A pocket guide to value: part three

The financial market values the Firm based on its prospects while the internal priority is very much around growing business unit profitability. The conundrum many CFO's face is how to join these two perspectives up.

By Ben Walters

Introduction

In "Pocket guide part two" I introduced Enron the race horse. Enron proved to be a bad investment for his owners who ended up selling him for less than they had bought him for. This was despite Enron being a very successful and winning a record number of races. The lesson from this story is that it is the expectation of success that sets the price of an asset: but ultimately will the asset beat or underperform against this expectation? It is possible to value this level of expectation and turn it into meaningful targets within the firm that align to the creation of value against external expectation. There is an impressive array of strategic financial uses for such a technique including budgeting, strategic capital allocation, performance measurement and M&A activity to name but a few. This adds a new dimension to the strategic input the finance function and CFO can add to their firm's success.

Lessons from Greek mythology

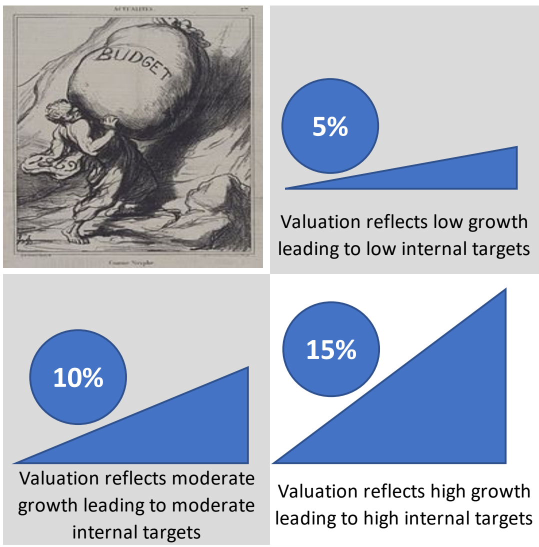


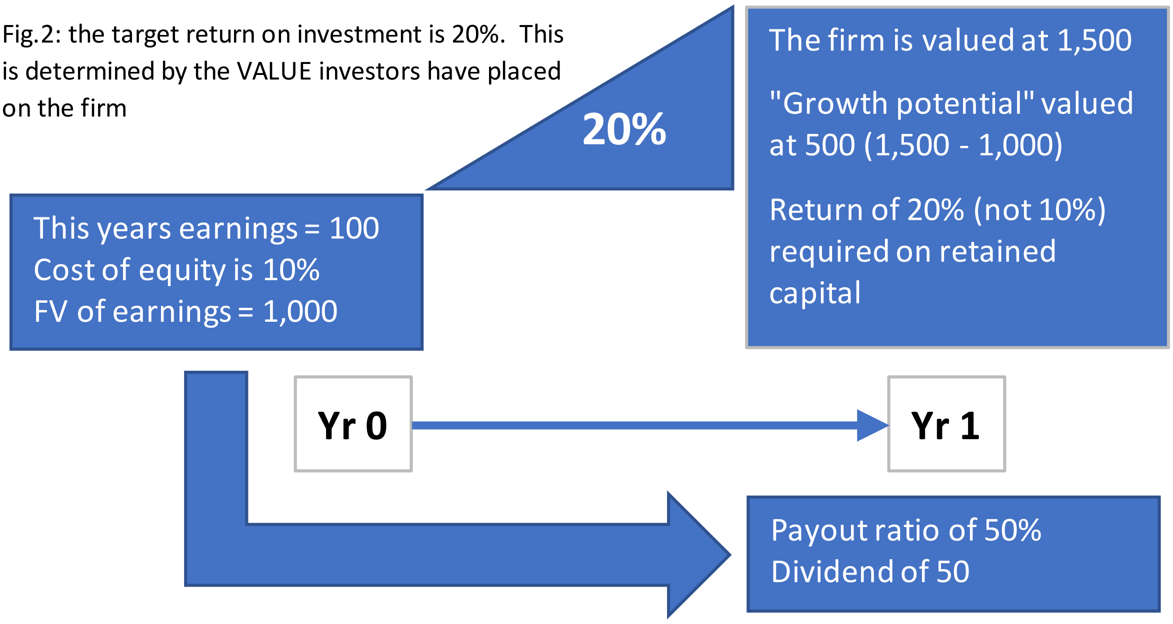
Fig1: Sisyphus struggled with his boulder, modern day executives struggle with targets, BUT HOW DO YOU SET THE RIGHT ONES?

Sisyphus was a Greek King who angered the Gods through his arrogance and clever antics (he tricked Death and chained him up for instance). His punishment was to spend eternity rolling a boulder up a hill. Though not quite as draconian, a modern-day equivalent could be seen as executives struggling to meet every increasing targets as fig. 1 illustrates. Setting the right target though should relate to the valuation the firm's owners have placed upon it. Where this valuation is observable through a share price for example, the size of the target is relatively easy to determine with some precision (see below). At its root this is of course a cash flow target, but it can be easily communicated in a variety of forms such as profit or revenue for easy dissemination through the firm to ensure understanding and common purpose.

