EXECUTIVE INSIGHTS

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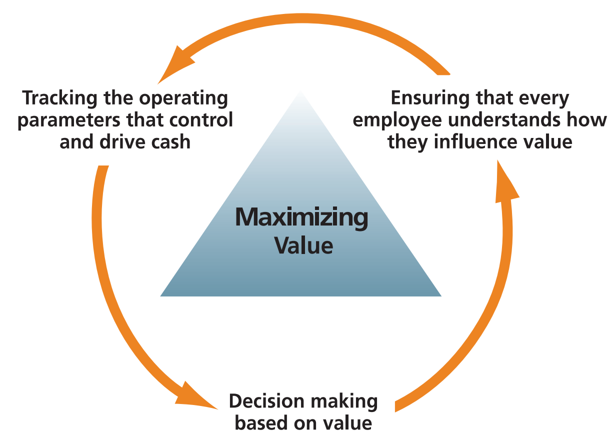
Shareholder Value Implementation: Turning Promise into Reality

The prospect of aligning the actions of an entire organization with the objectives of its owners and providers of capital has attracted many companies over the last decade. Indeed, many businesses are stronger today because they have implemented a shareholder value focus. Unfortunately, there are many examples of implementation attempts that have not lived up to their full promise. What are the key characteristics of organizations that have successfully embraced shareholder value and how have they achieved their goals? Shareholder value-oriented companies that are thriving share the following features:

- Operating parameters that control and drive cash-flow are collected and evaluated in a systematic way.
- Strategic decisions are made on the basis of a systematic analysis of potential value creation.
- Employees at all levels understand how their activities link to the creation of short- and long-term cash flow.

Although increasing numbers of companies are on their way to achieving these goals, many have found the practical applications challenging and frustrating. With over 15 years of shareholder value consulting and education worldwide, L.E.K. has acquired a broad and deep comprehension of the common misunderstandings and potential pitfalls that make implementation so difficult. This newsletter addresses these recurring problems and provides practical recommendations to enable them to be corrected or avoided altogether.

Characteristics of a Shareholder Value-Oriented Company



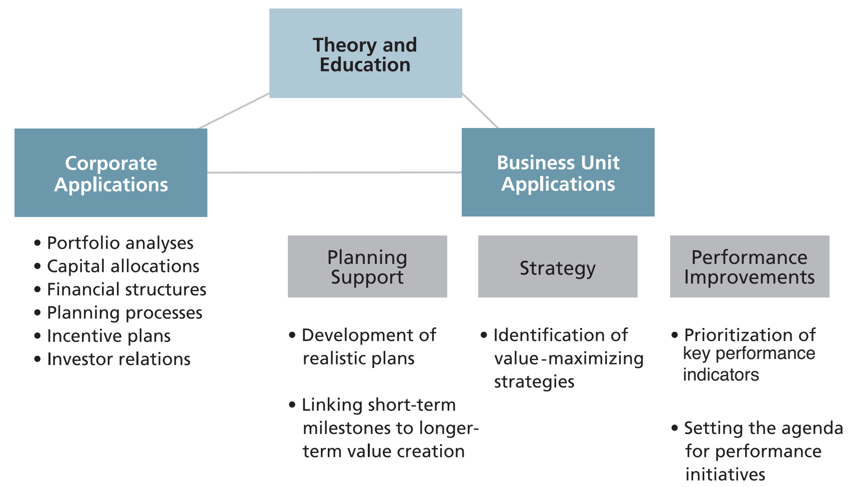
Shareholder Value Implementation: Turning Promise into Reality was written by **Peter Smith,** Partner in L.E.K.'s London office. Please contact L.E.K. at strategy@lek.com for additional information.

Six Common Obstacles to Successful Shareholder Value Implementation

Obstacle 1: Failing to define the objectives clearly

The diagram to the right illustrates the practical applications of shareholder value theory and education that can be applied to various corporate and business unit concerns. It would be a bold management team that attempted to address all these business issues simultaneously through a single initiative. However, that is precisely what happens when companies broadly pursue shareholder value without deciding which specific aspects of their business model they are trying to improve. Failing to agree on the primary objectives of a shareholder value implementation can lead to confusion, communication lapses, and ultimately breakdown of the mission.

