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It is now almost universally accepted that creating shareholder value is a fundamental requirement for all companies. Any company that fails to do so either risks being starved of capital, having its senior management replaced or being acquired. The requirement to create value has led to hundreds of the world's largest companies adopting a so-called 'value-based management' programme. This article explains why many of these programmes have failed to deliver the benefits originally intended and offers some practical advice on how to deliver improved value creation performance.

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 higher level of performance demanded by an increasingly hostile investment community, hundreds of the world's largest companies have chosen to espouse shareholder value and adopt an explicit approach to shareholder value creation commonly referred to as value-based management or VBM.

VBM is intended to be an analytical, fact-based approach to management where the primary purpose is to create long-term value for shareholders. When a company chooses to adopt VBM, it attempts to align a number of elements including its strategy, its day to day operations, its innovation efforts, its systems, its processes, its performance measures and its incentive systems around the guiding beacon of shareholder value creation. Pioneers of VBM include Coca-Cola, AT&T & Quaker Oats in the US and Boots & Lloyds TSB in the UK.

Common practice

Adoption of VBM usually results from one of three developments:

1. The major shareholders of a perennial underperformer make it clear to management that the clock is ticking.

2. A new more demanding investor acquires a significant stake in a company and makes it clear to management that from now on better performance is required.

3. A new management team is appointed and sets about trying to ratchet up performance.

In all three instances, the objective is the same: to sharpen economic performance by focusing on the interests of shareholders and aligning the company's processes & activities around this aim. Most of the programmes that companies have adopted in an attempt to bring about this alignment have usually been very similar in design and the typical VBM initiative proceeds something like this:

- Consultants are appointed.
- A new value-based financial performance measure is selected more often than not the chosen consulting firms' preferred or proprietary measure.
- Consultants model past & present value creation performance and project future value creation potential.
- Operating managers are 'sheep dipped' through financial awareness training programmes.
- Business units compete for resources & capital by way of strategic plans.
- Only value creating plans & investments secure funding.
- The new value-based financial performance measure is used to set targets and evaluate operating performance.
- Incentive programmes are devised to align the interests & rewards of managers with delivery against the new performance measure targets.

Considerable emphasis is usually placed on the two aspects commonly perceived to be the most critical to VBM's success: the selection of a new value-based financial performance measure and the alignment of managerial rewards with delivery against the new performance measure targets.

Many VBM adopters have been surprised to discover that they have not transformed themselves into the shareholder delighting paragons of virtue they had hoped to become. Indeed, some companies such as AT&T have abandoned VBM altogether. Where VBM has under-delivered, it has usually been because of the way companies have chosen to implement VBM and their underestimation of the scale of the challenge involved.

'We found putting value-based management (VBM) into practice was far more complicated than many of its proponents make it out to be, requiring a great deal of patience, effort and money. A successful VBM programme is really about introducing fundamental changes to a company's culture. And therein, lies the reason for most of the failures.'

Hapeslagh, Noda and Boulos, HBR 2001

Wrong definition: Serious obstacles often arise from the way companies choose to define VBM. In the worst case, 'financial' VBM, VBM is interpreted as being little more than a new financial performance measure to be used by the Finance function to monitor business performance. In such instances, the attitude that creating value 'has got nothing to do with me' is widely held outside the finance function and as a consequence, very little progress towards improved performance is made. The introduction of a new financial performance measure usually sits at the heart of VBM, but it is no substitute for managing the business processes that underpin value creation performance.

In the common practice case, 'managerial' VBM, companies usually become bogged down by the step by step process of implementing each piece of the VBM jigsaw rather than focusing on developing the necessary organisational capabilities that enable improved value creation performance to flow. This is a vital distinction and one that requires companies to take a much more holistic perspective of what VBM entails and what is required to deliver improved value creation performance.

‘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 & thousands of choices each day & every day within the body of the organisation.’

