Executive Insights

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Identifying and Managing Key Value Drivers

Over the years, L.E.K. Consulting has worked with a wide variety of companies to help them implement shareholder value techniques. In doing so, we have found that a number of fundamental questions are raised. We have created this series to address these specific questions and others of interest to our readers. Our hope is that this *Executive Insights* will spark a useful dialogue within your company.

This article presents an approach to increasing performance that will forge stronger links between operating performance measures and shareholder value creation. Our work has confirmed that many companies unintentionally reward managers for attaining performance measures which have little impact on value. We describe how companies can identify key drivers of value creation and structure a performance measurement approach around these value drivers.

Managing value drivers

Corporate management has an ongoing mandate to maximize shareholder returns. But while maximizing shareholder value is an important corporate objective, it is not specific and accountable enough for operating management, who must also know which factors most influence value and which factors can be most easily affected. We call these factors "value drivers," and they are the primary focus of companies that succeed in maximizing shareholder value.

Prioritizing value-creating activities — the role of value drivers

Identifying and managing value drivers helps management focus their attention on activities that will have the greatest impact on value. This focus enables management to translate the broad goal of value creation into the specific actions most likely to deliver that value.

Figure 1
How value drivers link to value creation

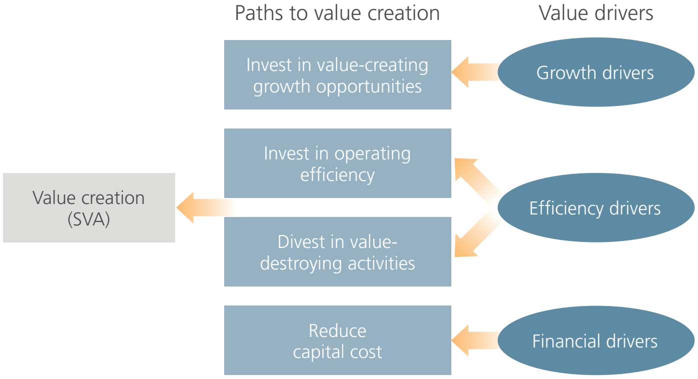
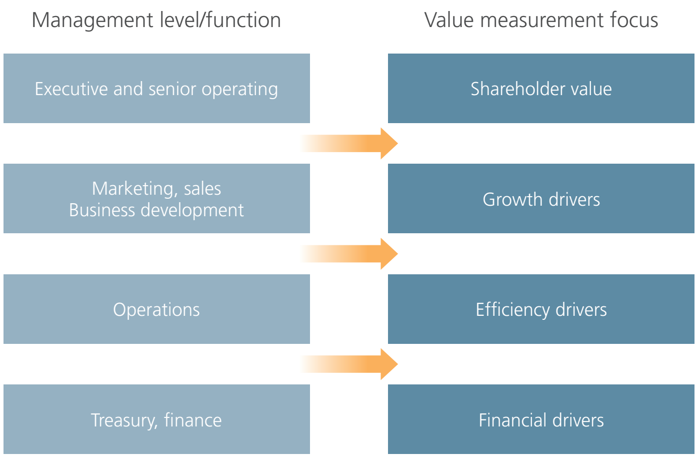


Figure 2
Aligning management responsibility for value drivers



There are three categories of value drivers: growth drivers, efficiency drivers, and financial drivers. As shown in Figure 1, companies tend to manage these value drivers in four ways. By focusing on value drivers, management can prioritize the specific activities that will affect performance in each area.

Examining and defining paths to value creation enables companies to identify and understand responsibilities by function and level within the organization. This in turn helps managers to focus their attention on factors that really matter, as shown in Figure 2.

What is a value driver?

We find that most companies manage their business as if every operating factor were equally important. Most operating managers have a solid knowledge of the variables that impact business performance and they manage that list aggressively. The problem is that the list of variables is often too long and may be prioritized against goals other than value creation. Valuable resources are marshaled to increase market share, maintain pricing, increase distribution, introduce new products, increase operating efficiency, etc., without a clear sense of what “true” value drivers are.

There are two easy ways to identify value drivers:

- Value drivers have a significant value impact.
- They are controllable. (For example, commodity inputs may be important to your business, but since they are not easily controlled, they may not deserve significant management attention.)

The Value Driver Matrix (see Figure 3) illustrates a framework for prioritizing value drivers. The task is to identify variables that reside in quadrant IV and manage the resources directed at influencing variables in quadrants I through III.

What is value driver analysis?

Value driver analysis is an important foundation for strategic planning, helping management sort through their operations to define critical strategic levers. If, for example, growth drivers are important to a particular firm, management can direct strategic planning to focus on growth strategies. In short, value drivers ensure that strategy is grounded in the reality of operating performance.