Practical Applications of Shareholder Value Theory



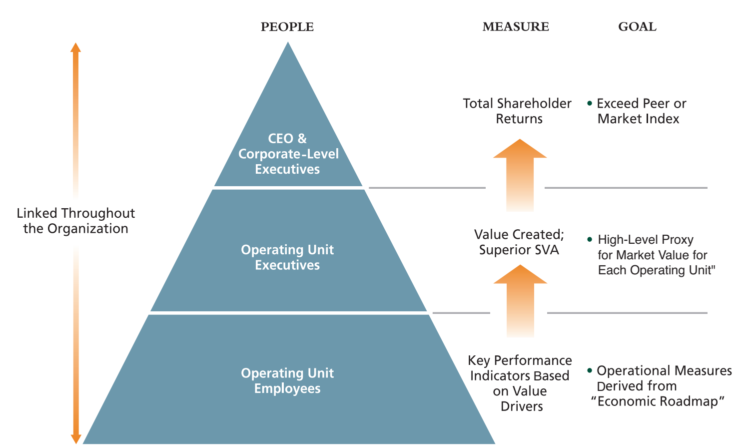
The term "shareholder value" is often misused to describe strategies that are better known and more readily understood as conventional change management activities. It is all too easy to describe any benchmarking of good performance as "shareholder value." This rebranding of existing initiatives under a new banner can bring resistance from managers. Quite understandably, they object to what they perceive as the status quo relabeled as the management theory flavor of the month. Shareholder value is not a fad, and successful implementations are becoming a worldwide standard for performance measurement. It is therefore important to understand and communicate what shareholder value is really about.

First, shareholder value is about providing coherent and aligned goals that all levels of the organization can understand. The figure below shows how the three broad layers of a company can be given targets that are quite different in nature and yet consistent with the common goal of value creation.

Second, shareholder value is about developing and applying analytical techniques that can be very powerful additions to the traditional management arsenal, particularly at the operational level. These include:

- Identification and prioritization of the most value-creating management activities and the rationalization of value-neutral or value-destroying tasks
- Trade-off analyses to guide operating and strategic decisions toward higher value results
- Discounted cash flow tools for operational applications such as contract pricing, make or buy trade-offs, and capital expenditures
- Detailed diagnostic tools for benchmarking performance

Aligning All Levels of the Organization with Value Creation



Source: L.E.K. Consulting

Third, a shareholder value initiative offers the opportunity to galvanize management and processes by creating performance targets and decision tools that are demonstrably aligned for success. Good managers do not want to be judged and rewarded for achieving goals that damage the long-term health of their business. Nor do they wish to be held accountable for events that are outside their control. Properly implemented, shareholder value addresses both of these concerns and can create high motivation for performance improvement.

Obstacle 2: Making shareholder value management a corporate planning or finance initiative

There are three reasons why this situation is so prevalent:

- The analysis appeals to finance people and in part requires their skills.
- The initial need and the resultant benefit are often perceived to be linked to corporate planning.
- Shareholder value is often initiated by the corporate executives who are closest to the pressure for higher performance from shareholders.

Although corporate ownership and the CEO's support are important success factors, it can be a problem if the objectives are developed by "corporate" for use by the business unit level without their buy-in. The operating managers who must inevitably take ownership of the process need convincing that a corporate initiative is in their interests. Similarly, they can find conventional planning a distraction from the everyday business of making money and may lose interest when a project is held closely by corporate finance.

Oddly enough, our experience has taught us that it is the operations managers who best grasp the principles of shareholder value and who most naturally see its practical application to their business. They see the advantage of cutting through the complexity of accounting rules and finance theory to get at the real issues that lie at the heart of value creation. So why not give them the lead? Nothing ignites enthusiasm across the organization more effectively than an excited business head who is able to describe, in operational terms, what shareholder value is achieving in his or her business.