Lord Browne, Chief Executive BP

Wrong champions: Part of the problem is also the type of people who champion VBM initiatives inside companies. Typically, these people come from a finance or strategy background and are ‘wired’ to think & behave with machine-like rationality. Almost inevitably, these people overemphasise the financial & analytical aspects of value creation and disregard the ‘softer’ human & organisational dimensions. And as more experience comes to light, these human & organisational factors such as the quality of management, the ability to execute strategy, the efficiency of decision making processes, the ability to adapt & respond to change are increasingly being recognised as the crux of a successful VBM programme.

Off-the-shelf solutions: The ‘wrong champion’ problem is usually compounded by the appointment of like-minded consultants who share the same preferences for analysis & facts and the same misplaced belief in rational behaviour as the internal champions. What is more, the consultants also bring with them a problem all of their own making. Almost every consulting firm that practices VBM has its ‘own brand’ solution. and consequently tends to prescribe its off-the-shelf solution to all client companies regardless of their unique market, competitor, investor & organisational circumstances. And most revealing of all, most consulting firms’ solutions are characterised more by their similarities rather than by their differences!

Seeking perfection: VBM recognises that traditional accounting measures such as net profit and earnings per share are often unreliable guides to shareholder value creation. In response to this, an alphabet soup of new measures has emerged, which advocates claim provides a much more accurate measure of a company’s ‘true’ value creation performance. This list of new measures includes total shareholder returns (TSR), total business returns (TBR), cash flow return on investment (CFROI), economic profit (EP), economic value added (EVA®), cash value added (CVA), market value added (MVA), and many others. Virtually every VBM adopter agonises at great length over the selection of its new financial performance measure. Despite this, it is important to remember that value creation depends on future discounted cash flows and beating shareholders’ expectations. The harsh reality is that there is no perfect all embracing financial performance measure that can reliably measure value creation performance. Nevertheless, this has not stopped the consultants trying to find one. For example, Stern Stewart’s proprietary measure of economic profit, EVA®, involves up to 164 adjustments to conventional accounting profit!

‘We have learned as a Group that the fascinating task of creating & realising economic value is far too complex & challenging to be reduced to the application of a single proprietary tool’

Lord Browne, Chief Executive BP

The 'black box': When a company has finally chosen the measure that best suits its circumstances, it usually attempts to 'explain' past & current performance in terms of an econometric 'value driver' model. These 'black box' models provide powerful insights into the company's most important & most sensitive value driving variables, but often provide little insight into what 'inputs' have to be managed in order to drive improved value creation performance. For example, price will often be found to be a key value driver, yet knowing this will not enable a company to know what elements of its business mix it needs to change in order sustain higher prices. Likewise when labour costs are shown to be a key value driver, attention usually focuses on headcount reduction rather than seeking ways to improve labour productivity or the quality of service provided, even though in some cases the latter options may be more beneficial routes to improve value creation performance. In all companies, it is the 'input' drivers, such as strategy, organisational capability, management capability, the quality of operations and so on that create & destroy value rather than the 'output' drivers that can be more easily measured & modelled. Nevertheless, when preoccupied with a new measure and a 'black box', it is very easy to see why many companies lose sight of what really matters and what 'inputs' need to be managed in order to underpin the improved value creation performance they desire.

Underestimating the learning required: Many VBM education programmes are inadequate and typically focus on one-dimensional classroom based financial awareness training. With these one-off baptisms, much of the early interest & indeed genuine enthusiasm for VBM is quickly dissipated by the pressure of the in-tray and the comfort zone of business-as-usual. 'Sheep dips' rarely succeed as the old ingrained beliefs & behaviours persist and no significant changes result. This should not really come as any great surprise particularly when you consider the scale of what is trying to be achieved:-

- An understanding of the need to improve performance & create shareholder value
- A willingness to unlearn the old ingrained beliefs about what constitutes 'good' performance and the behaviours that follow
- A commitment to change work priorities & practices to ways that are consistent with creating shareholder value
- The knowledge of what to do differently and the confidence to act

Most VBM programmes fail outside the classroom because of the failure to follow through and the failure to invest sufficient time & effort in reinforcing the key messages outside the classroom. There are no quick fix solutions to embedding value creation into the culture of an organisation, and it is as much about winning the 'political' battle for people's hearts & minds as it is about educating people with the technical know-how.

