It is perhaps worth remembering that the gains from cost reduction and efficiency are ultimately finite and capped, whereas the benefits from growth and new investments are only limited by a company's ability to identify and realise new opportunities.

Strategic Drivers

The four main strategic drivers of value are strategic position, strategy, innovation and brands.

A company's strategic position is the result of two complementary factors, the attractiveness of the market within which it operates and its relative competitive position within the market. A company's strategic position fundamentally affects its ability to create value. In terms of value, an attractive market is defined as one in which the average competitor expects to earn a return in excess of the WACC (or a positive economic profit). The relative competitive position of a business within a market is determined by the extent to which the company has the ability to earn returns that are higher than those earned by the average competitor in the market. Competitive position is usually a function of order of entry into a market and relative size, with disproportionate benefits accruing to first movers and market leaders. Competitive position is generally a much more important factor influencing value creation performance than market attractiveness.



Important as market attractiveness and competitive position are, neither of these are substitutes for 'good' strategy. Value creation is a level playing field and all companies have equal chances to create value irrespective of their current state of health, good or bad. Determining how best to deploy a company's scare resources in order to outmanoeuvre the competition, how to segment a market in order to identify the value creating seams of gold, whether to invest for growth or manage for cash, whether to enter new markets or to exit, whether to acquire or to dispose, are some of the most important strategic decisions that affect a company's value creation performance. Analysis has a key role to play in helping to shape strategy, but it can

only help so far. This is because ultimately strategy is about insights & foresight and the skill of taking judgmental decisions based on predictions about the future value creating alternatives.

Innovation is a popular and widely used & abused term within companies that covers a multitude of sins from minor improvements to existing products & services through to major paradigm shifting new initiatives. The common denominator is that almost every company claims to want more innovation, better innovation & faster innovation. This is because innovation can be a powerful creator of growth and value. Unfortunately, over 90% of innovations fail and an even greater percentage result in value destruction. Nevertheless, the disproportionate rewards that accrue from the one 'big success' keep companies chained to the innovation stove.

The final strategic driver is brands. A study by Interbrand & Citibank in 1998 showed that a group of heavily branded companies outperformed the FTSE 350 by around 20% during the years 1982-1997. Indeed, it is now commonly accepted even amongst the investment community that brands are powerful drivers of shareholder value and that companies with well-developed marketing and brand management skills produce better shareholder returns than those companies with less developed skills. And because the investment community has wised-up to the value destructive risks associated with growth by acquisition, it is now generally favourable to brand building marketing expenditure regarding it as catalyst to faster organic growth, a much more 'attractive' and lower risk driver of shareholder value than acquisition. Indeed, some people in the investment community are even expressing the view that it is one of the few business costs (along with R&D and training) that they want to see increasing given their belief in the potency of organic growth as a driver and creator of shareholder value.

Organisational Drivers

Companies are increasingly recognising that value creation is not just about the numbers and the machine-like mechanics of the financial drivers. What really drives value are the strategic drivers and the 'softer' organisational drivers of which the four main ones are organisational design, people, processes and capabilities. Many companies that have chosen to devote their efforts to the well-being of their shareholders have found that putting value creation into practice is a much more complicated task than they had initially envisaged. Managing for value requires fundamental changes to a company's culture and involves a greater deal of time, patience, money and effort. And therein lies the root cause of most companies' mediocre success with value-based management programmes. To create value long-term, companies have to be good at strategy, good at the implementation of strategy (Fortune magazine estimates 90% of strategies fail due to poor implementation), good at innovation, good at day to day operations, good at financial management and most importantly, good at the process of management. It is true that value is created & destroyed by a comparatively small number of top level strategic decisions, but it is also true that value is created & destroyed by hundreds & thousands of everyday operational decisions taken at all levels within companies. According to Sir John Browne, CEO of BP:

'What creates value in the first place, and the flow of high quality business opportunities, is the way in which people in BP work together and make thousands and thousands of choices each and every day within the body of the organisation'

This is the theme that we address in our article entitled 'Why Value-Based Management Goes Wrong'.

CONCLUSION

Shareholder value is a mantra that has become intoned with solemnity throughout many of the world's largest companies. Knowledge of what shareholder value is, how it is measured and how it is created & destroyed remains inadequate in many companies, including in some cases, those whose senior managers are vocal advocates. When companies decide to espouse shareholder value, they are choosing to serve a tough master and one that makes no allowance for previous good performance. All that matters is future performance. And in this regard, value creation is a fair master. All companies, irrespective of their past or current economic performance, face an equally difficult challenge to create value. The value creation challenge is about delivering performance that exceeds the markets' expectations and improving a company's future discounted free cash flows (or future discounted economic profits). Creating value long term requires companies to identify and implement a continual stream of new value creating surprises, which enhance underlying economic performance. This means focusing on the company's most important value drivers and managing them with proficiency year after year after year. Value creation is a tough challenge.

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