Obstacle 3: Treating shareholder value as a project rather than a process

Many companies struggle because they treat their shareholder value project as an end in itself. They allocate time and resources only through the analytical phase. This is akin to believing that you have arrived at a journey's end when you agree to the route on the map that must be followed. As a rule of thumb, the time required to promote real change will be three to four times the time taken to conduct the diagnostic analysis.

The adoption of shareholder value does not, in itself, dictate organizational or behavioral change. For example, if management has been allowed to miss performance targets without any penalties in the past, that same culture will most likely continue even if the new goals are aligned with their shareholders' interests. Conversely, an organization traditionally driven by short-term budget achievement will not change to a consensus-driven, strategic management style overnight. Managers must assess situations independently and, if necessary, adapt the implementation process to align with the cultural reality.

Obstacle 4: Omitting the analysis at the operational level

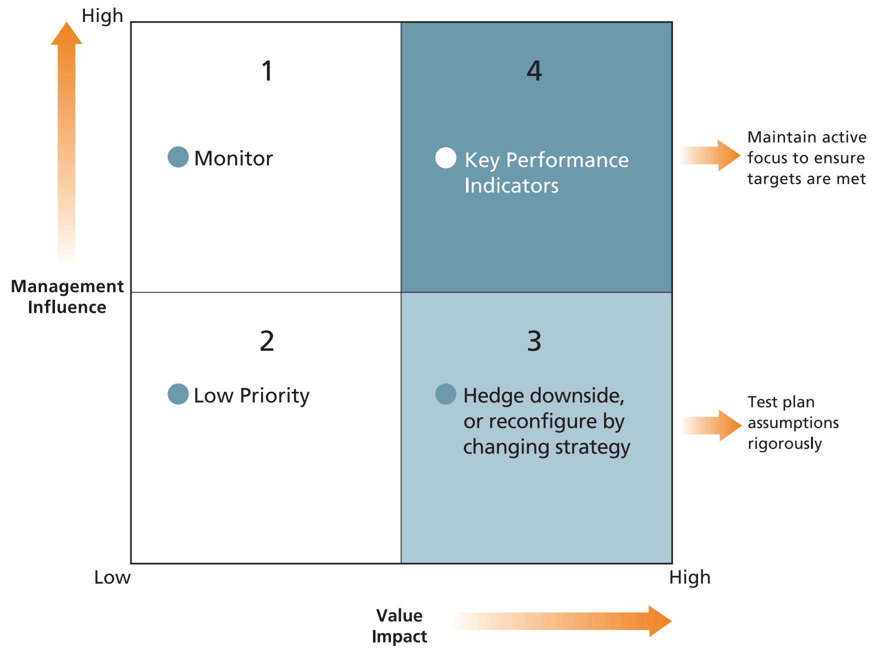
There appears to be no shortage of sophisticated analysis to address senior executive compensation and the measurement of business unit performance. However, the third level, the operational application of shareholder value, often gets omitted or is misunderstood. This is unfortunate, as this area is where many of the long-term gains can be realized. Analysis at the financial results level or above creates reminders that capital is not free and that results are now being measured with a more sophisticated yardstick. Neither of these two achievements should be expected to capture the imagination of line managers or result in a dramatic and progressive improvement in performance.

Cash enters the business only at the interface with customers, and except for capital expenditure decisions, all of the truly "controllable" elements of the business exist at the operating level. As the matrix below demonstrates, well-chosen key performance indicators at the operating level not only have a high impact on value, but also exert significant influence on the management team. It is difficult to make people accountable for performance measures over which they exert little or no control.

So why is the operational level analysis of shareholder value often overlooked? The issue lies in part with consulting firms that have found it attractive to focus on the theoretically complex aspects of valuation techniques applied to the data most readily available, namely the corporate financial results. Understanding value creation from the bottom up is conceptually straightforward but much harder to achieve in practice. It requires a dynamic team that can blend a mixture of commercial, financial accounting and modeling skills with the experience of the business managers.

Additionally, many executives and consultants find it hard to envisage the exact nature of the analysis required to identify, link, and prioritize the operating performance indicators through economic modeling. Those professionals who can develop the models are often convinced that the exercise will prove too complicated to be practical or will fail to yield new insights. L.E.K.'s experience,which draws upon dozens of such projects, suggests quite the reverse.