'Managing for value is 20% about the numbers and 80% about the people & culture because people create value'

John Sunderland, CEO Cadbury Schweppes

Not taking people with you: Many companies also fail to think through the presentation of their message at the front-line. Most employees will not set off for work filled with joy in their hearts at the prospect of enriching shareholders just because senior management has decided to espouse shareholder value and briefed them accordingly. Despite this, too many companies continue to flood their organisations with dry & uninspiring rhetoric, making long, complicated & uniform presentations about shareholder value which, as the message cascades down through the organisation, becomes increasingly divorced from the everyday roles of front line employees. Companies that succeed with VBM tend to take the wider workforce with them and do so by taking the time & effort to explain in simple terms how creating value is a common sense approach to management that benefits not only shareholders & senior managers, but also employees, suppliers, customers & consumers.

Swimming with sharks: VBM frequently comes unstuck in the political life of an organisation. Within the ranks of senior management, it is critical to secure a genuine & shared early commitment to shareholder value. Without this, the champions of VBM are likely to find themselves swimming in a sea of sharks eager to bite at the first sign of difficulty. Furthermore, it is also important to recognise upfront that many people in an organisation will first have to unlearn some of their existing beliefs before being able to move on and adopt the new behaviours appropriate for a company committed to creating shareholder value. For example, consider a real situation where the management of a 'star' operating business discovered that it had a history of consistent value destruction when viewed through the lens of a new financial performance measure. Not surprisingly, there was denial and a reluctance to accept the new perspective on what constituted 'good' performance. Overcoming this has taken time & effort. Pockets of resistance should be accepted as the norm and planned for right from the outset. Unfortunately, most VBM programmes do not take enough account of the differing interests at stake and assume the power of facts & the persuasiveness of rational argument.

'My own experience as a director of a large plc would indicate that many rational & analytical people have missed most of the plot. The secret is that introducing value-based thinking into an organisation requires dealing with a whole raft of political, emotional, organisational and plain irrational factors.'

Don Young, previously Group HR Director Redland

Focusing on efficiency alone: When a company adopts VBM it is usually in response to a period of recent poor performance. What usually follows is a disproportionate emphasis on cost cutting, downsizing and restructuring in an attempt to fast track improvements in near-term performance. Interestingly, a BCG study of US & European companies in the mid 1990's concluded that growth and new investments were much more powerful creators of value than either restructuring or squeezing more juice out of old investments. Companies would perform far better if they were to bear in mind that the benefits from cost reduction and improved efficiency are finite & capped, whereas the benefits from growth and new investments are limited only by the ability to identify & realise such opportunities.

Measurement myopia: All VBM programmes place great faith in the well-known adage 'you get what you measure'. When a new performance measure is adopted, management attention inevitably focuses on improving performance as recorded by the new yardstick. This is particularly the case where bonus payments are contingent on delivering improvements in the new measure. However, it is a mistake to assume that all improvements in the measure necessarily correspond with improved value creation performance. For example, improvements in a short-term financial measure such as economic profit can be achieved though postponing capital investments, reducing marketing & training expenditures or by divesting assets, each of which may have a positive effect on near term performance but could adversely impact upon long term value creation performance. Nevertheless, when incentivised with bonuses to 'manage for the measure' this is exactly what many managers will do irrespective of the consequences on shareholder value. A good example of this comes from a US study by James Wallace in 1997. Wallace compared the shareholder returns of 40 EVA® adopting companies with a matched pair of 40 companies that continued to use traditional accounting measures. What was not surprising was that the EVA® adopters demonstrated significantly improved EVA® performance versus the non-adopters, but what was more surprising was that EVA® adopters failed to produce better shareholder returns than the non-adopters!

VBM - the end?