Turning an asset valuation into a profit target

Figure 2 starts to get under the bonnet of what is really going on when the critically important role that the firm's external valuation plays in setting internal targets is fully appreciated. The firm in question currently generates a 100 in retained earnings and at a cost of equity of 10% this equates to a fair value for these earnings of 1,000. But hold on, something has gone a bit wrong though as the firm's valuation is actually 1,500. This is of course an entirely normal situation, in fact how many firms are valued at something like the fair value of their current earnings? Very few unless they are in extremely low growth sectors. Call this valuation gap what you will, we all accept it as being a very normal situation. As I have suggested in previous articles this gap relates to the value of the firm's strategy and is perceived ability to execute this strategy. We all commonly recognise this as the need for growth to underpin the valuation.

Fig.2: the target return on investment is 20%. This is determined by the VALUE investors have placed on the firm



But back to the maths. This firm pays out half of its retained earnings as a dividend, therefore retaining 50 of these earnings to reinvest into its businesses. With shareholders placing a value on the firm of 1,500, at a cost of equity of 10%, the dividend of 50 leaves another gap to fill. This gap arises from the total shareholder return required based on that valuation of 1,500 and a cost of equity of 10%. This gives rise to a total shareholder return of 150 with only 50 being directly returned to shareholder as cash through the dividend. The firm therefore needs to create a capital gain of 100 in order to meet shareholders' expectations and valuation. If the firm does not achieve this shareholders will most likely adjust the value of the firm down to a level where the valuation meets the capital gain that the firm actually achieves. They will have lost value though the firm may well have still grown its earnings and achieved a return on its investments above its cost of equity.

The last piece of the puzzle is this: how does the firm create the capital gain of 100 it must make over the course of the year? There is another simple step to take which gets us to the answer. Retained earnings are in essence internally generated capital, and in this case the firm has decided, through is dividend policy, to re-invest an extra 50 of its own capital into its business. The firm needs to take this up-front investment of 50 and turn it into a stream of earnings that are worth 100 today (the capital gain it requires). With a cost of capital of 10%, this means that the additional earnings it must generate on its capital outlay of 50 in the year are 10[1]. This equates to a rate of return of 20% on the capital invested of 50. We have put a "price tag" on a unit of capital.

[1] A stream of earnings into the future of 10 is worth 100 today at a cost of equity of 10%

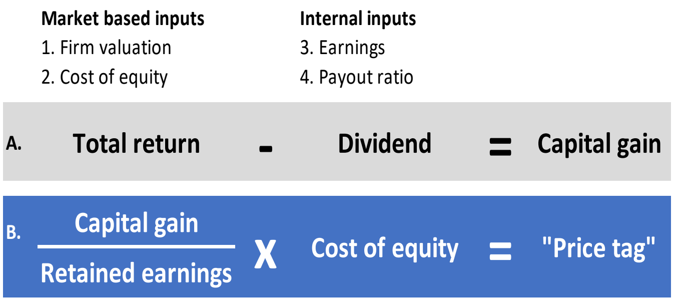


Fig.3: four inputs (1-4) and two equations (A&B) give us a "price tag" per unit of capital

We have now arrived at our profit target. Each unit of capital within the firm comes with a price tag equivalent to 20% of its value as incremental earnings over the next year. Reverse this back through the profit and loss account, this time working up from earnings to operating profit and revenue and the target setting it complete. Figure 3 summarises.

<u>The end of the profit and loss account…?</u>
Look at figure 3 again and notice that from a few simple inputs we end up with a price tag for a unit of internally invested capital. This allows for a completely new way of thinking about measuring both past and future performance. The annual budget becomes an exercise in assessing the level of incremental profit a business unit believes it can achieve balanced against the capital they are requesting to help deliver this. Either side of this equation can be changed: if more profit is required to balance the books then this bar can be raised, while at the same time the amount of capital budgeted can be scaled back to meet the earnings forecast.

Past performance can be measured against budgets of course. But they can also be measured in a much more dynamic manner now. More capital spent than budgeted: well did it create the extra profit that came with that price tag? Profit performance can be flexed in consideration of the capital consumed. This allows management to take decisions that create value rather than meet a short term and inflexible budgetary target.

Strategic decisions around capital allocation across business units within the firm can be made by assessing those that exceed the profit to capital equation and those that consistently underperform. Merger and acquisition targets can be analysed in this framework with the capital (price) of the target capable of being determined by the firm's assessment of profit growth under its ownership.

So, this is not an end by any means to the profit and loss account. But rather it should signal an end to the dominance of the profit and loss account and a move to a wider conversation about capital and value.

<u>Conclusions</u>
Across the three articles in this Pocket Guide to Value we have looked at how value means a different thing depending on whether your perspective is external or internal to the firm. It is possible, and quite straight forward to marry up these two perspectives. By doing so and turning the external view of value into meaningful internal targets the firm can align its financial nervous system behind creating value. Better still in doing so operational targets can still be communicated in traditional terms such as revenue or margin growth. But a shift in emphasis now allows the internal dialogue to be about value, capital usage <u>*and*</u> profit. Performance and budgets can be agile with performance set against the amount of capital consumed therefore allowing management can react to changing circumstance and opportunities.

If you would like to know more, please get in touch.

The author, Ben Walters, FCT, ACA is a practising corporate treasurer with a keen interest in the practical application of corporate finance in the business environment. He believes finance can better support strategic analysis and enhance the overall value of the firm and has developed innovative thinking in this area. He is always keen to be contacted through enquiries@mwacc.co.uk