Value Driver Matrix



Source: Volume I, Issue 1, *Identifying and Managing Key Value Drivers*

Obstacle 5: Fixation with the metrics

Senior managers in many organizations are obsessed with finding a single-period measure that can act as an accurate proxy for value creation, particularly at the divisional or business unit level. The popularity of a few evangelistically branded, prepackaged metrics confirms this to be the case. Unfortunately this search for the "Holy Grail" of the perfect metric is doomed to fail on account of one simple fact: Market value is related to expectations of future returns.

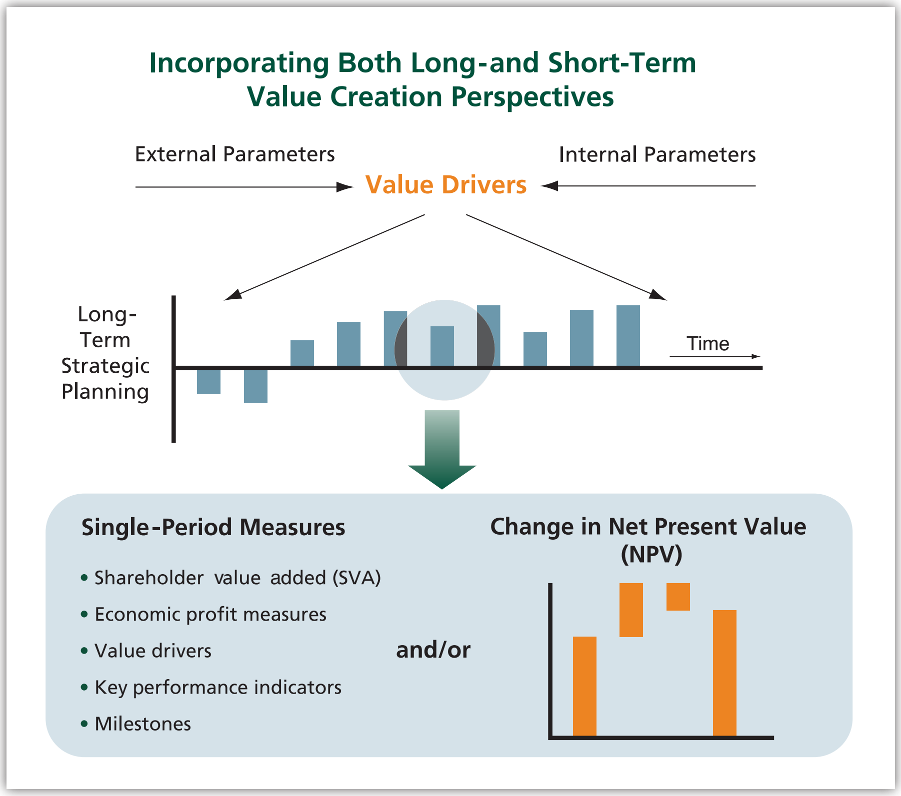
No amount of adjustment or analysis of historical numbers will reflect true market value. The futile attempts by some to extend the single-period measures to cover multiple periods in order to accommodate this economic reality seems only to reinforce the elegance of Alfred Rappaport's insights in his book, *Creating Shareholder Value*. The foundation of shareholder value thinking rests on the fact that valuations derived from discounted cash flow (DCF) share all the characteristics of true market value. DCF is by definition forward looking, cash based, long-term, and risk adjusted. In the absence of a true current market benchmark for any asset value, discounted cash flow offers the best proxy.

This message can be uncomfortable for line managers who find forecasting the next two quarters of revenues difficult enough. They know how easy it is to flex assumptions to create any value desired in a DCF calculation. Small fluctuations in key parameters several years into the future can wildly swing present values.

How can DCF offer an accurate measure of performance when the source of the long-term estimates is the management team that stands to gain or lose most from the process? These and other valid concerns are often at the core of arguments against using DCF and in favor of the short-term metrics. L.E.K. has experienced entire shareholder value initiatives stalled for months by disagreements over the metrics debate. The conflicts are usually overcome when both sides recognize that a single methodology cannot accomplish two very different objectives:

- The DCF "enthusiasts" are implicitly trying to promote genuine understanding and dialogue within the organization about the factors that influence long-term value. They contend that managers should accept the uncertainty and complexity of business as a given and be willing to take responsibility for their decisions in light of the available information. Being held accountable for the short-term results is only one aspect of this responsibility.