Identifying value drivers is a three-step process:

- Develop a value driver “map” of your business
- Test for value driver sensitivities
- Test for controllability

Step 1: Develop a value driver “map” of your business

To understand where your company’s value drivers lie, you must first break down the broad operating parameters of the business into progressively smaller components until you reach the level where daily operating management decisions reside. You then document which specific factors influence broad measures such as sales growth, operating profit, etc.

Figure 3
Value driver matrix

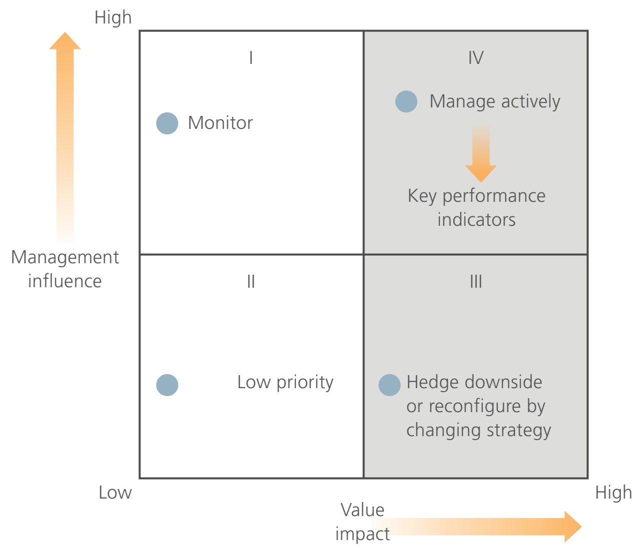
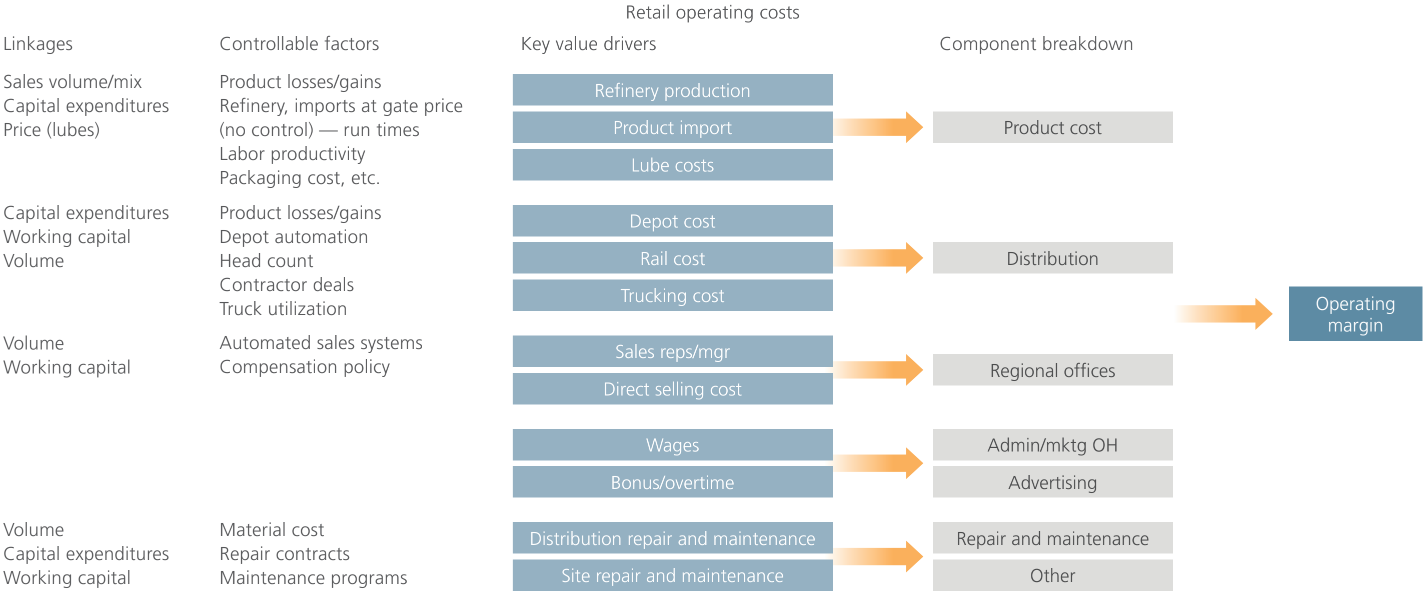


