



CREATING SHAREHOLDER VALUE IN THE MOST CHALLENGING MARKETS

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We are regularly told by the financial press that an uncomfortably large segment of Corporate America is beset by financial difficulties caused by rapid technological change, market-transforming competition and other forces seemingly beyond the control of corporate management. While these forces are real, and reports of companies agreeing to unwelcome takeovers or meeting worse fates are commonplace, the plight of Corporate America is wildly exaggerated. According to a recent survey of the membership of the Turnaround Management Association, representing over 4,000 corporate restructuring and turnaround professionals, the reality of corporate failure is far more prosaic than commonly believed. Poor management, in the opinion of most respondents (58%), was the primary reason for the underperformance of their corporate clients. Other leading factors mentioned included being over-leveraged (37%) and having faulty business models (30%). Unforeseen, abrupt shifts in customer demand and sudden introductions of disruptive technologies account for a small fraction of business failures, typically in new, high growth industries.

The vast majority of companies that are experiencing financial difficulties can not only overcome marketplace challenges but actually create shareholder value, according to turnaround professionals and academic research. The key is to develop a sound strategic plan with a foundation built on best practices in financial and performance analysis, and then ensure that the plan is properly implemented through best practices in management reporting. These “best practices” have been pioneered by academicians and market-leading corporations in such fields as Economic Value Added analysis, Activity-Based Costing, Business Process Re-Engineering, and Balanced Scorecard performance measurement and reporting. More often than not, the successful strategic planning process is now led by someone grounded in the financial disciplines rather than a traditional strategic planning “guru,” and the planning tools that have been developed permit middle-market companies in mature and declining industries to create successful strategic plans as readily as Fortune 100 companies. Building shareholder value, when done correctly, involves these sequential elements:

Step 1: Analyze Economic “Value Added” of Business Segments

The first step in building a successful business is to understand which activities contribute to profit and shareholder value, and which detract from them. Granted, all companies periodically look at company-wide and divisional profitability, but many fail to examine profitability at the strategic business unit, product group and market segment levels. Neither do all companies critically examine cost allocation and transfer pricing assumptions that underlie their business segment profitability statements. The application of Economic Value Added analysis, whereby each business segment is charged for the cost of capital of the assets it employs and the relative risk of its prospective earnings stream is an important tool in analyzing business segment contribution to shareholder value.

Step 2: Determine What the Marketplace is Telling You About Your Performance

A great deal of information can be gathered from the marketplace to analyze performance characteristics and Economic Value Added of the company and its business segments. Public sector competitors, and to a lesser degree private sector competitors, disclose information on their profitability, sales growth, market share, costs, margins, business strategies and day-to-day business developments. This data can help frame the evaluation of corporate performance and strategy.

Comparisons should also be made regarding the relative market prices of goods sold by the company and its competitors, and the relative costs of materials purchased by them. Stock market trading multiples, financial characteristics and strategies of public sector competitors should also be examined for insights into how investors and analysts view the industry, as well as the relative strengths and weaknesses of competitors.

Step 3: Identify and Address Performance Gaps

Companies must continually monitor the efficiency and effectiveness of their operations so that they can successfully respond to changing marketplace demands and ensure adequate returns to shareholders. Comparisons with industry peers often point to the need to trim costs or introduce new methods of producing or delivering goods and services.

A second and related framework for evaluating efficiency involves the study and application of best practices in a wide range of operational processes and corporate functions. The dramatic growth of outsourcing and the introduction of highly specialized and efficient systems for supply chain management, production management and customer relationship management are among the most prominent manifestations of "best practices" being adopted.

Additionally, most companies have fundamentally unique business processes, and there is no substitute for examining the specific details of how work is conducted. Activity-Based Costing is the ascendant framework for analyzing business processes. Business Process Re-Engineering is a set of methodologies through which day-to-day activity of employees can be analyzed and streamlined for increased efficiency.

Step 4: Articulate a Clear Strategy With a Strong Financial Foundation

While the creation of a sound strategic plan benefits from the contributions of the entire organization, it needs to be firmly grounded in the preceding financial disciplines and focused on the plan to create shareholder value. At the most basic level, a strategic plan is about the allocation of capital among the company's business segments. It also articulates objectives and how they can be reached, and sets financial targets through which budgets

are drafted and management held accountable. Capital allocation and the setting of expectations for returns on this capital are the keys to effective strategic planning.

Since shareholder value is a function of the current level of economic profit and the expected growth in this profit from each of the company's business segments, capital must be constantly re-distributed among them to capture the highest possible returns. In some cases, capital should be deployed to the highest performing units to expand their earnings capacity, and withdrawn from less profitable units. For underperforming companies, capital might be best applied to business segments where large and immediate improvements in profitability can be obtained through restructuring and business process improvements.

Step 5: Link the Balanced Scorecard to Strategy

Once a strategy has been adopted, the challenge is to devise a set of metrics with which performance against budget and strategic planning targets can be evaluated. The main difficulty in this area is that the widespread adoption of ERP systems and specialized software applications has resulted in a deluge of accounting and performance data that often overwhelms management's ability to distinguish between the unimportant and the critical.

The Balanced Scorecard approach to management accountability helps here. Its premise is that a relatively small number of Key Performance Indicators ("KPIs") should be developed to capture the most important performance attributes of the company along several dimensions:

- **Financial Measures:** Not surprisingly, the most important KPIs are financial in nature and focus on profitability, cash flow, and margins. Some financial KPIs, such as operating margins, might be especially strong determinants of overall success, and allow managers to "drill-down" into the constituent revenue or cost components to explain "cause and effect." However, financial measures should not dominate the Balanced Scorecard because they are "backward looking" at past performance and do not necessarily help management adapt to changing market conditions.
- **Process Measures:** Management typically has greater control over variables that affect process measurements than they do over financial measurements. Work processes can be managed in real time, but costs can often seem stubbornly fixed and adjusted only as invoices are presented for payment. Process-related KPIs might focus on targeted improvements to productivity measures as part of a strategically-important Business Process Re-Engineering initiative, plant efficiencies, or supply chain efficiencies.
- **Market Performance:** While financial performance is a good proxy for whether or not the company is enjoying marketplace success, other market-based measures can often

provide better real time and leading indicators of performance. The standout market-based metric is the public company's stock price, which is highly responsive to publicly disclosed information and industry developments. Other important market-based metrics include prices charged relative to those of competitors and market share data.

- **Critical Success Factors:** The strategic planning process often brings to light important initiatives or programs that are seen as essential to the success of the company. Examples might include maintaining a strong brand image among key customer groups, or implementing a new technology. These critical success factors, while not necessarily involving significant sums of money, should also be a component of the Balanced Scorecard.
- **Creation of New Shareholder Value:** Capital reallocation from less promising to more promising business units and new ventures is essential to building shareholder value, but it also contains many risks. Rapid growth and new ventures are difficult to manage, and the contraction of underperforming businesses can have adverse consequences throughout the organization. The Balanced Scorecard should highlight the progress of those activities that are critical to the creation of new shareholder value.

We have seen that management has a set of financial tools that are key components in building strategic plans that deliver shareholder value. The steps that we have reviewed in this process, when properly applied, can help management overcome the most challenging market conditions and competitive threats.