- The metric "maestros" have a different goal. They want to reinforce the discipline of short-term performance by using simple measures that allow comparisons across many different business units and levels. If shareholder value generates new enthusiasm for driving performance measurement and accountability through the organization, they are quite prepared to embrace it, but they may be disinterested in initiating a more strategic dialogue with their business unit heads.



When management recognizes that single-period metrics and DCF are not mutually exclusive, both can be incorporated into a strategy with the crucial caveat that the single-period metric on its own is not a reliable measure of shareholder value creation. The above figure shows how the short- and long-term perspectives can be brought into line using a consistent framework.

The change in net present value (NPV) from one period to the next represents the most accurate measure of value created or destroyed, whether it be for an individual business unit or for the company as a whole. However, since it is at the highest level of aggregation and it is forward looking, it suffers from the gaming problems with long-term estimates and external influences that concern detractors. There are no perfect solutions to these issues, but the following two observations help to explain why many companies have found change in NPV to be a satisfactory answer for their operational-level performance requirements:

- Analysis of the change in NPV exposes the major sources of variance between the two NPV estimates and between outcome and forecast. Used properly, this highlights unexplained shifts in key variables between periods, acts as a check on manipulation, and also creates a value-focused dialogue between the business and central functions that enhances the quality of the strategic debate. Once again, this approach holds little interest for a unit that wishes to manage through financial control rather than strategic dialogue.
- When a change in NPV is consistently measured over time, inflation in business value to cover a cash shortfall results in a higher target for value creation the following year. Careful monitoring results in a self-correcting mechanism that will create a clear picture of the components of real business value.

Obstacle 6: Leading the process with an information systems "white elephant"

Time and time again, performance-related strategy projects are replaced by supposedly flexible and powerful technologies. Determining which information is most important to the business seems to matter less when new systems can produce such overwhelming amounts of data and reports. Unfortunately, this lack of prioritization and focus frequently dooms systems-led projects for the following reasons:

- While in theory it may be possible to construct different desired reports on the new systems, in practice, the backlog of requests is massive and the skills required to execute them are in very short supply. Managers faced with the bewildering array of new data without a sense of priority or logical pattern find that it takes months to define what they want and sometimes years to make the necessary modifications to the system. These delays and the mounting investment in systems cause huge frustrations,unnecessary confusion and loss of interest in the process.

- Information systems are not usually flexible enough to capture a vital element of operating data if it has not been requested in the original design. For example,a major UK retailer invested millions of pounds in a system designed to ensure that a central merchandising team could be given P&L responsibility for store performance. The new system tracked the individual SKUs to the point of delivery to the stores, but it did not have the capability to record whether the items were placed on the shelves or held in the stockrooms. Therefore, the retailer could not gauge the success of the new product lines because the system could not tell whether the new stock was in front of the customers or waiting for available display space. This simple omission in the system design undermined the organizational strategy of centralizing the merchandising function and reducing the role and cost of store managers.

The complexity of information systems can distract management in the early stages of shareholder value implementation from the simplicity of the message. Only a handful of measures reflect the bulk of value creation opportunities for any business and these can often be easily recorded using relatively simplistic means. Waiting for a systems solution to catch up with the process can inject a damaging delay in the achievement of performance improvement.

Making It Happen: Steps for Success

1. Just start measuring!

So often we find that insights are delivered and accepted at the end of the analytical phase, the KPIs and priorities are agreed to and the implementation plans are written. Then there is a long pause and reasons are found to avoid the simple step of measuring the things that everyone has agreed are important. This is the moment when leadership can make or break the implementation process. The solutions are simple:

- Although it is important long term, don't delay implementation over the fine-tuning definitions.

- If necessary, incentivize the recording of accurate measurements.

- Make sure that the top 10 KPIs are measured and reviewed publicly at least once a month

- Consider retaining external advisors during this period, even if they are only used as a catalyst to ensure that the monthly reviews stay on track.