Figure 4

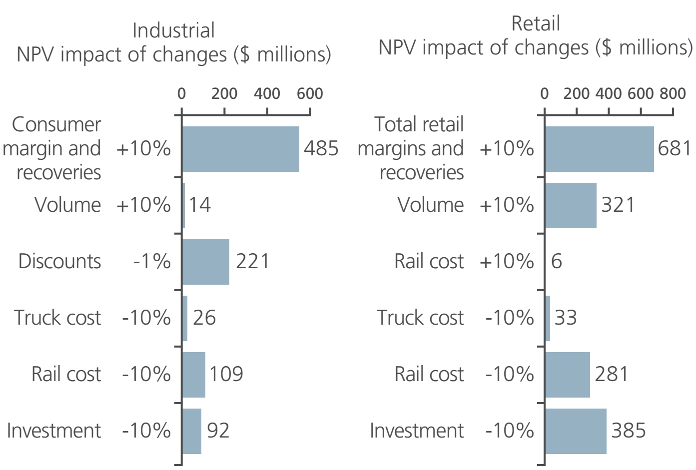
Value driver map for petroleum marketing



In the value driver map for petroleum marketing (see Figure 4), we disaggregate operating profit first into the main components of cost and then into the key drivers of cost, such as trucking, rail and depot costs. In order to develop the value driver map, the physical flows and processes within the business were examined to capture critical linkages between value drivers.

Figure 5

Value driver sensitivities — petroleum marketing



Step 2: Test for value driver sensitivities

After assembling base levels for each operating factor, you must examine how changes in each factor impact the overall value of the business. This usually leads to interesting insights that can change management priorities.

For example, the petroleum marketing business was very focused on increasing volume to industrial customers and managing trucking costs. However, as the value driver sensitivities example (see Figure 5) shows, these factors have a relatively minor impact on value relative to other factors.

Step 3: Test for controllability

Each variable must then be examined to discover those that management can control. For example, within petroleum marketing, the key value drivers were discounting, retail volume, investment and rail costs. This particular market is heavily regulated, so pricing was not a controllable variable.

Value driver analysis requires investing significant time and energy on the part of management. It may require information that is difficult to access. It also involves developing information about interrelationships between variables within your business.

However, companies that have made this investment have found that this analysis helps to focus management attention on a manageable number of value drivers. It can also provide the foundation for determining which strategies will optimize value driver performance and maximize value creation.

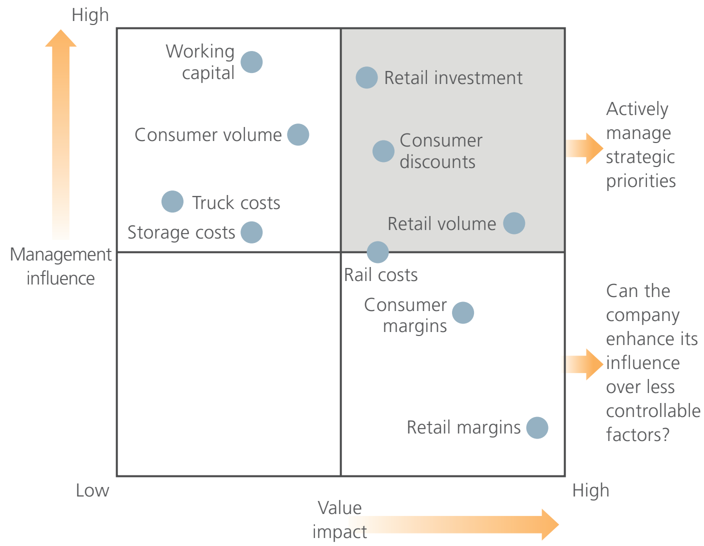
How do companies manage value driver performance?

Once management has built a consensus around key value drivers, they can focus on the logistics of increasing value driver performance. If, for example, inventory management is a key value driver, management can focus on the system and process improvements that will result in increased inventory turns. One way to highlight value driver performance is to build measures of this performance into the regular performance measurement systems and reward structures of the business. Management must agree on which value driver measures they want to track and then develop a regular reporting structure that includes these measures. Management incentives can also be an effective way to highlight value driver performance. Value drivers can be substituted for other objectives in annual incentive plans. These can be tailored by function to ensure that managers are tied to value drivers that they are responsible for managing.

Summary

Key value driver analysis can be a powerful way to focus management attention on activities that will have the greatest impact on value. However, it does involve a significant commitment from management and should be given high priority within the organization if it is to succeed. Once completed, this analysis can help to ensure that strategies and decision making are aligned within the true drivers of value for the business.

Figure 6
Key value driver matrix — petroleum marketing



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