A pocket guide to value: part two

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By Ben Walters

Introduction

Value can mean different things to different stakeholders: the Firm's owners see value as the worth of the Firm, while the internal management of the Firm see value as creating returns from the strategic position and real asset investments the Firm makes. In other words, 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. How do you create internal targets that align to the valuation owners of the Firm have placed on it? How do you measure which business units in the Firm are meeting or exceeding these targets and which are not? Answer these questions and you are long way down the road to efficiently allocating capital and increasing the value of the Firm.

The race horse and the banker

Paddy had been a mate for years. He was really into horses and always seemed to have a winning tip. One day he persuaded you and some of your friends to club together and buy a racehorse. Enron was a fine animal, best horse around and came with a matching price tag. At £100k he needed to win. A lot. A banker friend of yours said Enron needed to win 10 times next year. And boy did Enron come close. Nine wins was a record and Paddy was hailed as the greatest trainer ever. He scooped the owners award and end of season bonus prize money. But there was a problem: granny's gambling problem was getting out of hand and unfortunately this meant Enron had to be sold at the end of the season. You were all shocked when Enron only fetched £90k, a £10k loss for the horse that had broken all the records! Although as Enron's owners you were left out of pocket Paddy was nowhere to be seen, rumour has it he is tanning himself in Monaco having bought a super yacht with his prize money.

OR

Lessons learnt

Paddy scooped a huge amount of money as a very successful race horse trainer. The owners of Enron though lost out because the race horse lost value during Paddy's tenure. Despite breaking records, the horse just didn't win enough races to justify its initial price tag. Paddy did very well out of the venture and the race horse was oblivious to what was happening.

Why did they lose out? Simply put Paddy and the horse just didn't perform well enough. They smashed all the records, but they were expected to and more. And the banker's involvement? Well she had worked out early on that the horse had to win ten races, and if that had been Paddy's target (he won nine) things may have been different. But for once no one was listening to the banker…

I am sure you have seen through my subtle analogy here and can see that Enron represents a business unit within a firm, the firm is run by Paddy, and the horse's owners are shareholders. The shareholders were telling Paddy he had to win at least ten races to justify the price they had paid for the business. Unfortunately, that message wasn't clearly interpreted and the performance of the business and Paddy, while very good was not enough to match the valuation.

Of course, in the business world targets are not as simple as the number of races that need to be won. The shareholders are transmitting information through the share price, the business is looking at KPI's such as revenue growth, margin, and then levels down from these such as retention rates, footfall, average spend. Mapping these KPIs to the share price is the key to aligning both perspectives of value.

Alchemy in the real economy

If you strip the purpose of being in business down to its most basic level you could summarise it as the process of buying low, selling high. In other words, making something worth more than you pay for it. There is an alchemy going on here in which the business best positions its resources and products to create value. We call this process strategy.

And the great news is that the financial markets transmit the value of the firm's strategy to it through the share price. The share price tells the Firm how much value the market expects it to be able to create in the future. And here's the critical step: if you know the value of something and you know how much capital you have available to invest you can work out the rate of return needed to generate this value. This can be translated into internal targets in pretty much any form that really contribute to the realisation of the strategy. Better still by understanding precisely what these targets are, capital within the Firm can be re-allocated to those parts of the business that are expected to exceed them and produce a market beating performance.

Budgeting or target setting?

Budgeting is a critical part of the financial cycle within a firm and is essential in providing a financial framework for control and reward. But how often is the budget grind largely an exercise is batting about a bit of revenue growth and cost reduction rather than focused discussions about returns on capital. To get to the heart of target setting with purpose the firm needs to understand the cash flow growth its valuation demands of it. Once this is understood it can be turned into other targets such as revenue and profit growth which can be easily communicated within the firm. Embedding this process in the budget cycle creates a target setting process with genuine purpose.

Where can an appreciation of value take us?

I've concentrated so far on a discussion around setting targets for budgeting purposes. These clearly then fold into performance targets and incentive schemes. But there are many other areas a fundamental understanding of value creation can take you. These include capital allocation across the firm's business units to maximise value, business unit, product or brand portfolio management, M&A activity and divestitures, to name but a few. The whole gamut of strategic financial activities is addressable in a value-based framework bringing rigour, transparency and purpose of direction.

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