- Reinforce the commitment of the management team by taking action when the new KPI information indicates where improvements can be achieved.

2. Treat the analysis as dynamic rather than static:

At the business unit level, unless there is major structural change affecting the way that the industry conducts its affairs (e.g., the Internet), the mechanisms that link the important value drivers together do not alter significantly. What does change, however, is the relative importance of the KPIs as a business moves from underperforming to best practice. Consider the KPIs relating to volume of sales: If a business is performing poorly in a highly competitive market, it is possible that each unit sold destroys value. Under these conditions, the volume-related KPIs will not appear high on the list of value-creating opportunities. Fixing the margins will move these volume measures up the list of priorities.

As KPI information is monitored and actions are taken, the relationships between the KPIs must be re-evaluated. This process happens automatically if the DCF models of the business are being properly used to analyze trade-offs and to support better decision making. Success is more common when there are people within the businesses who are able to use and refine the models. It helps enormously if these employees were involved in developing the initial analysis.

3. Maintain alignment between reporting and planning: As business units discover the benefits of focusing on the vital KPIs and begin to see performance improve, it is important for the reporting requirements and planning processes to evolve in parallel. It helps if the corporate staff implicitly or explicitly recognizes and rewards business unit progress toward the KPI targets. It is discouraging for a unit management team prioritizing improvements in a range of operating measures to be told that next month's profit is still the only target that matters. The following sample questions used by our clients are not sophisticated, but they are effective in reaching the core issues:

- How has the value of the business unit changed over the last reporting period?
- How can that change in value be explained?
- What are the top five KPIs affecting the value of the business?
- What is the current level of these KPIs and what are the targets for the next period?
- What actions are being taken to ensure that these targets will be met?
- How much value is associated with hitting each target?
- What activities have been dropped because they are low priority?

Adding this discussion to the normal round of business review processes can improve the quality of the dialogue and understanding between corporate and business units.

4. Practice the 3 Cs: Commitment, Communication and Compensation: The old adage suggests that you get out what you put in, but halfhearted efforts can yield much less than half the desired results! Senior commitment is vital. Without the full support of the CEO, the board, and management, ownership of the initiative will be difficult for others to embrace.

Most people behave with their self-interest in mind. When senior managers stop talking about shareholder value, the assumption will be that it has slipped off the priority list and is no longer important. Constant communication to all levels of the organization reinforces the commitment to shareholder value. Business unit and function-specific education and value-enhancement workshops are helpful tools to demonstrate, in an operating-level language, how individual daily decisions impact shareholder value.

Linking compensation to value creation can help ensure ongoing commitment to the process. However, premature alignment of incentives to specific shareholder value targets can result in unintended consequences. It is sensible to introduce value-based incentives slowly and to provide plenty of encouragement to achieve the collective goals in the overall mix of compensation. In early stages, it is worth considering incentives that simply track the most important KPIs rather than pushing too soon for individual targeted improvements.

Shareholder value management is not implemented just to improve performance and returns. It is the basis that allows strategy to drive operations, not the other way around. It provides choices about where to steer the organization based on a solid understanding of a business' industry and competitive advantage.

It sets the priorities for all aspects of business operations. Stating the goals is not enough, they must be translated into action. L.E.K has helped businesses in many industries focus on improving their value. We are proud of our clients who have succeeded and have tried to diagnose what went wrong when the opportunity for improvement was not seized.

Tips for a Successful Shareholder Value Implementation

1. Pay attention to the different objectives for shareholder value management within the organization.
2. Give the lead to operational management rather than corporate management.
3. Set out to achieve a process change, not to complete a project.
4. Make sure that the operational applications of shareholder value are fully embraced.
5. Don't allow the process to get hung up on the metrics.
6. Leave the information systems changes until the end.
7. Above all, measure the things that matter; don't delay tracking the KPIs.
8. Remember that the priorities will change as you change your performance.
9. Keep the corporate response in line with the business units' progress
10. Be committed, communicate shareholder value consistently and eventually make sure that compensation becomes aligned with true value creation.

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