While the track record of VBM has been less than spectacular, it would be wrong to conclude that VBM has completely failed. VBM has outlived other managerial approaches such as total quality management & business process re-engineering and it is perhaps telling that many of the top performing wealth creating companies in the world formally practise VBM. How much of this good performance can be directly attributable to VBM and how much results from plain old fashioned good management is open to debate. Nevertheless many of VBM's adopters including Boots, Cadbury Schweppes, Diageo, Lloyds TSB & Unilever remain committed & vocal advocates. Even in those companies where VBM has underachieved, the introduction of VBM has had many lasting positive benefits. For example, the use of the new value-based performance measures such as economic profit and EVA® have helped reinforce the message that capital is not free and that assets need to be managed as vigorously as revenues & costs. In the case of United Biscuits, the explicit use of ROCE as the key performance measure contributed to £70m+ reduction in operational working capital, equivalent to nearly 4% of turnover, during the first two years of VBM. In additional to stimulating improved near term performance, VBM has also enabled many companies to take much better economically informed decisions about investments & resource allocations. It has encouraged companies to become more disciplined & systematic in evaluating the outcomes of past decisions and has thereby enabled them to apply the learnings from these experiences. But perhaps, the biggest testament to VBM to date has been its impact on reducing the incidence & frequency of the unintentional, but nevertheless reckless value destroying decisions that permeate every company at each & every level. In many companies, VBM has not so much failed in absolute terms, but more it has failed to deliver against its inherent potential and against its champions' initial expectations.

Our Counsel

VBM is still a comparatively new focus for management and knowledge about what works, why & how is still in its infancy. Nevertheless, there is now a wealth of available information that enable companies to approach the challenge of creating shareholder value with their eyes wide open and to avoid many of the painful 'mistakes' of the pioneers. Our counsel on what constitutes better practice is:

- Approach value creation as a long-term voyage of discovery. Accept the need to be patient. There are no quick fixes.
- Recognise that value creation is about more than analysis, facts, numbers & rational behaviour. The human & organisational dimensions really do matter, and if ignored, a value creation initiative will not succeed.
- To succeed, a value creation initiative has to address the four dimensions of finance, strategy, organisation & change management and it is the combination of all four that it is critical to success.
- Recognise that value is created and destroyed not only by the few 'big' strategic decisions, but also by hundreds & thousands of everyday operational decisions taken at all levels throughout the company. Front line employees have an important role to play, so view them as contributors to change
- A sustainable value creation culture & capability will only develop when value creation is brought to life and made relevant to the everyday lives of employees deep within the organisation. This means using a form of language that people can relate to and communicating how value creation benefits them & the other stakeholders. Tailor the presentation of your message to each audience.
- Make sure you understand what 'value' means to each different stakeholder group and build definitions that mobilise each group's commitment to action.
- Don't get hung up by trying to choose the 'perfect' new measure. You won't find one and you won't run any faster by timing yourself more accurately.
- Instead focus your efforts on the identifying the most important 'input' value drivers and then manage them rigorously. Incentivise good management of these 'inputs' rather than 'managing for the measure'.
- Also make sure that VBM is not seen simply as a way to enrich a small group of senior managers. Share the rewards widely. The breadth of inclusion is much more important than the size of the rewards pie.
- Choose your consultants wisely. Be very wary of their generic off-the-shelf solutions. Work only with those consultants who want to work alongside your teams to ensure it's your people's capabilities that are developed and not theirs.
- And finally, remember that value creation is fundamentally about good strategy, good organisation & good management rather than the mechanistic implementation of a VBM programme.

Conclusion

For most companies, creating value is no longer a nice to have optional extra. It is an everyday fact of 21st century business life. The track record of VBM programmes to date leaves plenty of scope for improvement and VBM is certainly no magic miracle cure for poor performance. There are many companies that have succeeded in creating great tracts of shareholder value with no conscious knowledge of VBM principles. Likewise, there are now plenty of famous companies struggling to create value despite many years of expensive VBM consultancy support. It really does beg the question why. There is no single 'right' way to proceed with VBM, but don't assume common practice represents best practice and don't underestimate the scale of the challenge involved. There are no quick fix solutions to embedding a value creation culture, so be patient and design a programme that is tailored to your unique market, competitor, investor & organisational circumstances. Also ensure that it addresses strategy, finance, organisation & change management and not just the first two. It is the combination of all four that is critical to success and the 'softer' human & organisational dimensions matter. Ignore them at your peril. Bon voyage!

A version of this article first appeared in Market Leader (Spring 2002)

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